SENATE FISCAL AGENCY
MEMORANDUM

DATE: May 2, 2006

TO: Members of the Senate

FROM: Gary S. Olson, Director

RE: Tobacco Settlement Revenue Update

On April 17, 2006, the State of Michigan received its annual payment from the United States tobacco industry pursuant to terms and conditions of the 1998 master settlement agreement between 46 states and the United States tobacco industry. The total payment received by Michigan was $256.0 million. This payment was $30.1 million below the expected full payment level of $286.1 million because two of the major tobacco companies utilized a provision of the master settlement agreement to reduce their scheduled payment to the states. This memorandum provides information regarding this payment reduction and the impact of this payment reduction on the State budget.

Tobacco Settlement Payments to Michigan

During the period FY 1999-2000 through FY 2004-05, Michigan has received a total of $1.82 billion of payments from the United States tobacco industry pursuant to terms and conditions of the 1998 master settlement agreement. Payments are made from the three major United States tobacco companies, Philip Morris USA, R.J. Reynolds Tobacco Company, and Lorillard Company, and from 47 other smaller tobacco companies that have joined with the settlement following the approval of the master settlement agreement in 1998. The payments that are made to Michigan each year are based on specific numbers spelled out in the master settlement agreement. These numbers are adjusted annually to reflect inflationary increases and reductions in the overall level of tobacco consumption across the country.

Based on the payment schedule outlined in the master settlement agreement and projections of inflationary and consumption adjustments, Michigan should have received a total payment of $286.1 million on April 17, 2006. This payment would have included $266.7 million from the three major tobacco companies and $19.4 million from the 47 smaller tobacco companies. Michigan did receive the $19.4 million payment from the 47 smaller tobacco companies, but the $266.7 million payment from the three major tobacco companies was reduced by $30.1 million as two of the major companies invoked a provision of the master settlement agreement which allowed them to reduce their payments to Michigan. Michigan received a full payment from Philip Morris USA, but received reduced payment levels from R.J. Reynolds and Lorillard Company. These payment reductions were made under a provision of the master settlement agreement referred to as the "Non-participating manufacturer adjustment".

Non-Participating Manufacturer Adjustment

The non-participating manufacturer adjustment is a provision of the master settlement agreement that requires states to enforce the terms of the settlement agreement, including payments to the states, with the smaller tobacco companies that were not part of the original settlement. The first step that states had to take to conform with the provision was to enact legislation which required the smaller tobacco companies to participate in the settlement agreement. Michigan passed a statute in 1999 that enforced these provisions (Public Act 244 of 1999). The master settlement agreement then required states to enforce these provisions on the smaller tobacco companies. The non-participating manufacturer adjustment is a mechanism for the three large tobacco companies to reduce their required payments to the states if it can be proven that the terms of the settlement agreement have resulted in a decline in the companies' share of the total United States tobacco market. The companies also must prove that this market share reduction results from the states not diligently enforcing the terms of the settlement on the smaller companies.

During March 2006, the R.J. Reynolds Company and Lorillard Company informed the states that they were exercising their rights in the settlement agreement to enforce a payment reduction to the states based on this adjustment. An independent economic analysis firm reviewed the companies' claims and backed their belief that the payments should be reduced under the non-participating manufacturer adjustment. The states then have notified the two tobacco companies that they dispute these claims and intend to challenge the payment reductions in court.

On April 17, 2006, the R.J. Reynolds Company and Lorillard Company deposited $30.1 million of their total scheduled payments to Michigan into a disputed payment account. The funds will stay in this disputed payment account until the courts determine if Michigan has diligently enforced all the terms of the settlement agreement on the smaller tobacco companies. If Michigan eventually succeeds in this court battle, the $30.1 million will be released from the disputed payment account and paid to the State along with interest payments.

It now appears that any resolution of this payment dispute between Michigan and R.J. Reynolds Company and Lorillard Company will take considerable time to be resolved. Therefore, the amount of tobacco settlement revenue to be received by Michigan in FY 2005-06 is reduced by the $30.1 million non-participating manufacturer adjustment.

State Budget Impact

The enacted FY 2005-06 State budget assumed a full payment from the tobacco companies under the master settlement agreement. The $30.1 million disputed payment means that the total level of FY 2005-06 appropriations supported from tobacco settlement revenue is overstated by approximately $22.0 million. Adjustments will have to be made in the current year budget to correct this funding shortfall. The most likely adjustment, at this point of the fiscal year, is to approve a supplemental appropriation bill before the end of the fiscal year, which shifts $22.0 million of appropriations supported by tobacco settlement revenue to General Fund/General Purpose (GF/GP) revenue. Based on the current estimates of FY 2005-06 GF/GP revenue and appropriations there should be sufficient surplus revenue to make this funding change. The overall budget impact will be to reduce the amount of surplus FY 2005-06 GF/GP revenue that will be available to help balance the FY 2006-07 GF/GP budget.

If you have any questions on this tobacco settlement revenue shortfall, please call my office at 517-373-5300.

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c: Ellen Jeffries, Deputy Director

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