XCALIBER

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February 15, 2023

HOUSE COMMITTEE ON JUDICIARY
Oregon State Capitol
900 Court Street, N.E.
Salem, Oregon 97301

Re: House Bill 2128

Dear Chair Kropf and Member of the House Committee on Judiciary:

This letter is written to provide a brief response to the written and oral testimony presented to the House Committee on Judiciary ("Committee") regarding House Bill 2128 ("legislation" or "bill") on February 14, 2023.

A. TESTIMONY THAT THE STATE OF OREGON HAS LIMITED ACCESS TO FUNDS SET ASIDE IN ESCROW BY NON-PARTICIPATING MANUFACTURERS SHOULD BE REGARDED AS AN ADMISSION THAT THOSE COMPANIES HAVE NO LIABILITY UNDER THE LAW.

In both written and oral testimony, the Office of the Attorney General made a significant admission that should not go unrecognized by this Committee. It stated, quite candidly, that a tax should be imposed on Non-Participating Manufacturers ("NPMs") because it "has limited ability to access the funds in the escrow accounts as a source for reimbursement for health care costs."[1] This should be seen for what it is: an admission that the NPMs have not undertaken the types of acts and practices that would create liability under Oregon law. The testimony further established that because it would be difficult to establish liability and provide due process to companies like Xcaliber International, Ltd., L.L.C. ("Xcaliber"), it would be easier to just take the monies currently sitting in escrow and create legal liability by mere legislative fiat. As outlined both in written testimony to this Committee on February 13, 2023, and by counsel to Xcaliber, this strategy likely violates both the Constitutions of Oregon and the United States and, therefore, carries significant legal risk. This Committee should not engage in legally deficient shortcuts for the sake of ease.

[1] Written Testimony of Kate Denison, Oregon Department of Justice, p. 2. This statement should be unsurprising; there is no liability for selling a product that is legally on the market and compliant with all regulatory requirements.

B. THE OREGON LEGISLATURE SHOULD ACT IN A NON-DISCRIMINATORY MANNER AND RAISE REVENUE BY IMPOSING ADDITIONAL STATE EXCISE TAX AMOUNTS ON ALL TOBACCO PRODUCT MANUFACTURERS.

A number of witnesses at the hearing on February 14, 2023, focused on the health effects of smoking. While cigarettes remain lawful and are, therefore, carefully regulated under both federal and state law, in 2023, there is little debate about their effect on health. [2] This is true regardless of whether the products are manufactured by a Participating Manufacturer ("PM") under the 1998 tobacco Master Settlement Agreement ("MSA") or an NPM. Additional witnesses focused on another issue: the need for resources for smoking prevention efforts and healthcare services. Rather than tax a small subset of tobacco product manufacturers – more specifically, NPMs – by the bill at issue, the Oregon Legislature should instead raise revenue by taxing all tobacco product manufacturers in a uniform manner. This non-discriminatory solution would avoid the constitutional issues outlined by Xcaliber and the other NPMs. Further, and perhaps more importantly, it would actually advance public health in a meaningful way.

As outlined by the American Lung Association as recently as November 17, 2022, raising tobacco taxes achieves real world results:

> Increasing taxes on cigarettes is a win-win proposition: significantly increasing cigarette taxes results in fewer kids starting to smoke, and in more adults quitting while at the same time providing substantial revenue to fund important health, as well as tobacco prevention programs. Every 10 percent increase in the price of cigarettes reduces consumption by about four percent among adults and about seven percent among youth.

American Lung Association, *Cigarette and Tobacco Taxes*, Nov. 17, 2022.[3] The Truth Initiative has published similar calls to action:

> The research is clear: increases in tobacco taxes decreases tobacco use. Indeed, raising taxes on tobacco and thereby increasing its price is one of the most effective ways to reduce tobacco use. Prices affect virtually all measures of cigarette use, including per capita consumption, smoking rates and the number of cigarettes smoked daily. These effects apply across a wide range of racial and socioeconomic groups.

Truth Initiative, *The importance of tobacco taxes*, Jan. 15, 2019.[4] If the goal of the legislation is to positively affect health outcomes and to not prop up the profits of the PMs that brought about the need for the MSA itself, Xcaliber encourages the Oregon

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[2] To make adult consumers aware of these harms, all tobacco product manufacturers, including Xcaliber, are required to print certain health warnings by the U.S. Surgeon General on the packaging of their products, as well as all advertisements, regardless of form.

[3] A copy of this article may be found on the following Internet link: https://www.lung.org/policy-advocacy/tobacco/tobacco-taxes

[4] A copy of this article may be found of the following Internet link: https://truthinitiative.org/research-resources/tobacco-prevention-efforts/importance-tobacco-taxes

Legislature to act in a non-discriminatory manner and uniformly tax all tobacco product manufacturers through state excise tax measures.

C. NPMs SHOULD NOT BE CRITICIZED FOR FOLLOWING THE LAW AND INVESTING ESCROWED FUNDS CONSISTENT WITH BOTH THE MODEL ESCROW STATUTE AND GUIDANCE OF THE ATTORNEY GENERAL.

In committee testimony, proponents of the legislation spent a great deal of time criticizing Xcaliber and other NPMs for investing escrowed funds. Simply stated, NPMs should not be criticized for following Oregon law and investing the funds consistent with both the Model Escrow Statute and guidance by the Office of the Attorney General. Before courts throughout the United States, the escrow obligation was justified by policy makers, in part, on the theory that it equated to "forced savings." This term was not used by NPMs; it originated with the expert witness of the Settling States, including Oregon. As asserted by Dr. Jonathon Gruber in an expert opinion in the United States District Court for the Northern District of Oklahoma, "The escrow statutes do not impose taxes on the NPMs, but rather impose *forced savings*."[5]

The use of the term "forced savings" by the witness of Oregon and other Settling States is consistent with the terms of the Model Escrow Statute, initially passed by the Oregon Legislature as OR. REV. STAT. §§ 323.800, *et seq*. Indeed, the statute provides that NPMs "shall receive the *interest or other appreciation* on such funds as earned." OR. REV. STAT. § 323.806(1)(b)(B) (emphasis added). To effectuate this measure, the Office of the Attorney General dictates, in the form of a Model Escrow Agreement, the types of investments that NPMs, such as Xcaliber, can utilize.[6] In that document, the term "Permitted Investments" is defined as "(a) United States Treasury Securities, (b) cash, or (c) Money Market Fund." Given that NPMs invested escrowed funds consistent with both state law and guidance from the Office of the Attorney General, it is insincere to now criticize those companies from somehow earning a limited amount of interest from those funds.

D. THE PURPOSE OF FUNDS RECOVERED UNDER THE TERMS OF THE MSA WAS NOT PUBLIC HEALTH.

In testimony before this Committee, witnesses for the Office of the Attorney General represented that the purpose of funds recovered from PMs under the terms of the MSA was to fund public health initiatives. The spending patterns of the Settling States, however, undermine that assertion. As outlined by the online publication MarketWatch the vast majority of funds received by the Settling States are not being spent on public health at all. MarketWatch instead reports that:

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[5] Expert Report of Jonathon Gruber, *Xcaliber International, Ltd, LLC, et al. v. Edmondson*, United States District Court for the Northern District of Oklahoma, No. 04-CV-922-EA(C), p. 11-12. A copy of this Report, without the exhibits, is attached as Attachment 1. Dr. Gruber later testified on behalf of Oregon in a multistate challenge to amendments to the Model Escrow Statute. *See Grand River Enters. Six Nations, Ltd. v. King, et al.*, 783 F.Supp.2d 516 (2011). Interestingly, Dr. Gruber further opined that the MSA payments due from Participating Manufacturers under the MSA mimic a tax. If MSA payments are a tax, it is improbable to assert that payments due to Oregon from NPMs are not.

[6] A copy of the mandated Model Escrow Agreement is attached hereto as Attachment 2.

[A]s states finalize their fiscal 2022 spending plans, those tobacco settlement revenues are generally being counted on to balance the budget – not to fund stop smoking programs or treat smoking-related health problems, such as lung cancer, even as an alarming uptick in vaping among high schoolers has anti-tobacco groups worried.

MarketWatch, "*Up in smoke: States are using tobacco settlement money to balance their budgets. Here's why that is a problem,*" June 29, 2021.[7] As further outlined by the online publication The Harvard Gazette:

What happened to [the money received from the MSA] has been the source of a lot of debate, discouragement, and disappointment. The $246 billion was used to fill budget gaps, build roads, and for other purposes; only very rarely was it used for any form of public health, let alone reducing tobacco use, treating those who were addicted, and protecting kids from becoming smokers. It has become a notorious example of collecting a lot of funds through litigation, but not getting those funds to those who most need or deserve them.

The Harvard Gazette, "*Learning the hard way,*" Aug. 4, 2021.[8] Even as stated by a proponent of the bill, Oregon has great discretion in how to spend its MSA funds, although in recent years, it has elected to use the funds for healthcare expenditures.

E. NPMs ARE NOT "BIG TOBACCO" AND HAVE NOT COMMITTED ANY OF THE ACTS AND PRACTICES THAT BROUGHT ABOUT THE NEED FOR THE 1998 TOBACO MASTER SETTLEMENT AGREEMENT.

During the hearing on February 14, 2023, there seemed to be confusion as to which cigarette manufacturers the legislation at issue would affect. In fact, many witnesses appeared to conflate the advertising and activities of NPMs, such as Xcaliber, with those undertaken by the PMs that brought about the need for the MSA. As outlined more fully in my letter to the Committee on February 13, 2023, the two are quite different.

For generations, the PMs advertised their products in a manner that was later alleged by the states to be false and otherwise deceptive in content. The companies purposefully targeted certain demographics, including women, communities of color, and children. Further, the manufacturers made statements in advertisements and before legislative bodies denying that their products were harmful to public health or addictive. In contrast, there is no allegation, and indeed no evidence to establish, that NPMs, who largely came into existence after the execution of the MSA, undertook any of these acts or activities.

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[7] A copy of this article may be found on the following Internet link:
https://www.marketwatch.com/story/up-in-smoke-states-are-using-tobacco-settlement-money-to-balance-their-budgets-heres-why-that-matters-11624990235

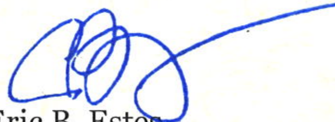
[8] A copy of this article may be found on the following Internet Link:
https://news.harvard.edu/gazette/story/2021/08/applying-lessons-learned-from-the-tobacco-settlement-to-opioid-negotiations/

Xcaliber does not advertise its products in publications typically available to the reading public. It does not use online media content to target smokers of any type. Indeed, its sole means of advertising to adult consumers is point-of-sale signage at the place of retail. These point-of-sale advertisements provide the name of the various products manufactured by Xcaliber, the price of the product, and the U.S. Surgeon General's warnings required under federal law.

Contrary to the opinions expressed during the February 14, 2023 hearing, the legislations under consideration would provide no further funding from those that that brought about the need for the MSA. In fact, in would punitively impact only NPMs, which largely entered the marketplace after the entry of the settlement. The legislation would further benefit the market share of the PMs, whose own acts and practices brought about the need for the MSA, at the expense of NPMs on whom liability cannot be established. Simply stated, the obligations imposed on NPMs, whether in the form of an escrow obligation or new tax, per the express terms of the MSA, were intended to "effectively and fully neutralize[] the cost disadvantages that the [PMs] experience vis-à-vis [NPMs]." 1998 TOBACCO MASTER SETTLMENT AGREEMENT, § IX(d)(2)(E). If the goal of the measure is to increase funding for public measures and expenditures in Oregon, there is a means of achieving that objective: taxes should be imposed on *all* manufacturers, regardless of settlement status.

If you have any questions, or need anything further, please do not hesitate to contact me.

Warmest Regards,



Eric B. Estes
General Counsel

attachments

ATTACHMENT 1

IN THE UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF OKLAHOMA

XCALIBER INTERNATIONAL LIMITED, LLC and KT&G CORP.	)	
Plaintiffs,	)	
vs.	)	**Case No. 04-CV-922-EA(C)**
W.A. DREW EDMONDSON, in his official capacity as Attorney General, State of Oklahoma	)	
Defendant.	)	

EXPERT REPORT OF JONATHAN GRUBER

Experience and Relevant Expertise

1. I am a Professor of Economics at the Massachusetts Institute of Technology, and a Research Associate of the National Bureau of Economic Research, where I direct the Program on the Economics of Children. From April 1997 through June 1998, I was Deputy Assistant Secretary for Economic Policy in the U.S. Treasury Department. In that capacity, I worked on a major legislative initiative to formulate comprehensive tobacco regulation (the "McCain bill"), which did not pass, but which was followed by the Master Settlement Agreement (MSA) with the states.

2. Since returning from Treasury, I have done extensive research on the tobacco industry and the economics of smoking. I have served as an expert for the Department of Justice in the federal government's RICO suit against the tobacco industry in which I was deposed twice. I have also submitted declarations as an expert witness in the Freedom Holdings case in

New York and in the S&M case in Tennessee. My curriculum vitae is attached to this report. I am being compensated for my work on this case at a rate of $650 per hour.

Purpose of Expert Report

3. I have been asked by counsel for Defendant in this case to analyze the economics of the Master Settlement Agreement and the escrow statutes that were subsequently enacted. In this regard, I first review the relevant details of the MSA related payments made by the original participating manufacturers (OPMs), the subsequent participating manufacturers (SPMs) and the non-participating manufacturers (NPMs). Next, I address whether the MSA and escrow statute authorized or required the OPMs or SPMs to fix prices or outputs. Third, I address the change to the allocable share release provisions of the escrow statute. Finally, I address some incorrect claims and assumptions made in the expert report by Plaintiffs' expert witness, Professor Bulow.

Payments Under the MSA

The OPMs

4. Under the MSA, the OPMs are responsible for making a series of payments. At the present time, the most important of these is the annual ongoing payment (including the strategic contribution payment) that began at $4.5 billion in 2000 and reaches a maximum of $9 billion in 2008. This payment is subject to several adjustments:

- An inflation adjustment, which adjusts the payments upwards by the rate of inflation measured by the Consumer Price Index (CPI) or by 3%, whichever is larger.
- A volume adjustment, which adjusts the payments downwards by

0.98*(1- OPM actual volume/OPM base volume)

- A previously settling states reduction, which adjusts payments downwards to account for payments made to states previously settling their tobacco lawsuits. This adjustment is 12.45% currently, but falls to 11.1% after 2018. This adjustment recognizes that the base payment (currently $8 billion) was to be the starting point for the calculation of payments to all states, including the four states (Previously Settled States) that settled their lawsuits against the OPMs before the MSA was executed and consequently are not parties to the MSA. The OPMs make payments separately to those four States pursuant to their agreements with those States in an amount that is somewhat in excess of the reduction.
- An NPM adjustment, which is a complicated formula that may operate to reduce the payments of the OPMs to a State, to the extent that NPMs increase their market share above a threshold, that increase is found to have resulted from disadvantages in the MSA, and the State either does not have in place an enforceable escrow or other qualifying statute or is determined not to have diligently enforced that statute. To date, there has been no finding that an increase in NPM market share has resulted from disadvantages in the MSA or that any state has not diligently enforced its escrow statute.
- Additional offsets, such as for federal legislation, that have also not been applied because the conditions under which they are triggered have not

arisen.

5. For 2004, the per cigarette payments due from the OPMs to the MSA States and previously settled states combined was approximately $0.02152 per cigarette.[1] In 2005, this amount will increase by the greater of 3% or the change in the CPI and will be approximately $0.02217.[2] In other words, for each 1 million cigarettes – or 5,000 cartons – an OPM sells in Oklahoma this year, it will owe annual settlement payments of approximately $22,170. (The OPM will also owe additional amounts based on its sales in Oklahoma and other states under the attorneys fee provisions of the MSA so that the total settlement payments it owes on account of additional sales will actually be somewhat greater than the above amounts.)

The SPMs

6. The SPMs are also responsible for making a series of annual payments under the MSA. SPMs were given an incentive to join the MSA. An SPM that became a Participating Manufacturer within 90 days of the execution of the MSA (by late February, 1999) is permitted to exclude a certain number of cigarettes – i.e., its "recalculated Grandfather share" computed as the greater of 125% of its 1997 Market Share of total US cigarette sales or 100% of its 1998 Market Share of total US cigarette sales -- from its payment calculation. SPMs that joined after

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[1] PricewaterhouseCoopers, the Independent Auditor for the MSA, presented a declaration in the Freedom Holdings case stating that the 2003 payments of the OPMs were $0.0208456 per cigarette. Applying the 2004 inflation adjustment of 3.26% yields an estimate for the OPM costs in 2004 of $0.02152 per cigarette. This estimate will be slightly too low if there was a decline in the volume of cigarettes sold by the OPMs between 2003 and 2004, since it does not include any volume adjustment.

[2] This is simply the 2004 OPM cost times 1.03; it may be slightly larger if the CPI change is more than 3%. Once again, this may be too low to the extent that there is a volume adjustment in 2005.

February, 1999 did not receive a recalculated Grandfather share. The amount owed by the SPM is equal to the product of the base amount due for the OPMs (after applying the volume adjustment) and the ratio of the difference between the SPM Market Share in the year in question and the base share (i.e., the recalculated Grandfather market share) and the OPM market share. That is, formulaically, the SPM owes:

$$\text{OPM base payment} * \text{volume adjustment} * \frac{(\text{SPM market share} - \text{SPM base share})}{\text{OPM market share}}$$

In the case of an SPM that joined the MSA more than 90 days after the effective date of the agreement, the SPM base share is deemed to be zero.

7. This SPM payment is then subject to the inflation adjustment and the potential NPM adjustment, as well as other minor adjustments that are not relevant to this analysis. The SPMs do not make settlement payments to the Previously Settled States, and the SPM payment is not subject to the Previously Settled States reduction.[3] For 2004, the per cigarette MSA annual payments due to be made by SPMs on account of each cigarette sold in excess of any grandfather share will be approximately $0.02051 per cigarette.[4] In 2005, this amount will increase by the greater of 3% or the change in the CPI and will be approximately $0.02112. In

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[3] The state of Minnesota has enacted legislation requiring payment by distributors selling in the state a fee of $0.0175 per cigarette made by manufacturers that are not making annual settlement payments to it (all manufacturers except the OPMs and Liggett). This has particular effects on the nature of the competitive environment in Minnesota, but does not affect the analysis for Oklahoma.

[4] The PricewaterhouseCoopers declaration in the Freedom Holdings case stated that the 2003 payments of the SPMs (without Grandfathered shares) were $0.0198606 per cigarette. Applying the 2004 inflation adjustment of 3.26% yields an estimate for SPM costs in 2004 of $0.02051 per cigarette. Once again, this may be too low to the extent that there are volume adjustments in 2004 or 2005.

other words, for each 1 million cigarettes – or 5,000 cartons – an SPM sells above its grandfather share, it will owe annual settlement payments of approximately $21,120.

The NPMs

8. The NPMs are not liable for payments under the MSA. Oklahoma and the other 45 states that are parties to the MSA have passed laws following the model statute found in Exhibit T to the MSA that give each NPM the option either to join the MSA as a Participating Manufacturer and therefore be treated as an SPM, or to make deposits into an escrow fund. These escrow payments are currently $ 0.0167539 per cigarette, and will rise to $ 0.0188482 per cigarette starting in 2007, plus an inflation adjustment identical to the inflation adjustment on MSA payment obligations. For 2004 sales, the escrow due on April 15, 2005, with the inflation adjustment will be $ 0.02013 per cigarette. For 2005 sales, the amount will increase by 3% or the increase in the CPI, whichever is greater, and will be approximately $ 0.02073 per cigarette. Thus, for each 1 million cigarettes – or 5,000 cartons – sold in 2005 in Oklahoma or another State with an escrow statute, the NPM will be required to put into an escrow account approximately $20,730.

9. Amounts paid into escrow are held for up to 25 years, earning interest which is paid out on a current basis to the company. If the State secures a judgment against the company within 25 years, the escrow account is available to fund payment of that judgment. If the State fails to secure such a judgment, funds in the escrow account are returned to the company. The escrow statute further ensures that an NPM cannot be required to place into escrow any more than it would be required to pay if it became a Participating Manufacture. Under the allocable share release provision as amended in Oklahoma, if for some reason the payments actually due

from SPMs are lower than what is set forth above and an NPM can show that the amount it was required to place into escrow exceeds the payments it would have made on its Oklahoma sales had it actually become an SPM, the excess is released back to the NPM.

The MSA Structure Does Not Mandate or Authorize Price Fixing or Output Restrictions

10. Nothing in the MSA mandates or authorizes that the OPMs and/or the SPMs fix prices, divide markets, or limit output. To the contrary, Participating Manufactures have the same incentive to price their products competitively and seek to increase their sales that they had before the MSA. If an OPM (or any Participating Manufacturer) increases its prices more than a nominal amount above its MSA payments and other costs, it risks losing customers to other tobacco companies, whether they be other OPMs, SPMs or NPMs.

Taxes and Competition

11. To understand the economics of the payment structure of the MSA, it is useful to consider the economic consequences of a uniform excise tax. In theory, such a tax can have one or more of three effects on a market: it can lead to lower profits; it can lead to higher prices; or it can lead to lower costs of production, including lower wages for workers in that industry. In practice, most past economic research suggests that per unit taxes are largely passed on in the form of higher prices to consumers. Past experience with the tobacco industry is that per unit excise tax increases have been passed forward to prices, both at the national level and the state level.

12. A tax that is passed forward to prices will have the effect of lowering the overall demand for the product, but does not make it any less attractive for any particular firm to expand output, or any more attractive for any particular firm to raise prices above costs. Intuitively, if

the price of tobacco leaf suddenly rose for all producers, per unit costs and prices would almost certainly increase, but we would not think of there being increased likelihood that industry participants would agree to fix prices or limit output in response to such an increase in cost. A rise in taxes operates the same way.

The MSA payments approximate a tax

13. A cigarette excise tax is a payment that is fixed per pack sold. Given the volume adjustment, the MSA payments made by the OPMs mimic such a tax: there is an incremental payment made per pack sold. If all cigarette manufacturers were party to the MSA in the same way as the OPMs, then the MSA payments would essentially constitute a voluntary tax. This point is worth emphasizing: a per pack charge that is levied on all producers equally is the economic equivalent of a tax. Such a tax may lead to a reduction in output, but an industry in no sense can be characterized as engaging in price fixing or operating as an output cartel as a result.

Tax differentials across manufacturers

14. Of course, all manufacturers are not party to the MSA in the same way as the OPMs. The SPMs have a different form of payment, and the NPMs are not party to the MSA at all. As a result, the MSA can lead to the benefit or detriment of particular actors in the tobacco market. If the OPMs make payments that are less than those made by the SPMs or NPMs, then the tax can be viewed as favoring the OPMs, though it would still not authorize them to fix prices or output. On the other hand, if the OPMs make payments that are *more* than the SPMs or NPMs, then the tax can be viewed as enhancing the position of SPMs and NPMs. In fact, it appears clear that the latter is the case.

15. Regardless of who benefits, and who loses, from the particular structure of this

MSA "tax", however, the payment structure of the MSA does not authorize or require manufacturers to fix prices or outputs. Once again, a rise in the price of tobacco leaf would not be viewed as creating an output cartel, even if the rise affected one group of manufacturers and not another. The effects of the MSA are substantively the same as such an increase in the cost of production. And no one would regard the existence of different costs as requiring or authorizing participants in the industry to fix prices or collude on output levels.

OPM Payments vs. SPM Payments

16. The SPM annual payment formula presented above results in SPM per cigarette payments for cigarettes in excess of an SPM's grandfathered share that are always about 4.55% lower than the per cigarette annual payments made by the OPMs.[5] Contrary to claims that have been made in other litigation, this is true notwithstanding that the formula involves dividing the SPM share by the aggregate OPM share. OPM payment calculations involve a similar division.

17. Many SPMs have a recalculated Grandfather share. This grandfathering allows a set of SPMs (those that signed up within 90 days of the MSA) to increase their sales to that level with no payments under the MSA. This provides the SPMs with a notable advantage over the

[5] The reason for this 4.55% difference is that the Previously Settling State reduction fails to give OPMs credit for the full payments they make to the Previously Settled States. The total payments the OPMs must make to the Previously Settling States currently amounts to approximately 17% of the MSA base payment amount. Yet the previously settling states reduction is only 12.45%. This means that the SPMs have a slight cost advantage relative to the OPMs: for each additional unit of cigarette sales they make in Oklahoma (and anywhere else in the country), the OPMs make a 17% payment to the Previously Settled States for which they only receive a 12.45% credit. This cost advantage for SPMs varies over time. Currently, the cost advantage is 4.55%. From 2008 through 2017, the cost advantage falls to 4.47%, since the OPMs pay the 17% of only $8 billion to the previously settling states, but receive a 12.24% adjustment on their full $8.139 billion MSA payment. Starting in 2018, the cost advantage falls to 4.04%, as the OPMs pay 17% on $8 billion to the previously settling states, and receive a credit of 11.067% on the $9 billion they are paying through the MSA.

OPMs until their sales reach this level.

18. The existence of this advantage does *not*, however, imply that these SPMs have no incentive to go beyond their grandfather share levels. Beyond that point, the SPMs *still* have a slight advantage over the OPMs resulting from the 4.55% differential noted above. Indeed, virtually all SPM sales now occur beyond the recalculated Grandfather level, with only a small number of very small SPMs having sales below that level.

19. Thus, recalculated Grandfather SPMs have a very large competitive advantage until they reach their recalculated Grandfather share. Beyond that point they continue to have a 4.55% settlement cost advantage over OPMs for additional units. In short, they have every reason to continue competing for additional market share above and beyond their recalculated Grandfather share. The dramatic increase in the market share of the SPMs since the MSA is completely at odds with claims that have been made that the grandfather share provisions of the MSA requires them to restrict their output. See the declaration from Pricewaterhouse Coopers attached as Exhibit A.

<u>OPM Payments vs. NPM Payments</u>

20. In the absence of escrow payments, payment obligations would be levied on the OPMs and SPMs, but not on the NPMs. That would provide very large competitive advantage for NPMs, allowing them to take market share away from OPMs and SPMs. It would also tend to undercut the very goals of the MSA, which are at least partly to cause manufacturers to internalize costs smoking imposes on the states. It appears that in addition to providing for a source of funds against which the States could recover smoking related damages, one goal of the escrow payments was to try to *equalize* the burdens on the OPMs/SPMs and the NPMs, by

requiring the NPMs to make payments into escrow that approximate what the MSA payments would make as SPMs.

21. In fact, under the escrow arrangement the NPMs do not incur greater burdens than they would make as participants in the MSA. That is so for three reasons.

22. First, the NPMs pay less into escrow than they would pay as an OPM or SPM, because (a) the NPM escrow charge is slightly lower per cigarette than the payment per cigarette for the OPMs and SPMs at the base volume level, (b) the volume adjustment for the OPMs (which flows to the payments by SPMs) does not fully compensate them for volume they lose, and (c) the previously settling states reduction in OPM payments is not enough to compensate the OPMs for their payments to those states. As a result, under the escrow statute, ignoring the allocable share release provision, the NPMs's escrow payments for 2004 sales will be about 6.5% less per cigarette than the MSA payments made by OPMs, and about 1.9% less per cigarette than the MSA payments of SPMs.

23. Second, the allocable share release in the amended escrow statutes ensures that NPMs don't pay more in escrow than they would in settlement payments if they sign on to the MSA as SPMs. Escrow payments are rebated to the NPMs for any amount over what they would pay as SPMs. This was an "insurance" mechanism inserted into the allocable share amendment explicitly to protect the NPMs from paying more than the participating manufacturers.

24. Finally, the NPMs enjoy an advantage because they do not actually make payments to the government, but rather put money in escrow, money that earns interest over time that is available on a current basis to the NPMs. The state escrow statutes do not impose taxes

on the NPMs, but rather impose forced savings. To the extent that the NPMs would have wanted to hold some safe assets in their portfolio anyway, this is not a very costly requirement. Even if they did not want to establish such accounts and were forced to borrow to finance the escrow, such borrowing is still economically less costly than actually paying a tax. Professor Bulow calculates that, if the NPMs were earning only a low 1% rate of return on their escrow accounts, and had a high 8% cost of capital, then the net cost of the escrow payments would be 75% of the contributions. That is, even with these extreme assumptions, he calculates that the cost of a dollar in escrow is only three-quarters of the cost of a dollar paid in tax.

25. In summary, without the Escrow Statute, the NPMs would have a substantially *increased* competitive advantage. For the reasons set forth above, however, even with the Escrow Statute, the NPMs are somewhat better off than they would have been without the adoption of the MSA and amended escrow statute together.

The Allocable Share Release

26. As originally enacted, the allocable share release provisions of the escrow statute did not simply serve as a safeguard for NPMs, but rather went beyond that to allow regionally concentrated NPMs to avoid escrow payments. Under the original statute, the Allocable share release compared the sales of an NPM in a *given state*, such as Oklahoma, to the amount Oklahoma would have received had the company been an SPM with national payment obligations under the MSA. The result was to exempt NPMs from any effective escrow obligation whenever the proportion of their sales in a given state exceeded that State's allocable share. A consequence was that any NPM that has sales concentrated in one state was required to escrow much less much than the MSA-equivalent amount that was the stated intent of the escrow

statutes.

27. For example, suppose that an NPM sold 1 million cigarettes in 2004. Under the payment per cigarette details noted above, the NPM would have an escrow obligation of approximately $20,130 (based on the NPM escrow per cigarette cited above, plus inflation adjustment). This is slightly less than the approximately $20,510 the NPM would have paid as an SPM selling that number of cigarettes.

28. Suppose that those 1 million cigarettes were sold nationally, in correspondence to the allocable shares of each state under the MSA. This would imply that, in Oklahoma, the company would have sold 10,360 cigarettes (518 packs). The company would then owe to the state of Oklahoma $208 dollars. This would mean that its escrow obligation for selling cigarettes in Oklahoma was $0.02013 per cigarette, slightly less than the $0.02051 it would have owed in MSA payments had it been an SPM. As a result, there would be no allocable share release.

29. Now, suppose instead that the NPM sold *all* of its 1 million cigarettes in Oklahoma. Then it would owe the state the entire $20,130. But, under the allocable share provision in effect in Oklahoma thought 2003, the NPM would be entitled to receive a refund for the difference between the $20,130 and the allocable share for Oklahoma, $208, a refund of $19,922. Thus, the NPM would face an escrow obligation of only $0.000208 per cigarette after this allocable share release. This is much lower than the settlement amount paid either by an SPM under the MSA or the escrow obligation owed by an NPM selling the identical number of cigarettes in Oklahoma but whose sales were distributed nationally.

30. In operation, for any NPM that has sales concentrated in a particular state, the

allocable share release, as originally written, required it to escrow (net of release) much less than the competing SPMs and OPMs pay in MSA payments per cigarette sold. This was an enormous competitive advantage for NPMs.

31. As a result of the Allocable share release amendment, the NPMs that previously obtained releases will likely be less profitable. They may well decide to raise their prices to reflect the fact that they now have to make escrow payments equal to those made by other NPMs and incur costs closer to the incremental MSA costs of the SPMs. This, in turn, will provide them with additional revenues to make the escrow payments though their unit sales will likely decline. It will not mean, however, that the OPMs and SPMs will be insulated from price competition. To the contrary, any attempt by them to increase prices above their marginal costs (including their marginal MSA costs) would lead NPMs to expand their own sales or output precisely as one would expect in a competitive market.

32. The allocable share release, as originally constructed, skewed the competitive playing field dramatically in favor of certain NPMs. Elimination of that advantage will tend to even the playing field. In no sense could it be said to authorize or require any participant in the market to fix prices or output.

Professor Bulow's Report

33. In his expert report, Professor Bulow presents a wide-ranging condemnation of the entire MSA structure. Unfortunately, a number of his conclusions are either not relevant to what I understand to be at issue in this case or not supported by the data.

Prices and Profits in the Wake of the MSA

34. In Paragraph 7 of his report, Professor Bulow points to dramatic increases in

prices after the effective date of the MSA, apparently to support the claim in paragraph 42 that profit margins have increased.

35. This claim, however, appears to be based not on the prices that the OPMs actually charged in the marketplace, but rather on "list" prices. The OPMs typically do not actually receive these list prices for their products. In the years following the MSA, price competition has increasingly taken the form of aggressive price discounting, promotional discounts paid to wholesalers and retailers, two-for-one promotions, and similar promotional tactics that have the actual effect of lowering the actual price of cigarettes. As a result, conclusions about revenues and profits based on list prices are inherently misleading.

36. The Federal Trade Commission issues a report each year entitled the "Federal Trade Commission Cigarette Report," an excerpt of which is attached hereto as Exhibit B. These data have been collected and interpreted by Professor Frank Chaloupka for his work in the Department of Justice RICO lawsuit, and a chart showing that information is attached as Exhibit C. These data show the advertising and promotional costs for the major tobacco companies, in aggregate, broken down by categories. The figures in this report show a massive increases in price discounting, wholesale and retail promotions that result in lower prices to consumers, two-for-one sales, coupons and similar devices. In 2002, for example, out of a total of $12.5 billion in promotional spending by the major companies, about $11 billion was for promotions that reduced the effective price of the majors' cigarettes. Professor Bulow acknowledges that such discounting takes place, but does not acknowledge its magnitude or account for it in his chart.

37. The conclusion that the OPMs do not actually charge the list price is confirmed

by the published financial statements of the OPMs. In 2001, for example, Reynolds, the second largest OPM, reported shipments of approximately 91 billion cigarettes, or 455 million cartons. Its revenue, excluding federal excise taxes, was $6.269 billion. Thus, according to its financial statements, the actual revenue to the company was $13.78 cents per carton, or substantially less than the 2001 cost per carton figure shown on Professor Bulow's chart of $22.50 per carton. By 2003, list prices had increased even further, but Reynolds reported revenues of $5.267 billion (on sales of approximately 400 million cartons) so that its average revenue per carton had fallen even further to $13.17. These figures are for revenues, not profits, and in 2003 Reynolds reported a net operating loss. See the financial statements from the SEC Reports on Form 10-K for Reynolds for 2002 and 2003 attached hereto as Exhibit D.

38. According to Exhibit Q of the MSA, which shows the Operating Income of each of the OPMs in 1996, the last year before any of the State settlements were reached, Reynolds had operating income of $1.468 billion. According to Reynolds' financial statements filed with the SEC, Reynolds never had an operating income as high during any year in which the MSA has been in effect. In fact, for the first five years in which the MSA was in effect, 1999-2003, Reynolds' financial statements show a cumulative net loss of operating income.

39. An analysis of similar documents for the largest and most profitable of the OPMs, Philip Morris, also confirms that revenues are far less than those that would be produced if list prices were charged. Thus, Phillip Morris reported revenues including federal excise tax of $17.001 billion in 2003 on shipments of 187.2 billion cigarettes. As a result, its 2003 revenues net of $3.90 in federal excise taxes were approximately $14.26 per carton, a decline from 2001's revenue per carton of $15.82 (assuming $0.34 federal excise tax per pack). At the same time,

Philip Morris's operating profit in 2003, adjusted for inflation, was 20.44 percent lower than its operating profit in 1996, the last year before it entered into any of its settlements with the States. See the financial statements from the SEC Reports on Form 10-K for Altria Group for 2002 and 2003 attached hereto as Exhibit E.

40. The conclusions are clear: because of price discounting OPMs individually and as a group charged dramatically less than the "list prices." Lower profits are not consistent with increasing prices more than cost increases. Rather, they reflect price competition in the U.S. cigarette market.

41. The FTC recently considered this very issue when it evaluated and approved the merger between R.J. Reynolds and Brown & Williamson, the second and third-largest domestic cigarette manufacturers. After a searching review of the industry, the FTC, approving the merger concluded: "On net, these changes by the Big Four substantially invigorated competition during 2002-2004, not only between Big Four and [discount] companies but also among the Big Four themselves, who have responded to each other's competitive moves." Report of the Federal Trade Commission, R.J. Reynolds Tobacco Holdings, Inc./British American Tobacco p.L.c., File No. 041-0017, attached hereto as Exhibit F. In short, neither the objective evidence nor the conclusion reached by the FTC is consistent with the allegation that an output cartel that inhibits price competition is in existence

Arguments on Grandfathering

42. Professor Bulow is correct that the grandfathering provisions can be regarded as a windfall to the SPMs that signed the MSA during the first 90 days, allowing them to avoid payments until they reach their recalculated grandfather shares. But competition in any product

market relates not to *average* cost but rather to *marginal* cost. The fact that the SPMs may pay less tax on their initial sales is irrelevant to their pricing decisions. What matters for the SPMs for pricing is the marginal cost of the next unit sold. As noted above, for virtually all SPM sales, this next unit is above the recalculated Grandfather level. Using figures set forth above for 2005, an SPM will incur approximately $21,120 in MSA costs for each additional 1 million cigarettes – or 5,000 cartons – it sells in Oklahoma. In deciding whether to try to sell those additional cigarettes, it will compare the total of its additional costs including the incremental NPM costs it will owe with the additional revenues it expects to receive. If the revenues exceed the costs, it will try to make the sales. If they do not, it will not. The same is true for an NPM though it would incur an escrow obligation rather than a settlement cost and the amount would be slightly lower, or approximately $20,730 for the same number of cigarettes. As a result, for the reasons discussed above, NPMs are at a competitive advantage to SPMs for current sales of cigarettes.

43. In a world of imperfect capital markets, as Professor Bulow highlights, it is possible that a windfall to the SPMs could promote their success in the tobacco market. This does not in any way, however, promote or facilitate price or output fixing among the participating manufacturers. A windfall to the SPMs does not provide any incentive to restrict output -- to the contrary, as Professor Bulow himself notes, the grandfathering provides an incentive to *increase* output for the SPMs, until they get to the recalculated Grandfather level. Many state regulations confer what could be regarded as windfalls on certain market participants and not on others. This does not imply that the recipients of the windfalls fix prices or output.

44. Professor Bulow claims that the SPMs could use their financial windfalls to "drive the NPMs out of the market." This claim is certainly at odds with the fact that the NPM

share has grown. Moreover, the MSA does not create any financial incentive for the SPMs to drive the NPMs out of the tobacco market. Finally, Professor Bulow does not provide any evidence that imperfect financial markets or financial constraints have hindered the growth of the NPMs or are likely to do so in the future.

45. In a footnote, Professor Bulow admits that replacing the MSA with a sales tax could drive NPMs out of business, but that would be acceptable in his view. The key, he says, is that NPMs face a level playing field with SPMs. But under the MSA the NPMs do face a level playing field with SPMs where it matters: in terms of the marginal cost of selling the next cigarette. Indeed, the NPMs have an advantage over the SPMs of 1.9% per cigarette, before taking account of gains from paying into escrow rather than paying a tax. Blocking the repeal of the allocable share release is exactly what would lead to an uneven playing field -- in favor of the NPMs.

Arguments on the Allocable Share Release

46. Professor Bulow's arguments with respect to the allocable share release are inconsistent with the rest of his report. He emphasizes throughout his report the desirability of a level playing field in the tobacco industry, and the benefits of an excise tax over the MSA. Yet repealing the allocable share release is exactly the approach that furthers this goal. By leaving the allocable share release in place, the MSA would provide an enormous competitive advantage for NPMs with geographically concentrated sales over the SPMs and OPMs.

47. The competitive advantage for the NPMs through the original formulation of the allocable share release causes four problems. First, it undercuts a fundamental goal of the MSA which is the promotion of public health through reduced smoking. If NPMs that are

concentrated in particular states are allowed to make payments which are so much lower than those made by those participating in the MSA, then they will be able to produce at a much lower marginal cost. This lower marginal cost may be reflected in lower prices. Lower prices, in turn, lead to more smoking. A large body of research demonstrates that smoking is price sensitive, with the elasticity of cigarette sales with respect to cigarette prices on the order of -0.5 (each 10% rise in prices leads to 5% less smoking). Lower prices for NPMs that are concentrated in particular states will therefore lead to more smoking and a lower level of public health, contrary to the goals of the MSA.

48. The second problem is that the allocable share release, as originally drafted, does not serve the expressly stated purpose of the escrow statutes to ensure that there are sufficient monies set aside to deal with any claims against the NPMs. By remaining outside of the MSA, the NPMs are subject to state litigation at some point in the future. A goal of the escrow funds was to ensure that there would be enough funding for the NPM to pay any damages found in favor of the state. But, with the very small amounts that would be accumulated in escrow for NPMs concentrated in particular states, this protection is not provided.

49. The third problem is that the allocable share release, as originally drafted, causes enormous inequities in the impact of the escrow statutes. Imagine that the two examples above were two different NPMs. Then, under the same law, one NPM would owe escrow on sales in Oklahoma of 2.01 cents per cigarette, while the other would owe 0.0208 cents per cigarette. This almost 100-fold difference in payments is clearly inequitable and violates the intention of the MSA to level the playing field.

50. The final problem is related: if the allocable share release were retained in its

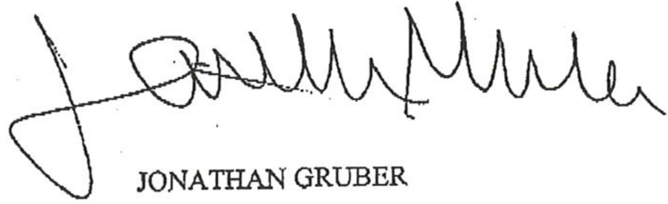
original form, it would lead NPMs to regionally concentrate their activities in order to take advantage of this loophole in the law (as emphasized as well by Professor Bulow in his report). NPMs would have an enormous production advantage if they could concentrate their sales in states such as Oklahoma, with a relatively small allocable share, and away from states such as California and New York, with a relatively large allocable share. This is not only inequitable, but could have particularly pernicious public health effects in states with small allocable shares, as NPMs attempt to concentrate their sales in those locations.

Conclusions

51. In summary, the payment provisions of the MSA and Escrow Statute operate substantially as a per unit tax, and in no sense establish an output cartel. The MSA and escrow statute do not require or authorize any manufacturer to fix prices or output. As is true with any similar tax (or input cost increase), output is likely to decline, but each market participant continues to have an incentive to increase output so long as its marginal revenues exceed its marginal costs.

52. I also conclude that the MSA does not provide a competitive advantage to the OPMs over the SPMs and NPMs. Indeed, exactly the opposite is true: the MSA payment structure clearly favors SPMs and, in particular, NPMs relative to the OPMs. This point is self-evident from an understanding of the MSA and escrow statutes.

53. Finally, I conclude that the very purpose of the MSA is undercut by the original version of the allocable share release provision. Unless these provisions are repealed, NPMs that are regionally concentrated will be at an enormous competitive advantage. This will lead to both more smoking and large inequities across NPMs in their obligations.



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March, 2005

ATTACHMENT 2

ESCROW AGREEMENT

This Escrow Agreement is made and entered into this _______ day of _______________, 20___, by ____ (the "Company") and ____ (the "Escrow Agent") and supersedes prior escrow agreements, if any, under which the Company and the Escrow Agent are currently operating regarding the Beneficiary States listed in Attachment A and those other MSA States that the Company and the Escrow Agent subsequently agree to include as Beneficiary States under this agreement.

WITNESSETH:

WHEREAS, all MSA States have enacted Non-Participating Manufacturer Statutes ("NPM Statute") that require Tobacco Product Manufacturers that have not entered into the Master Settlement Agreement (referred to as "Non-Participating Tobacco Manufacturers" or "NPMs") to establish a Qualified Escrow Fund, and

WHEREAS, the Company is an NPM and intends to comply with the NPM Statute by establishing a Qualified Escrow Fund with respect to MSA States in which the Company's Cigarettes are sold.

NOW, THEREFORE, in consideration of the mutual promises contained herein and other good and valuable consideration, the receipt and sufficiency of which are hereby acknowledged, the undersigned parties hereto agree as follows:

SECTION 1. Appointment of Escrow Agent.

The Company hereby appoints ____ to serve as Escrow Agent under this Escrow Agreement on the terms and conditions set forth herein. The Escrow Agent warrants that it is a federally or state chartered financial institution

organized and existing under the laws of the State of ______________________, having assets of at least $1 Billion ($1,000,000,000), and is not an Affiliate of any Tobacco Product Manufacturer as defined in the NPM Statute. By its execution hereof, the Escrow Agent hereby accepts such appointment and agrees to perform its duties and obligations set forth herein.

SECTION 2. Definitions.

A. Capitalized terms used in this Escrow Agreement and not otherwise defined herein or in the Beneficiary State's NPM Statute shall have the meaning given to such terms in the Master Settlement Agreement.

B. **"Beneficiary State"** means a MSA State for whose benefit funds are being escrowed pursuant to the NPM Statute. For purposes of this Escrow Agreement, the initial Beneficiary States are those listed in Attachment A hereto, which is hereby incorporated herein by reference, and those other MSA States that the Company and the Escrow Agent may hereafter agree to include as Beneficiary States. Escrow Agent is authorized to include other Beneficiary States under this Escrow Agreement by written notice from the Company and is further authorized to revise Attachment A from time to time to reflect additional Beneficiary States as instructed by the Company.

C. **"Cost Basis"** means (i) for cash, the dollar amount deposited, and (ii) for the other Permitted Investments, the amount paid, excluding accrued interest, by the holder to buy the United States Treasury Securities or the Money Market Fund shares. These amounts may also be known as the tax basis, book value, or tax cost basis.

D. **"Face Value"** means (i) for cash, the dollar amount deposited, (ii) for Money Market Funds, the number of shares held multiplied by the stated value per share, and (iii) for United States Treasury Securities, the amount of principal owed to the holder upon maturity of the security. These amounts may also be known as the par value or principal value.

E. **"Master Settlement Agreement"** or **"MSA"** means the settlement agreement entered into in 1998 by the four largest United States' tobacco manufacturing companies (the

"Original Participating Manufacturers" or "OPMs") and 46 states of the United States (excluding Texas, Florida, Minnesota, and Mississippi), the District of Columbia, Guam, Northern Mariana Islands, the U.S. Virgin Islands, Puerto Rico, and American Samoa to settle certain claims against the OPMs arising out of the sale, advertising, and consumption of certain tobacco products, including Cigarettes, a copy of which has been provided to the Escrow Agent by the Company and is available electronically at www.naag.org/assets/redesign/files/msa-tobacco/MSA.pdf.

F. **"Money Market Fund"** means a money market mutual fund invested solely in United States Treasury Securities and/or cash and regulated under Rule 2a-7 of the Investment Company Act of 1940.

G. **"MSA State"** means any one of the 46 states of the United States (excluding Texas, Florida, Minnesota, and Mississippi), the District of Columbia, Guam, Northern Mariana Islands, the U.S. Virgin Islands, Puerto Rico, and American Samoa, which jurisdictions settled under the MSA.

H. **"NPM Statute"** means the law or laws, as amended, enacted in each MSA State that require a Non-Participating Manufacturer to establish a Qualified Escrow Fund. The Company shall provide a copy of the NPM Statute for each Beneficiary State under this Escrow Agreement to the Escrow Agent.

I. **"Permitted Investments"** means the ways in which QEF Principal may be invested, which shall be limited to the following: (a) United States Treasury Securities, (b) cash, or (c) Money Market Fund.

J. **"Qualified Escrow Fund"** means an escrow arrangement with a federally or state chartered financial institution having no affiliation with any Tobacco Product Manufacturer and having assets of at least one billion ($1,000,000,000) where such arrangement requires that such financial institution hold the escrowed funds' principal for the benefit of Releasing Parties (as defined in the Master Settlement Agreement) and prohibits the Tobacco Product Manufacturer

placing the funds into escrow from using, accessing or directing the use of the funds' principal except as consistent with the applicable NPM Statute and this Escrow Agreement.

K. **"Qualified Escrow Fund Account"** or **"QEF Account"** means an escrow account consisting of segregated sub-accounts for each Beneficiary State established by the Company and maintained by the Escrow Agent into which the deposits required under the applicable NPM Statute are made.

L. **"Qualified Escrow Fund Principal"** or **"QEF Principal"** means the funds required by the applicable NPM Statute to be deposited and held for the benefit of one or more Beneficiary States in the QEF Account.

M. **"Qualified Escrow Fund Accumulated Principal"** or **"QEF Accumulated Principal"** means the aggregate amount of QEF Principal required to be held in each Beneficiary State's QEF Sub-Account.

N. **"Qualified Escrow Fund Sub-Account"** or **"QEF Sub-Account"** means the sub-division of the QEF Account that holds only the QEF Principal deposited for the benefit of a single Beneficiary State.

O. **"Sales Year"** means the calendar year during which the Company sold Cigarettes in a Beneficiary State requiring the deposit of QEF Principal.

P. **"United States Treasury Securities"** means bills, notes, and bonds issued by the United States Treasury (i) maturing no more than (20) twenty years from the date of purchase by the Company, (ii) that are direct obligations (other than an obligation subject to variation in principal repayment) of the United States government, and (iii) backed by the full faith and credit of the United States of America; provided however, that United States Treasury Securities (iv) shall **not** include state and local government series securities of the United States Treasury.

SECTION 3. The Qualified Escrow Fund Account and Release of Funds Therefrom.

A. From time to time the Company shall tender to the Escrow Agent for deposit in the QEF Account the funds that the Company is required to place into a Qualified Escrow Fund

pursuant to the NPM Statute of each Beneficiary State. The Company may appoint an authorized representative or agent, acting on its behalf, to give directions permitted of the Company under this Escrow Agreement, provided that in so doing, the Company shall also provide the Escrow Agent and the Attorney General for the Beneficiary States with evidence of that authorized appointment.

B. All funds received by the Escrow Agent pursuant to the terms of this Escrow Agreement shall be held, invested, and disbursed in accordance with the terms and conditions of this Escrow Agreement and the applicable NPM Statute, regardless of the source of the funds—whether the funds are paid by the Company or by a third-party such as a Cigarette importer or an entity sharing liability with the Company for making the required QEF Principal deposits.

C. For each Beneficiary State in which the Company's Cigarettes were sold after enactment of that Beneficiary State's NPM Statute, the Company shall deliver to the Escrow Agent for deposit pursuant to this section the following amounts as such amounts are adjusted for inflation pursuant to Exhibit C of the Master Settlement Agreement:

1999:	0.0094241 per Unit Sold
2000:	0.0104712 per Unit Sold
2001 through 2002:	0.0136125 per Unit Sold
2003 through 2006:	0.0167539 per Unit Sold
2007 and thereafter:	0.0188482 per Unit Sold

D. The Company shall make deposits as frequently as required by the NPM Statute of the applicable Beneficiary State. Typically, the NPM Statute requires deposits annually or quarterly.

E. <u>Segregated QEF Sub-Accounts</u>:

1. The Company shall designate to the Escrow Agent the amount to be placed in the QEF Sub-Account by Sales Year for each Beneficiary State based on the Units Sold therein in accordance with the applicable Beneficiary State's NPM Statute. All funds shall be held by the Escrow Agent in QEF Sub-Accounts separate and apart from all other funds of the Escrow Agent and the Company. The Escrow Agent shall

allocate all funds as designated by the Company and received by the Escrow Agent among the applicable Beneficiary States, each with its own separate, segregated QEF Sub-Account and its own QEF Sub-Account number.

2. The Escrow Agent shall place and hold such funds in each QEF Sub-Account for the benefit of the applicable Beneficiary State or any Releasing Party located or residing in the applicable Beneficiary State. The Escrow Agent shall further show a Beneficiary State's QEF Sub-Account by Sales Year to identify the amount of QEF Principal attributable to Units Sold in each Sales Year.

3. Within the QEF Account established under this Escrow Agreement, the Escrow Agent shall maintain a separate QEF Sub-Account for each Beneficiary State sufficient to enable tracking of (a) the QEF Principal allocated to each Beneficiary State, (b) all dates, transaction descriptions, and amounts of deposits, withdrawals, interest or other appreciation on each QEF Sub-Account, and (c) all investments of QEF Principal held in each QEF Sub-Account. The Escrow Agent may also maintain within the QEF Account a separate sub-account for the benefit of the Company to which interest or other appreciation on the QEF Principal (the "Interest Account") may be deposited.

4. Upon receipt of authorized written notice from the Company, the Escrow Agent shall establish additional QEF Sub-Accounts for additional Beneficiary States, which shall be subject to the terms and conditions of this Escrow Agreement.

F. The Company shall receive the interest or other appreciation on the QEF Principal as earned, provided however, that the Escrow Agent shall not pay interest or other appreciation on QEF Principal to the Company (i) if doing so will cause the aggregate Face Value or the aggregate Cost Basis of the Permitted Investments in any QEF Sub-Account to drop below its QEF Accumulated Principal amount or (ii) if the aggregate Face Value or the aggregate Cost Basis of the Permitted Investments in any QEF Sub-Account is below its QEF Accumulated Principal amount. Whenever any interest or other funds are payable under this Escrow

Agreement to the Company, such payment shall be subject to the payment of the Escrow Agent's fees, costs and expenses as provided in Section 9.

G. The NPM Statute of each Beneficiary State governs the release of QEF Principal from the applicable Beneficiary State's QEF Sub-Account and permits its release only under very limited circumstances, which include:

1. To pay a judgment or settlement on any Released Claim brought against the Company by the applicable Beneficiary State or by any Releasing Party located or residing in the applicable Beneficiary State.

i. Promptly after receiving a written request for release of funds under this subsection and prior to any such release, the Escrow Agent shall provide written notice to the Company, to the Releasing Party, and to the Attorney General or Attorney General's Designee of the applicable Beneficiary State as set forth and defined in Section 13 herein. The notice shall specify in reasonable detail the amount of the funds to be released, the payee and the basis for the requested release (which shall be provided to the Escrow Agent by the person requesting payment). The Company and the Attorney General or Attorney General's Designee of the applicable Beneficiary State whose QEF Sub-Account would be reduced by the requested release of funds shall provide a written response to the Escrow Agent with copies to each other, within forty-five (45) calendar days from the date of receipt of this notice.

ii. Should the Company or the applicable Beneficiary State timely object in writing to a requested release of funds under this subsection, the Escrow Agent shall not authorize the requested release of funds until such objection has been finally resolved.

iii. If no objection is received, the Escrow Agent shall pay the Released Claim after the expiration of the forty-five (45) calendar day period pursuant to payment instructions provided by the applicable Beneficiary State.

iv. The amount of funds shall be released from the QEF Sub-Account of the applicable Beneficiary State under this subsection (a) in the order in which they were placed into escrow and (b) only to the extent and at the time necessary to make payments required under such judgment or settlement.

2. To the extent that the Company establishes, pursuant to sub-paragraph (ii) below, that the amount required to be placed into escrow in a particular Sales Year for the applicable Beneficiary State was, depending on the law of such Beneficiary State, greater than either (A) that State's allocable share of the total payments that the Company would have been required to make in that year had it been a Participating Manufacturer under the Master Settlement Agreement (as determined pursuant to section IX(i)(2) of the Master Settlement Agreement, and before any adjustments or offsets described in Section IX(i)(3) of that Agreement other than the Inflation Adjustment); or (B) the Master Settlement Agreement payments, as determined pursuant to Section IX(i)(1) of that Agreement including after final determination of all adjustments, that the Company would have been required to make on account of such Units Sold in the Beneficiary State had it been a Participating Manufacturer under the Master Settlement Agreement (in either case the difference being referred to herein as the "Excess Amount"), such Excess Amount shall be released and revert back to the Company.

i. To the extent established, the Escrow Agent shall pay the Excess Amount to the Company upon the joint written instruction of the Company and the Attorney General or the Attorney General's Designee of the applicable Beneficiary State as set forth in Section 13 or upon entry of a final binding, non-appealable order of a court of competent jurisdiction

handling such matter after any appeal or any right of appeal has been exhausted.

ii. The Company shall submit in writing to the Attorney General for the applicable Beneficiary State the Company's calculation establishing the Excess Amount. If the applicable Beneficiary State and the Company cannot agree on the existence of an Excess Amount or the calculation of the Excess Amount, the dispute shall be resolved in a court of competent jurisdiction located in the applicable Beneficiary State, or if the laws of any Beneficiary State so require, then under the applicable Administrative Procedures Act of that Beneficiary State.

3. To the extent not released from escrow under sub-paragraphs 1 or 2 above, funds shall be released from escrow and revert back to the Company twenty-five (25) years after the date on which they were placed into escrow. At least forty-five (45) days before the proposed date of release of such funds, the Escrow Agent shall notify the applicable Beneficiary State in writing of the amount of QEF Principal proposed to be released from its QEF Sub-Account and, if available, provide bank records showing the date(s) on which such funds were deposited in the applicable QEF Sub-Account and the age of such deposits sought to be released under this provision.

H. When the Company has made the first deposit into a QEF Sub-Account, the Escrow Agent shall notify the Attorney General of the applicable Beneficiary State that the QEF Sub-Account has been established and provide to the Beneficiary State a copy of this Escrow Agreement, a copy of any instructions from the Company regarding Permitted Investments of QEF Principal, and the amount of the deposit made for the Beneficiary State. Thereafter, monthly, quarterly or as otherwise requested by the applicable Beneficiary State and, if no request is made, annually by April 30 of each year, the Escrow Agent shall provide to each applicable Beneficiary State:

1. Any new instructions from the Company regarding Permitted Investments of the QEF Principal, and

2. Bank statements for each Beneficiary State's QEF Sub-Account showing:

i. the amount of deposits and withdrawals made by the Company, including the identity of the payor(s) or payee(s), the date(s), transaction description, and dollar amount(s) of any deposits or withdrawals,

ii. the amount of QEF Principal attributable to each Sales Year,

iii. the manner in which all QEF Principal in the QEF Sub-Account is invested including the Face Value, Cost Basis, and market value of each investment, a description of each investment, its date of purchase by the Company, and its maturity date, if applicable,

iv. totals for the Face Value, Cost Basis, and market value of all cash and investments of QEF Principal in each QEF Sub-Account, and

v. the QEF Accumulated Principal for each QEF Sub-Account, or a list of annual Accumulated Principal for each QEF Sub-Account.

I. All amounts credited to a QEF Sub-Account, except for interest or other appreciation on the funds, which shall be payable to the Company as provided herein, shall be retained in such QEF Sub-Account until disbursed therefrom in accordance with the provisions of this Escrow Agreement.

J. Notwithstanding anything to the contrary contained herein, the Escrow Agent shall not be authorized to make distributions of QEF Principal in payment of Released Claims owed to any Beneficiary State (or the Releasing Party located or residing in such Beneficiary State) other than from the QEF Principal deposited in the QEF Sub-Account held for such Beneficiary State. The Escrow Agent and the Company are prohibited from: (1) exercising set-off, recoupment, or any other claim or right against any of the QEF Principal escrowed pursuant to this Escrow Agreement, or (2) accessing or allowing the Company to access the QEF Sub-Account of one Beneficiary State to remove or transfer QEF Principal to the QEF Sub-Account of another

Beneficiary State without the written consent of the Company and the Attorneys General of all Beneficiary States involved in the request for transfer of funds; provided however, that nothing contained herein shall prohibit the release or transfer of any funds from the Company's interest account to another account upon written direction of the Company.

K. If the Company intends to sell, assign, convey, gift, or transfer in any manner any of the Company's rights to the funds in the QEF Account or the earning thereon (including without limitation, the right to interest or other appreciation on QEF Principal, or the right to receive QEF Principal as permitted under the NPM Statute) to any person or entity, the Company shall send notification, including the name and complete address to whom such sale, assignment, conveyance, gift, or transfer is being made, in writing to all Beneficiary States with QEF Sub-Accounts no less than forty-five (45) days in advance of such transaction. The Company acknowledges that a change in ownership and control over any of its rights or interests under this Escrow Agreement cannot be completed or acknowledged by the Escrow Agent until after the Escrow Agent shall have received all necessary U.S. Patriot Act compliance information and completed a satisfactory regulatory compliance review. The Company further acknowledges that a gift or transfer of its rights does not constitute an assignment of its responsibilities hereunder, and that any sale or assignment of its rights and obligations hereunder shall first satisfy all legal obligations of the Company under this Escrow Agreement and any applicable federal or state laws or regulations.

L. To the extent it receives notice, the Escrow Agent shall notify all applicable Beneficiary States: (i) if the Company asserts a change in the ownership or control of the QEF Account or any of its QEF Sub-Accounts, (ii) if any action is taken against the funds in the QEF Account or any of its QEF Sub-Accounts, including without limitation, forfeiture, garnishment, liens or assignment. Notice shall be provided in writing and shall be provided as soon as possible, but in no event later than seven (7) calendar days after the event has occurred.

SECTION 4. Failure of Escrow Agent to Receive Instructions.

Except as to responses or objections to notice of a request for payment on any Released Claim, which shall be governed by subsection 3.G.1 above, in the event that the Escrow Agent fails to receive any written instructions contemplated by this Escrow Agreement, the Escrow Agent shall refrain from taking any action required to be taken under any section of this Escrow Agreement pursuant to written instructions until such written instructions are received by the Escrow Agent. In so refraining, the Escrow Agent shall be fully protected from any liability arising out of its inaction.

SECTION 5. Investment of QEF Principal by the Escrow Agent.

QEF Principal shall only be invested in Permitted Investments; provided however, that at all times (i) the aggregate Face Value of such Permitted Investments in each QEF Sub-Account, and (ii) the aggregate Cost Basis of such Permitted Investments in each QEF Sub-Account shall both be equal to or greater than the QEF Accumulated Principal in each QEF Sub-Account. Consistent with Section 3.F herein, the Escrow Agent shall not pay interest or other appreciation on QEF Principal to the Company: (i) if doing so will cause the aggregate Face Value or the aggregate Cost Basis of the Permitted Investments in any QEF Sub-Account to drop below its QEF Accumulated Principal amount or (ii) if the aggregate Face Value or the aggregate Cost Basis of the Permitted Investments in any QEF Sub-Account is below its QEF Accumulated Principal amount. The Escrow Agent shall retain interest or other appreciation on QEF Principal until the deficit in the aggregate Face Value and/or the aggregate Cost Basis has been cured and shall not be permitted to set-off the Escrow Agent's fees, costs and expenses from such interest or other appreciation until the deficit is cured. To the greatest extent practicable, Permitted Investments shall be administered in such a manner that QEF Principal will be available in cash for use at the times when QEF Principal is expected to be disbursed by the Escrow Agent from the QEF Account pursuant to the applicable NPM Statute. If the Company provides written instructions to the Escrow Agent regarding the investment of QEF Principal, the Escrow Agent

has no duty to follow them unless they comply with the Permitted Investments and the maintenance of QEF Principal as required in Section 5 herein. Instructions that fail to do this are null and void and have no effect and shall not be followed. If the Company does not provide investment instructions that comply with the Permitted Investments and the maintenance of QEF Principal as required in Section 5 herein, the Escrow Agent shall maintain the QEF Principal in cash.

If the Company has pre-existing investments that are not Permitted Investments under this Escrow Agreement, but were permitted under the prior escrow agreement, the Company may continue to own these specific investments until they mature or are sold by the Company; provided, however, that the aggregate Face Value in each QEF Sub-Account and the aggregate Cost Basis in each QEF Sub-Account shall both be equal to or greater than the QEF Accumulated Principal in each QEF Sub-Account, as required in Section 5 herein.

SECTION 6. Duties and Liabilities of Escrow Agent.

The Escrow Agent shall have no duty or obligation hereunder other than to take such specific actions as are required of it from time to time by the provisions of this Escrow Agreement, and it shall incur no liability hereunder or in connection herewith for anything whatsoever other than any liability resulting from its own gross negligence or willful misconduct or unlawful acts or omissions. The only duties and responsibilities of the Escrow Agent shall be the duties and obligations specifically set forth in this Escrow Agreement. The Escrow Agent has no duty to perform any calculations with respect to the proper amount to be deposited by the Company in any given year or to ensure that the Company deposits the proper amount in or for any given year. The Escrow Agent makes no representation as to the sufficiency of this Escrow Agreement for the purposes in which it is intended. The Escrow Agent may further rely upon the accuracy and completeness of documentation reasonably believed by it to be genuine and to have been signed or presented by the proper parties.

SECTION 7. Indemnification of Escrow Agent.

The Company shall indemnify, hold harmless and defend the Escrow Agent from and against any and all losses, claims, liabilities, and reasonable expenses, including the reasonable fees of its counsel, specifically including in-house counsel fees, which it may suffer or incur in connection with the performance of its duties and obligations under this Escrow Agreement and including any action taken under Section 19 hereof, except for those losses, claims, liabilities and expenses resulting solely and directly from its own gross negligence, willful misconduct, or unlawful act or omission. The Escrow Agent may seek the advice of counsel at any time, and such reasonable attorney fees shall be in addition to the administrative fees charged by the Escrow Agent for serving as Escrow Agent. The Escrow Agent may charge such costs against the interest which accrues on the QEF Principal if not otherwise paid by the Company, but the QEF Principal in any or all of the QEF Sub-Accounts shall not be charged, used as an offset, or otherwise encumbered by the Escrow Agent or the Company. In no event shall the Escrow Agent be liable to the Company for any indirect or consequential damages.

SECTION 8. Resignation or Removal of Escrow Agent.

The Escrow Agent may resign at any time by giving the Company and all of the Attorneys General of the Beneficiary States covered by this Escrow Agreement ninety (90) days prior written notice of such intention. The Company may remove the Escrow Agent, as such, by giving the Escrow Agent and all of the Attorneys General of the Beneficiary States covered by this Escrow Agreement ninety (90) days prior written notice of such removal. When an Escrow Agent resigns or is removed, the Company shall execute a new Escrow Agreement with the new Escrow Agent. Upon the effective date of its resignation or removal, the Escrow Agent shall deliver the escrow funds held hereunder only to such successor escrow agent directed by the written instructions of the Company, and shall provide written notice of the delivery of the escrow funds in the QEF Account to all of the Attorneys General of the Beneficiary States covered by this Escrow Agreement. Following receipt of the escrow funds, the new Escrow

Agent shall immediately provide to all of the Attorneys General of the Beneficiary States covered by this Escrow Agreement that information required by Section 3.H of the Escrow Agreement. After the effective date of its resignation or removal, the Escrow Agent shall have no duty with respect to the escrow funds except to hold such property in safekeeping and to deliver same to its successor or as is directed in writing by the Company. If no successor Escrow Agent has been appointed by the Company within ninety (90) days from the date such notice of resignation or removal has been given, the Escrow Agent shall be entitled to tender into the registry or custody of any court of competent jurisdiction located in the applicable Beneficiary State all or part of the escrowed funds held for the benefit of the applicable Beneficiary State by giving written notice of such action to the Company and all of the Attorneys General of the Beneficiary States.

In addition, the court to which funds in the QEF Account have been tendered may order such funds held by the State Treasurer of the underlying Beneficiary State if consented to by that Beneficiary State.

SECTION 9. Escrow Agent Fees and Expenses.

The Company shall pay the Escrow Agent its reasonable fees and expenses, including all reasonable expenses, charges, counsel fees, and other disbursements incurred by it or by its attorneys, agents and employees in the performance of its duties and obligations under this Escrow Agreement. Subject to the limitation found in Section 5 herein, fees, costs and expenses may be paid from interest or other appreciation earned on funds held in the QEF Account, but the QEF Principal in all QEF Sub-Accounts shall not be charged, used as an offset or otherwise encumbered by the Escrow Agent or the Company.

SECTION 10. Intended Beneficiaries; Successors.

No persons or entities other than the Beneficiary States and the Releasing Parties located or residing within them are intended beneficiaries of this Escrow Agreement, and only the

Beneficiary States, the Releasing Parties, the Company and the Escrow Agent shall be entitled to enforce the terms of this Escrow Agreement. The provisions of this Escrow Agreement shall be binding upon and inure to the benefit of the undersigned parties hereto and their respective successors.

SECTION 11. Governing Law.

This Escrow Agreement shall be construed in accordance with and governed by the laws of the state where the Escrow Agent is incorporated, except that the applicable Beneficiary State's NPM Statute shall only be construed and applied according to, and governed by, the law of the applicable Beneficiary State.

SECTION 12. Jurisdiction and Venue.

With the exception of any suit, action or proceeding involving a Beneficiary State or any Releasing Party located or residing in a Beneficiary State, any suit, action or proceeding seeking to interpret or enforce any provision of, or based on any right arising out of, this Escrow Agreement shall be brought in a court of original jurisdiction for matters involving contract, equity and damage claims in the state where the Escrow Agent is incorporated.

SECTION 13. Notices.

All notices required by this Escrow Agreement shall be in writing and shall be deemed to have been received (a) immediately if sent by electronic mail transmission (with a confirming copy sent the same business day by registered or certified mail), or by hand delivery (with signed return receipt), or (b) the next business day if sent by nationally recognized overnight courier, in any case to the respective addresses as follows:

If to Company:

If to the Escrow Agent:

If to the Beneficiary State(s), to the Attorney General Offices of all Beneficiary States as shown on Attachment A to the Escrow Agreement and incorporated herein by reference:

If the Company or the Escrow Agent changes its address for notices required by the Escrow Agreement, that entity shall immediately notify the other undersigned party and the Beneficiary States of that change. Written notice required by this Escrow Agreement shall be deemed sufficient and adequate if sent to the last known address of the Company, Escrow Agent, or the applicable Beneficiary State(s) in the manner provided under this section.

SECTION 14. Severability.

If any provision of this Escrow Agreement shall under any circumstances be deemed invalid or inoperative, this Escrow Agreement shall be construed with the invalid or inoperative provisions deleted and the rights and obligations of the parties shall be construed and enforced accordingly.

SECTION 15. Amendments.

This Escrow Agreement may be amended only by written instrument executed by the Company and the Escrow Agent; provided however, Attachment A may be amended to add Beneficiary States and new QEF Sub-Accounts for such added Beneficiary States by written notice to the Escrow Agent from the Company, and the Escrow Agent may amend the list of Beneficiary States by attachment hereto. The waiver by any party of any breach of this Escrow Agreement shall not be deemed to be or construed as a waiver of any other breach, whether prior, subsequent or contemporaneous, of this Escrow Agreement, nor shall such waiver be deemed to be or construed as a waiver by any other party. The Escrow Agent or the Company shall provide a copy of each amendment to the Escrow Agreement within forty-five (45) days of its execution to all Beneficiary States.

SECTION 16. Counterparts.

This Escrow Agreement may be signed in any number of counterparts, each of which shall be an original, with the same effect as if the signatures thereto were upon the same instrument. Delivery by electronic mail of a signed counterpart shall be deemed delivery for purposes of acknowledging acceptance hereof.

SECTION 17. Captions.

The captions herein are included for convenience of reference only and shall be ignored in the construction and interpretation hereof.

SECTION 18. Conditions to Effectiveness.

This Escrow Agreement shall become effective when signed by the Company and Escrow Agent.

SECTION 19. Resolution of Disputes.

In the event of any disagreement resulting in adverse claims or demands being made in connection with the subject matter of this Escrow Agreement, the Escrow Agent may, at its option, refuse to comply with any claims or demands on it, or refuse to take any other action hereunder, so long as such disagreement continues. In any such event, the Escrow Agent shall not be or become liable in any way or to any person or entity for its failure or refusal to act, and the Escrow Agent shall be entitled to continue to so refrain from acting until (i) the rights of all parties have been fully and finally adjudicated by a court of competent jurisdiction, or (ii) all differences shall have been adjudged and all doubt resolved by agreement among all of the interested persons, and the Escrow Agent shall have been notified thereof in writing signed by all such persons. In addition to the foregoing remedies, the Escrow Agent is hereby authorized in the event of any such disagreement, to petition any state court of competent jurisdiction located in the capital city of the applicable Beneficiary State, or such other city as may be agreed to in

writing by the applicable Beneficiary State, for instructions or to interplead the funds or assets so held into such court. The undersigned parties agree to the jurisdiction of either of said courts over their persons, waive personal service of process, and agree that service of process by certified or registered mail, return receipt requested, to the address set forth in Section 13 shall constitute adequate service. The Company agrees that upon final adjudication on such petition or interpleader action, the Escrow Agent, its servants, agents, directors, employees or officers will be relieved of further liability.

SECTION 20. Substitute Form W-9; Qualified Settlement Fund.

The Company shall provide the Escrow Agent with a correct taxpayer identification number on the most recently published Form W-9 (or W-8 for a foreign entity) as authorized by the U.S. Internal Revenue Service ("IRS"). The Escrow Agent shall comply with all applicable tax filing, payment and reporting requirements, including, without limitation, those imposed under 26 CFR 1.468B, and if requested to do so shall join in the making of the relation-back election under such regulation.

COMPANY:

____

By:___________________________

Title: _________________________

Date: _________________________

ESCROW AGENT:

____

By:___________________________

Title: _________________________

Date: _________________________