



ADJUSTMENTS TO THE STATES' TOBACCO SETTLEMENT RECEIPTS

The states' settlement agreements with the cigarette companies provide for *base payments* to the states totaling \$8.6 billion in 2001, with payments over the next decade averaging \$9 billion per year. But these base payment amounts will be adjusted to account for inflation, reduced nationwide cigarette sales, and, possibly, other factors.¹ Accordingly, the states will receive final payments in 2001 totaling about \$7.7 billion, with average annual payments of roughly \$8.5 billion per year over the next 10 years. At the same time, the increasing power of the compounded upward inflation adjustment will steadily reduce the annual reductions to the settling states' base payment amounts over the next 10 years, even with continued declines in U.S. smoking. In fact, the inflation adjustment is expected to offset the downward volume adjustments completely at the end of this decade and then begin to increase the settling states' payments. In addition, the reductions in U.S. cigarette consumption that produce the downward volume adjustments will inevitably produce enormous health benefits and related cost savings in those states with corresponding declines in their own smoking rates.

Adjustments to the States 2000 and 2001 Tobacco Settlement Receipts. The two payments the states received through the Multistate Settlement Agreement (MSA) in 2000 were reduced by 13.7 percent to account for the decline from 1997 to 1999 in the major cigarette companies' shipments for sale in the United States. But the states' second MSA payments, in April, also were adjusted upward by three percent to account for inflation, producing a net reduction in the MSA states' total 2000 settlement receipts of about 12.1 percent. For 2001, the downward volume adjustment has been preliminarily set at 14.4 percent and the upward inflation adjustment will total 6.09 percent, producing a net reduction to state MSA receipts of about 11.1 percent.

The Inflation Adjustment. The most powerful and predictable settlement payment adjustment is the automatic upward inflation adjustment, which increases the base amounts the settling states will receive each year by three percent or the actual rate of inflation, *whichever is highest*. Although the inflation adjustment does not apply to the MSA's "Initial Payments" that the states will receive each January through 2003, it applies to all other settlement payments and will quickly increase the states' receipts. Through 2005, the inflation adjustment will adjust the state's payments upward by about \$5 billion. Through 2015, it will add more than \$40 billion.

The Volume Adjustment. Whenever the major cigarette companies' total U.S. sales shipments in any year fall more than two percent lower than their 1997 level, the MSA's volume adjustment will reduce the companies' following-year payments to the settling states by 0.98 times the percentage volume decline. Because of the companies' recent price increases, their total U.S. cigarette shipments declined by 14.01 percent from 1997 to 1999, producing a year 2000 downward volume adjustment of 13.73 percent. The decline in shipments from 1999 to 2000 is currently estimated to be quite small, producing a total decline of 14.67 percent from 1997 to 2000, for a preliminary downward volume adjustment of 14.38 percent for the 2001 payments. Although the volume adjustment reflects the decline in U.S. cigarette consumption since 1997, it is specifically based on the change since 1997 to the major cigarette companies' shipments for sale in the United States, which is not the same thing. From 1997 to 1999, U.S. cigarette consumption dropped by 9.4 percent but the major U.S. companies' cigarette shipments declined by 14 percent, producing a 13.7 percent downward volume adjustment to state MSA payments in 2000.

Looking ahead, experts expect future U.S. sales declines to average about 1.5 percent per year. As Philip Morris Chairman and CEO Geoffrey Bible said in April 1999, "we've seen the biggest part of the decline" and future reductions to U.S. consumption should average roughly one to 1.5 percent per year.² Similarly, Brown & Williamson President Earl Kohnhorst stated that "we expect domestic volumes to improve. Our projections show the current decline will slow and an uptick in consumption may not be too far down the road."³ If a substantial number of states invest a significant portion of their settlement payments in

¹ The four independently settling states (MS, FL, TX, MN) experienced parallel adjustments to their payments.

comprehensive tobacco-control programs, however, national smoking declines could be somewhat higher than currently estimated, and the corresponding volume adjustments would increase more quickly than anticipated. But the states making such substantial tobacco prevention investments also would experience much larger off-setting health benefits and economic savings. Only those states with smoking declines below the national average would risk being net losers.

The Volume Adjustment Modifier. The downward volume adjustments will be reduced in any year that the cigarette companies' aggregate operating income (roughly equal to profits) from U.S. cigarette sales exceeds their inflation-adjusted operating income for 1996 – with the volume adjustment reduced by an amount equal to 25 percent of the companies' total operating income increase. As odd as it may sound, the cigarette companies could experience such increased profits even as their total sales volume drops. The cigarette companies' 1998-1999 price hikes, for example, will increase their combined revenues from U.S. cigarette sales well beyond what they need to cover all their settlement costs, despite the substantial decline in the number of packs sold. Whether the volume adjustment modifier will actually dampen the reported downward volume adjustment in the future, however, is not yet known.

Possible Impact of the Adjustments to the Settling States' Settlement Payments

The following table shows that the states' settlement payments will remain quite stable even if U.S. cigarette consumption continues to drop steadily – and even if only the minimum possible upward adjustments apply. The table's figures are based on a volume adjustment of 13.73 percent for 2000 and 14.38 percent for 2001, and on the following assumptions: 1) the cigarette companies' U.S. shipments will decline by 1.5 percent per year after 2000; 2) only the minimum three percent upward inflation adjustment will apply each year; and 3) the volume adjustments will not be reduced in any year to account for increased company profits.

The States' Projected Settlement Payment Adjustments & Receipts (all amounts in billions of dollars)

	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
Base Amount	3.36	8.04	8.64	10.28	9.93	8.29	8.29	8.29	8.29	9.26
+ Inflation Adj.	.25	0.17	0.36	0.68	0.90	1.36	1.65	1.95	2.26	2.87
- Volume Adj.	0.0	-1.13	-1.29	-1.74	-1.88	-1.81	-2.01	-2.22	-2.45	-2.99
Final Amount	3.61	7.08	7.70	9.23	8.96	7.84	7.93	8.02	8.10	9.14

	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Base Amount	9.26	9.26	9.26	9.26	9.26	9.26	9.26	9.26	9.26	9.27
+ Inflation Adj.	3.23	3.61	3.99	4.39	4.80	5.22	5.65	6.10	6.56	7.05
- Volume Adj.	-3.26	-3.55	-3.85	-4.17	-4.50	-4.85	-5.21	-5.60	-6.00	-6.42
Final Amount	9.23	9.31	9.40	9.48	9.56	9.63	9.70	9.77	9.83	9.89

Note: Amounts are rounded. Base payments stay at the 2018 amount in subsequent years, subject to all adjustments.

Offsetting Benefits from Volume Declines

The reductions in settlement payments to the states caused by reduced cigarette consumption will be accompanied by all of the many benefits and cost savings associated with the smoking declines in each state. Each year, smoking-caused health care expenditures in the settling states total at least \$89 billion, including smoking-caused Medicaid payments of about \$17 billion per year.⁴ Declines in smoking, nationwide, will reduce both these costs and the many others caused by tobacco use, while also saving lives and improving the public health of its citizens. Most notably, studies show that adequate investments in comprehensive statewide tobacco prevention efforts quickly reduce the number of smoking-caused birth complications and infant health problems, heart attacks, and strokes, and even start reducing lung cancer deaths within about five years – with large corresponding reductions in smoking-caused health care costs.⁵ Similarly a recent study found that Massachusetts – one of the very few states with a tobacco-prevention program that has been up and running for some time – is annually saving well over two dollars in reduced

smoking-caused health care costs for every single dollar it is spending on its comprehensive tobacco prevention efforts.⁶

Other Settlement Payment Adjustments Not Likely to Come Into Play

Nonparticipating Manufacturers Adjustment. This downward adjustment to the settlement payments is activated if any cigarette manufacturers that are not part of the settlement agreement take more than two percent of market share away from those companies that are. Although a January 2001 retroactive NPM adjustment to the 2000 payments to a dozen or so states is now under dispute, no NPM adjustment will be made to the 2001 payments and no NPM adjustments are likely in the future. Besides the fact that a large number of originally nonparticipating manufacturers have now signed onto the agreement (27 as of November 2000), virtually all the settling states have now passed the "Model Statute" pertaining to nonparticipating manufacturers that blocks the NPM adjustment from every being applied to them.

Federal Offset Provision. The settlement agreement also provides for reductions to the payments to the states if the federal government passes any new laws prior to November 30, 2002 that: 1) require the cigarette companies to make new payments to the federal government; and 2) direct those funds to the state governments for unrestricted, health care, or tobacco-related purposes. But it is highly unlikely that Congress will take any action that would reduce the cigarette companies' payments to the states. Even if Congress did increase federal tobacco taxes, for example, it would be easy to distribute the funds to the states without triggering the offset.

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¹ The complete text of the multistate settlement agreement between the states and the cigarette companies – which describes each of the payment adjustments – is available at the website of the National Association of Attorneys General (NAAG), www.naag.org. The individual tobacco settlement agreements separately entered into by Mississippi, Florida, Texas, and Minnesota include parallel adjustment provisions.

² Ress, D, "Philip Morris: Worst of Sales Slide is Over," *Richmond Times-Dispatch*, April 30, 1999.

³ PR Newswire, "B&W Executive Talks with Farmers About Difficult Year, Reasons for Optimism," December 6, 1999.

⁴ Zhang, X, et al., "Cost of Smoking to the Medicare Program, 1993," *Health Care Financing Review* 20(4):1-19, Summer 1999.

⁵ Lightwood, JM, Phibbs, CS & Glantz, SA, "Short-Term Health and Economic Benefits of Smoking cessation: Low Birth Weight," *Pediatrics* 104(6):1312-1320, December 1999; Lightwood, JM & Glantz, SA, "Short-Term Economic and Health Benefits of Smoking Cessation – Myocardial Infarction and Stroke," *Circulation* 96(4):1089-1096, August 19, 1997; U.S. Centers for Disease Control & Prevention, "Declines in Lung Cancer Rates—California 1988-1997," *Morbidity and Mortality Weekly Report* 49(47):1066-1069, December 1, 2000.

⁶ Harris, JE, "Status Report on the Massachusetts Tobacco Control Campaign, with a Preliminary Calculation of the Impact of the Campaign on Total Health Care Spending in Massachusetts," 2000.