CAMPAIGN for TOBACCO-FREE Kids®

It turns out that Philip Morris has been able to cover its settlement costs (and then some) with hefty price increases – due not so much to marketing magic but to the fact that cigarettes are so addictive that many customers can't quit.

Fortune Magazine, April 16, 2001

U.S. CIGARETTE COMPANIES' SETTLEMENT-RELATED PRICE HIKES ARE EXCESSIVE

The big cigarette companies have used their obligation to make tobacco lawsuit settlement payments to the states as an excuse for massive cigarette price increases. But the cigarette companies' price hikes since the first state settlements will bring them more than $20 billion dollars per year in additional new revenue – or at least $10 to $12 billion more per year than what they actually require to cover all of their ongoing settlement-related costs. As the Wall Street Journal reported on October 25, 2002, the cigarette companies price increases since 1997 are not just to cover their settlement-related costs but also have been driven by "the companies' hunger for ever-larger profits."

To look at it another way, from 1998 to 2000 the major cigarette companies raised their prices by more than $1.10 per pack, but Wall Street tobacco-industry analyst Martin Feldman calculates that the companies paid only about 51 cents per pack in 2000 to cover their settlement costs and approximately 59 cents per pack in 2001.* In other words, in 2000 and 2001 the major cigarette companies were receiving more than 50 cents per pack in surplus new revenue from their so-called settlement-related price hikes, and that does not even count their additional price hikes since Feldman made his analysis, which total 40 cents per pack.

While the cigarette companies pay some corporate taxes on the increased revenues produced by their price increases, they are also able to deduct their settlement payments as business expenses when calculating their federal and state corporate tax bills, which will reduce their taxes, and net settlement costs, by about $1.5 billion per year.

Total Cigarette Company Settlement-Related Payments: Less than $10 Billion Per Year

The cigarette companies' settlement-related costs of less than $10 billion per year, on average, consist of the following:

- **Payments to the States: $8.5 billion per year.**

  The settlement agreements call for base annual payments to the states ranging from $8.4 to $10.9 billion in each of the coming years, for an average annual payment of less than $9 billion over the next 20 years. But these base payments have already been reduced by more than 14% pursuant to the agreements' "volume reduction," which reduces payments according to reductions in the companies' U.S. cigarette sales. On the other hand, the agreement also calls for upward inflation adjustments of at least three percent per year.

- **Payments to National Foundation & Public Education Fund: $325 million per year.**

  As part of the multistate settlement agreement (MSA), the cigarette companies must pay $25 million per year through 2008 to a new National Foundation dedicated to reducing

* The increased per-pack cost in 2001 comes from the fact that the cigarette companies' settlement payments to the states vary from one year to the next, reaching a peak in 2002 before declining significantly.

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tobacco use among kids (now established as the American Legacy Foundation) and pay another $300 million per year through 2003 to fund a nationwide public education effort administered by the Foundation. In any year after 2003 when the settling cigarette companies' combined U.S. market share totals more than 99.05%, they must pay an additional $300 million to the fund – but it appears unlikely that they will meet that target.

- **Payments to states' private attorneys: $500 million per year.**

  The settlement agreements require that the cigarette companies pay attorneys fees to the private law firms that represented the states. But the MSA also sets a maximum total of $500 million per year for these payments. While the cigarette companies payments to the states theoretically go on forever, these attorney payments will at some point stop.

- **Phase II payments to U.S. tobacco growers: $450 million per year (through 2010).**

  As a "Phase II" follow-up to the MSA, the major cigarette companies agreed to pay the tobacco-growing states $5.15 billion over 12 years to compensate U.S. tobacco farmers and quota holders for reduced demand for U.S. leaf.[*]

The cigarette companies have also had to pay some unknown amount to cover their own settlement-related attorneys fees, and have had to make a one-time payment under the multistate settlement agreement to cover the states' own directly legal costs of $150 million. But these costs have already been paid and do not continue into the future.

<u>Cigarette Company Settlement-Related Tax Deductions: $1.5 billion Per Year</u>

Under existing federal tax law, the cigarette companies can deduct all of their settlement-related payments as necessary business expenses. Each year, these deductions will reduce their federal corporate tax payments by an amount equal to roughly 20 to 30 percent of their settlement-related expenses. In other words, their net settlement-related costs, after tax deductions, will be at least $1.5 billion per year lower than the total of the listed amounts set forth above (and $1.5 million is a very low, conservative estimate). At the same time, any profits from the cigarette companies' new price-hike revenues would be taxable corporate income.

<u>New Cigarette Company Revenue From Recent Price Hikes: $20+ Billion Per Year</u>

Since the beginning of 1998, when the cigarette companies first began making tobacco settlement payments, the companies have increased the prices they charge for cigarettes by more than $1.25 per pack. Even after the reductions in U.S. cigarette sales prompted by these massive price increases, the major cigarette companies are still selling roughly 20 billion packs per year. 20 billion packs per year times $1.25 per pack totals $25 billion in additional new cigarette company revenues each year – or more than $10 to $15 billion more than the companies' annual settlement-related costs before any tax deductions, even after accounting for increased retail-level discounting by the companies.

Using tobacco industry analyst Martin Feldman's per-pack estimates of the cigarette companies' settlement costs produce similar extra-revenue amounts. For example, if the companies are

[*] These cigarette company payments are appropriate since the recent sharp declines in the companies' purchases of U.S. tobacco leaf have little to do with either the tobacco settlements or the recent reductions in U.S. cigarette consumption but are a direct result of the cigarette companies' decisions to use more foreign instead of American-grown tobacco. [Eric Lindblom, *False Friends: The U.S. Cigarette Companies' Betrayal of American Tobacco Farmers* (December 1999), www.tobaccofreekids.org.]

paying 59 cents per pack to cover their settlement costs each year and sell 20 billion packs (a conservative estimate), their price hikes totaling $1.28 since 1998 will bring them 69 cents per pack above and beyond their settlement costs -- or well over $10 billion in new revenue over the course of the year, even after discounting for increased levels of retail-level discounting.

The major cigarette companies have sharply increased their retailer-based discounting following each of their recent price hikes, through issuing coupons, supporting buy-two-get-one-free-type deals, and inventory buydowns. While the costs associated with these temporary efforts to dampen the consumption-reducing impact of the price hikes and reduce market-share losses to smaller manufacturers have reduced the major companies' net increased revenue per pack, they are only temporary measures. In contrast, the companies' increases to their base cigarette prices will continue to bring them new revenue every single year from now on.

Given all their price increases – which have produced far more revenue than the companies have lost through decreased sales – the cigarette companies are already enjoying increased revenues and profits. For example, in 2000 Philip Morris's revenues from U.S. cigarette sales increased by 15.6%, while its operating income (roughly equal to profits) increased by 10 percent. Similarly, the R.J. Reynolds cigarette companies' revenues went up by more than eight percent, with its net income increasing by 9.5 percent.

In future years, the number of packs sold in the United States should continue to decline, thereby reducing the cigarette companies' total annual revenues. But any such reductions would also trigger the volume adjustment that reduces the companies' settlement payments to the states. Although the upward inflation adjustment in the tobacco settlements will steadily increase the amounts the cigarette companies have to pay to the states, those increases will be more than off-set by the complete termination of several of the cigarette companies' other major but temporary settlement-related costs, as detailed above. Accordingly, unless the cigarette companies sharply reduce their prices the increased extra revenues they are enjoying from their "settlement-related" price hikes will continue for as long as they sell cigarettes.

National Center for Tobacco-Free Kids, October 28, 2002

Sources

For the full text of the November 1998 Multistate Settlement Agreement and for related cigarette company payments information, see the National Association of Attorneys General (NAAG) website at www.naag.org. For the companies' earlier tobacco settlements with Mississippi, Florida, Texas, and Minnesota see the individual settlement agreements for these states, available from the states' attorneys general offices.

For cigarette company price increases and packs sold, see the tobacco briefing page of the Economic Research Service, U.S. Department of Agriculture, www.econ.ag.gov/Briefing/tobacco. Revenues and profits data for 2000 from the companies' annual reports. For deductibility of settlement payments see, e.g., *U.S. Congressional Record*, March 24, 1999, at S3223.

For Martin Feldman's per-pack settlement-cost estimates, see the staff and wire report, "RJR, Others Raise Cigarette Prices 6 Cents," *Winston Salem Journal*, August 1, 2000.

For Phase II payments, see, e.g., the tobacco pages of the Agricultural Policy Analysis Center, University of Tennessee, http://apacweb.ag.utk.edu/TobIndex.htm; and Tobacco Economics Online, University of Kentucky, www.uky.edu/Agriculture/TobaccoEcon.

Related Campaign for Tobacco-Free Kids Fact Sheets (available at www.tobaccofreekids.org)

- *U.S. Cigarette Co. Price Increases 1994-2001 (Compared to Fed. Cigarette Tax & Retail Prices)*
- *Summary of the Multistate Tobacco Settlement Agreement*
- *The Multistate Settlements' Shortcomings*