

MAINE STATE LEGISLATURE

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Tobacco Settlement Report



Maine State Treasurer Dale McCormick

December 14, 2001



STATE OF MAINE
OFFICE OF THE TREASURER
39 STATE HOUSE STATION
AUGUSTA, MAINE
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DALE McCORMICK
TREASURER OF STATE

HOLLY A. MAFFEI
DEPUTY TREASURER OF STATE

December 14, 2001

Dear Members of the Joint Standing Committee on Appropriations and Financial Affairs and Members of the Joint Standing Committee on Health and Human Services:

As you know, each year, by the second Friday of December, I report to both Committees on the status of Maine's Tobacco Settlement Payments. My report includes:

- Tobacco Settlement Payments received to date
- Deposits, Transfers, Earnings, and Available Balances in the Fund for a Healthy Maine
- Estimated Tobacco Settlement Payments for the current biennium and for the 2004/2005 biennium

In addition to what is required by Statute, I have reviewed the basic history of the Master Settlement Agreement in the Executive Summary, included a section on the determining factors of Maine's Tobacco Settlement Payments, discussed how my office projects future payments, and outlined what is happening elsewhere in the tobacco industry.

The State of Maine has received over \$111 million to date from the Tobacco Settlement. Each payment is deposited into the Fund for a Healthy Maine where it is invested in the Treasurer's Cash Pool. All earnings are deposited into the Fund. 2001 Public Law Chapter 358 repealed the Trust Fund and redirected all future revenues to the Fund for a Healthy Maine.

I hope you will feel free to call or stop by my office with any questions or comments at any time. My door is always open.

Sincerely,

Dale McCormick

C: Governor Angus S. King Jr., Legislative Leadership, Commissioner Janet Waldron, Attorney General G. Steven Rowe, Grant Pennoyer, Tim Leet, Dr. Dora Mills





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EXECUTIVE SUMMARY

- ◆ In 1998 Maine and the other states became creditors of the Participating Manufacturers: the Participating Manufacturers owe Maine money and our interests are linked by the Master Settlement Agreement.
 - The predominant determinant of Tobacco Settlement Payments to be received by Maine each year is the number of cigarettes sold nationwide during the previous calendar year.
- ◆ Tobacco Settlement Payments are a revenue stream that should be monitored and treated like a tax revenue.
- ◆ The Master Settlement Agreement presents the states with conflicting objectives:
 1. States want to maximize the Tobacco Settlement Payments to accomplish important policy goals.
 2. States want to reduce smoking, which will decrease the number of cigarettes smoked, which will in turn decrease the Tobacco Settlement Payment dollars received.
- ◆ Credit analysis of the Tobacco Settlement Payment revenue stream hinges on two key issues:
 1. The continuing enforceability of the manufacturer's obligation under the Master Settlement Agreement to make settlement payments and
 2. Total cigarette sales within the United States by Participating Manufacturers (94% of the market share). More tobacco companies have signed onto the Master Settlement Agreement (accounting for 4.5% of the market) as Subsequent Participating Manufacturers to protect their financial interests. The total market share included under the Master Settlement Agreement is 98.5%.
- ◆ Rating agencies have focused on two primary risks to the Master Settlement Agreement:
 1. A Participating Manufacturer enters bankruptcy and does not meet its obligation under the Master Settlement Agreement.
 2. Non-Participating Manufacturers gain market share at the expense of Participating Manufacturers.

Key

MSA	= Master Settlement Agreement
TSP	= Tobacco Settlement Payment
PM	= Participating Manufacturer
OPM	= Original Participating Manufacturer
SPM	= Subsequent Participating Manufacturer
NPM	= Non-Participating Manufacturer



PAYMENTS AND BALANCES

Tobacco Settlement Payments Received	
<u>Date of Payment</u>	<u>Amount of Payment</u>
12/14/99	\$18,995,496.82
12/31/99	\$16,545,959.59
12/31/99	\$ 212,903.95 ¹
04/17/00	\$27,422,282.74 ²
07/25/00	\$ 53,225.99 ¹
12/29/00	\$16,839,538.70
02/15/01	\$3,165.22 ³
04/16/01	\$30,878,625.32
06/14/01	\$ 44,724.44 ³
11/16/01	\$ 381,637.14 ⁴

Fund for a Healthy Maine Balance

Total Principal Deposits:	\$111,377,559.91	
Transfers:	(\$11,099,592.27)	To Trust in FY 01 ⁵
	(\$61,213,828.05)	FY 01 Expenditures
	(\$15,749,837.00)	FY 02 Expenditures to date
Earnings:	\$5,210,227.37	FY 00 & 01
	\$488,938.73	FY 02 to date
Fund Balance:	\$29,013,468.69	(as of 12/12/01)

¹ The December 31, 1999 payment of \$212,903.95 and the July 25, 2000 payment of \$53,225.99 were reimbursements for legal expenses. These were deposited into the Fund for a Healthy Maine and an allocation of \$260,000 was provided for the Attorney General's Office in PL 1999, C.731, §HHHH-3.

² The April 15, 2000 payment came in three parts due to a dispute by one of the smaller manufacturers. The bulk of the payment (\$27,063,980.01) was received on April 17, 2000. \$356,232.88 was received on April 19, 2000. The remaining \$2,069.85 was received on May 2, 2000, making the total payment \$27,422,282.74.

³ The February 15, 2001 and the June 14, 2001 payments were amounts originally withheld because of a dispute with a manufacturer. Once resolved, the payments were released to the states.

⁴ The November 16, 2001 payment of \$381,637.14 was the result of an IRS refund for 1999. We expect a refund of \$2,991.75 for 1998 in the near future. These refunds come after an IRS decision that State Tobacco Settlement Payments are not taxable.

⁵ The balance of the Trust Fund was transferred to the General Fund Unappropriated Surplus at the end of FY 2001 in accordance with 2001 PL Chapter 358 Section Q-8.



ESTIMATED FUTURE TOBACCO SETTLEMENT PAYMENTS

	<u>Original Estimates</u>	<u>Changes</u>	<u>Revised Estimates</u>	<u>FY TOTALS</u>
1/10/2002	\$17,065,627	(\$719,161)	\$16,346,466	} \$55,901,904 ⁶
4/15/2002	\$40,465,091	(\$909,653)	\$39,555,438	
1/10/2003	\$17,291,150	(\$1,012,531)	\$16,278,619	} \$55,669,879
4/15/2003	\$40,999,837	(\$1,608,577)	\$39,391,260	
4/15/2004	\$51,043,367	(\$2,001,251)	\$49,042,116	\$49,042,116
4/15/2005	\$51,608,274	(\$2,021,951)	\$49,586,323	\$49,586,323

- The Office of the Treasurer of State’s original Tobacco Settlement Payment (TSP) Projections shown above were estimated in November 2000 using the then current WEFA base case scenario econometric model.

- The revised estimates, in bold above, include the most recent information from DRI•WEFA. Adjustments to the econometric model were made as a result of one more full year’s data.

⁶ In addition to the 2 forthcoming TSPs in FY 2002, the State of Maine has just received a payment of \$381,637.14 from the IRS. This constitutes withheld taxes now being turned over to the State as a result of the ruling that TSPs are not taxable.



MAINE'S TOBACCO SETTLEMENT PAYMENTS

The Tobacco Settlement Payment that Maine will receive each year is driven by two key adjustments, the **inflation** factor and the **volume** of cigarettes sold nationwide.

Inflation Factor

- ◆ The base annual payments will increase annually by the *greater* of 3% or CPI (the Consumer Price Index).

National Sales Volume

- ◆ Maine's Tobacco Settlement Payments are directly related to the consumption of cigarettes nationwide.
- ◆ Even if Maine experiences a decline in cigarette consumption, its Tobacco Settlement Payments will not decrease as long as total national sales remain the same or increase.
- ◆ Conversely, if Maine's cigarette sales increase in any given year, the Tobacco Settlement Payments may remain the same or decline based upon the level of total national sales.

Revenue Forecasting and Tracking

- ◆ As a creditor of Participating Manufacturers, the State must track, forecast and reforecast Tobacco Settlement Payments as it would a tax revenue stream.
 - Maine will need to follow tobacco industry trends, including the financial health of the Participating Manufacturers as well as any federal, private or third-party litigation and/or settlements.
- ◆ The Independent Auditor, as specified in the Master Settlement Agreement, will verify the volume of cigarettes sold in a particular year to ensure that the states receive the correct Tobacco Settlement Payment amounts.
- ◆ Some industry observers predict that demand for cigarettes is likely to continue to decline as a result of price increases as well as behavioral changes reducing both the Tobacco Settlement Payments and Maine's cigarette sales tax receipts.
- ◆ Conversely, other industry observers believe that current industry consumption is sustainable based on factors such as:
 - The presence of a core group of smokers and
 - The recent rise in smoking among certain population classes.

How the Treasurer of State Estimates Tobacco Settlement Payments

- ◆ The Treasurer of State's Office estimates future Tobacco Settlement Payments using the econometric model developed by DRI•WEFA. This model was developed for the purpose of projecting payments to states using the most current information available.

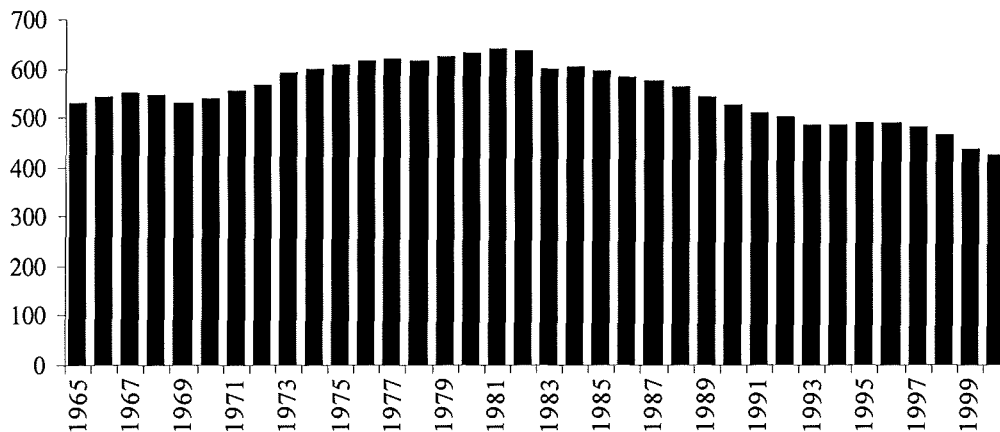


- ◆ The Treasurer of State’s projections of November 2000 were based on the then current WEFA base case scenario econometric model, which was developed to study U.S. Cigarette Consumption and addressed the volume adjustment – the adjustment with the greatest effect on Maine’s Tobacco Settlement Payments.
- ◆ Since then, WEFA has become DRI•WEFA.
- ◆ The DRI•WEFA base case scenario econometric model is still the most advanced study on which to base our projections.⁷ There are 2 reasons for this:
 - The newly revised study analyzes the reaction of the cigarette market in 1999 and 2000 to price and tax increases due to the Master Settlement Agreement, and uses this as a base for future assumptions.
 - The model in this study is based on economics and its primary purpose is for forecasting.
- ◆ The revised estimates, shown earlier in this report, include the most recent information from DRI•WEFA. The use of this model is substantiated by its inclusion in Official Statements for Tobacco Securitization deals. DRI•WEFA continues to make advancements and continues to keep the public up to date.

ELSEWHERE IN THE TOBACCO INDUSTRY

- ◆ The historical trend continues to be a modest, steady decline in domestic cigarette consumption since 1981, averaging 2.14% annually through 2000. The single largest decline was 6.45% from 1998 to 1999.

Domestic Cigarette Consumption, 1965 – 2000 est.
(billions)



Source: DRI•WEFA Report, November 1, 2001.

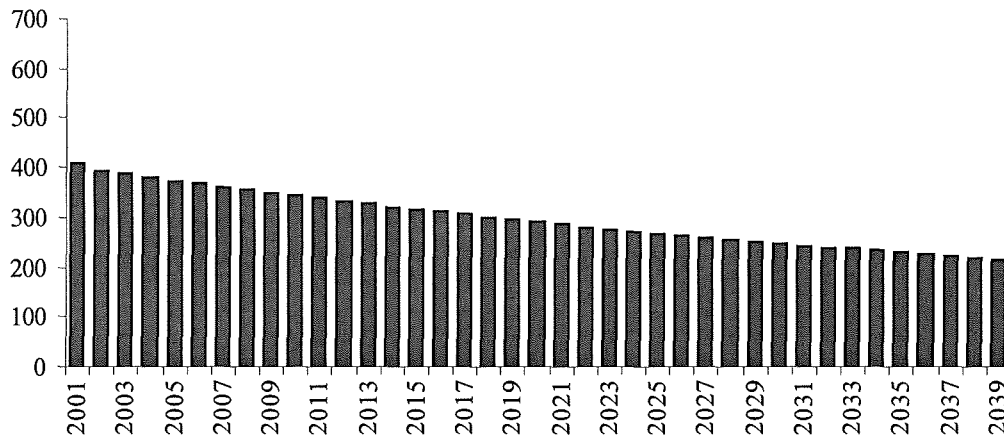
⁷ The econometric modeling is based on estimates and assumptions and cannot guarantee or predict all movements in the cigarette marketplace.



- ◆ DRI•WEFA, an econometrics consultant, has published the Base Case forecast of cigarette consumption shown below.

Projected Domestic Cigarette Consumption, 2001 - 2039

(billions)



Source: DRI•WEFA Report, November 1, 2001.

- ◆ DRI•WEFA increased its retail price assumption for 2000 from \$3.03 to \$3.39. however, aggressive discounting at the retail level has resulted in a lower average price for the year of \$3.20 per pack.
- ◆ As published in the DRI•WEFA Report, in the year 2000, lower than expected prices increased consumption and, after examining manufacturer's shipment data for the year, DRI•WEFA now estimates a consumption level for year 2000 of 423 billion, 12 billion more than its 2000 forecast. DRI•WEFA has also revised its year 2001 consumption projection upwards, to 408 billion from 401 billion.

Securitization of Tobacco Settlement Payments

- ◆ The tobacco companies are currently obligated to make payments to a national escrow account and the escrow account pays the respective proportional amount annually to the State.
- ◆ The State could sell or transfer to a dedicated trust fund, an independent authority, or a special purpose entity ("SPE") its right to receive the Settlement Payments.
- ◆ A governmental issuer or the SPE would sell bonds, the interest and principal of which are paid by the Settlement Payments.
- ◆ A portion of the overcollateralization amounts not used for debt service may transfer to the State free and clear of the financing transaction.
- ◆ The SPE would be a non-operating, bankruptcy-remote entity.
- ◆ 27 tobacco-backed bond issues have been sold as of December 6, 2001 totaling \$6.6 billion. Another 8 issues for approximately \$1.1 billion are expected to be sold through May 2002.



Office of Maine State Treasurer Dale McCormick

Completed Tobacco Settlement Payment Bond Issues as of December 6, 2001.

State/County	Issuer	Sale Date	Par Amount (000)
Alabama	Alabama 21 st Century Authority Tobacco Settlement Revenue Bonds, Series 2000	9/00 & 12/01	\$ 153,760
Alaska	Northern Tobacco Securitization Corporation Tobacco Settlement Asset-Backed Bonds, Series 2000	10/00 & 8/01	242,840
<u>Arkansas</u>	<u>Arkansas Development Finance Authority</u> Tobacco Settlement Revenue Bonds	09/99	60,000
California, Sacramento County	The Northern California Tobacco Securitization Authority Tobacco Settlement Bonds, Series 2001	08/01	199,620
California, Tulare County	Tulare County Public Financing Authority Variable Rate Demand Bonds, Series 1999	12/99	45,000
District of Columbia	District of Columbia Tobacco Settlement Financing Corp. Tobacco Settlement Asset-Backed Bonds, Series 2001	03/01	521,105
Guam	<u>Guam Economic Development Authority</u> <u>Tobacco Settlement Asset-Backed Bonds</u>	05/01 06/01	25,477
Iowa	Iowa Tobacco Settlement Authority Tobacco Settlement Bonds, Series 2001 A	10/01	644,245
Louisiana	Louisiana Tobacco Settlement Finance Corporation Tobacco Settlement Bonds, Series 2001 A/B	11/01	1,207,770
Mississippi-Litigation Attorneys	Legal Settlement Trust	5/01	51,000
New York City	New York City TSASC, Inc. Tobacco Flexible Amortization Bonds, Series 1999-1	11/99	709,280
New York, Chautauqua County	Chautauqua Tobacco Asset Securitization Corporation Tobacco Settlement Revenue Bonds, Series 2000	09/00	30,115
New York, Erie County	Erie Tobacco Asset Securitization Corporation Tobacco Settlement Asset-Backed Bonds, Series 2000A/B	09/00	246,325
New York, Monroe County	Monroe Tobacco Asset Securitization Corporation Tobacco Settlement Asset-Backed Bonds, Series 2000	08/00	163,400
New York, Nassau County	Nassau County Tobacco Settlement Corporation Tobacco Settlement Asset-Backed Bonds, Series A	11/99	294,500
New York, Niagra County	Niagara Tobacco Asset Securitization Corporation Tobacco Settlement Asset-Backed Bonds, Series 2000	10/00	47,920
New York, NYCTTI	New York Counties Tobacco Trust I Tobacco Settlement Pass-Through Bonds, Series 2000	11/00	227,130
New York, NYCTTH	New York Counties Tobacco Trust II Tobacco Settlement Pass-Through Bonds, Series 2001	11/01	215,220
New York, Ulster County	Ulster Tobacco Asset Securitization Corp. Tobacco Settlement Asset-Backed Bonds, Series 2001	01/01	28,352
New York, Westchester County	Westchester Tobacco Asset Securitization Corporation Tobacco Settlement Asset-Backed Bonds, Series 1999	12/99	103,504
North Dakota	North Dakota State Water Commission Water Development and Management Program Bonds, 2000A	03/00	32,100
Puerto Rico	The Children's Trust Fund (of Puerto Rico) Tobacco Settlement Asset-Backed Bonds, Series 2000	10/00	397,005



South Carolina	South Carolina Tobacco Settlement Management Authority Tobacco Settlement Asset-Backed Bonds, Series 2001A/B	03/01	934,530
TOTAL			<u>\$6,607,908</u>

Virgin Islands	Virgin Islands Tobacco Settlement Corporation Tobacco Settlement Bonds, Series 2001	11/01	21,710
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Tobacco Industry Litigation

- ◆ The jury in a class-action suit in Florida against R.J. Reynolds (the “Engle Case”) awarded \$12.7 million in compensatory damages to the three named plaintiffs on April 7, 2000 and awarded approximately \$145 billion as punitive damages to the entire class of plaintiffs on July 14, 2000. Philip Morris appealed the verdict to the Florida State Circuit Court, which then upheld the verdict. Other appeals remain outstanding.
- ◆ On May 7, 2001, Phillip Morris, Lorillard and Liggett reached a settlement agreement with the *Engle* plaintiffs whereby the three companies will forfeit a total of approximately \$709 million even if they are successful on appeal. The agreement provides that the three firms will post a \$2 billion bond and approximately \$1.3 billion will be refunded if the appeal is successful. Reynolds Tobacco and B&W are considering joining the agreement. The *Engle* plaintiffs have agreed not to challenge Florida’s legislation which caps the appeal bond.
- ◆ Some industry analysts believe that this judgement could materially adversely affect the ability of tobacco companies to make payments under the Master Settlement Agreement.
- ◆ The European Community (“EC”) brought suit against Reynolds Tobacco and Philip Morris alleging that the defendants engaged in a conspiracy to smuggle cigarettes into EC member states in an effort to evade taxes. On July 18, 2001, a US court found that the EC claims were without merit and dismissed the case. On August 6, 2001, the EC and 10 member states filed a second complaint against Reynolds Tobacco, Philip Morris and related companies. The EC’s second complaint is essentially a resubmission of the first complaint. It seeks unspecified damages including compensatory damages, injunctive relief, and treble damages under RICO.
- ◆ Several lawsuits are also being filed to recover health care costs. In June 2001, a federal jury in the Eastern District of New York awarded Empire Blue Cross \$17.8 million in compensatory damages for violations of consumer protection statutes and \$11.8 million in separate but overlapping claims.



Federal Litigation

- ◆ A trial date has been set for 2002 for a civil lawsuit the Justice Department filed September 22, 1999 against major tobacco companies to recoup health-related expenses paid to veterans, military personnel, federal employees and the elderly through Medicare payments.
- ◆ The suit also alleges industry collusion to conceal risks to consumers using the federal civil racketeering statute (RICO).
- ◆ The district court has granted the tobacco companies' motion to dismiss the Medical Care Recovery Act and the Medicare Secondary Payer Act claims. This motion has been upheld through two sets of appeals. The RICO claims portion of the suit remains.
- ◆ Maine's TSPs could be reduced if the Justice Department succeeds in its lawsuit or reaches a settlement requiring payment by the manufacturers. The reduction could occur under several circumstances:
 1. The Original Participating Manufacturers are required to make settlement payments to the federal government or to return "ill-gotten gains" as determined by a federal judge under RICO and subsequently must increase prices to afford the payments, initiating a decline in consumption; or
 2. The federal government gives amounts received from the OPMs to the Settling States either:
 - (a) unrestricted or
 - (b) "restricted to any form of health care or to any use related to tobacco" if certain other conditions are met.In this case, Maine's TSP would be reduced dollar-for-dollar by the amount received from the federal government.