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Budget Information Report

Tobacco Master Settlement Agreement

Master Settlement Agreement (ORS 323.800)

On November 23, 1998, Oregon and 45 other states (the "Settling States"), and the four largest domestic tobacco manufacturers (Philip Morris Incorporated, R.J. Reynolds Tobacco Company, Brown & Williamson Tobacco Corporation, and Lorillard Tobacco Company – referred to as the Original Participating Manufacturers or OPMs) ended a four year legal battle over past, present, and future smoking-related claims made by the states by executing the Tobacco Master Settlement Agreement ("MSA"). Four states had previously settled their lawsuits individually with the tobacco companies ("previously settled states").

The MSA settled state claims filed against the tobacco industry to recover state healthcare costs associated with treating smoking-related illnesses and settled all unlawful trade practices, antitrust, consumer protection, common law, and other relief alleged by the Settling States. In exchange, the OPMs agreed to make annual payments (due each April) to the Settling States in perpetuity beginning with the year 2000 and also voluntarily agreed to the imposition of restrictions on tobacco advertising and marketing. The MSA also allows additional tobacco manufacturers to join the MSA by agreeing to the MSA payment and public health provisions. Tobacco manufacturers who joined after November 1998, of which there are about 40 or so, are referred to as Subsequent Participating Manufacturers. Collectively, OPMs and SPMs are referred to as Participating Manufacturers or "PMs."

Nationwide, the MSA is projected to distribute $5.7 to $6.7 billion annually in payments to the Settling States over the next 30 years. Oregon's share of this total is roughly $75 million annually (+/- 1.3% of the total) or $150 million each biennium. Since December of 1999, Oregon has received $1.4 billion in MSA payments.

MSA payments have two main components: (1) the main payment, which is based on a state's allocable share percentage as set forth in the MSA; and (2) a strategic contribution payment. Unlike the main MSA payment which runs in perpetuity, the PMs are only required to make the strategic contribution payment from April 2008 to April 2017.

The main MSA payment, or allocable share percentage, is based on a formula related to the relative number of smokers in a given state vs. the total number of smokers in the United States. This number was set at the time the MSA was signed and does not change year-to-year. The main MSA payment is subject to a number of upward and downward adjustments. These include, but are not limited to, adjustments for inflation, volume reductions, previously settled states reduction, federal tobacco legislation, and disputed payments. Once all adjustments have been applied, each Settling State receives its allocable share of the total payment from the PMs via the MSA's escrow agent.

The purpose of the strategic contribution payment is to compensate states for their efforts in terms of litigation at the time of the settlement. In 1998, Oregon was next in line after the previously settled states to litigate the state's case. Therefore, Oregon receives a relatively large strategic payment. Oregon will receive its last strategic contribution payment, in April 2017 for the current 2015-17 biennium.

An annual payment, which is the combination of the annual main MSA payment and the strategic contribution payment, can be reduced by disputed payment withholding amounts, discussed in more detail below.

Limitations of the MSA

MSA payments are based exclusively on sales of cigarettes and roll-your-own tobacco products. The MSA does not cover "Other Tobacco Products" such as cigars or pipe tobacco, smokeless tobacco products, or vapor products; however, there is a Smokeless Tobacco Master Settlement Agreement under which manufacturers of smokeless products have agreed to advertising restrictions and public health provisions similar to the Tobacco MSA, but do not make any payments to the states.

Oregon appellate courts have decided that private party (non-state) litigation related to a cigarette claim fall outside of the MSA. For example, a recent Oregon Supreme Court case affirmed a $25 million lower court judgment against a major tobacco company for a plaintiff's smoking related death. The state's portion this judgment will be paid to the state as punitive damages and deposited into the Criminal Injuries Compensation Account, used to fund crime victims' assistance programs.

The federal government is not a party to the MSA.

Non-Participating Manufacturers (ORS 323.800)

There are a number of mostly smaller tobacco companies that elected not to participate in the MSA. These companies are termed non-participating manufacturers (NPMs). NPMs generally represent 2% or less of Oregon's cigarette market share with the rest comprised of sales by the PMs.

In order to avoid an MSA payment adjustment known as the "NPM Adjustment," the MSA requires Settling States to enact and enforce statutes that require NPMs to make escrow deposits based on their cigarette sales in a given state. After 25 years, any money in an NPM's escrow account that has not been used to either satisfy a court judgment, or settlement, related to past and present smoking-related claims made by a state (or released party under the MSA) will be returned to the NPM.

Since 1998, 39 NPMs have deposited $15.6 million into escrow accounts for the benefit of Oregon. There has been no state claim against NPM escrow funds; however, the Oregon Department of Justice (DOJ) continues to evaluate the potential legal basis for such a claim, which would likely differ in some respects from the legal claim made under the MSA. If Oregon were successful in making a legal claim, any moneys recovered would likely not be deposited to the Tobacco Settlement Funds Account as they would not be part of the original MSA settlement.

In contrast to the MSA, statute places no restriction on NPM advertising or marketing.

PM Disputed Payments and NPM Adjustment

The MSA allows PMs to dispute a portion of the annual MSA payment. Disputed payments may be either withheld (kept with the PMs), paid into a disputed payment account, or paid to states subject to "claw back" by the PMs.

The most significant disputed amount is related to the NPM adjustment. When the PMs have suffered a loss of market share (as defined by the MSA) in a given calendar year, and an economic firm has determined that the MSA was a "significant factor" in that loss, then the PMs can reduce their annual payment by the NPM Adjustment amount. If a particular state can show that it "diligently enforced" the provisions of its Escrow Statutes during the relevant year, then that state is not subject to the NPM Adjustment.

The MSA requires the arbitration of payment disputes. Whether a state "diligently enforced" its statutes in a given year is therefore determined by an arbitration panel of three retired federal judges.

Some of Oregon's annual payments are currently being withheld by the PMs, a portion of which is in the disputed payment account. The PMs and Settling States are currently in dispute over who receives interest or other earnings from withheld payments. There is a three year lag between the year the cigarettes are sold and a disputed payment based on the NPM Adjustment. For example, the 2016 calendar year payment was reduced by the disputed amount for calendar year 2013. The reason for this lag is for the PM's to evaluate the change in market share.

PMs have disputed each Settling State's annual payment beginning with the first sales year 1999. As a result, the PMs have placed into a disputed payment account a portion of the payments due to Settling States. In 2003, the Settling States and the PMs reached a resolution of the dispute regarding sales years 1999-2002. Oregon's portion of the settlement was $6.2 million, which represents the entire disputed amount for this period. For Oregon, there will be a total of approximately $94 million in annual payments withheld by PMs for the years 2004 through the spring of 2017.

Arbitration of Disputed Payment Amounts and Diligent Enforcement

To determine whether an NPM Adjustment applies to a given payment, the arbitration panel reviews the enforcement efforts of the state at issue, to determine whether that state "diligently enforced" its Escrow Statutes. The term "diligent enforcement" is not defined in the MSA.

There is significant incentive for Settling States to diligently enforce their Escrow Statutes. If a state is found by the arbitration panel to have not diligently enforced it statutes in a given calendar year, then the state's entire annual payment (allocable main payment and the strategic contribution payment) for that year is at risk rather than just the disputed amount for that particular year. Under such a scenario, the state could owe the PMs as much as the difference between the disputed payment and the annual payment for that particular year.

If a state prevails in diligent enforcement arbitration, amounts held in the disputed payment account will be released to the prevailing states. Determining whether a given state "diligently enforced" the state's Escrow Statutes can take years. For example, the 2003 disputed amount, withheld in 2006, was paid in 2014 after a favorable arbitration decision in 2013.

In September 2013, the arbitration panel found that Oregon diligently enforced its Escrow Statutes during calendar year 2003. The decision resulted in the release of $8.9 million in disputed payments back to Oregon. The next arbitration is for the 2004 payment year. This arbitration is just beginning and may not be fully concluded until the fall of 2017. As a result of the dispute, Oregon's annual MSA payment related to 2004 was reduced by approximately $7.7 million. NPM Adjustment arbitrations for sales years after 2003 are a year-by-year process that will involve determining for each of those years whether Oregon "diligently enforced" the state's Escrow Statutes during the year at issue.

Cost of Diligent Enforcement and the Arbitration of Disputed Payments

DOJ undertakes two types of MSA-related activities, which are funded from two different sources: litigation of payment disputes (including the NPM Adjustment arbitrations) and diligent enforcement of NPM statutes.

DOJ spends approximately $3 million General Fund each biennium defending the state's diligent enforcement actions in front of the arbitration panel. This includes costs for expert outside counsel (Special Assistant Attorney General contract with a private law firm), Oregon's share of the cost of the arbitration panel, Oregon's share of the multi-state counsel, expert witnesses, and DOJ staff attorneys. This expense was originally funded as a General Fund allocation from the Emergency Board and has since continued as General Fund.

DOJ expends approximately $1.3 million per biennium in MSA settlement funds for diligent enforcement activities, which include a DOJ lawyer, paralegal, and investigator/auditor. This program certifies manufacturers and maintains a directory of all compliant tobacco products that can be sold in Oregon, monitors quarterly escrow payments by NPMs, coordinates with the Department of Revenue on distributor cigarette sales, and performs other compliance duties directed by statute.

MSA Revenues

Oregon's MSA payments are deposited in the Tobacco Settlement Funds Account (TSFA), which is administered by the Department of Administrative Services (ORS 293.537). After August of 2001, interest earnings on the Account accrues to the General Fund.

MSA revenue estimates come from two sources: the National Association of Attorney Generals and the underwriting community (Global Insight). The most conservative of these estimates is used for budgeting purposes. Actual payments come from the MSA escrow agent (PricewaterhouseCoopers). MSA revenue, as an Other Funds revenue source, is not included in the state's General Fund revenue forecast, with the exception of accrued interest earnings.

The following table details MSA revenues over the 1999-01 through the 2015-17 biennia.

Table A: Master Settlement Agreement Revenue*

#	Biennia	Main Allocable Payment	Strategic Contribution Payment	Disputed Payment Withheld	Disputed Payment Received	Net Revenue	$ Chg.	% Chg.
1	1999-01	$161.6	$--	$--	$--	$161.6	--	--
2	2001-03	174.2	--	--	--	174.2	12.6	+8%
3	2003-05	145.2	--	--	--	145.2	(29.0)	-17%
4	2005-07	137.4	--	--	--	137.4	(7.8)	-5%
5	2007-09	155.1	39.0	(12.0)	6.2	188.4	51.0	+37%
6	2009-11	143.8	36.1	(20.1)	--	159.8	(28.6)	-15%
7	2011-13	142.5	35.8	(20.5)	--	157.8	(2.0)	-1%
8	2013-15	139.9	35.2	(20.4)	8.9	163.7	5.9	+4%
9	2015-17-E	141.0	35.5	(21.0)	--	155.5	(8.2)	-5%
	Total	**$1,340.7**	**$181.6**	**($94.0)**	**$15.1**	**1,443.3**		
	Average	$149.0	$36.3	($18.8)	$7.6	$160.4		

*The figures provided in this table were compiled and summarized by the Legislative Fiscal Office from estimated and actual revenue tracked by the Department of Justice and the Department of Administrative Services. Numbers and percentages may not foot due to rounding.

Since December of 1999, Oregon has received $1.44 billion in MSA revenue. In gross dollars, $1.34 billion, or 93%, of the revenue is attributable to the MSA main or allocable payment and $181.6 million, or 13%, to the strategic contribution payment. These figures are then reduced by approximately $94 million in disputed payments, as of estimates through the spring of 2017. The average main or allocable share payment has been $149 million per biennium and the average strategic payment has been $36.3 million per biennium.

In the early years of the MSA, states received initial payments for the years 1998 through 2003. These initial payments began with the 1999-01 biennium and were comprised of Oregon's main allocable payment plus TSFA investment earnings of $9.5 million during the 1999-01 biennium. The strategic payment began in 2008, but as noted will end in 2017.

MSA payment for the 2017-19 biennium is estimated to be $133.5 million, $21.85 million, or 14%, lower than the 2015-17 biennium due to the phase-out of the final strategic contribution payment for the state. The last such payment will be received in April of 2017 and total approximately $17.4 million before withholding for disputed payment. This forecast is expected to hold through the 2017-19 legislatively adopted budget process as an arbitration panel decision on the 2004 disputed payment account ($7.7 million) is not expected until the fall of 2017.

As noted previously, TSFA revenue is exclusively from the MSA as there is no NPM settlement proceeds deposited in the Account.

MSA Expeditures

The Legislature allocates MSA revenue up to a maximum amount from the TSFA through a budget measure each legislative session or makes adjustments to an MSA allocation with a budget measure. In order for a TSFA allocation to be expended, however, an agency requires Other Funds expenditure limitation.

There are no statutory priorities, restrictions, dedications, or MSA contractual obligations related to MSA revenue. Two consistent priorities for MSA revenue, however, are diligent enforcement and contractual debt service payments, discussed in more detail below.

Oregon voters, in a general election held on November 7, 2000, considered, but failed to approve Ballot Measure 89, which had sought a constitutional dedication of MSA proceeds for health, housing, and transportation programs.

The balance in the TSFA is never fully allocated by the Legislature because a reserve balance is set aside for cash flow purposes in order to pay the next biennium's debt service payment (revenue needed prior to the next scheduled April payment). For the current biennium, the reserve amount is $15.2 million. Any amount above the reserve represents the true carryforward for the Account.

The Legislature has allocated MSA funding for ten purposes, most of which are ongoing, but some were for one-time allocations.

MSA funding has consistently been allocated to support debt service payments and treasury fees on state appropriation bonds and Oregon Health and Science University (OHSU) for the Oregon Opportunity bonds, discussed in more detail below; for the Oregon Health Authority for the Oregon Health Plan; and for the Department of Justice for the Tobacco Enforcement Fund and NPM diligent enforcement activities.

MSA funding has been used somewhat less frequently to fund transfers to the state General Fund for general governmental use; the Oregon Health Authority for Public Health and tobacco prevention and cessation programs; and for the Oregon Department of Education for K-12 physical education grants. MSA funding has been used once for funding in the Oregon Health Authority for the Community Mental Health program and Business Oregon [Oregon Business Development Department] for Oregon Resources and Technology Development.

The following table details the use of tobacco settlement revenues over the period 2001-03 to the current 2015-17 biennium, listed from the largest allocation to the smallest.

Table B: Tobacco Settlement Funds Account Allocation History*

Allocation/Biennia (in millions)	2001-2003	2003-2005	2005-2007	2007-2009	2009-2011	2011-2013	2013-2015	2015-2017	Grand Total	% Total
State Appropriation Bonds Debt Service	--	$41.7	$86.4	$112.0	$138.9	$144.6	$28.8	--	$552.5	39%
Oregon Health Authority - Oregon Health Plan**	$229.0	$42.2	$9.0	--	$6.5	$30.0	116.1	$101.8	$534.6	37%
Oregon Health and Science University - Oregon Opportunity bonds Debt Service	--	$9.7	$31.8	$31.8	$28.5	$31.2	$31.1	$30.9	$195.1	14%
State General Fund	$99.2	--	--	$6.0	--	--	--	--	$105.2	7%
Oregon Health Authority - Community Mental Health	--	--	--	--	--	--	--	$16.0	$16.0	1%
Oregon Health Authority - Public Health	$1.9	--	--	--	--	--	$4.0	$4.1	$10.0	1%
Oregon Department of Education - Physical Education	--	--	--	--	--	--	$4.0	$4.1	$8.1	1%
Department of Justice - Tobacco Enforcement Fund	--	$0.7	$0.7	$0.9	$1.0	$1.2	$1.3	$1.3	$7.1	0.5%
Business Oregon/ Oregon Business Development Department - Oregon Resources and Technology Development	$5.0	--	--	--	--	--	--	--	$5.0	0.3%
State Treasurer - Bond Fees	--	--	--	$0.07	$0.09	$0.02	$0.01	$0.02	$0.21	.01%
Total Biennial Allocation	$335.1	$94.3	$127.9	$150.8	$175.1	$207.0	$185.4	$158.2	$1,433.8	100%

*The figures provided in this table were compiled and summarized from actual expenditures tracked by the Department of Administrative Services - Chief Financial Office. Numbers and percentages may not foot due to rounding.

**Includes a 2001-03 allocation to the Insurance Pool Governing Board in the amount of $17.2 million.

Oregon's Securitization of the MSA Revenue Stream

Since receiving MSA payments, some states have securitized their entire MSA settlement revenue stream in order to receive a lump-sum, up-front payment. Securitization is the process of selling bonds that are backed by settlement payments. The Oregon Legislature has securitized MSA revenue for only two purposes: OHSU for Oregon Opportunity bonds and state appropriation bonds.

The Oregon Opportunity Bonds (Article XI-L of the Oregon Constitution) were issued in 2002 and 2003 (later refinanced at a lower interest rate in 2010 and 2011) to fund the capital costs of the Oregon Opportunity Program of the OHSU. The state originally issued a combined total of $203.2 million in Opportunity bonds. The bonds will be retired in the 2023-25 biennium. The current outstanding balance is $97.9 million, as of July 2016. The Department of Administrative Services - Chief Financial Office provided the following description of how the bond proceeds have been used:

> The Oregon Opportunity Program is a program for research in health care and biotechnology that had five specific goals: (1) bring world-class researchers to OHSU; (2) add state of the art lab space; (3) improve ability to capture the economic value of academic research; (4) distribute the benefits to Oregonians statewide; and (5) more than match the state's contribution. State bond proceeds were used to help the program meet its five goals by successfully recruiting leading researchers, resulting in increased research and grant funding. Successful recruiting also led to the creation and expansion of research centers and programs. To support the expanded research, OHSU constructed new building space, purchased new equipment, made improvements to existing space, and increased its research administration. OHSU also created a physicians practice network and assisted in creating a high-speed communications network.

The 2001 economic recession reduced state General Fund revenues. The state appropriation bonds (technically "appropriation credits" rather than a specific type of constitutionally authorized bonds), authorized by Senate Bill 856 (2003), were issued April 16, 2003 in the amount of $431.6 million to assist the state in balancing its budget for the 2001-03 biennium. Proceeds of the bond sale were credited to the General Fund and were allowed to be used for purposes for which moneys in the General Fund could be expended. The issuance forestalled what otherwise would have been deeper spending cuts in the final months of that biennium. The bonds were completely repaid in September 2013 (2013-15 biennium).

Conclusion

The following conclusions can be drawn from Oregon's MSA history:

- The Legislature has consistently allocated MSA revenue for a narrow list of priorities
- MSA revenue has reduced what otherwise would have been General Fund expenses
- The majority of MSA allocations have funded state health-related investments
- The state has pursued a conservative MSA securitizing (i.e., bonding) strategy
- DOJ's diligent enforcement of NPM statutes has protected the state's MSA revenue stream

The expenditure history of the MSA shows the Legislature has consistently allocated MSA revenue for a relatively narrow list of priorities, even in absence of a constitution or statutory requirement. The majority of MSA allocations have funded state health-related investments totaling over $763.8 million, or 53.3%, of all MSA funding, which includes:

- Oregon Health Authority - Oregon Health Plan ($534.6 million)
- Oregon Health and Science University - Oregon Opportunity bonds Debt Service ($195.1 million)
- Oregon Health Authority - Community Mental Health ($16 million)
- Oregon Health Authority - Public Health ($10 million)
- Oregon Department of Education - Physical Education ($8.1 million)

The state has pursued conservative securitization of the MSA revenue stream by only obligating 52% of the available revenue for debt service prior to the repayment of the state appropriation bonds.

Additionally, as an Other Funds source of revenue, MSA funds have been used to reduce what otherwise would have been considered General Fund expenses, with the prime example being allocations supporting the Oregon Health Plan.

The state General Fund has benefited as interest earnings on the TSFA are used to fund general governmental purposes, including the $3 million needed each biennium to defend the state's diligent enforcement actions in front of the arbitration panel.

Oregon's diligent enforcement efforts, coupled with the state's representation at arbitration hearings, have been consistently funded and have protected the state's MSA revenue stream.