

# UNITED STATES INTERNATIONAL TRADE COMMISSION

In the Matter of: ) Investigation No.:  
4<sup>TH</sup> TIER CIGARETTES FROM KOREA ) 731-TA-1465 (PRELIMINARY)

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1 THE UNITED STATES INTERNATIONAL TRADE COMMISSION  
 2 In the Matter of: ) Investigation No.:  
 3 4TH TIER CIGARETTES FROM KOREA ) 731-TA-1465  
 4 ) (Preliminary)

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Wednesday, January 8, 2020

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Courtroom B (Room 111)

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U.S. International Trade Commission

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500 E Street, S.W.

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Washington, D.C.

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The meeting commenced, pursuant to notice, at  
 9:30 a.m., before the Investigative Staff of the United  
 States International Trade Commission, Nannette Christ  
 presiding.

16

APPEARANCES:

17

18

STAFF:

19

William R. Bishop, Supervisory Hearings and Information

20

Officer

21

Tyrell T. Burch, Program Support Specialist

22

23

24

25

1 APPEARANCES (continued):

2

3 Nannette Christ, Director of Investigations

4 Elizabeth Haines, Supervisory Investigator

5 Lawrence Jones, Investigator

6 Amelia Shister, International Trade Analyst

7 James Horne, International Economist

8 David Boyland, Accountant/Auditor

9 Michael Haldenstein, Attorney/Advisor

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1 OPENING REMARKS:  
2 In Support of Imposition (Daniel B. Pickard, Wiley Rein  
3 LLP)  
4 In Opposition to Imposition (Shara L. Aranoff, Covington &  
5 Burling LLP)  
6 In Support of the Imposition of Antidumping Duty Orders:  
7 Wiley Rein LLP  
8 Washington, DC on behalf of  
9 Coalition Against Korean Cigarettes ("CAKC")  
10 Derick Taylor, Chief Executive Officer, Xcaliber  
11 International  
12 Eric Estes, General Counsel, Xcaliber International  
13 Jay Smith, Chief Financial Officer, Xcaliber  
14 International  
15 Joe Nicholas, National Sales Manager, Xcaliber  
16 International  
17 Jesse Phillips, Assistant Director of Research and  
18 Development, Xcaliber International  
19 Bruce Freeman, Associate General Counsel, Xcaliber  
20 International  
21 Professor Allison Koester, Tenured Associate Professor  
22 of Accounting at Georgetown University's McDonough  
23 School of Business  
24 Claire Webster, Law Clerk, Wiley Rein LLP  
25 Daniel B. Pickard - Of Counsel

1 In Support of the Imposition of Antidumping Duty Orders

2 (continued):

3 Tabacos USA, Inc.

4 Suwanee, GA

5 Stephen M. Johnson, Director and Secretary

6 Tim Carpenter, Chief Operating Officer

7

8 In Opposition to the Imposition of Antidumping Duty Orders:

9 Covington & Burling LLP

10 Washington, DC

11 on behalf of

12 KT&G Corporation

13 KT&G USA Corporation

14 Jae Young Cho, President, KT&G USA Corporation

15 Byung Uk Yoon, Director of Marketing, KT&G USA

16 Corporation

17 Candice White, Regional Sales Manager of North Central

18 Region, KT&G USA Corporation

19 Kyeong-Soo Kim, Translator, TransPerfect Legal

20 Solutions

21 Shara L. Aranoff, James M. Smith - Of Counsel

22

23

24

25

1 REBUTTAL/CLOSING REMARKS:

2 In Support of Imposition (Daniel B. Pickard, Wiley Rein  
3 LLP)

4 In Opposition to Imposition (Shara L. Aranoff, Covington &  
5 Burling LLP)

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## P R O C E E D I N G S

(9:33 a.m.)

1  
2  
3 MR. BURCH: Will the room please come to order.

4 MR. CHRIST: Good morning. And for those of you  
5 from outside the area, welcome to a wonderful snowy day in  
6 the District. We weren't sure when we'd be starting this  
7 morning, but thankfully we are promptly starting.

8 Welcome to the United States International Trade  
9 Commission's Conference in connection with the Preliminary  
10 Phase of Antidumping Duty Investigation Number 731-TA-1465  
11 concerning 4th Tier Cigarettes from Korea.

12 My name is Nannette Christ. I am the Director of  
13 Investigations, and I will preside at this conference.  
14 Among those present from the Commission staff are, from my  
15 right, Betsy Haines, Supervisory Investigator; Larry Jones,  
16 the Investigator; Michael Haldenstein, the Attorney/Advisor;  
17 James Horne, the Economist; David Boyland, the Accountant  
18 Advisor; and Amelia Shister, the Industry Analyst.

19 I understand that parties are aware of the time  
20 allocations. Any questions regarding the time allocations  
21 should be addressed with the Secretary. I will remind  
22 speakers not to refer in your remarks to business  
23 proprietary information, and to speak directly into the  
24 microphones. We also ask that you state your name and  
25 affiliation for the record before beginning your



1 presentation or answering questions, for the benefit of the  
2 Court Reporter.

3 All witnesses must be sworn in before presenting  
4 testimony. Are there any questions?

5 (No response.)

6 MS. CHRIST: Mr. Secretary, are there any  
7 preliminary matters?

8 MR. BURCH: All witnesses have been sworn in, and  
9 there are no other preliminary matters.

10 MS. CHRIST: Thank you very much. We will begin  
11 with opening remarks.

12 MR. BURCH: Opening remarks on behalf of those in  
13 support will be given by Daniel Pickard of Wiley Rein on  
14 behalf of Petitioners. Mr. Pickard, you have five minutes.

15 STATEMENT OF DANIEL B. PICKARD

16 MR. PICKARD: Good morning. Again for the record  
17 I am Dan Pickard of Wiley Rein here today on behalf of the  
18 Petitioners.

19 I would like to start, as we traditionally do, by  
20 thanking the staff for their good work in this  
21 investigation. Luckily, this is a fairly small factual  
22 record, but we realize that there are some novel issues in  
23 this case. And quite frankly, as Petitioner's counsel we  
24 traditionally like to come in and say this is a cookie  
25 cutter case, to which you have always done, and consequently

1 we get an affirmative.

2 But on first blush, there really are some novel  
3 issues here, not least of which is you're looking at a new  
4 product and a new industry. And I'm sure that you will hear  
5 from opposing counsel today a challenge to our proposed  
6 domestic like product definition.

7 On top of that, you are looking at a very highly  
8 regulated industry. And you are going to hear a lot about  
9 the MSA and the obligation to make escrow payments as an  
10 important condition of competition. And we are going to  
11 respectfully submit that the Commission should focus more on  
12 issues of cash flow, as captured in the statute, than  
13 perhaps it has traditionally in cases.

14 We are going to take a look in an important issue  
15 in this case that is also going to be a regionality. How,  
16 for purposes of current material injury, should the  
17 Commission take a look at imports that began at the Period  
18 of Investigation in a very concentrated manner, and  
19 consequently some of the most obvious evidence of injury is  
20 where imports were most concentrated. And how, for purposes  
21 of current material injury and threat, you treat the fact  
22 that imports then spread throughout the Nation, and with  
23 the injurious effects also flowing out throughout the  
24 Nation.

25 So there are some novel issues, I would be

1 derelict if I didn't say, but in the fundamentals this is  
2 kind of basic volume-price impact case. So in regard to  
3 volume, I don't think there's really any contested facts.  
4 The official import statistics show in just the first three  
5 quarters of 2019 Korean imports of cigarettes were 2.8  
6 billion cigarettes. So I would suggest that, just on an  
7 absolute basis, that is significant under the law.

8           On top of that, as far as the increase in  
9 imports, there's a current surge in imports, and the  
10 official import statistics demonstrate an increase of  
11 greater than 50 percent from -- over the interim periods.  
12 And on top of that, while the market share data is business  
13 proprietary, the evidence also shows that imports took  
14 significant market share from the domestic industry over the  
15 Period of Investigation.

16           Similarly, with regard to price you're going to  
17 hear sworn testimony today in regard to the under-selling by  
18 imports. We respectfully submit that the pricing data is  
19 further supportive of price effects by subject imports.  
20 We're going to provide additional documentary evidence in  
21 our postconference brief, further supporting price effects.  
22 And I think in this case the average unit value derived from  
23 the official import statistics are particularly probative  
24 when it comes to issues of price because you don't have --  
25 you have a clean HTS number without real product mix in

1 those numbers. And that demonstrates a significant decline  
2 in imports over the POI, import values over the POI.

3 In regard to impacts, as you'll see the main  
4 financial indicators for the domestic industry deteriorate  
5 over the POI. And it becomes especially obvious once you  
6 look at the performance after the legally required escrow  
7 payments the domestic industry has to make.

8 And on top of that, and again there are  
9 significant market share losses to the domestic industry  
10 over the POI.

11 And lastly, I would submit that this case is just  
12 as strong in regard to current as far as threat, and  
13 possibly even a stronger case in regard to threat of  
14 material injury. And this is due in part from the evidence  
15 of the surge in imports, the price effects in imports,  
16 testimony, and further evidence that you're going to hear in  
17 regard to how imports have affected the domestic industry's  
18 ability to access credit or capital.

19 And certainly not least, the massive size of  
20 capacity in Korea. KT&G is the fifth largest cigarette  
21 producer in the world.

22 All of that evidence, we would respectfully  
23 submit, more than supports a reasonable indication of  
24 material injury or threat of material injury.

25 Thank you.

1 MR. BURCH: Thank you. The presentation in  
2 opposition will be given by Shara L. Aranoff from Covington  
3 & Burling. Ms. Aranoff, you have five minutes.

4 STATEMENT OF SHARA L. ARANOFF

5 MS. ARANOFF: Good morning, and happy new year,  
6 Ms. Christ and Commission Staff. I am Shara Aranoff from  
7 Covington & Burling, appearing on behalf of Respondent KT&G  
8 Corporation and KT&G USA.

9 The Petitioner's case rests on a fundamental  
10 mischaracterization of the U.S. market for cigarettes. As  
11 KT&G's panel of witnesses will explain, there is no clear  
12 definition of a 4th Tier Cigarette, nor is there a separate  
13 market for 4th Tier Cigarettes in the United States.

14 Petitioners attempted to identify features that  
15 distinguish so-called 4th Tier from other cigarettes, but  
16 just listen to all the adverbs that clarify the scope.  
17 Cigarettes are, quote, "commonly referred to as 4th Tier,"  
18 but there's no single definition of what that means.

19 The relevant sizes are, quote, "frequently  
20 referred to as Kings and 100s," but the specified size range  
21 also includes other products, like shorts and slims. 4th  
22 Tier products, quote, "typically have a tobacco blend with  
23 more than 10 percent stems," except that some don't, and  
24 some non-4th Tier cigarettes have more than 10 percent.

25 They are, quote, "typically sold in boxes with a

1 rounded edge corner," but that's true for many brands in the  
2 U.S. market, including premium brands. They're typically  
3 sold without embossed aluminum foil inside the pack. Now  
4 use of aluminum foil is standard, and if you look hard  
5 enough--and your eyes are better than mine--you might find  
6 some embossing in certain packs. But I'm not sure how that  
7 defines a distinct market.

8           When more than every feature that Petitioner uses  
9 to describe a product in a market is qualified, that's a red  
10 flag signaling a lack of clear dividing lines. In reality,  
11 the U.S. market for cigarettes is nothing like what the  
12 Petition describes. Competition is not segmented into  
13 distinct product tiers.

14           While there are different price levels in the  
15 market, and some people do use the word "tiers" to describe  
16 these price categories, domestic producers compete across  
17 all price tiers.

18           Some analysts identify four groupings, others see  
19 three, and use different labels for those. Cigarettes are  
20 arrayed along a price continuum that will be familiar to the  
21 Commission from other investigations. Similarly, the status  
22 of domestic producers under the Master Settlement Agreement  
23 that resolved claims of 46 states against the industry does  
24 not create separate product markets.

25           Original participating members like Phillip

1 Morris and RJR, subsequent participating members like  
2 Leggett and Commonwealth, and nonparticipating members such  
3 as Excaliber, Cheyenne, and KT&G are all competing for  
4 market share in the United States and offering cigarettes at  
5 multiple price levels.

6 For these reasons, the domestic like product is  
7 properly defined to include all cigarettes that meet the  
8 physical specifications that are set forth in the ITC's  
9 questionnaires, which is tobacco rolled in paper between 7  
10 and 12 centimeters in length, and less than 1.3 centimeters  
11 in diameter. That definition covers nearly all cigarettes  
12 that are produced and sold in the United States.

13 Imports of cigarettes from Korea have an  
14 exceedingly small share of the domestic cigarette market,  
15 and their share has fluctuated only modestly over time.

16 As Petitioner's witnesses present their testimony  
17 this morning, I would encourage you to ask them these  
18 questions:

19 Why should signatory status in the MSA, which is  
20 a litigation settlement agreement, be used to define a  
21 product market?

22 If there is a distinct 4th Tier, why does almost  
23 every cigarette made in the United States fit a physical  
24 description that is provided in scope in the Petition.

25 If Petitioner's products and cigarettes made by

1 participating members are all sold to distributors, and also  
2 are sold in retail outlets on the very same shelves, why do  
3 they claim to operate through distinct channels of  
4 distribution?

5           If the major producers don't compete with  
6 Petitioner's product, why do those majors have leaders  
7 programs with distributors and everyday low-price agreements  
8 with retailers designed to protect their market share from  
9 discount brands, and when U.S. distributors agree that  
10 discounted brands from domestic producers like Leggett and  
11 Commonwealth don't compete with Petitioners cigarettes?

12           And why do industry analysts like MSA and Euro  
13 Monitor include other domestic cigarettes produced by  
14 participating members in their lowest-price categories?

15           In sum, Petitioner's description of the U.S.  
16 market is not credible. It deserves close scrutiny. As a  
17 result, its claims of injury by subject imports and threat  
18 are similarly flawed.

19           For these reasons, the Commission can and should  
20 reach a negative preliminary determination, and we look  
21 forward to completing our presentation later today.

22           Thank you.

23           MR. BURCH: Thank you, Ms. Aranoff. Will the  
24 panel in support of the imposition of anti-dumping duty  
25 orders come and be seated? I would like to note, this panel



1 has 60 minutes for their direct testimony.

2 (Pause.)

3 MS. CHRIST: Welcome to all panel members and  
4 thank you. Please begin when ready.

5 MR. PICKARD: Thank you. For the record  
6 again, this is Dan Pickard of Wiley Rein. We'll begin with  
7 Dr. Phillips.

8 STATEMENT OF JESSE PHILLIPS

9 DR. PHILLIPS: Good morning. My name is Dr.  
10 Jesse Phillips, and I am the Assistant Director of Research  
11 and Development at Xcaliber International. I would like to  
12 begin by thanking you for your time and attention to this  
13 matter. This morning, I would like to provide an overview  
14 of some of the physical characteristics of 4th Tier  
15 cigarettes, and to also provide an overview of the  
16 manufacturing process.

17 By way of background, I hold a Bachelor's  
18 degree in Chemistry from the University of Florida and a  
19 Ph.D. in Materials Chemistry from the University of Tulsa.  
20 During my tenure at the University of Tulsa, I had the  
21 privilege to work at NASA's Jet Propulsion Lab, as well as  
22 Argonne National Lab, in collaborative efforts with  
23 researchers focusing on surface modification and early  
24 earth biochemical pathways.

25 More recently, I have brought my knowledge and

1 expertise in both chemistry and R&D to Xcaliber  
2 International, and perform a variety of functions within the  
3 company.

4 MS. CHRIST: I'm sorry. Can I just -- is  
5 there any way we can get that so that -- I don't want your  
6 back to hurt during this entire. Can we just move that so  
7 he doesn't have to lean? Just the move the mic underneath  
8 and around the legs please.

9 (Pause.)

10 DR. PHILLIPS: Thank you. My role within the  
11 company can be split into two major responsibilities:  
12 ensuring that all products currently produced by Xcaliber  
13 International comply with requirements set forth by FDA, as  
14 well as analyzing and addressing the R&D needs as they  
15 arise.

16 My work on FDA compliance has many facets, and  
17 involves testing of our products using instrumentation  
18 in-house, communicating with our vendors regarding third  
19 party components and their respective specifications, as  
20 well as working with external labs for further independent  
21 analysis. Although typically viewed as a single product, a  
22 cigarette is comprised of multiple components such as the  
23 filter, plug wrap, tipping paper, cigarette wrapper, various  
24 adhesives and of course tobacco.

25 When working to ensure compliance with FDA,

1 each individual component must be accounted for, and its  
2 effects on the overall cigarette understood. My work  
3 regarding Xcaliber International's R&D needs will be  
4 discussed at the end of my statement.

5           First, it is important to note that 4th Tier  
6 cigarettes are a distinct type of cigarette product with  
7 distinct physical characteristics. Specifically, our 4th  
8 Tier cigarettes are made with a tobacco blend that includes  
9 more than 10 percent tobacco stems. While many of the  
10 issues connected with tobacco blend recipes are proprietary  
11 in nature, it is my understanding that non-4th Tier  
12 cigarettes typically have less than ten percent stems in  
13 their tobacco, and I am aware of no information that would  
14 contradict that.

15           Similarly, there are differences in the types  
16 of filters used by 4th Tier as compared to non-4th Tier  
17 manufacturers. At Xcaliber International, we make our  
18 filters in-house. Again, while some of these details are  
19 proprietary, I can tell you that we use what is called in  
20 the industry single component filters.

21           These filters are made from thin sheets of  
22 cellulose acetate, which resemble cotton in both color and  
23 texture seen by the layperson. We use a plasticizer on the  
24 cellulose acetate to form the filter which hardens the  
25 compound. We then wrap the filters in a plug wrap, a type

1 of paper surrounding the cellulose acetate as it sets and  
2 hardens to become a usable filter.

3           While I do not have access to the proprietary  
4 information in regard to the specifics of the filters used  
5 in non-4th Tier cigarettes, I do know that they can be more  
6 complex products which can consist of multiple components  
7 with additions such as activated carbon. Similarly, 4th  
8 Tier and non-4th Tier can use different types of cigarette  
9 paper, basically a wood pulp versus a flax-based paper.

10           In sum, when comparing 4th Tier manufacturers  
11 such as (mic drop) to non-4th Tier manufacturers, 4th Tier  
12 manufacturers are a different industry, both in regard to  
13 the scale of the industry and the production process. As to  
14 this production process, non-4th Tier companies frequently  
15 have machines dedicated to one brand family. They can have  
16 entire rooms dedicated to running one SKU that may be a best  
17 seller.

18           They can split tobacco growth in a way that  
19 ensures that typical blends for their products are always  
20 available, even under the chaotic nature of agronomy. In  
21 addition, 4th Tier manufacturers are not integrated  
22 producers, in that they generally do not have primary  
23 facilities. On the other hand, the non-4th Tier producers  
24 own their own primaries, have contracts with the farmers who  
25 produce the tobacco and can control the process from seed to

1 sales. It allows them to streamline their process.

2 For 4th Tier manufacturers, tobacco blends are  
3 formulated and sold by a third party with its own contracts  
4 with primaries, as well as other cigarette manufacturers.  
5 Although both 4th Tier and non-4th Tier cigarette tobacco  
6 blends are constantly regulated by FDA, the integrated  
7 nature of the non-4th Tier producers allows quicker  
8 turnaround times at all points in the manufacturing process.

9 In essence, we buy boxes of cut and flavored  
10 tobacco blend and hope that it is in stock the next time we  
11 call. If we need to produce a different brand on any given  
12 day, machines need to be changed over, shutting down  
13 production for a given product during the interim. The  
14 majors may have four machines making one brand, whereas we  
15 have and other 4th Tier manufacturers may only have four  
16 machines total.

17 We may both produce tubes of tobacco for the  
18 consumer to smoke, but that is where the similarities in 4th  
19 Tier and non-4th Tier manufacturing ends. I would now like  
20 to review the production process.

21 So I'd like to begin by showing -- these are  
22 the boxes of tobacco mentioned. As I stated, these come in  
23 from third party primaries or third party tobacco rag  
24 producers, which we then offload and feed into a tobacco  
25 feeder. Those resemble a side dump truck. We're able to

1 pick this up, load it in here and then through pneumatic  
2 piping feed it into the maker.

3           The tobacco is then shuttled through here  
4 where it is wrapped in cigarette paper and it is metered and  
5 segmented to specifications, and then we have to combine it  
6 with the filters. The filters are made in a separate room  
7 shown here as the cellulose acetate that I had mentioned.  
8 The sheets are drawn up and then through this  
9 instrumentation here stretched out and at this point  
10 plasticized.

11           It's then recombined and then depending on if  
12 we mentholate it or not, we can add aerosolized menthol  
13 right here. It is then wrapped in plug wrap and again  
14 meaded and segmented to specification, to which it is then  
15 packed into these boxes shown here. The boxes, filters are  
16 then added to the maker, which combines them to the tubes of  
17 tobacco using tipping paper, and they are then moved over to  
18 the packer, where they are segmented into 20 sticks.

19           They're wrapped in the foil, wrapped in the  
20 packs, placed in cartons and the cartons are then ejected  
21 and packed into cases. Now the cases that we can provide  
22 are either in 60 or 30 count cases. If in 60 count cases  
23 they can go into this machine here; if 30 count cases we  
24 have to do that by hand.

25           The boxes then travel this conveyor belt to

1 where they are scanned and picked up by this robotic arm.  
2 It will palletize and wrap in shrink wrap, or we will then  
3 store it until it is sold. I would like to add one more  
4 thought. As I mentioned near the beginning of my statement,  
5 I've been brought in to address Xcaliber International's  
6 growing need for R&D. Because we are a small, close-knit  
7 company I hear on a regular basis how we're being  
8 negatively affected by lower-priced Korean products.

9 I also that as our overall cash flow is  
10 decreasing, our ability to invest in R&D decreases. We are  
11 currently in the process of trying to build a new R&D  
12 facility. This facility will be instrumental in keeping  
13 Xcaliber International relevant in an ever-changing  
14 landscape, heavily regulated by FDA and in constant need of  
15 product analysis and development.

16 Through these restraints being caused by  
17 Korean products, we are holding off on larger purchases  
18 necessary for this facility because we don't have the budget  
19 from a year ago. We are limiting ourselves to searching for  
20 used machines rather than new ones, and holding off on new  
21 construction because our cash flow is being negatively  
22 affected by imports.

23 I know that a company that loses the ability  
24 to invest in itself is a company that is threatened with  
25 ongoing harm. Thank you again for your time, and I'll be

1 happy to answer any questions.

2 STATEMENT OF JOE NICHOLAS

3 MR. NICHOLAS: Good morning. My name is Joe  
4 Nicholas and I'm the National Sales Manager at Xcaliber  
5 International. I've been employed by Xcaliber for a little  
6 more than three years. Before that I worked with Tantus  
7 Tobacco, a cigarette company that was acquired by Xcaliber.  
8 All toll, I have nearly 10 years in the cigarette industry  
9 with just that 20 years experience working in the tobacco  
10 industry.

11 My current position with Xcaliber -- excuse me  
12 -- in my current position with Xcaliber, I manage our entire  
13 sales staff as well as our Marketing Department. In a brief  
14 description, my responsibilities related to sales include  
15 directly managing our regional sales managers, accounts they  
16 are calling on, approving promotions that they extend to  
17 those accounts as well as a variety of administrative  
18 responsibilities related to Sales and Marketing.

19 I would like to provide you with a basic  
20 description of how 4th tier cigarettes go to market in the  
21 United States. Basically, there's one common path to  
22 distribution, which is through a wholesale account. A  
23 wholesale account is a supplier to retail outlets that would  
24 supply anything from cigarettes to candy to drinks or any  
25 other item that would be found in a convenience store or



1 like-trade outlet.

2           From the wholesale account the product is sent  
3 to two basic types of outlets, an independent retailer, or a  
4 chain account. A chain account is a group of two or more  
5 stores operating uniformly, while an independent retailer is  
6 one store. Xcaliber directly or indirectly deals with a  
7 three of these types of accounts -- wholesale, independent,  
8 and chains alike.

9           I would like to make two main points about these  
10 channels of distribution. First, we compete against KT&G  
11 throughout these channels. And second, there are  
12 distinctions between the channels of distribution for 4th  
13 tier and non-4th tier cigarettes. KT&G sells to many of the  
14 same wholesalers as we do and are constantly targeting the  
15 same national and regional accounts we sell to.

16           I would emphasize that both wholesale and retail  
17 customers are extremely price sensitive. There was a time  
18 when this was not always the case, but as lower prices were  
19 introduced the market started to demand decreased prices.  
20 Xcaliber has fulfilled that market demand with quality  
21 products at an affordable price to adult consumers. Other  
22 4th tier companies have done so as well, but with  
23 manufacturing, production, and taxation costs very similar,  
24 if not at parity across all lines, it is hard to understand  
25 how a 4th tier manufacturer can sell at some of the net

1 costs we see in our markets throughout the U.S. And to be  
2 perfectly clear, KT&G is the low price leader. They even  
3 mention this on their company's webpage. In addition to  
4 these points, I hear from our trade partners on a near daily  
5 basis about KT&G and their low-priced offerings.

6 My second point is there are differences in the  
7 channels of distribution between 4th tier and non-4th tier  
8 cigarettes. The non-4th tier cigarettes are sold largely  
9 through national chains, such as national convenience  
10 outlets like 7-11 or Quick Trip. In addition, there are  
11 wholesalers that only sell non-4th tier cigarettes. In  
12 fact, Phillip Morris and R.J. Reynolds, which I will refer  
13 to as the "Majors," often bought 4th tier cigarettes from  
14 being sold through wholesale accounts with their  
15 sales-to-share programs or at retail outlets with their EDLP  
16 or Every Day Low Price contracts.

17 These programs involve the Majors offering large  
18 incentive monies to distributor partners for limiting their  
19 sales of 4th tier brands to an agreed upon number. Briefly  
20 described, should a distributor or partner sell more of the  
21 4th tier offering than established by the Majors during a  
22 designated time period, they would not receive their  
23 incentive monies. Those incentive monies offered to  
24 distributors is often substantial and so substantial that  
25 the principals of these accounts monitor those sales almost

1 daily.

2           On the retail side, EDLP programs force  
3 retailers to sell no brand lower than the Majors' lowest  
4 priced offering. So, in essence, if a retailer is on an  
5 EDLP program and chooses to offer a 4th tier brand, they  
6 would be forced to sell that 4th tier brand at a non-4th  
7 tier price, which is unlikely. Fourth tier brands are  
8 predominately sold through independent operations, such as  
9 regional retailers or wholesalers. Just as there are  
10 wholesalers that only sell non-4th tier, there are also  
11 wholesalers that only sell 4th tier product. Hub, one of  
12 the nation's largest tobacco wholesalers, is an example of  
13 such a company.

14           Not only are 4th tier brands offered through  
15 different channels of distribution, but they are also  
16 perceived as different products by consumers. The fact is  
17 true for our wholesale partners, retail outlets, and the end  
18 user or consumer. Wholesalers look at and treat these  
19 brands as two different types of products. In addition, the  
20 National Association of Convenience Stores or NACS, the  
21 industry's leading trade association, has 4th tier segmented  
22 as a separate product category.

23           Retailers have a different perception of 4th  
24 tier as well. They see their customers asking for different  
25 products every day. Non-4th tier customers are brand loyal

1 and will stick with their favorite brand no matter the  
2 price. Fourth tier consumers are extremely price sensitive  
3 and are willing to switch brands to save pennies on a  
4 cheaper pack of cigarettes.

5 Now, with all this said, let me be very clear.  
6 I love my job. I'm very fond of my customers, often forming  
7 a long-lasting friendship with many of them and I love and  
8 respect the owners of my company. The owners of Xcaliber  
9 empower us to do what we need to do in a trade and they have  
10 always tried to provide us with the resources we need,  
11 giving us every opportunity for success. However, it is  
12 frustrating to see what is happening in the market and, more  
13 importantly, to the landscape of the 4th tier industry. It  
14 is discouraging to see the lost sales and lost revenue that  
15 we have incurred over the past several years. Even more so,  
16 to imagine the sales potential and what could've been  
17 accomplished and this is all due to the practices of KT&G.

18 I first notice KT&G when I was working Tantus  
19 Tobacco. They were selling Timeless Time, which is another  
20 KT&G brand at a very low price in the market. This is how  
21 they operate, introducing a brand at a low price, disrupting  
22 the market, all while taking share from U.S. producers. In  
23 some areas, their brands can be as much as four dollars per  
24 carton cheaper than competitive brands, including our own.

25 With these practices by KT&G, most manufacturers

1 are forced to react to protect sales and share. In order to  
2 protect what we already established, we are forced to  
3 implement a program known as a TPR or a Temporary Price  
4 Reduction. This proves effective in some cases, but always  
5 proves to be expensive, impacting our bottom line. The  
6 threat of lost share and lost revenue due to Korean imports  
7 is only growing. U.S. 4th tier manufacturers traditionally  
8 operated regionally. Xcaliber and Cheyenne sold primarily  
9 into the middle of the country, mostly focused on Missouri  
10 and the surrounding states.

11 Dosal was focused on Florida, Texas, and parts  
12 of the Southeast. Native Trading sold predominately in the  
13 Northeast. Different manufacturers were successful and  
14 their success was limited to certain geographic regions.  
15 Sometimes that success was s marginal it was limited to a  
16 state or two.

17 KT&G started its U.S. operations selling in the  
18 same region as Xcaliber, focusing heavily on Oklahoma, which  
19 is where Xcaliber was founded and still produces tobacco  
20 products today. But KT&G is now competing on a national  
21 level, often targeting our strongest accounts with industry  
22 data. This industry data is provided to a company named MSA  
23 from wholesalers. KT&G is using this information to target  
24 our existing customers, negatively impacting our sales.

25 KT&G is broadly distributed throughout the

1 country and now advertises that they operate in 40 states.  
2 We, too, are trying to diversify beyond Missouri. KT&G is,  
3 however, frustrating these efforts. If KT&G continues with  
4 their current practices -- and I understand this might sound  
5 pessimistic -- our ability to maintain our current business  
6 will be severely and possibly irreparably impaired. We have  
7 proof that KT&G is trying to get further into the national  
8 accounts that we partner with. Should KT&G find success  
9 with these retailers and that success be combined with  
10 their current pricing strategy is almost guaranteed to  
11 further impact our market share. From there, we would need  
12 to be concerned about a snowball effect where we could  
13 possibly lose payroll and personnel.

14           If they continue selling at their current prices  
15 and with their current strategy, the impact it will have on  
16 the 4th tier domestic manufacturers is unimaginable.  
17 Everything boils down to price and as I've already stated,  
18 this is a very price-sensitive industry. Production costs  
19 are essentially the same for all 4th tier manufacturers.  
20 Tobacco costs are similar, material costs are similar, and  
21 taxation is certainly similar for every 4th tier company  
22 operating in the United States.

23           KT&G is selling at prices so low I'm not sure  
24 they can cover their operating costs. We are often reducing  
25 our prices just to retain existing customers. This is not a

1 path to growth or profitability and should imports continue  
2 at this pace all at constantly lower prices the outlook is  
3 bleak, which is why we are here today. Thank you.

4 STATEMENT OF JAY SMITH

5 MR. SMITH: Good morning. My name is Jay Smith,  
6 and I am the Chief Financial Officer for Xcaliber  
7 International. I have been in my current position for  
8 approximately two and a half years, and prior to joining  
9 Xcaliber, I was the CFO for a safety equipment manufacturer  
10 for the oil and gas industries for the previous nine years.  
11 As CFO, I have responsibilities in regards to strategic  
12 planning, financial planning, financial reporting and cash  
13 flow management.

14 I want to share with you today about some of the  
15 competitive challenges facing the U.S. 4th Tier cigarette  
16 industry, including how we deal with MSA states, competing  
17 in a highly regulatory industry, which involves constraints  
18 on innovation or changes to products. And, of course, the  
19 threat posed to our company and our industry by the recent  
20 surge in imports from Korea.

21 The CFO position with Xcaliber was an attractive  
22 opportunity, including structuring an IPO for a growing  
23 company. As I'll discuss later, it was an IPO that failed  
24 in very large part due to unfair competition with low-priced  
25 Korean cigarettes. As I mentioned, I joined the company to

1 assist with an IPO attempt, and in this regard, the first  
2 time I really became aware of KT&G was in the Fourth Quarter  
3 of 2017. At this time, we started to see a softening of our  
4 sales volume, and this was due to competitive attacks by the  
5 Korean producer of cigarettes, KT&G.

6 At that time, one of our senior sales people let  
7 us know that KT&G was taking sales away from us and urged us  
8 to do something to protect volume. However, we were in the  
9 IPO process and the CEO at the time said, "No more rebates.  
10 We're not going to try to match KT&G, Korean prices. We  
11 should just stay the course." And that's what we did.

12 As a result we saw sales decline in the Fourth  
13 Quarter of 2017 and the First Quarter of 2018. So then, we  
14 knew we had to do something. We knew we had to change  
15 course. Wholesalers were telling us that they wanted more  
16 rebates in order for us to stay competitive with Korean  
17 prices. Now, it's important to note that in our industry  
18 the net price frequently includes rebates to wholesalers and  
19 the same ones offered to retailers as well.

20 So, in an attempt to compensate for a decrease in  
21 sales volume, we tried to get price increases in Missouri,  
22 but this only pushed us into a greater sales volume decline.  
23 At this point, our sales team was adamant that we needed to  
24 offer more rebates to stay competitive with KT&G. We were  
25 losing volume in our traditional core area, Oklahoma and



1 many surrounding states. We also knew that because Missouri  
2 is so crucial to our business, if KT&G really started to  
3 take market share in that state, that the viability of our  
4 company would be in question.

5           So in June, 2018, in part to protect our market  
6 in Missouri, we started to offer more rebates to compete  
7 with KT&G. And so, our net prices continued to decline.  
8 And then in June, 2018, the IPO was called off. This was  
9 due in part to the negative effect of KT&G's sales on cash  
10 flow. Without a doubt, KT&G contributed to our IPO failing.

11           The 4th Tier is a small industry of four or so  
12 players, and it has unique requirements to have huge amount  
13 of restricted cash. Because of the escrow payment that  
14 we're required to make as a matter of law, for every carton  
15 we sell, we have to hold back a certain amount of cash. The  
16 monies are locked up for twenty-five years and can cost us  
17 \$10 million per quarter. It is more like an expense, as it  
18 reduces cash flow.

19           Most businesses project three to five years down  
20 the road, but we've got restricted assets for twenty-five  
21 years. And anything can happen in twenty-five years. We  
22 may get these deposits back, but we may not. So in reality,  
23 we have to watch every dollar in a way that our top line  
24 might not immediately suggest. For us, it's really about  
25 operating performance post-escrow.

1           This is how the industry operates and we can and  
2 have done this successfully up to this point even with the  
3 requirement to have such a large amount of restricted cash.  
4 However, as imports came in -- we lost sales and we had to  
5 decrease net prices -- so after our escrow payments, we have  
6 even less cash on hand. The decreased cash flow due to  
7 decreasing revenues caused by Korean imports affected our  
8 ability to make capital expenditures and to invest in R&D.

9           Now, I'd like to focus on where we are today and  
10 what the future looks like. Our IPO failed, as I said in  
11 large part because of the net pricing of KT&G in the market.  
12 You should know that their net selling price is more than a  
13 dollar or two per carton lower than the prevailing U.S.  
14 price. They're priced lower than everybody. And as I also  
15 said, this affects our cash flow.

16           But then we see this massive surge in 2019, and  
17 this is what worries me today. We don't have the ability to  
18 raise net prices and maintain volumes because of KT&G, so  
19 cash flow minimizes. If cash flow goes negative, then we  
20 have to go to debt financing. And due to the nature of the  
21 industry, banks are not going to allow you to finance so  
22 much. At that point, we have to make very difficult  
23 decisions as to how we operate and whether we want to  
24 continue the business.

25           With our cash flow situation, I've told the

1 owners we need to squeeze out every efficiency because we  
2 don't have the money to build new offices or buy new  
3 equipment. We buy used equipment, or we have to retool  
4 existing equipment. R&D is in the same position. Of  
5 course, it would be nice to have our own R&D lab, but we  
6 don't have the cash flow to expand the lab with the  
7 situation we're in. Even though we can't expand the lab, we  
8 nevertheless have to invest large sums of money into R&D to  
9 comply with FDA regulations. Due to the effects of KT&G on  
10 the business, we are not able to invest in a way that would  
11 ultimately save us money.

12           And I cannot emphasize this enough: At the end  
13 of 2019, because of KT&G pricing, our cash flow was at or  
14 near zero for the year. Which pretty much says it all.

15           There are now conversations with the owners  
16 regarding minimizing cash outflow so, as an example,  
17 employee bonuses will not be paid in 2020. We're going to  
18 have to look at pay cuts. We're gonna have to look at  
19 layoffs, look at letting people go if cash flow doesn't  
20 improve. We do not want to do this, but we may have no  
21 choice.

22           If the Korean imports continue, things will go  
23 down two different paths, but they both end in the same  
24 location. The first path is if we decrease prices in order  
25 to try to match the falling Korean prices. If this happens,

1 then over the next eighteen months or so, not only will we  
2 not increase net pricing, but it will fall, and with the  
3 escrow payments increasing by 3% per year, we'll have  
4 declining cash flow. With a zero cash flow in 2019, we  
5 would be negative in 2020. So we would have to take on debt  
6 financing just to pay the bills.

7 Or the second path is that we try to maintain  
8 prices, but then we'll lose more sales volume to KT&G, which  
9 will also result in decreased cash flow and again lead to  
10 debt financing.

11 Either way, without relief, we'll end in the same  
12 place. Either we lose volume or price or both, we go into  
13 debt, more money goes to the interest expense and we can't  
14 pay the principal, and then you're in the death spiral.

15 What KT&G is doing is destroying the viability of  
16 our company. Morale throughout the company is at an  
17 all-time low. We're a small company and our people are  
18 getting discouraged and upset. And people are now getting  
19 scared.

20 If we get relief, this could be a good business.  
21 All we want is a level playing field. We can be a strong  
22 growing operation that takes care of its people and builds  
23 manufacturing in Oklahoma. But in the absence of trade  
24 relief, the writing is on the wall. Thank you.

25 STATEMENT OF DERICK TAYLOR

1 MR. TAYLOR: Good morning. And I do want to  
2 thank you for your time, and making time for us. It's very  
3 important.

4 I'm Derrick Taylor. I am the CEO of Xcaliber. I  
5 am also the son of one of Xcaliber's founders. I started  
6 with the company about 10 years ago as an Assistant to the  
7 Sales Manager. And before Xcaliber I built and ran a smoke  
8 shop. I worked retail, and I worked in distribution.

9 You could say I grew up in the business -- a fair  
10 statement. As the CEO, my responsibilities are pretty  
11 varied and involve personnel decisions, handling large  
12 accounts, chain accounts, and contract negotiations. I like  
13 to think I have my hand on the pulse of the business, right  
14 down to knowing which machines are -- how our machines are  
15 operating.

16 I am personally and unfortunately very familiar  
17 with Korean imports. KT&G first came across my radar when  
18 they launched TIMELESS TIME. This was big news in Oklahoma  
19 where we're located. KT&G began distributing out of  
20 Oklahoma. They came in supercheap, several dollars per  
21 carton under our price, and it was right in our backyard.

22 When KT&G came in with THIS, the brand THIS, they  
23 did the same thing as they had done with TIME, but it was  
24 even cheaper. And this time they launched the product with  
25 more of a national focus. It was truly an "oh, no" type of

1 moment where we were wondering where is this going to go?  
2 And jut how big can it get?

3 We knew that they'd sell a lot with those low  
4 prices. And we now know that they have and will continue to  
5 buy market share. They're solely competing on price. There  
6 is no brand equity or awareness in the 4th Tier. It is  
7 about one thing, and that is price alone. Now KT&G is  
8 leveraging relationships, and they're getting into the  
9 national big accounts.

10 It is important to understand the regional nature  
11 of this industry, although it is quickly changing. For  
12 whatever reason, when KT&G started in the United States they  
13 started in Oklahoma. Their first product was CARNIVAL,  
14 which is one of their brands, and they oddly now boast in  
15 their newest advertising that it was, quote, "born in  
16 Oklahoma."

17 For the period of 2016 to 2018, our shipments in  
18 our core region decreased by 20 percent as we lost sales to  
19 KT&G. We've now tried to move nationally. We were -- and  
20 still are to a certain extent -- heavily dependent on  
21 Missouri. But this can make us vulnerable. So after seeing  
22 the loss of shipments over that three-year period, we  
23 started to market outside of our traditional region of  
24 sales. But so as KT&G.

25 KT&G has invested in a new major facility in

1 Dallas. So we're not just threatened in our traditional  
2 region, they now threaten our sales throughout the country.

3           KT&G is impacting our business on a daily basis.  
4 Every Thursday I sign checks, I personally sign every single  
5 check. In every quarter, we have to send checks for  
6 rebates. And the number of those checks and, more  
7 importantly, the amounts for those checks are getting larger  
8 and larger. We are forced to pay larger rebates just to  
9 compete with KT&G's unfairly low prices.

10           Wholesalers are calling us to say KT&G is willing  
11 to give us "X" price for so long. So then of course we have  
12 to increase our rebates. Or the wholesalers state that KT&G  
13 is willing to pre-pay the rebates. So we have to decrease  
14 our price again.

15           Although we are trying to get national contracts,  
16 KT&G is always part of those discussions, too. The bottom  
17 line is this: If we meet KT&G's price, we'd be selling at a  
18 \$2 loss per carton in some states. KT&G tends to come into  
19 new regions like a tornado, something we're familiar with in  
20 Oklahoma, dropping prices and blanketing an area with ads  
21 and product. And again, they make it all about price which  
22 is the most important factor to our consumer.

23           We're dying on the vine. We need a positive cash  
24 flow to grow our business. We need to try to increase  
25 prices to cover the cost of doing business. But then we'll

1 lose volume. If this continues, we'll stop growing because  
2 the price decreases caused by KT&G will potentially put us  
3 in an untenable position for the future of our business.

4           If, however, relief is given, prices can recover  
5 and we can grow at a healthy pace. Our business is  
6 important to the town where we work. Pryor, Oklahoma, which  
7 is where I was born and raised, is a small town of about  
8 10,000 people. Everyone in Pryor knows at least someone who  
9 works at Xcaliber. These are good-paying jobs, and we offer  
10 good benefits.

11           We've always tried to take care of our people.  
12 And some of our workers are truly like family. Some of them  
13 have been with us since the very beginning, which is 18  
14 years now.

15           So that's the reason I am here today. Without  
16 relief from dumped Korean products, our company will  
17 continue to be injured. And Korean imports are continuing  
18 to increase and they're doing so at lower, and lower, and  
19 lower prices. And this is a real threat to my company and  
20 our company.

21           But if we're given relief, we can continue to  
22 grow, invest in our plant and our people, but this requires  
23 healthy cash flow -- which of course we do not have today.

24           Thank you very much again, and I'm happy to  
25 answer any questions that I possibly can.



1 STATEMENT OF DR. ALLISON KOESTER

2 PROF. KOESTER: Good morning. My name is Allison  
3 Koester, and I am a tenured associate professor of  
4 accounting at Georgetown University's McDonough School of  
5 Business. Please note that my views expressed today are  
6 mine and do not necessarily reflect the views of my  
7 employer.

8 In terms of background, I have a PhD in Business  
9 Administration with a focus on accounting. I have taught  
10 corporate financial reporting to more than 2,000 graduate  
11 students at Georgetown to date.

12 My research focuses on corporate financial  
13 reporting and taxation. I have been invited to present my  
14 research at nearly 50 academic institutions and conferences,  
15 including opportunities at the Securities and Exchange  
16 Commission and the Public Company Accounting and Oversight  
17 Board. My research has been published in leading accounting  
18 academic journals and featured in nonacademic outlets like  
19 the Wall Street Journal, Tax Notes, and Inside Investor  
20 Relations.

21 Before academic, I worked at KPMG which is one of  
22 the big four accounting firms. I was a practicing CPA,  
23 licensed in the Commonwealth of Virginia.

24 I've been invited here today to discuss five  
25 things:

1           First, I am going to provide a very brief  
2 overview of U.S. generally accepted accounting principles,  
3 referred to as US GAAP.

4           Then I will be discussing a unique aspect of the  
5 4th Tier domestic cigarette industry related to the  
6 financial implications of the 1998 Master Settlement  
7 Agreement, or the MSA.

8           I will then discuss why we should think about  
9 Coalition members' financial performance post-MSA.

10           I will also provide a comparison of Coalition  
11 member firms' post-MSA financial performance -- focusing on  
12 three key financial metrics -- during the import surge  
13 period, which is defined as the first three quarters of  
14 2019, and also to the pre-import surge period or the first  
15 three quarters of 2018.

16           And then I will explain how these analyses  
17 provide insight into whether Coalition members could be  
18 viewed as materially injured, or experiencing a threat to  
19 material injury, during the import surge period.

20           Note that while I use the term "Coalition  
21 members," or "Coalition member firms" throughout my  
22 discussion, my understanding is that Coalition members  
23 represent the vast majority of the 4th Tier domestic  
24 cigarette industry.

25           So I will begin with GAAP. Coalition members

1 prepare audited financial statements in accordance with US  
2 GAAP. And the basis of US GAAP is something called "accrual  
3 accounting," as opposed to cash accounting or tax  
4 accounting.

5 Accrual accounting depicts the effects of  
6 economic events irrespective of cash flows. This is because  
7 cash flow timing can occur in different periods from  
8 economic activity.

9 This is a simple illustration: John Doe works for  
10 me on December 31st, but I don't pay him until January 1st.  
11 I prepare GAAP-based financial statements, so I recognize  
12 labor expense in December even though my cash outflow  
13 doesn't occur until the next month. John Doe also prepares  
14 his own GAAP-based financial statements, so he recognizes  
15 labor income in December even though his cash inflow doesn't  
16 occur until January.

17 Accrual accounting is useful because it tells you  
18 about economic activity -- like John Doe worked --  
19 regardless of when the cash flows occur. And because it  
20 helps you predict future cash flows. So when I recognize  
21 labor expense but no cash outflow in December, that  
22 indicates that a labor-related cash outflow is going to  
23 happen in the future.

24 Now to MSA. A unique aspect of the 4th Tier  
25 cigarette industry relates to the financial implications of

1 the 1998 MSA.

2           Coalition members are considered nonparticipating  
3 manufacturers, or NPMs, so they are required by law to make  
4 annual, and often quarterly, cash payments to escrow  
5 accounts as a function of cigarette sales within a state.

6           Escrow account funds are expected to be used to  
7 satisfy future tobacco-related judgments and/or settlements  
8 in these MSA Settling States.

9           Technically, unutilized escrow funds are to be  
10 returned to NPMs 25 years after the applicable date the  
11 funds were placed into the escrow.

12           Given no payment has reached the 25-year mark,  
13 there isn't empirical evidence as to what percentage of  
14 funds, if any, will ever be returned to NPMs.

15           Now to Financial Reporting indications of the  
16 MSA.

17           While Coalition members prepared audited  
18 GAAP-compliant financial statements, they treat MSA-related  
19 obligations differently for financial reporting purposes.  
20 One member recognizes a MSA-related charge on its income  
21 statement as an expense included in cost of goods sold,  
22 while the other member does not.

23           However, regardless of financial reporting  
24 treatment, MSA-related obligations are a required condition  
25 for operating in the domestic tobacco producer market.

1 These required payments materially dampen economic  
2 performance and restrict cash resources available for use in  
3 operating, investing, and financing activities.

4           Let's first think about internal decisionmakers -  
5 - management. Management uses post-MSA numbers when  
6 constructing operating budgets, when determining whether  
7 sufficient cash is available for new machinery and  
8 production equipment upgrades, and determining whether  
9 capital can be disbursed to equity holders. Dr. Phillips  
10 and Mr. Smith provided specific examples of this in their  
11 prepared remarks today.

12           There is also evidence that external  
13 decisionmakers, like existing and potential capital  
14 providers, consider member firms' financial performance  
15 post-MSA. One member firm notes that its current lender  
16 considers "net income after MSA payments" when determining  
17 the amount of available credit to extend. One member firm  
18 also notes that during IPO discussions, potential equity  
19 investors from representative institutional investment firms  
20 consistently viewed the recurring MSA payment as an expense  
21 regardless of financial reporting treatment, and actually  
22 valued the firm as a multiple of adjusted earnings net of  
23 MSA-related charges.

24           As MSA financial performance appears to be what  
25 is relevant for both internal decisionmaking and external

1 decisionmaking, my analyses focus on post-MSA financial  
2 metrics.

3 For brevity, my discussion today will focus on  
4 three key financial metrics computed using aggregated CAKC  
5 member financial data. I compare metrics during the import  
6 surge period, again, the first three quarters of 2019,  
7 relative to the pre-import surge period, the first three  
8 quarters of 2018.

9 The three financial metrics I focused on are:

10 Net revenue per carton sold;

11 Adjusted net profit per carton sold -- "net" is  
12 defined as net revenues less net expenses including the MSA;

13 And then adjusted net profit margin. That is  
14 defined as net revenues less net expenses including the MSA  
15 as a percentage of net revenues. An intuitive way to think  
16 about this metric is for every dollar of net sales earned,  
17 what percentage is left over after all expenses and MSA  
18 charges are considered?

19 Analyses show that during the surge period, in  
20 the aggregate Coalition member firms earned materially less  
21 net revenue per carton sold. This is consistent with  
22 members being required to offer more lucrative wholesaler  
23 and retailer rebates in an attempt to maintain market share  
24 during the import surge. These rebates reduce net  
25 revenue dollar for dollar.

1           Two, members earned materially lower adjusted net  
2 profit margin per carton sold. This is due to less net  
3 revenue per carton, as analyses indicate that members' net  
4 expenses including the MSA on a per-carton basis, remained  
5 relatively flat during these two periods.

6           The third metric shows that in the aggregate  
7 Coalition member firms realized materially lower adjusted  
8 net profit margin. For every dollar of net sales earned,  
9 member firms had much less left over after all expenses and  
10 MSA charges are considered.

11           Collectively, a decline in these three key  
12 financial metrics can be viewed as consistent with Coalition  
13 members being materially injured, or experiencing a threat  
14 of material injury, during the import surge period.

15           Now looking forward, I don't purport to have a  
16 crystal ball, but if one attempts to extrapolate forward:

17           If these low-priced products continue to be  
18 imported, Coalition members are likely to continue to  
19 experience negative financial implications.

20           A further increase in import volume, or further  
21 decrease in imported product prices, is expected to  
22 exacerbate the speed and intensity of the negative financial  
23 implications for the domestic industry.

24           Thank you.

25           MR. PICKARD: Thanks, and this is Dan Pickard of

1 Wiley Rein again. To wrap up, I'd like to go through just  
2 some of the major legal issues that are involved in this  
3 case. So again, just to kind of tee up some of these  
4 issues, it's our position that there's a single domestic  
5 like product, essentially coextensive with scope. Imports  
6 have surged over the POI.

7 Domestic producers have lost market share and  
8 net margins have decreased, that there's an increased --  
9 there should be an increased focus on behalf of the  
10 Commission with regard to cash flow for this industry, and  
11 that the nature of the cigarette industry leaves domestic  
12 producers even more vulnerable to the threat of dumped  
13 imports.

14 Specifically, I'd also like to tee up right up  
15 front that we would like to explicitly ask that in the  
16 Appendix C to the staff report, that there would be a table  
17 broken out that indicates income post-MSA payments, because  
18 we think that most accurately reflects the performance of  
19 the domestic industry.

20 I know we're going to be talking a lot about  
21 domestic like product issues today. I would point that all  
22 4th Tier cigarettes share physical characteristics, that  
23 they don't bear the brand or trademark of any company that's  
24 a participant and member of the MSA, and that they've got  
25 stem contents greater than ten percent in their tobacco



1 blend, and that there are also distinctions in regard to the  
2 packaging and other physical differences in regard to  
3 filters and the actual cigarette paper used for non-4th Tier  
4 cigarettes.

5 I would also point out, this might be  
6 something that we discuss more in answers to questions, is  
7 that the units of sale for a cigarette and what is regulated  
8 by the FDA in large part is the entire package, which does  
9 involve everything from the graphics, the foil and the  
10 wrapping. I think that's important, and I think it's a  
11 distinction that you see from kind of a steel case, where  
12 packaging isn't part of a scope consideration or domestic  
13 like product consideration.

14 In regard to interchangeability, there's a  
15 considerable amount of publicly-available information  
16 regarding brand loyalty for non-4th Tier cigarette. As a  
17 matter of fact there is marketing reports that brands and  
18 cigarettes, brand importance is at a premium for non-4th  
19 Tier cigarettes, and there are even public statements from  
20 non-4th Tier producers about the significance of those  
21 brands to the extent that, as an example, a consumer of a  
22 Marlboro who walks into a store that doesn't offer his  
23 brand, is more likely to walk out of the store and go  
24 someplace else to buy a Marlboro than he is to buy another  
25 product in that store.

1           That is -- it's the inverse for 4th Tier  
2 cigarettes, which are incredibly price sensitive and  
3 consumers readily change between 4th Tier cigarette brands  
4 on the basis of price. There are also distinct channels of  
5 distribution, and I think you've heard some of that in the  
6 testimony this morning, that there are distinct wholesalers  
7 that are dedicated to non-4th Tier, and distinct wholesale  
8 channels that are dedicated to 4th Tier.

9           They're also marketed and sold through those  
10 4th Tiers in different ways that non-4th Tiers don't have  
11 the membership incentives or coupon programs that you see  
12 for 4th Tier, for non-4th Tier cigarettes. I think  
13 importantly in regard to common manufacturing facilities,  
14 there are literally zero facilities in the United States  
15 that manufacture both 4th Tier and non-4th Tier. There are  
16 -- they are completely distinct facilities, and similarly  
17 there are zero employees in the United States who  
18 manufacturer both 4th Tier and non-4th Tier.

19           We could also provide information in the  
20 post-conference brief because it's proprietary, that there  
21 are also specific differences in the types of machines that  
22 are used in producing a 4th Tier. On top of it, there are  
23 different production processes, not least of which is  
24 non-4th Tier producers are essentially integrated producers.  
25 They contracted with or grow their own tobacco, and that's

1 integrated all the way through to their cigarette  
2 manufacturing, which does not exist for 4th Tier producers.

3           And then I don't think anybody's seriously  
4 going to dispute that there's not a difference between the  
5 prices in 4th Tier and non-4th Tier, and I think you're  
6 going to hear a lot about that today, and that is also to  
7 the extent that there are any open questions about that. We  
8 can easily supplement the record with that and include that  
9 in our post-conference brief. So that's domestic like  
10 product issues.

11           In regard to the major conditions of  
12 competition that we talked about, there are the issues  
13 connected with the fact that domestic 4th Tier producers are  
14 also NPMs under the industry or under the SMA. They are a  
15 distinct industry, and this is -- the importance to this  
16 especially for purposes of the injury analysis I would say  
17 is high, that there are such significant annual or  
18 quarterly payments into the escrow amounts that get locked  
19 up for 25 years that the Commission, it would be appropriate  
20 for the Commission to evaluate the effect of imports in  
21 light of that relevant condition of competition.

22           More specifically, look at what is the  
23 financial performance of the domestic industry after they've  
24 been required to make those escrow payments.

25           Also, regionality is a huge issue here. To be

1 clear, we have not pled this case as a regional analysis.  
2 But it is a relevant condition of competition, that what  
3 you're going to see is KT&G essentially starting its  
4 operation in the middle of the United States in Oklahoma.  
5 There are -- because of how the MSA is implemented, the  
6 Missouri market is particularly of importance to the  
7 domestic industry, and you see the first maybe  
8 manifestations of material injury in the core part of the  
9 market, and we'll talk also about the effects of having to  
10 lower prices in Missouri for the domestic industry to be  
11 able to maintain its profitability, but which came at  
12 decreased revenues.

13           And then also at KT&G moves out throughout the  
14 country, how that is evidence of both material injury and is  
15 clearly supportive of threat of material injury. So volume,  
16 again as I said in my opening statement, I don't think  
17 anybody is going to dispute that the official import  
18 statistics and I'll limit volume discussions to just the  
19 official import statistics since we've got such a limited  
20 factual record but I'm happy to discuss similarities.

21           The absolute volume of imports, as I said, 2.8  
22 million cigarettes -- I'm sorry, 2.8 billion cigarettes from  
23 Korea in just the first nine months of 2019. Also, the  
24 significant increase of 52.6 percent, and while market share  
25 is proprietary, I would suggest fully consistent with ITC

1 practice. The market share gained by subject imports is  
2 significant, and subject imports are continuing to surge, so  
3 there should be no doubt about that.

4 So obviously the pricing product data is BPI.  
5 So I indicated in my opening statements that the average  
6 unit value from the official import statistics are probably  
7 more probative in this case or of more probative value in  
8 this case than maybe in a traditional case, and that's due  
9 in part to a couple of different things.

10 One, you've got a clean HTS number, meaning  
11 that everything covered by that HTS number are subject  
12 merchandise, and the fact that cigarette pricing is linked  
13 and that's a pack of full-flavored cigarettes as compared to  
14 100's or Kings are all priced at the same level. So what  
15 that allows you to do is kind of take a look at what happens  
16 with average unit values for imports.

17 It also has the added bonus of there are  
18 multiple levels of taxes involved and rebates involved in  
19 these programs. So this kind of gives you a fundamental  
20 look at import volumes or import values, excuse me, and you  
21 see the significant decrease over the POI, a decrease of 29  
22 percent. The evidence of record that is proprietary is I  
23 think you start to see more negative effects of imports at  
24 the same time that imports are surging.

25 Importantly, so first off, not infrequently

1 petitioners come in and they say imports are the low price  
2 leader, and then we have a little bit of a battle back and  
3 forth as far as whether imports are really the low price  
4 leader. Here, this is a little bit more straightforward.  
5 If you see in the highlighted part below, KT&G refers to  
6 itself as the low price leader. Also, for purposes of  
7 domestic like product analysis, I'm not suggesting that you  
8 would conflate what foreign operations do as compared to  
9 U.S. operations.

10                   But in regard to whether there really is kind  
11 of a 4th Tier products if products are held out that way, I  
12 would note that KT&G also highlights its products and refers  
13 to them as 4th Tier products in their advertising materials.  
14 I'm going to start to wrap up pretty quickly so we can get  
15 to answers to questions.

16                   There's clearly evidence of price suppression  
17 and price depression. Clearly, this is Business Proprietary  
18 Information. But you're going to hear from further  
19 testimony today we have a considerable amount of other  
20 documentary evidence that demonstrates the underselling by  
21 imports. I think the questionnaire responses also further  
22 confirm that subject imports are highly interchangeable,  
23 which only further supports the importance of price.

24                   So the evidence of material injury, among  
25 others, is viewed in low capacity utilization rates,

1 decreasing average unit values, declining capital  
2 expenditures, decreasing operating and net profit levels and  
3 evidence of confirmed lost sales. And as I -- to really  
4 start to wrap up, as I indicated in my opening statement,  
5 this might even be a stronger case in regard to threat of  
6 material injury. Clearly what's happened so far is put the  
7 domestic industry in a vulnerable spot.

8           You've heard Mr. Smith testify in regard to,  
9 for example, the failed IPO that was due in large part to  
10 price effects in the market caused by the Koreans, and some  
11 of the Business Proprietary Information regard to capacity,  
12 and other evidence in Korea I think is further supportive of  
13 a threat of material injury argument, not least of which is  
14 the fact that KT&G is huge. They are the fifth largest  
15 cigarette producer in the world.

16           So and as we've talked about that KT&G is  
17 spreading nationwide, again in regard to whether these are  
18 really referred to as 4th Tier, KT&G even refers to them as  
19 4th Tier. In regard to whether there are low-priced  
20 leaders, even KT&G indicates that they're a low price  
21 leader, and in regard to now shipping or selling throughout  
22 the country, even KT&G indicates that they're now in at  
23 least 48 different states.

24           So in conclusion, imports of 4th Tier  
25 cigarettes have materially injured the U.S. market. You've

1 seen the significance. We see it both reflected in the  
2 official import statistics and I would suggest other  
3 evidence of record is supportive of an increase on an  
4 absolute basis and on a market tier basis.

5 We've got price effects, we've got negative  
6 impact and we've got compelling evidence in regard to  
7 threat. With that, that concludes our direct presentation.  
8 We'll be happy to answer any questions that you have.

9 MS. CHRIST: Thank you very much. We'll now  
10 turn to staff questions and I would like to just remind in  
11 response to the questions to state your name and  
12 affiliation; particularly, as we bounce back and forth to  
13 different Respondents. It's very helpful for the Court  
14 Reporter. Thank you. And we'll start with the  
15 Investigator, Larry Jones.

16 MR. JONES: Good morning everyone. Lawrence  
17 Jones, Office of Investigations. Thanks for coming today  
18 and for all your testimony and your presentation.

19 The first thing I would ask is just basically  
20 what's going on with the -- there's only one of the  
21 Petitioner firms here today. There's no representatives  
22 from Cheyenne. Is there any reason why there's no one here  
23 from Cheyenne to answer our questions?

24 MR. PICKARD: Yes, I'll be happy to answer any  
25 questions from Cheyenne, either today or in the



1 post-conference brief, but, in part, I think it's witness  
2 management. We've got a pretty full panel as it is, but no  
3 real particular reason beyond that.

4 MR. JONES: Okay. So, in regard to that, in the  
5 petition there are four firms that are listed publicly as  
6 domestic producers. And of those firms, I can state safely,  
7 there are, -- listed in the petition, it's Cheyenne,  
8 Xcaliber, and then Native Trading, and Dasol. Is there any  
9 particular reason why Dasol and Native Trading have not  
10 joined with the petitioning firms? And also in relation to  
11 that question, there's a firm that went out of business in  
12 2019 as SM plans. Is there any reason why they have not  
13 attended or they're not a participant in the petition?

14 MR. PICKARD: We, obviously, put together as  
15 large a petition as possible and we invite all domestic  
16 producers. In regard to Dasol and Native Trading, in regard  
17 to why they're not supportive, I think you would have to ask  
18 them. In regard to S&M, although it's a little bit of  
19 speculation, I think the reason why they're not involved in  
20 the case is because they're out of business.

21 MR. JONES: Okay. So, the one question I had  
22 was going through the petition I noticed -- this is BPI, so  
23 this is information that doesn't have to be revealed, but  
24 basically, production in terms of domestic production it  
25 varied in terms of estimates of how big the domestic

1 production industry was. For example, one company, for  
2 example, have 25 percent -- I mean these aren't actual  
3 figures, just hypothetical ones -- another have 25 percent.  
4 That was listed in the petition at one point and then one  
5 of the statements from one of the actual company  
6 representatives listed completely different figures and so I  
7 guess this confusion is -- and this can be addressed  
8 obviously post-conference, but why such varying you know  
9 estimates for domestic production in terms of how much one  
10 company has compared to another. It doesn't seem like  
11 there's a solid grasp on how much is being produced.

12 MR. PICKARD: So, obviously, we'll provide the  
13 specifics in the post-conference brief. I think I would  
14 maybe quibble with the characterization as far as, yes,  
15 there are differences in the estimates, but I wouldn't say  
16 these differences are particularly significant. So, when  
17 you were talking a look at obviously a industry participant  
18 and they know what their share is and they've got a pretty  
19 good feel for what their competitor -- domestic competitor's  
20 production is and you've got industry experts out there who  
21 also provide sworn affidavits I would say that they're all  
22 in the same ballpark, but there's not perfect knowledge, but  
23 we can tease that out more in the post-conference brief, but  
24 I think that really goes to kind of a standing issue for  
25 Commerce more than anything else.

1 MR. JONES: Okay, thank you for that. And just  
2 turning to Xcaliber, going on their website looking around,  
3 it's -- correct me if I'm wrong, but the company was founded  
4 in 2001 or 2002 -- that time period -- and what I noticed  
5 there were 15 distinct plans. Are they all classified as 4th  
6 tier cigarettes or would they be -- any of them be  
7 classified in another tier?

8 MR. TAYLOR: So, you are correct. We were  
9 founded in 2001. If I remember right, our first sale may  
10 have been not until 2002. The brands vary. They're not all  
11 cigarette brands. That said, all the cigarette brands we  
12 make are 4th tier.

13 MR. JONES: Thank you. And just based on that,  
14 going on the website, there was something I noticed in  
15 particular. It looks like there were at least four states  
16 that Xcaliber does not sell in. They include Wyoming,  
17 Alaska, Hawaii, and pretty much all of New England. What  
18 was the reason or how come those states are listed as  
19 non-participants -- or not non-participants, but why aren't  
20 there any sales there?

21 MR. ESTES: At this point, we sell or we're  
22 licensed to sell in all but one state and that's Wyoming.  
23 We've chosen not to go into Wyoming because of regulatory  
24 issues there that aren't favorable to MPMs or 4th tier  
25 companies.

1 MR. JONES: So, on the website how come there  
2 are all these states blocked off; particularly, New England?  
3 Is there a reason doing that?

4 MR. ESTES: I have a feeling we just haven't  
5 updated our website in a little while; something we probably  
6 need to look at.

7 MR. JONES: Thank you. And also, one question  
8 regarding actual production in terms of what percent of  
9 production is cigars compared to cigarettes and as far as  
10 manufacturing how is that allocated out?

11 MR. SMITH: We do make filtered cigars and you  
12 roll your own tobacco. It's very immaterial compared to the  
13 cigarette volume of our business and those products are made  
14 on other machines within the organization or hand-bagged  
15 within manufacturing. And those are very immaterial  
16 compared to our cigarette volume.

17 MR. JONES: What percentage would you estimate  
18 that at being if you had to make an estimate?

19 MR. SMITH: That's proprietary.

20 MR. JONES: Thank you. And also, this is a  
21 question more towards Cheyenne. I don't know if you can  
22 answer this with them not being here, but going on their  
23 website it listed them having export sales. I just wanted  
24 to find out exactly how much they're exporting. And  
25 obviously, this might be business proprietary, but who are

1 they exporting to?

2 MR. PICKARD: Sure, we'll be happy to answer --  
3 I agree with you. Again, I agree with you that's probably  
4 proprietary information and we'll include it in the  
5 conference brief.

6 MR. JONES: Also, one question regarding  
7 customer preferences in the trends. So, we've heard a lot  
8 about there's not really -- for 4th tier cigarettes there's  
9 not a whole lot of customer preferences. A lot of times --  
10 correct me if I'm wrong here, but somebody will buy -- they  
11 have no problem buying an edge filled or others, just  
12 because it's cheaper and it's something that they have that  
13 they can smoke, for a better term. What effect does that  
14 have on import trends; particularly, we look at this -- you  
15 know is it something like, okay, someone doesn't care and if  
16 they don't really mind what type of cigarette it is what  
17 effect do you see on that if they're just like just give me  
18 whatever you have in the store. I don't know what someone  
19 would say in terms of that, but I'm just kind of -- you know  
20 clue me in on you know how would that affect import trends  
21 and also you guys, domestically?

22 MR. PICKARD: Again, why don't I start it off  
23 and then I'll kick it over to Jay or Derick. I think in  
24 regard to kind of theoretically the question when products  
25 are more price sensitive, right, if that's -- if price is a

1 very important factor, I think that allows, as a general  
2 rule, imports to access a market easier, right? So, if  
3 really what consumers are looking for is really kind of a  
4 price-based decision, to the extent that imports can compete  
5 on a lower basis, that lower price basis that allows them  
6 easier access to the marketplace. And I think that's  
7 exactly what's been borne out in regard to the evidence of  
8 record.

9           As to the official imports statistics and  
10 otherwise is as imports decrease in price they grab  
11 increased sales and they grab increase market. But I know  
12 -- yeah, sure.

13           MR. TAYLOR: So, the words -- and I hate to put  
14 it in your mouth, what they're looking for because we know  
15 it very -- more familiar with it is a consumer comes in,  
16 they say give me your cheapest and 4th tier it's solely  
17 about price and that is what drives the decision. We're not  
18 doing the customer incentives and you know having spent a  
19 lot of money on brand equity and building a brand fourth  
20 tier it is solely about price and that's usually what the  
21 consumer says when they come in.

22           MR. SMITH: You know I'd like to add to what  
23 Derick said on that and I think that it's quite clear. If  
24 any of you were in a certain gas station, quick trip,  
25 supermarket, store that sells these low, 4th tier

1 cigarettes, you can watch and see that if you stand there  
2 for 10 minutes that the people that are coming in that are  
3 buying in this category are saying give me the lowest you  
4 have and not even looking at what the brand or what the  
5 package is or what it is. It is all price sensitivity that  
6 they're looking for.

7 I've seen it myself, personally, from that  
8 standpoint and been in the market to see that. And even  
9 with the situation with -- you know KT&G is going to say  
10 that they are the lowest price everywhere, even on their  
11 website. That's what you're also seeing when you are in  
12 these stores that have these brands as well. Thank you.

13 MR. JONES: Thank you. And I think that leads  
14 to the next question I had; particularly, in the petition on  
15 page 12 you indicated there was some talk about some  
16 incentives or a lack thereof in terms of marketing  
17 strategies. What type of marketing strategies have 4th tier  
18 cigarette manufacturers employed?

19 MR. PICKARD: I'll tee it up. So, the point in  
20 the petition was that 4th tier is distinct from non-4th tier  
21 in that you don't see -- there's a distinction in regard to  
22 kind of the advertisements, coupons, customer incentives  
23 that are used in non-4th tier as compared to the 4th tier.

24 I don't know; Joe, do you want to address kind  
25 of more what you see from kind of non-4th tier incentives

1 that aren't done here?

2 MR. NICHOLAS: Just to be clear, you want me to  
3 elaborate on the differences between non-4th tier and 4th  
4 tier regarding -- yes, typically, the non-4th tier companies  
5 market to consumers through trade ads and things like that  
6 and we do not.

7 MR. JONES: And in terms of -- and this is also  
8 in the petition. It's on page 15. This is about  
9 regionality. So, you indicated there was some degree of  
10 regionality. And in that regard, this includes mentioning  
11 of the central region of the United States; particularly,  
12 Oklahoma, Missouri -- that region. And what I noticed was  
13 there are 40 states that the Korean cigarettes go to and so  
14 the question is was there something -- I talked to a couple  
15 of companies on the phone about, without giving out that  
16 information, but just trying to figure out. So, there were  
17 four states that did not sign the MSA and of those four  
18 states -- correct me if that's wrong -- there's three of  
19 them. It's Florida, Texas, and Mississippi. There's  
20 another one.

21 So, are these showing up in these four states?  
22 This is something that I'm still trying to figure out and if  
23 they aren't showing up in those four states, to what effect?  
24 And the reason I ask that is because Dasol is located --  
25 they're manufacturing out of Florida, so what effect does



1 that have on, not just you guys, but the domestic industry  
2 in terms of what you see coming from Korean cigarettes?

3 MR. PICKARD: Again, Dan Pickard from Wiley Rein.  
4 I'll start off. So, yes, in this quarter area, we see, at  
5 kind of the beginning of the period of investigation,  
6 imports overwhelming focused into this middle region,  
7 Oklahoma, Missouri and surrounding states. And then there's  
8 evidence that they've started, KT&G, has started to move  
9 nationwide. And I think we can supplement with some  
10 additional kinda documentary evidence that this includes  
11 both MSA states and previously settled states that we're  
12 seeing significant increases in imports from KT&G, for  
13 example, into Texas and Florida. So that's clearly going to  
14 impact Dasol.

15 And it's -- I apologize if maybe I wasn't as  
16 clear as I wanted to be in my direct presentation. I think  
17 that's a large part of our threat argument is that where  
18 imports first come in, we see the most negative effects,  
19 kind of in that geographic region. And we're not saying  
20 that other producers aren't damaged by that, but some of the  
21 most probative evidence in regard to causation is strongest  
22 there. And then as the imports continue to move out, that  
23 only further magnifies the threat as they continue to move  
24 into one or more markets throughout the U.S. That being  
25 said, didn't know if you wanted to add anything in addition

1 to? Sounds like I got one.

2 MR. JONES: Thanks, Dan. And this is regarding  
3 the two firms during the period of investigation that shut  
4 down. I believe it's Sandia Tobacco out of New Mexico, and  
5 S&M Brands in Virginia. This is on Page 23 of the petition,  
6 sorry, I'm talking too close. This was on Page 23 of the  
7 petition.

8 And what I noticed was, I looked at--there's a  
9 news article, I believe it was included in Exhibit 21 of the  
10 petition. This was regarding what S&M Brands actually  
11 produced. So these recently went out of business March,  
12 2019. The firm, based on what I was reading, not only in  
13 the exhibit, but also online, they were producing about 2.8  
14 billion cigarettes a year. That's what was estimated, so  
15 we're 2.8 billion in terms of cartons, or actually how the  
16 cartons they were producing, I could do the math real  
17 quick, but I don't wanna waste your time.

18 So the one thing I was gonna ask was, so that was  
19 based on what I read there. And then also, based on  
20 Excaliber's website, it cited about 40 million cigarettes a  
21 day, if that's correct. That's what I read on Excaliber's  
22 website. They were producing 40 million a day, which  
23 equates to about 10 billion cigarettes a year. So when you  
24 look at this, we see two companies that went out of  
25 business during the period of investigation, but they could

1 be, you know, Virginia and New Mexico.

2 So, there's a bunch of customers for those  
3 brands, particularly recently, that, you know, for the S&M  
4 Brands, it seems like they produced a good bit. Where did  
5 they migrate through, in terms of cigarettes? Like, did  
6 they just start buying this? Are they just shift over to  
7 Edgefield? What exactly did -- what do customers do now  
8 that those two, those less-offered domestic cigarettes?

9 MR. PICKARD: Sure. So I'm gonna ask Jay to chime  
10 in. But I think your question touches on an interesting  
11 legal issue that in previous ITC cases, there have been  
12 questions regarding survivor bias, that is, so the extent  
13 that imports kill off U.S. manufacturers, other remaining  
14 U.S. manufacturers may get a slight uptick in business as a  
15 result, which can be somewhat counterintuitive to say that  
16 the slight increase in business for a domestic industry that  
17 came as a result of one of the domestic producers being  
18 killed off in part by imports, sometimes is cited as  
19 evidence of a lack of injury, if that makes sense?

20 And that's why people have said the Commission  
21 should pay attention to survivor bias, that when certain  
22 U.S. producers are impaired or shuttered as a result of  
23 imports, any increase in the performance of the remaining  
24 U.S. producers shouldn't be considered a lack of injury.  
25 That being said, we talked about this a little bit in regard

1 to how much KT&G picked up from S&M when they went out of  
2 business. And I know, to the extent that there's been an  
3 uptick in some of Excaliber's sales due to S&M going out of  
4 business. That's a little proprietary, but Jay, I didn't  
5 know if you wanted to talk about it at a higher level.

6 MR. SMITH: Talking at a high level here is that,  
7 you know, we believe that there's a slight uptick in the 4th  
8 Tier market. There might be a slight uptick that we've  
9 gained from those companies going out of business. But with  
10 the surge of imports that you see, we believe that all that  
11 went to KT&G.

12 And to expand on that, even some of the volume  
13 that we may have received from that, you'd expect, you know,  
14 net prices to maintain, and I'd say net prices declined. So  
15 we know KT&G came in with lower prices to take that volume,  
16 so we believe that they took just about all or the majority  
17 of that volume from those two companies.

18 MR. JONES: Thank you. This is regarding, and  
19 it's a similar trend or similar topic for employment trends.  
20 So just based on you guys, Excaliber's employment trends, if  
21 you can describe to me your employment trends, so what you  
22 would see in terms of foreshadowing as well in the domestic  
23 industry.

24 I guess the one thing I would ask is, and this is  
25 a lack of familiarity with the cigarette production process

1 good for what we see on the screen today. Is there any new  
2 technology that is out, particularly automation, robotics,  
3 anything like that, that would render some of these  
4 positions, production-related positions obsolete or is there  
5 any, you know, incentive to go to these types of technology?  
6 Is that something that's on the horizon and it's happening?  
7 And to what extent?

8 MR. SMITH: This is Jay Smith, Excaliber. I  
9 believe there are two questions there that you've asked.  
10 And the first one is dealing with employment data, which I'm  
11 gonna say that's proprietary. And the second one dealt with  
12 innovation, I believe, and the possibilities of innovation.

13 You know, cigarettes, 4th Tier, are highly  
14 regulated by the FDA, and there's nothing you can change  
15 from that cigarette product. There's a ruling--and Eric  
16 knows more about this--I'm not at the highest level--is that  
17 the ruling with the FDA of having the same products from  
18 2007 equivalency is that there's really no innovation from  
19 the cigarette standpoint.

20 From an equipment standpoint, I'm sure that  
21 there's always, of course, innovation. But of course with  
22 our cash flow situation and the low prices of KT&G's in the  
23 market declining are net prices. The cash flow's not there  
24 to try to look at, improve, develop, design and increase  
25 efficiencies within our manufacturing processes at this

1 point.

2 MR. PICKARD: Just to follow up, this is Dan  
3 Pickard. Again, it raises an interesting question that  
4 maybe I'll ask Jay to expand upon this a little bit, too.  
5 There's always efforts to increase efficiencies, right?  
6 Obviously, all U.S. producers want to do so.

7 But we were talking about the nature of R&D in  
8 this industry, which is a little different than, frankly,  
9 the majority of cases that I've dealt with, in that there's  
10 required R&D just to stay FDA compliance. And then there's  
11 the R&D that a company wants to do in an effort to try and  
12 be as efficient, lower their costs as possible.

13 And I don't know, Jay, how comfortable you are  
14 going into maybe some of the specifics, but in some of our  
15 conversations, Excaliber's talked about the idea that there  
16 are R&D expenses that you have to do, even if now is not a  
17 great time, in order to stay compliant with the law -- maybe  
18 this is a better question for Eric, quite frankly, and  
19 sometimes that comes at the cost, because there's only so  
20 much dollars left over, from the R&D that you want to be  
21 doing for your business. Anything that you'd like to add?

22 MR. ESTES: Eric Estes, Excaliber International.  
23 Dan's right, that we do have to invest larger sums of money  
24 for a long period of time, and do research specifically.  
25 The FDA requires us to prove that all of our current

1 products by SKU are substantially equivalent to a product in  
2 the market in 2007.

3 As they request that data, we have to go in and  
4 pull very specific scientific information, either through  
5 testing or through our vendors, to get that information. We  
6 don't have a choice but to do that. If we fail to provide  
7 that data to the FDA, then sure as KT&G could put us out of  
8 business, the FDA could, too.

9 MR. JONES: So, one question, follow up regarding  
10 that. So is there any comparative advantage or any  
11 advantage that the Korean manufacturers might have in terms  
12 of production that would make their production processes  
13 more efficient than yours?

14 MR. ESTES: We're not familiar with KT&G's  
15 production facilities. We've never seen them in Korea. We  
16 just don't know.

17 MR. SMITH: Jay Smith, Excaliber. I will tell  
18 you that we do know that they have a significant amount of  
19 capacity within their manufacturing operations.

20 MR. JONES: Thank you. And this goes to a  
21 similar trend on the topic of capacity utilization. Due to  
22 the low capacity utilization in your presentation and just  
23 trying to find out, what goes on with such, I wanna say  
24 socially, but what would you consider a good capacity  
25 utilization rate? And where you're at now and where you

1   wanna be, and say, hypothetically, if you're at half, 50%,  
2   is that where you wanna be? Or where would you like to be  
3   and where you're at now? Without disclosing too much PBI.

4               MR. SMITH: I'll tell you this. I'm not getting  
5   into capacity numbers and where we would like to -- oh,  
6   sorry, Jay Smith with Excaliber. I'm not gonna get into  
7   capacity numbers and where we should be and how we compare  
8   to others in the market from that standpoint. But I will  
9   tell you that the U.S. domestic manufacturers have the  
10  capacity to produce all the 4th Tier, I should say the 4th  
11  Tier U.S. domestic manufacturers have the capacity to  
12  produce all the 4th Tier cigarettes in the U.S. from a  
13  capacity standpoint.

14              MR. PICKARD: And we can also, Mr. Jones, Dan  
15  Pickard again from Wiley Rein, we can give you more specific  
16  data in regard to that from -- in the press conference  
17  brief, obviously their targeted capacity utilization rates  
18  the companies treat as proprietary. But we've got some data  
19  points that we think might be of interest to you as far as  
20  historically some of the high capacity utilization rates,  
21  and kind of where we're at now.

22              MR. JONES: Thank you. And this goes to more a  
23  regulatory question and what you guys perceive being a  
24  trend. So I would say a safe number would say smokers  
25  decline about 5% a year and this is, from what I've heard,



1 that's a conservative number. And this is from the  
2 researches and the phone calls I've talked with some  
3 cigarette companies. And also there's, we have an aging  
4 population here, and there's now new laws out there to  
5 purchase tobacco, I think it's 21 now nationwide.

6 So, you know, these three things combined, a  
7 decline in smokers, an aging population and now, we see, you  
8 know, a new age requirement that's 21. What long-term  
9 plans, or how do we see this affecting the viability of your  
10 guys' company and the petitioners?

11 MR. PICKARD: Dan Pickard. Why don't I start  
12 this off again, and then I'll kick it over to one of the  
13 industry participants.

14 I think you're right. Some of the studies from  
15 CDC traditionally showed decreasing cigarette rates, and  
16 that has been a trend since at least 1998, since the signing  
17 of the MSA. Some of the information in regard to ADC for  
18 fourth-year cigarettes specifically I think is probably  
19 under the APO, but it's essentially flat.

20 So if your question is, in light of flat or  
21 decreasing demand, what's that -- how does that bode for the  
22 company, how does that bode for the industry, one, I think  
23 potentially it makes for a more vulnerable industry. And  
24 certainly increases in market share or increases in supply  
25 of unfairly priced imports in a flat or a decreasing market

1 are even more injurious than in a growing market.

2 But I would say, even if you have a slight uptick  
3 in ADC, what you would still continue to see is a large  
4 surge coming in from Korea, which only contributes to  
5 vulnerability and threat on a going-forward basis.

6 MR. JONES: Thank you. This is a follow-up to  
7 that. So in terms of the new requirement for the age of 21  
8 to purchase tobacco, this is kind of -- you've somewhat  
9 answered the question, but just to find out a little bit  
10 more, is the 18 to 20 age range crucial for new smokers, and  
11 for tobacco users? Particularly like is this a window that  
12 is necessary to reach new smokers, particularly because if  
13 the age requirement is 18 it would be, I won't say it's  
14 safe to say, but there's probably going to be some people  
15 starting at 16, 17, and then by the time they're 21 they've  
16 been smoking for 5 years, I'm just asking is this going to  
17 affect your industry substantially?

18 MR. ESTES: Eric Estes, Xcaliber International.  
19 Statistically you see the 18 to 21-year-old smokers were  
20 initiating on the marquee first tier brands. Those are  
21 usually Marlboro, Camel, Newport. I think the CDC said in  
22 2016 that 62 percent of the market was controlled by those  
23 three brands, and that's also where most of the kids are  
24 initiating.

25 Nobody is initiating smoking on a 4th Tier

1 cigarette; 4th Tier is strictly for prices of smokers, and  
2 not people that are interested in kind of the status of a  
3 1st Tier brand.

4 MR. JONES: Thank you. And I just have one last  
5 question for now. This is about official import stats. So  
6 we look at these, and you mentioned that official import  
7 stats are a pretty reliable measure of 4th Tier cigarettes.  
8 Just out of curiosity and from what you've obviously seen,  
9 there's two point I noticed about the official import stats,  
10 one is the question is how much of the actual non-4th Tier  
11 comes in under the official import stats, if any at all.

12 And then also, just looking at this, it seems  
13 like Canada is a larger importer, anyone from Canada than  
14 there were actually on non-subject imports from Canada and  
15 how it affects your industry.

16 MR. PICKARD: Sure. So -- Dan Pickard from Wiley  
17 Rein. I'll start off, again. So I think your question  
18 breaks down into two parts. As far as the official import  
19 statistics for the Korean data, we believe -- and I think  
20 the evidence supports -- that 100 percent of that is 4th  
21 Tier cigarettes.

22 And then the second part of your question is, in  
23 regard to the other non-Korean sources, what percentage of  
24 that is 4th Tier cigarettes. And we believe it's  
25 essentially zero. There was one Canadian producer of 4th

1 Tier cigarettes that has essentially exited the market, and  
2 it appears that essentially entirely that Canadian volume I  
3 believe is Phillip Morris, but I'll -- which is a non-4th  
4 Tier product -- but I'll see if Derick wants to add a  
5 little to that.

6 MR. TAYLOR: Yeah, Derick Taylor, Xcaliber. Just  
7 to echo what Dan said, yes, everything from Korea is in the  
8 4th Tier segment of our industry. The Canadian producer he  
9 was talking about I believe was GRE, and over time they've  
10 slowly withered away.

11 It's my understanding that, yes, it's either a  
12 premium or even an alter-premium that's coming from Canada  
13 from one of the majors.

14 MR. JONES: Thank you, and just one more  
15 question. Just based on some of the witnesses who are here,  
16 this is about non-subject cigarettes, or non-subject imports  
17 of 4th Tier cigarettes also, and that's about cigarettes  
18 from Paraguay. What effect, and what volumes have you seen  
19 coming in, in particular the one brand, coming in from  
20 Paraguay? Are they affecting your sales? And what have  
21 you seen in terms of that?

22 MR. ESTES: Eric Estes, Xcaliber. The Premiere  
23 brand may be listed in a number of state directories. I do  
24 not think that they have any significant sales volumes.

25 MR. JONES: Thank you. I don't have any other

1 questions for now.

2 MS. CHRIST: Thank you. We will now turn to  
3 Michael Haldenstein, the attorney.

4 MR. HALDENSTEIN: Michael Haldenstein, the Office  
5 of the General Counsel. Thank you for coming in this  
6 morning.

7 I have some questions about like product. I was  
8 wondering if you feel that the MSA agreement, if that has a  
9 major effect on the analysis? Does being a signatory, or a  
10 nonparticipating member, affect the like product analysis?  
11 And I was thinking maybe it would affect the channels of  
12 distribution, or the pricing.

13 MR. PICKARD: So it definitely affects the  
14 domestic like product analysis, but not as -- not as  
15 immediately apparent under the traditional six-factor test  
16 as you kind of dig into it.

17 So it's really that kind of status under the MSA  
18 is kind of further supportive of the fact that they are  
19 separate products, and separate industries. So most  
20 definitely what you see is the NPMs to -- under the MSA are  
21 the 4th Tier producers.

22 Now is that kind of a traditional analysis under  
23 the six prongs? No, but then it starts to go to your point,  
24 Mr. Haldenstein, in regard to kind of consumer and producer  
25 perceptions in that there are kind of clearly identified

1 brands that kind of fall under the first tier, and they are  
2 generally from the original participating members. And then  
3 you get second and third tier brands that are also  
4 coincident with subsequent participating members. And then  
5 your NPMs are your fourth tier producers.

6 Now we're not making an argument necessarily that  
7 the status under the MSA is part of kind of what the  
8 Commission traditionally looks at for the six factors, but I  
9 think it is supportive in regard to the idea that these  
10 really do operate as separate industries. And, that it  
11 further supports fourth tiers who are identified as a  
12 separate industry and who have a separate legal status under  
13 the documents.

14 And I think I would make a difference. There is  
15 a distinction between your legal status under the MSA which  
16 isn't a physical characteristic, for example. But clearly  
17 identifiable brands that are owned by a first or third tier  
18 producer is a physical characteristic. It's a brand, or  
19 it's a trademark that is included on a product, which is a  
20 physical bright-line difference between those who do not own  
21 those brands.

22 MR. HALDENSTEIN: Thank you. So does that fully  
23 explain why all the non-participating members are only in  
24 the fourth tier? Is that correct?

25 MR. PICKARD: That's correct. Only -- NPMs only

1 make fourth tier cigarettes, and in the United States 4th  
2 Tier cigarettes are only made by NPMs.

3 MR. HALDENSTEIN: Do you view the packaging as an  
4 important distinction in terms of physical characteristics  
5 for the purchaser? When I looked at the cartons of  
6 cigarettes on line, they looked like other cigarettes.  
7 There didn't seem to be an obvious distinction. And you  
8 mentioned that the FDA regulates all --

9 MR. BURCH: Could you please speak a little  
10 louder?

11 MR. PICKARD: Sure. So I'll start off, and maybe  
12 I'll turn it over to Eric from there. So I think really  
13 when you start talking about very bright lines for purposes  
14 of the domestic industry definition, which is different to a  
15 certain extent than some of the scope language, but the  
16 bright line is 10 percent stems or more for the domestic  
17 like product, and the brand and trademark.

18 But on top of that, there are additional physical  
19 characteristic differences. The filters are one of them,  
20 cigarette papers are one of them, and there are also two  
21 differences in regard to the packaging that are also  
22 included.

23 What you will see with non-4th Tier is frequently  
24 a rounded corner inside the package. You'll also see  
25 non-4th Tier stamped or an embossed aluminum foil that

1 covers the name. There are additional physical  
2 characteristics that are generally supportive.

3           And this is what I'm going to actually ask Eric  
4 to jump in on, in that all of that is regulated by the FDA.  
5 In a different case, you wouldn't think about rebar, right?  
6 You wouldn't think about the container that rebar was in as  
7 being relevant to kind of the domestic like product  
8 analysis, or the scope, at least to the best of my  
9 knowledge.

10           Here it's different because all of that is  
11 regulated by the FDA. And the unit of sale is essentially  
12 the pack, or a collection of the packs in a carton. And  
13 maybe Eric can talk a little bit about the extent that the  
14 packs are actually regulated, which I think is further  
15 supportive of what we're trying to suggest, which goes to  
16 your question.

17           MR. ESTES: Eric Estes, Xcaliber. Mr. Pickard is  
18 right, that the product regulated by the FDA expands beyond  
19 the cigarette to also the packaging. We have gone through  
20 the substantial equivalence process I believe 36 times over  
21 the last 10 years. And in those cases, of course they want  
22 to know what the individual components consist of, from  
23 tobacco blend to paper, to tipping paper, to filter, to  
24 adhesives. They want to know all that.

25           But they've also expanded that analysis beyond



1 the cigarette itself to the foil, to the inner box of the  
2 package, the outer box of the package, and even the tear  
3 tape and cellophane wrapper. So we're regulated from the  
4 very beginning of the cigarette really to everything that  
5 the consumers can hold in their hands.

6 MR. HALDENSTEIN: Thank you. So would you say  
7 the regulation is different for the 4th Tier cigarettes, or  
8 other cigarettes, other tiers have to face the same  
9 regulation in terms of packaging, and warnings, and all.

10 MR. ESTES: Are you talking specifically -- Eric  
11 Estes, I'm sorry -- are you talking specifically by the FDA?  
12 Or are you also --

13 MR. HALDENSTEIN: Yes, the FDA.

14 MR. ESTES: Okay, by the FDA I think that every  
15 manufacturer of a cigarette is going to have to do the same  
16 analysis. The difference for 4th Tier is we can't depend on  
17 internal abilities to do that. We do have Dr. Phillips  
18 inhouse. We do have some basic instrumentation inhouse.  
19 But we do not have the ability to do all testing inhouse.  
20 We'll have to send that testing out to a number of labs in  
21 the United States to do that kind of testing, a very great  
22 expense. The bigger manufacturers may not have to do that.  
23 To even test, you'll see that they have dedicated testing  
24 machines, makers like Worshan and Slide. Xcaliber would  
25 have to shut down production to actually run test products

1 to build it out for testing purposes.

2 So I think everybody is regulated in the same  
3 manner, but the effects themselves are very different  
4 depending on whether you're a 4th Tier manufacturer or  
5 manufacturing in a different Tier.

6 MR. HALDENSTEIN: Thank you. Reading the  
7 Petition and the scope, I was just going to ask about the  
8 stem count. That seems like it was an important distinction  
9 for the tobacco, and I was just wondering if this is  
10 something that purchasers are aware of, and how that affects  
11 the taste of the cigarette.

12 MR. PICKARD: Sure. Why don't I start it off  
13 and to the extent that Dr. Phillips would like to follow up,  
14 yeah. That ten percent stem content is an important bright  
15 line, particularly for purposes of the domestic like product  
16 and what I think you'll hear Dr. Phillips testify is, every  
17 cigarette that they manufacture has more than a ten percent  
18 stem content in their tobacco blend, and that the majors  
19 don't.

20 And then yes, there's a correlation between  
21 the quantity of stems and the quality of the product and  
22 consumer perceptions and that goes to issues in regard to  
23 like smoothness, and now I'm out of my avenue so I'm going  
24 to turn it over to Jesse.

25 DR. PHILLIPS: Good morning. There we go.

1 Jesse Phillips, Xcaliber. So I want to start by saying that  
2 a lot of the breakdown of our product is going to be  
3 proprietary, but we can draw that line on the percent stem.  
4 The 4th Tier manufacturers will produce with a tobacco blend  
5 with greater than ten percent stem, whereas the non-4th Tier  
6 will typically not do that, due to the fact that they do  
7 perform at a more premium level.

8 Taste, I can't talk to individuals' tastes  
9 because that's different from person to person. But quality  
10 is very different between the 4th Tier and the non-4th Tier  
11 when it comes to the tobacco blend.

12 MR. PICKARD: Which I think goes to your kind  
13 of fundamental -- I'm sorry, Dan Pickard again -- questions  
14 in regard to consumer perceptions, why consumers view 4th  
15 Tier different than for example a premium, because it's in  
16 some of the literature that we've seen they talk about a  
17 different smoking experience or differences in regard to the  
18 smoothness of the smoke.

19 MR. HALDENSTEIN: Thank you. So would you say  
20 that the major cigarette would like burn better because they  
21 have fewer stems, or is that not -- is that incorrect?

22 DR. PHILLIPS: Jesse Phillips, Xcaliber. We  
23 don't routinely practice testing on cigarettes performed in  
24 a different industry, on cigarettes produced by other  
25 manufacturers so I can't answer that. But we can I'm sure

1 look into putting something about that in our  
2 post-conference brief.

3 MR. PICKARD: And Mr. Haldenstein, we can  
4 provide additional information. Yeah, I think there are --  
5 I forget your exact words. You used something about burn  
6 differently. But I think the industry talks about a  
7 difference in draw if I get that correctly, and we can  
8 provide some additional information, you know. See, I did  
9 use the term correctly.

10 Yeah, that there are differences in the draw  
11 from when you have premium tobacco, non-4th Tier tobacco as  
12 compared to 4th Tier tobacco.

13 MR. HALDENSTEIN: Thank you. So would you say  
14 that the quality of tobacco is the major difference between  
15 the 4th Tier and the others?

16 DR. PHILLIPS: Jesse Phillips. The quality of  
17 tobacco is just one of many differences between the 4th Tier  
18 and non-4th Tier.

19 MR. PICKARD: Dan Pickard, follow-up, right.  
20 So obviously tobacco is huge. The amount of stems  
21 specifically when we're talking about quality are greater or  
22 less than ten, but there are also other different fiscal  
23 characteristics between them, including the experience  
24 connected with having a single element filter as compared to  
25 a multi-component filter, and other differences that I know

1 some of this gets pretty close to proprietary.

2 But I have a feeling that we'll be asking you  
3 to rate it, the best like product analysis and answers to  
4 questions, and we'll be briefing that fully.

5 MR. HALDENSTEIN: I saw in the petition you  
6 had some other categories of cigarettes. Would you say  
7 that's sort of a continuum of products, or is that  
8 over-simplifying it? The petition at page 12 you talk about  
9 premium branded discounts, subgeneric, private label and  
10 then 4th Tier cigarettes.

11 MR. PICKARD: Right. So I think that's  
12 synonymous with 1st Tier, 2nd Tier, 3rd Tier and 4th Tier,  
13 and we've taken the position that 4th Tier, that it's not a  
14 continuum of products from 1st to 4th, that 4th is its own  
15 distinct product and industry. In regard to where 1st ends  
16 and 2nd ends or 3rd to 1st, all we know is kind of the  
17 bright line between 4th and others, and which I suppose in  
18 its own way is also further supportive of the fact that it  
19 its own industry and that we're not knowledgeable or  
20 involved in the distinctions between, for example, 1st and  
21 2nd.

22 MR. HALDENSTEIN: Thank you. If the  
23 Commission views it as a quality difference, would you say  
24 that that's a sufficient basis for defining the product as a  
25 separate like product?

1 MR. PICKARD: No, I think what I would say --  
2 Dan Pickard again. I would say it's a physical measurable  
3 difference in characteristics, right, that ten percent has  
4 -- is a bright line and it's a physical difference. Now  
5 does that also mean that there are going to be quality  
6 difference that come along with those differences? Yeah,  
7 absolutely.

8 But our argument isn't that hey, this is more  
9 subjective. We're asking for a domestic. We are not asking  
10 for a domestic like product on something kind of more  
11 nebulous like a quality difference. But I think it's  
12 relevant in regard to, for example, the physical  
13 characteristic of ten percent that has a flow-on effect that  
14 there's a different quality experience.

15 And similarly, I think it might go most -- it  
16 might be most relevant in regard to the traditional six  
17 factor test in regard to consumer perceptions, that the  
18 consumers perceive these to be different products and that  
19 is also a function of quality. But we're not arguing that  
20 quality per se is the bright line, if that helps.

21 MR. HALDENSTEIN: Thank you. Turning to the  
22 interchangeability, you said the other tiers of cigarettes  
23 aren't interchangeable with 4th Tier cigarettes. When I  
24 read your discussion, it seemed mostly based on the price  
25 distinction. Is that all you would say it is?

1 MR. PICKARD: No. Actually, we'll supplement  
2 -- this is Dan Pickard again from Wiley Rein. We'll  
3 supplement this more in our post-conference brief. It's  
4 more than that. It's that there's a lack of  
5 interchangeability in the non-4th Tier due in part to the  
6 importance of brands, and we'll provide some kind of  
7 additional information that talks about the fact that people  
8 don't switch brands from non-4th Tier to 4th Tier, that that  
9 -- when I first started thinking about this, it would have  
10 been understandable to think like well, they're cigarettes.  
11 They'll just be interchangeable, right? They both smoke.

12 But that's not actually how the market works  
13 or how these products work, that you'll have -- and we'll  
14 bring in some additional literature. But as I talked about,  
15 for example, a Marlboro or a woman who smokes Camels won't  
16 switch between her brand and 4th Tier. They say brand  
17 loyal, as compared to 4th Tier cigarettes or 4th Tier  
18 consumers who are so price sensitive that they'll switch  
19 between brands, but only between brands in the 4th Tier.

20 MR. TAYLOR: Derrick Taylor, Xcaliber. This  
21 may be a little anecdotal. I was just sitting here thinking  
22 between branded and unbranded. I believe that is somewhat  
23 of a line, and if you were to think in similar terms of  
24 cereal and the generic versus the General Mills -- you've  
25 seen it on TV -- those brands are very, you know, in the

1 back of mind as very current.

2                   Once a guy buys the -- comes down to the  
3 unbranded brand, it's just whatever's the cheapest really,  
4 you know, if the form factor's the same. That's kind of how  
5 I look at that, if that helps at all.

6                   MR. HALDENSTEIN: Thank you. On the price  
7 distinctions, can we quantify the price differences between  
8 the 4th Tier cigarettes and other cigarettes? I was also  
9 wondering if you could try and do so for the other  
10 categories of cigarettes, including subgeneric?

11                   MR. PICKARD: Sure. So almost a little  
12 hesitant to talk about specific prices in a public setting.  
13 But clearly there are -- there's a difference and there's  
14 publicly available literature that backs up that 4th Tier is  
15 distinct as to a price. We'll rather than kind of start  
16 talking about pricing levels in a public hearing, we'll  
17 include that in the post-conference brief.

18                   MR. HALDENSTEIN: Thank you. Where do the 4th  
19 Tier producers get their tobacco blends and do they ever add  
20 anything to them for taste purposes?

21                   DR. PHILLIPS: So where we get our blends is  
22 going to be proprietary. I'm sorry, Jesse Phillips,  
23 Xcaliber. My apologies. Yeah, that's going to be  
24 proprietary in nature not just for us but I'm sure in the  
25 other manufacturers. They're not going to want to disclose



1 that. So if that's something that we can give you in  
2 post-conference, we can.

3 And to the adding, as our general counsel Eric  
4 Estes has mentioned, the FDA highly regulates every aspect  
5 of our industry, including the blend. If the blend wasn't  
6 on the market in '07, then the blend's not on the market  
7 now.

8 MR. HALDENSTEIN: Thank you. So is that also  
9 -- does that also explain why the 4th Tier cigarette  
10 manufacturers do not blend their own tobacco?

11 MR. ESTES: Tobacco is blended in primary  
12 facilities. Those are the facilities that are separate and  
13 distinct from -- it's kind of a secondary, which is the  
14 manufacturing process. In the 4th tier, I know of no  
15 domestic producers that have they own blending facility.  
16 That's not true as you get into the other tiers, though.  
17 Does that answer your question?

18 MR. HALDENSTEIN: I guess I'm wondering if you  
19 could, if you wanted to without -- you would need FDA  
20 approval for that; is that the way it would work or is it --

21 MR. ESTES: There would never be a new blend.  
22 There can't be a new blend for us. We could, theoretically,  
23 buy a primary and blend. The cost effectiveness simply  
24 isn't there for smaller manufacturers like 4th tier  
25 manufacturers. They're very expensive machines.

1                   MR. HALDENSTEIN: Thank you. Can you explain a  
2 little more about the escrow payments are made and are the  
3 4th tier manufacturers reimbursed for their escrow payments  
4 every year? Can you discuss that or how that works?

5                   MR. ESTES: How long do you have? Prior to  
6 joining Xcaliber, I was a senior assistant attorney general  
7 in charge of tobacco litigation and enforcement for  
8 Arkansas, so this is very much in my wheelhouse. For every  
9 cigarette that you sell in a state, you're required to  
10 deposit a statutorily prescribed sum in escrow. The sum  
11 goes up by 3 percent or the actual CPI every year. Every  
12 year, but one, since the MSA in '98 has been 3 percent.

13                   We make those to the state. They're held for  
14 the benefit of a state for a period of 25 years and we have  
15 no access to those funds during that interim period. After  
16 25 years, under statute, one of two things will happen.  
17 Either the MPM 4th tier manufacturer will be sued by a state  
18 for health-related claims, known as release claims, or that  
19 money will be released back to the MPM. We really haven't  
20 gotten to that 25-year point yet. I can tell from working  
21 on both sides of this issue that something both sides are  
22 interested in. The states very much want to keep that  
23 money. Understandably, because it can be a large sum and we  
24 don't know if we'll ever see that money back, but it is held  
25 by the states and we have no access to it for really who

1 knows how long, if ever.

2 MR. HALDENSTEIN: So, you pay it directly to  
3 individual states; is that --

4 MR. ESTES: We take the money and we deposit  
5 into an escrow bank and the escrow bank holds it subject to  
6 the conditions of a qualified escrow agreement that's  
7 dictated by each state.

8 MR. HALDENSTEIN: And does the rates for the  
9 states differ by state substantially? How does that look;  
10 how does the market look to you?

11 MR. ESTES: I guess I'd break it down into three  
12 categories. First, you have all the settling states, but  
13 Missouri. For those states, it's uniform. The amount that  
14 we would deposit on behalf of South Carolina is going to be  
15 the same that we deposit on behalf of Arkansas or Nebraska.  
16 Because it's defined by statute that statute was taken out  
17 of the Tobacco Master Settlement Agreement and passed by  
18 every state.

19 The second category would be previously settled  
20 states. I think somebody mentioned earlier that kind of  
21 status. That's Mississippi, Minnesota, Texas, Florida;  
22 those states have their own settlement agreement and  
23 non-participating manufacturers who weren't sued as part of  
24 that settlement and they have no escrow obligations in those  
25 states.

1           The final category is Missouri and Missouri is a  
2 little bit unique. All the settling states, but Missouri,  
3 have passed an amendment to the original tobacco legislation  
4 that changes the way that releases are calculated and  
5 Missouri hasn't, but what I mean by that is in Missouri  
6 they're only allowed to keep the amount that you would have  
7 paid to that state had you been a participating  
8 manufacturer. So, for example, in Arkansas, if our escrow  
9 obligation was ten million dollars and we only sold into  
10 Arkansas, Arkansas could still keep ten million dollars in  
11 that escrow account.

12           We did that in Missouri. Missouri's allocable  
13 share is 2.2 percent, roughly. If you took that same ten  
14 million dollar escrow obligation, we would only be required  
15 to keep an escrow of \$220,000, 2.2 percent of that ten  
16 million. It's about as clear as mud and I apologize for  
17 that, but the document is what the document is.

18           MR. HALDENSTEIN: So, it seems that maybe that  
19 would affect where you decide to sell or is that  
20 oversimplifying things?

21           MR. ESTES: I think that's originally where you  
22 saw a lot of that regionality. That's the reason Xcaliber  
23 sold in the states it sold in and continues to be why  
24 Missouri is an important market for us, despite the fact  
25 that we are seeing falling net prices. It's also a place

1 that we knew that we were vulnerable and we had to expand  
2 out of that comfort zone and get into other states to kind  
3 of limit that vulnerability.

4 MR. PICKARD: To follow up on your question, I  
5 think that hits the nail on the head in regard to some of  
6 these issues contribute to the regionality and importance of  
7 certain markets and that's why I think you heard some of the  
8 people testify today that there's kind of two issues that  
9 flow out of that. One is because of the difference in  
10 regard to how Missouri does business it is traditionally  
11 been of high importance to the domestic industry. And  
12 within the past 12 plus months, KT&G has just recently been  
13 authorized to do business in Missouri. And I'm sure if you  
14 talk to Joe or Jay or Derick that there are constant efforts  
15 on behalf of the Koreans to kind of crack that market which  
16 has been defended, to a certain extent, by increasing  
17 rebates in order to try and hold onto that volume, which has  
18 driven a large part of the decreased financial performance  
19 of the domestic industry. So, it's kind of the first part  
20 of it. So, that gives us kind of current material injury.

21 The second part goes into -- and I think you  
22 heard testimony about this too -- the idea that Missouri has  
23 traditionally been so important, but with that comes a  
24 certain -- with that almost dependency -- dependency might  
25 be a bit much, but the importance of that also has some

1 vulnerability, so the domestic industry has attempted to  
2 expand, diversify, and those attempts to kind of grow at a  
3 profitable basis have also been stymied as a result of the  
4 Korean imports. So, I think your question is spot on. It's  
5 just it's somewhat complicated in how it plays out.

6 MR. HALDENSTEIN: Thank you. So, you are  
7 expanding -- you're selling in other states, other than  
8 Missouri. Although, that's -- I guess it's correct to say  
9 that's where the industry was initially concentrated because  
10 of the regulatory structure?

11 MR. PICKARD: Yes. And what we'll do is we'll  
12 supply some additional information so that you see this kind  
13 of core grouping of states that was traditionally  
14 responsible for the majority of shipments. And then over a  
15 really kind of a '16 to '18 period you're seeing this core  
16 area domestic shipments drop by as much as 20 percent. So,  
17 then you see the industry attempt to grow out beyond the 40  
18 states -- I'm sorry -- between the core -- beyond the core  
19 states, but this is where you really start to see the price  
20 effects of the imports. Those attempts at growth have come  
21 at a huge cost to the company which is driven by the import  
22 competition and the increase in rebates. And now we start  
23 getting pretty proprietary, but that is something that we'll  
24 certainly be fleshing more in the post conference brief.

25 MR. HALDENSTEIN: Thank you. I had another

1 question because I read that there could be no new entrance  
2 into this market because of FDA regulations, but then you  
3 mentioned that Timeless Time entered the market and I was  
4 just wondering how that happened.

5 MR. ESTES: You can be in the market to the  
6 extent that you had a tobacco or blend in the market in  
7 2007. That's called your predicate product. So, if you  
8 have a blend today and it was in the market in 2007, you're  
9 fine to market that product until you get a  
10 non-substantially equivalent order. The ability to come  
11 into the market with a new product, meaning new blend,  
12 primarily, is severely limited. That's a very costly  
13 process with a very uncertain ending.

14 MR. PICKARD: How I understand it -- and feel  
15 free to correct me if I misstate this -- is while you really  
16 couldn't come in with a new product that didn't exist prior  
17 to 2007 that isn't necessarily the case in regard to how you  
18 would title it or brand it, yes. So, you couldn't come in  
19 with a new Product A, but if Product B you just wanted to  
20 call Super Cigarettes now with a different name, even though  
21 it's essentially the same cigarette, you could do that.  
22 Does that help?

23 MR. HALDENSTEIN: I think so. So, could a  
24 company purchase a predicate product from another  
25 manufacturer and enter the market that way?

1 MR. ESTES: They could.

2 MR. HALDENSTEIN: Thank you. I noticed in your  
3 petition and Exhibit I-5 that there are lower unit values  
4 for non-subject imports than subject imports and I was  
5 wondering if you had an explanation for that since you've  
6 said that those are likely a higher-tier product?

7 MR. PICKARD: I'll have to take a look at that  
8 and I'll get back to you in the post-conference brief.

9 MR. HALDENSTEIN: I looked over the data -- the  
10 pricing data briefly and I noticed there was a lot of what  
11 appears to be overselling. How is that consistent with your  
12 price effects story and can you address that further in your  
13 post-conference brief?

14 MR. PICKARD: Sure. And obviously, it's all  
15 BPI, but to talk at a very high level I would say that it  
16 becomes very probative if you start to look at that data --  
17 large parts of that data at the end of the POI at the time  
18 that the surge is going on, but we'll obviously tease that  
19 out more in the post-conference brief.

20 MR. HALDENSTEIN: Sort of as a higher level, I  
21 was just wondering how the Commission could consider this  
22 investigation that has to do with cigarettes and the product  
23 of cigarettes and a product that's deemed dangerous and how  
24 should -- should the Commission consider that?

25 MR. PICKARD: Sure, so how I think the



1 Commission will probably consider it is kind of just based  
2 on the facts, right, considering how -- I'm sorry, Dan  
3 Pickard ago. The Commission's position is kind of a  
4 quasi-judicial institution that doesn't traditionally get  
5 involved in public policy issues, per say, or taking a  
6 policy perception -- policy position. I would imagine that  
7 the Commission is going to look at this as a legitimate --  
8 it's a legal industry and it's going to look at it kind of  
9 consistent with what the statute requires, whether there's  
10 been significant volume price and impacts.

11           If the Commission kind of started to go into  
12 policy considerations, what would that probably look like?  
13 I think you would probably make the argument that actual an  
14 affirmative determination is consistent with the Public  
15 Health policies in the United States and this is why. One  
16 of the number one tools of the United States Government in  
17 order to decrease smoking rates has been by the use of  
18 increased taxes and the evidence shows -- and the CDC has  
19 this information available on their webpage -- that as the  
20 cost of cigarettes increase you get less smokers, which is  
21 from a public policy position a good thing.

22           So, what can you extrapolate from that? One,  
23 that a surge in very low-priced imports is contrary to the  
24 public health interest and the inverse is also true to the  
25 extent that an affirmative determination result in

1 additional taxes being placed on the Korean product. That  
2 would also promote the government's interest in regard to  
3 decreasing smoking rates. That being said, I wouldn't  
4 expect the ITC in a Title VII investigation to really kind  
5 of take a position in regard to public policy, but I think  
6 it's worth noting. I think it's a fair question.

7 MR. HALDENSTEIN: Thank you. That's all the  
8 questions I have.

9 MS. CHRIST: We'll now turn to the economist,  
10 James Horne.

11 MR. HORNE: I'm glad we left off with taxes,  
12 because I want to start my questions there. How are the  
13 taxes on 4th Tier Cigarettes changed since 2016?

14 MR. SMITH: Jay Smith, Xcaliber. I think you  
15 have to be very careful when you just say the word "taxes",  
16 okay? Because there's, you know, the way we sell our  
17 products is, we manufacture our products, we sell them 100%  
18 to wholesalers in certain states, and then wholesalers will  
19 sell them to retailers. At the wholesale level, there'll be  
20 state tax stamps. At our manufacturing to wholesalers,  
21 there's gonna be excise, federal excise tax. So you gotta  
22 be careful how you, you know, when you say just "taxes" from  
23 that standpoint.

24 So what I can say is, from manufacturing the  
25 product and shipping it to wholesalers, every carton that we

1 ship from the facility has an excise tax. In the period of  
2 investigation, that excise tax has been the same.

3 MR. HORNE: Have they changed for other types of  
4 cigarettes relative to 4th Tier, or is it just across the  
5 board?

6 MR. SMITH: That is across the board from my  
7 understanding.

8 MR. HORNE: As sales of 4th Tier Cigarettes are  
9 somewhat regionalized, is it possible that people are  
10 crossing state lines to buy cheaper 4th Tier Cigarettes  
11 because it's a tax differential, and are you losing sales  
12 that way?

13 MR. NICHOLAS: Joe Nicholas. As far as losing  
14 sales per se across state lines, that's definitely happening  
15 in certain areas based on geography. And I'm sorry, could  
16 you repeat the second part?

17 MR. HORNE: Are they changing brands because your  
18 distribution is somewhat regionalized?

19 MR. NICHOLAS: Possibly.

20 MR. SMITH: This is Jay Smith, Xcaliber. I would  
21 like to add onto that if that's possible. You know, there's  
22 always a possibility that people are gonna move across state  
23 lines, if they're close by the border, to buy a pack of  
24 cigarettes that's got a lower tax stamp from that  
25 standpoint. Probably shouldn't do it, but they probably

1 will.

2 I would say from that standpoint that that's not  
3 significantly material to us from that standpoint. If it's  
4 been happening, it's gonna continue to happen whether it's  
5 the previous investigation or whether it's been the last,  
6 you know, ten, twelve years. So it's not material from that  
7 standpoint. I would not say we're losing sales because of  
8 that.

9 MR. HORNE: Talking also about the further  
10 damages, some of your petition referenced the illegal sale  
11 of cigarettes. Have U.S. producers of 4th Tier cigarettes  
12 suffered damages from illegal sales or production of  
13 cigarettes?

14 MR. ESTES: Could you clarify that question? Can  
15 you repeat that mainly?

16 MR. HORNE: Certainly. Have U.S. Producers of  
17 4th Tier cigarettes suffered damage from the illegal sale or  
18 production of 4th Tier cigarettes?

19 MR. ESTES: Eric Estes. I would say no. There  
20 are contraband cigarettes that states will find. Those  
21 numbers are relatively small. That would not affect, or  
22 really think that would affect the 4th Tier domestic market  
23 in any significant way. And possibly that wasn't always the  
24 case, but I think that's the case today. The reason --

25 Okay, I see the follow-up. The reason it wasn't

1 always the case and you used to see a lot higher number of  
2 contraband cigarette sales, as state and federal enforcement  
3 got better from the period between, let's say, in 1998 and  
4 really through a period of, probably about 2007, 2008, most  
5 of those avenues were shut down.

6 MR. HORNE: So in Exhibit 111 on Page 91 of the  
7 petition, it seems to me that a number of consumers switched  
8 between generic and premium cigarettes. Would you class  
9 this as accurate?

10 MR. PICKARD: I'm sorry? Can I get the tail-end  
11 of that question again? Sorry.

12 MR. HORNE: In your petition, pretty much,  
13 there's some evidence that people do switch between generic  
14 and premium cigarettes, including Mr. Taylor -- well, Mr.  
15 Taylor also stated that people arrive at 4th Tier cigarettes  
16 by coming down to a generic. You've also stated that we  
17 usually start smoking premium. Is that accurate?

18 MR. PICKARD: I think not as a general rule. So  
19 I think here the general rule is that premium stays kind of  
20 at a premium brand, as we were talking about. 4th Tier will  
21 switch -- I'm sorry, let me take a step back. Dan Pickard.  
22 So premium, which I've been using interchangeably with  
23 non-4th Tier, are brand-loyal and will stick with their  
24 brand. So they, as a general rule, they won't switch back  
25 and forth.

1           4th Tier are price-sensitive and will switch back  
2 and forth. Now, to a certain degree, should a premium  
3 smoker at a subsequent point, drop down to become a 4th  
4 Tier, then they will switch back and forth between 4th Tier,  
5 but they won't be alternating between premium and 4th Tier  
6 cigarettes. But as far as the general rule, non-4th Tier  
7 stay within their tier. 4th Tier stay within their tier.

8           MR. HORNE: So for those who do move from premium  
9 to 4th Tier, can you give some light on what factors would  
10 cause them to do that?

11           MR. PICKARD: I don't know if we have a whole lot  
12 of data on that. I mean, obviously a large part of it is, I  
13 think driven by price, that 4th Tier are considerably  
14 lower-priced and I think there's some anecdotal evidence  
15 that says, when someone has changed kind of a fundamental  
16 socioeconomic position, then they might move into an entire  
17 market. But that's a different market. But that's not to  
18 say that there is kind of interchangeability in the market.  
19 That's somebody moving from one market into a separate  
20 market.

21           DR. PHILLIPS: Dan, I could add a brief thing to  
22 that that I think will kind of help clarify. Jesse  
23 Phillips, Xcaliber. This is anecdotal, but I think it helps  
24 go towards what you're asking. My dad was a premium smoker  
25 for thirty-six years and then he retired. Now he's a 4th

1 Tier smoker. That happened. But now, when he's in the 4th  
2 Tier, it doesn't matter what he smokes. He walks in and  
3 says, "Give me the cheapest you have," and he buys it. I  
4 work for Xcaliber, International, he doesn't care, okay?

5 MR. HORNE: So can you please provide a breakdown  
6 of the market share by premium and 4th Tier in your  
7 following brief so we can see how that's changed over time?

8 MR. PICKARD: I don't know if we have access to  
9 kind of non-4th Tier market share data, but we'll see what  
10 we can pull together. We'll give it our best shot.

11 MR. HORNE: So the tax structures as we stated  
12 are different state-to-state, in addition to the federal  
13 excise tax, and pricing data from, say. Missouri and  
14 Oklahoma will not be, therefore, comparable. How should the  
15 Commission gather pricing data to ensure that it captures  
16 the entire U.S. market and not simply a collection of  
17 states?

18 MR. PICKARD: That's a great question. So when  
19 we originally suggested the pricing product data, we had  
20 suggested it on a national basis. The Commission obviously  
21 went out in their questionnaires and they broke it into two  
22 different states. "Wonky" isn't necessarily a legal term,  
23 but I think there's some wonkiness in some of the pricing  
24 product data that some of it doesn't really kinda comport  
25 with what the guys are seeing in the marketplace from a kind

1 of a commercial perspective.

2 But if we're talking about going to, you  
3 know--assuming that we're fortunate enough to be in a final  
4 phase ITC investigation--what should we be doing on a  
5 pricing product data doesn't make sense, in light of the  
6 regional nature that maybe you go forward with it,  
7 state-basis. It might.

8 Honestly, I think that's just something that I'm  
9 gonna have to give more thought, as far as what's most  
10 perfect. Because I think you've tee'd up an issue, a good  
11 issue and that, where the point of pricing product data is  
12 to get as "apples to apples" as possible. If you have large  
13 degrees of regionality, then that can interfere with your  
14 "apples to apples" comparison.

15 But the Commission is always also concerned about  
16 coverage. So if you start doing state-specific pricing  
17 products, then you run the risk of not having representative  
18 data. So what's the answer to that? I, frankly, I don't  
19 know right now, but I have a feeling that, should there be  
20 draft questionnaires coming out months from now, that we'll  
21 be commenting on it.

22 MR. HORNE: Thank you for your time. Please let  
23 us know how you'd like us to deal with that issue, either in  
24 comments like you said, but thank you for your time. This  
25 concludes my questions.



1 MS. CHRIST: We will turn to David Boyland, the  
2 accountant.

3 MR. BOYLAND: Checking the time. I'm gonna say  
4 good afternoon. I do appreciate your time. As the  
5 accountant, a lot of my questions are specific to the  
6 financial information and a lot of these questions would be  
7 post-conference. I don't expect you to answer these -- but  
8 certainly a few of them maybe qualitative enough. So I'll  
9 try to go through it. And I appreciate the testimony,  
10 because you've already kind of made public a few things  
11 that I was not clear on how I would even ask the question,  
12 so I appreciate that.

13 First question, this is probably post-conference,  
14 but Xcaliber, on Page 8 of the U.S. producer questionnaire,  
15 on Table 2-2, listed events, activities that took place  
16 during the period. In post-conference, could you provide a  
17 description of how that impacted sales volume during the  
18 period? Or a couple of different discrete events which took  
19 place. So I'd like your perspective on, when I'm looking at  
20 the pattern of sales volume, does that tie back to what's  
21 being described?

22 MR. PICKARD: I'll be happy to do so.

23 MR. BOYLAND: Thank you. We've been talking  
24 about 4th Tier and I always ask a standard question about  
25 product mix. Within 4th Tier, are there sub products? Was

1 there any change within 4th Tier that would explain the  
2 pattern of the average per carton, sales value? In other  
3 words, when I take total revenue, do I divide total carton,  
4 I get a per-carton amount, did the period to period changes  
5 reflect product mix? Or is it just simply one basic  
6 product?

7 MR. PICKARD: I think that it's not a product mix  
8 switch. We'll be happy to kinda include that in the  
9 post-conference --

10 MR. BOYLAND: Part of it is I think I would  
11 basically conclude that it's essentially 4th Tier and  
12 product mix by definition, probably isn't an issue. But to  
13 the extent that it is, I'd like to --

14 MR. PICKARD: I think you're correct. But yeah.

15 MR. BOYLAND: Thank you. And I think in your  
16 testimony, you pretty much confirmed this, but with regard  
17 to rebates and other allowances, do sales values, what's  
18 being reported as the net, does that include all the  
19 deductions that I would be expecting?

20 MR. PICKARD: Consistent with the ITC's  
21 instructions, yeah, they're all rolled in there.

22 MR. BOYLAND: Okay, thank you. This question  
23 kinda gets to the MPM. I have a whole 'nother section about  
24 the MPM, but with regard to revenue, when I'm looking at  
25 that sales value, is the company essentially trying to pass

1 through the MPM? In other words, it's a cost that they have  
2 -- I mean, we're sort of in a gray area in terms of how  
3 you're treating it, but from a revenue perspective, is the  
4 company trying to recapture that? Or cover it?

5 MR. SMITH: Jay Smith with Xcaliber. What you'll  
6 see is that with the pricing of our products is that there's  
7 certain things that we wanna have paid for pass through as  
8 you'd say. But when you look at that net declining price,  
9 it just minimizes with that time period. But you see that.  
10 I wanna get all the details on that. I understand what  
11 you're asking.

12 MR. BOYLAND: Yeah, it's more just I take it,  
13 we're into the extent that it is being recovered or covered,  
14 a barrier changed during the period, but the idea would be  
15 the revenue itself is, in essence, it has to try to recover  
16 that amount, because it's something that you're obligated to  
17 pay.

18 MR. SMITH: Jay Smith, Xcaliber. Yes, I agree  
19 with that. And I think you've heard from our statements  
20 here that, you know, with what Eric was saying that if we  
21 were priced near what the low-price leader, KT&G, was, we  
22 would lose \$2 a carton. It was said in his statement, from  
23 Joe's statement, he's seeing up to a \$4 difference in the  
24 market, and also from what I said as well, is that we're  
25 seeing up to a \$2 difference.

1           With the additional rebates that we've had to do,  
2 leading to the trends of lower net pricing, then we're not  
3 able to, in 2019, cash flow was at or net zero, 2020, it's  
4 gonna be negative zero. From that standpoint, from that  
5 future perspective, when you look at that from those, for  
6 that reason.

7           MR. BOYLAND: Thank you. This is almost  
8 certainly a post-conference, with regard to the raw material  
9 cost that each company is reporting, I know Cheyenne is not  
10 here, but this is sort of directed at the Xcaliber and  
11 Cheyenne. But could you describe, or just basically  
12 identify what is included in raw material costs in Table  
13 39-A?

14           Thank you. And with that, were there any  
15 substantial fluctuations in those underlying items during  
16 the period? That's another kind of qualitative question.  
17 This is directed specifically at Cheyenne, who's not here,  
18 but I'm hoping they can respond. For 2017-18, if they could  
19 take a look at their unitized raw material costs and give me  
20 their description as to why it changed. I'm not  
21 characterizing how it changed, but it did change a little  
22 bit, so I'd like a little background.

23           MR. PICKARD: We'll do so.

24           MR. BOYLAND: Thank you. This is also  
25 post-conference. If both companies, Xcaliber and Cheyenne

1 could identify what was included or what activity is being  
2 --

3 MR. BURCH: Can you speak a little louder? Into  
4 the microphone.

5 MR. BOYLAND: If Xcaliber and Cheyenne could  
6 describe what activity is being included in direct labor,  
7 this gets at, we're coming up with a different average for  
8 direct labor per carton amount, so it'd be good to know why.  
9 It could just be a matter of who's included. So if each  
10 company could just basically -- like raw material, just tell  
11 me what's in there. The same thing with other factory  
12 costs, if you could identify the primary elements included.

13 And since it's an important part of the total  
14 cost, if you could describe how important the fixed part of  
15 this is, capacity utilization in terms of minimizing your  
16 total costs, if you could give me sort of your perspective  
17 on other factory costs and how important the fixed part of  
18 that is, how important the variable part is, and, bigger  
19 picture, how the capacity utilization part of this is  
20 explaining the total cost?

21 This section is MPM-related and I appreciate that  
22 you brought a accounting expert here, which is I think in  
23 order, for MPM in general, what were the objectives, sort of  
24 big picture, is this a, sort of a "level the playing field"  
25 type scenario?

1           MR. ESTES: Eric Estes, Xcaliber. I believe the  
2 question is, was the purpose of escrow to level the playing  
3 field?

4           MR. BOYLAND: Yes.

5           MR. ESTES: If you look at the face of the master  
6 settlement agreement and that's exactly what it was. It  
7 also, at the same time, created a fund against which states  
8 could recover health-related claims, but the short answer is  
9 yes.

10           MR. BOYLAND: It is? Okay. So, and I know you  
11 sort of did touch on this in terms of the actual triggering  
12 of MPM, and it appears to be--and I'm probably getting this  
13 wrong, so please correct me--but the settling states, they  
14 all have the same MPM? In other words, if you sell into  
15 that state, everybody's basically gonna pay the same thing?  
16 It wouldn't vary?

17           MR. ESTES: Eric Estes, Xcaliber. That's  
18 correct. As a condition to receiving monies under the  
19 master settlement agreement, you have to have the statute  
20 passed, the certain statute, and everybody that has executed  
21 the document receiving money has passed that statute in the  
22 form dictated by the master settlement agreement.

23           MR. BOYLAND: So Missouri is different in that  
24 they essentially are applying a release provision, something  
25 that the other states are not? Essentially, it's a lower

1 amount, ultimately, that the companies are obligated to pay?

2 MR. ESTES: That's correct. As passed, all the  
3 statutes were the same. Every state but Missouri has  
4 amended that one section to recalculate the manner in which  
5 releases are made.

6 MR. BOYLAND: And I think from my perspective,  
7 the U.S. producer questionnaire asked each producer to give  
8 us, you know, your MPM, escrow payments for each year and  
9 the quarterly amounts. And based on everything that's being  
10 said here, I wouldn't necessarily expect to have a carton  
11 amount that's the same for each company. I mean, basically  
12 we're talking about some states are the same, Missouri's  
13 not, and then you have the non-settling states, the  
14 original, Florida, Minnesota, etcetera. So given all of  
15 that, I guess the first question is, on a per-carton basis,  
16 would you expect each U.S. producer to be reporting the same  
17 MPM amount or not?

18 MR. ESTES: Eric Estes. I think no. I think it  
19 depends upon your mix of states that you're selling into, as  
20 whether or not you're gonna see that number. Because that  
21 number, I think, for your standpoint, is averaged. So I  
22 think it depends specifically on the mix of states that  
23 you're dealing with.

24 MR. BOYLAND: Okay. And here's -- this is a  
25 post-conference question, and it's Xcaliber and Cheyenne

1 specifically. But post-conference, if -- and this is really  
2 directed at the attorney, because you can look at the -- but  
3 the question is really getting a better feel for the  
4 difference that I'm calculating between the two companies.  
5 Again, I think it could be related to what you're  
6 describing, that they don't sell into the same states, it's  
7 not exactly the same.

8 MR. ESTES: I know exactly what you're asking.

9 MR. BOYLAND: But it's a different amount and  
10 it's different enough for me to kind of wonder. I guess I  
11 would've figured it would be pretty close, and it's --

12 MR. ESTES: I know the exact --

13 MR. BOYLAND: -- a little different.

14 MR. ESTES: -- answer to that. Yeah, but we'll  
15 include it in the post-conference.

16 MR. BOYLAND: Thank you. Professor Koester, you  
17 described--and I appreciate this--you know, publicly, we do  
18 have two different treatments and I guess my question would  
19 be, post-conference or now, if you could provide a  
20 description of why each company is coming to a different  
21 conclusion, you know, its gap. And I understand companies  
22 can have a different reason, but if you could provide why  
23 one company's doing it this way and one company's doing it  
24 that way. What's the underlying reason?

25 PROF. KOESTER: As you know, there is flexibility



1 and gap, right, in terms of transactions, differently for  
2 financial planning purposes that are otherwise fairly  
3 similar. Without going into these two companies  
4 specifically, I try to see that regardless of financial  
5 reporting treatment of any company, it's really a  
6 post-Embassy financial metric that matters for management  
7 and making decisions, as well as external potential and  
8 existing capital providers.

9           So gap is not a perfect system, kind of  
10 irrespective of what -- I think it's a very good system, but  
11 it's not perfect. But I really think that regardless of a  
12 firm's choice of financial reporting treatment, it's all at  
13 the financial metric post, I might say. That's where the  
14 real decisions are made within an external to the company.

15           MR. BOYLAND: I definitely appreciate that, and  
16 this is more for a -- the report is gonna lay all of this  
17 out and I think the reader's gonna be interested to know,  
18 well, why did Company A do this and that? So from a gap  
19 perspective, what was sort of the justification for one  
20 company do -- because we are talking about the same fact  
21 pattern, and so there must've been something a little  
22 different. So anyway --

23           PROF. KOESTER: That's fine, we can all provide  
24 that.

25           MR. BOYLAND: This is post-conference, I guess,

1 but for Xcaliber, if you could provide in response to two  
2 questions, 39-C, we had a question about the statement of  
3 cash flows. If you could provide what section --

4 MR. BURCH: Mr. Boyland, could you speak into the  
5 microphone for the court report?

6 MR. BOYLAND: I'm talking loud enough, I'm sorry.  
7 But the statement of cash flows, if you could identify where  
8 the MPM adjuster is being made, which section, operating,  
9 financing, investing? I have a pretty good idea of which  
10 one it probably is, but if you could, for the record,  
11 provide that. Or now, if not later. So the other question  
12 regarding, final question on MPM. For tax purposes, do you  
13 treat this as a deduction? And this would be, sorry, sorry,  
14 Xcaliber and Cheyenne, to get their treatment.

15 MR. SMITH: Jay Smith here. We will add that in  
16 the post-brief.

17 MR. BOYLAND: Okay, thank you. Appreciate it.  
18 And just to clarify, it's also -- my profession, just based  
19 on, sort of a background that I did was that there could be  
20 sort of an initial, you know, a private letter ruling that  
21 might actually be in effect that could be driving this. So,  
22 just so I'm not asking kinda for the broad, in general, is  
23 just sort of being really specific due, does each company  
24 treat it as a deduction?

25 In Table 3-10, we asked for the companies to

1 identify nonrecurring items and you did, and I appreciate  
2 that, for Xcaliber, if you wouldn't mind providing just a  
3 little additional narrative, each item that you identified,  
4 I think Item 1 and 3 would be the main ones. The second one  
5 is pretty self-explanatory. And I'm not looking for  
6 exhaustive, just a sentence or two.

7           And also for each company, Cheyenne and Xcaliber,  
8 in Table 39-A, we have a section below operating income, if  
9 you could describe what the "all other income" amounts  
10 represent? And I think, again, not to -- this sort of gets  
11 back to the MPM, I guess, but it's in an escrow account,  
12 it's on your balance sheet as restricted cash, but to what  
13 extent is this being invested in any -- does this have any  
14 kind of utility to the company?

15           MR. ESTES: Eric Estes, Xcaliber. As part of the  
16 escrow agreement for the Xcaliber signs, we're restricted in  
17 how we can invest that money. Some states use a model  
18 escrow statute, which essentially restricts us to anything  
19 covered by the Full Faith and Credit of the United States.  
20 Revised model escrow states restrict it further to  
21 treasuries not with a duration not more than twenty-five  
22 years.

23           MR. BOYLAND: So very conservative.

24           MR. ESTES: Very conservative.

25           MR. BOYLAND: Gotcha. Okay. And I appreciate

1 the fact that you, when you discussed R&D, that was a  
2 question I had, as well. Narratively, you did provide some  
3 detail. But is, your testimony kind of suggested that all  
4 of the R&D is basically directed at this FDA equivalency; is  
5 that correct? In other words, when I look at the R&D that's  
6 being reported --

7 MR. SMITH: Jay Smith, Xcaliber, that is correct,  
8 yes.

9 MR. BOYLAND: Okay. So that sort of second  
10 component where you said, "Well, R&D in theory, we should be  
11 investing in improving production, etcetera," so it's not in  
12 this case essentially R&D, it's this FDA-mandated  
13 equivalency?

14 MR. SMITH: Jay Smith, Xcaliber. Yes, as I  
15 mentioned earlier today is that it's all directed towards  
16 the FDA to maintain our certifications and sell products to  
17 states. You know, there's, with the cash-flow situation  
18 that we're in, there's no additional dollars of money to try  
19 to look at efficiency improvements, equipment-wise,  
20 efficiency improvements lab-wise. Efficiency and  
21 improvements across the board, excluding products.

22 MR. BOYLAND: Okay. And you mentioned lab. And  
23 I guess the initial testimony, and with the subsequent  
24 testimony, I assume what you are referring to is sort of  
25 like creating an in-house lab to do all of the equivalency

1 testing, instead of having it farmed out. But is that -- I  
2 mean, when you referenced, I believe it was you, Mr.  
3 Phillips, the R&D lab that you were describing,  
4 respectively, what would that include?

5 MR. PHILLIPS: Jesse Phillips, Xcaliber. I  
6 cannot go into too much detail in the public setting, but  
7 I'm sure we can talk about it a lot more postbrief.

8 You are correct. A lot of it, if we can do a lot  
9 of these tests inhouse in a long-term capacity it could save  
10 the company money. But because we don't have the ability to  
11 invest in that at the moment, we have to continue to farm  
12 these things out to those third-party external labs that I  
13 mentioned in my prepared statement.

14 MR. BOYLAND: Gotcha, okay.

15 MR. SMITH: Jay Smith, Xcaliber. When you look  
16 at the cost analysis versus external and internal for your  
17 lab, you could have justification to do your lab, from that  
18 standpoint. With the cash flow situation we're in, we  
19 pretty much have everything that's not vital to selling the  
20 product and be certified to sell the product on hold.  
21 Whether it's any future equipment, new office buildings,  
22 new office space, any of the R&D lab or R&D equipment, we're  
23 trying to find used and retool what we have.

24 MR. BOYLAND: You sort of touched on a point that  
25 I meant to ask before. But in my initial question about the

1 events and activities described in Table II-2, if you could  
2 sort of describe also the extent that that had an impact on  
3 operations, manufacturing specifically, if it had an impact.  
4 Again, not getting into the BPI part of it. You didn't  
5 really talk about it during your testimony, so I can't  
6 really elaborate on this convoluted question, but the big  
7 idea would be was there an impact on manufacturing,  
8 specifically.

9 MR. SMITH: Jay Smith with Xcaliber. I know  
10 exactly the timing that you're asking for and looking for in  
11 regards to manufacturing and some of the events that took  
12 place that we put into those tables. So, yes, we will go  
13 into more description and details for you.

14 MR. BOYLAND: I would appreciate that.

15 MR. SMITH: Yes.

16 MR. BOYLAND: And, I'm sorry, before I go back to  
17 R&D witness, directed at Cheyenne, based on the description  
18 that FDA equivalency testing is pretty much mandatory, if  
19 you could ask Cheyenne to take a look at what they reported  
20 in that table for R&D and make sure that it's consistent.

21 MR. SMITH: Yes.

22 MR. BOYLAND: Also for Cheyenne, total asset  
23 amount which they reported, could they confirm -- and it's  
24 in Table 12, I believe -- the total asset amount is supposed  
25 to include -- it's still assets, it's long-term, short-term,

1 it's everything -- if they could look and confirm that  
2 they've essentially reported everything, not just the  
3 subset.

4 MR. PICKARD: I'll do that.

5 MR. BOYLAND: Thank you.

6 And a request for Xcaliber for your total asset  
7 number reported in III-12, if you could for postconference  
8 provide a total asset value that's net of the restricted  
9 cash? I believe you provided a percentage that I could sort  
10 of extrapolate, but I'd prefer if you could give me for each  
11 year a specific amount.

12 And the final question, this is one where we have  
13 questions regarding the effects of imports on growth and  
14 development. Table III-16, it's boilerplate, every  
15 questionnaire has this, and there's one question about  
16 problems related to the issue of stocks or bonds. And I  
17 would ask if Xcaliber could revisit what you reported in  
18 that table, because the IPO -- and you discussed it  
19 publicly, so I can ask this question without it being  
20 convoluted -- the idea would be you basically explicitly  
21 said that Korean imports had an impact on that. And so if  
22 you could revisit III-16 and just make sure that your  
23 testimony here is -- is -- and the table, are consistent.  
24 And those are all my questions. Thank you.

25 MS. CHRIST: We will now turn to the Industry

1 Analyst Amelia Shister.

2 MS. SHISTER: Good afternoon. Thank you all for  
3 your -- for answering our questions and for your testimony.  
4 Many of my questions were actually addressed either in  
5 testimony or through my colleagues' questions, so a lot of  
6 what I'm going to say is sort of just confirming that I'm  
7 understanding your answers appropriately.

8 So in terms of your definition of what's  
9 differentiating 4th Tier from Premium or non-4th Tier, it's  
10 really sort of the stem count, and then the filter? Is that  
11 right?

12 MR. PICKARD: So I think two of the brightest  
13 lines are 10 percent stem count. The other is whether it  
14 has a brand or trademark, which is a physically identifiable  
15 difference. But on top of that, there are additional  
16 physical characteristics that also include filter, paper,  
17 packaging and in the pack, foil.

18 MS. SHISTER: Okay, thank you. And then sort of  
19 along those lines, and I know that in the Respondent's  
20 opening statement they sort of mentioned this, how is the  
21 rest of the market differentiated in terms of, you know, in  
22 some of my preliminary research I've seen three tiers, I've  
23 seen up to five tiers. So how are we sort of establishing  
24 4th Tier, everybody else, and how is everyone else broken  
25 out? And who is ultimately -- where should I go to find the



1 definitive source on that?

2 MR. PICKARD: Sure. The definitive source?

3 That's a good question. Um, there is publicly available  
4 information that essentially talks about four tiers. We've  
5 taken -- we're on the 4th Tier. Now I've kind of lost track  
6 of the question. Basically you just want kind of  
7 documentation as far as how it's split up?

8 MS. SHISTER: Right. And not just -- so what are  
9 Tiers one through three? How are those defined? And is  
10 there something common throughout that we can look at and  
11 say well clearly everything is defined by stem count, or  
12 clearly everything is defined by packaging, or paper, or  
13 anything like that.

14 MR. PICKARD: Right. So we will provide more  
15 information in the postconference brief, and we will also  
16 kind of point you to some of the NACK documents that clearly  
17 break out the fact that they characterize as the largest  
18 industry association, 1st Tier, 2nd Tier, 3rd Tier, 4th  
19 Tier.

20 MS. SHISTER: Thank you. This question is  
21 probably for Dr. Phillips. So thank you for the thorough  
22 sort of walk-through of the production process. For  
23 production of 4th Tier versus non 4th Tier, does it differ  
24 other than the fact that you're purchasing preblended  
25 tobacco? Is there any difference at all in terms of

1 production of 4th Tier and non 4th Tier?

2 MR. PHILLIPS: Jesse Phillips, Xcaliber. Yes,  
3 there is difference in production between non- 4th Tier and  
4 4th Tier cigarettes.

5 MS. SHISTER: Could you sort of describe how, to  
6 the best of your knowledge? Or if you need to --

7 MR. PHILLIPS: We can definitely go into more  
8 detail postbrief. But as I had mentioned in my statement,  
9 other than the physical characteristics that differentiate  
10 the packaging, that differentiate the scale and the  
11 streamlined effectiveness that they have in the, what we'll  
12 call the non- 4th Tier, allows them to manufacture in a  
13 different kind of way than we are.

14 MS. SHISTER: Okay. Any description of that  
15 would be really helpful. So I just want to confirm in the  
16 U.S. we're only looking at production in North Carolina,  
17 Oklahoma, New York, and Florida. Is that correct?

18 MR. PICKARD: I believe that's where the four  
19 largest producers are located. There are some incredibly  
20 small producers located on Tribal land, but for the four  
21 significant producers those are the right states.

22 MS. SHISTER: Thank you. So it's my  
23 understanding that the majors are vertically integrated.  
24 They have special contracts with tobacco farmers, and then  
25 special contracts with primaries, or do they have those

1 primaries inhouse?

2 MR. PHILLIPS: I'm going to start. Jesse  
3 Phillips, Xcaliber. Both. And they own their own  
4 primaries. They may have contracts with primaries that  
5 themselves may be owned by them in some way, shape, or form.  
6 To go into much more detail would be outside of what I know  
7 and outside of, you know -- because I'm sure it's  
8 proprietary to all of them.

9 MS. SHISTER: So you all are working -- you all  
10 don't have your own primaries. And so when you're looking  
11 at obtaining these blends, how are you ensuring sort of the  
12 consistency of blends like across acquisitions, I guess?

13 MR. PHILLIPS: Jesse Phillips, Xcaliber. A lot  
14 of that falls onto the third-party companies that we work  
15 with. As I mentioned, we do have to make phone calls and  
16 order the product to come in, and they have to tell us a  
17 lead time of some sort because they have to manufacture it  
18 for us, but to ensure consistency we have to go with the  
19 same companies because they are the ones who own the rights  
20 to the blends that we have. And as General Counsel had  
21 stated, the FDA has pretty much mandated that our blends  
22 can't change.

23 MS. SHISTER: And that sort of leads into my next  
24 question. So when you talk about specific brands, so I know  
25 that Xcaliber is unbranded, but then you also described that

1 you have like 15 different brands. Are they describing the  
2 different blends?

3 MR. PHILLIPS: Jesse Phillips, Xcaliber. No,  
4 they are not. The specifics to that are going to have to be  
5 discussed postbrief.

6 MS. SHISTER: Okay. So I guess that leads to my  
7 question of, so some of the products that we're seeing from  
8 KT&G entering the market have entered post-2007, which  
9 everyone has marked as this FDA regulation. So when you say  
10 that there are no new blends that can enter the market, are  
11 these new brands that are entering, are they a brand of  
12 something that had previously been in the market? Or is it  
13 a blend that existed at a different company in the market?  
14 How is this sort of laid out?

15 MR. ESTES: Eric Estes, Xcaliber. Traditionally  
16 you have to have -- the product you have in the market  
17 today is that product that had to exist in 2007. Those  
18 blends are consistent over time.

19 The FDA does allow you, with a regulatory  
20 framework, to rebrand existing brands into a new name. For  
21 instance, if you had a 2007 product that you were able to  
22 get a substantial equivalence order on, you could use that  
23 blend through an abbreviated process and name it something  
24 completely different for purposes of commercial marketing.

25 MS. SHISTER: But I wouldn't necessarily be able

1 to -- so Company X is producing something under whatever  
2 brand, and it has a specific blend associated with it, I  
3 wouldn't be able to produce a new brand to my company that  
4 has that same blend, or equivalent?

5 MR. ESTES: That blend would be proprietary to  
6 that company, so absence licensure or sale, you wouldn't be  
7 able to produce it.

8 MS. SHISTER: Okay. Thank you. So there was  
9 some discussion about limits of the ability to sell both 4th  
10 Tier and non- 4th Tier cigarettes through CL Share and EDLP.  
11 Are these actual contractual blocks of allowing 4th Tier?  
12 Or is it simply a disincentivization program?

13 MR. NICHOLAS: Joe Nicholas. They do sign a  
14 contract, per se, and I think the only way it would be in  
15 violation, or if it were in violation they just wouldn't  
16 receive their monies agreed upon.

17 So, yes, they can do both, or they can have a  
18 non- 4th Tier brand, and then be on contract, but should  
19 they sell a 4th Tier brand, they wouldn't be permitted to  
20 receive the backend monies.

21 MS. SHISTER: Thank you. You described a lot of  
22 the nature of sort of the customer base being different  
23 between 4th Tier and non- 4th Tier. But is there something  
24 prohibiting say a major from entering the 4th Tier market?  
25 Or, you know, inversely you all from starting to invest in a

1 non-4th Tier product?

2 MR. ESTES: Eric Estes, Xcaliber. I think it  
3 boils down to the fact that you can't, under FDA rules, come  
4 up with new products. I think basically the market's going  
5 to be largely set where it's set because of that prohibition  
6 by the FDA.

7 MS. SHISTER: Okay. So and I know this was  
8 mentioned earlier, but we're seeing an overall decline in  
9 cigarette sales regardless of tier, and so if you can just  
10 -- I know you  
11 mentioned --

12 We discussed it earlier, but if you could sort  
13 of elaborate on how that might be affecting general  
14 performance, and if possible Mr. Pickard, if there's some  
15 way to look at if that is affecting 4th Tier and non-4th  
16 Tier equally, or if we're seeing it differentiate by tier.  
17 And also has the rise of e-cigarettes impacted the market at  
18 all?

19 MR. NICHOLAS: Joe Nicholas. No, we haven't  
20 seen any substantial evidence that -- where e-cigs or any  
21 other like products impacted our business.

22 MS. SHISTER: Okay, thank you. So some of the  
23 preliminary research I've done have shown that cigarettes  
24 seem to sort of follow basic luxury good economic theory,  
25 and that as overall performance of the economy increases,

1 people are more willing to buy the premium non-4th Tier  
2 cigarettes, and conversely when we see economic decline, you  
3 see rise of -- you see an uptick in 4th Tier cigarette  
4 sales.

5                   Given that we're in a relatively strong  
6 economy right now, are you seeing any sort of impacts in  
7 that or if necessary if you want to address that in  
8 post-conference as well. Has the price, commodity level  
9 price in tobacco affected your general costs? Are you  
10 seeing fluctuations in just raw material? If you need to do  
11 it in post-conference, that's all right.

12                   And similarly, are you seeing any sort of  
13 environmental disruptions to tobacco supply?

14                   MR. ESTES: Eric Estes, Xcaliber. Because we  
15 don't buy that tobacco from the producers or blend that  
16 tobacco, that probably wouldn't be a question for us. It's  
17 information we simply don't have access to, being more of a  
18 question for the producer and the blender.

19                   MS. SHISTER: Okay, and in terms of the  
20 blender, I know that it was mentioned that this is probably  
21 proprietary, but are all of these primaries independent of  
22 majors, or are you also potentially buying from primaries  
23 that are say owned by Philip Morris or some of the other  
24 majors?

25                   MR. ESTES: I think the individuals from whom

1 we buy -- Eric Estes -- the individuals from whom we buy  
2 tobacco would be proprietary data, but it's something that  
3 we can definitely get you.

4 MS. SHISTER: Thank you. So I just wanted to  
5 confirm, I feel like we've probably talked this issue to  
6 death about the payments under the MSA. So your payment,  
7 it's not a flat fee, right? It's based on the volume of  
8 sales. So if you sell 10,000, you're paying less than if  
9 you were selling 20,000; is that correct?

10 MR. ESTES: Eric Estes, that's correct. It's  
11 a by individual stick calculation.

12 MS. SHISTER: And the payment, the escrow  
13 payments are state by state. It's not like you're paying  
14 into one pot for all of the MSA?

15 MR. ESTES: Eric Estes, Xcaliber, that is  
16 correct.

17 MS. SHISTER: Okay, great, and the four states  
18 that are not in the MSA, does having sort of separate escrow  
19 agreements, I guess, affect your ability to sell into those  
20 states?

21 MR. ESTES: Eric Estes, Xcaliber. Those  
22 states require no escrow from non-participating  
23 manufacturers.

24 MS. SHISTER: Okay. So I know that we heard  
25 that Cheyenne is exporting. Does Xcaliber export as well?



1 MR. ESTES: Eric Estes, Xcaliber. No.

2 MS. SHISTER: Thank you. Mr. Pickard, in  
3 post-conference if you could just indicate the markets that  
4 Cheyenne is exporting into, that would be helpful. Are you  
5 aware of any other exporting firms, or Dasol, in need of  
6 trading exporting at all that you're aware of?

7 MR. ESTES: Eric Estes, Xcaliber. That's not  
8 information that we have access to.

9 MS. SHISTER: Okay. So how if at all does  
10 your production process or like the product specifically,  
11 how is that differentiated from imported 4th Tier  
12 cigarettes?

13 MR. PICKARD: I don't think we have access to  
14 the production process of non-U.S. 4th Tier producers.

15 MS. SHISTER: Okay. So we've also talked a  
16 lot about this idea of brand loyalty and how that's sort of  
17 part of the dividing line between 4th Tier and non-4th Tier.  
18 Could you just provide some -- I found a lot of evidence on  
19 premium brand loyalty, less so on the non-4th Tier lack of  
20 brand loyalty and sort of why there is this disconnect.

21 So if you could just address in  
22 post-conference, just provide some resources about the lack  
23 of brand loyalty and perhaps why that is the case.

24 MR. PICKARD: I'll do so.

25 MS. SHISTER: I believe that is --

1 (Pause.)

2 MS. SHISTER: So the last question I have is,  
3 so we're not seeing any overlap, any production overlap  
4 between 4th Tier and non-4th Tier, and is that solely  
5 because of this FDA requirement, or is there another reason,  
6 because there was a mention that you could -- it would take  
7 a lot of time and energy, but you could conceivably apply to  
8 the FDA for a new brand or a new blend, is that right? I'm  
9 sort of --

10 MR. PICKARD: So as a practical matter, the  
11 U.S. producers are not enter a new product into the  
12 marketplace due to FDA regulations. So I guess in large  
13 part there are no current -- you are correct. There are no  
14 current common manufacturing facilities or employees between  
15 4th Tier and non-4th Tier, and as a result of the  
16 prohibition on entering a new product, that will continue to  
17 prevent there from being any common manufacturing  
18 facilities between 4th Tier and non-4th Tier.

19 MS. SHISTER: And is there any avenue at all  
20 that would enable a producer in the near future, or not in  
21 the near future but in general, from say entering into a  
22 different tier?

23 MR. ESTES: Eric Estes, Xcaliber. The only  
24 other pathway to bringing a product to market beyond  
25 substantial equivalence is a new market pathway, free market

1 pathway, and to get that through it requires millions of  
2 dollars of testing, and you have to establish that the net  
3 benefit of the new product would be beneficial to public  
4 health. So that pretty much prevents that from occurring.

5 MS. SHISTER: All right. That's all I have  
6 for right now.

7 MS. CHRIST: We'll turn to Betsy Haines,  
8 Supervisory Investigator.

9 MS. HAINES: Hi. I have a follow-up. Mr.  
10 Taylor, you mentioned the Canadian firm that was selling 4th  
11 Tier, that sort of a died a long, slow death I think you  
12 said. Could you either tell me now, or in the  
13 post-conference brief, an estimate of when they actually  
14 stopped selling 4th Tier cigarettes into the U.S.?

15 MR. TAYLOR: Sure, I'll be happy to.

16 MS. HAINES: Okay, because you're indicating  
17 we should use official stats, clean HTS. So if they were  
18 selling the 4th Tier during the Period of Investigation,  
19 could you give us an estimate of how big?

20 MR. PICKARD: Sure, and maybe just to clarify.  
21 We weren't saying that the ITC necessarily should use HTS as  
22 compared to the questionnaire.

23 MS. HAINES: Okay.

24 MR. PICKARD: Although I would say that  
25 essentially what you will see from the official import

1 statistics marries well with what you have on the official  
2 record. That being said, we'll get you the data regarding  
3 the one Canadian producer.

4 MS. HAINES: Okay, and then also in your  
5 brief, describe which data set, you think we should use for  
6 imports.

7 MR. PICKARD: Yeah. Happy to do so.

8 MS. HAINES: Also I have a question. What is  
9 the shelf life of the 4th Tier cigarettes? I mean do they  
10 ever go stale that you would never --

11 DR. PHILLIPS: So Doctor, I'm sorry. Jesse  
12 Phillips, Xcaliber. If I understood correctly, they are  
13 known to be stable. So it just comes down to how well  
14 they're stored. That's about what I can give you on that.

15 MS. HAINES: So you could hypothetically keep  
16 inventories for quite a while?

17 DR. PHILLIPS: They are facilities, and again  
18 to go into these facilities would probably be proprietary to  
19 those facilities. They can store individual components such  
20 as tobacco for extended periods of time under different  
21 methods.

22 MS. HAINES: Okay, okay. I think that's all I  
23 have actually.

24 MS. CHRIST: So I will just quickly scan to  
25 see if there are follow-up questions. We'll start with

1 Larry Jones.

2 MR. JONES: Thank you. Lawrence Jones, Office  
3 of Investigations. I'll make these quick. So I only have  
4 three additional questions. The first one is -- and at  
5 least two are going to be related. The first two are  
6 related. To what extent do the relationships and  
7 connections and distribution arrangements favor U.S.  
8 producers over Korean cigarettes, particularly for if  
9 there's any lower price?

10 MR. PICKARD: Sure, and we'll elaborate  
11 further in our post-conference brief. But I think the short  
12 answer is that the industry representatives would say that  
13 it has now become all about price, right? While I think  
14 there was testimony earlier that while that might not have  
15 been the case previously, now it's essentially an incredibly  
16 price-sensitive market.

17 MR. JONES: Thank you. And these lead to the  
18 next question. It was mention, I believe, in Mr. Taylor's  
19 testimony regarding a new facility in Dallas, Texas. And  
20 just to find out a little bit more about that, what was the  
21 reason for locating the new facility in Dallas;  
22 particularly, because I know you guys are in Oklahoma. This  
23 is kind of like a two-part question.

24 So, the first part is is it because it's a  
25 non-participating member; is that one of the reasons? And

1 obviously, it's local to you know Oklahoma, Missouri, but I  
2 guess what I would ask is is there another competitive  
3 reason beyond just non-participating members, being Texas,  
4 and you know what's the whole reasoning and logic behind  
5 that.

6 MR. PICKARD: Sure, so the new facility in  
7 Dallas is a KT&G facility, so I suppose we could speculate  
8 on it, but I bet you the best answer to your question is  
9 going to be asked to the second panel this afternoon.  
10 They'll be able to tell you directly.

11 MR. JONES: Okay, thanks. Sorry about that. I  
12 thought it was your guys' new facility. Okay. The one last  
13 question I have -- and this is just some information we  
14 recently received. And without disclosing business  
15 proprietary information, but is there a 5th tier of  
16 cigarettes? Is there a 5th tier level and if so what is it?

17 MR. PICKARD: I've never heard of a 5th tier.

18 MR. JONES: Okay. And if there were a 5th tier  
19 level would it be at the retail level? And the reason I ask  
20 that is because the tiers 2 through 4 they're compressed.  
21 Is that safe to say that they're compressed on price and the  
22 premium brands are more exclusive, more -- how would you  
23 describe that?

24 MR. PICKARD: So, I polling the panel really  
25 quickly I don't believe that we've ever heard of a 5th tier

1 of cigarettes and I suppose we could give it more thought on  
2 the post-conference brief, but I don't know if I would  
3 speculate too much on really kind of where the price breaks  
4 are between second and third or where the price break is  
5 between first and second, frankly, because we're not in the  
6 industry; but I don't know if there was more that you wanted  
7 to add.

8 MR. TAYLOR: I tend to agree. I keep going back  
9 to one through three as kind of being a branded -- a brand  
10 that you see and you've heard of before through using direct  
11 mailings, things like that, that we're not doing. As far as  
12 a price breakdown, I couldn't tell you that off the top of  
13 my head.

14 MR. JONES: Thank you. I don't have any other  
15 questions.

16 MS. CHRIST: I'll check with the other members.  
17 Michael Haldenstein.

18 MR. HALDENSTEIN: In the accounting testimony,  
19 there was a reference to increasing rebates during the  
20 period. I'm not sure if that's reflected in the financial  
21 statements, but could you document that for each of the  
22 producers.

23 MR. SMITH: We do have those net rebates within  
24 our numbers. We will take a detailed look of that and  
25 verify and detail out in the post-briefing.

1 MR. HALDENSTEIN: Thank you.

2 MS. CHRIST: Okay, it looks like we have a  
3 follow-up question from David Boyland.

4 MR. BOYLAND: Thank you. And again, this is  
5 unfortunately an MPM question. In the testimony, you  
6 referred to annually versus quarterly payments and I was  
7 wondering if you could -- I don't want to blame everything  
8 on Missouri, but is that Missouri, that they're the ones  
9 that do this annual?

10 MR. ESTES: We do have annual and quarterly  
11 payments. Almost all states at this point, except for a  
12 handful, have gone to quarterly payment structures. The  
13 reason is is that the sates want to make sure that  
14 non-participating manufacturers don't incur a large escrow  
15 obligation and go out of business. So, by breaking it into  
16 quarter, they're able to control that a little bit more.

17 MR. BOYLAND: Gotcha. So, it sounds like most  
18 are on a quarterly basis, but you have some states that are  
19 still on an annual basis where the obligation has accrued  
20 and they pay it one time?

21 MR. ESTES: Missouri is the primary one that we  
22 pay on an annual basis. There may be one or two others. I  
23 can't remember off the top of my head who exactly they are.  
24 We have another attorney that deals primarily with state  
25 regulatory matters at this point, but the vast majority it



1 would be quarterly payments.

2 MR. BOYLAND: Just sort of the mechanics of the  
3 MPM because I think you touched on this and you may have  
4 even answered the question, but just to confirm, when the  
5 obligation is triggered is it when it's manufactured and  
6 it's in inventory? Is it when it's at your wholesaler and  
7 it's being stamped? When does the MPM obligation become an  
8 obligation?

9 MR. ESTES: I think you're referring to the  
10 escrow obligation.

11 MR. BOYLAND: Yes, the escrow.

12 MR. ESTES: Yes.

13 MR. BOYLAND: I'm sorry.

14 MR. ESTES: It's typically tied to when a stamp  
15 is affixed to the product and that would be at wholesale.

16 MR. BOYLAND: Okay. And I guess this kind of  
17 gets to the whole idea of -- I realize you're not including  
18 it in your income statement, at least one company, but to  
19 the extent that you would consider it more of an operating  
20 expense versus a manufacturing expense I mean that would be  
21 something that -- again, I realize one company's doing it  
22 one way, another company's doing it another way, but, I  
23 guess from your perspective does this really kind of -- is  
24 it more of a manufacturing expense or more of an operating  
25 expense, regardless of how it winds up on the income

1 statement.

2 MR. SMITH: The escrow requirement is triggered  
3 when that carton is stamped during the month. So, I would  
4 classify it more as an expense to your operations from that  
5 standpoint.

6 MR. BOYLAND: Okay. And it's out of inventory  
7 at this point. It's no longer part of your inventory at  
8 that point once it's been stamped.

9 MR. SMITH: Correct. As I explained earlier, is  
10 we ship 100 percent to our wholesalers and the wholesalers  
11 are affixing the tax stamp, so that's when it triggers the  
12 escrow requirement for our company.

13 MR. BOYLAND: Okay, alright, I appreciate it. I  
14 have no further questions.

15 MS. CHRIST: Thank you. Thank you very much. I  
16 appreciate everybody's presence. It was a relatively long  
17 panel. I also thank you for the pictures of the production  
18 process. I think when you hear about these things you  
19 always have sort of your own images in your head and you're  
20 going to go, oh, that's not exactly what I thought it was.  
21 So, I appreciate the -- I'm a visual person, so I do  
22 appreciate the pictures of the production process. And  
23 also, a large panel to answer, as you can see, the diverse  
24 questions of the team and the different perspectives. And  
25 particularly, as you mentioned, Mr. Pickard, this is a new

1 industry and there's a lot of complexities that we're trying  
2 to dig into, so I appreciate your patience as we try to wrap  
3 our heads around this.

4 I do have a couple of follow ups, which probably  
5 may not be any more. And yes, a question regarding Majors  
6 and not Majors, are there companies that you refer to as  
7 Majors that are not 4th tier producers or are those two  
8 separate groupings?

9 MR. PICKARD: So, the Majors are non-4th tier  
10 producers. Majors are generally used anonymously with the  
11 original signatories to the MSA and I think your question  
12 was are there other non -- I'm sorry. Are there other  
13 non-4th tier who are also not the Majors? And I believe the  
14 answer to that is, yes, the subsequent manufacturers --  
15 subsequent participating manufacturers.

16 MS. CHRIST: Okay, thank you. A question on  
17 your presentation, on one page where you have the website  
18 for KT&G, it mentions that they are currently ranked fifth  
19 in the U.S. among the United States manufacturers and it  
20 follows that they do talk about the 4th tier selling on that  
21 page. When they say ranked fifth -- and I can also ask them  
22 subsequently, but is it fifth among all manufacturers?

23 MR. PICKARD: You know I believe the webpage  
24 says that they're the fifth largest cigarette manufacturer  
25 in the world, but -- and there's another page that talks

1 about their U.S. participation. Rather than characterize  
2 their performance I would defer to them to answer.

3 MS. CHRIST: A quick question about the quality  
4 and the blends, you did mention the role of the stems and  
5 the percentage of stems in the product. Is there also a  
6 role in sort of the -- I don't know how to say, but the  
7 purity level of the blend is it where there may be certain  
8 smaller number of variety in the blends or in terms of the  
9 quality or anything like that?

10 MR. PICKARD: I can say as a general matter,  
11 yes, that there are differences between kind of the higher  
12 quality of the tobacco used in non-4th tier as compared to  
13 4th tier, but all almost all of that blend information is  
14 proprietary. But if you went out and you talked to  
15 subject-matter experts out there, there are actually kind of  
16 taste-testing experts who will opine as far as a higher  
17 quality of tobacco in the non-4th tier, which actually is  
18 derived, in part, from what part of the tobacco leaf is used  
19 as compared to non-4th tier. As I said, most of -- almost  
20 the entirety of that blend information is proprietary.

21 MS. CHRIST: Thank you very much. Those are all  
22 mine. I think that I -- without attributing it to anybody  
23 particularly, I think I heard some grumbling, although it  
24 could've been me. But before moving to the next panel, I  
25 think it would be nice to take break, stretch legs, and

1 hopefully, get a little bit of food, so why don't we  
2 reconvene here at 1:45. That should give us all enough  
3 time. Thank you.

4 (Whereupon, a lunch recess was held at 1:06  
5 p.m.)

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1 AFTERNOON SESSION

2 (1:48 p.m.)

3 MR. BURCH: Will the room please come to order.

4 MS. CHRIST: Welcome back, everyone. Mr.

5 Secretary, are there any preliminary matters?

6 MR. BURCH: All witnesses have been sworn in, and  
7 they have 60 minutes for their direct testimony, and there  
8 are no other preliminary matters.

9 MS. CHRIST: Welcome to all the panel members,  
10 and thank you for returning promptly. Please begin when  
11 ready.

12 MS. ARANOFF: Good afternoon to the staff panel.  
13 Thanks for your time this afternoon.

14 On our panel this afternoon you will first hear  
15 from Mr. Cho, who is the President of KT&G USA. And then  
16 from Ms. White, to my right, who is a Regional Sales Manager  
17 for the North Central Region for KT&G USA. And then from my  
18 colleague, Mr. Smith.

19 We also have on our panel, available for  
20 questions, Mr. Yoon, who is on my far left, Director of  
21 Marketing for KT&G USA. And on my far right is our  
22 Interpreter, Ms. Kim.

23 So when we get to the Q&A portion, our witnesses  
24 will all testify in English, and we've given you their  
25 testimony, but when we get to the Q&A portion we are going

1 to try to wait while our interpreter translates the  
2 questions into Korean before your panel answers. And so we  
3 thank you for your patience. We know that that's a little  
4 bit time consuming, so we're glad everyone has had lunch.

5 With that, I am going to turn it over to Mr. Cho  
6 to begin.

7 STATEMENT OF JAE YOUNG CHO

8 MR. CHO: Good afternoon. My name is Jae Young  
9 Cho. I am the President of KT&G USA, a wholly owned  
10 subsidiary of KT&G Corporation. KT&G Corporation is engaged  
11 in all stages of the cigarette manufacturing process, from  
12 primary tobacco blending to final packaging.

13 I have been working KT&G for more than 20 years,  
14 and the last 2 with KT&G USA. As President of KT&G USA, I  
15 am responsible for KT&G's sales, marketing, and business  
16 development activities in the United States.

17 I appreciate the opportunity to share my  
18 company's experience in the U.S. market, and to correct  
19 important misstatements in the Petition. I will begin by  
20 briefly describing the structure of the market for  
21 cigarettes in the United States and the nature of the  
22 competition within the industry. Then I will address the  
23 physical characteristics of so-called "fourth-tier"  
24 cigarettes and other cigarettes.

25 Turning to my first point, I understand that the

1 Petitioner in this case has separated the market for  
2 cigarettes into four distinct subindustries or "tiers," with  
3 KT&G being part of the so-called "fourth tier."

4           While some use "tiers" to describe the market,  
5 they are referring to a loose pricing continuum for  
6 cigarettes sold in the United States, not distinct product  
7 markets. There is no clear dividing line between a "fourth  
8 tier" cigarette and a "third tier" cigarette, or any other  
9 cigarettes. Any cigarette's classification into a  
10 particular "tier" is a function of price alone. It says  
11 nothing specific about the physical characteristics of the  
12 cigarette or how it was produced. And even the pricing  
13 distinctions are fluid and imprecise.

14           There is no universally accepted definition of  
15 the tiers in this price system, and many in the industry do  
16 not recognize any fourth tier at all. For example,  
17 Management Science Associations and the Euromonitor do not  
18 classify the market into four "tiers." Instead, they rely  
19 on three general pricing categories, and use different words  
20 for each.

21           In the case of MSA, the tiers are "super  
22 premium," "premium," or "branded discount." In the case of  
23 Euromonitor, they are "premium," "mid-price," and "economy."

24           As my colleague Candice White will describe in  
25 more detail, cigarette manufacturers can and do regularly



1 compete across these price tiers. In other words, KT&G is  
2 in direct competition not just with Cheyenne, Xcaliber, and  
3 other small producers, but also with bigger producers such  
4 as Liggett and even with the "Majors," Philip Morris and  
5 RJR. Moreover, most domestic producers do not limit their  
6 production to only one tier. They produce cigarettes that  
7 sell at a variety of price points across the spectrum.

8 I'd like to briefly summarize my company's  
9 history in the U.S. market. KT&G has been in the U.S.  
10 market with high quality products for 20 years. With  
11 respect to production, KT&G uses an integrated production  
12 process that is similar to that of most major U.S.  
13 manufacturers that the Petition characterizes as outside the  
14 fourth tier.

15 As far as I am aware, other companies that  
16 produce discount cigarettes for the U.S. market, including  
17 Liggett, Commonwealth, and JTI, also have primary production  
18 facilities.

19 While our market share has fluctuated over time  
20 depending on market conditions, KT&G is only a very small  
21 part of the overall U.S. cigarette industry in which we  
22 compete. In recent years, the "Majors" have been very  
23 aggressive in their marketing program and pricing  
24 strategies.

25 In many instances, this results in cigarettes

1 produced by the Majors being the lowest priced at retail.  
2 As my colleague will explain, we compete with brands  
3 produced by the Majors, Liggett and Commonwealth, in  
4 addition to brands produced by the Petitioner.

5 Finally, I'd like to address the physical  
6 characteristics and uses of cigarettes produced in the  
7 United States. Cigarettes are fairly uniform in their  
8 construction and identical in their end use, which is  
9 smoking.

10 When removed from their packaging, cigarettes  
11 sold at different price levels are very difficult for  
12 consumers to identify. As part of our market surveying,  
13 market research, we conduct blind taste tests with  
14 consumers. When we ask them to try two cigarette brands,  
15 one is premium and the other is discount brand, consumers  
16 routinely cannot identify the premium brand.

17 The definition of "fourth tier cigarettes" that  
18 the ITC has used in this investigation covers all  
19 cigarettes. The physical characteristics in that definition  
20 are rolled in paper, longer than 7 centimeters, shorter than  
21 12 centimeters, and less than 1.3 centimeters in diameter.  
22 I am not familiar with any cigarettes sold in the United  
23 States that are outside of this definition.

24 In my experience, there are no clear dividing  
25 lines that differentiate a fourth tier cigarette from a

1 third-tier cigarette or any other cigarette. One thing that  
2 is clear, the dividing lines proposed by the Petitioner do  
3 not exist. I will address each in turn.

4           Regarding stem content, the Petitioner claims  
5 that 4th Tier cigarettes generally have a stem content  
6 greater than 10 percent. In my experience, no such cut-off  
7 exists. KT&G's Consumer Research Team has sampled  
8 cigarettes sold in the U.S. market for various physical  
9 properties, including stem content.

10           They found that some Cheyenne and Xcaliber  
11 cigarettes had stem content below 10 percent. Other  
12 supposedly non- 4th Tier cigarettes had more than 10 percent  
13 stems. Examples including Montego and Eagle 20 that is made  
14 by Liggett, which Petitioner says is a 3rd Tier  
15 manufacturer. We can provide further details in our brief.

16           Regarding filter type, the Petitioner claims that  
17 4th Tier cigarettes typically have single component filters,  
18 and that this makes them different from other cigarettes.  
19 But filter type affects the strength of the cigarette  
20 flavor, it does not signal any particular product type or  
21 price point. For example, certain premium brand cigarettes  
22 such as Marlboros have single component filters just like  
23 so-called 4th Tier cigarettes.

24           Regarding packaging, the Petitioner claims that  
25 4th Tier cigarettes, unlike other cigarettes, are typically

1 sold in a box with basic printing and without a rounded  
2 internal corner. Again, that is not accurate. The  
3 packaging for Xcaliber's discount brands and the premium  
4 Marlboro brand are very similar.

5 In closing, I do not recognize the market  
6 described in the Petition. The competition that KT&G,  
7 Xcaliber, and Cheyenne face in the United States is very  
8 different from what the Petition claims. I want to thank  
9 you for your time today, and I would be pleased to answer  
10 any question about the cigarette industry and KT&G.

11 STATEMENT OF CANDICE WHITE

12 MS. WHITE: Thank you. Good afternoon. My  
13 name is Candice White. I'm the regional sales manager for  
14 KT&G USA in the North Central Region of the United States.  
15 I started working for KT&G USA in January of 2018 as an  
16 account manager, and I was responsible for retail sales in  
17 Indiana, which is where I live. In May of 2018 I was  
18 promoted to regional sales manager for the Northeast Region,  
19 which covers Indiana, Ohio and Michigan.

20 In January of 2019, I started in my current  
21 role in which I manage wholesale and retail account managers  
22 in Indiana, Illinois, Wisconsin and Minnesota. In my  
23 current position, I work directly with customers at all  
24 stages of the process, from the initial sales communications  
25 to maintaining relationships with regular clients.

1                   Prior to joining KT&G USA, I had three decades  
2 of experience working in the consumer package industry,  
3 including both retail and wholesale. I'm grateful for the  
4 staff's time today and would like to spend the next several  
5 minutes providing an overview of the cigarette industry in  
6 the United States.

7                   I'll begin by summarizing the structure of the  
8 cigarette industry and role played by the major tobacco  
9 companies. I'll then address how cigarettes are marketed  
10 and sold in the United States, and I'll explain that there's  
11 no clear dividing line between so-called 4th Tier cigarettes  
12 and any other cigarette. To understand the industry, it's  
13 critical to begin with the context, that the market in the  
14 United States is and has long been dominated with the  
15 so-called majors, which today means Philip Morris and RJ,  
16 RJR.

17                   These large companies were established long  
18 before KT&G entered the U.S. market, at a time when there  
19 were fewer restrictions on cigarette advertising. As a  
20 consequence, the majors have been able to develop enduring  
21 brands that later entrants into the market could not. Brand  
22 recognition in turn allows the majors to command price  
23 premiums in the market that are not realistic to less  
24 established brands.

25                   With these advantages, the majors have been in

1 the past held as much as 98 percent of the market in the  
2 U.S., and more recently hold roughly 85 percent. Cigarette  
3 manufacturers that entered the market later like KT&G,  
4 Xcaliber and Cheyenne, are thus at a disadvantage compared  
5 to the majors.

6 It's challenging for us to win and grow market  
7 share in the United States. It is important to understand  
8 that the combined sales of the Petitioner and KT&G represent  
9 market share that at one point belonged to the majors. That  
10 is why the petition is wrong to claim that KT&G, Xcaliber  
11 and Cheyenne compete only against one another in a narrow,  
12 4th Tier sliver of the market.

13 Instead, all three companies are in direct  
14 competition with producers selling across the price  
15 continuum, including the majors, which fight hard to defend  
16 and grow their market share. For example, both majors offer  
17 discount brands such as RJR's Pall Mall and Philip Morris  
18 Chesterfield. They sell established premium brands at a  
19 large markup, and also compete to retain market share by  
20 placing other products in multiple price tiers.

21 The majors utilize two main tools to protect  
22 their position, everyday low price contracts with retailers,  
23 as well as leader programs with the distributors, everyday  
24 low price or EDLP contracts, which RJR uses very often and  
25 require a retail outlet to set the price for the major's

1 discount brands at a floor. No other cigarettes can be sold  
2 at a lower price without the retailer losing the benefits of  
3 that contract.

4                   These EDLP contracts exist because the majors  
5 rightly view discount cigarettes as competitors, and they  
6 would affect KT&G's ability to price and sell our products.  
7 Such agreements are widespread and I would estimate that  
8 over half the retailers in my region have EDLP contracts.  
9 The majors also use leaders program which requires  
10 wholesalers to sell their product in the way that maintains  
11 their current market share.

12                   For these programs, the market share is  
13 defined based on all categories across all tiers, including  
14 4th Tier cigarettes. This shows how the U.S. market works  
15 and how the domestic industry understands it. The majors  
16 know that they are competing not only against each other but  
17 also against KT&G, Cheyenne, Xcaliber, JTI, Liggett, ITG and  
18 others.

19                   So the majors compete at a range of price  
20 points in a way that directly affects the sales of KT&G  
21 brands. In addition, there are a number of smaller  
22 producers that the Petitioner did not define as 4th Tier,  
23 but that we compete with regularly. For example, our  
24 biggest competitor in Minnesota is Liggett's Montego brand,  
25 which is not a 4th Tier product according to the Petitioner.

1           In Indiana, my home state, we compete with  
2 Xcaliber Edgefield and Burley brands, and also with imports  
3 from LD brand cigarettes made by JTI. JTI stands for  
4 Japanese Tobacco International, and they are another foreign  
5 producer. In Kentucky, two of our biggest competitors are  
6 Liggett's Eagle brand and JTI LD brand.

7           Notably, Xcaliber operates in both Indiana and  
8 Kentucky. In these states, it competes not just against  
9 KT&G but also against discount cigarettes produced by  
10 Liggett and JTI. At the same time, the U.S. cigarette  
11 manufacturers must deal with the reality that the size of  
12 the U.S. market as a whole is shrinking. An increasing  
13 number of users are quitting smoking, or have moved to other  
14 products such as e-cigarettes.

15           For instance, I'm aware of tobacco shops in my  
16 region that have stopped selling cigarettes to focus on CBD  
17 products and e-cigarettes or vaping. This declining demand  
18 is not the only challenge that the industry faces. State  
19 and local taxes have also driven up the retail prices for  
20 cigarettes, and restrictive regulations have also become  
21 widespread.

22           In my region, for example, Minneapolis has  
23 imposed restrictions on the sale of menthol cigarettes. The  
24 Minneapolis example illustrates another somewhat unique  
25 aspect in the U.S. cigarette market, which is the degree to



1 which the competition varies from state to state due to  
2 regional preferences, and to the differences in the state  
3 and local taxes and regulations.

4                   Some brands and products are regional, while  
5 others are national. Some states have higher taxes and  
6 stricter regulations than others. The result is that the  
7 competition looks very different in Minnesota than it does  
8 in Indiana. Having summarized these general features in the  
9 U.S. market, I would like to turn to the specific aspects of  
10 how the domestic cigarettes are marketed, sold and  
11 perceived.

12                   The Petitioner claims that the so-called 4th  
13 Tier cigarettes are positioned differently in the U.S.  
14 market than all other cigarettes. This claim is not  
15 consistent with my knowledge or experience. First, almost  
16 all cigarettes in the United States are sold initially to  
17 distributors. As a result, cigarettes at all price tiers  
18 pass through the channel of distribution and are not sold  
19 directly to retailers. It is common for the U.S.,  
20 distributors to carry cigarette brands in all price points.  
21 KT&G sells its products exclusively through distributors.  
22 We form relationships with the distributors to help promote  
23 KT&G products to the retailers.

24                   After manufacture and sale to distributors,  
25 the distributors sell both premium and discount brands to

1 the retailers. Retailers market and sell what the  
2 Petitioner calls as 4th Tier cigarettes alongside with  
3 premium brands. For instance, national chain store Circle K  
4 displays KT&G products, including this, on the same rack  
5 with Xcaliber's Edgefield and Philip Morris Marlboro Reds.

6 In my region, KT&G products are routinely  
7 displayed by retailers along the side, both premium and  
8 other discount brands. Consumers and industry participants  
9 do not see a clear difference between so-called 4th Tier  
10 cigarettes and other cigarettes. For many consumers,  
11 cigarettes are interchangeable. For consumers that do not  
12 try different products, this brand loyalty is usually a  
13 result of long-term marketing and personal taste.

14 In selecting cigarettes, consumers primarily  
15 search for fulfillment, price and taste. Our repeat  
16 customers choose KT&G brands based more on taste and  
17 satisfaction than price. When it comes to price, there is  
18 no defying cutoffs. There is a continuum that varies from  
19 state to state, cigarettes at every price point along that  
20 spectrum with no clear gap. The industry uses different  
21 terms to describe the different price levels.

22 Regardless of the labels, the pricing  
23 categories are not well-defined or absolute and companies  
24 sell at multiple levels. As I discussed earlier, a brand  
25 made by the major can be and often is sold at the same price

1 as the 4th Tier through the EDLP contracts. Ultimately, the  
2 price paid by consumers is always set by the retailer, not  
3 by the manufacturer or the wholesaler.

4 In closing, I hope this overview of the  
5 competition in the U.S. cigarette market is helpful for the  
6 staff. Thank you for the time to consider these issues,  
7 which are very important to our company, and I would be  
8 happy to answer any questions you might have.

9 STATEMENT OF JAMES M. SMITH

10 MR. SMITH: Thank you, Ms. White. My name is  
11 James Smith to Covington and Burling, appearing on behalf of  
12 respondent KT&G. I'd like to make a few points that are  
13 relevant in particular to key legal issues, including some  
14 of the concededly novel but crucial issues identified by Mr.  
15 Pickard this morning.

16 The first is the relevance of the Master  
17 Settlement Agreement or MSA. In a nutshell, the Master  
18 Settlement Agreement's relevance has been greatly  
19 exaggerated. The Petitioner seems to have misinterpreted a  
20 legal instrument forged by 46 states in litigation against  
21 the majors, as somehow defining distinct product markets  
22 nationwide.

23 Invoking the MSA is a very unusual approach to  
24 scope, and the Commerce Department understandably raised  
25 questions about the Petitioners reliance on the trademarks

1 of participating manufacturers. We submit that it would be  
2 even stranger for the Commission to use MSA signatory status  
3 as a means of identifying the domestic industry.

4 I don't believe the Petitioner has so far  
5 cited to any ITC case adopting a similar methodology. This  
6 approach isn't just novel; in our view it's inappropriate.  
7 The simple fact is that cigarettes are not distinguished in  
8 the U.S. market based on whether their producer is or is not  
9 a signatory to the MSA.

10 The original participating manufacturers,  
11 Philip Morris and RJR, produce and sell cigarettes at  
12 multiple price levels and multiple tiers. Companies such as  
13 Liggett and Commonwealth are subsequent participating  
14 manufacturers. But they produce and sell deep discount  
15 cigarettes that are commonly regarded as being in the very  
16 same price category as so-called 4th Tier brands.

17 The participating manufacturers routinely  
18 compete with non-participating manufacturers, both within  
19 and across price tiers. This is how the U.S. market is  
20 widely understood to work. What's especially surprising  
21 about the Petitioners' reliance on the USA is that the MSA  
22 itself contradicts their claims about separate and distinct  
23 product markets.

24 Let me explain. If you look at the MSA's  
25 provisions, you will see that the MSA system itself assumes

1 ongoing competition between participating and  
2 non-participating manufacturers. For example, the MSA  
3 requires non-participating manufacturers such as KT&G to pay  
4 funds into escrow accounts.

5           At the outset, when the agreement was signed,  
6 these mandatory escrow agreements were designed in part to  
7 reduce the competitive impact of the substantial payments  
8 that participating manufacturers agreed to make in 46  
9 states. Mr. Estes this morning directly confirmed this  
10 level playing field objective.

11           But ask yourself, if there were no competition  
12 between signatories and non-signatories, escrow payments to  
13 level the playing field simply would not have been  
14 necessary. There's another example. The MSA system protects  
15 participating manufacturers against any market share that is  
16 lost to non-participating manufacturers. Specifically, it  
17 allows participating manufacturers to reduce their payment  
18 levels if they lose market share to a non-signatory.

19           Market share are assessed annually,  
20 adjustments are automatic. This compensation mechanism  
21 would be entirely unnecessary if the MSA had created  
22 multiple classes of manufacturers selling distinct products  
23 through unique sales channels. The fact of competition  
24 between participating and non-participating manufacturers is  
25 obvious. Xcaliber's own sales manager, Mr. Nicholas,

1 emphasized this morning how the biggest participating  
2 members often "block" 4th Tier cigarettes with their sales  
3 to share programs and their every day low price contracts.

4                   But why should the majors bother to block the  
5 4th Tier if they don't compete with the 4th Tier? Their  
6 claims about the MSA just don't add up.

7                   The second novel issue I'd like to address is  
8 how to define the domestic like product. This issue is  
9 fundamental to the case and to the investigation. As Mr.  
10 Cho and Ms. White have emphasized, there is no separate  
11 product market in the U.S. for so-called 4th Tier cigarette.  
12 The term 4th Tier does not relate to any distinct subset of  
13 cigarettes. It has nothing to do with any specific and  
14 consistent product characteristics.

15                   At most, it describes in broad terms the low  
16 end of a price continuum. But even as a price  
17 classification, there is no clear or accepted cutoff price  
18 between what the Petitioner calls 4th Tier cigarettes and  
19 other brands that are described as "economy" or as "branded  
20 discount" by leading industry analysts.

21                   As noted, the length and diameter ranges  
22 specified in the proposed scope cover virtually every  
23 cigarette manufactured in the United States. 72's, Kings at  
24 84, 100's, 120's. All main types are covered; all main  
25 types should be included in the domestic like product.

1           The Petitioner's proposed scope tries to  
2 narrow the market, by relying on a list of additional  
3 features that it claims are frequently, typically generally  
4 different for 4th Tier versus other cigarettes. As Ms.  
5 Aranoff noted, the adverbs in the proposed scope are the  
6 tell. This morning Dr. Phillips added a new and significant  
7 qualifier, can. He said non-4th Tier products "can be more  
8 complex," not "are."

9           He said they "can consist of multiple  
10 components and can use different prototypes," not do. I  
11 think it's helpful if we just step back and take some of  
12 these additional product characteristics that have been  
13 identified by the Petitioner and discuss them in turn. The  
14 first and the one on which they've relied most heavily this  
15 morning is stem content. This is the measurable bright line  
16 that Mr. Pickard and others emphasized.

17           But Petitioner so far has offered scarce  
18 evidence of stem content in different tiers or brands of  
19 cigarettes. There's a single bare declaration from an  
20 anonymous witness whose identity has been kept confidential.  
21 Today, they've added the testimony of Dr. Phillips. What  
22 did he say? He said "It is my understanding that non-4th  
23 Tier cigarettes typically have less than ten percent stems  
24 in their tobacco, and I'm aware of no information that would  
25 contradict that."

1                   As you've learned, our industry research team  
2 for KT&G has actually looked and measured what the stem  
3 content of different brands is, and has found that this ten  
4 percent cutoff line does not exist. It is measurable, but  
5 the Petitioner apparently has not even measured it, or if  
6 they have, they haven't shared the results of those  
7 measurements with the Commission or with the staff. I  
8 suspect the reason is because this bright line does not  
9 exist and will not hold up.

10                   Let's turn now to packaging, for which we have  
11 some images that might help illustrate our points. We would  
12 start on packaging by saying we could have an initial  
13 discussion about whether packaging is a product  
14 characteristic. As you've heard from Petitioner's counsel  
15 this morning, typically it's not and it's completely  
16 irrelevant. As we'll explain in our brief, we agree that it  
17 should be irrelevant here as well. But we're going to  
18 assume for the purposes of argument today that it is  
19 relevant and focus on the more fundamental question of  
20 whether assuming packaging is relevant, there's a clear  
21 dividing line in the packaging for 4th Tier cigarettes  
22 versus other cigarettes.

23                   The answer is no. Here in Slide 4 are  
24 photographs of premium brands, discount brands and so-called  
25 4th Tier brands. All our in similar boxes with aluminum



1 foil inside. From the outside, the consumer's perspective,  
2 nothing in the packaging distinguishes the so-called 4th  
3 Tier from the others. Well what if you open the boxes and  
4 deconstruct them, something consumers probably don't take  
5 the time to do? It's still hard to find any difference.

6 Slide 5 shows that there is nothing obvious in  
7 the packaging that distinguishes the premium Marlboros from  
8 the 4th Tier Edgefields. Maybe there is some embossing in  
9 the foil and some boxes but not in others. It's very hard  
10 to say without a very close look. Another feature on the  
11 packaging front is the rounded or what the Petitioner calls  
12 a rounded internal corner.

13 I have to say a box corner that's rounded and  
14 that is internal is a difficult concept at the outset. If  
15 it's internal, it's clearly not visible from the outside,  
16 and I'm not exactly sure what it means. But it might be  
17 what you see in the photograph of the Pall Mall box on Slide  
18 6. Note the rounded parts near the front on the interior  
19 part of the structure where the boxtop sits. That might be  
20 it.

21 But Pall Mall is not a premium brand.  
22 Marlboro is, and if you look at its box corners, they look  
23 just like the packaging of so-called 4th Tier brands, no  
24 rounding inside or out. I think we can all agree that these  
25 packaging distinctions are at most minor variations, if

1 that, and legally as the petition itself reminds us, minor  
2 variations are to be disregarded.

3           What about uses and interchangeability? The  
4 uses of all cigarettes is for smoking and for many consumers  
5 cigarettes are interchangeable in that use. The Petitioner  
6 claims that for so-called 4th Tier cigarettes, all that  
7 matter is price. But in the Essence survey of 600 adults,  
8 many of them smokers of 4th Tier brands, reported that  
9 fulfillment and taste were just as or more important than  
10 price as a key buying factor. Slide 7 shows how response  
11 rates across various non-price factors.

12           Let's turn to channels of distribution. On  
13 this, the U.S. market is uniform. As Slide 8 makes clear,  
14 almost all cigarettes manufactured in the United States are  
15 sold initially to distributors, not to retailers, not to end  
16 users. As a result, retailers determine the final price  
17 paid by the consumer. Okay, let's go to the retail level  
18 itself, Slide 9. If you look at a typical display rack, you  
19 will see so-called 4th Tier cigarettes on the same rack and  
20 even on the same shelf as premium brands.

21           In this photograph in Slide 9, cigarettes made  
22 by the Petitioner and by KT&G are at the bottom left in the  
23 green box, and I apologize. I can assure you it's difficult  
24 for me to see those as well. But we can give you a more  
25 zoomed-in view through a print copy.

1                   These 4th Tier cigarettes are on the same row  
2 directly beside super premium labels like American Spirits  
3 and Camels, premium Camels, which are in the small red box  
4 just to the right. Brands made by MSA participating  
5 manufacturers at various price levels are in the larger red  
6 boxes. There's nothing distinct about the distribution and  
7 display of the 4th Tier cigarettes compared to many others.

8                   The only ones that might stand out are the  
9 premium brands on the very top rows, but those are placed  
10 there by contract with a major that's willing to pay for top  
11 billing in a retail display, not because they're in a  
12 separate market. In terms of customer and producer  
13 perceptions, these photographs in Slide 2 shows that the  
14 Petitioner's product, Edgefield, is advertised directly  
15 alongside premium brands.

16                   The display on the left, which you can see  
17 includes some premium brands and Edgefield, is one poster  
18 describing one market. Even on price, as Slide 11 shows,  
19 there's no consistent dividing line or categorization of the  
20 4th Tier and other tiers of pricing for cigarettes. MSA and  
21 Euromonitor do not have a 4th tier at all. Their lowest  
22 price categories, branded discount and economy, include  
23 so-called 4th Tier and other cigarettes in the same  
24 category.

25                   The screenshots on Slide 12 show how each of

1 these reporting services classifies its data. They do so by  
2 price tier, by what they call a price ban, by what they call  
3 a price subcategory. Nothing in their presentation, nothing  
4 in the format suggests these are distinct markets, and  
5 that's because all cigarettes sold in the United States are  
6 in the same market arrayed along a price continuum.

7 I heard Mr. Jones this morning discussed  
8 evidence of price compression across -- he's not here for  
9 the benefit of this comment -- across Bands 2 to 4, price  
10 tiers 2 to 4. To the extent that's happening, there's yet  
11 more evidence that 4 is not distinct and separate from Tiers  
12 2 and 3 or others. I'd like to briefly address conditions  
13 of competition.

14 One clear and overriding aspect of competition  
15 in the domestic market for cigarettes is an extended and  
16 ongoing secular decline in demand. Euromonitor data on  
17 Slide 13 show the market shrinking roughly 2.5 percent per  
18 year since 2013. Other estimates of the decline on an  
19 annual basis are larger. Notably, if you look at the share  
20 by price tier according to Euromonitor on the right, the  
21 decline relatively speaking is bigger than the premium and  
22 mid-price segments and in the economy segment. That's the  
23 Petitioner's segment.

24 All right. So what explains this steady  
25 decline in demand? As Slide 14 suggests, and I apologize

1 those fonts are not legible at all on the slide as  
2 displayed, multiple forces are in play. Increases in tax  
3 rates, increases in the minimum age, bans on flavored  
4 cigarette, creation of tobacco-free places, stricter  
5 advertising regulations. They're all relevant.

6 But another key contributor that's come about  
7 in the last few years is increased competition from  
8 alternative products. As Slide 15 shows, e-cigarettes have  
9 steadily grown in market share, and are projected to expand  
10 further from roughly seven percent in 2018 to as high as 30  
11 percent by 2025. When surveyed retailers have responded and  
12 identified that shifting to e-cigarettes and to dual use  
13 alternatives is the main factor in any softening in demand  
14 that they've experienced.

15 Given these trends, it's notable that Mr.  
16 Nicholas I believe said that Xcaliber at least is seeing no  
17 impact from e-cigarettes, and they're obviously fortunate in  
18 that regard.

19 MR. SMITH: Finally, I want to come back to  
20 injury, the central issue. The bottom line is once you look  
21 at the market as a whole, not some artificially restricted  
22 corner of it, there's no evidence of injury caused by  
23 subject imports and no evidence of threat. While it is  
24 shrinking, the U.S. market has actually been relatively  
25 stable for years in terms of the relative shares of

1 producers based on their status under the MSA.

2 I think there was a question about this data  
3 earlier today. The data through the National Association of  
4 Attorneys General are readily available and public and  
5 reveal, as you can see in this slide, that the most striking  
6 aspect of the market under the MSA, especially over the last  
7 almost 20 years, has been stability in terms of market  
8 share.

9 The original participating members or OPMs -- I  
10 mean manufacturers are OPMs, Phillip Morris and RJR have  
11 hovered between 80 and 90 percent market share. The  
12 subsequent participating manufacturers and non-participating  
13 manufacturers have split the remainder, with the SPM,  
14 Subsequent Participating Manufacturers, have a larger share  
15 consistently 2002 through '18. Major shifts you will not  
16 find in this data.

17 And crucially, if you look at the market share  
18 of subject imports, the same kind of stability is clear.  
19 The only difference is that cigarettes from Korea are a tiny  
20 fraction of the U.S. market and Slide 19 shows you just how  
21 small. The thin, blue line across the bottom represents  
22 KT&G's U.S. market share from 2013 through 2018. The much  
23 larger green area above it is the U.S. market share of all  
24 their producers. This proper perspective on the U.S. market  
25 makes clear that there's no reasonable indication of present

1 material injury, no threat of future material injury by  
2 reason of cigarette imports from Korea.

3 I would like to thank the staff for your time  
4 and for your attention and we look forward to answering you  
5 questions. And as Ms. Aranoff noted previously, we are  
6 going to pause after each of your questions to allow our  
7 interpreter to translate into Korean, so thank you.

8 MS. CHRIST: We will now turn to the staff  
9 questions and we'll start with Larry Jones, Investigator.

10 MR. JONES: Good afternoon, Lawrence Jones,  
11 Office of Investigations. Thank you for coming today and if  
12 there's anything you don't understand regarding the  
13 translation or anything like that I can repeat. No problem.  
14 So, if you need to clarify, just let me know.

15 I think to start one thing I would ask is you  
16 guys -- you mentioned that there is not really any dividing  
17 line between the four tiers of cigarettes, that there's not  
18 anything that distinguishes them. And I guess the question  
19 would be if that is the case and -- correct me if I'm wrong  
20 -- KT&M is the fifth largest manufacturer of actual -- of  
21 cigarettes in the world wouldn't you think that R.J.  
22 Reynolds and Phillip Morris be involved in this. Why would  
23 you speculate they are not involved?

24 MS. ARANOFF: I think that had the Commission  
25 defined the market as we believe is correct and sent

1 questionnaires to the Majors you would've heard from them  
2 and they'd be here today, but Petitioner defined the market  
3 much, much more narrowly. That's how the questionnaires  
4 went out, so they deliberately kept the Majors coming here  
5 and knocking on your door. And we hope that you know  
6 should this matter go to a final phase thing will be  
7 different.

8 MR. JONES: Thank you. And regarding that, what  
9 effect would that have also, not just on R.J. Reynolds, but  
10 two of the firms that you mentioned in your testimony;  
11 particularly, Ligget and Commonwealth. Would they be  
12 involved and would you anticipate them being you know  
13 involved in as well?

14 MS. ARANOFF: Mr. Jones, as you know, receiving  
15 a questionnaire is not a guarantee that a company will  
16 either fill out the questionnaire or more so you know show  
17 up at a Commission hearing or staff conference to testify,  
18 but it certainly makes it more likely than if you don't  
19 issue a questionnaire to the company. So, our view is that  
20 the market is properly defined as -- the domestic industry  
21 is properly defined as all domestic cigarette  
22 manufacturers, including those two Majors as well as Ligget  
23 and Commonwealth and some of the other companies and we  
24 believe that if the market were properly defined they should  
25 all receive domestic producer questionnaires.



1                   MR. JONES: So, should we get them to collect  
2 information if this were to go to a final phase on all  
3 tiers; is that what you guys recommend?

4                   MS. ARANOFF: Yes. Yes, our view is that the  
5 product in this case is a continuum. That is true that  
6 people do use terms like tiers and segments and they use it  
7 to sort of roughly group things along a price continuum from  
8 things that sell at very high premium prices to ones in the  
9 middle to ones that are discounted, but we don't believe  
10 there's any clear dividing line based on any of the  
11 Commission's six like product factors. So, we believe the  
12 correct like product is all cigarettes and the correct  
13 industry is all domestic cigarette producers.

14                   MR. JONES: If you had to describe the role  
15 between Liggett and Commonwealth compared to R.J. Reynolds,  
16 just from what you were seeing in competition what are the  
17 big differences in terms of competition and how would that  
18 affect our analysis if we were going to go forward with it.  
19 And this is somewhat speculation, but for us we're trying to  
20 define an industry and what we received is fairly thorough.  
21 Now, also this goes to the question -- I guess the second  
22 part of the question would be is there a fifth tier? If we  
23 are defining it as such, is there -- because there's -- we  
24 have some information, without disclosing any business  
25 proprietary, that there is a possible fifth tier, so I'd

1 like to hear what you guys have to say about that.

2 MS. ARANOFF: Well, let me start by saying tiers  
3 don't exist in the abstract, right? The only way you can  
4 define a tier is by defining the specific brands or  
5 manufacturers whose products are in that tier and then  
6 defining some characteristic that distinguishes that basket  
7 from other baskets.

8 As Mr. Smith showed you on that slide, there are  
9 three data sources in the industry. They define these tiers  
10 differently. Everyone one agrees that some things are  
11 higher priced than others and that there are some things in  
12 the middle, but what you need to know is what exact brands,  
13 what exact skews are in each of those baskets and there is  
14 no agreed industry definition of what those things are. And  
15 so, you know Petitioner points, in particular, to the NACS,  
16 which as the four tiers instead of three, but they haven't  
17 shown you data on what NACS actually puts in each of those  
18 four tiers. They told you what they think, so you don't  
19 know what NACS defines as fourth tier.

20 I mean it's worth looking into how each of those  
21 tiers are defined in terms of what are the specific brands,  
22 specific manufacturers that those different data sources say  
23 fall into those different tiers. You know if you're just  
24 listening to folks who throw around terms causally about  
25 there's two tiers, there's four tiers, there's five tiers.

1 It doesn't really tell you anything, right? You've got to  
2 have a discrete set of product and then say what is it about  
3 this discrete set of products that makes it discrete and the  
4 fact that there is, in fact, no agreement on that should  
5 tell you something.

6 MR. JONES: And this was based on what Mr. Smith  
7 stated about a low end of the price continuum and this goes  
8 back to a question that I asked of the Petitioners regarding  
9 a compression between the tiers two through four if we are  
10 going to go with the definition that they utilized or came  
11 up with and what would -- would you see a compression at the  
12 second through fourth tier level? Let's just say at the  
13 premium brand compared to everything else.

14 MR. SMITH: I addressed this briefly in my  
15 statement and I apologize. I did so when you had stepped  
16 out, even though I knew it was of interest to you, and what  
17 I noted was that to the extent you or others have seen  
18 compression across price tiers two through four, it would  
19 appear to be confirmation of our witnesses' statements that  
20 they're competing with manufacturers in the second and third  
21 price tiers. And it would further suggest the impropriety  
22 of defining the product market to be limited to this  
23 so-called 4th tier which has no clear, consistent, defining  
24 characteristics.

25 MS. ARANOFF: I would just add to that too that

1 Petitioner was making an attempt to define tiers by  
2 manufacturer, right, certainly. But I think our point to  
3 you is manufacturers sell a variety of brands and those  
4 brands may appear in multiple tiers. That is certainly the  
5 case for the Majors which will sell premium brands and they  
6 will also place brands at a lower price in various tiers.  
7 As Mr. Smith said in his testimony, premium brands because  
8 you can collect a premium on them and lower-priced brands  
9 because that's how you maintain your market share.

10 MR. JONES: Thank you. And this goes to what  
11 you mentioned about brands and your testimony about Ligget's  
12 Eagle. That would be brands which is under JTI brands, so  
13 for those I assume that they are going to be classified as  
14 Tier 3. There's no differences, other than price, is that  
15 what you guys are saying regarding those compared to what  
16 you guys see domestically? Excuse me, more specifically  
17 from the JTI brands.

18 MS. WHITE: I think that goes back to the same  
19 statement that because the lines are not very defined it's  
20 hard to say whether that would be in a 4th tier or a 3rd  
21 tier or a 2nd tier, but we compete with that. We definitely  
22 compete with the LD, the Montego, you know, Edgefield, of  
23 course.

24 MR. JONES: Thank you. And the question  
25 regarding -- and I asked this of the Petitioners as well

1 about customer preferences. What have you noticed regarding  
2 customer preferences for, let's say, these level of  
3 cigarettes -- Ligget, Eagle brand, JTI LD brands, KT&G's and  
4 then Edgefield's and the other ones. What would you  
5 describe about customer preferences? Is it as the  
6 Petitioners say someone walks into a store and they say I  
7 don't care what it is, just give me one of those. And if  
8 that is not the case, then what is the case regarding  
9 customer preferences?

10 MR. CHO: I would like to explain something  
11 about the nature -- I would like to explain so I can help  
12 you understand the characteristics of the cigarette  
13 industry. I would like to begin explaining that first.

14 If we asked our customers why they choose  
15 particular kinds of cigarettes there would be hundreds of  
16 reasons, but I think the most important thing for us to  
17 determine is the customers' needs. If the answer was that  
18 customers make the decision based on the price alone, then  
19 the discount cigarettes would probably dominant the  
20 cigarette industry or cigarette market. And if the answer  
21 was that the brand image is more important for customer's  
22 decision to purchase brand cigarettes, then the dominant  
23 cigarette sellers would be the Majors which had dominated  
24 the market for over hundred years.

25 So, I would like to answer your question, Mr.

1 Jones, that the reason why customers choose our brand is not  
2 solely based on the price. There are other advantages that  
3 they see, including the quality and the satisfaction and  
4 this means that the fact that customers can prefer our KT&G  
5 product prove that KT&G cigarettes compete with other  
6 cigarettes of other tiers, not just limited to discount  
7 cigarettes.

8 So, we cannot easily define the preference of  
9 the consumer. It means they like the price, but also the  
10 particular function. There is various, various reasons. It  
11 means so we are not competing with the so-called discount  
12 brand, but also we are competing with the major brand  
13 because consumer like those kinds of things, not only price,  
14 but also cigarette itself.

15 MR. JONES: Thank you. Was there anything else  
16 you wanted to add on that or -- okay. So this next question  
17 also goes to the petitioners and it's gonna be amended  
18 slightly for the respondents, and it's based on the  
19 petition, what we've seen about the question regarding  
20 regionality, particularly the central region of the United  
21 States, Oklahoma and Missouri were the two states that were  
22 mentioned primarily. And it stated in the petition that  
23 there were forty states that KT&G cigarettes go to. So,  
24 let's try to find out a little bit more about those states  
25 that it goes to and also which states it will not go to, and

1 is there a reason for not, or it is just they haven't  
2 reached that market yet?

3 MR. CHO: [through translator] I don't there's  
4 any specific or special reason for what you have just  
5 indicated, but unlike what the strong market that the  
6 petitioner claims to have in Missouri, KT&G has only about  
7 nearly 1.8% in Missouri of total sales.

8 MR. CHO: Not only strong Georgia in the east  
9 part, like Georgia, Tennessee, producer, we are strong in  
10 California. So there is no region --

11 MS. ARANOFF: This is Shara Aranoff from  
12 Covington. Let me just follow that by saying, our speakers  
13 indicated earlier in their direct testimony, KT&G has been  
14 in the U.S. market for several decades. So they have had a  
15 long period of time to have developed a presence in multiple  
16 states, not all manufacturers have been in the market as  
17 long or may choose to pursue a narrower strategy. And I'm  
18 sure to add that the, you know, the Commission has a term  
19 about regional industries, regional markets that, you know,  
20 I think most people would agree that's not really a good  
21 descriptor of what's going on in this market.

22 MR. JONES: Thank you. Regarding the regionality  
23 question, and this goes back to what I asked previously to  
24 the petitioners. I think I asked inadvertently, this is  
25 regarding the Texas facility that was built, I believe it

1 was Mr. Taylor alluded to in his testimony, what was the  
2 reasoning for building the warehouse and the facility there  
3 compared to any of the other locations throughout the U.S.?  
4 Particularly because, the question is, is it because Texas  
5 is a non-participating member or one of the four states that  
6 were excluded from that agreement, or was there other  
7 justification for it?

8 MS. ARANOFF: Shara Aranoff from Covington. Just  
9 to clarify, Mr. Jones. The company removed its warehouse  
10 from one location in Texas to a different location in Texas.

11 MR. CHO: This is Cho, KT&G, so we assert our  
12 facility in Oklahoma. Have you ever heard of Inlet City? So  
13 that's why we move to Texas, because a small city is very  
14 difficult to hire good people, so that's why we switch them  
15 over to Texas, because they are very close and --

16 MR. CHO: [through translator] These two have  
17 warehouse through a third party, but because Texas was not  
18 too far, we ended up choosing a space in Texas to maintain  
19 our inventory, but on other particular reason to choose that  
20 region.

21 MR. JONES: Thank you. And one question. This  
22 is regarding a questionnaire and I'm being mindful of  
23 proprietary information, for the questionnaire. There were  
24 a lot of studies referenced and a lot of reports referenced  
25 in that. Would you be able to provide a lot of those



1 conference with your briefs?

2 MS. ARANOFF: Sure. We are looking forward to  
3 providing those on the confidential record in our brief. We  
4 will do so.

5 MR. JONES: Thank you. And this question is also  
6 regarding if we're using the term 4th Tier cigarettes,  
7 particularly what's manufactured in Korea, so is there a 4th  
8 Tier market in Korea? And basically what is significantly  
9 different between what's being sold in Korea compared to  
10 what's being sold in the United States?

11 MS. ARANOFF: I'll let Mr. Cho answer the  
12 question, but my understanding is that the company really  
13 thinks about their domestic market in Korea as having three  
14 tiers.

15 MR. CHO: [through translator] In Korea, the  
16 retail price is set by the government by law. In America,  
17 in the United States, the final end price is determined by  
18 the retailers, not by the manufacturers. So in Korea, it is  
19 clearly defined by the consumer prices. They are clearly  
20 defined as super premium, premium and then value for money  
21 category, in these three categories already fixed. So in  
22 the United States, yes, I understand there are different  
23 price ranges or price spans for consumers. But the prices,  
24 these price spans cannot be controlled. The manufacturers  
25 cannot control these final prices. Manufacturers are aware

1 of the existence of these price spans, but we do not have  
2 control over which brands or which products can be priced.

3 MR. JONES: Thank you. And this goes along with  
4 the previous question. For example, the regulations, the  
5 regulatory mechanisms within the U.S. compared to what  
6 you're seeing in the Korean market, how are they different?  
7 And also, not just a regulatory mechanisms, but the  
8 perceptions? At least, what the customers perceive? Is  
9 there a more negative perception with regard to this type of  
10 cigarette? Or is it perceived similarly?

11 MS. ARANOFF: Shara Aranoff from Covington.  
12 Before Mr. Cho answers that question, could you just clarify  
13 what you mean by this type of cigarette?

14 MR. JONES: Well, what's been classified as 4th  
15 Tier, what's being sold by the Korean manufacturer, by KT&G?

16 MR. CHO: So this is still KT&G USA. [through  
17 translator] I think that regulations, whether they are  
18 practiced in Korea or in the United States, I think the  
19 effect would be pretty much the same. Including the  
20 concerns, both concerns, for example, and the fact that a  
21 smoking areas, the number of smoking areas are declining.  
22 And I think these are pretty much a result of the same  
23 factors unrelated to any pricing or price spans between  
24 Korea and the U.S.

25 MR. JONES: Thank you. And this goes to the

1 production methods, just shifting a little bit. In terms of  
2 what you've seen today, as far as the production, on the  
3 screen, from what the petitioners presented, and also what  
4 your familiarity with the actual production processes here  
5 within the U.S., what would you say if there's anything that  
6 differs between your production? And this can be addressed  
7 post-conference, but what are the big differences between  
8 Korean production methods for cigarettes and what you see  
9 here in the U.S.?

10 MR. CHO: This is Cho, KT&G, so I'll just  
11 briefly, I think our manufacturing process is almost same as  
12 your U.S. major cigarette manufacturing. So we're [through  
13 translator] I think the manufacturing process is pretty  
14 similar to the manufacturing process happening in the United  
15 States starting from the raw material to packaging of  
16 cigarettes. I will submit further information later on.

17 MR. JONES: Thank you. And have there been any  
18 recent developments or changes within the cigarette industry  
19 in Korea that we should be aware of? More particularly if  
20 there's, are there any regulations or new technology for  
21 production that are not being employed that you're aware of  
22 in the U.S. currently?

23 MR. CHO: [through translator] I think the  
24 general trend that I notice is that, or the trend that I  
25 notice, a recent trend that I noticed might be quite

1 general, but as the alternative products or substitute  
2 product alternative to cigarettes such as e-cigarette,  
3 vapors or jeung-gi, we call in Korea, that the demands on  
4 combustible cigarette tends to go down.

5 MR. CHO: So we divided cigarettes by type. One  
6 is combustible cigarette and one is, we calling  
7 next-generation cigarette that is paper, but we also produce  
8 two type of things, but the definitely, if there does the  
9 vapor, it can affect the combustible cigarettes.

10 MR. JONES: Thank you. And I asked this question  
11 to the petitioners, but this is regarding the new age  
12 requirements for United States, particularly 21 being the  
13 age now to purchase tobacco. But how would you say, what  
14 would you say about that affecting industry, your industry,  
15 particularly with the ability to reach new smokers, and as I  
16 mentioned in the, with the petitioners, there's generally a  
17 decline in smokers, or people smoking, and an aging  
18 population, and now the new restrictions, what's the outlook  
19 for your industry now?

20 MR. CHO: This is KT&G USA. So that's why the  
21 government want to regulate cigarette condition, so that's  
22 why they regulate.

23 MR. JONES: Have you noticed an effect so far  
24 recently, within the last few years, of not just new  
25 regulations and a decline in cigarettes, but also the

1 introduction of e-cigarettes? I believe it was asked of the  
2 Petitioners, the vaping and e-cigarettes, are they affecting  
3 your industry? Or are they not relevant?

4 (Translation taking place.)

5 JAE YUNG CHO: As you have seen from one of the  
6 slides that James has used earlier, that, yes, there is a  
7 definite relation between the rising e-cigarettes and vaping  
8 devices and decline of cigarette demands, demands for  
9 cigarettes. There is that relation.

10 Furthermore, as to the question of whether or not  
11 the governmental regulation might have affected the overall  
12 consumption of cigarettes, I could not get up for Korea. I  
13 think I could also find out about it in the United States,  
14 as well, and if necessary I could submit later on.

15 MR. JONES: Thank you. I just have one last  
16 question. This is a two part. This is regarding our  
17 ability to collect information more specifically about the  
18 reported statistics. Are they relying in measure for  
19 imports of 4th Tier cigarettes, are they exclusive to 4th  
20 Tier? Or is there a lot of other cigarette types, 3rd  
21 Tier, premium brand, et cetera, within that HTS number?

22 MS. ARANOFF: I think we're going to have to  
23 address that postconference brief for you.

24 MR. JONES: Thank you. I don't have any other  
25 questions.

1 MS. CHRIST: We will now turn to the attorney,  
2 Michael Haldenstein.

3 MR. HALDENSTEIN: Thank you. Good afternoon.  
4 Michael Haldenstein, Office of the General Counsel.

5 How do you view the 4th Tier cigarettes, as  
6 Petitioner has defined them, as fitting into the overall  
7 market? Are they just -- are they just a lower quality and  
8 lower priced cigarettes? Or is there more to it?

9 MS. ARANOFF: Shara Aranoff from Covington.

10 Mr. Haldenstein, thanks for asking that question  
11 because we did want to clear up the question of what does  
12 "quality" mean in this industry, which I know came up some  
13 this morning. And we don't really agree with the way that  
14 Petitioner was presenting that issue.

15 Our understanding -- and Mr. Cho can address  
16 this, too -- is that quality is a measure of how well a  
17 company produces the cigarette. Is it consistent? Are the  
18 process controls good? Do they control moisture and  
19 impurities? Do they have a good inventory control system  
20 that keeps the product fresh? Those are measures of  
21 quality. And KT&G is certainly producing products, you  
22 know, according to these metrics.

23 Some of the other things that Petitioners  
24 mentioned this morning, what sort of mix of tobacco you put  
25 into your recipe, those are not issues of quality selection.

1 It's sort of taste or preference. So you could have, just  
2 as an analogy, you could have three types of coffee, let's  
3 say, right? You could have a French roast, you could have  
4 mocha, you could have a light roast, and they could all be  
5 high quality products but they have different recipes. Some  
6 are going to appeal to one person, and some to another, not  
7 because they differ in quality, they're just different  
8 recipes.

9           So we do want to distinguish what "quality" means  
10 versus some of these other product characteristics.

11           MR. HALDENSTEIN: I guess when I was asking about  
12 quality earlier, I was thinking of the stem count which  
13 they've -- Petitioners have emphasized as maybe suggesting a  
14 difference, a bright line even, between the Tiers. And I  
15 believe I heard your panel sort of reject the notion that  
16 there is a bright line, that there is more variation.

17           Can you elaborate on that, if not here in your  
18 postconference brief, and provide what testing results  
19 you've produced?

20           MS. ARANOFF: So this is Shara Aranoff. We will  
21 in our postconference brief provide you with the results  
22 from KT&G's R&D department which looked at a range of  
23 cigarette products and testing them for stem content, and  
24 it's the basis for our argument that in fact there are  
25 companies that are outside of what Petitioner defines as the

1 4th Tier that use more than 10 percent stems, and there are  
2 companies in that category as Petitioner defines it who use  
3 less than 10 percent stems.

4 I think we can also perhaps get KT&G to elaborate  
5 on this, but our understanding is that, like tobacco leaves,  
6 stems are a part of the recipe. You put them there, not  
7 like -- you know, we actually have properties that affect  
8 the product, and so you might choose to put them in your  
9 recipe for a variety of reasons. But suffice it to say that  
10 10 percent is not a clear dividing line that tells you what  
11 is 4th Tier and not 4th Tier, according to the way that  
12 Petitioner has defined it.

13 MR. HALDENSTEIN: Thank you. Does KT&G produce  
14 the other Tiers of cigarettes as Petitioner has defined  
15 them, at least for the United States.

16 MS. ARANOFF: Well have to answer that question  
17 in our postconference brief. But it all circles back to we  
18 don't know yet how Petitioners have defined them, because  
19 the 10 percent doesn't distinguish. The only solid  
20 measurable thing that Petitioner has given us is the length  
21 and circumference measurements for the cigarettes.

22 If there's another particular measure that would  
23 help you, we could answer the question as to what we produce  
24 that's on the other side of that measure. But everything  
25 else has been sort of maybe, or sometimes. So it would help



1 to clarify the question.

2 MR. HALDENSTEIN: Thank you. Please address  
3 that in your brief. How much of a total cigarette market is  
4 4th Tier product. I think I saw a graph that could quantify  
5 it more precisely, if not here in your postconference brief.

6 MR. SMITH: We can answer that in the  
7 postconference. But I think it really begs the question  
8 that we're trying to resolve, which is how is it defined?  
9 So it is very difficult to come up with reliable data for  
10 the 4th Tier when we don't know exactly what physical  
11 characteristics place the cigarettes in that Tier, as  
12 opposed to some other Tier.

13 We can, you know -- the only industry  
14 association, or analyst, that identify the 4th Tier  
15 Petitioner has identified is NACS. It might be possible to  
16 find out what exactly they are putting in the 4th Tier, but  
17 we suspect that even that would be difficult to determine.

18 MR. HALDENSTEIN: Thank you. Petitioners also  
19 stated, I believe, that the rebates and other promotions  
20 aren't used as frequently on the 4th Tier products. I was  
21 asking about rebates and promotions by the 4th Tier  
22 producers. Does KT&G use any type of rebates and promotions  
23 for its products?

24 MR. CHO: Yes, we do have rebates and promotions.

25 MR. HALDENSTEIN: Can you provide some sort of

1 documentation of that in your postconference brief, if you  
2 don't want to detail it here?

3 MR. CHO: Yes.

4 MR. HALDENSTEIN: Also with respect to the  
5 pricing of the different products, you've argued that  
6 there's a lot of overlap in sort of price bands, but they're  
7 not as clear cut as Petitioners have argued. Can you  
8 document and provide some concrete examples of the pricing  
9 among the different Tiers, or price bands?

10 MR. SMITH: Yes, we can provide examples for the,  
11 you know, the statistical reporting services that provide  
12 such data, and that create and maintain these definitions of  
13 which brands fall into which categories. But even that,  
14 with regard to NACS, may not be something that's consistent  
15 and verifiable on a readily confirmable basis. But for the  
16 others, we believe that we can and we can do that in the  
17 posthearing, as this is obviously subscription data--  
18 postconference, rather, I apologize.

19 MR. HALDENSTEIN: Thank you. In terms of the  
20 argument about different production processes between the  
21 Majors and the 4th Tier producers, do you have any  
22 information on the significance of whether the integrated  
23 producers that apply their own private tobacco blends from  
24 other tobacco companies, do you believe that has any  
25 significance?

1 MS. ARANOFF: Shara Aranoff from Covington. As  
2 with a number of the other factors suggested in this case,  
3 it is not -- we understand it is not as clear cut as  
4 Petitioners have portrayed it; that the Majors may get some  
5 of their tobacco directly, and then blend it themselves, but  
6 then they also purchase some blends. So I don't think  
7 you're going to find that whether you purchase blends or  
8 make blends is going to offer a clear dividing line.

9 MR. HALDENSTEIN: Thank you. If you have  
10 anything more specific, please put that in your brief, as  
11 well. From listening to your affirmative presentation, it  
12 sounds like you don't believe the Master Settlement  
13 Agreement has any significance for defining the domestic  
14 like product. Is that correct?

15 MS. ARANOFF: This is Shara Aranoff from  
16 Covington. We think that defining the like product in the  
17 industry, according to the Master Settlement Agreement, is  
18 sort of a circular proposition.

19 If you accept that there is a known definition of  
20 4th Tier, and that you can then map that and say, oh, well  
21 that's the nonparticipating members of the MSA, and then you  
22 can sort of -- but you first have to know who is in what  
23 Tier and how are you defining that.

24 If you just assume the definition of 4th Tier and  
25 then match it up to the MSA, you haven't said what put

1 someone in the 4th Tier in the first place. It's not just  
2 that they did or didn't sign a settlement agreement, because  
3 that doesn't tell you anything about the physical  
4 characteristics or uses of the product, or give you any  
5 other line that distinguishes the product itself. Just a  
6 company.

7 MR. HALDENSTEIN: Okay, thank you. Since you are  
8 going for an expanded like product, and we don't have the  
9 data on the universe of cigarettes that are produced in the  
10 United States, what do you propose that we will do in the  
11 Preliminary Phase? Just base it on what we have and gather  
12 more information in our Final Phase, assuming we require a  
13 final phase?

14 MS. ARANOFF: This is Sharon Aranoff from  
15 Covington. We have put in the record some of our slides at  
16 the end of Mr. Smith's presentation, information that is  
17 available publicly about things like market shares in the  
18 entire market. We'll look for more of that. We'll put it  
19 on the record for you to the extent we can in our  
20 post-conference brief. But we do understand the Commission  
21 has to make a preliminary determination based on the best  
22 information that it has.

23 MR. HALDENSTEIN: Thank you. There was some  
24 discussion of regulation of cigarettes in Korea. Has  
25 changing regulations made the U.S. market more attractive?

1 Is that something that accounts for an increase in imports  
2 from Korea?

3 MR. CHO: (Through translator) You can say  
4 there might have some changes in the government regulations,  
5 and whatever factors that they took into account to make  
6 those changes, I think are meant to improve, perhaps improve  
7 the practice. But I don't think this affected our decision.  
8 I don't think it necessarily made the U.S. market as more  
9 attractive.

10 MR. HALDENSTEIN: Thank you. One final  
11 question about the fact that this investigation involves  
12 cigarettes. I asked Mr. Pickard about that and whether the  
13 Commission should consider that fact when making its  
14 determination, how it should weigh that. Maybe it doesn't  
15 matter at all. What's your view on that?

16 MS. ARANOFF: Sharon Aranoff from Covington.  
17 On the basis of the statute, it's not clear to us that it  
18 has any particular significance with regard to the factors  
19 that the statute requires the Commission to consider.

20 MR. HALDENSTEIN: Thank you. That's all the  
21 questions I have.

22 MS. CHRIST: We'll now turn to James Horne,  
23 the Economist.

24 MR. HORNE: Good afternoon. So firstly, let  
25 me just get the important stuff out of the way. Thank you

1 for the market share information. Can we please have the  
2 underlying data and the methodology used to create those  
3 slides in your post brief?

4 MR. SMITH: Certainly.

5 MR. HORNE: Thank you. So Mr. Cho, you also  
6 in addition to using the term "quality," you used the term  
7 "satisfaction" to describe a portion factor cigarette.  
8 Could you tell me a little more about that?

9 MR. CHO: (Through translator) As I said  
10 earlier about customers' reasons for choosing particular  
11 cigarettes, there are several, many reasons. Between among  
12 customers, there are variations. On one side, there's a  
13 functional aspect they may choose. On the other side, they  
14 may prefer, they may go with the emotional aspect in their  
15 decision.

16 And I would say if you use the word  
17 "fulfillment" by customers, that refers to the functional  
18 aspect of enjoying the cigarettes or seeing how the  
19 cigarette is to the customer. Whereas if you're using the  
20 word "satisfaction" or "satisfied," we would say that is the  
21 emotional aspect of the customers' decision.

22 MR. HORNE: So Mr. Cho, you also referenced  
23 that many consumers could not tell the difference in blind  
24 taste tests between discount brands of cigarettes and  
25 premium brands of cigarettes. If that's the case, why isn't

1 everyone smoking discount brands if they can't tell?

2 MS. ARANOFF: While Mr. Cho is preparing, this  
3 is Sharon Aranoff from Covington. Brands have a brand  
4 equity in this market, and they're important to different  
5 consumers for different reasons. So I was trying to think  
6 of again an analogy that worked, but you might buy a Gucci  
7 purse, you might not personally do that. I might do that,  
8 and why am I spending that much money when I could go to TJ  
9 Maxx and get a purse that's pretty good looking and  
10 functional?

11 Well, for some people it might have a certain,  
12 you know, show off value to your friends and for some people  
13 you might think that that's, you know, a very prestigious  
14 thing, and for others you might get satisfaction just for  
15 knowing that you can afford that.

16 There's going to be a variety of reasons why  
17 brands are important to some people and they're willing to  
18 pay for them, and it may not have anything to do with  
19 whether the product performs the same way or differently  
20 than that lower priced version of the same thing. That is,  
21 that is true in this market. I'll see what Mr. Cho wants to  
22 add to that.

23 MR. CHO: As I said earlier, there are many  
24 different factors why to customers' decisions to buy one  
25 particular cigarette. If we think it is flavors, we can

1 narrow it down to oh, it's because of the flavors, I'm sure  
2 we could have been more successful and even made more  
3 saleable cigarettes.

4 So to identify and interpret correctly the key  
5 buying factors is one of our job as cigarette manufacturers,  
6 and we not only have to focus on the quality, what we say  
7 satisfaction, but also we need to also know and be aware of  
8 the brand factor. So it is a difficult question to answer  
9 in briefly.

10 MR. HALDENSTEIN: So would you -- oh, please  
11 go ahead.

12 MR. YOON: I'm Byung Uk Yoon, you can call me  
13 just 'Yoon.' I director of marketing at KT&G USA. So let me  
14 add some other points. We had to focus on the reason why we  
15 conducting the blind test, because it contributed to the  
16 marble or taste. We let customers, the blind tester to  
17 focus on the taste, the physical characteristics. So then  
18 by doing that, they can see, they can figure out if there is  
19 any implement regarding only physical characteristics.

20 After we're adding the brand, we took after,  
21 you know, we're talking of the brand balance. It's only  
22 different story because Marlboros may give, you know, the  
23 emotions like this brand's representing my coolness or, you  
24 know mock figures like that. So in the balance, the one  
25 biggest reason why customer paying more money, yeah.



1 MR. HORNE: So then just to beat a dead horse,  
2 could you please comment on the Petitioner's claim that if  
3 we were to accept 4th Tier cigarettes as a thing, there is  
4 no brand loyalty and they're highly interchangeable?

5 MS. ARANOFF: Sharon Aranoff from Covington.  
6 I'll let either Mr. Cho or Mr. Yoon respond to this, but I  
7 think as in all other things, it's a matter of degree. We  
8 just have very powerful brands and they have customers who  
9 are loyal to that brand for a variety of reasons, but not to  
10 the exclusive of all switching. Products are branded,  
11 right? You don't see them in, you know, white plain, plain  
12 white packages.

13 So you know, KT&G and other producers of more  
14 discounted cigarettes have repeat customers because those  
15 customers find something about the brand that satisfies  
16 them. So that's a type of brand loyalty, but it's not the  
17 type that necessarily commands the very large premiums.

18 MR. HORNE: Correct, but are they  
19 interchangeable? Would this be interchangeable with an  
20 Edward? Or do customers who tend to buy this buy this and  
21 that's the brand they buy, much like --

22 MS. ARANOFF: So I think what Mr. Yoon was  
23 telling you is it depends how you define interchangeability,  
24 right? In applying taste test, it's hard to tell the  
25 difference based on tastes or maybe they're interchangeable.

1 In the sense that you can smoke them all, they're  
2 interchangeable. In the sense of cache, not so  
3 interchangeable.

4 MR. CHO: (Through translator) However you  
5 define cigarettes, of course we do not agree with the  
6 definition relating to the 4th Tier cigarettes. Of course  
7 there are discounted brand cigarettes, but I cannot agree to  
8 any kind of claim that says high brand -- premium brand has  
9 higher loyalty customers, or discount brands have lower  
10 loyalty customers. You cannot define. You cannot say that.  
11 I don't believe that.

12 MR. HORNE: So, if the Commissioner were to  
13 accept that there's no clear line between 4th tier --  
14 defining 4th tier cigarettes, then proceed onto a final, how  
15 would you ever structure the pricing products to capture an  
16 adequate interchangeability with the U.S. cigarette market  
17 or the segment you would be competing in?

18 MS. ARANOFF: That's a good question and we  
19 would be happy to give that some thought and make some  
20 suggestions to you in our post-conference brief.

21 MR. CHO: Cigarettes are consumed every day or  
22 it's a product that is consumed daily. So, sometimes people  
23 choose cigarettes depending on the weather. When it's --  
24 let's say in one weather condition consumers might choose to  
25 smoke stronger flavored cigarettes and other days they may

1 choose weaker flavored cigarettes. And even if you were a  
2 menthol cigarette smoker, some days you might want to try  
3 something that is not menthol cigarette.

4           And if you were traveling and you couldn't find  
5 your ordinary brand, you make try some completely different  
6 brand or a friend visited you and that friend brought some  
7 different brand, then you might try that brand or you might  
8 run into some advertisement or poster in the street and you  
9 may then try that brand because you've just noticed it and I  
10 think any of these could occur in a daily life.

11           MR. HORNE: So, if we're saying that cigarettes  
12 are largely interchangeable with the exception of brand,  
13 what would the differential in pricing tell us when we get  
14 pricing data back?

15           MS. ARANOFF: The differential in pricing is a  
16 measure of brand equity which shows you that based on  
17 advertising and long-standing relationships with customers  
18 some brands have created a certain cache for themselves that  
19 allows them to charge a premium that can't be measured in  
20 any physical characteristic of the product.

21           MR. HORNE: So, last question, do taxes or  
22 regulations on cigarettes differ from the imported product  
23 to the domestic and could it be considered that regulations  
24 form some sort of barrier to the U.S. market that is not  
25 there for domestically-produced products?

1 MS. ARANOFF: We can obviously spell this out  
2 more in our brief, but our understanding is that the various  
3 regulatory regimes that apply in the U.S. to cigarettes  
4 apply equally to imported cigarettes and domestic  
5 cigarettes.

6 MR. HORNE: This concludes my questions.

7 MS. CHRIST: We'll now turn to the auditor,  
8 David Boyland.

9 MR. BOYLAND: Good afternoon. Thank you for  
10 your testimony. Actually, this kind of dovetails with the  
11 last question regarding the FDA trend of equivalency testing  
12 that the domestic producers referred to this morning, does  
13 your company perform the same testing? Are you required to  
14 do the same thing?

15 MR. CHO: Yes, the same. I would like to say  
16 something further regarding the FDA regulations. For  
17 products produced prior to 2017, and I understand are termed  
18 grandfathered in or grandfathered. And for those cigarettes  
19 that were produced after 2017 or as of 2017, I think are --

20 MR. BOYLAND: Are you referring to '07?

21 MR. CHO: 2007.

22 MR. BOYLAND: Okay.

23 MR. CHO: I apologize.

24 MR. BOYLAND: Oh, thank you.

25 MR. CHO: 2007, correct. And so, any cigarettes

1 produced after or as of 2007 these are provisional  
2 cigarettes. Now, the requirement is for their content or  
3 their ingredients to be same, but there is no limitations to  
4 or restrictions as to testing.

5 MR. BOYLAND: With regard to the testing, does  
6 that occur in the United States or Korea?

7 MR. CHO: The tests were conducted here, so it  
8 was in order to obtain the FDA approval.

9 MR. BOYLAND: Okay, thank you. And just to  
10 confirm, my impression was that the company is a  
11 non-participating member; is that the correct status of this  
12 company?

13 MS. ARANOFF: That is correct. The company is a  
14 non-participating manufacturer. That's their MSE status and  
15 that means that they're subject to escrow requirements.

16 MR. BOYLAND: Okay, that was my next question.  
17 The descriptions that U.S. producers provided this morning  
18 would be consistent with the obligations that your company  
19 is responsible for?

20 MS. ARANOFF: Yes.

21 MR. CHO: Yes, that is correct.

22 MR. BOYLAND: And those obligations are they --  
23 I mean I'm assuming it would be legally KT&G USA would be  
24 essentially responsible for the escrow, not the parent  
25 company or -- is that correct?

1 MR. CHO: No, actually, the financial  
2 responsibility as to paying the escrow lies to -- is borne  
3 by KT&G headquarters because they're the manufacturers.

4 MR. BOYLAND: Okay.

5 MR. CHO: Because the KT&G headquarters they are  
6 the manufacturers and KT&G USA is just an importer.

7 MR. BOYLAND: So, the entity that's responsible  
8 for it would be in Korea; that a manufacturer they're  
9 essentially on the hook for the escrow.

10 MR. CHO: Yes, that is indeed correct.

11 MR. BOYLAND: Alright, thank you very much.

12 MS. CHRIST: We'll turn to Amelia Shister, the  
13 industry analyst.

14 MS. SHISTER: Good afternoon. Thank you for  
15 answering all of our questions and for your very helpful  
16 testimony. So, understanding that you all are subject to  
17 the -- this sort of gets to one of my last questions this  
18 morning or from the earlier panel. So, understanding that  
19 you all are subject to the FDA regulations, you have this,  
20 which was entered into the market in 2018, and Time entered  
21 in 2010, both after the 2007 cutoff, so I'm confused as to  
22 how you can enter into a new product based on the  
23 regulations as I understood them from earlier.

24 MS. ARANOFF: Mr. Cho, do you want to start  
25 first?

1 MR. CHO: Yes.

2 MS. ARANOFF: Please do.

3 MR. CHO: So, we can call it grandfather which  
4 is interpreted as solely in the United States before 2007 we  
5 call it "grandfather." And it's the same as grandfather we  
6 can sell at any time, so that's why we have grandfather, so  
7 that's why we can launch our new product in here because of  
8 the grandfather rule.

9 MS. SHISTER: My understanding is you had  
10 previously been selling this same component or same blend,  
11 same ingredients, just under a different brand and this was  
12 a rebrand or you were selling it in a different market? I'm  
13 sort of confused.

14 MS. ARANOFF: We can get more specific about  
15 that in our post-conference brief because that's  
16 confidential information about the company's recipes, but  
17 broadly, we can correct the misapprehension that the  
18 Petitioner may have suggested that there's no way that you  
19 can bring a new brand to market. We are aware of companies  
20 that have done that. You know the domestic producer, which  
21 is not here today, but I believe Petitioner considers to be  
22 4th tier. They introduced new products with FDA approval  
23 since 2007 and so Petitioners' assertion that you can't do  
24 that in the current regulatory climate is actually not  
25 correct.

1 MS. SHISTER: Okay.

2 MR. SMITH: Just to add, I want to make sure  
3 that we all are on the same page as to what grandfathering  
4 means. It's not grandfather with respect to products that  
5 you, yourself, had approved and sold prior to 2007. It's  
6 with respect to any product or formula that was approved and  
7 sold in the U.S. market before that date and those  
8 proprietary formulas can be sold or licensed to new  
9 manufacturers who want to release a new brand.

10 MS. SHISTER: That's very helpful. Thank you.  
11 So, I believe this question was asked maybe slightly  
12 differently earlier. So, is this sort of tier, whether you  
13 agree with it being 4th tier -- let me back up. The  
14 cigarettes, the Carnival, Time, and this were they to be  
15 sold in Korea which tier would they fall under?

16 MS. ARANOFF: First, I think it's important that  
17 they can sell them in any tier they want to, as with any  
18 brand. The manufacturer can decide how they want to market  
19 the product and then, ultimately, it's the retailer who  
20 decides how to price the product.

21 MS. SHISTER: I guess I'm just trying to -- I'm  
22 trying to determine -- so does KT&G produce cigarettes that  
23 would fall across the range of tiers or just this -- what  
24 the Petitioners are describing as this 4th tier?

25 MS. ARANOFF: We can describe more of that in



1 our post-conference brief. The company does produce brands  
2 that it doesn't sell in the United States.

3 MS. SHISTER: Okay. And along those lines, in  
4 the earlier panel we saw sort of a screenshot of the KT&G  
5 website which does -- basically KT&G describes Timeless Time  
6 as a 4th tier selling brand and so, what is your definition  
7 then of this 4th tier? Is it solely based on price or are  
8 there other attributes?

9 MS. ARANOFF: Our assessment is that it's one  
10 way of referring to the discount end of the price spectrum.

11 MS. SHISTER: Okay. If you could expand more on  
12 where you see your products, especially, if we're going to  
13 get potentially a proprietary list of other products in the  
14 post-conference that would be very helpful and how you  
15 delineate the different levels.

16 MS. ARANOFF: Okay.

17 MS. SHISTER: In terms of -- there's been this  
18 discussion of brand loyalty. In terms of when you're  
19 marketing KT&G brand cigarettes or brands of cigarettes,  
20 what's differentiating your product from the similarly  
21 priced products in the U.S.?

22 MR. SMITH: Are you asking about how they are  
23 marketed?

24 MS. SHISTER: Basically, or is there some  
25 inherent difference between the -- or are we seeing a wildly

1 different flavor profile? Are we seeing a wildly different  
2 tobacco sort of mix? What's making the KT&G product stand  
3 out, as opposed to one of the domestic competitors? Whether  
4 it's the wide range or the narrow 4th tier?

5 MR. SMITH: James Smith for respondent KT&G. We  
6 can certainly provide, for example, the consumer survey that  
7 we have referenced, which asked, you know, consumers what  
8 they care about. And the answers to surveys like that  
9 inform the way in which KT&G has, you know, marketed,  
10 employed its products. And so that might be one way to help  
11 rely on your question.

12 MS. SHISTER: Thank you. And my last question  
13 is, what other markets globally are you all exporting into?  
14 Understanding that the domestic market is off -- your  
15 domestic market is also major.

16 MS. ARANOFF: Shara Aranoff from Covington. We  
17 did provide some of that information in the confidential  
18 record in our questionnaire response and we can provide that  
19 information in our brief.

20 MS. SHISTER: Thank you. And with that, I would  
21 just like to reiterate what some of my colleagues have said  
22 prior, where any of these reports that are referenced, any  
23 of those references would be very helpful. Thank you.

24 MS. CHRIST: We will now turn to supervisory  
25 investigator Betsy Haines.

1 MS. HAINES: I actually don't have any questions.  
2 Thank you very much for coming to testify. It was extremely  
3 helpful. Thank you.

4 MS. CHRIST: And I believe somebody next to me  
5 has already mentioned that he may have one more question.

6 MR. JONES: Hi, Lawrence Jones, Office of  
7 Investigations. I did have one follow-up and this about the  
8 tiers of cigarettes, so this is a publicly available  
9 document, so the National Association of Convenience Stores,  
10 NECS, has category definitions for cigarettes, and I just  
11 wanted to hear what you, how you would respond to that. And  
12 they go as defined, or they go as listed premium, branded  
13 discount, sub-generic private label, imports and 4th Tier.

14 Now, whether that's five tiers or actually four,  
15 depending on how you would interpret that, that's to be  
16 determined, but are they wrong for listing them as such?  
17 And are these tiers not a representation of the market?  
18 Particularly because they are the national council on  
19 retailers or whatever they're called.

20 MS. ARANOFF: Shara Aranoff from Covington. So  
21 NECS has defined marketing for different price groupings.  
22 There are two other industry data sources that use three, we  
23 had them on our slide earlier. You can take any market and  
24 decide you're gonna divide it up into four buckets. The  
25 important thing is, how do you define what you're putting in

1 each bucket?

2           And I don't think you'll find that information on  
3 NECS website or in anything that petitioners have submitted.  
4 So, yes, they do think that there are four tiers and that  
5 there is a fourth tier, but what's in that fourth tier?  
6 What manufacturers do you think are in it, or what brands  
7 they think are in it? So, yes, you can divide the market in  
8 four tiers or five or sixteen, but you have to define what's  
9 in them.

10           MR. JONES: Okay, thank you.

11           MS. CHRIST: Let me see if there's any follow-up  
12 questions? All right. Thank you very much. I am going to  
13 reiterate the appreciation on the part of the staff for you  
14 coming down and allowing us the opportunity to ask  
15 questions. Obviously, when we receive a petition and we are  
16 reading through it, there are a number of questions that  
17 come into our mind as well, and we don't often have the  
18 ability to have respondents show up and allow us to ask  
19 those questions of them, so I really appreciate that extra  
20 effort that you have made to come in.

21           I would also like to particularly thank Ms. Kim.  
22 If it were not for your participation, there is much  
23 information that we might not have been able to -- I  
24 appreciate you facilitating our ability to get a broader  
25 spectrum of information. Thank you.

1           I think I have just a couple of follow-ups, the  
2 first one I believe for Ms. White. You mentioned in your  
3 introductory comments the various positions that you've had  
4 over the time from Indiana to the Northeast and now the  
5 North Central. I'm curious how you've seen, in that  
6 evolution of your participation in this industry, how was  
7 competition different in what you were doing in your sales  
8 and marketing when you were just focusing on Indiana versus  
9 as you expanded? How did competition, what factors changed  
10 in the competitive market in that?

11           MS. WHITE: Well, every state is different. The  
12 laws, the regulations, the regionality of brands. And so it  
13 gave me a broader view of the cigarette industry itself in  
14 the U.S. And gave me an opportunity to learn that in  
15 different areas, etcetera. But it's just, I guess just  
16 different states, different locations had so many different  
17 regulations and laws that it's like each state is a little  
18 market, if you will. So did that answer your question?

19           MS. CHRIST: Yeah, and do you have to participate  
20 differently or take different things into consideration when  
21 you're working in these different sort of mini-markets?

22           MS. WHITE: Just know the market, knowing who  
23 your competition is or, you know, who it isn't, or  
24 understanding it a little bit better maybe, but it's really  
25 across the board, I guess, would encompass -- it ends up

1 being the same thing. If you take the regulations out of  
2 the state and the taxes out of the state, it's just a broad  
3 base across the category. That's really the same across the  
4 entire region.

5 MS. CHRIST: Thank you. This morning when the  
6 petitioners provided their presentation, there was a page  
7 which was KT&G's, which stated one of the best selling 4th  
8 Tie brands. How did you define that in making that  
9 statement?

10 MR. SMITH: While they're looking, I just wanted  
11 to make--this is Jim Smith for KT&G--the argument is that  
12 we've -- is not that knowing the industry uses the term,  
13 "4th Tier" -- they do, and they use it in a very particular  
14 way, not in a well-defined way, but for a specific purpose,  
15 which is to identify the lower or discount end of this price  
16 spectrum.

17 And in some materials like that on the website,  
18 KT&G, following industry usage, has done the same. So what  
19 did it mean? It referred to discount cigarettes. NECS uses  
20 it for a similar purpose. But that doesn't mean that  
21 before, usually term that's used in the industry, KT&G gave  
22 it content and defined regionally what exactly is in, what  
23 exactly is out. It's a loose reference to an end of a  
24 continuum.

25 And petitioners has had a lot of time to think

1 about what they mean by 4th Tier, and to identify the  
2 physical characteristics and any other characteristics that  
3 would distinguish it for the rest of the market. And they  
4 asked, "What is the definitive, or any definitive  
5 characteristic of 4th Tier cigarettes?" they struggled, and  
6 for good reason. There aren't any as far as we can tell.  
7 It's a description, a general description, in reference to  
8 price.

9 MS. CHRIST: Thank you. I can't remember, this  
10 is my last question. I can't remember which testimony it  
11 was, but there was a reference potentially to the majors  
12 representing about 95% of the market at one time and now  
13 down to maybe low 80s, if I recollect.

14 I'm just curious as to what factors, what  
15 purchasing factors were primarily responsible for that shift  
16 in market share to your knowledge? Whether it was, you  
17 know, pulling away from the brand, or more price  
18 sensitivity. What entrance used to convince people to move  
19 away from the majors?

20 MR. SON: This is Cho from KT&G. [through  
21 translator] I understand your question is about the decrease  
22 in market share of the majors from 95 to 85, something like  
23 that? It's difficult for me to answer exactly what affected  
24 that decline. Other than that it has something to do with  
25 the overall whole decline in cigarette consumption.

1 MS. CHRIST: Thank you very much. I appreciate  
2 it. If there's any --

3 MS. KIM: Just confirming that the witness has  
4 finished his answer.

5 MR. CHO: [through translator] Yes, I did.

6 MS. CHRIST: Thank you, I was a little bit fast  
7 there. Appreciate the response. If there's anything else  
8 that you wanna add to any of these, obviously in the  
9 post-conference brief, very helpful. Now we'll turn to the  
10 last part. Mr. Secretary, let's proceed with the rebuttal  
11 and closing remarks.

12 MR. BURCH: Closing and rebuttal remarks on  
13 behalf of orders in support of imposition will be given by  
14 Daniel B. Pickard of Wiley Rein. Mr. Pickard you have 10  
15 minutes.

16 CLOSING REMARKS BY DANIEL B. PICKARD

17 MR. PICKARD: Good afternoon. Again, for the  
18 record, this is Dan Pickard of Wiley Rein. And as usual,  
19 I'd like to thank everybody for a fairly long day. And as  
20 usual, I'm going to strive to finish my closing remarks in  
21 under 10 minutes.

22 Frankly, there were a lot of statements that you  
23 heard this afternoon that are demonstrably, factually  
24 incorrect. And I don't plan on taking the next 10 minutes  
25 and debating them point by point. We will provide



1 supporting documentation and evidence to confirm these in  
2 our post-conference brief.

3           But I think what I'd like to do is leave you with  
4 just a couple of big picture thoughts. First off, in regard  
5 to the whole issue of domestic-like products. And as the  
6 staff is well aware, there is a decades long practice at the  
7 ITC of identifying sub-groups of industries. That is, there  
8 is no one U.S. steel industry -- I don't know what the total  
9 count is as far as pipe cases that there have been, but  
10 there's a recognition that there's no monolithic pipe  
11 industry that it gets broken down into parts.

12           The same is true for this industry and that is  
13 demonstrated by application of the Commission's traditional  
14 six factor test. So, in regard to fiscal characteristics  
15 and a 10 percent standard, we will be putting in some  
16 particularly sensitive proprietary information, but which  
17 will demonstrate and support what we've been saying all  
18 along.

19           In regard to customer and producer perceptions  
20 regarding if it's a different industry, consistent with what  
21 Mr. Jones was talking about, the largest trade industry  
22 breaks out fourth year as a different type of product.

23           In regard to different production processes, on  
24 top of everything else you've heard about the difference  
25 between integrated production processes and what's done by

1 the fourth tier, and we'll continue to provide the  
2 Commission with information in regard to this.

3 I'm not saying it's conclusive, but I was  
4 somewhat surprised if I understood some of the arguments  
5 that were made this afternoon that legal status under the  
6 NSA is essentially irrelevant for identifying an industry.  
7 The fact that there is a binding legal document that sets up  
8 distinct legal obligations for certain industry participants  
9 as compared to others, I would suggest is certainly at least  
10 relevant for defining an industry.

11 In regard to common manufacturing and facilities  
12 -- and I don't know if you get a brighter line than this.  
13 There is not one fourth tier manufacturing facility in the  
14 United States that makes non-fourth tier products. There is  
15 not one employee in the United States who makes fourth tier  
16 products and makes non-fourth tier products.

17 And I'm not saying that this is binding on the  
18 Commission, but these same arguments were made to the  
19 Department of Commerce by Respondents arguing that we did  
20 not have standing because there is no fourth tier industry  
21 that the Department of Commerce had to look at the entire  
22 industry as a whole. Those arguments were rejected.

23 The Department of Commerce initiated the case  
24 finding that there is a fourth tier industry and that my  
25 clients represent the vast majority of the industry. And

1 they also initiated, to the extent that it's relevant, at  
2 rates of up to 113 percent dumping.

3 In regard to channels of distribution, and we all  
4 continued putting information in regard to this. The  
5 argument to say that if the manufacturer sells to  
6 distributors, therefore all channels of distribution are the  
7 same is extraordinarily simplistic. If anything, the  
8 testimony offered actually by both Petitioners and  
9 Respondents in regard to EDLP programs further supports that  
10 non-fourth tier goes through certain channels where they've  
11 blocked out fourth tier production, and will continue to  
12 provide additional information in regard to wholesalers who  
13 only sell fourth tier products.

14 That being said, and directly in response to a  
15 question by Mr. Haldenstein, should you expand the  
16 domestic-like product for purposes of this preliminary  
17 determination, I think under American Lamb, yes you would be  
18 compelled to go to a final investigation because you would  
19 not then have domestic producer questionnaires for the vast  
20 majority of the companies that Respondents are arguing are  
21 industry participants.

22 Obviously, we don't believe that you have to get  
23 there. And I understand why they're trying to expand the  
24 domestic-like products right? They are trying to dilute  
25 market share because otherwise, if you look at the scope as

1 initiated, and if you have domestic-like product definition  
2 coextensive with the scope, you're going to be looking at  
3 these essentially four producers and what happened to their  
4 performance over the past three years, and what have you  
5 seen.

6           And it's -- I don't think anybody is going to  
7 contest again, a massive surge in imports, really starting  
8 from '17 to '18 and then jumping up a quantum level from '18  
9 to '19 where imports increased by more than 50 percent and  
10 took market share away from the domestic industry.

11           And further, I'm not going to repeat all of our  
12 arguments in regard to threats, but I think there is  
13 compelling evidence in regard to this large producer who has  
14 surged as the U.S. market at lower prices.

15           The last thing I would ask you -- the last thing  
16 I would leave you with is -- and again, I'm not suggesting  
17 that this is conclusive. But where is the reality check?  
18 If fourth tier brands aren't a thing, if that doesn't mean  
19 something to consumers, right, why would you say that your  
20 product is one of the best fourth tier selling brands?

21           I think just kind of a common sense  
22 interpretation of that means fourth tier must mean  
23 something, right? Otherwise, why would you advertise that  
24 to your customers? That being said, I am barely under 10  
25 minutes and thank you again for everybody's time and

1 attention.

2 MR. BURCH: Thank you Mr. Pickard. Rebuttal and  
3 closing remarks on behalf of those in opposition of  
4 imposition will be given by Shara L. Aranoff of Covington  
5 and Burling. Ms. Aranoff you have 10 minutes.

6 CLOSING REMARKS BY SHARA L. ARANOFF

7 MS. ARANOFF: Good afternoon everyone. You've  
8 just heard from our panel at length, so I'll try to sum up  
9 briefly, not use 10 minutes. Let's see, so you've just  
10 heard that there's no such thing as a monolithic cigarette  
11 industry. Well, I don't think I have to tell you that  
12 cigarettes are not steel, but well -- cigarettes are not  
13 steel.

14 In order to have a distinct-like product, you've  
15 got to have a clear and dividing line and Petitioner has  
16 danced around that all day. They still haven't, you know,  
17 except for stems, exactly what is clear.

18 Mr. Pickard said this morning during Petitioner's  
19 panel presentation that he understands that a Petitioner  
20 needs to have a physical, measurable difference between  
21 fourth tier and everything else.

22 But what is that difference? Well, he says the  
23 NSA is very clear. I agree. The NSA is very clear about  
24 who is there, in supporting manufacturer and who is the  
25 non-participating manufacturer? Read one it's not clear

1 about. It's not clear about what product characteristics an  
2 original participating manufacturer or a non-participating  
3 manufacturer has in their product.

4           And it's not clear about what price the product  
5 sells at. So, is it clear? Yes. Will it tell you anything  
6 about a clear dividing line for like-product purposes? No.  
7 Mr. Pickard says no fourth tier producer makes non-fourth  
8 tier product. Well, that makes a question. None of the  
9 four producers that Petitioner says are fourth tier domestic  
10 producers apparently makes non-fourth tier products.

11           But two things -- number one, they could. The  
12 NSA and the FDA regulations don't preclude them from doing  
13 so, so that's a choice. But number two -- it begs a  
14 question of what fourth tier means. What criteria did  
15 Petitioner use to decide that those can be only made for  
16 fourth tier producers and that you know, they're distinct  
17 from everyone else. So, it's circular again. We keep  
18 coming back to it.

19           You need a physical measure of difference between  
20 a fourth tier and others. And Mr. Pickard harps on the fact  
21 that KT&G and other producers do use the term fourth tier in  
22 their advertising and on their websites, and in, you know,  
23 water cooler conversations.

24           That's true. And as Mr. Smith told you earlier,  
25 our understanding is that it let's the idea that there are

1 tier products that are at the low end of the continuum in  
2 the overall market for cigarettes. What it doesn't reflect  
3 is any particular physical characteristics of the product.  
4 It's just about whether it's relatively higher or relatively  
5 lower priced.

6           So, I think one important thing to remember here  
7 too is that in trying to set out these distinctions and  
8 create a clear dividing line, we don't think the Petitioners  
9 have yet shown, a lot of the examples that are given are  
10 describing the extremes of the product continuum -- what's  
11 going on for a very premium product and what's going on, you  
12 know, at the low end of the discount scale and ignoring the  
13 fact that there are in fact, gradations all between --  
14 gradations of price.

15           So, one example we wanted to give is Legit.  
16 Legit is an SMA, that joined the MSA after the original  
17 member, so it's at that third category. It does have  
18 primary blending production, but it also sells its product  
19 at a deep discount. So, does that put them in the fourth  
20 tier? No. Petitioner says not, but you know, what's the  
21 distinction?

22           So, I think we probably said all that we can say  
23 on the like product issue. We simply don't see any clear  
24 dividing lines. We think the correct like product and the  
25 correct domestic industry is all cigarettes. We think

1 that's manageable, it's not like saying all steel.

2           And we know that we have been light on our  
3 conditional volume pricing impact arguments in the course of  
4 today's conference, for which we apologize. We are one  
5 company, a foreign industry, and so a lot of that  
6 information is proprietary, and we promise you that we will  
7 have a longer discussion in our post-conference brief. We  
8 thank you all very much for your time today.

9           MS. CHRIST: Thank you very much. On behalf of  
10 the Commission and the staff, I would like to thank the  
11 witnesses who came here today, as well as counsel, for  
12 helping us to gain a better understanding of the product and  
13 conditions of competition in the fourth tier cigarettes  
14 industry.

15           Before concluding, please let me mention a few  
16 dates to keep in mind. The deadline for submission of  
17 corrections to the transcript and for submission of  
18 post-conference briefs, is Monday, January 13th.

19           If briefs contain business proprietary  
20 information, a public version is due Tuesday, January 14th.  
21 The Commission has tentatively scheduled its vote on this  
22 investigation for Friday, January the 31st, and will report  
23 its determination to the Commission -- to the Secretary of  
24 the Department of Commerce on Monday, February 3rd.

25           Commissioner's opinions will be issued Monday,



1 February 10th. Thank you all for coming. The Conference is  
2 adjourned.

3 (Whereupon, the Preliminary Conference adjourned  
4 at 4:06 p.m.)

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## CERTIFICATE OF REPORTER

TITLE: In The Matter Of: 4<sup>th</sup> Tier Cigarettes from Korea

INVESTIGATION NO.: 731-TA-1465

HEARING DATE: 1-8-20

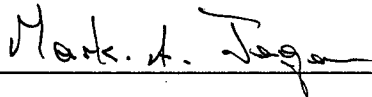
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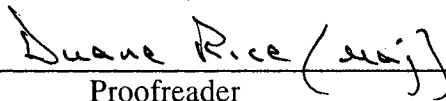
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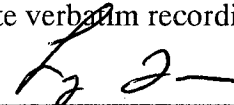
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