United States Department of Agriculture

Farm and Foreign Agricultural Services

Farm Service Agency

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Determination of the Administrator of the Farm Service Agency and Executive Vice President of the Commodity Credit Corporation Regarding the Current "Step A" and "Step B" Assessment Methods in the Tobacco Transition Payment Program

The Fair and Equitable Tobacco Reform Act of 2004 (FETRA or 2004 Act), 7 U.S.C. § 518 *et seq.*, terminated tobacco price support programs and marketing quotas for tobacco growers under the Agricultural Adjustment Act of 1938 and replaced them with the Tobacco Transition Payment Program (TTPP). *See* Pub. L. No 108-357, 118 Stat. 1418, 1522 (Oct. 22, 2004). Under the TTPP, the Commodity Credit Corporation (CCC), an agency within USDA, collects assessments from manufacturers and importers of tobacco products and then deposits those funds in the Tobacco Trust Fund. *See* 7 U.S.C. § 518d(d)(1); 7 C.F.R. § 1463.9. Those assessments are used to fund payments to eligible tobacco quota holders and growers in lieu of the prior price support programs. *See* 7 U.S.C. § 518a, *id.* § 518b. The TTPP is set to last for ten years, until 2014, and its total disbursements cannot exceed $10.14 billion. *See id.* § 518f. In essence, by these assessments administered by USDA, through the CCC and the Farm Service Agency (FSA), tobacco manufacturers and importers provide approximately one billion dollars of annual funding to assist tobacco growers and tobacco quota holders in transitioning away from price support programs and marketing quotas.

To enable USDA to administer the TTPP, Congress, through FETRA, conferred several powers upon USDA. For instance, under FETRA, USDA has the ability to promulgate regulations, *see* 7 U.S.C. § 519a; to administer the TTPP by imposing quarterly assessments, *see* 7 U.S.C. § 518d(b)(1); to assess additional amounts to cover insufficiencies, *see* 7 U.S.C. § 518d(c)(3); and to determine the volume of domestic sales for tobacco manufacturers and importers, *see* 7 U.S.C. § 518d(g)(1).

USDA uses a two-step process for determining the assessment amounts for tobacco manufacturers and importers under the TTPP. In Step A, the CCC apportions liability among the six classes of tobacco products specified in the 2004 Act: cigarettes, cigars, snuff, roll-your-own tobacco, chewing tobacco, and pipe tobacco. *See* 7 U.S.C. § 518d(c)(1)-(2); *id.* § 518d(f); 7 C.F.R. §§ 1463.4, 1463.5. In Step B, the CCC prorates each class's assessment among the manufacturers and importers in that class, so that each manufacturer's or importer's assessment is proportional to its market share within that class. *See* 7 U.S.C. § 518d(e)(1); 7 C.F.R. § 1463.7.

USDA's administration of both of these steps has been challenged through litigation. In *Prime Time Int'l Co. v. Vilsack*, 599 F.3d 678 (D.C. Cir. 2010), a cigar manufacturer challenged the Step B calculation process. The central issue in that litigation was whether, contrary to USDA's two-step assessment method, a three-step assessment method should be used to determine assessments within the cigar class. Specifically, Prime Time International Company (Prime Time) argued that after the Step A allocations by class, Step B for the cigar class should consist of two steps and that "USDA should divide the cigar class assessment into sub-classes of large and small cigars, with the relative allocation determined by total weight, and then divide the assessments among individual large and small cigar manufacturers and importers on a per-stick basis from the subdivided assessments." *See id.* at 682. On March 26, 2010, the Court of Appeals for the District of Columbia Circuit determined that "[t]he plain text of FETRA does not self-evidently vindicate USDA's two step assessment method," and, for that reason, the D.C. Circuit remanded the case to "the district court with instructions to remand Prime Time's FETRA claims to the USDA for further proceedings." *Id.* at 683. On June 29, 2010, the District Court for the District of Columbia ordered that Prime Time's claim under FETRA be remanded to USDA for further proceedings. *See Single Stick, Inc. v. Johanns*, 06-cv-1077-RWR (ECF No. 22) (docket reflects Prime Time's prior corporate name). In light of that remand instruction, USDA, in a March 22, 2011, Federal Register notice (76 F.R. 15859), asked for comments on the cigar assessment calculation method because that method potentially affects many cigar manufacturers and importers, whose assessments could change if the process for calculating assessments is altered, for instance, by adding a third step.

More recent litigation challenges the Step A process, *i.e.*, the apportionment of assessments among the six classes of tobacco products. In February 2011, cigarette manufacturer Philip Morris USA, Inc. (Philip Morris) filed suit against USDA challenging the method by which USDA makes Step A determinations. *See Philip Morris v. Vilsack*, No. 3:11-cv-087 (E.D. Va. filed Feb. 8, 2011). As discussed in more detail below, the initial Step A class allocations were set by FETRA on a percentage basis for the six classes of tobacco products. *See* 7 U.S.C. § 518d(c)(1). USDA updates the Step A class allocations, or percentages, annually using tobacco manufacturers' and importers' yearly volumes of tobacco products removed ("sticks" for cigars and cigarettes and "pounds" for the other classes) and the 2003 excise tax rates. (Throughout this document, a "unit" of volume will mean "sticks" for cigars and cigarettes and "pounds" for the other classes.) FSA issued a notice on December 10, 2010 (75 F.R. 76921) which clarified the regulations for the TTPP, codified at 7 C.F.R. part 1463, by explaining that the 2003 tax rates would continue to be used for the Step A calculation in subsequent years. After filing suit in federal court, by letter dated April 8, 2011 (and later supplemented on May 13, 2011), Philip Morris submitted an administrative petition, pursuant to 7 C.F.R. § 1.28, requesting that USDA amend 7 C.F.R. § 1463.5 to require the use of current federal excise tax rates in making Step A allocations among the six classes of tobacco products. The district court granted Philip Morris's request to stay proceedings in the lawsuit until USDA issues a final decision on both this petition for rulemaking and an administrative appeal of Philip Morris's FETRA assessment for the first quarter of 2011.

This determination addresses the challenges to USDA's assessment methods that have been raised in these two lawsuits. Specifically, this determination examines the question remanded in *Prime Time v. Vilsack*, and it rules on the administrative petition for new rulemaking by Philip Morris. USDA considers these two distinct challenges to the TTPP calculation process in the same determination because both issues involve the term "gross domestic volume" and related provisions in FETRA. *See* 7 U.S.C. § 518d(a)(2); *id.* § 518d(e)-(g). This determination first explains USDA's calculation methods under Step A and Step B. It then addresses the challenges raised in both lawsuits in chronological order of the time of the filing of the lawsuits, turning first to the Prime Time challenge, then to the Philip Morris challenge.

USDA's Calculation Process for Step A and Step B

<u>The initial Step A allocations and USDA's adjustment responsibility.</u> USDA did not calculate the initial Step A allocations for each class of tobacco product. Instead, the plain text of FETRA set those initial Step A percentages for each class of tobacco product. *See* 7 U.S.C. § 518d(c)(1). As set by FETRA, Step A percentages were as follows: approximately

96% was allocated to cigarettes; approximately 3% was allocated to cigars; and the remaining approximately 1% was allocated among the other four classes of tobacco products. The text of FETRA does not provide an explicit explanation of how these initial Step A percentages were determined.

Nonetheless, in the course of administering the TTPP, USDA determined that those statutorily mandated percentages were the result of a systematic algorithm apparently used as the basis for the statutory text enacted by Congress. The key feature of this algorithm is that it starts with different measures for the "volumes" of tobacco products – some are measured by weight and others by stick count – and converts them into a common metric. Two pieces of publicly available information were used for this conversion: the 2003 excise tax rates per "volume" (or unit measure) of tobacco products removed for each class, and the total "volume" of tobacco products removed for each class. To arrive at a common metric across the different classes of tobacco products, the volume of tobacco products removed (per unit measure) for a given class of tobacco product was multiplied by the maximum 2003 excise tax rates (per unit measure) for each class of tobacco products. Through that calculation, different volumetric measures for different tobacco products (sticks for cigarettes and cigars, and weight for the other classes) were converted into a common metric: dollar amounts.

To explain that calculation process further requires a more detailed reference to the tax code. Under the tax code, different units of measure apply to different tobacco products for excise tax purposes. The unit of measure for snuff, roll-your-own tobacco, chewing tobacco, and pipe tobacco is weight, measured in pounds. *See* 26 U.S.C. § 5701(e), (f), and (g). For cigarettes and cigars, the unit measure for excise tax purposes is the number of sticks. *See* 26 U.S.C. § 5701(a) and (b). Government-published data series provided the total units of measure or "volume" of tobacco products removed (by either weight or stick count) for different classes of tobacco products. *See* Monthly Statistical Release - Tobacco Products, Alcohol and Tobacco Tax and Trade Bureau, National Revenue Center, Report Symbol TTB S 5200-12-2003 (August 19, 2004). In other words, USDA learned from public records the total number of pounds removed into commerce for snuff, roll-your-own tobacco, chewing tobacco, and pipe tobacco, as well as the total number of sticks removed into commerce for cigarettes and cigars. These volumes of tobacco products removed (whether measured by weight or by stick count), when multiplied by the maximum 2003 excise tax rates for the corresponding tobacco product, generate a dollar figure. For example, multiplying the total pounds of roll-your-own tobacco by the excise tax rate per pound for roll-your-own tobacco generates a dollar figure for roll-your-own tobacco. Thus, the 2003 excise tax rates can be thought of as a "conversion factor" by which disparate tobacco products (whether measured by weight or by stick count) can be compared to one another in a common unit of measure (dollars). Note that the purpose is not to create new volume numbers. Rather, it is to compute liability for a government assessment, where the volumes are an input, but not the only input. The volumes are not the dollar amounts that result from the calculation process. Notwithstanding alternative approaches to determine Step A liability, this is the approach Congress adopted.

The computation process is straightforward for all classes of tobacco products except cigars, because cigars are the only class for which tax rates are not uniform. For classes of tobacco products subject to a uniform excise tax rate, the dollar figure resulting from the conversion noted above is identical to the excise tax liability for those products. The calculations become more complex for cigars that are subject to variable excise tax rates.

Cigars are taxed at two different rates: one rate for "small" cigars and one rate for "large" cigars. (Here, "small" cigars use the tax definition--those that weigh no more than 3 pounds per thousand.)

To account for different excise tax rates, two sub-calculations are necessary. First, for small cigars, the total volume removed, measured in number of sticks, is multiplied by the uniform tax rate for small cigars, and that generates a dollar amount for small cigars. Second, for large cigars, total volume removed, measured in the number of sticks, is multiplied by the maximum per-stick excise tax rate (even though not all large cigars are actually taxed at that maximum rate), and this again generates a dollar amount. The totals from those two sub-calculations are added together to arrive at a dollar figure for the cigar class as a whole. Unlike all the other classes of tobacco products that are subject to a uniform rate, this dollar figure for the cigar class does not correspond to the excise tax liability for the cigar class because not all large cigars are taxed at the maximum rate.

After conversion to a common metric (dollars), the algorithm is then used to calculate the percentages attributable to each class of tobacco product. To arrive at those percentages, the dollar figures for each of the six classes of tobacco products are added together, and that aggregate dollar figure is the denominator. The dollar figure for each class of tobacco product is used as the numerator. When divided by the aggregate dollar figure, the resulting quotient for each class corresponds exactly with the initial Step A percentages in FETRA when base period volumes are used in the formula.

In sum, although FETRA did not provide an explicit formula or a method for arriving at the initial Step A percentages, USDA, in administering the TTPP, determined (from 2003 excise tax rates and excise volume tax data) that an algorithm could be used to arrive at those exact percentages.

Discovery of this algorithm has guided USDA's administration of the TTPP. After the initial allocation of 2003 Step A percentages was set, USDA is required to adjust periodically the original Step A percentages "to reflect changes in the share of *gross domestic volume* held by that class of tobacco product." 7 U.S.C. § 518d(c)(2) (emphasis added). The term "gross domestic volume" is defined in the text of FETRA to mean "the volume of tobacco products -- (A) removed (as defined by section 5702 of Title 26); and (B) not exempt from tax under chapter 52 of Title 26 at the time of their removal under that chapter or the Harmonized Tariff Schedule of the United States." 7 U.S.C. § 518d(a)(2).

In making the annual adjustments to the class percentages, USDA has construed the term "gross domestic volume." The start is the "gross domestic volume" definition in (a)(2) of the statute, which states for purposes of FETRA that "gross domestic volume" means all classes of non tax-exempt products removed into commerce. In understanding that term further, and how to manipulate the class volumes that figure into the definition, USDA has relied upon the same algorithm that Congress apparently used to generate the initial Step A percentages. Consistent with that approach, USDA recognizes that there is no common metric for "volumes" across the different classes of tobacco products -- inasmuch as some are measured by weight, while others are measured by stick count. Thus, without a common metric for the different classes of tobacco product, USDA interprets the term "gross domestic volume" as the sum total of disparate tobacco products removed into commerce – regardless of how the "volume" of products for a given class is measured. For example, if several disparate objects (a notepad, a ruler, and some pencils) were placed in a basket, the gross volume of the products in the basket would be the collection of the products themselves and the share of the party who contributed the ruler to the basket would be the ruler itself. But because the term "gross domestic volume" is not measured in the same units for different classes of tobacco products, each class's share of gross domestic volume must be converted into a common metric for purposes of determining annual adjustments to class Step A percentages. Those are Step A percentages and not, as earlier noted, a newly-created measure of volume.

As Congress did in its algorithm, USDA takes the volume of tobacco products removed for a class of tobacco products (measured in sticks for cigarettes and cigars, and pounds for the other classes) and multiplies those figures by the same conversion factor – the 2003 excise tax rates –to generate a dollar figure for each class of tobacco product. This assures that the adjustment is for changes in each class's share of total gross volume (the collection of all products in the tobacco "basket") and not for changes in other factors, such as taxes. By using 2003 excise tax rates as the conversion factor for subsequent years, USDA ensures that only one variable changes – the "volume" of tobacco products within each class removed in a given year. By keeping the excise tax rate constant year to year, USDA ensures that adjustments reflect only changes in the volumes of tobacco products removed and thus that changes in each class's share of the tobacco "basket" are accurately taken into account.

The Step A class percentages as noted do not reflect GDV percentages, but rather, percentages of the dollar tally. Step A percentages are determined by dividing the dollar total for a given class by the aggregated sum of the dollar figures from all tobacco classes. Those resulting percentages constitute the Step A class percentages for the subsequent year. In short, under USDA's interpretation of "gross domestic volume," annual adjustments to the Step A class percentages are made using the same algorithm as Congress used to determine the initial class percentages and assure that year-to-year changes reflect only changes in each class's share of the total composition of the basket of products . This view comports directly with (a)(2) in that (a)(2) defines GDV as the collection of products in the hypothetical basket.

USDA's Step B Calculation Methodology. After the Step A percentages are determined, USDA makes Step B calculations, which determine a tobacco manufacturer's or importer's individual assessment liability within its class of tobacco product. USDA's basis for making the Step B determinations is grounded in the text of FETRA, specifically subsections (e), (f), (a)(3), and (g), which rely on the concepts of "market share" and "volume of domestic sales." 7 U.S.C. §§ 518d(a)(3), (e)-(g).

Subsection (e) establishes that the data used for the Step B determination will be based on gross domestic volume. First, subsection (e)(1) of FETRA provides the computational process for determining the assessments for each class of tobacco product: "[t]he assessment for each class of tobacco product . . . shall be allocated on a pro rata basis among manufacturers and importers based on each manufacturer's or importer's *share of gross domestic volume*." 7 U.S.C. § 518d(e)(1) (emphasis added). As discussed above, the term "gross domestic volume" lacks a common metric, and as a result, the term "share of gross domestic volume" also lacks a common metric. One manufacturer or importer may have a "share of gross domestic volume" that is composed of numbers of cigarettes; another may have a "share of gross domestic volume" that is measured in pounds of roll-your-own tobacco. In short, under (a)(2), gross domestic volume is the collection of all products. Without any more direction in the statute, then it would seem that each class's "share" of that total is the class's contribution to the total. It then follows that a party's "share" of the total volume is its own contribution to its class's share. Note that this makes sense of the statute and produces logical results for all program purposes. Thus, if a party removed 100 cigars into commerce, then that party's "share" of total GDV is 100 cigars. The calculations required under (e) and other sections for Step B proceed from there based, as they must, on those 100 cigars. Note that a share does not have to be a percentage, but can be the goods themselves. Notably, (e) does not provide that the Step B assessment shall be "equal" to the party's GDV "share," except for specificity elsewhere in the statute (beginning in (f)), which suggests that the share involves some separate mathematical percentage calculation under (e) rather than the contributed volume itself. Rather, the assessment is an amount "based" on that share, thus reinforcing the notion that the necessary and controlling mathematics are set out elsewhere—apart from (e) itself—as USDA indicated in our March 22, 2010 notice. Reconsideration has enhanced and sharpened our understanding of the issues in this determination and conviction about the proper outcome. In fact, other parts of the statute tell USDA how to make that calculation and produce the most logical reading of the statute using "share" to mean the tobacco products themselves. This is how USDA has made the calculations to date. We have treated (f) and its associated subsections as telling us how to make the calculations, taking into account and not exceeding each party's share of GDV. Calculating the assessments in this way provides for a clear, consistent, and logical administration of the statute. [1]

[1] Even if (e) required that the Step B share "equal" the share of GDV rather than be "based on" that share, USDA would end up at the same place. That is due to the specificity of (f) and the related sections, including the "market share" definition in (a)(3), the lack of any provision for different calculations, and the lack of viable and persuasive alternatives noted here and in the March notice.

USDA believes that the Step B provisions in subsections (a)(3), (f), and (g) provide the specifics as to how those different units of measure are to be used to compute the manufacturers' and importers' Step B liability within a class. This specification provides justification for the view that "share" means the actual contribution of products (100 cigars) rather than some unspecified percentage of the total weight or size or taxes paid of all products in the class. Ultimately, the calculation of the Step B assessment for a cigar company is based on the number of sticks that are involved in its share of GDV—the number of taxable cigars removed into commerce as specified in (a)(2)— because that is what Congress instructs USDA to do in (f) and (g), as explored below. Thus, USDA believes that, as explained here and below, when all provisions are taken together, Prime Time's "share" of GDV is the cigars themselves. It is not some separately calculated percentage.

Second, subsection (e)(2) ensures that the relevant Step B calculations are made using the same underlying quantities of tobacco products as the Step A calculations: the volume of tobacco products removed that are not tax exempt. *See* 7 U.S.C. § 518d(e)(2) (providing that "no manufacturer or importer shall be required to pay an assessment that is based on a share that is in excess of the manufacturer's or importer's share of domestic volume"). Pursuant to subsection (e)(2), USDA ensures that no manufacturer or importer pays an assessment greater than an amount based on its "share of" GDV. For instance, if a manufacturer had a "share of" of GDV that was 100 cigars, that manufacturer would not pay more than the amount of a Step B assessment that is calculated using 100 cigars. Also, by operation of subsection (e)(2), USDA does not reassign any unpaid part of the class assessment (by a delinquent manufacturer or importer) to a paying manufacturer or importer.

Subsection (f) provides more detail on how the data described, and concepts set forth, in subsection (e) should be incorporated. Subsection (f) specifies exactly how much the Step B assessment must be for a party by class in each one of the six classes. Accordingly, there is only one method of computing the Step B liability of a party. That liability is not the lesser of two amounts--one computed pursuant to (e), and another pursuant to (f). No one has suggested otherwise. Such a two-part liability determination would leave part of the class's liability to be paid by the public, which would be contrary to the nature of the statute. The statute is designed so that the "buyout" program will be privately funded. In any event, subsection (f) is very direct on this issue. Specifically, under subsection (f), a manufacturer's or importer's Step B assessment is determined by the manufacturer's or importer's "market share" for the "class" multiplied by the class's dollar assessment. 7 U.S.C. § 518d(f). Here, subsection (f) is explicit: the amount that a manufacturer or importer shall pay will be the product of the total amount of the assessment for the class multiplied by "the market share of the manufacturer or importer of the class of tobacco product." The term "market share" is defined by FETRA in subsection (a)(3) to mean "the share of each manufacturer or importer of a class of tobacco product (expressed as a decimal to the fourth place) of the total *volume of domestic sales* of the class of tobacco product during the base period for a fiscal year for an assessment under this section." 7 U.S.C. § 518d(a)(3) (emphasis added). Thus, by operation of subsections (f) and (a)(3), the definition of "market share" is built on the definition of the term "volume of domestic sales."

Subsection (g) gives further meaning and detail to the necessary calculations. Subsection (g)(1) specifies that the data for determining the "volume of domestic sales" shall be certified copies of excise tax returns and forms or other relevant information available to

USDA. *See* 7 U.S.C. § 518d(g)(1). Subsection (g)(2) requires that "the volume of domestic sales shall be calculated based on gross domestic volume." *See* 7 U.S.C. § 518d(g)(2). This provision reaffirms subsection (e) and ensures that only tobacco products that meet the definition of GDV will be used to calculate the volume of domestic sales. Thus to avoid confusion over what constitutes a "domestic sale," subsection (e)(2) makes clear that tobacco products not removed into commerce (which are not included in the definition of GDV) will not be used as a basis for determining gross domestic sales. Finally, subsection (g)(3) specifies that the metric used for measuring volume of tobacco products in (g)(2) corresponds to sticks for cigarettes and cigars and to weight for the other classes: "the volumes of domestic sales shall be measured by – (A) in the case of cigarettes and cigars, the number of cigarettes and cigars; and (B) in the case of the other classes of tobacco products . . . in terms of number of pounds, or fraction thereof, of those products." *See* 7 U.S.C. § 518d(g)(3). Based on that subsection, USDA concludes that volumes of domestic sales will be apportioned by stick count for cigarettes and cigars and weight for the other classes of tobacco products.

Putting those pieces together, USDA calculates the volume of domestic sales for a class of tobacco product by determining the total volume of tobacco products (in either sticks or pounds) for that class. To determine the "market share" of a manufacturer or importer within a class of tobacco products, USDA divides the volume of tobacco products (in either sticks or pounds) attributable to a manufacturer or importer by the total volume of tobacco products (in either sticks or pounds) for that class. (Taxes paid can be used as a proxy for volume when the tax rate by volume (sticks or pounds) is uniform for the whole class since this uniformity produces the same results.) That market share is then multiplied by the assessment amount attributed to the class of tobacco products to determine a specific manufacturer's or importer's TTPP assessment liability.

Despite the statutory, empirical, and practical reasons for USDA's calculation method for TTPP assessments, Philip Morris and Prime Time challenge USDA's approach. However, unlike those of Philip Morris and Prime Time, USDA's reading of FETRA is consistent with the algorithm that Congress used to compute the original Step A percentages and ensures consistency between the Step A and Step B calculations.

Prime Time's Challenges

Prime Time's challenges to its assessments. In contesting the amounts of its TTPP assessments, Prime Time raises several arguments. First, Prime Time challenges USDA's Step B calculation methodology. They argue that the term "volume" as used in FETRA should only mean weight, and when that meaning is applied to the term "gross domestic volume," the limitations placed on assessments by subsection (e)(2) require that Prime Time's assessment not exceed its weight-based proportion of all cigars. As an alternative, because weight data are not collected for cigars (or for cigarettes, for that matter--which would be necessary if Prime Time's theory were applied uniformly), Prime Time suggests that taxes paid should be used as a proxy for TTPP assessment liability. Moreover, since excise taxes consist of two classes – one for "small" cigars and one for "large" cigars (which are added up separately in the Step A dollar calculation) – Prime Time suggests that the Step A cigar assessment should be divided into two subcategories, one for "small" cigars and one for "large" cigars. Then, based on those proposed Step A amounts for "small" cigars and for "large" cigars, Prime Time urges that the Step B determination should use stick count as a means of apportioning assessment liability between the manufacturers and importers for each proposed subclass ("small" and "large" cigars) separately. Prime Time also suggests that USDA's calculation method is incorrect because it purportedly ignores the pro rata limitation in subsection (e)(1).

In addition to these challenges, Prime Time disputes the data that USDA uses to calculate Prime Time's assessments. Prime Time contends that USDA should account for A.C. Nielsen data for industry and individual sales volumes in making TTPP assessments. Furthermore, Prime Time argues that it lacks access to all of the necessary data used to make the TTPP calculations, and therefore has had its due process rights violated.

<u>The Remand from the Court of Appeals.</u> On appeal, the D.C. Circuit analyzed USDA's calculation methods as solely matters of statutory interpretation, *i.e.*, whether FETRA was unambiguous as to the requisite calculation methods. *Prime Time Int'l Co.*, 599 F.3d at 683. In that case, USDA argued that subsection (g)(3) unambiguously required the current Step B calculations, but the D.C. Circuit determined that subsection (g)(3) did not, as the government contended, compel that result unambiguously and questioned whether USDA's view gave meaning to the terms in subsection (e)(1), which requires a distribution among classes on a pro rata basis. *See id.* at 682-83. The D.C. Circuit suggested that Prime Time's method could provide meaning to all sections of the statute. *See id.* As a result of finding that FETRA was ambiguous, the D.C. Circuit reversed the District Court's judgment in favor of USDA and ordered the District Court to remand Prime Time's claims to USDA for further consideration. Also, the D.C. Circuit contemplated that USDA would address the data issues on remand, such as the A.C. Nielsen survey results and Prime Time's lack of

information claim. The District Court remanded this matter to USDA by order dated June 29, 2010.

In compliance with that remand instruction, on March 22, 2011, USDA issued Federal Register notice (76 F.R. 15859) seeking comments on the interpretation of FETRA. In response, USDA received five comments. One was in favor of changing USDA's current interpretation (submitted by Prime Time). All other comments opposed altering USDA's present calculation method.

Comments received in response to the March 22 notice. The following viewpoints were advanced in the comments:

1. Retroactivity. None of the commenters wanted a retroactive rule. If, however, the Step B assessment for a manufacturer or importer is lowered for a past period, then presumably another manufacturer or importer must pay more, subject, perhaps to other procedural considerations. Otherwise the public would have to make up the difference. The program, as noted above, is designed to operate without public funds to the extent practicable.

2. A decimal correction. One party addressed an error in the Federal Register notice. Due to a decimal error, USDA's March 22, 2011 notice overstated the effect that Prime Time's alternative Step B calculation would have had on the 2010 assessments for makers of large cigars by an order of magnitude. USDA caught that error, published a correction notice, 76 F.R. 19710 (April 8, 2011), and notified all parties paying cigar assessments by letter. The correction noted that, in 2006, Prime Time's method would have generated per-unit "small" cigar assessments that would have been substantially reduced, but that per stick

"large" cigars assessments would have increased by approximately 80 percent. The correction further noted that 2010 assessments for large cigars would have changed only slightly since the volume of small cigars has been greatly reduced due to tax rate changes legislated in 2009. To be clear, the commenter who supports change (Prime Time) calculates the proposed 2010 effect of its alternative methodology at a 4 percent increase in the hypothetical assessment on large cigars from what the assessment for all cigars actually was for 2010.

3. Maintaining the status quo is an option. One comment appeared to suggest that the matter was resolved by the appellate court's decision to remand the case to USDA. USDA does not perceive that the remand compels changes in Step B procedures, but rather, that USDA must address the D.C. Circuit's concerns, such as resolving the ambiguity that it identified in the statute. USDA also perceives its obligation on remand as requiring it to give full and fair consideration to Prime Time's alternative methodologies and any theories of calculation that are presented. This determination is consistent with those goals and obligations for remand.

4. General applicability of FETRA to cigars. One commenter stated that cigars were not the focus of the defunct price support programs for tobacco growers. Accordingly, that commenter urged that cigars be exempt from all TTPP assessments. USDA does not view that as a legal option in light of FETRA's provisions, which expressly reference cigars as one of the six classes of tobacco products. (Notably, those same FETRA provisions do not subdivide large cigars and small cigars into separate classes – there is only one "cigar" class under FETRA.)

General background in addition to comments received. There has been some question about the "fairness" of assessing a small cigar with as much liability as a "large" cigar, and furthermore, whether the statutory provisions for Step A and Step B allow USDA to adjust its calculations if some notion of unfairness were perceived. USDA does not perceive any latitude for fairness in the calculations given that (f) and (g) state how to make them. USDA notes further for the record that both small and large cigars were taxed at approximately 1/3rd of one cent per cigar prior to 2009. Small cigars proliferated during the buyout period until 2009, but have subsequently dwindled because of 2009 tax changes that resulted in the relatively more favorable treatment of large cigars. Now, more large cigars are manufactured, as it is easy for a manufacturer to increase the size of a small cigar so that it falls in the large cigar category. Also, despite Prime Time's complaint about the treatment of small cigars, until the per-stick small cigar excise tax rates were equalized with cigarette excise tax rates in 2009, small cigars had a significant excise tax advantage over cigarettes. As indicated above, there is reason to believe that the loss of favorable excise tax treatment for small cigars in 2009 motivated small cigar manufacturers and importers to increase the size of their "small" cigars so that they could be taxed more cheaply as "large" cigars. Small cigars increased in number every year of the buyout until the 2009 excise tax changes, when the industry shifted away from small cigars and to large cigars. Given these changes, the Prime Time theory would result in assessments being made on taxes paid as a proxy for weight--when in fact cigar weight and taxes paid now have an inverse relationship in some instances, as USDA indicated in the March notice. Taxes are thus not, even in a rough sense, a consistent proxy for weight. In any event, a lower small cigar assessment might well have been seen as unfair to cigarette makers and to makers of "smaller" large cigars, which are not much different, it turns out, than small cigars.

USDA concludes that its Step B methodology is the optimal reading of FETRA. Having considered the comments and the background for the issues, for the reasons set forth in USDA's March notice, as well as the explanations provided here, USDA determines that it will maintain its Step B calculation methodology. That is, USDA rejects Prime Time's plea for a different interpretation.

It is a superior reading of the term "gross domestic volume" to have it refer to the relevant unit of measure for tobacco products (sticks or weight) and not simply weight. The statute does not compel a reading of GDV as referring only to the weight of tobacco products, and interpreting GDV in that way is logistically problematic. Rather, treating "share" to mean the party's contribution to the basket of products in terms of numbers comports with the provisions of the statute and with the particular calculation provisions of (f) and (g). No one has cited anything that would indicate that USDA is to compute the weight of cigars, or even that "volume" means "weight" for cigars in this context. Further, beyond the excise tax cutoff dividing large cigars from small cigars, cigars are not commonly measured by weight. Cigars are not marketed by the pound, but rather, by the stick, or pack of sticks. As a result, data are non-existent for specific cigar weights, or for cigarettes--which contribute another part of GDV. Thus, the relationship between the weight of Prime Time's sticks to the average weight of all cigars is speculative. Moreover, Congress did not use weight for cigars in the Step A calculation. After all, under the algorithm that USDA discovered for calculating the original Step A percentages, the number of large cigars (measured in sticks) is multiplied by the maximum excise tax rate, and not a weight-specific excise tax rate. Congress made separate tax-related calculations for small and large cigars in the Step A calculation, using sticks as the measure. Congress then, pointedly, combined the small and large cigar tallies and made them one class. Regardless, FETRA does not use the term "volume" in isolation. Rather, the critical term is "gross domestic volume," which means the sum total of tobacco products removed into commence – regardless of the unit of measure (stick count or weight) for those tobacco products.

As described above, USDA's interpretation of "share" thus reflects and is in accord with the algorithm apparently used by Congress in setting the initial Step A percentages and with the overall statutory provisions, not just the provisions of (g)(3). That algorithm for initial class percentages and USDA's reading of the relevant subsections of FETRA both convert different classes of tobacco products that are measured by different units of measure into a common unit of measure (dollars) for comparison purposes for Step A. That conversion takes place by using the excise tax measuring unit (sticks for cigarettes and cigars, and pounds for all other classes of tobacco products) to measure the amount or volume of tobacco product removed into commerce for each class of tobacco products (this is each class's share of GDV), and then multiplying that share of GDV by the appropriate 2003 excise tax rates for the relevant class of tobacco product. The resulting product is the dollar tally for each class of tobacco product's share of GDV, and those figures are used for a pro rata comparison among different classes of tobacco products. Then, however, each class's liability is apportioned among individual participants using the formula of (f) and (g), and the actual contribution of the party to the overall basket of tobacco products. That contribution is the party's share of GDV under this formulation--namely their part of the basket of goods that meets the GDV definition. That contribution for Prime Time is its cigars. Their cigar assessment is thus based on their share of GDV. We plug those cigars into the statute in the manner specified in (f) and elsewhere. The result is consistent with the statute. No more consistent result is presented to USDA in this proceeding.

Furthermore, other provisions of FETRA contemplate the term "volume" as having a meaning that corresponds to the relevant metric for tobacco products and not a pre-set meaning as either weight or stick count. For instance, in subsection (g)(3), FETRA provides that "*volume* of domestic sales" shall be measured by stick count for cigarettes and cigars and by pounds for all other classes of tobacco products. Thus, subsection (g)(3) incorporates the concept that the term "volume" as generally used in FETRA does not refer to a fixed unit of measurement, but one that varies, depending on the product measured. That is why subsection (g)(3) explicitly defines which unit of measure shall apply to volumes for different classes of tobacco product.

<u>Prime Time's alternative theory is not persuasive.</u> In seeming recognition of the defects of its preferred interpretation (due to the lack of weight data as a metric for cigars), Prime Time offers an alternative theory. Specifically, Prime Time suggests that the Step A cigar assessment should be divided into two subcategories – small cigars and large cigars – based on the amount that each contributes to the dollar tally under the Step A calculation. According to Prime Time, the assessment liability within those two categories should be apportioned on a per-stick basis among manufacturers and importers within those two proposed classes.

For the reasons given in this document, USDA concludes that Prime Time's alternative reading is not more plausible than, or equally plausible to, USDA's reading of the statute. To the contrary, Prime Time's method appears to directly contradict the statute. Prime Time's method is no different than having seven classes of products instead of six. By ignoring the fact that FETRA designates six (not seven) classes of tobacco products, Prime Time's theory cannot reconcile subsections (a)(2), (c)(1), (e), (f), and (g), which all reference assessment calculations being made on a "class" basis. FETRA provides for only one class of cigars under subsection (c). More practically, it is reasonable to conclude that because Congress knew how to account for the variable excise tax rates for small cigars and large cigars in figuring the original Step A percentage, Congress could have also subdivided small cigars and large cigars in subsection (c)(1) if it had desired Prime Time's interpretation. FETRA, however, makes no mention of subclasses for small cigars and large cigars; rather, subsection (c)(1) refers to only one cigar class.

Moreover, as one comment against changing the procedure noted, if Congress intended the interpretation that Prime Time advocates, then other provisions of FETRA would have to have been changed. For instance, subsection (f) would have required that the market share calculation be made separately for small cigars and large cigars. Beyond the fact that subsection (f) does not contain such a provision, prior legislation (see the March 22, 2011 notice) suggests that Congress did not intend to create two classes of cigars under FETRA. In a bill preceding passage of FETRA, Congress created an FDA assessment on tobacco products, which treated "little" cigars as a separate category. Yet, in FETRA, Congress did not create a separate class for small cigars. Thus, despite knowing of the differences between small cigars and large cigars, and having demonstrated the ability to account for those differences in a statutory assessment program, Congress did not do so in the plain text of FETRA, which provides for only one category of cigars.

Prime Time's alternative theory also suffers from the same deficiencies that it purports to correct. According to Prime Time, after subdividing the Step A assessment for cigars between small and large cigars, USDA should then use a per-stick method to apportion assessment liability within those subcategories. But any per-stick measurement fails to account for weight differences within a class – even within the subcategories that Prime Time proposes. For instance, within the proposed large cigar category, heavy "large" cigars and very light "large" cigars (those that barely qualify as "large") would pay the same per-stick amount. This result contradicts Prime Time's premise, that in the interest of equity, cigars weighing less should pay a smaller share of the assessments. The flaw in the purported equities of Prime Time's theory provides further reason for USDA to reject Prime Time's approach.

<u>USDA's Step B calculation method gives meaning to all terms in FETRA, while Prime Time's method does not.</u> Under USDA's interpretation of FETRA, subsection (e)(1) is read consistently with other sections of FETRA, including the Step A calculation process. Specifically, subsection (e)(1) provides that "the share of GDV" shall be used to determine the pro rata allocation among the classes of tobacco products. Thus, by using the term "share of GDV," subsection (e)(1) builds off of the term GDV, which is measured differently for different classes of tobacco products. This approach is consistent with the algorithm that was used to calculate the initial Step A percentages and with the provisions of the statute as noted.

In short, Prime Time's share of GDV reflects, and is, the cigars that it markets. How USDA is to count those cigars in calculating Step B assessments is defined explicitly in (f) and (g). Hence, any suggestion that USDA is in error must be pinned to (f) and (g). Prime

Time assumes without merit that "share" as used in (e) means some calculated weight percentage rather than the cigars themselves. In fact, that suggestion produces results that violate the six-category orientation of the statute in addition to the results noted above.

In contrast to the position of Prime Time, if the term "share of GDV" already had a common unit of measure, then Congress's algorithm for initial Step A calculations and the provisions of FETRA that seek to convert various units of measure into a common metric would not be necessary. Rather than assume that FETRA had no further use of the algorithm used by Congress to generate the original Step A percentages, or that several provisions of FETRA are meaningless, it makes sense to read subsection (e)(1) as recognizing the fact that there is not a common metric for GDV or share of GDV. Further, Congress did not ask USDA to convert a party's "share" of the GDV for cigars to a weight percentage or a tax percentage. Rather, (f) and (g) instruct USDA how to treat the party's share, taking that party's share to be its marketings (the cigars themselves), which meets the GDV definition. USDA does just that. USDA only counts marketings that meet that definition in its calculations. Below, an adjustment is referenced that was made at the end of year 1 of the program. USDA made that adjustment when it was learned that certain marketings had been counted that did not meet the GDV definition, and they were subsequently eliminated.

Similarly, USDA understands subsection (e)(2) to mean that liability for any unpaid part of the class assessment (by a delinquent manufacturer or importer) is not transferred to a paying manufacturer or importer. Otherwise, the assessment for the paying parties could exceed the amount that can be attributed to their actual share or contribution to the GDV. In a sense, USDA reads subsection (e)(2) as preventing joint and several liability among manufacturers and importers in a class of tobacco product. Accordingly, USDA reads subsection (e)(2) to mean that no manufacturer or importer pays an assessment greater than the amount calculated on the basis of its "share of" GDV, however GDV is measured. These interpretations of subsection (e) are consistent with USDA's reading of subsections (f), (a)(3), and (g) and do not interfere with USDA's calculation methods for Step A annual adjustments and Step B intra-class apportionments. This understanding of the statute and its terms thus provides a coherent basis for applying all terms of the statute and is not contrary to any plain meaning of any of the statutory terms.

In contrast, Prime Time's proposed reading of subsection (e) cannot be harmonized with other provisions of FETRA and does not "correct" the "problem" it seeks to correct. Prime Time proposes a weight-based determination of GDV, or alternatively an approach that uses the amount of excise taxes paid as a proxy for "share of GDV." Those readings ignore the fact that "share of" GDV is not a weight-denominated (or a dollar-denominated) figure under any term of the statute. A party's "share," by a normal dictionary definition and by logic of the statute, is its part of the total--its contribution to the total. That part of the total for Prime Time is its cigars, and its assessment is based on those cigars. Subsections (f) and (g) instruct USDA how to make the calculations, which produces consistency between (e) and (f) and (g). Either of Prime Time's methods of calculation (weight-denominated or dollar-denominated) would ignore or make pointless significant other portions of FETRA. For instance, there would be no need for separate Step A and B calculations. All assessments would be based purely on a manufacturer's or importer's percentage contribution to the total dollar tally for all classes per Step A. Administering the program in this way would be inconsistent with the class concept as it applies to cigars and FETRA's reference to concepts such as "market share" and "volume of domestic sales," and would ignore entirely subsections (a)(3), (f), or (g). It would not be reasonable or appropriate to embrace an approach that renders useless so many statutory provisions, that transforms the six classes identified in subsection (c) into seven classes, and that is favored by only one commenter, Prime Time.

Lack of rebuttal in the comments received. As indicated earlier, in response to USDA's Federal Register notice, only one commenter, Prime Time, advocated a change in USDA's calculation method. Although USDA's notice pointed out many problems with the theories Prime Time advocates, Prime Time's comment in support of change ignored those problems and cited no new theory of calculation. By its silence in several areas, Prime Time's comment suggests that it has no interpretation of FETRA that would give meaning to all of the statute's terms.

Other issues raised in the Prime Time litigation: the A.C. Nielsen data. In addition to challenging USDA's calculation methods, Prime Time also suggested a lack of accuracy in the data used in USDA's Step B calculation. The decision of the court of appeals notes the vast difference between USDA's market share computation and Prime Time's statement of market share based on A.C. Nielsen Company data. Several possible explanations exist for this discrepancy. For instance, one commenter, who opposed changing USDA's calculation method, noted that Nielsen data do not cover all outlets and do not measure "removals" as specified in the definition of GDV contained in subsection (a)(2). In addition, the Nielsen measurements contain both stick and package data. USDA conducted a preliminary reexamination of the Nielsen data provided by Prime Time and it appears that the discrepancies noted in the court of appeals decision may be due to one set of percentages being based not on sticks but instead on package count (where, for instance, a package of 20 cigars would count as "1" instead of "20"). If so, the Nielsen percentages would measure a different market share than those described in FETRA in (f) and (g). FETRA does not use packages as a potential metric. If the Nielsen percentages are package percentages, it follows that the Nielsen-derived percentages referred to in the court decision do not indicate in any substantial way a difficulty with the government's percentages. In short, because small cigars are likely to be sold in packages, sales data that counts packages (and not the number of sticks) would produce a lower GDV percentage than data based on sticks. Thus, USDA believes that, if the controversial Nielsen percentages are package percentages, then the Nielsen data provide an unhelpful comparison because Nielsen's methodology is inconsistent with the FETRA definition of GDV and because it measures sales by package count and not by stick count.

USDA will address more closely the Nielsen data in the adjudicatory phases of the remand of Prime Time's claims. But, there is another indicator that the Nielsen data do not measure the same percentages as USDA in calculating market share in accord with (f) and the other provisions of the statute. Specifically, USDA's market share calculation is based on a manufacturer's or importer's submitted excise tax filings, *see* 7 U.S.C. § 518d(h). Those tax filings are compared with data compiled by the Department of the Treasury and by Customs and Border Protection at the end of the year. Hence, if the Nielsen percentages were correct, the percentages derived from Nielsen data would also mean that the Treasury data are off by a factor of 3. No one has suggested that such a discrepancy is plausible. This fact as well suggests that the Nielsen percentages may well be package data, not stick data, and/or that not all sales outlets are covered.

Other issues raised in the Prime Time litigation: the market share of other manufacturers and importers. Another matter of controversy noted in the court decision of general import involves the market share (within the meaning of FETRA) of other industry participants. At the time that Prime Time filed its initial complaint in District Court, USDA did not make available market share determinations for all other manufacturers and importers due to concerns about confidentiality of that excise tax information under the Internal Revenue Code. That concern formed an issue in the case. Over time, those concerns have been resolved, presumably by the changed practice of releasing, by ranking number, market share information for all manufacturers and importers for every TTPP quarterly assessment. If this remains an issue, it can be addressed in the adjudicatory phase. In addition, the court of appeals noted that there was some concern about the adjustments made at the end of the first program year, but those adjustments were made because of new information from the Department of Treasury regarding whether certain marketings satisfied the statutory GDV definition. USDA sent a letter to all interested parties concerning that adjustment. If this remains an issue it can be addressed in the adjudicatory portion of the remand.

In sum, USDA has considered the comments received and the argument that Prime Time makes in support of altering USDA's TTPP assessment methodology. After such consideration, USDA does not adopt Prime Time's suggestions for a change in the assessment method in favor of small cigars makers and contrary to the interest of large cigar makers. Further, USDA will not alter its TTPP assessment methods or, pending any change justified in the adjudicatory phase of the proceeding, the data it uses for those calculations. USDA believes that its current method for handling Step B determinations has been, and remains, the most appropriate method.

Prime Time and all other parties in the cigar class are treated the same. They are each assessed based on their part or share of the GDV in the manner we have described. Hence, USDA believes that the cigar class allocation is, all things considered, properly allocated on a "pro rata" basis among manufacturers and importers based on each manufacturer's or importer's "share" of GDV. Hence, no manufacturer or importer is required to pay an assessment that is based on a share that is in excess of the manufacturer's or importer's share of domestic volume. For cigars, and for the reasons given, sticks, we believe, are the "pro rata" rate referenced in (e). A party's "share" of GDV is its own "sticks" or cigars and its "pro rata" amount of the Step B assessment is its proportion of the total cigar sticks in the total GDV (as GDV is defined in (a)(2)). That is, we read (e) to set the general rule. The provisions that follow (and which reference terms in previous sections) inform us and direct us on how to implement the general rule of (e). Under (f) and (g) and the related sections, after consideration on remand, we are told specifically how to compute the Step B amount using, as specified in the statute, sticks as the " pro rata" rate on a cigar party's "share" of GDV which we understand to be the party's cigars. GDV and "volume of domestic sales" are different things within the statute. One is a basket of products. The other is a within-class calculation under the formula set out under (f) and (g) and related sections for calculating a party's Step B assessment based on their share (contribution to) the GDV or basket of goods. This view of the statute gives meaning to all provisions, is consistent with the actual language of the statute, and makes sense of the mandatory provisions starting in (f), but relating back to other provisions of the statute regarding the calculation of Step B assessments for cigars. The only alternative suggested to us does not produce a consistent result for large cigars, does not give meaning to (f), and has other problems as noted. In any event, we can think of no better reading of the statute than the one we give it. None is suggested to us. We note, too, again that our view of what is a "share" of GDV and the metric for measuring cigar volume is consistent with the Step A calculation and our determination below on Step A. We address Step A now.

The Philip Morris Challenge

Philip Morris has challenged USDA's methodology for making the Step A annual adjustments in an administrative petition and in a lawsuit in federal district court, *Philip Morris v. Vilsack*, No. 3:11-cv-087 (E.D. Va. filed Feb. 8, 2011). Both of these challenges stem largely from the fact that, in 2009, excise taxes rates were changed for cigars compared to cigarettes. Specifically, the large cigar maximum tax rate (only paid by some cigar producers and importers) went from $48.75 per thousand to more than $400 per thousand. Pub. L. No. 111-3, Sec. 701(a)(3) of P.L. 111-3 substituted "40.26 cents per cigar" for "$48.75 per thousand ($42.50 per thousand on cigars removed during 2000 or 2001)". In the wake of that change in tax rates, Philip Morris contends that USDA should use the current tax rates (and not those from 2003) to compute the annual adjustments to the Step A percentages. USDA previously addressed the Step A calculation methodology in a December 2010, Federal Register notice. *See Tobacco Transition Payment Program: Tobacco Transition Assessments*, 75 Fed. Reg. 76921 (Dec. 10, 2010). But, in light of Philip Morris's administrative petition, which challenges that Federal Register notice, as well as USDA's Step A methodology more generally, USDA revisits the Step A issue in this decision-making.

<u>The annual adjustment process.</u> As explained above, FETRA instructs USDA to adjust the Step A percentages periodically, which USDA does annually, but FETRA provides

no specific formula or methodology for calculating those adjustments. 7 U.S.C. § 518d(c)(2). The most direction that FETRA provides is that the adjustments should "reflect changes in the share of GDV held by that class of tobacco product." *Id.* Nonetheless, having determined the algorithm that generated the original Step A percentages, USDA uses that algorithm – including its reliance on the 2003 excise tax rates – to adjust the Step A percentages annually.

This approach assures that annual adjustments reflect changes in the "volumes" of tobacco products removed in each class. By using the same excise tax rate each year, USDA ensures that only one variable changes in the annual adjustment process – the amount or the "volume" of tobacco products removed. If a second variable were changed, such as the excise tax rate, then the Step A percentages per class would change for reasons that do not correspond exclusively with the amount of tobacco removed into commerce in a given year. Under that dual-variable scenario, even if the actual amount or "volume" of tobacco products removed for all classes remained unchanged from one year to the next, a change in the excise tax rate could result in greater or lesser TTPP assessment liability for a tobacco manufacturer or importer. For example, if the 2009 tax rates were used in the Step A calculation and assuming that there were no actual changes in the volume or marketing activity of cigars or that of any other class, then the current cigar Step A percentage would more than double its current amount, and the cigarette percentage (currently at 91.6 percent) would be reduced significantly. That result is a dramatic change, and USDA finds no provision of FETRA that requires use of different annual excise tax rates to calculate the annual Step A adjustments. Thus, USDA will not vary its calculation method based on fluctuations in excise tax rates; instead USDA will use a constant excise tax rate, changing only the variable (volumes) that

Congress mandated and maintaining consistency with the algorithm used to generate the original Step A percentages.

This determination now addresses the arguments made in Philip Morris's petition for rulemaking concerning Step A:

1. GDV is not a measure of taxes paid. Philip Morris argues that GDV is a measure of taxes paid and that annual TTPP adjustments should account for the new excise tax rates (the result of which would be favorable to cigarettes). But, as noted above, the meaning that USDA gives to the term GDV is not a proxy for aggregate excise taxes paid. Rather, as defined in (a)(2) of the statute, GDV is the entirety of the basket of tobacco products removed into commerce, which for Step A purposes are accounted by class share in a variety of units which are then converted into tax-related Step A (not GDV) dollar (not volume) subtotal amounts for comparison purposes. Those dollar tallies used in the conversion process do not necessarily correspond to the excise tax liability for all classes of tobacco products. Rather, as explained above, the dollar tally used to determine the Step A allocations for the cigar class does not correspond with the excise tax liability for that class and hence the Step A tax-related dollar tallies do not measure the relative tax liabilities generated by the GDV among classes.

Nowhere in the statute is GDV defined to be a dollar amount. Instead, it is defined in (a)(2) to be the products themselves. Moreover, taking the Step A calculation as a proxy for GDV produces results that USDA believes are illogical and inconsistent with the statutory language. In that case (that is, if the Step A percentages were taken as GDV proxies), even if the physical amount of tobacco products removed into commerce did not vary from year to year, there could still be significant changes in Step A percentages if the excise tax rates changed annually or otherwise. By statute, however, the Step A calculation is to change only if the shares of the overall volume have changed. Given the definition of GDV in the statute, there must, USDA believes, first be some product change and that change would have to be independent of the change in tax rates. The change taken into account would have to be the change in the products themselves, given the definition in the statute and the common understanding of the terms involved. It is unclear how a change in tax rates could, on its own, be considered a change in the share of the national volume of tobacco products. In any event, the definition of volume in (a)(2) does not include any reference to taxes. This is significant. Without such a reference, USDA believes that an approach must be rejected which would, in theory, treat a change of taxes as affecting the volume level of any class or group of classes.

2. The "share of" argument applied to classes of tobacco products. Philip Morris next argues that USDA's methodology fails to give meaning to the "share of" language in FETRA subsection (c)(2). Based on the statute, for the reasons previously stated, USDA believes that a "share" is the party's contribution in units to the gross volume of the basket of tobacco products. USDA's calculation method accounts for each class of tobacco products' "share of" GDV and uses those volumes consistent with the approach used by Congress. As explained above, USDA believes that a party's or class's "share of GDV" refers to the amount of tobacco products themselves removed into commerce for each class of tobacco product and that otherwise meet the GDV definition in (a)(2). Thus, cigarettes' share of GDV is the totality of cigarettes that match the GDV definition for the relevant period. The "share of GDV" for each class of tobacco products is measured differently (by stick count for

cigarettes and cigars, and by weight for the other classes) and those figures are multiplied by the 2003 excise tax rates corresponding to each class of tobacco product to convert the class's "share of GDV" into a common metric (dollars) for pro rata comparison purposes to compute the Step A percentages. USDA has thoroughly reviewed this issue. Those Step A percentages are not in fact GDV percentages under the terms of the statute. USDA's method uses changes in each class's share of GDV (a change in the volume numbers) and the same conversion factor (the 2003 tax rates) used by Congress. This results in the same Step A numbers that Congress would have gotten in 2004 had Congress used the new volumes instead of the old volumes. Thus, USDA's method adjusts for changes in the share of GDV in a way that is totally consistent with the statute. In USDA's view, no better alternative has been suggested, and we can think of no alternative that would be more appropriate to implement now.

It is suggested that Congress would not have used the phrase "share of" in the statute if it meant to only measure changes in the actual removals into commerce. The use of "share of" is important because the significance of the change depends on what happens in other classes, not just the percentage change in marketings for one class. This principle can also be explained through a hypothetical example. Suppose that, after the conversion of "share of GDV" to a dollar figure, one of the six classes of tobacco product had an annual Step A tally of $98 (as a result of multiplying the volume of products removed by the 2003 excise tax rate(s)). Also suppose that the sum of the corresponding dollar tallies for the remaining five classes of tobacco products was $2. Under this scenario, the dominant class with a $98 amount would have 98% of the Step A percentage, arrived at through the calculation (100% * $98 / ($98 + $2)). But from year to year that Step A percentage would be likely to change based on new volume data and the resulting changes in that class's "share of" GDV. For instance, now suppose that in the following year, the dominant class's aggregate dollar tally (from multiplying the volume of products removed by the 2003 excise tax rate(s)) was reduced to only $48, but that the other five classes' combined dollar tallies remained at $2. The result would be that the new denominator would be $50, and the largest class would still have a Step A percentage of 96%, based on the same methodology (with a specific calculation of 100% * $48 / ($48 + $2)). Thus, despite reducing its volume of tobacco products by over half, the dominant class's Step A percentage of 96% would still reflect its relative volume of the tobacco removed into commerce, and the other classes' collective Step A liability would increase – from 2% to 4%. In contrast, if the party's liability were changed by the percentage change within its own class and the dominant classes' volume were halved, then that class's share of the Step A percentage would also be halved.

3. Legislative history and 2009 legislation. In support of its petition for rulemaking, Philip Morris cites two events in 2009 that it believes should affect USDA's calculation method for the Step A percentages: the enactment of the Children's Health Insurance Program Reauthorization Act ("CHIPRA"), Pub. L. No. 111-3, 123 Stat. 8 (2009), and various pieces of correspondence with Congress in connection with that effort. Under CHIPRA, federal excise tax rates were increased for all classes of tobacco products. Members of Congress received correspondence from members of the cigar industry regarding the use of excise tax rates for determining Step A percentages. In addition, members of Congress sent letters to USDA urging the use of the 2009 excise tax rates in the Step A calculation. On the basis of those developments, Philip Morris advocates that USDA use 2009 excise tax rates in computing the Step A percentages. In addition to the already

identified practical and equitable issues, USDA does not accept Philip Morris's suggestion because none of the developments Philip Morris identifies change either the text of FETRA or the algorithm used to calculate the original Step A percentages. USDA does not feel that the current FETRA language lends itself to the construction that Philip Morris seeks. Our current interpretation does not produce, in any way, results that would justify some novel view that adds terms that Congress did not add. Under both Step A and Step B, for the reasons given, USDA believes that a "share" of GDV consistently means the party's actual contribution to the basket of goods. The share of GDV is not in whole or in part the percentage of total taxes paid. This is a logical construct of the statute and the only one that makes sense absent some change in the language by the only party able to change it -- Congress. As a practical matter, USDA believes that Congress would have added a reference to taxes if that was intended in 2004-- especially if it was considering a tax change as significant as the 2009 change. In any event, there is no reference in the statute to the amount of taxes paid as being a volume measure. Accordingly, USDA has no authority to treat it that way.

4. The reference to the FDA legislation. In addition to changes to excise tax rates, Congress in 2009 also imposed other legislation on the tobacco industry. Through the enactment of the Family Smoking Prevention and Tobacco Control Act (FSPTCA), Pub. L. No. 111-31, 123 Stat. 1776, 1784 (June 22, 2009), Congress provided for regulation of tobacco products by the Food and Drug Administration (FDA). Under that statute, a new FDA assessment on tobacco products has a similar Step A process that assigns liability percentages for assessments among classes of tobacco products. The statute states that FDA's Step A process is to use the same percentages calculated in administering the TTPP.

See 21 U.S.C. § 387s. Philip Morris contends that USDA should alter its methodology for determining Step A percentages under the TTPP because the FDA is required to follow USDA's methodology. USDA's response draws upon and incorporates our previous comments. USDA notes that nothing in the FSPTCA affects the text of FETRA; for that reason, USDA stands by its reading of FETRA and the algorithm that it has used. The results are logical, equitable, and consistent with the statute. USDA has no latitude to add terms to the statute and thinks that Philip Morris' view would require doing so. We believe that any such change must come from Congress.

5. Effects of potential future legislation. Philip Morris also raises the concern that USDA's methodology is susceptible to potential difficulty should, for example, there be a Congressional changes in the tax definition of "cigarettes" or to potential congressional alterations to FETRA that might address any after-effects of the 2009 tax changes. Philip Morris notes a passage in USDA's recent Federal Register Notice, 76 Fed. Reg. 15859 (Mar. 22, 2011), where USDA expressed the view that it did not believe that Congress meant for USDA to rely upon weights in calculating the Step B assessments for cigars without providing USDA the data or the tools to do so. By analogy, Philip Morris suggests that USDA may find itself in a similar situation in making the Step A calculation if Congress changes the tax definition of "cigarettes" and/or amends FETRA to address the after-effects of the 2009 tax changes. Philip Morris's concerns about potential future legislation do not dissuade USDA from its confidence that its current Step A methodology is consistent with the current statutory text and is fair, equitable, feasible, and efficient. Should there be any new legislation in the future, USDA will address any new problems as they may arise.

6. <u>Allegations of an inconsistent definition of "volume."</u> Philip Morris next argues that USDA construes the term "volume" differently in different parts of the statute. Philip Morris premises this argument on the fact that the Step B regulations for cigarettes call for using excise taxes paid to calculate the Step B percentages for the cigarette class. *See* 7 C.F.R. § 1463.7. That reference in the regulations reflects a matter of convenience and not a variance from the true standards of the statute. The text of FETRA requires that, for cigarettes, as for cigars, the allocation be made on the basis of sticks, not taxes paid. *See* 7 U.S.C. § 518d(g)(3). Sticks are thus the standard for cigarettes. But using taxes paid for the cigarette Step B determination is a matter of convenience because for cigarettes that are currently marketed, tax revenues and number of sticks are directly proportional to one another because those cigarettes are subject to a uniform excise tax rate.[2] Thus, because cigarettes are taxed at a uniform rate (and not a variable rate like that which applies to cigars), a manufacturer or importer's percentage of the excise taxes paid will be the same as the dollar tally for its share of sticks removed into commerce. By contrast, for the cigar class, tax revenues and number of sticks removed into commerce are not directly proportional. In that instance, there is no algebraic shortcut for USDA to use, and consequently, USDA does not rely on excise taxes paid as a proxy for determining the dollar tally for a cigar class's share of GDV. Instead, USDA uses, as it must, a stick count method: it multiplies the number of cigars removed into commerce by the appropriate tax rates (which differ for "large" and "small" cigars). In short, where the tax rates are not constant, USDA does not use excise taxes as a proxy for the dollar tally attributable to a class's share of GDV removed into commerce. Regarding Step A, it is important to have constant tax rates across

[2] Although there is technically a separate "large" cigarette tax category, there are no marketings in that category.

time in order to compare like volumes across time. Without constant tax rates, two sets of volumes cannot be compared on a fair (equitable) basis.

Step A calculations do not measure actual taxes paid. Finally, Philip Morris's theory seems to rest on the premise that GDV is a measure of taxes paid rather than a collection of goods, which is not correct. Even before 2009, the Step A apportionments were not a calculation of excise taxes actually paid. For some classes of tobacco products, the amount of excise taxes paid is the same as the dollar figure used in the numerator for determining that class's Step A percentage, but that is not universally true. As explained above, assessments for "large" cigars are calculated using the maximum excise tax rate, although not all "large" cigars pay that amount in excise taxes (in some cases, large cigars generate a smaller tax amount that small cigars). This distinction tends to confirm that USDA is not required to vary the 2003 excise tax rate because the original 2003 Step A percentages were not based on actual taxes paid and since Congress was not actually basing even the Step A calculation on taxes paid. Further, the initial Step A percentages did not accurately correspond to actual tax rates; all "large" cigars were included in the dollar tally using the maximum excise tax rate, even if they were actually taxed at a lower rate. Because the original Step A percentages set by Congress in FETRA did not accurately mirror either actual taxes paid or actual tax rates, USDA also rejects Philip Morris's theory that the Step A percentages should be calculated with current excise tax rates.

In summary, we periodically adjust the percentage of the total amount required under subsection (b) of the statute to be assessed against, and paid by, the manufacturers and importers of each class of tobacco product specified in paragraph (c)(1) to reflect changes in the share of gross domestic volume held by that class of product and believe that the method we use is the most consistent with the instructions given us.

Conclusion

USDA appreciates the submissions made on both issues and has carefully considered the arguments. However, USDA determines that the Step A and Step B calculations should not be changed. For both issues, on reconsideration, USDA believes that a party's or class's share of GDV within the meaning of the statute is the party's or class's part of GDV. USDA believes that the "part" is the tobacco product so long as it meets the GDV definition. For Step B, the assessment is based on the party's share of GDV using the specific and only instructions in the statute. For Step A, USDA calculates what would be Congress' number had it used current share data, thus reflecting Congress's own method. Regarding both Step A and B, USDA's results are consistent with the statute and are the best construction possible. The alternatives are less acceptable because they produce results that are illogical and contrary to the statute.

Moreover, the "fairness" of the suggested alternatives are, at the very least, debatable. In the Prime Time case, the competitive balance, past and present, between small and large cigars is at issue. However, any discussion of fairness must also consider the competitive balance between small cigars and cigarettes. Further, the proposed changes made by Philip Morris in their case would dramatically shift assessment liability toward cigars, based only on 2009 excise tax rate changes. Such fairness issues, in any event, are for Congress to consider to the extent there is a need for such consideration. We do not believe that we have the power to adjust these results based on our view of what is fair or not fair. USDA will, of course, implement any changes Congress deems fit to enact.

Any questions or comments concerning this determination should be directed to Jane Reed at jane.reed@wdc.usda.gov.

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