

**UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF COLUMBIA**

UNITED STATES OF AMERICA,)	
)	
Plaintiff,)	Civil Action No. 99-CV-2496 (GK)
)	
v.)	Next scheduled appearance:
)	Trial (ongoing)
PHILIP MORRIS USA INC.)	
(f/k/a Philip Morris Incorporated), <i>et al.</i>,)	
)	
Defendants.)	

**WRITTEN DIRECT EXAMINATION OF DENNIS W. CARLTON, Ph.D.
SUBMITTED BY THE JOINT DEFENDANTS PURSUANT TO ORDER #471**

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1 **I. INTRODUCTION.**

2 **Q. Please introduce yourself to the court.**

3 A. My name is Dennis William Carlton.

4 **Q. Where do you live?**

5 A. I live in Glencoe, Illinois.

6 **Q. Can you describe your education?**

7 A. Yes, I received a Bachelors degree in applied math and economics from Harvard in 1972,
8 and a master's degree in operations research in 1974 and a Ph.D. in economics from the
9 Massachusetts Institute of Technology in 1975.

10 **Q. Please describe your current employment.**

11 A. I am a Professor of Economics at the University of Chicago, where I have been since
12 1976. My first appointment was in the economics department; I subsequently moved to the law
13 school and then to the Graduate School of Business.

14 **Q. What type of courses do you teach?**

15 A. I have taught a wide variety of courses, primarily in microeconomics and industrial
16 organization. I also have taught courses in antitrust and corporate finance.

17 **Q. Do you have any particular areas of specialization?**

18 A. Yes. I describe my specialization as microeconomics, which is the study of how
19 individual firms and consumers make decisions. Within that broader field, I have a specialty in
20 the field of industrial organization. Industrial organization is the study of how individual
21 industries operate, how firms compete with each other, and the effect of competition on
22 consumers.

23 **Q. Have you written any books or articles that relate to industrial organization?**

1 A. Yes. I have written two books, and in total I have published over 70 articles, many
2 dealing with industrial organization issues. One of my books, which I coauthored, is a leading
3 textbook in the United States, and it has been translated into several foreign languages.

4 **Q. What is the name of that textbook?**

5 A. Modern Industrial Organization.

6 **Q. Do you have any other academic responsibilities?**

7 A. Yes. I am a co-editor of the Journal of Law and Economics, which is a journal that
8 specializes in the application of economics to legal matters and regulation; I am also co-editor of
9 Competition Policy International, a journal that specializes in competition policy.

10 **Q. Do you do any work in addition to your academic responsibilities?**

11 A. Yes, I do.

12 **Q. What type of work?**

13 A. I am a senior managing director of Lexecon, an economics consulting firm that
14 specializes in the application of economics to litigation and regulation.

15 **Q. Have you ever been asked to work as a consultant for or an advisor to the federal**
16 **government?**

17 A. Yes, on several occasions.

18 **Q. Please describe your work for the federal government.**

19 A. Currently I am a commissioner on the Antitrust Modernization Commission, a
20 commission established by Congress. It is composed of twelve members, and I am the only
21 economist; the other members are lawyers. Our charge is to examine the antitrust laws and to
22 make recommendations as to whether they need to be changed so that they can be improved.

1 **Q. Are there any other occasions when you have been asked to consult with the federal**
2 **government?**

3 A. Yes. In the early 1990s I was asked by the Department of Justice to serve as a special
4 consultant to help write the Merger Guidelines, which are used by the Department of Justice and
5 the Federal Trade Commission. More recently, I worked for the Federal Trade Commission to
6 review whether the Merger Guidelines needed to be changed. I also was asked by the Federal
7 Trade Commission to put on a seminar explaining the latest advances in economic theory as
8 applied to antitrust. I also have been retained by both the Department of Justice and the Federal
9 Trade Commission to work on individual cases on their behalf.

10 **Q. Have you served as an advisor to any other governmental agencies or bureaus?**

11 A. Yes. I was appointed by the American Economics Association to a panel to advise the
12 Bureau of the Census on the collection and interpretation of economic and statistical information.

13 **Q. Have you been asked to serve as the Deputy Assistant Attorney General for**
14 **Antitrust?**

15 A. Yes, by both Democratic and Republican administrations.

16 **Q. Have you ever consulted or testified on behalf of defendants in this case?**

17 A. Yes. I have previously served as a consulting expert for, and testified on behalf of,
18 defendants in this case, including on antitrust matters, merger cases, and a prior phase of this
19 case.

20 **Q. What is your understanding of the purpose of your testimony here today?**

21 A. I have been asked by counsel for defendants to review and evaluate proposed remedies
22 submitted by Professor Jonathan Gruber, Professor Michael C. Fiore, Dr. Cheryl Healton, and
23 Dr. Michael Eriksen.

1 **II. SUMMARY OF OPINIONS.**

2 **Q. Please provide an overview of your conclusions regarding each of these proposed**
3 **remedies.**

4 A. I conclude that the remedies proposed by each Plaintiff's expert contain three major
5 flaws: (1) each expert fails to show that his or her proposed remedy is targeted at any future
6 specific defendant misconduct; (2) each expert fails to show that his or her proposed remedy
7 would reduce or prevent any future misconduct; and (3) each expert fails to acknowledge or
8 address potentially adverse effects of his or her proposed remedy on competition.

9 **III. COMPETITION AMONG SUPPLIERS HAS CHANGED SUBSTANTIALLY**
10 **SINCE THE 1980s AND ESPECIALLY SINCE THE ADVENT OF THE MASTER**
11 **SETTLEMENT AGREEMENT.**

12 **Q. Is the competitive environment in which defendants operate relevant to your**
13 **analysis?**

14 A. Yes. Changes in the tobacco industry over the last 50 years provide valuable background
15 for the remedies proposed by Plaintiff's experts.

16 B. Pre-MSA Competition.
17

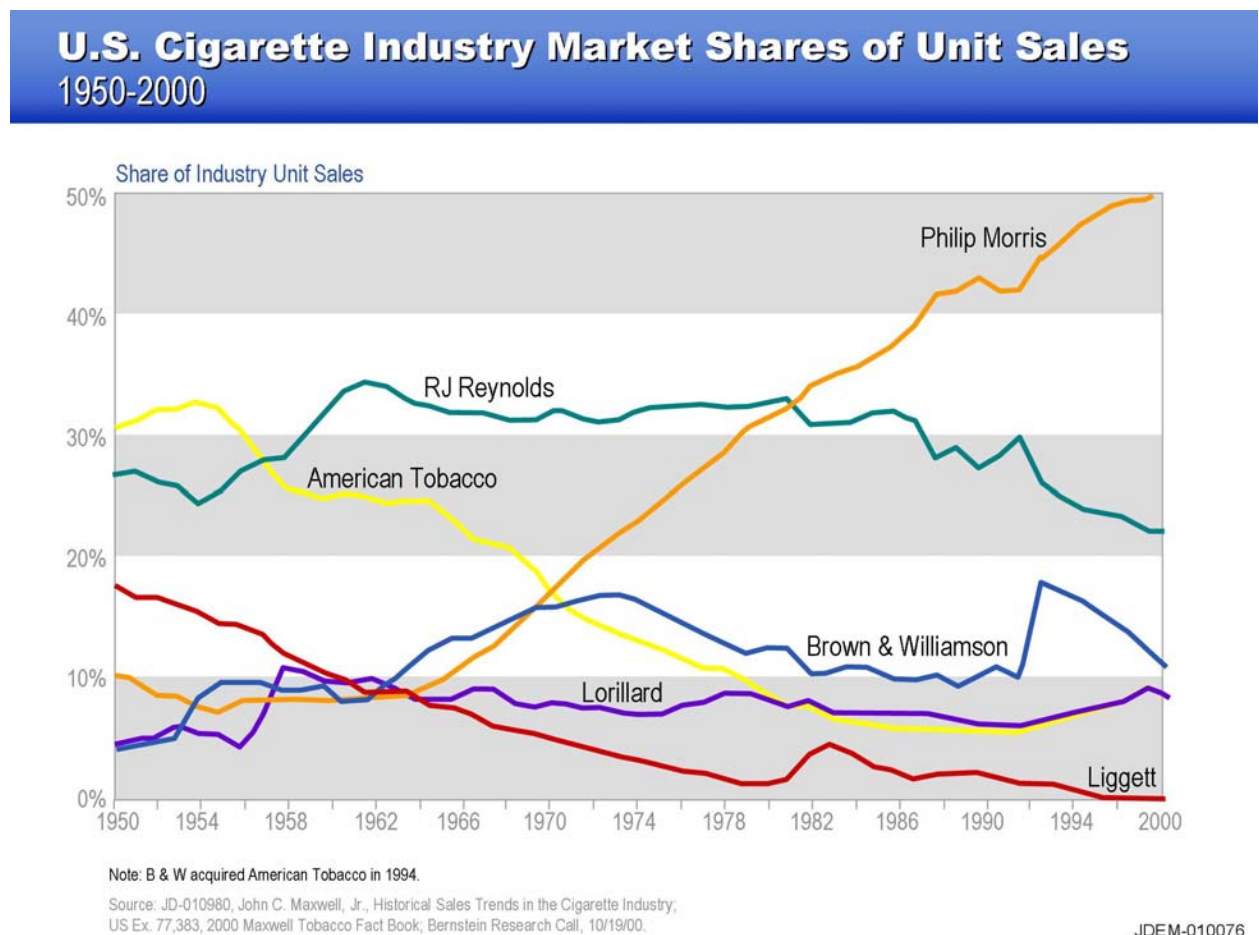
18 **Q. Let's begin by discussing the competitive environment that existed prior to the 1998**
19 **MSA. Please describe briefly competition among cigarette suppliers beginning in the**
20 **1950s.**

21 A. Since the 1950s (and earlier) through the late 1990s, most cigarettes sold in the United
22 States were produced by four to six major firms (American Tobacco was acquired by Brown &
23 Williamson in 1994; Reynolds American was created from RJ Reynolds and Brown &
24 Williamson in 2004).

25 **Q. Have relative market shares among these major firms changed since 1950?**

A. Yes. From the 1950s through the 1980s, the relative positions of the major manufacturers changed substantially. For example, in 1950, American Tobacco was the leading seller of cigarettes in the United States (with a share of about 30 percent); the next two largest sellers were RJ Reynolds (about 27 percent); and Liggett (about 18 percent). By 1960, RJ Reynolds had surpassed American Tobacco as the leading U.S. seller of cigarettes. By the early 1980s, Philip Morris surpassed RJ Reynolds. By the early 1980s, Philip Morris USA surpassed RJ Reynolds. (See John C. Maxwell, Jr., Historical Sales Trends in the Cigarette Industry, JD-010980; 2000 Maxwell Fact Book, U.S. Ex. 77,383.)

Q. Does the following graphic illustrate the shifts in market share you have just described?



Q.

A. Yes.

1 **Q. Please describe cigarette pricing during this period.**

2 A. In the 1950s through the 1970s, “prices were generally stable or rising, with few
3 outbreaks of more intense competition.” (Federal Trade Commission, “Competition and the
4 Financial Impact of the Proposed Tobacco Industry Settlement,” September 1997 (“1997 FTC
5 Study”), at 1-2, JD-041820). As the Supreme Court has noted, in reference to the cigarette
6 industry prior to 1980:

7 The cigarette industry . . . has long been one of America’s most profitable, in part
8 because for many years there was no significant price competition among rival firms . . .
9 List prices for cigarettes increased in lockstep, twice a year, for a number of years,
10 irrespective of the rate of inflation, changes in the cost of production, or shifts in
11 consumer demand. (Brooke Group, Ltd. v. Brown & Williamson Tobacco Corp., 509
12 U.S. 209, 213 (1993) (citation omitted).
13

14 **Q. At some point, did the nature of cigarette pricing change?**

15 A. Yes. In 1980, Liggett introduced low price “generic” cigarettes, which were priced 25 to
16 40 percent below “premium” cigarettes (1997 FTC Study, at 2, JD-041820). In 1984, RJ
17 Reynolds introduced “branded discount” cigarettes (also referred to as “value” brands), priced
18 between generics and premium brands (1997 FTC Study, at 2). Value brands, such as GPC,
19 Basic and Doral, gained share at the expense of premium brands, such as Marlboro, Newport and
20 Camel. During the early 1990s, the “price gap” between premium and value brands increased.
21 By 1993, value brands accounted for over 40 percent of sales in the United States. (*Williamson*
22 *Oil Company, Inc. v. Philip Morris USA*, 346 F.3d 1287, 1291-92 (11th Cir. 2003) (“Holiday
23 Decision”)).

24 **Q. Are you familiar with “Marlboro Friday”?**

25 A. Yes. In response to the rise of value brands, Philip Morris USA reduced the price of
26 Marlboro, the leading premium brand, on April 2, 1993 – “Marlboro Friday.” As a result, the
27 price gap between Marlboro and value brands was reduced substantially. The other major

1 manufacturers – RJ Reynolds, Brown & Williamson and Lorillard – matched Philip Morris
2 USA’s price reductions on premium brands, and the share captured by value brands declined.
3 (Holiday Decision, at 1292; 1997 FTC Study, at 13, footnote 51.)

4 C. Post-MSA Competitive Environment.

5
6 **Q. Are you generally familiar with the effects of the MSA on the cigarette industry?**

7 A. Yes.

8 **Q. Please briefly describe the MSA.**

9 A. The MSA was reached between major U.S. cigarette manufacturers and 46 states.
10 (Before the MSA was entered in November 1998, the major cigarette manufacturers reached
11 settlements with four states in 1997 and 1998 – Mississippi, Florida, Texas and Minnesota.) The
12 MSA imposed various conditions on cigarette manufacturers, including substantial advertising
13 restrictions. For example, signatories to the MSA are prohibited from advertising on billboards,
14 in stadiums and arenas, in shopping malls and on buses and taxis; signatories also are prohibited
15 from distributing branded merchandise to consumers and from paying for “product placement” in
16 movies or television shows. The MSA also prohibits the use of cartoon characters in any
17 advertising. (See November 1998 Master Settlement Agreement §III, U.S. Ex. 64,359.)

18 **Q. Did the MSA impose any other obligations on the cigarette company signatories?**

19 A. Yes. In addition to advertising restrictions, the MSA imposed substantial payment
20 obligations on the cigarette manufacturer signatories that depend on unit sales. (Smaller costs
21 were imposed on subsequent signatories.)

22 **Q. Who were the original cigarette manufacturer signatories to the MSA?**

23 A. The MSA was originally signed by Philip Morris USA, RJ Reynolds, Brown &
24 Williamson and Lorillard; these firms often are referred to as “Original Participating

1 Manufacturers,” or “OPMs.” Since 1998, “an additional 31 Subsequent Participating
2 Manufacturers (SPMs) have signed the MSA. These manufacturers are now subject to all the
3 terms of the agreement as well, but make lower up-front payments than do the OPMs.” (Council
4 of State Governments, Tobacco Settlement and Declining State Revenues, March 2002, at 2.)

5 **Q. Are there any cigarette manufacturers that are not subject to the terms of the MSA?**

6 A. Yes. These firms are referred to as “Non-Participating Manufacturers” (NPMs).
7 Although these NPMs are subject to certain MSA-related payments based on state legislative
8 enactments, the NPMs are not subject to the MSA’s other terms, including its prohibitions on
9 youth targeting.

10 **Q. Did cigarette prices change after the MSA was signed?**

11 A. Yes. Cigarette prices increased substantially in 1998 and thereafter. For example, the
12 cigarette Producer Price Index increased 63.0 percent between January 1997 and January 1999.

13 **Q. Has the MSA affected competition among cigarette manufacturers?**

14 A. Yes. Since the MSA was signed, non-defendants have substantially increased their share
15 of sales. For example, in 1997, non-defendants’ share of U.S. unit sales was only 1.8 percent;
16 non-defendants’ share reached 12.1 percent in 2002 and 13.7 percent in 2003. (*See*
17 *PriceWaterhouseCoopers Financial Reports re MSA Payments; Confidential -*
18 *PriceWaterhouseCoopers, Independent Auditor's Notice of Final Calculation for the Tobacco*
19 *Litigation Master Settlement Agreement Subsection IX(c)(1) Account Payments Due April 15,*
20 *2004 - NOTICE ID: 0139.*) During this time period, total U.S. cigarette sales fell substantially.
21 For example, total U.S. sales of cigarettes fell about 20 percent between 1997 and 2002 (from
22 478.6 billion units in 1997 to 376.4 billion units in 2002). (*See Federal Trade Commission,*

1 Cigarette Report for 2002, Issued: 2004 (“FTC Cigarette Report, 2002,” JD-013056, Tables 1
2 and 1A).)

3 **Q. Do defendants face competition only from non-defendant manufacturers?**

4 A. No. In addition to competition from non-defendants, each defendant also faces
5 substantial “interbrand” competition from other defendants. For example, in 2004, the Federal
6 Trade Commission did not challenge the combination of the tobacco businesses of RJ Reynolds
7 and Brown & Williamson, in part, because of the remaining competition that the combined firm
8 would face from Philip Morris USA and Lorillard. (*See* Statement of Chairman Timothy J.
9 Muris, Commissioner Orson Swindle and Commissioner Thomas B. Leary, June 22, 2004 (“Our
10 investigation revealed that RJR and Brown & Williamson face two principal sources of
11 competition: (1) price competition from NB4 [non-Big 4] discount cigarettes; and (2)
12 competition among premium brands in the form of brand equity investments, including various
13 types of price discounts and promotions such as buy-some-get-some-free and direct mail
14 coupons.”).)

15 **Q. Has the MSA affected how cigarette companies compete?**

16 A. Yes. The major manufacturers responded to the rise of the “non-Big 4” (as they were
17 then known) by increasingly competing on price terms. In particular, the major manufacturers’
18 promotional expenditures increased substantially, and were primarily in the form of price
19 reductions. For example, in 1997, total cigarette advertising and promotional expenditures were
20 \$5.7 billion; by 2002, the total had more than doubled to \$12.5 billion. (*See* FTC Cigarette
21 Report, 2002, Tables 2B and 2C.) Approximately 90 percent of this total reflects price
22 reductions. (*See* FTC Cigarette Report, 2002, Table 2C, based on the categories “Price
23 Discounts”; “Promotional Allowances – Retailers”; “Promotional Allowances – Wholesalers”;

1 “Coupons”; and “Retail Value Added – Bonus Cigarettes.”) In contrast, price reductions
2 accounted for only about 70 percent of the 1997 total. (See FTC Cigarette Report, 2002, Table
3 2B; in 1997, different data categories are reported; I use “Promotional Allowances”; “Coupons”;
4 and “Retail Value Added.”)

5 During the same period, advertising expenditures (newspapers, magazines, outdoor and
6 transit) fell from \$575.6 million in 1997 to \$156.6 million in 2002. (See FTC Cigarette Report,
7 Tables 2B and 2C.) Total advertising and promotional expenditures excluding price reductions
8 fell from about \$1.5 billion in 1997 to about \$1.2 billion in 2002.

9 **Q. Do all of the defendants rely on mass media advertising to the same extent?**

10 A. No. I understand that defendants’ reliance on mass media advertising varies across firms.

11 D. Plaintiff’s Proposed Remedies in Light of the Post-MSA Competitive
12 Environment.
13

14 **Q. Is the post-MSA competitive environment relevant to your opinions in this case?**

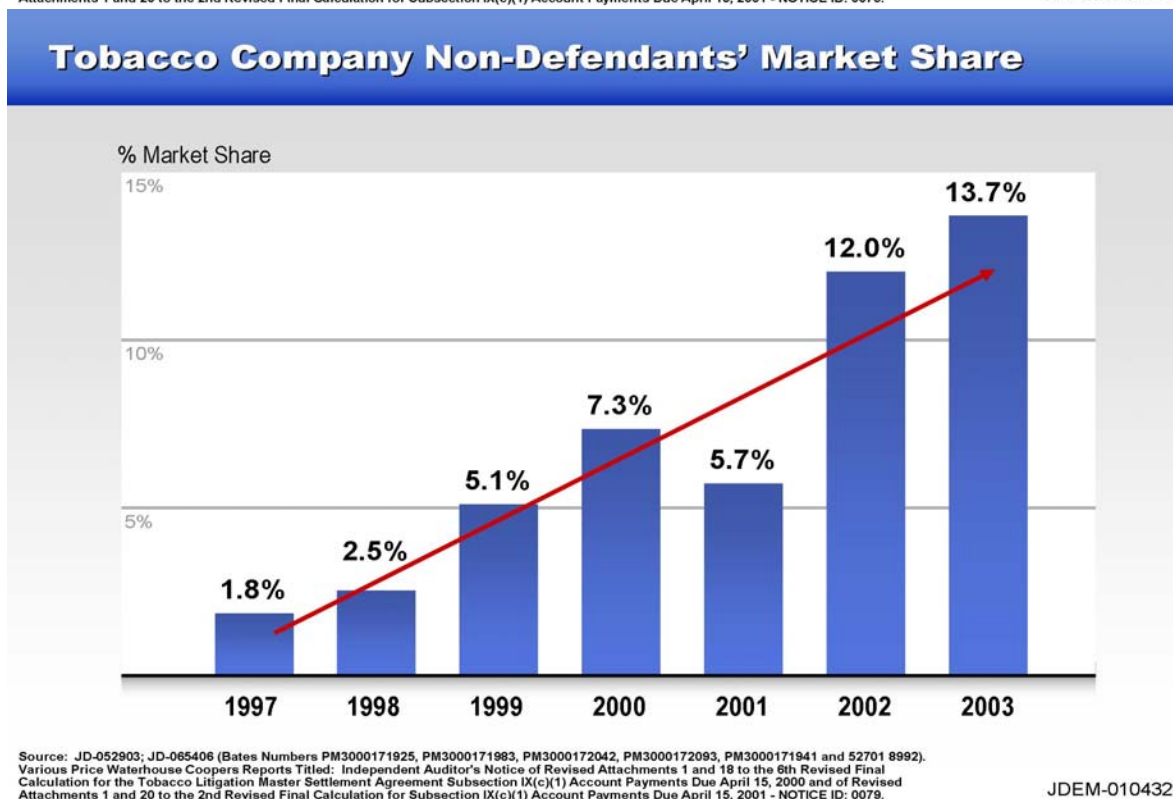
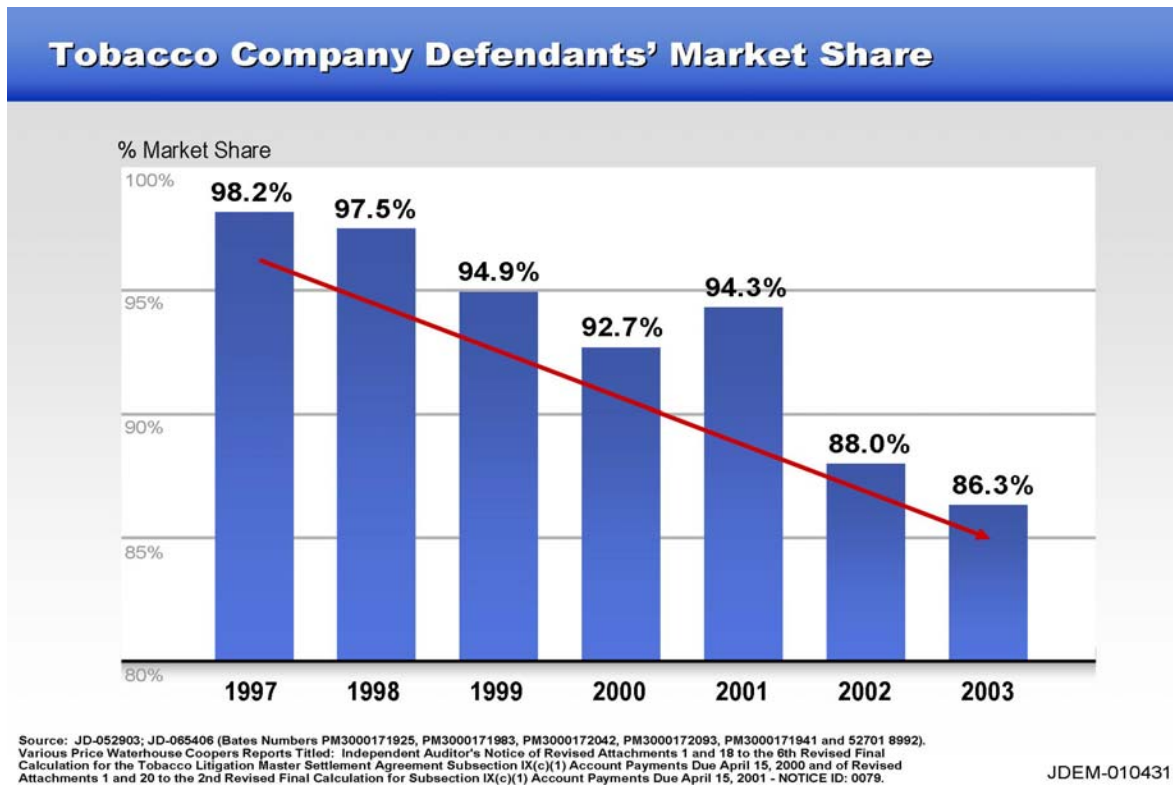
15 A. Yes. The economic evidence available on the effect of the MSA provides valuable
16 background information that informs my economic analysis of the proposed remedies.

17 **Q. What are some of the economic lessons learned from the MSA that are relevant to**
18 **your opinions?**

19 A. The MSA experience provides real-world empirical evidence that shows the effect of
20 applying a differential “tax” on the major cigarette manufacturers. As Professor Gruber
21 explained in his live testimony, MSA (or equivalent) assessments have historically differed
22 across manufacturers, and defendants have paid higher assessments than many of their rivals.
23 These differential payments put defendant firms at a competitive disadvantage.

24 **Q. In light of the presence of this competitive disadvantage, were there major shifts in**
25 **the cigarette industry?**

- 1 A. Yes. As the following bar charts show (JDEM-010431, JDEM-010432), the effect has
2 been a significant shift from defendants to non-defendants.



1 Because at least some of the remedies proposed by the Government’s experts will operate as a
2 “tax” imposed on defendants, the economic evidence indicates that the manufacturers who are
3 subject to the tax (i.e., defendants) likely will lose further share to non-defendants.

4 **Q. Would the proposed remedies have the same effect on cigarette manufacturers as an**
5 **increase in excise taxes?**

6 A. No. An increase in the federal excise tax would affect all cigarette manufacturers. The
7 remedies proposed by each of Plaintiff’s experts would function essentially as taxes or marketing
8 restrictions imposed only on defendants. As I discuss in more detail later in my testimony,
9 remedies imposed on defendants but not on non-defendants likely would adversely affect
10 defendant firms’ ability to compete with non-defendants and thus result in consumer switching
11 from defendant to non-defendant brands.

12 **IV. PROFESSOR GRUBER FAILS TO SHOW THAT HIS PROPOSED REMEDY**
13 **WOULD BE EFFECTIVE IN PREVENTING OR REDUCING FUTURE**
14 **UNLAWFUL CONDUCT BY DEFENDANTS AND NEGLECTS POTENTIAL**
15 **ADVERSE CONSEQUENCES THAT LIKELY WOULD RESULT FROM ITS**
16 **IMPLEMENTATION.**

17
18 A. Professor Gruber’s Proposed Remedy.
19

20 **Q. Please briefly describe Professor Gruber’s proposed remedy.**

21 A. Professor Gruber presents what he calls “a forward-looking remedy to reduce the
22 incentive for the defendants to engage in future RICO violations that make their brands
23 appealing to young people.” (United States’ Written Direct Examination of Jonathan Gruber,
24 Ph.D. (“Gruber Written Direct Examination”), at 7.) As Professor Gruber acknowledges, his
25 remedy is based on youth-smoking reduction targets contained in never-implemented legislation
26 proposed prior to the implementation of the MSA – in particular, Professor Gruber explains that
27 “[t]he basis for these targets is the 1997 Proposed Resolution between tobacco manufacturers

1 and the states.” (Gruber Written Direct Examination, at 15.) The objective of these targets was
2 to reduce youth smoking by 60 percent below 1986-1996 levels over a 10-year period. Professor
3 Gruber explains that his proposed remedy is intended to achieve a result that “is slightly lower
4 than the ultimate target imposed by the Proposed Resolution, due to rounding, but on a slower
5 time frame.” (Gruber Written Direct Examination, at 17.)

6 Professor Gruber’s proposed remedy is based on “targeted reductions in youth smoking
7 [of] 6% per year from 2007-2013, for a total of a 42% reduction in youth smoking by 2013,
8 compared to a 2003 baseline. These targeted reductions apply to each defendant: each defendant
9 must decrease youth use of their product by 6% per year from 2007-2013.” (Gruber Written
10 Direct Examination, at 15.) Professor Gruber’s target is a 42 percent reduction below current
11 youth smoking levels (instead of 60 percent) because youth smoking levels have declined
12 substantially since 1997. (See Gruber Written Direct Examination, at 17-8.) If a manufacturer
13 misses its target, it would be required to pay an “assessment” of \$3,000 per youth smoker over
14 the target level.

15 **Q. What is the basis for Professor Gruber’s \$3,000 per smoker assessment?**

16 A. Professor Gruber’s proposed assessment is based solely on his interpretation of Philip
17 Morris USA’s financial results in 1992. As Professor Gruber testified at his deposition:

18 Q. . . . What you did here is you based your assessment on the most profitable
19 company in its most profitable year, correct?

20 A. Correct.

21 Q. Okay. And that was Philip Morris and that was 1992, right?

22 A. Correct. (Deposition of Jonathan H. Gruber, April 21, 2005, (“Gruber dep.”), at
23 814-15)
24

25 According to Professor Gruber, he uses this approach “to ensure that it’s a number large enough
26 that whoever’s large at that time [i.e., in the future] doesn’t make profits from attracting a

youth smoker.” (Gruber dep., at 816; *see also* 5/10/05 Tr. (a.m.) 20603-04.) In general, different defendants have different profit levels per cigarette.

Q. What effect do these differing profit levels per cigarette have on the application of Professor Gruber’s proposed remedy?

A. Because Professor Gruber’s proposed remedy would assess the same amount (i.e., \$3,000 per youth smoker over the target level) on each defendant, his proposed remedy would have a differential impact on each defendant’s financial incentive to reduce youth smoking. Professor Gruber’s proposed remedy also could result in multiple assessments of \$3,000 for the same smoker because of brand switching. (*See* Gruber dep., at 830-31; *see also* 5/10/05 Tr. (a.m.) 20726-27.)

B. Professor Gruber’s Proposed Remedy Does Not Specifically Target Any Defendant Misconduct.

Q. Does Professor Gruber’s proposed remedy specifically target any alleged defendant misconduct?

A. No. Professor Gruber’s proposed remedy addresses only the prevention of unspecified acts in the future that cannot now be adequately defined and monitored – if those acts could be defined and monitored, the remedy would be to prohibit those acts. For example, Professor Gruber testified at his deposition:

presuming that you could perfectly capture all RICO violations and perfectly target your penalties to those RICO violations, then that would be – and presuming the penalties were large enough to remove any economic incentive for those RICO violations, then from an economics perspective, that would be enough. There may be other factors that go into a firm’s decisions on whether to commit RICO violations that go beyond economics, and I can’t speak to those. (Gruber dep., at 770.)

Professor Gruber’s remedy is based on his view that “there are a large number of actions that defendants can take to make their brands appealing to young people. It would be difficult for the

1 Court to comprehensively monitor and restrict all of those actions.” (Gruber Written Direct
2 Examination, at 9.)

3 **Q. Does Professor Gruber provide any basis on which to determine whether his**
4 **proposed remedy would affect alleged misconduct by defendants or would instead affect**
5 **lawful conduct, such as pricing?**

6 A. No. Because Professor Gruber’s proposed remedy is based only on “outcomes,” he
7 provides no such basis. Professor Gruber conceded that his proposed remedy does not
8 specifically target defendant misconduct:

9 Q. Now, the assessment that you propose in this case would be levied whenever a
10 defendant exceeds its youth smoking target, correct?

11 A. Correct.

12 Q. And under the remedy that you propose in this case, it doesn't matter why, it
13 doesn't matter why a defendant cigarette manufacturer failed to meet its youth
14 smoking target, correct?

15 A. That's correct.

16 Q. And specifically, it doesn't matter at all whether or not the cigarette manufacturer
17 exceeded its youth smoking target in the future because it committed a RICO
18 violation in the future, correct?

19 A. Once again, the other plaintiff's experts have suggested that RICO violations are
20 important determinants of youth smoking, so I'd imagine they're related, but no,
21 you are correct that I don't tie it specifically to RICO-violating activities. (See
22 5/10/05 Tr. (a.m.) 20625; *see also* Gruber dep., at 752.)
23

24 **Q. Would Professor Gruber’s proposed remedy always affect a defendant’s incentive to**
25 **engage in misconduct?**

26 A. No. Professor Gruber concedes that his proposed remedy would not affect a defendant’s
27 incentive to engage in misconduct under at least some circumstances. Professor Gruber testified:

28 Q. If a defendant is below its youth smoking target and it could attract additional
29 youth smokers to its brands by committing future RICO violations, your proposed
30 remedy would not alter its economic incentives to commit those future RICO
31 violations except to the extent that they happen to overshoot the target, right?

32 A. I’ll repeat to make sure I understand. You’re saying, to the extent they’re below
33 and they’re going to take an action which they can be sure will not cause them to
34 exceed the target, then my specific remedy does not alter from today their

1 financial incentives? Yes, that's true. (5/10/05 Tr. (a.m.) 20632; *see also* Gruber
2 dep., at 756-58.)

3
4 C. Professor Gruber Provides No Empirical Evidence in Support of Any Claim That
5 His Proposed Remedy Would Reduce Any Future Misconduct.

6
7 **Q. Does Professor Gruber provide any empirical evidence that his proposed remedy**
8 **will lead to a reduction in alleged future misconduct?**

9 A. No. Professor Gruber explains that his proposed remedy would reduce a defendant's
10 incentive to engage in future misconduct by reducing the profits associated with attracting youth
11 smokers. However, Professor Gruber provides no empirical evidence that his proposed remedy
12 would substantially reduce any future misconduct. At his deposition, for example, he testified:

13 Q. . . . Is the remedy described in your April 2005 expert report effective in
14 preventing defendants from committing RICO violations in the future?

15 A. I don't know. I'm not an expert on what drives firms to commit RICO violations.
16 (Gruber dep., at 745.)

17
18 During his trial cross examination, Professor Gruber appeared to supplement this opinion by
19 stating that he "believe[s] strongly that this puts financial incentives in place to stop [defendants]
20 from engaging in those violations." (5/10/05 Tr. (a.m.) 20614.) However he provided no
21 empirical evidence supporting this belief.

22 **Q. But doesn't Professor Gruber explain that "[i]f the defendants are trying to decide**
23 **whether to commit a future RICO violation, part of that calculation is going to be an**
24 **expectation that they will ultimately pay a penalty if they do?" (5/10/05 Tr. (a.m.) 20616.)**

25 A. Yes. But Professor Gruber concedes that such a result would be an "indirect effect" of
26 his remedy. (5/10/05 Tr. (a.m.) 20616.) Professor Gruber agreed that there is a "difference
27 between giving the defendants an economic incentive to achieve the targeted reductions in youth
28 smoking on the one hand and on the other hand removing any economic incentives for
29 defendants to commit RICO violations in the future." (5/10/05 Tr. (a.m.) 20619.) Professor

1 Gruber agreed that he did not tie his penalty “specifically to RICO-violating activities.” (5/10/05
2 Tr. (a.m.) 20625.) In addition, Professor Gruber testified that he does not know what the
3 prevalence of youth smoking would be if the defendants committed no RICO violations in the
4 future, and further conceded that he did not claim that his targets reflect the prevalence or the
5 number of youth smokers that would occur in the future if the defendants commit no future
6 RICO violations. (5/10/05 Tr. (a.m.) 20654-55.)

7 **Q. Does Professor Gruber’s proposed remedy have any relationship to the level of**
8 **youth smoking that would have occurred “but for” future defendant misconduct?**

9 A. No. Professor Gruber does not show that the proposed target levels of youth smoking are
10 the levels that would be reached in the absence of future defendant misconduct. Professor
11 Gruber testified:

12 Q. Isn’t it true that you do not know what the prevalence of youth smoking would be
13 if defendants commit no RICO violations in the future?

14 A. That’s true.

15 Q. And you don’t claim that your targets reflect the prevalence or the number of
16 youth smokers that would obtain in the future if the defendants commit no future
17 RICO violations, correct?

18 A. That’s true. (5/10/05 Tr. (a.m.) 20654-55; *see also* Gruber dep., at 752-53.)
19

20 Furthermore, the targets in Professor Gruber’s proposed remedy are based on smokers in the age
21 range 12 to 20 (*see* Gruber Written Direct Examination, at 8), but the June 1997 Proposed
22 Resolution that is the basis for Professor Gruber’s proposed remedy is based on smokers in the
23 age range 12 to 17. Thus, even if future smoking levels for 12-to-17-year olds would fall to the
24 June 1997 target levels in the but-for world, Professor Gruber provides no basis for assuming
25 that future but-for world smoking levels for 12-to-20-year olds would be at that level. (*See*
26 Gruber dep., at 776 (“Q. You offer no justification for the assumption that the targeted reductions
27 in youth smoking prevalence in the 1997 proposed resolution for 12- to 17-year-olds can

1 reasonably be achieved for the 12- to 20-year-old group to which you apply it, correct? A. I
2 don't discuss that issue, no").) Professor Gruber does not attempt to quantify the effect of his
3 proposed remedy on the ability of defendants to influence lawful retail sales to adult consumers
4 (i.e., smokers age 18-20 in most states).

5 **Q. Does Professor Gruber claim that the proposed targets could be achieved if**
6 **defendants implemented only non-price restrictions?**

7 A. No. Professor Gruber acknowledges that prior studies conducted by the U.S. government
8 concluded that non-price restrictions alone (including marketing and access restrictions) would
9 have only a small effect on youth smoking. (*See* Gruber dep., at 803-05 and Gruber dep. Ex. 55;
10 *see also* Congressional Budget Office, "The Proposed Tobacco Settlement: Issues from a Federal
11 Perspective," April 1998, JD-053453; Department of Treasury, 7/27/98 Draft "Effects of Non-
12 Price Initiatives on Teen Smoking," JD-049055.)

13 D. Professor Gruber Provides No Empirical Evidence in Support of Any Claim That
14 His Proposed Remedy Would Substantially Reduce Future Youth Smoking.
15

16 **Q. Does Professor Gruber provide any empirical evidence that his proposed remedy**
17 **would reduce future youth smoking levels substantially regardless of whether future youth**
18 **smoking would be the result of any future misconduct by defendants?**

19 A. No. Professor Gruber provides no such empirical evidence. Professor Gruber conceded
20 that youth smoking levels could be explained by a variety of causes. In particular, Professor
21 Gruber testified that the causes of the substantial increase in youth smoking during the 1990s are
22 not well understood and determining which factor or factors were responsible is "hard to pin
23 down."

24 Q. We cannot at present today, looking back at that period 10 years ago, determine
25 which candidate factors, if any, were responsible for the increase in youth

1 smoking above the 30 percent of the increase that you can account for with price;
2 correct?

3 A. . . . It's hard to explain time series. A lot of things are going on, so it's hard to
4 really pin down which factor. (5/10/05 Tr. (p.m.) 20717; *see also* Gruber dep., at
5 788.)
6

7 **Q. Does Dr. Gruber provide empirical evidence that defendants' marketing practices**
8 **increase youth smoking?**

9 A. No. Professor Gruber does not provide his own empirical evidence that establishes that
10 defendants' marketing practices increase youth smoking. In addition, he admits that not only is
11 there "uncertainty" in the literature regarding the effects of marketing restrictions on youth
12 smoking behavior, (5/10/05 Tr. (p.m.) 20710; *see also* Gruber dep., at 855), but also that factors
13 associated with youth smoking, such as peer and family smoking, are not exclusively within
14 defendants' control. (5/10/05 Tr. (p.m.) 20714.)

15 **Q. Does Professor Gruber provide any empirical support for any claim that his**
16 **proposed \$3,000 assessment would lead to substantial reductions in youth smoking?**

17 A. No. The effect of the proposed \$3,000 assessment on youth smoking would depend on
18 the cost of reducing youth smoking. If the cost to a defendant of reducing youth smoking is
19 extremely high, the proposed assessment may have little effect on defendants' actions. Because
20 Professor Gruber does not analyze the costs that defendants would have to incur to reduce youth
21 smoking of their brands, he cannot – and does not – predict what effect, if any, his proposed
22 remedy would have on youth smoking.

23 **Q. Professor Gruber testified that his targets are achievable based on the following**
24 **three factors:**

25 **First these are targets which were suggested by tobacco**
26 **manufacturers, including the defendants themselves, as part of**
27 **the 1997 Proposed Resolution. Second, as plaintiff's other**
28 **experts have testified on repeated occasions, there are a**

1 number of marketing/promotion activities that defendants can
2 undertake to make their products appealing to youth and,
3 therefore, by discontinuing those activities, it would be possible
4 to move at least part way towards meeting these goals. And
5 finally, as has been shown repeatedly in the health economics
6 literature, youth are very price sensitive in their smoking
7 decisions, so these targets can also be met by increasing prices
8 to reduce youth smoking. (5/10/05 Tr. (a.m.) 20594.)
9

10 **Do these factors show that Professor Gruber's targets likely would be**

11 **achieved?**

12 A. No.

13 **Q. Why doesn't the fact that the tobacco manufacturers had agreed to similar targets**
14 **as part of the 1997 Proposed Resolution show that such targets are achievable?**

15 A. Professor Gruber conceded that he did not know whether "defendants might have agreed
16 to the targeted reductions in youth smoking in 1997 Proposed Resolution even though they did
17 not think they could achieve them." (5/10/05 Tr. (a.m.) 20655.) Professor Gruber also conceded
18 that it "certainly" is possible that "the protections afforded to the industry by the 1997 Proposed
19 Resolution were valuable enough that they might be willing to agree to reductions in youth
20 smoking that they didn't think they could achieve." (5/10/05 Tr. (a.m.) 20657-58.)

21 **Q. What about Professor Gruber's second factor?**

22 A. As I have discussed, Professor Gruber acknowledges that prior studies conducted by the
23 U.S. government concluded that non-price restrictions alone (including marketing and access
24 restrictions) would have only a small effect on youth smoking. Furthermore, even assuming
25 defendants' marketing did have the effect of attracting youths to their products, Professor
26 Gruber's proposed remedy would not reduce non-defendants' incentives to make cigarettes
27 attractive to youth.

1 **Q. If Professor Gruber’s opinions regarding youth price sensitivities are correct, does**
2 **this show that defendants would meet the proposed targets by raising their prices?**

3 A. No. The adverse competitive effects of raising prices substantially (which I discuss later
4 in this testimony) may cost far more than the “penalty” for not meeting the targets. Thus, each
5 defendant may choose to simply pay the penalty rather than raise price substantially and risk
6 losing additional share to non-defendant manufacturers.

7 E. Professor Gruber’s Proposed Remedy Likely Would Lead to Adverse Effects,
8 Including Reduced Competition Among Defendants, Resulting in Increased
9 Youth Smoking of Non-Defendant Brands and Harm to Adult Consumers.
10

11 **Q. Have you considered whether Professor Gruber’s proposed remedies may have**
12 **unintended effects?**

13 A. Yes. There are several adverse effects that would likely occur should the Court
14 implement (or at least must be considered when examining) Professor Gruber’s proposed
15 remedies. These effects flow from the competitive consequences that would result from
16 Professor Gruber’s proposal and include the following: (1) higher prices on defendants’ brands;
17 and (2) increased youth smoking of non-defendant brands.

18 **Q. How would Professor Gruber’s proposed remedy affect defendants’ lawful conduct**
19 **in the future?**

20 A. Because Professor Gruber’s proposed remedy is based on “outcomes” and thus is not
21 targeted at any specific misconduct, it likely would affect defendants’ lawful conduct in the
22 future. In particular, Professor Gruber’s proposed remedy likely would reduce defendants’
23 incentives to compete – both on price and non-price dimensions – because any action that
24 increases a defendant’s sales could increase the number of youth smokers it attracts and thus its
25 expected assessments.

1 **Q. Did Professor Gruber account for the likely competitive effects of his proposed**
2 **remedy?**

3 A. No. Professor Gruber conceded that he ignores the effect of his proposed remedy on
4 competition in the cigarette industry:

5 Q. In preparing your expert report and your testimony in this case, isn't it true that
6 you did not consider the effect of the remedy that you are proposing on
7 competition in the cigarette industry or on these defendants?

8 A. I didn't spend -- you know, it's not something that was the focus of my
9 preparation. (5/10/05 Tr. (p.m.) 20746; *see also* Gruber dep., at 898.)
10

11 **Q. Would Professor Gruber's proposed remedy reduce defendants' incentives to**
12 **compete on price?**

13 A. Yes, it likely would. Because empirical studies show that the level of youth smoking
14 responds to price changes, Professor Gruber's proposed remedy likely would give defendants an
15 incentive to increase price -- as compared to the level they would set if the proposed remedy were
16 not in place -- to reduce the expected cost of the proposed assessments. (*See* Chaloupka and
17 Warner, "The Economics of Smoking," National Bureau of Economic Research, NBER Working
18 Paper 7047, March 1999, U.S. Ex. 72,984.) At his deposition, Professor Gruber conceded that
19 his proposed remedy could give defendants an incentive to raise price:

20 Q. . . . If there were a group of defendants who had exceeded their target, would
21 they have an economic incentive to collude to raise prices in an effort to reduce
22 youth smoking?

23 A. There would be an economic incentive to raise prices. I don't know whether there
24 would be an incentive to collude to do so. (Gruber dep., at 760, emphasis added.)
25

26 **Q. Could cigarette manufacturers limit price increases to only youth smokers?**

27 A. No, not in general. Professor Gruber agreed with the Court's recognition that "of course,
28 if defendants chose [raising prices as a] method of complying, the prices would apply to
29 everyone, not just youth." (5/10/05 Tr. (a.m.) 20596.)

1 Youth smokers appear to account for less than five percent of cigarette consumption, so
2 Professor Gruber's suggested price increase would be borne almost entirely by adult consumers.
3 (See Congressional Budget Office, "The Proposed Tobacco Settlement: Issues from a Federal
4 Perspective," April 1998, at 9, JD-053453 ("Teenage smokers account for only 2 percent of all
5 cigarettes consumed in the United States"); U.S. Department of Health and Human Services,
6 Reducing Tobacco Use: A Report of the Surgeon General – 2000, at 207, U.S. Ex. 64,316
7 ("Daily smokers aged 12-17 years smoked an estimated 924 million packs of cigarettes in
8 1997.")) Total reported U.S. cigarette sales in 1997 were 478.6 billion, or 23.93 billion packs
9 (FTC Cigarette Report, 2002, Table 1), which implies that daily youth smokers accounted for 3.9
10 percent of total cigarette consumption in 1997 (i.e., 0.924 divided by 23.93).

11 Furthermore, many youth smokers do not buy cigarettes. The 2003 Youth Risk Behavior
12 Survey, for example, indicates that only about half of smokers under age 18 usually pay for the
13 cigarettes they smoke. In particular, the responses to the question "During the past 30 days, how
14 did you usually get your own cigarettes?" were: I bought them in a store such as a convenience
15 store, supermarket, discount store, or gas station (21.9 percent); I bought them from a vending
16 machine (1.1 percent); I gave someone else money to buy them for me (25.0 percent); I
17 borrowed (or bummed) them from someone else (25.4 percent); A person 18 years old or older
18 gave them to me (9.3 percent); I took them from a store or family gave them to me (5.6 percent);
19 and I got them some other way (11.7 percent).

20 **Q. Has Professor Gruber attempted to quantify the price increase that he believes**
21 **would be necessary to meet his proposed targets through price increases alone?**

22 A. Yes. Professor Gruber testified that a 42 percent price increase would be needed to
23 reduce youth smoking to his proposed target levels. (5/10/05 Tr. (a.m.) 20595.)

1 **Q. Does Professor Gruber assess the likely competitive consequences to defendants if**
2 **they raised their prices by 42 percent?**

3 A. No. Professor Gruber testified that he does not “really know of good evidence about the
4 extent to which a rise in price by one manufacturer leads to a shift in demand for another
5 manufacturer’s product.” (5/10/05 Tr. (a.m.) 20674-75.) But he recognized that “if these
6 defendants were to increase their prices while other cigarette manufacturers did not, they will
7 lose market share.” (5/10/05 Tr. (a.m.) 20678.)

8 **Q. In response to the Court’s question at trial, Professor Gruber testified that he had**
9 **not made any calculations “as to what amount of the . . . adult market defendants would**
10 **lose by these price increases.” (5/10/05 Tr. (a.m.) 20596.) Would such an analysis be**
11 **important?**

12 A. Yes. By neglecting these competitive effects that could result from his proposed
13 remedies, Professor Gruber fails to take into account the harm not only to defendants’
14 businesses, but also to the public in terms of higher prices.

15 **Q. What would be the likely effect of a price increase in terms of defendants’**
16 **competitive position?**

17 A. The economic evidence indicates that price increases, if attempted by defendants, likely
18 would result in switching by some smokers to lower-price brands produced by manufacturers not
19 subject to Professor Gruber’s proposed remedy. As I have discussed, the aggregate share of non-
20 defendant manufacturers increased substantially after the implementation of the MSA. If
21 defendants attempted to achieve Professor Gruber’s proposed targets through substantial price
22 increases, defendants’ share losses likely would continue.

23 **Q. Assuming that defendants’ prices would increase substantially, have you considered**
24 **the likely effects of price increases on youth smoking behaviors?**

1 A. Yes. Professor Gruber's remedy may have the perverse effect of actually increasing
2 smoking among some youth. For example, in response to such defendant price increases, at least
3 some youth smokers likely would switch to lower-price cigarettes sold by non-defendants.
4 Youth smokers who switch to lower-price cigarettes could smoke more because the cigarettes
5 they would be smoking would be cheaper. (See 5/10/05 Tr. (p.m.) 20752.)

6 **Q. What effect would Professor Gruber's proposed remedy have on defendants'**
7 **incentives to compete on non-price terms?**

8 A. His proposed remedy would likely reduce defendants' incentives to compete on non-price
9 terms. For example, if Professor Gruber's proposal were implemented, cigarette companies
10 would have less incentive to advertise or to introduce new products for fear of attracting more
11 youth smokers from rivals.

12 **Q. Could Professor Gruber's proposed remedy affect a defendant's incentive to engage**
13 **in lawful advertising to adult consumers?**

14 A. Yes. At his deposition, Professor Gruber testified:

15 Q. A defendant that is over its youth smoking target would be deterred from
16 engaging in perfectly lawful advertising targeted to smokers over the age of 21 to
17 the extent that advertising to such older smokers has a spill-over effect upon
18 smokers under the age of 21, correct?

19 A. Once again, relative to the but-for world, relative to – relative to the world – they
20 still may want to do that advertising because it may still be worth it to attract the
21 older smokers, but the disincentive on the margin will – would cause them – if the
22 spill-overs to youth would cause them to want to do less advertising overall
23 (Gruber dep., at 760-61.)
24

25 **Q. What would be the likely result of a reduction in competition among defendants on**
26 **non-price terms?**

27 A. Such a reduction in competition among defendants likely would encourage further entry
28 and expansion by lower-price, non-defendant manufacturers. Again, a gain in the competitive

1 position of the lower-price manufacturers as compared to defendants could lead to an increase in
2 smoking by youth smokers who would switch to lower-priced brands. Furthermore, the harmful
3 effects of a reduction in non-price competition (e.g., a reduction in the introduction of new
4 products) among defendants would be borne almost entirely by adult consumers.

5 **Q. What effects, if any, could Professor Gruber’s proposed remedies have on non-**
6 **defendants’ incentives to use non-price means to attract youth smokers?**

7 A. One perverse result of Professor Gruber’s proposed remedy is that it may undercut some
8 of the public health goals of the MSA. For example, if Professor Gruber’s proposed remedy
9 were imposed, non-defendant manufacturers, not being subject to the youth smoking assessments
10 or the MSA’s youth targeting prohibitions, could have a greater incentive to promote their
11 products to youth smokers. Indeed, Professor Gruber testified that “[i]t’s possible that to the
12 extent that more business shifts to nonsignatories, then that could have some negative effects on
13 some [of] the restrictions in the MSA.” (5/10/05 Tr. (p.m.) 20752.)

14 **V. PROFESSOR FIORE AND DR. HEALTON FAIL TO SHOW THAT THEIR**
15 **PROPOSED REMEDIES WOULD BE EFFECTIVE IN PREVENTING OR**
16 **REDUCING FUTURE UNLAWFUL CONDUCT BY DEFENDANTS AND**
17 **NEGLECT POTENTIAL ADVERSE CONSEQUENCES THAT LIKELY WOULD**
18 **RESULT FROM THEIR IMPLEMENTATION.**

19
20 A. Professor Fiore’s and Dr. Heaton’s Proposed Remedies.

21
22 **Q. Please briefly describe Professor Fiore’s proposed remedy.**

23 A. The “key components” of Professor Fiore’s proposed remedy are:

24 (1) a national tobacco quitline network that will provide universal, barrier-free access to
25 evidence-based counseling and medications for tobacco cessation; (2) an extensive paid
26 media campaign to encourage all smokers in the United States to quit using tobacco; (3) a
27 new, broad, and balanced research agenda (basic, clinical, public health, translational,
28 dissemination) to achieve future improvements in the reach, effectiveness and adoption of
29 tobacco dependence interventions across both individuals and populations; and (4)
30 training and education to ensure that all clinicians in the United States have the
31 knowledge, skills and support systems necessary to help their patients quit tobacco use

1 (United States' Written Direct Examination of Michael C. Fiore, M.D., M.P.H. Submitted
2 Pursuant to Order #471 ("Fiore Written Direct Examination"), at 18.)
3

4 In addition, Professor Fiore's proposed cessation program "should also: (5) mobilize health
5 systems to implement system-level changes that result in effective utilization of tobacco
6 dependence treatments; (6) mobilize national quality assurance and accreditation organizations,
7 clinicians, health systems, and others to establish and measure the treatment of tobacco
8 dependence as part of the standard of care; and (7) mobilize communities to ensure that policies
9 and programs are in place to increase demand for services and to ensure access to such services."
10 (Fiore Written Direct Examination, at 18.)

11 **Q. What is the basis for Professor Fiore's proposed remedy?**

12 A. Professor Fiore's proposed remedy, like Professor Gruber's, is based on a legislative
13 proposal that was not implemented. (*See*, for example, Subcommittee on Cessation, Interagency
14 Committee on Smoking and Health, "Preventing 3 Million Premature Deaths, Helping 5 Million
15 Smokers Quit: A National Action Plan for Tobacco Cessation," February 13, 2003, U.S. Ex.
16 89,464.)

17 **Q. Please describe Dr. Healton's proposed remedy.**

18 A. Dr. Healton, President and CEO of the American Legacy Foundation ("ALF")
19 submitted testimony that discusses youth-smoking-prevention education campaigns funded by
20 ALF. (United States' Written Direct Examination of Dr. Cheryl G. Healton Submitted Pursuant
21 to Order #471 ("Healton Written Direct Examination"), at 2.) Dr. Healton testified that "[b]ased
22 on our experience in running what is the only national independent youth tobacco prevention
23 campaign . . . it is my judgment that an effective and comprehensive national campaign [to
24 prevent and reduce youth smoking] will cost between \$100 and 150 million, in current dollars,
25 on an annual basis." (Healton Written Direct Examination, at 38.) Dr. Healton also testified that

1 “[t]he foundation is facing what can only be called a financial crisis.” (Healton Written Direct
2 Examination, at 34.)

3 Although Dr. Healton has not proposed a specific remedy in this case, I have been asked
4 to assume that Plaintiff intends to rely on her testimony in support of a proposed remedy that
5 would include payments by defendants to fund programs similar to those described by Dr.
6 Healton.

7 B. Neither Proposed Remedy Specifically Targets Defendant Misconduct, and
8 Neither Expert Provides Empirical Evidence in Support of Any Claim That The
9 Proposed Remedies Would Prevent or Reduce Future Misconduct.
10

11 **Q. Does Professor Fiore’s proposed remedy specifically target alleged misconduct?**

12 A. No. Professor Fiore’s remedy is intended to reduce current smoking levels among all
13 smokers, including adult consumers. For example, Professor Fiore explains that his proposed
14 remedy “creates an environment that encourages quitting through a multifaceted media
15 campaign, it includes a health care delivery system that includes clinicians who are trained and
16 equipped in tobacco dependence treatments, and it supports a research infrastructure that
17 identifies new treatments that assist all smokers to quit successfully.” (Fiore Written Direct
18 Examination, at 17 (emphasis added).) Professor Fiore further testified that his proposed remedy
19 would neither require a smoker to show that he or she smoked the brands manufactured by the
20 defendant tobacco companies, nor to show that he or she in any way relied on any
21 misrepresentation by the Defendant tobacco companies. (5/18/05 Tr. (a.m.) 21548-49.)

22 **Q. Does Professor Fiore demonstrate that his proposed remedy would reduce or**
23 **prevent future misconduct by defendants?**

24 A. No. Professor Fiore’s proposed remedy appears to be independent of future defendant
25 misconduct. Professor Fiore does not demonstrate – or even claim – that his proposed remedy

1 would reduce or prevent future misconduct by defendants. Indeed, Professor Fiore
2 acknowledged that he was not charged with the task of determining whether his proposed
3 remedy might, or might not, prevent or reduce future misconduct, that he had not conducted any
4 independent analysis into the subject, and that he was not offering any expert opinion on the
5 subject. (5/18/05 Tr. (a.m.) 21547.)

6 **Q. Does Dr. Healton’s proposed remedy specifically target future misconduct?**

7 A. No. Dr. Healton’s proposed remedy is primarily intended to reduce youth smoking
8 levels. For example, Dr. Healton explains that ALF devotes most of its resources to reducing
9 youth smoking because “[t]he great majority of smokers begin smoking before their 18th
10 birthday. . . . The theory is straight-forward. If we can stop teen-agers from starting to smoke,
11 the tobacco epidemic will slowly end as current smokers will no longer be replaced.” (Healton
12 Written Direct Examination, at 11.)

13 **Q. Does Dr. Healton demonstrate that her proposed remedy would reduce or prevent**
14 **future misconduct by defendants?**

15 A. No. Dr. Healton suggests that anti-youth-smoking campaigns presented by defendants
16 increase youth smoking. (*See*, for example, Healton Written Direct Examination, at 45.) Dr.
17 Healton’s proposed remedy does not, however, appear to include a prohibition on such
18 defendant-sponsored programs.

19 Dr. Healton’s proposed remedy, like Professor Fiore’s, appears to be independent of
20 future defendant misconduct. In particular, Dr. Healton’s proposed national anti-youth-smoking
21 campaign would be targeted at audiences that she describes as “rebellious, risk-taking, open to
22 smoking youth,” whether or not such youth are potential or likely smokers of defendants’ brands

1 (Healton Written Direct Examination, at 46.) Dr. Healton does not demonstrate – or even claim
2 – that her proposed remedy would reduce or prevent future misconduct by defendants.

3 C. Each Proposed Remedy Would be Costly to Implement and Thus Could Lead to
4 Increased Youth Smoking of Non-Defendant Brands and Likely Would Harm
5 Adult Consumers.
6

7 **Q. What would be the cost of implementing Professor Fiore’s proposed remedy?**

8 A. More than \$5 billion per year. According to Professor Fiore, “[t]he annual cost estimate
9 for a national tobacco quitline network is \$3.2 billion.” (Fiore Written Direct Examination, at
10 50.) Professor Fiore also claims that “[t]he annual cost estimate for an independent,
11 comprehensive paid media campaign to accomplish its objectives and to reach all segments of
12 society, including hard-to-reach populations, is \$1 billion.” (Fiore Written Direct Examination, at
13 55.) In addition, Professor Fiore proposes expenditures of \$500 million per year for support of
14 additional research and \$500 million per year to support a training initiative. (See Fiore Written
15 Direct Examination, at 61, 65.)

16 **Q. How would Professor Fiore’s proposed remedy be funded?**

17 A. Professor Fiore does not explain how his proposed remedy would be funded. Previously,
18 Professor Fiore chaired a Subcommittee on Cessation, which recommended establishing “a
19 Smokers’ Health Fund by increasing the federal excise tax on cigarettes by \$2.00 per pack (from
20 the current rate of \$0.39 to \$2.39) with a similar increase in the excise tax of other tobacco
21 products. At least 50% of the new revenue generated by this tax increase (at least \$14 billion of
22 the estimated \$28 billion generated) should be earmarked for the components of this action
23 plan.” (See Subcommittee on Cessation, Interagency Committee on Smoking and Health,
24 “Preventing 3 Million Premature Deaths, Helping 5 Million Smokers Quit: A National Action
25 Plan for Tobacco Cessation,” February 13, 2003, at 24, U.S. Ex. 89,464.)

1 **Q. Assuming the proposed remedy would be funded by means of an assessment, what**
2 **effect, if any, would this have on defendants' costs?**

3 A. To the extent that his proposed remedy would be funded by means of an assessment on
4 each defendant (where each defendant's share of the total cost presumably would depend on that
5 firm's volume or sales share), Professor Fiore's proposed remedy would create substantial
6 incremental costs for defendants. However, unlike an increased federal excise tax, which would
7 apply to all cigarettes, the cost of Professor Fiore's proposed remedy would be imposed only on
8 defendants.

9 **Q. Have you compared the cost of Professor Fiore's proposed remedy to payments by**
10 **tobacco companies pursuant to the MSA?**

11 A. Yes. The MSA imposes annual costs of approximately the same order of magnitude or
12 higher than the cost of Professor Fiore's proposed remedy. For example, total MSA payments
13 were \$2.0 billion in 1999, \$5.9 billion in 2000 and \$6.4 billion in 2001. In addition, cigarette
14 manufacturer payments to the four states that were not MSA signatories (Mississippi, Florida,
15 Texas and Minnesota) were \$2.0 billion in 1999, \$2.0 billion in 2000 and \$2.3 billion in 2001.
16 (*See* Campaign for Tobacco Free Kids, "Actual Payments Received by the States from the
17 Tobacco Settlements," September 9, 2004.)

18 **Q. Assuming Professor Fiore's proposal is funded by defendants, what would be the**
19 **likely effects of these increased costs?**

20 A. As I have discussed, after the MSA-imposed payment obligations began, cigarette prices
21 increased substantially, and non-defendants have substantially increased their share of sales since
22 the MSA was signed. Thus, the imposition of Professor Fiore's proposed remedy likely would
23 also lead to price increases by defendant firms and a further increase in non-defendants' share of
24 sales. Indeed, because the MSA imposed additional costs on at least some smaller firms as well

1 as on defendants, while Professor Fiore's proposed remedy would be funded only by defendants,
2 his proposed remedy would adversely affect the competitive position of defendants vis-à-vis
3 non-defendants more than did the MSA. Thus, the imposition of Professor Fiore's proposed
4 remedy could lead to even larger declines in defendants' share of cigarette sales than did the
5 MSA.

6 **Q. Have you considered whether the increased costs associated with Professor Fiore's**
7 **proposed remedies could have differential effects among defendants?**

8 A. Yes, I have. For example, Liggett competes almost exclusively in the low-price segment
9 of the cigarette market. There are firms in this segment that would not be subject to the "tax"
10 that would effectively be imposed if defendants were required to fund a national smoking
11 cessation program and national youth smoking prevention program. Therefore, compared to
12 other defendants, Liggett likely would be especially affected by such a "tax" imposed on the
13 defendants.

14 **Q. Could some youth smokers be harmed if Professor Fiore's proposed remedy is**
15 **implemented?**

16 A. Yes. A price increase on defendants' brands (relative to non-defendants' brands) likely
17 would lead some youth smokers to switch from defendants' to non-defendants' brands. Because
18 non-defendants are lower-price providers, youth smokers who switch to non-defendant brands
19 could smoke more as a result. That is, Professor Fiore's proposed remedy could
20 increase cigarette consumption by at least some youth smokers. Furthermore, any price
21 increase associated with Professor Fiore's proposed remedy would harm adult consumers.

22 **Q. How would Dr. Heulton's proposed remedy be funded?**

1 A. Dr. Heulton also does not explain how her proposed remedy would be funded. To the
2 extent that it would be funded by any mechanism in which a defendant's share of the total costs
3 would vary with its sales or share, it also would impose an incremental cost on defendants, which
4 likely would lead to higher prices, potential increases in youth smoking by at least some youth
5 smokers and harm to consumers.

6 **VI. DR. ERIKSEN FAILS TO SHOW THAT HIS PROPOSED REMEDY WOULD BE**
7 **EFFECTIVE IN PREVENTING OR REDUCING FUTURE UNLAWFUL**
8 **CONDUCT BY DEFENDANTS AND NEGLECTS POTENTIAL ADVERSE**
9 **CONSEQUENCES THAT LIKELY WOULD RESULT FROM ITS**
10 **IMPLEMENTATION.**

11 A. Dr. Eriksen's Proposed Remedy.

12
13 **Q. Please briefly describe Dr. Eriksen's proposed remedy.**

14 A. Dr. Eriksen's remedy consists of two components: *First*, Dr. Eriksen proposes a
15 "counter-marketing campaign to correct the misperceptions of the glamour, acceptability, appeal
16 and safety of tobacco use." (May 9, 2005 Written Direct Examination of Michael Eriksen, Sc.D.
17 Submitted by the United States Pursuant to Orders #471 and #924 ("Eriksen Written Direct
18 Examination"), at 1.) The campaign would consist of both a "nationwide youth-focused counter-
19 marketing campaign," funded by tobacco companies (*id.* at 7), as well as so-called "corrective
20 communications" focusing on the health risks of smoking. (*id.* at 20-24)

21 *Second*, Dr. Eriksen proposes implementing "certain reasonable restrictions on the
22 marketing of cigarettes," including "(1) replacing any youth-appealing or misleading imagery in
23 cigarette advertising and promotion (but not cigarette packaging) to factual, black and white
24 communication; (2) restriction of visibility of any youth-appealing or misleading imagery and
25 logos at retail; and (3) restriction of promotional devices that lower the price of cigarettes."
26 (Eriksen Written Direct Examination, at 1, 24-25.)

1 B. Dr. Eriksen's Proposed Remedy Does not Specifically Target Defendant's Future
2 Misconduct.
3

4 **Q. Dr. Eriksen states that the purpose of his testimony is not “to provide the public**
5 **health evidence for each of the remedies that [he] [is] proposing,” but rather that his**
6 **“intent was to provide the court remedies to consider that would change the industry’s**
7 **behavior, but they will have the sequential effect of . . . benefiting the public health.”**
8 **(5/16/05 Tr. (a.m.) 21125.) In your opinion, does each component of Dr. Eriksen’s**
9 **proposed remedy specifically target Defendants’ alleged future misconduct or behavior?**

10 A. No, Dr. Eriksen’s proposed “counter-marketing campaign” does not target any specific
11 future misconduct by defendants. In fact, Dr. Eriksen has testified that he prepared his remedies
12 opinions “at the request of the Department of Justice who wanted to draw upon [his] experience
13 and expertise as to what could be done in conjunction with the litigation that might improve
14 public health.” (5/16/05 Tr. (a.m.) 21086-87; *see also id.* at 21092.)

15 **Q. But wouldn’t Dr. Eriksen’s proposed remedies regarding marketing restrictions**
16 **specifically target future misconduct?**

17 A. Dr. Eriksen does “not propose a test” or a definition for the Court or Defendants to utilize
18 to determine what imagery is “misleading,” but rather puts forth remedies “to provide a
19 framework for the Court’s consideration as to the type of steps that could be taken, but not to
20 specify in detail how it could be done.” (5/16/05 Tr. (p.m.) 21196-97, 21208.) Absent such
21 detail, it is hard to evaluate Dr. Eriksen’s proposed remedy.

1 C. Dr. Eriksen Provides No Empirical Econometric Evidence in Support of Any
2 Claim that His Proposed Marketing Restriction Remedy Would Reduce Future
3 Youth Smoking Substantially.
4

5 **Q. Let's discuss Dr. Eriksen's proposed marketing restrictions. Does he provide**
6 **econometric evidence that implementation of these restrictions would reduce youth**
7 **smoking?**

8 A. No. Dr. Eriksen agrees that econometric studies on advertising bans show that "where
9 you only restrict advertising, it does not affect consumption." (5/16/05 Tr. (p.m.) 21212.) In
10 addition, I understand from the testimony of Professor James Heckman that the claimed causal
11 link between tobacco advertising and youth smoking has not been established. (*See* Written
12 Direct Examination of James J. Heckman Submitted by the Joint Defendants Pursuant to Order
13 #471, at 24 ("The evidence that the government's experts rely on does not demonstrate that
14 tobacco company advertising is a causal factor for youth smoking initiation or for continued use
15 of cigarettes, nor does other evidence that I am aware of, not relied upon by the government's
16 experts but relevant to the question at issue, support that assertion."); *see also* Heckman Live
17 Testimony, 4/13/05 Tr. (a.m.) 18808-9.)

18 In addition, although Dr. Eriksen claims that marketing is a "substantial contributing
19 factor" with respect to youth smoking, he agrees that "[t]here is not one longitudinal study that
20 directly measures the impact of exposure to cigarette marketing on the one hand, with the
21 initiation of smoking on the other." (Eriksen Live Testimony, 2/2/05 Tr. (a.m.) 11798.) In any
22 event, Dr. Eriksen has made no attempt to quantify the effect of his proposed remedy, including
23 advertising restrictions, on future youth smoking. (*See* Eriksen Live Testimony, 2/2/05 Tr.
24 (a.m.) 11857-58 ("Q: We are clear, and it's true today, that you've used the term 'substantial
25 contributing factor" to specifically avoid making a statement regarding statistical significance,

1 true? A: Yes. Q: And you've also used those terms to specifically avoid making a quantitative
2 estimate, true? A: Yes.”.)

3 **Q. Does Dr. Eriksen acknowledge that there are multiple factors that affect youth**
4 **smoking initiation?**

5 A. Yes, some of those factors include peer smoking, the socio-cultural environment and
6 racial and ethnic differences. (See Eriksen Live Testimony, 2/2/05 Tr. (a.m.) 11866, 11868 and
7 11872.) Dr. Eriksen fails to show, in light of the multiple factors associated with smoking
8 initiation, what the overall effect of his proposed remedy would be on future youth smoking of
9 defendants' cigarettes. Specifically, Dr. Eriksen fails to show, given current restrictions on
10 defendants' practices (e.g., because of the MSA), what effect the advertising restriction
11 component of his proposed remedy would have on future youth smoking.

12 D. Dr. Eriksen's Proposed Remedy Likely Would Reduce Competition Among
13 Defendants, and thus Lead to Increased Youth Smoking of Non-Defendant
14 Brands and Harm to Adult Consumers.
15

16 **Q. What effects would Dr. Eriksen's proposed remedies have on competition among**
17 **defendants and other cigarette manufacturers?**

18 A. To the extent his remedies, such as required funding of the counter-marketing media
19 campaign, simply act as a tax levied only against defendants, the same adverse competitive
20 effects that would likely result from the remedies proposed by Professors Gruber, Fiore and Dr.
21 Healton would result should the Court implement Dr. Eriksen's proposals.

22 **Q. Could Dr. Eriksen's proposed marketing restrictions have effects on competition?**

23 A. Yes. Advertising and promotion are standard means of competition between producers
24 of differentiated products. (See, for example, Dennis W. Carlton and Jeffrey M. Perloff, Modern
25 Industrial Organization, 4th ed., Chapter 14; see also Aug. 7, 1997 letter from J. Gruber to D.

1 Rubin, JD-068057 (advertising “largely leads to brand substitution and not new smoking”).)
2 Thus, as a consequence of higher prices for defendants’ brands and further restrictions on
3 defendants’ ability to advertise and promote their products, defendants’ competitive position
4 likely would be weakened relative to non-defendant cigarette producers. This would lead to an
5 expansion of cigarette sales by non-defendant producers. Because non-defendants are lower-
6 price providers, youth smokers who switch to non-defendant offerings could respond to these
7 lower prices by increasing the amount they smoke.

8 **VII. COMBINED IMPACT OF PROPOSED REMEDIES.**

9 **Q. What would be the likely impact of implementing each of the proposed remedies?**

10 A. Each of the proposed remedies, if implemented, likely would adversely affect the
11 competitive position of defendants vis-à-vis their rivals. If all of the proposed remedies were
12 implemented, defendants’ competitive position would be even more adversely affected than if
13 only one were implemented.

14 **Q. How would implementing each of the proposed remedies affect defendants’ ability**
15 **to compete with non-defendants?**

16 A. As I have discussed, the imposition of each of the proposed remedies likely would lead to
17 a further increase in non-defendants’ share of sales. Indeed, because the proposed remedies
18 would apply only to defendants, each proposed remedy likely would adversely affect the
19 competitive position of defendants vis-à-vis non-defendants, and so imposition on defendants of
20 all the proposed remedies could lead to significant declines in defendants’ share of cigarette
21 sales. Furthermore, to the extent that a Court-imposed remedy would cause some youth smokers
22 to shift from defendant to non-defendant manufacturers, such a remedy would not be likely to
23 lead to any public health benefit for those smokers.