

MINUTES OF THE HOUSE APPROPRIATIONS COMMITTEE

The meeting was called to order by Chairman Melvin Neufeld at 9:00 a.m. on March 26, 2004 in Room 514-S of the Capitol.

All members were present except:

Representative Dean Newton- excused
Representative Vern Osborne- excused

Committee staff present:

Alan Conroy, Legislative Research
Amy VanHouse, Legislative Research
Michele Alishahi, Legislative Research
Carolyn Rampey, Legislative Research
Jim Wilson, Revisor of Statutes
Mike Corrigan, Revisor of Statutes
Nikki Feuerborn, Administrative Analyst
Shirley Jepson, Committee Secretary

Conferees appearing before the committee:

Others attending:

See Attached List.

- Attachment 1 Testimony on **HB 2946** by Karl Hansen, Attorney General Office
- Attachment 2 Testimony on **HB 2946** by Keith Burdick, Xcaliber International, Pryor, OK
- Attachment 3 Additional information on **HB 2946** provided by the Council of Independent Tobacco Manufacturers of America (CITMA)

Hearing on HB 2946 - Payments by certain tobacco product manufacturers under the master settlement agreement.

Chairman Neufeld recognized Keith Hansen, Assistant Attorney General, who presented testimony as a neutral conferee on **HB 2946** (Attachment 1). Mr. Hansen explained that the proposed amendment to state tobacco settlement proceeds statutes, is intended to impose an assessment on nonparticipating manufacturers (NPM) similar to that required to be paid by Participating Manufacturers (PM) under the Master Settlement Agreement (MSA). The assessment paid by NPMs is placed in an escrow account, ensuring that funds would be available to pay any judgments or penalties the state may obtain against the NPM in the future. However, current law includes a loophole in the escrow calculation which allows the NPM to be obligated for making a net escrow payment based only upon the state's allocable share as determined by the MSA, regardless of the quantity of cigarettes actually sold by a given NPM in the State of Kansas. The practical effect has been that some NPMs have significantly reduced their escrow obligations far below what the NPM would have been required to pay to the states had it been a PM under the MSA, thus negating two intended effects of the statute, those being to level the playing field between participating and nonparticipating manufacturers, and to achieve an adequate reserve of funds from which to collect future judgments and penalties, if any.

Mr. Hansen presented several options for amendments to **HB 2946**, which possibly could make the assessment more equitable to both PMs and NPMs:

- Amend the current escrow structure to allow the escrow calculation to be based on the actual number of units sold in the state and not based on the state's national allocable share. This amendment does not address bankruptcy or litigation issues; however, is supported by the National Association of Attorney Generals and PMs.
- An Equity Fee Assessment would require that the current escrow structure remain in place. In addition to escrow payments, there would be an assessment levied against NPMs only for a specified amount, generally proposed at a rate of \$.0175 per stick. This assessment would in essence recapture and possibly exceed any escrow amount refunded to the NPM.
- The Council of Independent Tobacco Manufacturers of America (CITMA) have proposed that the

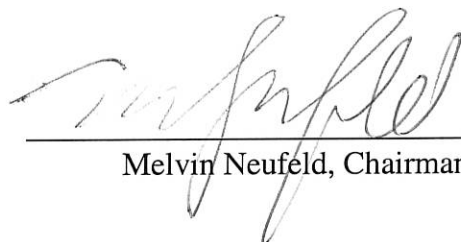
CONTINUATION SHEET

MINUTES OF THE HOUSE APPROPRIATIONS COMMITTEE at 9:00 a.m. on March 26, 2004 in Room 514-S of the Capitol.

current escrow structure remain in place, including the refund provision. An assessment would be levied on all manufacturers, with the PMs getting a credit for amounts due under the MSA. The NPMs would be required to pay the difference between the assessment, and whatever may be left in escrow after the refund, directly to the state. The levy on NPMs would require individualized calculations for each manufacturer, resulting in some NPMs paying more into escrow, and others paying a larger assessment to the state. Ownership of money in escrow is retained by the NPM both under current law and this proposal. An early draft of this bill also contained a provision mandating that the state provide either a tax credit or deduction for amounts paid into escrow.

The Chair recognized Keith Burdick, Partner/CFO, Xcaliber International of Pryor, OK, who presented testimony on behalf of the Council of Independent Tobacco Manufacturers of America (CITMA) in opposition to **HB 2946** (Attachment 2). Additional information provided by the CITMA was distributed to the Committee (Attachment 3). Mr. Burdick stated that the CITMA opposes the legislation because it gives special treatment to select cigarette manufacturers. Mr. Burdick further indicated that CITMA supports an assessment that would apply equally to all cigarette manufacturers, such as the legislation currently pending before the Alabama Legislature. Responding to a question from the Committee concerning problems with the Master Settlement Agreement, Mr. Burdick noted that there has been growth in sales beyond the agreement with regard to exempt sales.

Chairman Neufeld recessed the hearing on **HB 2946** at 10:00 a.m. The hearing will be continued at 9:00 a.m. on March 31, 2004.



Melvin Neufeld, Chairman

HOUSE APPROPRIATIONS COMMITTEE

March 26, 2004

9:00 A.M.

NAME	REPRESENTING
Ron Hein	R J Reynolds Tobacco Co.
Karl Hansen	ATTORNEY GENERAL OFFICE
Dickie Lynn Hessel	Budget
Mike Recht	CITMA
Keith Burdick	XCALIBER MANUFACTURING

TOBACCO / MSA PAYMENTS

The attached outlines current issues regarding the Tobacco/MSA payments received by the state, as well as alternative remedies to be considered.

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ISSUES TO BE ADDRESSED

Current Statute

The statute was intended to impose an assessment on nonparticipating manufacturers (NPM) similar to that required to be paid by Participating Manufacturers (PM) under the Master Settlement Agreement (MSA). The assessment paid by NPMs is placed in an escrow account, ensuring that funds would be available to pay any judgments or penalties the state may obtain against the NPM in the future. However, a loophole in the escrow calculation allows the NPM to be obligated for making a net escrow payment based only upon the state's allocable share as determined by the MSA, regardless of the quantity of cigarettes *actually* sold by a given NPM in the State of Kansas. The practical effect has been that some NPM's have significantly reduced their escrow obligations far below what the NPM would have been required to pay to the states had it been a PM under the MSA, thus negating two intended effects of the statute, those being to level the playing field between participating and nonparticipating manufacturers, and to achieve an adequate reserve of funds from which to collect future judgments and penalties, if any.

Illustration: An NPM sells its entire production of 1 million cigarettes in Kansas during the year. Kansas' allocable share under the MSA is .83367%. Thus, the amount this NPM would need to leave in escrow would be based on only 8,366.7 cigarettes, allowing the NPM to avoid any assessment for the remaining 991,633.3 cigarettes it sold in the state.

Unintended Consequences

The NPM therefore enjoys a cost advantage over PM's, which it can then use to substantially undercut the PM's retail price for cigarettes. The NPM market share has risen, reducing the overall market share of the PM's. The payments received by the states under the MSA is determined in large part by the market share of the PM's. As the PM market share is reduced, so are the payments made by the PM's to the states.

OTHER MATTERS FOR CONSIDERATION:

- 1) Bankruptcy - It is a very real possibility, whether as a result of litigation, or business issues, that one or more participating tobacco manufacturers may one day seek the protection of bankruptcy proceedings. The MSA payments from these manufacturers would likely cease, even though the manufacturer may continue to operate while reorganizing or liquidating.
- 2) MSA Dissolution - There have been multiple ongoing legal attacks on the MSA. A significant blow was dealt by the 2nd Circuit, raising questions that the MSA may violate of antitrust laws.
- 3) Overall Market Shares are Shrinking - Fewer people smoke each year. The overall market is shrinking, leaving PMs, SPMs, and NPMs to fight for a slice of an ever shrinking pie.
- 4) NPM Adjustment - There is the potential for a significant "NPM Adjustment" to be applied to the MSA payments due from PMs in 2006, and years thereafter. If the adjustment is applied, it would further reduce the MSA payments received by the state.

Proposed Remedies

The following are prominent bills that have been introduced around the country in an attempt to address the shrinking MSA revenue stream to the states:

- 1) HB 2946
- 2) Allocable Share
- 3) Equity Fee Assessment
- 4) CITMA Bill

A Brief Summary of Each Follows

1)

HB 2946

The escrow provisions will be repealed effective as of January 1, 2005, and replaced with a like assessment to be paid to the state. The assessment would be based upon the rate schedule appearing in the current statute for escrow assessments.

The assessment would be levied against all cigarettes sold in the state, regardless of whether manufactured by a participating manufacturer (PM) under the Master Settlement Agreement (MSA), or by a nonparticipating manufacturer (NPM).

The PM will receive a credit against its payment obligations under the MSA for any amounts paid by the manufacturer to the state via the new assessment. There would be no credits applied to the NPMs, as these manufacturers will not have any other payment obligations.

Some subsequent participating manufacturers (SPM), those joining the master settlement agreement within 60 days of the settlement, were given a grandfather share not subject to assessment under the MSA. HB 2946 recognizes this grandfather share, by allowing these select manufacturers to request a refund for any amounts paid under this new alternative assessment that are attributable to their grandfather share. The grandfather share under HB 2946 is a like percentage, not actual units sold, to that exempted under the MSA, which should discourage "dumping" of cigarettes in Kansas by these select SPMs.

Payment of the assessment shall be evidenced by an additional stamp to be applied to the cigarette packaging or container, much like the current tax stamp. The same procedures governing the procurement of tax stamps would govern the procurement and application of the assessment stamp, including the same rate of discount to compensate the distributor for its record keeping and related expenses.

The assessment is levied on the manufacturer, not the consumer, and would be collected and forwarded to the state by cigarette distributors. The payment would be made to the distributors either by a credit against the negotiated wholesale price for cigarettes, or by cash payment. The stamp discount is to be retained solely by the distributor, and the distributor reimbursed by the manufacturer for the full face value of the assessment stamp.

Effect of HB 2946 on Present Problem: The NPMs are held accountable and pay an assessment to the state for each cigarette actually sold in the state. Likewise, the PMs are held accountable and pay an assessment for each cigarette actually sold in the state. Thus, equity in the market place has likely been achieved.

Fiscal Impact: Based upon 2003 reported sales, it is estimated that this bill would have generated \$14.1 million more than that assessed via the MSA. (Due to some adjustments carried over from the prior year, the actual net produced by HB2926 versus the MSA amount actually due the state for 2003 would be approximately \$13.9 million.

Other: HB 2946 protects revenue streams in the event that the master settlement agreement is struck by a court. It further provides protection from a manufacturer operating while in bankruptcy, and insulates the state from the effects of any future NPM adjustment.

The bill deviates from the model "qualifying statute" under the MSA. A qualifying statute is one that levels any cost disadvantages to those PMs under the MSA. Deviations from the model are permitted under the MSA, as long as the proposed statute meets the definition of a qualifying statute. This bill appears to meet that threshold.

2) **Allocable Share Amendment**

The proposed amendment would not eliminate the current escrow structure. It would however amend that structure, in that the escrow calculation would be based upon the actual number of units sold in the state and not based upon the state's national allocable share.

Effect of Allocable Share Amendment on Present Problem: By amending the calculation of the escrow to be based upon actual units sold in the state, the amendment should eliminate the situation illustrated above.

Fiscal Impact: By effectively eliminating the current escrow refund loophole, the NPMs should then operate on a level playing field with the PMs. Theoretically, this should slow or perhaps even stop the degradation of the PMs market share attributable to the NPMs, and in turn protect the MSA revenue stream to the state.

Other: The allocable share amendment does not address the issue of bankruptcy or the potential for dissolution of the MSA by a court. Nor, does this proposal insulate the state from the affects of an NPM adjustment to the MSA payments.

3) **Equity Fee Assessment**

The Equity Fee Assessment would require that the current escrow structure remain in place. In addition to escrow payments, there would be an assessment levied against NPMs only for a specified amount, generally proposed at a rate of \$.0175 per stick. This assessment would in essence recapture and possibly exceed any escrow amount refunded to the NPM.

Effect of Equity Fee Assessment on Current Problem: This proposal would almost certainly increase the operating costs of an NPM. However, it is unclear whether the bill would actually "level the playing field," as some NPMs could end up paying more (escrow and assessment combined) per stick than that required of PMs under the MSA.

Fiscal Impact: The Equity Fee Assessment bill based upon 2003 data, at a rate of \$.0175 per stick, would generate approximately \$4.8 million.

Other: The Equity Fee Assessment provides no protection against a PM in bankruptcy, nor is there protection of revenue streams from PMs should the MSA be struck by a court. Assessing only the NPMs in this manner could invite a challenge. Further, this bill does not insulate the state from the effects of an NPM adjustment.

4) **CITMA Bill** "Tobacco Product Manufacturers' Assessment" Proposes that the current escrow structure remain in place, including the refund provision. An assessment would be levied on all manufacturers, with the PMs getting a credit for amounts due under the MSA. The NPMs would be required to pay the difference between the assessment, and whatever may be left in escrow after the refund, directly to the state. The levy on NPMs would require individualized calculations for each manufacturer, resulting in some NPMs paying more into escrow, and others paying a larger assessment to the state. Ownership of money in escrow is retained by the NPM both under current law and this proposal. An early incarnation of this bill also contained a provision mandating that the state provide either a tax credit or deduction for amounts paid into escrow.

Effect of CITMA Bill on Current Problem: The bill would likely increase the operating costs for NPMs. The NPMs would continue retention of ownership over the funds in escrow, while enjoying a significant tax benefit. The PMs may receive tax benefit for their MSA payments, but do not however, retain ownership over the funds paid to the state via the MSA.

Fiscal Impact: Not clear. Additional revenues generated by this bill and paid to the state could fluctuate significantly.

Other: The CITMA bill provides no protection from a manufacturer operating in bankruptcy, but may provide, if amended and worded properly, a marginal level of protection in the event that the MSA is struck by a court. The wording would be extremely important. However, this bill does not insulate the state from the effects of an NPM adjustment to the MSA payments.



Position Statement Regarding House Bill No. 2946

On behalf of the Council of Independent Tobacco Manufacturers of America ("CITMA"), I am writing to address House Bill No. 2946, which would impose a per-pack assessment on cigarettes sold in the State, but which would allow certain cigarette manufacturers to pay only a fraction of the assessment payments made by others. Although CITMA supports an assessment that would apply equally to all cigarette manufacturers, such as the one currently pending before the Alabama Legislature, CITMA opposes any assessment that gives special treatment to select cigarette manufacturers.

The membership of CITMA consists of independent tobacco companies all located within the United States who have chosen to compete in the cigarette manufacturing business and are doing so fully compliant with the "rules of the game." Such rules were established in 1999 when the various states and major tobacco companies entered into the Master Settlement Agreement ("MSA") which required settling states to enact a "qualifying statute," which Kansas adopted and codified at K.S.A. 50-6a01. The qualifying statute requires those tobacco manufacturers that have not signed the MSA to make certain escrow payments and such tobacco manufacturers that do so are considered to be "fully escrow compliant." In other words, the membership of CITMA consists of fully escrow compliant companies seeking only to compete as the free enterprise system of our country allows.

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Currently, the MSA and the Kansas qualifying statute operate in a fair and balanced manner. MSA signatories, known as Participating Manufacturers, make certain nationwide payments, a portion of which goes to Kansas. Non-MSA signatories, known as Non-Participating Manufacturers, must make escrow payments. Those escrow payments are limited to what a Non-Participating Manufacturer would have paid to the state had it been a Participating Manufacturer. In short, the current economic conditions require that Non-Participating Manufacturers pay the same amount of money that Participating Manufacturers pay, although Non-Participating Manufacturers (unlike Participating Manufacturers) cannot deduct such payments as ordinary business expenses.

Although House Bill No. 2946 is said to be necessary to eliminate Non-Participating Manufacturers' "continued enjoyment of a cost advantage over" Participating Manufacturers, there is no such cost advantage. In fact, the supposed cost advantage -- the allocable share release provision in the Kansas qualifying statute -- simply ensures that Non-Participating Manufacturers pay no more to the state than Participating Manufacturers. If the allocable share release provision did not exist, Non-Participating Manufacturers would be required to pay substantially more than a similarly-situated Participating Manufacturer would pay to the state for the same sales.

Any legislation intended to "level the playing" field among Participating Manufacturers and Non-Participating Manufacturers should be modeled upon an industry assessment. Such legislation would simply charge all cigarette manufacturers x cents per cigarette for cigarettes sold in the state, due and payable April 15 for prior year's sales, with a credit for MSA payments. Such a proposal is currently pending before the Alabama Legislature. The Alabama proposal, like House Bill 2946, reflects an

assessment imposed on all tobacco companies and eliminates the current escrow requirement for Non-Participating Manufacturers. The assessment gives credits for MSA payments by Participating Manufacturers.

However, unlike the Alabama proposal, which truly levels the playing field for all cigarette manufacturers, House Bill No. 2946 gives special treatment to certain cigarette manufacturers by requiring those manufacturers to make only a fraction of the payments made by others (or perhaps even no payments at all). Specifically, House Bill No. 2946 provides that cigarette companies that signed the MSA "within 60 days of the execution date" are required to make assessment payments only to the extent that their current sales exceed their 1998 sales (or 125% of their 1997 sales, whichever is greater). Thus, House Bill No. 2946 creates a huge cost advantage for certain cigarette companies -- these Participating Manufacturers will be required to make no assessment payments whatsoever if their sales have not grown since 1998, and will be required to make assessment payments based only on the extent to which their current sales exceed their 1998 sales.

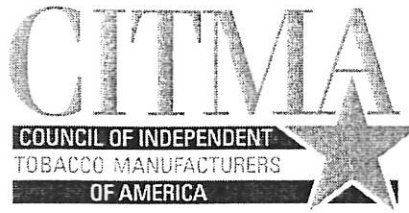
CITMA supports fair and equal treatment for all cigarette manufacturers, such as the approach currently being considered by the Alabama Legislature. However, CITMA opposes special treatment for certain manufacturers, particularly when there is no rational basis for the distinction. Therefore CITMA opposes House Bill No. 2946 to the extent that it permits certain companies to make only a fraction of the payments made by others. If this special payment exemption, contained on pages 6 (lines 40-43) and 7 (lines 1-16), is eliminated, House Bill No. 2946 would truly level the playing field for all cigarette

manufacturers and if the reference on Page 2 at LL 14-21 that Non participating members enjoy a cost advantage in the MSA were eliminated, CITMA would support it.

Keith Burdick

Partner/CFO—Xcaliber International

Pryor, Oklahoma



Tobacco Product Manufacturers' Assessment Proposal

NPMs have never sought special treatment, only a level playing field. We are proposing a Manufacturers' Assessment charged to all manufacturers on a per carton basis of cigarettes sold in the State. The general theme of this plan is that this assessment will level the playing field for all manufacturers. The premise is to charge a Manufacturers' Assessment that is equal to the payments made, on a per carton or stick basis, by the OPMs under the terms of the MSA without consideration of the phase II payments. However, each manufacturer shall be given credit for all payments made into either the MSA or the amount per carton paid into escrow by NPMs.

Therefore, if the assessment is tied to big tobacco's payment, no amount will be due from them. NPMs that would otherwise get refunds will have the refunds retained by the States with those refunds going to the general fund of the State. SPMs with market share allowances will be required to pay to the State an amount that equals the difference of the assessment amount and the per carton average that they paid into the MSA. For instance, if a SPM paid on average \$1.50 per carton into the MSA fund and, assuming the assessment was \$4.00 per carton, the SPM would be required to pay an additional \$2.50 to the State for each carton sold into the State. This money too would go to the general fund of the State.

This plan will result in all manufacturers paying the same per carton amount in total between the MSA, escrow or assessment payments. It is predicted that this approach will result in states gaining millions over and above the effect of the best possible outcome of the Allocable Share Amendment. This plan will have the same effect of the Allocable Share Amendment -- higher cigarette prices for NPMs -- but will result in excess payments going directly to the State rather than into an escrow account. This plan also creates additional revenue from the SPMs. And finally it truly creates a level playing field for all manufacturers.

Some of the advantages of the Manufacturers' Assessment are as follows:

1. Puts all manufacturers on a level playing field through a combination of payments into MSA, Escrow and the Assessment

Under this plan and through the combination of escrow/MSA and the Manufacturers' Assessment, each manufacturer shall be required to pay the same total amount as a result of selling cigarettes. So regardless of how much a manufacturer pays either to the MSA or the State escrow (for instance \$1.00 per carton) that manufacturer will pay -- and such payments go the state -- the difference between their per carton amount paid and the per carton amount paid by OPMs. For instance, if the OPMs paid \$3.90 per carton the SPM or NPM that paid \$1.00 per

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carton would be required to pay an additional \$2.90 per carton to the State for each carton sold in the State. This will add millions to the State's general fund.

2. Levels the playing field for SPMs with a market share allowance and those SPMs without a market share allowance

SPMs with market share allowances have an advantage over those SPMs that signed without a market share allowance. With the implementation of the Manufacturers' Assessment, not only will the NPMs pay more but so will the SPMs with market share allowances, which payment will ultimately equal that of the other SPMs and NPMs.

3. Creates millions more in revenues to be used by the State

Through the additional payments by NPMs to the State, added to those payments by SPMs with market share allowances, we anticipate that the increase in revenues will be millions over and above results provided by the Allocable Share Legislation. The additional amounts paid by NPMs under the Manufacturers' Assessment would significantly increase payments to States if the escrow rules remain as originally outlined in the MSA.

Since the difference between the payments by NPMs into escrow (after the refund) and the Manufacturers' Assessment would be paid directly to the State, it would be advisable for the State to keep the escrow rules as originally designed under the MSA. Under the Manufacturers' Assessment, a manufacturer would be given dollar for dollar credit for all escrow paid to States (the net amount after any refunds). Therefore, if a State keeps the escrow rules as originally intended a manufacturer may pay an amount of \$1.00 per carton. If the Manufacturers' Assessment is determined to be \$3.90 (NPM per stick amount for 2004 payment year for a carton of cigarettes) the manufacturer would pay directly to the State \$2.90 per carton. A State that removes the refund would get no Manufacturers' Assessment from NPMs since the full stick amount is paid into the escrow account with no refund. SPMs would also be required to pay the Manufacturers' Assessment if they pay less than the full stick amount paid by OPMs thus adding additional revenues to the State and equalizing or leveling the playing field for all manufacturers.

4. Increases the prices of discount cigarettes for all manufacturers that sell cigarettes with less than the full per stick amount in the price

Obviously these changes will increase the cost of business to most NPMs and many SPMs. The companies that currently pay less than the full amount into the escrow accounts, or under MSA payments, will most likely have to increase prices to make the additional payments that are not currently being made by them. Typically, when costs are increased to a manufacturer, those increases are passed along to consumers in the form of higher prices. Higher prices may then have an adverse effect on smokers and further reduce cigarette sales which was one of the goals of the MSA in the first place.