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Associated Press Financial Wire

March 8, 2006 Wednesday 3:09 PM GMT

SECTION: BUSINESS NEWS

LENGTH: 1084 words

HEADLINE: Big **tobacco** seeks $**1.2** billion cut in payments to states

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BODY:

State governments, addicted to billions in revenue from the **tobacco** industry, have begun to worry that they will have to cut back.

Forty-six states are expecting a total of $6.5 billion this spring, the latest in a series of annual payments stemming from the 1998 Master Settlement Agreement with major **tobacco** companies. But Altria Group Inc.'s Philip Morris USA and others suggest they might be entitled to reduce their payments by as much as $**1.2** billion this year, raising the possibility that they will seek similar cuts in years to come.

The $206 billion agreement which requires big **tobacco** companies to pay into state treasuries for at least 25 years has been seen as a success by the states. At a news conference Wednesday in Washington, D.C., state attorneys general plan to release figures showing that U.S. cigarette consumption has dropped to a 55-year low. They credit the settlement, which, among other things, imposed sharp curbs on cigarette marketing.

For budget-stretched state governments, the agreement has provided a windfall. So far, the **tobacco** companies have paid states $41.1 billion, with each year's payments based roughly on cigarette sales volume the previous year.

But the pact has also proved to be subject to interpretation. In the current dispute, Philip Morris, Reynolds American Inc. and other major companies are citing an "adjustment" provision that allows them to cut their payments if their collective market share drops below certain thresholds. In 2003, the companies say, they hit such a threshold: Their collective market share dropped to 92 percent from 99.6 percent in 1997 the year before the settlement.

The companies inserted the adjustment provision into the agreement out of concern that they would lose market share to smaller upstart cigarette makers that they expected to come into the market. The big companies have argued that, because these smaller rivals such as S&M Brands, Inc., Keysville, Va., which makes Bailey's cigarettes aren't subject to the marketing limits and cost burdens of the settlement, the small players can sell cigarettes at lower prices.

The states, in turn, argue that the market-share drop was caused not by the settlement, but rather because of consumers' growing preference for generic brands, and because of the growth in cigarette sales over the Internet. Furthermore, they argue that they have taken the steps required in the settlement to create a level playing field; they say they've enacted and enforced laws requiring the companies not in the settlement group to set aside similar payments in escrow accounts. (Unlike the big companies' payments, the escrow money is refundable, but only after 25 years. Some of the smaller

companies are suing the states over these laws.)

The provision also requires the big **tobacco** companies to show that their market-share loss is significantly attributable to the burdens of the agreement and that the states didn't try hard enough to level the playing field.

The states have vowed to fight for the full payments. But they've already been hit with one setback: An independent arbiter's preliminary ruling, rendered March 1, found that the burdens of the settlement agreement were a significant factor in the market-share loss.

States have until March 13 to submit arguments to the arbiter, an economist with Brattle Group, a consulting firm based in Cambridge, Mass., whose final decision is due March 27. Meanwhile, the states aren't taking chances. Massachusetts, Iowa, California and others have begun notifying the **tobacco** companies, as required under the settlement, that they could sue for the full payments.

"This is something we're discussing with the companies,"" said Iowa Attorney General Tom Miller, a co-chair of the **tobacco** committee for the National Association of Attorneys General. He believes that "most if not all of the states"" have passed and enforced the necessary laws to deny the upstart **tobacco** companies unfair advantages. The companies should go ahead and make the expected payments, Mr. Miller says, until the issue is legally resolved.

"This is a long way from being final," added Tom Dresslar, spokesman for California Attorney General Bill Lockyer. California, which expected about $826.8 million in payments this year, could get roughly $158 million less.

A loss of revenue could be bad news for many states that have come to count on the billions flowing from the **tobacco** companies. The money has helped finance health-care programs, education and public works, and increasingly, general operating expenses. Many states have floated bonds secured by the payments.

"It's important money and it's perpetual money and at this point, it is part of states' ongoing budgets," says Joy Johnson Wilson, director of the health committee at the National Conference of State Legislatures in Washington. "A major reduction ...would require some juggling."

Some observers think this fight could actually lead to a stronger agreement by making the two sides renegotiate. "We're not convinced that the major manufacturers will succeed in getting the $1 billion ...but this battle could lead to another settlement (and) an ironclad partnership between the states and **tobacco** manufacturers," said Bonnie Herzog, a **tobacco** analyst for Citigroup, in a March 6 report.

The feud could resonate in the bond markets too. At least ten cash-strapped states and many cities and counties have issued almost $32 billion in bonds that are explicitly backed by the future flow of settlement money, according to Fitch Ratings. If the bonds are viewed as riskier, the states would be forced to pay higher interest rates.

Fitch said it will review the spring payments, due April 17, and at that point determine whether there's any reason to review the ratings. Moody's Investors Service rates most **tobacco** securitizations as low investment-grade bonds "under review with direction uncertain." Moody's declined to comment on whether the latest dispute might trigger a downgrade.

The **tobacco** companies are optimistic. "We fully expect the (arbiter's) final determination will be the same as the preliminary determination," said Robert Buell, Phillip Morris's assistant general counsel, in a March 2 letter to PricewaterhouseCoopers, the auditor for the settlement agreement. Mr. Buell wrote that Philip Morris "made an overpayment" for 2003 and thus is entitled to a dollar-for-dollar offset, plus interest. A Philip Morris spokesman said it hasn't threatened to withhold payment to the states.

LOAD-DATE: March 9, 2006