ALTRIA GROUP, INC.
Form 10-Q
August 07, 2007
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

(Mark One)

(X) QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended June 30, 2007

OR

( ) TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the transition period from to

Commission file number 1-8940

Altria Group, Inc.

(Exact name of registrant as specified in its charter)

Virginia (State or other jurisdiction of incorporation or organization)	13-3260245 (I.R.S. Employer Identification No.)
120 Park Avenue, New York, New York (Address of principal executive offices)	10017 (Zip Code)

Registrant s telephone number, including area code (917) 663-4000

Former name, former address and former fiscal year, if changed since last report

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant is required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes X No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. Large accelerated filer X Accelerated filer Non-accelerated filer

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes No X

At July 31, 2007, there were 2,105,209,020 shares outstanding of the registrant s common stock, par value $0.33 1/3 per share.

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ALTRIA GROUP, INC.

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PART I FINANCIAL INFORMATION

Item 1. Financial Statements.

Altria Group, Inc. and Subsidiaries

Condensed Consolidated Balance Sheets

(in millions of dollars)

(Unaudited)

	June 30, 2007	December 31, 2006
ASSETS		
Consumer products		
Cash and cash equivalents	$ 6,156	$ 4,781
Receivables (less allowances of $16 in 2007 and $17 in 2006)	2,525	2,808
Inventories:		
Leaf tobacco	4,040	4,383
Other raw materials	1,247	1,109
Finished product	2,976	3,188
	8,263	8,680
Current assets of discontinued operations		7,647
Other current assets	1,552	2,236
Total current assets	18,496	26,152
Property, plant and equipment, at cost	15,712	14,882
Less accumulated depreciation	7,832	7,301
	7,880	7,581
Goodwill	6,794	6,197
Other intangible assets, net	1,938	1,908
Prepaid pension assets	1,299	761
Investment in SABMiller	3,934	3,674
Long-term assets of discontinued operations		48,805
Other assets	2,687	2,402
Total consumer products assets	43,028	97,480
Financial services		
Finance assets, net	6,414	6,740
Other assets	53	50
Total financial services assets	6,467	6,790

TOTAL ASSETS	$49,495	$104,270

See notes to condensed consolidated financial statements.

Continued

Altria Group, Inc. and Subsidiaries

Condensed Consolidated Balance Sheets (Continued)

(in millions of dollars, except share and per share data)

(Unaudited)

	June 30, 2007	December 31, 2006
LIABILITIES		
Consumer products		
Short-term borrowings	$ 483	$ 420
Current portion of long-term debt	3,521	648
Accounts payable	1,072	1,414
Accrued liabilities:		
Marketing	819	824
Taxes, except income taxes	4,100	3,620
Employment costs	530	849
Settlement charges	2,408	3,552
Other	1,739	1,641
Income taxes	948	782
Dividends payable	1,460	1,811
Current liabilities of discontinued operations		9,866
Total current liabilities	17,080	25,427
Long-term debt	3,195	6,298
Deferred income taxes	1,679	1,391
Accrued pension costs	547	541
Accrued postretirement health care costs	1,916	2,009
Long-term liabilities of discontinued operations		19,629
Other liabilities	2,208	2,658
Total consumer products liabilities	26,625	57,953
Financial services		
Long-term debt	1,109	1,119
Deferred income taxes	5,212	5,530
Other liabilities	360	49
Total financial services liabilities	6,681	6,698
Total liabilities	33,306	64,651
Contingencies (Note 11)		
STOCKHOLDERS EQUITY		
Common stock, par value $0.33 1/3 per share (2,805,961,317 shares issued)	935	935
Additional paid-in capital	6,797	6,356
Earnings reinvested in the business	32,770	59,879

Accumulated other comprehensive losses	(767)	(3,808)
	39,735	63,362
Less cost of repurchased stock (701,074,111 shares in 2007 and 708,880,389 shares in 2006)	(23,546)	(23,743)
Total stockholders equity	16,189	39,619
TOTAL LIABILITIES AND STOCKHOLDERS EQUITY	$49,495	$104,270

See notes to condensed consolidated financial statements.

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Altria Group, Inc. and Subsidiaries

Condensed Consolidated Statements of Earnings

(in millions of dollars, except per share data)

(Unaudited)

	For the Six Months Ended June 30,	
	2007	2006
Net revenues	$ 36,365	$ 33,382
Cost of sales	8,174	7,682
Excise taxes on products	17,531	15,441
Gross profit	10,660	10,259
Marketing, administration and research costs	3,844	3,742
Italian antitrust charge		61
Asset impairment and exit costs	517	55
(Recoveries) provision (from) for airline industry exposure	(207)	103
Amortization of intangibles	12	11
Operating income	6,494	6,287
Interest and other debt expense, net	176	266
Earnings from continuing operations before income taxes, and equity earnings and minority interest, net	6,318	6,021
Provision for income taxes	2,117	1,415
Earnings from continuing operations before equity earnings and minority interest, net	4,201	4,606
Equity earnings and minority interest, net	139	103
Earnings from continuing operations	4,340	4,709
Earnings from discontinued operations, net of income taxes and minority interest	625	1,479
Net earnings	$ 4,965	$ 6,188
Per share data:		
Basic earnings per share:		
Continuing operations	$ 2.07	$ 2.26
Discontinued operations	0.30	0.71
Net earnings	$ 2.37	$ 2.97
Diluted earnings per share:		
Continuing operations	$ 2.05	$ 2.24
Discontinued operations	0.30	0.70

Net earnings	$	2.35	$	2.94
Dividends declared	$	1.55	$	1.60

See notes to condensed consolidated financial statements.

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Altria Group, Inc. and Subsidiaries

Condensed Consolidated Statements of Earnings

(in millions of dollars, except per share data)

(Unaudited)

	For the Three Months Ended June 30,	
	2007	2006
Net revenues	$ 18,809	$ 17,150
Cost of sales	4,265	3,958
Excise taxes on products	9,012	7,895
Gross profit	5,532	5,297
Marketing, administration and research costs	1,966	1,909
Asset impairment and exit costs	394	53
(Recoveries) provision (from) for airline industry exposure	(78)	103
Amortization of intangibles	6	6
Operating income	3,244	3,226
Interest and other debt expense, net	62	119
Earnings from continuing operations before income taxes, and equity earnings and minority interest, net	3,182	3,107
Provision for income taxes	1,066	1,041
Earnings from continuing operations before equity earnings and minority interest, net	2,116	2,066
Equity earnings and minority interest, net	99	46
Earnings from continuing operations	2,215	2,112
Earnings from discontinued operations, net of income taxes and minority interest		599
Net earnings	$ 2,215	$ 2,711
Per share data:		
Basic earnings per share:		
Continuing operations	$ 1.05	$ 1.01
Discontinued operations		0.29
Net earnings	$ 1.05	$ 1.30
Diluted earnings per share:		
Continuing operations	$ 1.05	$ 1.00
Discontinued operations		0.29
Net earnings	$ 1.05	$ 1.29
Dividends declared	$ 0.69	$ 0.80

See notes to condensed consolidated financial statements.

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Altria Group, Inc. and Subsidiaries

Condensed Consolidated Statements of Stockholders Equity

for the Year Ended December 31, 2006 and

the Six Months Ended June 30, 2007

(in millions of dollars, except per share data)

(Unaudited)

				Accumulated Other Comprehensive Earnings (Losses)				
	Common Stock	Additional Paid-in Capital	Earnings Reinvested in the Business	Currency Translation Adjustments	Other	Total	Cost of Repurchased Stock	Total Stock-holders Equity
Balances, January 1, 2006	$935	$6,061	$54,666	$(1,317)	$(536)	$(1,853)	$(24,102)	$35,707
Comprehensive earnings:								
Net earnings			12,022					12,022
Other comprehensive earnings (losses), net of income taxes:								
Currency translation adjustments				1,220		1,220		1,220
Additional minimum pension liability					233	233		233
Change in fair value of derivatives accounted for as hedges					(11)	(11)		(11)
Other					(11)	(11)		(11)
Total other comprehensive earnings								1,431
Total comprehensive earnings								13,453
Initial adoption of FASB Statement No. 158, net of income taxes					(3,386)	(3,386)		(3,386)
Exercise of stock options and issuance of other stock awards		295	145				359	799
Cash dividends declared ($3.32 per share)			(6,954)					(6,954)
Balances, December 31, 2006	935	6,356	59,879	(97)	(3,711)	(3,808)	(23,743)	39,619
Comprehensive earnings:								
Net earnings			4,965					4,965
Other comprehensive earnings (losses), net of income taxes:								
Currency translation adjustments				446		446		446
Change in net loss and prior service cost					493	493		493
Change in fair value of derivatives accounted for as hedges					(7)	(7)		(7)
Total other comprehensive earnings								932

Total comprehensive earnings								5,897
Adoption of FIN 48 and FAS 13-2			711					711
Exercise of stock options and issuance of other stock awards (1)		441					197	638
Cash dividends declared ($1.55 per share)			(3,265)					(3,265)
Spin-off of Kraft Foods Inc.			(29,520)	89	2,020	2,109		(27,411)
Balances, June 30, 2007	$935	$6,797	$32,770	$438	$(1,205)	$(767)	$(23,546)	$16,189

(1) Includes $179 million increase to additional paid-in capital for the reimbursement from Kraft for Altria stock awards. See Note 1.

Total comprehensive earnings were $2,992 million and $3,031 million, respectively, for the quarters ended June 30, 2007 and 2006, and $7,000 million for the first six months of 2006.

See notes to condensed consolidated financial statements.

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Altria Group, Inc. and Subsidiaries

Condensed Consolidated Statements of Cash Flows

(in millions of dollars)

(Unaudited)

	For the Six Months Ended June 30,	
	2007	2006
CASH PROVIDED BY (USED IN) OPERATING ACTIVITIES		
Earnings from continuing operations - Consumer products	$4,158	$4,685
- Financial services	182	24
Earnings from discontinued operations, net of income taxes and minority interest	625	1,479
Net earnings	4,965	6,188
Impact of earnings from discontinued operations, net of income taxes and minority interest	(625)	(1,479)
Adjustments to reconcile net earnings to operating cash flows:		
Consumer products		
Depreciation and amortization	462	450
Deferred income tax provision	559	24
Equity earnings and minority interest, net	(139)	(103)
U.S. tobacco headquarters relocation charges, net of cash paid	(1)	(1)
Escrow bond for the *Price* U.S. tobacco case		1,850
Asset impairment and exit costs, net of cash paid	387	7
Income tax reserve reversal		(1,006)
Cash effects of changes, net of the effects from acquired and divested companies:		
Receivables, net	(108)	26
Inventories	640	45
Accounts payable	(84)	(171)
Income taxes	(43)	976
Accrued liabilities and other current assets	76	(274)
U.S. tobacco accrued settlement charges	(1,144)	(1,276)
Pension plan contributions	(72)	(341)
Pension provisions and postretirement, net	150	208
Other	100	338
Financial services		
Deferred income tax benefit	(234)	(256)
Provision for airline industry exposure		103
Other	69	203
Net cash provided by operating activities, continuing operations	4,958	5,511
Net cash provided by operating activities, discontinued operations	161	1,606
Net cash provided by operating activities	5,119	7,117

See notes to condensed consolidated financial statements.

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Altria Group, Inc. and Subsidiaries

Condensed Consolidated Statements of Cash Flows (Continued)

(in millions of dollars)

(Unaudited)

	For the Six Months Ended June 30, 2007	For the Six Months Ended June 30, 2006
CASH PROVIDED BY (USED IN) INVESTING ACTIVITIES		
Consumer products		
Capital expenditures	$ (598)	$ (475)
Purchases of businesses, net of acquired cash	(413)	
Proceeds from sales of businesses	3	10
Other	84	32
Financial services		
Investments in finance assets	(3)	(8)
Proceeds from finance assets	340	202
Net cash used in investing activities, continuing operations	(587)	(239)
Net cash provided by (used in) investing activities, discontinued operations	26	(296)
Net cash used in investing activities	(561)	(535)
CASH PROVIDED BY (USED IN) FINANCING ACTIVITIES		
Consumer products		
Net issuance (repayment) of short-term borrowings	40	(273)
Long-term borrowings by PMI	730	
Long-term debt repaid	(1,030)	(2,121)
Financial services		
Long-term debt repaid		(821)
Dividends paid on Altria Group, Inc. common stock	(3,616)	(3,339)
Issuance of Altria Group, Inc. common stock	330	208
Kraft Foods Inc. dividends paid to Altria Group, Inc.	728	670
Other	(229)	(384)
Net cash used in financing activities, continuing operations	(3,047)	(6,060)
Net cash used in financing activities, discontinued operations	(176)	(1,249)
Net cash used in financing activities	(3,223)	(7,309)
Effect of exchange rate changes on cash and cash equivalents:		
Continuing operations	51	57
Discontinued operations	1	25
Cash and cash equivalents, continuing operations:		
Increase (Decrease)	1,375	(731)

Balance at beginning of period	4,781	5,942
Balance at end of period	$ 6,156	$ 5,211

See notes to condensed consolidated financial statements.

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Altria Group, Inc. and Subsidiaries

Notes to Condensed Consolidated Financial Statements

(Unaudited)

Note 1. Basis of Presentation and Kraft Spin-Off

Basis of Presentation

The interim condensed consolidated financial statements of Altria Group, Inc. and subsidiaries (Altria Group, Inc.) are unaudited. It is the opinion of Altria Group, Inc. s management that all adjustments necessary for a fair statement of the interim results presented have been reflected therein. All such adjustments were of a normal recurring nature. Net revenues and net earnings for any interim period are not necessarily indicative of results that may be expected for the entire year. Throughout this Form 10-Q, the term Altria Group, Inc. refers to the consolidated financial position, results of operations and cash flows of the Altria family of companies and the term ALG refers solely to the parent company.

These statements should be read in conjunction with the consolidated financial statements and related notes, which appear in Altria Group, Inc. s Annual Report to Stockholders and which are incorporated by reference into Altria Group, Inc. s Annual Report on Form 10-K for the year ended December 31, 2006 (the 2006 Form 10-K).

Balance sheet accounts are segregated by two broad types of businesses. Consumer products assets and liabilities are classified as either current or non-current, whereas financial services assets and liabilities are unclassified, in accordance with respective industry practices.

On March 30, 2007, Altria Group, Inc. distributed all of its remaining interest in Kraft Foods Inc. (Kraft) on a pro-rata basis to Altria Group, Inc. stockholders in a tax-free distribution. *For further discussion, please refer to the Kraft Spin-Off discussion below.* Altria Group, Inc. has reflected the results of Kraft prior to the distribution date as discontinued operations on the condensed consolidated statements of earnings and the condensed consolidated statements of cash flows. The assets and liabilities related to Kraft were reclassified and reflected as discontinued operations on the condensed consolidated balance sheet at December 31, 2006.

The products of ALG s subsidiaries include cigarettes and other tobacco products sold in the United States by Philip Morris USA Inc. (PM USA) and outside the United States by Philip Morris International Inc. (PMI). Beginning with the second quarter of 2007, Altria Group, Inc. revised its reportable segments to reflect PMI s operations by geographic region. Altria Group, Inc. s revised segments, which are reflected in these financial statements, are U.S. tobacco; European Union; Eastern Europe, Middle East and Africa; Asia; Latin America; and Financial Services. Accordingly, prior period segment results have been restated.

Certain prior year amounts have been reclassified to conform with the current year s presentation, due primarily to the classification of Kraft as discontinued operations and revised segment information.

Kraft Spin-Off

On March 30, 2007 (the Distribution Date), Altria Group, Inc. spun-off all of its remaining interest (88.9%) in Kraft on a pro-rata basis to Altria Group, Inc. stockholders of record as of the close of business on March 16, 2007 (the Record Date) in a tax-free distribution. Based on the number of shares of Altria Group, Inc. outstanding at the Record Date, the distribution ratio was 0.692024 of a share of Kraft for every share of Altria Group, Inc. common stock outstanding. Altria Group, Inc. stockholders received cash in lieu of fractional shares of Kraft. Following the distribution, Altria Group, Inc. does not own any shares of Kraft. During the second quarter of 2007, Altria Group, Inc. adjusted its current quarterly dividend to $0.69 per share, so that its stockholders who retain their Altria Group, Inc. and Kraft shares will receive, in the aggregate, the same dividend rate as before the distribution. As a result, the present annualized dividend rate is $2.76 per Altria Group, Inc. common share. As in the past, all decisions regarding future dividend increases will be made

Altria Group, Inc. and Subsidiaries

Notes to Condensed Consolidated Financial Statements

(Unaudited)

independently by the Altria Group, Inc. Board of Directors and the Kraft Board of Directors, for their respective companies.

Holders of Altria Group, Inc. stock options were treated similarly to public stockholders and accordingly, had their stock awards split into two instruments. Holders of Altria Group, Inc. stock options received the following stock options, which, immediately after the spin-off, had an aggregate intrinsic value equal to the intrinsic value of the pre-spin Altria Group, Inc. options:

- a new Kraft option to acquire the number of shares of Kraft Class A common stock equal to the product of (a) the number of Altria Group, Inc. options held by such person on the Distribution Date and (b) the distribution ratio of 0.692024 mentioned above; and

- an adjusted Altria Group, Inc. option for the same number of shares of Altria Group, Inc. common stock with a reduced exercise price.

The new Kraft option has an exercise price equal to the Kraft market price at the time of the distribution ($31.66) multiplied by the Option Conversion Ratio, which represents the exercise price of the original Altria Group, Inc. option divided by the Altria Group, Inc. market price immediately before the distribution ($87.81). The reduced exercise price of the adjusted Altria Group, Inc. option is determined by multiplying the Altria Group, Inc. market price immediately following the distribution ($65.90) by the Option Conversion Ratio.

Holders of Altria Group, Inc. restricted stock or stock rights awarded prior to January 31, 2007, retained their existing award and received restricted stock or stock rights of Kraft Class A common stock. The amount of Kraft restricted stock or stock rights awarded to such holders was calculated using the same formula set forth above with respect to new Kraft options. All of the restricted stock and stock rights will vest at the completion of the original restriction period (typically, three years from the date of the original grant). Recipients of Altria Group, Inc. stock rights awarded on January 31, 2007, did not receive restricted stock or stock rights of Kraft. Rather, they received additional stock rights of Altria Group, Inc. to preserve the intrinsic value of the original award.

To the extent that employees of the remaining Altria Group, Inc. received Kraft stock options, Altria Group, Inc. reimbursed Kraft in cash for the Black-Scholes fair value of the stock options received. To the extent that Kraft employees held Altria Group, Inc. stock options, Kraft reimbursed Altria Group, Inc. in cash for the Black-Scholes fair value of the stock options. To the extent that holders of Altria Group, Inc. stock rights received Kraft stock rights, Altria Group, Inc. paid to Kraft the fair value of the Kraft stock rights less the value of projected forfeitures. Based upon the number of Altria Group, Inc. stock awards outstanding at the Distribution Date, the net amount of these reimbursements resulted in a payment of $179 million from Kraft to Altria Group, Inc. in April 2007. The reimbursement from Kraft is reflected as an increase to the additional paid-in capital of Altria Group, Inc. on the June 30, 2007 condensed consolidated balance sheet.

Kraft was previously included in the Altria Group, Inc. consolidated federal income tax return, and federal income tax contingencies were recorded as liabilities on the balance sheet of ALG. As part of the intercompany account settlement discussed below, ALG reimbursed Kraft in cash for these liabilities, which as of March 30, 2007, were approximately $305 million, plus pre-tax interest of $63 million. ALG also reimbursed Kraft in cash for the federal income tax consequences of the adoption of Financial Accounting Standards Board (FASB) Interpretation No. 48, Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109 (FIN 48) (approximately $70 million plus pre-tax interest of $14 million). See Note 12. *Income Taxes* for a discussion of the FIN 48 adoption and the Tax Sharing Agreement between Altria Group, Inc. and Kraft.

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Altria Group, Inc. and Subsidiaries

Notes to Condensed Consolidated Financial Statements

(Unaudited)

A subsidiary of ALG previously provided Kraft with certain services at cost plus a 5% management fee. After the Distribution Date, Kraft undertook these activities, and any remaining limited services provided to Kraft will cease in 2007. All intercompany accounts were settled in cash within 30 days of the Distribution Date. The settlement of the intercompany accounts (including the amounts discussed above related to stock awards and tax contingencies) resulted in a net payment from Kraft to ALG of $85 million in April 2007.

The distribution resulted in a net decrease to Altria Group, Inc. s stockholders equity of $27.4 billion on the Distribution Date.

Note 2. Asset Impairment and Exit Costs:

Pre-tax asset impairment and exit costs consisted of the following:

		For the Six Months Ended June 30,		For the Three Months Ended June 30,	
		2007	2006	2007	2006
		(in millions)			
Separation program	U.S. tobacco	$ 283	$ -	$ 283	$ -
Separation program	European Union	88	22	59	20
Separation program	Eastern Europe, Middle East and Africa	12			
Separation program	Asia	20	1	6	1
Separation program	Latin America	18		11	
Separation program	General corporate	17	30		30
Total separation program		438	53	359	51
Asset impairment	U.S. tobacco	35		35	
Asset impairment	General corporate		2		2
Total asset impairment		35	2	35	2
Kraft spin-off fees	General corporate	44			
Asset impairment and exit costs		$ 517	$ 55	$ 394	$ 53

The movement in the asset impairment and exit cost liabilities for Altria Group, Inc. for the six months ended June 30, 2007 was as follows:

Severance	Asset write-downs	Other	Total

		(in millions)		
Liability balance, January 1, 2007	$ 131	$ -	$ -	$ 131
Charges	414	35	68	517
Cash spent	(85)		(45)	(130)
Charges against assets		(35)		(35)
Currency/other	1		(23)	(22)
Liability balance, June 30, 2007	$ 461	$ -	$ -	$ 461

Altria Group, Inc. and Subsidiaries

Notes to Condensed Consolidated Financial Statements

(Unaudited)

Manufacturing Optimization Program

In June 2007, Altria Group, Inc. announced plans by its tobacco subsidiaries to optimize worldwide cigarette production by moving U.S.-based cigarette production for non-U.S. markets to PMI facilities in Europe. Due to declining U.S. cigarette volume, as well as PMI s decision to re-source its production, PM USA will close its Cabarrus, North Carolina manufacturing facility and consolidate manufacturing for the U.S. market at its Richmond, Virginia manufacturing center. PMI is expected to shift sourcing of approximately 57 billion cigarettes from U.S. manufacturing to PMI facilities in Europe by the third quarter of 2008 and PM USA will close its Cabarrus manufacturing facility by the end of 2010.

As a result of this program, from 2007 through 2011, PM USA expects to incur total pre-tax charges of approximately $670 million, comprising accelerated depreciation of $143 million (including the above mentioned asset impairment charge of $35 million recorded in the second quarter of 2007), employee separation costs of $353 million and other charges of $174 million, primarily related to the relocation of employees and equipment, net of estimated gains on sales of land and buildings. Approximately $440 million, or 66% of the total pre-tax charges, will result in cash expenditures. PM USA recorded an initial pre-tax charge for the program of $318 million or $0.10 per diluted share in the second quarter of 2007 related primarily to employee separation programs. Additional charges of approximately $55 million are expected during the remainder of 2007.

Philip Morris International Asset Impairment and Exit Costs

During 2005, 2006 and 2007, PMI announced plans for the streamlining of various administrative functions and operations. These plans resulted in the announced closure or partial closure of 9 production facilities through June 30, 2007. As a result of these announcements, PMI recorded pre-tax charges of $138 million and $76 million during the six months and three months ended June 30, 2007, respectively, and $23 million and $21 million during the six months and three months ended June 30, 2006, respectively. These pre-tax charges primarily related to severance costs. Additional pre-tax charges of approximately $110 million are expected during the remainder of 2007.

Cash payments related to exit costs at PMI were $73 million and $50 million for the six months and three months ended June 30, 2007, respectively. Future cash payments for exit costs incurred to date are expected to be approximately $165 million.

The streamlining of these various functions and operations are expected to result in the elimination of approximately 2,300 positions. As of June 30, 2007, approximately 1,700 of these positions have been eliminated.

Corporate Asset Impairment and Exit Costs

General corporate charges primarily related to investment banking fees associated with the Kraft spin-off in 2007 and charges related to the streamlining of various corporate functions in 2007 and 2006.

Note 3. Benefit Plans:

Altria Group, Inc. sponsors noncontributory defined benefit pension plans covering substantially all U.S. employees. Pension coverage for employees of ALG s non-U.S. subsidiaries is provided, to the extent deemed appropriate, through separate plans, many of which are governed by local statutory requirements. In addition, ALG and its U.S. subsidiaries provide health care and other benefits to substantially all retired employees. Health care benefits for retirees outside the United States are generally covered through local government plans.

Altria Group, Inc. and Subsidiaries

Notes to Condensed Consolidated Financial Statements

(Unaudited)

Pension Plans

Components of Net Periodic Benefit Cost

Net periodic pension cost consisted of the following:

	U.S. Plans For the Six Months Ended June 30,		Non-U.S. Plans For the Six Months Ended June 30,	
	2007	2006	2007	2006
	(in millions)			
Service cost	$ 54	$ 58	$ 68	$ 62
Interest cost	153	142	64	56
Expected return on plan assets	(211)	(200)	(105)	(81)
Amortization:				
Net loss	50	74	14	12
Prior service cost	6	6	2	3
Other	24	5		
Net periodic pension cost	$ 76	$ 85	$ 43	$ 52

	U.S. Plans For the Three Months Ended June 30,		Non-U.S. Plans For the Three Months Ended June 30,	
	2007	2006	2007	2006
	(in millions)			
Service cost	$ 26	$ 29	$ 33	$ 31
Interest cost	75	71	31	28
Expected return on plan assets	(108)	(100)	(53)	(41)
Amortization:				
Net loss	20	37	7	6
Prior service cost	3	3	1	2
Other	22	5		
Net periodic pension cost	$ 38	$ 45	$ 19	$ 26

Other above was due primarily to curtailment losses related to PM USA s announced closure of its Cabarrus, North Carolina manufacturing facility in 2007 and a workforce reduction program within Altria corporate headquarters in 2006. In conjunction with the 2007 curtailment, as of June 30, 2007, Altria Group, Inc. remeasured its benefit obligation and plan assets for its U.S. pension plans. This remeasurement resulted in an increase in prepaid pension assets of approximately $500 million and a corresponding increase to stockholders equity.

Employer Contributions

Altria Group, Inc. presently makes, and plans to make, contributions, to the extent that they are tax deductible and do not generate an excise tax liability, in order to maintain plan assets in excess of the accumulated benefit obligation of its funded U.S. and non-U.S. plans. Employer contributions of $18 million and $54 million were made to U.S. plans and non-U.S. plans, respectively, during the six months ended June 30, 2007. Currently,

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Altria Group, Inc. anticipates making additional contributions during the remainder of 2007 of approximately $5 million to its U.S. plans and approximately $65 million to its non-U.S. plans, based on current tax law. However, these estimates are subject to change as a result of changes in tax and other benefit laws, as well as asset performance significantly above or below the assumed long-term rate of return on pension assets, or changes in interest rates.

Postretirement Benefit Plans

Net postretirement health care costs consisted of the following:

	For the Six Months Ended		For the Three Months Ended	
	June 30,		June 30,	
	2007	2006	2007	2006
	(in millions)			
Service cost	$ 24	$ 27	$ 12	$ 13
Interest cost	63	61	31	30
Amortization:				
Net loss	17	18	9	9
Prior service cost	(4)	(1)	(2)	
Other	(4)	3	(5)	3
Net postretirement health care costs	$ 96	$ 108	$ 45	$ 55

Other above was due primarily to curtailment gains related to PM USA s announced closure of its Cabarrus, North Carolina manufacturing facility in 2007 and a workforce reduction program within Altria corporate headquarters in 2006.

Note 4. Goodwill and Other Intangible Assets, net:

Goodwill and other intangible assets, net, by segment were as follows (in millions):

	Goodwill		Other Intangible Assets, net	
	June 30,	December 31,	June 30,	December 31,
	2007	2006	2007	2006
U.S. tobacco	$ -	$ -	$ 281	$ 281
European Union	1,332	1,307	64	65
Eastern Europe, Middle East and Africa	663	657	163	164
Asia	4,260	3,778	1,363	1,339
Latin America	539	455	67	59

Total	$ 6,794	$ 6,197	$ 1,938	$ 1,908

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Intangible assets were as follows (in millions):

	June 30, 2007		December 31, 2006	
	Gross Carrying Amount	Accumulated Amortization	Gross Carrying Amount	Accumulated Amortization
Non-amortizable intangible assets	$1,592		$1,566	
Amortizable intangible assets	405	$59	388	$46
Total intangible assets	$1,997	$59	$1,954	$46

Non-amortizable intangible assets substantially consist of brand names from PMI s 2005 acquisition of a business in Indonesia. Amortizable intangible assets consist primarily of certain trademark licenses and non-compete agreements. Pre-tax amortization expense for intangible assets during the six months ended June 30, 2007 and 2006, was $12 million and $11 million, respectively, and $6 million for the three months ended June 30, 2007 and 2006. Amortization expense for each of the next five years is estimated to be $25 million or less, assuming no additional transactions occur that require the amortization of intangible assets.

Goodwill is due primarily to PMI s acquisitions in Indonesia, Greece, Serbia, Colombia and Pakistan. The movement in goodwill and gross carrying amount of intangible assets from December 31, 2006, is as follows (in millions):

	Goodwill	Intangible Assets
Balance at December 31, 2006	$6,197	$1,954
Changes due to:		
Currency	172	43
Acquisitions	423	
Other	2	
Balance at June 30, 2007	$6,794	$1,997

The increase in goodwill from acquisitions is related to the preliminary allocation of the purchase price for PMI s acquisition in Pakistan. The allocation is based upon preliminary estimates and assumptions and is subject to revision when appraisals are finalized, which is expected to occur by the end of 2007.

During the first quarter of 2007, Altria Group, Inc. completed its annual review of goodwill and intangible assets, and no charges resulted from this review.

Note 5. Financial Instruments:

During the six months and three months ended June 30, 2007 and 2006, ineffectiveness related to fair value hedges and cash flow hedges was not material. Altria Group, Inc. is hedging forecasted transactions for periods not exceeding the next seventeen months and expects gains of approximately $13 million reported in accumulated other comprehensive earnings (losses) to be reclassified to the consolidated statement of earnings within the next twelve months.

Within currency translation adjustments at June 30, 2007 and 2006, Altria Group, Inc. recorded gains of $21 million, net of income taxes, and losses of $154 million, net of income taxes, respectively, which represented effective hedges of net investments.

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Hedging activity affected accumulated other comprehensive earnings (losses), net of income taxes, as follows:

	For the Six Months Ended June 30,		For the Three Months Ended June 30,	
	2007	2006	2007	2006
	(in millions)			
Gain at beginning of period	$13	$24	$ 5	$36
Derivative gains transferred to earnings	(41)	(18)	(17)	(12)
Change in fair value	34	11	20	(7)
Kraft spin-off	2			
Gain as of June 30	$ 8	$17	$ 8	$17

Note 6. Acquisitions:

During the first quarter of 2007, PMI acquired an additional 50.2% stake in a Pakistan cigarette manufacturer, Lakson Tobacco Company Limited (Lakson Tobacco), and completed a mandatory tender offer for the remaining shares, which increased PMI s total ownership interest in Lakson Tobacco from 40% to approximately 98%, for $388 million. The effect of this acquisition was not material to Altria Group, Inc. s consolidated financial position, results of operations or operating cash flows in any of the periods presented.

Note 7. Divestitures:

Discontinued Operations:

As further discussed in Note 1. *Basis of Presentation and Kraft Spin-Off*, on March 30, 2007, Altria Group, Inc. completed the spin-off of all of its remaining interest (88.9%) in Kraft on a pro rata basis to Altria Group, Inc. stockholders in a tax-free distribution. Altria Group, Inc. stockholders received 0.692024 of a share of Kraft for every share of Altria Group, Inc. common stock outstanding. Altria Group, Inc. stockholders received cash in lieu of fractional shares of Kraft. The distribution was accounted for as a dividend and as such resulted in a net decrease to Altria Group, Inc. s stockholders equity of $27.4 billion on March 30, 2007.

Altria Group, Inc. has reflected the results of Kraft prior to the distribution date as discontinued operations on the condensed consolidated statements of earnings and the condensed consolidated statements of cash flows. The assets and liabilities related to Kraft were reclassified and reflected as discontinued operations on the condensed consolidated balance sheet at December 31, 2006.

Summarized financial information for discontinued operations for the six months and three months ended June 30, 2007 and 2006 were as follows (in millions):

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	For the Six Months Ended June 30,		For the Three Months Ended June 30,	
	2007	2006	2007	2006
Net revenues	$ 8,586	$ 16,742	$ -	$ 8,619
Earnings before income taxes and minority interest	$ 1,059	$ 1,952	$ -	$ 1,030
Provision for income taxes	(356)	(262)		(347)
Minority interest in earnings from discontinued operations, net	(78)	(211)		(84)
Earnings from discontinued operations, net of income taxes and minority interest	$ 625	$ 1,479	$ -	$ 599

Summarized assets and liabilities of discontinued operations as of December 31, 2006 were as follows (in millions):

	December 31, 2006
Assets:	
Cash and cash equivalents	$ 239
Receivables, net	3,262
Inventories	3,506
Other current assets	640
Current assets of discontinued operations	7,647
Property, plant and equipment, net	9,693
Goodwill	27,038
Other intangible assets, net	10,177
Prepaid pension assets	1,168
Other assets	729
Long-term assets of discontinued operations	48,805
Liabilities:	
Short-term borrowings	1,715
Current portion of long-term debt	1,418
Accounts payable	2,602
Accrued liabilities	3,980
Income taxes	151
Current liabilities of discontinued operations	9,866

Long-term debt		7,081
Deferred income taxes		3,930
Accrued pension costs		1,022
Accrued postretirement health care costs		3,014
Minority interest		3,109
Other liabilities		1,473
Long-term liabilities of discontinued operations		19,629
Net Assets	$	26,957

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Note 8. Stock Plans:

In connection with the Kraft spin-off, Altria Group, Inc. employee stock options were modified through the issuance of Kraft employee stock options and the adjustment of the stock option exercise prices for the Altria Group, Inc. awards. For each employee stock option outstanding the aggregate intrinsic value of the option immediately after the spin-off was not greater than the aggregate intrinsic value of the option immediately before the spin-off. Due to the fact that the Black-Scholes fair values of the awards immediately before and immediately after the spin-off were equivalent, as measured in accordance with the provisions of Statement of Financial Accounting Standards (SFAS) No. 123(R), no incremental compensation expense was recorded as a result of the modification of the Altria Group, Inc. awards.

In January 2007, Altria Group, Inc. issued 1.7 million rights to receive shares of stock to eligible U.S.-based and non-U.S. employees. Restrictions on these rights lapse in the first quarter of 2010. The market value per right was $87.36 on the date of grant. Recipients of these Altria Group, Inc. stock rights did not receive restricted stock or stock rights of Kraft upon the Kraft spin-off. Rather, they received approximately 0.6 million additional stock rights of Altria Group, Inc. to preserve the intrinsic value of the original award.

During the six months ended June 30, 2007, 2.1 million shares of restricted stock and rights to receive shares of stock vested. The total fair value of restricted stock and rights vested during the six months ended June 30, 2007 was $182 million. The grant date fair value per share of these awards was $55.34.

Note 9. Earnings Per Share:

Basic and diluted EPS from continuing and discontinued operations were calculated using the following:

	For the Six Months Ended June 30,		For the Three Months Ended June 30,	
	2007	2006	2007	2006
	(in millions)			
Earnings from continuing operations	$4,340	$4,709	$2,215	$2,112
Earnings from discontinued operations	625	1,479		599
Net earnings	$4,965	$6,188	$2,215	$2,711
Weighted average shares for basic EPS	2,099	2,083	2,101	2,085
Plus incremental shares from assumed conversions:				
Restricted stock and stock rights	2	4	2	3
Stock options	12	15	13	14
Weighted average shares for diluted EPS	2,113	2,102	2,116	2,102

For the six months and three months ended June 30, 2007, there were no antidilutive stock options. For the six months and three months ended June 30, 2006, the number of stock options excluded from the calculation of weighted average shares for diluted EPS because their effects were antidilutive was immaterial.

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Note 10. Segment Reporting:

The products of ALG s subsidiaries include cigarettes and other tobacco products sold in the United States by PM USA and outside of the United States by PMI. PMI s operations are organized and managed by geographic region. Another subsidiary of ALG, PMCC, maintains a portfolio of leveraged and direct finance leases.

As discussed in Note 1. *Basis of Presentation and Kraft Spin-Off*, Altria Group, Inc. revised its reportable segments. Beginning with the second quarter of 2007, Altria Group, Inc. s reportable segments are U.S. tobacco; European Union; Eastern Europe, Middle East and Africa; Asia; Latin America; and Financial Services.

Altria Group, Inc. s management reviews operating companies income to evaluate segment performance and allocate resources. Operating companies income for the segments excludes general corporate expenses and amortization of intangibles. Interest and other debt expense, net (consumer products), and provision for income taxes are centrally managed at the ALG level and, accordingly, such items are not presented by segment since they are excluded from the measure of segment profitability reviewed by Altria Group, Inc. s management.

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Segment data were as follows:

	For the Six Months Ended June 30,		For the Three Months Ended June 30,	
	2007	2006	2007	2006
	(in millions)			
Net revenues:				
U.S. tobacco	$ 9,054	$ 9,108	$ 4,809	$ 4,785
European Union	13,421	11,790	6,867	6,064
Eastern Europe, Middle East and Africa	5,893	5,109	3,103	2,655
Asia	5,537	5,081	2,787	2,528
Latin America	2,365	2,131	1,191	1,063
Total International tobacco	27,216	24,111	13,948	12,310
Financial Services	95	163	52	55
Net revenues	$ 36,365	$ 33,382	$ 18,809	$ 17,150
Earnings from continuing operations before income taxes, and equity earnings and minority interest, net:				
Operating companies income (loss):				
U.S. tobacco	$ 2,134	$ 2,417	$ 1,004	$ 1,301
European Union	2,105	1,780	1,075	957
Eastern Europe, Middle East and Africa	1,201	1,057	634	564
Asia	898	1,007	429	488
Latin America	190	262	102	130
Total International tobacco	4,394	4,106	2,240	2,139
Financial Services	299	37	139	(59)
Amortization of intangibles	(12)	(11)	(6)	(6)
General corporate expenses	(321)	(262)	(133)	(149)
Operating income	6,494	6,287	3,244	3,226
Interest and other debt expense, net	(176)	(266)	(62)	(119)
Earnings from continuing operations before income taxes, and equity earnings and minority interest, net	$ 6,318	$ 6,021	$ 3,182	$ 3,107

Items affecting the comparability of results from continuing operations were as follows:

Asset Impairment and Exit Costs See Note 2. *Asset Impairment and Exit Costs*, for a breakdown of asset impairment and exit costs by segment.

Recoveries/Provision from/for Airline Industry Exposure During the six months and three months ended June 30, 2007, PMCC recorded pre-tax gains of $207 million and $78 million, respectively, on the sale of its ownership interests and bankruptcy claims in certain leveraged lease investments in aircraft, which represented a partial cash recovery of amounts that had been previously written down. During the second

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quarter of 2006, PMCC increased its allowance for losses by $103 million, due to continuing issues within the airline industry.

Italian Antitrust Charge During the first quarter of 2006, PMI recorded a $61 million charge related to an Italian antitrust action. This charge was included in the operating companies income of the European Union segment.

Note 11. Contingencies:

Legal proceedings covering a wide range of matters are pending or threatened in various United States and foreign jurisdictions against ALG, its subsidiaries and affiliates, including PM USA and PMI, as well as their respective indemnitees. Various types of claims are raised in these proceedings, including product liability, consumer protection, antitrust, tax, contraband shipments, patent infringement, employment matters, claims for contribution and claims of competitors and distributors.

Overview of Tobacco-Related Litigation

Types and Number of Cases

Claims related to tobacco products generally fall within the following categories: (i) smoking and health cases alleging personal injury brought on behalf of individual plaintiffs, (ii) smoking and health cases primarily alleging personal injury or seeking court-supervised programs for ongoing medical monitoring and purporting to be brought on behalf of a class of individual plaintiffs, including cases in which the aggregated claims of a number of individual plaintiffs are to be tried in a single proceeding, (iii) health care cost recovery cases brought by governmental (both domestic and foreign) and non-governmental plaintiffs seeking reimbursement for health care expenditures allegedly caused by cigarette smoking and/or disgorgement of profits, (iv) class action suits alleging that the uses of the terms Lights and Ultra Lights constitute deceptive and unfair trade practices, common law fraud, or violations of the Racketeer Influenced and Corrupt Organizations Act (RICO), and (v) other tobacco-related litigation described below. Damages claimed in some of the tobacco-related litigation range into the billions of dollars. Plaintiffs theories of recovery and the defenses raised in pending smoking and health, health care cost recovery and Lights/Ultra Lights cases are discussed below.

The table below lists the number of certain tobacco-related cases pending in the United States against PM USA and, in some instances, ALG or PMI, as of August 1, 2007, August 1, 2006 and August 1, 2005, and a page-reference to further discussions of each type of case.

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Type of Case	Number of Cases Pending as of August 1, 2007	Number of Cases Pending as of August 1, 2006	Number of Cases Pending as of August 1, 2005	Page References
Individual Smoking and Health Cases (1)	195	191	261	34
Smoking and Health Class Actions and Aggregated Claims Litigation (2)	10	9	9	34-35
Health Care Cost Recovery Actions	3	6	5	35-40
Lights/Ultra Lights Class Actions	17	21	24	40-43
Tobacco Price Cases	2	2	2	43
Cigarette Contraband Cases	0	0	1	44
Asbestos Contribution Cases	0	0	1	-

(1) Does not include 2,623 cases brought by flight attendants seeking compensatory damages for personal injuries allegedly caused by exposure to environmental tobacco smoke (ETS). The flight attendants allege that they are members of an ETS smoking and health class action, which was settled in 1997. The terms of the court-approved settlement in that case allow class members to file individual lawsuits seeking compensatory damages, but prohibit them from seeking punitive damages. Also, does not include nine individual smoking and health cases brought against certain retailers that are indemnitees of PM USA.

(2) Includes as one case the aggregated claims of 933 individuals (of which 540 individuals have claims against PM USA) that are proposed to be tried in a single proceeding in West Virginia. The West Virginia Supreme Court of Appeals has ruled that the United States Constitution does not preclude a trial in two phases in this case. Issues related to defendants conduct, plaintiffs entitlement to punitive damages and a punitive damages multiplier, if any, would be determined in the first phase. The second phase would consist of individual trials to determine liability, if any, and compensatory damages.

There are also a number of other tobacco-related actions pending outside the United States against PMI and its affiliates and subsidiaries, including an estimated 134 individual smoking and health cases as of August 1, 2007 (Argentina (57), Australia (3), Brazil (55), Chile (8), Costa Rica (1), Greece (1), Italy (5), the Philippines (1), Poland (2) and Scotland (1)), compared with approximately 139 such cases on August 1, 2006, and approximately 117 such cases on August 1, 2005. In addition, in Italy, 2,043 cases are pending in the Italian equivalent of small claims court where damages are limited to 2,000 per case, and three cases are pending in Finland and one in Israel against defendants that are indemnitees of a subsidiary of PMI.

In addition, as of August 5, 2007, there were two smoking and health putative class actions pending outside the United States against PMI or its affiliates in Brazil (1) and Israel (1) compared with two such cases on August 1, 2006, and two such cases on August 1, 2005. Seven health care cost recovery actions are pending in Nigeria (4), Israel (1), Canada (1) and Spain (1), against PMI or its affiliates, and two Lights/Ultra Lights class actions are pending in Israel. PM USA is also a named defendant in the smoking and health putative class action in Israel, a Lights class action in Israel and health care cost recovery actions in Israel and Canada.

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Pending and Upcoming Trials

As of August 1, 2007, four individual smoking and health cases against PM USA are scheduled for trial in 2007. Cases against other tobacco companies are also scheduled for trial through the end of 2007. Trial dates are subject to change.

Recent Trial Results

Since January 1999, verdicts have been returned in 45 smoking and health, Lights/Ultra Lights and health care cost recovery cases in which PM USA was a defendant. Verdicts in favor of PM USA and other defendants were returned in 28 of the 45 cases. These 28 cases were tried in California (4), Florida (9), Mississippi (1), Missouri (2), New Hampshire (1), New Jersey (1), New York (3), Ohio (2), Pennsylvania (1), Rhode Island (1), Tennessee (2), and West Virginia (1). Plaintiffs appeals or post-trial motions challenging the verdicts are pending in California, the District of Columbia and Florida. A motion for a new trial has been granted in one of the cases in Florida. In addition, in December 2002, a court dismissed an individual smoking and health case in California at the end of trial.

In July 2005, a jury in Tennessee returned a verdict in favor of PM USA in a case in which plaintiffs had challenged PM USA s retail promotional and merchandising programs under the Robinson-Patman Act.

Of the 17 cases in which verdicts were returned in favor of plaintiffs, eight have reached final resolution. A verdict against defendants in a health care cost recovery case has been reversed and all claims were dismissed with prejudice. In addition, a verdict against defendants in a purported Lights class action in Illinois has been reversed and the case has been dismissed with prejudice. After exhausting all appeals, PM USA has paid six judgments totaling $71,392,295, and interest totaling $33,799,284.

The chart below lists the verdicts and post-trial developments in the nine pending cases, as well as the Illinois Lights class action, that have gone to trial since January 1999 in which verdicts were returned in favor of plaintiffs.

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Date	Location of Court/ Name of Plaintiff	Type of Case	Verdict	Post-Trial Developments
May 2007	California/ *Whiteley*	Individual Smoking and Health	Approximately $2.5 million in compensatory damages against PM USA and the other defendant in the case, as well as $250,000 in punitive damages against the other defendant in the case.	In July 2007, the trial court granted plaintiff s motion for a limited re-trial against PM USA on the question of whether plaintiffs are entitled to punitive damages against PM USA, and if so, the amount.
August 2006	District of Columbia/ *United States of America*	Health Care Cost Recovery	Finding that defendants, including ALG and PM USA, violated the civil provisions of the Racketeer Influenced and Corrupt Organizations Act (RICO). No monetary damages assessed, but court made specific findings and issued injunctions. See *Federal Government s Lawsuit*, below.	Defendants filed notices of appeal to the United States Court of Appeals in September 2006 and the Department of Justice filed its notice of appeal in October. In October 2006, a three-judge panel of the Court of Appeals stayed implementation of the trial court s remedies order pending its review of the decision. In March 2007, the trial court denied in part and granted in part defendants post-

				trial motion for clarification of portions of the court s remedial order. Briefing of the parties consolidated appeal is scheduled to conclude in May 2008. See *Federal Government s Lawsuit*, below.
March 2005	New York/ *Rose*	Individual Smoking and Health	$3.42 million in compensatory damages against two defendants, including PM USA, and $17.1 million in punitive damages against PM USA.	PM USA s appeal is pending.

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Date	Location of Court/ Name of Plaintiff	Type of Case	Verdict	Post-Trial Developments
May 2004	Louisiana/ *Scott*	Smoking and Health Class Action	Approximately $590 million against all defendants including PM USA jointly and severally, to fund a 10- year smoking cessation program.	In June 2004, the state trial court entered judgment in the amount of the verdict of $590 million, plus prejudgment interest accruing from the date the suit commenced. As of February 15, 2007, the amount of prejudgment interest was approximately $444 million. PM USA s share of the verdict and prejudgment interest has not been allocated. Defendants, including PM USA, appealed. In February 2007, the Louisiana Court of Appeal upheld the class certification and finding of liability, but reduced the judgment by $312 million and vacated the award of prejudgment interest. The Court of Appeal also remanded the case to the trial court

with instructions to further reduce the remaining $279 million judgment to eliminate amounts awarded to any individual who began smoking after the Louisiana Product Liability Act became effective on September 1, 1988. In March 2007, the Louisiana Court of Appeal rejected defendants motion for rehearing and clarification. Plaintiffs and defendants have filed petitions for writ of certiorari with the Louisiana Supreme Court. See *Scott Class Action* below.

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Date	Location of Court/ Name of Plaintiff	Type of Case	Verdict	Post-Trial Developments
March 2003	Illinois/ *Price*	Lights/Ultra Lights Class Action	$7.1005 billion in compensatory damages and $3 billion in punitive damages against PM USA.	In December 2005, the Illinois Supreme Court reversed the trial court s judgment in favor of the plaintiffs and remanded the case to the trial court with instructions to dismiss the case against PM USA. In May 2006, the Illinois Supreme Court rejected the plaintiffs motion for rehearing. In November 2006, the United States Supreme Court denied plaintiffs petition for writ of certiorari and in December 2006, the trial court dismissed the case with prejudice. In May 2007, the trial court granted plaintiffs motion to certify certain questions to the Illinois Fifth District Appellate Court, and plaintiffs petitioned the Fifth District to review the certified

questions. In May 2007, PM USA filed applications for a supervisory order and writ of mandamus with the Illinois Supreme Court seeking an order compelling the lower courts to deny plaintiffs motion to vacate and /or withhold final judgment. The Illinois appellate court has stayed the plaintiffs appeal until the related matters pending before the Illinois Supreme Court are resolved. See the discussion of the *Price* case under the heading Lights/Ultra Lights Cases.

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Date	Location of Court/ Name of Plaintiff	Type of Case	Verdict	Post-Trial Developments
October 2002	California/ *Bullock*	Individual Smoking and Health	$850,000 in compensatory damages and $28 billion in punitive damages against PM USA.	In December 2002, the trial court reduced the punitive damages award to $28 million. In April 2006, the California Court of Appeal affirmed the $28 million punitive damage award. See discussion (1) below.
June 2002	Florida/ *Lukacs*	Individual Smoking and Health	$37.5 million in compensatory damages against all defendants, including PM USA.	In March 2003, the trial court reduced the damages award to $24.86 million. PM USA s share of the damages award is approximately $6 million. The court has not yet entered the judgment on the jury verdict. In January 2007, defendants petitioned the trial court to set aside the jury s verdict and dismiss plaintiffs punitive damages claim. On August 1, 2007, the trial court deferred ruling on plaintiffs motion for entry of judgment until after the

United States Supreme Court s

review of *Engle* is complete and after

further submissions by the parties. If

a judgment is entered in this case,

PM USA intends to appeal.

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Date	Location of Court/ Name of Plaintiff	Type of Case	Verdict	Post-Trial Developments
March 2002	Oregon/ *Schwarz*	Individual Smoking and Health	$168,500 in compensatory damages and $150 million in punitive damages against PM USA.	In May 2002, the trial court reduced the punitive damages award to $100 million. In May 2006, the Oregon Court of Appeals affirmed the compensatory damages verdict, reversed the award of punitive damages and remanded the case to the trial court for a second trial to determine the amount of punitive damages, if any. In June 2006, plaintiff petitioned the Oregon Supreme Court to review the portion of the Court of Appeals decision reversing and remanding the case for a new trial on punitive damages. In October 2006, the Oregon Supreme Court announced that it would hold this

petition in abeyance until the United States Supreme Court decided the *Williams* case discussed below. In February 2007, the United States Supreme Court vacated the punitive damages judgment in *Williams* and remanded the case to the Oregon Supreme Court for proceedings consistent with its decision. The parties have submitted their briefs to the Oregon Supreme Court setting forth their respective views on how the *Williams* decision impacts the plaintiff s pending petition for review.

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Date	Location of Court/ Name of Plaintiff	Type of Case	Verdict	Post-Trial Developments
July 2000	Florida/ *Engle*	Smoking and Health Class Action	$145 billion in punitive damages against all defendants, including $74 billion against PM USA.	In July 2006, the Florida Supreme Court ordered that the punitive damages award be vacated, that the class approved by the trial court be decertified, that certain Phase I trial court findings be allowed to stand as against the defendants in individual actions that individual former class members may bring within one year of the issuance of the mandate, compensatory damage awards totaling approximately $6.9 million to two individual class members be reinstated and that a third former class member s claim was barred by the statute of limitations. In December 2006, the Florida Supreme Court denied all motions by the parties for rehearing but issued a

revised opinion. In January 2007, the Florida Supreme Court issued the mandate from its revised December opinion and defendants filed a motion with the Florida Third District Court of Appeal requesting the court s review of legal errors previously raised but not ruled upon. This motion was denied in February 2007. In May 2007, defendants motion for a partial stay of the mandate pending the completion of appellate review was denied by the Third District Court of Appeal. In May 2007, defendants filed a petition for writ of certiorari with the United States Supreme Court. In June 2007, the United States Supreme Court ordered plaintiffs to respond to defendants petition. See *Engle Class Action* below.

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Date	Location of Court/ Name of Plaintiff	Type of Case	Verdict	Post-Trial Developments
March 1999	Oregon/ *Williams*	Individual Smoking and Health	\$800,000 in compensatory damages, \$21,500 in medical expenses and \$79.5 million in punitive damages against PM USA.	See discussion (2) below.

(1) Bullock: In August 2006, the California Supreme Court denied plaintiffs petition to overturn the trial court s reduction of the punitive damage award and granted PM USA s petition for review challenging the punitive damage award. The court granted review of the case on a grant and hold basis under which further action by the court is deferred pending the United States Supreme Court s decision on punitive damages in the *Williams* case described below. In February 2007, the United States Supreme Court vacated the punitive damages judgment in *Williams* and remanded the case to the Oregon Supreme Court for proceedings consistent with its decision. Parties to the appeal in *Bullock* requested that the court establish a briefing schedule on the merits of the pending appeal. In May 2007, the California Supreme Court transferred the case to the Second District of the California Court of Appeal with directions that the court vacate its 2006 decision and reconsider the case in light of the United States Supreme Court s decision in *Williams*.

(2) Williams: The trial court reduced the punitive damages award to \$32 million, and PM USA and plaintiff appealed. In June 2002, the Oregon Court of Appeals reinstated the \$79.5 million punitive damages award. Following the Oregon Supreme Court s refusal to hear PM USA s appeal, PM USA recorded a provision of \$32 million in connection with this case and petitioned the United States Supreme Court for further review. In October 2003, the United States Supreme Court set aside the Oregon appellate court s ruling and directed the Oregon court to reconsider the case in light of the 2003 *State Farm* decision by the United States Supreme Court, which limited punitive damages. In June 2004, the Oregon Court of Appeals reinstated the \$79.5 million punitive damages award. In February 2006, the Oregon Supreme Court affirmed the Court of Appeals decision. Following this decision, PM USA recorded an additional provision of approximately \$20 million in interest charges related to this case. The United States Supreme Court granted PM USA s petition for writ of certiorari in May 2006. In February 2007, the United States Supreme Court vacated the \$79.5 million punitive damages award, holding that the United States Constitution prohibits basing punitive damages awards on harm to non-parties. The Court also found that states must assure that appropriate procedures are in place so that juries are provided with proper legal guidance as to the constitutional limitations on awards of punitive damages. Accordingly, the Court remanded the case to the Oregon Supreme Court for further proceedings consistent with this decision.

In addition to the cases discussed above, in October 2003, a three-judge appellate panel in Brazil reversed a lower court s dismissal of an individual smoking and health case and ordered PMI s Brazilian affiliate to pay plaintiff approximately \$256,000 and other unspecified damages. PMI s Brazilian affiliate appealed. In December 2004, the three-judge panel s decision was vacated by an *en banc* panel of the appellate court, which upheld the trial court s dismissal of the case. The case is currently on appeal to the Superior Court.

With respect to certain adverse verdicts currently on appeal, excluding amounts relating to the *Engle* case, as of August 1, 2007, PM USA has posted various forms of security totaling approximately \$193 million, the

majority of which have been collateralized with cash deposits, to obtain stays of judgments pending appeals. The cash deposits are included in other assets on the consolidated balance sheets.

Engle Class Action

In July 2000, in the second phase of the *Engle* smoking and health class action in Florida, a jury returned a verdict assessing punitive damages totaling approximately $145 billion against various defendants, including $74 billion against PM USA. Following entry of judgment, PM USA posted a bond in the amount of $100 million and appealed.

In May 2001, the trial court approved a stipulation providing that execution of the punitive damages component of the *Engle* judgment will remain stayed against PM USA and the other participating defendants through the completion of all judicial review. As a result of the stipulation, PM USA placed $500 million into a separate interest-bearing escrow account that, regardless of the outcome of the appeal, will be paid to the court and the court will determine how to allocate or distribute it consistent with Florida Rules of Civil Procedure. In July 2001, PM USA also placed $1.2 billion into an interest-bearing escrow account, which will be returned to PM USA should it prevail in its appeal of the case. (The $1.2 billion escrow account is included in the June 30, 2007 and December 31, 2006 consolidated balance sheets as other assets. Interest income on the $1.2 billion escrow account is paid to PM USA quarterly and is being recorded as earned, in interest and other debt expense, net, in the consolidated statements of earnings.) In connection with the stipulation, PM USA recorded a $500 million pre-tax charge in its consolidated statement of earnings for the quarter ended March 31, 2001. In May 2003, the Florida Third District Court of Appeal reversed the judgment entered by the trial court and instructed the trial court to order the decertification of the class. Plaintiffs petitioned the Florida Supreme Court for further review.

In July 2006, the Florida Supreme Court ordered that the punitive damages award be vacated, that the class approved by the trial court be decertified, and that members of the decertified class could file individual actions against defendants within one year of issuance of the mandate. The court further declared the following Phase I findings are entitled to res judicata effect in such individual actions brought within one year of the issuance of the mandate: (i) that smoking causes various diseases; (ii) that nicotine in cigarettes is addictive; (iii) that defendants cigarettes were defective and unreasonably dangerous; (iv) that defendants concealed or omitted material information not otherwise known or available knowing that the material was false or misleading or failed to disclose a material fact concerning the health effects or addictive nature of smoking; (v) that all defendants agreed to misrepresent information regarding the health effects or addictive nature of cigarettes with the intention of causing the public to rely on this information to their detriment; (vi) that defendants agreed to conceal or omit information regarding the health effects of cigarettes or their addictive nature with the intention that smokers would rely on the information to their detriment; (vii) that all defendants sold or supplied cigarettes that were defective; and (viii) that all defendants were negligent. The court also reinstated compensatory damage awards totaling approximately $6.9 million to two individual plaintiffs and found that a third plaintiff s claim was barred by the statute of limitations.

In August 2006, PM USA sought rehearing from the Florida Supreme Court on parts of its July 2006 opinion, including the ruling (described above) that certain jury findings have res judicata effect in subsequent individual trials timely brought by *Engle* class members. The rehearing motion also asked, among other things, that legal errors that were raised but not expressly ruled upon in the Third District Court of Appeal or in the Florida Supreme Court now be addressed. Plaintiffs also filed a motion for rehearing in August 2006 seeking clarification of the applicability of the statute of limitations to non-members of the decertified class. In December 2006, the Florida Supreme Court refused to revise its July 2006 ruling, except that it revised the set of Phase I findings entitled to res judicata effect by excluding finding (v) listed above (relating to agreement to misrepresent information), and added the finding that defendants sold or supplied cigarettes that, at the time of sale or supply, did not conform to the representations of fact made by defendants. On January 11, 2007, the Florida Supreme Court issued the mandate from its revised opinion. Defendants then filed a motion with the

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Florida Third District Court of Appeal requesting that the court address legal errors that were previously raised by defendants but have not yet been addressed either by the Third District or by the Florida Supreme Court. In February 2007, the Third District Court of Appeal denied defendants motion. In May 2007, defendants motion for a partial stay of the mandate pending the completion of appellate review was denied by the District Court of Appeal. In May 2007, defendants filed a petition for writ of certiorari with the United States Supreme Court. In June 2007, the United States Supreme Court ordered plaintiffs to respond to defendants petition.

It is currently unknown how many members of the decertified class will file individual claims by January 10, 2008, as required by the Florida Supreme Court s decision. Since the Florida Supreme Court ruling, twenty-five cases have been served upon PM USA or other defendants asserting individual claims on or on behalf of 76 persons based upon the ruling. All such cases have been removed from various Florida state courts to the federal district courts in Florida. On July 27, 2007, PM USA and other defendants requested that the multi-district litigation panel order the transfer of all such cases pending in the federal courts, as well as any other *Engle* progeny cases that may be filed, to the Middle District of Florida for pretrial coordination.

Scott Class Action

In July 2003, following the first phase of the trial in the *Scott* class action, in which plaintiffs sought creation of a fund to pay for medical monitoring and smoking cessation programs, a Louisiana jury returned a verdict in favor of defendants, including PM USA, in connection with plaintiffs medical monitoring claims, but also found that plaintiffs could benefit from smoking cessation assistance. The jury also found that cigarettes as designed are not defective but that the defendants failed to disclose all they knew about smoking and diseases and marketed their products to minors. In May 2004, in the second phase of the trial, the jury awarded plaintiffs approximately $590 million against all defendants jointly and severally, to fund a 10-year smoking cessation program.

In June 2004, the court entered judgment, which awarded plaintiffs the approximately $590 million jury award plus prejudgment interest accruing from the date the suit commenced. As of February 15, 2007, the amount of prejudgment interest was approximately $444 million. PM USA s share of the jury award and prejudgment interest has not been allocated. Defendants, including PM USA, appealed. Pursuant to a stipulation of the parties, the trial court entered an order setting the amount of the bond at $50 million for all defendants in accordance with an article of the Louisiana Code of Civil Procedure, and a Louisiana statute (the bond cap law) fixing the amount of security in civil cases involving a signatory to the MSA (as defined below). Under the terms of the stipulation, plaintiffs reserve the right to contest, at a later date, the sufficiency or amount of the bond on any grounds including the applicability or constitutionality of the bond cap law. In September 2004, defendants collectively posted a bond in the amount of $50 million.

In February 2007, the Louisiana Court of Appeal issued a ruling on defendants appeal that, among other things: affirmed class certification but limited the scope of the class; struck certain of the categories of damages that comprised the judgment, reducing the amount of the award by approximately $312 million; vacated the award of prejudgment interest, which totaled approximately $444 million as of February 15, 2007; and ruled that the only class members who are eligible to participate in the smoking cessation program are those who began smoking before, and whose claims accrued by, September 1, 1988. As a result, the Louisiana Court of Appeal remanded for proceedings consistent with its opinion, including further reduction of the amount of the award based on the size of the new class. In March 2007, the Louisiana Court of Appeal rejected defendants motion for rehearing and clarification. Plaintiffs and defendants have filed petitions for writ of certiorari with the Louisiana Supreme Court.

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Smoking and Health Litigation

Overview

Plaintiffs allegations of liability in smoking and health cases are based on various theories of recovery, including negligence, gross negligence, strict liability, fraud, misrepresentation, design defect, failure to warn, nuisance, breach of express and implied warranties, breach of special duty, conspiracy, concert of action, violations of deceptive trade practice laws and consumer protection statutes, and claims under the federal and state anti-racketeering statutes. Plaintiffs in the smoking and health actions seek various forms of relief, including compensatory and punitive damages, treble/multiple damages and other statutory damages and penalties, creation of medical monitoring and smoking cessation funds, disgorgement of profits, and injunctive and equitable relief. Defenses raised in these cases include lack of proximate cause, assumption of the risk, comparative fault and/or contributory negligence, statutes of limitations and preemption by the Federal Cigarette Labeling and Advertising Act.

Smoking and Health Class Actions

Since the dismissal in May 1996 of a purported nationwide class action brought on behalf of allegedly addicted smokers, plaintiffs have filed numerous putative smoking and health class action suits in various state and federal courts. In general, these cases purport to be brought on behalf of residents of a particular state or states (although a few cases purport to be nationwide in scope) and raise addiction claims and, in many cases, claims of physical injury as well.

Class certification has been denied or reversed by courts in 57 smoking and health class actions involving PM USA in Arkansas (1), the District of Columbia (2), Florida (2), Illinois (2), Iowa (1), Kansas (1), Louisiana (1), Maryland (1), Michigan (1), Minnesota (1), Nevada (29), New Jersey (6), New York (2), Ohio (1), Oklahoma (1), Pennsylvania (1), Puerto Rico (1), South Carolina (1), Texas (1) and Wisconsin (1). A class remains certified in the *Scott* class action discussed above.

A smoking and health class action is pending in Brazil. Plaintiff is a consumer organization, the Smoker Health Defense Association (*ADESF*), which filed a claim against Souza Cruz, S.A. and Philip Morris Marketing, S.A. (now Philip Morris Brasil Industria e Commercio Ltda.) at the 19th Civil Court of São Paulo. Trial and appellate courts found that the action could proceed as a class under the Brazilian Consumer Defense Code. Philip Morris Brasil Industria e Commercio Ltda. appealed this decision and this appeal is pending before the Supreme Federal Court in Brazil. In addition, in February 2004, the trial court awarded the equivalent of approximately R$1,000 (at the current exchange rate, approximately U.S. $519) per smoker per full year of smoking for moral damages plus interest at the rate of 1% per month, as of the date of the ruling. The court order contemplates a second stage of the case in which individuals are to file their claims. Material damages, if any, will be assessed in this second phase. Defendants have appealed this decision to the São Paulo Court of Appeals, and execution of the judgment has been stayed until the appeal is resolved.

There are currently pending two purported class actions against PM USA brought in New York (*Caronia*, filed in January 2006 in the United States District Court for the Eastern District of New York) and Massachusetts (*Donovan*, filed in March 2007 in the United States District Court for the District of Massachusetts) on behalf of each state s respective residents who: are age 50 or older; have smoked the *Marlboro* brand for 20 pack-years or more; and have neither been diagnosed with lung cancer nor are under examination by a physician for suspected lung cancer. Plaintiffs in these cases seek to impose liability under various product-based causes of action and the creation of a court-supervised program providing members of the purported class Low Dose CT Scanning in order to identify and diagnose lung cancer. Neither claim seeks punitive damages. Plaintiffs motion for class certification is pending in *Caronia*.

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Espinosa Class Action

In December 2006, plaintiffs brought this putative class action against PM USA and other defendants in the Circuit Court of Cook County, Illinois on behalf of individuals from throughout Illinois and/or the United States who purchased cigarettes manufactured by certain defendants from 1996 through the date of any judgment in plaintiffs favor. Excluded from the purported class are any individuals who allege personal injury or health care costs. The complaint alleges, among other things, that defendants were negligent and violated the Illinois consumer fraud statute by certain defendants steadily and purposefully increasing the nicotine level and absorption of their cigarettes into the human body, including in brands most popular with young people and minorities. In January 2007, PM USA removed the case to the United States District Court for the Northern District of Illinois. In March 2007, the United States District Court rejected plaintiffs motion to remand the case to the Circuit Court of Cook County. In June 2007, the United States District Court granted PM USA s motion to dismiss the action, finding that the Federal Cigarette Labeling and Advertising Act expressly preempts plaintiffs claims. Plaintiffs did not appeal this decision.

Health Care Cost Recovery Litigation

Overview

In health care cost recovery litigation, domestic and foreign governmental entities and non-governmental plaintiffs seek reimbursement of health care cost expenditures allegedly caused by tobacco products and, in some cases, of future expenditures and damages as well. Relief sought by some but not all plaintiffs includes punitive damages, multiple damages and other statutory damages and penalties, injunctions prohibiting alleged marketing and sales to minors, disclosure of research, disgorgement of profits, funding of anti-smoking programs, additional disclosure of nicotine yields, and payment of attorney and expert witness fees.

The claims asserted include the claim that cigarette manufacturers were unjustly enriched by plaintiffs payment of health care costs allegedly attributable to smoking, as well as claims of indemnity, negligence, strict liability, breach of express and implied warranty, violation of a voluntary undertaking or special duty, fraud, negligent misrepresentation, conspiracy, public nuisance, claims under federal and state statutes governing consumer fraud, antitrust, deceptive trade practices and false advertising, and claims under federal and state anti-racketeering statutes.

Defenses raised include lack of proximate cause, remoteness of injury, failure to state a valid claim, lack of benefit, adequate remedy at law, unclean hands (namely, that plaintiffs cannot obtain equitable relief because they participated in, and benefited from, the sale of cigarettes), lack of antitrust standing and injury, federal preemption, lack of statutory authority to bring suit, and statutes of limitations. In addition, defendants argue that they should be entitled to set off any alleged damages to the extent the plaintiffs benefit economically from the sale of cigarettes through the receipt of excise taxes or otherwise. Defendants also argue that these cases are improper because plaintiffs must proceed under principles of subrogation and assignment. Under traditional theories of recovery, a payor of medical costs (such as an insurer) can seek recovery of health care costs from a third party solely by standing in the shoes of the injured party. Defendants argue that plaintiffs should be required to bring any actions as subrogees of individual health care recipients and should be subject to all defenses available against the injured party.

Although there have been some decisions to the contrary, most judicial decisions have dismissed all or most health care cost recovery claims against cigarette manufacturers. Nine federal circuit courts of appeals and six state appellate courts, relying primarily on grounds that plaintiffs claims were too remote, have ordered or affirmed dismissals of health care cost recovery actions. The United States Supreme Court has refused to consider plaintiffs appeals from the cases decided by five circuit courts of appeals.

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In March 1999, in the first health care cost recovery case to go to trial, an Ohio jury returned a verdict in favor of defendants on all counts. In addition, a $17.8 million verdict against defendants (including $6.8 million against PM USA) was reversed in a health care cost recovery case in New York, and all claims were dismissed with prejudice in February 2005 (*Blue Cross/Blue Shield*). The trial in the health care cost recovery case brought by the City of St. Louis, Missouri and approximately 50 Missouri hospitals, in which PM USA and ALG are defendants, is scheduled to begin in February 2010.

Individuals and associations have also sued in purported class actions or as private attorneys general under the Medicare As Secondary Payer statute to recover from defendants Medicare expenditures allegedly incurred for the treatment of smoking-related diseases. Cases brought in New York (*Mason*), Florida (*Glover*) and Massachusetts (*United Seniors Association*) have been dismissed by federal courts, and plaintiffs appeal in *United Seniors Association* is pending.

In addition to the cases brought in the United States, health care cost recovery actions have also been brought against tobacco industry participants, including PM USA, PMI and certain PMI subsidiaries in Israel (1), the Marshall Islands (1 dismissed), Canada (1), France (1 dismissed), Spain (1) and Nigeria (4) and other entities have stated that they are considering filing such actions. In September 2005, in the case in Canada, the Canadian Supreme Court ruled that legislation passed in British Columbia permitting the lawsuit is constitutional, and, as a result, the case which had previously been dismissed by the trial court was permitted to proceed. PM USA, PMI and other defendants challenge to the British Columbia court s exercise of jurisdiction was rejected by the Court of Appeals of British Columbia and in April 2007, the Supreme Court of Canada denied review of that decision. Several other provinces in Canada have enacted similar legislation.

Settlements of Health Care Cost Recovery Litigation

In November 1998, PM USA and certain other United States tobacco product manufacturers entered into the Master Settlement Agreement (the MSA) with 46 states, the District of Columbia, Puerto Rico, Guam, the United States Virgin Islands, American Samoa and the Northern Marianas to settle asserted and unasserted health care cost recovery and other claims. PM USA and certain other United States tobacco product manufacturers had previously settled similar claims brought by Mississippi, Florida, Texas and Minnesota (together with the MSA, the State Settlement Agreements). The State Settlement Agreements require that the original participating manufacturers make substantial annual payments in the following amounts (excluding future annual payments, if any, under the National Tobacco Grower Settlement Trust discussed below), subject to adjustments for several factors, including inflation, market share and industry volume: 2007, $8.4 billion and thereafter, $9.4 billion each year. In addition, the original participating manufacturers are required to pay settling plaintiffs attorneys fees, subject to an annual cap of $500 million.

The State Settlement Agreements also include provisions relating to advertising and marketing restrictions, public disclosure of certain industry documents, limitations on challenges to certain tobacco control and underage use laws, restrictions on lobbying activities and other provisions.

Possible Adjustments in MSA Payments for 2003, 2004 and 2005

Pursuant to the provisions of the MSA, domestic tobacco product manufacturers, including PM USA, who are original signatories to the MSA (OPMs), are participating in proceedings that may result in downward adjustments to the amounts paid by the OPMs and the other MSA participating manufacturers to the states and territories that are parties to the MSA for the years 2003, 2004, and 2005. The proceedings are based on the collective loss of market share in 2003, 2004 and 2005, respectively, by all manufacturers who are subject to the payment obligations and marketing restrictions of the MSA to non-participating manufacturers (NPMs) who are not subject to such obligations and restrictions.

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In these proceedings, an independent economic consulting firm jointly selected by the MSA parties is required to determine whether the disadvantages of the MSA were a significant factor contributing to the collective loss of market share for the year in question. If the firm determines that the disadvantages of the MSA were such a significant factor, each state may avoid a downward adjustment to its share of the OPMs annual payments for that year by establishing that it diligently enforced a qualifying escrow statute during the entirety of that year. Any potential downward adjustment would then be reallocated to those states that do not establish such diligent enforcement. PM USA believes that the MSA s arbitration clause requires a state to submit its claim to have diligently enforced a qualifying escrow statute to binding arbitration before a panel of three former federal judges in the manner provided for in the MSA. A number of states have taken the position that this claim should be decided in state court on a state-by-state basis.

In March of 2006, an independent economic consulting firm determined that the disadvantages of the MSA were a significant factor contributing to the participating manufacturers collective loss of market share for the year 2003. In February 2007, this same firm determined that the disadvantages of the MSA were a significant factor contributing to the participating manufacturers collective loss of market share for the year 2004. As of April 2007, PM USA is also participating in another such proceeding before the same economic consulting firm to determine whether the disadvantages of the MSA were a significant factor contributing to the participating manufacturers collective loss of market share in 2005. The economic consulting firm is expected to render its final determination on the significant factor issue for 2005 sometime in January 2008. Following the economic consulting firm s determination with respect to 2003, thirty-eight states filed declaratory judgment actions in state courts seeking a declaration that the state diligently enforced its escrow statute during 2003. The OPMs and other MSA-participating manufacturers have responded to these actions by filing motions to compel arbitration in accordance with the terms of the MSA, including filing motions to compel arbitration in eleven MSA states and territories that have not filed declaratory judgment actions. Courts in over 40 states have ruled that the question of whether a state diligently enforced its escrow statute during 2003 is subject to arbitration and only one state court has ruled to the contrary. Many of these rulings, including the one ruling against arbitration, remain subject to appeal or further review. Additionally, one state has filed a declaratory judgment action in state court with respect to the 2004 diligent enforcement issue.

The availability and the precise amount of any NPM Adjustment for 2003 and 2004 will not be finally determined until late 2007 or thereafter. The availability and the precise amount of any NPM Adjustment for 2005 will not be finally determined until late 2008 or thereafter. There is no certainty that the OPMs and other MSA-participating manufacturers will ultimately receive any adjustment as a result of these proceedings. If the OPMs do receive such an adjustment through these proceedings, the adjustment would be allocated among the OPMs pursuant to the MSA s provisions, and PM USA s share would likely be applied as a credit against a future MSA payment.

National Grower Settlement Trust

As part of the MSA, the settling defendants committed to work cooperatively with the tobacco-growing states to address concerns about the potential adverse economic impact of the MSA on tobacco growers and quota holders. To that end, in 1999, four of the major domestic tobacco product manufacturers, including PM USA, established the National Tobacco Grower Settlement Trust (NTGST), a trust fund to provide aid to tobacco growers and quota holders. The trust was to be funded by these four manufacturers over 12 years with payments, prior to application of various adjustments, scheduled to total $5.15 billion. Provisions of the NTGST allowed for offsets to the extent that industry-funded payments were made for the benefit of growers or quota holders as part of a legislated end to the federal tobacco quota and price support program.

In October 2004, the Fair and Equitable Tobacco Reform Act of 2004 (FETRA) was signed into law. FETRA provides for the elimination of the federal tobacco quota and price support program through an industry-funded buy-out of tobacco growers and quota holders. The cost of the buy-out, which is estimated at approximately

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$9.5 billion, is being paid over 10 years by manufacturers and importers of each kind of tobacco product. The cost is being allocated based on the relative market shares of manufacturers and importers of each kind of tobacco product. The quota buy-out payments offset already scheduled payments to the NTGST. FETRA also obligated manufacturers and importers of tobacco products to cover any losses (up to $500 million) that the government incurred on the disposition of tobacco pool stock accumulated under the previous tobacco price support program. PM USA has paid $138 million for its share of the tobacco pool stock losses. ALG does not currently anticipate that the quota buy-out will have a material adverse impact on its consolidated results in 2007 and beyond.

Other MSA-Related Litigation

In June 2004, a putative class of California smokers filed a complaint against PM USA and the MSA s other Original Participating Manufacturers (OPMs) seeking damages from the OPMs for post-MSA price increases and an injunction against their continued compliance with the MSA s terms. The complaint alleges that the MSA and related legislation protect the OPMs from competition in a manner that violates federal and state antitrust and consumer protection laws. The complaint also names the California Attorney General as a defendant and seeks to enjoin him from enforcing California s Escrow Statute. In March 2005, the United States District Court for the Northern District of California granted defendants motion to dismiss the case. Plaintiffs appeal of this decision is pending before the United States Court of Appeals for the Ninth Circuit.

Without naming PM USA or any other private party as a defendant, manufacturers that have elected not to sign the MSA (Non-Participating Manufacturers or NPMs) and/or their distributors or customers have filed several other legal challenges to the MSA and related legislation. New York state officials are defendants in a lawsuit pending in the United States District Court for the Southern District of New York in which cigarette importers allege that the MSA and/or related legislation violates federal antitrust laws and the Commerce Clause of the United States Constitution. In a separate proceeding pending in the same court, plaintiffs assert the same theories against not only New York officials but also the Attorneys General for thirty other states. The United States Court of Appeals for the Second Circuit has held that the allegations in both actions, if proven, establish a basis for relief on antitrust and Commerce Clause grounds and that the trial courts in New York have personal jurisdiction sufficient to enjoin other states officials from enforcing their MSA-related legislation. On remand in those two actions, one trial judge preliminarily enjoined New York from enforcing its allocable share amendment to the MSA s Model Escrow Statute against the plaintiffs, while another trial judge refused to do so after concluding that the plaintiffs were unlikely to prove their allegations. Summary judgment motions are pending in both cases.

In another action, the United States Court of Appeals for the Fifth Circuit reversed a trial court s dismissal of challenges to MSA-related legislation in Louisiana under the First and Fourteenth Amendments to the United States Constitution. The case will now proceed to motions for summary judgment and, if necessary, a trial. Summary judgment proceedings in another challenge to Louisiana s participation in the MSA and its MSA-related legislation will begin in February 2008. Yet another proceeding has been initiated before an international arbitration tribunal under the provisions of the North American Free Trade Agreement. Appeals from trial court decisions holding that plaintiffs have failed either to make allegations establishing a claim for relief or to submit evidence supporting those allegations are currently, or will soon be, pending before the United States Court of Appeals for the Eighth and Tenth Circuits. The United States Court of Appeals for the Sixth Circuit has affirmed the dismissal of two similar challenges.

Federal Government s Lawsuit

In 1999, the United States government filed a lawsuit in the United States District Court for the District of Columbia against various cigarette manufacturers, including PM USA, and others, including ALG, asserting claims under three federal statutes, the Medical Care Recovery Act (MCRA), the Medicare Secondary Payer

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(MSP) provisions of the Social Security Act and the civil provisions of RICO. Trial of the case ended in June 2005. The lawsuit sought to recover an unspecified amount of health care costs for tobacco-related illnesses allegedly caused by defendants fraudulent and tortious conduct and paid for by the government under various federal health care programs, including Medicare, military and veterans health benefits programs, and the Federal Employees Health Benefits Program. The complaint alleged that such costs total more than $20 billion annually. It also sought what it alleged to be equitable and declaratory relief, including disgorgement of profits which arose from defendants allegedly tortious conduct, an injunction prohibiting certain actions by the defendants, and a declaration that the defendants are liable for the federal government s future costs of providing health care resulting from defendants alleged past tortious and wrongful conduct. In September 2000, the trial court dismissed the government s MCRA and MSP claims, but permitted discovery to proceed on the government s claims for relief under the civil provisions of RICO.

The government alleged that disgorgement by defendants of approximately $280 billion is an appropriate remedy. In May 2004, the trial court issued an order denying defendants motion for partial summary judgment limiting the disgorgement remedy. In February 2005, a panel of the United States Court of Appeals for the District of Columbia Circuit held that disgorgement is not a remedy available to the government under the civil provisions of RICO and entered summary judgment in favor of defendants with respect to the disgorgement claim. In April 2005, the Court of Appeals denied the government s motion for rehearing. In July 2005, the government petitioned the United States Supreme Court for further review of the Court of Appeals ruling that disgorgement is not an available remedy, and in October 2005, the Supreme Court denied the petition.

In June 2005, the government filed with the trial court its proposed final judgment seeking remedies of approximately $14 billion, including $10 billion over a five-year period to fund a national smoking cessation program and $4 billion over a ten-year period to fund a public education and counter-marketing campaign. Further, the government s proposed remedy would have required defendants to pay additional monies to these programs if targeted reductions in the smoking rate of those under 21 are not achieved according to a prescribed timetable. The government s proposed remedies also included a series of measures and restrictions applicable to cigarette business operations including, but not limited to, restrictions on advertising and marketing, potential measures with respect to certain price promotional activities and research and development, disclosure requirements for certain confidential data and implementation of a monitoring system with potential broad powers over cigarette operations.

In August 2006, the federal trial court entered judgment in favor of the government. The court held that certain defendants, including ALG and PM USA, violated RICO and engaged in 7 of the 8 sub-schemes to defraud that the government had alleged. Specifically, the court found that:

- defendants falsely denied, distorted and minimized the significant adverse health consequences of smoking;
- defendants hid from the public that cigarette smoking and nicotine are addictive;
- defendants falsely denied that they control the level of nicotine delivered to create and sustain addiction;
- defendants falsely marketed and promoted low tar/light cigarettes as less harmful than full-flavor cigarettes;
- defendants falsely denied that they intentionally marketed to youth;

defendants publicly and falsely denied that ETS is hazardous to non-smokers; and

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defendants suppressed scientific research.

The court did not impose monetary penalties on the defendants, but ordered the following relief: (i) an injunction against committing any act of racketeering relating to the manufacturing, marketing, promotion, health consequences or sale of cigarettes in the United States; (ii) an injunction against participating directly or indirectly in the management or control of the Council for Tobacco Research, the Tobacco Institute, or the Center for Indoor Air Research, or any successor or affiliated entities of each; (iii) an injunction against making, or causing to be made in any way, any material false, misleading, or deceptive statement or representation or engaging in any public relations or marketing endeavor that is disseminated to the United States public and that misrepresents or suppresses information concerning cigarettes ; (iv) an injunction against conveying any express or implied health message through use of descriptors on cigarette packaging or in cigarette advertising or promotional material, including lights, ultra lights and low tar, which the court found could cause consumers to believe a cigarette brand is less hazardous than another brand; (v) the issuance of corrective statements in various media regarding the adverse health effects of smoking, the addictiveness of smoking and nicotine, the lack of any significant health benefit from smoking low tar or light cigarettes, defendants manipulation of cigarette design to ensure optimum nicotine delivery and the adverse health effects of exposure to environmental tobacco smoke; (vi) the disclosure on defendants public document websites and in the Minnesota document repository of all documents produced to the government in the lawsuit or produced in any future court or administrative action concerning smoking and health until 2021, with certain additional requirements as to documents withheld from production under a claim of privilege or confidentiality; (vii) the disclosure of disaggregated marketing data to the government in the same form and on the same schedule as defendants now follow in disclosing such data to the Federal Trade Commission, for a period of ten years; (viii) certain restrictions on the sale or transfer by defendants of any cigarette brands, brand names, formulas or cigarette businesses within the United States; and (ix) payment of the government s costs in bringing the action.

In September 2006, defendants filed notices of appeal to the United States Court of Appeals for the District of Columbia Circuit. In September 2006, the trial court denied defendants motion to stay the judgment pending defendants appeals, and defendants then filed an emergency motion with the Court of Appeals to stay enforcement of the judgment pending their appeals. In October 2006, the government filed a notice of appeal to the Court of Appeals in which it appeals the denial of certain remedies, including the disgorgement of profits and the cessation remedies it had sought. In October 2006, a three-judge panel of the United States Court of Appeals granted defendants motion and stayed the trial court s judgment pending its review of the decision. Certain defendants, including PM USA and ALG, have filed a motion to clarify the trial court s August 2006 Final Judgment and Remedial Order. In March 2007, the trial court denied in part and granted in part defendants post-trial motion for clarification of portions of the court s remedial order. As noted above, the trial court s judgment and remedial order remain stayed pending the appeal to the Court of Appeals. In May 2007, the United States Court of Appeals for the District of Columbia scheduled briefing of the parties consolidated appeal to begin in August 2007 and conclude in May 2008.

Lights/Ultra Lights Cases

Overview

Plaintiffs in these class actions (some of which have not been certified as such), allege, among other things, that the uses of the terms Lights and/or Ultra Lights constitute deceptive and unfair trade practices, common law fraud, or RICO violations, and seek injunctive and equitable relief, including restitution and, in certain cases, punitive damages. These class actions have been brought against PM USA and, in certain instances, ALG and PMI or its subsidiaries, on behalf of individuals who purchased and consumed various brands of cigarettes, including *Marlboro Lights, Marlboro Ultra Lights, Virginia Slims Lights* and *Superslims, Merit Lights* and *Cambridge Lights.* Defenses raised in these cases include lack of misrepresentation, lack of causation, injury,

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and damages, the statute of limitations, express preemption by the Federal Cigarette Labeling and Advertising Act and implied preemption by the policies and directives of the Federal Trade Commission, non-liability under state statutory provisions exempting conduct that complies with federal regulatory directives, and the First Amendment. Seventeen cases are pending in Arkansas (2), Delaware (1), Florida (1), Illinois (1), Maine (1), Massachusetts (1), Minnesota (1), Missouri (1), New Hampshire (1), New Jersey (1), New Mexico (1), New York (1), Oregon (1), Tennessee (1), and West Virginia (2). In addition, there are two cases pending in Israel. Other entities have stated that they are considering filing such actions against ALG, PMI, and PM USA.

To date, 11 courts in 12 cases have refused to certify class actions, reversed prior class certification decisions or have entered judgment in favor of PM USA. Trial courts in Arizona, Kansas, New Mexico, Oregon and Washington have refused to certify a class, an appellate court in Florida has overturned class certification by a trial court, the Ohio Supreme Court has overturned class certifications in two cases, the United States Court of Appeals for the Fifth Circuit has dismissed a purported Lights class action brought in Louisiana federal court (*Sullivan)* on the grounds that plaintiffs claims were preempted by the Federal Cigarette Labeling and Advertising Act, a federal trial court in Maine has dismissed a purported class action on federal preemption grounds (*Good),* plaintiffs voluntarily dismissed an action in a federal trial court in Michigan after the court dismissed claims asserted under the Michigan Unfair Trade and Consumer Protection Act, and the Supreme Court of Illinois has overturned a judgment in favor of a plaintiff class in the *Price* case, which is discussed below. Plaintiffs appeal of the action in Maine is pending before the United States Court of Appeals for the First Circuit. An intermediate appellate court in Oregon and the Supreme Court in Washington have denied plaintiffs motions for interlocutory review of the trial courts refusals to certify a class. Plaintiffs in the Oregon case failed to appeal by the deadline for doing so. Plaintiffs in the case in Washington voluntarily dismissed the case with prejudice. Plaintiffs in the New Mexico case renewed their motion for class certification. Plaintiffs in the Florida case have petitioned the Florida Supreme Court for further review, and the Supreme Court has ordered briefing on why its *Engle* opinion should not control the decision in that case.

Trial courts have certified classes against PM USA in Massachusetts (*Aspinall*), Minnesota (*Curtis*), Missouri (*Craft*) and New York (*Schwab)*. PM USA has appealed or otherwise challenged these class certification orders. In addition, the United States Supreme Court has reversed the trial and appellate courts rulings denying plaintiffs motion to remand the case to state trial court in a purported Lights class action brought in Arkansas (*Watson*). Developments in these cases include:

Watson: In June 2007, the United States Supreme Court reversed the lower court rulings that denied plaintiffs motion to have the case heard in a state, as opposed to federal, trial court. The Supreme Court rejected defendants contention that the case must be tried in federal court under the federal officer statute. The case will be remanded to the state trial court in Arkansas.

Aspinall: In August 2004, the Massachusetts Supreme Judicial Court affirmed the class certification order. In April 2006, plaintiffs filed a motion to redefine the class to include all persons who after November 25, 1994 purchased packs or cartons of *Marlboro Lights* cigarettes in Massachusetts that displayed the legend Lower Tar & Nicotine (the original class definition did not include a reference to lower tar and nicotine). In August 2006, the trial court denied PM USA s motion for summary judgment based on the state consumer protection statutory exemption and federal preemption. On motion of the parties, the trial court has subsequently reported its decision to deny summary judgment to the appeals court for review and the trial court proceedings are stayed pending completion of the appellate review. Motions for direct appellate review with the Massachusetts Supreme Judicial Court were granted in April 2007.

Curtis: In April 2005, the Minnesota Supreme Court denied PM USA s petition for interlocutory review of the trial court s class certification order. In September 2005, PM USA removed *Curtis* to federal court based on the Eighth Circuit s decision in *Watson,* which upheld the removal of a Lights

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case to federal court based on the federal officer jurisdiction of the Federal Trade Commission. In February 2006, the federal court denied plaintiffs motion to remand the case to state court. The case is now pending in federal court. The case has been stayed pending the outcome of *Dahl v. R. J. Reynolds Tobacco Co.*, which was argued before the United States Court of Appeals for the Eighth Circuit in December 2006. In February 2007, the United States Court of Appeals for the Eighth Circuit issued its ruling in *Dahl*, and reversed the federal district court s denial of plaintiffs motion to remand that case to the state trial court. *Curtis* continues to be stayed pending an appeal of the Minnesota state trial court s dismissal of the *Dahl* Lights class action based on preemption.

Craft: In August 2005, a Missouri Court of Appeals affirmed the class certification order. In September 2005, PM USA removed *Craft* to federal court based on the Eighth Circuit s decision in *Watson.* In March 2006, the federal trial court granted plaintiffs motion and remanded the case to the Missouri state trial court. In May 2006, the Missouri Supreme Court declined to review the trial court s class certification decision. A status conference in the trial court was held in July 2007.

Schwab: In September 2005, the trial court granted in part defendants motion for partial summary judgment dismissing plaintiffs claims for equitable relief and denied a number of plaintiffs motions for summary judgment. In November 2005, the trial court ruled that the plaintiffs would be permitted to calculate damages on an aggregate basis and use fluid recovery theories to allocate them among class members. In September 2006, the trial court denied defendants summary judgment motions and granted plaintiffs motion for certification of a nationwide class of all United States residents that purchased cigarettes in the United States that were labeled light or lights from the first date defendants began selling such cigarettes until the date trial commences. The court also declined to certify the order for interlocutory appeal, declined to stay the case and ordered jury selection to begin in January 2007, with trial scheduled to begin immediately after the jury is impaneled. In October 2006, a single judge of the United States Court of Appeals for the Second Circuit granted PM USA s petition for a temporary stay of pre-trial and trial proceedings pending disposition of the petitions for stay and interlocutory review by a three-judge panel of the Court of Appeals. In November 2006, the Second Circuit granted interlocutory review of the trial court s class certification order and stayed the case before the trial court pending the appeal. Oral argument was heard on July 10, 2007.

In addition to these cases, in December 2005, in the *Miner* case pending in the United States District Court for the Western District of Arkansas, plaintiffs moved for certification of a class composed of individuals who purchased *Marlboro Lights* or *Cambridge Lights* brands in Arkansas, California, Colorado, and Michigan. In December 2005, defendants filed a motion to stay plaintiffs motion for class certification until the court ruled on PM USA s motion to transfer venue to the United States District Court for the Eastern District of Arkansas. The defendants motion was granted in January 2006. PM USA s motion for summary judgment based on preemption and the Arkansas statutory exemption is pending. Following the filing of this motion, plaintiffs moved to voluntarily dismiss *Miner* without prejudice, which PM USA opposed. The court then stayed the case pending the United States Supreme Court s decision on a petition for writ of certiorari in the *Watson* case discussed above. In July 2007, the case was remanded to a state trial court in Arkansas, and plaintiffs have filed a motion to lift the stay in the case. In addition, plaintiffs motions for class certification are pending in cases in New Jersey and Tennessee.

The Price Case

Trial in the *Price* case commenced in state court in Illinois in January 2003, and in March 2003, the judge found in favor of the plaintiff class and awarded approximately $7.1 billion in compensatory damages and $3 billion in punitive damages against PM USA. In April 2003, the judge reduced the amount of the appeal bond that PM USA must provide and ordered PM USA to place a pre-existing 7.0%, $6 billion long-term note from ALG to PM USA in an escrow account with an Illinois financial institution. (Since this note is the result of an

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intercompany financing arrangement, it does not appear on the consolidated balance sheets of ALG.) The judge s order also required PM USA to make cash deposits with the clerk of the Madison County Circuit Court in the following amounts: beginning October 1, 2003, an amount equal to the interest earned by PM USA on the ALG note ($210 million every six months), an additional $800 million in four equal quarterly installments between September 2003 and June 2004 and the payments of principal on the note, which are due in April 2008, 2009 and 2010. Plaintiffs appealed the judge s order reducing the bond. In July 2003, the Illinois Fifth District Court of Appeals ruled that the trial court had exceeded its authority in reducing the bond. In September 2003, the Illinois Supreme Court upheld the reduced bond set by the trial court and announced it would hear PM USA s appeal on the merits without the need for intermediate appellate court review. In December 2005, the Illinois Supreme Court reversed the trial court s judgment in favor of the plaintiffs and remanded the case to the trial court with instructions that the case be dismissed. In May 2006, the Illinois Supreme Court denied plaintiffs motion for rehearing. In June 2006, the Illinois Supreme Court ordered the return to PM USA of approximately $2.2 billion being held in escrow to secure the appeal bond in the case and terminated PM USA s obligations to pay administrative fees to the Madison County Clerk. In November 2006, the United States Supreme Court denied plaintiffs petition for writ of certiorari and, in December 2006, the Circuit Court of Madison County entered final judgment in favor of PM USA and dismissed the case with prejudice. In December 2006, the pre-existing 7.0%, $6 billion long-term note from ALG to PM USA that was in escrow pending the outcome of plaintiffs petition for writ of certiorari to the United States Supreme Court was returned to PM USA. Plaintiffs have filed a motion to vacate or withdraw the *Price* decision based upon the United States Supreme Court s grant of the petition for writ of certiorari in the *Watson* case discussed above. In May 2007, the trial court granted plaintiffs motion to certify certain questions to the Illinois Fifth District Appellate Court, and plaintiffs petitioned the Fifth District to review the certified questions. In May 2007, PM USA filed applications for writ of prohibition and writ of mandamus with the Illinois Supreme Court seeking an order compelling the lower courts to deny plaintiffs motion to vacate and/or withhold final judgment. In June 2007, the appellate court granted PM USA s motion to stay plaintiffs appeal pending resolution of related matters before the Illinois Supreme Court.

Certain Other Tobacco-Related Litigation

Tobacco Price Cases: As of August 1, 2007, two cases were pending in Kansas and New Mexico in which plaintiffs allege that defendants, including PM USA and PMI, conspired to fix cigarette prices in violation of antitrust laws. ALG and PMI are defendants in the case in Kansas. Plaintiffs motions for class certification have been granted in both cases. In February 2005, the New Mexico Court of Appeals affirmed the class certification decision. In June 2006, defendants motion for summary judgment was granted in the New Mexico case. Plaintiffs in the New Mexico case have appealed.

Wholesale Leaders Cases: In June 2003, certain wholesale distributors of cigarettes filed suit in Tennessee against PM USA seeking to enjoin the PM USA 2003 Wholesale Leaders (WL) program that became available to wholesalers in June 2003. The complaint alleges that the WL program constitutes unlawful price discrimination and is an attempt to monopolize. In addition to an injunction, plaintiffs seek unspecified monetary damages, attorneys fees, costs and interest. The states of Tennessee and Mississippi intervened as plaintiffs in this litigation. In August 2003, the trial court issued a preliminary injunction, subject to plaintiffs posting a bond in the amount of $1 million, enjoining PM USA from implementing certain discount terms with respect to the sixteen wholesale distributor plaintiffs, and PM USA appealed. In September 2003, the United States Court of Appeals for the Sixth Circuit granted PM USA s motion to stay the injunction pending PM USA s expedited appeal. In January 2004, Tennessee filed a motion to dismiss its complaint, and its complaint was dismissed without prejudice in March 2004. In August 2005, the trial court granted PM USA s motion for summary judgment, dismissed the case, and dissolved the preliminary injunction. Plaintiffs appealed to the United States Court of Appeals for the Sixth Circuit. In February 2007, the Sixth Circuit affirmed the trial court s grant of PM USA s motion for summary judgment. Plaintiffs have filed a petition for writ of certiorari with the United States Supreme Court seeking review of the Sixth Circuit s decision.

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Cigarette Contraband Cases: In May 2000 and August 2001, various departments of Colombia and the European Community and 10 Member States filed suits in the United States against ALG and certain of its subsidiaries, including PM USA and PMI, and other cigarette manufacturers and their affiliates, alleging that defendants sold to distributors cigarettes that would be illegally imported into various jurisdictions. In February 2002, the federal district court granted defendants motions to dismiss the actions. In January 2004, the United States Court of Appeals for the Second Circuit affirmed the dismissals of the cases based on the common law Revenue Rule, which bars a foreign government from bringing civil claims in U.S. courts for the recovery of lost taxes. It is possible that future litigation related to cigarette contraband issues may be brought. In this regard, ALG believes that Canadian authorities are contemplating a legal proceeding based on an investigation of ALG entities relating to allegations of contraband shipments of cigarettes into Canada in the early to mid-1990s.

Cases Under the California Business and Professions Code: In June 1997 and July 1998, two suits (*Brown* and *Daniels*) were filed in California state court alleging that domestic cigarette manufacturers, including PM USA and others, have violated California Business and Professions Code Sections 17200 and 17500 regarding unfair, unlawful and fraudulent business practices. Class certification was granted in both cases as to plaintiffs claims that class members are entitled to reimbursement of the costs of cigarettes purchased during the class periods and injunctive relief. In September 2002, the court granted defendants motion for summary judgment as to all claims in one of the cases (*Daniels*), and plaintiffs appealed. In October 2004, the California Fourth District Court of Appeal affirmed the trial court s ruling, and also denied plaintiffs motion for rehearing. In February 2005, the California Supreme Court agreed to hear plaintiffs appeal. On August 2, 2007, the California Supreme Court affirmed the dismissal of the *Daniels* class action on federal preemption grounds. In September 2004, the trial court in the other case granted defendants motion for summary judgment as to plaintiffs claims attacking defendants cigarette advertising and promotion and denied defendants motion for summary judgment on plaintiffs claims based on allegedly false affirmative statements. Plaintiffs motion for rehearing was denied. In March 2005, the court granted defendants motion to decertify the class based on a recent change in California law, which, in two July 2006 opinions, the California Supreme Court ruled applicable to pending cases. Plaintiffs motion for reconsideration of the order that decertified the class was denied, and plaintiffs have appealed. In September 2006, an intermediate appellate court affirmed the trial court s order decertifying the class in *Brown*. In November 2006, the California Supreme Court accepted review of the appellate court s decision.

In May 2004, a lawsuit *(Gurevitch)* was filed in California state court on behalf of a purported class of all California residents who purchased the *Merit* brand of cigarettes since July 2000 to the present alleging that defendants, including PM USA, violated California s Business and Professions Code Sections 17200 and 17500 regarding unfair, unlawful and fraudulent business practices, including false and misleading advertising. The complaint also alleges violations of California s Consumer Legal Remedies Act. Plaintiffs seek injunctive relief, disgorgement, restitution, and attorneys fees. In July 2005, defendants motion to dismiss was granted; however, plaintiffs motion for leave to amend the complaint was also granted, and plaintiffs filed an amended complaint in September 2005. In October 2005, the court stayed this action pending the California Supreme Court s rulings on two cases not involving PM USA. In July 2006, the California Supreme Court issued rulings in the two cases and held that a recent change in California law known as Proposition 64, which limits the ability to bring a lawsuit to only those plaintiffs who have suffered injury in fact and lost money or property as a result of defendant s alleged statutory violations, properly applies to pending cases. In September 2006, the stay was lifted and defendants filed their demurrer to plaintiffs amended complaint. In March 2007, the court, without ruling on the demurrer, again stayed the action pending rulings from the California Supreme Court in another case involving Proposition 64 that is relevant to PM USA s demurrer.

Certain Other Actions

IRS Challenges to PMCC Leases: The IRS concluded its examination of ALG s consolidated tax returns for the years 1996 through 1999, and issued a final Revenue Agent s Report (RAR) on March 15, 2006. The RAR

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disallowed benefits pertaining to certain PMCC leveraged lease transactions for the years 1996 through 1999. Altria Group, Inc. has agreed with all conclusions of the RAR, with the exception of the disallowance of benefits pertaining to several PMCC leveraged lease transactions for the years 1996 through 1999. PMCC will continue to assert its position regarding these leveraged lease transactions and contest approximately $150 million of tax and net interest assessed and paid with regard to them. The IRS may in the future challenge and disallow more of PMCC s leveraged leases based on Revenue Rulings, an IRS Notice and subsequent case law addressing specific types of leveraged leases (lease-in/lease-out (LILO) and sale-in/lease-out (SILO) transactions). PMCC believes that the position and supporting case law described in the RAR, Revenue Rulings and the IRS Notice are incorrectly applied to PMCC s transactions and that its leveraged leases are factually and legally distinguishable in material respects from the IRS s position. PMCC and ALG intend to vigorously defend against any challenges based on that position through litigation. In this regard, on October 16, 2006, PMCC filed a complaint in the U.S. District Court for the Southern District of New York to claim refunds for a portion of these tax payments and associated interest. However, should PMCC s position not be upheld, PMCC may have to accelerate the payment of significant amounts of federal income tax and significantly lower its earnings to reflect the recalculation of the income from the affected leveraged leases, which could have a material effect on the earnings and cash flows of Altria Group, Inc. in a particular fiscal quarter or fiscal year. PMCC considered this matter in its adoption of FASB Interpretation No. 48 and FASB Staff Position No. FAS 13-2.

It is possible that there could be adverse developments in pending cases. An unfavorable outcome or settlement of pending tobacco related litigation could encourage the commencement of additional litigation. Although PM USA has historically been able to obtain required bonds or relief from bonding requirements in order to prevent plaintiffs from seeking to collect judgments while adverse verdicts have been appealed, there remains a risk that such relief may not be obtainable in all cases. This risk has been substantially reduced given that 42 states now limit the dollar amount of bonds or require no bond at all.

ALG and its subsidiaries record provisions in the consolidated financial statements for pending litigation when they determine that an unfavorable outcome is probable and the amount of the loss can be reasonably estimated. Except as discussed elsewhere in this *Note 11, Contingencies:* (i) management has not concluded that it is probable that a loss has been incurred in any of the pending tobacco-related cases; (ii) management is unable to estimate the possible loss or range of loss that could result from an unfavorable outcome of any of the pending tobacco-related cases; and (iii) accordingly, management has not provided any amounts in the consolidated financial statements for unfavorable outcomes, if any.

It is possible that PM USA s or Altria Group, Inc. s consolidated results of operations, cash flows or financial position could be materially affected in a particular fiscal quarter or fiscal year by an unfavorable outcome or settlement of certain pending litigation. Nevertheless, although litigation is subject to uncertainty, management believes the litigation environment has substantially improved. ALG and each of its subsidiaries named as a defendant believe, and each has been so advised by counsel handling the respective cases, that it has a number of valid defenses to the litigation pending against it, as well as valid bases for appeal of adverse verdicts against it. All such cases are, and will continue to be, vigorously defended. However, ALG and its subsidiaries may enter into settlement discussions in particular cases if they believe it is in the best interests of ALG s stockholders to do so.

Third-Party Guarantees

At June 30, 2007, Altria Group, Inc. s third-party guarantees, which are primarily related to excise taxes and divestiture activities, were $286 million, of which $280 million have no specified expiration dates. The remainder expire through 2011, with none expiring through June 30, 2008. Altria Group, Inc. is required to

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perform under these guarantees in the event that a third party fails to make contractual payments or achieve performance measures. Altria Group, Inc. has a liability of $22 million on its condensed consolidated balance sheet at June 30, 2007, relating to these guarantees. In the ordinary course of business, certain subsidiaries of ALG have agreed to indemnify a limited number of third parties in the event of future litigation.

In July 2007, a guarantee agreement for $179 million between Altria Group, Inc. and the Pension Benefit Guaranty Corporation related to Miller Brewing Company was terminated.

Note 12. Income Taxes:

Altria Group, Inc. accounts for income taxes in accordance with SFAS No. 109, Accounting for Income Taxes. Under SFAS No. 109, deferred tax assets and liabilities are determined based on the difference between the financial statement and tax bases of assets and liabilities, using enacted tax rates in effect for the year in which the differences are expected to reverse. Significant judgment is required in determining income tax provisions and in evaluating tax positions.

Altria Group, Inc. s U.S. subsidiaries join in the filing of a U.S. federal consolidated income tax return. The U.S. federal statute of limitations remains open for the year 2000 and onward with years 2000 to 2003 currently under examination by the Internal Revenue Service (IRS). Foreign and U.S. state jurisdictions have statutes of limitations generally ranging from 3 to 5 years. Years still open to examination by foreign tax authorities in major jurisdictions include Germany (2002 onward), Indonesia (2000 onward), Russia (2005 onward), and Switzerland (2005 onward). Altria Group, Inc. is currently under examination in various U.S. state and foreign jurisdictions.

On January 1, 2007, Altria Group, Inc. adopted the provisions of the Financial Accounting Standards Board (FASB) Interpretation No. 48, Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109 (FIN 48). The Interpretation prescribes a recognition threshold and a measurement attribute for the financial statement recognition and measurement of tax positions taken or expected to be taken in a tax return. For those benefits to be recognized, a tax position must be more-likely-than-not to be sustained upon examination by taxing authorities. The amount recognized is measured as the largest amount of benefit that is greater than 50 percent likely of being realized upon ultimate settlement. As a result of the January 1, 2007 adoption of FIN 48, Altria Group, Inc. lowered its liability for unrecognized tax benefits by $1,021 million. This resulted in an increase to stockholders equity of $857 million ($835 million, net of minority interest), a reduction of Kraft s goodwill of $85 million and a reduction of federal deferred tax benefits of $79 million.

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Unrecognized tax benefits and Altria Group, Inc. s consolidated liability for contingent income taxes, interest and penalties were as follows:

	January 1, 2007	June 30, 2007
	(in millions)	
Unrecognized tax benefits - Altria Group, Inc.	$434	$437
Unrecognized tax benefits - Kraft	619	270
Unrecognized tax benefits	1,053	707
Accrued interest and penalties	292	268
Tax credits and other indirect benefits	(104)	(117)
Liability for tax contingencies	$1,241	$858

The amount of unrecognized tax benefits that, if recognized, would impact the effective tax rate at January 1, 2007 was $848 million, with the remaining $205 million affecting deferred taxes. The amount of unrecognized tax benefits that, if recognized, would impact the effective tax rate at June 30, 2007 was $308 million, along with $129 million affecting deferred taxes and the remainder of $270 million affecting the receivable from Kraft discussed below.

Altria Group, Inc. s unrecognized tax benefits decreased to $707 million as of June 30, 2007, principally due to the spin-off of Kraft. Under the Tax Sharing Agreement between Altria Group, Inc. and Kraft, Kraft is responsible for its own pre spin-off tax obligations. However, due to regulations governing the U.S. federal consolidated tax return, Altria Group, Inc. remains severally liable for Kraft s pre-spin-off federal taxes. As a result, Altria Group, Inc. continues to include $270 million of Kraft s unrecognized tax benefits in its liability for uncertain tax positions, and a corresponding receivable from Kraft of $270 million is included in other assets.

Altria Group, Inc. recognizes accrued interest and penalties associated with uncertain tax positions as part of the tax provision. As of January 1, 2007, Altria Group, Inc. had $292 million of accrued interest and penalties of which approximately $125 million related to Kraft. The accrued interest and penalties decreased to $268 million at June 30, 2007, principally as a result of the Kraft spin-off. This amount includes $76 million of Kraft federal interest for which Kraft is responsible under the Tax Sharing Agreement. A corresponding receivable from Kraft is included in other assets.

It is reasonably possible that within the next 12 months certain U.S. state and foreign examinations will be resolved, which could result in a decrease in unrecognized tax benefits and interest and penalties of up to $150 million and $60 million, respectively.

Altria Group, Inc. adopted the provisions of FASB Staff Position No. FAS 13-2, Accounting for a Change or Projected Change in the Timing of Cash Flows Relating to Income Taxes Generated by a Leveraged Lease Transaction, effective January 1, 2007. This Staff Position requires the revenue recognition calculation to be reevaluated if the projected timing of income tax cash flows generated by a leveraged lease is revised. The adoption of this Staff Position by Altria Group, Inc. resulted in a reduction to stockholders equity of $124 million as of January 1, 2007.

The IRS concluded its examination of Altria Group, Inc. s consolidated tax returns for the years 1996 through 1999, and issued a final Revenue Agents Report (RAR) on March 15, 2006. Altria Group, Inc. agreed with the RAR, with the exception of certain leasing matters discussed below. Consequently, in March 2006, Altria Group, Inc. recorded non-cash tax benefits of $1.0 billion, which principally represented the reversal of tax reserves following the issuance of and agreement with the RAR. Altria Group, Inc. reimbursed $337 million in cash to Kraft for its portion of the $1.0 billion in tax benefits, as well as pre-tax interest of $46 million. The amounts related to Kraft were reclassified to income

from discontinued operations. The tax reversal resulted in an increase to earnings from continuing operations of $631 million for the six months ended June 30, 2006.

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Altria Group, Inc. has agreed with all conclusions of the RAR, with the exception of the disallowance of benefits pertaining to several PMCC leveraged lease transactions for the years 1996 through 1999. PMCC will continue to assert its position regarding these leveraged lease transactions and contest approximately $150 million of tax and net interest assessed and paid with regard to them. The IRS may in the future challenge and disallow more of PMCC s leveraged leases based on Revenue Rulings, an IRS Notice and subsequent case law addressing specific types of leveraged leases (lease-in/lease-out (LILO) and sale-in/lease-out (SILO) transactions). PMCC believes that the position and supporting case law described in the RAR, Revenue Rulings and the IRS Notice are incorrectly applied to PMCC s transactions and that its leveraged leases are factually and legally distinguishable in material respects from the IRS s position. PMCC and ALG intend to vigorously defend against any challenges based on that position through litigation. In this regard, on October 16, 2006, PMCC filed a complaint in the U.S. District Court for the Southern District of New York to claim refunds for a portion of these tax payments and associated interest. However, should PMCC s position not be upheld, PMCC may have to accelerate the payment of significant amounts of federal income tax and significantly lower its earnings to reflect the recalculation of the income from the affected leveraged leases, which could have a material effect on the earnings and cash flows of Altria Group, Inc. in a particular fiscal quarter or fiscal year. PMCC considered this matter in its adoption of FIN 48 and FASB Staff Position No. FAS 13-2.

Note 13. New Accounting Standard:

In September 2006, the FASB issued SFAS No. 157 Fair Value Measurements, which will be effective for financial statements issued for fiscal years beginning after November 15, 2007. This statement defines fair value, establishes a framework for measuring fair value and expands disclosures about fair value measurements. Altria Group, Inc. anticipates that the adoption of this statement will not have a material impact on its financial statements.

Note 14. Subsequent Event:

On July 18, 2007, PMI announced that it had reached an agreement in principle to acquire an additional 30% stake in its Mexican tobacco business from its joint venture partner, Grupo Carso, S.A.B. de C.V. (Grupo Carso). PMI currently holds a 50% stake in its Mexican tobacco business and this transaction would bring PMI s stake to 80%. Grupo Carso would retain a 20% stake in the business. The transaction has a value of approximately $1.1 billion and is expected to be completed later this year, subject to the execution of definitive agreements and customary regulatory approvals. When completed, the transaction is expected to increase Altria s annualized net earnings by approximately $0.03 per share.

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Item 2. **MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

Description of the Company

Throughout Management s Discussion and Analysis of Financial Condition and Results of Operations, the term Altria Group, Inc. refers to the consolidated financial position, results of operations and cash flows of the Altria family of companies and the term ALG refers solely to the parent company. ALG s wholly-owned subsidiaries, Philip Morris USA Inc. (PM USA) and Philip Morris International Inc. (PMI), are engaged in the manufacture and sale of cigarettes and other tobacco products. The operations of PMI are organized and managed by geographic region. Philip Morris Capital Corporation (PMCC), another wholly-owned subsidiary, maintains a portfolio of leveraged and direct finance leases. In addition, ALG held a 28.6% economic and voting interest in SABMiller plc (SABMiller) at June 30, 2007. ALG s access to the operating cash flows of its subsidiaries consists of cash received from the payment of dividends and interest, and the repayment of amounts borrowed from ALG by its subsidiaries.

Kraft Spin-Off

On March 30, 2007 (the Distribution Date), Altria Group, Inc. spun-off all of its remaining interest (88.9%) in Kraft Foods Inc. (Kraft) on a pro rata basis to Altria Group, Inc. stockholders of record as of the close of business on March 16, 2007 (the Record Date) in a tax-free distribution. Based on the number of shares of Altria Group, Inc. outstanding at the Record Date, the distribution ratio was 0.692024 of a share of Kraft for every share of Altria Group, Inc. common stock outstanding. Altria Group, Inc. stockholders received cash in lieu of fractional shares of Kraft. Following the distribution, Altria Group, Inc. does not own any shares of Kraft. During the second quarter of 2007, Altria Group, Inc. adjusted its current quarterly dividend to $0.69 per share, so that its stockholders who retain their Altria Group, Inc. and Kraft shares will receive, in the aggregate, the same dividend rate as before the distribution. As a result, the present annualized dividend rate is $2.76 per Altria Group, Inc. common share. As in the past, all decisions regarding future dividend increases will be made independently by the Altria Group, Inc. Board of Directors and the Kraft Board of Directors, for their respective companies.

Holders of Altria Group, Inc. stock options were treated similarly to public stockholders and accordingly, had their stock awards split into two instruments. Holders of Altria Group, Inc. stock options received the following stock options, which, immediately after the spin-off, had an aggregate intrinsic value equal to the intrinsic value of the pre-spin Altria Group, Inc. options:

- a new Kraft option to acquire the number of shares of Kraft Class A common stock equal to the product of (a) the number of Altria Group, Inc. options held by such person on the Distribution Date and (b) the distribution ratio of 0.692024 mentioned above; and

- an adjusted Altria Group, Inc. option for the same number of shares of Altria Group, Inc. common stock with a reduced exercise price.

The new Kraft option has an exercise price equal to the Kraft market price at the time of the distribution ($31.66) multiplied by the Option Conversion Ratio, which represents the exercise price of the original Altria Group, Inc. option divided by the Altria Group, Inc. market price immediately before the distribution ($87.81). The reduced exercise price of the adjusted Altria Group, Inc. option is determined by multiplying the Altria Group, Inc. market price immediately following the distribution ($65.90) by the Option Conversion Ratio.

Holders of Altria Group, Inc. restricted stock or stock rights awarded prior to January 31, 2007, retained their existing award and received restricted stock or stock rights of Kraft Class A common stock. The amount of Kraft restricted stock or stock rights awarded to such holders was calculated using the same formula set forth

above with respect to new Kraft options. All of the restricted stock and stock rights will vest at the completion of the original restriction period (typically, three years from the date of the original grant). Recipients of Altria Group, Inc. stock rights awarded on January 31, 2007, did not receive restricted stock or stock rights of Kraft. Rather, they received additional stock rights of Altria Group, Inc. to preserve the intrinsic value of the original award.

To the extent that employees of the remaining Altria Group, Inc. received Kraft stock options, Altria Group, Inc. reimbursed Kraft in cash for the Black-Scholes fair value of the stock options received. To the extent that Kraft employees held Altria Group, Inc. stock options, Kraft reimbursed Altria Group, Inc. in cash for the Black-Scholes fair value of the stock options. To the extent that holders of Altria Group, Inc. stock rights received Kraft stock rights, Altria Group, Inc. paid to Kraft the fair value of the Kraft stock rights less the value of projected forfeitures. Based upon the number of Altria Group, Inc. stock awards outstanding at the Distribution Date, the net amount of these reimbursements resulted in a payment of $179 million from Kraft to Altria Group, Inc. in April 2007. The reimbursement from Kraft is reflected as an increase to the additional paid-in capital of Altria Group, Inc. on the June 30, 2007 condensed consolidated balance sheet.

Kraft was previously included in the Altria Group, Inc. consolidated federal income tax return, and federal income tax contingencies were recorded as liabilities on the balance sheet of ALG. As part of the intercompany account settlement discussed below, ALG reimbursed Kraft in cash for these liabilities, which as of March 30, 2007, were approximately $305 million, plus pre-tax interest of $63 million ($41 million after taxes). ALG also reimbursed Kraft in cash for the federal income tax consequences of the adoption of Financial Accounting Standards Board (FASB) Interpretation No. 48, Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109 (FIN 48) (approximately $70 million plus pre-tax interest of $14 million, $9 million after taxes). See Note 12. *Income Taxes* for a discussion of the FIN 48 adoption and the Tax Sharing Agreement between Altria Group, Inc. and Kraft.

A subsidiary of ALG previously provided Kraft with certain services at cost plus a 5% management fee. After the Distribution Date, Kraft undertook these activities, and any remaining limited services provided to Kraft will cease in 2007. All intercompany accounts were settled in cash within 30 days of the Distribution Date. The settlement of the intercompany accounts (including the amounts discussed above related to stock awards and tax contingencies) resulted in a net payment from Kraft to ALG of $85 million in April 2007.

The distribution resulted in a net decrease to Altria Group, Inc. s stockholders equity of $27.4 billion on the Distribution Date.

Altria Group, Inc. has reflected the results of Kraft prior to the Distribution Date as discontinued operations on the condensed consolidated statements of earnings and the condensed consolidated statements of cash flows. The assets and liabilities related to Kraft were reclassified and reflected as discontinued operations on the condensed consolidated balance sheet at December 31, 2006.

Other

Beginning with the second quarter of 2007, Altria Group, Inc. revised its reportable segments to reflect PMI s operations by geographic region. Altria Group, Inc. s revised segments are U.S. tobacco; European Union; Eastern Europe, Middle East and Africa; Asia; Latin America; and Financial Services. Accordingly, prior period segment results have been restated.

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Executive Summary

The following executive summary is intended to provide significant highlights of the Discussion and Analysis that follows.

Consolidated Operating Results for the Six Months Ended June 30, 2007 The changes in Altria Group, Inc. s earnings from continuing operations and diluted earnings per share (EPS) from continuing operations for the six months ended June 30, 2007, from the six months ended June 30, 2006, were due primarily to the following (in millions, except per share data):

	Earnings from Continuing Operations	Diluted EPS from Continuing Operations
For the six months ended June 30, 2006	$ 4,709	$ 2.24
2006 Italian antitrust charge	61	0.03
2006 Asset impairment and exit costs	37	0.02
2006 Interest on tax reserve transfers to Kraft	29	0.01
2006 Tax items	(631)	(0.30)
2006 Provision for airline industry exposure	66	0.03
Subtotal 2006 items	(438)	(0.21)
2007 Asset impairment and exit costs	(341)	(0.17)
2007 Recoveries from airline industry exposure	133	0.06
2007 Interest on tax reserve transfers to Kraft	(50)	(0.02)
Subtotal 2007 items	(258)	(0.13)
Currency	121	0.06
Change in tax rate	13	0.01
Higher shares outstanding	-	(0.01)
Operations	193	0.09
For the six months ended June 30, 2007	$ 4,340	$ 2.05

Adjusted for the 2006 and 2007 items listed above, diluted EPS for the six months ended June 30, 2007 of $2.18 increased 7.4% from $2.03 in 2006.

See discussion of events affecting the comparability of statement of earnings amounts in the Consolidated Operating Results section of the following Discussion and Analysis.

Asset Impairment and Exit Costs In June 2007, Altria Group, Inc. announced plans by its tobacco subsidiaries to optimize worldwide cigarette production by moving U.S.-based cigarette production for non-U.S. markets to PMI facilities in Europe. Due to declining U.S. cigarette volume, as well as PMI s decision to re-source its production, PM USA will close its Cabarrus, North Carolina manufacturing facility and consolidate manufacturing for the U.S. market at its Richmond, Virginia manufacturing center. From 2007 through 2011, PM USA expects to incur total pre-tax charges of approximately $670 million for the program, including $318 million incurred during the second quarter of 2007 ($205 million after taxes). During the first six months of 2007 and 2006, PMI recorded pre-tax asset impairment and exit costs of $138 million ($100 million after taxes) and $23 million ($16 million after taxes), respectively. In addition, during the first six months of 2007 and 2006, pre-tax asset impairment and exit costs of $61 million ($36 million after taxes) and $32 million ($21 million after taxes), respectively, were recorded for

general corporate purposes. *For further details, see Note 2 to the Condensed Consolidated Financial Statements and the Tobacco Business Environment section of the following Discussion and Analysis.*

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Italian Antitrust Charge During the first quarter of 2006, PMI recorded a $61 million charge related to an Italian antitrust action.

Recoveries/Provision from/for Airline Industry Exposure During the six months ended June 30, 2007, PMCC recorded a pre-tax gain of $207 million ($133 million after taxes) on the sale of its ownership interests and bankruptcy claims in certain leveraged lease investments in aircraft, which represented a partial cash recovery of amounts that had been previously written down. During the second quarter of 2006, PMCC increased its allowance for losses by $103 million ($66 million after taxes), due to continuing issues within the airline industry.

Currency The favorable currency impact is due primarily to the weakness of the U.S. dollar versus the euro and the Russian ruble, partially offset by the strength of the U.S. dollar versus the Japanese yen.

Income Taxes Altria Group, Inc. s income tax rate increased 10.0 percentage points to 33.5%. The 2006 tax rate includes $631 million of non-cash tax benefits, representing the reversal of tax reserves after the U.S. Internal Revenue Service (IRS) concluded its examination of Altria Group, Inc. s consolidated tax returns for the years 1996 through 1999 in the first quarter of 2006.

Interest on Tax Reserve Transfers to Kraft As further discussed in Note 1. *Basis of Presentation and Kraft Spin-Off,* and Note 12. *Income Taxes*, the interest on tax reserves transferred to Kraft is related to the spin-off and the adoption of Financial Accounting Standards Board (FASB) Interpretation No. 48, Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109 (FIN 48) in 2007 and the conclusion of an IRS audit in 2006.

Shares Outstanding Higher shares outstanding during the six months ended June 30, 2007, primarily reflects exercises of employee stock options (which become outstanding when exercised) and the incremental share impact of stock options outstanding.

Continuing Operations The increase in earnings from continuing operations was due primarily to the following:

- Higher European Union income, reflecting higher pricing and lower marketing, administration and research costs, partially offset by unfavorable volume/mix;

- Higher Eastern Europe, Middle East and Africa income, reflecting higher pricing and higher volume/mix, partially offset by higher marketing, administration and research costs; and

- Higher U.S. tobacco income, reflecting lower marketing, administration and research costs, and lower wholesale promotional allowance rates, partially offset by lower volume and higher ongoing resolution costs;

partially offset by:

- Lower Asia income, reflecting lower volume/mix and higher marketing, administration and research costs, partially offset by higher pricing, lower fixed manufacturing costs and the Lakson Tobacco acquisition;

- Lower financial services income (after excluding the impact of the provision/recoveries from/for airline industry exposure), reflecting lower asset management gains and lower lease revenues.

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Consolidated Operating Results for the Three Months Ended June 30, 2007 The changes in Altria Group, Inc. s earnings from continuing operations and diluted EPS from continuing operations for the three months ended June 30, 2007, from the three months ended June 30, 2006, were due primarily to the following (in millions, except per share data):

	Earnings from Continuing Operations	Diluted EPS from Continuing Operations
For the three months ended June 30, 2006	$2,112	$1.00
2006 Asset impairment and exit costs	36	0.02
2006 Provision for airline industry exposure	66	0.03
Subtotal 2006 items	102	0.05
2007 Asset impairment and exit costs	(260)	(0.12)
2007 Recoveries from airline industry exposure	50	0.02
Subtotal 2007 items	(210)	(0.10)
Currency	59	0.03
Change in tax rate	3	
Operations	149	0.07
For the three months ended June 30, 2007	$2,215	$1.05

Adjusted for the 2006 and 2007 items listed above, diluted EPS for the quarter ended June 30, 2007 of $1.15 increased 9.5% from $1.05 in 2006.

See discussion of events affecting the comparability of statement of earnings amounts in the Consolidated Operating Results section of the following Discussion and Analysis.

Asset Impairment and Exit Costs During the second quarter of 2007, PM USA recorded pre-tax charges of $318 million ($205 million after taxes) related to the announced closure of its Cabarrus, North Carolina manufacturing facility. During the second quarter of 2007 and 2006, PMI recorded pre-tax asset impairment and exit costs of $76 million ($55 million after taxes) and $21 million ($15 million after taxes), respectively. In addition, during the second quarter of 2006, pre-tax asset impairment and exit costs of $32 million ($21 million after taxes) were recorded for general corporate purposes. *For further details, see Note 2 to the Condensed Consolidated Financial Statements and the Tobacco Business Environment section of the following Discussion and Analysis.*

Recoveries/Provision from/for Airline Industry Exposure During the second quarter of 2007, PMCC recorded a pre-tax gain of $78 million ($50 million after taxes) on the sale of bankruptcy claims in certain leveraged lease investments in aircraft, which represented a partial cash recovery of amounts that had been previously written down. During the second quarter of 2006, PMCC increased its allowance for losses by $103 million ($66 million after taxes), due to continuing issues within the airline industry.

Currency The favorable currency impact is due primarily to the weakness of the U.S. dollar versus the euro and the Russian ruble, partially offset by the strength of the U.S. dollar versus the Japanese yen.

Continuing Operations The increase in earnings from continuing operations was due primarily to the following:

Higher European Union income, reflecting higher pricing, and lower marketing, administration and research costs, partially offset by lower volume/mix;

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- Higher Eastern Europe, Middle East and Africa income, reflecting higher pricing, favorable costs and higher volume/mix, partially offset by higher marketing, administration and research costs;

- Higher U.S. tobacco income, reflecting lower marketing, administration and research costs, and lower wholesale promotional allowance rates, partially offset by lower volume and higher ongoing resolution costs;

- Higher financial services income (after excluding the impact of the provision/recoveries from airline industry exposure), reflecting higher asset management gains, partially offset by lower lease revenues;

partially offset by:

- Lower Asia income, reflecting lower volume/mix and higher marketing, administration and research costs, partially offset by higher pricing and the Lakson Tobacco acquisition.

For further details, see the Consolidated Operating Results and Operating Results by Business Segment sections of the following Discussion and Analysis.

2007 Forecasted Results On July 18, 2007, Altria Group, Inc. revised its forecast for reported 2007 full-year diluted earnings per share from continuing operations to a range of $4.05 to $4.10, reflecting $0.15 in additional charges for asset impairment and exit costs, versus its previously announced range of $4.20 to $4.25. The revised forecast includes charges of $0.24 per share, which are $0.15 per share higher ($0.12 for PM USA and $0.03 for PMI) than the $0.09 per share in previously forecasted charges. The forecast also includes $0.06 per share for cash recoveries at PMCC, which were recorded in the first half of 2007. The forecast excludes Kraft, which is accounted for as a discontinued operation in 2007, reflecting the distribution of Kraft shares. The forecast also excludes the impact of any potential future acquisitions. The factors described in the *Cautionary Factors That May Affect Future Results* section of the following *Discussion and Analysis* represent continuing risks to this forecast.

Discussion and Analysis

Consolidated Operating Results

See pages 80-83 for a discussion of Cautionary Factors That May Affect Future Results.

	For the Six Months Ended June 30,		For the Three Months Ended June 30,	
	2007	2006	2007	2006
	(in millions)			
Net revenues:				
U.S. tobacco	$ 9,054	$ 9,108	$ 4,809	$ 4,785
European Union	13,421	11,790	6,867	6,064
Eastern Europe, Middle East and Africa	5,893	5,109	3,103	2,655
Asia	5,537	5,081	2,787	2,528
Latin America	2,365	2,131	1,191	1,063
Total International tobacco	27,216	24,111	13,948	12,310
Financial services	95	163	52	55
Net revenues	$ 36,365	$ 33,382	$ 18,809	$ 17,150
Operating income:				
Operating companies income (loss):				
U.S. tobacco	$ 2,134	$ 2,417	$ 1,004	$ 1,301
European Union	2,105	1,780	1,075	957
Eastern Europe, Middle East and Africa	1,201	1,057	634	564
Asia	898	1,007	429	488
Latin America	190	262	102	130
Total International tobacco	4,394	4,106	2,240	2,139
Financial services	299	37	139	(59)
Amortization of intangibles	(12)	(11)	(6)	(6)
General corporate expenses	(321)	(262)	(133)	(149)
Operating income	$ 6,494	$ 6,287	$ 3,244	$ 3,226

As discussed in Note 10. *Segment Reporting*, management reviews operating companies income, which is defined as operating income before general corporate expenses and amortization of intangibles, to evaluate segment performance and allocate resources. Management believes it is appropriate to disclose this measure to help investors analyze the business performance and trends of the various business segments.

The following events that occurred during the six months ended June 30, 2007 and 2006, affected the comparability of statement of earnings amounts.

Income Tax Benefit The IRS concluded its examination of Altria Group, Inc. s consolidated tax returns for the years 1996 through 1999, and issued a final Revenue Agent s Report (RAR) on March 15, 2006. Consequently, in March 2006, Altria Group, Inc. recorded non-cash tax benefits of approximately $1.0 billion, which principally represented the reversal of tax reserves following the issuance of and agreement with the RAR. Altria Group, Inc. reimbursed $337 million in cash to Kraft for its portion of the $1.0 billion in tax benefits, as well as pre-tax interest of $46 million. The amounts related to Kraft were reclassified to

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income from discontinued operations. The tax reversal resulted in an increase to earnings from continuing operations of $631 million for the first quarter of 2006.

Italian Antitrust Charge During the first quarter of 2006, PMI recorded a $61 million charge related to an Italian antitrust action. This charge was included in the operating companies income of the European Union segment.

Asset Impairment and Exit Costs For the six months and three months ended June 30, 2007 and 2006, pre-tax asset impairment and exit costs consisted of the following:

		For the Six Months Ended June 30,		For the Three Months Ended June 30,	
		2007	2006	2007	2006
		(in millions)			
Separation program	U.S. tobacco	$ 283	$ -	$ 283	$ -
Separation program	European Union	88	22	59	20
Separation program	Eastern Europe, Middle East and Africa	12			
Separation program	Asia	20	1	6	1
Separation program	Latin America	18		11	
Separation program	General corporate	17	30		30
Total separation program		438	53	359	51
Asset impairment	U.S. tobacco	35		35	
Asset impairment	General corporate		2		2
Total asset impairment		35	2	35	2
Kraft spin-off fees	General corporate	44			
Asset impairment and exit costs		$ 517	$ 55	$ 394	$ 53

Manufacturing Optimization Program

In June 2007, Altria Group, Inc. announced plans by its tobacco subsidiaries to optimize worldwide cigarette production by moving U.S.-based cigarette production for non-U.S. markets to PMI facilities in Europe. Due to declining U.S. cigarette volume, as well as PMI s decision to re-source its production, PM USA will close its Cabarrus, North Carolina manufacturing facility and consolidate manufacturing for the U.S. market at its Richmond, Virginia manufacturing center. PMI is expected to shift sourcing of approximately 57 billion cigarettes from U.S. manufacturing to PMI facilities in Europe by the third quarter of 2008 and PM USA will close its Cabarrus manufacturing facility by the end of 2010.

As a result of this program, from 2007 through 2011, PM USA expects to incur total pre-tax charges of approximately $670 million, comprising accelerated depreciation of $143 million (including the above mentioned asset impairment charge of $35 million recorded in the second quarter of 2007), employee separation costs of $353 million and other charges of $174 million, primarily related to the relocation of employees and equipment, net of estimated gains on sales of land and buildings. Approximately $440 million, or 66% of the total pre-tax charges, will result in cash expenditures. PM USA recorded an initial pre-tax charge for the program of $318 million or $0.10 per diluted share in the second quarter of 2007 related primarily to employee separation programs. Additional charges of approximately $55 million are expected during the remainder of 2007.

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Philip Morris International Asset Impairment and Exit Costs

During 2005, 2006 and 2007, PMI announced plans for the streamlining of various administrative functions and operations. These plans resulted in the announced closure or partial closure of 9 production facilities through June 30, 2007. As a result of these announcements, PMI recorded pre-tax charges of $138 million and $76 million during the six months and three months ended June 30, 2007, respectively, and $23 million and $21 million during the six months and three months ended June 30, 2006, respectively. These pre-tax charges primarily related to severance costs. Additional pre-tax charges of approximately $110 million are expected during the remainder of 2007.

Cash payments related to exit costs at PMI were $73 million and $50 million for the six months and three months ended June 30, 2007, respectively. Future cash payments for exit costs incurred to date are expected to be approximately $165 million.

The streamlining of these various functions and operations are expected to result in the elimination of approximately 2,300 positions. As of June 30, 2007, approximately 1,700 of these positions have been eliminated.

Corporate Asset Impairment and Exit Costs

General corporate charges primarily related to investment banking fees associated with the Kraft spin-off in 2007 and charges related to the streamlining of various corporate functions in 2007 and 2006.

Recoveries/Provision from/for Airline Industry Exposure During the six months and three months ended June 30, 2007, PMCC recorded pre-tax gains of $207 million and $78 million, respectively, on the sale of its ownership interests and bankruptcy claims in certain leveraged lease investments in aircraft, which represented a partial cash recovery of amounts that had been previously written down. During the second quarter of 2006, PMCC increased its allowance for losses by $103 million, due to continuing issues within the airline industry.

Discontinued Operations As more fully discussed in Note 1. *Basis of Presentation and Kraft Spin-Off*, and Note 7. *Divestitures*, on March 30, 2007, Altria Group, Inc. distributed all of its remaining interest in Kraft on a pro-rata basis to Altria Group, Inc. stockholders in a tax-free distribution. Altria Group, Inc. has reflected the results of Kraft prior to the distribution date as discontinued operations on the condensed consolidated statements of earnings and the condensed consolidated statements of cash flows. The assets and liabilities related to Kraft were reclassified and reflected as discontinued operations on the condensed consolidated balance sheet at December 31, 2006.

Consolidated Results of Operations for the Six Months Ended June 30, 2007

The following discussion compares consolidated operating results for the six months ended June 30, 2007, with the six months ended June 30, 2006.

Net revenues, which include excise taxes billed to customers, increased $3.0 billion (8.9%). Excluding excise taxes, net revenues increased $893 million (5.0%), due primarily to the favorable impact of currency and higher revenues from the European Union segment, the Eastern Europe, Middle East and Africa segment and the Latin America segment, partially offset by lower revenues from the financial services segment.

Operating income increased $207 million (3.3%), due primarily to higher operating results from the European Union segment and the Eastern Europe, Middle East and Africa segment; an increase at PMCC due to cash recoveries in 2007 from assets which had previously been written down versus a provision in 2006 for its airline industry exposure; the favorable impact of currency; and the 2006 Italian antitrust charge. These items were

partially offset by higher charges for asset impairment and exit costs and lower operating results from the Asia segment and Latin America segment.

Currency movements increased net revenues by $1,508 million ($548 million, after excluding the impact of currency movements on excise taxes) and operating income by $183 million. These increases were due primarily to the weakness versus prior year of the U.S. dollar against the euro and Russian ruble, partially offset by the strength of the U.S. dollar against the Japanese yen.

Interest and other debt expense, net, of $176 million decreased $90 million, due primarily to lower debt levels, partially offset by higher interest on tax reserve transfers to Kraft.

Altria Group, Inc. s income tax rate increased 10.0 percentage points to 33.5%. The 2006 tax rate includes $631 million of non-cash tax benefits, principally representing the reversal of tax reserves after the U.S. IRS concluded its examination of Altria Group, Inc. s consolidated tax returns for the years 1996 through 1999 in the first quarter of 2006.

Equity earnings and minority interest, net, was $139 million for the six months ended June 30, 2007, compared with $103 million for the six months ended June 30, 2006. The change primarily reflected higher equity earnings from SABMiller.

Earnings from continuing operations of $4.3 billion decreased $369 million (7.8%), due primarily to the reversal of tax reserves in 2006, partially offset by higher operating income and lower interest and other debt expense, net. Diluted and basic EPS from continuing operations of $2.05 and $2.07, respectively, decreased by 8.5% and 8.4%, respectively.

Earnings from discontinued operations, net of income taxes and minority interest (which represent the results of Kraft prior to the spin-off), decreased $854 million (57.7%).

Net earnings of $5.0 billion decreased $1.2 billion (19.8%). Diluted and basic EPS from net earnings of $2.35 and $2.37, respectively, decreased by 20.1% and 20.2%, respectively.

Consolidated Results of Operations for the Three Months Ended June 30, 2007

The following discussion compares consolidated operating results for the three months ended June 30, 2007, with the three months ended June 30, 2006.

Net revenues, which include excise taxes billed to customers, increased $1.7 billion (9.7%). Excluding excise taxes, net revenues increased $542 million (5.9%), due primarily to higher revenues from the U.S. tobacco segment, European Union segment and Eastern Europe, Middle East and Africa segment, the favorable impact of currency and the impact of the 2007 acquisition in Pakistan.

Operating income increased $18 million (0.6%), due primarily to higher operating results from the European Union segment and the Eastern Europe, Middle East and Africa segment; an increase at PMCC due to cash recoveries in 2007 from assets which had previously been written down versus a provision in 2006 for its airline industry exposure; and the favorable impact of currency. These items were partially offset by higher charges for asset impairment and exit costs, and lower operating results from the Asia segment.

Currency movements increased net revenues by $786 million ($274 million, after excluding the impact of currency movements on excise taxes) and operating income by $87 million. These increases were due primarily to the weakness versus prior year of the U.S. dollar against the euro and Russian ruble, partially offset by the strength of the U.S. dollar against the Japanese yen.

Interest and other debt expense, net, of $62 million decreased $57 million, due primarily to lower debt levels.

Equity earnings and minority interest, net, was $99 million for the quarter ended June 30, 2007, compared with $46 million for the quarter ended June 30, 2006. The change primarily reflected higher equity earnings from SABMiller.

Earnings from continuing operations of $2.2 billion increased $103 million (4.9%), due primarily to lower interest and other debt expense, net, and higher equity earnings and minority interest, net. Diluted and basic EPS from continuing operations of $1.05, increased by 5.0% and 4.0%, respectively.

Earnings from discontinued operations, net of income taxes and minority interest (which represent the results of Kraft prior to the spin-off), were $599 million for the second quarter of 2006.

Net earnings of $2.2 billion decreased $496 million (18.3%). Diluted and basic EPS from net earnings of $1.05, decreased by 18.6% and 19.2%, respectively.

Operating Results by Business Segment

Tobacco

Business Environment

Taxes, Legislation, Regulation and Other Matters Regarding Tobacco and Smoking

The tobacco industry, both in the United States and abroad, faces a number of challenges that may adversely affect the business, volume, results of operations, cash flows and financial position of PM USA, PMI and ALG. These challenges, which are discussed below and in the *Cautionary Factors That May Affect Future Results* section, include:

- pending and threatened litigation and bonding requirements as discussed in Note 11. *Contingencies* (Note 11);
- competitive disadvantages related to price increases in the United States attributable to the settlement of certain tobacco litigation;
- actual and proposed excise tax increases worldwide as well as changes in tax structures in foreign markets;
- the sale of counterfeit cigarettes by third parties;
- the sale of cigarettes by third parties over the Internet and by other means designed to avoid the collection of applicable taxes;
- price gaps and changes in price gaps between premium and lowest price brands;
- diversion into one market of products intended for sale in another;
- the outcome of proceedings and investigations, and the potential assertion of claims, relating to contraband shipments of cigarettes;
- governmental investigations;

actual and proposed requirements regarding the use and disclosure of cigarette ingredients and other proprietary information;

- actual and proposed restrictions on imports in certain jurisdictions outside the United States;
- actual and proposed restrictions affecting tobacco manufacturing, marketing, advertising and sales;
- possible tobacco regulation and legislation in the United States that could put PMI at a competitive disadvantage;
- governmental and private bans and restrictions on smoking;
- the diminishing prevalence of smoking and increased efforts by tobacco control advocates to further restrict smoking;
- governmental requirements setting ignition propensity standards for cigarettes; and
- actual and proposed tobacco legislation and regulation both inside and outside the United States.

In the ordinary course of business, PM USA and PMI are subject to many influences that can impact the timing of sales to customers, including the timing of holidays and other annual or special events, the timing of promotions, customer incentive programs and customer inventory programs, as well as the actual or speculated timing of pricing actions and tax-driven price increases.

Excise Taxes: Cigarettes are subject to substantial excise taxes in the United States and to substantial taxation abroad. Significant increases in cigarette-related taxes or fees have been proposed or enacted and are likely to continue to be proposed or enacted within the United States, the Member States of the European Union (the EU) and in other foreign jurisdictions. In addition, in certain jurisdictions, PMI s products are subject to discriminatory tax structures and inconsistent rulings and interpretations on complex methodologies to determine excise and other tax burdens.

Tax increases and discriminatory tax structures are expected to continue to have an adverse impact on sales of cigarettes by PM USA and PMI, due to lower consumption levels and to a shift in consumer purchases from the premium to the non-premium or discount segments or to other low-priced or low-taxed tobacco products or to counterfeit and contraband products.

Minimum Retail Selling Price Laws: Several EU Member States have enacted laws establishing a minimum retail selling price for cigarettes and, in some cases, other tobacco products. The European Commission has commenced infringement proceedings against these Member States, claiming that minimum retail selling price systems infringe EU law. In March 2007, the European Commission brought an action against France in the European Court of Justice on the ground that France s minimum retail selling price system infringes EU law. On July 2, 2007, the European Commission announced that it has formally called upon Austria, Ireland and Italy to amend their legislation setting minimum retail selling prices for cigarettes. The announcement further stated that if these Member States do not respond satisfactorily to this request within two months of the announcement, the Commission may refer the matters to the European Court of Justice. If the European Commission s actions are successful, they could adversely impact excise tax levels and/or price gaps in those markets.

Tar and Nicotine Test Methods and Brand Descriptors: A number of governments and public health organizations throughout the world have determined that the existing standardized machine-based methods for measuring tar and nicotine yields do not provide useful information about tar and nicotine deliveries and that such results are misleading to smokers. For example, in the 2001 publication of Monograph 13, the U.S. National Cancer Institute (NCI) concluded that measurements based on the Federal Trade Commission (FTC) standardized method do not offer smokers meaningful information on the amount of tar and nicotine they will receive from a cigarette or on the relative amounts of tar and nicotine exposure likely to be received from smoking different brands of cigarettes. Thereafter, the FTC issued a press release indicating that it would be working with the NCI to determine what changes should be made to its testing method to correct the limitations identified in Monograph 13. In 2002, PM USA petitioned the FTC to promulgate new rules

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governing the use of existing standardized machine-based methodologies for measuring tar and nicotine yields and descriptors. That petition remains pending. In addition, the World Health Organization (WHO) has concluded that these standardized measurements are seriously flawed and that measurements based upon the current standardized methodology are misleading and should not be displayed. The International Organization for Standardization (ISO) established a working group, chaired by the WHO, to propose a new measurement method which would more accurately reflect human smoking behavior. The working group has issued a final report proposing two alternative smoking methods. While a working group has been organized to begin preparatory work on further developing these methods, ISO has decided to await further guidance from the WHO before proceeding further.

In light of public health concerns about the limitations of current machine measurement methodologies, governments and public health organizations have increasingly challenged the use of descriptors such as light, mild, and low tar that are based on measurements produced b those methods. For example, the European Commission has concluded that descriptors based on standardized tar and nicotine yield measurements may mislead the consumer and has prohibited the use of descriptors. Public health organizations have also urged that descriptors be banned. For example, the Scientific Advisory Committee of the WHO concluded that descriptors such as light, ultra-light, mild and low tar are misleading terms and should be banned. In 2003, the WHO proposed the FCTC, a treaty that requires signatory nations to adopt and implement measures to ensure that descriptive terms do not create the false impression that a particular tobacco product is less harmful than other tobacco products. Such terms may include low tar, light, ultra-light, or mild. For a discussion of the FCTC, see below under the h The WHO s Framework Convention on Tobacco Control. In addition, public health organizations in Canada and the United States have advocated a complete prohibition of the use of deceptive descriptors such as light and mild. In July 2005, PMI s Australian affiliates agreed to refrain from using descriptors in Australia on cigarettes, cigarette packaging and on material intended to be disseminated to the general public in Australia in relation to the marketing, advertising or sale of cigarettes.

See Note 11, which describes pending litigation concerning the use of brand descriptors. As discussed in Note 11, in August 2006, a federal trial court entered judgment in favor of the United States government in its lawsuit against various cigarette manufacturers and others, including PM USA and ALG, and enjoined the defendants from using brand descriptors, such as lights, ultra-lights and low tar. In October 2006, the Court of Appeals stayed enforcement of the judgment pending its review of the trial court s decision.

Food and Drug Administration (FDA) Regulations: In February 2007, bipartisan legislation was introduced in the United States Senate and House of Representatives that, if enacted, would grant the FDA broad authority to regulate the design, manufacture and marketing of tobacco products and disclosures of related information. This legislation would also grant the FDA the authority to address counterfeit and contraband tobacco products and would impose fees to pay for the cost of regulation and other matters. ALG and PM USA support this legislation. On August 1, 2007, the Senate Health, Education, Labor and Pensions Committee approved a revised version of this legislation. Whether Congress will grant the FDA broad authority over tobacco products, and the precise nature of that authority if granted, cannot be predicted.

Tobacco Quota Buy-Out: In October 2004, the Fair and Equitable Tobacco Reform Act of 2004 (FETRA) was signed into law. FETRA provides for the elimination of the federal tobacco quota and price support program through an industry-funded buy-out of tobacco growers and quota holders. The cost of the buy-out is approximately $9.5 billion and is being paid over 10 years by manufacturers and importers of each kind of tobacco product. The cost is being allocated based on the relative market shares of manufacturers and importers of each kind of tobacco product. The quota buy-out payments will offset already scheduled payments to the National Tobacco Grower Settlement Trust (the NTGST), a trust fund established in 1999 by four of the major domestic tobacco product manufacturers to provide aid to tobacco growers and quota holders. Manufacturers and importers of tobacco products are also obligated to cover any losses (up to $500 million) that the government may incur on the disposition of tobacco pool stock accumulated under the previous tobacco price support program. PM USA has paid $138 million for its share of the tobacco pool stock losses. For a discussion of the NTGST, see Note 11. Altria Group, Inc. does not anticipate that the quota buy-out will have a material adverse impact on its consolidated results in 2007 and beyond.

Ingredient Disclosure Laws: Jurisdictions inside and outside the United States have enacted or proposed legislation or regulations that would require cigarette manufacturers to disclose the ingredients used in the manufacture of cigarettes and, in certain cases, to provide toxicological information. In some jurisdictions, governments have prohibited the use of certain ingredients, and proposals have been discussed to further prohibit the use of ingredients. Under an EU tobacco product directive, tobacco companies are now required to disclose ingredients and toxicological information to each Member State. In implementing the EU tobacco product directive, the Netherlands has issued a decree that would require tobacco companies to disclose the ingredients used in each brand of cigarettes, including quantities used. PMI and other tobacco companies filed an action to contest this decree on the grounds of lack of protection of proprietary information. In December 2005, the District Court of the Hague agreed with the tobacco companies that certain information required to be disclosed under the decree constitutes proprietary trade secrets. However, the court also held that the companies interests in protecting their trade secrets must be balanced against the public s right to information about the ingredients in tobacco products. The court therefore upheld the decree and instructed the government to weigh the public s interests against the companies interests, in implementing the ingredient disclosure requirements in the decree. In March 2006, PMI, the government and others appealed these decisions. Concurrently with pursuing this appeal, PMI is discussing with the relevant authorities the appropriate implementation of the EU tobacco product directive in the Netherlands and throughout the European Union.

Health Effects of Smoking and Exposure to Environmental Tobacco Smoke (ETS): Reports with respect to the health risks of cigarette smoking have been publicized for many years, including most recently in a June 2006 United States Surgeon General report on ETS entitled The Health Consequences of Involuntary Exposure to Tobacco Smoke. The sale, promotion, and use of cigarettes continue to be subject to increasing governmental regulation. Further, it is not possible to predict the results of ongoing scientific research or the types of future scientific research into the health risks of tobacco exposure. Although most regulation of ETS exposure to date has been done at the local level through bans in public establishments, the State of California is in the process of regulating ETS exposure in the ambient air at the state level. In January 2006, the California Air Resources Board (CARB) listed ETS as a toxic air contaminant under state law. CARB is now required to consider the adoption of appropriate control measures utilizing best available control technology in order to reduce public exposure to ETS in outdoor air to the lowest level achievable. In addition, in June 2006, the California Office of Environmental Health Hazard Assessment (OEHHA) listed ETS as a contaminant known to the State of California to cause reproductive toxicity. Consequently, under California Proposition 65, businesses employing 10 or more persons must post warning signs in certain areas stating that ETS is known to the State of California to be a reproductive toxicant.

It is the policy of PM USA and PMI to support a single, consistent public health message on the health effects of cigarette smoking in the development of diseases in smokers, smoking and addiction, and on exposure to ETS. It is also their policy to defer to the judgment of public health authorities as to the content of warnings in advertisements and on product packaging regarding the health effects of smoking, addiction and exposure to ETS.

PM USA and PMI each have established websites that include, among other things, the views of public health authorities on smoking, disease causation in smokers, addiction and ETS. These sites reflect PM USA s and PMI s agreement with the medical and scientific consensus that cigarette smoking is addictive, and causes lung cancer, heart disease, emphysema and other serious diseases in smokers. The websites advise smokers, and those considering smoking, to rely on the messages of public health authorities in making all smoking-related decisions. The website addresses are www.philipmorrisusa.com and www.philipmorrisinternational.com. The information on PM USA s and PMI s websites is not, and shall not be deemed to be, a part of this document or incorporated into any filings ALG makes with the Securities and Exchange Commission.

The WHO s Framework Convention on Tobacco Control (FCTC): The FCTC entered into force on February 27, 2005. As of August 1, 2007, the FCTC had been signed by 168 countries and the EU, ratified by 145 countries and confirmed by the EU. The FCTC is the first treaty to establish a global agenda for tobacco regulation. The treaty recommends (and in certain instances, requires) signatory nations to enact legislation that would, among other things, establish specific actions to prevent youth smoking; restrict and gradually eliminate

tobacco product advertising and promotion; inform the public about the health consequences of smoking and the benefits of quitting; regulate the ingredients of tobacco products; impose new package warning requirements that may include the use of pictures or graphic images; adopt measures that would eliminate cigarette smuggling and counterfeit cigarettes; restrict smoking in public places; increase cigarette taxes; adopt and implement measures that ensure that descriptive terms do not create the false impression that one brand of cigarettes is safer than another; phase out duty-free tobacco sales; and encourage litigation against tobacco product manufacturers.

Each country that ratifies the treaty must implement legislation reflecting the treaty s provisions and principles. While not agreeing with all of the provisions of the treaty, PM USA and PMI have expressed hope that the treaty will lead to the implementation of meaningful, effective and coherent regulation of tobacco products around the world.

Reduced Cigarette Ignition Propensity Legislation: Legislation requiring cigarettes to meet reduced ignition propensity standards is being considered in many states, at the federal level and in jurisdictions outside the United States. New York State implemented ignition propensity standards in June 2004. To date, the same standards have been enacted by twenty other states, effective as follows: Vermont (May 2006), California (January 2007), Oregon (April 2007), New Hampshire (October 2007), Illinois (January 2008), Maine (January 2008), Massachusetts (January 2008), Kentucky (April 2008), Montana (May 2008), Alaska (August 2008), New Jersey (June 2008), Maryland (July 2008), Utah (July 2008), Connecticut (July 2008), Rhode Island (August 2008), Delaware (January 2009), Iowa (January 2009), Minnesota (January 2009), Texas (January 2009) and Louisiana (August 2009). Similar legislation has been enacted in Canada and took effect in October 2005. PM USA supports the enactment of federal legislation mandating a uniform and technically feasible national standard for reduced ignition propensity cigarettes that would preempt state standards and apply to all cigarettes sold in the United States. Similarly, PMI believes that reduced ignition propensity standards should be uniform, technically feasible, and applied to all manufacturers.

Other Legislation or Governmental Initiatives: Legislative and regulatory initiatives affecting the tobacco industry have been adopted or are being considered in a number of countries and jurisdictions. In 2001, the EU adopted a directive on tobacco product regulation requiring EU Member States to implement regulations that reduce maximum permitted levels of tar, nicotine and carbon monoxide yields; require manufacturers to disclose ingredients and toxicological data; and require cigarette packs to carry health warnings covering no less than 30% of the front panel and no less than 40% of the back panel. The directive also gives Member States the option of introducing graphic warnings as of 2005; requires tar, nicotine and carbon monoxide data to cover at least 10% of the side panel; and prohibits the use of texts, names, trademarks and figurative or other signs suggesting that a particular tobacco product is less harmful than others. All 27 EU Member States have implemented the directive.

The European Commission has issued guidelines for optional graphic warnings on cigarette packaging that Member States may apply as of 2005. Graphic warning requirements have also been proposed or adopted in a number of other jurisdictions. In 2003, the EU adopted a directive prohibiting radio, press and Internet tobacco marketing and advertising, which has now been implemented in most EU Member States. Tobacco control legislation addressing the manufacture, marketing and sale of tobacco products has been proposed or adopted in numerous other jurisdictions.

In the United States in recent years, various members of federal and state governments have introduced legislation that would subject cigarettes to various regulations; restrict or eliminate the use of descriptors such as lights or ultra lights; establish educational campaigns relating to tobacco consumption or tobacco control programs, or provide additional funding for governmental tobacco control activities; further restrict the advertising of cigarettes; require additional warnings, including graphic warnings, on packages and in advertising; eliminate or reduce the tax deductibility of tobacco advertising; provide that the Federal Cigarette Labeling and Advertising Act and the Smoking Education Act not be used as a defense against liability under state statutory or common law; and allow state and local governments to restrict the sale and distribution of

cigarettes. In addition, legislation and regulation inside the United States could put PMI at a disadvantage vis a vis its international competitors.

It is not possible to predict what, if any, additional legislation, regulation or other governmental action will be enacted or implemented relating to the manufacturing, advertising, sale or use of cigarettes, or the tobacco industry generally. It is possible, however, that legislation, regulation or other governmental action could be enacted or implemented in the United States and in other countries and jurisdictions that might materially affect the business, volume, results of operations and cash flows of PM USA or PMI and ultimately their parent, ALG.

Governmental Investigations: From time to time, ALG and its subsidiaries are subject to governmental investigations on a range of matters. In this regard, ALG believes that Canadian authorities are contemplating a legal proceeding based on an investigation of ALG entities relating to allegations of contraband shipments of cigarettes into Canada in the early to mid-1990s. ALG and its subsidiaries cannot predict the outcome of this investigation or whether additional investigations may be commenced.

PMI Cooperation Agreements to Combat Illicit Trade of Cigarettes: PMI has entered into agreements with several governments to combat the illicit trade of cigarettes and may continue to do so. In July 2004, PMI entered into an agreement with the European Commission (acting on behalf of the European Community) and 10 Member States of the EU that provides for broad cooperation with European law enforcement agencies on anti-contraband and anti-counterfeit efforts. To date, 26 of the 27 Member States have signed the agreement. The agreement resolves all disputes between the European Community and the Member States that signed the agreement, on the one hand, and PMI and certain affiliates, on the other hand, relating to these issues. Under the terms of the agreement, PMI will make 13 payments over 12 years. In the second quarter of 2004, PMI recorded a pre-tax charge of $250 million for the initial payment. The agreement calls for payments of approximately $150 million on the first anniversary of the agreement (this payment was made in July 2005), approximately $100 million on the second anniversary (this payment was made in July 2006), and approximately $75 million each year thereafter for 10 years, each of which is to be adjusted based on certain variables, including PMI s market share in the EU in the year preceding payment. PMI will record these payments as an expense in cost of sales when product is shipped. PMI is also responsible to pay the excise taxes, VAT and customs duties on qualifying product seizures of up to 90 million cigarettes and is subject to payments of five times the applicable taxes and duties if product seizures exceed 90 million cigarettes in a given year. To date, PMI s payments related to product seizures have been immaterial.

State Settlement Agreements: As discussed in Note 11, during 1997 and 1998, PM USA and other major domestic tobacco product manufacturers entered into agreements with states and various United States jurisdictions settling asserted and unasserted health care cost recovery and other claims. These settlements require PM USA to make substantial annual payments. The settlements also place numerous restrictions on PM USA s business operations, including prohibitions and restrictions on the advertising and marketing of cigarettes. Among these are prohibitions of outdoor and transit brand advertising; payments for product placement; and free sampling (except in adult-only facilities). Restrictions are also placed on the use of brand name sponsorships and brand name non-tobacco products. The State Settlement Agreements also place prohibitions on targeting youth and the use of cartoon characters. In addition, the State Settlement Agreements require companies to affirm corporate principles directed at reducing underage use of cigarettes; impose requirements regarding lobbying activities; mandate public disclosure of certain industry documents; limit the industry s ability to challenge certain tobacco control and underage use laws; and provide for the dissolution of certain tobacco-related organizations and place restrictions on the establishment of any replacement organizations.

Manufacturing Optimization Program

In June 2007, Altria Group, Inc. announced plans by its tobacco subsidiaries to optimize worldwide cigarette production by moving U.S.-based cigarette production for non-U.S. markets to PMI facilities in Europe. Due to declining U.S. cigarette volume, as well as PMI s decision to re-source its production, PM USA will close its Cabarrus, North Carolina manufacturing facility and consolidate manufacturing for the U.S. market at its Richmond, Virginia manufacturing center. PMI is expected to shift sourcing of approximately 57 billion

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cigarettes from U.S. manufacturing to PMI facilities in Europe by the third quarter of 2008 and PM USA will close its Cabarrus, North Carolina manufacturing facility by the end of 2010.

As a result of this program, from 2007 through 2011, PM USA expects to incur total pre-tax charges of approximately $670 million, comprising accelerated depreciation of $143 million, employee separation costs of $353 million and other charges of $174 million, primarily related to the relocation of employees and equipment, net of estimated gains on sales of land and buildings. Approximately $440 million, or 66% of the total pre-tax charges, will result in cash expenditures. PM USA recorded an initial pre-tax charge for the program of $318 million or $0.10 per diluted share in the second quarter of 2007 related primarily to employee separation programs. Additional charges of approximately $55 million or $0.02 per diluted share are expected during the remainder of 2007. In addition, the program will entail capital expenditures of approximately $230 million at PM USA and $50 million at PMI.

The program is expected to generate pre-tax cost savings beginning in 2008, with total estimated annual cost savings of approximately $335 million by 2011, of which $179 million will be realized by PMI and $156 million by PM USA.

Philip Morris International Asset Impairment and Exit Costs

During 2005, 2006 and 2007, PMI announced plans for the streamlining of various administrative functions and operations. These plans resulted in the announced closure or partial closure of 9 production facilities through June 30, 2007. As a result of these announcements, PMI recorded pre-tax charges of $138 million and $76 million during the six months and three months ended June 30, 2007, respectively, and $23 million and $21 million during the six months and three months ended June 30, 2006, respectively. These pre-tax charges primarily related to severance costs. Additional pre-tax charges of approximately $110 million are expected during the remainder of 2007.

Cash payments related to exit costs at PMI were $73 million and $50 million for the six months and three months ended June 30, 2007, respectively. Future cash payments for exit costs incurred to date are expected to be approximately $165 million.

The streamlining of these various functions and operations are expected to result in the elimination of approximately 2,300 positions. As of June 30, 2007, approximately 1,700 of these positions have been eliminated.

The streamlining of these various functions and operations generated pre-tax cost savings beginning in 2005, with cumulative estimated annual cost savings of approximately $240 million expected by the end of 2007, of which $160 million are incremental savings in 2007.

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Operating Results Six Months Ended June 30, 2007

The following discussion compares tobacco operating results for the six months ended June 30, 2007, with the six months ended June 30, 2006.

	For the Six Months Ended June 30,			
	Net Revenues		Operating Companies Income	
	2007	2006	2007	2006
	(in millions)			
U.S. tobacco	$ 9,054	$ 9,108	$ 2,134	$ 2,417
European Union	13,421	11,790	2,105	1,780
Eastern Europe, Middle East and Africa	5,893	5,109	1,201	1,057
Asia	5,537	5,081	898	1,007
Latin America	2,365	2,131	190	262
Total tobacco	$ 36,270	$ 33,219	$ 6,528	$ 6,523

U.S. tobacco. PM USA s net revenues, which include excise taxes billed to customers, decreased $54 million (0.6%). Excluding excise taxes, net revenues increased $33 million (0.5%) to $7.4 billion, due primarily to lower wholesale promotional allowance rates and higher list prices ($516 million), partially offset by lower volume ($487 million).

Operating companies income decreased $283 million (11.7%), due primarily to lower volume ($327 million) and the 2007 pre-tax charges for asset impairment and exit costs related to the announced closing of the Cabarrus, North Carolina cigarette manufacturing facility ($318 million), partially offset by lower marketing, administration and research costs ($193 million) and lower wholesale promotional allowance rates, net of higher ongoing resolution costs ($181 million).

PM USA s shipment volume was 86.2 billion units, a decrease of 4.8% or 4.3 billion units. In the first half of 2007, PM USA estimates that total cigarette industry volume declined between 4% and 5%, and for the full year 2007 PM USA is maintaining its prior estimate of a 3% to 4% decline in total cigarette industry volume. In the premium segment, PM USA s shipment volume decreased 4.4%. *Marlboro* shipment volume decreased 3.0 billion units (4.1%) to 71.0 billion units. In the discount segment, PM USA s shipment volume also decreased, with *Basic* shipment volume down 7.8% to 6.6 billion units.

The following table summarizes PM USA s cigarette volume performance by brand for the six months ended June 30, 2007 and 2006:

	For the Six Months Ended June 30,	
	2007	2006
	(in billion units)	
Marlboro	71.0	74.0
Parliament	2.9	3.0
Virginia Slims	3.5	3.7
Basic	6.6	7.2
Focus on Four Brands	84.0	87.9
Other	2.2	2.6
Total PM USA	86.2	90.5

The following table summarizes PM USA s retail share performance, based on data from the IRI/Capstone Total Retail Panel, which is a tracking service that uses a sample of stores to project market share performance in retail stores selling cigarettes. This panel was not designed to capture sales through other channels, including Internet and direct mail:

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	For the Six Months Ended June 30,	
	2007	2006
Marlboro	40.9%	40.5%
Parliament	1.9	1.8
Virginia Slims	2.2	2.3
Basic	4.1	4.2
Focus on Four Brands	49.1	48.8
Other	1.4	1.6
Total PM USA	50.5%	50.4%

Effective December 18, 2006, PM USA reduced its wholesale promotional allowance on its Focus on Four brands by $1.00 per carton, from $5.00 to $4.00, and increased the price of its other brands by $5.00 per thousand cigarettes or $1.00 per carton. Effective February 12, 2007, PM USA increased the price of its other brands by $9.95 per thousand cigarettes or $1.99 per carton.

PM USA cannot predict future long-term changes or rates of change in U.S. tobacco industry volume, the relative sizes of the premium and discount segments or its shipment or retail market share; however, it believes that its results may be materially adversely affected by the other items discussed under the caption Tobacco Business Environment.

European Union. Net revenues, which include excise taxes billed to customers, increased $1.6 billion (13.8%). Excluding excise taxes, net revenues increased $499 million (12.6%) to $4.5 billion, due primarily to favorable currency ($390 million) and price increases ($178 million), partially offset by unfavorable volume/mix ($69 million).

Operating companies income increased $325 million (18.3%), due primarily to favorable currency ($194 million), price increases, net of higher costs ($168 million), the Italian antitrust charge in 2006 ($61 million) and lower marketing, administration and research costs ($56 million), partially offset by unfavorable volume/mix ($74 million), higher pre-tax charges for asset impairment and exit costs ($66 million) and higher fixed manufacturing costs ($13 million).

In the European Union, PMI s cigarette volume increased 1.2%, due largely to gains in the Baltic States, Hungary, Italy, the Netherlands, Poland and Spain, partially offset by declines in France, Germany and Greece. PMI s cigarette market share in the European Union rose 0.3 share points to 39.6%, with strong performances in Austria, the Baltic States, Finland, France, Hungary, Italy, the Netherlands, Poland, Portugal and Sweden, largely offset by declines in the Czech Republic, Germany, the Slovak Republic, Spain, Switzerland and the United Kingdom.

In Italy, the total cigarette market was down 1.0%. PMI s cigarette shipment volume increased 1.1%, due to favorable inventory movements. PMI s market share in Italy increased 0.9 share points to 54.4%, driven by *Chesterfield, Merit, Diana* and *Marlboro*.

In Germany, PMI s total tobacco volume (which includes other tobacco products) decreased 7.7%, due mainly to lower volume of other tobacco products, and PMI s share of total tobacco consumption decreased 0.4 share points to 29.6%. PMI s cigarette volume declined 3.8%. The total cigarette market in Germany declined 1.1%, following the October 2006 tax-driven price increase. PMI s cigarette market share declined 0.8 share points to 36.6%, reflecting a 37.7% volume decline in the vending channel. The vending channel accounted for 14.6% of total industry volume in the first half of 2007, compared with 23.2% in the comparative period last year due to the reduction in vending machines resulting from new regulations that require electronic age verification. PMI s share of the vending channel at 50.4% is greater than its overall market share, and as a consequence, PMI has been adversely impacted by this development. PMI expects the volume share of the vending channel to

gradually improve. *Marlboro* share was down 3.2 share points to 26.0%, due primarily to the increase of the low-price segment and shrinkage in the vending channel. *L&M* continued to grow strongly, adding 2.5 share points to reach 4.4%.

In Spain, the total cigarette market declined 0.3%. PMI s shipment volume increased 1.6%, due mainly to the favorable timing of shipments. PMI s market share declined 0.5 share points to 31.6%, primarily reflecting declines in *Marlboro,* following a tax-driven price increase.

In France, shipment volume decreased 2.5%, due mainly to unfavorable timing of shipments. Market share increased 0.6 share points to 43.3%, driven by *Marlboro* and the *Philip Morris* brand.

In Poland, PMI s shipment volume was up 2.1% and market share increased 0.6 share points to 40.3%, driven mainly by *Marlboro* and *L&M*, partially offset by the continuing decline of PMI s brands in the declining low-price 70mm segment.

Eastern Europe, Middle East and Africa. Net revenues, which include excise taxes billed to customers, increased $784 million (15.3%). Excluding excise taxes, net revenues increased $332 million (11.8%) to $3.1 billion, due primarily to price increases ($115 million), favorable currency ($111 million) and higher volume/mix ($106 million).

Operating companies income increased $144 million (13.6%), due primarily to price increases and lower costs ($122 million), higher volume/mix ($63 million) and favorable currency ($21 million), partially offset by higher marketing, administration and research costs ($44 million) and pre-tax charges for asset impairment and exit costs in 2007 ($12 million).

In Eastern Europe, Middle East and Africa, volume increased 0.8%, driven by gains in Algeria, Egypt, Ukraine and worldwide duty-free, partially offset by declines in Russia and Turkey.

In Russia, shipments were down 4.6%, due largely to *L&M* and local low-price brands. This decline was partially offset by higher shipments and market share of higher-margin international brands, *Marlboro*, *Parliament* and *Chesterfield.*

In Turkey, shipments declined 3.9% and market share declined 2.5 share points to 40.7%, due to the February 2007 tax-driven retail price increase. Volume declines in low-priced *L&M* and *Bond Street* were partially offset by growth in *Parliament*.

In Ukraine, shipments grew 5.3% and share rose 0.5 share points to 33.4%, driven by continued consumer up-trading to premium brands, particularly *Marlboro* and *Chesterfield*.

In Egypt, improved economic conditions and increased tourism continued to fuel the growth of the total cigarette industry and premium brands. PMI s shipments rose 25.8% and share advanced 1.4 share points to 11.5%, driven by *L&M* and *Merit.*

Asia. Net revenues, which include excise taxes billed to customers, increased $456 million (9.0%). Excluding excise taxes, net revenues increased $19 million (0.7%) to $2.8 billion, due primarily to price increases ($52 million), the Lakson Tobacco acquisition ($48 million) and favorable currency ($48 million), partially offset by lower volume/mix ($129 million).

Operating companies income decreased $109 million (10.8%), due primarily to lower volume/mix ($99 million), higher marketing, administration and research costs ($43 million, including $30 million for a distributor termination in Indonesia), unfavorable currency ($27 million) and higher pre-tax charges for asset impairment and exit costs ($19 million), partially offset by price increases, net of higher costs ($38 million), lower fixed manufacturing costs ($31 million) and the Lakson Tobacco acquisition ($10 million).

In Asia, volume increased 7.9%, reflecting the acquisition in Pakistan. Excluding this acquisition, volume in Asia was down 3.3%, due primarily to lower volume in Japan, partially offset by gains in Indonesia and Korea.

In Japan, the total market declined 13.9%, driven by the July 1, 2006 tax-driven price increase. Market share in Japan decreased 0.1 share point to 24.5%. PMI s shipments in Japan were down 13.3%, due to the effects of the 2006 price increase and an unfavorable comparison with the prior-year period, which included significant trade purchases in advance of the 2006 price increase, and a build-up of trade inventories at year-end 2006.

In Indonesia, PMI shipment volume rose 3.5% and market share increased 0.1 share point to 28.1%, led by *A Hijau*.

In Korea, shipments increased 22.3%, reflecting the timing of shipments and the performance of *Parliament*, *Marlboro* and *Virginia Slims*. Market share in Korea increased 1.1 share points to 9.6% with *Marlboro* market share up 1.0 point to 4.2%.

Latin America. Net revenues, which include excise taxes billed to customers, increased $234 million (11.0%). Excluding excise taxes, net revenues increased $78 million (9.2%) to $929 million, due primarily to price increases ($53 million) and the acquisition of the Dominican Republic cigarette business ($23 million).

Operating companies income decreased $72 million (27.5%), due primarily to higher marketing, administration and research costs ($38 million), the divestiture of the Dominican Republic beer business ($31 million), pre-tax charges for asset impairment and exit costs in 2007 ($18 million) and lower volume/mix, partially offset by price increases, net of higher costs ($36 million).

In Latin America, volume decreased 1.2%, driven by declines in Mexico, due to the timing of shipments, and the Dominican Republic, partially offset by gains in Argentina.

In Mexico, PMI shipments declined 6.1%, reflecting increased trade purchases in the fourth quarter of 2006 ahead of the January 2007 tax increase. However, market share rose 1.0 share point to 63.2%, driven by the launch of *Delicados* Supremos in January 2007 and the continued growth of *Benson & Hedges*.

In Argentina, the total market was up 1.0%, while PMI shipments grew 6.0% and share was up 3.2 share points, due mainly to the *Philip Morris* brand.

In the Dominican Republic, shipment volume declined 29.1%, reflecting a lower total market following price increases in January and February 2007 to partially compensate for a very significant excise tax increase imposed on cigarettes in January 2007. Market share declined 0.6 share points to 77.9%, due primarily to *Marlboro*, partially offset by gains for other PMI brands.

Operating Results Three Months Ended June 30, 2007

The following discussion compares tobacco operating results for the three months ended June 30, 2007, with the three months ended June 30, 2006.

	For the Three Months Ended June 30,			
	Net Revenues		Operating Companies Income	
	2007	2006	2007	2006
	(in millions)			
U.S. tobacco	$ 4,809	$ 4,785	$ 1,004	$ 1,301
European Union	6,867	6,064	1,075	957
Eastern Europe, Middle East and Africa	3,103	2,655	634	564
Asia	2,787	2,528	429	488
Latin America	1,191	1,063	102	130
Total tobacco	$18,757	$17,095	$3,244	$3,440

U.S. tobacco. PM USA s net revenues, which include excise taxes billed to customers, increased $24 million (0.5%). Excluding excise taxes, net revenues increased $56 million (1.5%) to $3.9 billion, due primarily to lower wholesale promotional allowance rates ($232 million), partially offset by lower volume ($177 million).

Operating companies income decreased $297 million (22.8%), due primarily to the 2007 pre-tax charges for asset impairment and exit costs related to the announced closing of the Cabarrus, North Carolina cigarette manufacturing facility ($318 million) and lower volume ($117 million), partially offset by lower marketing, administration and research costs ($101 million), and lower wholesale promotional allowance rates, net of higher ongoing resolution costs ($47 million).

PM USA s shipment volume was 45.6 billion units, a decrease of 3.3% or 1.6 billion units reflecting an overall decline in industry volume. In the premium segment, PM USA s shipment volume decreased 2.9%. *Marlboro* shipment volume decreased 0.9 billion units (2.3%) to 37.7 billion units. In the discount segment, PM USA s shipment volume also decreased, with *Basic* shipment volume down 8.1% to 3.5 billion units.

The following table summarizes PM USA s cigarette volume performance by brand for the three months ended June 30, 2007 and 2006:

	For the Three Months Ended June 30,	
	2007	2006
	(in billion units)	
Marlboro	37.7	38.6
Parliament	1.5	1.5
Virginia Slims	1.8	2.0
Basic	3.5	3.8
Focus on Four Brands	44.5	45.9
Other	1.1	1.3
Total PM USA	45.6	47.2

The following table summarizes PM USA s retail share performance, based on data from the IRI/Capstone Total Retail Panel, which is a tracking service that uses a sample of stores to project market share performance in retail stores selling cigarettes. This panel was not designed to capture

sales through other channels, including Internet and direct mail:

	For the Three Months Ended June 30,	
	2007	2006
Marlboro	41.0%	40.6%
Parliament	1.9	1.9
Virginia Slims	2.2	2.3
Basic	4.0	4.2
Focus on Four Brands	49.1	49.0
Other	1.4	1.5
Total PM USA	50.5%	50.5%

European Union. Net revenues, which include excise taxes billed to customers, increased $803 million (13.2%). Excluding excise taxes, net revenues increased $258 million (12.6%) to $2.3 billion, due primarily to favorable currency ($203 million) and price increases ($106 million), partially offset by lower volume/mix ($51 million).

Operating companies income increased $118 million (12.3%), due primarily to price increases ($106 million), favorable currency ($85 million) and lower marketing, administration and research costs ($29 million), partially offset by lower volume/mix ($54 million) and higher pre-tax charges for asset impairment and exit costs ($39 million).

In the European Union, PMI s cigarette volume decreased 0.9%, due mainly to declines in the Czech Republic and Germany, and unfavorable distributor inventory movements in France and Italy. However, cigarette market share in the European Union rose 0.4 share points to 39.7%, with strong performances in Austria, the Baltic States, Finland, France, Hungary, Italy, the Netherlands, Portugal and Sweden, largely offset by declines in Germany, Greece, Poland, the Slovak Republic, Switzerland and the United Kingdom.

In the Czech Republic, the total cigarette market was down 26.6%, due to trade purchases prior to the March 2007 excise tax increase. PMI s shipment volume declined 22.7%, but market share increased 3.1 share points to 60.4%.

In France, PMI s market share continued to improve, reaching 43.4%, up 0.6 share points, driven by *Marlboro* and the *Philip Morris* brand. PMI s shipment volume decreased 2.6%, reflecting unfavorable distributor inventory movements.

In Germany, PMI s total tobacco volume (which includes other tobacco products) decreased 7.0%. PMI s cigarette volume declined 4.0%. Total tobacco consumption in the German market was down 4.7% and PMI s share of total tobacco consumption declined 0.7 share points to 30.1%. The total cigarette market in Germany declined 2.5%, mainly driven by the effects of higher prices. PMI s cigarette market share declined 0.6 share points to 37.0%, reflecting a 38.4% volume decline in the vending channel. The vending channel accounted for 15% of total industry volume in the quarter, compared with 23.7% in the comparative period last year due to the reduction in vending machines resulting from new regulations that require electronic age verification. PMI s share of the vending channel at 51% is greater than its overall market share, and as a consequence, PMI has been adversely impacted by this development. PMI expects the volume share of the vending channel to gradually improve. *Marlboro* share declined 2.8 share points to 26.1%, due primarily to the increase of the low-price segment and shrinkage in the vending channel. *L&M* continued to grow strongly, adding 2.5 share points to reach 4.7%.

In Italy, the total cigarette market was down 1.4% while PMI s cigarette shipment volume declined 4.7%, due to unfavorable distributor inventory movements and the timing of shipments. PMI s market share in Italy increased 1.0 share point to 54.6%, driven by *Merit*, *Chesterfield, Philip Morris* and *Muratti*.

In Spain, the total cigarette market declined less than 1%. PMI s market share declined 0.1 share point to 31.5%, as share gains for *Chesterfield* and *L&M* were mostly offset by a decline for *Marlboro.* PMI s

shipment volume increased 2.8%, but was essentially flat when adjusted for favorable trade inventory movements.

Eastern Europe, Middle East and Africa. Net revenues, which include excise taxes billed to customers, increased $448 million (16.9%). Excluding excise taxes, net revenues increased $156 million (10.6%) to $1.6 billion, due primarily to favorable currency ($60 million), price increases ($56 million), and higher volume/mix ($40 million).

Operating companies income increased $70 million (12.4%), due primarily to price increases and favorable costs ($72 million), favorable currency ($21 million) and higher volume/mix ($14 million), partially offset by higher marketing, administration and research costs ($29 million).

In Eastern Europe, Middle East and Africa, volume increased 0.8%, driven by gains in Ukraine and Egypt, and the timing of shipments in Saudi Arabia and Israel, partially offset by the continued decline of *L&M* in Turkey and Russia, and lower worldwide duty-free volume.

In Egypt, shipment volume increased 23.3%, driven mainly by *L&M*, while market share grew 1.4 share points to 11.4%.

In Russia, shipment volume was down 2.6%, but share increased 0.2 share points to 26.7%, as share gains for *Marlboro*, *Parliament, Virginia Slims* and *Chesterfield* were mostly offset by a share decline for *L&M*. PMI s brand portfolio in Russia was also strengthened by new brand initiatives, including *Muratti* Slims, *Virginia Slims* Uno in an innovative package and *Marlboro* Filter Plus.

In Turkey, shipment volume was down 4.4% and market share declined 2.7 share points to 40.2%, due mainly to the decline of *L&M* and *Lark*, which face intense competition at the low-price end of the market. *Marlboro* s share was down slightly, but *Parliament* was up 0.8 share points to 5.8%.

In Ukraine, shipment volume grew 4.3% and share increased 0.5 share points to 33.7%, driven by gains in *Marlboro*, *Parliament* and *Chesterfield*. *Marlboro* s share advanced 0.5 share points to 5.1%, as consumers continued to trade up to international brands at the expense of lower-priced local brands.

Asia. Net revenues, which include excise taxes billed to customers, increased $259 million (10.2%). Excluding excise taxes, net revenues increased $42 million (3.0%) to $1.4 billion, due primarily to the Lakson Tobacco acquisition ($48 million), price increases ($21 million) and favorable currency ($7 million), partially offset by lower volume/mix ($34 million).

Operating companies income decreased $59 million (12.1%), due primarily to lower volume/mix ($32 million), higher marketing, administration and research costs ($30 million) and unfavorable currency ($22 million), partially offset by price increases, net of higher costs ($12 million) and the Lakson Tobacco acquisition ($8 million).

In Asia, volume increased 15.9%, due to acquisition volume in Pakistan and gains in Korea, Indonesia and the Philippines, partially offset by a volume decline in Japan. Excluding acquired volume, shipment volume in Asia declined 1.2%.

In Indonesia, PMI shipment volume rose 1.3%. Market share of 28.0% was down slightly, reflecting the impact of the tax-driven price increase that took effect in May, following the March 2007 excise tax increase. *A Hijau* s share increased 0.8 share points to 6.0%, but *A Mild* and *Dji Sam Soe* declined 0.6 and 0.3 share points, respectively, due to low-price competition and temporarily widened price gaps with competitive brands. *Marlboro* share grew 0.1 share point to 4.1%.

In Japan, the total cigarette market declined 20.3%, reflecting significant trade purchases in June 2006 ahead of the July 2006 excise tax increase. Market share in Japan declined 0.1 share point to 24.3%. PMI s shipments in

Japan were down 8.7%, due to lower in-market sales, partially offset by favorable distributor inventory movements. PMI estimates that the underlying industry decline after the July 2006 price increase has been approximately 6%, but anticipates that by the fourth quarter of 2007 the market contraction will return to a more normalized 2.5% to 3.0% rate of decline.

In Korea, shipment volume increased 19.1%, due mainly to better performance of *Parliament*, *Marlboro* and *Virginia Slims*. Volume benefited from recent new line extensions, including *Marlboro* Filter Plus and *Virginia Slims* One. Market share increased 1.3 share points to 9.5%, with *Marlboro* up 0.9 share points to 4.2%.

Latin America. Net revenues, which include excise taxes billed to customers, increased $128 million (12.0%). Excluding excise taxes, net revenues increased $33 million (7.7%) to $464 million, due primarily to price increases ($25 million) and the acquisition of the Dominican Republic cigarette business ($7 million).

Operating companies income decreased $28 million (21.5%), due primarily to the divestiture of the Dominican Republic beer business ($17 million), pre-tax charges for asset impairment and exit costs in 2007 ($11 million), and higher marketing, administration and research costs, partially offset by price increases, net of higher costs ($20 million).

In Latin America, volume declined 2.6%, due mainly to declines in the Dominican Republic and Mexico, partially offset by gains in Argentina.

In Argentina, the total cigarette market was stable and PMI s shipment volume grew 2.2%. Market share increased 1.7 share points, due mainly to the *Philip Morris* brand and *Marlboro*.

In the Dominican Republic, shipment volume declined 35.8%, reflecting a lower total market following price increases in January and February 2007 to partially compensate for a very significant excise tax increase imposed on cigarettes in January 2007. Market share declined 0.5 share points to 77.6%, due primarily to *Marlboro*, partially offset by gains for other PMI brands.

In Mexico, the total cigarette market declined 8.5%, due primarily to the timing of Easter holiday shipments in March 2007 versus April 2006, as well as tax-driven price increases and unfavorable inventory movements. However, PMI market share was up 1.4 share points to 64.2%, due primarily to *Marlboro*, *Benson & Hedges* and *Delicados*. PMI shipments declined 5.9%, due to the lower total market.

Financial Services

Business Environment

In 2003, PMCC shifted its strategic focus and is no longer making new investments but is instead focused on managing its existing portfolio of finance assets in order to maximize gains and generate cash flow from asset sales and related activities. Accordingly, PMCC s operating companies income will fluctuate over time as investments mature or are sold. During the first six months of 2007 and 2006, PMCC received proceeds from asset sales, maturities and bankruptcy recoveries of $340 million and $202 million, respectively, and recorded gains of $246 million and $66 million, respectively, in operating companies income. During the second quarter of 2007 and 2006, PMCC received proceeds from asset sales, maturities and bankruptcy recoveries of $141 million and $32 million, respectively, and recorded gains of $109 million and $8 million, respectively, in operating companies income.

Included in the proceeds for 2007 were partial recoveries of amounts previously provided for in the allowance for losses related to aircraft exposure, which resulted in additional operating companies income of $207 million and $78 million for the six months and three months ended June 30, 2007, respectively.

PMCC leases a number of aircraft, predominantly to major U.S. passenger carriers. At June 30, 2007, $1.5 billion of PMCC s finance asset balance related to aircraft. One of PMCC s aircraft lessees, Northwest Airlines, Inc. (Northwest), exited bankruptcy on May 31, 2007 and assumed PMCC s leveraged leases for three Airbus A-320 aircraft. With this emergence, none of PMCC s aircraft lessees are operating under bankruptcy protection.

In addition, PMCC leases one 750 megawatt (MW) natural gas-fired power plant (located in Pasadena, Texas) to an indirect subsidiary of Calpine Corporation (Calpine). Calpine, which has guaranteed the lease, is currently operating under bankruptcy protection. The subsidiary was not included as part of the bankruptcy filing of Calpine. PMCC does not record income on leases when the lessee or its guarantor is in bankruptcy. At June 30, 2007, PMCC s finance asset balance for this lessee was $60 million. In addition, PMCC s leases for two 265 MW natural gas-fired power plants (located in Tiverton, Rhode Island, and Rumford, Maine), which were part of the bankruptcy filing, were rejected and written off during 2006. PMCC s interest in these plants was foreclosed upon in July 2007, which will result in the acceleration of approximately $50 million in deferred taxes. Based on PMCC s assessment of the prospect for recovery on the Pasadena plant, a portion of the outstanding finance asset balance has been provided for in the allowance for losses.

At June 30, 2007, PMCC s allowance for losses was $223 million. During the six months ended June 30, 2007, PMCC s allowance for losses decreased by $257 million related to the partial recovery and write-off of certain aircraft leveraged lease investments. During the second quarter of 2006, PMCC increased its allowance for losses by $103 million due to continuing issues within the airline industry.

As discussed further in Note 12. *Income Taxes*, the IRS has disallowed benefits pertaining to several PMCC leverage lease transactions for the years 1996 through 1999.

Operating Results

	2007	2006
	(in millions)	
Net revenues:		
Six months ended June 30,	$ 95	$ 163
Three months ended June 30,	$ 52	$ 55
Operating companies income (loss):		
Six months ended June 30,	$ 299	$ 37
Three months ended June 30,	$ 139	$ (59)

PMCC s net revenues for the six months ended June 30, 2007, decreased $68 million (41.7%) from the comparable period in 2006, due primarily to lower gains from asset management activity and lower lease revenues due to lower investment balances. Net revenues for the three months ended June 30, 2007, decreased $3 million (5.5%) from the comparable period in 2006, due primarily to lower lease revenues, partially offset by higher gains from asset management activity.

PMCC s operating companies income for the six months ended June 30, 2007 increased $262 million (100.0+%) from the comparable period in 2006, due primarily to cash recoveries in 2007 on aircraft leases previously written down versus an increase to the loss provision in 2006, partially offset by lower revenues. PMCC s operating companies income for the three months ended June 30, 2007, increased $198 million (100.0+%) from the comparable period in 2006, due primarily to cash recoveries in 2007 on aircraft leases previously written down versus an increase to the loss provision in 2006.

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Financial Review

Net Cash Provided by Operating Activities, Continuing Operations

During the first six months of 2007, net cash provided by operating activities on a continuing operations basis was $5.0 billion compared with $5.5 billion during the comparable 2006 period. The decrease in cash provided by operating activities was due primarily to the return in 2006 of approximately $2 billion of escrow bond deposits related to the *Price* U.S. tobacco case, partially offset by higher earnings from continuing operations (after excluding the non-cash reversal of income tax reserves in 2006) and lower pension plan contributions.

Net Cash Used in Investing Activities, Continuing Operations

One element of PMI s growth strategy is to strengthen its brand portfolio and/or expand its geographic reach through active programs of selective acquisitions. PM USA from time to time considers acquisitions as part of its adjacency strategy.

During the first six months of 2007, net cash used in investing activities on a continuing operations basis was $587 million, compared with $239 million during the first six months of 2006. The increase in cash used was due primarily to PMI s purchase of an additional stake of a cigarette manufacturer in Pakistan in the first quarter of 2007.

Net Cash Used in Financing Activities, Continuing Operations

During the first six months of 2007, net cash used in financing activities on a continuing operations basis was $3.0 billion, compared with $6.1 billion during the first six months of 2006. The decrease in cash used in financing activities was due primarily to higher repayment of debt in 2006.

Debt and Liquidity

Credit Ratings At June 30, 2007, ALG s debt ratings by major credit rating agencies were as follows:

	Short-term	Long-term	Outlook
Moody s	P-2	Baa1	Stable
Standard & Poor s	A-2	BBB	Positive
Fitch	F-2	BBB+	Stable

ALG s credit quality, measured by 5 year credit default swaps, has improved over the past year with levels which approximate that of Single-A rated issuers.

Credit Lines ALG and PMI maintain separate revolving credit facilities. ALG intends to use its revolving credit facilities to support the issuance of commercial paper.

The purchase price of the Sampoerna acquisition was primarily financed through a euro 4.5 billion bank credit facility arranged for PMI and its subsidiaries in May 2005, consisting of a euro 2.5 billion three-year term loan facility (which, through repayments has been reduced to euro 1.5 billion) and a euro 2.0 billion five-year revolving credit facility. These facilities, which are not guaranteed by ALG, require PMI to maintain an earnings before interest, taxes, depreciation and amortization (EBITDA) to interest ratio of not less than 3.5 to 1.0. At June 30, 2007, PMI s ratio calculated in accordance with the agreements was 34.0 to 1.0.

In March 2007, ALG negotiated a new 364-day revolving credit facility in the amount of $1.0 billion, which expires on March 27, 2008, and replaces ALG s 364-day facility which matured on March 30, 2007. In addition, ALG maintains a multi-year credit facility in the amount of $4.0 billion, which expires in April 2010. The ALG facilities require the maintenance of an earnings to fixed charges ratio, as defined by the agreements,

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of not less than 2.5 to 1.0. At June 30, 2007, the ratio calculated in accordance with the agreements was 18.8 to 1.0.

ALG and PMI expect to continue to meet their respective covenants. These facilities do not include any credit rating triggers or any provisions that could require the posting of collateral. The multi-year facilities enable the respective companies to reclassify short-term debt on a long-term basis.

At June 30, 2007, credit lines for ALG and PMI, and the related activity, were as follows (in billions of dollars):

ALG	June 30, 2007			
			Commercial	
		Amount	Paper	Lines
Type	Credit Lines	Drawn	Outstanding	Available
364-day	$1.0	$ -	$ -	$1.0
Multi-year	4.0			4.0
	$5.0	$ -	$ -	$5.0

PMI	June 30, 2007		
		Amount	Lines
Type	Credit Lines	Drawn	Available
euro 2.5 billion, 3-year term loan	$2.0	$2.0	$ -
euro 2.0 billion, 5-year revolving credit	2.7	0.2	2.5
	$4.7	$2.2	$2.5

In addition to the above, certain international subsidiaries of PMI maintain credit lines to meet their respective working capital needs. These credit lines, which amounted to approximately $2.2 billion are for the sole use of these international businesses. Borrowings on these lines amounted to approximately $0.5 billion and $0.4 billion at June 30, 2007 and December 31, 2006, respectively.

Debt Altria Group, Inc. s total debt (consumer products and financial services) was $8.3 billion and $8.5 billion at June 30, 2007 and December 31, 2006, respectively. Total consumer products debt was $7.2 billion and $7.4 billion at June 30, 2007 and December 31, 2006, respectively. Total consumer products debt includes PMI third-party debt of $3.1 billion and $2.8 billion at June 30, 2007 and December 31, 2006, respectively. At June 30, 2007 and December 31, 2006 (after giving effect to the Kraft spin-off), Altria Group, Inc. s ratio of consumer products debt to total equity was 0.44 and 0.58, respectively. The ratio of total debt to total equity was 0.51 and 0.67 at June 30, 2007 and December 31, 2006 (after giving effect to the Kraft spin-off), respectively.

ALG does not guarantee the debt of PMI.

Guarantees As discussed in Note 11, at June 30, 2007, Altria Group, Inc. s third-party guarantees, which are primarily related to excise taxes and divestiture activities, were $286 million, of which $280 million have no specified expiration dates. The remainder expire through 2011, with none expiring through June 30, 2008. Altria Group, Inc. is required to perform under these guarantees in the event that a third party fails to make contractual payments or achieve performance measures. Altria Group, Inc. has a liability of $22 million on its condensed consolidated balance sheet at June 30, 2007, relating to these guarantees. In the ordinary course of business, certain subsidiaries of ALG have agreed to indemnify a limited number of third parties in the event of future litigation. In July 2007, a guarantee agreement for $179 million between Altria Group, Inc. and the

Pension Benefit Guaranty Corporation related to Miller Brewing Company was terminated. At June 30, 2007, subsidiaries of ALG were also contingently liable for $2.5 billion of guarantees related to their own performance, consisting of the following:

- $2.3 billion of guarantees of excise tax and import duties related primarily to international shipments of tobacco products. In these agreements, financial institutions provide guarantees of tax payments to the respective governments. PMI then issues guarantees to the respective financial institutions for the payment of the taxes. These are revolving facilities that are integral to the shipment of tobacco products in international markets, and the underlying taxes payable are recorded on Altria Group, Inc. s condensed consolidated balance sheet.

- $0.2 billion of other guarantees related to the tobacco businesses.

Although Altria Group, Inc. s guarantees of its own performance are frequently short-term in nature, they are expected to be replaced, upon expiration, with similar guarantees of similar amounts. These items have not had, and are not expected to have, a significant impact on Altria Group, Inc. s liquidity.

Payments Under State Settlement and Other Tobacco Agreements As discussed previously and in Note 11, PM USA has entered into State Settlement Agreements with the states and territories of the United States and also entered into a trust agreement to provide certain aid to U.S. tobacco growers and quota holders, but PM USA s obligations under this trust have now been eliminated by the obligations imposed on PM USA by FETRA. During 2004, PMI entered into a cooperation agreement with the European Community. Each of these agreements calls for payments that are based on variable factors, such as cigarette volume, market shares and inflation. PM USA and PMI account for the cost of these agreements as a component of cost of sales as product is shipped.

As a result of these agreements and the enactment of FETRA, PM USA and PMI recorded the following amounts in cost of sales (in millions):

	For the Six Months Ended June 30,		For the Three Months Ended June 30,	
	2007	2006	2007	2006
PM USA	$2,675	$2,468	$1,419	$1,289
PMI	45	54	22	28
Total	$2,720	$2,522	$1,441	$1,317

Based on current agreements and current estimates of volume and market share, the estimated amounts that PM USA and PMI may charge to cost of sales under these agreements will be approximately as follows (in billions):

	PM USA	PMI	Total
2007	$5.4	$0.1	$5.5
2008	5.5	0.1	5.6
2009	5.5	0.1	5.6
2010	5.5	0.1	5.6
2011	5.5	0.1	5.6
2012 to 2016	5.6 annually	0.1 annually	5.7 annually
Thereafter	5.7 annually		5.7 annually

The estimated amounts charged to cost of sales in each of the years above would generally be paid in the following year. As previously stated, the payments due under the terms of these agreements are subject to adjustment for several factors, including cigarette volume, inflation and certain contingent events and, in general, are allocated based on each manufacturer s market share. The amounts shown in the table above are estimates, and actual amounts will differ as underlying assumptions differ from actual future results. See Note

11. *Contingencies* for a discussion of proceedings that may result in a downward adjustment of amounts paid under State Settlement Agreements for the years 2003 and 2004.

Litigation Escrow Deposits As discussed in Note 11, in connection with obtaining a stay of execution in the *Engle* class action, PM USA placed $1.2 billion into an interest-bearing escrow account. The $1.2 billion escrow account and a deposit of $100 million related to the bonding requirement are included in the June 30, 2007 and December 31, 2006 condensed consolidated balance sheets as other assets. As discussed in Note 11, in July 2006, the Florida Supreme Court issued its ruling in the *Engle* case. The escrow and deposit amounts will be returned to PM USA subject to and upon the completion of final review of the judgment. Interest income on the $1.2 billion escrow account is paid to PM USA quarterly and is being recorded as earned in interest and other debt expense, net, in the condensed consolidated statements of earnings.

Also, as discussed in Note 11, in June 2006 under the order of the Illinois Supreme Court, cash deposits of approximately $2.2 billion related to the *Price* case were returned to PM USA, and PM USA s obligations to deposit further cash payments were terminated. A pre-existing 7.0%, $6 billion long-term note from ALG to PM USA that was placed in escrow pending the outcome of plaintiffs petition for writ of certiorari to the United States Supreme Court was returned to PM USA in December 2006, following the Supreme Court s denial of the petition. Since this note is the result of an intercompany financing arrangement, it does not appear on the condensed consolidated balance sheet of Altria Group, Inc.

With respect to certain adverse verdicts and judicial decisions currently on appeal, other than the *Engle* case discussed above, as of June 30, 2007, PM USA has posted various forms of security totaling approximately $193 million, the majority of which have been collateralized with cash deposits, to obtain stays of judgments pending appeals. These cash deposits are included in other assets on the condensed consolidated balance sheets.

Although litigation is subject to uncertainty and could result in material adverse consequences for the financial condition, cash flows or results of operations of PM USA or Altria Group, Inc. in a particular fiscal quarter or fiscal year, management believes the litigation environment has substantially improved and expects cash flow from operations, together with existing credit facilities, to provide sufficient liquidity to meet the ongoing needs of the business.

Leases PMCC s investment in leases is included in the line item finance assets, net, on the condensed consolidated balance sheets as of June 30, 2007 and December 31, 2006. At June 30, 2007, PMCC s net finance receivable of $6.2 billion in leveraged leases, which is included in the line item on Altria Group, Inc. s condensed consolidated balance sheet of finance assets, net, consists of rents receivable ($21.1 billion) and the residual value of assets under lease ($1.5 billion), reduced by third-party nonrecourse debt ($13.9 billion) and unearned income ($2.5 billion). The payment of the nonrecourse debt is collateralized by lease payments receivable and the leased property, and is nonrecourse to the general assets of PMCC. As required by accounting principles generally accepted in the United States of America (U.S. GAAP), the third-party nonrecourse debt has been offset against the related rents receivable and has been presented on a net basis within the line item finance assets, net, in Altria Group, Inc. s condensed consolidated balance sheets. Finance assets, net, at June 30, 2007, also include net finance receivables for direct finance leases ($0.4 billion) and an allowance for losses ($0.2 billion).

Equity and Dividends

As discussed in Note 1. *Basis of Presentation and Kraft Spin-Off*, on March 30, 2007, Altria Group, Inc. spun-off all of its remaining interest (88.9%) in Kraft on a pro rata basis to Altria Group, Inc. stockholders of record as of the close of business on March 16, 2007 in a tax-free distribution. The distribution resulted in a net decrease to Altria Group, Inc. s stockholders equity of $27.4 billion on March 30, 2007.

As discussed in Note 8. *Stock Plans*, in January 2007, Altria Group, Inc. issued 1.7 million rights to receive shares of stock to eligible U.S.-based and non-U.S. employees. Restrictions on these rights lapse in the first quarter of 2010. The market value per right was $87.36 on the date of grant. Recipients of these Altria Group,

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Inc. stock rights did not receive restricted stock or stock rights of Kraft upon the Kraft spin-off. Rather, they received 0.6 million additional stock rights of Altria Group, Inc. to preserve the intrinsic value of the original award.

Dividends paid in the first six months of 2007 and 2006 were $3.6 billion and $3.3 billion, respectively, an increase of 8.3%, primarily reflecting a higher dividend rate on Altria Group, Inc. stock and a greater number of shares outstanding in 2007.

During the second quarter of 2007, Altria Group, Inc. adjusted its quarterly dividend rate to $0.69 per share so that its stockholders who retain their Altria Group, Inc. and Kraft shares will receive in the aggregate the same dividend rate as before the distribution. As a result, the present annualized dividend rate is $2.76 per Altria Group, Inc. common share.

Market Risk

ALG s subsidiaries operate globally, with manufacturing and sales facilities in various locations around the world. ALG and its subsidiaries utilize certain financial instruments to manage foreign currency exposures. Derivative financial instruments are used by ALG and its subsidiaries, principally to reduce exposures to market risks resulting from fluctuations in foreign exchange rates by creating offsetting exposures. Altria Group, Inc. is not a party to leveraged derivatives and, by policy, does not use derivative financial instruments for speculative purposes.

A substantial portion of Altria Group, Inc. s derivative financial instruments are effective as hedges. Hedging activity affected accumulated other comprehensive earnings (losses), net of income taxes, as follows:

	For the Six Months Ended June 30,		For the Three Months Ended June 30,	
	2007	2006	2007	2006
	(in millions)			
Gain at beginning of period	$13	$24	$5	$36
Derivative gains transferred to earnings	(41)	(18)	(17)	(12)
Change in fair value	34	11	20	(7)
Kraft spin-off	2			
Gain as of June 30	$8	$17	$8	$17

The fair value of all derivative financial instruments has been calculated based on market quotes.

Foreign exchange rates. Altria Group, Inc. uses forward foreign exchange contracts, foreign currency swaps and foreign currency options to mitigate its exposure to changes in exchange rates from third-party and intercompany actual and forecasted transactions. The primary currencies to which Altria Group, Inc. is exposed include the Japanese yen, Swiss franc and the euro. At June 30, 2007 and December 31, 2006, Altria Group, Inc. had contracts with aggregate notional amounts of $2.2 billion and $3.2 billion, respectively.

In addition, Altria Group, Inc. uses foreign currency swaps to mitigate its exposure to changes in exchange rates related to foreign currency denominated debt. These swaps typically convert fixed-rate foreign currency denominated debt to fixed-rate debt denominated in the functional currency of the borrowing entity. These swaps are accounted for as cash flow hedges. The unrealized gain (loss) relating to foreign currency swap agreements that do not qualify for hedge accounting treatment under U.S. GAAP was insignificant as of June 30, 2007 and December 31, 2006. At June 30, 2007 and December 31, 2006, the notional amounts of foreign currency swap agreements aggregated $1.4 billion.

Altria Group, Inc. also designates certain foreign currency denominated debt as net investment hedges of foreign operations. During the six months ended June 30, 2007 and 2006, these hedges of net investments resulted in gains, net of income taxes of $21 million, and losses, net of income taxes, of $154 million, respectively, and were reported as a component of accumulated other comprehensive earnings (losses) within currency translation adjustments.

New Accounting Standard

See Note 13 to the Condensed Consolidated Financial Statements for a discussion of a new accounting standard.

Contingencies

See Note 11 to the Condensed Consolidated Financial Statements for a discussion of contingencies.

Cautionary Factors That May Affect Future Results

Forward-Looking and Cautionary Statements

We* may from time to time make written or oral forward-looking statements, including statements contained in filings with the SEC, in reports to stockholders and in press releases and investor webcasts. You can identify these forward-looking statements by use of words such as strategy, expects, continues, plans, anticipates, believes, will, estimates, intends, projects, goals, targets and other words of similar identify them by the fact that they do not relate strictly to historical or current facts.

We cannot guarantee that any forward-looking statement will be realized, although we believe we have been prudent in our plans and assumptions. Achievement of future results is subject to risks, uncertainties and inaccurate assumptions. Should known or unknown risks or uncertainties materialize, or should underlying assumptions prove inaccurate, actual results could vary materially from those anticipated, estimated or projected. Investors should bear this in mind as they consider forward-looking statements and whether to invest in or remain invested in Altria Group, Inc. s securities. In connection with the safe harbor provisions of the Private Securities Litigation Reform Act of 1995, we are identifying important factors that, individually or in the aggregate, could cause actual results and outcomes to differ materially from those contained in any forward-looking statements made by us; any such statement is qualified by reference to the following cautionary statements. We elaborate on these and other risks we face throughout this document, particularly in the Business Environment sections preceding our discussion of operating results of our subsidiaries businesses. You should understand that it is not possible to predict or identify all risk factors. Consequently, you should not consider the following to be a complete discussion of all potential risks or uncertainties. We do not undertake to update any forward-looking statement that we may make from time to time.

Tobacco-Related Litigation. There is substantial litigation related to tobacco products in the United States and certain foreign jurisdictions. It is possible that there could be adverse developments in pending cases. An unfavorable outcome or settlement of pending tobacco-related litigation could encourage the commencement of additional litigation. Although PM USA has historically been able to obtain required bonds or relief from bonding requirements in order to prevent plaintiffs from seeking to collect judgments while adverse verdicts have been appealed, there remains a risk that such relief may not be obtainable in all cases. This risk has been substantially reduced given that 42 states now limit the dollar amount of bonds or require no bond at all.

It is possible that the consolidated results of operations, cash flows or financial position of PM USA or Altria Group, Inc. could be materially affected in a particular fiscal quarter or fiscal year by an unfavorable outcome

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* This section uses the terms we, our and us when it is not necessary to distinguish among ALG and its various operating subsidiaries or when any distinction is clear from the context.

or settlement of certain pending litigation. Nevertheless, although litigation is subject to uncertainty, management believes the litigation environment has substantially improved. ALG and each of its subsidiaries named as a defendant believe, and each has been so advised by counsel handling the respective cases, that it has a number of valid defenses to the litigation pending against it, as well as valid bases for appeal of adverse verdicts against it. All such cases are, and will continue to be, vigorously defended. However, ALG and its subsidiaries may enter into settlement discussions in particular cases if they believe it is in the best interests of ALG s stockholders to do so. Please see Note 11 for a discussion of pending tobacco-related litigation.

Tobacco Control Action in the Public and Private Sectors. Our tobacco subsidiaries face significant governmental action, including efforts aimed at reducing the incidence of smoking, restricting marketing and advertising, imposing regulations on warnings and disclosure of ingredients and seeking to hold us responsible for the adverse health effects associated with both smoking and exposure to environmental tobacco smoke. Governmental actions, combined with the diminishing social acceptance of smoking and private actions to restrict smoking, have resulted in reduced industry volume, and we expect this decline to continue.

Excise Taxes. Cigarettes are subject to substantial excise taxes in the United States and to substantial taxation abroad. Significant increases in cigarette-related taxes and fees have been proposed or enacted and are likely to continue to be proposed or enacted within the United States, the EU and in other foreign jurisdictions. In addition, in certain jurisdictions, PMI s products are subject to discriminatory tax structures, and inconsistent rulings and interpretations on complex methodologies to determine excise and other tax burdens.

Tax increases and discriminatory tax structures are expected to continue to have an adverse impact on sales of cigarettes by our tobacco subsidiaries, due to lower consumption levels and to a shift in consumer purchases from the premium to the non-premium or discount segments or to other low-priced or low-taxed tobacco products or to counterfeit or contraband products.

Minimum Retail Selling Price Laws. Several EU Member States have enacted laws establishing a minimum retail selling price for cigarettes and, in some cases, other tobacco products. The European Commission has commenced infringement proceedings against these Member States, claiming that minimum retail selling price systems infringe EU law. In March 2007, the European Commission brought an action against France in the European Court of Justice on the ground that France s minimum retail selling price system infringes EU law. On July 2, 2007, the European Commission announced that it has formally called upon Austria, Ireland and Italy to amend their legislation setting minimum retail selling prices for cigarettes. The announcement further stated that if these Member States do not respond satisfactorily to this request within two months of the announcement, the Commission may refer the matters to the European Court of Justice. If the European Commission s actions are successful, they could adversely impact excise tax levels and/or price gaps in those markets.

Increased Competition in the United States Tobacco Market. Settlements of certain tobacco litigation in the United States have resulted in substantial cigarette price increases. PM USA faces competition from lowest priced brands sold by certain United States and foreign manufacturers that have cost advantages because they are not parties to these settlements. These manufacturers may fail to comply with related state escrow legislation or may avoid escrow deposit obligations on the majority of their sales by concentrating on certain states where escrow deposits are not required or are required on fewer than all such manufacturers cigarettes sold in such states. Additional competition has resulted from diversion into the United States market of cigarettes intended for sale outside the United States, the sale of counterfeit cigarettes by third parties, the sale of cigarettes by third parties over the Internet and by other means designed to avoid collection of applicable taxes, and increased imports of foreign lowest priced brands.

Counterfeit Cigarettes in International Markets. Large quantities of counterfeit cigarettes are sold in the international market. PMI believes that *Marlboro* is the most heavily counterfeited international cigarette brand. PMI cannot quantify the amount of revenue it loses as a result of this activity.

Governmental Investigations. From time to time, ALG and its tobacco subsidiaries are subject to governmental investigations on a range of matters. Ongoing investigations include allegations of contraband shipments of

cigarettes and allegations of unlawful pricing activities within certain international markets. We cannot predict the outcome of those investigations or whether additional investigations may be commenced, and it is possible that our business could be materially affected by an unfavorable outcome of pending or future investigations.

New Tobacco Product Technologies. Our tobacco subsidiaries continue to seek ways to develop and to commercialize new product technologies that have the objective of reducing constituents in tobacco smoke identified by public health authorities as harmful while continuing to offer adult smokers products that meet their taste expectations. We cannot guarantee that our tobacco subsidiaries will succeed in these efforts. If they do not succeed, but one or more of their competitors do, our tobacco subsidiaries may be at a competitive disadvantage.

PM USA and PMI have adjacency growth strategies involving potential moves into complementary tobacco or tobacco-related products or processes. We cannot guarantee that these strategies, or any products introduced in connection with these strategies, will be successful.

Foreign Currency. Our international tobacco subsidiary conducts its business in local currency and, for purposes of financial reporting, its results are translated into U.S. dollars based on average exchange rates prevailing during a reporting period. During times of a strengthening U.S. dollar, our reported net revenues and operating income will be reduced because the local currency will translate into fewer U.S. dollars.

Competition and Economic Downturns. Each of our tobacco subsidiaries is subject to intense competition, changes in consumer preferences and local economic conditions. To be successful, they must continue to:

- promote brand equity successfully;
- anticipate and respond to new consumer trends;
- develop new products and markets and to broaden brand portfolios in order to compete effectively with lower priced products; and
- improve productivity.

The willingness of consumers to purchase premium cigarette brands depends in part on local economic conditions. In periods of economic uncertainty, consumers tend to purchase more private label and other economy brands, and the volume of our consumer products subsidiaries could suffer accordingly.

Our finance subsidiary, PMCC, holds investments in finance leases, principally in transportation (including aircraft), power generation and manufacturing equipment and facilities. Its lessees are also subject to intense competition and economic conditions. If counterparties to PMCC s leases fail to manage through difficult economic and competitive conditions, PMCC may have to increase its allowance for losses, which would adversely affect our profitability.

Strengthening Brand Portfolios Through Acquisitions. One element of PMI s growth strategy is to strengthen its brand portfolio and/or expand its geographic reach through active programs of selective acquisitions. PM USA from time to time considers acquisitions as part of its adjacency strategy. Acquisition opportunities are limited, and acquisitions present risks of failing to achieve efficient and effective integration, strategic objectives and anticipated revenue improvements and cost savings. There can be no assurance that we will be able to continue to acquire attractive businesses on favorable terms or that all future acquisitions will be quickly accretive to earnings.

Asset Impairment. We periodically calculate the fair value of our goodwill and intangible assets to test for impairment. This calculation may be affected by the market conditions noted above, as well as interest rates and general economic conditions. If an impairment is determined to exist, we will incur impairment losses, which will reduce our earnings.

IRS Challenges to PMCC Leases. The IRS concluded its examination of Altria Group, Inc. s consolidated tax returns for the years 1996 through 1999, and issued a final Revenue Agent s Report (RAR) on March 15, 2006. The RAR disallowed benefits pertaining to certain PMCC leveraged lease transactions for the years 1996 through 1999. Altria Group, Inc. has agreed with all conclusions of the RAR, with the exception of the disallowance of benefits pertaining to several PMCC leveraged lease transactions for the years 1996 through 1999. PMCC will continue to assert its position regarding these leveraged lease transactions and contest approximately $150 million of tax and net interest assessed and paid with regard to them. The IRS may in the future challenge and disallow more of PMCC s leveraged leases based on Revenue Rulings, an IRS Notice and subsequent case law addressing specific types of leveraged leases (lease-in/lease-out (LILO) and sale-in/lease-out (SILO) transactions). PMCC believes that the position and supporting case law described in the RAR, Revenue Rulings and the IRS Notice are incorrectly applied to PMCC s transactions and that its leveraged leases are factually and legally distinguishable in material respects from the IRS s position. PMCC and ALG intend to vigorously defend against any challenges based on that position through litigation. In this regard, on October 16, 2006, PMCC filed a complaint in the U.S. District Court for the Southern District of New York to claim refunds for a portion of these tax payments and associated interest. However, should PMCC s position not be upheld, PMCC may have to accelerate the payment of significant amounts of federal income tax and significantly lower its earnings to reflect the recalculation of the income from the affected leveraged leases, which could have a material effect on the earnings and cash flows of Altria Group, Inc. in a particular fiscal quarter or fiscal year. PMCC considered this matter in its adoption of FIN 48 and FASB Staff Position No. FAS 13-2.

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Item 4. Controls and Procedures.

Altria Group, Inc. carried out an evaluation, with the participation of Altria Group, Inc. s management, including ALG s Chief Executive Officer and Chief Financial Officer, of the effectiveness of Altria Group, Inc. s disclosure controls and procedures (as defined in Rule 13a-15(e) under the Securities Exchange Act of 1934, as amended) as of the end of the period covered by this report. Based upon that evaluation, ALG s Chief Executive Officer and Chief Financial Officer concluded that Altria Group, Inc. s disclosure controls and procedures are effective. There have been no changes in Altria Group, Inc. s internal control over financial reporting during the most recent fiscal quarter that have materially affected, or are reasonably likely to materially affect, Altria Group, Inc. s internal control over financial reporting.

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Part II - OTHER INFORMATION

Item 1. Legal Proceedings.

See Note 11. *Contingencies*, of the Notes to the Condensed Consolidated Financial Statements included in Part I, Item 1 of this report for a discussion of legal proceedings pending against Altria Group, Inc. and its subsidiaries. See also Exhibits 99.1 and 99.2 to this report.

Item 1A. Risk Factors.

Information regarding Risk Factors appears in MD&A *Cautionary Factors That May Affect Future Results*, in Part I Item 2 of this Form 10-Q and in Part I Item 1A. *Risk Factors* of our Report on Form 10-K for the year ended December 31, 2006. Other than as set forth in Part I Item 2. of this Form 10-Q, there have been no material changes from the risk factors previously disclosed in our Report on Form 10-K.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds.

ALG s share repurchase activity for each of the three months ended June 30, 2007, was as follows:

Period	Total Number of Shares Repurchased (1)	Average Price Paid Per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	Approximate Dollar Value of Shares that May Yet be Purchased Under the Plans or Programs
April 1, 2007				
April 30, 2007	172,564	$69.36		
May 1, 2007				
May 31, 2007	2,926	$68.86		
June 1, 2007				
June 30, 2007	3,123	$70.79		
For the Quarter Ended June 30, 2007	178,613	$69.37		

(1) The shares repurchased during the periods presented above represent shares tendered to ALG by employees who vested in restricted stock and rights, or exercised stock options, and used shares to pay all, or a portion of, the related taxes and/or option exercise price.

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Item 6. Exhibits.

3	Amended and Restated By-Laws (Incorporated by reference to ALG s Current Report on Form 8-K dated July 3, 2007).
12	Statement regarding computation of ratios of earnings to fixed charges.
31.1	Certification of Chief Executive Officer pursuant to Rule 13a-14(a)/15d-14(a) of the Securities Exchange Act of 1934, as amended, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certification of Chief Financial Officer pursuant to Rule 13a-14(a)/15d-14(a) of the Securities Exchange Act of 1934, as amended, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1	Certification of Chief Executive Officer pursuant to 18 U.S.C. 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
32.2	Certification of Chief Financial Officer pursuant to 18 U.S.C. 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
99.1	Certain Litigation Matters and Recent Developments.
99.2	Trial Schedule for Certain Cases.

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Signature

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

ALTRIA GROUP, INC.

/s/ DINYAR S. DEVITRE

Dinyar S. Devitre
Senior Vice President and

Chief Financial Officer

August 7, 2007