

Memorandum

To : Honorable Betty T. Yee, Interim Chairwoman
Honorable Bill Leonard, Interim Vice-Chair
Honorable Michelle Steel, Third District
Honorable Judy Chu, Ph.D., Fourth District
Honorable John Chiang, Controller

Date: January 23, 2007

From : Kristine Cazadd
Chief Counsel 

Subject: Report on Tobacco Master Settlement Agreement Status
February 1, 2007 Board Meeting
Item P2, Number 2

In 1998, the attorneys general of 46¹ states and various territories settled more than 40 pending lawsuits against the tobacco industry by entering into a Master Settlement Agreement (MSA) with the nation's four major tobacco companies. The MSA requires the four "original participating manufacturers" (OPMs) to pay \$206 billion for at least 25 years and to substantially limit the advertising, promotion and marketing of cigarettes.² The Settling States agreed to release the "original participating manufacturers" (OPMs) from specified claims that the states (but not individuals) had, and might have in the future, for costs arising out of tobacco-related illnesses. The MSA requires a reduction in the OPM payments to the 46 states and territories if the companies experience a market share loss to cigarette manufacturers (NPMs)³ that did not participate in the MSA. Terms of the MSA allow a state to avoid a payment reduction by adopting a "qualifying statute" or model statute which requires NPMs to make payments into an escrow account and requires the state to diligently enforce the statute. California adopted the model statute (SB 822) in 1999, and believes it has diligently enforced the model statute.

¹ Four states—Florida, Minnesota, Mississippi, and Texas—had previously settled their cases with the tobacco industry.

² From the MSA payments due to the states, California receives approximately 13 percent (approximately \$1 billion annually). Fifty percent is allocated to the state and 50 percent to local governments, which is allocated 90 percent to the counties with the remaining 10 percent equally to the cities of Los Angeles, San Diego, San Francisco, and San Jose. In 2002-03 and 2003-04, California securitized the future MSA payments by selling bonds backed by their future share of the annual payments under the MSA. A backup General Fund appropriation provides additional bond security.

³ Also known as Non-Participating Manufacturers.

For the year 2003, the determination was made in 2006 that the disadvantages built into the MSA were a significant factor contributing to the Participating Manufacturer's (PM's)⁴ Market Share Loss in 2003, and litigation then ensued regarding whether California had diligently enforced the model statute.

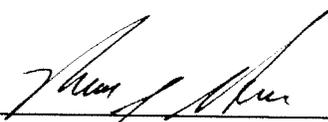
On January 16, 2007, after performing its economic analysis, the Brattle Group (Firm) of Cambridge, Massachusetts, released its Preliminary Determination for the 2004 Significant Factor determination. The Firm concluded, as it did for 2003, that the disadvantages built into the MSA were a significant factor contributing to the Participating Manufacturer's (PM's) Market Share Loss in 2004. This determination is not final, however, and the parties have two weeks within which to submit comments on the preliminary determination.

The Office of Attorney General (AGO) has not had an opportunity to study the ruling or to discuss it with other Settling States or outside counsel. However, the AGO's initial impression is that the ruling represents another carefully-considered determination from the Firm that the MSA's disadvantages were a significant factor in its determination. Accordingly, the Firm likely will not reverse its finding. Thus, the AGO will assume for its planning purposes that the Firm's final determination for 2004 will be adverse and that it should start working on California's diligent enforcement case for 2004.

As with the 2003 Final Decision now in litigation, the anticipated 2004 Final Decision, regarding the significant factors which contributed to the 2004 market share loss, could result in a 2004 NPM adjustment for California. A 2004 adjustment would be triggered if California failed to diligently enforce its NPM escrow statute during 2004. The AGO will file suit seeking a determination that no adjustment is proper on the ground that California diligently enforced its NPM escrow statute in 2004. The 2004 Final Decision from the Firm is expected on or about February 15, 2007.

If you have any questions, please contact Legal Affairs Tax Counsel III Michael Llewellyn at (916) 324-2674 or Legal Affairs Assistant Chief Counsel Janice Thurston at (916) 324-2588.

Approved:



Ramon J. Hirsig
Executive Director

KC:pl

⁴ Participating Manufacturers include the "original participating manufacturers" and manufacturers who later entered into the MSA.

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