

# CAMPAIGN For TOBACCO-FREE Kids®

## HOW THE MSA VOLUME ADJUSTMENT IS CALCULATED

All of the Multistate Settlement Agreement (MSA) payments to the states are subject to a volume adjustment, which is calculated by multiplying each state's base payment amounts by:

$$.98 \times \frac{\text{OPM's Prior Year United States Cigarette Shipments} \text{ minus } \text{OPM's 1997 Shipments}}{\text{(1997 U.S. Cigarette Shipments By Original Participating Manufacturers)}}$$

OPMs = Original Participating Manufacturers = Philip Morris, RJR Tobacco, Brown & Williamson, Lorillard.

United States Cigarette Shipments = Manufacturers' cigarette shipments intended for U.S. Sale to U.S. smokers (Actual numbers used are, pursuant to the MSA, the U.S. cigarette shipment data available from Management Science Associates, Inc., a private company that collects such data for the tobacco companies).<sup>\*</sup> It is important to note that the declines in OPM shipments intended for U.S. sale do not necessarily equal the declines in U.S. cigarette sales over the same time period. For 2000, for example, the volume adjustment percentage based on the decline in OPM shipments from 1977 to 1999 was significantly larger than the percentage decline in U.S. cigarette consumption from 1997 to 1999.

In other words, for any given year's MSA payments a ten percent decline in the major cigarette companies' US shipments from 1997 to the prior year would produce a 9.8 percent reduction to the MSA payments to the states for that year – subject to the following.

**Volume Adjustment Modifier.** The size of any downward volume adjustment amount is reduced if the Original Participating Manufacturers' aggregate operating income from prior year cigarette sales in the fifty United States, DC, and Puerto Rico is greater than \$7,195,340,000 (adjusted upward to account for inflation). If this adjustment to the volume adjustment applies, the size of the downward volume adjustment is reduced by the following amount:

$$.25 \times (\text{OPMs' Prior Year Aggregate Operating Income} \text{ minus } \text{the inflation-adjusted } \$7,195,340)$$

Aggregate Operating Income = Aggregate operating income from sales of cigarettes in the fifty United States, the District of Columbia, and Puerto Rico: (a) before goodwill amortization, trademark amortization, restructuring charges and restructuring related charges, minority interest, net interest expense, non-operating income and expense, general corporate expenses and income taxes; and (b) excluding extraordinary items, cumulative effect of changes in method of accounting and discontinued operations -- all as such income is reported to the United States Securities and Exchange Commission ("SEC") or, in the case of an Original Participating Manufacturer that does not report income to the SEC, as reported in financial statements prepared in accordance with U.S. generally accepted accounting principles and audited by a nationally recognized accounting firm.

\$7,195,340 = OPMs' aggregate operating income from U.S. cigarette sales in 1996.

Inflation Adjustment = the greater of three percent or the actual inflation rate per year since 1996.

The volume adjustment modifier did not apply to the volume adjustments to the states' 2000 payments.

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Settlement payments to the states are also subject to other adjustments, most notably the automatic, upward, inflation adjustment based on the greater of three percent or the actual inflation rate for each year from 1997.

### **Additional Information**

The full text of the MSA can be found at [www.naaq.org](http://www.naaq.org). See relevant MSA text, below.

For an extensive analysis of the MSA by the Tobacco Control Resource Center, see <http://www.tobacco.neu.edu/msa/index.html>.

Campaign for Tobacco-Free Kids fact sheet, *Adjustments to the State's Tobacco Settlement Receipts*, <http://tobaccofreekids.org/research/factsheets/index8.shtml> or [www.tobaccofreekids.org](http://www.tobaccofreekids.org).

*National Center for Tobacco-Free Kids, November 14, 2000*

### **Relevant Text from the Multistate Settlement Agreement**

#### **EXHIBIT E**

#### **FORMULA FOR CALCULATING VOLUME ADJUSTMENTS**

Any amount that by the terms of the Master Settlement Agreement is to be adjusted pursuant to this Exhibit E (the "Applicable Base Payment") shall be adjusted in the following manner:

- (A) In the event the aggregate number of Cigarettes shipped in or to the fifty United States, the District of Columbia, and Puerto Rico by the Original Participating Manufacturers in the Applicable Year (as defined hereinbelow) (the "Actual Volume") is greater than 475,656,000,000 Cigarettes (the "Base Volume"), the Applicable Base Payment shall be multiplied by the ratio of the Actual Volume to the Base Volume.
- (B) In the event the Actual Volume is less than the Base Volume,
  - i. The Applicable Base Payment shall be reduced by subtracting from it the amount equal to such Applicable Base Payment multiplied both by 0.98 and by the result of (i) 1(one) minus (ii) the ratio of the Actual Volume to the Base Volume.
  - ii. Solely for purposes of calculating volume adjustments to the payments required under subsection IX(c)(1), if a reduction of the Base Payment due under such subsection results from the application of subparagraph (B)(i) of this Exhibit E, but the Original Participating Manufacturers' aggregate operating income from sales of Cigarettes for the Applicable Year in the fifty United States, the District of Columbia, and Puerto Rico (the "Actual Operating Income") is greater than \$7,195,340,000 (the "Base Operating Income") (such Base Operating Income being adjusted upward in accordance with the formula for inflation adjustments set forth in Exhibit C hereto beginning December 31, 1996 to be applied for each year after 1996) then the amount by which such Base Payment is reduced by the application of subsection (B)(i) shall be reduced (but not below zero) by the amount calculated by multiplying (i) a percentage equal to the aggregate Allocable Shares of the Settling States in which State-Specific Finality has occurred by (ii) 25% of such increase in such operating income.

For purposes of this Exhibit E, "operating income from sales of Cigarettes" shall mean operating income from sales of Cigarettes in the fifty United States, the District of Columbia, and Puerto Rico: (a) before goodwill amortization, trademark amortization, restructuring

charges and restructuring related charges, minority interest, net interest expense, non-operating income and expense, general corporate expenses and income taxes; and (b) excluding extraordinary items, cumulative effect of changes in method of accounting and discontinued operations -- all as such income is reported to the United States Securities and Exchange Commission ("SEC") for the Applicable Year (either independently by the Participating Manufacturer or as part of consolidated financial statements reported to the SEC by an Affiliate of such Participating Manufacturer) or, in the case of an Original Participating Manufacturer that does not report income to the SEC, as reported in financial statements prepared in accordance with U.S. generally accepted accounting principles and audited by a nationally recognized accounting firm. For years subsequent to 1998, the determination of the Original Participating Manufacturers' aggregate operating income from sales of Cigarettes shall not exclude any charges or expenses incurred or accrued in connection with this Agreement or any prior settlement of a tobacco and health case and shall otherwise be derived using the same principles as were employed in deriving such Original Participating Manufacturers' aggregate operating income from sales of Cigarettes in 1996.

- iii. Any increase in a Base Payment pursuant to subsection (B)(ii) above shall be allocated among the Original Participating Manufacturers in the following manner:
  - (1) only to those Original Participating Manufacturers whose operating income from sales of Cigarettes in the fifty United States, the District of Columbia and Puerto Rico for the year for which the Base Payment is being adjusted is greater than their respective operating income from such sales of Cigarettes (including operating income from such sales of any of their Affiliates that do not continue to have such sales after the MSA Execution Date) in 1996 (as increased for inflation as provided in Exhibit C hereto beginning December 31, 1996 to be applied for each year after 1996); and
  - (2) among the Original Participating Manufacturers described in paragraph (1) above in proportion to the ratio of (x) the increase in the operating income from sales of Cigarettes (as described in paragraph (1)) of the Original Participating Manufacturer in question, to (y) the aggregate increase in the operating income from sales of Cigarettes (as described in paragraph (1)) of those Original Participating Manufacturers described in paragraph (1) above.
- (C) "Applicable Year" means the calendar year immediately preceding the year in which the payment at issue is due, regardless of when such payment is made.
- (D) For purposes of this Exhibit, shipments shall be measured as provided in subsection II(mm).

\* \* \* \* \*

II(mm) "Relative Market Share" means an Original Participating Manufacturer's respective share (expressed as a percentage) of the total number of individual Cigarettes shipped in or to the fifty United States, the District of Columbia and Puerto Rico by all the Original Participating Manufacturers during the calendar year immediately preceding the year in which the payment at issue is due (regardless of when such payment is made), **as measured by the Original Participating Manufacturers' reports of shipments of Cigarettes to Management Science Associates, Inc.** (or a successor entity acceptable to both the Original Participating Manufacturers and a majority of those Attorneys General who are both the Attorney General of a Settling State and a member of the NAAG executive committee at the time in question). A Cigarette shipped by more than one Participating Manufacturer shall be deemed to have been shipped solely by the first Participating Manufacturer to do so. For purposes of the definition and determination of "Relative Market Share," 0.09 ounces of "roll your own" tobacco shall constitute one individual Cigarette.

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**EXHIBIT C**

**FORMULA FOR CALCULATING INFLATION ADJUSTMENTS**

- (1) Any amount that, in any given year, is to be adjusted for inflation pursuant to this Exhibit (the “Base Amount”) shall be adjusted upward by adding to such Base Amount the Inflation Adjustment.
- (2) The Inflation Adjustment shall be calculated by multiplying the Base Amount by the Inflation Adjustment Percentage applicable in that year.
- (3) The Inflation Adjustment Percentage applicable to payments due in the year 2000 shall be equal to the greater of 3% or the CPI%. For example, if the Consumer Price Index for December 1999 (as released in January 2000) is 2% higher than the Consumer Price Index for December 1998 (as released in January 1999), then the CPI% with respect to a payment due in 2000 would be 2%. The Inflation Adjustment Percentage applicable in the year 2000 would thus be 3%.
- (4) The Inflation Adjustment Percentage applicable to payments due in any year after 2000 shall be calculated by applying each year the greater of 3% or the CPI% on the Inflation Adjustment Percentage applicable to payments due in the prior year. Continuing the example in subsection (3) above, if the CPI% with respect to a payment due in 2001 is 6%, then the Inflation Adjustment Percentage applicable in 2001 would be 9.1800000% (an additional 6% applied on the 3% Inflation Adjustment Percentage applicable in 2000), and if the CPI% with respect to a payment due in 2002 is 4%, then the Inflation Adjustment Percentage applicable in 2002 would be 13.5472000% (an additional 4% applied on the 9.1800000% Inflation Adjustment Percentage applicable in 2001).
- (5) “Consumer Price Index” means the Consumer Price Index for All Urban Consumers as published by the Bureau of Labor Statistics of the U.S. Department of Labor (or other similar measures agreed to by the Settling States and the Participating Manufacturers).
- (6) The “CPI%” means the actual total percent change in the Consumer Price Index during the calendar year immediately preceding the year in which the payment in question is due.
- (7) Additional Examples.

(A) Calculating the Inflation Adjustment Percentages:

Payment Year	Hypothetical CPI%	Percentage to be applied on the Inflation Adjustment Percentage for the prior year (i.e., the greater of 3% or the CPI%)	Inflation Adjustment Percentage
2000	2.4%	3.0%	3.0000000%
2001	2.1%	3.0%	6.0900000%
2002	3.5%	3.5%	9.8031500%
2003	3.5%	3.5%	13.6462603%
2004	4.0%	4.0%	18.1921107%
2005	2.2%	3.0%	21.7378740%
2006	1.6%	3.0%	25.3900102%

(B) Applying the Inflation Adjustment:

Using the hypothetical Inflation Adjustment Percentages set forth in section (7)(A):

- the subsection IX(c)(1) base payment amount for 2002 of \$6,500,000,000 as adjusted for inflation would equal \$7,137,204,750;
- the subsection IX(c)(1) base payment amount for 2004 of \$8,000,000,000 as adjusted for inflation would equal \$9,455,368,856;
- the subsection IX(c)(1) base payment amount for 2006 of \$8,000,000,000 as adjusted for inflation would equal \$10,031,200,816.