



# Tobacco Retail Price Manipulation Policy Strategy Summit Proceedings

California Department of Public Health  
California Tobacco Control Program

# **Tobacco Retail Price Manipulation Policy Strategy Summit Proceedings**

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**Arnold Schwarzenegger, Governor**  
State of California

**Kimberly Belshé, Secretary**  
California Health and Human Services Agency



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# Acknowledgments

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CTCP also expresses its gratitude to all of the summit attendees, many of whom traveled great distances to participate in enlightening discussions about retail price manipulation policy strategies. The willingness of these individuals to express their views and share their expertise added greatly to everyone's knowledge of the issue and generated the primary substance for these proceedings. The presenters and facilitators deserve special thanks for their outstanding contribution to the success of the summit.

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# Section I: Introduction and Purpose of the Summit

by April Roeseler

*April Roeseler is Chief of Local Programs and Information Services of the California Department of Public Health, California Tobacco Control Program (CTCP). She reviewed the purpose of the Summit, which was convened by the CTCP in order to craft California's strategy in response to the tobacco industry's retail price manipulation practices.*

The primary purpose of the Summit was to advance understanding of:

- How the industry manipulates prices to influence consumption
- What policy interventions are feasible

The second intention was that the proceedings from this Summit would inform similar tobacco control efforts elsewhere in the United States and abroad.

Key topics addressed during the Summit included: how tobacco prices are manipulated by the Tobacco Industry, tobacco retailer licensing, tobacco product sales, marketing and pricing strategies, legal issues, and potential points of intervention as products move from manufacturer to retail. In addition, Summit participants brainstormed possible tobacco price discounting policy strategies, including bans on promotional allowances and buy-downs and the enactment of minimum price laws.

The planners of the Summit noted that discussion of excise tax increases, while important, needed to be addressed separately from price manipulation since the impact of tax increases as a strategy was already proven. However, with California's tobacco excise tax ranking 30<sup>th</sup> in the nation, ([www.tobaccofreekids.org/reports/prices](http://www.tobaccofreekids.org/reports/prices)) a CTCP analysis of tobacco prices found that the real price of cigarettes in California declined by \$0.71 per pack between 2003 and 2007. In the last two years, two proposals to increase tobacco excise taxes in California were unsuccessful: the 2006 Proposition 86, which proposed a \$2.60 tax increase per pack of cigarettes; and the Governor's 2008 Health Care Reform proposal, which included a tax increase of \$1.75 per pack.

Summit participants were charged with two tasks:

- To react to the current tobacco retail environment, and
- To formulate strategies that would shape a new environment—one that would give greater consideration to public health interests.

To that end, participants were asked specifically to identify strategies that could be bundled with an excise tax increase or tobacco licensing, in order to achieve two goals: to maximize the public health impact that would result from higher prices, and to enable the State of California to obtain reliable data on price promotions and retailer incentives by shifting the burden for collecting and reporting these existing practices on the tobacco industry. Because of the tobacco industry's

significant focus on marketing and sales promotions at the retail level, participants were asked to concentrate on those issues—and not on strategies to reduce tobacco sales to minors, nor on emerging tobacco marketing methods such as Internet sales, stealth marketing, text messaging, and use of tobacco industry databases.

### **Participants**

The Summit was designed to provide an environment where experts from a range of disciplines could present provocative ideas and explore their feasibility. Experts in law, tobacco control, economics, marketing, and business were identified in collaboration with CTCP staff. A total of 35 participants were involved in all or part of the Summit. A month before the event, a packet of readings was sent to invitees to provide background information on relevant issues, including:

- The rationale for concern about price discounting strategies
- Background on the tobacco industry
- Pricing and its effects on smoking behavior
- Legal issues, and
- Potential policy interventions

The annotated list of readings is included in the Appendix.

### **Structure**

The agenda provided substantial blocks of time for group brainstorming and discussion. In preparation for these sessions, the Summit began with a series of presentations to ensure that all participants were oriented to its purpose and background. The remainder of the meeting included a series of both small and large group discussions of potential options for controlling the tobacco industry's price discounting strategies, through the proposals summarized in **Section 3: Discussion of Policy Options for Addressing Retail Tobacco Price Manipulation**. After these proposals were discussed, the Summit closed with reflections from different perspectives with the charge to identify a comprehensive approach to the retail environment, both in California and the rest of the country.

# Section 2: Background Information

The agenda for the first morning included a series of presentations to ensure that participants were oriented to the purpose and background of the Summit. The presentations included:

- Why tobacco price manipulation is a problem
- What we know about how prices are set
- The legal issues related to retail tobacco price manipulation, and
- An overview of potential points of intervention as products move from manufacturer to stores

## Why is Tobacco Price Manipulation a Problem?

by Frank Chaloupka

*Frank Chaloupka, Professor of Economics at University of Illinois, Chicago, presented a brief review of recent trends in cigarette company marketing expenditures and the impact of these expenditures on price. He also presented a review of studies that assessed the impact of cigarette marketing on smoking, and the effects of point-of-sale (POS) marketing on youth smoking uptake.*

Cigarette company marketing expenditures increased steadily over a 20 year period, peaking in 2003. Although these expenditures then declined slightly, in 2005 over \$13 billion dollars was spent on different types of marketing, including image-oriented strategies, those related to price, promotional allowances, merchandise offers, and others.

Nearly 90 percent of these expenditures were devoted to price reduction strategies at the POS, following a shift that started in the early 1980s. After the 1998 Master Settlement Agreement (MSA), cigarette manufacturers substantially increased their marketing and promotional spending in unconstrained venues, such as price-related marketing activities in retail outlets (Wakefield, et al., 2002; Ruel, et al., 2004; Loomis et al., 2006; FTC, 2007). This is consistent with empirical evidence on the impact of marketing restrictions on smoking behavior, where partial restrictions stimulated movement to unregulated venues (Saffer and Chaloupka, 2000). Indeed, internal tobacco industry documents reveal that price-related marketing was used to soften the impact of tax increases (Chaloupka et al., 2002; Chaloupka et al., 1998). Additionally, more price-related marketing has been observed in states with greater spending on comprehensive tobacco control programs (Loomis, et al., 2006; Slater et al., 2001).

According to Feighery, et al., (2008), there is growing use of POS ads to highlight sales promotions, such as those involving a special price, special offers, cents off, a reduced price, or multi-pack

**More price-related marketing has been observed in states with greater spending on comprehensive tobacco control programs**

specials. The percentage of stores in California with at least one ad featuring sales promotions rose from 68 percent in 2002 to 79 percent in 2005—with more rapid increases in neighborhoods with a higher than average proportion of African Americans.

### **The Effect of Price**

The cigarette manufacturers have focused so much of their marketing on price because it has such a consistent impact on tobacco use.

Higher cigarette prices:

- Induce quitting
- Prevent relapse
- Reduce consumption, and
- Prevent initiation

**A 10 percent price increase induces 10 to 12 percent of smokers to try to quit**

A 10 percent price increase induces 10 to 12 percent of smokers to try to quit and reduces overall cigarette consumption by four percent, with half of the impact of price increases occurring because of decreased consumption among continuing smokers. Marketing efforts that lower price; however, can offset the impact of taxes and other factors that raise cigarette prices. This is an especially important distinction for those who are most price sensitive, such as low-income populations and youth (Chaloupka et al., 2000; Chaloupka, in press).

Young people are more responsive to price increases for a number of reasons. The proportion of disposable income that they spend on cigarettes is likely to exceed that for adults. As well as being more influenced by peers and parents, young people are less addicted than adult smokers, so it is easier for them to cut down or quit (Liang, et al., 2003; Chaloupka, 2003). Thus, higher cigarette prices significantly reduce the probability that teens will become daily, addicted smokers.

**Marketing efforts that lower price can offset the impact of taxes**

For example, a 10 percent increase in price:

- Reduces smoking prevalence among youth by nearly seven percent
- Reduces average cigarette consumption among young smokers by over six percent
- Cuts the probability of starting to smoke by about three percent
- Reduces initiating daily smoking by nearly nine percent, and
- Reduces initiating heavy daily smoking by over 10 percent

(Sources: Chaloupka and Grossman, 1996; Tauras, et al., 2001; Ross, et al., 2001)

A study of POS cigarette marketing and youth smoking uptake was undertaken as part of the *Bridging the Gap* program, funded by the Robert Wood Johnson Foundation since late 1997, and focusing on adolescent tobacco, alcohol, and drug use. The *ImpacTeen* component of the project, based at the University of Illinois, Chicago, collected observational data on POS cigarette marketing at the community level from 1999 through 2003, along with detailed state tobacco control policy data. The Youth, Education and Society component of the project (run by the Institute of Social Research at the University of Michigan) built upon the Monitoring the Future study funded by the National Institute on Drug Abuse. This focused on collecting data on school policies, programs, and other school-level influences on youth tobacco use.

The repeated cross-sectional study included student surveys and observational data collection at retail outlets in communities near schools participating in the Monitoring the Future survey. Data collection occurred at approximately 200 schools per year from students divided, about equally, between 8<sup>th</sup>, 10<sup>th</sup>, and 12<sup>th</sup> grades. A census of retail outlets selling tobacco was surveyed in most of these communities, with a random sample of 30 in larger communities. An average of 18.1 stores were observed per community, with a total of 17,476 stores observed between 1999 and 2003.

POS tobacco advertising was associated with the early stages of uptake (from non smoker to puffer). The relationship weakened at the later stages of uptake, but sales promotions such as multi-pack discounts and special offers were found to increase the likelihood that youth would move from experimentation to regular smoking.

The *ImpacTeen* researchers used these findings in simulations to assess the impact of different levels of advertising on stages of uptake:

- If no stores had advertising, the estimated prevalence of never smoking would increase by nearly nine percent
- If promotions were removed in the retail environment, there would be a 13 percent decrease in established smoking among youth, and
- A \$1 increase in price would reduce the odds of moving from one stage to next by 24 percent, which is consistent with other recent evidence on price and youth smoking uptake

The researchers found a weak association between self-service placement and youth smoking uptake. The cross-sectional data limited their ability to assess the causal impact of POS marketing, and they were unable to match store-specific data to youth based data in stores they frequented most. Also, measures of cigarette marketing strategies are relatively crude.

In summary, cigarette marketing and promotional expenditures have increased sharply since the MSA. Despite recent declines, per-pack promotional spending remains more than doubled since the MSA, with cigarette marketing increasingly dominated by spending on price-reducing promotions. Higher cigarette prices encourage smokers to quit smoking, prevent former smokers and youth from starting, and reduce consumption among continuing smokers. And price-lowering promotions do the opposite: they offset any impact of higher cigarette taxes on youth and adult smoking.

**If promotions were removed in the retail environment, there would be a 13 percent decrease in established smoking among youth**

**Cigarette marketing and promotional expenditures have increased sharply since the MSA**

# What Do We Know About How Prices Are Set?

How the beverage industry uses promotional incentives, and the implications for tobacco

by Perry Cutshall

*Perry Cutshall is President and Founder of the Cutch Group, Inc. and a 28 year veteran of The Coca-Cola Company, where he held domestic and international positions of responsibility spanning several disciplines, including marketing, operations, public affairs and communications. He related his observations and experiences with the soft drink industry to the role of retail pricing in any brand business, including those involving tobacco.*

The behavior of large brand companies is driven by a fundamental commitment to grow their business in economic terms, which is accomplished by simply “selling more stuff to more people.” To do this in the highly competitive and fragmented markets they play in, brand companies (such as those in the tobacco industry) must be flexible and nimble, with a deep understanding of their own strengths and vulnerabilities—as well as of consumers’ wants, needs, and choice-making capabilities.

Brand experience and brand value live in the mind of the consumer. For companies like Coca-Cola, the value of the cornerstone brand can be 60 to 70 percent of the market capitalization of the company (the infrastructure and hard assets represent a much smaller component of overall value). The brand owner’s job is to grow the relationship between brand and consumer, and leverage that relationship to create value for the owners of the company.

Brand-selling fundamentals are similar regardless of the brand or the industry. It is a matter of managing the mix of marketing variables that companies can use. Price is only one element of revenue growth—in many cases a small element. Price is also a retailer-managed element; in the case of the non-alcoholic beverage industry, neither the brand owner nor the bottler can dictate retail prices. They can, however, influence retailer behavior in setting prices through a mix of various economic and/or experiential elements, such as discounting.

Prices generally reflect value as seen by the consumer, who is willing to pay more on a unit basis for additional value in various forms. Convenience and access are highly leveraged elements and both brand owners and retailers recognize and capture that value. Key forms of convenience and access are found in product variety, package formats, cold availability (if appropriate), and placement “within immediate reach.”

Share has always been a traditional battlefield for the industry, but that fight is becoming more focused on share of revenues in a category, in addition to share of volume. Route to market is

**Brand-selling fundamentals are similar regardless of the brand or the industry. It is a matter of managing the mix of marketing variables**

another growing focus, given the diversity of product choices and expanding product forms. Traditional infrastructure is proving to be slow and inflexible in serving the modern market, so alternatives are being developed rapidly.

Traditionally, non-alcoholic beverage brand owners are volume driven, as they typically price beverage concentrates at a fixed level, leaving the bottler to manage margins in the competitive retail market. The economic results clearly reflect the realities of the business model, with the parent company enjoying an operating income percent of revenue that is three to four times that of the bottler. Costs are a key element of that difference, as well as invested capital with parent company assets covering worldwide operations, while bottler assets are for specific countries. Bottlers are more vulnerable than parent companies to volatile commodities markets for packaging, sweeteners, and transport costs.

Consumer tastes and preferences drive their purchase behaviors; and marketers constantly try to determine, predict, and influence those behaviors. Numerous dynamics in the market have changed traditional revenue sources and category growth rates, leaving the marketers to diversify and chase consumer dollars. Innovation has become a critical function, both internally and through acquisition. Margins must be protected by ever increasing cost containment across all elements of the supply chain.

**Margins must be protected by ever increasing cost containment across all elements of the supply chain**

Soft drink companies have historically fought to increase effective pricing at the consumer level, with little success. With market share near parity, there is fierce competition for share swing through private labels, discount brands, and retail channel dynamics, which combine to keep consumer prices low and stable. With the help of innovative cost-containment measures and packaging/pricing combinations, revenue growth has been possible with no growth in real pricing.

In 2007, for example, price growth represented only two percent of the 20 percent revenue growth generated by the Coca-Cola Company, with the rest of that growth consisting of acquisition (eight percent), volume (six percent), currency variations (four percent), and price. During that year, the Coca-Cola Company spent roughly five billion dollars in promotion and marketing, including three billion dollars in advertising.

**In simple terms: sell the product for as much as possible while meeting all other objectives**

The strategic objective of pricing is to maintain and grow share of market revenues, while contributing to brand value and enhancing the consumer-brand bond. In simple terms: sell the product for as much as possible while meeting all other objectives.

Retailer strategies differ considerably, depending on the brand and its relationship with consumers. Retailers know consumers want their favorite brands, and they want the value that the brand

provides, at fair prices. Pricing practices—such as specific time periods of regular and discount prices, and shared “deal” periods with competitors are common in supermarkets, as with some mass merchandisers and clubs, while some retailers have a brand image of “everyday low price.” Retailers often price leading brands at low prices as traffic builders and loss leaders, creating considerable stress on the relationships with bottlers and brand owners.

One lucrative area for price enhancement in the non-alcoholic beverage industry on a per-ounce basis is in providing occasions for cold (and immediate) consumption. Marketers understand the consumer’s willingness to pay for convenience and thus provide ready access to products ready for immediate use—for example, giving you numerous opportunities to pick up a cold drink as you shop, as you pay, or as you leave your local supermarket. This is a far different environment than the traditional beverage aisle stocked with warm cases, 6-packs, 12-packs and large bottles.

**It is critical to recognize that prices are but one component in the marketing mix that influences consumer behavior and consumption**

When considering the implications for tobacco product price interventions, it is critical to recognize that prices are but one component in the marketing mix that influences consumer behavior and consumption. To identify effective countermeasures to seller tactics, goals must be succinctly defined, with great clarity of purpose. Simply increasing prices through intercession with market dynamics (for example, through regulation) may be counterproductive, because it may increase incentives to find ways around established channels. Increased tax revenues also increase government agency revenue dependencies, and drive actions to protect those revenues.

**Increasing prices through regulation may be counterproductive**

Understanding what the sellers are doing to drive sales will help give you insights as to potential counter measures that could prove productive. For example, price segmentation across brands (premium versus generics versus store brands, etc.) gives sellers latitude in mix management. If these opportunities were to be restrained or eliminated it could affect price-point manipulation. Display and dominant visual presence are means to market-share growth among competitors and drive a significant investment strategy on the seller’s part. If that element of the mix were removed or standardized, consumer manipulation could be reduced.

In summary, we need to understand three main points:

1. Pricing is only one variable that brand companies use to grow revenue. Many other elements are included in the mix, and price is not usually the key element for revenue growth.
2. We need to know more about the “value chain,” and the complex relationships among manufacturers, wholesalers and retailers. Interventions that create imbalances in these relationships have the potential to affect efficiencies and thus revenue.

3. The market thrives on differentiation (image, price, etc.) and this may be its greatest vulnerability. Anything that can be done to disrupt the industry's ability to differentiate its products would affect consumer behavior. The imagery of the brand and how it is presented are important aspects of price because of the consumer brand relationship. Exploit this vulnerability by thinking about why and how a marketer would utilize specific strategies to grow the business and increase revenue.

## California Licensing of Tobacco Distributors, Wholesalers and Retailers

by Lynn Bartolo

*Lynn Bartolo, Chief of the Excise Taxes Division, California Board of Equalization, provided background information on the California licensing program. The California Board of Equalization collects excise taxes for seven tax programs including cigarettes and other tobacco products.*

The cigarette tax in California is \$0.87 per pack of 20 cigarettes and is paid upon purchase of tax stamps by cigarette distributors. The tax rate on other tobacco products (OTP) is a percentage of the wholesale cost, currently set at 45.13 percent. This tax is paid by the licensed distributor, and the tax is self-assessed each month.

Four years ago there was no State licensing program in California, and the State did not know how many retailers existed. In October 2003, the State enacted the Cigarette and Tobacco Products Licensing Act (Business and Professional Code Section 22971.3, 22972-22973.1, 22980.2) with the main purpose of decreasing tax evasion on the sales of cigarettes and tobacco products in California. Licensing requirements were imposed on all manufacturers, importers, distributors, wholesalers and retailers of cigarette and tobacco products. These licensing requirements are in addition to any other permits and licenses that may be required, depending on the business operations. Local jurisdictions also license retailers and impose a range of annual licensing fees that may be quite high (in Santa Ana, for example, retailers pay \$600 a year to obtain a license to sell tobacco products).

The cigarette and tobacco distribution process includes several key players:

**Licensed manufacturers** and/or importers, who can only sell to a licensed distributor.

**Licensed distributors**, who buy tax stamps and affix them to products, pay excise taxes and file monthly tax returns. They must also post mandatory security deposits with the State Board of Equalization (BOE) as long as they are in business, and submit monthly reports to the BOE including inventory and the amount of product moved. Distributors may only sell the authorized products to licensed retailers or wholesalers.

**Wholesalers** must be licensed and must obtain products from licensed distributors. They service retailers in defined geographic areas.

**Retailers** may only have product in their possession on which the tax has been paid, and can only sell to consumers. Retailers cannot buy from each other, nor purchase from the Internet, but can only make purchases through California licensed distributors or wholesalers. They have no reporting requirements, but upon request must provide invoices to inspectors. The BOE checks cigarette packages for the excise tax stamp which is an indication that the tax has been paid. If retailers are selling OTP then they must have invoices on their premises to show the BOE inspectors or the products will be seized. Retailers must also display a valid tobacco license in a public area so that anyone may be able to determine its validity.

### **The Numbers**

Here is a breakdown of the businesses involved in tobacco manufacturing, distribution and sales in California:

- 34 cigarette manufacturers
- 70 tobacco importers
- 111 cigarette and 580 tobacco product distributors
- 437 wholesalers
- 38,185 tobacco retailers

### **Who Enforces the Law?**

The Office of the Attorney General and any law enforcement officer in California has the authority to enforce the provisions of the Cigarette and Tobacco Products Licensing Act. In addition:

- The licensing of manufacturers, importers, retailers, distributors, and wholesalers is administered and enforced by the staff of the BOE.
- Underage purchases are monitored by the California Department of Public Health and local authorities.
- The BOE Investigations Division performs inspections, focusing mainly on tax stamps. They issue citations that may involve multiple violations. Penalties include warning notices, fines (\$500-\$5000), suspensions (10 to 30 days), and revocations.

## **Cigarette Sales in Stores: Sales, Marketing and Pricing Strategies**

*by Ellen Feighery*

*Ellen Feighery is a Research Scientist with the Public Health Institute. She focused her presentation on retail stores and the use of financial incentives by cigarette companies to stimulate product sales in this venue.*

According to the 2002 Economic Census, 221,173 stores sold tobacco in this country in 2001 and they had \$50.8 billion in tobacco sales. Convenience stores were responsible for 50 percent of all tobacco sold and represented 50 percent of all outlets.

The 2007 Federal Trade Commission (FTC) Cigarette report showed that in 2005, almost 90 percent of marketing expenditures occurred at the Point of Sale (POS).

## Why?

Stores were one of the few marketing venues not restricted by the MSA, and since manufacturers must gain visibility, they do it through prominent shelf space and POS displays. These are secured through retailer contracts that require signage and specify shelf space. In return, retailers receive financial incentives.

Price discounts are effective strategies for several reasons:

- They decrease price gaps between cigarette tiers (brands) while maintaining cigarette revenue by increasing sales
- They are changeable on a monthly basis, and
- They are flexible and so allow targeting of specific stores, populations, and regions

In sum, they are a dynamic price strategy that allows for maximum use of retail space.

Three studies conducted by Feighery et al., indicate that approximately two thirds of tobacco retailers participate in incentive programs with at least one tobacco company, with the majority participating in multi-pack discounts. The figures are higher for convenience stores, where about 65 percent of single packs are sold: about 90 percent of these stores are involved in incentive promotions. Most participate with Philip Morris USA (85 percent), followed by R.J. Reynolds (70 percent), trailed by Lorillard (32 percent) and Brown and Williamson (30 percent). In the Feighery study, retailers generally had promotional contracts with multiple companies, with only 30 percent having exclusive contracts with one company.

The amount and type of financial incentives depend on the store's willingness to accept tobacco company control over retail space, and on what the retailer is willing to give up. The degree of control varies according to the Category Merchandising Option (CMO) that the retailer signs up for. In general, retailers are obligated to:

- Follow plan-o-grams depicting the placement of displays and fixtures
- Offer and advertise packs for sale
- Allocate specific shelf space, and
- Agree to inspections, inventory checks and audits by the tobacco company

In return, the retailer receives a CMO allowance, such as 50 cents per carton if the store sells 1000 cartons a month. These are discretionary funds, so the retailer can choose whether to pocket the money or reduce the price for the consumer.

**Financial incentives depend ... on what the retailer is willing to give up**

Cigarette companies offer two types of discounts: off-invoice promotions, which are given when an order is placed and is accompanied by signage, and retail price promotions which are multi-pack discounts or other discounts on products in the store (referred to as buydowns). These offers must be passed on to the consumer, and tobacco advertising studies indicate that approximately one-third of all ads in stores promote price reductions.

Obviously, the amount of money spent in stores and the extent of price discounting indicates that this venue is incredibly important to tobacco companies. The contracts with retailers are not only used to manipulate prices, but to maximize use of retail space to reach both present and future customers.

## Taxation of Rebates and Allowances

by Lynda Cardwell

*Lynda Cardwell is a Program Policy Specialist with the California Board of Equalization, and presented information on the tax implications of price promotions.*

Price promotions are designed to reduce the selling price for each promoted brand. Two types are generally taxable:

- Buydowns (retail price promotion)
- Promotional allowances (in which the retailers are given a sum at least as great as the amount to be subtracted from their regular price)

A retail price promotion is a price reduction that is offered for a defined time period during which the retailer contracts to reduce the selling price of specified brands by at least the specified amount, in exchange for an allowance of an equal amount. Generally, to participate in the tobacco price promotions, the retailer must maintain at least one interior POS sign to advertise the promoted price, and at least two “We Card” signs. These sales may also be limited to a specified carton limit (for example, no more than 10 cartons for any one consumer).

### **Taxable Promotions**

Rebates, discounts and allowances are taxable when the retailer is *required by a third party* to reduce the selling price of specified products, when the rebate is *certain*, and when it is for the same amount as reimbursement for the price reduction on a *transaction-by-transaction* basis.

A rebate payment is considered certain when fulfillment of the requirements of the agreement is within the control of the retailer at the time of the underlying sale. A rebate payment is not certain when the retailer must meet a threshold or sales quota before the rebate is earned. It is also not certain when receipt of the rebate is subject to a contract variable outside the retailer’s control at the time of sale. The rebate payment does not have to be exactly the amount of the retailer’s reduction in selling price so the payment may exceed the price. It does have to be on a transaction-by-transaction basis.

### **Non-Taxable Allowances**

Sales tax does not apply to money not associated with an actual sale, such as a display or shelving allowance, a merchandising or signage allowance, slotting fees, purchase discounts, and off-invoice promotions.

# Legal Issues Related to Retail Tobacco Price Manipulation: Barriers and Constraints

by Leslie Zellers

*Leslie Zellers is the Legal Director at the Technical Assistance Legal Center, Public Health Institute. She provided background information on legal issues and constraints that must be considered when governments want to combat tobacco price manipulation and its associated advertising. The purpose of this presentation was to shed light on potential risks in order to ensure that potential strategies are effective, they are politically feasible, and they can withstand legal challenge.*

The types of strategies that address price discounting generally fall into three broad categories:

1. New state or federal laws such as banning coupons, slotting fees, or multi pack discounts
2. Government enforcement of existing laws, such as anti-trust laws and laws against monopolies, and
3. Companies could file lawsuits against other companies

## **I. New State or Federal Laws**

First and most importantly, new laws must be evaluated for compliance with the preemption provisions of the Federal Cigarette Labeling and Advertising Act (FCLAA), the First Amendment regarding free speech, and other laws such as those concerned with anti-trust provisions, takings, and interstate commerce.

### **The Federal Cigarette Labeling and Advertising Act**

The federal preemption provision of FCLAA is the most important and challenging issue to address. FCLAA was passed in the late 1960's to require warning labels on cigarette packs. While proposed new federal laws are not affected, the law prohibits state or local jurisdictions from regulating labels, advertising, or promotions in order to ensure a uniform law across states. (Proposed federal laws are not affected by the preemption clause.) The three major components of the FCLAA preemption clause law say that states cannot enact a (1) "requirement or prohibition" if (2) "based on smoking and health", (3) "with respect to the advertising or promotion of any cigarettes . . ." 15 U.S.C. Section 1334(b). This language is confusing, but laws must meet all three elements to be valid.

Laws passed by several states attempting to restrict advertising and promotions have been struck down by the courts for various reasons. So it is important to conduct a risk analysis to make sure a proposed law meets these three criteria, and that the jurisdiction can win if sued. That means answering the following questions:

a) **Does the law include a requirement or prohibition?**

A government law is always going to do this.

b) **Is the rationale for the law based on smoking and health?**

Several states have tried to avoid this restriction, but it is tough—even when the law aims to avoid the sale of an illegal product to minors, as happened with many provisions of a Massachusetts law that were struck down by the United States Supreme Court in 2001 (Lorillard versus Reilly). If a law is attempting to decrease tobacco use, the courts will apply the “smoking and health” provision, so another purpose that is not health-related must be used. Health cannot even be mentioned in testimony when proposed laws are being considered, and the courts have gone as far as reviewing who testifies to ensure that tobacco control experts are not in an advocacy role.

**c) Does the law attempt to control “advertising” or “promotion” of cigarettes?**

First, it is important to point out that FCLAA only applies to cigarettes—not smokeless tobacco (SLT)—so there may be opportunities to regulate price discounting SLT. Most courts have focused on “advertising,” but “promotion” has no clear definition in FCLAA or in the Supreme Court decision of 2001. For regulation purposes, these definitions need to be clarified. To date, the courts have relied on numerous sources including a dictionary definition of promotion: “the act of furthering the growth or development of something.” FTC reports define “distribution of cigarette samples and specialty gift items” as “sales promotion activities”—in other words, as POS *promotions*. The Surgeon General’s 1994 report provides examples of promotions such as point-of-purchase displays, coupons, gifts such as cigarette lighters with the purchase of two packs of cigarettes, and free samples.

Specifically regarding free samples, the courts have made conflicting decisions revolving around three fundamental issues:

- Are *free* cigarettes a “promotion”?
- What constitutes promotion?
- Where is the line between giving away cigarettes and promoting product?

The California Supreme Court ruled that giving away a product is distribution, not promotion, so this state can regulate the giving away of cigarettes (People versus R.J.R., 2006). However, a District Court in the state of Washington ruled that free samples are product promotions, so a law attempting to ban them is preempted under FCLAA (R.J.R. versus McKenna, 2006). On the other hand, the state of Iowa tried to restrict retailer practices by banning give-

**Because of the FCLAA preemption, health cannot even be mentioned in testimony when proposed laws are being considered**

**FCLAA only applies to cigarettes—not smokeless tobacco (SLT), so there may be opportunities to regulate price discounting SLT**

**Regarding free samples, the courts have made conflicting decisions**

aways of tobacco products and prohibiting free gifts (such as a cigarette lighter, or another pack of cigarettes) in exchange for purchase of tobacco. Retailers complained that the law prohibited redeeming cents-off coupons, proofs of purchase, and two-for-one sales. The Iowa law was found to be preempted by FCLAA because it was considered to regulate cigarette “promotion” (Jones versus Vilsack, 8th Circuit, 2001).

Certain laws are allowable under FCLAA, but these do not involve advertising or promotion and do nothing to rein in price discounting strategies. Such laws include banning self-service displays, requiring a license to sell tobacco, and limiting the location of tobacco retailers.

Given this background, here is an examination of two potential strategies designed to control price discounting, and an assessment of the risk that they would violate the FCLAA preemption.

**Certain laws are allowable under FCLAA, but these... do nothing to rein in price discounting strategies**

**Example 1: A local law prohibiting buydowns (special sales) is proposed:**

- *Would this law be considered a requirement or prohibition? Yes.*
- *Is the law based on smoking and health?*  
That would depend on the rationale presented for it. If the rationale is health related, then it violates the preemption clause. If a non health related rationale is presented (for example, the aim is to address unfair competition) then it probably is allowed under FCLAA.
- *Does the law regulate advertising or promotion? Maybe.*  
While the buydown itself might not be considered a promotion, its associated advertising might impede meeting this standard. But it might be possible to avoid violating the preemption clause through careful crafting of the language.

**Example 2: State law setting a minimum price for cigarettes is proposed:**

- *Requirement or prohibition? Yes.*
- *Based on smoking and health?*  
Again, this would depend on the rationale for the law. About half the states currently have minimum tobacco price laws—for competitive rather than health reasons—so this rationale might be used successfully for new laws.
- *Does the law regulate advertising or promotion?*  
Maybe. While the law is regulating the price, there are promotions that go along with price regulation. (Note that a minimum tobacco price law in New York was upheld in a legal challenge, as discussed in the next section.)

**The First Amendment**

Governments can place some limits on commercial speech under the First Amendment; proposed state or local laws should be assessed for compliance with the applicable standards. The Supreme Court identified a four-part Central Hudson test, which provides a benchmark for the validity of a law:

1. Speech must concern lawful activity and not be misleading.
2. There must be a substantial governmental interest.

- Protecting children from tobacco advertising is sufficient.
3. The regulation must directly advance the governmental interest. Does the law solve the problem?
  4. The law must be no more extensive than necessary.

## **Governments can place some limits on commercial speech under the First Amendment**

In addition to problems with preemption under FCLAA, the proposed Massachusetts advertising limits did not pass the First Amendment test (*Lorillard versus Reilly*, 2001). In this case, the Court found the Massachusetts limits on outdoor advertising failed to meet the fourth part of the test (the law was more extensive than necessary because it would have eliminated nearly 100 percent of all outdoor advertising). Additionally, the Massachusetts limits on indoor advertising (prohibiting tobacco ads from the ground up to five feet in retail outlets) did not meet the third part of the test because children could still see advertising that was above their eye level; therefore, the law did not advance the governmental interest of protecting them from exposure to ads. Additionally, although there is substantial government interest in protecting children from tobacco, tobacco is legal for adults and so retailers have some right to advertise this product to adults.

### **Other Laws to Consider**

There are many other potential legal issues, but these are probably not relevant to strategies that may control price discounting. Anti-trust laws such as the Sherman Act do not cover actions by states. Additionally, it is unlikely that laws to control price manipulation would be viewed as a regulatory taking or be found to violate the Commerce Clause of the Constitution. Legal considerations may differ, based on what level of government passes the law.

The federal government is not affected by the preemption provisions of FCLAA, but it must not violate the First Amendment. State and local governments must comply with the FCLAA and must not violate the First Amendment. Proposed laws should also be reviewed for other legal issues, such as laws governing interstate commerce.

### **2. Government Enforcement of Existing Laws**

The government can enforce federal laws such as anti-trust laws, laws against monopolies, and price discrimination laws to help rein in price discounting strategies. State laws such as those concerning unfair competition and consumer protection might also be considered.

### **3. Companies Suing Each Other**

Companies may sue their competitors for a variety of reasons. In 2003, R.J.R. sued Philip Morris (P.M.), attacking P.M.'s "Retail Leaders" program. R.J.R. claimed that it was monopolistic and resulted in unreasonable restraint on trade (for example, by limiting shelf space). During the course of the suit, P.M. loosened its retailer requirement, and the court ruled that the P.M. program did not unreasonably stifle competition. In another suit, the Conwood Company successfully claimed that the United States Tobacco Company had an illegal monopoly in the moist snuff market (2002).

# Opportunities and Loopholes

by Matt Meyers

*Matt Meyers is the President of the Campaign for Tobacco-Free Kids.*

One of lessons learned when attempting to regulate the tobacco industry is that we have brought a lot of these problems on ourselves by our lack of specificity. We tend to think too broadly, and then get called on it repeatedly by the tobacco industry.

In preparation for our discussions at this meeting, I would like to present several ideas and options that I think are worthy of consideration. These fall into five broad categories:

## **1. Change the law**

If a law is bad, we need to change it.

## **2. Use the courts**

Despite the fact that some bad decisions have been made, there are not a lot of court rulings that specifically involve promotions. The 2001 Supreme Court case of *Lorillard v. Reilly* did not really take on the issue of promotions.

## **3. Make new laws**

We have meaningful opportunities for new laws if we go about it correctly. For example, we need to legislate and litigate over the line between “promotion” and “sales and distribution.” These are big issues that will impact the retailer industry in a very big way.

## **4. Use minimum price laws**

Refine and energize minimum price law ideas based on theories unrelated to health, such as those involving unfair competition, predatory pricing, and loss of revenue.

## **5. Find other types of laws**

Certain laws not related to tobacco may be worth consideration.

## **I. Change the law**

Food and Drug Administration (FDA) authority has a chance of passing. We cannot change the preemption provision of the FCLAA directly, so the best way to address the preemption issue is with broad FDA authority over tobacco (SB 625 and HRI108). HR 1108 Section 916 says states are not preempted of any measure relating to prohibiting sale, distribution, and so on. This section is very broad—which is good—but it does not solve the problems regarding clear definitions of “distribution” and “sales promotion.” HR 1108, Section 203 has been included to return FCLAA to its original purpose, which was to bring about consistency across states. It will not try to make national advertisers change their approach state by state, but will give states control over the time, place, and manner of advertising. Under the proposed legislation, states would be able to restrict retail specific price promotions, ad placement, advertising within the store, and so on. There would no longer be a debate about measures involving “promotion” or “health,” so we could be honest about intention. It is important to understand; however, that years of litigation over terms would ensue.

If the FDA is given authority, it would have a broader mandate than the Federal Trade Commission (FTC). The FTC’s mandate covers misleading and deceptive advertising; it has no public health mandate, and thus cannot justify its actions by a desire to prevent youth initiation, or to reduce the impact on tobacco-related morbidity. The FTC has never been able to take on politically controversial actions—if it makes Congress unhappy, it risks getting its budget cut.

The pending legislation would also provide the FDA with the authority to demand information from tobacco companies in any form that would be useful. Thus, all of the information about pricing, marketing, etc. that tobacco control advocates are currently lacking could be made available through industry filings in response to FDA regulations.

## **2. Use the Courts**

We cannot make much worse case law than already exists, but we are intimidated about trying things. The good news is that there are very few cases on core issues. Lorillard had a chilling effect although it is not directly on point with issues we are discussing today. Earlier in the Summit, Leslie Zellers discussed court rulings in Washington and Iowa that categorized restrictions on promotions such as free sampling, product give-aways, couponing, and two for the price of one. At least the California Supreme Court decided that sampling was “distribution,” not “promotion,” so it concluded that this restriction can be made. It is a strong and good decision—and no coincidence that it came from California.

## **3. Make New Laws**

We need to ask ourselves, “What strategies merit taking a risk in these areas?” And CTCP needs to ask itself, “Is it politically feasible to do what the State Supreme Court seems to say we can do?” While we have lost previous cases, we need to be mindful of how we contributed to those losses. The tobacco industry sticks the nail in us by using our own words against us, taken from our well-meaning reports and documents. Even some of the materials for this Summit repeatedly used the word “promotion” in connection with distribution. This lack of clarity in terminology will likely mean that future court decisions will continue to be confused.

Court decisions to date have been mostly outcome-driven, not rationale-driven. Indeed, they are so outcome-driven that each of the decisions is internally inconsistent. For example, in the Washington State decision on the King County free-sampling ban, the court went through a tortured analysis to resolve the inconsistency regarding distribution versus promotion. In the 8th Circuit decision in Iowa, the court also struggled with the question of whether free sampling is distribution or promotion. And the Massachusetts law was written poorly.

**The best way to address the FCLAA preemption issue is with broad FDA authority over tobacco**

**We can not make much worse case law than already exists, but we are intimidated about trying things**

It is difficult to find a rationale that does not run up against FCLAA preemptions—for example, on “promotional” decisions. But while existing case law is bad, it has not closed the barn door, by any stretch of the imagination. Somebody really thoughtful could craft legislation that would focus on distribution rather than promotion, and survive a court challenge, especially in a “friendly” environment. For example, in 1992 Congress passed the Synar Amendment requiring states to prevent tobacco sales to minors, and thus set the stage for states to enact laws that reduce such illegal sales (for example, by limiting where and how cigarettes are sold). It might be possible to use the Synar requirement to ban permanent self-service displays, arguing that these are not compatible with the prevention of sales to minors. The California Supreme Court decision regarding restrictions on non-sale distribution makes a strong argument that the law upholds Congress’s intent.

#### **4. Use Minimum Price Laws**

These laws merit more thought and consideration. Over 20 states have enacted them, mostly in the 1940-50’s. And although most were originally designed to address unfair competition and related economic issues, such as loss of revenue to the state, it does not mean they cannot be employed for tobacco control purposes today. New laws cannot be based on public health, but would have to be based on economic arguments for example, that some stores are being disadvantaged, or that the state is losing revenue due to the discounts. The state would be acting to ensure maximum tax revenue.

The highest court in New York recently ruled in favor of its minimum price law which has a formula that precludes the use of buydowns and coupons to drop price below the minimum price. New York State focused on a combination of revenue-related and competition-related issues (for example, pitting the little retailer against the big chains). New York law was upheld by the appeals court, which totally ignored Federal preemption issues. New Jersey has also revisited its minimum price law.

#### **5. Find Other Types of Laws**

Other types of laws worth consideration include restricting the number of licenses in order to cut the number of retailers; a good idea, but politically challenging. Yet another would be to restrict the sale of tobacco products within certain areas (for example, around schools or near playgrounds). Advocates would need strong political support because the retailers will come out en masse against such proposals.

**The tobacco industry sticks the nail in us by using our own words against us, taken from our well-meaning reports and documents**

**Somebody really thoughtful could craft legislation that would ... survive court challenge**

**One Final Point**

We are mostly getting hung up on preemption in FCLAA. Remember that it does not apply to SLT so it is worth pursuing the regulation of SLT price discounting strategies. What we learn from the experience could then be applied to cigarettes.

# Section 3: Discussion of Policy Options for Addressing Retail Tobacco Price Manipulation

## Overview of the Process

Following the background presentations, the group was divided into two pre assigned groups to brainstorm, assess and prioritize policy and enforcement options. One group was asked to address the issue of minimum price laws, and the other to explore issues around the banning of price-related promotions. The groups were provided with criteria to assess their range of options, including:

- Description of the policy, the level of intervention, and who would implement it
- Hypothetical impact
- Feasibility, including legal issues, implementation, and financial considerations
- Unintended consequences

On the second day of the Summit, the two groups reconvened to review and evaluate the resulting policy options and discuss them in the large group. In several cases, the subgroups independently generated the same option and we have merged their comments to reflect insights from the whole group.

## Policy Options

### I. Minimum Price or “Fair Trade” Law

With this policy, the state imposes a minimum retail price for cigarettes (e.g., \$50.00 per carton; \$5.00 per pack). About half of U.S. states have a minimum price law for cigarettes, generally based on minimum mark-ups (e.g., 7 percent) when the wholesaler sells to the retailer, and another markup (e.g., 7 percent) for when the retailer sells to the consumer. California could innovate and set a minimum manufacturers list price for selling to distributors. Unfortunately, a “loophole” in most minimum price laws allows manufacturers to circumvent these laws through reduced prices or buydowns. California could avoid this pitfall by setting a minimum manufacturer’s price for selling to distributors. Some suggested separate minimum prices for Participating Manufacturers (PMs) and Non-Participating Manufacturers (NPMs), who do not pay settlement costs so can offer cigarettes more cheaply than PMs. The policy would be implemented by the BOE and should incorporate periodic adjustments to respond to inflation.

Hypothesized Impact	Feasibility			Unintended Consequences
	Legal	Implementation	Financial	
<p>This policy should increase the price and reduce consumption.</p> <p>Setting the minimum price at the manufacturer level would prevent manipulation of price geographically, by store type or season, which are strategies used to target specific demographic groups or markets.</p> <p>A minimum price policy should increase prices for some brands, which should also increase sales tax revenue.</p> <p>A minimum price policy is not a replacement strategy for increased excise taxes. However, in an anti-tax environment it may be beneficial—and combined with an excise tax could have a synergistic impact. In addition, this measure could protect the public health benefit of a tax increase.</p>	<p>Feasible.</p> <p>To avoid running afoul of FCLAA, the rationale would need to be based on unfair competition and not on health.</p> <p>If FDA regulation of tobacco passes and preemption is lifted, there will be few legal impediments.</p> <p>In the absence of FDA regulation, minimum price regulation could be implemented now for SLT (which is not covered by FCLAA).</p>	<p>Supporters are smaller retailers and health groups.</p> <p>Opponents include larger retailers, possibly tobacco manufacturers.</p> <p>Approximately half of U.S. states already have minimum price laws.</p> <p>Minimum price law may be easier to pass in California than an excise tax because it would require a simple majority vote, rather than a two thirds vote in the legislature.</p>	<p>Feasible.</p> <p>Precedent for doing this.</p> <p>Potential to increase sales tax revenue, since no one can sell the product below a specified threshold.</p> <p>Potential to decrease smuggling since all products must be sold at a minimum price.</p>	<p>Benefits the tobacco industry because it may increase their profit margins.</p> <p>Might allow manufacturers to set up “boutiques” in stores where they sell directly to consumers and bypass the minimum retail price.</p>

## 2. Ban or Constrain Buydowns and Tobacco Industry Promotions Such as Multi pack Offers (Pre- or Post-FDA)

**Pre-FDA:** The preemption clause in FCLAA means these bans and constraints are not permissible for cigarettes, so the focus would only be on other tobacco products (OTP).

**Post-FDA:** California could act as a pioneer to stimulate federal law. Alternatively, California could wait for federal action, but this would involve significant delays.

Hypothesized Impact	Feasibility			Unintended Consequences
	Legal	Implementation	Financial	
<p><b>Pre-FDA:</b> Should be effective in raising the price of OTP.</p> <p><b>Post-FDA:</b> Should be effective in raising the price of cigarettes.</p> <p>Levels the playing field among retailers since approximately two-thirds of tobacco retailers participate in these price promotions. The amount of POS advertising should decrease.</p> <p>The tobacco manufacturers' influence and control over the tobacco retail environment would diminish and the policy should weaken the relationship link between the manufacturer, distributor, and retailer.</p>	<p><b>Pre-FDA:</b> Due to conflicting legal decisions regarding the inclusion of "promotion" in FCLAA preemption, this option needs to be tested.</p> <p>However, it would be very difficult to pass because of FCLAA preemption.</p> <p>Some believe that pre-FDA is worth pursuing for OTP.</p> <p><b>Post-FDA:</b> It will probably be legal, but should be scrutinized.</p>	<p>Hard to pass because this would be opposed by retailers, manufacturers and those in other business sectors who would view this policy as a threat to price promotions on other consumer products.</p> <p>A tough sell to policy makers because few understand price reduction practices or their negative health impacts. It may be necessary to educate the public, policy makers, and opinion leaders about these practices.</p> <p>This policy has not been tested in the US, but other countries such as Canada have implemented it. Their policy language should be reviewed.</p> <p>Tying compliance to the state tobacco retail license would deter violations.</p>	<p>Potential to streamline and decrease complexity of state sales tax levied on cigarettes.</p>	<p><b>Pre-FDA:</b> Consumers may move to other sources to purchase tobacco products (e.g., OTP, Internet, casinos).</p> <p><b>Post-FDA:</b> May encourage greater use of discount brands as consumers shift to cheaper products when promotions are banned.</p>

### 3. Fairness Doctrine for Buydowns and Price Promotions

This policy would mandate a 1:1 to 3:1 placement of counter-advertising for each buydown or promotion offered by cigarette companies, and require prime locations for this counter advertising. The counter-advertisements could be drawn from a pool of approved ads (for example, from the CDC Media Resource Center).

Hypothesized Impact	Feasibility			Unintended Consequences
	Legal	Implementation	Financial	
<p>Manufacturers would probably be less likely to offer buydowns and price promotions in order to avoid the required counter advertising. This could result in a modest increase in cigarette prices.</p> <p>Counter-advertising would increase awareness and negative attitudes about tobacco use, and would promote more quitting behavior.</p>	<p>Probably feasible. There is a precedent at the federal level. Might survive FCLAA challenge. Would be easy to do post-FDA.</p>	<p>Likely vehement opposition from tobacco retailers who do not want to lose control over their store environment; also from the food industry, who would view this type of policy as a “slippery slope” threat to junk food marketing.</p> <p>Only requires majority vote in the legislature.</p> <p>Could be framed as a youth smoking prevention measure to boost political acceptability.</p> <p>Somewhat challenging to enforce.</p>	<p>Feasible.</p>	<p>Buydown funds might be diverted to other marketing and promotional categories (e.g., direct mail coupons).</p> <p>May encourage more discount cigarette sales.</p>

**4. Performance-Based Regulation. (Look-backs for Smoking Reduction as Proposed in the FDA Regulations)**

Performance-based regulation (“look-back” provisions) would give manufacturers declining prevalence targets for both adult and youth tobacco use, with severe consequences for failure. The rationale is that the actions of the tobacco manufacturers have led to increased tobacco use, and this has caused increased financial and social costs for the government that need to be recaptured. Example: Reduce youth smoking by 25 percent in two years. If tobacco manufacturers miss the targets, the state assesses a large fine and earmarks the revenue for tobacco use prevention and control. The structure of fines would need to factor in:

- A final floor (e.g., a youth smoking prevalence of five percent) in recognition that tobacco industry practices are not the only issue influencing youth
- Youth market share

Hypothesized Impact	Feasibility			Unintended Consequences
	Legal	Implementation	Financial	
<p>If big fines were levied for failure to meet targets for reduced youth smoking rates, this would likely lead to big price increases. Cigarette companies could receive some benefit if they meet the target.</p> <p>Strategy has potential to increase price, which contributes to the goals of prevalence reduction, and health improvement. The measure should thus reduce health care costs, and create a demand for cessation services.</p>	<p>Likely to be feasible although “takings” arguments are likely.</p>	<p>Cigarette companies will say much of youth smoking is out of their control, and argue the proposal is not fair, reasonable, or possible. Smoking prevalence measurements at the brand level would need to be improved before fines were levied.</p> <p>This approach is similar to a provision sponsored by Senator McCain (Senate Bill 1415, the National Tobacco Policy and Youth Smoking Reduction Act). Public will like the youth focus. Somewhat difficult to implement. Would have to be sold to public and policy makers based on the social costs of smoking.</p>	<p>Need good survey data regarding youth smoking and market share. Need to speed up development and release of data. Formula needs to be designed to look reasonable, fair, relatively conservative, and easy to understand.</p>	<p>Could increase use of OTPs instead of cigarettes. To mitigate this, smoking could be defined broadly to include “cigar” and cigar brands. Perhaps focus could be on all youth tobacco use?</p> <p>Measure might drive people into harmful (or black market) products not covered.</p> <p>It would be important to ensure that reductions did not occur disproportionately among specific racial/ethnic or socio-economic groups.</p>

### 5. Minimum Transaction Tax

This policy would increase the minimum amount of tobacco products purchased. For instance, pack sales could be banned and only carton sales allowed.

Another alternative would be to permit individual pack sales, but each pack would carry the same minimum tax as cartons. Given the tax amount, it would likely deter single pack sales. This policy can be implemented at the state or federal level.

Hypothesized Impact	Feasibility			Unintended Consequences
	Legal	Implementation	Financial	
<p>Psychologically, many smokers do not perceive themselves as smokers and do not want to buy cartons because it would be an admission of their addiction. As a result, many of these smokers would quit.</p> <p>The impact is uncertain. The cost of each purchase will go up, although the unit price would be lower for people switching from pack to carton purchasing.</p> <p>Affects the retailers' ability to display and store product.</p> <p>Would reduce the number of brands available and disrupt marketing.</p>	Feasible.	Will be difficult to get sponsors for this legislation as it will not be very popular. It might require two thirds majority vote in the California Legislature.	<p>Minimal cost to state.</p> <p>Increased cost to tobacco manufacturers since the tax would be applied at the manufacturer level vs. the wholesaler distributor level.</p> <p>Increased evaluation costs to track consumption.</p>	<p>Might encourage smokers to shift to the Internet, or join group-purchasing rings on an organizational basis.</p> <p>Consumption among users could increase (although might reduce number of users).</p> <p>People may buy in big quantities and resell on the black market in smaller quantities.</p> <p>May reduce litter; would disadvantage smaller "mom and pop" stores, which typically sell by the pack.</p>

## 6. State Control of Distribution

Much as some states have control over retail sales of alcohol, tobacco would be available only through state-run outlets.

Hypothesized Impact	Feasibility			Unintended Consequences
	Legal	Implementation	Financial	
Presumably, prices would rise because government is less efficient than the private sector.	Feasible.	Complex; would require a large state infrastructure. Would be difficult to get passage.	Significant.	State has dual obligation to protect population health, but is also selling a deadly and addictive product.

## 7. Sunshine or Disclosure Law

The state would require that all manufactures publicly disclose payments to retailers (e.g., incentives, buydowns, and promotions.) This would be similar to political campaign donation regulations.

Hypothesized Impact	Feasibility			Unintended Consequences
	Legal	Implementation	Financial	
This may discourage payments if they are viewed by the public as stigmatizing. If there are fewer payments, prices would increase.	Feasible.	Relatively easy to implement.  Probably worth trying because it is not too complicated. Unlikely that chain stores would welcome the measure since they get the best deals.  Might be more appealing to independents.	Modest impact. Would facilitate efficiencies in state government if it promoted a uniform data collection system that could be used to ensure that appropriate sales taxes are collected. (Currently, only 10 percent of tobacco retailers have their tobacco product invoices audited by the State BOE.)	None.

## 8. Collaboration with National Retailers

The state would work with large chains and discourage them voluntarily from participating in buydowns/promotions.

Hypothesized Impact	Feasibility			Unintended Consequences
	Legal	Implementation	Financial	
Effectiveness would depend on how many national chains of retailers participate.	Feasible.	<p>Relatively easy to implement.</p> <p>Probably worth trying because it is not too complicated.</p> <p>The Attorney General's Office has entered into other agreements with chains as a precedent.</p>	Modest.	None.

**9. Implement Price-Increasing Strategies for SLT Products So They Do Not Seem Significantly “Cheaper” Than Cigarettes.**

This would require a tax stamp on OTP to make sure those tax rates match cigarette tax rates, with a parallel Minimum Price Law for SLT.

A new Non-Participating Manufacturers (NPM) law for SLT companies would require that any companies that have not signed onto SLT Master Settlement Agreement (MSA) would have to pay into state escrow accounts. (UST is the only current signer.)

Adding an OTP tax stamp could be framed as an anti-smuggling measure.

Hypothesized Impact	Feasibility			Unintended Consequences
	Legal	Implementation	Financial	
Modest impact but worth pursuing. This should keep users from shifting to cheaper OTPs when cigarette tax increases (although some would argue that is a desirable switch.)	Feasible.	<p>If presented as an anti smuggling measure, hard to oppose publicly.</p> <p><b>Supporters:</b> Those wanting new revenue. UST might support minimum tax on smokeless for NPM.</p> <p><b>Opponents:</b> Smugglers, cigar companies, most SLT companies, distributors that have to apply stamps (but could give them discount to cover costs.)</p>	<p>Significant; state could receive much larger new revenues. Tax stamp companies might help finance implementation if they were compensated by a small portion of the increased revenues, especially if they could expect other states to require OTP stamps, following California’s lead.</p>	None.

# Section 4: Conclusion and Reflections on the Meeting

## Thoughts on Mega-Trends

by David Altman

*David Altman is the Senior Vice President of Research and Innovation at the Center for Creative Leadership.*

Let us start with the ancient fable about the frog and the scorpion. The scorpion asks the frog to carry him across a river. Given the scorpion's reputation, the frog is naturally reluctant, but the scorpion promises not to sting him, and after some hesitation the frog agrees. When they are half-way across the river, however, the scorpion stings the frog, who laments as he expires, "Why did you do that? Now we will both die!" "I could not help it," replies the scorpion. "It is my nature."

In tobacco control, we have many opportunities to work with scorpions of all kinds. And as much as we would like to refuse their requests to carry them across the river, we know that to make progress, we sometimes have to take a chance that we will not get stung, or that if we are stung, it will not kill us. In the past two days, a number of people here have spoken about what is politically doable. But in considering what is politically doable, it is important that we remember what disaster can strike even when a scorpion promises co-operation. As the one in the fable said, "It is my nature."

So if you are going to be interacting with scorpions, you had better conduct sophisticated analyses that give you a very good sense both of the expected consequences and of potential unintended consequences. As one participant noted, we are in uncharted territory with respect to having empirical data that can guide us to potential solutions. Moreover, what we have come up with are concepts rather than well-thought-out policy solutions.

I was struck yesterday by the number of comments about the unintended consequences that bedeviled previous tobacco control policies. By definition, unintended consequences can not all be known in advance, and there is considerable unpredictability in the work that we do. Yet I think we could do a much better job in scenario planning to ensure that the negative impact of unintended consequences is reduced. One problem is that we know a lot less about the topics of retail pricing strategy and industry manipulation than about other policy issues we have pursued. Thus, while I came away from our sessions energized by the creative thinking, I cannot help being a bit nervous about what will happen during execution.

**We are in uncharted territory with respect to having empirical data**

We have a great starting point: There seems to be complete consensus that price matters a great deal. No one here has argued against raising the price of tobacco. Few issues in tobacco control generate as much consensus as this.

But let me share a few thoughts about my nervousness.

### **Learning From the Industry**

First, when you talk to the folks who were tasked with recruiting participants to this Summit, they will tell you how difficult it was to bring in people from outside the field of tobacco control. The list of participants here is impressive and represents some of the best researchers, policy wonks, and thinkers within the tobacco control field. The work we produced in a day and a half attests to their quality, and I think the CTCP staff should be quite pleased. Yet because of the general homogeneity of the group here, we undoubtedly missed some key issues.

We should not overlook the fact that nearly a dozen “pro-industry” people were approached. Some initially agreed to come, but only one actually participated. Why was there so much difficulty recruiting speakers from “the industry” or related industries? I suspect that business school professors were concerned that their consulting opportunities might be jeopardized. Private sector experts may have been worried about the reaction of tobacco industry representatives, and the possible impact on their business. While I do not know all of the details for the turn-downs, I think it is reasonable to conclude they indicate that we are onto a topic that matters. That is the good news. The bad news is that without more industry participation, we do not have a good enough understanding of the intricacies of the retail market, the value chain, the underlying business drivers, and the like.

With Perry Cutshall’s permission, let me shine a light on him for a moment.

There was keen interest in his talk, which contained much new information. If Perry had given that same talk to brand marketers, I suspect their reaction would be, “Ho-hum...it is just Brand Marketing 101.” But our level of engagement and interest in his thoughts were palpable, and more references were made to him in our discussions than to any other speaker. Is that because the others did not do a good job? No, the quality of the presentations was excellent. But we were fascinated because he brought us a different perspective to the topic at hand, and gave us an invaluable insight into the question of how the brand marketer thinks.

Take the matter of product differentiation, for example. As Perry told us, marketing is built on differentiation. That is why you have so many product varieties. As he said, “If I can differentiate, I can sell.” And that could suggest some useful strategies for us. But what type of differentiation do we want to block or allow? I am not sure we have a consensus on this, or a strategic or tactical approach going forward.

**Without more industry participation, we do not have a good enough understanding of the intricacies of the retail market**

Making another key point, Perry said that the fewer variables you give marketers to deal with, the less successful they will be. I think some of the solutions we came up with today achieved just this: reducing the number of variables.

Then there was the question of price. As Perry explained, revenue is not driven only (or even primarily), by price, we also need to consider such factors as volume, product/package/channel, market share, competition, innovation, brand value enhancement, cost containment, in-market execution, and so on. We should pay attention to the value chain, in which products gain value as they pass through—in the case of Coca Cola from the parent company to bottlers and retailers. Any disruption of the value chain will affect how the product gets to the market. But these are not factors that we typically talk about.

**The fewer variables you give marketers to deal with, the less successful they will be**

### **Our Vantage Point**

My second area of concern involves our vantage point. During the presentations and subsequent discussion, the metaphor that kept coming into my head was that we were tasked with steering a car from point A to point B by looking in the rear view mirror. For example, the presentations yesterday gave us a good snapshot of public health perspectives on various issues related to price. Yet much of the data was backward looking in that it reflected what happened in the past—in some cases, quite a number of years ago. As one participant observed, our surveillance systems are inadequate to the tasks at hand, and others stressed the need for better data. Compared to the retail environment, we are certainly handicapped. For example, if you look at what makes Wal-Mart successful, one major factor is the information technology that underlies their supply chain. If we establish Wal-Mart as the gold standard, our data systems are very far behind.

We have a hard time being able to understand what is happening in the retail environment right now, in real time, let alone anticipating what the future holds. And the retail environment in which we are trying to work is highly dynamic, with new marketing campaigns each month, and a steady flow of new product innovations. The challenge is keeping up. Manufacturers and retailers are more time urgent than most of us. They wake up every day to examine their new numbers, and make changes in tactics and strategies. Who in tobacco control does this, day in and day out?

Our definition of speed, and the way speed is defined by private sector tobacco interests, are very different.

**Our definition of speed, and the way speed is defined by private sector tobacco interests, are very different.**

We do not have a concrete sense of what the manufacturers (or retailers) will do under various policy options. For example, if promotions were dropped, how would the companies respond? And would their response create other problems for us? I am not sure that we have well-thought-out responses to this. Indeed, we have so little

knowledge of the fine details that are involved in these issues that it is hard to envision coming up with strategies that address the consequences of various policy strategies. We need to do more scenario planning.

According to Steve Schroeder, the former President of the Robert Wood Johnson Foundation, execution trumps strategy. I do not agree that this is always the case, and I do believe that we have come up with some good strategies in the past two days. But it is true that to be successful in the complex environments in which we work, execution will be really key.

### **Finding Solutions**

A third area of concern involves our desire to find solutions that fix the problem. On the one hand, as we have heard from several presenters, the approaches we pursue must be comprehensive. Yet the process we used involved looking at a number of specific strategies separately—not in any integrated or comprehensive way. So I think we still have some work to do if we are to achieve synergies. We also need to keep in mind the distinction between technical versus adaptive challenges/solutions (first order/second order change).

Throughout this meeting, people have noted that language is key. Time and again, we have gotten hung up on words such as “promotion.” Despite our good intentions, we get ourselves in trouble with our words, and in new areas, like the ones we are discussing today, I do not think we are as deeply knowledgeable as we need to be if we are to reduce the likelihood of negative unintended consequences.

As I was reflecting on the presentations made yesterday, our discussion (especially around unintended consequences) reminded me that concepts in systems theory were very much in play. A few people mentioned the metaphor of the balloon: when you depress it in one area, it expands in another. Concepts such as deviation amplification and counteraction, reverberation, ripple effects, adaptive capacity, and so on are all important in this discussion. We should all re-read the March 2006 special issue of the American Journal of Public Health on the topic of systems thinking. It will remind us:

**Despite  
our good  
intentions, we  
get ourselves  
in trouble with  
our words**

- “System” means a configuration of parts connected and joined together by a web of relationships.
- An open system is a state of a system in which the system continuously interacts with its environment. Actions create reactions.
- Adaptive capacity is an important part of the resilience of systems in the face of a perturbation, helping to minimize loss of function.
- Deviation-counteracting and deviation-amplifying mutual causal systems are ways in which the elements within a system influence each other either simultaneously or alternately. The difference between the two types of systems is that the deviation counteracting system has mutual negative feedbacks between the elements in it, while the deviation amplifying system has mutual positive feedbacks between elements.

## Final Thoughts

The last time I presented at a CTCP meeting, we talked about innovation and the way that it is often achieved by spending time in the periphery of your areas of knowledge. As Andrew Hargadon noted, it is not really about thinking outside the box. Rather, it is thinking in different boxes and bringing that thinking back to your box.

California is a vanguard state in tobacco control, and in many other areas. What is done here often affects the rest of the country and, at times, the rest of the world. Thus, while our focus at this meeting was on California, I want to end my comments by asking you to think beyond the immediate task at hand and to consider the leadership role the state might play in advancing this very important goal: achieving tobacco control through initiatives that increase the retail price of tobacco.

**It is not really about thinking outside the box. Rather, it is thinking in different boxes and bringing that thinking back to your box.**

## Where Do We Go From Here? The Next Steps for California

by Greg Oliva

*Greg Oliva is Chief of Strategic Planning and Policy at the California Department of Public Health, California Tobacco Control Program.*

Thanks for being here. Rarely do we take the time away from our day-to-day activities to allow ourselves to be strategic and think big picture. We did that in this meeting thanks to the contributions all of you made through your participation.

I, too, am nervous about tackling this issue. The words that come to mind are, “Difficult,” “Sticky,” “Problem,” “Cost,” “Squishy.” These are the negative words we heard applied to what we will try to accomplish over the next couple of years.

But I am also excited because other words also come to mind: “Worthwhile.” “Legitimate.” “Important.” There is no question that what we talked about in this meeting is critical to the goals of the tobacco control movement, both here and in the rest of the nation.

Now to the mechanics of where we need to go from here. Here is a to-do list:

- I. We will create a workgroup comprised of a broad range of people, in order to avoid insularity. This workgroup will hash over and discuss the content of this meeting in order to identify long and short term strategies that can be pursued in California.

**What we talked about in this meeting is critical to the goals of the tobacco control movement, both here and in the rest of the nation**

2. We will need to develop research and surveillance strategies that more systematically track what the industry is doing regarding pricing. We currently have tools available to address evaluation and needs assessments at the local level and we may be able to build the regular collection of information at the local level into Communities of Excellence, a planning system used by local health departments to determine priorities for tobacco control action. But we also need to identify new tools to help us capture the information we will need if we are to learn more about the issues we discussed here.
3. We will need new research, which means we should educate our own funding organizations—including CTCP and the California Tobacco Related Disease Research Program (TRDRP)—as to the pertinence and validity of this type of research. And we need to develop model policies.
4. Our focus for interventions has been at the federal and state levels. But how can we work on local strategies? The California program is built on local actions, so we need to explore those, perhaps starting with disclosure. State legislative proposals also present an opportunity, one for which we will need to depend on our partners, the voluntaries such as the American Lung Association and the American Cancer Society. They have more flexibility and freedom to push the legislation.
5. We need to educate our own administrators in the CDPH on the importance of the issue, which is somewhat esoteric and not typically considered to be within the realm of “public health.” With funding shifting to other priorities, we need to protect tobacco control resources so we can work on issues of importance, such as pricing.
6. Since there is very little awareness about tobacco company price discounting strategies, we will need to engage in public relations and marketing to raise awareness about it among policy makers and consumers. We will also need to go through the Midwest Academy Strategy Chart process to identify allies and opponents so we can be comprehensive and avoid being broadsided.
7. We will need to figure out how to evaluate our efforts and outcomes while also moving forward with policy options. Our aim should be more than just trying to increase the price of tobacco products. With the potential to impact broader public health outcomes, we need to articulate what we really want to accomplish.
8. Attention to unintended consequences is also paramount. They should not paralyze our efforts to move forward, but we need to take them into account in order to minimize the risk.

**We will need to engage in public relations and marketing to raise awareness... among policy makers and consumers**

In all of this work, we cannot compromise social norm strategy, nor community mobilization. These have been near and dear to CTCP since its inception—indeed, they are the magic of the program. We need to build onto those strategies and not take away from them.

# Elsewhere—Campaign for Tobacco-Free Kids

by Matt Myers

*Matt Meyers is the President of the Campaign for Tobacco-Free Kids.*

I would like to thank the California folks for arranging this meeting. Tobacco pricing is an incredibly important topic, and there has been much too little focus on it until now. We have had a great exchange of information; it was an important meeting.

We know how to reduce tobacco use to low levels, and should not lose sight of those priorities. But the question of pricing can undermine those efforts, and we need to pursue it with maximum effort, relying on the tools that we know will work.

The recommendations on policy initiatives were really useful—but the small group discussions were even better, because we challenged each other and came up with valuable nuances in the course of the discussions. We also have a good set of recommendations developed over a day and a half, but these are only a starting point. We also need to look at background information, not just the priorities.

We need to be mindful of our insularity and do reality testing with really bright people outside of tobacco control, and it was great to have some of them here. What may seem perfectly logical to those of us who live and breathe tobacco may sound bizarre to those who do not. So we need to flesh out the concepts we have discussed here, and then obtain a variety of perspectives from people outside the tobacco control field.

People outside of tobacco control do not have a clue about the impact of pricing mechanisms on public health. We need a decent, strong and sustained educational effort to inform them about the role of price manipulation. Otherwise, we fly in the face of some basic tenets: that you do not regulate competitive strategies used by business people, you can not interfere with pricing, and you do not tell people that they can not compete. We need to make pricing—and the need to affect it—part of the public health debate. We need to make the case with media, editorial boards and others, showing them how the tobacco industry has systematically and evilly used strategies to undermine tobacco control. If we do not do that, we can not make a difference.

If nothing happens after this meeting, we will have failed. We all have to take responsibility for moving forward. We need to make connections with people to chart the course on these issues, to discuss options and strategies, figure out the next steps, and identify where there may be a opportunities to test them out. Otherwise, this meeting will have been only an interesting exercise, accomplishing nothing.

**What may seem perfectly logical to those of us who live and breathe tobacco may sound bizarre to those who do not**

I like Steve Shroeder's comment that execution trumps strategy; but it cannot be mindless execution, otherwise we will wind up with bad laws. We have to do this right because these ideas have the potential to boomerang on us if we do not, and we will get nailed. We will need to be very strategic in order to get good laws passed. For example, as we move into new areas, we may give priority to something that may not have maximum impact, but may be able to move the issue forward by establishing the role of government in this issue.

We will know soon whether the FDA is granted authority to regulate tobacco. The current bill has strong support, but we do not know if it will pass. Whether it passes or fails, we need to have a conversation about the best alternatives to pursue this fall; we will need concrete assessments as to tactics and strategies if we are to go into state legislatures next year. We at the Campaign for Tobacco-Free Kids are committed to reaching out to this meeting's participants to find out who would like to follow up and brainstorm about these issues. We will start a list serve for this purpose and put together the necessary background materials to move these concepts forward.

I thoroughly enjoyed this meeting and applaud everyone for making it so stimulating and thought provoking.

**If nothing happens after this meeting, we will have failed. We all have to take responsibility for moving forward**

# Closing

by April Roeseler

*April Roeseler is Chief of Local Programs and Information Services of the California Department of Public Health, CTCP. She reviewed the purpose of the Summit, which was convened by the CTCP in order to craft California's strategy in response to the tobacco industry's retail price manipulation practices.*

One of my favorite books is “Good to Great” by Jim Collins. The first page starts with “Good is not enough.” That is an ideal we strive for in the CTCP. We want to be a great program and have great results, and one of the things that differentiates “great” from merely “good” is the willingness to embrace big, audacious goals. This group has really done that by giving us challenging ideas to think about and approach.

Since the Lorillard v. Reilly decision, I have been pretty depressed about our inability to do anything to control the retail environment. But I am walking away from this meeting surprised and inspired by the breadth of ideas that emerged. I am confident that there is a comprehensive retail strategy in this bag of manure and that we WILL find the pony!

Darwin's rule is that it is not always the biggest or smartest creatures that survive, but the ones that are most adaptable to change. That is a strength of CTCP. We embrace this important concept: that we do not just want to react, but to control the environment in which we work. This will continue to be an important concept as we move forward.

I want to thank everyone for taking the time to come to this meeting. I appreciate that the Attorney General's Office and the BOE were here. It is a great opportunity to figure out how to work together, collaborate on mutual goals, and further each other's missions. I want to acknowledge the planning group. They worked hard to figure out how to make this meeting work so that we would have good information and ideas about how to move forward with this issue. And a special thanks to Dave Altman, who helped to make sense of the meeting and to remind us of some important caveats. Sometimes when we are too close to a topic, we miss things that need to be checked out, and he provided a more global view and reminded us of some of the potential pitfalls.

**We do not just  
want to react,  
but to control the  
environment in  
which we work**

I am looking forward to identifying a comprehensive approach to the retail environment here in California and the rest of the country. Thank you.

# Appendix I: Agenda

May 29-30, 2008

## Day I

**Moderator:** *Mary Strode, M.S., STAKE Act Coordinator, California Tobacco Control Program, California Department of Public Health*

- 8:30 Welcome and purpose-April Roeseler, M.S.P.H., Acting Chief, California Tobacco Control Program, California Department of Public Health
- 8:45 Why is tobacco price manipulation a problem?—Frank Chaloupka, Professor, Economics, University of Illinois, Chicago
- 9:15 What do we know about how prices are set?  
How the beverage industry uses promotional incentives: implications for tobacco Perry Cutshall, Cutch Group, Inc.  
California licensing of tobacco distributors, wholesalers and retailers Lynn Bartolo, Chief, Excise Taxes Division, California Board of Equalization  
Cigarette sales in stores: sales, marketing and pricing strategies—Ellen Feighery, Research Scientist, Public Health Institute  
Taxation of Rebates and Allowances—Lynda Cardwell, Program Policy Specialist, Business Taxes Committee Team, California Board of Equalization  
Group discussion facilitated by Todd Rogers, Research Program Director, Public Health Institute
- 10:45 Break
- 11:00 What are the legal issues related to retail tobacco price manipulation?  
Constraints and barriers—Leslie Zellers, Legal Director, Technical Assistance Legal Center, Public Health Institute  
Opportunities and loopholes—Matt Myers, President, Campaign for Tobacco-Free Kids  
Group discussion facilitated by Greg Oliva, Chief, Strategic Planning and Policy, Tobacco Control Program, California Department of Public Health
- 12:30 Lunch
- 1:30 Potential points of intervention as products move from manufacturer to stores  
Kurt Ribisl, Associate Professor, Department of Health Behavior and Health Education, University of North Carolina School of Public Health
- 2:00 Directions for small group sessions—Todd Rogers

- 2:15 Small group brainstorming  
Facilitators: Todd Rogers and April Roeseler
- 3:15 Break
- 3:30 Small group priority setting
- 4:30 Large group reconvenes to review next day's agenda
- 4:45 Adjourn
- Dinner on your own (options to be provided)

## **Day 2**

**Moderator:** *Mary Strobe, M.S., STAKE Act Coordinator, California Tobacco Control Program, California Department of Public Health*

- 7:30 Continental breakfast
- 8:30 Small groups reconvene to finalize presentations of priorities to large group
- 9:30 Large group identifies priorities for action  
Facilitators: April Roeseler and Todd Rogers
- 12:00 Lunch  
Reflections on the meeting—David Altman, Senior Vice President, Research and Innovation, Center for Creative Leadership
- 1:00 Where do we go from here?  
In California: Greg Oliva  
Elsewhere: Matt Myers
- 1:30 Adjourn—April Roeseler

# Appendix 2: List of Participants

**David Altman**, Senior Vice President, Research and Innovation, Center for Creative Leadership

**Lynn Bartolo**, Chief, Excise Taxes Division, California Board of Equalization

**Bhumi Bhutani**, Program Consultant, California Tobacco Control Program, California Department of Public Health

**Doug Blanke**, Director, Tobacco Law Center, and Executive Director of the Tobacco Control Legal Consortium, William Mitchell College of Law

**Lynda Cardwell**, Program Policy Specialist, Business Taxes Committee Team, California Board of Equalization

**Frank Chaloupka**, Professor of Economics, University of Illinois Chicago

**Joanna Cohen**, Director of Research and Training, Ontario Tobacco Research Unit, Assistant Professor, Department of Public Health Sciences, University of Toronto

**David Cowling**, Ph.D., Chief, Evaluation Unit, California Tobacco Control Program, California Department of Public Health

**Mike Cummings**, Chair, Department of Health Behavior, Roswell Park Cancer Institute

**Perry Cutshall**, President, Cutch Group

**Matthew Farrelly**, Senior Director of the Public Health Policy Research Program, Public Health and Environment Division, RTI International

**Ellen Feighery**, Research Scientist, Public Health Institute

**Tonia Hagaman**, Chief, Local Programs and Advocacy Campaigns Unit, California Tobacco Control Program, California Department of Public Health

**Andrew Hyland**, Research Scientist, Department of Health Behavior, Division of Cancer Prevention and Population Sciences, Roswell Park Cancer Institute

**Paul Knepprath**, Vice President of Government Relations, American Lung Association of California

**Ilana Knopf**, Attorney, National Association of Attorneys General

**Matthew LeVeque**, Senior Vice President, The Rogers Group

**Alan Lieberman**, Deputy Attorney General, Department of Justice, State of California

**Eric Lindblom**, Director, Policy Research and General Counsel, Campaign for Tobacco Free Kids

**Ian McLaughlin**, Staff Attorney, Tobacco Assistance Legal Center, Public Health Institute

**Ed Mierzwinski**, Director, Federal Consumer Program U.S. PIRG

**Matt Meyers**, President, Campaign for Tobacco-Free Kids

**Jack Nicholl**, Campaign Consultant, California Center for Tobacco Policy and Organizing

**Greg Oliva**, Chief, Strategic Planning and Policy, California Tobacco Control Program,  
California Department of Public Health

**Michael Ong**, Assistant Professor in Residence, Division of General Internal Medicine and Health  
Services, Department of Medicine, University of California, Los Angeles

**Sarah B. Perl**, Assistant Commissioner, Bureau of Tobacco Control, NYC Department of Health  
and Mental Hygiene

**John Pierce**, Professor, Cancer Center/Family & Preventive Medicine, Cancer Prevention and  
Control Program, University of California, San Diego

**Kurt Ribisl**, Associate Professor, Department of Health Behavior and Health Education,  
University of North Carolina School of Public Health

**April Roeseler**, M.S.P.H., Acting Chief, California Tobacco Control Program, California  
Department of Public Health

**Todd Rogers**, Research Program Director, Public Health Institute

**Mary Strode**, M.S., STAKE Act Coordinator, California Tobacco Control Program, California  
Department of Public Health

**Steve Sugarman**, Professor of Law, Boalt Hall School of Law, University of California, Berkeley

**Mitch Zeller**, Vice President for Policy and Strategic Communications, Pinney and Associates

**Leslie Zellers**, Legal Director, Tobacco Assistance Legal Center, Public Health Institute

**Barbara Lowell**, Conference Coordinator, California State University, Sacramento, CCE  
Conference and Training Services

# Appendix 3: Bibliography

Sixteen articles were identified through careful consideration as being highly relevant, and full-text copies of 10 of them (those with no asterisk) were sent to participants in preparation for the Summit. Abstracts of all 16 follow.

## Section One: Rationale for Concern

**\*Pierce, J., T. Gilmer, L. Lee., E. Gilpin, J. de Beyer, and Messer, K. 2005. Tobacco industry price-subsidizing promotions may overcome the downward pressure of higher prices on initiation of regular smoking. *Health Economics*, 14 (1061-1071), 1061-1071.**

This article examines the relationship among tobacco product price incentives, taxation, price increases, and adolescent and young adult smoking initiation. Data from the Current Population Survey Tobacco Use Supplement surveys (n=336,343) were examined to determine trends in regular smoking initiation among 14 to 17 year-old adolescents and 18-21 year-old young adults from the early 1960s to mid 1990s. In addition, consumer price-index-adjusted cigarette price and tobacco industry expenditures for price subsidizing promotions were also analyzed. The price and price-subsidizing tobacco industry expenditures were compared to trends in initiation in these two age groups. The results of this economic trend analysis found that tobacco industry price subsidizing promotions provided the tobacco industry with an effective way to segment the market. These promotions effectively lowered prices to population subgroups that are more price sensitive (e.g., young smokers not yet addicted), which countered the effect of general price increases, including taxes, on smoking. Young adults showed higher initiation rates than adolescents until the late 1970s. From the mid 1970s through mid 1980s, initiation rates were similar, but from the 1985 onward the 14 to 17 year-old adolescents showed higher initiation rates. Considering that real cigarette prices in the U.S. increased from the early 1980s to early 1990s, adolescent initiation of regular smoking should have declined during this period. The authors conclude that the relationship of cigarette price to smoking behavior is more complex than previously described. Price subsidizing promotional activities appear to overcome the effect of higher prices in discouraging adolescents from becoming regular smokers. The tobacco industry may need to continue to increase prices to pay for these subsidizing activities.

**Slater S., F. Chaloupka, M. Wakefield, L. Johnston, and P. O'Malley. The Impact of retail cigarette marketing practices on youth smoking uptake. *Archives of Pediatrics and Adolescent Medicine* 2007;161:440-445.** This study examined the differential associations of cigarette retail marketing practices (POS advertising, promotions, prices, and placement) on youth smoking uptake. Data were from analyses of the February 1999 through June 2003 annual, nationally representative, cross-sectional Monitoring the Future surveys of 8th, 10th, and 12th graders in the U.S. These surveys involved 109,308 students and data on retail cigarette marketing collected from 966 communities in which the students resided. A total of 26,301 students were selected for this study. The results showed that higher levels of advertising, lower cigarette prices, and greater availability of cigarette promotions were associated with smoking uptake. POS advertising was associated with encouraging youth to try smoking, whereas cigarette promotions were associated with influencing those youth already experimenting with cigarettes to progress to regular smoking, with established smokers being the most influenced by promotional offers. Price increased the likelihood of smoking at most levels of uptake. These results are significant because no previous study examined the differential impact of cigarette marketing on smoking uptake. These findings provide evidence that restricting POS advertising will discourage youth from trying smoking, and policies that increase cigarette prices and/or restrict price-based promotions will have a long-term positive impact by preventing youth from moving farther along the smoking uptake continuum toward regular smoking. The authors predict that removing POS tobacco ads in a community with moderate levels of ads would cut experimentation with cigarettes by 11.25 percent, whereas increasing ads to maximum levels would increase experimentation by 11 percent.

**Chaloupka F.J., K.M. Cummings, C.P. Morley, and J.K. Horan. Tax, price and cigarette smoking: evidence from the tobacco documents and implications for tobacco company marketing strategies. *Tobacco Control* 2002;11 Suppl 1:162-72.**

**Objective:** To examine tobacco company documents to determine what the companies knew about the impact of cigarette prices on smoking among youth, young adults, and adults, and to evaluate how this understanding affected their pricing and price related marketing strategies. **Methods:** Data for this study comes from tobacco industry documents contained in the Youth and Marketing database created by the Roswell Park Cancer Institute and available through <http://roswell.tobaccodocuments.org>, supplemented with documents obtained from <http://www.tobac-codocuments.org>. **Results:** Tobacco company documents provide clear evidence on the impact of cigarette prices on cigarette smoking, describing how tax related and other price increases lead to significant reductions in smoking, particularly among young persons. This information was very important in developing the industrys pricing strategies, including the development of lower price branded generics and the pass through of cigarette excise tax increases, and in developing a variety of price related marketing efforts, including multi-pack discounts, couponing, and others. **Conclusions:** Pricing and price related promotions are among the most important marketing tools employed by tobacco companies. Future tobacco control efforts that aim to raise prices and limit price related marketing efforts are likely to be important in achieving reductions in tobacco use and the public health toll caused by tobacco.

## Section Two: Background on Tobacco Industry

**Levine S. Pushing smoke: how the U.S. tobacco industry moves its product from leaf to lip: California Dept. of Health Services, Tobacco Control Program. 2001.**

This report provides an overview of the steps and activities involved in the growing, manufacturing, distribution and sales processes for the domestic U.S. tobacco industry. Chapters cover: tobacco industry overview; tobacco as an agricultural commodity (farming, tobacco price supports and quotas, leaf auctions, direct business relations with farmers); tobacco dealer industry; tobacco leaf processing; cigarette manufacturing process; manufacturer storage and distribution; federal and state excise taxes including state tax stamps; cigarette distributors and wholesalers; case study of Core-Mark Industries (distributor); retail practices (slotting, signage, incentive programs, sales representatives); retail outlets including Internet sales, discount cigarette stores and military sales; smuggling and the black market; and “gray market” sales (cigarette manufacturing in the US for sales abroad). Includes numerous charts, statistical tables, and references.

**\*Pierce J.P., and E. Gilpin. How did the Master Settlement Agreement change tobacco industry expenditures for cigarette advertising and promotions? *Health Promotion Practice* 2004;5(3):84S-90S.** The 1998 multi-state MSA with the tobacco industry restricted cigarette advertising and promotions. The MSA monetary settlement was also associated with an average cigarette price increase of U.S. \$1.19/pack between 1998 and 2001 to fund, in part, industry payments to the states. This study examined Federal Trade Commission (FTC) reports on how the tobacco industry spends its cigarette advertising and promotional dollars to see if changes expected as a result of the MSA occurred. Expected changes included reduced total expenditures and reductions for outdoor advertising, specialty promotional items identified with a brand (e.g., caps, t-shirts, lighters), and public entertainment. However, tobacco industry spending for advertising and promotions increased 96 percent between 1995 and 2001, with large increases in 1998 and 1999, as the MSA took effect. Between 1997 and 2001, outdoor advertising declined 98 percent, expenditures for specialty promotional items decreased 41 percent, although public entertainment increased 45 percent. However, in 2001, these categories represented only a small fraction of the total budget. Expenditures for retail value added increased 344 percent between 1997 and 2001 (to 42.5 percent of total), perhaps to mitigate increased cigarette prices. In 2001, the incentives-to-merchants and retail value added categories comprised more than 80 percent of total expenditures. To adequately monitor tobacco industry expenditures as they adapt to the MSA and other tobacco control efforts, more refined reporting categories are essential.

### **Retail Leaders Contract**

<http://legacy.library.ucsf.edu/action/search/basic?fd=0&q=3002957891&df=pgmap&c=at&c=bw&c=ct&c=da&c=ll&c=lm&c=mg&c=mm&c=pm&c=rj&c=ti&c=ub> (**Accessed April 2008**) Tobacco companies such as Philip Morris and R.J. Reynolds offer merchandizing contracts to retailers that include financial incentives such as volume discounts, special price promotions, and money for display and placement of their products in prominent locations in the store. These companies offer a wide range of contracts that consider (1) store volume, e.g., larger volume equates to larger discounts on orders, and (2) the extent of the retailer's willingness to allow a company to control the amount and placement of advertising and product merchandizing, e.g., participating retailers follow store plan o grams and company representatives check on retailer compliance. Approximately two thirds of tobacco retailers in the U.S.A. have a contract with PM USA. The enclosed copy of its 2005 Retail Leaders contract that describes in detail the contractual arrangement between the manufacturer and retailers.

## **Section Three: Pricing**

**Loomis B., M. Farrelly, J. Nonnemaker, and N. Mann. Point of purchase cigarette promotions before and after the Master Settlement Agreement: exploring retail scanner data. *Tobacco Control* 2006;15:140-142.** This study describes trends in the proportion of cigarettes sold under point of purchase (POP) advertising and promotions using scanner sales data from a national sample of U.S. grocery stores from 1994 through 2003. The report also describes changes in promoted sales before and after the 1998 MSA, and during periods of sustained cigarette tax increases. Sales data is reported for cigarette packs and for three types of POP promotions (buy-one-pack, get-one-pack-free offers, price reductions, and free merchandise with purchase). The data analyses showed that the proportion of cigarettes sold under a POP promotion increased notably over the sample period. Promoted cigarette sales spiked in the fourth quarter of 1998, coinciding with the implementation of the MSA and rose again in 2001 and 2002, corresponding with widespread increases in state cigarette taxes. The authors conclude that this pattern of promoted cigarette sales suggests of a positive relationship between retail cigarette promotions, the MSA, and state cigarette tax increases. More research is needed to describe fully the relationship between cigarette promotions and tobacco control policy.

**Feighery E., K. Ribisl, C. PI, and H. Haladjian. How the tobacco companies ensure prime placement of their advertising and products in stores: Interviews with retailers about tobacco company incentive programs. *Tobacco Control* 2003;12:184-188.** Background: About 81 percent of cigarette manufacturers' marketing expenditures in the U.S. is spent to promote cigarette sales in stores. Relatively little is known about how these expenditures help the manufacturers achieve their marketing goals in stores. A better understanding of how tobacco companies influence the retail environment would help researchers and tobacco control activists to monitor industry presence in stores. Objective: To describe the types of tobacco company incentive programs offered to retailers, how these programs impact the store environments, and possible visual indicators of retailer participation in incentive programs. Study design: In-depth qualitative interviews with a convenience sample of 29 tobacco retailers were conducted in 2001. Setting: U.S. Main outcome measures: The types and requirements of retailer incentive programs provided by tobacco companies, and how participation in a program alters their stores. Results: The retailers provided insights into how tobacco companies convey promotional allowances and special offers to them and how these incentives shape the retail environment. Retailers noted that tobacco companies exert substantial control over their stores by requiring placement of products in the most visible locations, and of specific amounts and types of advertising in prime locations in the store. Retailers also described how tobacco companies reduce prices by offering them volume based discounts, "buy two, get one free" specials, and "buying down" the price of existing product. Conclusions: Tobacco companies are concentrating their marketing dollars at the POS to the extent that the store is their primary communication channel with customers. As a result, all shoppers regardless of age or smoking status are exposed to pro-smoking messages. Given the financial resources spent by tobacco companies in stores, this venue warrants closer scrutiny by researchers and tobacco control advocates.

**\*Levy M., D. Grewal, P.K. Kopalle, and J.D. Hess. 2004. Emerging Trends in retail pricing practice: implications for research. *Journal of Retailing*, 80, xiii-xxi.**

This article represents the first of several editorials to appear in the *Journal of Retailing* designed to examine the nexus between retail practice and research, with the goal of stimulating further research. This essay on emerging trends in pricing discusses recent advances in retail pricing optimization. It begins with a review of how retailers typically make pricing decisions using time honored heuristics and attempt to infer the optimal decisions. However, current methods are suboptimal because they do not consider the affects of advertising, competition, substitute products, or complementary products on sales. Most fail to take into account how price elasticity changes over time, particularly for fashion merchandise, or how market segments react differentially to price changes. In addition, many retailers find it difficult to know how to price merchandise when their suppliers offer temporary "deals." They are also generally unaware of how their pricing strategy influences their overall image. As these issues demonstrate, optimal pricing is not a static problem. Retailers must be able to react quickly to changes in the environment or sales patterns. This paper also provides examples of the more sophisticated pricing techniques that are currently being tested in practice; it concludes with a discussion of the critical components that must be incorporated into retail pricing.

**\*Feighery, E., K. Ribisl, N. Schleicher, and P. Clark. 2004. Retailer participation in cigarette company incentive programs is related to increased levels of cigarette advertising and cheaper cigarette prices. *Preventive Medicine*, 38, 876 884.** Purpose: The retail outlet is the cigarette companies' major marketing channel to reach present and future customers. Of the \$11.2 billion spent by them to market their products in 2001, approximately 85 percent was spent on retailer and consumer incentives to stimulate sales. This study examines the extent of retailer participation in these incentive programs, and the relationship between participation and the amount and placement of cigarette marketing materials and products, and prices in stores. Methods: Observational assessments of cigarette marketing materials, products, and prices were conducted in 468 stores in 15 U.S. states. Telephone interviews were conducted with store owners or managers of these stores to determine the details of their participation in incentive programs. Results: Cigarette companies engaged 65 percent of retailers in an incentive program. Nearly 80 percent of participating retailers reported cigarette company control over placement of marketing materials in their stores. Stores that reported receiving over \$3,000 from incentive programs in the past three months averaged 19.5 cigarette marketing materials, and stores receiving no money averaged only 8.2 marketing materials. In multivariate analyses, participation in incentive programs offered by Philip Morris and R.J. Reynolds was positively related to the number of cigarette marketing materials for each of these companies' brands in stores and the placement of their cigarettes on the top shelf. The price of Newports was significantly lower in stores that received incentives; no price difference was found for Marlboro. Conclusions: Stores that participate in cigarette company incentive programs feature more prominent placement of cigarettes and advertising, and may have cheaper cigarette prices.

**Feighery, E., N. Schleicher, and H. Haladjian. 2006. *How cigarette company financial incentives affect advertising and product promotions in a sample of California convenience stores: Public Health Institute.*** Objective: In 2003, cigarette companies spent 84 percent of their \$15.1 billion marketing expenditures on various price reduction strategies and retailer promotional allowances to promote product sales in stores. The purpose of the study was to examine the extent of retailer participation in cigarette company incentive programs, and to assess and the impact of these programs on cigarette marketing in stores. A secondary goal was to understand how tobacco company incentive programs might differ from incentive programs offered by soda companies. Methods: In 2005, a total of 100 in-person interviews were conducted with managers or owners of convenience stores in California that were also included in a tobacco retail outlet advertising survey. Results: 90 percent of our sample participated in at least one cigarette company price promotion or merchandising contract in the two months prior to the interview. Stores participating in at least one incentive program averaged 26.6 cigarette marketing materials compared to 15.9 materials in stores that did not participate. The results indicate that cigarette companies use financial incentives to influence the store environment, and that soda companies use these practices less extensively.

**\*Francella, B. G. May 30, 2005. Rebate Debate. *Convenience Stores News*, 41, 20 24. [http://www.csnews.com/csn/search/article\\_display.jsp?vnu\\_content\\_id=1000913722](http://www.csnews.com/csn/search/article_display.jsp?vnu_content_id=1000913722) (Accessed April 2008).** Retail display allowances, slotting fees, rebates, discounts: Call them what you will, but by many retailer accounts, manufacturer trade marketing programs are a double-edged sword. While some convenience store operators view trade monies and the merchandising agreements attached to them as insurance against new product risks and compensation for practicing a suppliers vision of category management, others charge manufacturer programs keep retailers focused on the buy rather than the sell, stress brand over category, cripple their ability to realize the best possible return from their valuable shelf space and, at their worst, prevent fair trade. All agree; however, in the wake of volatile market dynamics—including a decrease in tobacco dollars from up to 80 percent of a retailers total trade monies five years ago to just 30 or 40 percent today—changes are coming their way.

## Section Four: Legal/Policy interventions

**Kim, S. 2005. *Shelf-access payments: slotting fees, pay-to-stay fees and exclusivity deals*. Sacramento, CA: Senate Office of Research. <http://sor.govoffice3.com/vertical/Sites/{3BDD1595-792B-4D20-8D44-626EF05648C7}/uploads/{56E4C129-EACC-41DI-B575-86A0E6692716}.PDF>**

This background paper details the different types of shelf-access payments identified by participants in the 2000 FTC workshop on slotting allowances in the grocery industry as the most frequently used and potentially harmful to competition. The paper also describes what is known regarding the frequency with which the payments are used and the magnitude of the fees paid, as well as the potential benefits and harms of each payment. The paper identifies relevant statutes as well as a description of several cases challenging these payments. Finally, the paper notes the work that has been done in several other countries on this issue.

**Cigarette Minimum Price Laws: An Analysis of Possible Benefits and Effects; Technical Assistance Legal Center, Public Health Law and Policy; originally produced September 2002, revised April 2008.** A minimum purchase price law for cigarettes offers the potential for a public health benefit, because a high minimum price is likely to lead to a reduction in cigarette consumption. In order for such a law to be effective, it must restrict tobacco industry marketing practices such as “buy downs” and “master-type” programs. However, a law strict enough to prohibit these marketing practices is likely to provoke considerable opposition. Before moving forward with a minimum price law, there are several issues to consider in determining the feasibility of such a law in achieving public health goals: (1) Practical—the price paid by the consumer may not actually increase with a minimum purchase price law because of marketing promotions by the industry that could be permissible due to loopholes in such a law; (2) Philosophical/political—if the price for tobacco products does actually increase, someone in the tobacco manufacturing, wholesaling, or retailing industry is likely to make more money from selling or producing cigarettes; (3) Uncertainty—the consequences of this type of indirect engineering on price are complex and not altogether foreseeable; (4) Legal the greater the extent to which a minimum price law is pursued for public health goals, the greater the risk it carries of being preempted by the FCLAA. All of these difficulties raise questions about price restriction as a tobacco control strategy. It is possible that the original goals (higher prices, less promotion) could be achieved in other ways with fewer complications, uncertainties, and political costs.

**Feighery E., K. Ribisl, N. Schleicher, L. Zellers, and N. Wellington. How do minimum cigarette price laws affect cigarette prices at the retail level. *Tobacco Control* 2005;14:80-85.** Objectives: Half of U.S. states have minimum cigarette price laws that were originally passed to protect small independent retailers from unfair price competition with larger retailers. These laws prohibit cigarettes from being sold below a minimum price that is set by a formula. Many of these laws allow cigarette company promotional incentives offered to retailers, such as buydowns and master-type programs, to be calculated into the formula. Allowing this provision has the potential to lower the allowable minimum price. This study assesses whether stores in states with minimum price laws have higher cigarette prices and lower rates of retailer participation in cigarette company promotional incentive programs. Design: Retail cigarette prices and retailer participation in cigarette company incentive programs in 2001 were compared in eight states with minimum price laws and seven states without them. New York State had the most stringent minimum price law at the time of the study because it excluded promotional incentive programs in its price setting formula; cigarette prices in New York were compared to all other states included in the study. Results: Cigarette prices were not significantly different in our sample of U.S. states with and without cigarette minimum price laws. Cigarette prices were significantly higher in New York stores than in the 14 other states combined. Conclusions: Most existing minimum cigarette price laws appear to have little impact on the retail price of cigarettes. This may be because they allow the use of promotional programs, which are used by manufacturers to reduce cigarette prices. New York’s strategy to disallow these types of incentive programs may result in higher minimum cigarette prices, and should also be explored as a potential policy strategy to control cigarette company marketing practices in stores. Strict cigarette minimum price laws may have the potential to reduce cigarette consumption by decreasing demand through increased cigarette prices and reduced promotional activities at retail outlets.

**\*Gundlach G., and B. PN. Slotting Allowances and the Retail Sale of Alcohol Beverages. *Journal of Public Policy and Marketing* 1998;17(2):173-184.**

Considerable controversy and debate surrounds the practice of slotting allowances, or fees, paid by manufacturers for obtaining the patronage of retailers. To date, regulators have yet to agree on public policy toward these practices: at least one federal antitrust agency suggests that slotting fees may be competitive, another has conducted investigations into these practices, and still another suggests banning them altogether. In this article, the authors examine the recent decision by the Bureau of Alcohol, Tobacco, and Firearms (BATF) to prohibit slotting allowances in the retail sale of alcohol beverages. Focusing on the regulatory environment, industry structure, marketing practices, and consumer consumption behavior in the alcohol beverage industry, the authors analyze the BATF's decision and attempt to reconcile disparate public policy treatment of these practices. Implications for understanding slotting allowances and recommendations for further public policy development and research then are explored.