The Tobacco Arbitration Settlement:

What will it mean for Kansas children?

HISTORY OF TOBACCO SETTLEMENT

Kansas was one of a number of states that filed suit against the big tobacco companies in the 1990s to recoup money lost because of smoking-related Medicaid spending. After Florida, Minnesota, Mississippi and Texas individually settled their cases out of court, the tobacco companies and remaining states reached a settlement called the Master Settlement Agreement (MSA). The agreement was signed on Nov. 23, 1998, by 46 states, including Kansas.

The agreement imposed a number of restrictions on the participating tobacco companies and required them to make $206 billion in payments to the states over 25 years. A schedule for the payments was included in the agreement along with provisions for adjustment, reduction and offset. The agreement also compelled states to adopt and enforce legislation aimed at protecting participating tobacco companies from losing market share to non-participating companies.

HISTORY OF ARBITRATION

The original MSA agreement protected participating tobacco companies, referred to as "Participating Manufacturers," from losing market share to smaller, non-participating manufacturers of tobacco products. The MSA allows participating manufacturers to trigger an arbitration process to challenge state enforcement. Under the MSA, if the following criteria are met, the participating manufacturer may reduce their annual payment by three times the amount of market share loss:

- If the participating manufacturer lost more than 2 percent of its market share in a year
- If the loss in market share was due to participation in the MSA
- If the state failed to diligently enforce statutes requiring non-participating manufacturers to pay into a state-overseen escrow account for 25 years

In the spring of 2006, the three largest participating manufacturers, Lorriland Tobacco Co., R.J. Reynolds Tobacco Co. and Philip Morris USA (Altria Group), gave notice that they were withholding a portion of their MSA payments to states, noting that their collective market share had fallen from 99.6 percent in 1997 to 92 percent in 2003. The arbitration process that was triggered continued until a settlement was reached with Kansas and a number of other states in December 2012. This settlement was approved by the arbitration panel on March 12, 2013, ending the dispute for 18 states, including Kansas.

ARBITRATION SETTLEMENT AND ITS IMPACT IN KANSAS

The arbitration settlement allowed Kansas to avoid uncertainty and significant potential reductions in state MSA tobacco payments for 2003-2010 and beyond. In addition to eliminating the risk that the state would be required to return money to the tobacco companies, the settlement also provided Kansas with a share of the money that tobacco companies had withheld from their payments during the arbitration process. These dollars from the Disputed Payment Account (DPA) total approximately $46 million for Kansas.

While the terms of the settlement benefitted the state by eliminating risks, it also provided a number of benefits to the participating manufacturers. Among these were credits against current and future tobacco settlement payments and a portion of the DPA money. The regular Kansas tobacco payment was reduced by $18 million in 2013 and will be reduced by an additional $17 million total in future years when credits awarded to the participating manufacturers are claimed.

Unlike the rest of the states participating in the arbitration settlement, Kansas opted to receive only a portion of its DPA, $28.9 million, in 2013. The remaining $17.2 million is expected to be received in 2014.

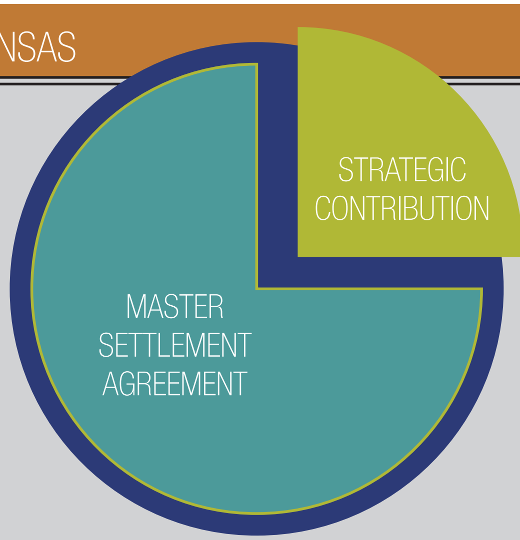
EXPECTED DROP IN TOBACCO REVENUES FOR KANSAS

The original MSA had two types of payments. One was the standard annual payment based on smoking-related health costs to the state. This payment goes on into perpetuity and fluctuates based on a number of factors, including the current smoking rate in the state. The second type of payment was based on the strategic contribution of the state to the original tobacco litigation. This payment started in 2008 and will end in 2017. The strategic contribution is a significant part of the annual Kansas tobacco payment. In 2013, the strategic contribution portion was 24 percent—almost a quarter—of the total MSA tobacco payment.

ANNUAL MSA PAYMENTS TO KANSAS

FY 1999	$49,705,586
FY 2000	$52,935,158
FY 2001	$61,465,211
FY 2002	$61,511,858
FY 2003	$52,531,729
FY 2004	$53,453,765
FY 2005	$49,463,355
FY 2006	$47,515,501
FY 2007	$46,900,000
FY 2008	$66,347,833
FY 2009	$72,278,198
FY 2010	$60,838,465
FY 2011	$57,091,087
FY 2012	$57,985,065
FY 2013	$68,000,000
FY 2014 (EST.)	$55,000,000

PAYMENTS TO KANSAS



THE STRATEGIC CONTRIBUTION PORTION IS 24% OF THE MSA. AFTER 2017 THIS WILL BE DISCONTINUED.

RELATIONSHIP BETWEEN MSA PAYMENTS AND KANSAS CHILDREN

In Kansas, lawmakers decided to use MSA tobacco dollars to invest in children. They created a system in which MSA tobacco dollars flow first to the Kansas Endowment for Youth (KEY) Fund and then to the Children's Initiatives Fund (CIF) to provide varying levels of support for most programs that provide services to young children in Kansas. Under this system, the KEY Fund serves as an endowment to insulate programs from short-term fluctuation in tobacco revenue. Unfortunately, repeated raids of the KEY Fund to balance the State General Fund have left the endowment empty. This system is overseen by the Kansas Children's Cabinet and Trust Fund, which also makes recommendations for spending MSA tobacco dollars. Approximately 200,000 — roughly one-third of the state's children — were served last year by programs that rely on CIF dollars.

Since the original tobacco settlement, the number and type of programs funded through the CIF have varied from a low of 16 programs in FY 2000 to a high of 26 programs in FY 2009. In FY 2014, lawmakers appropriated CIF funding for 19 programs administered by three state agencies: the Kansas Department of Health and Environment, the Kansas Department of Children and Families and the Kansas Department of Education.

Kansas statute reflects the intent for the CIF to serve as an additional and innovative source of funding for children's programs by prohibiting lawmakers from supplanting existing State General Fund investments for CIF dollars. However, in reality, lawmakers have shifted the funding responsibility for a number of existing programs over the years from the State General Fund to the CIF and reliance on MSA tobacco dollars. This creates a high-stakes environment surrounding MSA tobacco issues for advocates for Kansas children.

THE 2013 KANSAS LEGISLATIVE SESSION AND THE "SWEEP."

Leading up to the 2013 legislative session, there was a great deal of uncertainty in Kansas about the anticipated April 2013 MSA tobacco payment. In fact, state officials tasked with developing an estimate of the 2013 payment amount failed to reach a consensus on the estimate for the first time.

The FY 2014 Governor's Budget Report released in January 2013 acknowledged the arbitration settlement that Kansas and other states had reached with the participating tobacco manufacturers, noting that states would receive their share of disputed payments, manufacturers would receive credits against future payments and that the arbitration panel must approve the agreement. However, the Governor's Budget Recommendation for the CIF was based on a $51.5 million payment in FY 2014 and a $52 million payment in FY 2015, both of which were significantly lower than any payment received since the strategic contribution payments began in 2008.

Information detailing estimated payment amounts was kept confidential throughout much of the legislative process in spite of requests for information through the Kansas Open Records Act (KORA). Legislative budget committees were given no reason to believe that additional funding might be available for children's programs funded through the CIF during the sub-committee process. By the time it became clear that 2013 MSA tobacco payments would exceed the level projected by the Governor's Budget Report by $12.2 million, most of the detail-level budget work for FY 2014 and FY 2015 had been completed.

A series of three MSA tobacco payments were received by Kansas between April 16, 2013, and April 25, 2013, totaling nearly $68.0 million. Shortly thereafter, on April 26, a Governor's Budget Amendment (GBA) was issued increasing the estimated MSA tobacco receipts for FY 2014 and FY 2015 and recommending the sweep of $9.5 million from the tobacco MSA payment to shore up the State General Fund. Ultimately, the Legislature approved the governor's recommendation to sweep the MSA tobacco dollars from the endowment for children's programs.

One justification for the sweep was that children's programs were not cut in the budget and the $9.5 million were not necessary to fund children's programs. However, this ignores the increasing need for early childhood services and the growing cost of providing those services. In one example, the Infants and Toddlers Program (Tiny-K) is required to provide early childhood special education services to all qualified children but must do so on the same dollar amount of state funding they received in 2008 in spite of significant increases in the number of children served each year. It also fails to acknowledge the anticipated drop in MSA tobacco payments after the strategic contribution payments end in 2017. Retaining MSA tobacco dollars in the KEY Fund and allowing it to serve as a true endowment would mitigate the negative impact of decreasing tobacco revenues.

INFORMATION TIMELINE FOR KANSAS TOBACCO ARBITRATION

SPRING 2006	Participating manufacturers withhold a portion of payments and trigger the arbitration process.
NOVEMBER 2012	Kansas officials fail to reach consensus on 2013 MSA tobacco payment estimate.
DECEMBER 2012	Kansas and other states reach an agreement with participating manufacturers in tobacco arbitration.
JANUARY 2013	Governor releases budget report acknowledging arbitration settlement but estimating lowest MSA payment since 2007.
MARCH 12, 2013	MSA tobacco arbitration panel approves the arbitration settlement.
APRIL 16-25, 2013	Kansas receives a series of three MSA tobacco payments totaling $68 million.
APRIL 26, 2013	Governor's Budget Amendment is issued recommending the sweep of $9.5 million in MSA tobacco dollars to the State General Fund.
MAY 1, 2013	Child advocates make first KORA request for information regarding payments resulting from the tobacco arbitration.
MAY 8, 2013	Child advocates revise and reissue a KORA request for information regarding payments resulting from the tobacco arbitration.
MAY 10, 2013	Kansas Action for Children filed suit in Shawnee County District Court to obtain information regarding tobacco payments.
MAY 20, 2013	Office of the Kansas Attorney General releases heavily redacted PricewaterhouseCoopers accounting document regarding tobacco arbitration payments.
MAY 20, 2013	Kansas House Appropriations Committee votes to adopt the GBA sweeping $9.5 million in MSA tobacco payments to the State General Fund.
AUG. 13, 2013	Child advocates submit a new KORA request for information regarding the earliest estimates of Kansas 2013 MSA tobacco payments.
OCT. 9, 2013	Office of the Kansas Attorney general releases heavily redacted PricewaterhouseCoopers versions of accounting document regarding tobacco arbitration payments between March 29, 2013, and April 12, 2013.
NOV. 5, 2013	Child advocates revise their KORA request for information regarding the earliest estimates of the Kansas 2013 MSA tobacco payment as well as requesting any documents estimating the state's 2014 MSA tobacco payment.

THE FUTURE FOR KANSAS MSA TOBACCO PAYMENTS

Kansas will receive the second part of its DPA dollars resulting from the arbitration settlement in April 2014. This is expected to be $17.2 million. The Kansas Children's Cabinet and Trust Fund has recommended that these dollars be placed into a grant fund for innovative early childhood programs called the Early Childhood Block Grant. Advocates want to protect against another sweep of these dollars to fill a hole in the State General Fund.

Kansas lawmakers decided over a decade ago that the best way to protect against the cost of smoking-related health care costs is to ensure that future generations are put on a path to health and prosperity early in life. A decision to either retain the MSA tobacco dollars in the endowment for children's programs or to invest it in current children's programs will strengthen Kansas children and provide a better start for future generations.

Kansas Action For Children

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