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FTC news

Federal Trade Commission

Washington, D.C. 20580

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**SUBSTANTIAL PROFITS FOR TOBACCO COMPANIES COULD RESULT FROM
TOBACCO SETTLEMENT, SAYS FTC STAFF**
Value of Proposed Agreement Also Could Be Less Than \$368.5 Billion

According to a Federal Trade Commission staff report to Congress, cigarette manufacturers could realize substantial profits by increasing the price of cigarettes significantly above the level needed to satisfy their payments under the proposed settlement between the tobacco industry and 40 state Attorneys General. Profit increases could rise substantially, in part because of an antitrust exemption, which is much broader than necessary to achieve the legitimate public health goals of the settlement, the report says. The public sector -- federal and state governments -- also will gain financially from the settlement proposal, but the payments made by the companies most likely will be considerably less than the \$368.5 billion in the agreement, the staff suggested. The report, an analysis of the potential economic impact of the proposed tobacco settlement, was requested by the House of Representatives Task Force on Tobacco and Health.

FTC Chairman Robert Pitofsky emphasized that the report takes no position on whether the settlement agreement, if modified, would be in the public interest. "Rather the goal," he said, "is to explain how the proposed settlement might affect the tobacco industry and how prices could increase well beyond the amount of annual payments called for under the agreement resulting in substantial profits for the companies. The report raises the question of what ought to be done with any additional monies the settlement could generate."

The FTC staff report, titled "Competition and the Financial Impact of the Proposed

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(Tobacco Report--09/22/97)

Tobacco Industry Settlement" provides an overview of the U.S. cigarette industry and analyzes the effects of the proposed tobacco settlement on competition, prices, profits and public sector revenues. It identifies several features of the industry's past history and current structure that suggest why the industry is susceptible to coordinated price rises, including the tendency for price increases to consistently outpace cost increases, the small number of significant firms in the market, and the historical insulation of the cigarette industry from entry by new firms. Because of these features and the industry's historical response to tax increases, cigarette companies almost surely would raise prices by at least the amount they would be required to pay the public sector under the terms of the settlement, the report observes. "Moreover," according to the report, "certain features of the proposed settlement, particularly the antitrust exemption, have the potential to reduce competition and enhance the ability of the cigarette companies to 'coordinate' price increases," thus producing even greater price increases and profits.

The report provides several examples of the profits that could be generated if the cigarette manufacturers, through more effective coordination, raise prices by more than necessary to simply "pass through" to consumers the amount of the annual payments. If prices increase by 125 percent of the payments to consumers, their profits could increase by \$36 billion over the next 25 years. Assuming prices rise by 200 percent of the annual payments, profit levels could be \$123 billion higher over the next 25 years.

Public sector revenues also would increase if more effective coordination produces higher cigarette prices. "In general," the report says, "the companies would keep about two-thirds of the financial benefits . . . leaving one-third for the public sector."

An antitrust exemption under the settlement would allow the cigarette companies to coordinate their activities in order to achieve the goals of the agreement. A much more limited exemption might be justified, according to the report, in order to permit the companies to cooperate in limiting advertising and marketing so as to achieve the public health goals of the agreement. The current language of the agreement, however, could allow the parties to eliminate competition in the pricing of cigarettes, the report suggests.

The report also points out that the public sector would gain from the settlement proposal principally through annual payments made by the tobacco companies but these "will most likely be considerably less than the \$368.5 billion in 'face value' of the proposed settlement," because it fails to account for the likely decrease in smoking and in cigarette sales. The settlement would require a fixed \$10 billion payment from the industry due at signing and annual payments that increase in value over the term of the agreement. The staff report spells out the payment structure: "Unlike the initial payment due at signing, these payments are not fixed in value, but instead vary according to the volume of cigarettes sold each year and industry profits." Tax

(Tobacco Report--09/22/97)

revenues also vary with sales volume and profits. After taking into account an anticipated decrease in smoking, the staff suggests that the public sector would only realize approximately \$207 billion, if the settlement did not cause prices to rise by more than the level needed to satisfy the required annual payments.

The report concludes that "passage of an unnecessary or overly broad immunity runs the risk of facilitating price increases greater than that required simply to pass through the per-unit cost of their [a]nnual [p]ayments."

The views expressed in the staff report are not necessarily those of the Commission or any individual Commissioner. The Commission's vote to release the staff report was 4-0.

Copies of the staff report are available from the FTC's World Wide Web site at <http://www.ftc.gov> and from the FTC's Public Reference Branch, Room 130, 6th Street and Pennsylvania Avenue, N.W., Washington, D.C. 20580; 202-326-2222; TTY for the hearing impaired 202-326-2502. To find out the latest news as it is announced, call the FTC's NewsPhone at 202-326-2710.

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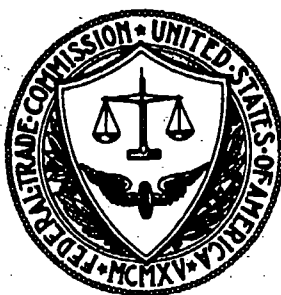
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Competition and the Financial Impact of the Proposed Tobacco Industry Settlement



Requested by the
Congressional Task Force
on Tobacco and Health.

Prepared by the
staff of the
Federal Trade Commission.

September 1997

This report has been prepared by staff members of the Bureaus of Economics, Competition, and Consumer Protection. The views expressed do not necessarily reflect those of the Commission or any individual Commissioner.