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# Legislative Fiscal Division

## Revenue Estimate Profile

### Tobacco Settlement

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**Revenue Description:** Montana receives revenue as a settling party to a Master Settlement Agreement (MSA) with four original tobacco companies and 56 subsequent companies to end a four-year legal battle with 46 states, Puerto Rico, American Samoa, the U.S. Virgin Islands, the North Mariana Island, Guam and the District of Columbia (52 total settling entities).

Montana was eligible for four types of payments: reimbursement for legal costs (FY 2000), five initial payments (FY 2000 through FY 2003), on-going annual payments, and strategic contribution payments (FY 2008 through 2017). The MSA places no restrictions on how the settling parties spend the money.

The total amount of tobacco settlement funds available to Montana is affected by a number of adjustments. These may include inflation, sales volume changes, non-participating manufacturers (NPM) adjustment for the loss of market shares, operating income of the original four tobacco companies, number and operating income of subsequent participating manufactures, number of states reaching state specific finality, settlements reached by the four states not party to the agreement (Florida, Texas, Minnesota, and Mississippi), litigation offsets, disputed payments, and federal tobacco legislation offsets among others.

The reduction for the NPM adjustment was first included in the revenue estimates beginning FY 2006. Amounts paid by manufacturers who participate in the MSA may decrease if they have lost market shares and it is proven that a significant portion of the loss (to companies not participating in the MSA) is due to the disadvantages caused by the MSA. An economics firm must determine if this is the case. The adjustment does not apply if a state has enacted “model statutes” and enforced them. Although it has not yet been determined if all these conditions have been met, it is expected that participating manufactures will withhold a portion of their payments in disputed escrow accounts until the matter is resolved, thus reducing payments to the settling entities.

#### **Statutory Reference:**

Tax Rate – NA

Tax Distribution (MCA) – Montana Constitution, Article X11, Section 4; 17-6-606; 53-4-1011

Date Due – annual payments from settling entities due April 15<sup>th</sup> (Master Settlement Agreement, Chapter IX(c)), General Tobacco annual payments through calendar 2016 due August 30<sup>th</sup> (General Tobacco Adherence Agreement)

**Applicable Tax Rate(s):** NA

**Distribution:** Due to passage of Constitutional Amendment 35 by the electorate in November 2000, the legislature is required to dedicate no less than 40% of tobacco settlement money to a permanent trust fund. Since the legislature has not yet determined the exact percentage to be deposited to the trust fund, the revenue estimate assumes 40%. For FY 2003, the remaining 60% of the money was deposited to the general fund. Due to passage of Initiative 146 by the electorate in November 2002, beginning FY 2004, 32% of the tobacco settlement money funds tobacco prevention programs and 17% of the funds is used for the Children’s Health Insurance Program (except in the 2011 biennium [due the enactment of HB 676] when the allocation was used to fund the healthy Montana kids plan). In HB 743, the 2007 Legislature added chronic disease programs to the allowable uses of the 32% distribution. The remaining 11% of the money is deposited to the general fund.

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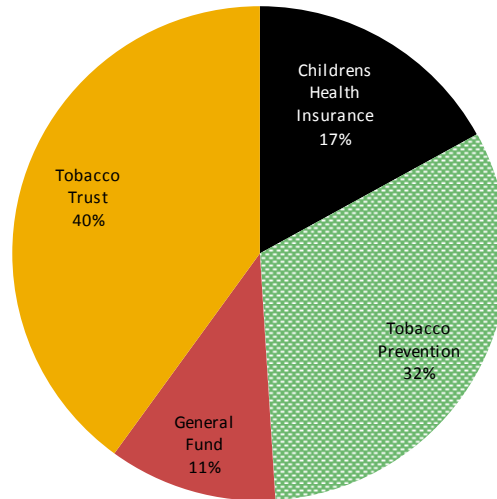
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#### Distribution Chart:



**Collection Frequency:** Annual payments are expected each April 15<sup>th</sup> into perpetuity. General Tobacco, a subsequent participating manufacturer, is required to make annual payments every August 30<sup>th</sup> through calendar 2016 for obligations incurred from 2000 to 2003.

#### **% of Total General Fund Revenue:**

FY 2004 – 0.21%	FY 2007 – 0.16%	FY 2010 – 0.21%
FY 2005 – 0.19%	FY 2008 – 0.19%	FY 2011 – 0.18%
FY 2006 – 0.16%	FY 2009 – 0.23%	FY 2012 – 0.18%

#### **Revenue Estimate Methodology:**

The derivation of the tobacco settlement revenue estimate involves many factors. The Master Settlement Agreement specifies base amounts to be paid by all participating manufacturers, but also allows various adjustments to be made to these payments.

#### Data

The Master Settlement Agreement, signed by the settling entities and participating tobacco manufacturers (PM), is the driving document for the procedure to use in determining how much the original participating manufacturers (OPM) to the agreement and the subsequent participating manufacturers (SPM) have to pay to the settling entities. PriceWaterhouseCoopers, the independent auditor to the agreement, gathers all the data and makes all the calculations required by the Master Settlement Agreement for determining what the PM owe. Documents produced by PriceWaterhouseCoopers provide the historic data needed to project future payments. Staff at the Montana Attorney General's Office and the National Association of Attorneys General may also be consulted. Since an adjustment for a change in volume of cigarettes shipped is necessary, various knowledgeable sources are consulted as to expected changes in smoking or the sale of cigarettes.

#### Payments

Currently, there are two types of payments from OPM:

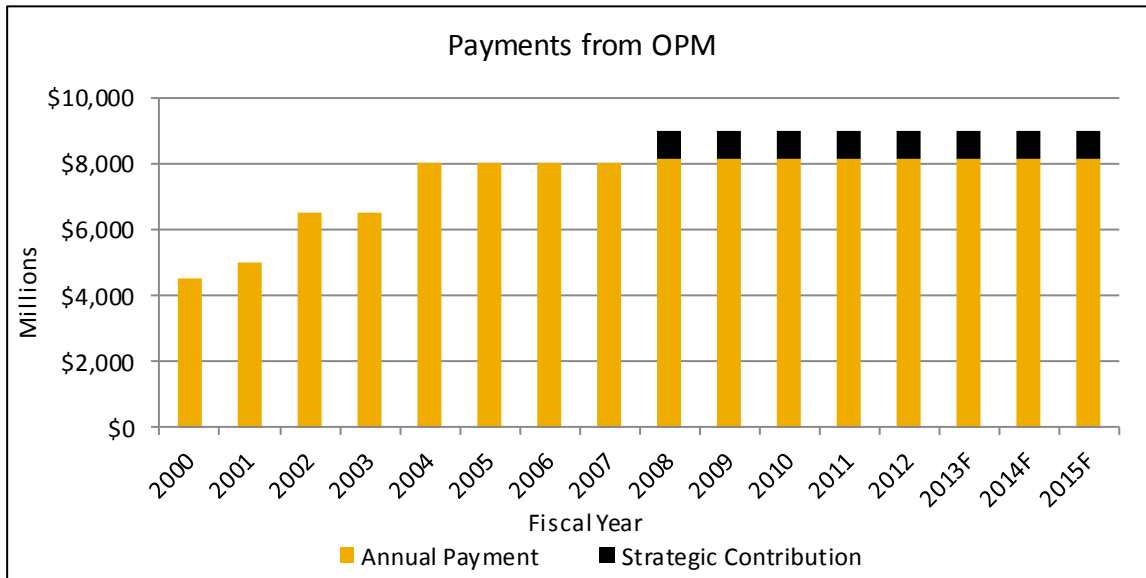
1. On-going annual payments to be received April 15<sup>th</sup> each year of which Montana receives 0.4247591%. These payments are to be made in perpetuity and increased in FY 2008 and will increase again in FY 2018; and
2. Strategic contribution payments are to be made from FY 2008 through FY 2017 of which Montana receives 1.0447501%.

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The table below shows the total of these payments available to all settling entities before any adjustments.

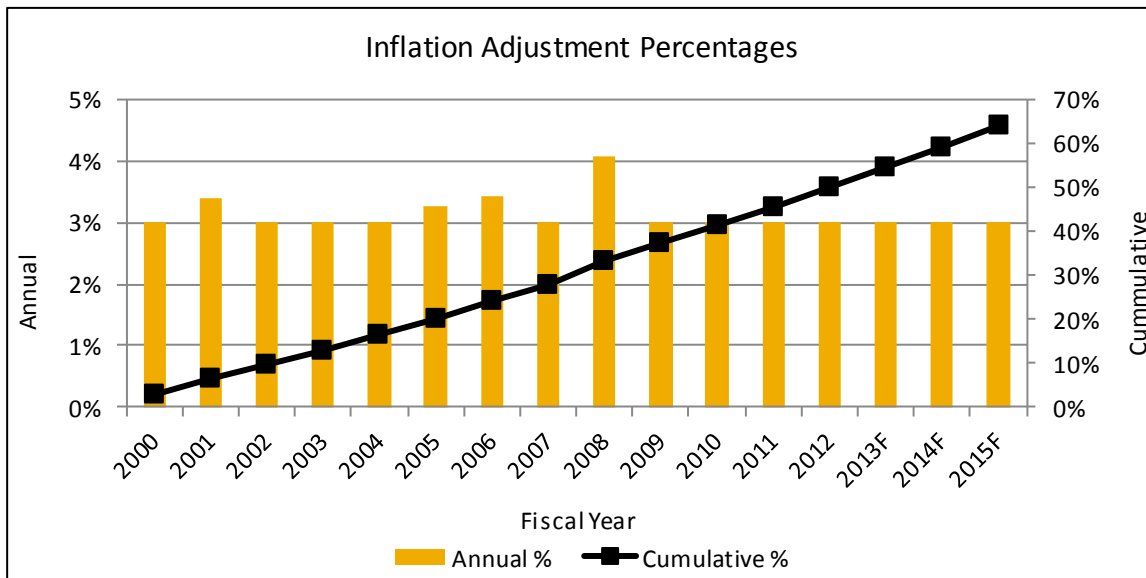


Manufacturers who subsequently participate in the agreement also make payments based on the total annual and strategic contribution payments required by the OPM. The amount of these payments is also subject to various adjustments.

#### Adjustments

There are five potential adjustments to the payments.

1. Inflation – This adjustment increases the amount owed by PM. The set amounts of the annual and the strategic contribution payments are increased by the greater of 3% or the amount of the Consumer Price Index for Urban Consumers. The effect is cumulative so that the previous year’s inflation percentage is increased by the current year’s amount plus the amount of the current year’s percentage. The chart shows the annual and cumulative inflation factors.



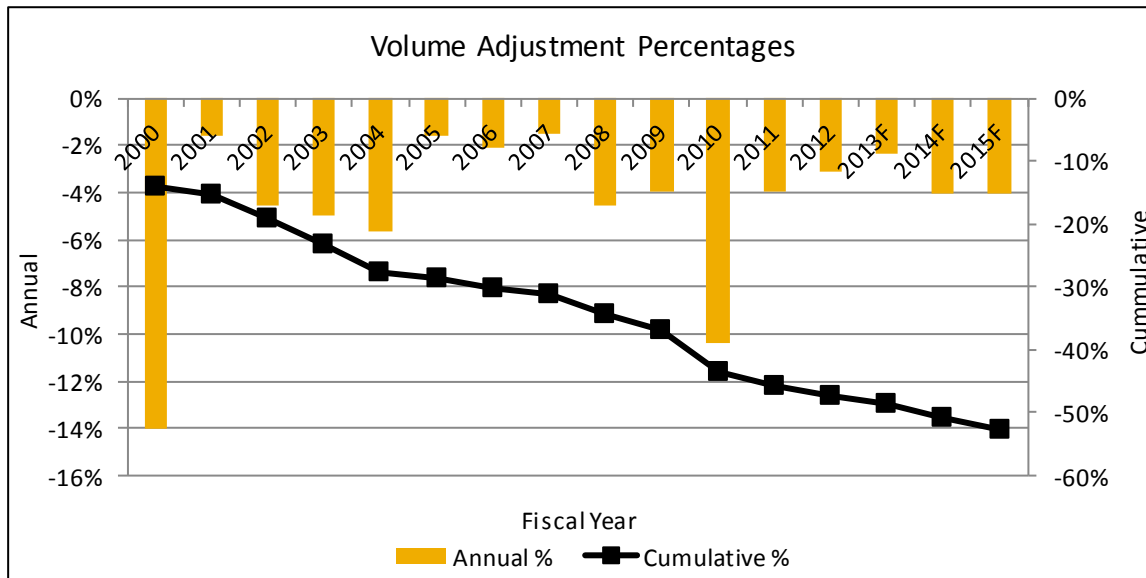
2. Volume – As the number of cigarettes shipped nationally decreases, payments by PM are reduced. The current number of cigarettes is compared to the 1997 base number of 475.7 billion cigarettes. A proxy for the estimated annual change in the number of cigarettes shipped is determined by developing an estimate for the percentage change in cigarette consumption. For this analysis, the trend (downward) of the number of cigarette shipped from FY 2000 to FY 2012

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was applied to estimate each subsequent fiscal years. Like the inflation adjustment, the effect is cumulative so that the previous year's percentage adjustment is increased by the current year's amount plus the amount of the current year's percentage. According to the settlement agreement, the cumulative percentage is then reduced by 2%. The chart shows the annual and adjusted cumulative volume factors.



3. Operating income – If the aggregate operating income from the OPM sales of cigarettes exceeds the 1996 base amount of \$7,060.840 million, as adjusted for inflation (see above) and by the percentage of states who have finalized acceptance of the agreement (100% since calendar 2001), then the dollar amount of the volume reduction is reduced and the amount of OPM payments increases. This adjustment has not been applied since 2000.
4. Previous settling states – Previous to the Master Settlement Agreement, four states had settled lawsuits with certain cigarette manufacturers. The agreement recognized this by allowing reductions to the OPM annual payments (as adjusted for inflation and volume) of 12.45% through the FY 2007 payment, 12.24% through the FY 2017 payment, and 11.07% thereafter.
5. Non-participating manufacturers (NPM) – If tobacco manufacturers who participate in the Master Settlement Agreement lose market share to those manufacturers who do not, their payments may be reduced. It must be shown that there was a loss of market share to NPM and that the disadvantages caused by the agreement were a significant factor contributing to the loss. However, the NPM adjustment does not apply to a state that had a “qualifying statute” in effect for the full year in question and had diligently enforced it. The “qualifying statute” requires a manufacturer who is not a PM to pay into a state-specific escrow account \$0.0167539 per cigarette sold in that state in CY 2006 and \$0.0188482 thereafter. Money in the account may be used to pay a judgment or settlement against the manufacturer. The Montana legislature enacted SB 359 (1999 session) and HB 663 (2003 session) in response to the agreement (see Title 15, Chapter 11, Parts 4 and 5). Although the agreement’s independent auditor calculates the NPM adjustment, it has never applied it to required payments.

The NPM adjustment is three times the market share loss of PM. Market share loss is determined by subtracting the current year market share of PM from the 1997 base market share of 99.5835% less 2% or 97.5835%. This percentage difference is multiplied by the annual payment amount adjusted for inflation, volume, and previous settling states. If the computed market share loss exceeds 16-2/3%, the formula changes to reduce the percentage adjustment. For this to occur, the change in market share for all PM would have to fall to 80%. It is unlikely that this will occur. Based on this formula, the NPM adjustment could reduce Montana’s payments by a maximum of \$4.0 million in FY 2013, \$3.9 million in FY 2014 and \$3.9 million in FY 2015, if all the conditions were met. The estimates include a portion of these reductions; not because all the conditions have been met, but because the PM may dispute a portion of a payment. Many PM feel the adjustment should be applied and have subsequently deposited disputed amounts into special escrow accounts until the issue is resolved. However, not all companies dispute the full amount, so the revenue estimate reduces the maximum amount that could be disputed by a percentage adjustment. The end result for the settling entities is that some portion of the money is unavailable even though the adjustment was not applied to the payments. This

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unavailability of money has occurred in Montana: FY 2006-\$3.5 million, FY 2007- \$3.0 million, FY 2008-\$2.3 million, FY 2009-\$2.3 million, FY 2010-\$3.2 million, FY 2011-\$4.6, and FY 2012-\$3.9 million. It is anticipated that PM will continue to dispute a portion of future payments.

#### Analysis

Once adjustments amounts have been calculated, the applicable adjustments to the OPM and SMP payments can be applied and other revenue components calculated.

**OPM Annual Payment** - The estimate for tobacco settlement revenue from OPM is derived by first multiplying the payment amount by 1 plus the cumulative percentages for the inflation and volume adjustments and the previous settled states' percentage then adding the dollar amount of the operating income adjustment (zero) and the NPM adjustment. To this total amount, Montana's allocation of 0.4247591% is applied.

**SPM Annual Payment** - The estimate for tobacco settlement revenue from SPM is derived by a five-step process:

1. The volume adjustment (a reduction) is calculated by multiplying the annual OPM amount by the cumulative volume percentage.
2. A market share adjustment (a reduction to the amount owed) is calculated by: a) subtracting the volume adjustment, derived above, from the OPM amount; b) multiplying the result by a market share proxy to derive the base amount owed; c) the inflation adjustment is applied by multiplying the annual OPM amount by the cumulative inflation percentage; and d) the inflation adjustment is added to the base amount owed.
3. The proxy is calculated in the last completed year by dividing the SPM adjusted base payment (adjust for volume) by the total known amount due after adjustments for market share changes. The proxy from the last known fiscal year is used in all subsequent years.
4. The NPM maximum adjustment (a possible reduction), as determined above, is calculated. Since not all companies will dispute the entire amount, a percentage is applied to reduce the reduction. For FY 2008, this percentage was 61.6% and is used in all subsequent years.
5. The total SPM amount is adjusted by the above three adjustments and multiplied by 0.4247591% to obtain Montana's share.

**OPM Strategic Contribution Payment** – From FY 2008 through FY 2017, the OPM owe yearly strategic contribution payments to the settling entities in the amount of \$861,000,000. This amount is increased by the inflation adjustment and decreased by the volume adjustment, both described above. The result is multiplied by Montana's share of 1.0447501%.

**SPM Strategic Contribution Payment** – From FY 2008 through FY 2017, the SPM owe yearly strategic contribution payments to the settling entities based on the OPM amount of \$861,000,000. This amount is increased by the inflation adjustment, decreased by the market share adjustment, and decreased by the volume adjustment, all described above. The result is multiplied by Montana's share of 1.0447501%.

**General Tobacco** – The General Tobacco Company joined the Master Settlement Agreement in August 2004 and will make future payments the same as the other SPM. However, the company entered into a separate agreement with the settling entities for making the required payments owed retroactively from the date of its joining to the date the Master Settlement Agreement was signed. These obligations total \$272.3 million. This "principal" amount will be paid yearly over a 12-year period based on a percentage schedule based on the year.

For FY 2014 and 2015, the percentage of the "principal" to be paid is 12% and 13%, respectively. Interest on unpaid balances at 5% is then added to the "principal" payment. Once the total annual payment is calculated, it is multiplied by 0.4247591% to obtain Montana's share.

#### Adjustments and Distribution

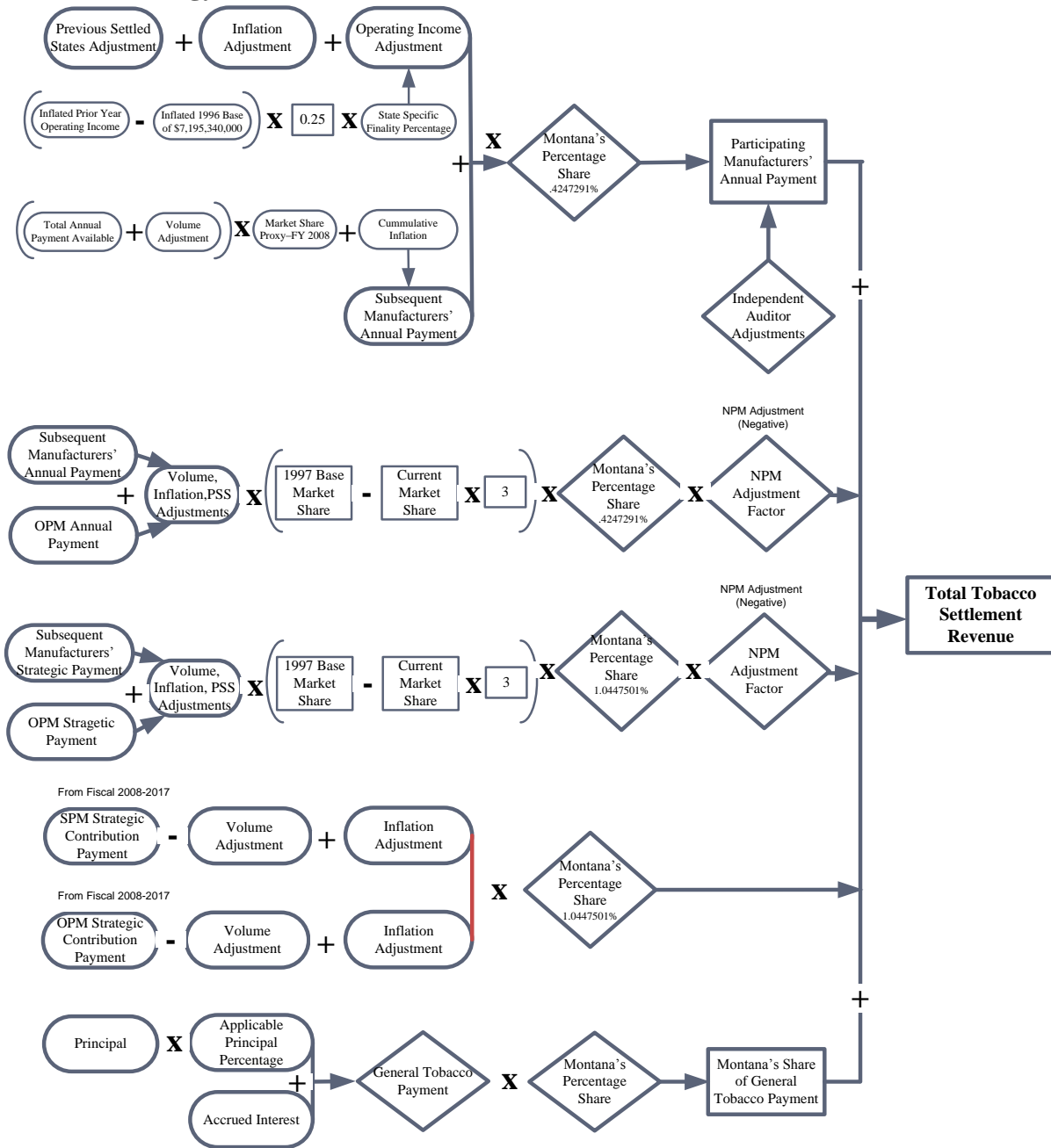
Once total tax revenue for each fiscal year is determined, the applicable distribution percentages are applied.

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#### Forecast Methodology:



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#### Revenue Estimate Assumptions:

	t	Total Settle	GF Settle	Initial	Annual	Annual	PSS	GF Allocation
	<u>Fiscal</u>	<u>Millions</u>	<u>Millions</u>	<u>Payment</u>	<u>Payment</u>	<u>Share</u>	<u>Reduction</u>	<u>Percent</u>
				<u>Millions</u>	<u>Millions</u>	<u>Percent</u>	<u>Percent</u>	<u>Percent</u>
Actual	2002	31.079	18.647	2622.545	6500.000	0.4%	-12.5%	60.0%
Actual	2003	31.166	18.700	2701.221	6500.000	0.4%	-12.5%	60.0%
Actual	2004	26.672	2.934	0.000	8000.000	0.4%	-12.5%	11.0%
Actual	2005	27.071	2.978	0.000	8000.000	0.4%	-12.5%	11.0%
Actual	2006	24.851	2.734	0.000	8000.000	0.4%	-12.5%	11.0%
Actual	2007	25.931	2.861	0.000	8000.000	0.4%	-12.5%	11.0%
Actual	2008	34.614	3.808	0.000	8139.000	0.4%	-12.2%	11.0%
Actual	2009	37.524	4.128	0.000	8139.000	0.4%	-12.2%	11.0%
Actual	2010	31.533	3.469	0.000	8139.000	0.4%	-12.2%	11.0%
Actual	2011	29.625	3.259	0.000	8139.000	0.4%	-12.2%	11.0%
Actual	2012	30.203	3.322	0.000	8139.000	0.4%	-12.2%	11.0%
Forecast	2013	32.291	3.552	0.000	8139.000	0.4%	-12.2%	11.0%
Forecast	2014	31.993	3.519	0.000	8139.000	0.4%	-12.2%	11.0%
Forecast	2015	31.688	3.486	0.000	8139.000	0.4%	-12.2%	11.0%

	t	Annual	Cummulative	Adjustment	Adjusted	Annual	Cummulative	NPM Adj.
	<u>Fiscal</u>	<u>Vol. Change</u>	<u>Vol. Change</u>	<u>Factor</u>	<u>Vol. Change</u>	<u>CPI Change</u>	<u>CPI Change</u>	<u>Factor</u>
		<u>Percent</u>	<u>Percent</u>	<u>Percent</u>	<u>Percent</u>	<u>Percent</u>	<u>Percent</u>	<u>Percent</u>
Actual	2002	-4.6%	-19.2%	98.0%	-18.8%	3.0%	9.7%	
Actual	2003	-4.9%	-23.2%	98.0%	-22.7%	3.0%	13.0%	
Actual	2004	-5.6%	-27.5%	98.0%	-27.0%	3.0%	16.4%	
Actual	2005	-1.6%	-28.7%	98.0%	-28.1%	3.3%	20.2%	
Actual	2006	-2.1%	-30.2%	98.0%	-29.6%	3.4%	24.3%	
Actual	2007	-1.5%	-31.2%	98.0%	-30.6%	3.0%	28.0%	
Actual	2008	-4.5%	-34.3%	98.0%	-33.6%	4.1%	33.2%	61.6%
Actual	2009	-3.9%	-36.9%	98.0%	-36.2%	3.0%	37.2%	61.6%
Actual	2010	-10.3%	-43.4%	98.0%	-42.6%	3.0%	41.3%	61.6%
Actual	2011	-4.0%	-45.7%	98.0%	-44.8%	3.0%	45.6%	61.6%
Actual	2012	-3.1%	-47.3%	98.0%	-46.4%	3.0%	49.9%	61.6%
Forecast	2013	-2.4%	-48.6%	98.0%	-47.6%	3.0%	54.4%	61.6%
Forecast	2014	-4.0%	-50.7%	98.0%	-49.6%	3.0%	59.1%	61.6%
Forecast	2015	-4.0%	-52.6%	98.0%	-51.6%	3.0%	63.8%	61.6%

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	t	Op. Income Adjustment	SPM Payment	General Tobacco	NPM Adjustment	Strategic Payment	Strategic Share	SPM Strat. Pay.
	<u>Fiscal</u>	<u>Millions</u>	<u>Millions</u>	<u>Millions</u>	<u>Millions</u>	<u>Millions</u>	<u>Percent</u>	<u>Millions</u>
Actual	2002	0.000	144.418			0.000	0.0%	
Actual	2003	0.000	240.733			0.000	0.0%	
Actual	2004	0.000	293.807			0.000	0.0%	
Actual	2005	0.000	433.300			0.000	0.0%	
Actual	2006	0.000	441.940	0.072	-2.906	0.000	0.0%	
Actual	2007	0.000	531.993	0.080	-2.477	0.000	0.0%	34.166
Actual	2008	0.000	430.211	0.091	-2.669	861.000	1.0%	45.511
Actual	2009	0.000	512.377	0.112	-3.210	861.000	1.0%	54.203
Actual	2010	0.000	516.812	0.132	-3.038	861.000	1.0%	54.672
Actual	2011	0.000	511.973	0.140	-3.168	861.000	1.0%	54.160
Actual	2012	0.000	511.641	0.147	-3.166	861.000	1.0%	54.125
Forecast	2013	0.000	514.960	0.153	-3.186	861.000	1.0%	54.476
Forecast	2014	0.000	509.915	0.171	-3.155	861.000	1.0%	53.942
Forecast	2015	0.000	504.952	0.175	-3.125	861.000	1.0%	53.417

	t	Strategic NPM Adj.	NPM Adj. Factor	Montana Share
	<u>Fiscal</u>	<u>Millions</u>	<u>Percent</u>	<u>Millions</u>
Actual	2000			
Actual	2001			
Actual	2002			
Actual	2003			
Actual	2004			
Actual	2005			
Actual	2006			
Actual	2007			
Actual	2008	-0.823	61.6%	-0.507
Actual	2009	-0.825	61.6%	-0.508
Actual	2010	-0.769	61.6%	-0.474
Actual	2011	-0.762	61.6%	-0.470
Actual	2012	-0.761	61.6%	-0.469
Forecast	2013	-0.766	61.6%	-0.472
Forecast	2014	-0.759	61.6%	-0.468
Forecast	2015	-0.752	61.6%	-0.463

+ Op. Income Adjustment) × Annual Share + General Tobacco + (SPM Payment × Annual Share)  
 + (NPM Adjustment × NPM Adjustment Factor)  
 + Strategic Payment × ((1+ Cumulative CPI Change) × (1+ Adjusted Vol. Change) + SPM Strategic Payment)  
 × Strategic Share  
 GF Settle = Total Settle × GF Allocation

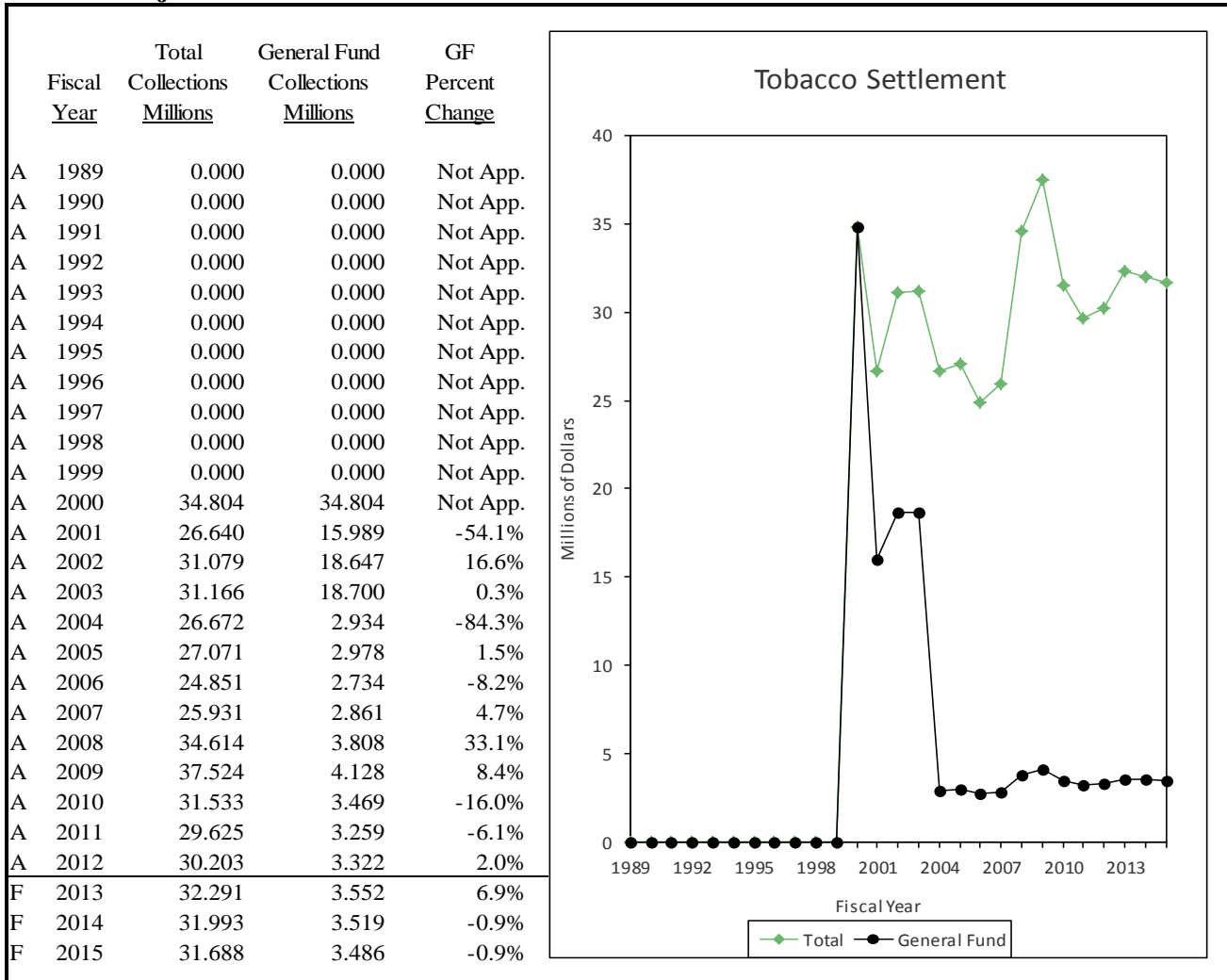


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#### Revenue Projection:



#### Data Source(s):

Master Settlement Agreement (as amended), Center for Disease Control and Prevention, National Council of State Legislatures, National Association of Attorneys General, Tobacco companies' 10Q report

**Contacts:** Department of Justice