



GOVERNOR
BRIAN SCHWEITZER
STATE OF MONTANA

TOBACCO REVENUE SECTION 7

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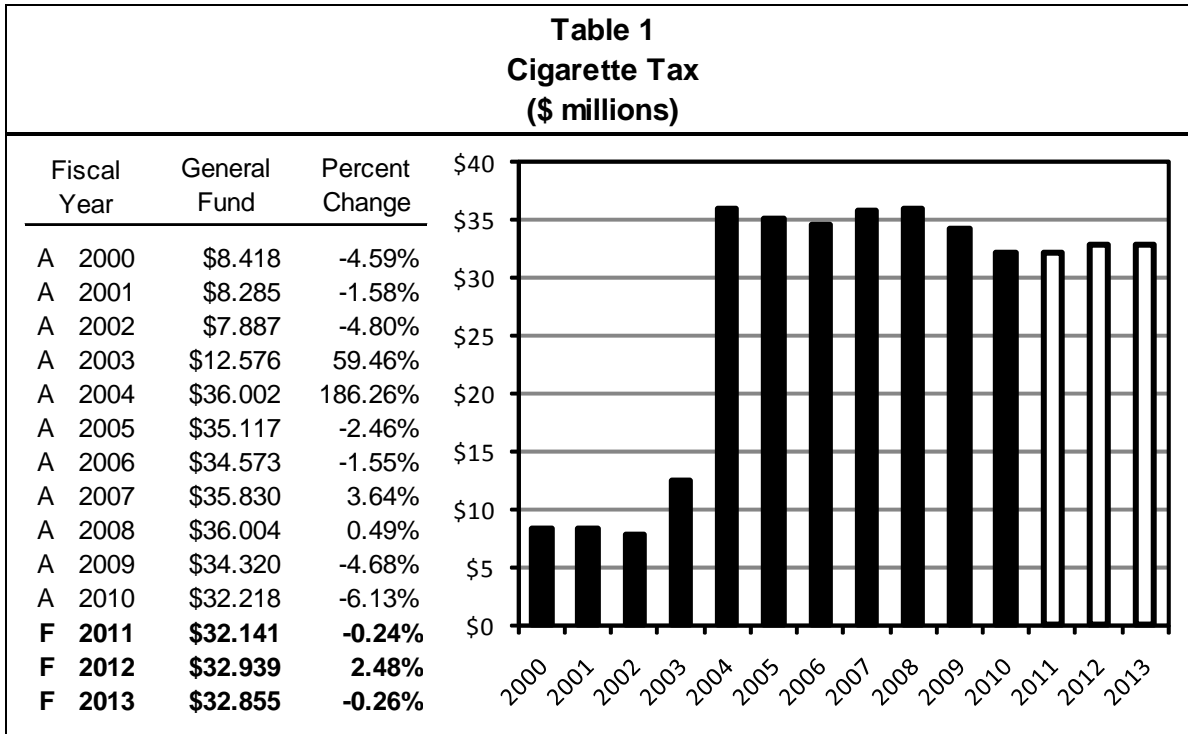
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GOVERNOR'S OFFICE OF
BUDGET AND PROGRAM PLANNING

Revenue Description

According to 16-11-111, MCA, a specific tax of \$1.70 is imposed on each pack of 20 cigarettes. If a pack contains more than 20 cigarettes, the tax is pro-rated by 1/20th of the \$1.70 tax for each cigarette exceeding 20 cigarettes. Currently, revenue generated from the cigarette tax is distributed as follows: 45.1% to the general fund; 44.0% to the health and Medicaid initiatives account; 2.6% to the long-range building account; and the greater of 8.3% or \$2 million for operation of state veterans' nursing homes.



HB 166, (1997 Session) distributed cigarette tax revenue 73.04% to the general fund; 15.85% to the long-range building account; and 11.11% to the Department of Public Health and Human Services (DPHHS), as provided for in section 16-11-119, MCA. Beginning May 1, 2003, SB 407 (2003 Session) increased the tax on cigarettes from \$0.18 to \$0.70 per pack. SB 407 also changed the distribution of cigarette taxes, increasing the general fund portion to 87.40%, the long-range building account to 4.3%, and the DPHHS portion to the greater of 8.3% or \$2.0 million. The tax increase under SB 407 explains the FY 2003 and FY 2004 increase in cigarette tax revenue shown in Table 1.

Initiative 149 (I-149) further increased the tax on each pack of cigarettes to \$1.70 as of January 1, 2005. I-149 also changed the allocation of total collections as follows: 45.1% to the general fund; 44.0% to the health and Medicaid initiatives account; 2.6% to the long-range building account; and the greater of 8.3% or \$2 million for operation of state veterans' nursing homes.

For FY 2010 and FY 2011 only, 1.2% of the state portion is designated for the Southwest Montana Veterans' Home, reducing the general fund portion to 43.9%. In FY 2012, the general fund distribution returns to 45.1%.

Risks and Significant Factors

- Per capita consumption has experienced an average annual decrease of 2.01% between 2006 and 2010.
- Montana population age 15 and over, which experienced an average annual increase of 1.17% between 2006 and 2010, was used for this forecast because, according to statistical analysis, this demographic tracked total

cigarette consumption over time better than changes in other age demographics such as total population, the population between 30 and 60 years old, etc.

- Although national trends indicate an overall downward trend for cigarette consumption, the rate at which consumption declines is also declining. According to the Center for Disease Control, the national prevalence of cigarette smoking has not declined significantly since 2004, which would imply a break in the previous seven year decline in cigarette smoking in the United States. This model assumes a 1% annual decrease in per capita consumption in future years.
- There are three types of arrangements for cigarette taxes with the seven Indian reservations in Montana:
 1. The Northern Cheyenne has a tax-free quota agreement with the state.
 2. The Flathead Reservation abides by the tax-free quota law with no specific agreement with the state.
 3. The Blackfeet, Fort Belknap, Rocky Boy, Fort Peck, and Crow Reservations have a revenue sharing agreement with the state.
- Tribes in categories 1 and 2 receive cigarettes tax free for the enrolled tribal members residing on the reservation. Under the revenue sharing agreements, the tribe and state cigarette tax rates are the same. The tribe's share of the tax revenue is 150% of the per capita cigarette tax collected for each of the tribes' enrolled members residing on the reservation.

Forecast Methodology

The general fund share of the cigarette tax is prepared in four steps:

- Step 1.** Estimate taxable per capita cigarette consumption.
- Step 2.** Estimate cigarette tax revenue.
- Step 3.** Calculate tribal revenue sharing agreement payments.
- Step 4.** Calculate state cigarette tax revenue and allocation.

Distribution

Table 2 shows the calculation and allocation of state cigarette tax revenue for FY 2011 through FY 2013. The tribes' revenue allocations are subtracted from the gross cigarette tax revenue to yield total state cigarette tax revenue. Revenue is allocated to each fund by multiplying state cigarette tax revenue by the fund's share.

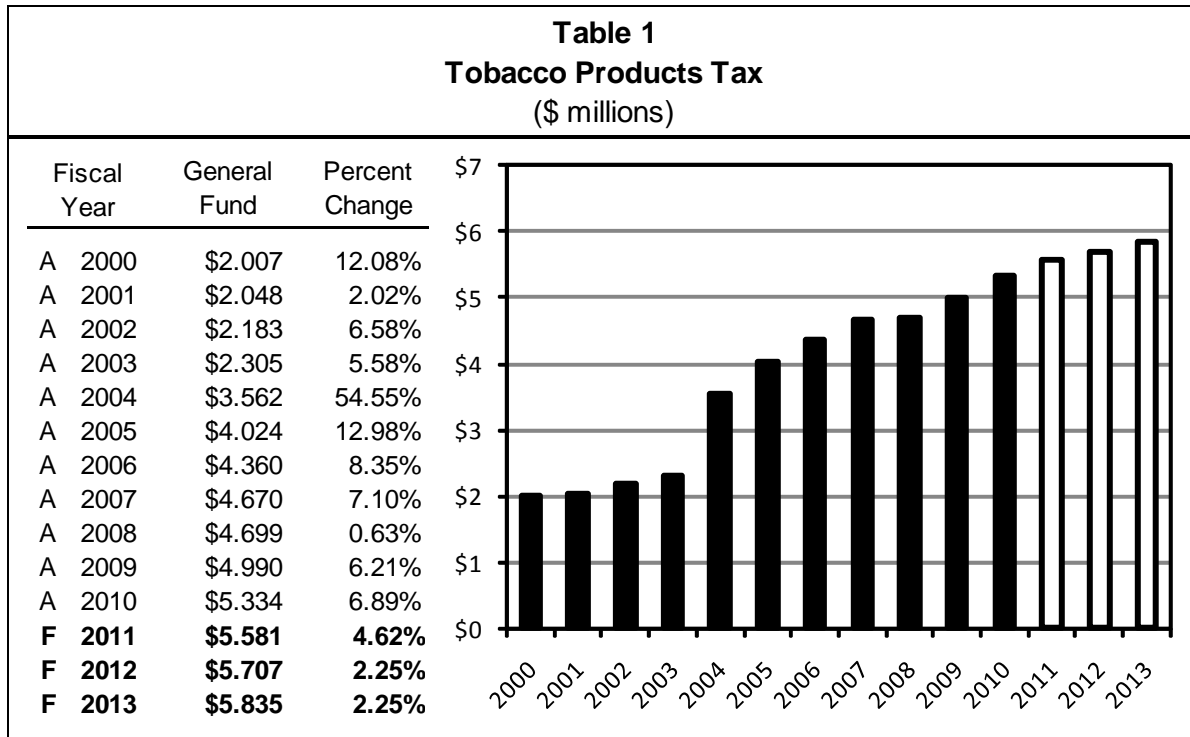
Table 2			
Calculation and Distribution of Cigarette Tax Revenue			
Calculation	FY 2011	FY 2012	FY 2013
Gross Cigarette Tax Revenue	\$76,897,387	\$76,710,286	\$76,514,064
Subtract Tribe Payments	\$3,683,767	\$3,674,804	\$3,665,404
Total State Cigarette Tax Revenue	\$73,213,619	\$73,035,482	\$72,848,660
Allocation			
General Fund (45.1%)	\$32,140,779	\$32,939,002	\$32,854,746
SW Veteran's Home (1.2%)	\$878,563		
Long Range Building Fund (2.6%)	\$1,903,554	\$1,898,923	\$1,894,065
State Veterans' Nursing Homes (8.3%)	\$6,076,730	\$6,061,945	\$6,046,439
Health and Medicaid (44.0%)	\$32,213,992	\$32,135,612	\$32,053,410
Total State Cigarette Tax Revenue	\$73,213,619	\$73,035,482	\$72,848,660

Data Sources

The general fund revenue data was obtained from SABHRS. Current tribal payments are provided by DOR Revenue Sharing Agreement Quarterly Reports. Population data forecasts are provided by Global Insight.

Revenue Description

According to 16-11-111, MCA, the Department of Revenue (DOR) is directed to collect a tax of 85 cents per ounce of moist snuff and 50% of the wholesale price of all other tobacco products, excluding cigarettes. Tobacco products destined for retail sale and consumption outside Montana are not subject to this tax. The general fund and the health and Medicaid initiatives account each receive 50% of the tobacco products tax revenue after payments are made as per tribal revenue sharing agreements.



In FY 2004 there was a 54.52% increase in tobacco tax revenue due to SB 407 (2003 session). On May 1, 2003, SB 407 changed the tax on moist snuff from 12.5% of the wholesale price to 35 cents per ounce, an effective increase of 7 cents per ounce. SB 407 also increased the tax on all other tobacco from 12.5% of the wholesale price to 25% of the wholesale price.

On January 1, 2005, Initiative 149 (I-149) changed the tax on moist snuff to 85 cents per ounce and increased the tax on all other tobacco to 50% of the wholesale price. This tax increase explains the increase in total tobacco tax revenue in FY 2005 and FY 2006. Revenue increased 7.10% in FY 2007 as a result of a larger than usual proportion of refunds for unsalable tobacco product being credited back to sellers for sales in FY 2006.

Risks and Significant Factors

- Montana population age 15 and over has experienced an average annual increase of 1.17% between 2006 and 2010. This demographic was used for this forecast because, according to statistical analysis, this demographic tracked total tobacco consumption over time better than changes in other age demographics such as total population, the population between 30 and 60 years old, etc
- Moist snuff per capita consumption has experienced an increase of 2.20% from 2006 to 2010.
- The excise tax on tobacco products is imposed on retail consumers, but the tax is collected by wholesalers. In accordance with 16-11-112, MCA, wholesalers are allowed a discount equal to 1.5% of total tax collections to defray collection and administrative costs.

- Tobacco product sellers can obtain a refund credit for tobacco products that could not be sold due to defect. The average percentage of defective product credits of total collections in FY 2006 through FY 2010 (2.39%) is used to forecast refund credits for FY 2011 through FY 2013.
- Five Indian reservations in Montana have a tobacco revenue sharing agreement with the state: Blackfeet, Fort Belknap, Rocky Boy, Fort Peck, and Crow Reservations. Under the revenue sharing agreements, the tribe tobacco tax and the state tobacco tax are the same. The tribe's share of the tax revenue is 150% of the per capita state tobacco tax collected for each of the tribes' enrolled members residing on the reservation.

Forecast Methodology

The tobacco tax revenue is comprised of two taxes: (1) moist snuff tax of 85 cents per ounce; and (2) all tobacco tax of 50% of the wholesale price. The six steps in estimating tobacco tax revenues are:

Step 1: Estimate per capita tobacco consumption, based on the trend over the past five years;

Step 2: Estimate projected gross tobacco tax revenue by multiplying the per capita consumption times the population over 15 times the tax rate;

Step 3: Calculate wholesaler discounts at 1.5% of total tobacco tax revenue;

Step 4: Calculate refunds for unsalable product, using the average percentage over last 5 years;

Step 5: Calculate tribes' revenue allocation, using the average percentage over last 5 years;

Step 6: Calculate state tobacco tax revenue and allocation.

Distribution

Wholesaler discounts and refund credits are subtracted from total tobacco tax revenue and tribal allocation payments are subtracted from net revenue to determine total state other tobacco tax revenue. Fifty percent of the state tobacco tax revenue goes to the general fund and 50% goes to the health and Medicaid initiatives account.

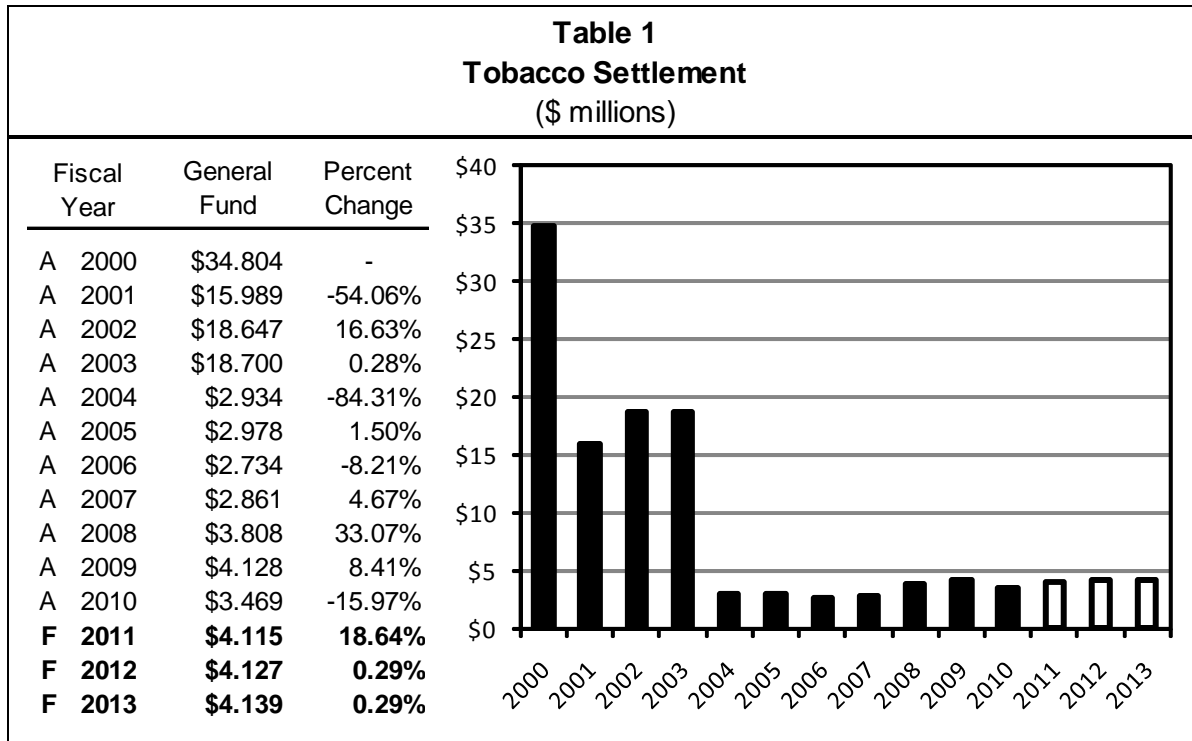
Calculate Tobacco Tax Revenue	FY 2011	FY 2012	FY 2013
Total Tobacco Tax Revenue	\$12,193,181	\$12,467,947	\$12,748,626
Subtract Wholesaler Discounts	\$182,898	\$187,019	\$191,229
Subtract Refund Credits	\$291,446	\$298,014	\$304,723
Net Tax	\$11,718,837	\$11,982,914	\$12,252,674
Subtract Tribal Payments	\$557,007	\$569,559	\$582,381
Total State Tobacco tax Revenue	\$11,161,830	\$11,413,356	\$11,670,293
Allocate State Tobacco Tax Revenue			
Total to General Fund (50%)	\$5,580,915	\$5,706,678	\$5,835,147
Total to Health and Medicaid (50%)	\$5,580,915	\$5,706,678	\$5,835,147
Total State Tobacco Tax Revenue	\$11,161,830	\$11,413,356	\$11,670,293

Data Sources

General fund revenue data is from SABHRS. Tobacco product collections and current tribe revenue allocation payments are provided by DOR reports. Other data provided by DOR includes the amount of discounts and credits applied to distributors of other tobacco products. Population data is provided by Global Insight, Inc.

Revenue Description

In 1998, Montana, along with 45 other states, signed a settlement agreement with major tobacco companies. Pursuant to the agreement Montana will receive approximately \$832 million by the year 2025. Payments are made annually beginning in FY 2000. The schedule of payments provided for under the settlement agreement is subject to change depending on adjustment criteria specified in the agreement.



In FY 2008 the base payment paid to states increased from \$8 billion to \$9 billion. This accounts for the large percentage increase from FY 2007 to FY 2008. However, the forecast payments, when adjusted for inflation, are decreasing or flat because cigarette consumption per capita (nationwide) has slightly decreased. Further, additional adjustments to the annual payments have been made since FY 2005 to compensate for changes in market share among the participating and non-participating manufacturers. These market share adjustments are forecast to continue through FY 2011.

Two major arrangements in the allocation of the tobacco settlement revenue have existed since the first payment was received in FY 2000. First, in November 2000, Montana’s electorate passed Constitutional Amendment 35. The amendment required no less than 40% of tobacco settlement revenue to be deposited in a trust fund, with the remaining money deposited in the state general fund. The trust fund was established to provide a permanent source of revenue to fund the costs associated with programs for tobacco disease prevention and healthcare benefits, services, or coverage. The amendment further stated that 90% of the interest income from the trust fund could be appropriated; with 10% of the interest income from the trust fund to be deposited in the trust fund on or after January 1, 2001. The principal of the trust fund and 10% of the interest income was to be deposited in the trust fund and remain forever inviolate unless appropriated by a vote of two-thirds of the members of each house of the Legislature.

Second, in the November 2002 election, Initiative 146 (I-146) was passed. I-146 required the tobacco settlement payments received after June 30, 2003, be deposited as follows: 32% in a state special revenue account for tobacco prevention; 17% in a state special revenue account for health insurance benefits; 40% in the trust fund; and 11% in the state general fund.

Risks and Significant Factors

If Original Participating Manufacturer's (OPMs) and Subsequent Participating Manufacturer's (SPMs) lose market share to Non-Participating Manufacturer's (NPMs), OPMs and SPMs may be entitled to pay less. The NPM adjustment is conditional upon two factors: (1) whether there has been a loss in market share by participating manufacturers to NPMs; and (2) whether that loss is attributable to disadvantages resultant from the tobacco settlement.

A specific provision of the Master Settlement Agreement (MSA), referred to as the safe harbor provision, is relevant to this adjustment. Under the safe harbor provision, a state can avoid a payment reduction due to the NPM adjustment if a qualifying statute is enacted and "diligently enforced". The qualifying statute provides for an amount to be paid into an escrow account for each cigarette sold by NPMs in the state that is equivalent to the amount that would have been paid had the NPMs participated in the settlement.

Currently, all participating states (including Montana) have enacted qualifying statutes under the safe harbor provision. Because every state enacted these statutes, NPM adjustments were set to zero in the past. However, with the increasing market loss to NPMs, the meaning of "diligent enforcement" is now in question. "Diligent enforcement" is not defined in the MSA. Consequently, there is uncertainty as to how, or who, will determine the meaning of "diligent enforcement". States contend the decision should be made in state court, tobacco companies would rather the decision be made in arbitration. "Diligent enforcement" likely includes some combination of legislation and enforcement actions. An independent auditor determined that, beginning in 2003, participating manufacturers started losing market share to NPMs. Pursuant to this finding, OPMs and SPMs can pay a portion of their tobacco settlement payments into a dispute account. Withheld disputed amounts are not to be distributed to the states until the dispute is resolved.

There are numerous possible outcomes to the dispute over the NPM adjustment. The following is a short list of possible outcomes over this disputed money.

- If it is found that the loss in market share for participating manufacturers was not due to disadvantages resulting from the tobacco settlement, then the monies withheld will likely be distributed to the states immediately.
- If a settlement is reached between the states and the participating manufacturers, payments could be reduced by some amount, the safe harbor statute could be revised, or some combination of the two. The fiscal impacts of such a settlement are unknown because the terms of such a settlement are uncertain.
- Litigation may extend beyond FY 2011. If this is the case, then OPMs and SPMs will continue to place the disputed money in the separate dispute account.
- It may be found that the loss in market share is due to disadvantages as a result of the tobacco settlement and that every state did not "diligently enforce" their safe harbor statutes. This finding would mean that states would have to face an undetermined reduction to the settlement funds they receive.
- Many possible outcomes exist and it is unknown at this time which scenarios are more likely. However, for purposes of this estimate, it is assumed that the dispute over the NPM adjustment will not be resolved prior to the FY 2011 payment, and that for FY 2011 through FY 2013, the participating manufacturers will withhold NPM adjustment amounts proportional to those withheld in FY 2008 through FY 2010.
- OPM shipment volume has decreased due to a decrease in overall cigarette consumption and a loss in market share to other manufacturers (OPM volume has decreased 38.6% between 1998 and 2010).
- Pursuant to the finding of an independent auditor, OPMs and SPMs can pay a portion of their tobacco settlement payments into a dispute account. Withheld disputed amounts are not to be distributed to the states until the dispute is resolved.
- The largest NPM, General Tobacco, signed the tobacco settlement agreement in August 2004 and became a SPM beginning in FY 2005. Along with making normal MSA payments, General Tobacco will also make payments on a separate ten-year schedule for prior obligations. The prior obligation payments are based on the amount they would have paid under the MSA, had General Tobacco participated since the agreement's inception in 1998.

Forecast Methodology

The MSA provides for complex methods and formulas to calculate annual payments made by the settling tobacco companies to each state. Several clauses in the tobacco settlement set forth the precise calculations for the adjustments to the payments due from the two categories of settling companies: (1) OPMs and (2) SPMs.

Seven major steps are used to calculate the annual amount due to Montana from tobacco companies which are parties to the MSA. These calculations are summarized in Table 2 and include:

- Step 1.** The inflation adjustment;
- Step 2.** The volume adjustment to the base payment;
- Step 3.** The volume adjustment to the base operating income;
- Step 4.** Previously settled states' reduction;
- Step 5.** SPM payments;
- Step 6.** The NPM adjustment; and
- Step 7.** Montana's share of the total payment.

Table 2			
Summary Calculation of Tobacco Settlement Revenue			
Description	FY 2011	FY 2012	FY 2013
Non-Strategic Base Payment	\$8,139,000,000	\$8,139,000,000	\$8,139,000,000
Inflation Adjustment	\$3,723,179,853	\$4,079,045,419	\$4,445,586,912
Net Volume Adjustment	(\$4,682,560,361)	(\$5,017,462,336)	(\$5,362,799,139)
Previously Settled States Reduction	(\$878,597,004)	(\$881,162,397)	(\$883,757,295)
Adjusted OPM Base Payment	\$6,301,022,488	\$6,319,420,686	\$6,338,030,478
Adjusted SPM Base Payment	\$500,359,888	\$501,820,876	\$503,298,667
Adjustments	\$7,947,028	\$7,947,028	\$7,947,028
Sub-total Adjusted Base Payment	\$6,809,329,404	\$6,829,188,590	\$6,849,276,174
Montana's Percentage	0.4247591%	0.4247591%	0.4247591%
Total Adjusted Non-Strategic Payment	\$28,923,246	\$29,007,600	\$29,092,924
Strategic Base Payment	\$861,000,000	\$861,000,000	\$861,000,000
Inflation Adjustment	\$393,863,847	\$431,509,781	\$470,285,088
Volume Adjustment	(\$495,353,787)	(\$530,782,046)	(\$567,314,174)
Adjusted OPM Base Payment	\$759,510,060	\$761,727,735	\$763,970,914
Adjusted SPM Base Payment	\$52,931,547	\$53,086,101	\$53,242,432
Adjustments	(\$24,521)	(\$24,521)	(\$24,521)
Sub-total Adjusted Base Payment	\$812,417,086	\$814,789,314	\$817,188,825
Montana's Percentage	1.0447501%	1.0447501%	1.0447501%
Total Adjusted Strategic Payment	\$8,487,728	\$8,512,512	\$8,537,581
Total MT Payment	\$37,410,975	\$37,520,112	\$37,630,505

Distribution

Table 3 shows the calculation and distribution of Montana's share of the Tobacco Master Settlement Agreement for FY 2011 through FY 2013.

	FY 2010	FY 2011	FY 2012	FY 2013
Tobacco Trust Fund (40%)	14.960	14.964	15.008	15.052
Tobacco Prevention Account (32%)	10.091	11.972	12.006	12.042
Health Insurance Benefits Acc. (17%)	5.361	6.360	6.378	6.397
General Fund (11%)	3.469	4.115	4.127	4.139
Forecast Total MT Payment	37.400	37.411	37.520	37.631

Data Sources

Tobacco Settlement data was obtained from SABHRS, Price Waterhouse Coopers Tobacco Master Litigation Master Settlement website, and the Tobacco Master Settlement Agreement (MSA). Historical inflation data was obtained from the Bureau of Labor Statistics, and forecasted inflation was derived from Global Insight.