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A meeting of the Tobacco Strategy Group was held in Windsor House on Wednesday 9th November 1994.

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Present: Mr U G V Herter, Mr D P Allvey, Mr N G Brookes, Mr R D Brown, Mr A M de Castro, Mr E E Ettegui, Mr R Pilbeam (standing in for Mr B D Bramley), Mr T E Sandefur, Dr B Schweitzer, Miss H C Barton.

Mr N Davis was present for items 1 to 32. Mr S P Chalfen, Dr I Kausch, Mr C Proctor and Mr G Read were present for items 1 to 17. Mr I Snowden and Mr E Watt were present for items 18 to 29. Mr D C Potter and Mr N R Withington were present for items 33 to 40.

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#### Scientific Research Group (SRG)

1. Mr C Proctor reported on the work of the SRG during 1994. The SRG is aware of other external research into smoking and health issues, such as that carried out by the Tobacco Council, and ensures that there is no duplication. If the SRG thought that a project would have a significant impact on smoking and health issues but the SRG did not have sufficient funding available in its budget, it would approach BAT for additional funding. Whilst the researchers are not obliged to publish their results, typically they do publish them and the results are in the public domain.

#### Group Technical Programme (GTP)

2. Dr Kausch reported on the two main aspects of the GTP: R&D and the World-Wide Best programmes: Quality and Manufacturing Control Technology.
3. World-wide best US blend full flavour: The benchmark is clearly Marlboro Full Flavour. B&W has achieved parity on king size and superiority in 100s. BATCF has achieved parity on king size. Souza Cruz has achieved parity vs Marlboro-US with Lucky Strike. Hollywood tests superior to local Marlboro in Brazil, but it is not known how Lucky Strike tests against local Marlboro.
4. Parity has been achieved therefore in US, Germany and exports. However, there are many other domestic markets where the local product is not at parity. BATCo is about to embark on a programme to learn about WWB US blend FF in order to identify the building blocks which can be used to develop products for other domestic markets. Mr Herter asked BATCo to report to the TSG meeting in June 1995 on their progress in adopting WWB US blends in BATCo markets.

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5. **World-wide best Virginia full flavour (13-15mg):** It was less easy to identify a suitable benchmark. The UK market was chosen and the brands used were B&H, Dunhill, Marlboro, Camel, Mild Seven and du Maurier. The product was redesigned from first principles. The four blends which were tested all outperformed the benchmarks, but even the best of them was too high in harshness, impact and aftertaste, and lacked sweetness and moisture. The best blend is now being adapted for local leaf and local taste preferences in Malaysia.
6. **World-wide best Virginia Lights (7-8mg):** The benchmarks chosen fell into two clusters. The more acceptable cluster was Silk Cut, B&H Special Mild and Marlboro Lights. Camel Lights, Mild Seven Lights and du Maurier Mild had significantly lower acceptability. A pure Virginia blend achieved parity at best. A modified Virginia achieved superiority.
7. **World-wide best US blend Lights:** B&W has achieved directional preference over Marlboro Lights at 9mg. BATCF expects to achieve parity at 6mg in a CPT in January. Souza Cruz has launched one product at 9mg which achieved acceptability by Free and L&M Lights smokers, but has not yet achieved superiority. Final testing will take place early in 1995.
8. **Project Grasp** Tests so far have achieved higher scores in aroma intensity and similar scores in strength, giving a 9mg product that tests as well as a conventional 11mg product. Specific blends will now be tested.
9. BATCF is working with Hauni on machinery development. It is believed that there is sufficient benefit for the consumer to outweigh the manufacturing difficulties, but this question will be reviewed regularly.
10. The second Marketing meeting was cancelled because the technical development will take another 12 to 16 months, therefore it is premature, and risky, to start media development. It would not be possible to speed up the technical development by applying additional resource.
11. **World-wide best Ultra Low Tar:** A programme was set up in August. Benchmarks are currently being discussed.
12. The GTP also co-ordinates know-how transfer on product cost reduction programmes and environmental programmes, such as bio-degradable filters and bleach-free papers. One recent R&D secondment has been arranged and several more are planned. Two GTP meetings have been planned for 1995, one on processing technology and one on product development.
13. It was agreed that the co-ordination of R&D units was working well, with a focus on development rather than fundamental research, and close co-operation with Marketing. Any other structure would be disruptive and risk losing key staff, for little benefit.

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14. Mr Read demonstrated a filter box for enclosed spaces, which performed as well as the best air filtration systems for a fraction of the price. If the cost can be reduced sufficiently the boxes would be economic for airline manufacturers to install in airline seats.

#### Key Issues Council

15. Mr Chalfen reported that the Key Issues Council met for the first time in early November. It identified eight issues for which a Group-wide shared coherent vision would be developed within the next two months. Draft position statements and action points will be recommended to the TSG in February 1995. Mr Herter asked the TSG members to support their own staff in the development of this work, providing more resource if necessary.

#### Legal & Regulatory Issues

16. Mr Chalfen reported on the time scale for the American Tobacco acquisition. The court hearings start on 5th December with a decision by the year end, and a decision on any appeal by the end of March 1995.
17. Phase 1 of Project ReMark has concluded on schedule, giving user friendly operation. Phase 2, which automates the registrations, has a target date of Easter 1995. The process of implementing phase 2 will slow the operation of the system, but the response times will recover once phase 2 is implemented.

#### Leaf Review

18. Mr Snowden reported that, during the recent period of over-supply and falling prices, dealers were in a difficult position, farmers' margins were squeezed, but cigarette manufacturers benefited.
19. Stock levels have now fallen, but the mix has changed with a higher proportion of more expensive, higher quality tobaccos and a lower proportion of traditional tobaccos and "CIS" stocks. Prices for flue-cured and burley are expected to rise by 5 to 10% in 1995 but they could be affected by a major crop failure or by the outcome of the debate on GATT "Article 23".
20. The oriental surplus is still working its way through the system and price increases are not expected until 1996.
21. In 1994, 68% of Group purchases are expected to come from BAT companies. 38% of the purchases from non-Group dealers are from Standard Commercial. Both these percentages have increased from 1993 in line with the Group policy to buy firstly from BAT and secondly from Standard Commercial.
22. With respect to buying tobacco, BAT has higher security of supply than its competitors. Its prices are also "damped". If more risk is shared with the farmers, we will also have to share more of the upside when prices are high, which is accepted.

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23. Market information appears to suggest that Standard Commercial's \$100m bond placement is likely to fail. It is reported that \$46m stock was sold to the major manufacturers last week ahead of a major meeting with its European bankers. This appears to have resulted in lines of credit being extended to 31st March 1995. It is believed that the sale of the wool business is being negotiated.
24. BAT exports about 90m kg p.a. to third parties. Any failure of Standard Commercial would cause problems for Brazil and Zimbabwe. In the short term, customers would still have to come to Souza Cruz. In the longer term, Souza Cruz would lose the business if it did not have an export structure, which gives time to develop this. The same is true of all the businesses.
25. Loss of Standard Commercial business would result in Zimbabwe's processing cost becoming uncompetitive. There are many options, such as developing direct sales, expanding our business with other dealers, expanding the agent network. None of the options resolves the problem by itself, and a combination must be used. The options will be developed and presented to the TSG in February.

#### Purchasing

26. Mr Watt reported that the outlook for 1995 for the three core materials is for large price increases and tightening supply availability. Estimated savings in 1994 are \$19.4m against an ambitious \$26m target. The co-operation in the Group is good and still growing.
27. By the end of 1995 the great majority of wrapping materials will be covered by the global sourcing strategy and the supplier appraisals will be complete.
28. BAT is developing long term relationships with the same high quality suppliers as appear to be used by its competitors, all of whom are rationalising the number of suppliers with whom they deal. This is resulting in shortage of capacity at the best suppliers and spare capacity at the second rate suppliers.
29. The purchasing programme for 1996 will be developed and presented at the TSG meeting in September 1995.

#### Manufacturing Capacity and Machine Utilisation

30. Mr Davis presented the Group-wide picture of machine utilisation and spare capacity. Proposed new machinery purchases are either renewals made for quality reasons or to increase capacity as a result of source specific requirements, or import tariffs, or specific size requirements.
31. PP&D in BATCo now has a production database which is available to all Operating Groups, and a machinery database is being set up.
32. Mr Ettegui and Mr Surdeau will discuss a capital expenditure process with the Finance Directors and make a proposal to Mr Herter.

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### Project Stem

33. The total system profit is needed firstly for the end market managers to run the business and secondly for the TSG to judge progress. Transitional systems are needed for 1995. A steering committee will be set up to oversee the development of the long term systems.
34. The underlying systems in the Operating Groups have been diverging. There is an opportunity as systems have to be changed to make them converge. An impact analysis will identify the opportunities.
35. Macon is working at maximum capacity but frequent changes to export orders are making production scheduling very difficult. It would be very helpful if orders were either more definite or gave a more clearly defined delivery schedule.
36. Mr Herter will discuss a transitional arrangement for end market responsibility in Turkey and Central Asia with Mr Johnston and Mr Tomat.
37. Mr Withington explained that changes to the existing trade mark ownership were unlikely, at present, mainly for tax reasons. BATMark will be a trade mark management organisation, which will provide a trade mark protection facility in accordance with best international practice, thereby seeking to make legal ownership irrelevant for commercial purposes. BATMark will be a Group resource to maintain trade mark registrations and manage trade marks more proactively, for example, by integrating trade mark issues into brand strategies, through agreed operating procedures, and by leveraging the strength of the tobacco trade mark portfolio to best effect.
38. The draft legal documentation for Project Stem will be discussed with the Finance and Legal Directors for implementation at the beginning of 1995.

### 1994 Trading Results and Forecasts

39. The trading profit forecast is slightly ahead of budget and last year. BATCo expects to achieve forecast but with the weakening of the US\$ does not expect any significant improvement. There is significant spend on Project Regal in the fourth quarter. B&W is confident of its forecast, with the possibility of a small upside. The BATCF forecast excludes the sale of Bahrenfeld which is expected to take place in 1994. Souza Cruz may slightly exceed its forecast. Imperial will achieve its trading profit forecast if not its volume forecast. Overall, it has been a good year for Tobacco.

### Minutes of meeting on 7th September

40. It was agreed minute 3 should be deleted and replaced by:  
  
"The producer costs as defined in the Project Stem guidelines will be recovered on a cost plus basis."

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### Matters Arising

41. **South Korea:** B&W has reduced its brand styles from 18 to 4: Kent, Finesse, Kool and Sky Slim Lights. Line extensions are planned, for example, Kent 1 and Kool Lights. B&W will make a small contribution from Korea for the first time this year. By 1999, it expects to have 3% market share, which is 12% of the import segment and to make \$21m profit. This is an organic growth strategy. B&W will review and evaluate other strategies and make a recommendation to the TSG Marketing meeting in June 1995.
42. **Philip Morris changes in Spain:** PM has taken control of all marketing in Spain but has paid a high price in concessions on manufacturing. However, as sales grow they will be able to import 80% of the increased volume from Holland. There may be a window of opportunity for BAT to take control of its operations in Spain and exit from the factory in the Canary Islands. BATCo will present a note to the CEC within the next month with options and recommendations.
43. **Brand exchange with La Moderna:** Group would like to regain the rights to Belmont in Mexico. There are other less important items which could be regained, such as the technology on Capri Slim and the rights to Raleigh in Czechia. The license to La Moderna on JPS expired in June and could be renewed for another 5 years. Mr Sandefur gave a paper with the proposals to Mr Herter.
44. Mr Pilbeam will ask BATCo's trade mark lawyers to check the status of Players in Mexico and to brief Mr Brown on the trade mark position before he meets La Moderna later this month.
45. **Viceroy packaging:** The new proposal has large shields for all the packs. Mr Herter will check this with Mr Rembiszewski on Friday. The new pack should be used for new markets but the pack must not be changed in existing markets, for example, Brazil where this might risk current volumes and any change must be tested first.

### Progress Reports

46. **Competitors:** PM is exporting from Brazil to Belgium at very low prices, for example, \$5.42 for Bond Street. Mr Castro will investigate how they can make a product so cheaply and also whether Souza Cruz can make a competitive product.
47. Mr Pilbeam will discuss the format of competitor reports to agencies with Mr Rembiszewski.
48. **New markets:** A significant presence has now been achieved in Central and Eastern Europe. Assuming that the Uzbekistan deal is closed, the top priorities are now Poland, Romania and former Yugoslavia. Beyond that, the opportunities may become more marginal. In the near East and Africa, the priorities are Turkey and Lebanon, but there are also opportunities in Egypt and Tanzania. In the Far East, there are opportunities in Vietnam, Myanmar and the Philippines, and in Latin America, in Paraguay and Cuba.

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49. **Eastern Europe:** 1994 is proving a much more successful year for BAT in Eastern Europe, particularly with the success of the new local brands.
50. **Canada:** Mr Brown reported that the size of the Canadian market has increased in 1994 and the roll your own segment has declined, resulting in growth of domestic tailor-made. Since this is the segment where Imperial is strongest, their share has increased by 4 percentage points. RBH and RJR have lost volume but increased profits.
51. The government is monitoring smoking incidence among the young, and is researching plain packaging, with results expected in February 1995. Plain packaging may be open to legal challenge, but this would not apply to the size of the health warning.
52. **US International Brands:** Kent, Lucky Strike, Pall Mall and Hilton are well up on last year; Barclay and Kool are slightly up; Viceroy is slightly down. October was B&W's largest exporting month ever. The Lucky Strike development is on schedule, with a Marketing meeting to be held shortly. The Lucky Strike parent is continuing to grow in West Germany, and it is looking better in Indonesia. Pall Mall is close to 5% in East Germany, with the success of the 24 pack priced below DM5.
53. **UK International Brands:** UKIBs are ahead of last year but below budget. SE555 is doing well in China, but the success of the "birthday" is vital. It is doing less well in Taiwan because of the problem of counterfeit. The JPGL relaunch in South Africa is not quite as good as hoped because of the problem of achieving distribution in the black community.
54. **Hollywood:** Hollywood export volumes are good, but profitability has been hit by the appreciation of the Real. Souza Cruz will address in its company plan whether the price can be increased or the cost reduced to make this business viable for the longer term. In the domestic market, Hollywood volumes were 28% higher in the third quarter than the second quarter, as a result of the uptrading and the growth of Hollywood Box and Hollywood Lights.
55. **German International Brands:** HB volumes are up in both domestic and export markets. Sales of him are disappointing, mainly due to Italy.

H C Barton  
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