

Prepared Statement of the Federal Trade Commission

Presented by

Robert Pitofsky, Chairman

Before the

Subcommittee on Antitrust, Business Rights and Competition Committee on the
Judiciary United States Senate on the Proposed Tobacco Settlement

October 29, 1997

Mr. Chairman and members of the Subcommittee, I am pleased to appear before you today to present the testimony of the Federal Trade Commission.⁽¹⁾ This testimony will discuss the competitive and economic implications of the antitrust immunity sought by the tobacco industry as part of the proposed settlement of tobacco litigation brought by various states, as well as certain other potential economic ramifications of the proposed settlement.

The proposal for antitrust immunity is a serious matter, and it deserves careful examination. Antitrust immunity that is unnecessary, imprecise or excessively broad can enable firms to engage in collusive arrangements that could harm consumers.

We recognize at the outset that one goal of the proposed settlement is to discourage underage smoking through higher prices. The settlement contemplates that higher prices will result from the pass-through of the stipulated Annual Payments (also called "Industry Payments"), which are earmarked for public health programs, federal and state enforcement of access restrictions, and other purposes. So we begin with the basic premise that some level of price increase is contemplated by the settlement itself and is in the public interest. The questions are whether antitrust immunity will lead to prices and industry profits that are even higher than contemplated, and, more broadly, whether immunity is really necessary to achieve the purposes of the settlement.

As the Subcommittee knows, on September 22, 1997, the Commission authorized release of a Staff Report, prepared at the request of a bipartisan group of congressional representatives, that addressed the anticipated effect of the settlement on various aspects of the cigarette market.⁽²⁾ The analysis contained in the FTC Staff Report demonstrates that approximately two-thirds of any additional revenues generated as a result of increased industry coordination will go to the manufacturers as excess profits. If a price increase larger than contemplated by the settlement -- that is, a price increase that exceeds the per-unit cost of the Annual Payments -- is desired to deter further underage smoking, it is appropriate to ask whether that price increase can be better achieved through mechanisms such as greater Annual Payments, rather than permitting collusive arrangements among the manufacturers that will allow them to reap the excess profits

resulting from those higher prices.

Let me now turn to the antitrust immunity provision contemplated by the proposed settlement.

An Analysis of the Proposed Immunity Provision

The immunity provision contained in the proposed settlement is very broad and presents a significant risk of price increases higher than those contemplated by the settlement.⁽³⁾ The provision reads as follows:

In order to achieve the goals of this agreement and the Act relating to tobacco use by children and adolescents, the tobacco product manufacturers may, notwithstanding the provisions of the Sherman Act, the Clayton Act, or any other federal or state antitrust law, . . . jointly confer, coordinate or act in concert, for this limited purpose.⁽⁴⁾

As a general matter, immunity from the antitrust laws is exceptional and disfavored -- there are few industries or competitive situations in which the antitrust laws do not apply.⁽⁵⁾ Nonetheless, it appears that the tobacco product manufacturers believe they need the proposed immunity provision to protect them in three hypothetical situations. First, manufacturers have suggested that they may need to discuss and agree on issues relating to the pass-through of Annual Payment amounts. Second, manufacturers contend that they may need to agree to implement privately the proposed marketing and advertising restrictions in the event that the statutory provisions are invalidated on First Amendment grounds. Third, manufacturers say they may find it necessary to join forces to deal with retailers that undermine efforts to reduce underage smoking. The following is a discussion of whether any of these situations warrants a grant of immunity.

(1) Collaboration on the Pass-Through of Annual Payment Amounts

It is the Commission's view that it would not be necessary for the manufacturers to discuss and agree on the Annual Payment pass-through. The proposed settlement contemplates a statutory requirement that the Annual Payments be passed on to consumers in the form of higher prices. But because manufacturers can comply individually with this statutory requirement, an antitrust exemption is not needed to implement the pass-through. Even without a legal requirement to pass on the Annual Payment amounts, the industry's historical record, as well as economic logic and common sense, demonstrate that firms would pass on the Annual Payment amounts without engaging in an agreement that would require an antitrust exemption. The Annual Payments would be treated as an added (marginal) cost of business and would be taken into account in setting price.⁽⁶⁾

Moreover, as currently worded, the proposed immunity provision could be construed to permit agreements that go even beyond an agreement to pass on the Annual Payment amounts. In the rare instances where Congress has made a statutory grant of immunity for joint action of competitors, the provisions more typically exclude specific classes of

commerce from the antitrust laws or exempt a specific transaction or agreement that has been approved by a federal agency, usually in the context of a regulated industry.⁽⁷⁾ Prior approval of an agreement by a federal agency has not been required where the scope of the immunity was very limited, but broader grants of immunity have been accompanied by strict controls on the development and implementation of agreements.⁽⁸⁾

In contrast, the immunity proposed in the tobacco settlement does not seek to exempt defined categories of transactions or agreements. The scope of the immunity provision is limited only by the general reference to the goals of the settlement agreement and the proposed implementing statute.⁽⁹⁾ Because one of the goals of the settlement is to discourage underage smoking through higher prices that reflect a pass-through of the Annual Payment amounts,⁽¹⁰⁾ the immunity provision might be construed to permit the manufacturers to agree on the actual prices of their cigarettes, not simply on the amount of their Annual Payments. Although the proposed immunity provision does include a requirement of prior approval by the Department of Justice for "any plan or process for taking action pursuant to this section,"⁽¹¹⁾ there is a big exception to that requirement. Under the proposal, prior approval would not be required for "specific actions taken in accordance with an approved plan."⁽¹²⁾ Since the specific actions need not be disclosed, a number of anticompetitive agreements could take place without the government's knowledge.

The risk of unintended effects is heightened because even a limited discussion of pass-through amounts, or any other subject, could include impermissible "signaling" and result in price increases that substantially exceed the per-unit cost of the Annual Payments. It would be difficult to monitor and control the scope of such discussions.

A related issue is whether an antitrust exemption would be necessary for the purpose of allocating shares of the Annual Payment amounts. Although the proposed settlement does not address how the Annual Payment amounts are to be allocated among the manufacturers,⁽¹³⁾ the tobacco firms would not have to enter into agreements for that purpose if an appropriate statutory mechanism is provided. For example, if the Annual Payment amounts are to be allocated according to each manufacturer's share of sales or some similar method, the statute could specify the mechanism for doing so. A neutral third party could be assigned the task of making the allocations, and the manufacturers could be directed to transmit sales information to the third party. Such an approach would obviate any agreement among the manufacturers.

(2) Collaboration on Marketing and Advertising Restriction

Another argument that has been raised as a reason for providing antitrust immunity is that certain marketing or advertising restrictions may have to be implemented by agreement among the manufacturers. At first blush, it is not clear why such an agreement would be necessary, since no antitrust issue would arise if the legislation embodied the restrictions and each manufacturer simply complied unilaterally with the statutory requirements. Although each manufacturer would be expected to conform to the same standards of conduct, that would be achieved through operation of the statute, and collaboration

among competitors would be unnecessary. The argument has been made, however, that legislation imposing such restrictions might be challenged by a nonparticipant in the settlement as a violation of the First Amendment guarantee of freedom of expression. If such a challenge were successful, and were to result in complete invalidation of all or part of the legislative restrictions, the participant companies would no longer be under a legal obligation to refrain from the specified types of advertising and marketing. In that event, the cigarette manufacturers claim that it may be necessary for the manufacturers to implement those restrictions by private agreement.

The Commission believes the call for antitrust immunity is premature. The concern regarding a First Amendment challenge is, at this point, hypothetical; we cannot now predict the likelihood and outcome of any First Amendment suit.⁽¹⁴⁾ In addition, one question that must be examined more closely is whether the embodiment of the marketing and advertising restrictions in state and possibly federal consent decrees might obviate the need for an antitrust exemption.

If an antitrust exemption is deemed appropriate, it should be drafted very narrowly so that (1) it is limited to an agreement to comply with the marketing and advertising provisions of the statute as if they were still in effect, and (2) it would take effect only in the event of a successful First Amendment challenge.

(3) Joint Action to Address Problems with Uncooperative Retailers

The third reason advanced for antitrust immunity is that the manufacturers may need to join forces to deal with retailers that undermine the manufacturers' efforts to reduce underage smoking. Although this, too, is a somewhat hypothetical problem, the manufacturers' concern regarding such retailers is understandable because a failure to meet the targets for reducing underage smoking might trigger penalties under the proposed settlement. It does not appear, however, that manufacturers would have to engage in potentially anticompetitive conduct, such as a group boycott, to address the problem of an uncooperative retailer.

First, the proposed legislation, as contemplated by the settlement, would contain incentives for the manufacturers to respond individually to non-complying retailers. There are strong penalties for not meeting target reductions in underage smoking, but they could be abated to some extent under the proposed legislation if a manufacturer has acted in good faith and taken all reasonable steps to achieve the required reduction.⁽¹⁵⁾ A unilateral decision to reduce or stop dealing with a non-complying retailer should be evidence of good faith, and hence a manufacturer would have an incentive to take such action. No antitrust immunity would be required to achieve this result.

Second, the proposed legislation would provide additional mechanisms for enforcement by a state if a retailer fails adequately to control sales to minors. For example, the state could suspend or revoke the retailer's license to sell cigarettes, or assess other penalties.⁽¹⁶⁾ Assuming state enforcement is rigorous, private agreement among the

manufacturers to engage in self-help enforcement appears unnecessary.

In sum, it appears that a *potential* need for antitrust immunity exists only for an agreement on private implementation of the proposed marketing and advertising restrictions in the event that statutory requirements for such restrictions are invalidated on First Amendment grounds, and only if court orders incorporating such restrictions are not sufficient to protect the manufacturers from antitrust liability. We want to emphasize that while there are significant problems with the antitrust immunity provision as currently worded, we do not believe that, as a result of the settlement, the tobacco companies ought to be subject to increased exposure to potentially damaging private antitrust suits. This is a legitimate concern that should be considered.

Additional Economic Analysis

As discussed above, an antitrust exemption could permit firms to raise cigarette prices beyond the level necessary to satisfy payments under the settlement, resulting in a windfall to industry. Other features of the settlement, such as the advertising and marketing restrictions and disparate treatment afforded non-participating companies, also have the potential to reduce competition. Any analysis of the anticompetitive effects that may flow from the settlement requires consideration of the potential economic impact of the settlement on the industry and public sector. A critical question is who will benefit from the increased revenues that flow from the expected price increases.

The FTC Staff Report addressed the anticipated effect of the settlement on various aspects of the cigarette market, including product prices, quantity sold, retail sales revenues, and cigarette manufacturing industry profits, as well as the impact on public sector revenues. The Staff Report is part of an ongoing examination of the potential economic impact of the proposed settlement, in which many analysts, including industry analysts, are engaged. The Staff Report analyzed several variables, including (1) the extent to which cost increases historically have been "passed through" to consumers, (2) the degree of competition presently in the market and the consequences for competition as a result of the settlement, (3) the reduction in advertising expenses and in litigation expenses from the settlement, and (4) consumer responsiveness to price increases.

The hypothetical examples presented in the Staff Report suggest that, if coordination is enhanced through the various features of the agreement, and cigarette prices are thereby increased by more than is necessary simply to "pass through" the cost of the Annual Payments to consumers, significant incremental profits and revenues would be generated for industry and the public sector, respectively. Among the findings presented in the Staff Report is that the allocation of those additional profits between industry and the public sector would be unequal -- about two-thirds of the resulting additional profits would be retained by the firms and one-third would go as revenues to the public sector.[\(17\)](#)

The Commission is aware that the industry's analysis, recently submitted to the Senate Democratic Task Force on the Tobacco Settlement,[\(18\)](#) takes issue with many of the conclusions of the FTC Staff Report. Based upon a preliminary review by FTC staff, it

appears that while the industry analysis and the Staff Report reach strikingly different conclusions, the actual differences may be fairly modest. The industry analysis posits that by 2007, there will be an increase of approximately \$1.50 in the price of a pack of cigarettes. Under the "baseline scenario" in the FTC Staff Report, the estimated price increase caused by the settlement is \$0.72.⁽¹⁹⁾ Staff indicates that the difference between those figures is due to an "apples to oranges" comparison, which results from differences in the treatment of inflation.⁽²⁰⁾ In effect, the industry's \$1.50 estimate is presented in "nominal" terms, which means it is not adjusted for inflation. The FTC staff's \$0.72 estimate, however, is presented in "real" terms, which means it is in constant 1997 dollars. If we compare "apples to apples" and exclude inflationary effects, staff finds that the industry's prediction is equivalent to no more than a \$0.79 per pack increase.⁽²¹⁾ If the proposed settlement did in fact achieve a "real" price increase of \$1.50, the FTC Staff Report concludes that the windfall from the approximate additional 0.70 to \$0.80 per-pack price increase would disproportionately favor industry.

The industry analysis presents additional criticisms of FTC staff's report. Staff, however, indicates that nothing in the industry's analysis leads the staff to question the overall findings in its original report.

To summarize, there will continue to be vigorous debate on the potential economic impact of the proposed settlement. Based upon the history and structure of the tobacco industry and several features of the settlement -- most important, the inclusion of a broad antitrust exemption that, as presently drafted, could allow the tobacco companies to coordinate future price increases -- it is not unreasonable to expect cigarette prices to rise more than the amount of the Annual Payments, resulting in additional revenues to the tobacco companies and, to a lesser extent, to the public sector. The Commission believes a broad antitrust exemption would significantly enhance coordination in the tobacco industry and is not justifiable. I would be happy to address any questions you may have.

(1) This written statement represents the views of the Federal Trade Commission. My oral presentation and response to questions are my own, and do not necessarily represent the views of the Commission or any other Commissioner.

(2) Federal Trade Commission, "Competition and the Financial Impact of the Proposed Tobacco Industry Settlement," Report prepared by the staff of the Bureaus of Economics, Competition and Consumer Protection at the request of the Congressional Task Force on Tobacco and Health, September 1997 ("Staff Report"). A copy of the Staff Report was provided to the Subcommittee on September 22 in response to its request.

(3) FTC staff has examined the proposed immunity provision in detail. The staff's analysis is presented in the appendix to the Staff Report and is attached to this testimony.

(4) Proposed Resolution, Appendix IV, part C.2.

(5) See generally ABA Section of Antitrust Law, *Antitrust Law Developments* 1135 (4th ed. 1997) ("With few exceptions, the antitrust laws apply to all industries.") Some of the exceptions are cited in the Staff Report at A-3 - A-5.

(6) In fact, certain studies have shown that tobacco products manufacturers historically have been able, without any apparent express collaboration, to impose price increases that exceed any additional costs they may have incurred. Staff Report at v, 25-26.

(7) Id. at A-3 - A-4.

(8) Id. at A-4 - A-5.

(9) Manufacturers are left to determine on their own, in the first instance, what joint activity may be appropriate to carry out the purposes of the statute. Although those determinations are subject to review, the resolution may require costly litigation.

(10) Proposed Resolution, Title VI, part B.7.

(11) Id., Appendix IV, part C.2.

(12) Id.

(13) The proposed settlement stipulates a total Annual Payment for all participating manufacturers.

(14) Similar marketing and advertising restrictions contained in FDA regulations have been challenged on First Amendment grounds, and the case is now on appeal in the Fourth Circuit. *Coyne Beahm, Inc. v. FDA*, 966 F. Supp. 1374 (M.D.N.C. 1997), appeal pending.

(15) See Proposed Resolution, Title II and Appendix IV.

(16) See *id.*, Title I, Part D, and Appendix II.

(17) Staff also concludes that the \$368.5 billion "face value" of the proposed settlement is probably overstated because it fails to take into account the general decline in smoking in the United States and the increase in that decline because of the proposed increase in cigarette prices.

(18) Lorillard Tobacco Company, Philip Morris Companies, Inc., R.J. Reynolds Tobacco Company, and U.S. Tobacco, Inc., "Impact of the Proposed Resolution on the U.S. Cigarette Industry," October 8, 1997.

(19) The Staff Report indicates that the Annual Payment under the proposed settlement would amount to \$0.62 per pack, which the settlement anticipates will be passed through to consumers in the form of higher prices. The report further assumes that the settlement would lead to advertising and legal cost savings of \$0.05 per pack that also would be passed through to consumers. Assuming no additional price increases as a result of enhanced industry coordination as presented in the baseline scenario, the per-pack price thus would increase by \$0.57. If the recently passed \$0.15 per pack increase in federal excise taxes is added, the estimated total price increase is \$0.72 per pack.

(20) Staff is currently examining the industry analysis in further detail, and a supplemental report will be provided to the Subcommittee once it is available.

(21) Additionally, staff observes that nominal estimates of the price of a pack of cigarettes will not shed light on how the price will affect the demand for cigarettes, because inflation raises consumers' money incomes and the prices of all other goods as well as the price of cigarettes.