COMMENTS ON FAIR AND EQUITABLE TOBACCO REFORM ACT OF 2004

Submitted to the United States Department of Agriculture
by Liggett Group Inc.
100 Maple Lane
Mebane, North Carolina 27302
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Liggett Group Inc. ("Liggett") respectfully submits these comments in response to the notice published in the Federal Register by the United States Department of Agriculture ("USDA"), soliciting comments on the implementation of the assessment provisions of the Fair and Equitable Tobacco Reform Act of 2004 (the "Act"). Meeting Notice, 69 Fed. Reg. 67,298 (Nov. 17, 2004).

THE ACT

On October 22, 2004, the President signed into law the American Jobs Creation Act of 2004. Sections 601 through 642 of that statute comprise the Act. The Act terminates the federal tobacco quota and price support programs in place since the 1930s. §§ 611-612. It provides for payments to tobacco quota holders and to producers of quota tobacco during federal fiscal years 2005 through 2014.

The payments to tobacco quota holders and producers under the Act are to be funded by quarterly assessments on each manufacturer and importer of tobacco products that sells those products in domestic commerce in the United States. § 625(b). Specifically, manufacturers and importers of cigarettes, cigars, snuff, roll-your-own tobacco, chewing tobacco, and pipe tobacco are subject to the assessment, § 625(c)(1), without regard to the manufacturer's or importer's historical use, if any, of quota tobacco.

Under the Act, USDA, acting through the Commodity Credit Corporation ("CCC"), imposes quarterly assessments on tobacco product manufacturers and importers in amounts sufficient to cover the government's liability for payments to quota holders and producers and for other expenditures of the Tobacco Trust Fund. § 625(b)(2). It provides that if USDA determines that the assessments imposed under section 625(b) are insufficient to meet these obligations, it must assess such additional amounts as it determines to be necessary to carry out the purpose of the Act during the relevant fiscal year. § 625(c)(3). The amount USDA may expend between fiscal years 2005 and 2014 from the Tobacco Trust Fund is capped at $10.1 billion. § 627.

LIGGETT GROUP INC.

Liggett and its predecessor, Liggett & Myers Tobacco Company, have manufactured tobacco products in the United States for more than a century. Today, Liggett manufactures only cigarettes and sells only in the United States. With a domestic cigarette market share of approximately 2.5 percent, Liggett is the fifth largest tobacco company in the United States.

Virtually all of Liggett's cigarette brands sell in the lower-priced "discount" segment of the market. Liggett's largest-selling brand is LIGGETT SELECT. It also manufactures a number of store brands. Liggett is the second largest of the approximately 40 smaller tobacco companies (known as Subsequent Participating Manufacturers or SPMs) that are parties to the 1998 tobacco Master Settlement Agreement ("MSA") with 46 states. Liggett's headquarters and manufacturing facility are located in Mebane, North Carolina.

As a manufacturer that sells its cigarettes in domestic commerce in the United States, Liggett is among those market participants that will receive quarterly assessments imposed under the Act. Accordingly, Liggett has a significant interest in the manner in which USDA implements the Act's assessment provisions. Liggett applauds the USDA for calling together parties impacted by the assessment provisions to discuss the issues associated with their implementation, and appreciates the opportunity to participate in this important discussion.[1]

GENERAL COMMENTS

In implementing the assessment provisions of the Act, USDA must recognize and take into account the dramatic changes that have occurred in the U.S. tobacco industry over the last decade. Seven years ago, four companies controlled 97 percent of the domestic cigarette industry.[2] Liggett and Commonwealth Brands, the fifth and sixth largest tobacco companies, together represented just two percent of the market at that time. Thus, six companies comprised essentially 99 percent of the U.S. tobacco industry.

Moreover, conventional wisdom held that barriers to entry into domestic tobacco manufacturing were high. Tobacco manufacturing equipment was expensive and complicated. Labor costs in the U.S. industry and advertising and promotional costs to introduce a new brand were considerable. It was generally assumed that to be successful, tobacco product sales would need to be conducted on a national basis, requiring the substantial cost of a national sales force.

Today, the conventional wisdom of a just few years ago has been turned on its head. Barriers to entry to the U.S. tobacco marketplace seem virtually non-existent. Since 1998, some 200 new companies have entered the U.S. market as manufacturers or importers of tobacco products.[3] With the merger of R.J. Reynolds Tobacco Company and Brown & Williamson Tobacco Corporation, the "Big Four" cigarette companies are now the "Big

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[1] Liggett believes that the assessment provisions and other aspects of the Act suffer from Constitutional defects. Liggett recognizes that USDA has no authority to correct the Act's Constitutional infirmities. By commenting on the implementation of the assessment provisions, Liggett does not waive its Constitutional and other claims regarding the Act but rather expressly reserves them.

[2] The four companies and their approximate shares of the U.S. cigarette market at the beginning of 1998 were as follows: Philip Morris Inc. (48%), R.J. Reynolds Tobacco Company (24%), Brown & Williamson Tobacco Corporation (16%), and Lorillard Tobacco Company (9%).

[3] A list of manufacturers and importers, broken down into the MSA categories of OPMs, SPMs, and NPMs, is attached as Exhibit A. This list was derived from several different sources, including lists appearing on the websites of various state attorneys general. Because of the volatility in the industry this list may not necessarily reflect all present market participants.

Three." The collective market share of the Big Three has declined to approximately 85 percent.[4] Along with this dramatic influx of new market entrants has come a dramatic change in the nature of the U.S. tobacco products marketplace. That marketplace is now highly volatile, with constant change being the norm.

An important consequence of the volatility in the tobacco industry is that manufacturer and importer market shares can change significantly over relatively short periods of time. The method for calculating individual assessments under the Act must account for these rapid changes by basing assessments on current market shares, not historical market shares. Of course, new manufacturers and importers enter the market without historical market shares. Thus, any method for calculating assessments that uses historical market share data will unfairly excuse new entrants from assessments for some period of time, thereby providing these new entrants an unfair competitive advantage over long-standing market participants such as Liggett.

The assessments imposed on tobacco product manufacturers and importers take on an added significance in the "discount" segment of the market where Liggett operates. Profit margins in this segment are relatively thin. If new entrants are exempted from assessments until they have developed historical market shares, they will have a substantial and artificial price advantage and will be able to gain market share based solely on this unfair advantage.

In addition, the extent to which a company is able to pass assessment costs through to its customers could well determine whether that company operates at a profit or a loss for a given period. If assessments are not fair, accurate, and predictable, companies run the substantial risk that they will not be able to adjust their pricing in a sufficient amount or with sufficient lead time to collect the funds to pay the assessments. On the other hand, if a company increases its prices too much, it runs the risk of losing market share to lower-priced competitors. Thus, it is critical that assessments be implemented fairly and accurately so as not to create an artificial impact on the marketplace.

USDA will need to be vigilant in its enforcement efforts, and must avoid any assessment structure that will create loopholes or promote evasion of payment obligations by allowing companies to sell their products in the marketplace without having to pay assessments on those sales until much later. If such a "lag time" is allowed, some companies will simply disappear when their assessment payment comes due, only to reappear in another form thereafter and begin the same process of evasion again. As the industry's experience with the MSA and the related state escrow statutes demonstrates, some manufacturers and/or importers will likely be very creative and agile in evading and avoiding their obligations under the Act. Adding insult to injury is the possibility under § 625(c)(3) of the Act that legitimate market participants could be left to pick up the costs incurred by participants who avoid paying their fair shares. Compliant companies should not be punished for their compliance by increased assessments resulting from noncompliant companies.

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4 See, e.g., John C. Maxwell, *The Maxwell Report*, *Third Quarter 2004 Sales Estimates for the Cigarette Industry* at 2 (Nov. 2004).

SPECIFIC COMMENTS

I. A Company's Specific Assessments for Any Quarter Must Be Based on Market Shares for that Quarter, Establishing a "Pay as You Go" Structure.

A. The Act Provides for Two Separate Calculations in Determining a Company's Assessment.

Before assessments may be levied, USDA is required by the Act to make two calculations. First, USDA must calculate the total assessment to be paid by all manufacturers and importers in the same class of tobacco product. Section 625(c)(1) sets the percentages for each tobacco product class for fiscal year 2005 as:

- Cigarette: 96.331%
- Cigar: 2.783%
- Snuff: 0.539%
- Roll-your-own: 0.171%
- Pipe: 0.066%

Pursuant to § 625(c)(2), USDA must recalculate the product class percentages for subsequent fiscal years to reflect any change in the share of gross domestic sales volume held by each class of tobacco product.

Once the total amount of assessment for each class of tobacco products is determined, a second calculation must be made as to what share of that total each manufacturer and importer of products within that class must bear. Under § 625(e)(1), the total assessment for each class is to be "allocated on a pro rata basis among manufacturers and importers based on each manufacturer's or importer's share of gross domestic volume."

B. The Act Provides for a "Pay as You Go" Structure For Determining Individual Company Assessments, and a "Historic" Structure for Determining Product Class Allocations.

The Act requires that in making its "second" calculation – determining each company's share of the assessment levied against its entire class – USDA use a quarter-by-quarter "pay as you go" basis whereby a company's assessment for a particular quarter reflects that company's market share for the same quarter. This structure will ensure a payment scheme that is simple, fair and accurate, will prevent the creation of a major loophole that would result from a "lag time" assessment structure, and will clarify and harmonize language in the Act regarding assessment timing and market shares.

Section 625(f) of the Act, for example, contemplates such a quarter-by-quarter "pay as you go" structure. That section mandates that a company's assessment "shall be determined for each quarterly payment period" by multiplying the company's market share "as calculated with respect to that payment period . . . ." § 625(f) (emphasis added). This language indicates that a manufacturer's or importer's assessment for a quarter should be calculated with respect to its actual market share for the same quarter, and is consistent with the mandate of §

625(e)(1) that the total assessment for each class be "allocated on a pro rata basis among manufacturers and importers based on each manufacturer's or importer's share of gross domestic volume."

The calculation of the overall assessment paid by each class of tobacco product is handled differently, and is based on historical, as opposed to current, market shares. Such a structure is logical. The use of historical data in determining the total assessment for which each class of tobacco product is responsible provides manufacturers and importers with certainty in determining their own individual assessments. A manufacturer could use the historical data to estimate the total amount of assessment for which its class will be responsible, and then estimate its own burden based on its own projected market share within its class during the quarter for which the assessment is to be collected.

The Act's intent that historical data be used in the assessment determination for a product class is apparent from the initial allocations specified in § 625(c)(1) (*see* above for specific percentages). This allocation is based on federal tobacco excise tax data compiled and published by the Department of Treasury's Alcohol and Tobacco Tax and Trade Bureau ("TTB") with respect to removals of tobacco products during the 2003 calendar year. Thus, in setting the initial allocation for each of the classes of tobacco based on historic data, Congress has made clear that this calculation be handled differently than the calculation of companies' individual market shares.

The use of historical or "lagging" market data in determining allocations of each product class so as to facilitate planning by manufacturers and importers is consistent with § 625(d)(3)(B), setting forth the "Timing of Assessment Payments." This section provides that the "assessment for a calendar year quarter shall correspond to the base period quarter that ended at the end of the preceding calendar year quarter." This provision serves the important function of "timing" the assessment process so as to give manufacturers and importers notice of the estimated overall monetary burden each class of tobacco product will bear in an upcoming quarter, and allow manufacturers and importers to plan accordingly based on their projections for their own market share in that quarter.

C. The Act's Failure to Require Historical Federal Excise Tax Returns Demonstrates Congressional Intent to Base Individual Market Share on Current Quarters.

If Congress had intended individual company market shares to be calculated based on an earlier quarter than the quarter on which the assessment is based, it would have required manufacturers and importers to provide their federal excise tax ("FET") returns for the earlier period. The Act does not do so. Instead, it prospectively requires manufacturers and importers to provide USDA with certified copies of their FET returns, "on the same date that those returns or forms are filed, or required to be filed with the agency." § 625(h)(1)-(2).

Congressional intent that the USDA determine the market shares of manufacturers and importers based on current quarters is demonstrated by its requirement that current information, rather than historical information, be provided to USDA by manufacturers and importers in order to aid USDA in its calculation of the appropriate market share for each assessment quarter.

D. Basing Overall Class Allocations on Historical Data, and Individual Manufacturer and Importer Shares on Present Data Serves Public Policy Goals.

If, on the other hand, USDA interprets the Act as requiring company market shares to be based on historical (often obsolete) data, the result will be a lag between the date that market share is calculated and the quarter for which the company is being assessed. Such a lag will create artificial distortions in the marketplace, which Congress certainly did not intend.

As stated above, using a market share from an earlier period to determine individual market shares makes the assessment process inaccurate, unfair, and open to abuse. For example, where the assessment lags from market share and a manufacturer's market share has declined since the earlier period, the manufacturer is penalized by having to pay more of an assessment than its current market share warrants. On the other hand, if a manufacturer's market share has increased since the earlier period, that manufacturer receives a windfall and does not pay its fair share.

Calculating individual market shares based on a prior period creates a potentially huge loophole for new entrants into the market. A new entrant will not have any market share for the earlier period, since it did not exist. Thus, if individual market shares were calculated based on the 12 months ending June 30 before the fiscal year begins, a new manufacturer or importer would have up to 15 months (July 1 of one year through September 30 of the next) during which it could operate and sell tobacco products without paying any assessments. During this period, it would have a distinct market pricing advantage over other participants who are paying the assessment and charging prices reflecting the cost of the assessment. Based solely on this distinction, the new entrant could use its pricing advantage to gain market share otherwise held by those manufacturers or importers who have been in the market continuously.

The potential abuse of such a loophole could commence as soon as the initial assessments are made by USDA. An importer could enter the domestic market on that date and take advantage of a 15-month period or "assessment holiday" during which it would be relieved of any obligation to remit funds to the USDA. Likewise, a market participant can exit the market just before being required to pay any assessment by changing its corporate structure or otherwise. It might thereafter be able to reappear, undetected, as a different corporation and begin the process again. Thus, under certain scenarios, new market participants could systematically enter and exit the market continuously, each time returning as a "new" entity, so as to avoid paying assessments under the Act.

A perverse impact of this loophole is that under the statute, any revenues lost by CCC due to the exploitation of this loophole may be "charged back" to the compliant market participants. Thus, an entity exploiting this loophole would not only avoid a cost being incurred by its competitors, it could actually succeed in shifting this cost to those competitors who are honest and complying with the law. Honest market participants could be penalized for their honesty and would in effect be paying assessments on the sales of their non-compliant competitors. This clearly was not the intent of Congress. Furthermore, any losses due to non-payment by market participants—whether they are the result of bankruptcy, evasion, or market exit—should be left to CCC to cover, not the remaining market participants.

The potential for abuse of the assessment system created by any lag in collecting assessments will also create an administrative nightmare for USDA. As is noted above, the structure of the tobacco industry has changed dramatically in recent years. With literally hundreds of market participants who may be liable for assessments, and the possibility of numerous market entries and exits during any "lag period," USDA would assume a significant enforcement burden as it tries to keep track of, and assure proper payments by these numerous market participants.

In contrast, under the more logical interpretation whereby individual manufacturer and importer assessments are calculated on the current quarter, the potential for unwarranted market distortions and abuse is limited. Manufacturers and importers can better be held accountable for their fair shares of the overall assessment of their product class. They could plan their business more precisely by incorporating the cost of each quarter's assessment into its price per pack, and pay the amount owed for each quarter at the conclusion of the subsequent quarter.

Furthermore, use of a market participant's current market share would make administration of the assessment scheme very simple. Under the Act, companies must file copies of their FET returns at the same time they file them with TTB twice a month. § 625(h). Given this requirement, USDA can determine on an ongoing basis whether a market participant fails to file its FET return.

More importantly, within 15 days after the end of a calendar quarter, USDA can easily determine the market share for each of the taxpayers subject to the requirement to file a FET return. Using filed FET returns, USDA can then send out an assessment notification by the middle of the second month of a quarter and require that all market participants make their payments into escrow at the end of that quarter.

To protect the integrity of the assessment program, USDA should assure that assessments closely follow the quarter for which they are being imposed, and take steps to obtain funds from new market entrants as soon as possible after their entry. Implementing the assessment provisions of the Act so that individual assessments are calculated on a quarter-by-quarter basis and then paid at the end of the next quarter ensures that the assessments are based on accurate market shares and lessens the already substantial burden on manufacturers and importers subject to the assessment.

II. <u>USDA Should Establish a Payment Plan for the Quarterly Assessments.</u>

As explained above, USDA should calculate market share for individual manufacturers and importers on a quarter-by-quarter basis, and then require payment of the assessment based on that market share at the end of the next quarter. However, should USDA interpret the Act as requiring lag time between the determination of individual market shares and the calculation of and receipt of the assessment, USDA can minimize the negative impacts inherent in the lag time and ensure a fairer and more accurate implementation of the assessment regime. It can accomplish this by establishing an escrow system under which, on a quarterly basis, manufacturers and importers would be required to place into an interest-bearing account payments based on the entity's most recent FET returns and on USDA's estimate of the amount it will require based on that entity's market share as indicated by those returns. USDA could then withdraw its assessments from each entity's individual account when the payments become due.

The use of such a payment plan is not without precedent. For example, in the states that are parties to the MSA, tobacco companies that are not party to the MSA ("Non-Participating Manufacturers" or "NPMs") are required to make escrow deposits based on their cigarette sales in the state during the prior quarter or year. *See*, *e.g.*, Va. Code Ann. § 3.1-366.2. Indeed, the Act itself contemplates the escrow of challenged amounts of assessments. *See* § 625(i)(5) (providing that in challenging an assessment, a manufacturer or importer may place into escrow that amount of the assessment it contests).

III. <u>USDA Should Promptly Make Clarifications Regarding the Initial Assessment Periods.</u>

A. <u>The Date When The First Assessment Period Commences Should Be Clarified.</u>

USDA should clarify the date when the first assessment period commences. Confusion as to the first assessment period was apparent from some of the comments received by USDA during its public meeting of November 22, 2004. Because of the relatively small profit margins in the "discount" segment of the market, how and when assessments are to be collected – and how market participants react to this uncertainty – could have significant impact with respect to market shares. Regardless of when the first assessments are to be collected, to avoid confusion in the marketplace, USDA should as soon as possible formally announce both the starting date for the first assessment period and the starting date for payments.

B. <u>Clarification Should Be Made As To Which Quarter's Market Share Will Be Used in Determining Initial Assessments</u>.

If USDA finds that the Act requires a lag time between the determination of individual market shares and the calculation of and receipt of assessments, it should determine the identity and market shares of all market participants for the quarter upon which the first assessment is based. To protect the program's integrity, USDA should then take steps to ensure that participants, especially those with minimal investment in the United States, cannot exit the marketplace without remitting assessments they will owe.

C. <u>Clarification Should be Made As to the Likely Size of the Initial Assessments</u>.

Under § 625(b)(2) of the Act, assessments for any quarter must correspond to the disbursements and expenses of the Tobacco Trust Fund for that quarter. Presumably the disbursements and expenses of the Tobacco Trust Fund for the fourth quarter of calendar year 2004 will be minimal. However, §§ 622(e)(2) and 623(d)(2) of the Act provide that tobacco producers and quota holders are to receive 10% of their total payments in each of fiscal years 2005-2014.

This suggests the possibility that payments to producers and quota holders during the first three quarters of calendar year 2005 could be larger than usual in order to make up for the minimal payments being made during the fourth quarter of calendar year 2004. If USDA determines that assessments will track this irregular payment schedule, it should make this known as soon as possible to permit manufacturers and importers to plan accordingly.

Under section 625(d)(1), USDA has considerable discretion regarding how soon it may notify manufacturers and importers of the amount to be assessed for each quarterly payment period. Liggett respectfully suggests that USDA notify manufacturers and importers as soon as possible after USDA has determined the amounts to be assessed, regardless of when those assessments are to be collected, so as to permit those affected to plan accordingly.

IV. <u>USDA Should Clarify the Definition of Gross Domestic Volume Used to Calculate the Total Assessment for Each Class of Tobacco Product.</u>

As noted above, § 625(c)(1) assigns each class of tobacco product a percentage of the total assessments to be paid in fiscal year 2005. As also discussed above, the assessment for each class of tobacco product is allocated on a *pro rata* basis among manufacturers and importers based on each entity's market share of the gross domestic sales volume for that product. §§ 625(e)(1), 625(f). The Act specifically provides that "[n]o manufacturer or importer shall be required to pay an assessment that is based on a share that is in excess of the manufacturer's or importer's share of domestic volume." § 625(e)(2).

In promulgating its rule, for the purposes of determining an individual manufacturer's or importer's *pro rata* share, USDA should exclude returned goods from its definition of gross domestic volume, so as to most accurately reflect market share. Otherwise, a manufacturer or importer with a percentage of returned goods that is higher than the industry average will be unfairly penalized and one with a returned goods percentage below the industry average – or one that does not accept returns – is unfairly rewarded. To achieve a more accurate and fair reflection of the true size of each manufacturer's and importer's share of the market, USDA should define gross domestic volume taking into account returned goods consistent with the calculation of FET liability.

CONCLUSION

The Act represents perhaps the most significant change in the manner in which tobacco is grown and sold in this country since the creation of the tobacco quota and price support programs. USDA's interpretation of the Act and clarification of its ambiguities directly affect the marketplace and its participants. USDA's solicitation of comments with respect to its rulemaking indicates that the Department recognizes the weighty responsibility it carries with respect to the Act's implementation. Liggett appreciates having the opportunity to participate in this process through these and its previously filed comments, and urges USDA to issue a rule which will assure implementation of the Act in the fairest and most judicious means possible consistent with the statute. At the same time, recognizing the complexity of the program to be implemented under this Act, Liggett urges USDA to issue an interim final rule so as to give industry an opportunity to assess the details of the program and identify for USDA any potential problems.