to buy from loan stocks. The amount of purchases will likely depend on the amount that loan stocks are discounted.

It might be realistic, although optimistic, to assume that understatements of needs and discounted prices would result in sales of 100 to 125 million pounds of loan stock tobacco. These assumed sales, together with the 3 percent Secretarial discretion could boost the quota to between 660 million and 705 million pounds — 13 to 18 percent below a year earlier. However, to affect the 1999 quota level, the sales would have to occur by December 15, 1998.

No-Net-Cost Analysis:

As of July 31, 1998, Stabilization's debt, including principal and interest, equaled approximately $550 million on the 1997 and 1998 crop inventories. After excluding approximately $66 million for projected losses on the 1994 buyout, which covered the 1990 through 1993 crops, the no-net-cost account for Stabilization would total approximately $158 million to be used to offset losses on current 1997 and 1998 inventories of 231 million pounds (dry weight) and projected 1999 crop loan receipts. Stabilization has proposed an 18 percent reduction in current list prices to the industry without any positive response. The industry has requested a 25 percent discount from current list prices. An 18 percent reduction from current Association list prices for the 1997 crop would result in a no-net-cost assessment level of approximately 4 cents per pound for the 1999 crop year.

SUMMARY:

U.S. cigarette consumption is expected to decline 10 percent or more during the next year. Cigarette exports will do well to hold their own and leaf exports are down because of economic problems in importing countries and large world supplies of leaf tobacco. This translates into reduced demand for U.S. leaf. Although there are good prospects for some loan stock sales, it seems almost inevitable that supply and demand conditions mandate at least a double-digit cut in the 1999 flue-cured tobacco quota.

DRAFT: CHILDREN AND FAMILIES
USES OF FUNDS FOR FY 2000 BUDGET
(Dollars in Millions)

DISCRETIONARY	Request FY 2000	OMB Passback FY 2000	Agency Appeal FY 2000	WH Priorities FY 2000	COMMENTS
Food Safety					Admin. Priority
FDA	$48.9	$0	$48.9	$48.9	
CDC	$18	$0	$18	$18	
USDA	$20	$20	($30.5)*	$30.5	
Equal Pay					Next step
EEOC	$17.3	$0	$17.3	$17.3	
DOL-OFCCP	$10.4	$0.383	$0	$10.4	
Native American Educ: 1000 Teachers	$0	$0	$10	$10	POTUS Executive order
Interior: Econ Dev	$0	$0	$0	$1	POTUS Directive
Interior: BIA School Construction	$108.8	$78.3	$30.5 (to make up diff)		Followup to FY99 Req
HHS-IHS budget	$382	$175	$207 (to make up diff)		

*Although no part of the Food Safety Initiative, USDA objects to denial of salary increases, arguing that this will cut the number of inspections and undercut the Initiative.

Let me know if you want me to send this

INFORMATIONAL MEMORANDUM FOR THE SECRETARY

THROUGH: August Schumacher, Jr.
Under Secretary for Farm and
Foreign Agricultural Services

FROM: Keith Kelly
Administrator

SUBJECT: Drop in 1999 Crop Year Purchase Intentions for Flue-Cured Tobacco

ISSUE:

To provide an update on the drop in cigarette manufacturers' purchase intentions, its effect on establishing the 1999 flue-cured quota, and the options available in establishing the quota.

DISCUSSION:

The national flue-cured tobacco marketing quota is based on 3 components: 1) purchase intentions submitted by domestic cigarette manufacturers, 2) three-year average of unmanufactured flue-cured exports, and 3) reserve supply level.

The 5 major cigarette manufacturers were required to submit purchase intentions for the 1999 crop year by December 1. The Department (USDA) must announce the 1999 national marketing quota by December 15 based on the 3-part formula. The Secretary must announce the quota within a 97 percent to 103 percent range of the 3-part formula total.

The purchase intentions submitted bymmanufacturers on December 1 totaled 327 million pounds, a decline of 127.6 million pounds or 28 percent from the 1998 level. The 1999 purchase intentions are the second lowest since this method for establishing quotas was initiated in 1986.

Reasons for Decline:

Purchase intentions for leaf tobacco reveal manufacturers perceived needs for leaf used in cigarettes during the next 2 or 3 years. With settlements between states attorneys general and the cigarette manufacturers totaling around $250 billion, cigarette manufacturers have already announced wholesale price increases equivalent to 45 cents per pack, or a 30 percent increase. This will result in a 10 to 15 percent decline in domestic cigarette consumption with further price increases and consumption declines likely.

In addition to the decline in domestic cigarette consumption, cigarette exports have declined during the last two years. With depressed economic conditions in Southeast Asia and some other countries, cigarette export prospects have weakened. Furthermore, many countries prefer to manufacture cigarettes locally rather than import them. This trend is further reducing cigarette export potential.

Other Quota Factors:

Leaf tobacco exports are also down. Leaf exports in 1997/98 totaled 334 million pounds, the lowest level since 1942. The three year average of exports for 1996/97, 1997/98, and a projected optimistic figure of 340 million pounds for 1998/99 gives a figure of 355 million pounds for the 3-year average of exports for use in the 3-part formula for setting hhe flue-cured national marketing quota.

The third part of the quota formula, reserve stocks, are in excess supply. The Flue-Cured Tobacco Cooperative Stabilization Corporation (Stabilization) currently holds 265 million pound of flue-cured (green-weight) tobacco. The reserve supply formula calls for 121 million pounds (15 percent of last year's basic quota--807.6 million pounds).

Of the 3 components of the quota formula, only the reserve stock figure can change before the quota is set on December 15. The Office of General Counsel has ruled that cigarette manufacturers cannot revise the purchase intentions they submitted on December 1. Several inquiries have been made concerning this possibility. The export number is also firm.

Consequently, the only component that can be changed to modify the quota number is the uncommitted loan stocks number. Currently, that part of the formula is a minus 144 million pounds. Without any loan stock sales the quota would be set as follows:

Purchase Intentions:	327 million pounds
Average Exports (3 years)	355 million pounds
Reserve Stock Adjustment	- 144 million pounds
TOTAL	538 million pounds

The worst case scenario would be a flue-cured national marketing quota of 538 million --or a 33 percent reduction from the 1998 crop year.

If all 265 million pounds of loan stocks are sold, the loan stock adjustment would become plus (+) 121 million pounds and the quota would total 803 million pounds, almost the same as last year. With the Secretary's 3 percent adjustment, the quota could conceivably increase from last year level.

Realistically, the most optimistic quota scenario is not iikely to occur. However, there is a very good possibility that some cigarette manufacturers understated purchase intentions and will need

Gary Black: TI Up To Tricks [12/08-3]

Article Entitled Old Idea, New Twist: Sell RJR USA To The Highest Bidder.

Gary Black, Tobacco BBS [12/07/98]

RJR senior management is now suggesting that the long-promised spinoff of Nabisco may be delayed until 1999/2H—or at least until it becomes clear that the company's domestic tobacco business "is viable," following the industry's agreement to pay to the states $.45/pack to settle all AG lawsuits (settlement costs are variable, rather than fixed), financed by a $.45/pack price hike to pay for the settlement, which may or may not stick. But as we have pointed out before, and as RJR itself has contemplated, RJR management could unlock value now by selling its domestic tobacco business outright, with all its contingent liabilities, to the highest bidder. Divesting domestic tobacco assets and liabilities would allow RJR to then spin off Nabisco and Reynolds International without fear of fraudulent conveyance risks. The new buyer of RJR USA would assume the legal risks, and indemnify the parent against future risks associated with RJR USA going bankrupt and claimants coming after the RJR parent's assets. This is the same value-unlocking plan implemented successfully by American Brands (now Fortune Brands) in selling American Tobacco to BAT in 1994. This idea of RJR selling its domestic tobacco assets, and having the buyer assume the contingent liabilities could become more tangible in January if Brooke's Chairman Bennett LeBow, who has suggested often that he would like to merge Liggett with RJR domestic tobacco, makes a bid for RJR's domestic tobacco business once he restructures his own BGL balance sheet. This could become evident once LeBow is sure that the second $150 million from Philip Morris' purchase of three Liggett brands is in the bank (H-S-R approval needed).

The biggest risk to LeBow emerging as successful buyer for RJR USA is that RN shareholders may not give credence to BGL indemnifying RN, the parent. BGL would have to guarantee RJR that if tobacco liabilities bankrupt a combined RJR/Liggett after the sale, and plaintiffs come after RN (or whatever is left of RN), BGL would somehow pay the claimants off. BAT indemnified American Brands shareholders after buying American Tobacco's assets and liabilities in 1994. Given a vastly improving litigation picture on the class action front, and the AG claims settled, we see low risk of RJR/Liggett going bankrupt. BGL could finance a LBO-type buyout of RJR USA by issuing $2 billion of a new class of common or preferred equity via an IPO, which would likely be concurrent with a Liggett buyout bid for RJR USA (RJR would not accept BGL equity in payment for RJR USA). We expect RJR USA to generate some $570 million after-tax in equity free cash flow in 1999, if we assume 2/3 of tobacco debt and interest expense can be loaded onto RJR USA. (we assume that RJR Tobacco bondholders can be persuaded—with money -- to load 2/3 of debt onto RJR USA, which would give it a fixed charge coverage of 3.1x, or above the 2.8x FCC we see for RJR's worldwide tobacco company). If BGL promised new holders of BGL preferred or a separate class of common a return of 15% after-tax, BGL, in buying RJR at our assumed 3.2x EFCF, could retire all new preferred in about 7 years. The math is as follows: The return on RJR equity is 1 / 3.2x = 30%, vs. after-tax cost of preferred = 15%. The excess cash flow to retire the preferred would be 15% (30% - 15%); this implies it would take 7 years to retire 100% of preferred if BGL used all excess cash flow from RJR (after financing costs) to pay off the new preferred or separate class of common. Since Philip Morris senior management and RJR shareholders who also own Philip Morris shares might be very troubled by the prospect of Bennett LeBow taking control of the #2 tobacco company, RJR might be pressured to cast any BGL offer as bait to attract bids from other well-heeled players—Japan Tobacco, Fortune Tobacco, or others currently trying to build their way into the U.S. market. RJR USA would also look attractive to a smokeless maker (Swisher, Swedish Match) or cigar company seeking scale.

We compute $41-$43/share in value under this "sell domestic tobacco and spin" plan (see full analysis in the Exhibit). With 2/3 of tobacco debt on RJR USA, we compute $1.91 in equity free cash flow, which we believe could sell for 3.0-3.5x after-tax at auction ($6/share if no capital gain;

$4/share if gain). Under this debt allocation, Reynolds International would show $.60/share in EFCF before any cost savings or revenue opportunities; this could be worth $10-$11/share (15-16x) to a BAT or another player who can leverage RJR's global American blend brands and consolidate costs. Valuing RN's Nabisco interest at its current $26/share ($40 x .65) we compute a total value of $41 – assuming RJR pays a capital gains tax on the sale of domestic tobacco.

NATIONAL TOBACCO GROWERS ASSOCIATION
1326 County Line Road • Benson, NC 27504
Business: (910) 897-5269 • Fax: (910) 897-4411 • Home: (910) 897-5482

tob. farmers
quota

PROPOSAL for FLUE-CURED TOBACCO SETTLEMENT

FUNDS TO STAKE HOLDERS

Quota holders:	$.80/lb for 10 years-based on average quota for baseline period
Producers:	$.20/lb for 10 years-based on average quota grown for baseline period
Baseline Period:	1994,1995,1996,1997,1998
Price Support:	reduction of average price support of $.40/lb
Program Changes:	new base quota attached to individual producer ID (ID number to be determined)

TOBACCO PROGRAM'S BASIC OPERATIONS REMAIN THE SAME (EXCEPT):

A) REDUCE RESERVE LEVEL (FC) 80 MIL LBS
B) REDUCE PRICE SUPPORT
C) CHANGE QUOTA ASSIGNMENT TO INDUVIDUAL
D) CROP INSURANCE REVISED FOR SAVINGS (POSSIBLE ADMINISTRATIVELY)
E) ADMINISTRATIVE FEES PAID BY PRODUCERS FOR TOBACCO PROGRAM
F) AGREEMENT ON SETTLEMENT OF STABILIZATION STOCKS

FUNDING: TRUST FUNDS - SEPARATE FUND SOLELY TOBACCO STAKEHOLDERS

A) TRUST TO START RECIEVING FUNDS 1999
B) PROGRAM CHANGES INITIATED DURING 1999, ACTUAL BEGINNING IN 2000
C) PAYMENTS TO STAKEHOLDERS-10 YEARS- 2000 thru 2010

FLUE-CURED TOBACCO GROWER COMPENSATION
PAYOUT OVER 10 YEARS

CROP YEAR	FC BASIC QUOTA (MIL LBS)
1994	802.6
1995	934.6
1996	873.6
1997	973.8
1998	806.7
AVERAGE	878.26

GROWER COMPENSATION

$7.0 B	FOR QUOTA HOLDERS @ $8/LB
$1.8 B	FOR GROWERS@ $2/LB
$8..8 B	TOTAL COMPENSATION FOR ALL GROWERS AND QUOTA HOLDERS

NATIONAL TOBACCO GROWERS ASSOCIATION
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PROPOSAL for BURLEY TOBACCO SETTLEMENT

FUNDING TO BURLEY STAKEHOLDERS:

Quota holders:	\$.20/lb for 10 years based on average quota for the baseline period
Producers:	\$.80/lb for 10 years based on average quota for the baseline period
Baseline:	same as FC

Program changes are basically the same as FC with recommendations requested from Burley Leadership

BURLEY TOBACCO GROWER COMPENSATION

PAYOUT OVER 10 YEARS

CROP YEAR	BURLEY BASIC QUOTA (MIL LBS)
1994	536.3
1995	546.5
1996	631.3
1997	704.5
1998	635.4
AVERAGE	610.8

GROWER COMPENSATION

$1.2 B	FOR QUOTA HOLDERS @ $2/LB
$4.9 B	FOR BURLEY GROWERS @ $8/LB
$6.1 B	TOTAL COMPENSATION FOR BURLEY GROWERS AND QUOTA HOLDERS
$14.9 B	TOTAL TOBACCO COMPENSATION (BIL $)

PURCHASER SAVINGS	(MIL LBS)		10 yrs	25yrs
FC TOTAL MARKETINGS	900	$.40/LB	3.6	9.0
BURLEY TOTAL MARKETINGS	650	$.20/LB	1.3	3.3
TOTAL SAVINGS on US TOBACCO (BIL $)			4.9	12.3

Public relations

tobacco farmers 90 m

FAX COVER SHEET

U.S. DEPARTMENT OF AGRICULTURE
Office of the Under Secretary
Farm and Foreign Agricultural Services
14th Street and Independence Avenue, S.W.
Washington, D.C. 20250-0105

Fax No: (202) 720-8254
Telephone: (202) 720-3111

Date: 12/9/98

TO: Tom Freedman
WH

FAX NO: 456-7431

PAGES: 8
(including cover)

FROM:

- ☐ AUGUST SCHUMACHER
- ☒ DALLAS R. SMITH — Job for
- ☐ JIM SCHROEDER
- ☐ TERESA GRUBER
- ☐ JOHN WINSKI
- ☐ BUTCH MAY
- ☐ KATHY BLYTHE
- ☐ JACKIE BURRELLO
- ☐ VICKIE PAIGE

COMMENTS:

~~Attachment~~

USDA

(1) Stabilization has 15% w/ offers w/o quality 12/14

(2) no clearing price — offers

(4) released press

(1) 90 mill.

(2) 15% discount

(3) clearing price qualities — best

FACSIMILE MESSAGE

Flue-Cured Tobacco Cooperative Stabilization Corporation
P. O. Box 12300
Raleigh, North Carolina 27605-2300
Telephone: (919) 821-4560 *Fax: (919) 821-4564*

SENT BY: Arnold Hamm

DATE: 12-9-98 **Page 1 of** 7

TO: Deputy Under Secretary's Office

ATTENTION: Mr. Dallas Smith

SUBJECT:

The information contained in this facsimile message is ***CONFIDENTIAL*** *and intended only for the party indicated above.*

Message

PHILIP MORRIS
U. S. A.
P.O. BOX 26603, RICHMOND, VIRGINIA 23261 TELEPHONE (804) 274-2000

December 8, 1998

Mr. J. R. Stocks
Flue-Cured Tobacco Cooperative Stabilization Corporation
P. O. Box 12300
Raleigh, NC 27605

Dear Mr. Stocks:

Philip Morris USA hereby offers to purchase one half of the 1997 crop portion of Stabilization's reserve supply inventory. As shown in the enclosed attachment, this offer is stated at prices reflecting a 15% discount against the January 1, 1999 base price. This offer represents approximately 95 million green pounds and represents prices that would reduce the no-net-cost impact for the following crop compared to Stabilization's current offer.

We continue to emphasize that a large portion of these tobaccos will be shipped to Philip Morris affiliates around the globe, including non-traditional purchasers of U.S. grown tobacco. Our worldwide affiliates' participation makes this offer possible and requires some selectivity to meet our affiliates' usage needs.

We understand that this offer, if accepted, would be subject to the terms and conditions outlined in Stabilization's Price Schedule and Inventory dated January 9, 1998.

Philip Morris USA continues to be the world's largest customer for U. S. tobacco producers. In this context we believe that offer this provides the American farmer the very best approach to the upcoming year's tobacco production situation.

Sincerely,

W. K. Riggan
Vice President, Leaf Department

Attachment

DEP\FC Pool Offer\sbb

Philip Morris U. S. A.
Purchase Offer
December 8, 1998

Crop	Gov't Grade	Strip Pounds	Offer Price CWT.
97	C4F	984,280	$ 280.25
97	C4GK	839,860	$ 264.56
97	C4KM	858,880	$ 272.09
97	H4F	91,080	$ 295.72
97	X3F	2,241,360	$ 272.51
97	X4F	298,760	$ 269.54
97	B3DK	134,640	$ 284.67
97	B3F	107,800	$ 297.84
97	B3K	7,621,680	$ 293.34
97	B3KF	1,598,520	$ 282.37
97	B3KM	4,876,320	$ 284.92
97	B4F	6,230,840	$ 294.44
97	B4KM	12,527,240	$ 280.84
97	X4G	212,520	$ 255.34
97	X4KM	116,600	$ 262.65
97	X4KV	1,536,040	$ 251.26
97	B5DK	88,000	$ 278.55
97	B5GK	458,040	$ 247.69
97	B5K	1,620,520	$ 280.33
97	B5KM	2,359,280	$ 269.28
97	B5KV	1,056,440	$ 262.65
97	B4KF	6,777,320	$ 278.65
97	B4K	7,801,200	$ 288.83
	TOTAL	60,248,320	

CONFIDENTIAL

To John Hoffel — MG → Wash

To Arnold FAX 919-821-4564

To Arnold H.: Arnold Hamm

12/8/98

Philip Morris USA Announces Offer To Purchase Half Of Stabilization's '97 Flue-Cured Crop Inventory.

Philip Morris USA announced today its offer to purchase half, or approximately 95 million pounds, of the 1997 crop inventory that Flue-Cured Stabilization is currently attempting to sell to the Tobacco industry. ?

what is this price — ?

It is important to note that Philip Morris USA is offering to purchase this quantity of tobacco at a higher price than is currently being offered by Stabilization to the industry. This offer should help minimize the impact and significantly help the No Net assessment fee for the growers and manufacturers for the '99 growing season.

Another benefit of the offer, if accepted by Stabilization is that it will increase the 1999 flue-cured quota by 95 million pounds, since each pound that is purchased will increase the quota by that amount. Philip Morris USA hopes that Stabilization will accept its offer in time to have a positive effect on the 1999 quota and on US tobacco growers.

Philip Morris USA is and will continue to be the single largest worldwide purchaser of U.S. grown tobacco.

Today's offer is representative of Philip Morris USA's ongoing commitment to the U.S. tobacco growers.

— Arnold doesn't know

Farmers pay proposal to finance long discount

Will it? They offer from reserve

→ David Milby, supt of procurement and operations service for PMUSA
— 274 7840 — 2 leaf —

— price — won't give competitive

→ "stabltn — this is at a price for stabltn better than that — it allows them to get a better deal ..." for net assest —

"it's beneficial cust empt that it makes another no-net assessment" — effects farmers to the hue

the grower will have to pay

~~[illegible]~~ makes up difference in no net cost

[illegible]

Southern Tobacco Communities Project

December 17, 1998

Washington, DC

DRAFT AGENDA

8:30 <u>**Continental Breakfast and Welcome**</u>
Rebecca Reeve, Southern Tobacco Communities Project

9:00 <u>**Understanding the Current Tobacco Farm Situation**</u>
- **Current Outlook for Tobacco Production**
Tom Capehart, USDA
- **Status of Industry Proposals for "Phase II" of AG Settlement**
Danny McKinney, Burley Tobacco Growers Cooperative
Arnold Hamm, Flue-Cured Stabilization Corporation
- **Role of Co-ops in Agricultural Diversification for Tobacco Farmers**
Karen Armstrong-Cummings, Commodity Growers Cooperative

10:15 <u>**Break**</u>

10:30 <u>**National Legislative Prospects**</u>
- **Potential Federal Farm Legislation**
Ridge Schuyler, legislative aide to Sen. Robb
- **Potential Public Health Legislation**
Mary Wallace, American Public Health Association
- **FDA Authority**
Scott Ballin, National Center for Tobacco-Free Kids

11:30 <u>**Anti-trust Implications of Phillip Morris Strategies**</u>

12:00 <u>**Lunch**</u> **(provided)**

1:00 <u>**Settlement with States' Attorneys-General**</u>
- **Status of Settlement – prospects for funding coming to states**

- **Strategies for Uses of Funding** - KY, NC, VA, TN, SC, GA
Farmer/Health advocate from each state report state prospects

3:30 <u>**Next Steps**</u>