

Bondholders Beware

A Review and Analysis Of The
Washington Tobacco Settlement Authority
Tobacco Settlement Asset-Backed Bonds, Series 2002
Public Offering Prospectus Dated October 25, 2002

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Sections And Content Summary

Preface: The sole and exclusive source of revenue to service Washington tobacco settlement asset-backed bonds is receipt of its proportionate share of 1998 tobacco Master Settlement Agreement (MSA) payments by the State of Washington. The source of MSA payments is defined by language in the MSA to be exclusively tobacco company domestic sales because international tobacco affiliates, non-tobacco affiliates, and holding companies that are not signatories to the MSA are not responsible for MSA payments. An important MSA term that defines responsibility for MSA payments is described in the Washington tobacco bond prospectus, page 16:

“The MSA expressly provides that the obligations of each PM are not the obligation or responsibility of any affiliate of such PM and, further, that the remedies, penalties or sanctions that may be imposed or assessed in connection with a breach or violation of the MSA will apply only to the PMs and not to any other person or entity.”

Terms in the MSA that support the prospectus’ statement can be found in Section VII. (d), “Applicability.” A copy of the MSA is included with the prospectus. MSA terms were crafted so the economic burden of the tobacco settlement falls exclusively on tobacco consumers, presumably to maximize the impact of cigarette price increases on smokers and impose a financial incentive to quit smoking.

For example, in the case of Philip Morris only Philip Morris USA as a signatory to the MSA is responsible for MSA payments. Its parent holding company Altria Group is not responsible for MSA payments, nor are Philip Morris’ food affiliates Kraft Foods and Nabisco Brands, nor is Philip Morris International responsible for MSA payments. April 9, 2003 *The Seattle Times* reported in “Judge Might Give Philip Morris Break On Bond,” that Illinois Judge Nicholas Byron (who ordered Philip Morris post a \$12 billion appeal bond) said “Altria isn’t obligated by any decision in this court.” Philip Morris USA exclusively bears the economic burden of MSA payments.

We therefore arrive at the statement on page 15 of the prospectus which says:

“The settlement represents the resolution of a large potential financial liability of the PMs [Participating Manufacturers] for smoking-related injuries, the costs of which have been borne and will likely continue to be borne by cigarette consumers.” (Underline, bracket added.)

We also arrive at a source of revenue to support MSA payments that is *uniquely and exclusively focused on tobacco consumers to provide funds that service obligations to Washington tobacco bondholders*. Those revenues are only provided by persons who purchase cigarettes and other tobacco products. In light of that unique focus, what has influenced, may influence, or is intended to influence tobacco consumer behavior of purchasing cigarettes is directly material to bondholder risk disclosures that must be included in the public offering prospectus.

1. Recent Events Background: Recent events concerning tobacco companies ability to make tobacco Master Settlement Agreement payments raise questions that effect tobacco settlement asset-backed bondholders. Those events give rise to a need for careful examination of results produced by tobacco control intervention. *Page 1*

2. Youth Smoking: Under Project ASSIST interventions youth daily smokers increased 43 percent 1992 to 1997, and smoking persistence increased as well. As of 2002 there are more youth daily smokers than before tobacco control began its interventions. Youth are not “beneficiaries” of tobacco control since 1991, they have been and are being systematically abused and exploited by it. *Page 2*

3. Adult Tobacco Use: Today, adult prevalence statistics show a stabilization of adult Current Smoker populations and a decrease in Former Smokers since 1990. There is a new smoking persistence that did not exist before Dr. Koop’s 1988 report that declared nicotine to be addictive was published. Tobacco control advocates have aggressively promoted the concept that nicotine is as addictive as heroin or cocaine, or more so. States exploit new smoking persistence through MSA payments and new taxes. *Page 3*

4. Youth And Adult Tobacco Use Overview: Net results under tobacco control initiatives are increased youth and adult smoker populations compared to 1990 before tobacco control began. *Page 4*

5. A Brief History Of Tobacco Control: In Washington, recommendations for use of MSA funds are made by the Attorney General’s Tobacco Control and Prevention Task Force. Senior members of the task force are by and large the same people who supervised tobacco control interventions during the 1990s. *Page 5*

6. Dependence On Tobacco Consumers: As stated in the Washington tobacco bond prospectus, the costs of the MSA have been borne and likely will continue to be borne by tobacco consumers. Tobacco bond service is dependent on MSA payments. What has influenced, is intended to influence, or reasonably may influence tobacco consumer behavior is therefore relevant to bond investors' ability to assess the risks of their investment and is material information that must be included a public offering prospectus. *Page 5*

7. Undisclosed Effects Of Tobacco Control Intervention: After a decade of Project ASSIST and MSA tobacco control influence Current Smoker populations have not materially changed *but that population is consuming fewer tobacco products*. Tobacco control advocates have a current published goal to reduce the prevalence of cigarette smoking among adults to 12 percent or less (a 50 percent decline) by 2010. What occurs with tobacco company revenues, and therefore funds to make MSA payments and to service tobacco bonds, if that goal is achieved and remaining smokers purchase fewer tobacco products? For declines in tobacco consumption to exceed the most extreme worst case stress scenario set forth in Appendix A all that would need to occur is for tobacco control advocates to achieve one-half of their stated goal for decline in adult smoking prevalence. Current tobacco control published goals and their potential consequences on tobacco consumption are not addressed in the prospectus. *Page 6*

8. Undisclosed Tobacco Control Agendas: What purpose would be served by a several-hundred-million-dollar nationwide tobacco control intervention that stabilized the number of Current Smokers but resulted in those consumers purchasing fewer cigarettes? Such an intervention would preserve the number of prospective customers for smoking cessation products, while reflecting the extent to which "Tobacco Free" nicotine products are successfully substituted for tobacco nicotine products. The Washington tobacco bond prospectus does not discuss the vested interests and motivations for tobacco control advocates to aggressively promote the substitution of "Tobacco Free" pharmaceutical nicotine products for tobacco nicotine products. By failing to discuss that subject the prospectus' Appendix A omits mention of a material competitive force to tobacco company revenues. *Page 9*

9. Bondholders In The Breach: Through bond rating downgrades the interests of tobacco bondholders have been damaged because the price of their bonds declines to produce higher yields that reflect increased risk. Current reports say that tobacco bondholders face grim prospects: the principal value of their bonds has declined to produce higher yields, costs to hedge existing tobacco bond positions have increased, and they face increased risk for timely payment of interest and principal due to cash flow drains that new tobacco verdicts impose. *Page 12*

10. Washington Tobacco Bond Prospectus Requirements: Initial Public Offering of securities are subject to the Securities Act of 1933. Exemption from registration does not equal exemption from compliance with the act's requirements or SEC rules. The act requires full and fair disclosure of material information to prospective investors. That requirement includes omissions of material information, as well as misstatements. SEC rule 10 (b)(5) prohibits misstatements or omissions of material information in connection with the purchase or sale of a security.

The scope of 1933 act and SEC rule requirements is that not only must statements that are made in a prospectus be truthful and accurate for purposes of reliance by investors, but also that material information cannot be withheld. When evaluating a prospectus and offering materials is not sufficient to merely analyze what was said or forecast, one must also examine whether material information was withheld, as well.

Material information regarding tobacco control advocacy is not fully or fairly discussed in Appendix A, nor does the forecast properly consider material effects of tobacco control advocacy on tobacco consumption. Moreover, statements by public officials regarding the efficacy of tobacco control programs often misrepresent the effects of tobacco control advocacy, which further misleads investors because they believe facts about consequences of anti-tobacco programs that are frequently slanted for political reasons. *Page 13*

11. A Materially Different Cigarette Market: At least three primary issues indicate that the tobacco market at the time the Washington tobacco bond prospectus was issued was materially different than historical markets on which cigarette consumption forecasts were based. *Page 15*

12. Appendix A Tobacco Consumption Forecasts: Per capita cigarette consumption fails three regression tests based on historical trends: in all three cases per capita consumption is negative (below zero) before 2032. Total cigarette consumption fails two of three regression tests based on historical trends because those trends produce negative or sharply lower cigarette consumption by 2032. *Page 16*

13. Prospectus Facts Relied On: Eight statements from Appendix A that are relied on in conclusions about Appendix A and its tobacco consumption forecasts. *Page 18*

14. Conclusions Regarding Washington Tobacco Bond Prospectus: Conclusions in this report focus on four subject areas: *Page 19*

1.0 Tobacco Control Goals: The Washington tobacco bond prospectus and its Appendix A omit material information about current tobacco control goals. The information omitted would reasonably influence a purchaser's risk analysis.

2.0 Effectiveness Of Tobacco Control: Tobacco control programs have not been effective. Statements to that effect are both false and materially misleading. The effect of such false and misleading statements is to lull prospective bond purchasers as to the true risks of their investment.

3.0 Competitive Nicotine Products And Conflicts Of Interest:

3.1 Competitive Nicotine Products: Non-tobacco products aggressively compete for tobacco consumer's—nicotine consumer's—dollar. None of those products existed in tobacco nicotine markets 1965 to 1980. Not only is today's nicotine market materially different as to underlying economic structure, but there are now new competitive nicotine products that divert nicotine consumer's dollars away from those that support MSA payments. The prospectus and Appendix A are wholly insufficient in disclosure of and discussion about the fact and consequences of those products.

3.2 Conflicts Of Interest: It is apparent that serving the vested interests of tobacco control advocates' financial sponsors conflicts with the interests of tobacco bondholders and that such activity has had a demonstrable effect on smoking prevalence and total tobacco consumption. Tobacco control advocate conflicts of interest are not disclosed or discussed in the Washington tobacco bond prospectus.

4.0 Forecast Projections: The forecasts contained in Appendix A do not represent the current tobacco market and the forecasts materially understate likely future rates of decline in tobacco consumption.

In March 2003 Madison County, Illinois Circuit Court Judge Nicholas Byron ordered that Philip Morris post a \$12 billion bond to appeal a verdict against the company. Judge Byron previously awarded \$10.1 billion in damages, including \$3 billion in punitive damages. On March 27, 2003 Philip Morris notified states by letter that “. . . it is presently uncertain whether Philip Morris USA will be able to make the Section IX(c) payment on April 15.” Philip Morris cited the \$12 billion appeal bond as the reason it was uncertain whether the company could make its \$2.5 billion April 15 Master Settlement Agreement (MSA) payment.

April 7, 2003 Washington Attorney General Christine Gregoire issued a news release stating that she and 36 other state attorneys general had filed a brief with the trial court. The brief asked Judge Byron to consider public health consequences around the nation when he set the appeal bond. Excerpts from the attorneys general brief appear in the box below.

Attorney General Gregoire’s press release said “The Attorneys General emphasized in the brief they are not seeking to protect the interests of Philip Morris, but ‘the interests of innocent third parties—the states themselves and their citizens, including their young people, who are the beneficiaries of the state programs supported by the payments that are threatened.’”

As noted in 4. below, the attorneys general brief also addressed tobacco settlement asset-backed bondholders. Interest and principal payments on those bonds are to be made from MSA revenues.

Philip Morris resolved the appeal bond issue by depositing in escrow a preexisting \$6 billion term note from its parent Altria Group and agreeing to deposit an additional \$800 million with the court in four equal quarterly installments.

Attorneys general intervened to protect the financial interests of Philip Morris, and that intervention resulted in court action beneficial to the company. Moreover, the court reduced the

appeal bond by an amount sufficient to accommodate Philip Morris’ payment to Settling States, and the court adopted receiving a portion of the bond in future cash flows as recommended by attorneys general (see 5. below.) It is also noted that Settling States and Philip Morris are tobacco sales revenue sharing partners under the MSA. A partner would intervene on behalf of another’s financial interests under such circumstances.

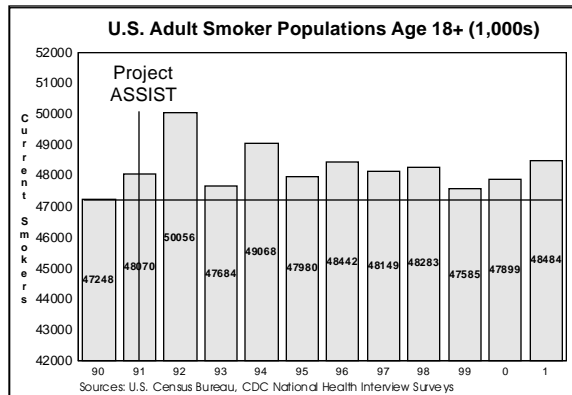
Settling States made themselves financially dependent on the MSA revenue partnership by executing the agreement. That an intervening partner has the clout of 37 state attorneys general merely demonstrates Philip Morris’ political prowess and the extent to which tobacco consumers are not represented by their attorneys general.

The attorneys general brief focuses on the need for funds to continue tobacco control programs, cites the success of such interventions, and pleads the interests of youth in receiving funds to continue them. Considering that emphasis in the brief, the extent to which tobacco control has produced beneficial results to date merits careful examination. \$18 billion in bondholders

financial interests also rest on MSA payments, which provides additional reason to thoroughly review the influence of tobacco control.

In this commentary we first examine the influence of tobacco control on youth smoking and adult tobacco use, and then discuss that information in context of the Washington tobacco bond prospectus and its forecasts.

To what extent has tobacco control truly produced beneficial results? In what manner have tobacco control interventions influenced tobacco consumption?



“Brief Of Amici Curiae” In The Circuit Court Third Judicial Circuit Madison County, Illinois Claim No. 00-I-112

1. “The States have a strong interest in preserving the value of the settlements they fought for and won, and the results in this lawsuit should not prejudice those settlements.” Page 3

2. “NCSL’s [National Conference of State Legislatures] interest in this case is in protecting state finances during the most difficult state budget period in fifty years.” Page 2

3. The States’ objective is to ensure that Philip Morris meets all its legal obligations to consumers and to public entities. . . . The States seek to permit the appellate process to go forward without endangering the payments that are due the States.” Page 4

4. “Where MSA payments have been pledged to service bonds, a delay in payment could adversely affect the interests of bondholders.” Page 4

5. “For example, this court might consider whether cash flows that will become available to Philip Morris during the pendency of the appeal might be accessed gradually during the course of the appeal to provide security for the plaintiffs rather than to require the immediate posting of the entire bond.” Page 5

6. “Since the MSA was executed, tobacco usage in the United States has declined substantially, and underage tobacco usage has

declined by an even greater percentage, reversing a decade of increases.” Page 6

7. “At a time when severe financial crisis has already caused many states to cut budgets for important programs, failure of states to receive such payments promptly would severely threaten public health and safety programs in numerous States and undermine the progress in reducing youth smoking that has been made since the MSA was executed.” Page 7

8. “. . . the States are not seeking to protect the interests of a wrongdoer; rather, they seek to protect the interests of innocent third parties—the States themselves and their citizens, including their young people, who are beneficiaries of the State programs supported by the payments that are threatened.” Page 10

9. In the state of Washington, which has an active Tobacco Control and Prevention program funded primarily by MSA payments, a survey of 137,000 students conducted in 2002 showed sharp declines in youth smoking, far in excess of the national average.” Page 13

10. “Not only is it vital for States to receive Philip Morris’ payment, but any substantial delay in the receipt of that payment would be severely prejudicial to the States.” Page 16

Youth Smoking

Attorneys general stated in their brief to the Madison County, Illinois Circuit Court (see excerpt 6.): "Since the MSA was executed, tobacco usage in the United States has declined substantially, and underage tobacco usage has declined by an even greater percentage, reversing a decade of increases."

The above statement is technically correct as to its precise content, but it is also materially misleading by what it fails to mention. Principal among its omissions is that compared to a previous period that was not influenced by tobacco control intervention (1977 to 1982) the present decreasing trend in youth smoking (1997 to 2002)—with a 67 percent increase in cigarette cost—is less than that two decades ago, when tobacco companies reduced cigarette costs 5.5 percent.

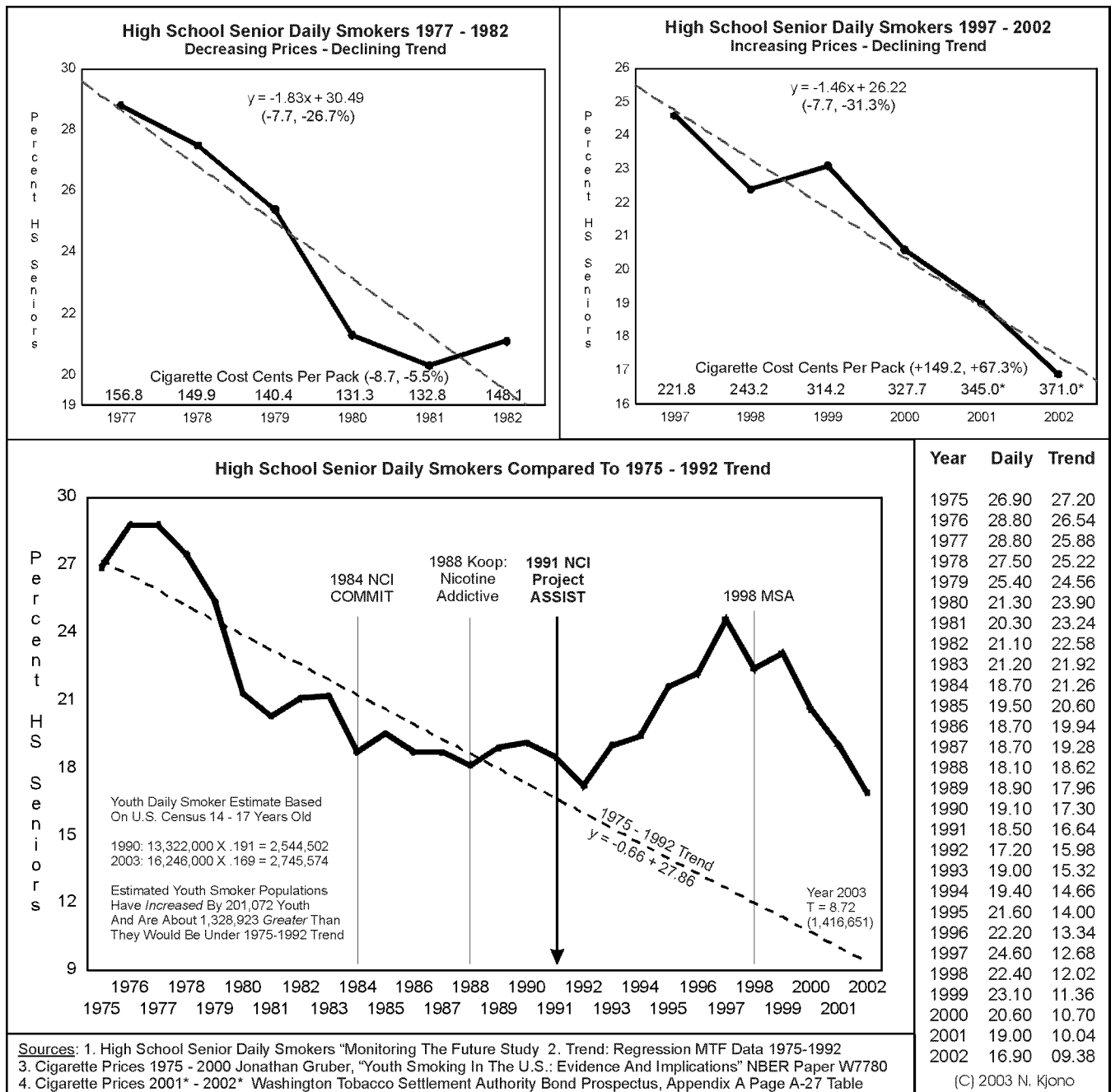
Tobacco control intervention 1997 to 2002 produced the same percentage point decline in High School Senior Daily

Smokers with a 67 percent increase in the price per pack of cigarettes as occurred 1977 to 1982 with a 5.5 percent decrease in cost. Tobacco control interventions under the MSA exploit a new youth cigarette price tolerance that did not exist before anti-tobacco began.

Historic data present a troubling perspective: from 1975 to 1992 the trend for youth daily smokers was -0.66 percent per year, but under Project ASSIST (American Stop Smoking Intervention Study) that trend sharply reversed and youth smoking prevalence increased 43 percent 1992 to 1997.

As of 2002 16.9 percent of high school seniors were daily smokers, compared to what should be 9.38 percent under the 1975 to 1992 trend. Since Project ASSIST began in 1991 youth daily smoker populations increased 9.0 percent to 2002.

Based on the data I conclude as a father that youth are not "beneficiaries" of tobacco control intervention, they have been and are being systematically abused and exploited by it.



Adult Tobacco Use

Adult smoking data in the Centers for Disease Control and Prevention's "National Health Interview Surveys" dates back to 1965, immediately after the first U.S. Surgeon General's report that linked smoking to cancer was published.

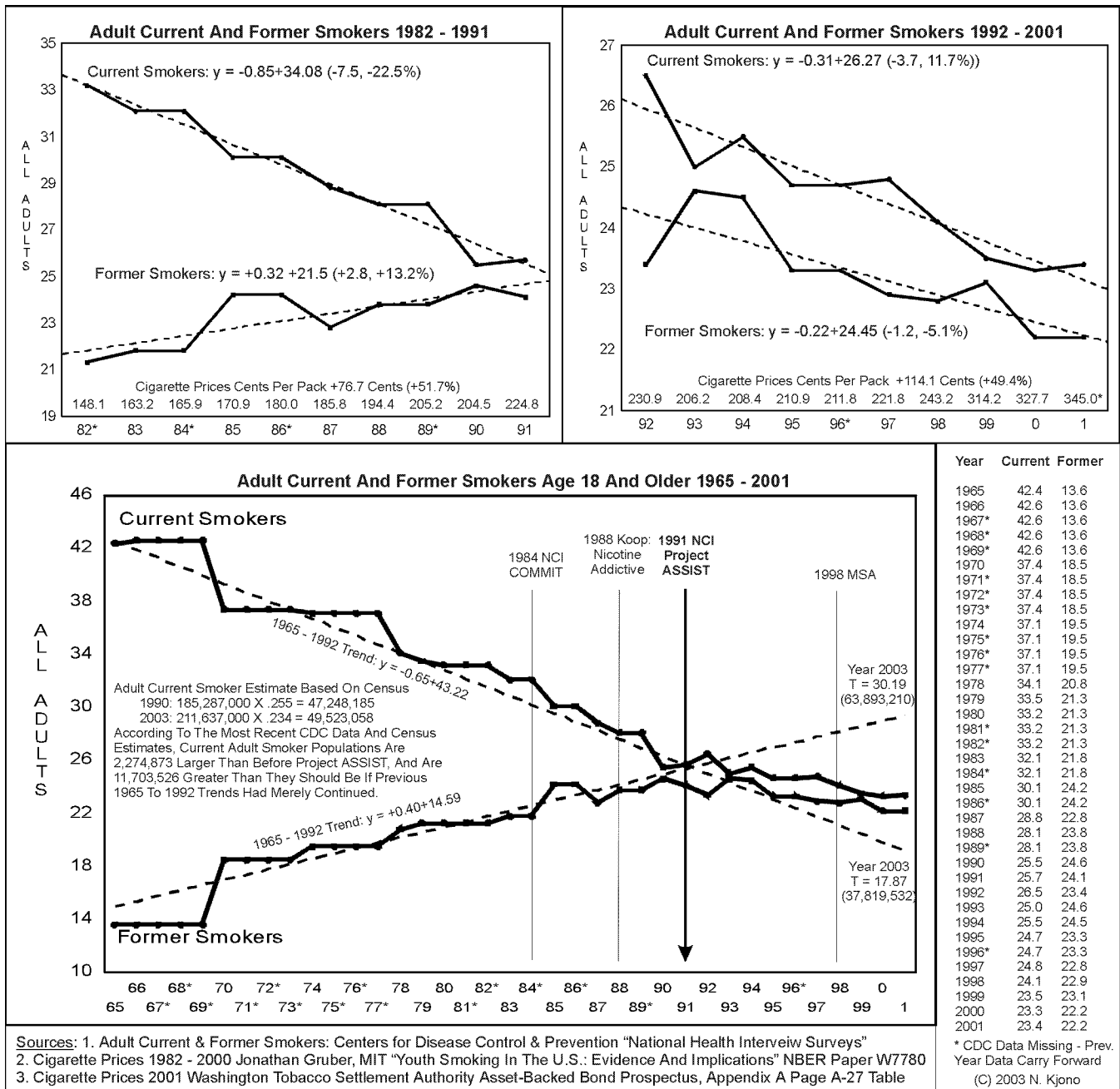
1965 to 1992 adult Current Smokers declined -0.65 percent per year and Former Smokers increased +0.40 annually. 42.4 percent of adults were Current Smokers in 1965. The year before Project ASSIST began its intervention strategies in 1993 26.5 percent of adults were Current Smokers. 1992 was the year that the two trends would cross over, where there would be more Former Smokers than Current Smokers. Had those twenty-seven-year trends merely continued, today about 30 percent of the adult population would be Former Smokers and only 18 percent would be Current Smokers.

That trend crossover did not occur. Under Project ASSIST and the MSA 1992 to 2001 the rate of decline in adult

Current Smokers reduced to less than half of its preceding trend (-0.31 percent per year versus 1965 to 1992 trend of -0.65) and the Former Smoker trend *reversed* to negative (-0.22 percent per year.) Not only did the rate of decline in Current Smokers reduce by half, but *fewer smokers are quitting under the MSA* than before tobacco control began.

Comparing nine year periods before and after Project ASSIST yields startling information. 1982 to 1991 adult Current Smokers declined by -0.85 percent per year and Former Smokers increased +0.32 percent per year. During ASSIST and MSA years 1992 to 2001 Current Smoker trend decline is only -0.31 and the Former Smoker trend *reversed* to -0.22.

Today adult prevalence statistics show a *stabilization* of adult smoker populations, restoring a previously-declining tobacco market. That stabilization has occurred *with a 49 percent increase in cigarette cost*, which implies significant adult smoking persistence. States exploit that smoking persistence through MSA payments and new cigarette taxes.



Youth And Adult Tobacco Use Analysis Overview

Tobacco settlement payments are based on market share portion of fixed payment amounts specified in the MSA. While the fixed payments are subject to several adjustments, the basis for the initial allocation is market share. The scheduled payments are derived from nationwide tobacco product sales and the allocation between tobacco companies is based on national market share. The appropriate statistical measures are therefore nationwide youth and adult prevalence figures and total national tobacco consumption.

The primary nationwide tobacco control intervention program was federal Project ASSIST, announced October 1991. That intervention was followed by an economic tobacco-revenue distribution agreement as set forth in the MSA. Both Project ASSIST and the MSA are nationwide tobacco control initiatives, so nationwide smoking prevalence data are again indicated to be the appropriate measure. The Washington tobacco bond prospectus also uses nationwide data.

The nature of Project ASSIST and the MSA, as well as the basis for tobacco company MSA payments, incorporate diversity of states because they are inherently nationwide.

The first two years of Project ASSIST were planning years. The program's first "Action Plans" were published October 1993. The tobacco settlement (MSA) is dated November 1998.

Critical analysis dates are therefore 1991, 1993 and 1998 when measuring benefits and/or consequences of tobacco control intervention and revenue distribution. Preceding base lines for those critical analysis years are 1990, 1992 and 1997.

Presently available data for youth and adult smoking prevalence are the University of Michigan's "Monitoring The Future Study" (MTF) 2002 data for youth, and 2001 adult smoking prevalence data from the Centers for Disease Control and Prevention's (CDC) "National Health Interview Surveys" (NHIS). MTF High School Senior Daily Smokers is used for youth smoking data. Two measures from CDC NHIS data are applied: Current Smokers and Former Smokers.

Two additional variables are applied to youth and adult data for purposes of this analysis: U.S. Census Bureau (USCB) population estimates to estimate youth and adult smoker populations, and per capita tobacco consumption; U.S. Department of Agriculture (USDA) Total Tobacco Consumption is also used for various analysis measures.

A table of pertinent tobacco use statistics derived from the above-described data appears at bottom left on this page.

Youth Smoking: As of 2002, despite more than a decade of Project ASSIST and MSA interventions, we had more (+6.6%) youth smokers than base line year 1990, before ASSIST was announced. Since the MSA youth smoker populations have declined 28.9 percent, compared to base line year

1997. Under Project ASSIST youth smoker populations *increased* 49.8 as of 1997, compared to base line 1990. The net result of Project ASSIST and MSA interventions is *increased* youth smoker populations.

Adult Smoking: As of 2001 CDC data adult Current Smoker populations increased 2.6 percent compared to 1990. 1990 to 1997 adult Current Smoker populations increased 4.0 percent. Under the MSA adult Current Smoker populations declined 1.4 percent. Applying 2001 CDC adult prevalence to 2003 USCB population estimates indicates adult Current Smoker populations have *increased* 0.8 percent since the MSA. The net result of Project ASSIST and MSA interventions is *increased* adult Current Smoker populations.

Such results do not indicate "success" of either Project ASSIST or the MSA. Those results are charitably characterized as a public health disaster.

But where does the above data leave Washington tobacco bondholders? As will be shown, in a precarious position, despite increases in smoker populations.

Adult And Youth Tobacco Use Statistics							
Year	Total Consumption	Population	Prevalence	Number Smokers	Cons. Adj. (3%)	Adj. Consumption	Per Capita
DATA FOR: ADULTS 18 AND OVER							
1990	525,000,000,000	185,287,000	25.50	47,248,185	15,750,000,000	509,250,000,000	10,778
1991	510,000,000,000	187,042,000	25.70	48,069,794	15,300,000,000	494,700,000,000	10,291
1992	500,000,000,000	188,892,000	26.50	50,056,380	15,000,000,000	485,000,000,000	9,689
1993	485,000,000,000	190,737,000	25.00	47,684,250	14,550,000,000	470,450,000,000	9,866
1994	486,000,000,000	192,422,000	25.50	49,067,610	14,580,000,000	471,420,000,000	9,608
1995	487,000,000,000	194,249,000	24.70	47,979,503	14,610,000,000	472,390,000,000	9,846
1996	487,000,000,000	196,121,000	24.70	48,441,887	14,610,000,000	472,390,000,000	9,752
1997	480,000,000,000	198,180,000	24.80	49,148,640	14,400,000,000	465,600,000,000	9,473
1998	465,000,000,000	200,344,000	24.10	48,282,904	13,950,000,000	451,050,000,000	9,342
1999	435,000,000,000	202,491,000	23.50	47,585,385	13,050,000,000	421,950,000,000	8,867
2000	430,000,000,000	205,576,000	23.30	47,899,208	12,900,000,000	417,100,000,000	8,708
2001	419,000,000,000	207,197,000	23.40	48,484,098	12,570,000,000	406,430,000,000	8,383
	475,750,000,000	195,711,500	24.72	48,328,987			9,550
	31,275,989,192	6,897,761	0.96	750,055			638
					Statistical Mean		
					Standard Deviation		
DATA FOR: YOUTH AGE 14-17							
1990	525,000,000,000	13,322,000	19.10	2,544,502	509,250,000,000	15,750,000,000	6,190
1991	510,000,000,000	13,452,000	18.50	2,488,620	494,700,000,000	15,300,000,000	6,148
1992	500,000,000,000	13,703,000	17.20	2,356,916	485,000,000,000	15,000,000,000	6,364
1993	485,000,000,000	13,989,000	19.00	2,657,910	470,450,000,000	14,550,000,000	5,474
1994	486,000,000,000	14,492,000	19.40	2,811,448	471,420,000,000	14,580,000,000	5,186
1995	487,000,000,000	14,828,000	21.60	3,202,848	472,390,000,000	14,610,000,000	4,562
1996	487,000,000,000	15,213,000	22.20	3,377,286	472,390,000,000	14,610,000,000	4,326
1997	480,000,000,000	15,499,000	24.60	3,812,754	465,600,000,000	14,400,000,000	3,777
1998	465,000,000,000	15,518,000	22.40	3,476,032	451,050,000,000	13,950,000,000	4,013
1999	435,000,000,000	15,654,000	23.10	3,616,074	421,950,000,000	13,050,000,000	3,609
2000	430,000,000,000	15,743,000	20.60	3,243,058	417,100,000,000	12,900,000,000	3,978
2001	419,000,000,000	15,821,000	19.00	3,005,990	406,430,000,000	12,570,000,000	4,182
2002	404,400,000,000	16,047,000	16.90	2,711,943	392,268,000,000	12,132,000,000	4,474
	470,261,538,461	14,867,769	20.27	3,023,490			4,791
	35,558,695,538	931,886	2.25	448,952			933
					Statistical Mean		
					Standard Deviation		

Data Sources: 1. Total Consumption: U.S. Department of Agriculture 2. Population: U.S. Census Bureau 3. Adult Smoking Prevalence: CDC National Health Interview Surveys 4. Youth Prevalence: Monitoring The Future Study
Footnotes: 1. 3% cons. adj. allocates adults and youth per tobacco control estimate. 2. Statistical Mean and Std. Dev. Microsoft Foxpro.

The George H.W. Bush administration's seven-year \$135 million Project ASSIST (in which Washington was a Participating State) as announced October 1991 was the principal nationwide tobacco control intervention. The program was managed nationwide by the American Cancer Society (ACS) and received extensive support from the American Lung Association (ALA). Washington's tobacco control activities were carried out by the state health department through the Tobacco-Free Washington Coalition, of which ACS and ALA were members. Many of the program's activities were undertaken by ASSIST contractors such as Washington DOC, a Washington tobacco control advocacy group.

Senior members of tobacco control organizations also served as officers and managers of the Washington Tobacco-Free Coalition. For example, Dr. Robert Jaffe was the Executive Director of Washington DOC and the President of the Washington Tobacco-Free Coalition during the 1990s. Officers or managers of local ACS and ALA chapters were also members of the coalition.

In 1996 Attorney General Gregoire joined the growing list of state attorneys general who were suing tobacco companies to recover alleged Medicaid costs. Ms. Gregoire later became a leading national figure by negotiating the MSA with four major tobacco companies.

When the MSA was executed in November 1998 tobacco control began to operate through state health department programs funded by the MSA. In Washington, recommendations for use of MSA funding are made by the attorney general's Tobacco Prevention and Control Task Force. Senior managers of the tobacco control task force at the time the MSA was executed were by and large the same people who supervised Project ASSIST interventions through the Tobacco-Free Washington Coalition. For example, Dr. Jaffe of Washington DOC became a Co-Chair of the task force, and representatives from the American Cancer Society and the American Lung Association were appointed as task force members. The task force has operated since 1998 under the supervision of Attorney General Gregoire's office, continuing her direct and personal involvement with tobacco control initiatives. Members of the public who were not part of tobacco control organizations were excluded from task force membership.

The preceding history of tobacco control is important because the same people and the same special-interest advocacy groups that now claim "success" for their intervention programs are, by and large, those who presided over historic increases in youth smoking populations 1992 to 1997 and who participated in the stabilization of previously-declining adult smoker populations. Having managed programs that produced a 43 percent increase in youth smoking prevalence 1992 to 1997 those managers now bark self-accolades in press releases over a 31 percent decline in youth smoking rates 1997 to 2002.

Truthful and fair disclosure involves telling the whole story, not just the portion of the facts that make one look good. Perhaps ignoring nearly a decade of failure as one touts today's "success" is an acceptable standard for tobacco control press releases, but the quality of truth rises to a higher standard when making representations to the courts. Certainly the standards for full and fair disclosure in a prospectus include not omitting material facts that could influence an investor's decision.

Dependence On Tobacco Consumers

As set forth in the prospectus for the offering of \$517 million in Washington Tobacco Settlement Asset-Backed Bonds (see excerpts at center of this page), the costs of the MSA have been borne and likely will continue to be borne by tobacco consumers. What has influenced,

is intended to influence, or reasonably may influence tobacco consumer behavior is therefore relevant to bond investors' ability to assess the risks of their investment and is material information that must be included a public offering prospectus. Unfortunately, the Washington tobacco bond prospectus is little more forthcoming on material facts as to tobacco control influence on tobacco consumer behavior than was the brief filed by attorneys general with the Illinois trial court.

To receive interest and principal payments tobacco settlement bondholders are dependent on receipt of MSA payments by states that have issued such bonds. To meet MSA obligations tobacco companies are dependent on tobacco consumers continuing to purchase cigarettes. Given the mounting multi-billion-dollar judgements against tobacco companies their cash flow requirements will increase in the future. But what happens if a stable number of smokers buy *fewer* cigarettes per capita, while tobacco company cash flow demands increase?

The Washington Tobacco Settlement Revenue Bond Offering Prospectus

\$517,905,000 Tobacco Settlement Authority Tobacco Settlement Asset- Backed Bonds, Series 2002

Under "Summary of the MSA, Page 15:"

"The settlement represents the resolution of a large potential financial liability of the PMs [Participating Manufacturers] for smoking-related injuries, the costs of which have been borne and will likely continue to be borne by cigarette consumers. Pursuant to the MSA, the Settling States agreed to settle all their past, present and future smoking-related claims against the PMs in exchange for agreements and undertakings by the PMs concerning a number of issues." (Underline, brackets added.)

Prospectus statements confirm that tobacco companies do not bear the economic burden of the 1998 tobacco Master Settlement Agreement (MSA), *tobacco consumers do.* Attorneys general and tobacco company executives sat down at the bargaining table and decided how much consumers' money they would spend to satisfy their mutual interests. According to the Washington Tobacco Settlement Asset-Backed Bonds prospectus, page 58:

"In 1998 the average price of a pack of cigarettes in nominal terms was \$2.20. This increased to \$2.88 per pack in 1999, representing a nominal growth in the price of cigarettes of 30.9% from 1998. During 1999 consumption declined 6.45 percent. This was primarily due to a \$0.45 per pack increase in November 1998 to offset the costs of the MSA and the agreements with the previously Settled States."

According to Appendix A in the prospectus, 1998 to 2001 total tobacco consumption decreased from 465 billion cigarettes to 419 billion (-9.9%). During that same period CDC data say adult Current Smokers modestly decreased from 24.1 to 23.4 percent (-2.9%) and Former Smokers declined from 22.9 to 22.2 percent (-3.1%). Appendix A and CDC data for 1998 to 2001 present an interesting equation: during a period of aggressive cigarette price and tax increases a -2.9 percent decrease in the number of tobacco consumers equaled a -9.9 percent decrease in total tobacco consumption, *despite Former Smokers decreasing 3.1 percent. Each percentage point decrease in Current Smokers equaled a 3.41 percentage point decline in total tobacco consumption during that period.*

The above data suggests that a relatively stable Current Smoker population is purchasing fewer cigarettes. At a 3.4:1 ratio of percent decline in total tobacco consumption to percent decrease in Current Smokers the data are highly leveraged to the disadvantage Settling States and bondholders, both of whom are dependent on continuing cigarette sales to realize their economic goals.

Today's tobacco consumer market is materially different than before tobacco control interventions began in 1991. As noted below, the ratio of decline in tobacco consumption to decline in Current Smoker populations was only 0.87 (1/4th of the current ratio of 3.41) for the 1982 to 1991 decade that preceded the announcement of Project ASSIST.

After a decade of Project ASSIST and MSA tobacco control influence Current Smoker populations have not materially changed *but that population is consuming fewer tobacco products.*

That phenomenon is due in large part to tobacco control's aggressive emphasis on promoting pharmaceutical Nicotine Replacement Therapy products such as gums and patches, mandating smoking bans, and increasing the price of cigarettes. Those policy initiatives by tobacco control advocates have clearly had a material influence on the tobacco market and must be considered in any prospectus data that purport to project declines in tobacco consumption.

At the present ratio of 3.4:1, to stay within the 1.72 percent "Base Case Forecast" for decline in tobacco consumption stated on page A-25 of Appendix A in the Washington tobacco bond prospectus *adult smoking prevalence cannot decline more than 0.5 percent per year.*

The problem with that, however, is that according to a Centers for Disease Control and Prevention "Morbidity and

Mortality Weekly Review" (MMWR) dated April 11, 2003 [52(14);303-307] tobacco control advocates have published a clear and specific goal for adult smoking prevalence:

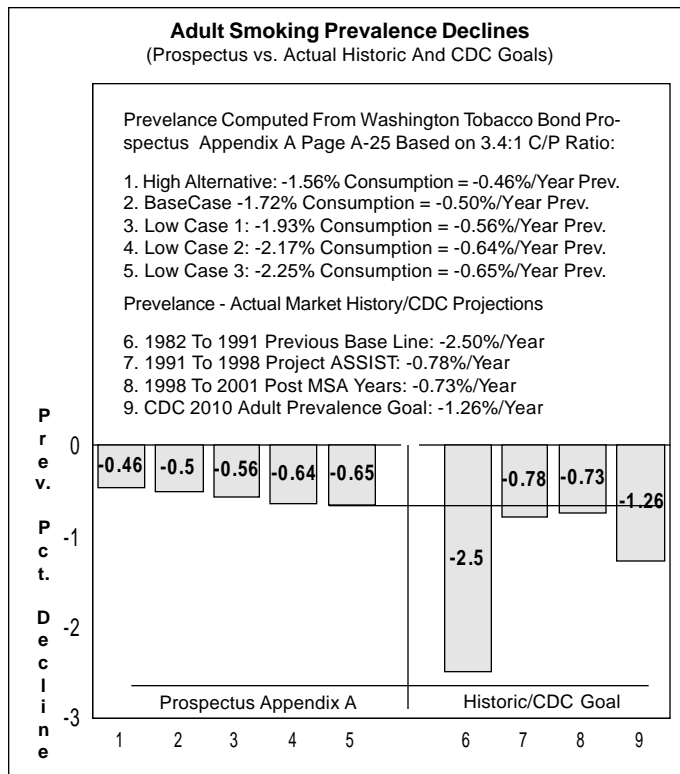
"One of the national health objectives for 2010 is to reduce the prevalence of cigarette smoking among adults to less than or equal to 12% (objective 27.1)"

The goal as stated above has been part of tobacco control's published literature prior to April 2003. For example, the same goal is stated in CDC's MMWR dated July 26, 2002 [51(29);642-645], three months before the prospectus date of October 2002. To accomplish that goal adult smoking prevalence must decline 11.4 percentage points from 2001 to 2010, or 1.26 percentage points per year over that nine-year period.

2001 adult prevalence was 23.4 percent, so the CDC goal requires a 48.7 percent decline in nine years, an average of 5.4 percent per year. Assuming linear decreases in consumption and prevalence, that decline is 140 percent greater than the "Low Case 3" stated on page A-25 of Appendix A.

At a 1998 to 2001 post-MSA ratio of 3.4:1 reduction in consumption for each percent decline in adult smoking prevalence the CDC goal implies total tobacco consumption declining at a rate of 4.3 percent per year, 91 percent greater than the "Low Case 3" on page A-25.

Comparative percent declines in adult Current Smoker populations based on the current ratio of 3.4:1 are



presented in the graphic at center. Those to the left are for the five projections under "Hypothetical Stress Scenario" on page A-25 of the Washington tobacco bond prospectus' Appendix A. The four to the right are for historical periods, post-MSA period, and future CDC tobacco control goals as described above. The calculations measure consumption volatility.

At the current 3.4:1 ratio of decline in consumption to decline in Current Smokers there are no projections that satisfy the decreases in tobacco consumption in the prospectus. The lowest actual historic decline in prevalence during Post MSA years of 0.73 percent per year is still 12.3 percent higher than that implied by the prospectus' worst "Low Case 3."

Were declines in adult smoking prevalence to return to their previous historic 1982 to 1991 trend of -2.50 percent before Project ASSIST, coupled with the current influence of tobacco control on reduction of cigarettes consumed by adult smokers, the percent decline in annual tobacco consumption would be 8.5 percent per year or 495 percent of the 1.72 percent per year "Base Case Forecast" in the prospectus.

Were adult smoking prevalence to drop to 17.87 percent of total adult population indicated by the 1965 to 1992 trend (see page 3.), at today's current ratio of 3.4:1 that implies a decline in tobacco consumption of -18.9 percent. A -18.9 percent decline in tobacco consumption presents a serious and sustaining risk to bondholders, even if it were to occur over a five year period. A five year decline of -18.9 percent is 3.78 percent per year, *219.8 percent of the projected 1.72 percent "Base Case Forecast" decline in total tobacco consumption as stated in Appendix A to the prospectus.*

In the 1994-1995 Project ASSIST "Action Plan" a "Goal To Success" was stated on page 2:

"To reduce tobacco use to 17 percent of the adult population by 1998."

As is evident from the preceding adult Current Smoker data Project ASSIST never came within shouting distance of that goal. So which will it be? Will tobacco control advocates and programs again fail to achieve their published goals, or will tobacco bondholders watch tobacco sales revenues evaporate from their interest and principal payments at a rate of 250 percent greater than projected as a "Base Case Forecast" in the prospectus that they relied on?

My personal view is that tobacco bond holders should fervently pray anti-tobacco programs are equally inept at accomplishing their future goals as they have been in the past.

What would it take for tobacco consumption declines to exceed even the most extreme stress scenario stated in Appendix A to the Washington tobacco bond prospectus on page A-25? Tobacco control advocates would merely need to accomplish one-half of their stated and published goal to reduce adult smoking prevalence to 12 percent by 2010.

Unfortunately, the Washington tobacco bond prospectus does not thoroughly discuss tobacco control advocacy, let alone disclosing that tobacco control's stated goals could devastate bond service revenue. The subject is discussed on pages A-11 to A-16 of the prospectus' Appendix A, however comparative time periods are not provided to assess program impact.

Prospective bondholders are entitled to material information that if tobacco control advocates were to accomplish their goals by 2010, based on current market influences of tobacco control programs *tobacco consumption could decline by percentages in excess of those set forth in the prospectus.*

We can express the relationship between tobacco consumption and adult smoking prevalence as the ratio of percent change in total consumption to percent change in adult Current Smoker prevalence in absolute values (C/P Ratio.) Annual C/P Ratio computations for the period from the year Project ASSIST was announced in 1991 to most recent CDC Current Smokers 2001 data are presented in the table at bottom of this page. Current Smoker data for 1996 (*) are not available from CDC and that year shows no change in USDA Total Tobacco Consumption on page A-30 in Appendix A. Consequently, that year shows zero change for each data item.

During Project ASSIST years 1991 to 1998 the C/P Ratio shows a decline, particularly 1992 to 1995. 1993 to 1995 show a small increase in tobacco consumption, despite the number of Current Smokers modestly decreasing from 25.0 to 24.7 percent. In contrast, 1998 to 2001 show higher C/P Ratios, indicating a greater consumption volatility. Clearly there was a change in tobacco consumer behavior after the MSA as compared to Project ASSIST years preceding the MSA. The data indicate that during Project ASSIST intervention years tobacco consumption modestly increased despite a small decrease in current smokers and that since the MSA there are significant and sustaining decreases in tobacco consumption by a stable Current Smoker population.

There are three periods that can be analyzed for comparative C/P Ratio results:

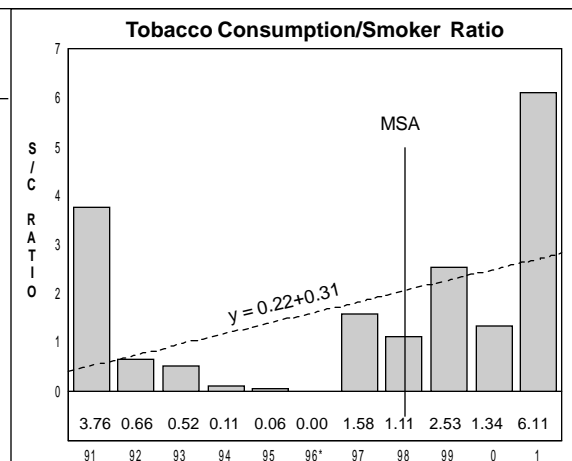
1. 1982 to 1991: A base line prior to Project ASSIST.
2. 1991 to 1998: Project ASSIST years.
3. 1998 to 2001: Post-MSA years:

1982 to 1991: Tobacco Consumption decreased from 634.0 billion cigarettes to 510.0 billion (-19.5%), while Current Smokers declined from 33.2 to 25.7 percent (-22.5%). The C/P Ratio for that period is 0.87.

1991 to 1998: During Project ASSIST years tobacco consumption decreased from 510.0 billion cigarettes to 465.0 billion (-8.82%), while Current Smokers declined from 25.7 to 24.1 percent (-6.2%). The C/P Ratio for that period is 1.41, a 62 percent increase in tobacco consumption volatility compared to the preceding base line years.

1998 to 2001: For post-MSA years to date as noted above the C/P Ratio is 3.41, which is a 142 percent increase compared to Project ASSIST years and a 292 percent increase over base line years 1982 to 1991. C/P Ratios show a marked increase 1997 to 2001.

	Tobacco Consumption			Current Smokers			C/P Ratio
	Total	Chg.	% Chg.	Pct.	Chg.	% Chg.	
1991	510.0	-15.0	-2.94%	25.7	+0.2	+0.78%	3.76
1992	500.0	-10.0	-2.00%	26.5	+0.8	+3.02%	0.66
1993	485.0	-15.0	-3.09%	25.0	-1.5	-6.00%	0.52
1994	486.0	+1.0	+0.21%	25.5	+0.5	+1.96%	0.11
1995	487.0	+1.0	+0.21%	24.7	-0.8	-3.24%	0.06
1996*	487.0	+0.0	+0.00%	24.7	+0.0	+0.00%	0.00
1997	480.0	-3.0	-0.63%	24.8	+0.1	+0.40%	1.58
1998	465.0	-15.0	-3.22%	24.1	-0.7	-2.90%	1.11
1999	435.0	-30.0	-6.45%	23.5	-0.6	-2.55%	2.53
2000	430.0	-5.0	-1.16%	23.3	-0.2	-0.86%	1.34
2001	419.0 ^E	-11.0	-2.63%	23.4	+0.1	+0.43%	6.11



There are two discernible effects of tobacco control intervention: first, the adult Current Smoker tobacco consumer population has been stabilized; second, that consumer population is purchasing fewer cigarettes.

Those phenomenon create a negative leverage that works to the economic disadvantage of Settling States and tobacco bondholders: smaller percentages of decrease in Current Smokers equals greater declines in tobacco consumption. With fixed annual payment obligations tobacco companies will become less able to meet their payment schedules, which ultimately puts MSA payments as scheduled in extreme jeopardy. The present trend is for the C/P Ratio to increase, which says tobacco consumption will become increasingly volatile, even with a stable Current Smoker population.

Per capita tobacco consumption listed in the “Historical/Base Case Forecast” table on pages A-30 to A-31 of Appendix A to the Washington tobacco bond prospectus does not address, in fact masks, the above phenomenon because the base for the per capita calculation is total adult population, not the Current Smoker population. Consequently, as the Current Smoker population declines the prospectus per capita consumption figure becomes more nonrepresentative because it does not consider the relationship between the Current Smoker population and current tobacco consumption. As stated in the prospectus, *tobacco consumers* bear the burden of MSA payments, not the total adult population. Per capita consumption should consider that fact to not be misleading.

We examine per capita tobacco consumption based on estimated adult Current Smoker populations in the table on page 4 and in the graphic at center bottom of this page. Data are for the year before announcement of Project ASSIST in 1991 to the most recent CDC data available for adult smoker populations, 2001. Comparative per capita data in the Washington tobacco bond prospectus is a table on pages A-30 to A-31 of Appendix A addressed in the preceding paragraph, for which a graphic appears at center top this page.

The U.S. Census data for adults 18 and older as listed on page 4 is also applied in the Appendix A table because dividing total consumption by those figures produces the per capita consumption listed on pages A-30 to A-31. The principal difference between the per capita consumption figures in Appendix A and on page 4 is that the page 4 figures are based on

adult Current Smoker population estimates and those in Appendix A are based on total adult population estimates. Page 4 data also include an allocation of 3 percent youth consumption not disclosed in Appendix A per capita consumption.

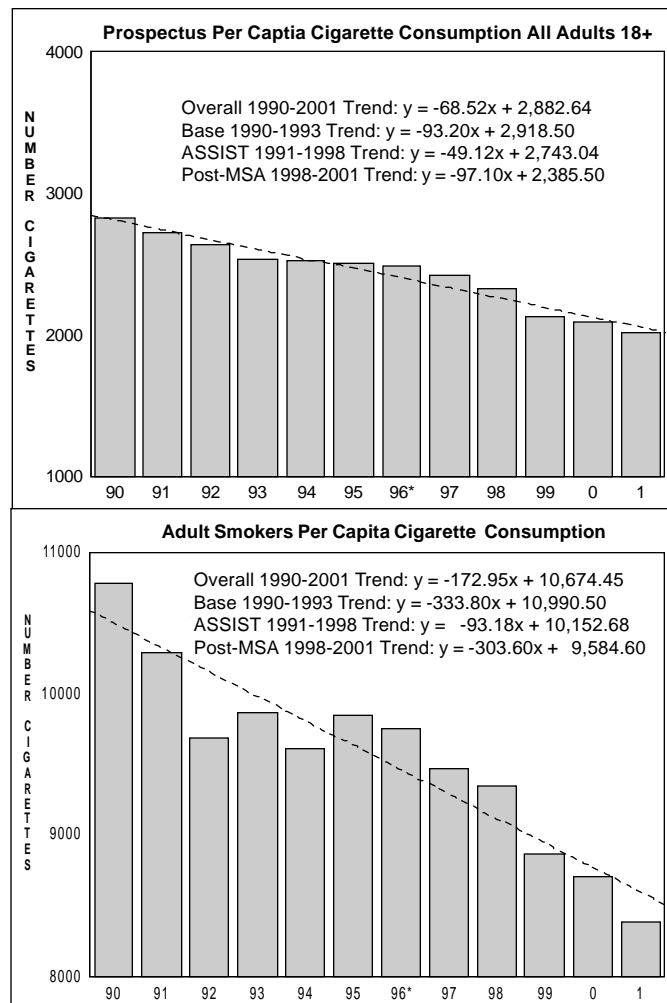
To begin this brief analysis it is noted that *people smoke cigarettes, cigarettes do not smoke themselves*. Any analysis that seeks to project tobacco consumption for purposes of reliance by prospective investors must consider that data in light of the behavior of adult Current Smokers, as a subset of overall adult population. This is important for several reasons: first, the Washington tobacco bond prospectus states that tobacco consumers—not all adults—bear the costs of the MSA; second, adult Current Smoker behavior most influences revenues to tobacco companies, and therefore revenues available

for MSA payments; and third, tobacco consumers have been the explicit target for consumer behavior change imposed by tobacco control advocates for the past decade. Those facts mandate that tobacco consumption projections consider adult Current Smoker data.

When we examine tobacco consumption based on adult Current Smoker population we arrive at a set of facts that is materially different than those based on total adult population. Moreover, the facts based on Current Smoker population imply considerably greater risks to MSA and bond service revenues than disclosed in the Washington tobacco bond prospectus. Finally, data based on adult Current Smoker populations confirm the importance of test hypothesis calculations such as the C/P Ratio previously discussed.

From 1991 to 2001 per capita tobacco consumption in Appendix A decreased from 2,727 cigarettes to 2,017 (-710, or -26.0.) During that same period per capita tobacco consumption based on adult Current Smoker populations decreased from 10,291 cigarettes to 8,383 (-1,908, or -18.5%) While the percentage decline for adult Current Smokers appears to be smaller (18.5 percent vs. 26.0 percent for all adults), the actual number of fewer cigarettes consumed by the specific consumer group at issue is more than double (-1,908 for adult Current Smokers versus only 710 for all adults.) We therefore observe consumption declines by the consumer group *that are 268.7 percent greater than for all adults* as stated in the prospectus’ Appendix A.

The pattern for decline of per capita consumption based on Current Smokers is different than that for all adults (see graphics at center.) The slope of the linear regression for Cur-



rent Smokers is steeper, showing a greater rate of decline, and the sharp drops in cigarette consumption per smoker that begin 1996 are more pronounced than data in the prospectus. Finally, overall, pre-MSA, and post-MSA trends are materially different. The overall trend for computations based on all adults is only -68.52 cigarettes per year, whereas the overall trend for Current Smokers is more than double at -172.95; the ASSIST trend for all adults is -49.12 cigarettes per year versus -93.18 for Current Smokers; and the post-MSA trend for decline in per capita consumption by all adults is -97.10, only 32 percent of the -303.60 cigarettes per year for Current Smokers. *Current Smoker data show more precipitous and accelerating declines in per capita consumption.*

Before ASSIST trends for both per capita cigarette consumption based on all adults and adult Current Smoker populations are substantially similar to Post-MSA trends. *That pattern presents extreme risks to tobacco revenue bondholders: declines in per capita cigarette consumption are returning to their pre-intervention levels but with no material change in adult Current Smoker populations. What happens to tobacco company revenues when adult Current Smoker prevalence and populations begin to materially decrease, in conjunction with higher declines in per capita cigarette consumption?*

The data examined to this point establish that the result of tobacco control interventions to date has been to stabilize adult Current Smoker populations, yet cause declines in the number of cigarettes consumed by those smokers.

The differences in the two data sets—per capita tobacco consumption based on all adults 18 and older or based on adult Current Smokers only—are important and material.

Which set of per capita data would most appeal to prospective MSA bond investors who rely on tobacco consumers continuing to purchase cigarettes: a decade long trend where consumers purchased only 68 fewer cigarettes per year or where consumers purchased 173 fewer cigarettes per year? Which trend since the MSA would be most attractive to an investor who was purchasing bonds due in 2026 and 2032: one that showed sharp and accelerating declines in Current Smoker cigarette consumption or one that showed modest and relatively consistent declines over the entire adult population?

Undisclosed Tobacco Control Agendas

What purpose would be served by a several-hundred-million-dollar nationwide tobacco control intervention that stabilized the number of Current Smokers but resulted in those consumers purchasing fewer cigarettes? That is a \$200 million-plus question for which there is a simple answer: such

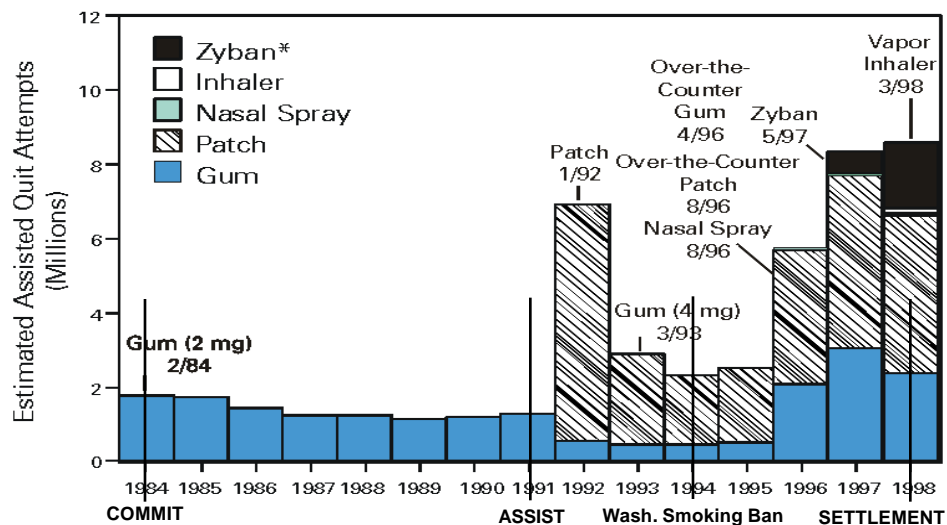
an intervention would preserve the number of prospective customers for smoking cessation products, while reflecting the extent to which “Tobacco Free” nicotine products are successfully substituted for tobacco nicotine products.

As illustrated in the CDC graphic below, introduction of pharmaceutical nicotine products coincides with tobacco control programs. There is a marked increase in sales of those products after 1994 when the first nationwide initiative to mandate smoking bans was undertaken under Project ASSIST. As Dr. C. Everett Koop remarked February 1998 (see insert page 10), “Within the next five or 10 years we will still have a tremendous number of nicotine addicts, but we will have smoking nicotine addicts and nonsmoking nicotine addicts.”

Needless to say, 43 percent more children who began to smoke 1992 to 1997 are now a part of Dr. Koop’s “addict” population.

How would such an intervention be successfully undertaken? By doing precisely what tobacco control advocates did: first, emphasize that nicotine is as addictive as heroin or cocaine, as began with Dr. Koop’s 1988 report; second, nega-

FIGURE 1. Use of pharmacologic aids to smoking cessation, by year, and month aid was introduced — United States, 1984–1998



* Use of trade names and commercial sources is for identification only and does not constitute endorsement by CDC or the U.S. Department of Health and Human Services.

tively label smokers as “addicts” and unfavorably stereotype them as killing their co-workers with secondhand smoke; third, aggressively promote work place smoking bans to coerce nicotine consumers to use “Tobacco Free” pharmaceutical nicotine products in “Smoke Free” work environments.

That nicotine is as addictive as heroin or cocaine or more so has been aggressively promoted since Dr. Koop’s report. The MSA includes language (see insert page 10) that authorizes use of MSA funds to advertise the addictiveness of tobacco. With smoking increasingly banned, nicotine “addicts” get their “fix” from patches and gums, in place of cigarettes.

In December 1989 National Cancer Institute standards for tobacco control programs smokers are defined as a “Target Group.” Project ASSIST Booklets published under federal contract, such as “Planning For A Tobacco Free Washington,” state policy and/or goals to reduce public acceptance of and tolerance for tobacco use. Many tobacco control documents disparagingly refer to tobacco consumers as “addicts.”

To support regulatory smoking bans was an action item included in the first Project ASSIST "Action Plans" dated October 1, 1993. Project ASSIST was a nationwide tobacco control initiative that successfully lobbied for promulgation of smoking bans. Washington's prohibition on smoking in office work environments was promulgated March 15, 1994 with Department of Labor and Industries Administrative Order of Adoption 93-18, to be effective September 15, 1994.

New initiatives for expanded smoking bans have been undertaken, primarily under the stated objective to "reduce exposure to secondhand smoke." Those efforts have been generously supported through grants from the Robert Wood Johnson Foundation, but have met with mixed success: Washington's proposed legislation to expand the ban on smoking in office work environments to restaurants, taverns, etc. has died in committee, while New York City recently passed a comprehensive smoking ban including restaurants and taverns.

There were a large number of smoking bans passed 1994 to 1995, with renewed initiatives to reduce exposure to secondhand smoke undertaken in 2001.

The effects of such agendas must be considered. The Washington tobacco settlement asset-backed bond prospectus states on page A-10 of Appendix A that "... workplace smoking bans reduce smoking prevalence by 5 percentage points and reduce consumption by nearly 10 percent." On page A-14 Appendix A says:

"Based on the regression analysis using data from 1965 to 1999, the restriction on public smoking appear to have an independent effect on per capita cigarette consumption. We estimate that the restriction instituted beginning in the late 1970's has reduced smoking by about 2%. However, the timing and the restrictions within and across states makes such statistical identification difficult. The trend variable included in our econometric analysis is likely to incorporate some part of the cumulative impact of various smoking bans and restrictions."

Increasing cigarette cost and imposing restrictions on where one can smoke influences the number of cigarettes smoked by tobacco consumers. Increasing the cost for cigarettes and imposing restrictions on where persons can smoke are primary intervention strategies undertaken by tobacco

control advocates. Yet, despite such tobacco control initiatives, we still have a remarkably stable adult tobacco consumer population, which is to say a remarkably stable *source consumer base* for Tobacco-Free nicotine has been preserved.

An additional influence on total tobacco consumption is the aggressive promotion of smoking cessation products, primarily Nicotine Replacement Therapy (NRT) gums and patches, by tobacco control advocates. While such products may reduce the number of cigarettes smoked during cessation attempts, the long term effect of smoking cessation products on reducing smoking prevalence is, at best, questionable.

A September 11, 2002 a Journal of the American Medical Association (JAMA) article (Vol. 288 No. 10) reported on three California studies about smoking cessation products that included more than 21,000 smokers. The article, "Impact Of Over-The Counter Sales On Effectiveness of Pharmaceutical Aids For Smoking Cessation." stated:

"Nicotine Replacement Therapy is heavily promoted to the general public by both the pharmaceutical industry and tobacco control advocates." and;

"Since becoming available over-the-counter, NRT appears no longer effective in increasing long-term successful-cessation in California smokers."

June 30, 2001 the Associated Press published "Questions Raised About Nicotine Patches." The study concluded that *nonsmoked* nicotine (in gums and patches) stimulates

the growth of blood vessels, which in turn can increase the growth of tumors. AP quoted Dr. John Cooke, director of vascular medicine at Stanford University School of Medicine:

"This [increased blood flow to tumors] was totally a shock to us. We expected just the opposite."

So what we have from tobacco control to date is an undisclosed agenda and intervention strategies that have not reduced adult current smoker populations, but have successfully preserved a source consumer base for Nicotine Replacement Therapy products that do not work, and which may add to smokers' health risks. That performance is "beneficial"?

Tobacco control advocates' motivations for doing so are set forth in part on page 11. \$200 million in special-interest grants appears to buy considerable public policy intervention.

From Master Settlement Agreement, Section VI. (h):

"The national Public Education Fund shall be used only for public education and advertising regarding the addictiveness, health effects, and social costs related to the use of tobacco products" (Underline, italic added.)

"Koop Predicts Nicotine Inhalers, Sprays"

United Press International, Feb. 15, 1998 Michael Smith

"Within the next five years, America's nicotine addicts increasingly will get their fix without the dangers of smoking cigarettes, former surgeon-general C. Everett Koop said."

"Koop said he foresees nicotine nasal sprays and inhalers joining the currently available chewing gum and nicotine patch products. Said Koop: 'Nicotine is not the dangerous part of a cigarette.'"

"Within the next five or 10 years, Koop said, 'we will still have a tremendous number of nicotine addicts, but we will have smoking nicotine addicts and nonsmoking nicotine addicts.'"

"Drug Makers Find A Risky New Role For Nicotine"

The Wall Street Journal, February 27, 1998 Suein Hwang

"Cigarette makers may be facing an unusual rival as long term suppliers of nicotine fixes: the pharmaceutical industry"

"I'd rather see people dependent on nicotine than tobacco." Dr. Neal Benowitz, technical editor of Dr. Koop 1988 report that declared nicotine to be addictive.

"If it's the nicotine that people want, why not give it to them?" Dr. Karl Fagerstrom, former director of scientific information for Pharmacia & Upjohn.

"To be crass about it, virtually every pharmaceutical company sees a tremendous market here." Dr. David Sachs.

Robert Wood Johnson Foundation \$34,997,194 1996 Tobacco Control Grants

Source: RWJ Foundation 1996 Annual Report

(1996 Tobacco Control Grants Only, 1993 To 1999 Total Is More Than \$200 Million)

According to *Value Line* The Robert Wood Johnson Foundation is the largest single shareholder of Johnson & Johnson. During ASSIST years Johnson & Johnson distributed Nicotrol smoking cessation products through its McNeil Consumer Products subsidiary.

ID No.	Recipient	Grant Amount	Grant Purpose	Location
30499	Allina Health System	48,171	Smoking Cessation	Minneapolis, MN
29319	American Bar Association	482,219	Substance Abuse Law	Washington, DC
30066	American Cancer Society	500,000	SmokeLess States	Atlanta, GA
29549	American Heart Association	1,063,392	SmokeLess States	Portland, OR
28494	American Lung Association	200,000	Local Preemption Law	Washington, DC
30065	American Lung Association	900,000	SmokeLess States	Louisville, KY
28189	American Medical Association	748,595	SmokeLess States	Chicago, IL
28586	American Medical Association	95,300	Media Briefing on Tobacco	Chicago, IL
29398	American Medical Association	29,855	11th World Conf. on Tobacco	Chicago, IL
29466	American Medical Association	70,983	Primary Care Dist. AHCPDR	Chicago, IL
30691	American Society of Addiction Medicine	197,844	Alt.Nicotine Delivery Syst.	Chevy Chase, MD
27340	Battelle Memorial Institute	105,870	Minors' Access to Tobacco	Baltimore, MD
28367	Boston University	50,000	Tobacco Control Website	Boston, MA
30308	Burness Communications	17,000	Communications, Conf. on AHCPDR	Bethesda, MD
28757	Center for the Advancement of Health	49,699	Managed Care Tobacco Prev.	Washington, DC
28495	Creighton University	182,399	Smoking Cessation Videos	Omaha, NE
29471	Dana-Farber Cancer Institute	49,981	Distribute AHCPDR Org. Labor	Boston, MA
30695	Foundation for State Legislatures	19,137	Survey of Medicaid	Denver, CO
29718	George Washington University	37,615	Eval. Tucson Youth Tob. Proj.	Washington, DC
29386	Girl Scouts of America	17,500	Girl Scouts Against Smoking	New York, NY
30825	Governor's Partnership	826,021	Worker Protection	Hartford, CT
28635	Harvey J. Weiss and Associates	449,344	National Inhalant Prevention	Austin, TX
29283	Hayes, Domenici & Assoc.	65,622	Conf. Women and Smoking	McLean, VA
30067	Health Education Inc.	782,317	SmokeLess States	Lincoln, NE
28040	Hedrick Smith Productions	150,000	PBS Series on Tobacco Lobby	Bethesda, MD
26857	Institute for Public Policy Advocacy	147,529	Tech. Assist. SmokeLess States	Washington, DC
29514	Jacksonville Jaguars Foundation	332,802	NFL Youth Anti-Tobacco	Jacksonville, FL
29558	Lehigh Valley Hospital	50,000	Comm. Alcohol/Tobacco Policy	Allentown, PA
30068	Medical & Chirurgical Facility	823,476	SmokeLess States	Baltimore, MD
29831	Miller & Associates	8,000	Econometric Model Review	Oakland, CA
30069	Minn. Coalition for Smoke-Free Society	1,199,987	SmokeLess States	Minneapolis, MN
29050	Miriam Hospital	46,816	Nurse Smoking Cessation Implem	Providence, RI
29600	National Center for Tobacco-Free Kids	19,510,110	National Youth Campaign	Washington, DC
30145	National Foundation for CDC	451,185	Race/Gender Smoking Resrch.	Atlanta, GA
30531	New Jersey Nets	164,000	NBA Health Risks of Tobacco	East Rutherford, NJ
30298	New Sounds Inc.	27,000	Anti-Tobacco Radio Spots	New York, NY
28191	Oral Health America	767,986	Major League Baseball Init.	Chicago, IL
27474	Pinney Associates	72,000	Implementing AHCPDR Guidelines	Bethesda, MD
29354	Pinney Associates	36,750	Tobacco Dependence Work Group	Bethesda, MD
30465	Pinney Associates	35,500	AHCPDR Conf. Proceedings	Bethesda, MD
30055	Pyramid Communications	197,843	Conf. Preventing Tobacco Use	Seattle, WA
29060	Roswell Park Cancer Institute	23,309	RWJF Tobacco Control Policy	Buffalo, NY
30235	Scholastic Inc.	20,000	Teacher Panels - Tobacco Educ.	New York, NY
27123	St. Peter's Medical Center	46,531	Exhibits About Tobacco Prod.	New Brunswick, NJ
28627	St. Peter's Medical Center	27,833	Alternative Nicotine Delivery	New Brunswick, NJ
30735	Strategic Consulting Services	12,175	RWJF Science Conf. Facilitator	Portage, WI
31072	The Lewin Group	83,830	Tobacco Policy Assessment	Fairfax, VA
27375	University of Alabama	484,167	Smoke Free Families	Birmingham, AL
28946	University of Arizona	146,061	Reduce Youth Tobacco Use	Tucson, AZ
29273	University of Arizona	792,565	Reduce Youth tobacco Use	Tucson, AZ
28042	University of California	597,012	Study Tobacco Marketing	San Diego, CA
28676	University of Illinois	54,858	Adolescent Tobacco Use	Chicago, IL
29015	University of Kentucky	253,347	Research Etiology of Tobacco	Lexington, KY
30070	University of Virginia	749,992	SmokeLess States	Charlottesville, VA
29389	University of Wisconsin	45,699	Distribute AHCPDR Guidelines	Madison, WI
30072	Washington DOC	649,967	SmokeLess States	Seattle, WA

Notable Grants: \$500,000 to Project ASSIST's nationwide manager, the American Cancer Society; \$900,00 to American Lung Association and \$19,510,110 to National Campaign for Tobacco-Free Kids, who sponsored Washington's 2001 I-773, adding 60 cents per pack new cigarette taxes to finance anti-tobacco programs and expanding medical insurance; \$649,967 to Washington DOC that participated in ASSIST's Washington youth interventions; \$826,021 to Governors Partnership; and \$451,185 to CDC. The Campaign for Tobacco-Free Kids was awarded and additional \$50 million RWJ foundation grant 1999. Additional foundation grants (beyond those to expand health insurer coverage) include those for reducing exposure to secondhand smoke, which is to say to promote smoking bans.

Bondholders did not come out of the recent Philip Morris appeal bond fracas unscathed. April 4, 2003 *The New York Times* reported that Moody's Investors Service reduced the credit rating for Altria Group bonds to Baa1, and also cut credit ratings on \$18 billion of tobacco bonds. The *Time's* article, "Moody's And Fitch May Cut Reynolds Tobacco Credit Rating," reported "Moody's said that R.J. Reynolds faced the same problems that prompted it to downgrade Altria." The attorneys general brief filed in Judge Byron's court included notices of credit rating actions on tobacco bonds by Moody's. Tobacco bond troubles are rippling beyond Philip Morris.

Through bond downgrades the interests of tobacco bondholders have been damaged because the price of their bonds declines to produce higher yields that reflect increased risk. Bernstein Investment Research reported that Wisconsin tobacco bond "yields have risen from 6.30% to 7.10%, and their prices have fallen by 9%."

April 17, 2003 Washington 6.625% tobacco settlement revenue bonds due 2032 priced at 89.624, current yield 7.4% and rating A3/A. On the same day Washington 6.50% tobacco settlement bonds due 2026 A3/A rating were traded at 92.641, current yield 7.0%. Washington tobacco bonds have declined in value, consistent with the market.

In contrast, King County (WA) Housing Authority 5.1% revenue bonds due 2029 traded at 101, current yield 5.0%, and Washington State Health Care Facilities 5.125% revenue bonds due 2031 traded at 102.382, current yield 5.00%

Reuters reported April 4, 2003 in "Altria Default Protection Costs Soar, Fate Unclear," that costs for hedging tobacco bond positions have increased, saying "Altria's default swap spreads traded as high as 675 basis points during the session, far above the 170 basis points where it traded just last week."

Current reports say that tobacco bondholders face grim prospects: the principal value of their bonds has declined to produce higher yields, costs to hedge existing tobacco bond positions have increased, and they face increased risk for timely payment of interest and principal due to cash flow drains that new tobacco verdicts impose. In addition, the source of MSA payment revenues—*tobacco consumer dollars*—could diminish in the foreseeable future if adult Current Smoker populations finally begin to decline. Should that occur with a 3.4:1 C/P Ratio tobacco consumption declines could be precipitous, well beyond declines that were forecast in the prospectus. All of those conditions materially increase bondholders' risk.

Public statements regarding the efficacy of tobacco control interventions, such as those by Washington Attorney Gen-

eral Gregoire in her April 7, 2003 press release and those included in the attorneys general brief filed in Judge Byron's court, create public impressions and understandings about tobacco use and the tobacco products market. The public understanding of tobacco control from such statements is that its programs have been effective, *and therefore sustaining reductions in smoking prevalence have been achieved to date*. Similar statements and impressions are included in the Washington tobacco bond prospectus, notably on pages A-11 to A-16 which discusses "Factors Influencing Cigarette Consumption."

But what if the impressions and understandings created

by public official and offering prospectus statements are misleading, due to significant omissions of important material information? Where does that leave bondholders who relied on prospectus statements because they appeared to be consistent with what public officials said in the press?

One answer to those questions is that it leaves tobacco bondholders far up the creek, in the backwaters of diminishing tobacco revenue streams, without a viable fact paddle to protect their interests.

What do investors who relied on declines in tobacco consumption set forth in Appendix A to the Washington tobacco bond prospectus do when they realize that material and sustaining reductions

in Current Smoker populations *have yet to come* as a result of tobacco control intervention? And how should Washington tobacco bond purchasers react, should it become evident in the future that along with decreases in adult Current Smoker populations also comes a current ratio of -3.4:1 reduction in cigarette sales revenues that support bond service?

Perhaps Washington tobacco bond investors should consult the prospectus they relied on (see excerpts at center page.) What investors will find on the prospectus cover is that the bonds they purchased *are not* an obligation of the State of Washington; page 7 will inform them that the state could amend the MSA to again accommodate tobacco company financial interests, this time by reducing MSA payments as presently scheduled; and page 8 makes it abundantly clear that the state could put its economic interests ahead of bondholders, just like it has the interests of tobacco consumers for years.

Have Settling States sold \$18 billion in tobacco settlement asset-backed bonds to transfer the risk of potentially sharp future declines in tobacco consumption that they saw coming from the states to bond investors?

The answer to that question is in the eye of the bondholder, but consulting with a competent securities attorney about possible violations of the 1933 Securities Act appears to be a good decision at this point. Propsectus information would be material to that consultation.

The Washington Tobacco Settlement Revenue
Bond Offering Prospectus

\$517,905,000

**Tobacco Settlement Authority
Tobacco Settlement Asset-
Backed Bonds, Series 2002**

"The Series 2002 bonds shall not be obligations of the state and shall be obligations only of the [Tobacco Settlement] Authority. Neither the faith and credit nor the taxing power of the state . . . is pledged to the payment of the principal of, interest on, and premium, if any, on the series 2002 bonds." (Cover)

"While the economic interests of the State and the Bondholders are expected to be the same in many circumstances, no assurance can be given that the amendment, waiver or termination of the MSA would not have a material adverse effect on the [Tobacco Settlement] Authority's ability to make payments to bondholders." (Page 7)

"It is possible that the State could attempt to claim some or all of the Pledged TSRs [Tobacco Settlement Revenues] for itself or otherwise interfere with the security for the series 2002 bonds." (Page 8)

The Washington tobacco bond prospectus includes Appendix A, “Forecast of U.S. Cigarette Consumption (2001 - 2032) for the Tobacco Settlement Authority.” The appendix is prepared by DRI-WEFA, Inc., and is dated October 10, 2002. Excerpts from that Appendix A report appear at center.

Initial Public Offering of securities are subject to the Securities Act of 1933. The act requires full and fair disclosure of material information to prospective investors. That requirement includes omissions of material information, as well as misstatements. SEC rule 10 (b)(5) prohibits misstatements or omissions of material information in connection with the purchase or sale of a security.

The scope of 1933 act and SEC rule requirements is that not only must statements that are made in a prospectus be truthful and accurate for purposes of reliance by investors, but also that material information cannot be withheld. When evaluating a prospectus and offering materials is not sufficient to merely analyze what was said or forecast, one must also examine whether material information was withheld, as well.

As will be set forth in the final sections of this work, the Washington tobacco bond prospectus, including its Appendix A, may be long on what is represented to investors, but it falls far short in disclosure of additional material information. In the case of this prospectus and its Appendix A what was not said eclipses what was represented to investors.

Tobacco bond investors should note that DRI-WEFA discloses in its executive summary that its forecast in this prospectus differs from one prepared for other issuers earlier in 2002, and that tobacco consumption as reported by USDA for 2000 has varied from that projected in earlier reports. While such disclosures appear to be made in compliance with 1933 act requirements, those statements raise a troubling question: what forecast of cigarette consumption by DRI-WEFA, if any, should tobacco settlement bond investors rely on?

Issues related to that question extend beyond the presumed competence of DRI-WEFA to develop econometric models and make forecasts based on them. Those issues also relate spe-

cifically to subjects that the DRI-WEFA model purports to consider: “. . . the future effect of the incidence of smoking amongst underage youth, and qualitative variables that captured the impact of anti-smoking regulations, legislation, and health warnings.” (underline added.) In short, the DRI-WEFA forecast of tobacco consumption to appears to a prospectus reader to consider the effects of tobacco control advocacy on

tobacco consumption.

Considering the effects of tobacco control advocacy on tobacco consumption is, however, a complex and often vociferously debated issue. From the Executive Summary to its forecast and the text of its Appendix A prospectus readers are lead to believe that material issues and information regarding tobacco control advocacy are fully addressed in the text and/or considered in forecast tables. In reality, material information regarding tobacco control advocacy is not fully or fairly discussed in Appendix A, nor does the forecast properly consider material effects of tobacco control advocacy on tobacco consumption. Moreover, statements by public officials regarding the efficacy of tobacco control programs (see page 1) often misrepresent the effects of tobacco control advocacy, which further misleads investors because they believe facts about consequences of anti-tobacco programs that are frequently slanted for political reasons.

Three subjects illustrate the preceding points about contents of Appendix A:

1. Tobacco Use: It is clear

from historical Monitoring The Future Study and Centers for Disease Control and Prevention data that the net effect of 1991-1998 Project ASSIST was to dramatically *increase* youth smoking prevalence and to *stabilize* adult smoking prates (see pages 2 and 3.) Prior to ASSIST interventions both youth and adult smoking prevalence were declining.

Whether by crafted special-interest design or through advocacy default the fact remains that previously declining youth smoking rates *increased* 43 percent, preceding declines in adult smoking prevalence *leveled off*, and previously increasing adult quit smoking rates *reversed* under the auspices of Project ASSIST. That data observation is confirmed by the fact that both Per Capita Tobacco Consumption and Total Tobacco Consumption as set forth on page A-30 of Appendix A

**Washington Tobacco Bond Prospectus
Appendix A Executive Summary Excerpts**

“DRI-WEFA has developed a cigarette consumption model based on historical U.S. data between 1965 and 2000. This econometric model, coupled with our long term forecast of the U.S. economy, has been used to project total U.S. cigarette consumption from 2001 to 2032.” (Underline added.)

“Our base case forecast indicates that total consumption in 2032 will be 247 billion cigarettes (approximately 12.6 billion packs), a 43% decline from the 2000 level.”

“We considered the impact of demographics, cigarette prices, disposable income, employment and unemployment, industry advertising expenditures, the future effect of the incidence of smoking amongst underage youth, and qualitative variables that captured the impact of anti-smoking regulations, legislations and health warnings.”

“This forecast differs slightly from the one presented by DRI-WEFA in 2001 (“DRI-WEFA’s 2001 Forecast”). In the year 2000, lower than expected prices, resulted in higher than expected consumption. The United States Department of Agriculture (USDA), now estimates a consumption level for 2000 of 430 billion, 7 billion more than DRI-WEFA’s forecast in 2001. DRI-WEFA also revised its year 2001 consumption upwards, to 419 billion from 408 billion. This forecast also differs from one presented to other issuers earlier in 2002. While that forecast had anticipated some state excise tax increases in response to state budget difficulties, a slightly greater number of states than anticipated have raised taxes on cigarette purchases, and as a result, consumption is projected to be lower in the near term. Cigarette consumption is now expected to fall to 403 billion in 2002, 2 billion fewer than the forecast of early 2002, and 394 billion in 2003, 4 billion fewer than earlier forecast.”

“No representation or warranty of any kind is or can be made with respect to the accuracy or completeness of, and no representation or warranty should be inferred from, these projections and forecasts.”

also leveled off from preceding declines during Project ASSIST years (see graphics pages 15 and 16.) In combined data from MTF, CDC and Appendix A we observe both the stabilization of smoking rates compared to previous trends and the predictable result of that phenomenon on consumption.

That the net consequences of seven years of tobacco control programs under the auspices of Project ASSIST was the *opposite* of what advocates publicly claimed their goals to be—to *stabilize*, which is to say to *artificially inflate* smoking prevalence and tobacco consumption—is material information to prospective bondholders who are dependent on tobacco product sales to achieve their financial goals of interest income and return of principal when due.

There is a direct correspondence between tobacco consumption and tobacco company income. That correspondence provides revenues necessary for MSA payments, which in turn service Washington tobacco bonds. Failing to discuss Project ASSIST at all, to not disclose the now-historically-documented results on youth and adult smoking prevalence that occurred under the program's auspices, and failing to provide material information that explained the stabilization of tobacco consumption in the Appendix A table on page A-30 during that program's term, are clear omissions of material information for prospective tobacco bondholders.

The omission of that information is the functional equivalent of failing to disclose that an issuer's historic income has been artificially inflated, when projecting future revenues.

2. Conflicts of Interest: As previously discussed under "Undisclosed Tobacco Control Agendas" (see pages 9 to 11) the stabilization of adult smoking prevalence was beneficial to Nicotine Replacement Therapy distributors who sponsored tobacco control activists with hundreds-of-millions in special-interest grants during the 1990s. Pharmaceutical nicotine distributors directly benefit from a stabilization of smoking prevalence because to do so also stabilizes—in the case of tobacco consumers, *artificially inflates*—the *exclusive source consumer base* for smoking cessation products.

In the case of tobacco consumption the effects of that phenomenon are two-fold: first, artificially inflated figures ultimately return to their natural level, in this case smoking prevalence would return to *previously declining trends* that were the uninfluenced response of tobacco consumers; second, as stated in the February 1998 *Wall Street Journal* article (see page 10) pharmaceutical nicotine distributors and their paid tobacco control advocates have

stated a goal *to substitute pharmaceutical nicotine for tobacco nicotine*. That mercantile goal establishes a conflict of interest on the part of anti-tobacco activists: on the one hand their alleged purpose is to *reduce* smoking prevalence, but on the other the interests of their financial sponsors are only served by *stabilizing* smoking rates. Failing to disclose that conflict of interest misleads investors: first, it masks the fact that tobacco consumer populations were stabilized in a manner that suited and supported undisclosed mercantile purposes; second, it lulled bond investors by not disclosing that tobacco consumer populations could decline precipitously, should the effects of artificial stabilization be no longer felt; and third, it failed to disclose significant competitive interests that aggressively compete for tobacco consumers' nicotine dollar. Each dollar that is spent on pharmaceutical nicotine products is a dollar that is not spent on tobacco nicotine products. Competition with tobacco companies for nicotine consumer dollars is not addressed at all in the Washington tobacco bond prospectus.

3. Conflicting Goals: As previously discussed (see page 6) tobacco control has a published goal to sharply reduce smoking prevalence to 12 percent of the adult population. That goal (to reduce smoking

prevalence *by 50 percent*) is opposed to the interests of bondholders because if it were achieved it would reduce tobacco company revenues to where MSA payments that service bonds would be at serious and material risk. Neither the published goal nor its potential impact are discussed in Appendix A.

In light of the above we should carefully examine what the Appendix A tobacco consumptions are, as well as what influencing factors may have been omitted in the prospectus.

Washington Tobacco Bond Prospectus
Appendix A, "DRI-WEFA Report:"

Page A-18, Paragraph 2: "The low value of the elasticity indicates that cigarette consumption is price inelastic, or relatively unresponsive to changes in price."

According to DRI-WEFA, increasing cost does not materially reduce cigarette consumption. That would be of interest to bondholders who rely on tobacco consumers continuing to buy cigarettes, to receive interest and principal payments. The statement is, however, *opposite* to tobacco control's representations that new tobacco taxes *reduce* cigarette consumption. Paragraph 3 in the Executive Summary for the DRI-WEFA Appendix A says that "In the year 2000, lower than expected prices, resulted in higher than expected consumption." and "While that [2001] forecast had anticipated some state excise tax increases in response to state budget difficulties, a slightly greater number of states than expected have raised taxes on cigarette purchases, and as a result, consumption is projected to be lower in the near term." If cigarette consumption is relatively unresponsive to changes in price, why would 2001 and 2002 DRI-WEFA reports be different or require adjustment? Which forecast statement should prospective bond purchasers rely on?

Page A-19, Paragraph 1: "However, the low value of elasticity indicates that the demand for cigarettes is income inelastic, or relatively unresponsive to changes in income."

Anti-tobacco demographics say the majority of smokers are lower income, less educated, blue collar. What induces smokers to continue buying cigarettes, regardless of cost or income? Are bondholders "banking on addiction?"

Page A-19, Paragraph 2: "The negative coefficient on the variable implies that smoking decreases as a result of smoking bans."

But smoking does decrease in "Smoke-Free" environments promoted by tobacco control advocates who receive grants from pharmaceutical "Tobacco-Free" nicotine distributors. How many people chew nicotine gum or wear the patch at work, but smoke elsewhere? The number of smokers is not materially decreasing but the number of cigarettes they smoke is.

A Materially Different Cigarette Market

In its Executive Summary on page A-2 of Appendix A DRI-WEFA says:

“DRI-WEFA has developed a cigarette consumption model based on historical U.S. data between 1965 and 2000. This econometric model, coupled with our long term forecast of the U.S. economy, has been used to project total U.S. cigarette consumption from 2001 to 2032.”

On page A-21 of Appendix A DRI-WEFA says:

“After developing the regression equation specified above, we used it to project CPC for the period 2001 through 2032. In using the regression equations developed on the basis of historical data to project future values of the dependent variable, we must also assume that the underlying economic structure captured in the equation will remain essentially the same.”

On page A-15 of Appendix A DRI-WEFA says:

“Our research has indicated, and our model incorporates, a negative impact on cigarette consumption of tax increases, and a negative trend decline in levels of smoking since the Surgeon General’s 1964 warning, subsequent anti-smoking initiatives, and regulations which restrict smoking. Our model and forecast acknowledges the efficacy of those activities in reducing smoking and assumes that the effectiveness of such anti-smoking efforts will continue.”

The above statements must be presumed to be true, factual, and accurate for purposes of reliance by Washington tobacco bond purchasers. That the above statements regarding the efficacy of anti-smoking initiatives are similar to those by attorneys general to an Illinois court in their brief adds substance to the above statements that prospective investors would rely on in making their investment decisions.

Historical facts about tobacco control presents a materially different view, however, and were available before the date of the Washington tobacco bond prospectus. States are repositories of information regarding their anti-smoking campaigns and states also had access to nationwide anti-smoking information through the MSA and Project ASSIST.

Material differences in today’s cigarette market can be discussed in context of at least of three primary issues:

1. Efficacy of tobacco control programs: As is evident from historical youth and adult smoking prevalence data, results under Project ASSIST were to dramatically *increase* youth daily smokers, *stabilize* adult smoking prevalence, and *reduce* adult quit smoking rates. There are substantially more youth and adults who smoke today than there should be, had previously-declining trends continued. Tobacco control also failed to approach, let alone achieve, its stated 1993 goal of reducing adult smoking prevalence to 17 percent. Reductions in youth and adult smoking under the MSA, with sharp price increases, are less today than during the 1970s and 1980s when cigarette prices declined. Based on census and smoking prevalence data, youth and adult smoker populations are larger today than before tobacco control began.

Based on those facts neither Project ASSIST nor MSA programs can be characterized as “effective” by any reasonable measure. Failing to disclose, indeed misstating, the effects of tobacco control programs to date affirmatively misleads prospective Washington tobacco bond investors because it leads them to believe that material and sustaining reductions in tobacco use have already been achieved, when in fact *the opposite results are the case*. Omission of those material facts lulls investors because it fails to disclose that the current tobacco consumption market is artificially inflated.

2. Differences in tobacco consumer behavior: The DRI-WEFA model incorporates statistical data for 1965 to 1981 when the overall trend was a sustaining increase in Total Tobacco Consumption. Total Tobacco Consumption increased for 15 years after the Surgeon General’s 1964 warning, which is not a negative impact, as stated. DRI-WEFA’s data also include reductions in Per Capita Consumption during that period. The focus on Per Capita Consumption in the DRI-WEFA report that uses total adult population, rather than adult Current Smoker populations, as the denominator of the per capita consumption figure masks—hides—significant differences in both the magnitude and trends of smokers’ behavior. For example, when viewing per capita consumption with adult Current Smokers as the denominator (see graphics page 8) it is evident that per capita cigarette consumption was declining before Project ASSIST “Action Plan” interventions began in 1993, stabilized during ASSIST years, and began to decline in again 1997 one year before the MSA was executed.

Including historical data of tobacco consumption increases 1965 to 1980 in the basis for projections 2001 onward inflates forecast tobacco consumption. This is important to prospective Washington tobacco bond purchasers because it hides the fact that previous adult smoking trends that no longer apply to current markets are included in forecast calculations.

3. Competitive considerations: Those who manage MSA tobacco control programs today are by and large the same people and advocacy groups that managed nationwide anti-smoking initiatives under Project ASSIST 1991-1998. Individuals and organizations that managed Project ASSIST received substantive and sustaining grants from pharmaceutical nicotine distributors. Many of those individuals and advocacy groups continue to receive pharmaceutical smoking cessation distributor grants. That creates a conflict of interest on the part of those individuals and advocacy groups: the vested interests of their financial sponsors can only be served by stabilizing adult smoking prevalence—thereby *stabilizing the exclusive source consumer base* for smoking cessation products—and by aggressively *substituting* “Tobacco Free” pharmaceutical nicotine products for tobacco nicotine products.

Today’s market also includes nicotine delivery products such as patches and gums, etc. that did not exist during the 1965 to 1980 period of increasing tobacco consumption.

This is important to prospective Washington bond investors because it fails to disclose that while adult prevalence may be stable the vested interests of tobacco control advocates and their sponsors is to aggressively decrease adult per capita tobacco products consumption. In addition, it is clear that *the same underlying economic structure does not apply to today’s tobacco consumer market as did 1965 to 1991*.

Appendix A Tobacco Consumption Forecasts

Two sets of data that appear on pages A-30 to A-31 of Appendix A are analyzed in this work: Per Capita Consumption and Total Consumption in billions of cigarettes.

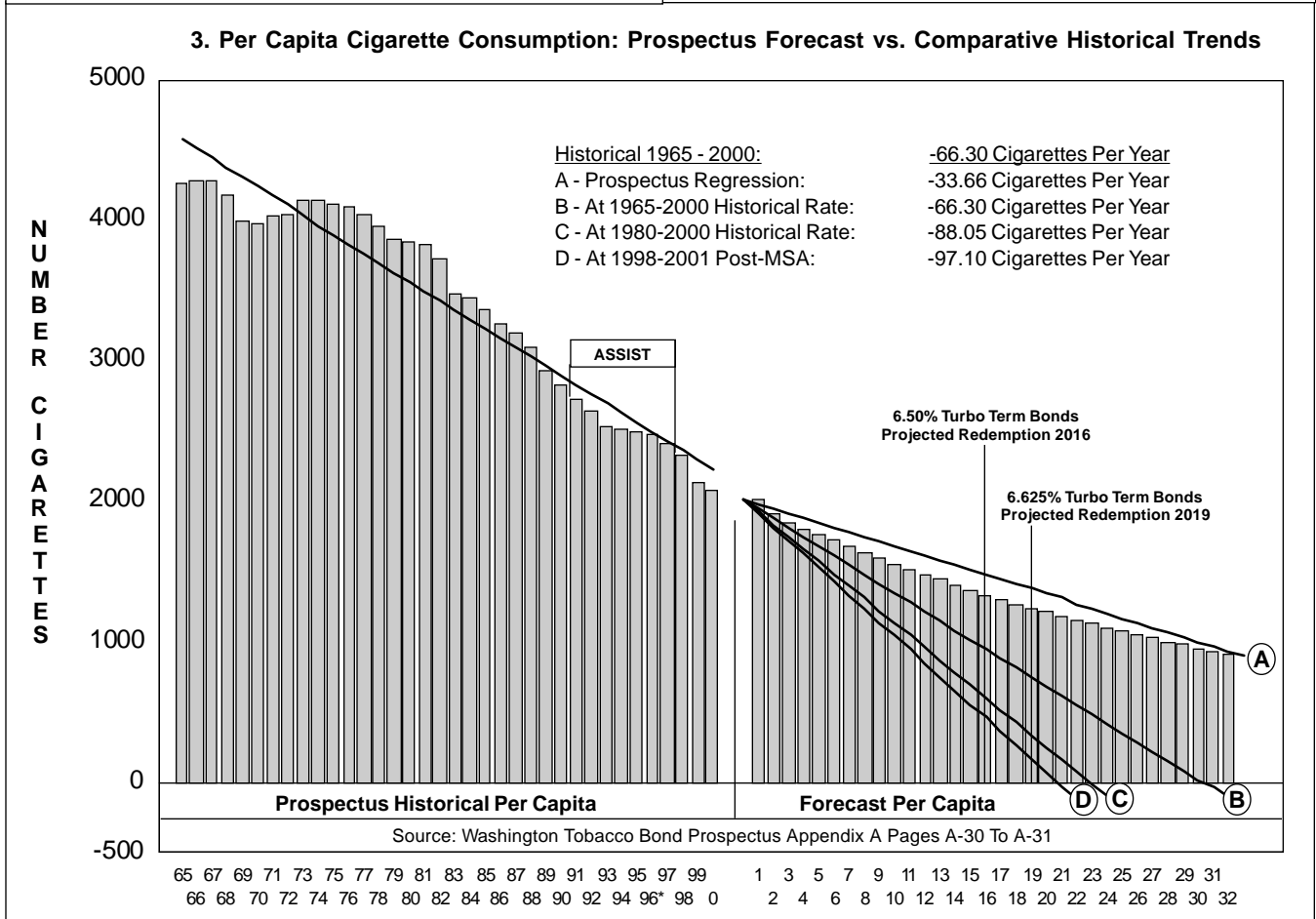
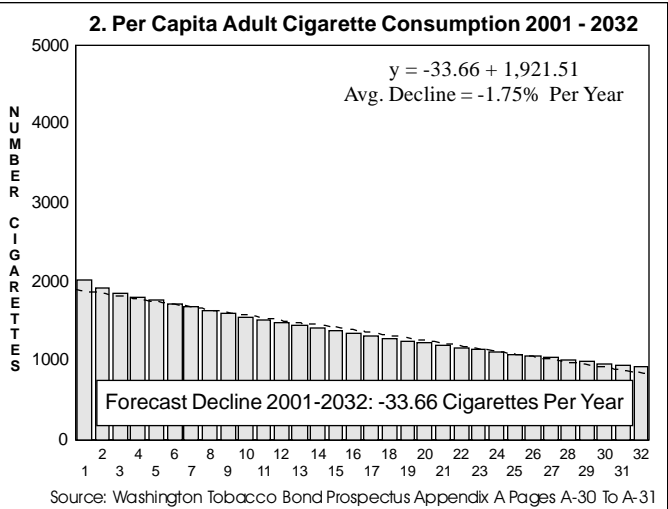
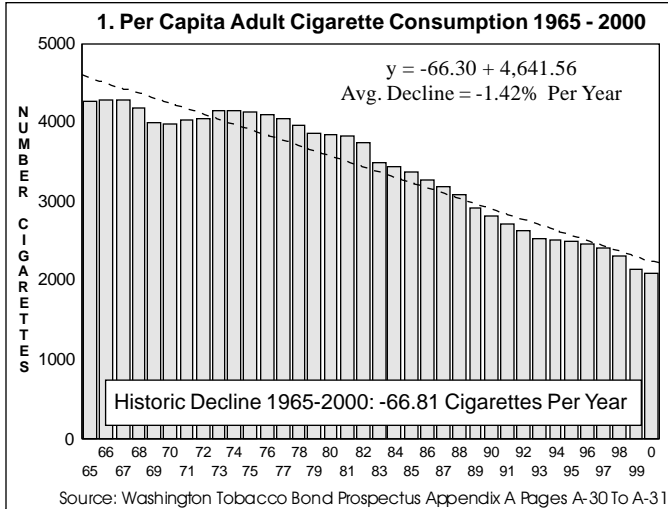
1. Per Capita Consumption: As previously mentioned, per capita figures in Appendix A are computed as Total Consumption divided by adults 18 and over. The formula disproportionately reduces consumption because it includes an increasing all adults population in the denominator for declining cigarette consumption. Consequently, it appears that per capita consumption is decreasing faster than it is. While tobacco control advocates may appreciate that method of calculation

to prove the value of their programs, it misleads investors because it appears that bond service can be maintained with inflated values for per capita cigarette consumption.

Distortion of Per Capita Consumption due to the computation method applied is illustrated in the graphics below:

1.1 The historical linear decline in per capita consumption 1965 to 2000 is -1.42%, or 66.30 cigarettes per year

1.2 The forecast linear decline in per capita consumption 2001 to 2032 is -1.75%, or -33.66 cigarettes per year. The greater percent on a smaller number of cigarettes is created by the fact that the forecast percent begins with 2017 cigarettes per year vs. 4259 for 1965. *One-half* the number of cigarettes decline per year produces a *higher* annual percent.



1.3 But the formula for Per Capita Consumption does not work under actual market conditions other than as forecast.

A. Based on forecast (-33.66 cigarettes per year) we arrive at 2032 with per capita consumption of +917 cigarettes per year. Cigarettes are still being smoked.

B. Based on historical declines 1965 to 2000 (-66.30 cigarettes per year) per capita consumption is *negative* in 2030.

C. Based on historical declines two decades prior to forecast, 1980 to 2000, (-88.05 cigarettes per year) per capita consumption is *negative* in 2023, nine years before forecast end.

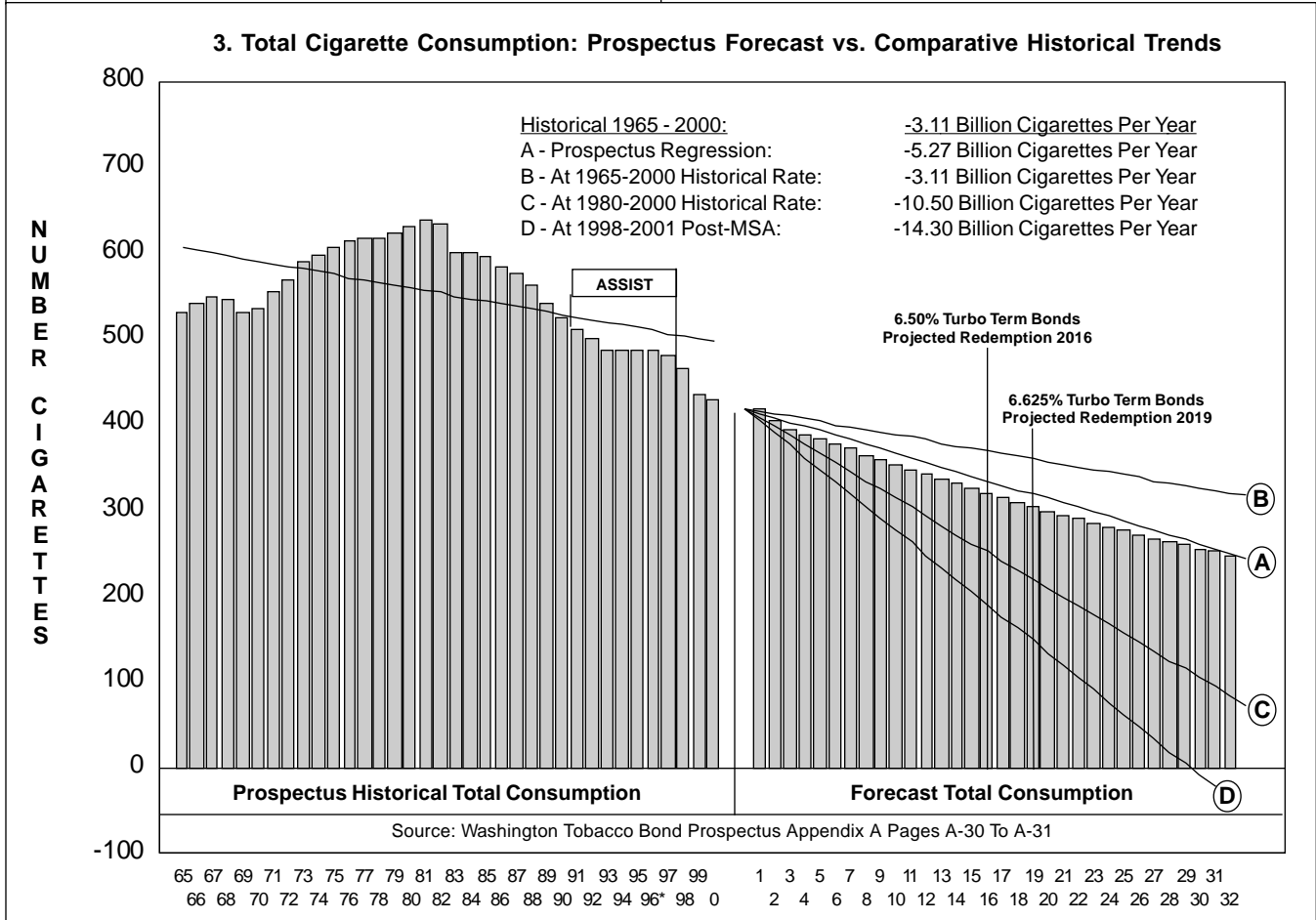
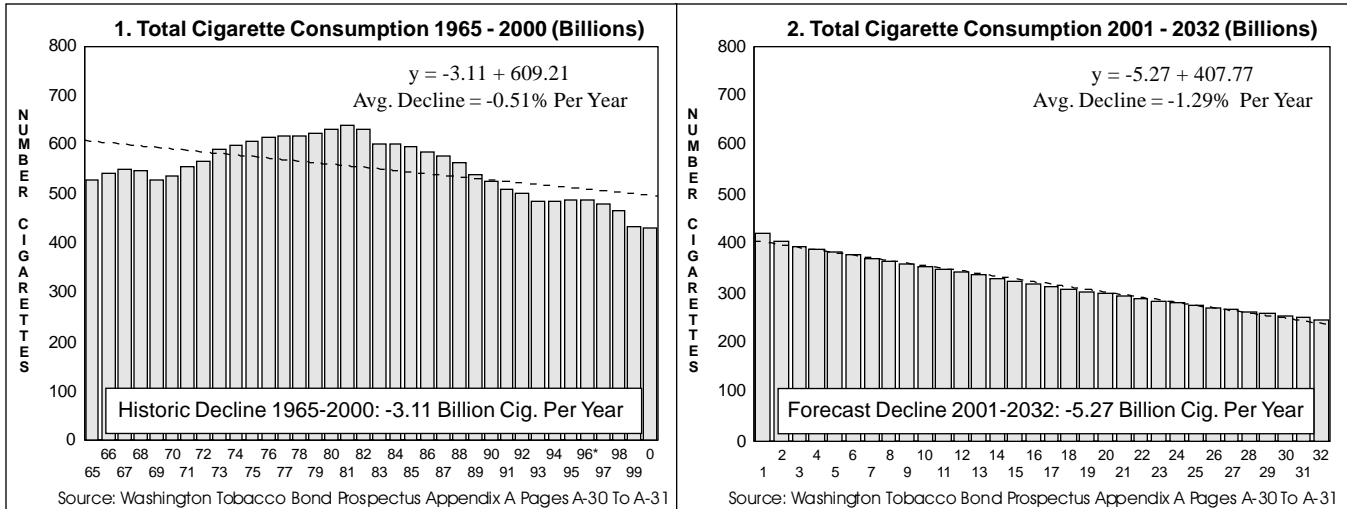
D. Based on the Post-MSA historical trend 1998 to 2001 (-97.10 cigarettes per year) per capita consumption goes *negative* in 2019, 13 years before forecast end.

Applying actual historical decreases in per capita cigarette consumption, somewhere between 2019 and 2030 bondholders will run out of smokes and be in tobacco company MSA payment bond service cash flow withdrawal.

2. Total Cigarette Consumption: Similar, though somewhat less striking, results are obtained through analysis of Total Consumption.

2.1 The historical linear decline in total consumption 1965 to 2000 is -0.51%, or -3.11 billion cigarettes per year

2.2 The forecast total consumption linear decline 2001 to 2032 is -1.29%, or -5.27 billion cigarettes per year. In this case we have a higher decline in cigarettes consumed per year during the forecast period, vs. the lower number in per capita.



2.3 The formula for Total Consumption does not work under two out of three actual market conditions tested:

A. Based on forecast (-5.27 billion cigarettes per year) 2032 total consumption is 247.16 billion cigarettes per year.

B. Based on historical declines 1965 to 2000 (-3.11 cigarettes per year) 2032 total consumption is 316.67 billion.

C. Based on historical declines two decades prior to forecast, 1980 to 2000, (-10.50 billion cigarettes per year) 2032 total consumption is 83 billion, 80.7 percent *less* than the 430 billion base line in 2000. That figure assumes MSA payments and bond service can be maintained by tobacco companies with a -2.52 percent per year decline in cigarette consumption, 46.5 percent greater than forecast. The decline is greater than “Low Case 3” forecast of -2.25 percent per year.

D. Based on the Post-MSA historical trend 1998 to 2001 (-14.3 billion cigarettes per year) total consumption is negative in 2030, 2 years before forecast end. Bondholders again find themselves in bond service cash flow withdrawal.

Prospectus Facts Relied On

Fact No. 1. Cigarette consumption model, DRI-WEFA Executive Summary, A-2:

“DRI-WEFA has developed a cigarette consumption model based on historical U.S. data between 1965 and 2000. This econometric model, coupled with our long term forecast of the U.S. economy, has been used to project total U.S. cigarette consumption from 2001 to 2032.”

Fact No. 2: Historical regressions, A-21:

“After developing the regression equation specified above, we used it to project CPC for the period 2001 through 2032. Then using the standard adult population projections of DRI-WEFA’s macroeconomic model, we converted per capita consumption to aggregate adult consumption. We then added our estimate of teenage smoking volume going forward.

In using the regression equations developed on the basis of historical data to project future values of the dependent variable, we must also assume that the underlying economic structure captured in the equation will remain essentially the same.”

Fact No. 3: Per Capita Cigarette Consumption, A-17:

“CPC measures the average annual cigarette consumption of the American adult. It is calculated by dividing the total adult cigarette consumption by the size of the population 18 and above. Of the different measures of cigarette consumption available this [Per Capita] is considered to be the most reliable. It also directly reflects the changing behavior of individual smokers over the historical period.” (Bracket added.)

Fact No. 4: Historical Cigarette Consumption, A-4:

“The United States Department of Agriculture (“USDA”), which has compiled data on cigarette consumption since 1900, reports that consumption grew from 2.5 billion in 1900 to a peak of 640 billion in 1981³. Consumption declined in the 1980’s and 1990’s, reaching a level of 465 billion cigarettes in 1998 and 430 billion cigarettes in 2000⁴.”

Fact No. 5: Tobacco control interventions, A-15:

“Our research has indicated, and our model incorporates, a negative impact on cigarette consumption of tax increases, and a negative trend decline in levels of smoking since the Surgeon General’s 1964 warning, subsequent anti-smoking initiatives, and regulations which restrict smoking. Our model and forecast acknowledges the efficacy of those activities in reducing smoking and assumes that the effectiveness of such anti-smoking efforts will continue.”

Fact No. 6: General Population Growth, A-11:

“On December 28, 2000 the Bureau reported results from the 2000 census that estimate the US population on April 1, 2000 to be 281 million. We have not yet incorporated this data into our analysis because it has yet to be reconciled, by the Bureau, to its 1990 estimate. That 1990 Census likely suffered from a significant undercount of population.”

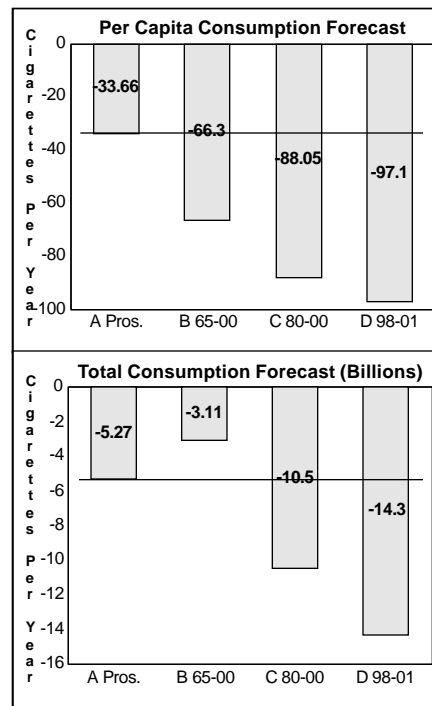
NOTE: U.S. Census Bureau estimated population data release date January 2, 2001 were used in this work, which state a U.S. population of 276,059,000 November 1, 2000. Census Bureau data release date January 13, 2000 give a projected U.S. population of 277,803,000 July 1, 2001. Those population figures appear to be reconciled

Fact No. 7: Price elasticity (price sensitivity) of cigarette consumption, A-18:

“The low value of elasticity indicates that cigarette consumption is price inelastic, or relatively unresponsive to changes in price.”

Fact No. 8: Comparison With Prior Forecasts, A-23:

“Increased consumption due to lower than anticipated prices explains most of the revision to our 2000 and 2001 forecasts. . . . This forecast also differs somewhat from one presented to other issuers earlier in 2002. While that forecast had anticipated some state excise tax increases in response to state budget difficulties, a slightly greater number of states than expected have raised taxes on cigarette purchases, and as a result, consumption is expected to be lower in the near term.”



*Conclusions Regarding Washington
Tobacco Bond Prospectus*

It is recommended that readers review “Risk Factors” on pages 2 and 3 of the Washington tobacco bond prospectus, beginning with “Decline In Cigarette Consumption Materially Beyond Forecasted Levels May Adversely Effect Payments”

A statement under *Smoking Trends* says: “A decline in overall consumption of cigarettes beyond the levels forecasted in the DRI-WEFA Report could materially effect the payments by PMs under the MSA and the amounts available to the Authority to pay principal and/or interest on the Series 2002 bonds and/or turbo redemptions of the Turbo Term Bonds.”

A statement under *Regulatory Restrictions and Legislative Initiatives* says in part on page 3: “No assurance can be given that future federal or state legislation or administrative regulations will not seek to further regulate, restrict or discourage the manufacture, sale and use of cigarettes.”

On the surface it appears that bondholders were informed of material risks that could influence MSA payments, receipt of interest and principal, and redemption of bonds.

As discussed in some detail in the preceding pages there are material problems, however, with what the prospectus fails to disclose as risk factors, tobacco control goals, the nature of calculations used in preparing forecasts, competitive business interests, the alleged efficacy of tobacco control programs to date, and tobacco control nationwide goals as published by the Centers for Disease Control and Prevention. Each of those issues have direct bearing on material risks to bondholders.

It is recommended that readers review the Preface to “Sections And Content Summary” on page (i). That the source of revenue to support MSA payments is *exclusively focused on tobacco consumers* is fundamentally important to both the contents of this report and the conclusions that follow. MSA—and therefore Washington tobacco bond service—revenues are exclusively provided by persons who purchase cigarettes and other tobacco products. In the Appendix A forecasts cigarette consumption is the only tobacco product addressed.

Given the unique focus on tobacco consumers, what has influenced or may influence tobacco consumer behavior of purchasing cigarettes is material to bond purchaser risk disclosures and must be included in the offering prospectus.

The following conclusions begin with tobacco control goals and influence on tobacco consumer behavior, as well as the effectiveness of tobacco control programs. Conclusions then focus on competitive and conflict of interest issues, and proceed to forecast projections as set forth in Appendix A.

1.0 Tobacco Control Goals: Tobacco control goals are to reduce tobacco consumption. If one accepts what tobacco control says about the consequences of smoking, including that tobacco use kills 420,000 people per year, public policy should be zero consumption, or prohibition of sale or use of tobacco.

1.1 Tobacco control advocacy is now funded in large part through MSA grants and revenue sharing, which aggregates to hundreds of millions of dollars each year across all Settling States. Tobacco control goals and those of bondholders conflict: tobacco control advocates declining or zero tobacco use, but stable or increasing tobacco use serves bondholders’ interests by ensuring revenues to service bonds.

1.2 As stated on page 6, the Centers for Disease Control and Prevention has a goal regarding tobacco use published in its April 11, 2003 and July 26, 2002 “Morbidity and Mortality Weekly Review:” “One of the national health objectives for 2010 is to reduce the prevalence of cigarette smoking among adults to less than or equal to 12% (objective 27.1)”

a.) Adult smoking prevalence as of most recent 2001 CDC data is 23.4 percent of adult populations. Achieving that goal requires a 11.4 percentage point decline (-48.7 percent) over a nine year period, or -5.4 percent per year.

b.) The most negative “Low Case 3” alternative forecast in Appendix A on page A-25 for total tobacco consumption is -2.25 percent per year, *only 41.7 percent of the annual decline required* to reach the CDC 2010 goal. If tobacco control achieves less than one-half of its prevalence goal total consumption declines break the lower forecast boundary.

d.) The prospectus does not disclose specific tobacco control goals and omits reference to such goals when discussing anti-smoking initiatives. The prospectus also does not disclose that for the tobacco consumption forecast to fall below the lower boundary stated tobacco control advocates would merely need to achieve *less than one-half* of their stated goal.

Conclusion: The Washington tobacco bond prospectus and its Appendix A omit material information about current tobacco control goals. The information omitted would reasonably influence a purchaser’s risk analysis.

2.0 Effectiveness Of Tobacco Control: Public statements regarding the effectiveness of tobacco control programs influence public opinion regarding tobacco consumption. As is clear from statements in Appendix A (see Fact No. 5, page 18) and attorneys general representations to Illinois courts (see page 1, items 6 to 9) the beliefs communicated by the prospectus and Washington Attorney General Gregoire are that tobacco programs have been effective and beneficial.

Such statements are important to prospective bond purchasers because they lead one to believe that material and sustaining reductions in tobacco use have been achieved, which lends credibility to the level of decline in tobacco consumption forecast in Appendix A. If such reductions have not been achieved, however, a different set of revenue risk parameters applies: tobacco consumption may have been *artificially sustained* by tobacco control programs, in which case the probability of sharp declines in tobacco consumption is increased when tobacco use returns to previous trends.

2.1 As presented on page 7, tobacco control had a previous goal: to reduce adult smoking prevalence to 17 percent of adult populations. That goal was not approached or achieved.

2.2 Since the primary tobacco control public intervention, Project ASSIST, was announced in 1991 there are discernible effects of tobacco control interventions:

a.) Youth: Under Project ASSIST previously-declining youth smoking prevalence trends sharply reversed and prevalence increased 43 percent 1992 to 1997. Present declines under the MSA with sharp cigarette cost increases are less than during the 1970s and 1980s when tobacco companies reduced cigarette costs.

b.) Adults: Under the auspices of Project ASSIST adult Current Smokers stabilized and Former Smokers declined, reversing previously favorable trends for both measures.

c.) Based on most recent smoking prevalence data and census bureau estimates both youth and adult smoker populations are larger today than before ASSIST was announced.

Conclusion: Based on the above observations tobacco control programs have not been effective. Statements to that effect are both false and materially misleading. The effect of such false and misleading statements is to lull prospective bond purchasers as to the true risks of their investment.

3.0 Competitive Products And Conflicts Of Interest: As stated in a Journal of the American Medical Association article (see page 10) nicotine replacement products such as patches and gums are heavily promoted by both pharmaceutical companies and tobacco control advocates. The JAMA article concludes that such products are no longer effective for smoking cessation. As also discussed on page 10 and listed on page 11, tobacco control advocates have received substantive grants from pharmaceutical nicotine distributors.

3.1 Competitive Nicotine Products: Include three subjects:

a.) Nicotine Replacement Therapy Products (gums, patches, etc.): The negative effect on tobacco use is threefold: first, every dollar spent on pharmaceutical nicotine products is a dollar not spent on tobacco products, and therefore does not support MSA payments or bond service; second, such products are often used in work environments where smoking is banned; and third, to the extent that such products aid individuals in quitting smoking (subject to substantive questions) they permanently remove tobacco consumers from MSA support revenues. The extent to which such products reduce tobacco consumption by a stable tobacco consumer group is evident in Current Smoker per capita consumption and total consumption declines. These products are given one-paragraph mention in Appendix A (see for example page A-10.)

b.) Vaccines: Two anti-nicotine vaccines have been reported. *U.S. News & World Report's* April 28, 2003 article "No In A Needle" reported a Cabi Biopharmaceuticals anti-nicotine vaccine that blocks pleasure receptors in the brain has completed safety trials. That vaccine was first reported by USN&WR June 24, 2002 under the headline "Immune To Vice," when it began safety tests, more than four months before the prospectus' date.

c.) Alternative Nicotine Products: May 2001 Duke University announced a nicotine additive for soft drinks. Several other products, such as nicotine lozenges, lollypops, and bottled water, have also been announced recently.

Conclusion: Each of the above non-tobacco nicotine products aggressively compete for tobacco consumer's—nicotine consumer's—dollar. None of those products existed in tobacco nicotine markets 1965 to 1980. Not only is today's nicotine market materially different as to underlying economic structure, but there are now new competitive nicotine products that divert nicotine consumer's dollars away from those that support MSA payments. The prospectus and Appendix A are wholly insufficient in disclosure of and discussion about the fact and consequences of those products.

3.2 Conflicts Of Interest: Tobacco control advocates are recipients of substantive grants from pharmaceutical nicotine distributors. That is not addressed in the prospectus.

a.) The interests of tobacco control advocates' financial sponsors are served by *sustaining* adult smoker populations

as source consumers and aggressively *substituting* pharmaceutical nicotine for tobacco nicotine products.

b.) The likely result of serving those vested interests is that adult smoking prevalence would stabilize but Current Smoker per capita tobacco consumption would decline. Adult Current Smoker populations have been stabilized under Project ASSIST (see graphic page 3 and table page 4) and Current Smoker per capita consumption has sharply declined since 1996 under ASSIST and the MSA (see graphic page 8.)

c.) Such results are contrary to both public health policy and the financial interests of tobacco settlement asset-backed bondholders. Tobacco control and public health officials have concluded that reducing the number of cigarettes smoked does not materially reduce the risks of smoking, and reductions in total consumption of cigarettes reduces the revenue base to support bond service through MSA payments. As noted in the graphic on page 17, Post-MSA trends for total tobacco consumption place consumption at *negative* values in 2030, and the Post-MSA trend is nearly three times the projected rate of decline regression of the Appendix A forecast (-14.3 billion cigarettes per year vs. forecast regression of -5.27 billion.)

Conclusion: Based on the above observations it is apparent that serving the vested interests of tobacco control advocates' financial sponsors conflicts with the interests of tobacco bondholders and that such activity has had a demonstrable effect to stabilize smoking prevalence and to reduce total tobacco consumption. Tobacco control advocate conflicts of interest are not disclosed or discussed in the prospectus.

4.0 Forecast Projections: Are addressed at length in pages 15 to 18 of this report.

4.1 Principal among the observed deficiencies in the forecasts are the following:

a.) They are based on 1965 to 2000 data that includes fifteen years (1965 to 1980) of increasing adult tobacco consumption in a materially different tobacco market.

b.) If relevant periods from 1980 onwards are used for trend projections the decline in tobacco consumption is greater than that which includes 1965 to 1980 data. The net effect of that data is to increase the regression line used as basis for calculations and thereby reduce the extent to which tobacco consumption is declines in the forecast tobacco market.

c.) Per capita consumption in the forecast is based on all adults over age 18 rather than Current Smokers, which incorporates an expanding population base in the equation and tends to mask or hide current sharp declines in per capita

4.2 Comparative Computations: That apply trends for relevant time periods demonstrate:

a.) Per Capita Consumption (page 16) fails three of three tests using relevant time period trends, in that under all cases cigarette consumption is *negative* before 2032.

b.) Total Tobacco Consumption (page 17) fails two of three tests using relevant time period trends: (Post-MSA trend) consumption is *negative* by 2032, (1980 to 2000 trend) consumption is 66.4 percent lower than forecast as of 2032.

Conclusions: Based on the above it is concluded that the forecasts contained in Appendix A do not represent the current tobacco market and that the forecasts materially understate likely future rates of decline in tobacco consumption.

Redmond WA May 19, 2003