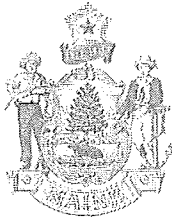


MAINE STATE LEGISLATURE

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DALE MCCORMICK
Treasurer of State

State of Maine
Office of the Treasurer of State

39 State House Station
Augusta ME 04333-0039
207.624-7477 (voice) 207.287-2367 (fax)

December 12, 2003

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

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 2006/2007 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 \$224.2 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 All earnings are deposited into the Fund. 2001 Public Law Chapter 358 repealed the Trust Fund and redirected all future revenues to the Fund for a Healthy Maine.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,

A handwritten signature in black ink that reads 'Dale McCormick'.

Dale McCormick

C: Governor John E. Baldacci, Legislative Leadership, Attorney General G. Steven Rowe, Grant Pennoyer, Dr. Dora Mills, Paul D. Stern, Melissa O'Dea



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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>
	FY 00 Total	\$63,176,643.10
	FY 01 Total	\$47,819,279.67
	FY 02 Total	\$56,317,761.88
.....		
FY 03	12/31/02	\$12,337,911.34
	01/10/03	\$ 4,120,260.50 ¹
	04/15/03	\$37,943,522.05
	04/17/03	\$ 1,405,338.82 ²
.....		
FY 04 to date	06/30/03	\$ 514,338.92 ³
	06/30/03	\$ 128,481.54 ⁴
	10/01/03	\$ 480,058.81 ⁵
	10/01/03	\$ 5,447.04 ⁶

Fund for a Healthy Maine (FHM) Balance

Total Principal Deposits:	\$224,249,043.67	Life to Date
Earnings:	\$7,125,981.90	FY 00, 01, 02, & 03
	\$8,042.56	FY 04 to date
Transfers In (in FY 04):	\$3,000,000	YTD Working Capital Advances
Fund Balance:	\$919,994.02	(as of 12/08/2003)

¹ This payment represents the remainder of the Initial Payment that was not released on 12/31/2002.

² Remainder of payment due from R J Reynolds. Their full wire did not meet the cut-off for the regular payment.

³ Release of disputed funds held from FY03 payment. Booked in FY04.

⁴ Came with the \$514,338.92 payment as an advance against the FY04 payment (for a total deposit of \$642,820.46). RJR owed the states less than was on deposit in the disputed escrow account, so the Independent Auditor released the entire amount and booked the difference as a credit against FY04.

⁵ Release of further disputed funds held from FY03 – two companies were under-reporting sales. Booked in FY 04.

⁶ Came with the \$480,058.81 as a credit against the FY04 payment (for a total deposit of \$485,505.85). The credit will be applied towards the FY04 payment.



ESTIMATED FUTURE TOBACCO SETTLEMENT PAYMENTS

	<u>Original Estimates</u>	<u>Revision</u>	<u>Current Estimates</u>
4/15/2004	\$49,654,499	(\$515,649)	\$49,138,850
4/15/2005	\$50,307,367	(\$1,535,240)	\$48,772,127
4/15/2006	\$51,215,374	(\$1,645,684)	\$49,569,690
4/15/2007	\$52,075,923	(\$1,747,640)	\$50,328,283

- The Office of the Treasurer of State's original Tobacco Settlement Payment (TSP) Projections shown above were estimated in November 2002 using the then current DRI•WEFA base case scenario econometric model.
- The revised estimates, in bold above, include the most recent information from Global Insight (formerly known as DRI•WEFA). Adjustments to the econometric model were made as a result of the newest data. The revised forecast was presented to the Revenue Forecasting Committee on November 14, 2003.
- In addition to the downward revisions for the TSP's, there were also downward revisions to the interest earnings on the Fund for a Healthy Maine as a result of severely decreased cash balances in the fund. The balance in the fund will be minimal, with working capital advances made from the General Fund when major program expenditures are required from the Fund for a Healthy Maine.



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's Office estimates future Tobacco Settlement Payments using the econometric model developed by Global Insight (formerly DRI•WEFA). This model was developed for the purpose of projecting payments to states using the most current information available.

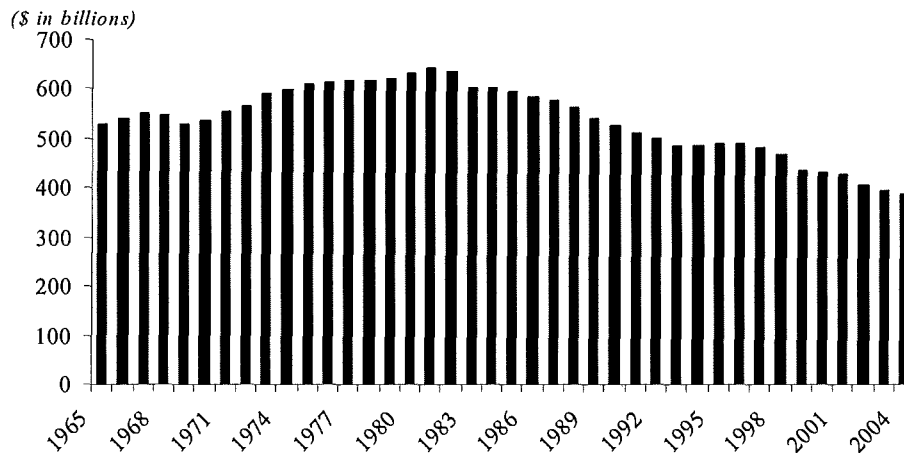


- ◆ The Treasurer of State’s projections of November 2003 were based on the current Global Insight base case scenario econometric model, which was developed to study U.S. Cigarette Consumption and addressed the volume adjustment – the adjustment with the greatest effect on Maine’s Tobacco Settlement Payments.
- ◆ The Global Insight 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 is based on historical U.S. data between 1965 and 2001.
 - 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 Global Insight. The use of this model is substantiated by its inclusion in Official Statements for Tobacco Securitization deals. Global Insight 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. Between 1981 and 1990, consumption declined at an average annual rate of 2.18%, and from 1990 to 1998, the average annual rate of decline was 1.51%, but for 1998 the decline increased to 3.13% and then the decline for 1999 accelerated to 6.45%. These sharp recent declines are correlated with the large price increases in 1998 and 1999. In 2000 and 2001, the rate of decline moderated, to 1.15% and 1.16%, respectively.

Domestic Cigarette Consumption, 1965 – 2004 est.



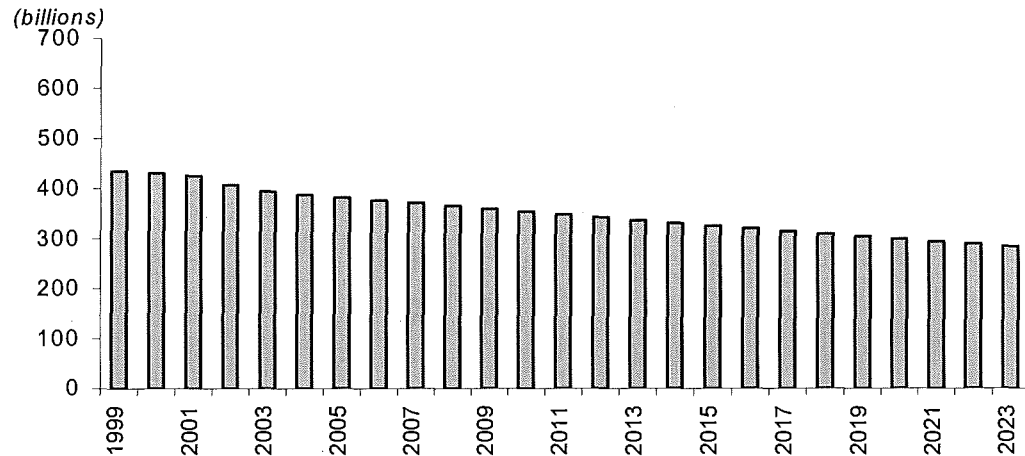
Source: Global Insight Report, November 6, 2003.

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



- ◆ Global Insight, an econometrics consultant, has published the Base Case forecast of cigarette consumption shown below.

Projected Domestic Cigarette Consumption, 1999 - 2023



Source: Global Insight Report, November 6, 2003.

- ◆ Global Insight estimated that for the year 2000, the average price per pack was \$3.20, representing a nominal growth in the price of cigarettes of 11.0% from 1999. For 2001, we estimate that the average price was \$3.45.
- ◆ As published in the Global Insight Report, in the year 2000, lower than expected prices increased consumption and, after examining manufacturer's shipment data for the year, Global Insight now estimates a consumption level for year 2000 of 430 billion, 7 billion more than its 2001 forecast. Global Insight has also revised its year 2001 consumption projection upwards, to 425 billion, 6 million more than previously projected. Cigarette consumption is now estimated to have fallen to 407 billion in 2002, and is expected to further decrease to 394 billion in 2003. Global Insight estimates that consumption declined by 4.4% in 2002, and will decline by 3.2% in 2003.

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 over collateralization 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.
- ◆ 51 tobacco-backed bond issues have been sold as of December 5, 2003 totaling \$22.6 billion. An additional issue is expected to be sold in January 2004 for approximately \$2.2 billion.



Office of Maine State Treasurer Dale McCormick

Completed Tobacco Settlement Payment Bond Issues as of December 5, 2003.

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 & 2001	10/00 & 8/01	242,840
Arkansas	Arkansas Development Finance Authority Tobacco Settlement Revenue Bonds, Series 2001	09/99	60,000
California/Alameda County	California County Tobacco Securitization Agency Tobacco Settlement Asset-Backed Bonds, Series 2002	10/02	220,525
California/Fresno County	California County Tobacco Securitization Agency Tobacco Settlement Asset-Backed Bonds, Series 2002	07/02	92,955
California/Golden State	Golden State Tobacco Securitization Corporation Tobacco Settlement Asset-Backed Bonds Series A	01/03	3,000,000
California/Golden State	Golden State Tobacco Securitization Corporation Tobacco Settlement Asset-Backed Bonds Series B	09/03	2,572,285
California/Kern County	California County Tobacco Securitization Agency Tobacco Settlement Bonds, Series 2002A-C	04/02 & 05/02	105,245
California/Litigation Attorneys	Legal Settlement Trust, 2002-A	06/02	53,750
California/Marin County	California County Tobacco Securitization Agency Tobacco Settlement Asset-Backed Bonds, Series 2002A & B	06/02	34,345
California/Merced County	California County Tobacco Securitization Agency Tobacco Settlement Bonds, Series 2002A & B	03/02	30,515
California/Placer County	California County Tobacco Securitization Agency Tobacco Settlement Asset-Backed Bonds, Series 2002	06/02	41,590
California/Pooled Program	California Statewide Financing Authority Tobacco Settlement Asset-Backed Bonds, Series 2002A&B	06/02 & 07/02	196,545
California, Sacramento County	The Northern California Tobacco Securitization Authority Tobacco Settlement Bonds, Series 2001	08/01	199,620
California/San Diego County	Southern California Tobacco Securitization Authority Tobacco Settlement Bonds, Series 2001A & B	12/01	466,840
California/Sonoma County	California County Tobacco Securitization Agency Tobacco Settlement Bonds, Series 2002A	04/02	67,410
California/Stanislaus County	California County Tobacco Securitization Agency Tobacco Settlement Bonds, Series 2002A & B	03/02	67,305
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	Guam Economic Development Authority Tobacco Settlement Asset-Backed Bonds, Series 2001 A & B	05/01 06/01	25,477
Hawaii	Board of Regents of the University of Hawaii University Bonds, Series 2002A	06/02	150,000
Iowa	Iowa Tobacco Settlement Authority Tobacco Settlement Bonds, Series 2001 A & B	10/01	644,245
Louisiana	Louisiana Tobacco Settlement Finance Corporation Tobacco Settlement Bonds, Series 2001 A & B	11/01	1,202,770



Office of Maine State Treasurer Dale McCormick

Mississippi-Litigation Attorneys	Legal Settlement Trust	5/01	50,500
New Jersey	Tobacco Settlement Financing Corporation Tobacco Settlement Asset-Backed Bonds, Series 2002	08/02	1,801,455
New York	Tobacco Settlement Financing Corporation Asset-Backed Revenue Bonds Series 2003A	06/03	2,310,705
New York City	New York City TSASC, Inc. Tobacco Flexible Amortization Bonds, Series 1999-1 & 2002-1	11/99 & 08/02	1,209,280
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/Niagara 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	7/01	215,220
New York/Rensselaer County	Rensselaer Tobacco Asset Securitization Corporation Tobacco Settlement Asset-Backed Bonds, Series A	12/01	34,555
New York/Rockland County	Rockland Tobacco Asset Securitization Corporation Tobacco Settlement Asset-Backed Bonds, Series 2001	12/01	47,750
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	103,505
Puerto Rico	The Children's Trust Fund (of Puerto Rico) Tobacco Settlement Asset-Backed Bonds, Series 2000 & 2002	10/00 & 10/02	1,568,205
Rhode Island	Tobacco Settlement Financing Corporation Tobacco Settlement Asset-Backed Bonds, Series 2002A & B	06/02	685,390
South Carolina	South Carolina Tobacco Settlement Management Authority Tobacco Settlement Asset-Backed Bonds, Series 2001A & B	03/01	934,530
South Dakota	Educational Enhancement Funding Corporation Tobacco Settlement Asset-Backed Bonds, Series 2002A & B	09/02	278,045
Virgin Islands	Virgin Islands Tobacco Settlement Corporation Tobacco Settlement Bonds, Series 2001	11/01	21,710
Washington	Tobacco Settlement Authority Tobacco Settlement Asset-Backed Bonds, Series 2002	10/02	517,905
Wisconsin	Badger Tobacco Asset Securitization Corp. Tobacco Settlement Bonds	05/02	1,591,095
TOTAL			\$ 22,601,719



Tobacco Industry Litigation

- ◆ On January 27, 2003, Philip Morris formally changed its name to Altria Group Inc. Altria's domestic and international tobacco companies will continue to be known as Philip Morris USA and Philip Morris International Inc.
- ◆ As of August 1, 2003, there were approximately 65 class action lawsuits pending against cigarette manufacturers as purported class actions in the United States, compared with approximately 45 such cases on December 31, 2001.
- ◆ On September 16, 2003, the Illinois Supreme Court agreed to hear Philip Morris' appeal in the *Price v. Philip Morris Cos., Inc.* case. The plaintiffs in this case alleged consumer fraud claims and sought economic damages in the form of a refund of purchases of cigarettes. In light of this case and other litigation, several rating agencies have downgraded the ratings of Philip Morris' parent company, Altria Group, Inc., and the ratings on tobacco settlement securitization.

Tobacco Environment

- ◆ On September 1, 2003, Alabama became the fiftieth state to require smoke-free indoor air in certain public places.
- ◆ In March 2003, the New York State Legislature passed, and the governor signed, legislation banning smoking in indoor workplaces, including restaurants and bars. Delaware had banned smoking in indoor public areas in 2003.
- ◆ These states join California in imposing comprehensive statewide smoking bans. The California ban has been in place since 1998.
- ◆ The States of Connecticut and Maine recently adopted legislation which will ban smoking in restaurants and bars.
- ◆ The state of Florida also, as a result of a referendum in 2002, established a smoking ban, though it exempts certain bars.
- ◆ Comprehensive bans took effect in New York City and Dallas in March 2003 and Boston in May 2003.

Federal Litigation

- ◆ 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.