October 31, 1996

To: Greg Scott

From: Rita O'Rourke Rita

Subject: **Implementation of New Tobacco Products Pricing Policy by DoD**

Following is a copy of a "Notice To The Trade" sent by the Defense Commissary Agency (DeCA) to all tobacco companies that outlines specifics for the physical implementation of the new tobacco pricing policy effective November 1, 1996. The military sales department in New York received a copy, but thought you might be interested.

For those copied on this memo, who did not receive a copy of Chris Brewster's memo of the radio broadcast this morning on the NPR, I forward a copy for your information. The Tobacco Institute has requested a full transcript and will make it available upon receipt. After the broadcast I spoke to Cary Brick, Congressman McHugh's administrative assistant, and told him I thought his boss had handled two difficult people (Congressman Meehan and Eric Schmitt, *New York Times*) quite well. He thanked me for calling and said: "next year is going to be very interesting." I also shared with him some of the following information.

Because of the controversy over the tobacco pricing issue the 1997 DeCA legislative program has been altered considerably. As reported earlier, that package would have ask Congress for relief under Title 10, U.S. Code for variable pricing, variable surcharges, the introduction of private-label products, transferring oversight authority to the Government Operations Committee, etc. I am told now that none of these initiatives will be pursued. The new legislative package will include only those initiatives desperately needed if DeCA is to survive as a PBO. They are:

1. A single fund for DeCA operations; now there are separate funds -- surcharge and revolving funds -- plus, DeCA is a part of the Defense Business Operating Fund (DBOF). Surcharge funds are the 5 percent collected at the cash register from the consumer to renovate and/or build new stores, and the revolving fund that is used to re-supply consumer products on the shelves.

2. Changes in the Office of Personnel Management (OPM) regulations that relate to hiring and/or dismissing employees and salaries.

3. Approval of the compensation and incentive programs for DeCA employees.

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As they have said privately in the past, some DeCA employees are still saying they estimate a loss of $30 million to the DeCA surcharge account due to increased tobacco prices. Translated: On $600 million in total sales, five percent is $30 million. Some say the overall impact will be recognized immediately, others say it will be after the first of the year.

Operating DeCA as a Performance Based Organization, the PBO must generate considerable new revenues if it is to be successful. When the Administration's budget is submitted to Congress in January 1997, the Office of Management and Budget (OMB) will request approximately $940 million in appropriated funds to operate the commissary system. DeCA estimates its operating expenses will exceed the budget request by about $75 million. If they lose another $30 million due to price increases on tobacco products, success appears questionable.

As a result, DeCA plans to ask industry to provide much, much more support in pricing and services than currently are provided by all companies doing business with the commissary system; e.g., slotting allowances, etc. Unfortunately, DeCA believes that manufacturers, brokers and distributors are "getting rich" at the expense of the system. They believe it costs these entities far more money to sell consumer products to the commercial marketplace and they "want their fair share" of these monies, whatever that means. In my opinion, the military resale industry will be very reluctant to acquiesce on these issues and will regret that they remained "neutral" on the tobacco pricing initiative.

Stay tuned!

c: R. Stirlen (enclosure: 4 pages)
T. Bartlett (enclosure: 2 pages)
S. Smith (enclosure: 2 pages)
C. Brewster (enclosure: 2 pages)

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