

MINUTES OF THE HOUSE APPROPRIATIONS COMMITTEE

The meeting was called to order by Chairman Melvin Neufeld at 9:00 a.m. on March 31, 2004 in Room 514-S of the Capitol.

All members were present.

Committee staff present:

Alan Conroy, Legislative Research
J. G. Scott, Legislative Research
Amy VanHouse, Legislative Research
Michele Alishahi, 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:

Ron Hein for R. J. Reynolds
Kathy Damron for Philip Morris
Keith Burdick, Xcaliber International, Pryor, OK

Others attending:

See Attached List.

- Attachment 1 Testimony on **HB 2946** by Ron Hein, Legislative Counsel for R. J. Reynolds
- Attachment 2 Letter presented by Kathy Damron on behalf of Philip Morris by Derek Crawford, Altria Corporate Services, Inc. in opposition to **HB 2946**

Chairman Neufeld complemented the Budget Conference Committee on their work with the budget during the Conference Committee meetings. The Chair announced that the Appropriations Committee will meet at 10:00 a.m. on April 21 to begin work on the Omnibus bill.

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

Chairman Neufeld recognized Ron Hein, who presented testimony on behalf of R.J. Reynolds in opposition to **HB 2946** (Attachment 1). Mr. Hein noted that R. J. Reynolds is a participant in the original Master Settlement Agreement (MSA). Although **HB 2946** was drafted because of a loophole in the MSA concerning non-participating manufacturers (NPMs), R. J. Reynolds opposes the legislation because it adds a third mechanism for them in making payments to the state. Mr. Hein's testimony includes a proposed bill with an amendment to the MSA addressing the loophole in the MSA which R.J.Reynolds feels is a better solution to the inequity that allows NPMs to sell a greater market share of total cigarettes in the state; however, only having to make escrow payments on their allocable share as provided in the MSA.

Responding to a question from the Committee, Mr. Hein indicated that the original participating manufacturers (OPMs) and the subsequent participating manufacturers (SPMs), through the MSA, make payments directly to the State; however, payments, made by NPMs on their allocable share, go directly into an escrow account and are returned to those NPMs at a later date if not used for litigation cases. Mr. Hein further noted that the NPMs have not signed the MSA and are not bound by any of the marketing restrictions of the MSA. A Committee member voiced concern because **HB 2946** deviates from the original MSA by increasing the cost burdens for OPMs and SPMs and could result in the State's Escrow Statute to no longer qualify as being a "Model Statute" or "Qualifying Statute" making the State subject to litigation.

The Committee noted that **HB 2946** is proposed because the current MSA gives a disadvantage to the OPMs and SPMs, and gives an advantage to the NPMs resulting in the need for legislation to "level the playing field". Mr. Hein indicated that R. J. Reynolds would support legislation to correct the inequity in the allocable share directed at NPMs.

CONTINUATION SHEET

MINUTES OF THE HOUSE APPROPRIATIONS COMMITTEE at 9:00 a.m. on March 31, 2004 in Room 514-S of the Capitol.


The Chair recognized Kathy Damron, who presented testimony in opposition to **HB 2946** on behalf of Philip Morris and shared a letter with the Committee written by Derek Crawford, District Director of Altria Corporate Services, Inc. on behalf of Philip Morris USA (Attachment 2).

Chairman Neufeld recognized Keith Burdick, Xcaliber International, Pryor, OK, who had presented testimony in opposition to **HB 2946** at the previous meeting. Mr. Burdick indicated that after further consideration, he has changed his position on the bill and would now support the legislation because he feels that it corrects the inequities in the MSA.

Chairman Neufeld closed the hearing on **HB 2946**.

Representative Shriver moved to approve the minutes as written of March 17, March 18 and March 19. The motion was seconded by Representative Howell. Motion carried.

The meeting was adjourned at 9:50 a.m. The next meeting will be held at 10:00 a.m. on April 21, 2004.



Melvin Neufeld, Chairman

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**Testimony re: HB 2946
House Appropriations Committee
Presented by Ronald R. Hein
on behalf of
R. J. Reynolds Tobacco Company
March 26, 2004**

Mr. Chairman, Members of the Committee:

My name is Ron Hein, and I am legislative counsel for R. J. Reynolds Tobacco Company (RJR).

RJR strongly opposes HB 2496, and any similar legislation which would place additional taxes upon our company, our products, or our customers. Currently our customers pay a state excise tax which was raised by 230% two years ago in addition to the MSA payments which accrue to the state. We oppose this legislation, which adds a third mechanism for us making payments to the state, for numerous reasons, including the following issues which have been raised by our legal counsel:

If HB 2946 is enacted, the state's Escrow Statute would no longer be a "Model Statute," and the state would potentially suffer adverse consequences as a result. The MSA provides that if a state enacts the legislation set forth in MSA Exhibit T without additions or modifications, the legislation will be deemed a "Model Statute." The Escrow Statute currently qualifies as a "Model Statute." HB 2946 would materially modify the state's Escrow Statute. As a result, the state's Escrow Statute would no longer be a "Model Statute." Having a "Model Statute" protects the state against a reduction in its MSA payments due to the "NPM Adjustment," from disputes about whether the statute is a "Qualifying Statute," and, if the "Model Statute" is invalidated, protects the state from absorbing the full adjustment. (MSA Sec. IX(d)(2)(B), (E)-(G)). Therefore, by disqualifying the Escrow Statute from being a "Model Statute," HB 2946 could have negative consequences for the state.

If HB 2946 is enacted, the state's Escrow Statute would no longer be a "Qualifying Statute," and the state would potentially suffer adverse consequences as a result. A "Qualifying Statute" is one that "effectively and fully neutralizes the cost disadvantages that the Participating Manufacturers experience vis-a-vis [NPMs] . . . as a result of [the MSA]." MSA Sec. IX(d)(2)(B). HB 2946 does not take into account the MSA downward adjustments that may (and do) reduce a participating manufacturer's MSA payments. HB 2946 would therefore increase the cost burdens on Participating M:

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non-participating manufacturers, and Kansas would therefore no longer have a Qualifying Statute. The result would be no protection against the NPM adjustment.

If a state is found to be non-qualifying, or the statute is no longer deemed to be a model statute, the state may bear the full brunt of any MSA adjustments. States that are non-qualifying, have non-model statutes, or are not diligently enforcing their MSA obligations can be penalized by having to absorb up to 100% of the MSA adjustments. If only one state falls under this category, its revenues would be impacted on this entire nationwide adjustment. This would seriously jeopardize Kansas' MSA payments.

HB 2946 would subject the state to years of expensive MSA litigation with potentially costly results. Kansas is a party to the MSA. HB 2946 amounts to a unilateral amendment of the MSA. Such action would give rise to a breach-of-contract claim by Participating Manufacturers, as well as a claim for impairment of contracts in violation of the Contracts Clause of the U.S. Constitution. And by unlawfully seeking to modify the MSA, HB 2946 would place all of Kansas's MSA payments at risk.

By abrogating the MSA, HB 2946 would eliminate the marketing restrictions prescribed by the MSA. Released from the MSA, the participating manufacturers would, once again, be able to post billboards for advertising many well-known brands, and under the Supreme Court's decision in *Lorillard v. Reilly*, the states would be preempted from restricting such advertising under the Federal Cigarette Labeling and Advertising Act, and prohibited from restricting such advertising by the First Amendment.

HB 2946 would make it difficult, if not impossible for Kansas to securitize its MSA payments. HB 2946 would result in reducing those payments and substitute unpredictable general tax revenues for more certain MSA payments. Under these circumstances, securitization would probably be impossible.

When RJR and other tobacco companies entered into the Master Settlement Agreement with the Attorneys General of the various states involved in the litigation, a provision was written into the agreement which was designed to insure that participating manufacturers who had entered into the agreement would not have to make duplicative payments to each of the states involved in the settlement. This provision, oftentimes referred to as allocable share, provided that payments made to the states under the settlement were allocated to the respective states dependent upon their share of the nationwide sales of cigarettes.

Subsequent to the Master Settlement Agreement, numerous states, including Kansas, enacted legislation to implement an escrow system for tobacco companies which did not enter into the original Master Settlement Agreement, known as non-participating manufacturers (NPMs). [Companies that signed the original MSA are known as original

participating manufacturers (OPMs), and those who signed later are known as subsequent participating manufacturers (SPMs).]

Many of the NPMs are marketing cigarettes in a small number of states, as opposed to nationwide. The NPMs have been utilizing a loophole in the post-MSA legislation that permits them to utilize the "allocable share" provision to reduce the amount that would be escrowed with any specific state. The net effect of the utilization of this loophole has been to permit NPMs to escrow a small fraction of the escrow amount they should be making in a particular state by applying the allocable share percentage applicable to that state even though such NPM's sales in that specific state as a percentage of their total sales is considerably higher.

The net effect of this loophole is that the states are receiving less escrow payments than they should from the non-participating manufacturers. This also negates the original intent of the MSA and the original intent of the post-MSA legislation, by permitting NPMs to market their cigarettes at a lower price. The NPMs' utilization of this loophole has also resulted in the states receiving less escrow.

Another effect of the NPMs selling their cigarettes at a cheaper price is that a greater percentage of market share of total cigarettes sold is now sales by NPMs. This has the effect of reducing payments to the states, including Kansas, under the formula set out in the MSA.

As a result, the National Association of Attorneys General (NAAG) has endorsed legislation which would amend the existing post-MSA legislation in the various states. The bill draft attached to my testimony, which is consistent with the NAAG endorsed proposal, would correct that loophole. We would urge your support for the legislation attached to solve the allocable share problem facing Kansas in lieu of the provisions of HB 2946.

I believe 21 states have adopted allocable share language to date and others are considering legislation to correct the allocable share loophole for NPMs.

We would respectfully request that the committee substitute the legislation attached to my testimony to remedy the allocable share problem and to generate additional dollars in MSA payments for the state, in lieu of the provisions of HB 2946. This will avoid the payment/refund gymnastics and the legal problems associated with HB 2946 as written.

Thank you very much for permitting me to testify, and I will be happy to yield to questions.

BILL No. _____

By _____

AN ACT implementing an amendment to the tobacco master settlement agreement; amending K.S.A. 50-6a03.

Be it enacted by the Legislature of the State of Kansas:

Section 1. K.S.A. 50-6a03 is hereby amended to read as follows: 50-6a03. Requirements for sale of cigarettes; penalties.

Any tobacco product manufacturer selling cigarettes to consumers within the state (whether directly or through a distributor, retailer or similar intermediary or intermediaries) after the effective date of this act shall do one of the following:

(a) Become a participating manufacturer (as that term is defined in section II(jj) of the master settlement agreement) and generally perform its financial obligations under the master settlement agreement; or

(b) (1) place into a qualified escrow fund by April 15 of the year following the year in question the following amounts (as such amounts are adjusted for inflation):

(A) 1999: \$.0094241 per unit sold after the effective date of this act;

(B) 2000: \$.0104712 per unit sold;

(C) for each of 2001 and 2002: \$.0136125 per unit sold;

(D) for each of 2003 through 2006: \$.0167539 per unit sold;

(E) for each of 2007 and each year thereafter: \$.0188482 per unit sold.

(2) A tobacco product manufacturer that places funds into escrow pursuant to paragraph (1) of subsection (b) shall receive the interest or other appreciation on such funds as earned. Such funds themselves shall be released from escrow only under the following circumstances:

(A) To pay a judgment or settlement on any released claim brought against such tobacco product manufacturer by the state or any releasing party located or residing in the state. Funds shall be released from escrow under this subparagraph (i) in the order in which they were placed into escrow and (ii) only to the extent and at the time necessary to make payments required under such judgment or settlement;

(B) to the extent that a tobacco product manufacturer establishes that the amount it was required to place into escrow *on account of units sold in the state* in a particular year was greater than the state's allocable share of the total payments that such manufacturer would have been required to make in that year under the master settlement agreement (as determined pursuant to section IX(i)(2) of the master settlement agreement, and before any of the adjustments or offsets described in section IX(i)(3) of that agreement other than the inflation adjustment) *Master Settlement Agreement payments, as determined pursuant to section IX(i) of that Agreement including after final determination of all adjustments, that such manufacturer would have been required to make on account of such units sold* had it been a participating manufacturer, the excess shall be released from escrow and revert back to such tobacco product manufacturer; or

(C) to the extent not released from escrow under subparagraphs (A) or (B) of paragraph (2) of subsection (b), funds shall be released from escrow and revert back to such tobacco product manufacturer 25 years after the date on which they were placed into escrow.

(3) Each tobacco product manufacturer that elects to place funds into escrow pursuant to this subsection shall annually certify to the attorney general that it is in compliance with this subsection. The attorney general may bring a civil action on behalf of the state against any tobacco product manufacturer that fails to place into escrow the funds required under this section. Any tobacco product manufacturer that fails in any year to place into escrow the funds required under this section shall:

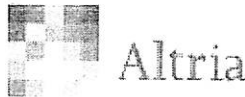
(A) Be required within 15 days to place such funds into escrow as shall bring it into compliance with this section. The court, upon a finding of a violation of this subsection, may impose a civil penalty to be credited to the state general fund in an amount not to exceed 5% of the amount improperly withheld from escrow per day of the violation and in a total amount not to exceed 100% of the original amount improperly withheld from escrow;

(B) in the case of a knowing violation, be required within 15 days to place such funds into escrow as shall bring it into compliance with this section. The court, upon a finding of a knowing violation of this subsection, may impose a civil penalty to be paid to the state general fund in an amount not to exceed 15% of the amount improperly withheld from escrow per day of the violation and in a total amount not to exceed 300% of the original amount improperly withheld from escrow; and

(C) in the case of a second knowing violation, be prohibited from selling cigarettes to consumers within the state (whether directly or through a distributor, retailer or similar intermediary) for a period not to exceed two years.

Each failure to make an annual deposit required under this section shall constitute a separate violation. A tobacco product manufacturer who is found in violation of this section shall pay, in addition to other amounts assessed under this section and pursuant to law, the costs and attorney's fees incurred by the state during a successful presentation under this paragraph (3).

Sec. 2. If this act, or any portion of the amendment to subsection (b)(2)(B) of K.S.A. 50-6a03 made by this act, is held by a court of competent jurisdiction to be unconstitutional, then such subsection (b)(2)(B) of K.S.A. 50-6a03 shall be deemed to be repealed in its entirety. If subsection (b)(2) of K.S.A. 50-6a03 shall thereafter be held by a court of competent jurisdiction to be unconstitutional, then this act shall be deemed repealed, and subsection (b)(2)(B) of K.S.A. 50-6a03 be restored as if no such amendment had been made. Neither any holding of unconstitutionality nor the repeal of subsection (b)(2)(B) of K.S.A. 50-6a03 shall affect, impair, or invalidate any other portion of K.S.A. 50-6a03, or the application of such section to any other person or circumstance, and such remaining portions of K.S.A. 50-6a03 shall at all times continue in full force and effect.



Derek L. Crawford
District Director
SGA

Altria Corporate Services, Inc.
Time Warner Entertainment Centers

847 646 2000
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March 30, 2004

The Honorable Representative Neufeld
Kansas State Capitol
Topeka, KS

Dear Chairman Neufeld,

I am writing to you on behalf of Philip Morris USA, an Altria Group company. Philip Morris USA is very much opposed to HB 2946.

We are opposed for the following key reasons:

- This proposed tax would violate the MSA by abrogating many of its' central provisions.
- By violating the MSA, the tax would jeopardize Kansas' MSA payments as well as its important public health provisions.
- This new tax may result in years of litigation.

We do not believe that the intent of the bill is to dismantle the agreement that Kansas, 45 other states and the US territories worked for just a few years ago. If the intent is to close the loophole in the state's existing NPM escrow, we recommend and support the "Allocable Share" proposal supported by National Association of Attorney Generals. It is unfortunate that this type of bill has not been introduced in Kansas yet.

I hope that your committee considers the potentially risky situation HB 2946 would place the state's fiscal standing and recommend that HB 2946 be tabled.

Thank you in advance for your consideration. If you have further questions or need additional information, please do not hesitate to contact me.

Sincerely,

Derek Crawford
District Director, SGA
Altria Corporate Services, Inc.

CC: Mark Berling
Henry Turner
Scott Fisher

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