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Uncertainties Ahead for NPM Cigarettes

Legislation to settle NPM adjustments with the states will also make the playing field tougher for NPM manufacturers, benefiting major manufacturers. >BY TROUTMAN SANDERS TOBACCO TEAM

This year, legislation is being considered by several states that will make it even harder for non-participating cigarette manufacturers (NPMs) to compete in the marketplace. Versions of this legislation have already been adopted by at least three states, and more state legislatures will likely consider the legislation later this year.

Although major tobacco manufacturers (the majors) ostensibly intend this legislation to settle issues related to the NPM adjustment with the states, the majors are also using the legislation as an opportunity to chip away at competition from NPMs.

The proposed legislation will make it harder for NPMs to find wholesalers and distributors for their products, increase barriers for NPMs seeking to expand into new markets, and prevent sales by tribal tobacco companies to non-Natives without payment of state excise taxes and escrow required under the Master Settlement Agreement (MSA).

THE NPM ADJUSTMENT

Currently, the states and the majors are engaged in arbitration regarding the NPM adjustment. The NPM adjustment in the MSA reduces the total payments owed to all the states by participating manufacturers to compensate for market share lost by the majors to NPMs.

Specifically, the payments of participating manufacturers to a state may be reduced under the MSA whenever these three conditions exist:

- From 1997 to the year at issue, the participating manufacturers, as a whole, have lost market share to NPMs;
- The MSA was a "significant factor" in this market share loss; and
- A state or states did not "diligently enforce" the MSA model statute in the year at issue.

The participating manufacturers are authorized to withhold a portion of their payments going forward if the first two conditions are met. The third factor is used to determine which state or states

should bear the burden of reduced MSA payments.

When the first two factors are present, the MSA authorizes a downward adjustment of three times the market share lost since 1997, less two percent. As an example, if the major companies lost five percent of the market to NPMs from 1997 to the subject year and it is determined that the MSA was "a significant factor" in that loss, then the maximum possible reduction to the cigarette companies' total MSA payments owed for that year would be about 9 percent ($3 \times (5\% - 2\%)$).

To carry out the NPM adjustment, an independent auditor who oversees the MSA first determines whether the majors lost market share to the NPMs from 1997 to the subject year and also determines the extent of the loss. Once a market share loss is found, an independent economic research firm determines whether the MSA was a "significant factor" in that market share loss.

The independent auditor determined that the majors lost 6.25 percent of market share to NPMs from 1997 to 2003 and found that the MSA was a "significant factor" in that market share loss. The final factor, whether the states have diligently enforced the MSA, is now being determined by arbitration, as provided in the MSA.

If some states are found to have "diligently enforced" their escrow statutes, but others are found not to have done so, the entire nationwide NPM adjustment amount is taken out of the MSA payments of those states that have been found not to have diligently enforced (with the diligently enforcing states receiving any amounts withheld from their past payments, plus interest). As a result, the stakes are extremely high for states to show that they have diligently enforced the model statute.

PROPOSED LEGISLATION

The participating manufacturers are now using the legislative process to settle the NPM adjustment claims with the states and further tilt the marketplace in their favor. Some have referred to this proposed legislation as a "new model MSA

statute.” Although purportedly aimed at the NPM adjustment, several aspects of the legislation have significant ramifications for NPMs and tribal tobacco sellers.

First, one of the most troublesome aspects of the proposed legislation is an attempt to shift the escrow requirement from the manufacturer to the distributors selling NPM cigarettes, in the event that the manufacturer fails to meet its obliga-

NPM products is significant. NPMs may find themselves searching for wholesalers and distributors willing to take on the risk of selling and distributing their products.

Second, another provision of the proposed legislation requires a NPM to post a bond: (1) if its cigarettes have not previously been sold in the state in the last quarter; (2) if the NPM or any per-

this provision) could require the NPM to post at least a \$25,000 bond.

Third, the new model MSA statute contains provisions aimed at tribal tobacco, which have a net effect of imposing full escrow payments and state excise taxes on every cigarette sold on tribal lands to non-Natives. The legislation would enable each state to track every cigarette sold in or through the state, including tribal cigarette sales. The statute also prohibits the state from entering into any compact with a Native American tribe that is contrary to the new statute’s provisions. These portions of the statute are aimed directly at smokeshops operating on Native American lands which sell NPM products in accordance with state laws that do not, as of now, impose escrow on such sales.

Each state legislature will have to decide whether to enact the new model MSA statute and each of these provisions. Given the tight budgets states continue to face, however, and the prospect of losing significant revenue due to the NPM adjustment provisions, more and more states are expected to enact these provisions in the coming years. ■

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tions. In the words of the proposed legislation: “A stamping agent shall be responsible for escrow deposits required under [the state’s escrow statute and the MSA] in the event it receives notice from the state that there is a shortfall amount with respect to non-participating manufacturer cigarettes stamped by it.”

If the legislation passes, the risk to distributors and wholesalers selling NPM products will be considerable. The escrow due on a carton of cigarettes currently is approximately \$6.00. In the event a manufacturer fails to pay its escrow obligation, the state could look to the distributor for payment. The chilling effect that such a provision could have on the sale and distribution of

son affiliated with the NPM has failed to make a full escrow deposit for any of the preceding calendar years, unless the failure was not knowing or “reckless;” or (3) if the NPM has been removed from the state directory in any of the preceding five years, unless the removal is determined to be erroneous. The minimum bond required under the legislation is \$25,000, and the maximum bond is the amount of the NPM’s greatest required escrow during the preceding 12 calendar quarters.

The barriers to entry for a new NPM into a market will be significant under this provision, when one considers that each state in which the NPM wishes to sell its products (and which has enacted

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