

KANSAS LEGISLATIVE RESEARCH DEPARTMENT

68-West-Statehouse, 300 SW 10th Ave.
Topeka, Kansas 66612-1504
(785) 296-3181 • FAX (785) 296-3824

kslegres@klrd.ks.gov

<http://www.kslegislature.org/klrd>

January 18, 2017

TOBACCO SETTLEMENT

Master Settlement Agreement

In 1998, Kansas became 1 of 46 states to accept a tobacco settlement negotiated with four major tobacco companies. (The remaining 4 states settled individually.) The settlement, called the Master Settlement Agreement, was aimed at reducing the use of tobacco by young persons, settling legal claims by states against the tobacco industry, and providing reimbursement for health care costs of treating Medicaid patients whose illnesses were caused by tobacco. Under terms of the agreement, the tobacco industry is prohibited from targeting youth in marketing and is subject to restrictions concerning sponsorships, advertising, and tobacco promotions.

Each state and territory gets the proportion of the settlement that its smoking-related health care costs bear to the total. The allocation formula is based on each state's smoking-related health care costs, with equal weight given to Medicaid-related and non-Medicaid-related costs. Kansas' share of the recovery is 0.83 percent, which, based on the original estimate, was expected to exceed \$1.5 billion over the first 25 years of the agreement. Payments are based on the tobacco companies' market share of tobacco product sales and are subject to an annual inflation factor of three percent, or the increase in the Consumer Price Index, whichever is greater.

The Master Settlement Agreement also provides that payments to states could be reduced if tobacco sales go down or if tobacco companies go out of business. It is this latter provision that causes concern over future payments.

The tobacco industry is required to make payments to the states in perpetuity. Original estimates were that the industry would pay states \$206 billion through the year 2025. Not all tobacco companies are party to the settlement. Those that are not are required to put into escrow an amount of money equal to what they would pay under the settlement. This is to level the playing field so non-participating manufacturers will not have a competitive advantage over participating manufacturers.

Arbitration

Under the Master Settlement Agreement, companies are allowed to make payments into a disputed payments account, and those funds are held until a legal resolution is reached regarding those payments. In December 2012, through an arbitrated "settlement in principal," Kansas agreed to receive 54.0 percent, approximately \$46.0 million, of the money remaining in the disputed payments account, and the tobacco manufacturers received the other 46.0 percent of the money. The arbitration panel found the "settlement in principal" to be sufficient and issued

an award to that effect. If the “settlement in principal” is allowed to stand, Kansas’ liability for past allegations of failure to diligently enforce its obligation will be eliminated. A final agreement has not been signed, and several states have filed lawsuits seeking to set aside the “settlement in principal.” If a final agreement is signed, it will resolve the disputes for enforcement years 2003 to 2012.

Tobacco Payments to Kansas

Kansas received its first tobacco revenues in 1999. In general, payments have been less than originally estimated. In FY 2016, tobacco revenues and interest earnings totaled \$59.1 million. Revenues were estimated to be \$58.0 million in FY 2017.

It is important to note that beginning in FY 2008 revenues include funds from the “Strategic Contribution Fund” provisions of the Master Settlement Agreement. These provisions require the tobacco companies to pay, from 2008 through 2017, a total of \$861 million into the Strategic Contribution Fund. Money from the Strategic Contribution Fund is to be allocated to states based on the percentage each state contributed to the original Master Settlement Agreement. Kansas’ share of this amount is 1.85 percent. According to the Kansas Attorney General’s Office, it is unclear how the Strategic Contribution Fund payments will be affected by recent actions of the tobacco companies to withhold payments under the agreement while they are disputing the basis of payments to be made.

KANSAS TOBACCO REVENUES AND INTEREST EARNINGS	
FY 1999	\$ 49,705,586
FY 2000	52,935,158
FY 2001	61,465,211
FY 2002	61,511,858
FY 2003	52,531,729
FY 2004	53,453,765
FY 2005	49,463,355
FY 2006	47,515,501
FY 2007	46,900,000
FY 2008	66,347,833
FY 2009	72,278,198
FY 2010	60,838,465
FY 2011	57,091,087
FY 2012	57,985,065
FY 2013	68,034,311
FY 2014	62,378,062
FY 2015	62,452,849
FY 2016	59,133,333
FY 2017 (est)	58,000,000
FY 2018 (est)	49,000,000
FY 2019 (est)	48,000,000

Concern Over Future Payments

The amount of tobacco money the states will receive is affected by several factors, including an overall decrease in tobacco consumption which results in diminished sales of

tobacco products and lower payments to states. The market share of tobacco companies that are participating in the settlement also is being reduced by sales of nonparticipating manufacturers, and the possibility exists that one or more of the major participating manufacturers could declare bankruptcy. The most immediate and direct threat to the tobacco revenue stream is a clause in the Master Settlement Agreement that permits participating manufacturers to seek refund of money paid to the states when there is a drop in their market share below a threshold established in 1997.

That threshold was triggered in 2003, and 2006 was the first year for which revenues were affected. In 2006, R. J. Reynolds Tobacco Company and Lorillard Tobacco Company withheld all or part of their payments to the states, contending that under the Master Settlement Agreement, the payments were not due because of declining market shares. The National Association of Attorneys General, which has played a leadership role among the states with regard to the tobacco settlement, takes the position that the tobacco companies owe the states the full payment until the industry can demonstrate that the states have failed to exercise due diligence in enforcing the tobacco settlement. (The Settlement is complicated, and there is disagreement between the industry and the states as to exactly how the downward adjustment clause should be interpreted or applied.) In June 2007, the state received \$394,424 in funding from the disputed payments account. In March 2009, the state received \$4.5 million from the disputed payments account.

Kansas Endowment for Youth/Children's Initiatives Fund

The Master Settlement Agreement does not impose any constraints on how the states may use their tobacco money. In Kansas, the 1999 Legislature enacted legislation that established a trust fund into which tobacco payments are credited and created the Kansas Children's Cabinet to advise the Governor and the Legislature on programs to be funded from the tobacco money. The trust fund, named the "Kansas Endowment for Youth (KEY) Fund," is invested and managed by the Board of Trustees of the Kansas Public Employees Retirement System. The settlement payments are placed in the KEY Fund.

The Legislature also created the Children's Initiatives Fund. The Children's Initiatives Fund is administered by the Children's Cabinet, a 15-member committee consisting of appointees of the Governor and Legislature and *ex officio* members. The Cabinet is responsible for initiating audits and reviews of the programs receiving Children's Initiatives Fund money. The legislation provided that transfers would be made from the KEY Fund to the Children's Initiatives Fund on an annual basis.

Transfers from the KEY Fund to the Children's Initiatives Fund are set at 102.5 percent of the amount transferred the previous year. Expenditures from the Children's Initiatives Fund are requested by the Children's Cabinet through the Department of Education, recommended by the Governor, and approved by the Legislature. The Kansas tobacco settlement is the primary revenue source for the Children's Initiatives Fund.

In general, the KEY Fund has not served as the endowment fund that was envisioned. This is attributed to a combination of less tobacco payment revenue than expected and shortfalls to the State General Fund which have resulted in balances in the KEY Fund being transferred to the State General Fund rather than allowing them to accumulate. The following chart details transfers from the KEY Fund to the State General Fund. The transfers in the first two fiscal years were authorized in the 1999 enabling statute, KSA 38-2102.

**KEY FUND TRANSFERS TO THE
STATE GENERAL FUND**

FY 2001	\$	91,078,133
FY 2002		16,000,000
FY 2003		24,326,752
FY 2004		9,900,000
FY 2005		1,654,514
FY 2006		375,957
FY 2009		4,097
FY 2010		14,291,913
FY 2013		9,500,000
FY 2015		12,000,000
FY 2016		9,578,000
FY 2017 approved		15,300,000