Blum, Alan

From: Wolinsky, Howard [HWolinsky@suntimes.com] **Sent:** Wed 1/7/2004 9:24 AM
To: Blum, Alan
Cc:
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States' Tobacco Settlement Has Failed to Clear the Air
By Myron Levin, Times Staff Writer

Five years ago, it seemed some of the smoke was beginning to clear in the tobacco wars.

A landmark legal settlement forged by the four top cigarette makers and state attorneys general snuffed out the companies' worst litigation nightmare.

State treasuries were assured of a windfall of $246 billion, a chunk of which would go to helping smokers quit and stopping kids from starting. Both sides could see themselves as winners.

Nothing turned out quite as expected. States didn't live up to pledges to invest settlement payments in aggressive antismoking campaigns. Smoking rates have fallen, particularly among teens, but the credit goes as much to bans on public smoking and sharp increases in cigarettes taxes. States have become so dependent on those taxes, and on settlement payments, that their financial interests and those of the industry are in some ways intertwined.

And tobacco's Big Four have ratcheted up spending on advertising and promotions -- one thing most people figured the settlement was sure to diminish -- in part to combat discounters that have picked up market share.

In the end, the settlement was "certainly not the breakthrough agreement that we hoped it would be," said Rep. Henry A. Waxman (D-Los Angeles), a leading critic of the tobacco industry. Instead of "a major plus ... it's turned out to be a minor plus."

Announced on Nov. 16, 1998, the deal required cigarette makers to pay an estimated $206 billion over the next 25 years to 46 states in exchange for the states' dropping lawsuits filed to recoup smoking-related medical costs. Separate pacts with Mississippi, Florida, Texas and Minnesota raised the tab to $246 billion.

Swiftly, the four majors -- Altria Group Inc.'s Philip Morris USA, R.J. Reynolds Tobacco Co., Brown & Williamson Tobacco Corp. and Lorillard Tobacco Co. -- raised prices by at least 35 cents a pack to meet their payment obligations. They knew higher prices would weaken sales but reasoned that states, for a while at least, wouldn't target smokers for more revenue.

"Our hope had been that with the significant amount of [settlement] revenues ... there wouldn't be the perceived need by the states to raise excise taxes," said Steve Parrish, executive vice president for corporate affairs at Altria.

But the economy swooned, tax receipts plunged, and the states came back for another fix. In fact, states have raised cigarette taxes since the settlement more sharply and more often than ever before.

In 2002 and 2003, 39 states hiked cigarette taxes, according to Merrill Lynch & Co. On average, state taxes have nearly doubled since the settlement to 73 cents a pack. California, at 87 cents, is no longer even a high-tax state -- 16 others charge $1 or more.

Facing staunch resistance to broad-based tax increases, lawmakers found they could target cigarettes at no political cost: Smokers are a dwindling minority and mostly react passively to tax increases, in some cases hoping higher prices will drive them to quit.

Now, between settlement payments from the industry and taxes collected on smokers, states are pulling in about $19.4 billion a year from cigarette sales, according to an estimate by the Campaign for Tobacco-Free Kids. States' financial interests and those of the companies have converged to a degree no one anticipated.

"There's no doubt that the largest financial stakeholder in the industry is our state governments," said Tommy Payne, executive vice president for external affairs at R.J. Reynolds. "Some would say that whole issue has a fair amount of irony associated with it."

Recently, many states have taken steps to preserve the cash flow by running interference for the industry in ways that would have been unthinkable not long ago.

Although the settlement resolved the huge state suits, it did not eliminate individual and class-action suits by smokers. The companies face the risk of damage awards so great that the mere act of posting a bond to protect their assets while they appeal a case could be financially devastating -- to the companies and to the states to which the companies owe so much money.

So lawmakers in about 25 states, including California, have enacted caps on appeal bonds (typically of $25 million to $100 million) no matter how big the judgment. In Illinois, which has no bond cap, attorneys general lined up last spring to back Philip Morris' bid for a reduced appeal bond after it suffered a $10.1-billion loss in a class-action case. More than 30 attorneys general signed an amicus brief warning of dire budgetary harm should the firm file for bankruptcy protection and delay payments to the states.

Since the settlement, the average price of a premium brand, such as Marlboro, has nearly doubled to more than $3.40 a pack. Smokers as a group have below-average incomes and are doing what they can to save, said Sam Moghrabi, who owns tobacco shops in Woodland Hills and Chatsworth. "Some of them are quitting," he said, "and some of them are [cutting] down."

Smoking rates for adults 18 and older fell from 24.1% in 1998 to 22.8% in 2001. Among price-sensitive teens, the shift has been more pronounced. According to data from the University of Michigan, the number of high school seniors who were daily smokers fell from 22.4% in 1998 to 16.9% in 2002 -- "the lowest rate since we started keeping records," said Matt Myers, president of the Campaign for Tobacco-Free Kids.

After puffing their way through 461 billion cigarettes in 1998, Americans will consume about 372 billion this year, a sign that smokers are lighting up less often, said Martin Feldman, tobacco analyst for Merrill Lynch. But price alone isn't responsible for the slide. Smoking bans are having a big effect.

About 1,650 U.S. communities restrict public smoking, an increase of more than 20% since 1998, said Cynthia Hallett, executive director of Americans for Nonsmokers' Rights. At the time of the settlement, California was the only state to ban indoor smoking in public places. Four more states have since followed suit, and three others ban it everywhere but in bars, said Chris Bostic of the American Lung Assn.

Survey data show surprising growth in the number of smokers who have no-smoking policies at home, possibly reflecting the wishes of spouses or a commitment not to light up near their children, said Kenneth E. Warner, a professor of public health and director of the University of Michigan Tobacco Research Network.

Judye Woods of Palmdale smoked two or three packs a week in the days when "you could smoke just about anywhere" but says she is down to a pack a week now. She says she doesn't even light up at home "because of my kids."

Antaures Osborne, 25, of Orange began smoking at 12 and quit two months ago. She said smoking bans were a "huge" assist. Among the toughest temptations is continually "seeing other people smoke," Osborne said. It helped to "have to make the conscious effort to walk outside and smoke."

Back in 1990, the Big Four had an iron grip on the market, with a combined share of about 97%. Their lucrative oligopoly was expected to persist. Then cigarette prices rose sharply and the economy faltered, leaving smokers with less disposable income. Small discount manufacturers seized the day. Today more than 120 producers, domestic and foreign, are selling cigarettes in the U.S. market.

Discount brands -- like Bailey's, Double Diamond and Scenic 101 -- go for more than $1 a pack less than the premium price. And the market share of the big companies has slipped to between 87% and 89%.

Indeed, the small fry have a bigger combined share than the third- and fourth-largest firms, Brown & Williamson and Lorillard. The planned merger of R.J. Reynolds and Brown & Williamson derives in part from the threat from pint-size producers.

By allowing price-conscious smokers to trade down rather than quit or smoke less, the discounters have tempered the drop in smoking.

Though usually inclined to favor any threat to the industry, antismoking groups are not thrilled about the surge in cheap, off-brand smokes.

"I think a proliferation of people who are offering a product that we know kills people is bad," said Lyndon Haviland, chief operating officer of the American Legacy Foundation, whose antismoking commercials appear on network TV.

The settlement eliminated cigarette billboards and transit signs, banished tobacco ads from sports stadiums, banned T-shirts and caps with cigarette logos and limited each company to a single brand-name sponsorship of entertainment or sporting events.

The restrictions have made it "more difficult for the manufacturers to deliver ... the 'cool' factor to smokers," particularly to kids, said Feldman of Merrill Lynch.

Yet in tobacco's version of the arms race, promotional spending has spiraled upward since 1998, from $6.73 billion that year to $11.22 billion in 2001 -- about $230 for each of the country's 46 million smokers. The spending, partly an effort to blunt the challenge of deep-discount brands, reflects the fierce battle for market share.

Though the outpouring falls under the heading of advertising and promotion, little of it is advertising in the usual sense. Instead, the companies pay hefty bonuses to retailers who meet sales targets and post in-store signs.

The majors also give discounts to smokers, with, for instance, direct-mail coupons good for a free pack for each purchase of two.

In essence, the companies are giving away large amounts of product to narrow the price advantage of discounters and keep customers in the fold.

The immense investment is a case of "history repeating itself," said Dr. Ronald M. Davis, a trustee of the American Medical Assn. and former director of the federal Office on Smoking and Health. He recalled how the industry ramped up spending after the ban on broadcast ads in 1971.

"Cigarette companies have done what they've always done, and that's find the loopholes ... to reach their target audiences, one of which is youth," Davis said.

Parrish of Altria defended the marketing as focused more than ever on current adult smokers.

Christopher Anderson, director of the California Smokers Help Line, called the campaigns "predatory" and said studies showed most smokers wanted to quit and would benefit if the industry just left them alone.

For tobacco foes, the main disappointment in the five years since the settlement has been the states' failure to stick to the cherished goal of using the payments to fight smoking. Over and over, officials had insisted the lawsuits they filed against cigarette makers weren't about money but about helping smokers quit and keeping kids from taking up a deadly habit.

So the Centers for Disease Control and Prevention developed minimum guidelines for spending by the states to run comprehensive tobacco prevention campaigns, including counter-ads, public education and smoking cessation classes. On average, such programs would cost individual states about 20% of their settlement proceeds.

Only a few states -- including Indiana, Maine, Minnesota and Mississippi -- have consistently funded smoking prevention at or near levels suggested by the CDC. A few others have met the CDC guidelines in at least one year. Most haven't come close.

All together, the states have committed about $1.8 billion of their settlement funds to date for antismoking programs, or about 4% of the total, according to a report by the National Conference of State Legislatures.

For some states, it is too late for second thoughts. Sixteen have exhausted all or part of future settlement income by selling bonds backed by tobacco money so that they could get smaller lump sums now.

The states have been guilty of "moral treason," said Mississippi Atty. Gen. Mike Moore, who filed the first of the state tobacco lawsuits in 1994. Moore says the budget crises are no excuse. Most states "made the choice from Day 1, when times were good," he said, "to spend the money some other way."

At the time the settlement was negotiated, Moore said, "I really believed we were making a difference in this country, and I think we did." But, he said, "we could have made a much larger impact if the states had been true to the cause."