Issue Brief - Tobacco MSA Payments

NUMBER HHS 05-07-01

SUMMARY

Landmark litigation between tobacco companies and the states was settled in 1998 in the Master Settlement Agreement (MSA). The MSA requires participating tobacco companies to pay approximately $206 billion over 25 years, of which Utah's share is approximately $836 million. To date, payments to Utah total $230.2, which includes the withholding of Non-Participating Manufacturer (NPM) adjustments of $3.5 million in FY 2006 and $3.3 million in FY 2007.

Utah Code Title 63, Chapter 97, *Tobacco Settlement Funds and Endowment*, directs the use of all funds received by the State related to the MSA. For FY 2007, 75% of all payments ($20.3 million) accrued to the Tobacco Settlement Restricted Account and the remaining amount ($6.8 million) was deposited to the Tobacco Settlement Trust Fund. Including a beginning balance, FY 2007 restricted account monies are sufficient to cover $22.9 million in appropriations from the account. Depending on tobacco companies' pursuit of future NPM adjustments, future balances may not adequately cover appropriations from the account and therefore the Analyst suggests further research of options to mitigate possible shortfalls.

OBJECTIVE

This issue brief outlines how revenues from the Master Settlement Agreement accrue and are distributed. The brief also identifies current and potential downward adjustments to revenues and how they may affect future funding of programs.

DISCUSSION & ANALYSIS

Background

On November 23, 1998, the four largest and several smaller tobacco companies entered into the Master Settlement Agreement (MSA) with 46 states, the District of Columbia, and five territories.[1] In exchange for assurance that all pending lawsuits against them would be dropped and no new suits filed, the tobacco companies agreed to change their marketing practices and to pay the states approximately $206 billion over 25 years. In order to provide a more "level playing field" between companies participating in the MSA and non-participants, the MSA encouraged states to enact the model statute which requires non-participating cigarette manufacturers to make deposits into an escrow account for use in the event that a state files a lawsuit against the manufacturer.[2]

Master Settlement Agreement Payments

Included in the $206 billion participating manufacturers have agreed to pay are $12.7 billion in initial state payments over the first 5 years of the agreement and $183.2 billion in annual state payments to be paid through 2025. Distribution of these payments to the states is based on allocation percentages agreed upon by the state attorneys general and listed in the MSA. Percentages range from 0.2483449% (Wyoming) to 12.76% (California and New York). Utah's allocation is 0.4448869%.

Each state's annual payment is subject to three adjustments:

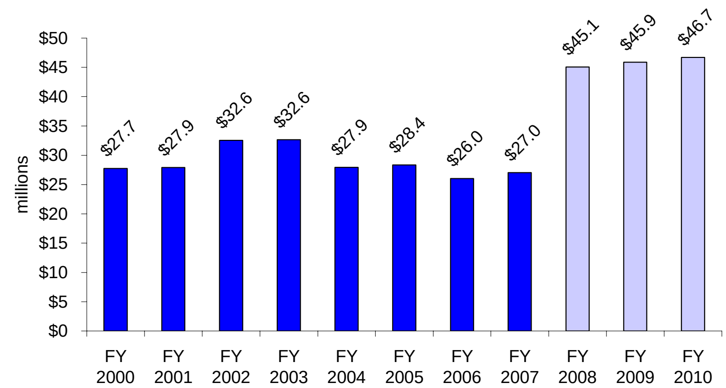
- An inflation adjustment equal to the greater of 3% or the annual Consumer Price Index percent change;
- A volume adjustment based on increases or decreases in the manufacturers' total sales; and

[1] Florida, Minnesota, Mississippi, and Texas did not participate in the Master Settlement Agreement.
[2] The MSA did not require states to enact this statute; however annual payments to states without the statute in place could be subject to more significant reductions in their payments than the other states to cover Non-Participating Manufacturer Adjustments. Utah enacted the statute in Utah Code Title 59, Chapter 22, *Model Tobacco Settlement Act*.

- A Non-Participating Manufacturers (NPM) adjustment if participating manufacturers have suffered a market share loss as a result of the MSA and that states have not diligently enforced their model tobacco statutes.

Figure 1 at the right shows actual tobacco settlement payments to Utah through April, 2007 and estimates for upcoming payments (annual payments are made in April of each year). Payments total $230.2 million to date, which includes 2003 and 2004 NPM adjustment withholdings of $3.5 million and $3.3 million, respectively. These withholdings were placed in a disputed payments account for FY 2006 and FY 2007 pending determination of whether or not Utah diligently enforced its model statute.

Figure 1. Utah Tobacco Settlement Payments
FY 2000 - FY 2010



Note: FY 08 - FY 10 are estimates; they do not include possible NPM adjustments.
Source: LFA analysis of Governor's Office of Planning & Budget data

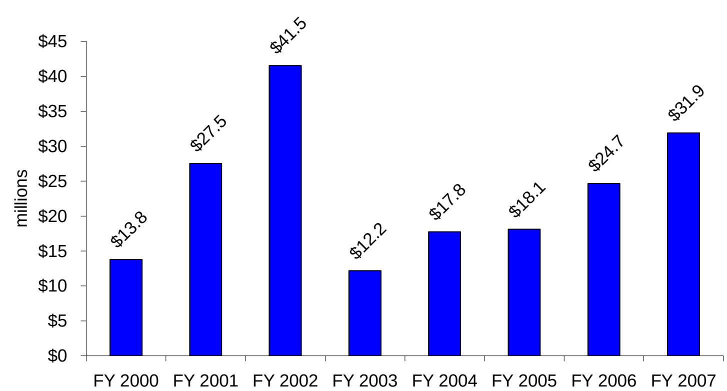
In addition to annual payments, annual Strategic Contribution Fund payments begin in 2008 and end in 2017. Strategic Contribution Fund Monies will be allocated to states based on a strategic contribution formula which reflects the contribution made by states toward resolution of the state lawsuits against tobacco companies. These additional payments will be subject to the same adjustments as the annual base payments. The estimates in Figure 1 do not include any NPM adjustments; the implications of such possible adjustments are addressed in a later section of this brief.

Use of Settlement Payments

Utah Code Title 63, Chapter 97, *Tobacco Settlement Funds and Endowment*, directs the use of all funds received by the State related to the MSA. Through the end of FY 2003, funds were deposited equally between the Tobacco Settlement Restricted Account and the Tobacco Settlement Trust Fund; for FY 2004, 80% was deposited to the restricted account and 20% was deposited to the trust fund; 70% went to the restricted account and 30% went to the trust fund in 2005; the split for FY 2006 and FY 2007 is 75% to 25%; finally, 60% of all funds received after July 1, 2007 will accrue to the restricted account and 40% will accrue to the trust fund.

According to Article 22 of the Utah Constitution, the state treasurer shall hold all trust funds and assets in trust and invest them for the benefit of the people of the state in perpetuity; any income from the trust fund shall be deposited into the General Fund. The Legislature may, with the support of the governor and three-fourths of each body, remove funds or assets for deposit into the General Fund. The ending balance in the Tobacco Settlement Trust Fund between FY 2000 and FY 2007 is shown in Figure 2 at the right. The Legislature used about $44 million to mitigate budget shortfalls during FY 2003. Since then, the trust fund balance has grown to $31.9 million.

Figure 2. Utah Tobacco Settlement Trust Fund Balance
FY 2000 - FY 2007



Source: LFA analysis of Governor's Office of Planning & Budget data

Utah Code Title 63, Chapter 97, Part 2 (last amended in 2005) requires funds from the Tobacco Settlement Restricted Account to be appropriated as funds are available in any given year in the following order:

1. $10,300,000 to the Department of Health for the Children's Health Insurance Program;

2. $4,000,000 to the Department of Health for alcohol, tobacco, and drug prevention—with a preference given to tobacco-related programs;
3. $193,700 to the Administrative Office of the Courts and $1,296,300 to the Department of Human Services for the drug court program;
4. $77,400 to the Board of Pardons, $350,900 to the Department of Human Services, and $81,700 to the Department of Corrections for a drug board pilot program;
5. $4,000,000 to the University of Utah Health Sciences Center for health education, research, and treatment.

The Legislature may appropriate any additional available funds as they see fit or they may allow excess funds to remain in the restricted account.

Figure 3 shows additions to and distributions from the Tobacco Settlement Restricted Account. Total account distributions exceeded payments in all years except FY 2005. After FY 2007 appropriations of $22.9 million, the restricted account balance is anticipated to be approximately $600,000. Absent any NPM adjustments to the FY 2008 payment, which includes the new strategic contribution fund payment, the restricted account balance would be sufficient to cover existing appropriations of $24.9 million.

Figure 3. Tobacco Settlement Restricted Account Payments and Distributions
FY 2000 - FY 2007

Restricted Account	FY 2002	FY 2003	FY 2004	FY 2005	FY 2006	FY 2007	FY 2008 Estimate
Account Balance as of July 1	***$ 13,608,800***	***$ 12,338,000***	***$ 11,232,400***	***$ 5,246,800***	***$6,101,800***	***$3,190,300***	***$583,900***
Tobacco Payments	16,275,900	16,321,500	22,348,800	19,847,400	19,521,500	20,275,200	27,046,400
Interest/Market Valuation/Other	53,300	231,400	73,700	75,500	158,700	18,200	28,800
Distributions to Agencies							
CHIP	($5,500,000)	($5,496,800)	($6,424,900)	($6,818,900)	($10,272,400)	($10,321,000)	($12,333,100)
Tobacco Prevention	(4,000,000)	(4,062,100)	(4,062,100)	(4,076,000)	(4,000,000)	(4,000,000)	(4,000,000)
Drug Courts	(1,490,000)	(1,490,000)	(1,490,000)	(1,490,000)	(1,489,700)	(1,490,000)	(1,490,000)
Drug Board	(510,000)	(510,000)	(510,000)	(510,000)	(510,000)	(510,000)	(510,000)
U of U Health Sciences Center	(4,000,000)	(4,000,000)	(4,000,000)	(4,000,000)	(4,000,000)	(4,000,000)	(4,000,000)
Additional Dept. of Health Funding	(2,000,000)	(1,999,600)	(1,999,600)	(2,073,000)	(2,219,600)	(2,303,600)	(2,377,600)
Attorney General's Office	(100,000)	(100,000)	(100,000)	(100,000)	(100,000)	(275,200)	(275,200)
SB 3 (2003) to General Fund	0	0	(9,821,500)	0	0	0	0
Total Account Distributions	**($17,600,000)**	**($17,658,500)**	**($28,408,100)**	**($19,067,900)**	**($22,591,700)**	**($22,899,800)**	**($24,985,900)**
Account Balance as of June 30	***$12,338,000***	***$11,232,400***	***$5,246,800***	***$6,101,800***	***$3,190,300***	***$583,900***	***$2,673,200***

Note: FY 2008 Estimate does not include potential NPM adjustments.
Source: *Governor's Office of Planning and Budget*

Future Funding Risks: The NPM adjustment

A Non-Participating Manufacturer (NPM) adjustment may be applied to an individual state payment if the participating manufacturers experience a market share loss, an independent economic consultant determines that the MSA was a significant factor in this loss, and the state fails to "diligently enforce" its statute requiring non-participating manufacturers to contribute to an escrow account. To date, an independent economic consultant has found that the MSA was a significant factor in the national market share losses experienced by participating companies in 2003 and 2004. Most of the participating companies withheld NPM adjustments for 2003 and 2004 from their total 2006 and 2007 payments, placing the funds in a disputed payments account.[3] Of total monies placed in a disputed payments account, Utah's share was approximately $3.5 million and $3.3 million in 2006 and 2007, respectively.

The Utah Attorney General expects that the independent economic consultant will also find the MSA a significant factor in market share loss of participating manufacturers for 2005, leading to the placement of a portion of 2008

[3] The largest MSA company, Philip Morris, made full payments in 2006 and 2007; R.J. Reynolds, Lorillard, and most of the other MSA cigarette companies made NPM adjustments to the 2006 and 2007 payments.

payments into the disputed payments account. A new independent economic consultant will determine whether or not the MSA was a significant factor in future years—anticipated findings are currently unpredictable.

Monies will remain in the disputed payments account pending determination of which states did, and which states did not diligently enforce their model statutes. Since the MSA does not provide a clear definition of "diligent enforcement," many states, including Utah, filed Motions for Declaratory Order with their MSA Courts to find that they diligently enforced their statutes. In response, the participating manufacturers filed motions to compel arbitration and most of the courts have ruled that the matter should be resolved through the arbitration procedures outlined in the MSA. Nationally, all of the state attorneys general are working to determine whether or not individual state proceedings should take place or if they should consolidate their efforts into a national arbitration proceeding. Ultimate actions could be a couple of years away.

There are a number of scenarios for the future of disputed payment amounts. In the worst-case, if Utah is individually found to have failed to diligently enforce in 2003 and 2004 and all other states are found to have diligently enforced, Utah could loose its total payments for those years (the deduction would be applied to future payments). Other possibilities include Utah being found to have diligently enforced, in which case it would receive the disputed payment amounts and interest, and all states (including Utah) being found to have failed at diligent enforcement, in which case Utah's deduction would be based on its allocated percentage.

As described in the previous section, estimated deposits to the restricted account for FY 2008 are sufficient to cover FY 2008 appropriations from the account in the event that no monies are withheld due to an NPM adjustment. Based on current data, the Analyst estimates that participating manufacturers could withhold up to 10% from their 2008 payments to Utah and the Tobacco Settlement Restricted Account would be sufficient to cover FY 2008 appropriations (the withheld amounts in 2006 and 2007 were approximately 11% and could have been as much as 18% if Philip Morris had chosen to withhold). Any amount greater than 10% would result in a budget shortfall.

LEGISLATIVE ACTION

Since annual MSA payments are made in April, whether or not participating manufacturers will withhold an NPM adjustment from their 2008 payment will not be known until after the Legislature convenes and has the opportunity to provide supplemental appropriations for FY 2008. The Analyst, therefore, recommends that the Executive Appropriations Committee or the Health and Human Services Appropriations Subcommittee direct the Office of the Legislative Fiscal Analyst to work with the Governor's Office of Planning and Budget and the Office of the Attorney General to provide the 2008 Legislature with options to address the possible shortfall in the Tobacco Settlement Restricted Account for FY 2008. Options could include determining an appropriate amount to be transferred from the Tobacco Settlement Trust Fund or the General Fund, amending the restricted account-trust fund distribution formula, or the supplemental reduction of programs funded with restricted account monies.

SOURCES

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