

NEW ISSUE

In the opinion of Hawkins Delafield & Wood LLP, Bond Counsel to the Corporation, under existing statutes and court decisions, assuming continuing compliance with certain tax covenants as described herein, interest on the Series 2008 Bonds is excluded from gross income for federal income tax purposes under Section 103 of the Internal Revenue Code of 1986, as amended (the "Code"). In addition, interest on the Series 2008 Bonds is not treated as a preference item in calculating the alternative minimum tax imposed on individuals and corporations under the Code. Such interest, however, is included in the adjusted current earnings of certain corporations for purposes of computing the alternative minimum tax imposed on such corporations. In addition, in the opinion of Bond Counsel, under the Act, interest on the Series 2008 Bonds is exempt from personal income taxes imposed by the State of New York and its political subdivisions, including The City of New York. See "TAX MATTERS" herein regarding certain other tax considerations.

**\$443,875,000**  
**Tobacco Settlement Financing Corporation**  
**(State of New York)**  
**Asset-Backed Revenue Bonds, Series 2008**  
**(State Contingency Contract Secured)**  
**Consisting of**

**\$219,935,000**  
**Asset-Backed Revenue Bonds,**  
**Series 2008A**  
**(State Contingency Contract Secured)**

**\$223,940,000**  
**Asset-Backed Revenue Bonds,**  
**Series 2008B**  
**(State Contingency Contract Secured)**

Dated: Date of Delivery

Due: June 1, as shown on the inside front cover

**Payment and Security:** The Asset-Backed Revenue Bonds, Series 2008 (the "Series 2008 Bonds") are special obligations of the Tobacco Settlement Financing Corporation (the "Corporation"), consisting of the Asset-Backed Revenue Bonds, Series 2008A (the "Series 2008A Bonds") and the Asset-Backed Revenue Bonds, Series 2008B (the "Series 2008B Bonds").

The Series 2008A Bonds are issued under the Indenture, dated as of June 1, 2003, as supplemented by the Series 2003A Supplement and the Series 2008A Supplement (collectively, the "Series A Indenture"), between the Corporation and The Bank of New York, as indenture trustee (the "Series A Trustee"). The Series 2008A Bonds, together with all outstanding bonds previously issued and any additional refunding bonds to be issued under the Series A Indenture (collectively, the "Series A Bonds"), are payable from and secured by a pledge of the "Series A Pledged Revenues," which consist primarily of (i) the Series A Pledged Settlement Payments (defined below) sold by the State of New York (the "State") to the Corporation pursuant to the Purchase and Sale Agreement, dated as of June 1, 2003 (the "Series A Sale Agreement"), between the State and the Corporation and (ii) the payments (the "Series A Contract Payments") to be made by the State pursuant to the Contingency Contract, dated as of June 1, 2003 (the "Series A Contract"), between the State and the Corporation, in such amounts, subject to appropriation by the State Legislature, as are necessary to pay when due the principal of and interest on the Series A Bonds, including the Series 2008A Bonds, to the extent that amounts on deposit in the Series A Pledged Revenues Account, the Series A Debt Service Account, the Series A Supplemental Account and the Series A Debt Service Reserve Account (collectively, the "Series A Pledged Accounts") are insufficient therefor. Upon the issuance of the Series 2008A Bonds and the application of the proceeds thereof, \$1,939,615,000 of Series A Bonds will be outstanding under the Series A Indenture.

Pursuant to the Act and the Series A Sale Agreement, the State sold to the Corporation the "Series A Pledged Settlement Payments," consisting of (i) fifty percent (50%) of the annual payments and strategic contribution fund payments (as defined herein) and of all adjustments to prior payments, payable to the State pursuant to the MSA (as defined below) and received on and after January 1, 2004 and (ii) fifty percent (50%) of all Series A Lump Sum Payments (as defined herein) received at any time on or after June 19, 2003.

The Series 2008B Bonds are issued under the Indenture, dated as of December 1, 2003, as supplemented by the Series 2003B Supplement and the Series 2008B Supplement (collectively, the "Series B Indenture"), between the Corporation and The Bank of New York, as indenture trustee (the "Series B Trustee"). The Series 2008B Bonds, together with all outstanding bonds previously issued and any additional refunding bonds to be issued under the Series B Indenture (collectively, the "Series B Bonds"), are payable from and secured by a pledge of the "Series B Pledged Revenues," which consist primarily of (i) the Series B Pledged Settlement Payments (defined below) sold by the State to the Corporation pursuant to the Purchase and Sale Agreement, dated as of December 1, 2003 (the "Series B Sale Agreement"), between the State and the Corporation and (ii) the payments (the "Series B Contract Payments") to be made by the State pursuant to the Contingency Contract, dated as of December 1, 2003 (the "Series B Contract"), between the State and the Corporation, in such amounts, subject to appropriation by the State Legislature, as are necessary to pay when due the principal of and interest on the Series B Bonds, including the Series 2008B Bonds, to the extent that amounts on deposit in the Series B Pledged Revenues Account, the Series B Debt Service Account, the Series B Supplemental Account and the Series B Debt Service Reserve Account (collectively, the "Series B Pledged Accounts") are insufficient therefor. Upon the issuance of the Series 2008B Bonds and the application of the proceeds thereof, \$1,930,655,000 of Series B Bonds will be outstanding under the Series B Indenture.

Pursuant to the Act and the Series B Sale Agreement, the State sold to the Corporation the "Series B Pledged Settlement Payments," consisting of (i) fifty percent (50%) of the annual payments and strategic contribution fund payments (as defined herein) and of all adjustments to prior payments, payable to the State pursuant to the MSA (as defined below) and received on and after January 1, 2004 and (ii) fifty percent (50%) of all Series B Lump Sum Payments (as defined herein) received at any time on or after December 2, 2003.

The Master Settlement Agreement (the "MSA") was entered into by participating cigarette manufacturers (the "PMs"), the State, 45 other states and six other U.S. jurisdictions (collectively, the "Settling States"), in November 1998 in the settlement of certain smoking-related litigation pursuant to which the PMs agreed to make certain payments to the Settling States (such payments as more fully described herein, the "Tobacco Settlement Revenues").

The Series A Bonds and the Series B Bonds are each separately secured by the Series A Pledged Revenues and the Series B Pledged Revenues, respectively. The Series A Trustee shall not have the right to make a claim to mitigate all or any part of an asserted deficiency in the Series A Pledged Revenues from the Series B Pledged Revenues and, likewise, the Series B Trustee shall not have the right to make a claim to mitigate all or part of an asserted deficiency in the Series B Pledged Revenues from the Series A Pledged Revenues. The rights of the Series A Trustee and the Series B Trustee to receive its respective Pledged Revenues are equal to and on a parity with each other and one right is not inferior or superior to the other.

The Corporation will apply the proceeds of the Series 2008 Bonds to (i) refund (A) its Asset-Backed Revenue Bonds, Series 2003A-2 through 2003A-4 (State Contingency Contract Secured) (Auction Rate), of which \$217,500,000 are outstanding (the "Series A Refunded Bonds"), and (B) its Asset-Backed Revenue Bonds, Series 2003B-2 through 2003B-5 (State Contingency Contract Secured) (Auction Rate), of which \$225,000,000 are outstanding (the "Series B Refunded Bonds," and items (A) and (B), collectively, the "Refunded Bonds"), and (ii) pay the costs of issuance incurred in connection with the issuance of the Series 2008 Bonds.

The proceeds of the Series 2008A Bonds, and other assets of the Corporation (other than the Series A Pledged Revenues) are not pledged to the payment of, and are therefore not available to the holders of, the Series 2008A Bonds. The proceeds of the Series 2008B Bonds, and other assets of the Corporation (other than the Series B Pledged Revenues) are not pledged to the payment of, and are therefore not available to the holders of, the Series 2008B Bonds. Pursuant to the Act and each of the Series A Sale Agreement and the Series B Sale Agreement, the State has covenanted for the benefit of each of the Series A Bondholders and the Series B Bondholders, respectively, that it will not in any way impair the rights and remedies of each of the Series A Bondholders and the Series B Bondholders, respectively, or the security for each of the Series A Bonds and the Series B Bonds, respectively.

Numerous lawsuits have been filed challenging the MSA and related statutes, including two cases (*Grand River* and *Freedom Holdings*, discussed in "BONDHOLDERS' RISKS" herein), that are pending in the United States District Court for the Southern District of New York. The plaintiffs in both cases seek, inter alia, a determination that state statutes enacted pursuant to the MSA conflict with and are preempted by the federal antitrust laws. The plaintiffs in the *Grand River* case also seek a determination that state statutes enacted pursuant to the MSA violate the Commerce Clause of the United States Constitution. A determination in any of these cases that the MSA or a defendant state's legislation enacted pursuant to the MSA is void or unenforceable (a) could have a materially adverse effect on the payments by PMs under the MSA and the amount and/or the timing of the Series A Pledged Settlement Payments and the Series B Pledged Settlement Payments available to the Corporation, and (b) could lead to a decrease in the market value and/or liquidity of the Series 2008 Bonds. Such a determination could result in a complete loss of the Series A Pledged Settlement Payments and the Series B Pledged Settlement Payments. See "BONDHOLDERS' RISKS" and "LEGAL CONSIDERATIONS RELATING TO SERIES A PLEDGED SETTLEMENT PAYMENTS AND SERIES B PLEDGED SETTLEMENT PAYMENTS" herein.

**PURSUANT TO THE ACT, THE SERIES 2008 BONDS SHALL NOT CONSTITUTE A DEBT OR MORAL OBLIGATION OF THE STATE OR A STATE SUPPORTED OBLIGATION WITHIN THE MEANING OF ANY CONSTITUTIONAL OR STATUTORY PROVISION OR A PLEDGE OF THE FAITH AND CREDIT OF THE STATE OR OF THE TAXING POWER OF THE STATE, AND THE STATE SHALL NOT BE LIABLE TO MAKE ANY PAYMENTS THEREON NOR SHALL ANY SERIES 2008A BONDS BE PAYABLE OUT OF ANY FUNDS OR ASSETS OTHER THAN THE SERIES A PLEDGED REVENUES OR ANY SERIES 2008B BONDS BE PAYABLE OUT OF ANY FUNDS OR ASSETS OTHER THAN THE SERIES B PLEDGED REVENUES. THE CORPORATION HAS NO TAXING POWER.**

**Description:** The Series 2008 Bonds will be dated their date of delivery, mature on the dates and in the aggregate principal amounts set forth on the inside front cover. Interest on the Series 2008 Bonds will be payable on June 1 and December 1 of each year, commencing on June 1, 2008.

**Redemption:** The Series 2008 Bonds are not subject to redemption prior to maturity. See "THE SERIES 2008A BONDS" and "THE SERIES 2008B BONDS."

See Inside Front Cover for Maturity Schedule,  
Interest Rates and Yields

**Citi**  
**Banc of America Securities LLC**  
**M.R. Beal & Company**  
**Ramirez & Co., Inc.**

**Goldman, Sachs & Co.**  
**RBC Capital Markets**

**Bear, Stearns & Co. Inc.**  
**Merrill Lynch & Co.**  
**Roosevelt & Cross Incorporated**  
**UBS Investment Bank**

The Series 2008 Bonds are offered when, as and if issued and accepted by the Underwriters, subject to the approval of legality by Hawkins Delafield & Wood LLP, New York, New York, as Bond Counsel to the Corporation. Certain legal matters will be passed upon for the Corporation by its Counsel. Certain legal matters will be passed upon for the State by the Attorney General. Certain legal matters will be passed upon for the Underwriters by Sidley Austin LLP, New York, New York, as Underwriters' Counsel. It is expected that the Series 2008 Bonds will be available for delivery in book-entry form only through The Depository Trust Company in New York, New York on or about March 27, 2008.

March 19, 2008

**\$443,875,000**  
**Tobacco Settlement Financing Corporation (State of New York)**  
**Asset-Backed Revenue Bonds (State Contingency Contract Secured), Series 2008**

**\$219,935,000**  
**Series 2008A Bonds†**

Maturity Date (June 1)	Principal Amount	Interest Rate	Yield	CUSIP††
2009	\$20,000,000	4.00%	2.85%	88880TLG9
2010	5,000,000	3.00%	3.25%	88880TLK0
2010	8,000,000	4.00%	3.25%	88880TLH7
2010	21,140,000	5.00%	3.25%	88880TLJ3
2011	5,000,000	4.00%	3.42%	88880TLL8
2011	73,830,000	5.00%	3.42%	88880TLM6
2012	86,965,000	4.00%	3.65%	88880TLN4

**\$223,940,000**  
**Series 2008B Bonds†**

Maturity Date (June 1)	Principal Amount	Interest Rate	Yield	CUSIP††
2009	\$38,270,000	4.00%	2.85%	88880TLP9
2010	84,070,000	5.00%	3.25%	88880TLQ7
2011	22,170,000	5.00%	3.42%	88880TLR5
2012	79,430,000	5.00%	3.65%	88880TLS3

† Not subject to redemption prior to maturity.

†† Copyright 2007, American Bankers Association. CUSIP data herein are provided by Standard & Poor's, CUSIP Service Bureau, a division of The McGraw-Hill Companies, Inc. The CUSIP numbers listed above are being provided solely for the convenience of Bondholders only at the time of issuance of the Series 2008 Bonds and the Corporation, the State and the Underwriters do not make any representation with respect to such numbers or undertake any responsibility for their accuracy now or at any time in the future. The CUSIP number for a specific maturity is subject to being changed after the issuance of the Series 2008 Bonds as a result of various subsequent actions including, but not limited to, a refunding in whole or in part of such maturity or as a result of the procurement of secondary market portfolio insurance or other similar enhancement by investors that is applicable to all or a portion of certain maturities of the Series 2008 Bonds.

THE UNDERWRITERS PARTICIPATING IN THIS OFFERING MAY ENGAGE IN TRANSACTIONS THAT STABILIZE OR MAINTAIN THE PRICE OF THE SECURITIES AT A LEVEL ABOVE THAT WHICH MIGHT OTHERWISE PREVAIL IN THE OPEN MARKET, OR OTHERWISE AFFECT THE PRICE OF THE SECURITIES OFFERED HEREBY, INCLUDING OVER-ALLOTMENT AND STABILIZING TRANSACTIONS. SUCH STABILIZING, IF COMMENCED, MAY BE DISCONTINUED AT ANY TIME.

**NO DEALER, BROKER, SALESPERSON OR OTHER PERSON IS AUTHORIZED BY THE CORPORATION, THE STATE, OR THE UNDERWRITERS IN CONNECTION WITH ANY OFFERING MADE HEREBY TO GIVE ANY INFORMATION OR MAKE ANY REPRESENTATION OTHER THAN AS CONTAINED HEREIN, AND, IF GIVEN OR MADE, SUCH INFORMATION OR REPRESENTATION MUST NOT BE RELIED UPON AS HAVING BEEN AUTHORIZED BY THE CORPORATION, THE STATE OR THE UNDERWRITERS. THIS OFFICIAL STATEMENT DOES NOT CONSTITUTE AN OFFER TO SELL, OR A SOLICITATION OF AN OFFER TO BUY, NOR SHALL THERE BE A SALE OF ANY OF THE SECURITIES OFFERED HEREBY BY ANY PERSON IN ANY JURISDICTION IN WHICH IT IS UNLAWFUL FOR SUCH PERSON TO MAKE SUCH AN OFFER, SOLICITATION OR SALE.**

This Official Statement contains information furnished by the Corporation, the State, Global Insight, and other sources, all of which are believed to be reliable. Information concerning the State contained in “APPENDIX B - INFORMATION CONCERNING THE STATE OF NEW YORK” has been obtained from the State. The information contained under the caption “SUMMARY OF THE GLOBAL INSIGHT REPORT” and in “APPENDIX E - GLOBAL INSIGHT REPORT” hereto has been included in reliance upon Global Insight as an expert in econometric forecasting. Information concerning the tobacco industry and participants therein has been obtained from certain publicly available information provided by certain participants and certain other sources (see “APPENDIX F - CERTAIN INFORMATION RELATING TO THE TOBACCO INDUSTRY”). The participants in such industry have not provided any information to the Corporation for use in connection with this offering. In certain cases, tobacco industry information provided herein (such as market share data) may be derived from sources which are inconsistent or in conflict with each other. The Corporation has no independent knowledge of any facts indicating that the information contained in APPENDIX F hereto is inaccurate in any material respect, but has not independently verified this information and cannot and does not warrant the accuracy or completeness of this information.

The information and expressions of opinion contained herein are subject to change without notice and neither the delivery of this Official Statement nor any sale made hereunder shall, under any circumstances, create any implication that there has been no change in the affairs of the Corporation or the State or the matters covered by the report of Global Insight included as APPENDIX E to this Official Statement since the date hereof or that the information contained herein is correct as of any date subsequent to the date hereof. Such information and expressions of opinion are made for the purpose of providing information to prospective investors and are not to be used for any other purpose or relied on by any other party. See “CONTINUING DISCLOSURE AGREEMENTS.”

This Official Statement contains forecasts, projections and estimates that are based on current expectations or assumptions. In light of the important factors that may materially affect the amount of Series A Pledged Settlement Payments and of Series B Pledged Settlement Payments (see “BONDHOLDERS’ RISKS” and “APPENDIX C - MASTER SETTLEMENT AGREEMENT”), the inclusion in this Official Statement of such forecasts, projections and estimates should not be regarded as a representation by the Corporation, the State, Global Insight or the Underwriters that the results of such forecasts, projections and estimates will occur. Such forecasts, projections and estimates are not intended as representations of fact or guarantees of results.

References in this Official Statement to the Act, the Series A Indenture, the Series B Indenture, the Series A Sale Agreement, the Series B Sale Agreement, the Series A Contract, the Series B Contract and the Continuing Disclosure Agreements do not purport to be complete. Refer to the Act, the Series A Indenture, the Series B Indenture, the Series A Sale Agreement, the Series B Sale Agreement, the Series A Contract, the Series B Contract and the Continuing Disclosure Agreements for full and complete details of their provisions. Copies of the Act, the Series A Indenture, the Series B Indenture, the Series A Sale Agreement, the Series B Sale Agreement, the

Series A Contract, the Series B Contract and the Continuing Disclosure Agreements are on file with the Corporation, the Series A Trustee and the Series B Trustee, as applicable.

The order and placement of material in this Official Statement, including its appendices, are not to be deemed a determination of relevance, materiality or importance, and all materials in this Official Statement, including its appendices, must be considered in its entirety.

If and when included in this Official Statement, the words “expects,” “forecasts,” “projects,” “intends,” “anticipates,” “estimates,” “assumes” and analogous expressions are intended to identify forward-looking statements and any such statements inherently are subject to a variety of risks and uncertainties that could cause actual results to differ materially from those that have been projected. Such risks and uncertainties include, among others, general economic and business conditions, changes in political, social and economic conditions, regulatory initiatives and compliance with governmental regulations, litigation and various other events, conditions and circumstances, many of which are beyond the control of the Corporation. These forward-looking statements speak only as of the date of this Official Statement. The Corporation disclaims any obligation or undertaking to release publicly any updates or revisions to any forward-looking statement contained herein to reflect any changes in the Corporation’s expectations with regard thereto or any change in events, conditions or circumstances on which any such statement is based.

THE SERIES 2008 BONDS HAVE NOT BEEN APPROVED OR DISAPPROVED BY THE UNITED STATES SECURITIES AND EXCHANGE COMMISSION, ANY STATE SECURITIES COMMISSION OR ANY OTHER REGULATORY AUTHORITY, NOR HAVE ANY OF THE FOREGOING PASSED UPON THE ACCURACY OR ADEQUACY OF THIS OFFICIAL STATEMENT. ANY REPRESENTATION TO THE CONTRARY IS A CRIMINAL OFFENSE.

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## SUMMARY STATEMENT

This Summary Statement is subject in all respects to more complete information contained in this Official Statement and should not be considered a complete statement of the facts material to making an investment decision. The offering of the Series 2008 Bonds to potential investors is made only by means of the entire Official Statement. Terms used herein and not previously defined have the meanings ascribed to them in “APPENDIX G – DEFINITIONS AND SUMMARIES OF THE TRANSACTION DOCUMENTS — Definitions.” For locations of definitions of certain terms used herein, see the “Index of Defined Terms.”

Overview ..... The Tobacco Settlement Financing Corporation (the “**Corporation**”), is issuing \$443,875,000 aggregate principal amount of its Asset-Backed Revenue Bonds, Series 2008 (State Contingency Contract Secured) consisting of \$219,935,000 Asset-Backed Revenue Bonds, Series 2008A (State Contingency Contract Secured) (the “**Series 2008A Bonds**”) and \$223,940,000 Asset-Backed Revenue Bonds, Series 2008B (State Contingency Contract Secured) (the “**Series 2008B Bonds**”) and, together with the Series 2008A Bonds, the “**Bonds**” or the “**Series 2008 Bonds**”). The Series 2008A Bonds are issued under the Indenture, dated as of June 1, 2003, as supplemented by the Series 2003A Supplement and the Series 2008A Supplement (collectively, the “**Series A Indenture**”), between the Corporation and The Bank of New York, as indenture trustee (the “**Series A Trustee**”). The Series 2008B Bonds are issued under the Indenture, dated as of December 1, 2003, as supplemented by the Series 2003B Supplement and the Series 2008B Supplement (collectively, the “**Series B Indenture**”), between the Corporation and The Bank of New York, as indenture trustee (the “**Series B Trustee**”). “**Trustee**” as used herein refers to the Series A Trustee or the Series B Trustee, as applicable.

The Series 2008A Bonds, together with all outstanding bonds previously issued and any additional refunding bonds to be issued under the Series A Indenture (collectively, the “**Series A Bonds**”), are special obligations of the Corporation, payable from and secured by a pledge of the “**Series A Pledged Revenues**,” which consist primarily of (i) the Series A Pledged Settlement Payments (defined below) sold by the State of New York (the “**State**”) to the Corporation pursuant to the Purchase and Sale Agreement, dated as of June 1, 2003 (the “**Series A Sale Agreement**”), between the State and the Corporation and (ii) the payments (the “**Series A Contract Payments**”) to be made by the State pursuant to the Contingency Contract, dated as of June 1, 2003 (the “**Series A Contract**”), between the State and the Corporation, in such amounts, subject to appropriation by the State Legislature, as are necessary to pay when due the principal of and interest on the Series A Bonds, including the Series 2008A Bonds, to the extent that amounts on deposit in the Series A Pledged Revenues Account, the Series A Debt Service Account, the Series A Supplemental Account and the Series A Debt Service Reserve Account (collectively, the “**Series A Pledged Accounts**”) are insufficient therefor. The Series 2008B Bonds, together with all outstanding bonds previously issued and any additional refunding bonds to be issued under the Series B Indenture (collectively, the “**Series B Bonds**”), are special obligations of the Corporation, payable from and secured by a pledge of the “**Series B Pledged Revenues**,” which consist primarily of (i) the Series B Pledged Settlement Payments (defined below) sold by the State to the Corporation pursuant to the Purchase and Sale Agreement, dated as of December 1, 2003 (the “**Series B Sale Agreement**”), between the State and the Corporation and (ii) the payments (the “**Series B Contract Payments**”) to be made by the State pursuant to the Contingency Contract, dated as of December 1, 2003 (the “**Series B**

**Contract**”), between the State and the Corporation, in such amounts, subject to appropriation by the State Legislature, as are necessary to pay when due the principal of and interest on the Series B Bonds, including the Series 2008B Bonds, to the extent that amounts on deposit in the Series B Pledged Revenues Account, the Series B Debt Service Account, the Series B Supplemental Account and the Series B Debt Service Reserve Account (collectively, the “**Series B Pledged Accounts**”) are insufficient therefor.

Issuer ..... The Corporation is a public benefit corporation of the State, established as a subsidiary of the State of New York Municipal Bond Bank Agency (the “**Agency**”), separate and apart from the State and created by the Tobacco Settlement Financing Corporation Act (the “**Act**”).

Securities Offered ..... The Series 2008 Bonds are being issued pursuant to the Act, the Series A Indenture and the Series B Indenture. The Series A Indenture permits the issuance of additional parity refunding bonds. See “THE SERIES 2008A BONDS – Refunding Bonds.” The Series B Indenture permits the issuance of additional parity refunding bonds. See “THE SERIES 2008B BONDS – Refunding Bonds.”

It is expected that the Series 2008 Bonds will be delivered in book-entry form through the facilities of The Depository Trust Company, New York, New York (“**DTC**”), on or about March 27, 2008 (the “**Closing Date**”). Beneficial owners of the Series 2008 Bonds will not receive physical delivery of bond certificates.

Security for the Series A Bonds..... The Series A Bonds, including the Series 2008A Bonds, are special obligations of the Corporation, payable from and secured by a pledge of the Series A Pledged Revenues.

Pursuant to the Act and the Series A Sale Agreement, the State sold to the Corporation the “**Series A Pledged Settlement Payments**,” consisting of (i) fifty percent (50%) of the Annual Payments and Strategic Contribution Fund Payments (as defined below) and of all adjustments to prior payments, payable to the State pursuant to the MSA (as defined below) and received on and after January 1, 2004 and (ii) fifty percent (50%) of all Series A Lump Sum Payments (as defined herein) received at any time on or after June 19, 2003.

The Master Settlement Agreement (the “**MSA**”) was entered into by participating cigarette manufacturers (the “**PMs**”), the State and the other Settling States (as defined below) in November 1998 in the settlement of certain smoking-related litigation pursuant to which the PMs agreed to make certain payments to the Settling States (such payments as more fully described herein, the “**Tobacco Settlement Revenues**”) to be made by the PMs under the MSA.

The Series A Bonds and the Series B Bonds are each separately secured by the Series A Pledged Revenues and the Series B Pledged Revenues, respectively. The Trustee for the Series A Bonds shall not have the right to make a claim to mitigate all or any part of an asserted deficiency in the Series A Pledged Revenues from the Series B Pledged Revenues and, likewise, the Trustee for the Series B Bonds shall not have the right to make a claim to mitigate all or part of an asserted deficiency in the Series B Pledged Revenues from the Series A Pledged Revenues. The rights of the



Trustee for the Series A Bonds and the Trustee for the Series B Bonds to receive its respective Pledged Revenues are equal to and on a parity with each other and one right is not inferior or superior to the other.

Pursuant to the Series A Contract, the State has agreed to pay Series A Contract Payments to the Corporation, subject to appropriation by the State Legislature, in such amounts as are necessary to pay when due the principal of and interest on the Series A Bonds, including the Series 2008A Bonds, to the extent that amounts on deposit in the Series A Pledged Accounts are insufficient therefor.

The Series A Bonds, including the Series 2008A Bonds, are additionally secured by the amounts on deposit in the Series A Pledged Accounts. See “SECURITY AND SOURCES OF PAYMENT FOR THE SERIES 2008A BONDS.”

**PURSUANT TO THE ACT, THE SERIES A BONDS, INCLUDING THE SERIES 2008A BONDS, SHALL NOT CONSTITUTE A DEBT OR MORAL OBLIGATION OF THE STATE OR A STATE SUPPORTED OBLIGATION WITHIN THE MEANING OF ANY CONSTITUTIONAL OR STATUTORY PROVISION OR A PLEDGE OF THE FAITH AND CREDIT OF THE STATE OR OF THE TAXING POWER OF THE STATE, AND THE STATE SHALL NOT BE LIABLE TO MAKE ANY PAYMENTS THEREON NOR SHALL ANY SERIES A BONDS, INCLUDING THE SERIES 2008A BONDS, BE PAYABLE OUT OF ANY FUNDS OR ASSETS OTHER THAN THE SERIES A PLEDGED REVENUES. THE CORPORATION HAS NO TAXING POWER.**

Security for the Series B Bonds.....

The Series B Bonds, including the Series 2008B Bonds, are special obligations of the Corporation, payable from and secured by a pledge of the Series B Pledged Revenues.

Pursuant to the Act and the Series B Sale Agreement, the State sold to the Corporation the “**Series B Pledged Settlement Payments**,” consisting of (i) fifty percent (50%) of the Annual Payments and Strategic Contribution Fund Payments (as defined below) and of all adjustments to prior payments, payable to the State pursuant to the MSA (as defined below) and received on and after January 1, 2004 and (ii) fifty percent (50%) of all Series B Lump Sum Payments (as defined herein) received at any time on or after December 2, 2003.

The Master Settlement Agreement (the “**MSA**”) was entered into by participating cigarette manufacturers (the “**PMs**”), the State and the other Settling States (as defined below) in November 1998 in the settlement of certain smoking-related litigation pursuant to which the PMs agreed to make certain payments to the Settling States (such payments as more fully described herein, the “**Tobacco Settlement Revenues**”) to be made by the PMs under the MSA.

The Series B Bonds and the Series A Bonds are each separately secured by the Series B Pledged Revenues and the Series A Pledged Revenues, respectively. The Trustee for the Series B Bonds shall not have the right to make a claim to mitigate all or any part of an asserted deficiency in the Series B Pledged Revenues from the Series A Pledged Revenues and, likewise, the Trustee for the Series A Bonds shall not have the right to make

a claim to mitigate all or part of an asserted deficiency in the Series A Pledged Revenues from the Series B Pledged Revenues. The rights of the Trustee for the Series B Bonds and the Trustee for the Series A Bonds to receive its respective Pledged Revenues are equal to and on a parity with each other and one right is not inferior or superior to the other.

Pursuant to the Series B Contract, the State has agreed to pay Series B Contract Payments to the Corporation, subject to appropriation by the State Legislature, in such amounts as are necessary to pay when due the principal of and interest on the Series B Bonds, including the Series 2008B Bonds, to the extent that amounts on deposit in the Series B Pledged Accounts are insufficient therefor.

The Series B Bonds, including the Series 2008B Bonds, are additionally secured by the amounts on deposit in the Series B Pledged Accounts. See “SECURITY AND SOURCES OF PAYMENT FOR THE SERIES 2008B BONDS.”

**PURSUANT TO THE ACT, THE SERIES B BONDS, INCLUDING THE SERIES 2008B BONDS, SHALL NOT CONSTITUTE A DEBT OR MORAL OBLIGATION OF THE STATE OR A STATE SUPPORTED OBLIGATION WITHIN THE MEANING OF ANY CONSTITUTIONAL OR STATUTORY PROVISION OR A PLEDGE OF THE FAITH AND CREDIT OF THE STATE OR OF THE TAXING POWER OF THE STATE, AND THE STATE SHALL NOT BE LIABLE TO MAKE ANY PAYMENTS THEREON NOR SHALL ANY SERIES B BONDS, INCLUDING THE SERIES 2008B BONDS, BE PAYABLE OUT OF ANY FUNDS OR ASSETS OTHER THAN THE SERIES B PLEDGED REVENUES. THE CORPORATION HAS NO TAXING POWER.**

Covenants .....

Pursuant to the Act and each of the Series A Sale Agreement and the Series B Sale Agreement, the State has covenanted for the benefit of the Bondholders, among other things, that it will (i) enforce, at the expense of the State, its right to collect all monies due from the PMs under the MSA, (ii) diligently enforce, at the expense of the State, the Qualifying Statute as contemplated in section IX(d)(2)(B) of the MSA against all tobacco product manufacturers selling tobacco products in the State that are not in compliance with the Qualifying Statute and (iii) not, in any way, impair the rights and remedies of the Bondholders or the security for the Bonds. See “COVENANTS OF THE STATE.” The Corporation and the State have covenanted not to impair the exclusion of interest on the Series 2008 Bonds from gross income for federal income tax purposes. See “APPENDIX A – THE SERIES 2008A CONTINGENCY CONTRACT AND THE SERIES 2008B CONTINGENCY CONTRACT BETWEEN THE STATE OF NEW YORK AND THE CORPORATION” and “APPENDIX G – DEFINITIONS AND SUMMARIES OF THE TRANSACTION DOCUMENTS – The Indentures” for a summary of the covenants made by the Corporation. See “APPENDIX G – DEFINITIONS AND SUMMARIES OF THE TRANSACTION DOCUMENTS – the Series A Sale Agreement and the Series B Sale Agreement” and “APPENDIX A – THE SERIES 2008A CONTINGENCY CONTRACT AND THE SERIES 2008B CONTINGENCY CONTRACT BETWEEN THE STATE OF NEW YORK AND THE CORPORATION” for the covenants made by the State.

Use of Proceeds ..... The proceeds of the Series 2008 Bonds will be applied by the Corporation to: (i) refund (A) its Asset-Backed Revenue Bonds, Series 2003A-2 through 2003A-4 (State Contingency Contract Secured) (Auction Rate), of which \$217,500,000 are outstanding, and (B) its Asset Backed Revenue Bonds, Series 2003B-2 through 2003B-5 (State Contingency Contract Secured) (Auction Rate), of which \$225,000,000 are outstanding (items (A) and (B), collectively, the “**Refunded Bonds**”), and (ii) pay the costs of issuance incurred in connection with the issuance of the Series 2008 Bonds.

Master Settlement Agreement ..... The MSA was entered into on November 23, 1998 among the attorneys general of the 46 states (including the State), Puerto Rico, Guam, U.S. Virgin Islands, the District of Columbia, American Samoa and the Commonwealth of the Northern Mariana Islands (collectively, the “**Settling States**”) and the then four largest United States tobacco manufacturers: Philip Morris Incorporated (“**Philip Morris**”), R.J. Reynolds Tobacco Company (“**Reynolds Tobacco**”), Brown & Williamson Tobacco Corporation (“**B&W**”) and Lorillard Tobacco Company (“**Lorillard**”) (collectively, the “**Original Participating Manufacturers**” or “**OPMs**”).

On January 5, 2004, Reynolds American Inc. (“**Reynolds American**”) was incorporated as a holding company to facilitate the combination of the U.S. assets, liabilities and operations of B&W with those of Reynolds Tobacco. References herein to the Original Participating Manufacturers or OPMs means, for the period prior to June 30, 2004, collectively, Philip Morris, Reynolds Tobacco, B&W and Lorillard and for the period on and after June 30, 2004, collectively, Philip Morris, Reynolds American and Lorillard. As reported by the OPMs, the OPMs accounted for approximately 86.4%\* of the U.S. domestic cigarette market in 2007, based upon shipments.

The MSA resolved cigarette smoking-related litigation between the Settling States and the OPMs and released the OPMs from past and present smoking-related claims by the Settling States, and provides for a continuing release of future smoking-related claims, in exchange for certain payments to be made to the Settling States (including Initial Payments, Annual Payments and Strategic Contribution Fund Payments, each as defined herein), and the imposition of certain tobacco advertising and marketing restrictions, among other things.

The Corporation is not a party to the MSA.

The MSA is an industry-wide settlement of litigation between the Settling States and the Participating Manufacturers (as such term is defined below). The MSA permits tobacco companies other than the OPMs to become parties to the MSA. Tobacco companies other than OPMs that become parties to the MSA are referred to herein as “**Subsequent Participating Manufacturers**” or “**SPMs**,” and the SPMs, together with the OPMs, are

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\* Market share information for the OPMs based on domestic industry shipments may be materially different from Relative Market Share for purposes of the MSA and the respective obligations of the OPMs to contribute to Annual Payments and Strategic Contribution Fund Payments. See “SUMMARY OF THE MASTER SETTLEMENT AGREEMENT – Annual Payments” and “– Strategic Contribution Fund Payments.” Additionally, aggregate market share information as reported by the OPMs is different from that utilized in the bond structuring assumptions and may differ from the market share information reported by the OPMs for purposes of their filings with the Securities and Exchange Commission. See “SUMMARY OF SERIES A AND SERIES B PLEDGED SETTLEMENT PAYMENTS METHODOLOGY AND BOND STRUCTURING ASSUMPTIONS” and “APPENDIX F – CERTAIN INFORMATION RELATING TO THE TOBACCO INDUSTRY.” The aggregate market share information used in the Collection Methodology and Assumptions may differ materially from the market share information used by the MSA Auditor in calculating adjustments to Annual Payments and Strategic Contribution Fund Payments. See “SUMMARY OF THE MASTER SETTLEMENT AGREEMENT – Adjustments to Payments.”

referred to herein as the “**Participating Manufacturers**” or “**PMs**”. Tobacco companies that do not become parties to the MSA are referred to herein as “**Non-Participating Manufacturers**” or “**NPMs**”.

Litigation Regarding MSA and  
Related Statutes .....

Numerous lawsuits have been filed challenging the MSA and related statutes, including two cases (*Grand River* and *Freedom Holdings*, discussed in “BONDHOLDERS’ RISKS” herein), that are pending in the United States District Court for the Southern District of New York. The plaintiffs in both cases seek, inter alia, a determination that state statutes enacted pursuant to the MSA conflict with and are preempted by the federal antitrust laws. The plaintiffs in the *Grand River* case also seek a determination that state statutes enacted pursuant to the MSA violate the Commerce Clause of the United States Constitution. A determination in any of these cases that the MSA or a defendant state’s legislation enacted pursuant to the MSA is void or unenforceable (a) could have a materially adverse effect on the payments by PMs under the MSA and the amount and/or the timing of the Series A Pledged Settlement Payments and the Series B Pledged Settlement Payments available to the Corporation, and (b) could lead to a decrease in the market value and/or liquidity of the Series 2008 Bonds. Such a determination could result in a complete loss of the Series A Pledged Settlement Payments and the Series B Pledged Settlement Payments. See “BONDHOLDERS’ RISKS” and “LEGAL CONSIDERATIONS RELATING TO SERIES A PLEDGED SETTLEMENT PAYMENTS AND SERIES B PLEDGED SETTLEMENT PAYMENTS” herein.

Payments Pursuant to the MSA .....

Under the MSA, the OPMs are required to pay to the Settling States:

- (a) five initial payments, all of which have been paid (the “**Initial Payments**”);
- (b) annual payments on each April 15, commencing April 15, 2000 and continuing in perpetuity (of which the 2000 through 2007 annual payments have already been paid) (the “**Annual Payments**”) in the following base amounts (subject to adjustment as described herein):

<u>Year</u>	<u>Base Amount</u> *	<u>Year</u>	<u>Base Amount</u> *
2000*	\$4,500,000,000	2010	\$8,139,000,000
2001*	5,000,000,000	2011	8,139,000,000
2002*	6,500,000,000	2012	8,139,000,000
2003*	6,500,000,000	2013	8,139,000,000
2004*	8,000,000,000	2014	8,139,000,000
2005*	8,000,000,000	2015	8,139,000,000
2006*	8,000,000,000	2016	8,139,000,000
2007*	8,000,000,000	2017	8,139,000,000
2008	8,139,000,000	Thereafter	9,000,000,000
2009	8,139,000,000		

- (c) ten annual payments of \$861 million (subject to adjustment as described herein) on each April 15, commencing April 15, 2008 and

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\* As described herein, the base amounts of Annual Payments are subject to various adjustments that have resulted in reduced Annual Payments in certain prior years. See “BONDHOLDERS’ RISKS—Decline in Cigarette Consumption Materially Beyond Forecasted Levels May Adversely Affect Payments,” “—Other Potential Payment Decreases Under the Terms of the MSA,” and “SUMMARY OF THE MASTER SETTLEMENT AGREEMENT—Annual Payments” herein.

continuing through April 15, 2017 (the “**Strategic Contribution Fund Payments**”).

Under the MSA, each OPM is required to pay an allocable portion of each Annual Payment and each Strategic Contribution Fund Payment based on its respective market share of the United States cigarette market during the preceding calendar year, in each case, subject to certain adjustments as described herein. Each SPM has Annual Payment and Strategic Contribution Fund Payment obligations under the MSA (separate from the payment obligations of the OPMs) according to its market share. However, any SPM that became a party to the MSA within 90 days after it became effective pays only if its market share exceeds the higher of its 1998 market share or 125% of its 1997 market share.

The payment obligations under the MSA follow tobacco product brands if they are transferred by any of the PMs. Payments by the PMs under the MSA are required to be made to the MSA Escrow Agent, which is required pursuant to the instructions of the MSA Escrow Agreement to remit an allocable share of such payments to the parties entitled thereto.

Under the MSA, the Annual Payments and the Strategic Contribution Fund Payments due may be subject to numerous adjustments, some of which are material. Such adjustments include, among others, reductions when a PM experiences a loss of market share to NPMs as a result of such PM’s participation in the MSA, reductions for decreased domestic cigarette shipments and to account for those states that settle or have settled their claims against the PMs independently of the MSA and increases related to inflation in an amount of not less than 3% per year. See “**BONDHOLDERS’ RISKS.**”

New York Consent Decree .....

Pursuant to the allocation percentages set forth in the MSA, the State is entitled to 12.7620310% of the total amount of Annual Payments. In addition, pursuant to the procedures agreed to in the MSA, the State is entitled to receive 5.4873402% of the total amount of Strategic Contribution Fund Payments. The “**Consent Decree,**” which was entered in the Supreme Court of the State of New York for the County of New York in December 1998, allocates to the State 100% of the Strategic Contribution Fund Payments and 51.176% of the Annual Payments (which represents 6.5310970% of the Annual Payments payable under the MSA), of which the amounts received by the State on and after January 1, 2004 constitute the “**State’s Share**”. The remaining 48.824% of Annual Payments is allocated among The City of New York and all other counties located within the State.

Sale of Pledged Settlement  
Payments.....

Pursuant to the Act and the Series A Sale Agreement, the State sold the Series A Pledged Settlement Payments to the Corporation. Under the Series A Indenture, the Corporation assigned and pledged the Series A Pledged Settlement Payments to the Trustee. Such Series A Pledged Settlement Payments are paid directly by the MSA Escrow Agent to the Trustee and the Trustee causes the Series A Pledged Settlement Payments to be deposited under the Series A Indenture. Pursuant to the Act and the Series B Sale Agreement, the State sold the Series B Pledged Settlement Payments to the Corporation. Under the Series B Indenture, the Corporation assigned and pledged the Series B Pledged Settlement Payments to the Trustee. Such Series B Pledged Settlement Payments are paid directly by the MSA Escrow Agent to the Trustee and the Trustee

causes the Series B Pledged Settlement Payments to be deposited under the Series B Indenture. Neither the Series A Pledged Settlement Payments nor the Series B Pledged Settlement Payments are subject to appropriation by the State.

Series A Contract.....

Pursuant to the Series A Contract, the State, acting through the Director of Budget of the State of New York, has entered into the Series A Contract to provide additional security for the Series A Bonds, including the Series 2008A Bonds. The Series A Contract contains the agreement of the State, subject to the making of annual appropriation therefor by the State Legislature, for the payment to the Corporation on or before each Distribution Date of such amount, if any, as shall be necessary to provide for the payment of the principal of and interest on the Series A Bonds, including the Series 2008A Bonds, scheduled to be paid on such date, if the amounts on deposit in the Series A Pledged Accounts are insufficient therefor. The Corporation has covenanted to request from the State annually by certification of an Authorized Officer thereof to the Director of the Budget, by October 31<sup>st</sup> of each year, but in any event not later than December 15 of each year, an appropriation of an amount equal to the principal of and interest on the Series A Bonds, including the Series 2008A Bonds, scheduled to come due during the next succeeding Fiscal Year. The State has covenanted that the Director of the Budget on behalf of the State shall include, as a requested appropriation item in the State's budget for such Fiscal Year, an amount equal to such certified amount.

The Corporation and the State have both complied with their respective covenants in each year since the issuance of the Series 2003A Bonds.

Payments made by the State pursuant to the Series A Contract are only available to pay the principal of and interest on the Series A Bonds, including the Series 2008A Bonds. The Series A Contract is attached hereto as APPENDIX A.

If, on the fifth Business Day preceding any Distribution Date the sum of the amounts on deposit to the credit of the Series A Pledged Accounts shall be less than the principal of and interest on the Series A Bonds, including the Series 2008A Bonds, payable or scheduled to be payable on such Distribution Date, then the Trustee shall cause written notice thereof, and demand for payment of an amount necessary to eliminate any such deficiency, to be promptly submitted on behalf of the Corporation to the Director of the Budget of the State pursuant to the terms of the Series A Contract, such payment to be received in any event on or before such Distribution Date, and any amounts paid pursuant to the Series A Contract shall be deposited directly to the credit of the Series A Debt Service Account for the purpose of paying the debt service coming due on such Distribution Date.

**PURSUANT TO THE ACT, THE SERIES 2008A BONDS SHALL NOT CONSTITUTE A DEBT OR MORAL OBLIGATION OF THE STATE OR A STATE SUPPORTED OBLIGATION WITHIN THE MEANING OF ANY CONSTITUTIONAL OR STATUTORY PROVISION OR A PLEDGE OF THE FAITH AND CREDIT OF THE STATE OR OF THE TAXING POWER OF THE STATE, AND THE STATE SHALL NOT BE LIABLE TO MAKE ANY PAYMENTS THEREON NOR SHALL ANY SERIES 2008A BONDS BE PAYABLE OUT OF ANY FUNDS OR ASSETS OTHER THAN**

**THE SERIES A PLEDGED REVENUES. THE CORPORATION HAS NO TAXING POWER. SEE “APPENDIX A – THE SERIES 2008A CONTINGENCY CONTRACT AND THE SERIES 2008B CONTINGENCY CONTRACT BETWEEN THE STATE OF NEW YORK AND THE CORPORATION.”**

Series B Contract.....

Pursuant to the Series B Contract, the State, acting through the Director of Budget of the State of New York, has entered into the Series B Contract to provide additional security for the Series B Bonds, including the Series 2008B Bonds,. The Series B Contract contains the agreement of the State, subject to the making of annual appropriation therefor by the State Legislature, for the payment to the Corporation on or before each Distribution Date of such amount, if any, as shall be necessary to provide for the payment of the principal of and interest on the Series B Bonds, including the Series 2008B Bonds, scheduled to be paid on such date, if the amounts on deposit in the Series B Pledged Accounts are insufficient therefor. The Corporation has covenanted to request from the State annually by certification of an Authorized Officer thereof to the Director of the Budget, by October 31<sup>st</sup> of each year, but in any event not later than December 15 of each year, an appropriation of an amount equal to the principal of and interest on the Series B Bonds, including the Series 2008B Bonds, scheduled to come due during the next succeeding Fiscal Year. The State has covenanted that the Director of the Budget on behalf of the State shall include, as a requested appropriation item in the State’s budget for such Fiscal Year, an amount equal to such certified amount.

The Corporation and the State have both complied with their respective covenants in each year since the issuance of the Series 2003B Bonds.

Payments made by the State pursuant to the Series B Contract are only available to pay the principal of and interest on the Series B Bonds, including the Series 2008B Bonds. The Series B Contract is attached hereto as APPENDIX A.

If, on the fifth Business Day preceding any Distribution Date the sum of the amounts on deposit to the credit of the Series B Pledged Accounts shall be less than the principal of and interest on the Series B Bonds, including the Series 2008B Bonds, payable or scheduled to be payable on such Distribution Date, then the Trustee shall cause written notice thereof, and demand for payment of an amount necessary to eliminate any such deficiency, to be promptly submitted on behalf of the Corporation to the Director of the Budget of the State pursuant to the terms of the Series B Contract, such payment to be received in any event on or before such Distribution Date, and any amounts paid pursuant to the Series B Contract shall be deposited directly to the credit of the Series B Debt Service Account for the purpose of paying the debt service coming due on such Distribution Date.

**PURSUANT TO THE ACT, THE SERIES 2008B BONDS SHALL NOT CONSTITUTE A DEBT OR MORAL OBLIGATION OF THE STATE OR A STATE SUPPORTED OBLIGATION WITHIN THE MEANING OF ANY CONSTITUTIONAL OR STATUTORY PROVISION OR A PLEDGE OF THE FAITH AND CREDIT OF THE STATE OR OF THE TAXING POWER OF THE STATE, AND THE STATE SHALL NOT BE LIABLE TO MAKE ANY PAYMENTS THEREON NOR SHALL ANY SERIES 2008B BONDS**

**BE PAYABLE OUT OF ANY FUNDS OR ASSETS OTHER THAN THE SERIES B PLEDGED REVENUES. THE CORPORATION HAS NO TAXING POWER. SEE “APPENDIX A – THE SERIES 2008A CONTINGENCY CONTRACT AND THE SERIES 2008B CONTINGENCY CONTRACT BETWEEN THE STATE OF NEW YORK AND THE CORPORATION.”**

Series A

Debt Service Reserve Account .....

A reserve account (the “**Series A Debt Service Reserve Account**”) is held by the Trustee and was funded from proceeds of the Series 2003A Bonds in an amount equal to \$227,545,572.00 (the “**Debt Service Reserve Requirement**”). The balance in the Series A Debt Service Reserve Account must be maintained, to the extent of available investment earnings therein and Series A Pledged Settlement Payments, at the Series A Debt Service Reserve Requirement. Series A Contract Payments will not be applied to satisfy any deficiencies in the Series A Debt Service Reserve Account.

Amounts on deposit in the Series A Debt Service Reserve Account will be available to pay the principal of and interest on the Series A Bonds, including the Series 2008A Bonds, to the extent amounts on deposit in the Series A Debt Service Account and the Series A Supplemental Account are insufficient for such purpose.

Series B

Debt Service Reserve Account .....

A reserve account (the “**Series B Debt Service Reserve Account**”) is held by the Trustee and was funded from proceeds of the Series 2003B Bonds in an amount equal to \$221,582,343.75 (the “**Debt Service Reserve Requirement**”). The balance in the Series B Debt Service Reserve Account must be maintained, to the extent of available investment earnings therein and Series B Pledged Settlement Payments, at the Series B Debt Service Reserve Requirement. Series B Contract Payments will not be applied to satisfy any deficiencies in the Series B Debt Service Reserve Account.

Amounts on deposit in the Series B Debt Service Reserve Account will be available to pay the principal and Sinking Fund Installments of and interest on the Series B Bonds, including the Series 2008B Bonds, to the extent amounts on deposit in the Series B Debt Service Account and the Series B Supplemental Account are insufficient for such purpose.

Series A Supplemental Account .....

An account (the “**Series A Supplemental Account**”) has been established and is held by the Trustee and is funded from Series A Pledged Settlement Payments in excess of those required to make the deposits required by clauses (i) through (vi) of paragraph (A) set forth herein under the caption “SECURITY AND SOURCES OF PAYMENT FOR THE SERIES 2008A BONDS – Series A Flow of Funds” (the “**Series A Surplus Pledged Revenues**”). Amounts on deposit in the Series A Supplemental Account may be used to purchase, redeem or defease the Series A Bonds (but only to purchase or defease the Series 2008A Bonds) as set forth under the caption “THE SERIES 2008A BONDS —Redemption and Purchase Provisions — *Application of Surplus Pledged Revenues.*”

Amounts on deposit in the Series A Supplemental Account will not be released from the lien of the Series A Indenture until (i) applied to the purchase, redemption, or defeasance of Series A Bonds, (ii) applied to the



payment of principal of or interest on Series A Bonds to the extent amounts on deposit in the Series A Debt Service Account are insufficient therefor or (iii) there are no Series A Bonds Outstanding under the Series A Indenture.

In addition, between April 15 and the next Distribution Date in each year, no amounts in the Series A Supplemental Account shall be applied or set aside to defease Series A Bonds or to pay the optional redemption or purchase price of Series A Bonds unless there is held in the Series A Debt Service Account sufficient amounts to pay all principal of and interest on Series A Bonds, including the Series 2008A Bonds, scheduled to be paid in such year.

Series B Supplemental Account .....

An account (the “**Series B Supplemental Account**”) has been established and is held by the Trustee and is funded from Series B Pledged Settlement Payments in excess of those required to make the deposits required by clauses (i) through (vi) of paragraph (A) set forth herein under the caption “SECURITY AND SOURCES OF PAYMENT FOR THE SERIES 2008B BONDS – Series B Flow of Funds” (the “**Series B Surplus Pledged Revenues**”). Amounts on deposit in the Series B Supplemental Account may be used to purchase, redeem or defease the Series B Bonds (but only to purchase or defease Series 2008B Bonds) as set forth under the caption “THE SERIES 2008B BONDS —Redemption and Purchase Provisions — *Application of Surplus Pledged Revenues.*”

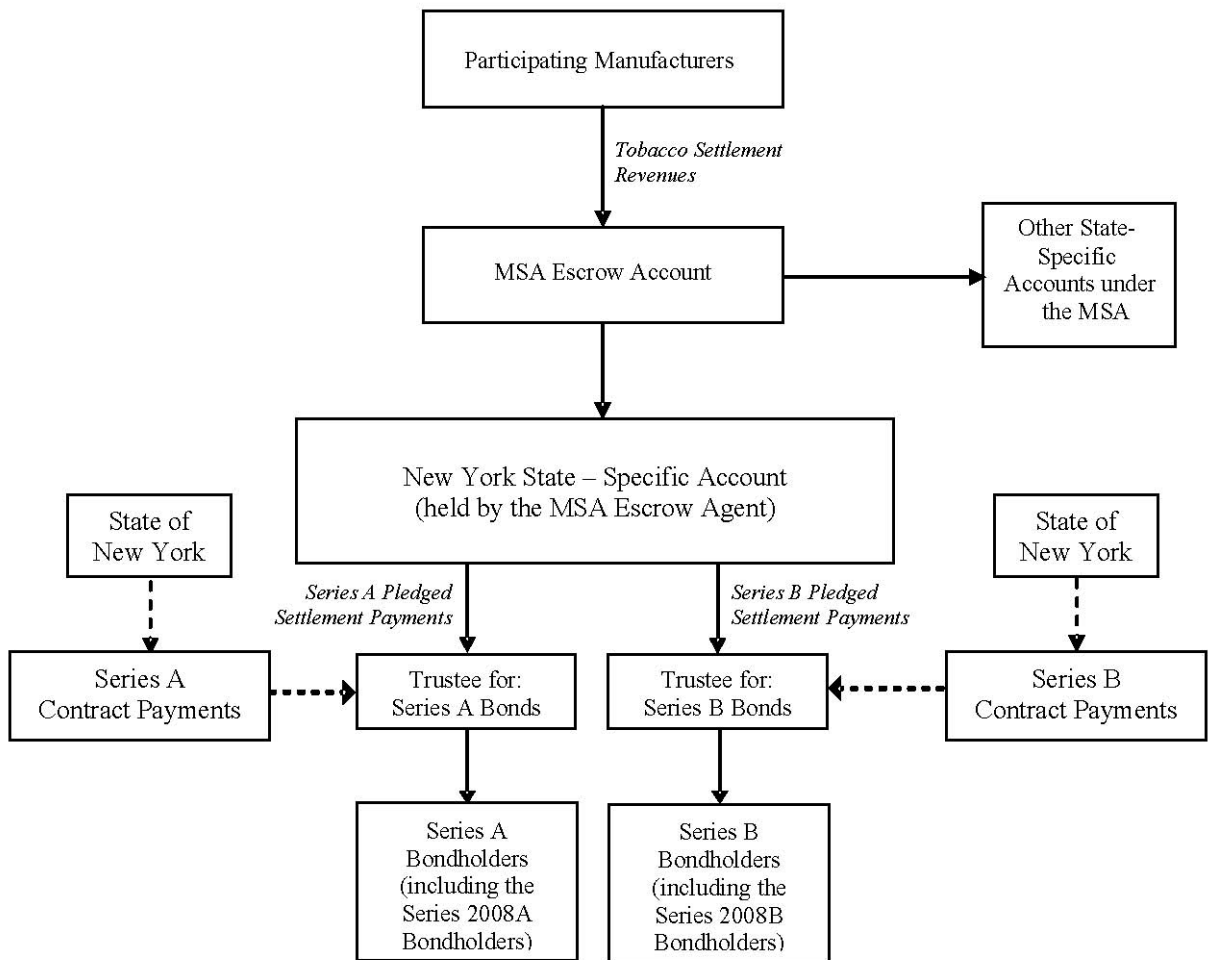
Amounts on deposit in the Series B Supplemental Account will not be released from the lien of the Series B Indenture until (i) applied to the purchase, redemption, or defeasance of Series B Bonds, (ii) applied to the payment of principal and Sinking Fund Installments of or interest on Series B Bonds to the extent amounts on deposit in the Series B Debt Service Account are insufficient therefor or (iii) there are no Series B Bonds Outstanding under the Series B Indenture.

In addition, between April 15 and the next Distribution Date in each year, no amounts in the Series B Supplemental Account shall be applied or set aside to defease Series B Bonds or to pay the optional redemption or purchase price of Series B Bonds unless there is held in the Series B Debt Service Account sufficient amounts to pay all principal of and interest on Series B Bonds, including the Series 2008B Bonds, scheduled to be paid in such year.

Flow of Funds to the Trustee .....

The MSA Escrow Agent disburses the Series A Pledged Settlement Payments and the Series B Pledged Settlement Payments from the New York State-Specific Account directly to the Trustee. Additionally, the State pays any Series A Contract Payments and Series B Contract Payments, to the extent funds have been appropriated for such purposes, directly to the Trustee in accordance with the provisions of the Series A Contract and the Series B Contract.

The following diagram depicts the flow of the State’s Share of Tobacco Settlement Revenues and Contract Payments.



Series 2008A Bonds Not Subject to Redemption.....

The Series 2008A Bonds are not subject to redemption prior to maturity.

The Corporation, at the direction of the State (which direction shall specify the maturities of the Series 2008A Bonds to be purchased), may cause the Trustee to purchase Series 2008A Bonds in the open market from Series A Surplus Pledged Revenues, at a price not exceeding 100% of the Outstanding principal amount of such Series 2008A Bonds being purchased at such time, plus accrued interest thereon.

Series 2008B Not Subject to Redemption.....

The Series 2008B Bonds are not subject to redemption prior to maturity.

The Corporation, at the direction of the State (which direction shall specify the maturities of the Series 2008B Bonds to be purchased), may cause the Trustee to purchase Series 2008B Bonds in the open market from Series B Surplus Pledged Revenues, at a price not exceeding 100% of the Outstanding principal amount of such Series 2008B Bonds being purchased at such time, plus accrued interest thereon.

Application of Series A  
Surplus Pledged Revenues.....

Series A Surplus Pledged Revenues may be applied by the Corporation, at the direction of the State, to purchase, redeem or defease Series A Bonds (but only to purchase or defease the Series 2008A Bonds) at the times, with such maturities and in such amounts as the State directs, and by lot if within a maturity. To the extent not used to purchase, redeem or defease Series A Bonds, all Series A Surplus Pledged Revenues will remain in the Series A Supplemental Account until (i) applied to the payment of principal of or interest on Series A Bonds, including the Series 2008A Bonds, to the extent amounts on deposit in the Series A Debt Service Account are insufficient therefor or (ii) there are no Series A Bonds Outstanding under the Series A Indebtedness.

In addition, between April 15 and the next Distribution Date in each year, no amounts in the Series A Supplemental Account shall be applied or set aside to defease Series A Bonds or to pay the optional redemption or purchase price of Series A Bonds unless there is held in the Series A Debt Service Account sufficient amounts to pay all principal of and interest on the Series A Bonds, including the Series 2008A Bonds, scheduled to be paid in such year.

The State currently intends to direct all or a significant portion of the Series A Surplus Pledged Revenues to purchase, redeem or defease Series A Bonds (and only to purchase or defease the Series 2008A Bonds) but has no obligation to do so and has reserved its right to do otherwise at any time or from time to time. See “OUTSTANDING BONDS.” See also “TABLE OF PROJECTED PLEDGED SETTLEMENT PAYMENTS AND DEBT SERVICE – Series A Bonds” for the projection of Series A Pledged Settlement Payments. This projection is based upon, among other things, the Base Case Forecast of cigarette consumption shown in the Global Insight Report. The actual amounts of Series A Pledged Settlement Payments may be more or less than such projections of Series A Pledged Settlement Payments. See “BONDHOLDERS’ RISKS” and see “APPENDIX E - GLOBAL INSIGHT REPORT” for a discussion of the other consumption forecasts prepared by Global Insight. There can be no assurance of the actual amounts of Series A Surplus Pledged Revenues or the application thereof to the purchase, redemption or defeasance of Series A Bonds.

Since the issuance of the Series 2003A Bonds, \$135,730,000 of the Series 2003A Bonds have been redeemed by operation of the Series A Debt Service Account, representing 5.9% of the original principal amount of the Series 2003A Bonds, and \$237,795,000 of the Series 2003A Bonds have been redeemed by operation of the Series A Supplemental Account, representing 10.3% of the original principal amount of the Series 2003A Bonds, together representing 16.2% of the original principal amount of the Series 2003A Bonds. See “SECURITY AND SOURCES OF PAYMENT FOR THE SERIES 2008A BONDS—Series A Pledged Accounts—*Series A Supplemental Account.*”

Application of Series B  
Surplus Pledged Revenues.....

Series B Surplus Pledged Revenues may be applied by the Corporation, at the direction of the State, to purchase, redeem or defease Series B Bonds (but only to purchase or defease the Series 2008B Bonds) at the times, with such maturities and in such amounts as the State directs, and by lot if within a maturity. To the extent not used to purchase, redeem or defease Series B

Bonds, all Series B Surplus Pledged Revenues will remain in the Series B Supplemental Account until (i) applied to the payment of principal and Sinking Fund Installments of or interest on Series B Bonds, including the Series 2008B Bonds, to the extent amounts on deposit in the Series B Debt Service Account are insufficient therefor or (ii) there are no Series B Bonds Outstanding under the Series B Indebtedness.

In addition, between April 15 and the next Distribution Date in each year, no amounts in the Series B Supplemental Account shall be applied or set aside to defease Series B Bonds or to pay the optional redemption or purchase price of Series B Bonds unless there is held in the Series B Debt Service Account sufficient amounts to pay all principal of and interest on the Series B Bonds, including the Series 2008B Bonds, scheduled to be paid in such year.

The State currently intends to direct all or a significant portion of the Series B Surplus Pledged Revenues to purchase, redeem or defease Series B Bonds (and only to purchase or defease the Series 2008B Bonds) but has no obligation to do so and has reserved its right to do otherwise at any time or from time to time. See “OUTSTANDING BONDS.” See also “TABLE OF PROJECTED PLEDGED SETTLEMENT PAYMENTS AND DEBT SERVICE – Series B Bonds” for the projection of Series B Pledged Settlement Payments. This projection is based upon, among other things, the Base Case Forecast of cigarette consumption shown in the Global Insight Report. The actual amounts of Series B Pledged Settlement Payments may be more or less than such projections of Series B Pledged Settlement Payments. See “BONDHOLDERS’ RISKS” and see “APPENDIX E- GLOBAL INSIGHT REPORT” for a discussion of the other consumption forecasts prepared by Global Insight. There can be no assurance of the actual amounts of Series B Surplus Pledged Revenues or the application thereof to the purchase, redemption or defeasance of Series B Bonds.

Since the issuance of the Series 2003B Bonds, \$134,515,000 of the Series 2003B Bonds have been redeemed by operation of the Series B Debt Service Account, representing 6.0% of the original principal amount of the Series 2003B Bonds, and \$174,185,000 of the original principal amount of the Series 2003B Bonds have been redeemed by operation of the Series B Supplemental Account, representing 7.8% of the original principal amount of the Series 2003B Bonds, together representing 13.8% of the original principal amount of the Series 2003B Bonds. See “SECURITY AND SOURCES OF PAYMENT FOR THE SERIES 2008B BONDS—Series B Pledged Accounts—*Series B Supplemental Account.*”

Events of Default..... For a description of the Events of Default under the Series A Indenture and the Series B Indenture and the remedies available therefor, see “THE SERIES 2008A BONDS – Events of Default and Remedies” and “THE SERIES 2008B BONDS – Events of Default and Remedies,” respectively. In no event shall principal of any Bond be declared due and payable in advance of its stated maturity.

Distributions and Priorities..... The Trustee will deposit all Series A Pledged Revenues in the Series A Pledged Revenues Account and distribute them in accordance with the “Series A Flow of Funds” set forth herein under the caption “SECURITY AND SOURCES OF PAYMENT FOR THE SERIES 2008A BONDS.” The Trustee will deposit all Series B Pledged Revenues in the Series B

Pledged Revenues Account and distribute them in accordance with the “Series B Flow of Funds” set forth herein under the caption “SECURITY AND SOURCES OF PAYMENT FOR THE SERIES 2008B BONDS.”

Series A Refunding Bonds.....	The Series A Indenture provides that additional series of bonds may be issued by the Corporation solely for refunding purposes (each, a “Series”) only upon receipt by the Corporation and the Trustee of a contingency contract for such refunding Series A Bonds. The Series A Contract is the contingency contract for the Series A Bonds. Additional refunding Series A Bonds would be issued on a parity with the Series 2003A Bonds and the Series 2008A Bonds. See “THE SERIES 2008A BONDS – Refunding Bonds.” No other additional bonds may be issued under the Series A Indenture with a parity claim against the Series A Pledged Revenues.
Series B Refunding Bonds.....	The Series B Indenture provides that additional series of bonds may be issued by the Corporation solely for refunding purposes (each, a “Series”) only upon receipt by the Corporation and the Trustee of a contingency contract for such refunding Series B Bonds. The Series B Contract is the contingency contract for the Series B Bonds. Additional refunding Series B Bonds would be issued on a parity with the Series 2003B Bonds and the Series 2008B Bonds. See “THE SERIES 2008B BONDS – Refunding Bonds.” No other additional bonds may be issued under the Series B Indenture with a parity claim against the Series B Pledged Revenues.
Continuing Disclosure Agreements.....	The Corporation and the State have agreed to provide, or cause to be provided, to each nationally recognized municipal securities information repository and any public or private repository or entity designated by the State as a repository for purposes of Rule 15c2-12(b)(5) adopted by the Securities and Exchange Commission (the “SEC”) certain annual financial information and operating data and, in a timely manner, notices of certain material events. See “CONTINUING DISCLOSURE AGREEMENTS” herein.
Ratings.....	Standard & Poor’s Ratings Services (“S&P”) has rated the Series 2008 Bonds AA-. Fitch, Inc. (“Fitch”) has rated the Series 2008 Bonds A+.
Legal Considerations Relating to Series A Pledged Settlement Payments and Series B Pledged Settlement Payments.....	Reference is made to “LEGAL CONSIDERATIONS RELATING TO SERIES A PLEDGED SETTLEMENT PAYMENTS AND SERIES B PLEDGED SETTLEMENT PAYMENTS” for a description of certain legal issues relevant to receipt of payments under the MSA.
Bondholders’ Risks.....	Reference is made to “BONDHOLDERS’ RISKS” for a description of certain considerations relevant to an investment in the Series 2008 Bonds.

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## INTRODUCTORY STATEMENT

*Terms used herein and not previously defined have the meanings ascribed to them in “APPENDIX G – DEFINITIONS AND SUMMARIES OF THE TRANSACTION DOCUMENTS — Definitions.”*

**This Official Statement sets forth information concerning the issuance by the Corporation of \$443,875,000 aggregate principal amount of its Asset-Backed Revenue Bonds, Series 2008 (State Contingency Contract Secured) consisting of \$219,935,000 Asset-Backed Revenue Bonds, Series 2008A (State Contingency Contract Secured) (the “Series 2008A Bonds”), \$223,940,000 Asset-Backed Revenue Bonds, Series 2008B (State Contingency Contract Secured) (the “Series 2008B Bonds” and, together with the Series 2008A Bonds, the “Bonds” or the “Series 2008 Bonds”).**

The Corporation is a public benefit corporation of the State, established as a subsidiary of the State of New York Municipal Bond Bank Agency (the “Agency”) and created and empowered to effectuate the purposes of the Act. By the terms of the Act, the Corporation is treated and accounted for as a legal entity separate from the State with its separate corporate purposes set forth in the Act. The directors of the Agency serve as members of the Corporation. The Corporation is governed by a seven member board: the Chairman of the Agency, the Secretary of State, the Director of the Budget of the State, three directors appointed by the Governor of the State and the State Comptroller or his appointee. For additional information regarding the organization and management of the Corporation, see “THE CORPORATION.”

The Series 2008A Bonds are special obligations of the Corporation issued under the Indenture, dated as of June 1, 2003, as supplemented by the Series 2003A Supplement and the Series 2008A Supplement (collectively, the “**Series A Indenture**”), between the Corporation and The Bank of New York, as indenture trustee (the “**Series A Trustee**”). The Series 2008A Bonds, together with all outstanding bonds previously issued and any additional refunding bonds to be issued under the Series A Indenture (collectively, the “**Series A Bonds**”), are payable from and secured by a pledge of the “**Series A Pledged Revenues,**” which consist of (i) the Series A Pledged Settlement Payments (defined below) sold by the State to the Corporation pursuant to the Purchase and Sale Agreement, dated as of June 1, 2003 (the “**Series A Sale Agreement**”), between the State and the Corporation, (ii) the payments (the “**Series A Contract Payments**”) to be made by the State pursuant to the Contingency Contract, dated as of June 1, 2003 (the “**Series A Contract**”), between the State and the Corporation, in such amounts, subject to appropriation by the State Legislature, as are necessary to pay when due the principal of and interest on the Series A Bonds, including the Series 2008A Bonds, to the extent that amounts on deposit in the Series A Pledged Revenues Account, the Series A Debt Service Account, the Series A Supplemental Account and the Series A Debt Service Reserve Account (collectively, the “**Series A Pledged Accounts**”) are insufficient therefor, (iii) payments made to the Corporation or the Series A Trustee under any Series A Ancillary Contracts and swap contracts and (iv) all fees, charges, payments, investment earnings and other income and receipts paid or payable to the Corporation or the Series A Trustee for the account of the Corporation or the Beneficiaries. See “SECURITY AND SOURCES OF PAYMENT FOR THE SERIES 2008A BONDS.” Upon the issuance of the Series 2008A Bonds and the application of the proceeds thereof, \$1,939,615,000 of Series A Bonds will be outstanding under the Series A Indenture.

Pursuant to the Act and the Series A Sale Agreement, the State sold to the Corporation the “**Series A Pledged Settlement Payments,**” consisting of (i) fifty percent (50%) of the annual payments and strategic contribution fund payments (as defined herein) and of all adjustments to prior payments, payable to the State pursuant to the MSA (as defined below) and received on and after January 1, 2004 and (ii) fifty percent (50%) of all Series A Lump Sum Payments (as defined herein) received at any time on or after June 19, 2003. See “SECURITY AND SOURCES OF PAYMENT FOR THE SERIES 2008A BONDS – The Series A Sale Agreement” and “APPENDIX G – DEFINITIONS AND SUMMARIES OF THE TRANSACTION DOCUMENTS – The Series A Sale Agreement and the Series B Sale Agreement.”

The Series 2008B Bonds are special obligations of the Corporation issued under the Indenture, dated as of December 1, 2003, as supplemented by the Series 2003B Supplement and the Series 2008B Supplement (collectively, the “**Series B Indenture**”), between the Corporation and The Bank of New York, as indenture trustee (the “**Series B Trustee**”). The Series 2008B Bonds, together with all outstanding bonds previously issued and any additional refunding bonds to be issued under the Series B Indenture (collectively, the “**Series B Bonds**”), are

payable from and secured by a pledge of the “**Series B Pledged Revenues,**” which consist of (i) the Series B Pledged Settlement Payments (defined below) sold by the State to the Corporation pursuant to the Purchase and Sale Agreement, dated as of December 1, 2003 (the “**Series B Sale Agreement**”), between the State and the Corporation, (ii) the payments (the “**Series B Contract Payments**”) to be made by the State pursuant to the Contingency Contract, dated as of December 1, 2003 (the “**Series B Contract**”), between the State and the Corporation, in such amounts, subject to appropriation by the State Legislature, as are necessary to pay when due the principal of and interest on the Series B Bonds, including the Series 2008B Bonds, to the extent that amounts on deposit in the Series B Pledged Revenues Account, the Series B Debt Service Account, the Series B Supplemental Account and the Series B Debt Service Reserve Account (collectively, the “**Series B Pledged Accounts**”) are insufficient therefor, (iii) payments made to the Corporation or the Series B Trustee under any Series B Ancillary Contracts and swap contracts and (iv) all fees, charges, payments, investment earnings and other income and receipts paid or payable to the Corporation or the Series B Trustee for the account of the Corporation or the Beneficiaries. See “SECURITY AND SOURCES OF PAYMENT FOR THE SERIES 2008B BONDS.” Upon the issuance of the Series 2008B Bonds and the application of the proceeds thereof, \$1,930,655,000 of Series B Bonds will be outstanding under the Series B Indenture.

Pursuant to the Act and the Series B Sale Agreement, the State sold to the Corporation the “**Series B Pledged Settlement Payments,**” consisting of (i) fifty percent (50%) of the Annual Payments and Strategic Contribution Fund Payments (as defined herein) and of all adjustments to prior payments, payable to the State pursuant to the MSA (as defined below) and received on and after January 1, 2004 and (ii) fifty percent (50%) of all Series B Lump Sum Payments (as defined herein) received at any time on or after December 2, 2003. See “SECURITY AND SOURCES OF PAYMENT FOR THE SERIES 2008B BONDS – The Series B Sale Agreement” and “APPENDIX G – DEFINITIONS AND SUMMARIES OF THE TRANSACTION DOCUMENTS – The Series A Sale Agreement and the Series B Sale Agreement.”

The Series A Bonds and the Series B Bonds are each separately secured by the Series A Pledged Revenues and the Series B Pledged Revenues, respectively. The Series A Trustee shall not have the right to make a claim to mitigate all or any part of an asserted deficiency in the Series A Pledged Revenues from the Series B Pledged Revenues and, likewise, the Series B Trustee shall not have the right to make a claim to mitigate all or part of an asserted deficiency in the Series B Pledged Revenues from the Series A Pledged Revenues. The rights of the Series A Trustee and the Series B Trustee to receive its respective Pledged Revenues are equal to and on a parity with each other and one right is not inferior or superior to the other.

Under the Series A Indenture, the Series A Bonds, including the Series 2008A Bonds, are, and any other Series of refunding Series A Bonds will be, payable solely from and secured by a statutory pledge of the Series A Pledged Revenues, including without limitation, the Series A Pledged Settlement Payments and Series A Contract Payments. See “SECURITY AND SOURCES OF PAYMENT FOR THE SERIES 2008A BONDS.” Under the Series B Indenture, the Series B Bonds, including the Series 2008B Bonds, are, and any other Series of refunding Series B Bonds will be, payable solely from and secured by a statutory pledge of the Series B Pledged Revenues, including without limitation, the Series B Pledged Settlement Payments and Series B Contract Payments. See “SECURITY AND SOURCES OF PAYMENT FOR THE SERIES 2008B BONDS.”

## PLAN OF FINANCE

The Corporation has previously issued pursuant to the Series A Indenture its Asset-Backed Revenue Bonds, Series 2003A-2 through 2003A-4 (State Contingency Contract Secured) (Auction Rate), of which \$217,500,000 are outstanding (the “**Series 2003A Refunded Bonds**”). The Corporation will apply a portion of the proceeds from the sale of the Series 2008A Bonds to establish an irrevocable escrow to refund the Series 2003A Refunded Bonds. Such escrowed proceeds of the Series 2008A Bonds will be deposited with The Bank of New York, as escrow agent (the “**Refunding Escrow Agent**”) pursuant to an Escrow Agreement dated as of March 1, 2008 (the “**Series 2003A Refunding Escrow Agreement**”), by and between the Corporation and the Refunding Escrow Agent. The amounts deposited under the Series 2003A Refunding Escrow Agreement will be held by the Refunding Escrow Agent and invested in Eligible Defeasance Securities (as defined in the Series 2003A Refunding Escrow Agreement), the principal of and interest on which, when received, will be sufficient to pay the redemption price of and interest on the Series 2003A Refunded Bonds upon maturity or redemption thereof. See also “VERIFICATION OF MATHEMATICAL COMPUTATIONS.”



The Corporation has previously issued pursuant to the Series B Indenture its Asset Backed Revenue Bonds, Series 2003B-2 through 2003B-5 (State Contingency Contract Secured) (Auction Rate), of which \$225,000,000 are outstanding (the “**Series 2003B Refunded Bonds**”). The Corporation will apply a portion of the proceeds from the sale of the Series 2008B Bonds to establish an irrevocable escrow to refund the Series 2003B Refunded Bonds. Such escrowed proceeds of the Series 2008B Bonds will be deposited with the Refunding Escrow Agent pursuant to an Escrow Agreement dated as of March 1, 2008 (the “**Series 2003B Refunding Escrow Agreement**”), by and between the Corporation and the Refunding Escrow Agent. The amounts deposited under the Series 2003B Refunding Escrow Agreement will be held by the Refunding Escrow Agent and invested in Eligible Defeasance Securities (as defined in the Series 2003B Refunding Escrow Agreement), the principal of and interest on which, when received, will be sufficient to pay the redemption price of and interest on the Series 2003B Refunded Bonds upon maturity or redemption thereof. See also “VERIFICATION OF MATHEMATICAL COMPUTATIONS.”

## **SECURITY AND SOURCES OF PAYMENT FOR THE SERIES 2008A BONDS**

*Set forth below is a narrative description of certain contractual and statutory provisions relating to the sources of payments and security for the Series 2008A Bonds issued under the Series A Indenture. These provisions have been summarized and this description does not purport to be complete. Reference should be made to the Act, the Series A Indenture, the Series A Sale Agreement and the Series A Contract for a more complete description of such provisions. Copies of the Act, the Series A Indenture, the Series A Sale Agreement and the Series A Contract are on file with the Corporation and the Trustee. See also “APPENDIX A- THE SERIES 2008A CONTINGENCY CONTRACT AND THE SERIES 2008B CONTINGENCY CONTRACT BETWEEN THE STATE OF NEW YORK AND THE CORPORATION” and “APPENDIX G- DEFINITIONS AND SUMMARIES OF THE TRANSACTION DOCUMENTS” for a more complete statement of the rights, duties and obligations of the parties thereto.*

### **The Series 2008A Bonds**

The Series A Bonds, including the Series 2008A Bonds, are special obligations of the Corporation, secured and payable solely from the Series A Pledged Revenues consisting of (i) the Series A Pledged Settlement Payments sold by the State to the Corporation pursuant to the Series A Sale Agreement, (ii) the Series A Contract Payments to be made by the State pursuant to the Series A Contract in such amounts, subject to appropriation by the State Legislature, as are necessary to pay when due the principal of and interest on the Series A Bonds, including the Series 2008A Bonds, to the extent that amounts on deposit in the Series A Pledged Accounts are insufficient therefor, (iii) payments made to the Corporation or Trustee under any Series A Ancillary Contracts and Swap Contracts and (iv) all fees, charges, payments, investment earnings and other income and receipts paid or payable to the Corporation or the Trustee for the account of the Corporation or the Series A Beneficiaries. The Series A Pledged Revenues and the right to receive them have been pledged to the Trustee for the benefit of the Holders of the Series A Bonds, including the Series 2008A Bonds.

The Series A Bonds and the Series B Bonds are each separately secured by the Series A Pledged Revenues and the Series B Pledged Revenues, respectively. The Trustee for the Series A Bonds shall not have the right to make a claim to mitigate all or any part of an asserted deficiency in the Series A Pledged Revenues from the Series B Pledged Revenues and, likewise, the Trustee for the Series B Bonds shall not have the right to make a claim to mitigate all or part of an asserted deficiency in the Series B Pledged Revenues from the Series A Pledged Revenues. The rights of the Trustee for the Series A Bonds and the Trustee for the Series B Bonds to receive its respective Pledged Revenues are equal to and on a parity with each other and one right is not inferior or superior to the other.

**Under the Act, the State is not liable on the Series A Bonds, including the Series 2008A Bonds. Pursuant to the Act, the Series A Bonds, including the Series 2008A Bonds, do not constitute a debt or a moral obligation of the State or a State supported obligation within the meaning of any constitutional or statutory provision or a pledge of the faith and credit of the State or of the taxing power of the State, and the State is not liable to make any payments thereon nor are any Series A Bonds, including the Series 2008A Bonds, payable out of any funds or assets other than the Series A Pledged Revenues. The Corporation has no taxing power.**

## The Series A Sale Agreement

Pursuant to the Act and the Series A Sale Agreement, the State sold to the Corporation the Series A Pledged Settlement Payments, consisting of (i) fifty percent (50%) of the annual payments and Strategic Contribution Fund Payments (as defined in the MSA) and of all adjustments to prior payments, payable to the State pursuant to the MSA (as defined below) and received on and after January 1, 2004 and (ii) fifty percent (50%) of any payment received by the Trustee as a payment from a PM which results in, or is due to, a release of that PM from all or a portion of its obligations due on and after January 1, 2004 under the MSA (each a “**Series A Lump Sum Payment**”), received at any time on or after June 19, 2003. The MSA requires that the PMs make several types of payments, including Initial Payments, Annual Payments and Strategic Contribution Fund Payments.<sup>†</sup> See “SUMMARY OF THE MASTER SETTLEMENT AGREEMENT — Initial Payments,” “— Annual Payments” and “—Strategic Contribution Fund Payments.” These payments (with the exception of the up-front Initial Payment) are subject to various adjustments and offsets, some of which could be material.

The MSA Escrow Agent will disburse Series A Pledged Settlement Payments directly to the Trustee. The disbursement of Series A Pledged Settlement Payments is required to be made to the Trustee by the MSA Escrow Agent 10 business days after the MSA Escrow Agent receives the related Annual Payments and Strategic Contribution Fund Payments from the PMs. The Trustee will, within two Business Days after receipt, transfer the Series A Pledged Settlement Payments to the Series A Pledged Revenues Account established by the Series A Indenture. Series A Pledged Settlement Payments will be disbursed from the Series A Pledged Revenues Account in accordance with the provisions of the Series A Indenture. See “Series A Flow of Funds” below.

The Series A Sale Agreement contains certain representations and covenants of the State for the benefit of the holders of the Series A Bonds. See “COVENANTS OF THE STATE” and “APPENDIX G- DEFINITIONS AND SUMMARY OF THE TRANSACTION DOCUMENTS – The Series A Sale Agreement and the Series B Sale Agreement” for a more detailed discussion of such representations and covenants.

## The Series A Contract

The Series A Bonds, including the Series 2008A Bonds, are secured by a pledge of all of the Corporation’s interest under the Series A Contract, including, without limitation, the Series A Contract Payments made by the State thereunder. The Series A Contract provides for payment to the Corporation on or before each June 1, December 1 or other Distribution Date of such amount, if any, as shall be necessary to provide for the payment of principal of and interest on the Series A Bonds, including the Series 2008A Bonds, coming due on such date, if all other funds pledged and available therefor, as described herein, are inadequate. The Series A Contract provides that the State’s obligation to make the payments due thereunder is absolute and unconditional, and shall be deemed executory only to the extent of the moneys available to the State and no liability shall be incurred by the State beyond the moneys available and appropriated for such purpose. The Series A Contract further provides that neither the Corporation nor the State will terminate the Series A Contract for any reason, including any acts or circumstances which may constitute failure of consideration or frustration of purpose or the failure of either party to perform and observe any duty, liability or obligation arising out of or connected with the Series A Contract.

The Director of the Budget on behalf of the State has agreed in the Series A Contract to include in the appropriation bill submitted by the Governor to the State Legislature each year for the ensuing fiscal year, as a requested appropriation item, an amount equal to the amount of principal of and interest on the Series A Bonds, including the 2008A Bonds, coming due in such ensuing fiscal year. The obligations of the State pursuant to the Series A Contract shall not terminate so long as any Series A Bond is Outstanding.

**The obligation of the State to fund or pay the amounts provided for by the Series A Contract is subject to and dependent upon annual appropriations being made by the State Legislature for such purpose, and pursuant to the Act, shall not constitute a debt or moral obligation of the State or a State supported obligation within the meaning of any Constitutional or statutory provision or a pledge of the faith and credit**

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<sup>†</sup> Other payments that are required to be made by the PMs, such as payments of attorneys’ fees and payments to a national foundation established pursuant to the MSA, are not sold by the State and are not available to the Corporation and consequently are not discussed herein.

**of the State or of the taxing power of the State, and the State shall not be liable to make any payments thereon beyond moneys available for the purposes thereof. The Corporation has no taxing power.**

Simultaneously with the delivery of the Series 2008A Bonds, the State Attorney General will deliver an opinion that (i) the Act has been duly enacted by the State and is in full force and effect and (ii) the Series A Contract has been duly authorized, executed and delivered by the State, and assuming the due execution and delivery by the Corporation, the Series A Contract constitutes a legal, valid and binding obligation of the State, enforceable in accordance with its terms.

For a more detailed discussion of the provisions of the Series A Contract, see “SUMMARY OF THE SERIES A CONTRACT.” A copy of the Series A Contract is attached hereto as APPENDIX A.

### **Series A Pledged Accounts**

Each of the following accounts were established under the Series A Indenture as a segregated trust account and are held by the Trustee for the benefit of the holders of the Series A Bonds, including the Series 2008A Bonds. All moneys on deposit in the following accounts will be invested in Eligible Investments as defined in the Series A Indenture.

*Series A Pledged Revenues Account.* The Trustee holds the “**Series A Pledged Revenues Account**” into which the Trustee deposits all Series A Pledged Revenues. Funds on deposit in the Series A Pledged Revenues Account are transferred to various other accounts under the Series A Indenture and applied to certain other purposes as described below.

*Series A Debt Service Account.* The Trustee holds the “**Series A Debt Service Account**” into which the Trustee deposits amounts transferred from the Series A Pledged Revenues Account in respect of principal of and interest on the Series A Bonds, including the Series 2008A Bonds. The Trustee makes payments on the Series A Bonds, including the Series 2008A Bonds, in accordance with the priority of payments as described below under “Series A Flow of Funds.”

*Series A Debt Service Reserve Account.* The Trustee holds the “**Series A Debt Service Reserve Account**”, which was funded from Series 2003A Bond proceeds in the amount of \$227,545,572.00 (the “**Series A Debt Service Reserve Requirement**”). To the extent of available investment earnings therein and Series A Pledged Settlement Payments, the balance in the Series A Debt Service Reserve Account must be maintained at the Series A Debt Service Reserve Requirement. Series A Contract Payments are not applied to satisfy any deficiencies in the Series A Debt Service Reserve Account.

Amounts in the Series A Debt Service Reserve Account are available to pay principal of and interest on the Series A Bonds, including the Series 2008A Bonds, to the extent that amounts on deposit in the Series A Debt Service Account and the Series A Supplemental Account are insufficient for such purpose. All earnings on amounts in the Series A Debt Service Reserve Account are retained in it if the amount therein is not equal to the Series A Debt Service Reserve Requirement. On each Distribution Date, amounts on deposit in the Series A Debt Service Reserve Account in excess of the Series A Debt Service Reserve Requirement will be transferred to the Series A Pledged Revenues Account and from there, immediately to the Series A Debt Service Account.

*Series A Supplemental Account.* The Trustee holds the “Supplemental Account” into which the Trustee deposits Series A Pledged Settlement Payments in excess of those required to make the deposits required by clauses (i) through (vi) of paragraph (A) set forth below under the sub-caption “Series A Flow of Funds” (the “**Series A Surplus Pledged Revenues**”). Amounts on deposit in the Series A Supplemental Account may be used to purchase, redeem or defease Series A Bonds (but only to purchase or defease the Series 2008A Bonds) as set forth under the caption “THE SERIES 2008A BONDS — Redemption and Purchase Provisions — *Application of Surplus Pledged Revenues.*”

Amounts on deposit in the Series A Supplemental Account will not be released from the lien of the Series A Indenture until (i) applied to the purchase, redemption or defeasance of Series A Bonds, (ii) applied to the

payment of principal of or interest on Series A Bonds, including the Series 2008A Bonds, to the extent amounts on deposit in the Series A Debt Service Account are insufficient therefor or (iii) there are no Series A Bonds Outstanding under the Series A Indenture.

In addition, between April 15 and the next Distribution Date in each year, no amounts in the Series A Supplemental Account shall be applied or set aside to defease Series A Bonds or to pay the optional redemption or purchase price of Series A Bonds unless there is held in the Series A Debt Service Account sufficient amounts to pay all principal of and interest on Series A Bonds, including the Series 2008A Bonds, scheduled to be paid in such year.

### **Series A Additional Accounts**

Each of the following accounts were established under the Series A Indenture and held by the Trustee. None of these accounts is a Series A Pledged Account and amounts on deposit therein are not available to pay principal of and interest on the Series A Bonds, including the Series 2008A Bonds.

*Series A Costs of Issuance Account.* The Trustee holds the “**Series A Costs of Issuance Account**” into which the Trustee shall deposit amounts funded from the proceeds of Series 2008A Bonds and disburse such amounts for the Costs of Issuance for the Series 2008A Bonds. Amounts in the Series A Costs of Issuance Account certified by the Corporation as being in excess of required Series 2008A Costs of Issuance shall be transferred to the Series A Pledged Revenues Account.

*Series A Operating Account.* The Trustee holds the “**Series A Operating Account**” into which the Trustee will deposit amounts transferred from the Series A Pledged Revenues Account as set forth in the Officers’ Certificate as Series A Operating Expenses and from which the Trustee will pay Series A Operating Expenses in accordance with the priority of payments as described below under “Series A Flow of Funds.”

*Series A Rebate Account.* The Trustee holds the “**Series A Rebate Account**” into which the Trustee will deposit amounts to the extent required to satisfy the Series A Rebate Requirement (as defined, computed and provided to the Trustee in accordance with the Tax Certificate), for payment to the United States Treasury.

### **Series A Flow of Funds**

Except as provided in the Series A Indenture and described in paragraph (A) below, the Trustee will deposit all Series A Pledged Revenues in the Series A Pledged Revenues Account. Subject to the foregoing, amounts deposited during the period January 1 through June 30 in any Fiscal Year (each period from July 1 through the following June 30, a “**Bond Year**”) will be applied to expenses and debt service requirements on the Series 2008A Bonds for the current Bond Year and the first half of the next Bond Year. Amounts, if any, deposited during the period July 1 through December 31 in any Bond Year will be applied to expenses and debt service requirements on the Series A Bonds, including the Series 2008A Bonds, for the current Bond Year.

As used herein, the term “**Deposit Date**” means the date of actual receipt by the Trustee of any Series A Pledged Revenues, provided that any payment received prior to January 1 of the year in which due will be deemed to have been received on January 1.

(A) No later than five Business Days following each deposit of Series A Pledged Revenues to the Series A Pledged Revenues Account (but in no event later than the next Distribution Date), the Trustee will withdraw Series A Pledged Revenues on deposit in the Series A Pledged Revenues Account and transfer such amounts as follows and in the following order of priority; provided, however, that (x) payments received on Swap Contracts and investment earnings on amounts in the funds and accounts (other than the Series A Debt Service Reserve Account, investment earnings on which shall be retained therein until the amounts on deposit therein are at least equal to the Series A Debt Service Reserve Requirement, and on the second Business Day preceding each Distribution Date amounts on deposit in the Series A Debt Service Reserve Account in excess of the Series A Debt Service Reserve Requirement shall be deposited directly to the Series A Debt Service Account) will be deposited directly to the

Series A Debt Service Account and (y) the Series A Contract Payments, whether or not a Series A Event of Default has occurred, will be deposited directly to the Series A Debt Service Account.

- (i) (a) to the Trustee the amount required to pay the Trustee fees and expenses (including reasonable attorneys' fees, if applicable) due during the current Fiscal Year and, if the Deposit Date is during the period from May 1 through October 31 of any year, during the first full six months of the next Fiscal Year and (b) to the Series A Operating Account, an amount specified by an Officer's Certificate for all operating and administrative expenses incurred by the Corporation and the Agency (related to its activities on behalf of the Corporation) (the "**Series A Operating Expenses**") (provided that such amounts paid pursuant to clauses (a) and (b) shall not exceed \$500,000.00, adjusted for inflation, plus any arbitrage and rebate penalties calculated as set forth in the Series A Indenture, plus, in each Fiscal Year, the amount of Broker-Dealer Fees set forth in the related Series Supplement plus annual bond insurance premiums, the "**Series A Operating Cap**," and Series A Operating Expenses will not include any termination payments, term-out payments or loss amounts on Series A Ancillary Contracts or Swaps), in each case for the current Fiscal Year and, if the Deposit Date is between May 1 and October 31, for the first full six months of the following Fiscal Year;
- (ii) to the Series A Debt Service Account an amount sufficient to cause the amount on deposit therein (together with interest and earnings reasonably expected by the Corporation to be received on investments in the Series A Debt Service Account on or prior to the next succeeding Distribution Date, as evidenced by an Officer's Certificate), to equal interest (including interest at the stated rate on the principal of Outstanding Series A Bonds, including the Series 2008A Bonds, and on overdue interest, if any) due on the next succeeding Distribution Date, together with any unpaid interest due on prior Distribution Dates, pro rata, based upon the respective amounts of interest due;
- (iii) to the Series A Debt Service Account an amount sufficient to cause the amount on deposit therein (together with interest and earnings reasonably expected by the Corporation to be received on investments in the Series A Debt Service Account on or prior to the next succeeding Distribution Date, as evidenced by an Officer's Certificate) exclusive of the amount on deposit therein pursuant to clause (ii) above, to equal the principal and Sinking Fund Installments due during the current Fiscal Year;
- (iv) to replenish the Series A Debt Service Reserve Account until the amount on deposit therein equals the Series A Debt Service Reserve Requirement;
- (v) to the Series A Debt Service Account the amount which, together with the amounts deposited pursuant to clause (ii) above, exclusive of amounts deposited therein pursuant to clause (iii) above, will be sufficient to cause the amount on deposit therein (together with interest and earnings reasonably expected by the Corporation to be received on investments in the Series A Debt Service Account on or prior to the next succeeding Distribution Date, as evidenced by an Officer's Certificate) to equal interest (including interest at the stated rate on the principal of Outstanding Series A Bonds, including the Series 2008A Bonds, and on overdue interest, if any) due (a) during the current Bond Year and (b) if the Deposit Date is during the period from January 1 through June 30 of any year, during the first full six months of the next Bond Year, assuming that principal of the Series A Bonds, including the Series 2008A Bonds, will be paid in the amounts deposited pursuant to clause (iii) above;
- (vi) in the amounts and to the funds and accounts established by the Series A Indenture for (a) termination payments and loss amounts on Series A Ancillary Contracts and any payments on Swap Contracts, (b) Series A Bond principal payable under term-out provisions of Series A Ancillary Contracts and any payments on Swap Contracts, (c) other amounts due under Series A Ancillary Contracts and not payable as debt service, (d) payments of principal of and interest on Series A Subordinate Indebtedness, (e) the purchase price of the Series A Bonds, including the Series 2008A Bonds, (f) annual payments required to be paid by the Corporation pursuant to

subdivisions 2 and 3 of Section 2975 of the Public Authorities Law, (g) litigation expenses incurred by the Corporation and (h) any other junior payments, but not in excess of \$500,000 in the aggregate for any Fiscal Year, identified as such by the Series A Indenture (the “**Series A Junior Payments**”); and

(vii) to the Series A Supplemental Account, all Series A Surplus Pledged Revenues.

On each December 31 and each April 15, the Trustee shall calculate the amount of cash and investments on deposit in the Series A Pledged Accounts. On or before (i) each January 5 (based on the preceding December 31 calculation) and (ii) April 20 (based on the preceding April 15 calculation), the Trustee shall notify the Corporation and the State as to whether such amounts are sufficient to pay all principal of and interest on the Series A Bonds, including the Series 2008A Bonds, scheduled to be paid on the next succeeding June 1 and December 1.

(B) On each Distribution Date (except with respect to clause (i) below), the Trustee will apply amounts in the various accounts in the following order of priority:

- (i) at any time, from the Series A Operating Account, to the parties entitled thereto, to pay Series A Operating Expenses in the amount specified in an Officer’s Certificate;
- (ii) from the Series A Debt Service Account (and to the extent that amounts in the Series A Debt Service Account are insufficient therefor, from amounts that shall be transferred on such Distribution Date to the Series A Debt Service Account from the Series A Supplemental Account and the Series A Debt Service Reserve Account, in that order), to pay interest on the Outstanding Series A Bonds, including the Series 2008A Bonds, (including interest on overdue interest, if any) due on such Distribution Date, plus any such unpaid interest due on prior Distribution Dates;
- (iii) from the Series A Debt Service Account (and to the extent that amounts in the Series A Debt Service Account are insufficient therefor, from amounts that shall be transferred on such Distribution Date to the Series A Debt Service Account from the Series A Supplemental Account and the Series A Debt Service Reserve Account, in that order), to pay, in order of maturity dates and Sinking Fund Installment Dates, the principal and Sinking Fund Installments due on such Distribution Date;
- (iv) from the Series A Debt Service Reserve Account, any amount in excess of the Series A Debt Service Reserve Requirement to the Series A Pledged Revenues Account and from there immediately to the Series A Debt Service Account;
- (v) from the Series A Funds and Series A Accounts therefor, to make Series A Junior Payments; and
- (vi) from the Series A Supplemental Account, to one or more separate subaccounts therein, to provide irrevocably for the payment of the Series A Bonds, including the Series 2008A Bonds, in accordance with the Series A Indenture or to pay the optional redemption or purchase price of the Series A Bonds (but only the purchase price of the Series 2008A Bonds) to be redeemed or purchased on such Distribution Date.

#### **SECURITY AND SOURCES OF PAYMENT FOR THE SERIES 2008B BONDS**

*Set forth below is a narrative description of certain contractual and statutory provisions relating to the sources of payments and security for the Series 2008B Bonds issued under the Series B Indenture. These provisions have been summarized and this description does not purport to be complete. Reference should be made to the Act, the Series B Indenture, the Series B Sale Agreement and the Series B Contract for a more complete description of such provisions. Copies of the Act, the Series B Indenture, the Series B Sale Agreement and the Series B Contract are on file with the Corporation and the Trustee. See also “APPENDIX A - THE SERIES 2008A CONTINGENCY CONTRACT AND THE SERIES 2008B CONTINGENCY CONTRACT BETWEEN THE STATE OF NEW YORK*

*AND THE CORPORATION” and “APPENDIX G- DEFINITIONS AND SUMMARIES OF THE TRANSACTION DOCUMENTS” for a more complete statement of the rights, duties and obligations of the parties thereto.*

### **The Series 2008B Bonds**

The Series B Bonds, including the Series 2008B Bonds, are special obligations of the Corporation, secured and payable solely from the Series B Pledged Revenues consisting of (i) the Series B Pledged Settlement Payments sold by the State to the Corporation pursuant to the Series B Sale Agreement, (ii) the Series B Contract Payments to be made by the State pursuant to the Series B Contract in such amounts, subject to appropriation by the State Legislature, as are necessary to pay when due the principal of and interest on the Series B Bonds, including the Series 2008B Bonds, to the extent that amounts on deposit in the Series B Pledged Accounts are insufficient therefor, (iii) payments made to the Corporation or Trustee under any Series B Ancillary Contracts and Swap Contracts and (iv) all fees, charges, payments, investment earnings and other income and receipts paid or payable to the Corporation or the Trustee for the account of the Corporation or the Series B Beneficiaries. The Series B Pledged Revenues and the right to receive them have been pledged to the Trustee for the benefit of the Holders of the Series B Bonds, including the Series 2008B Bonds.

The Series B Bonds and the Series A Bonds are each separately secured by the Series B Pledged Revenues and the Series A Pledged Revenues, respectively. The Trustee for the Series B Bonds shall not have the right to make a claim to mitigate all or any part of an asserted deficiency in the Series B Pledged Revenues from the Series A Pledged Revenues and, likewise, the Trustee for the Series A Bonds shall not have the right to make a claim to mitigate all or part of an asserted deficiency in the Series A Pledged Revenues from the Series B Pledged Revenues. The rights of the Trustee for the Series B Bonds and the Trustee for the Series A Bonds to receive its respective Pledged Revenues are equal to and on a parity with each other and one right is not inferior or superior to the other.

**Under the Act, the State is not liable on the Series B Bonds, including the Series 2008B Bonds. Pursuant to the Act, the Series B Bonds, including the Series 2008B Bonds, do not constitute a debt or a moral obligation of the State or a State supported obligation within the meaning of any constitutional or statutory provision or a pledge of the faith and credit of the State or of the taxing power of the State, and the State is not liable to make any payments thereon nor are any Series B Bond, including the Series 2008B Bonds, payable out of any funds or assets other than the Series B Pledged Revenues. The Corporation has no taxing power.**

### **The Series B Sale Agreement**

Pursuant to the Act and the Series B Sale Agreement, the State sold to the Corporation the Series B Pledged Settlement Payments, consisting of (i) fifty percent (50%) of the annual payments and Strategic Contribution Fund Payments (as defined in the MSA) and of all adjustments to prior payments, payable to the State pursuant to the MSA (as defined below) and received on and after January 1, 2004 and (ii) fifty percent (50%) of any payment received by the Trustee as a payment from a PM which results in, or is due to, a release of that PM from all or a portion of its obligations due on and after January 1, 2004 under the MSA (each a “**Series B Lump Sum Payment**”), received at any time on or after December 2, 2003. The MSA requires that the PMs make several types of payments, including Initial Payments, Annual Payments and Strategic Contribution Payments.<sup>†</sup> See “SUMMARY OF THE MASTER SETTLEMENT AGREEMENT — Initial Payments,” “— Annual Payments” and “—Strategic Contribution Fund Payments.” These payments (with the exception of the up-front Initial Payment) are subject to various adjustments and offsets, some of which could be material.

The MSA Escrow Agent will disburse Series B Pledged Settlement Payments directly to the Trustee. The disbursement of Series B Pledged Settlement Payments is required to be made to the Trustee by the MSA Escrow Agent 10 business days after the MSA Escrow Agent receives the related Annual Payments and Strategic Contribution Fund Payments from the PMs. The Trustee will, within two Business Days after receipt, transfer the Series B Pledged Settlement Payments to the Series B Pledged Revenues Account established by the Series B

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<sup>†</sup> Other payments that are required to be made by the PMs, such as payments of attorneys’ fees and payments to a national foundation established pursuant to the MSA, are not sold by the State and are not available to the Corporation and consequently are not discussed herein.

Indenture. Series B Pledged Settlement Payments will be disbursed from the Series B Pledged Revenues Account in accordance with the provisions of the Series B Indenture. See “Series B Flow of Funds” below.

The Series B Sale Agreement contains certain representations and covenants of the State for the benefit of the holders of the Series 2008B Bonds. See “COVENANTS OF THE STATE” and “APPENDIX G- DEFINITIONS AND SUMMARY OF THE TRANSACTION DOCUMENTS – The Series A Sale Agreement and the Series B Sale Agreement” for a more detailed discussion of such representations and covenants.

### **The Series B Contract**

The Series B Bonds, including the Series 2008B Bonds, are secured by a pledge of all of the Corporation’s interest under the Series B Contract, including, without limitation, the Series B Contract Payments made by the State thereunder. The Series B Contract provides for payment to the Corporation on or before each June 1, December 1 or other Distribution Date of such amount, if any, as shall be necessary to provide for the payment of principal of and interest on the Series B Bonds, including the Series 2008B Bonds, coming due on such date, if all other funds pledged and available therefor, as described herein, are inadequate. The Series B Contract provides that the State’s obligation to make the payments due thereunder is absolute and unconditional, and shall be deemed executory only to the extent of the moneys available to the State and no liability shall be incurred by the State beyond the moneys available and appropriated for such purpose. The Series B Contract further provides that neither the Corporation nor the State will terminate the Series B Contract for any reason, including any acts or circumstances which may constitute failure of consideration or frustration of purpose or the failure of either party to perform and observe any duty, liability or obligation arising out of or connected with the Series B Contract.

The Director of the Budget on behalf of the State has agreed in the Series B Contract to include in the appropriation bill submitted by the Governor to the State Legislature each year for the ensuing fiscal year, as a requested appropriation item, an amount equal to the amount of principal of and interest on the Series B Bonds, including the Series 2008B Bonds, coming due in such ensuing fiscal year. The obligations of the State pursuant to the Series B Contract shall not terminate so long as any Series B Bond is Outstanding.

**The obligation of the State to fund or pay the amounts provided for by the Series B Contract is subject to and dependent upon annual appropriations being made by the State Legislature for such purpose, and pursuant to the Act, shall not constitute a debt or moral obligation of the State or a State supported obligation within the meaning of any Constitutional or statutory provision or a pledge of the faith and credit of the State or of the taxing power of the State, and the State shall not be liable to make any payments thereon beyond moneys available for the purposes thereof. The Corporation has no taxing power.**

Simultaneously with the delivery of the Series 2008B Bonds, the State Attorney General will deliver an opinion that (i) the Act has been duly enacted by the State and is in full force and effect and (ii) the Series B Contract has been duly authorized, executed and delivered by the State, and assuming the due execution and delivery by the Corporation, the Series B Contract constitutes a legal, valid and binding obligation of the State, enforceable in accordance with its terms.

For a more detailed discussion of the provisions of the Series B Contract, see “SUMMARY OF THE SERIES B CONTRACT.” A copy of the Series B Contract is attached hereto as APPENDIX A.

### **Series B Pledged Accounts**

Each of the following accounts were established under the Series B Indenture as a segregated trust account and are held by the Trustee for the benefit of the holders of the Series B Bonds, including the Series 2008B Bonds. All moneys on deposit in the following accounts will be invested in Eligible Investments as defined in the Series B Indenture.

*Series B Pledged Revenues Account.* The Trustee holds the “**Series B Pledged Revenues Account**” into which the Trustee deposits all Series B Pledged Revenues. Funds on deposit in the Series B Pledged Revenues



Account are transferred to various other accounts under the Series B Indenture and applied to certain other purposes as described below.

*Series B Debt Service Account.* The Trustee holds the “**Series B Debt Service Account**” into which the Trustee deposits amounts transferred from the Series B Pledged Revenues Account in respect of principal and Sinking Fund Installments of and interest on the Series B Bonds, including the Series 2008B Bonds. The Trustee makes payments on the Series B Bonds, including the Series 2008B Bonds, in accordance with the priority of payments as described below under “Series B Flow of Funds.”

*Series B Debt Service Reserve Account.* The Trustee holds the “**Series B Debt Service Reserve Account**”, which was funded from Series 2003B Bond proceeds in the amount of \$221,582,343.75 (the “**Series B Debt Service Reserve Requirement**”). To the extent of available investment earnings therein and Series B Pledged Settlement Payments, the balance in the Series B Debt Service Reserve Account must be maintained at the Series B Debt Service Reserve Requirement. Series B Contract Payments will not be applied to satisfy any deficiencies in the Series B Debt Service Reserve Account.

Amounts in the Series B Debt Service Reserve Account are available to pay principal and Sinking Fund Installments of and interest on the Series B Bonds, including the Series 2008B Bonds, to the extent that amounts on deposit in the Series B Debt Service Account and the Series B Supplemental Account are insufficient for such purpose. All earnings on amounts in the Series B Debt Service Reserve Account are retained in it if the amount therein is not equal to the Series B Debt Service Reserve Requirement. On each Distribution Date, amounts on deposit in the Series B Debt Service Reserve Account in excess of the Series B Debt Service Reserve Requirement will be transferred to the Series B Pledged Revenues Account and from there, immediately to the Series B Debt Service Account.

*Series B Supplemental Account.* The Trustee holds the “Supplemental Account” into which the Trustee deposits Series B Pledged Settlement Payments in excess of those required to make the deposits required by clauses (i) through (vi) of paragraph (A) set forth below under the sub-caption “Series B Flow of Funds” (the “**Series B Surplus Pledged Revenues**”). Amounts on deposit in the Series B Supplemental Account may be used to purchase, redeem or defease Series B Bonds (but only to purchase or defease the Series 2008B Bonds) as set forth under the caption “THE SERIES 2008B BONDS — Redemption and Purchase Provisions — *Application of Surplus Pledged Revenues.*”

Amounts on deposit in the Series B Supplemental Account will not be released from the lien of the Series B Indenture until (i) applied to the purchase, redemption or defeasance of Series B Bonds, (ii) applied to the payment of principal and Sinking Fund Installments of or interest on the Series B Bonds, including the Series 2008B Bonds, to the extent amounts on deposit in the Series B Debt Service Account are insufficient therefor or (iii) there are no Series B Bonds Outstanding under the Series B Indenture.

In addition, between April 15 and the next Distribution Date in each year, no amounts in the Series B Supplemental Account shall be applied or set aside to defease Series B Bonds or to pay the optional redemption or purchase price of Series B Bonds unless there is held in the Series B Debt Service Account sufficient amounts to pay all principal and Sinking Fund Installments of and interest on the Series B Bonds, including the Series 2008B Bonds, scheduled to be paid in such year.

### **Series B Additional Accounts**

Each of the following accounts were established under the Series B Indenture and held by the Trustee. None of these accounts is a Series B Pledged Account and amounts on deposit therein are not available to pay principal and Sinking Fund Installments of and interest on the Series B Bonds, including the Series 2008B Bonds.

*Series B Costs of Issuance Account.* The Trustee holds the “**Series B Costs of Issuance Account**” into which the Trustee shall deposit amounts funded from the proceeds of Series 2008B Bonds into the Series B Costs of Issuance Account, and disburse such amounts for the Costs of Issuance for the Series 2008B Bonds. Amounts in the

Series B Costs of Issuance Account certified by the Corporation as being in excess of required Series 2008B Costs of Issuance shall be transferred to the Series B Pledged Revenues Account.

*Series B Operating Account.* The Trustee holds the “**Series B Operating Account**” into which the Trustee will deposit amounts transferred from the Series B Pledged Revenues Account as set forth in the Officers’ Certificate as Series B Operating Expenses and from which the Trustee will pay Series B Operating Expenses in accordance with the priority of payments as described below under “Series B Flow of Funds.”

*Series B Rebate Account.* The Trustee holds the “**Series B Rebate Account**” into which the Trustee will deposit amounts to the extent required to satisfy the Series B Rebate Requirement (as defined, computed and provided to the Trustee in accordance with the Tax Certificate), for payment to the United States Treasury.

### **Series B Flow of Funds**

Except as provided in the Series B Indenture and described in paragraph (A) below, the Trustee will deposit all Series B Pledged Revenues in the Series B Pledged Revenues Account. Subject to the foregoing, amounts deposited during the period January 1 through June 30 in any Fiscal Year (each period from July 1 through the following June 30, a “**Bond Year**”) will be applied to expenses and debt service requirements on the Series B Bonds for the current Bond Year and the first half of the next Bond Year. Amounts, if any, deposited during the period July 1 through December 31 in any Bond Year will be applied to expenses and debt service requirements on the Series B Bonds, including the Series 2008B Bonds, for the current Bond Year.

As used herein, the term “**Deposit Date**” means the date of actual receipt by the Trustee of any Series B Pledged Revenues, provided that any payment received prior to January 1 of the year in which due will be deemed to have been received on January 1.

(A) No later than five Business Days following each deposit of Series B Pledged Revenues to the Series B Pledged Revenues Account (but in no event later than the next Distribution Date), the Trustee will withdraw Series B Pledged Revenues on deposit in the Series B Pledged Revenues Account and transfer such amounts as follows and in the following order of priority; provided, however, that (x) investment earnings on amounts in the funds and accounts (other than the Series B Debt Service Reserve Account, investment earnings on which shall be retained therein until the amounts on deposit therein are at least equal to the Series B Debt Service Reserve Requirement, and on the Business Day preceding each Distribution Date amounts on deposit in the Series B Debt Service Reserve Account in excess of the Series B Debt Service Reserve Requirement shall be transferred to the Pledged Revenues Account and from there immediately to the Series B Debt Service Account) will be transferred to the Series B Pledged Revenues Account and, from there, immediately to the Series B Debt Service Account and (y) the Series B Contract Payments, whether or not a Series B Event of Default has occurred, will be deposited directly to the Series B Debt Service Account.

- (i) (a) to the Trustee the amount required to pay the Trustee fees and expenses (including reasonable attorneys’ fees, if applicable) due and not previously paid or funded, during the current Fiscal Year and, if the Deposit Date is during the period from May 1 through October 31 of any year, during the first full six months of the next Fiscal Year and (b) to the Series B Operating Account, an amount specified by an Officer’s Certificate for all operating and administrative expenses incurred by the Corporation and the Agency (related to its activities on behalf of the Corporation) (the “**Series B Operating Expenses**”) (provided that such amounts paid pursuant to clauses (a) and (b) shall not exceed the Series B Operating Cap<sup>†</sup> and Series B Operating Expenses will not include any termination payments, term-out payments or loss amounts on Series B Ancillary

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<sup>†</sup> The “**Series B Operating Cap**” is the sum of (i) in connection with the issuance of the Series 2003B Bonds, the one-time fee payable in one or more installments (without interest), owing to the State from Series B Pledged Revenues in an amount not exceeding \$31,857,840.00, (ii) in connection with the issuance of the Series 2008B Bonds, the one-time fee, payable in one or more installments (without interest), owing to the State from Series B Pledged Revenues, in an amount not exceeding \$3,107,125.00 (such fees collectively referred to as the “**Series B State Fee**”), (iii) \$500,000.00 in the Fiscal Year ending October 31, 2004 and adjusted for inflation in subsequent Fiscal Years, (iv) any arbitrage and rebate penalties, the amount of Broker-Dealer fees calculated as set forth in the Series B Indenture and (v) in each Fiscal Year, annual bond insurance premiums and fees and charges of the State in addition to the State Fee that are payable by the Corporation after the Closing Date.

Contracts or Swaps), in each case for the current Fiscal Year and, if the Deposit Date is between May 1 and October 31, for the first full six months of the following Fiscal Year; *provided*, that the amount required to pay any portion of the State Fee in connection with the Series 2008B Bonds shall not be deposited to the Series B Operating Account unless it is specified in an Officer's Certificate that sufficient amounts have been deposited in the Series B Debt Service Account (exclusive of any transfers from the Series B Debt Service Reserve Account pursuant to (B)(ii) or (B)(iii) described below) to meet all principal and interest funding requirements set forth in clauses (ii) and (iii) below for the period ending on (but not including) December 1, 2008 (the transfers to the Series B Operating Account for the State Fee in connection with any Series of Refunding Bonds may include similar restrictions, as set forth in the applicable Series Supplement);

- (ii) to the Series B Debt Service Account an amount sufficient to cause the amount on deposit therein (together with interest and earnings reasonably expected by the Corporation to be received on investments in the Series B Debt Service Account on or prior to the next succeeding Distribution Date, as evidenced by an Officer's Certificate), to equal interest (including interest at the stated rate on the principal of Outstanding Series B Bonds, including the Series 2008B Bonds, and on overdue interest, if any) due on the next succeeding Distribution Date, together with any unpaid interest due on prior Distribution Dates, pro rata, based upon the respective amounts of interest due;
- (iii) to the Series B Debt Service Account an amount sufficient to cause the amount on deposit therein (together with interest and earnings reasonably expected by the Corporation to be received on investments in the Series B Debt Service Account on or prior to the next succeeding Distribution Date, as evidenced by an Officer's Certificate) exclusive of the amount on deposit therein or credited thereto pursuant to clause (ii) above, to equal the principal and Sinking Fund Installments due during the current Fiscal Year;
- (iv) to replenish the Series B Debt Service Reserve Account until the amount on deposit therein equals the Series B Debt Service Reserve Requirement;
- (v) to the Series B Debt Service Account the amount which, together with the amounts deposited or credited pursuant to clause (ii) above, exclusive of amounts deposited therein or credited thereto pursuant to clause (iii) above, will be sufficient to cause the amount on deposit therein (together with interest and earnings reasonably expected by the Corporation to be received on investments in the Series B Debt Service Account on or prior to the next succeeding Distribution Date, as evidenced by an Officer's Certificate) to equal interest (including interest at the stated rate on the principal of Outstanding Series B Bonds, including the Series 2008B Bonds, and on overdue interest, if any) due (a) during the current Bond Year and (b) if the Deposit Date is during the period from January 1 through June 30 of any year, during the first full six months of the next Bond Year, assuming that principal and Sinking Fund Installments of the Series B Bonds, including the Series 2008B Bonds, will be paid in the amounts deposited pursuant to clause (iii) above;
- (vi) in the amounts and to the funds and accounts established by the Series B Indenture for (a) termination payments and loss amounts on Series B Ancillary Contracts, (b) Series B Bond principal payable under term-out provisions of Series B Ancillary Contracts, (c) other amounts due under Series B Ancillary Contracts and not payable as debt service, (d) annual payments required to be paid by the Corporation pursuant to subdivisions 2 and 3 of Section 2975 of the Public Authorities Law, (e) litigation expenses incurred by the Corporation and (f) any other junior payments, but not in excess of \$500,000 in the aggregate for any Fiscal Year, identified as such by the Series B Indenture (the "**Series B Junior Payments**"); and
- (vii) to the Series B Supplemental Account, all Series B Surplus Pledged Revenues.

On each December 31 and each April 15, the Trustee shall calculate the amount of cash and investments on deposit in the Series B Pledged Accounts. On or before (i) each January 5 (based on the preceding December 31 calculation) and (ii) April 20 (based on the preceding April 15 calculation), the Trustee shall notify the Corporation and the State as to whether such amounts are sufficient to pay all principal and Sinking Fund Installments of and interest on the Series B Bonds, including the Series 2008B Bonds, scheduled to be paid on the next succeeding June 1 and December 1.

(B) On each Distribution Date (except with respect to clause (i) below), the Trustee will apply amounts in the various accounts in the following order of priority:

- (i) at any time, from the Series B Operating Account, to the parties entitled thereto, to pay Series B Operating Expenses in the amount specified in an Officer's Certificate;
- (ii) from the Series B Debt Service Account (a) at any time, as directed in an Officer's Certificate, to the Series B Pledged Revenues Account any balance therein in excess of the amount required to be on deposit therein pursuant to clause (A)(ii) above, and (b) to pay interest on the Outstanding Series B Bonds, including the Series 2008B Bonds, (including interest on overdue interest, if any) due on such Distribution Date, plus any unpaid interest due on prior Distribution Dates (and to the extent that amounts in the Series B Debt Service Account are insufficient therefor, from amounts that shall be transferred on such Distribution Date to the Series B Debt Service Account from the Series B Supplemental Account and the Series B Debt Service Reserve Account, in that order);
- (iii) from the Series B Debt Service Account (and to the extent that amounts in the Series B Debt Service Account are insufficient therefor, from amounts that shall be transferred on such Distribution Date to the Series B Debt Service Account from the Series B Supplemental Account and the Series B Debt Service Reserve Account, in that order), to pay, in order of maturity dates, the principal and Sinking Fund Installments due on such Distribution Date;
- (iv) from the Series B Debt Service Reserve Account, any amount in excess of the Series B Debt Service Reserve Requirement to the Series B Pledged Revenues Account and from there immediately to the Series B Debt Service Account;
- (v) from the Series B Funds and Series B Accounts established by the Series Supplement, to make Series B Junior Payments; and
- (vi) from the Series B Supplemental Account, to one or more separate subaccounts therein, to provide irrevocably for the payment of the Series B Bonds, including the Series 2008B Bonds, in accordance with the Series B Indenture or to pay the optional redemption or purchase price of the Series B Bonds (but only the purchase price of the Series 2008B Bonds) to be redeemed or purchased on such Distribution Date.

#### **COVENANTS OF THE STATE**

The Act states that the State pledges and agrees with the Corporation, and the owners of the Corporation's Bonds that the State will (i) irrevocably direct, through the Attorney General, the independent auditor and the escrow agent under the MSA to transfer all Series A Pledged Settlement Payments and Series B Pledged Settlement Payments directly to the Trustee, (ii) enforce, at the expense of the State, its right to collect all monies due from the PMs under the MSA, (iii) diligently enforce, at the expense of the State, the Qualifying Statute as contemplated in section IX(d)(2)(B) of the MSA against all tobacco product manufacturers selling tobacco products in the State that are not in compliance with the Qualifying Statute, in each case in the manner and to the extent deemed necessary in the judgment of the Attorney General, provided, however, as stated in each of the Series A Sale Agreement and the Series B Sale Agreement, (a) that the remedies available to the Corporation and the Bondholders for any breach of the pledges and agreements of the State set forth in this clause (iii) shall be limited to injunctive relief, and (b) that the State shall be deemed to have diligently enforced the Qualifying Statute so long as there has been no judicial determination by a court of competent jurisdiction in the State, in an action commenced by a PM under the MSA,

that the State has failed to diligently enforce the Qualifying Statute for the purposes of section IX(d)(2)(B) of the MSA, (iv) neither amend the MSA nor the Consent Decree or take any other action in any way that would materially adversely (a) alter, limit or impair the Corporation's right to receive Series A Pledged Settlement Payments and Series B Pledged Settlement Payments, or (b) limit or alter the rights vested by the Act in the Corporation to fulfill the terms of its agreements with the Bondholders, or (c) in any way impair the rights and remedies of the Bondholders or the security for the Bonds, until the Bonds, together with the interest thereon and all costs and expenses in connection with any action or proceedings by or on behalf of the Bondholders, are fully paid and discharged (provided, that nothing in the Act, the Series A Indenture or the Series B Indenture shall be construed to preclude the State's regulation of smoking and taxation and regulation of the sale of cigarettes or the like or to restrict the right of the State to amend, modify, repeal or otherwise alter statutes imposing or relating to the taxes), and (v) not amend, supersede or repeal the Qualifying Statute and the Complementary Legislation in any way that would materially adversely affect the rights of, the Corporation or the Bondholders. Notwithstanding these pledges and agreements by the State, the Attorney General may in his or her discretion enforce any and all provisions of the MSA without limitation.

The State has covenanted in each of the Series A Contract and the Series B Contract that the Director of the Budget on behalf of the State shall include, as a requested appropriation item in the State's budget for each State fiscal year, an amount equal to the amount certified by the Authorized Officer of the Corporation as being the amount of Series A Scheduled Debt Service and Series B Scheduled Debt Service, as applicable, coming due during such next succeeding fiscal year. The State has complied with such covenants in each year since the issuance of the Series 2003A Bonds.

## **THE SERIES 2008A BONDS**

*The following summary describes certain terms of the Series 2008A Bonds. This summary does not purport to be complete and is subject to, and qualified in its entirety by reference to, the provisions of the Series A Indenture and the Series 2008A Bonds. Copies of the Series A Indenture and the Series A Contract may be obtained upon written request to the Trustee.*

### **Description of the Series 2008A Bonds**

The Series 2008A Bonds will initially be represented by one or more bond certificates registered in the name of The Depository Trust Company or its nominee ("DTC"), New York, New York. DTC will act as securities depository for the Series 2008A Bonds. The Series 2008A Bonds will be available for purchase in denominations of \$5,000 or any integral multiple thereof, in book-entry form only. Except under the limited circumstances described herein, no Beneficial Owner of the Series 2008A Bonds will be entitled to receive a physical certificate representing its ownership interest in such Series 2008A Bonds. See "BOOK-ENTRY ONLY SYSTEM" herein.

The Series 2008A Bonds will be issued pursuant to the Act and the Series A Indenture, will be dated as of the Closing Date and will mature at the times and in the aggregate principal amounts set forth on the inside front cover hereof. Interest on the Series 2008A Bonds will be payable on each Distribution Date, commencing on June 1, 2008. For each Distribution Date, payments that are to be made on the Series 2008A Bonds will be made to holders of the Series 2008A Bonds of record (the "**Series 2008A Bondholders**") as of the applicable Record Date.

Interest will accrue from and including the Closing Date, or from and including the most recent Distribution Date on which interest has been paid to, but excluding, the subsequent Distribution Date. Interest on the Series 2008A Bonds will be computed on the basis of a 360-day year consisting of twelve 30-day months.

### **Redemption and Purchase Provisions**

#### Series 2008A Bonds Not Subject to Redemption

The Series 2008A Bonds are not subject to redemption prior to maturity.

### Purchase of Outstanding Series 2008A Bonds

The Corporation, at the direction of the State (which direction shall specify the maturities of the Series 2008A Bonds to be purchased), may cause the Trustee to purchase Series 2008A Bonds in the open market from Series A Surplus Pledged Revenues, at a price not exceeding 100% of the Outstanding principal amount of such Series 2008A Bonds being purchased at such time, plus accrued interest thereon.

### Application of Surplus Pledged Revenues

Series A Surplus Pledged Revenues may be applied by the Corporation, at the direction of the State, to purchase, redeem or defease Series A Bonds (but only to purchase or defease the Series 2008A Bonds) at the times, with such maturities and in such amounts as the State directs, and by lot if within a maturity. To the extent not used to purchase, redeem or defease Series A Bonds, all Series A Surplus Pledged Revenues will remain in the Series A Supplemental Account until (i) applied to the payment of principal of or interest on Series A Bonds to the extent amounts on deposit in the Series A Debt Service Account are insufficient therefor, or (ii) there are no Series A Bonds Outstanding under the Series A Indenture. In addition, between April 15 and the next Distribution Date in each year, no amounts in the Series A Supplemental Account shall be applied or set aside to defease Series A Bonds or to pay optional redemption or the purchase price of Series A Bonds unless there is held in the Series A Debt Service Account sufficient amounts to pay all principal of and interest on Series A Bonds, including the Series 2008A Bonds, scheduled to be paid in such year.

The State currently intends to direct all or a significant portion of the Series A Surplus Pledged Revenues to purchase, redeem or defease Series A Bonds (and only to purchase or defease the Series 2008A Bonds) but has no obligation to do so and has reserved its right to do otherwise at any time or from time to time. See “OUTSTANDING BONDS.” See also “BONDHOLDERS’ RISKS” and “TABLE OF PROJECTED PLEDGED SETTLEMENT PAYMENTS AND DEBT SERVICE” for the projection of Series A Pledged Settlement Payments. This projection is based upon, among other things, the Base Case Forecast of cigarette consumption shown in the Global Insight Report. The actual amounts of Series A Pledged Settlement Payments may be more or less than such projection of Series A Pledged Settlement Payments. See “APPENDIX E- GLOBAL INSIGHT REPORT” for a discussion of the other consumption forecasts prepared by Global Insight. There can be no assurance of the actual amounts of Series A Surplus Pledged Revenues or the application thereof to the redemption, purchase or defeasance of Series A Bonds.

### **Refunding Bonds**

The Corporation may authorize, issue, sell and deliver Series A Bonds from time to time in such principal amounts as the Corporation may determine but solely to refund Series A Bonds, by exchange, purchase, redemption or payment, and establish such escrows therefor as it may determine. Only Refunding Bonds may be issued and only upon receipt by the Corporation or the Trustee of a contingency contract for such Refunding Bonds.

### **Events of Default and Remedies**

#### Events of Default

The Series A Indenture provides that each of the following shall be a “**Series A Event of Default**” thereunder:

- (i) principal of or interest on any Series A Bond has not been paid when due;
- (ii) the Corporation fails to observe or perform any other provision of the Series A Indenture which failure is not remedied within 60 days after written notice thereof has been given to the Corporation by the Trustee or to the Corporation and the Trustee by the holders of at least 25% of the principal amount of the Outstanding Series A Bonds, provided that if the default cannot be corrected within the said 60-day period and is diligently pursued until corrected, it shall not

constitute a Series A Event of Default if corrective action is instituted by the Corporation within said 60-day period and diligently pursued until the default is corrected;

- (iii) the State fails to observe or perform its covenants described herein under “COVENANTS OF THE STATE,” “APPENDIX G- DEFINITIONS AND SUMMARIES OF THE TRANSACTION DOCUMENTS— The Indentures” or “— The Series A Sale Agreement and the Series B Sale Agreement,” which failure is not remedied within 60 days after written notice thereof has been given to the Corporation and the State by the Trustee or to the Corporation and the Trustee by holders of not less than 25% of the principal amount of the Outstanding Series A Bonds;
- (iv) the State fails to provide the amounts demanded by the Trustee for payment of principal of or interest on the Series A Bonds in accordance with the Series A Indenture;
- (v) the failure of the Director of the Budget on behalf of the State, prior to the commencement of any fiscal year of the State, to include as a requested appropriation item in the State’s budget for such fiscal year, an amount equal to the principal of and interest on the Series A Bonds scheduled to come due during such fiscal year; or
- (vi) bankruptcy, reorganization, arrangement or insolvency proceedings, or other proceedings for relief under any bankruptcy or similar law or laws for the relief of debtors, are instituted by or against the Corporation and, if instituted against the Corporation, are not dismissed within 60 days after such institution.

#### Remedies

If an Event of Default occurs the Trustee may, and upon written request of the holders of 25% in principal amount of the Series A Bonds Outstanding shall, in its own name by action or proceeding in accordance with the law:

- (i) enforce all rights of the holders and require the Corporation or, to the extent permitted by law, the State to carry out its agreements with the holders and to perform its duties under the Series A Sale Agreement;
- (ii) sue upon such Series A Bonds;
- (iii) require the Corporation to account as if it were the trustee of an express trust for the holders of such Series A Bonds; and
- (iv) enjoin any acts or things which may be unlawful or in violation of the rights of the holders of such Series A Bonds.

In no event shall the outstanding principal of any Series A Bond be declared due and payable in advance of its stated maturity.

### **THE SERIES 2008B BONDS**

*The following summary describes certain terms of the Series 2008B Bonds. This summary does not purport to be complete and is subject to, and qualified in its entirety by reference to, the provisions of the Series B Indenture and the Series 2008B Bonds. Copies of the Series B Indenture and the Series B Contract may be obtained upon written request to the Trustee.*

#### **Description of the Series 2008B Bonds**

The Series 2008B Bonds will initially be represented by one or more bond certificates registered in the name of The Depository Trust Company or its nominee (“DTC”), New York, New York. DTC will act as securities

depository for the Series 2008B Bonds. The Series 2008B Bonds will be available for purchase in denominations of \$5,000 or any integral multiple thereof, in book-entry form only. Except under the limited circumstances described herein, no Beneficial Owner of the Series 2008B Bonds will be entitled to receive a physical certificate representing its ownership interest in such Series 2008B Bonds. See “BOOK-ENTRY ONLY SYSTEM” herein.

The Series 2008B Bonds will be issued pursuant to the Act and the Series B Indenture, will be dated as of the Closing Date and will mature at the times and in the aggregate principal amounts set forth on the inside front cover hereof. Interest on the Series 2008B Bonds will be payable on each Distribution Date, commencing on June 1, 2008. For each Distribution Date, payments that are to be made on the Series 2008B Bonds will be made to holders of the Series 2008B Bonds of record (the “**Series 2008B Bondholders**”) as of the applicable Record Date.

Interest will accrue from and including the Closing Date, or from and including the most recent Distribution Date on which interest has been paid to, but excluding, the subsequent Distribution Date. Interest on the Series 2008B Bonds will be computed on the basis of a 360-day year consisting of twelve 30-day months.

## **Redemption and Purchase Provisions**

### Series 2008B Bonds Not Subject to Redemption

The Series 2008B Bonds are not subject to redemption prior to maturity.

### Purchase of Outstanding Series 2008B Bonds

The Corporation, at the direction of the State (which direction shall specify the maturities of the Series 2008B Bonds to be purchased), may cause the Trustee to purchase Series 2008B Bonds in the open market from Series B Surplus Pledged Revenues, at a price not exceeding 100% of the Outstanding principal amount of such Series 2008B Bonds being purchased at such time, plus accrued interest thereon.

### Application of Surplus Pledged Revenues

Series B Surplus Pledged Revenues may be applied by the Corporation, at the direction of the State, to purchase, redeem or defease Series B Bonds (but only to purchase or defease the Series 2008B Bonds) at the times, with such maturities and in such amounts as the State directs, and by lot if within a maturity. To the extent not used to purchase, redeem or defease Series B Bonds, all Series B Surplus Pledged Revenues will remain in the Series B Supplemental Account until (i) applied to the payment of principal and Sinking Fund Installments of or interest on Series B Bonds to the extent amounts on deposit in the Series B Debt Service Account are insufficient therefor, or (ii) there are no Series B Bonds Outstanding under the Series B Indenture. In addition, between April 15 and the next Distribution Date in each year, no amounts in the Series B Supplemental Account shall be applied or set aside to defease Series B Bonds or to pay the optional redemption or purchase price of Series B Bonds unless there is held in the Series B Debt Service Account sufficient amounts to pay all principal and Sinking Fund Installments of and interest on Series B Bonds, including the Series 2008B Bonds, scheduled to be paid in such year.

The State currently intends to direct all or a significant portion of the Series B Surplus Pledged Revenues to purchase, redeem or defease Series B Bonds (and only to purchase or defease the Series 2008B Bonds) but has no obligation to do so and has reserved its right to do otherwise at any time or from time to time. See “OUTSTANDING BONDS.” See also “BONDHOLDERS’ RISKS” and “TABLE OF PROJECTED PLEDGED SETTLEMENT PAYMENTS AND DEBT SERVICE” for the projection of Series B Pledged Settlement Payments. This projection is based upon, among other things, the Base Case Forecast of cigarette consumption shown in the Global Insight Report. The actual amounts of Series B Pledged Settlement Payments may be more or less than such projection of Series B Pledged Settlement Payments. See “APPENDIX E- GLOBAL INSIGHT REPORT” for a discussion of the other consumption forecasts prepared by Global Insight. There can be no assurance of the actual amounts of Series B Surplus Pledged Revenues or the application thereof to the redemption, purchase or defeasance of Series B Bonds.



## **Refunding Bonds**

The Corporation may authorize, issue, sell and deliver Series B Bonds from time to time in such principal amounts as the Corporation may determine but solely to refund Series B Bonds, by exchange, purchase, redemption or payment, and establish such escrows therefor as it may determine. Only Refunding Bonds may be issued and only upon receipt by the Corporation or the Trustee of a contingency contract for such Refunding Bonds.

## **Events of Default and Remedies**

### Events of Default

The Series B Indenture provides that each of the following shall be a “**Series B Event of Default**” thereunder:

- (i) principal and Sinking Fund Installments of or interest on any Series B Bond has not been paid when due;
- (ii) the Corporation fails to observe or perform any other provision of the Series B Indenture which failure is not remedied within 60 days after written notice thereof has been given to the Corporation by the Trustee or to the Corporation and the Trustee by the holders of at least 25% of the principal amount of the Outstanding Series B Bonds, provided that if the default cannot be corrected within the said 60-day period and is diligently pursued until corrected, it shall not constitute a Series B Event of Default if corrective action is instituted by the Corporation within said 60-day period and diligently pursued until the default is corrected;
- (iii) the State fails to observe or perform its covenants described herein under “COVENANTS OF THE STATE,” “APPENDIX G- DEFINITIONS AND SUMMARIES OF THE TRANSACTION DOCUMENTS— The Indentures” or “— The Series A Sale Agreement and the Series B Sale Agreement,” which failure is not remedied within 60 days after written notice thereof has been given to the Corporation and the State by the Trustee or to the Corporation and the Trustee by holders of not less than 25% of the principal amount of the Outstanding Series B Bonds;
- (iv) the State fails to provide the amounts demanded by the Trustee for payment of principal and Sinking Fund Installments of or interest on the Series B Bonds in accordance with the Series B Indenture;
- (v) the failure of the Director of the Budget on behalf of the State, prior to the commencement of any fiscal year of the State, to include as a requested appropriation item in the State’s budget for such fiscal year, an amount equal to the principal and Sinking Fund Installments of and interest on the Series B Bonds scheduled to come due during such fiscal year; or
- (vi) bankruptcy, reorganization, arrangement or insolvency proceedings, or other proceedings for relief under any bankruptcy or similar law or laws for the relief of debtors, are instituted by or against the Corporation and, if instituted against the Corporation, are not dismissed within 60 days after such institution.

### Remedies

If an Event of Default occurs the Trustee may, and upon written request of the holders of 25% in principal amount of the Series B Bonds Outstanding shall, in its own name by action or proceeding in accordance with the law:

- (v) enforce all rights of the holders and require the Corporation or, to the extent permitted by law, the State to carry out its agreements with the holders and to perform its duties under the Series B Sale Agreement;

- (vi) sue upon such Series B Bonds;
- (vii) require the Corporation to account as if it were the trustee of an express trust for the holders of such Series B Bonds; and
- (viii) enjoin any acts or things which may be unlawful or in violation of the rights of the holders of such Series B Bonds.

In no event shall the outstanding principal of any Series B Bond be declared due and payable in advance of its stated maturity.

### **BOOK-ENTRY ONLY SYSTEM**

The Depository Trust Company (“DTC”), New York, New York, will act as securities depository for the Series 2008 Bonds (the “Securities”). The Securities will be issued as fully-registered securities registered in the name of Cede & Co. (DTC’s partnership nominee) or such other name as may be requested by an authorized representative of DTC. One fully-registered Security certificate will be issued for each CUSIP of each maturity of each Series of Securities, each in the aggregate principal amount of such maturity, and will be deposited with DTC.

DTC, the world’s largest securities depository, is a limited-purpose trust company organized under the New York Banking Law, a “banking organization” within the meaning of the New York Banking Law, a member of the Federal Reserve System, a “clearing corporation” within the meaning of the New York Uniform Commercial Code, and a “clearing agency” registered pursuant to the provisions of Section 17A of the Securities Exchange Act of 1934. DTC holds and provides asset servicing for over 3.5 million issues of U.S. and non-U.S. equity issues, corporate and municipal debt issues, and money market instruments (from over 100 countries) that DTC’s participants (“**Direct Participants**”) deposit with DTC. DTC also facilitates the post-trade settlement among Direct Participants of sales and other securities transactions in deposited securities, through electronic computerized book-entry transfers and pledges between Direct Participants’ accounts. This eliminates the need for physical movement of securities certificates. Direct Participants include both U.S. and non-U.S. securities brokers and dealers, banks, trust companies, clearing corporations, and certain other organizations. DTC is a wholly-owned subsidiary of The Depository Trust & Clearing Corporation (“**DTCC**”). DTCC is the holding company for DTC, National Securities Clearing Corporation and Fixed Income Clearing Corporation, all of which are registered clearing agencies. DTCC is owned by the users of its regulated subsidiaries. Access to the DTC system is also available to others such as both U.S. and non-U.S. securities brokers and dealers, banks, trust companies, and clearing corporations that clear through or maintain a custodial relationship with a Direct Participant, either directly or indirectly (“**Indirect Participants**”) and together with Direct Participants, “**DTC Participants**”). DTC has S&P’s highest rating: AAA. The DTC Rules applicable to its Participants are on file with the Securities and Exchange Commission. More information about DTC can be found at [www.dtcc.com](http://www.dtcc.com) and [www.dtc.org](http://www.dtc.org).

Purchases of the Securities under the DTC system must be made by or through Direct Participants, which will receive a credit for the Securities on DTC’s records. The ownership interest of each actual purchaser of each Security (“**Beneficial Owner**”) is in turn to be recorded on the DTC Participants’ records. Beneficial Owners will not receive written confirmation from DTC of their purchase. Beneficial Owners are, however, expected to receive written confirmations providing details of the transaction, as well as periodic statements of their holdings, from the DTC Participant through which the Beneficial Owner entered into the transaction. Transfers of ownership interests in the Securities are to be accomplished by entries made on the books of DTC Participants acting on behalf of Beneficial Owners. Beneficial Owners will not receive certificates representing their ownership interests in the Securities, except in the event that use of the book-entry system for the Securities is discontinued.

To facilitate subsequent transfers, all the Securities deposited by Direct Participants with DTC are registered in the name of DTC’s partnership nominee, Cede & Co. or such other name as may be requested by an authorized representative of DTC. The deposit of the Securities with DTC and their registration in the name of Cede & Co. or such other DTC nominee do not effect any change in beneficial ownership. DTC has no knowledge of the actual Beneficial Owners of the Securities; DTC’s records reflect only the identity of the Direct Participants to whose accounts such Securities are credited, which may or may not be the Beneficial Owners. DTC Participants will remain responsible for keeping account of their holdings on behalf of their customers.

Conveyance of notices and other communications by DTC to Direct Participants, by Direct Participants to Indirect Participants, and by DTC Participants to Beneficial Owners will be governed by arrangements among them, subject to any statutory or regulatory requirements as may be in effect from time to time. Beneficial Owners of the Securities may wish to take certain steps to augment the transmission to them of notices of significant events with respect to the Securities, such as tenders, defaults, and proposed amendments to the Security documents. For example, Beneficial Owners of the Securities may wish to ascertain that the nominee holding the Securities for their benefit has agreed to obtain and transmit notices to Beneficial Owners. In the alternative, Beneficial Owners may wish to provide their names and addresses to the registrar and request that copies of notices be provided directly to them.

Neither DTC nor Cede & Co. (nor any other DTC nominee) will consent or vote with respect to the Securities unless authorized by a Direct Participant in accordance with DTC's MMI procedures. Under its usual procedures, DTC mails an Omnibus Proxy to the Corporation as soon as possible after the record date. The Omnibus Proxy assigns Cede & Co.'s consenting or voting rights to those Direct Participants to whose accounts Securities are credited on the record date (identified in a listing attached to the Omnibus Proxy).

Except as described below, neither DTC nor Cede & Co. will take any action to enforce covenants with respect to any security registered in the name of Cede & Co. Under its current procedures, on the written instructions of a Direct Participant, DTC will cause Cede & Co. to sign a demand to exercise Bondholder rights as record holder of the quantity of securities specified in the Direct Participant's instructions, and not as record holder of all the securities of that issue registered in the name of Cede & Co. Also, in accordance with DTC's current procedures, all factual representations to be made by Cede & Co. to the Corporation, the Trustee or any other party must be made to DTC and Cede & Co. by the Direct Participant in its instructions to DTC.

For so long as the Securities are issued in book-entry form through the facilities of DTC, any Beneficial Owner desiring to cause the Corporation or the Trustee to comply with any of its obligations with respect to the Securities must make arrangements with the Direct Participant or Indirect Participant through whom such Beneficial Owner's ownership interest in the Securities is recorded in order for the Direct Participant in whose DTC account such ownership interest is recorded to make the instructions to DTC described above.

NONE OF THE CORPORATION, THE TRUSTEE OR ANY UNDERWRITER (OTHER THAN IN ITS CAPACITY, IF ANY, AS A DIRECT PARTICIPANT OR INDIRECT PARTICIPANT) WILL HAVE ANY OBLIGATION TO DIRECT PARTICIPANTS OR INDIRECT PARTICIPANTS OR THE PERSONS FOR WHOM THEY ACT AS NOMINEES WITH RESPECT TO DTC'S PROCEDURES OR ANY PROCEDURES OR ARRANGEMENTS BETWEEN DIRECT PARTICIPANTS, INDIRECT PARTICIPANTS AND THE PERSONS FOR WHOM THEY ACT RELATING TO THE MAKING OF ANY DEMAND BY CEDE & CO. AS THE REGISTERED OWNER OF THE SECURITIES, THE ADHERENCE TO SUCH PROCEDURES OR ARRANGEMENTS OR THE EFFECTIVENESS OF ANY ACTION TAKEN PURSUANT TO SUCH PROCEDURES OR ARRANGEMENTS.

Distributions and dividend payments on the Securities will be made to Cede & Co., or such other nominee as may be requested by an authorized representative of DTC. DTC's practice is to credit Direct Participants' accounts upon DTC's receipt of funds and corresponding detail information from the Corporation or the Trustee, on payable date in accordance with their respective holdings shown on DTC's records. Payments by Participants to Beneficial Owners will be governed by standing instructions and customary practices, as is the case with securities held for the accounts of customers in bearer form or registered in "street name," and will be the responsibility of such Participant and not of DTC, the Trustee or the Corporation, subject to any statutory or regulatory requirements as may be in effect from time to time. Payment of distributions, and dividend payments to Cede & Co. (or such other nominee as may be requested by an authorized representative of DTC) is the responsibility of the Corporation or the Trustee, disbursement of such payments to Direct Participants will be the responsibility of DTC, and disbursement of such payments to the Beneficial Owners will be the responsibility of DTC Participants.

So long as Cede & Co. is the registered owner of the Securities, as nominee for DTC, references in this Official Statement to Bondholders or registered owners of the Securities (other than under the caption "TAX MATTERS" herein) shall mean Cede & Co., as aforesaid, and shall not mean the Beneficial Owners of the Securities.

As long as the book-entry system is used for the Securities, the Trustee and the Corporation will give any notice required to be given to Bondholders only to DTC or its nominee. Any failure of DTC to advise any Direct Participant, or of any Direct Participant to notify any Indirect Participant, or of any Direct Participant or Indirect Participant to notify any Beneficial Owner, of any such notice and its content or effect will not affect any action premised on such notice. Conveyance of notices and other communications by DTC to Direct Participants, by Direct Participants to Indirect Participants and by Direct Participants and Indirect Participants to Beneficial Owners will be governed by arrangements among them, subject to any statutory or regulatory requirements as may be in effect from time to time.

BENEFICIAL OWNERS SHOULD MAKE APPROPRIATE ARRANGEMENTS WITH THEIR BROKER OR DEALER TO RECEIVE NOTICES AND OTHER INFORMATION REGARDING THE SECURITIES THAT MAY BE SO CONVEYED TO DIRECT PARTICIPANTS AND INDIRECT PARTICIPANTS.

For every transfer and exchange of a beneficial ownership interest in the Securities, the Beneficial Owner may be charged a sum sufficient to cover any tax, fee or other governmental charge, that may be imposed in relation thereto.

DTC may discontinue providing its services as depository with respect to the Securities at any time by giving reasonable notice to the Corporation or Trustee. Under such circumstances, in the event that a successor depository is not obtained, such Security certificates are required to be printed and delivered.

The Corporation may decide to discontinue use of the system of book-entry-only transfers through DTC (or a successor securities depository). In that event, Security certificates will be printed and delivered.

THE ABOVE INFORMATION CONCERNING DTC AND DTC'S BOOK-ENTRY SYSTEM HAS BEEN OBTAINED FROM SOURCES THAT THE CORPORATION BELIEVES TO BE RELIABLE, BUT THE CORPORATION TAKES NO RESPONSIBILITY FOR THE ACCURACY THEREOF. NEITHER THE CORPORATION, THE STATE NOR THE TRUSTEE WILL HAVE ANY RESPONSIBILITY OR OBLIGATION TO DTC PARTICIPANTS, BENEFICIAL OWNERS OR OTHER NOMINEES OF SUCH BENEFICIAL OWNERS FOR (1) SENDING TRANSACTION STATEMENTS; (2) MAINTAINING, SUPERVISING OR REVIEWING, OR THE ACCURACY OF, ANY RECORDS MAINTAINED BY DTC OR ANY DTC PARTICIPANT OR OTHER NOMINEES OF SUCH BENEFICIAL OWNERS; (3) PAYMENT OR THE TIMELINESS OF PAYMENT BY DTC TO ANY DTC PARTICIPANT, OR BY ANY DTC PARTICIPANT OR OTHER NOMINEES OF BENEFICIAL OWNERS TO ANY BENEFICIAL OWNER, OF ANY AMOUNT DUE IN RESPECT OF THE PRINCIPAL OR INTEREST ON THE SECURITIES; (4) DELIVERY OR TIMELY DELIVERY BY DTC TO ANY DTC PARTICIPANT, OR BY ANY DTC PARTICIPANT OR OTHER NOMINEES OF BENEFICIAL OWNERS TO ANY BENEFICIAL OWNERS, OF ANY NOTICE OR OTHER COMMUNICATION WHICH IS REQUIRED OR PERMITTED UNDER THE TERMS OF EACH OF THE SERIES A INDENTURE AND THE SERIES B INDENTURE TO BE GIVEN TO OWNERS OF THE SECURITIES; OR (5) ANY ACTION TAKEN BY DTC OR ITS NOMINEE AS THE REGISTERED OWNER OF THE SECURITIES.

None of the Corporation, the State, the Trustee or the Underwriters can give any assurance that DTC or DTC Participants will distribute payments of principal, premium or interest on the Securities paid to DTC or its nominee, or send any notice, to the Beneficial Owners, or that they will do so in a timely manner or that DTC will act in the manner described in this Official Statement.

## THE CORPORATION

### General

The Corporation is a public benefit corporation of the State of New York (the "State"), established as a subsidiary of the State of New York Municipal Bond Bank Agency (the "Agency") and created pursuant to the Act. By the terms of the Act, the Corporation is treated and accounted for as a legal entity separate from the State and the

Agency with its separate corporate purposes set forth in the Act. The directors of the Agency serve as members of the Corporation. The Corporation is governed by a seven member board: the Chairman of the Agency, the Secretary of State, the Director of the Budget of the State, three directors appointed by the Governor of the State and the State Comptroller or his appointee.

The members of the Corporation are:

<u>Name</u>	<u>Title</u>
Judd S. Levy	Chairman
Kenneth M. Bialo	Vice Chairman
Lorraine Cortes-Vasquez	<i>Ex officio</i> , Secretary of State
Laura L. Anglin	<i>Ex officio</i> , Director of the Budget of the State of New York
Charles Capetanakis	Member
Michael J. Townsend	Member
Andrew A. SanFilippo	Representing the State Comptroller

The officers of the Corporation are:

<u>Name</u>	<u>Title</u>
Priscilla Almodovar	Executive Director
Marian Zucker	Executive Vice President
Joy S. Willig	Senior Vice President and Counsel
Charles Rosenwald	Senior Vice President and Chief Financial Officer

**ESTIMATED SOURCES AND USES OF FUNDS**

The expected sources and uses of funds of the Series 2008 Bonds is set forth below:

Sources of Funds:

	<b>Series 2008A Bonds</b>	<b>Series 2008B Bonds</b>
Initial Principal Amount	\$219,935,000.00	\$223,940,000.00
Net Original Issue Premium (discount)	5,865,191.60	8,731,129.90
Total Sources	\$225,800,191.60	\$232,671,129.90

Uses of Funds:

Refunding Escrows for Refunded Bonds	\$224,078,669.93	\$230,942,947.97
Costs of Issuance*	637,782.03	651,566.18
Underwriters' Discount	\$1,083,739.64	\$1,076,615.75
Total Uses	\$225,800,191.60	\$232,671,129.90

\* Includes legal fees, verification agent fees, printing costs and certain other expenses related to the issuance of the Series 2008 Bonds.

## OUTSTANDING BONDS

### Series A Bonds

After giving effect to the issuance of the Series 2008A Bonds and the application of the proceeds thereof, the following Series A Bonds will be outstanding under the Series A Indenture:

Serial Maturity Date (June 1)	2003A Principal Amount	2008A Principal Amount	Total
2008	\$65,535,000	\$	\$65,535,000
2009	20,000,000	20,000,000	40,000,000
2010	25,000,000	34,140,000	59,140,000
2011	35,190,000	78,830,000	114,020,000
2012	34,860,000	86,965,000	121,825,000
2013	104,825,000		104,825,000
2014	112,385,000		112,385,000
2015	120,420,000		120,420,000
2016	129,225,000		129,225,000
2017	138,465,000		138,465,000
2018	163,885,000		163,885,000
2019	174,885,000		174,885,000
2020	186,220,000		186,220,000
2021	198,160,000		198,160,000
2022	210,625,000		210,625,000
<b>Total</b>	<b>\$1,719,680,000</b>	<b>\$219,935,000</b>	<b>\$1,939,615,000</b>

### Retirement and Redemption of Series A Bonds

Since the issuance of the Series 2003A Bonds, \$135,730,000 of the Series 2003A Bonds have been redeemed by operation of the Series A Debt Service Account, representing 5.9% of the original principal amount of the Series 2003A Bonds, and \$237,795,000 of the Series 2003A Bonds have been redeemed by operation of the Series A Supplemental Account, representing 10.3% of the original principal amount of the Series 2003A Bonds, together representing 16.2% of the original principal amount of the Series 2003A Bonds. See “SECURITY AND SOURCES OF PAYMENT FOR THE SERIES 2008A BONDS—Series A Pledged Accounts—*Series A Supplemental Account.*”

## Series B Bonds

After giving effect to the issuance of the Series 2008B Bonds and the application of the proceeds thereof, the following Series B Bonds will be outstanding under the Series B Indenture:

<b>Serial Maturity Date (June 1)</b>	<b>2003B Principal Amount</b>	<b>2008B Principal Amount</b>	<b>Total</b>
2008	\$73,870,000	\$	\$73,870,000
2009	25,000,000	38,270,000	63,270,000
2010	25,000,000	84,070,000	109,070,000
2011	94,435,000	22,170,000	116,605,000
2012	45,400,000	79,430,000	124,830,000
2013	109,680,000		109,680,000
2014	118,110,000		118,110,000
2015	127,100,000		127,100,000
2016	137,030,000		137,030,000
2017	147,475,000		147,475,000
2018	161,990,000		161,990,000
2019	173,860,000		173,860,000
2020	186,300,000		186,300,000
2021	199,690,000		199,690,000
2022	81,775,000		81,775,000
<b>Total</b>	<b>\$1,706,715,000</b>	<b>\$223,940,000</b>	<b>\$1,930,655,000</b>

## Retirement and Redemption of Series B Bonds

Since the issuance of the Series 2003B Bonds, \$134,515,000 of the Series 2003B Bonds have been redeemed by operation of the Series B Debt Service Account, representing 6.0% of the original principal amount of the Series 2003B Bonds, and \$174,185,000 of the original principal amount of the Series 2003B Bonds have been redeemed by operation of the Series B Supplemental Account, representing 7.8% of the original principal amount of the Series 2003B Bonds, together representing 13.8% of the original principal amount of the Series 2003B Bonds. See “SECURITY AND SOURCES OF PAYMENT FOR THE SERIES 2008B BONDS—Series B Pledged Accounts—*Series B Supplemental Account*.”



**TABLE OF PROJECTED PLEDGED SETTLEMENT PAYMENTS AND DEBT SERVICE**

**Series A Bonds**

The following table sets forth (i) the estimated amounts required to be paid by the Corporation during each calendar year of the years shown for the payment of debt service on the Series A Bonds, (ii) the projected amount of Series A Pledged Settlement Payments<sup>(1)</sup> to be received by the Corporation, which projection has been calculated based on the Global Insight Base Case Forecast and other structuring assumptions and (iii) the projected debt service coverage provided by the projected Series A Pledged Settlement Payments. The denominator of the coverage ratios does not include redemptions prior to maturity from the Series A Surplus Revenues and calculations of coverage ratios are based on the assumption that no such redemptions will occur. No assurances can be given that the Series A Pledged Settlement Payments will be received in the amounts projected using the Global Insight Base Case Forecast and other structuring assumptions. See “SUMMARY OF SERIES A AND SERIES B PLEDGED SETTLEMENT PAYMENTS METHODOLOGY AND BOND ASSUMPTIONS” for the structuring assumptions used to calculate the projected amount of Series A Pledged Settlement Payments.

<b>Year</b>	<b>Series A Pledged Settlement Payments<sup>(1)</sup></b>	<b>Outstanding Series 2003A Debt Service<sup>(2)</sup></b>	<b>Series 2008A Principal</b>	<b>Series 2008A Interest</b>	<b>Total Series A Debt Service</b>	<b>Projected Debt Service Coverage Provided by Projected Series A Pledged Settlement Payments<sup>(3)</sup></b>
2008	\$255,694,079	\$154,581,596	\$	\$6,572,479	\$161,154,075	1.59x
2009	258,880,196	107,115,203	20,000,000	9,297,100	136,412,303	1.90x
2010	261,784,893	111,167,746	34,140,000	8,133,600	153,441,346	1.71x
2011	264,846,070	120,007,371	78,830,000	5,424,350	204,261,721	1.30x
2012	267,855,599	118,027,021	86,965,000	1,739,300	206,731,321	1.30x
2013	270,822,590	184,416,496			184,416,496	1.47x
2014	273,695,091	186,143,703			186,143,703	1.47x
2015	276,495,806	187,785,878			187,785,878	1.47x
2016	279,814,918	189,753,340			189,753,340	1.47x
2017	283,143,258	191,661,661			191,661,661	1.48x
2018	291,139,533	208,853,104			208,853,104	1.39x
2019	294,407,752	210,691,338			210,691,338	1.40x
2020	297,570,203	212,412,444			212,412,444	1.40x
2021	301,076,023	214,318,813			214,318,813	1.40x
2022	304,552,194	216,126,822			216,126,822	1.41x
<b>Total</b>	<b>\$4,181,778,204</b>	<b>\$2,613,062,534</b>	<b>\$219,935,000</b>	<b>\$31,166,829</b>	<b>\$2,864,164,363</b>	

(1) Series A Pledged Settlement Payments include Series A Pledged Settlement Payments plus earnings on Series A Pledged Settlement Payments and Series A Debt Service Reserve Account less Series A Operating Expenses.

(2) Assumes refunding of Series 2003A Refunded Bonds.

(3) Assumes that the Series 2003A Bonds are paid in full at maturity and that the Corporation does not exercise its right to redeem, purchase or defease the Series 2003A Bonds prior thereto. Assumes that the State does not direct the open market purchase of the Series 2008A Bonds prior to maturity.

The Series A Bonds are further secured by a pledge of all of the Corporation’s interest under the Series A Contract, including, without limitation, the Series A Contract Payments required to be made by the State thereunder if the Series A Pledged Settlement Payments and amounts on deposit in the Series A Debt Service Reserve Account and the other Series A Pledged Accounts are inadequate to pay when due the principal of and interest on the Series A Bonds. The State’s obligation to make Series A Contract Payments under the Series A Contract is subject to and dependent upon annual appropriations being made by the State Legislature for such purpose. See “SECURITY AND SOURCES OF PAYMENT FOR THE SERIES 2008A BONDS — The Series A Sale Agreement” and “—Series A Pledged Accounts” and “SUMMARY OF THE SERIES A CONTRACT.”

## Series B Bonds

The following table sets forth (i) the estimated amounts required to be paid by the Corporation during each calendar year of the years shown for the payment of debt service on the Series B Bonds, (ii) the projected amount of Series B Pledged Settlement Payments<sup>(1)</sup> to be received by the Corporation, which projection has been calculated based on the Global Insight Base Case Forecast and other structuring assumptions and (iii) the projected debt service coverage provided by the projected Series B Pledged Settlement Payments. The denominator of the coverage ratios does not include redemptions prior to maturity from the Series B Surplus Revenues and calculations of coverage ratios are based on the assumption that no such redemptions will occur. No assurances can be given that the Series B Pledged Settlement Payments will be received in the amounts projected using the Global Insight Base Case Forecast and other structuring assumptions. See “SUMMARY OF SERIES A AND SERIES B PLEDGED SETTLEMENT PAYMENTS METHODOLOGY AND BOND ASSUMPTIONS” for the structuring assumptions used to calculate the projected amount of Series B Pledged Settlement Payments.

Year	Series B Pledged Settlement Payments <sup>(1)</sup>	Outstanding Series 2003B Debt Service <sup>(2)</sup>	Series 2008B Principal	Series 2008B Interest	Total Series B Debt Service	Projected Debt Service Coverage Provided by Projected Series B Pledged Settlement Payments <sup>(3)</sup>
2008	\$254,462,314	\$163,701,620	\$	\$7,329,692	\$171,031,312	1.49x
2009	260,755,556	112,471,948	38,270,000	10,048,900	160,790,848	1.62x
2010	263,660,253	111,334,026	84,070,000	7,181,750	202,585,776	1.30x
2011	266,721,430	177,783,151	22,170,000	4,525,750	204,478,901	1.30x
2012	269,730,959	125,330,058	79,430,000	1,985,750	206,745,808	1.30x
2013	272,697,950	185,673,739			185,673,739	1.47x
2014	275,570,451	188,014,976			188,014,976	1.47x
2015	278,371,166	190,300,064			190,300,064	1.46x
2016	281,690,278	192,966,489			192,966,489	1.46x
2017	285,018,618	195,622,954			195,622,954	1.46x
2018	293,014,893	201,663,020			201,663,020	1.45x
2019	296,283,112	204,297,145			204,297,145	1.45x
2020	299,445,563	206,868,285			206,868,285	1.45x
2021	302,951,383	209,679,100			209,679,100	1.44x
2022	306,427,554	84,023,813			84,023,813	3.65x
<b>Total</b>	<b>\$4,206,801,480</b>	<b>\$2,549,730,388</b>	<b>\$223,940,000</b>	<b>\$31,071,842</b>	<b>\$2,804,742,230</b>	

(1) Series B Pledged Settlement Payments include Series B Pledged Settlement Payments plus earnings on Series B Pledged Settlement Payments and Series B Debt Service Reserve Account less Series B Operating Expenses and State Fee.

(2) Assumes refunding of Series B Refunded Bonds.

(3) Assumes that the Series 2003B Bonds are paid in full at maturity and that the Corporation does not exercise its right to redeem, purchase or defease the Series 2003B Bonds prior thereto. Assumes that the State does not direct the open market purchase of the Series 2008B Bonds prior to maturity. Assumes that there is no transfer from the Series B Debt Service Account, as directed in an Officer's Certificate, to the Series B Pledged Revenues Account of any balance therein pursuant to paragraph (B) clause (ii)(a) of “SECURITY AND SOURCES OF PAYMENT FOR THE SERIES 2008B BONDS - Series B Flow of Funds” herein.

The Series B Bonds are further secured by a pledge of all of the Corporation's interest under the Series B Contract, including, without limitation, the Series B Contract Payments required to be made by the State thereunder if the Series B Pledged Settlement Payments and amounts on deposit in the Series B Debt Service Reserve Account and the other Series B Pledged Accounts are inadequate to pay when due the principal of and interest on the Series B Bonds. The State's obligation to make Series B Contract Payments under the Series B Contract is subject to and dependent upon annual appropriations being made by the State Legislature for such purpose. See “SECURITY AND SOURCES OF PAYMENT FOR THE SERIES 2008B BONDS — “The Series B Sale Agreement” and “— Series B Pledged Accounts” and “SUMMARY OF THE SERIES B CONTRACT.”

## SUMMARY OF THE SERIES A CONTRACT

The State and the Corporation have entered into the Series A Contract to provide additional security for the Series A Bonds, including the Series 2008A Bonds. The Series A Contract contains the agreement of the State, subject to the making of annual appropriation therefor by the State Legislature, for the payment to the Corporation on or before each Distribution Date of such amount, if any, as shall be necessary to provide for the payment of the principal of and interest on the Series A Bonds, including the Series 2008A Bonds, scheduled to be paid on such date, if the amounts on deposit in the Series A Pledged Accounts are insufficient therefor.

Terms used herein and not previously defined have the meanings ascribed to them in the Series A Contract. The following summary describes certain terms of the Series A Contract. This summary does not purport to be complete and is subject to, and qualified in its entirety by reference to the provisions of the Series A Contract. See “APPENDIX A – THE SERIES 2008A CONTINGENCY CONTRACT AND THE SERIES 2008B CONTINGENCY CONTRACT BETWEEN THE STATE OF NEW YORK AND THE CORPORATION.”

### Payments by the State

Pursuant to the Series A Contract, the State has agreed subject to the third and fourth paragraphs below to pay to the Corporation, on or before each Distribution Date of any year for which the Corporation shall have outstanding Series A Bonds, including the Series 2008A Bonds, secured by the Series A Contract, the amount of money, if any, certified by the Chairman of the Corporation to the Director of the Budget and to the Comptroller no later than five (5) business days prior to each such Distribution Date as the amount which is necessary, after taking into account application of all amounts of Series A Collateral pledged therefor under the Series A Indenture, including receipts from Series A Pledged Settlement Payments or from any other Series A Ancillary Contract (as defined in the Series A Indenture) or amounts in the Series A Debt Service Account, the Series A Debt Service Reserve Account or the Series A Supplemental Account on the date of such certification, to pay the scheduled principal (as to which the failure to make payment thereof constitutes a default under the Series A Indenture, including mandatory sinking fund payments, if any) of and interest on the Series A Bonds, including the Series 2008A Bonds, coming due on such next succeeding Distribution Date (the “**Series A Scheduled Debt Service**”). (Section 1.1)

In addition, the State has agreed that, subject to the third and fourth paragraphs below, its obligations to make the payments provided for in the Series A Contract shall be absolute and unconditional, without any rights of set-off, recoupment or counterclaim the State may have against the Corporation or any other person or entity having an interest in the Series A Contract or the payments made thereunder. (Section 1.2)

Notwithstanding anything in the Series A Contract to the contrary, (1) the obligation of the State to fund or to pay the amounts therein provided for is subject to annual appropriation by the State Legislature, (2) the obligation of the State, to fund or to pay the amounts therein provided for shall not constitute a debt of the State, or pursuant to the Act, State supported debt, within the meaning of any constitutional or statutory provision and shall be deemed executory only to the extent of moneys available and no liability shall be incurred by the State beyond moneys available and appropriated for such purpose, and (3) the amounts paid to the Corporation pursuant to the Series A Contract shall be applied by the Corporation solely for deposit under the Series A Indenture to pay the Series A Scheduled Debt Service. (Section 1.3)

The Series A Contract shall not constitute a debt or moral obligation of the State or a State supported obligation within the meaning of any constitutional or statutory provision or a pledge of the faith and credit of the State or of the taxing power of the State, and the State shall not be liable to make any payments thereon nor shall it be payable out of any funds or assets other than those received from the State under the Series A Contract and pledged therefor under the Series A Indenture. (Section 1.4)

## **Duties of the Corporation**

The Corporation has agreed to deposit under the Series A Indenture all amounts received pursuant to the Series A Contract, which amounts shall be held, administered and applied by the Trustee, as provided in the Series A Indenture, and shall not be commingled with any other funds of the Corporation. (Section 2.2)

## **Pledge and Assignment**

The State has consented to the pledge and assignment by the Corporation under the Series A Indenture for the benefit of the owners of any of its Series A Bonds, including the Series 2008A Bonds, of all or any part of the benefits or rights of the Corporation under the Series A Contract and of the payments by the State as provided therein. (Section 3.1)

## **Special Covenants**

In accordance with the Act, by October 31<sup>st</sup> in each year, but in any event not later than December 15 of each year, the Corporation has agreed to request from the State annually by certification of an authorized officer thereof an appropriation of an amount equal to the Series A Scheduled Debt Service (provided that with respect to any Series A Bond, for which the interest thereon is subject to variation between Distribution Dates, the amount of interest thereon shall be at the maximum rate as set forth or as provided for in the Series A Indenture) coming due during such next succeeding fiscal year, and the State has agreed that the Director of the Budget on behalf of the State shall include, as a requested appropriation item in the State's budget for such fiscal year, an amount equal to such certified amount. (Sections 4.1 and 4.2)

The State has agreed that whenever requested by the Corporation with reasonable advance notification it shall provide and certify, or cause to be provided and certified, in form satisfactory to the Corporation, such information concerning (A)(i) the State and various public authorities, or (ii) the operations and finances of the State and such other matters, that the Corporation considers necessary to enable it to complete and publish an official statement, placement memorandum or other similar document relating to the sale or issuance of the Series A Bonds, including the Series 2008A Bonds, and (B) the payments to be made by the State as provided in the Series A Contract or any funds established under the Series A Indenture, or information necessary to enable the Corporation to make any reports required by law or governmental regulations (including the Rule) in connection with any Series A Bond, including any Series 2008A Bond. (Section 4.3)

The Corporation and the State have both complied with their respective covenants above in each year since the issuance of the Series 2003A Bonds.

Neither the Corporation nor the State will terminate the Series A Contract for any reason whatsoever. In addition, the Series A Contract may not be amended, changed, modified or altered so as to adversely affect the rights of the owners of any Series A Bonds, including the Series 2008A Bonds, the payments to be made by the State as provided therein or the funds required by the Series A Indenture without the consent of such owners or the Trustee given in accordance with the provisions of the Series A Indenture. (Sections 4.4 and 4.5)

## **Events of Default by the State and Remedies**

Pursuant to the Series A Contract, if, for any reason (other than a failure by the State Legislature to appropriate moneys for such purpose), the State shall (i) fail to pay when due any of the payments provided for in the first paragraph under the caption "Payments by the State" above or (ii) fail to observe or perform any other covenant, condition or agreement on its part to be observed or performed and such failure to observe or perform shall have continued for 60 days after written notice, specifying such failure and requesting that it be remedied, is given to the State by the Corporation, the Corporation shall, if such default has not been cured, have the right to institute any action in the nature of mandamus or take whatever action at law or in equity may appear necessary or desirable to collect the payments then due or thereafter to become due or to enforce performance and observance of any obligation, agreement or covenant of the State thereunder. (Section 5.1)

The remedies conferred upon or reserved to the Corporation in the foregoing paragraph in respect of any default described therein are not intended to be exclusive of any other available remedy or remedies and shall be in addition to every other remedy now or hereafter existing at law or in equity; provided, however, that such remedy or remedies may in no event include a termination of the Series A Contract, nor may they include any amendment, change, modification or alteration that is referred to under the Series A Contract. (Section 5.2)

### **Events of Default by the Corporation and Remedies**

Pursuant to the Series A Contract, if the Corporation fails to observe or perform any covenant, condition or agreement on its part to be observed or performed and such failure to observe or perform shall have continued for 60 days after written notice, specifying such failure and requesting that it be remedied, is given to the Corporation by the State, the State shall, if the default has not been cured, have the right to institute any action in the nature of mandamus or take whatever action at law or in equity may appear necessary or desirable to enforce the performance and observance of any obligation, agreement or covenant of the Corporation thereunder. (Section 6.1)

The remedies conferred upon or reserved to the State in the foregoing paragraph in respect of any default described therein are not intended to be exclusive of any other available remedy or remedies and shall be in addition to every other remedy now or hereafter existing at law or in equity; provided, however, that such remedy or remedies may in no event include a termination of the Series A Contract or of the obligations of the State to make the payments provided for above under the caption "Payments by the State," nor may they include any amendment, change, modification or alteration of the Series A Contract that is prohibited thereunder. (Section 6.2)

### **Miscellaneous**

The Series A Contract has a term ending on such date as there are no Series A Bonds Outstanding under the Series A Indenture. (Section 7.4)

Nothing in the Series A Contract shall be construed to confer upon or to give notice to any person or entity other than the State, the Corporation, and the owners of any Series A Bonds, including the Series 2008A Bonds, the Trustee or any other trustee acting on their behalf, any right, remedy or claim under or by reason of the Series A Contract or any provision thereof. (Section 7.8)

In accordance with the Act, neither the members of the Corporation nor any other person executing the Series A Contract shall be subject to any personal liability or accountability by reason of the issuance or execution and delivery thereof. (Section 7.9)

## **SUMMARY OF THE SERIES B CONTRACT**

The State and the Corporation have entered into the Series B Contract to provide additional security for the Series B Bonds, including the Series 2008B Bonds. The Series B Contract contains the agreement of the State, subject to the making of annual appropriation therefor by the State Legislature, for the payment to the Corporation on or before each Distribution Date of such amount, if any, as shall be necessary to provide for the payment of the principal of and interest on the Series B Bonds, including the Series 2008B Bonds, scheduled to be paid on such date, if the amounts on deposit in the Series B Pledged Accounts are insufficient therefor.

Terms used herein and not previously defined have the meanings ascribed to them in the Series B Contract. The following summary describes certain terms of the Series B Contract. This summary does not purport to be complete and is subject to, and qualified in its entirety by reference to the provisions of the Series B Contract. See "APPENDIX A – THE SERIES 2008A CONTINGENCY CONTRACT AND THE SERIES 2008B CONTINGENCY CONTRACT BETWEEN THE STATE OF NEW YORK AND THE CORPORATION."

### **Payments by the State**

Pursuant to the Series B Contract, the State has agreed subject to the third and fourth paragraphs below to pay to the Corporation, on or before each Distribution Date of any year for which the Corporation shall have

outstanding Series B Bonds, including the Series 2008B Bonds, secured by the Series B Contract, the amount of money, if any, certified by the Chairman of the Corporation to the Director of the Budget and to the Comptroller no later than five (5) business days prior to each such Distribution Date as the amount which is necessary, after taking into account application of all amounts of Series B Collateral pledged therefor under the Series B Indenture, including receipts from Series B Pledged Settlement Payments or from any other Series B Ancillary Contract (as defined in the Series B Indenture) or amounts in the Series B Debt Service Account, the Series B Debt Service Reserve Account or the Series B Supplemental Account on the date of such certification, to pay the scheduled principal (as to which the failure to make payment thereof constitutes a default under the Series B Indenture, including mandatory sinking fund payments, if any) of and interest on the Series B Bonds, including the Series 2008B Bonds, coming due on such next succeeding Distribution Date (the “**Series B Scheduled Debt Service**”). (Section 1.1)

In addition, the State has agreed that, subject to the third and fourth paragraphs below, its obligations to make the payments provided for in the Series B Contract shall be absolute and unconditional, without any rights of set-off, recoupment or counterclaim the State may have against the Corporation or any other person or entity having an interest in the Series B Contract or the payments made thereunder. (Section 1.2)

Notwithstanding anything in the Series B Contract to the contrary, (1) the obligation of the State to fund or to pay the amounts therein provided for is subject to annual appropriation by the State Legislature, (2) the obligation of the State, to fund or to pay the amounts therein provided for shall not constitute a debt of the State, or pursuant to the Act, State supported debt, within the meaning of any constitutional or statutory provision and shall be deemed executory only to the extent of moneys available and no liability shall be incurred by the State beyond moneys available and appropriated for such purpose, and (3) the amounts paid to the Corporation pursuant to the Series B Contract shall be applied by the Corporation solely for deposit under the Series B Indenture to pay the Series B Scheduled Debt Service. (Section 1.3)

The Series B Contract shall not constitute a debt or moral obligation of the State or a State supported obligation within the meaning of any constitutional or statutory provision or a pledge of the faith and credit of the State or of the taxing power of the State, and the State shall not be liable to make any payments thereon nor shall it be payable out of any funds or assets other than those received from the State under the Series B Contract and pledged therefor under the Series B Indenture. (Section 1.4)

### **Duties of the Corporation**

The Corporation has agreed to deposit under the Series B Indenture all amounts received pursuant to the Series B Contract, which amounts shall be held, administered and applied by the Trustee, as provided in the Series B Indenture, and shall not be commingled with any other funds of the Corporation. (Section 2.2)

### **Pledge and Assignment**

The State has consented to the pledge and assignment by the Corporation under the Series B Indenture for the benefit of the owners of any of its Series B Bonds, including the Series 2008B Bonds, of all or any part of the benefits or rights of the Corporation under the Series B Contract and of the payments by the State as provided therein. (Section 3.1)

### **Special Covenants**

In accordance with the Act, by October 31<sup>st</sup> in each year, but in any event not later than December 15 of each year, the Corporation has agreed to request from the State annually by certification of an authorized officer thereof an appropriation of an amount equal to the Series B Scheduled Debt Service (provided that with respect to any Series B Bond, for which the interest thereon is subject to variation between Distribution Dates, the amount of interest thereon shall be at the maximum rate as set forth or as provided for in the Series B Indenture) coming due during such next succeeding fiscal year, and the State has agreed that the Director of the Budget on behalf of the State shall include, as a requested appropriation item in the State’s budget for such fiscal year, an amount equal to such certified amount. (Sections 4.1 and 4.2)

The State has agreed that whenever requested by the Corporation with reasonable advance notification it shall provide and certify, or cause to be provided and certified, in form satisfactory to the Corporation, such information concerning (A)(i) the State and various public authorities, or (ii) the operations and finances of the State and such other matters, that the Corporation considers necessary to enable it to complete and publish an official statement, placement memorandum or other similar document relating to the sale or issuance of the Series B Bonds, including the Series 2008B Bonds, and (B) the payments to be made by the State as provided in the Series B Contract or any funds established under the Series B Indenture, or information necessary to enable the Corporation to make any reports required by law or governmental regulations (including the Rule) in connection with any Series B Bond, including any Series 2008B Bond. (Section 4.3)

The Corporation and the State have both complied with their respective covenants above in each year since the issuance of the Series 2003B Bonds.

Neither the Corporation nor the State will terminate the Series B Contract for any reason whatsoever. In addition, the Series B Contract may not be amended, changed, modified or altered so as to adversely affect the rights of the owners of any Series B Bonds, including the Series 2008B Bonds, the payments to be made by the State as provided therein or the funds required by the Series B Indenture without the consent of such owners or the Trustee given in accordance with the provisions of the Series B Indenture. (Sections 4.4 and 4.5)

#### **Events of Default by the State and Remedies**

Pursuant to the Series B Contract, if, for any reason (other than a failure by the State Legislature to appropriate moneys for such purpose), the State shall (i) fail to pay when due any of the payments provided for in the first paragraph under the caption "Payments by the State" above or (ii) fail to observe or perform any other covenant, condition or agreement on its part to be observed or performed and such failure to observe or perform shall have continued for 60 days after written notice, specifying such failure and requesting that it be remedied, is given to the State by the Corporation, the Corporation shall, if such default has not been cured, have the right to institute any action in the nature of mandamus or take whatever action at law or in equity may appear necessary or desirable to collect the payments then due or thereafter to become due or to enforce performance and observance of any obligation, agreement or covenant of the State thereunder. (Section 5.1)

The remedies conferred upon or reserved to the Corporation in the foregoing paragraph in respect of any default described therein are not intended to be exclusive of any other available remedy or remedies and shall be in addition to every other remedy now or hereafter existing at law or in equity; provided, however, that such remedy or remedies may in no event include a termination of the Series B Contract, nor may they include any amendment, change, modification or alteration that is referred to under the Series B Contract. (Section 5.2)

#### **Events of Default by the Corporation and Remedies**

Pursuant to the Series B Contract, if the Corporation fails to observe or perform any covenant, condition or agreement on its part to be observed or performed and such failure to observe or perform shall have continued for 60 days after written notice, specifying such failure and requesting that it be remedied, is given to the Series 2008B Corporation by the State, the State shall, if the default has not been cured, have the right to institute any action in the nature of mandamus or take whatever action at law or in equity may appear necessary or desirable to enforce the performance and observance of any obligation, agreement or covenant of the Corporation thereunder. (Section 6.1)

The remedies conferred upon or reserved to the State in the foregoing paragraph in respect of any default described therein are not intended to be exclusive of any other available remedy or remedies and shall be in addition to every other remedy now or hereafter existing at law or in equity; provided, however, that such remedy or remedies may in no event include a termination of the Series B Contract or of the obligations of the State to make the payments provided for above under the caption "Payments by the State," nor may they include any amendment, change, modification or alteration of the Series B Contract that is prohibited thereunder. (Section 6.2)

**Miscellaneous**

The Series B Contract has a term ending on such date as there are no Series B Bonds Outstanding under the Series B Indenture. (Section 7.4)

Nothing in the Series B Contract shall be construed to confer upon or to give notice to any person or entity other than the State, the Corporation, and the owners of any Series B Bonds, including the Series 2008B Bonds, the Trustee or any other trustee acting on their behalf, any right, remedy or claim under or by reason of the Series B Contract or any provision thereof. (Section 7.8)

In accordance with the Act, neither the members of the Corporation nor any other person executing the Series B Contract shall be subject to any personal liability or accountability by reason of the issuance or execution and delivery thereof. (Section 7.9)



## BONDHOLDERS' RISKS

*Prospective investors should carefully consider the factors set forth below regarding an investment in the Series 2008 Bonds as well as other information contained in this Official Statement. The following discussion of risks is not meant to be a complete list of the risks associated with the purchase of the Series 2008 Bonds and does not necessarily reflect the relative importance of various risks. Potential purchasers of the Series 2008 Bonds are advised to consider the following factors, among others, and to review the other information in this Official Statement in evaluating the Series 2008 Bonds. Any one or more of the risks discussed, and others, could lead to a decrease in the market value and/or liquidity of the Series 2008 Bonds. There can be no assurance that other risk factors will not become material in the future.*

### **Litigation Challenging the MSA, the Qualifying Statutes and Related Legislation**

*General Overview.* Certain smokers, consumer groups, cigarette importers, cigarette wholesalers, cigarette distributors, cigarette manufacturers, Native American tribes, taxpayers, taxpayers' groups and other parties have instituted lawsuits against various PMs, certain of the Settling States and other public entities challenging the MSA and/or the Qualifying Statutes and related legislation. One or more of the lawsuits, several of which remain pending, allege, among other things, that the MSA and/or the Qualifying Statutes and related legislation are void or unenforceable under the Commerce Clause and certain other provisions of the U.S. Constitution and the federal antitrust laws, as described below under "*Grand River, Freedom Holdings and Related Cases*" and "*Other Litigation Challenging the MSA, Qualifying Statutes and Related Legislation*" in this subsection. In addition, some of the lawsuits allege that the MSA and/or related state legislation are void or unenforceable under the federal civil rights laws, state constitutions, consumer protection laws, and unfair competition laws. Certain of these lawsuits seek, and, if ultimately successful, could result in, a determination that the MSA and/or the Qualifying Statutes and related legislation are void or unenforceable. Certain of the lawsuits further seek, among other things, an injunction against one or more of the Settling States from collecting any moneys under the MSA and barring the PMs from collecting cigarette price increases related to the MSA. In addition, class action lawsuits have been filed in several federal and state courts alleging that under the federal Medicaid law, any amount of tobacco settlement funds that the Settling States receive in excess of what they paid through the Medicaid program to treat tobacco related diseases should be paid directly to Medicaid recipients. To date, challenges to the MSA or related legislation have not been ultimately successful, although three such challenges (the *Grand River* and *Freedom Holdings* cases in federal court in New York, and the *Xcaliber* case in federal court in Louisiana, all of which are discussed below) have survived initial appellate review of motions to dismiss. Moreover, these three cases and the *A.B. Coker* case in federal court in Louisiana (discussed below) are the only cases challenging the MSA or related legislation that have proceeded to a stage of litigation where the ultimate outcome may be determined by, among other things, findings of fact based on extrinsic evidence as to the operation and impact of the MSA and the related statutes. In *Grand River* and *Freedom Holdings*, certain decisions by the U.S. Court of Appeals for the Second Circuit have created heightened uncertainty as a result of that court's interpretation of federal antitrust immunity and Commerce Clause doctrines as applied to the MSA and related statutes, which interpretation appears to conflict with interpretations by other courts, which have rejected challenges to the MSA and related statutes. Prior district court and appellate court decisions in Circuits other than the Second Circuit rejecting such challenges (in the Third, Fourth, Fifth, Sixth, Ninth and Tenth Circuits) have concluded that the MSA and related statutes do not violate the Commerce Clause of the U.S. Constitution and/or are protected from antitrust challenges based on established antitrust immunity doctrines. In addition, proceedings are pending or on appeal in certain other cases, including two challenges by certain NPMs in federal court in Louisiana. One case (*Xcaliber*) alleges inter alia, that the Louisiana Allocable Share Release Amendment violates the rights of free speech, due process of law, and equal protection of the laws guaranteed under the U.S. Constitution and the Louisiana Constitution and the federal antitrust laws. On March 1, 2006, the U.S. Court of Appeals for the Fifth Circuit vacated the district court's dismissal of the plaintiffs' complaint in this case and remanded the case for reconsideration. The other case (*A.B. Coker*) alleges that the MSA and Louisiana's Complementary Legislation are violations of the Commerce Clause, Due Process Clause and First Amendment of the U.S. Constitution and the Federal Cigarette Labeling and Advertising Act. See "*Other Litigation Challenging the MSA, Qualifying Statutes and Related Legislation*" in this subsection. The MSA and related state legislation may also continue to be challenged in the future. A determination by a court having jurisdiction over the State and the Corporation that the MSA or related State legislation is void or unenforceable (a) could have a materially adverse effect on the payments by the PMs under the MSA and the amount and/or the timing of Series A Pledged Settlement Payments and Series B Pledged Settlement Payments available to the Corporation and (b) could

lead to a decrease in the market value and/or liquidity of the Series 2008 Bonds. Such a determination could result in a complete loss of the Series A Pledged Settlement Payments and the Series B Pledged Settlement Payments. A determination by any court that the MSA or state legislation enacted pursuant to the MSA is void or unenforceable could also lead to a decrease in the market value and/or liquidity of the Series 2008 Bonds. See “LEGAL CONSIDERATIONS RELATING TO SERIES A PLEDGED SETTLEMENT PAYMENTS AND SERIES B PLEDGED SETTLEMENT PAYMENTS” herein.

*Qualifying Statute and Related Legislation.* Under the MSA’s NPM Adjustment, downward adjustments may be made to the Annual Payments and Strategic Contribution Fund Payments payable by a PM if the PM experiences a loss of market share in the United States to NPMs as a result of the PM’s participation in the MSA. See “Other Potential Payment Decreases Under the Terms of the MSA–NPM Adjustment” below and “SUMMARY OF THE MASTER SETTLEMENT AGREEMENT–MSA Provisions Relating to Model/Qualifying Statutes” herein. A Settling State may avoid the effect of this adjustment by adopting and diligently enforcing a Qualifying Statute, as hereinafter described. The State has adopted the Model Statute, which by definition is a Qualifying Statute under the MSA. The Model Statute, in its original form, required an NPM to make escrow deposits approximately in the amount that the NPM would have had to pay to all of the states had it been a PM and further authorized the NPM to obtain from the applicable Settling State the release of the amount by which the escrow deposit in that state exceeded that state’s allocable share of the total payments that the NPM would have made as a PM. Legislation has been enacted in at least 44 of the Settling States, including the State, amending the Qualifying Statutes in those states by eliminating the reference to the allocable share and limiting the possible release an NPM may obtain under the statute to the excess above the total payment that the NPM would have paid had it been a PM (each an “**Allocable Share Release Amendment**”). A majority of the PMs, including all OPMs, have indicated in writing that the State’s Model Statute, as amended, will continue to constitute a Qualifying Statute within the meaning of the MSA. In addition, at least 45 Settling States (including the State) have passed legislation (often termed “**Complementary Legislation**”) to further ensure that NPMs are making required escrow payments under the states’ respective Qualifying Statutes. The Qualifying Statutes and related legislation, like the MSA, have also been the subject of litigation alleging that the Qualifying Statutes and related legislation violate certain provisions of the United States Constitution and/or state constitutions and are preempted by federal antitrust laws. The lawsuits seek, among other things, injunctions against the enforcement of the Qualifying Statutes and the related legislation. To date such challenges have not been ultimately successful, although the enforcement of Allocable Share Release Amendments has been preliminarily enjoined in New York and certain other states. Appeals are also possible in certain other cases. The Qualifying Statutes and related legislation may also continue to be challenged in the future. Pending challenges to the Qualifying Statutes and related legislation are described below under “*Grand River, Freedom Holdings and Related Cases*” and “*Other Litigation Challenging the MSA, Qualifying Statutes and Related Legislation*” in this subsection.

A determination that a Qualifying Statute is unconstitutional would have no effect on the enforceability of the MSA itself; such a determination could, however, have an adverse effect on payments to be made under the MSA if one or more NPMs were to gain market share. See “Other Potential Payment Decreases Under the Terms of the MSA–NPM Adjustment” below, “SUMMARY OF THE MASTER SETTLEMENT AGREEMENT–MSA Provisions Relating to Model/Qualifying Statutes” herein and “LEGAL CONSIDERATIONS RELATING TO SERIES A PLEDGED SETTLEMENT PAYMENTS AND SERIES B PLEDGED SETTLEMENT PAYMENTS” herein.

A determination that an Allocable Share Release Amendment is unenforceable would not constitute a breach of the MSA but could permit NPMs to exploit differences among states, target sales in states without Allocable Share Release Amendments, and thereby potentially increase their market share at the expense of the PMs. See “SUMMARY OF THE MASTER SETTLEMENT AGREEMENT–MSA Provisions Relating to Model/Qualifying Statutes” herein.

A determination that the State’s Complementary Legislation is unenforceable would not constitute a breach of the MSA or affect the enforceability of the State’s Qualifying Statute; such a determination could, however, make enforcement of the State’s Qualifying Statute against NPMs more difficult for the State. See “SUMMARY OF THE MASTER SETTLEMENT AGREEMENT–MSA Provisions Relating to Model/Qualifying Statutes” herein.

*Grand River, Freedom Holdings and Related Cases.* Among the pending challenges to the MSA and/or related state legislation are two lawsuits referred to herein as *Grand River* and *Freedom Holdings*, both of which are pending in the U.S. District Court for the Southern District of New York. The *Grand River* case is pending against the attorneys general of 30 states<sup>†</sup>, including the State, and alleges, among other things, that: (1) the MSA creates an unlawful output cartel under federal antitrust law, and state legislation enacted pursuant to the MSA mandates or authorizes such cartel and is thus preempted by federal law; and (2) the MSA and related statutes are invalid or unenforceable under the Commerce Clause and other provisions of the U.S. Constitution. The plaintiff in *Grand River* seeks to enjoin the enforcement of the Qualifying Statutes and Complementary Legislation by the Grand River Defendant States (defined below). The *Freedom Holdings* case is pending against the Attorney General and the Commissioner of Taxation and Finance of the State of New York and is based on the same purported claims as the *Grand River* case (including, as discussed below, a Commerce Clause claim asserted by the plaintiffs in their Second Supplemental and Amended Complaint following a Second Circuit ruling on the issue in the *Grand River* case). The plaintiffs in *Freedom Holdings* seek to enjoin the enforcement of New York's Qualifying Statute and Complementary Legislation. These suits have survived appellate review of motions to dismiss for failure to state a claim upon which relief can be granted and *Grand River* is in the discovery phase of litigation in preparation for the development of a factual record to support possible findings of fact that may be used by the court in its decision as to the pending claims. The discovery deadline has passed in *Freedom Holdings*, and a request has been made to permit five months of further discovery. Motions for summary judgment were fully submitted to the Court on March 7, 2007. To date, *Grand River* and *Freedom Holdings*, along with *Xcaliber v. Ieyoub* and *A.B. Coker v. Foti* (both discussed below), are the only cases challenging the MSA or related legislation that have survived initial appellate review of motions to dismiss. Moreover, these four cases are the only cases challenging the MSA or related legislation that have proceeded to a stage of litigation where the ultimate outcome may be determined by, among other things, findings of fact based on extrinsic evidence as to the operation and impact of the MSA and the related legislation.

On July 1, 2002, *Grand River Enterprises Six Nations Ltd. v. Pryor* was filed in the U.S. District Court for the Southern District of New York by certain NPMs against current and former attorneys general of 31 states, including the State (the "**Grand River Defendant States**"). The plaintiffs seek to enjoin the enforcement of the Grand River Defendant States' Qualifying Statutes and Complementary Legislation, alleging that such Qualifying Statutes and Complementary Legislation violate the plaintiffs' constitutional rights under the Commerce Clause and other provisions of the U.S. Constitution and also that such Qualifying Statutes and Complementary Legislation conflict with and are therefore preempted by the federal antitrust laws. In September 2003, the District Court held that it lacked personal jurisdiction over the non New York attorneys general and dismissed the plaintiffs' complaint against them. In addition, the District Court dismissed the plaintiffs' complaint against the New York attorney general, finding that the plaintiffs had failed to state a claim upon which relief could be granted. After the Second Circuit's decision in *Freedom Holdings* (discussed below), however, the District Court granted the plaintiffs' motion in *Grand River* to reinstate, against the New York attorney general only, that portion of the complaint alleging that New York's Qualifying Statute and New York's Complementary Legislation conflict with antitrust laws and are preempted by federal law.

The plaintiffs appealed the dismissal of their other claims to the Second Circuit. On September 28, 2005, the Second Circuit reinstated portions of the Commerce Clause challenge and reinstated the non New York attorneys general, as defendants, finding that a federal court in New York could exercise personal jurisdiction over them, and affirmed the dismissal of certain remaining claims, including the claim that the Qualifying Statutes and related legislation violated the Indian Commerce Clause of the U.S. Constitution. The case was remanded to the District Court. On May 31, 2006, the District Court denied *Grand River's* motion for a preliminary injunction seeking to bar defendants from: (1) enforcing their states' Allocable Share Release Amendments; (2) denying *Grand River's* application to become a party to the Master Settlement Agreement; and (3) banning sales in the defendants' states of *Grand River*-produced cigarettes. The District Court held that *Grand River* failed to show either a likelihood of irreparable injury absent an injunction or a likelihood of success on the merits of its claims. On June 7, 2006, *Grand River* filed an appeal of this decision before the Second Circuit. Separately, *Grand River* also filed a motion for an injunction pending appeal, which the District Court denied on June 29, 2006. On March 6, 2007, the Second Circuit denied *Grand River's* appeal, solely on the basis that the District Court had not abused its discretion in finding that

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<sup>†</sup> The complaint was initially filed against 31 defendant states, but by stipulation so-ordered by Judge Keenan on February 26, 2008, plaintiff and defendant Stumbo and the State of Kentucky agreed to a voluntary dismissal of the complaint as against those defendants.

plaintiff *Grand River* had failed to show a likelihood of irreparable injury. On June 12, 2007, the Second Circuit issued a judgment confirming its May 23, 2007 order denying plaintiff *Grand River*'s petition for a rehearing.

On October 12, 2005, the defendants filed a petition with the Second Circuit for rehearing with regard to the Second Circuit's ruling on the issue of personal jurisdiction. The plaintiffs filed a petition with the Second Circuit for rehearing on the Indian Commerce Clause ruling. On January 3, 2006, the Second Circuit denied all parties' petitions for rehearing. On April 18, 2006 the non-New York defendants filed a petition for certiorari review with the U.S. Supreme Court challenging the Second's Circuit ruling on the issue of personal jurisdiction. See *King v. Grand River Enterprises Six Nations, Ltd.* On October 10, 2006, the U.S. Supreme Court denied the defendants' petition for certiorari.

With regard to the Commerce Clause challenge, the Second Circuit in *Grand River* noted that because it was reviewing a motion to dismiss, it was required to accept as true the material facts alleged in the complaint and to draw all reasonable inferences in the plaintiffs' favor. The Second Circuit held that although each state's Qualifying Statute and Complementary Legislation apply to cigarette sales within such state, the plaintiffs sufficiently stated a possible claim that these statutes together create a national or "interstate" regulatory policy and thereby exert "extraterritorial control" over out of state transactions in contravention of the Commerce Clause. The Second Circuit acknowledged that in *Freedom Holdings* (discussed below) it had ruled that plaintiffs failed to state a claim that the state's Complementary Legislation had violated the Commerce Clause, but explained that it did so because plaintiffs there had not sufficiently alleged an extraterritorial effect of that legislation. To date, *A.B. Coker* (discussed below), *Grand River*, and, as a technical matter, *Freedom Holdings* (pursuant to the grant of a motion to amend the complaint in that matter to include a Commerce Clause claim), are the only cases in which a Commerce Clause challenge to the MSA and related statutes has not been dismissed at the pleading stage or at summary judgment. However, other such challenges are currently pending in various jurisdictions. An adverse ruling on Commerce Clause grounds could potentially lead to invalidation of the MSA and the Qualifying Statutes in their entirety.

With regard to the reinstatement of the non New York defendants, the Second Circuit explained that where an out of state defendant has "transacted business" in the State of New York and there is "substantial nexus" between that transaction and the litigation in question, the federal courts in the state can obtain jurisdiction over the defendants. The Second Circuit concluded that by negotiating the MSA in New York, the attorneys general "transacted business" for the purpose of conferring jurisdiction in federal courts in New York. The Court also held that there was "substantial nexus" between the MSA negotiations and the lawsuit, because although the challenged statutes are discrete acts of each state, they were integral to the operation of the MSA and were negotiated as such.

*Grand River* remains pending before the U.S. District Court for the Southern District of New York, wherein the defendants filed an answer to the complaint on October 25, 2006. Currently, *Grand River Enterprises Six Nations, Ltd.* is the only plaintiff in the case. The District Court has ruled that the pre-trial discovery period will conclude in March 2008. Any decision by the Second Circuit in this case would not be subject to appeal as of right to the U.S. Supreme Court. No assurance can be given: (1) that the Supreme Court would choose to hear and determine any appeal relating to the validity or enforceability of MSA or related legislation in this or any other case; or (2) as to the outcome of any petition of writ of certiorari or any appeal, even if heard by the Supreme Court. A Supreme Court decision to affirm or to decline to review a Second Circuit ruling that is adverse to the defendants in *Grand River* (which includes the State) or other similar cases, challenging the validity or enforceability of the MSA or related legislation, could ultimately result in the complete cessation of the Series A Pledged Settlement Payments and the Series B Pledged Settlement Payments available to the Corporation and, in any event, could lead to a decrease in the market value and/or liquidity of the Series 2008 Bonds. Moreover, even if ultimately reversed by the Supreme Court, a Second Circuit decision adverse to the defendants in *Grand River* could, unless stayed pending appeal at the discretion of the court, also lead to a decrease in the market value and/or the liquidity of the Series 2008 Bonds.

On April 16, 2002, in *Freedom Holdings, Inc. v. Spitzer*, certain cigarette importers filed an action against the Attorney General and the Commissioner of Taxation and Finance of the State of New York (the "**New York State Defendants**"), challenging New York's Complementary Legislation, alleging in their initial complaint that New York's Complementary Legislation enforces a market sharing and price fixing cartel, and allows the OPMs to charge supra competitive prices for their cigarettes. Plaintiffs also alleged that New York's Complementary

Legislation violates the Commerce Clause of the U.S. Constitution and establishes an output cartel in violation of federal antitrust law. The initial complaint also alleged that the legislation is selectively enforced in violation of the Equal Protection Clause of the U.S. Constitution. The Southern District dismissed the action on May 14, 2002.

In its *Freedom Holdings* decision, the Southern District applied two U.S. Supreme Court doctrines known as the “state action” immunity doctrine (based on a U.S. Supreme Court case known as “*Parker*”) and the First Amendment based immunity doctrine (based on two U.S. Supreme Court cases known collectively as *Noerr Pennington* (“*NP*”). The applicability of the *Parker* immunity doctrine requires two levels of analysis. Where a state confers authority on private parties to engage in conduct that would otherwise be per se violative of antitrust laws, cases subsequent to *Parker* (most notably a U.S. Supreme Court case known as “*MidCal*”) have required both a clear articulation of state policy and active supervision by the state of the otherwise anticompetitive conduct for *Parker* immunity to apply. When a state is acting unilaterally, in its capacity as the sovereign, however, no *MidCal* analysis is required, and *Parker* immunity applies directly. *NP* immunity applies to conduct that is protected by the First Amendment, most particularly conduct that constitutes petitioning activity directed at courts or governmental bodies. The Southern District held, among other things, that New York’s Complementary Legislation was protected from antitrust challenge by both direct *Parker* immunity and *NP* immunity.

The plaintiffs in *Freedom Holdings* appealed, and on January 6, 2004, the Second Circuit partially reversed the decision of the Southern District. In its reversal, the Second Circuit noted, because it was reviewing a motion to dismiss, that it was required to accept as true the material facts alleged in the complaint and to draw all reasonable inferences in the plaintiffs’ favor. The Second Circuit affirmed the Southern District’s dismissal of that portion of the complaint that alleged a Commerce Clause violation. The Second Circuit reversed the dismissal of the plaintiffs’ Equal Protection claim, based on uncertainty both as to the basis for the district court’s ruling and the allegations of the complaint. The Second Circuit remanded the case to allow the plaintiffs to amend their complaint to correct deficiencies in the pleadings. The Second Circuit held, however, that the plaintiffs had alleged facts sufficient to state a claim that New York’s Complementary Legislation conflicts with federal antitrust law, and that based on the facts alleged, the legislation was not protected from an antitrust challenge based on either of the *Parker* or *NP* immunity doctrines. The Second Circuit determined, on the record before it, that a *MidCal* analysis was required and, on that record and solely for the purpose of reviewing the Southern District’s dismissal of the complaint, found insufficient active supervision and insufficient articulation of state policy to support a conclusion that there was antitrust immunity under *Parker* and *MidCal*. On March 25, 2004, the Second Circuit denied the New York State Defendants’ petition for a rehearing.

In April 2004, the plaintiffs in *Freedom Holdings* filed an amended complaint, which was supplemented in November 2004 and included requests for: (1) a declaratory judgment that the operation of the MSA, New York’s Qualifying Statute, and New York’s Complementary Legislation implements an illegal per se output cartel in violation of the federal antitrust laws and are thus preempted by federal antitrust law; and (2) injunctive relief enjoining the enforcement of New York’s Qualifying Statute and New York’s Complementary Legislation. The amended complaint did not seek an injunction enjoining the enforcement or administration of the MSA, was limited only to claims under the federal antitrust laws, and did not allege that the MSA, New York State’s Qualifying Statute, or Complementary Legislation violates the Commerce Clause or the Equal Protection Clause of the U.S. Constitution.

On September 14, 2004, the Southern District denied the plaintiffs’ motion for a preliminary injunction enjoining New York, during the pendency of the action, from enforcing the MSA, New York’s Qualifying Statute and New York’s Complementary Legislation. The Southern District held that, based on the evidence presented by the parties, the plaintiffs had failed to establish a likelihood of success on the merits of their claims: (1) that New York’s Qualifying Statute and New York’s Complementary Legislation authorized or mandated a per se violation of the federal antitrust laws; or (2) that the MSA, New York’s Qualifying Statute, and New York’s Complementary Legislation would not be entitled to *Parker* antitrust immunity under a *MidCal* analysis. The Southern District also determined that the plaintiffs had failed to make a showing of irreparable harm sufficient to justify preliminary injunctive relief. The Southern District, however, granted the plaintiffs’ motion to enjoin New York from enforcing its Allocable Share Release Amendment, holding that the plaintiffs had established a likelihood of success on their claim that New York’s Allocable Share Release Amendment conflicts with the federal antitrust laws and that its enforcement would cause plaintiffs and other NPMs irreparable harm. The plaintiffs appealed the Southern District’s denial of their motion for a preliminary injunction as to New York’s Qualifying Statute and New York’s

Complementary Legislation. The plaintiffs did not appeal the denial of their motion for a preliminary injunction to enjoin the enforcement of the MSA and supplemented their amended complaint to state that they do not seek a permanent injunction to enjoin the enforcement of the MSA. The New York State Defendants did not appeal the granting of the plaintiffs' motion to enjoin enforcement of New York's Allocable Share Release Amendment. On May 18, 2005, the Second Circuit affirmed the Southern District's denial of the plaintiffs' request for a preliminary injunction. The Second Circuit held that the plaintiffs failed to satisfy the irreparable harm requirement for a preliminary injunction. The Second Circuit made no determination as to the likelihood of the plaintiffs' ultimate success on the merits. On November 1, 2005, the Southern District denied, without prejudice and upon agreement of the parties, plaintiffs' motion for partial summary judgment which sought a determination that New York's Allocable Share Release Amendment violates federal antitrust law. On December 28, 2005, the Southern District denied the plaintiffs' motion to file an amended complaint to add a Commerce Clause claim similar to the plaintiffs' claims in *Grand River*, as described above. In its decision, however, the Southern District granted the plaintiffs leave to renew their motion to amend upon the condition that the plaintiffs show what additional discovery would be required to support such additional claims.

On February 6, 2006, the Southern District granted plaintiffs' renewed motion for leave to assert a claim under the Commerce Clause. On February 10, 2006, plaintiffs filed a Second Supplemental and Amended Complaint. The plaintiffs now seek: (1) a declaratory judgment that the operation of the MSA, New York's Qualifying Statute and New York's Complementary Legislation implements an illegal per se output cartel in violation of the federal antitrust laws and is preempted thereby; (2) a declaratory judgment that New York's Qualifying Statute and Complementary Legislation, together with the Qualifying Statutes and Complementary Legislation of other states, regulate interstate commerce in violation of the Commerce Clause of the U.S. Constitution; and (3) an injunction permanently enjoining the enforcement of New York's Qualifying Statute and Complementary Legislation. The amended complaint does not seek to enjoin the enforcement or administration of the MSA. On May 2, 2006, plaintiffs filed a motion for summary judgment. On July 12, 2006, defendants filed a motion to dismiss the Second Supplemental and Amended Complaint and cross-moved for summary judgment. A hearing took place on December 11, 2006 to resolve certain discovery issues. The summary judgment motion and cross-motion were fully submitted on March 7, 2007. A final decision by Judge Alvin K. Hellerstein of the Southern District remains pending in *Freedom Holdings*.

*Possibility of Conflict Among Federal Courts.* Certain decisions by the United States Court of Appeals for the Second Circuit in *Freedom Holdings* have created heightened uncertainty as a result of the court's interpretation of federal antitrust law immunity doctrines, as applied to the MSA and related statutes, which interpretation appears to conflict with interpretations by the United States Court of Appeals for the Third Circuit (*A.D. Bedell Wholesale Co. v. Philip Morris, Inc. and Mariana v. Fisher*), the Sixth Circuit (*Tritent International Corp. v. Commonwealth of Kentucky and S&M Brands Inc. v. Summers*), the Ninth Circuit (*Sanders v. Brown*) and other lower courts which have rejected challenges to the MSA and related statutes. Prior decisions rejecting such challenges have concluded that the MSA and related statutes are protected from an antitrust challenge based on the *Parker* or *NP* doctrines.

An adverse decision by the Second Circuit in *Grand River* regarding the enforceability of the MSA and/or related statutes under federal antitrust law or the Commerce Clause of the U.S. Constitution would be controlling law not only within the Second Circuit but also in each of the Grand River Defendant States, at least as to the *Grand River* plaintiff and possibly as to other potential plaintiffs as well.

In addition, an adverse decision by the Second Circuit in *Freedom Holdings* regarding the enforceability of the MSA and related statutes under federal antitrust law or the Commerce Clause of the U.S. Constitution would be controlling law only within the Second Circuit, from which no appeal as of right to the U.S. Supreme Court would exist. If, however, the Second Circuit were to make a final determination in *Freedom Holdings* that: (1) the MSA constitutes a per se federal antitrust violation, not immunized by the *NP* or *Parker* doctrines, or that New York's Qualifying Statute and Complementary Legislation authorize or mandate such a per se violation; or (2) New York's Qualifying Statute and New York's Complementary Legislation operate with the Qualifying Statutes and Complementary Legislation of other states to regulate interstate commerce in violation of the Commerce Clause of the U.S. Constitution, such determination could be considered to be in conflict with decisions rendered by other federal courts that have come to different conclusions on these issues. The existence of a conflict as to the rulings of different federal courts on these issues, especially between Circuit Courts of Appeals, is one factor that the U.S. Supreme Court may take into account when deciding whether to exercise its discretion in agreeing to hear an appeal.

No assurance can be given that the U.S. Supreme Court would choose to hear and determine any appeal relating to the substantive merits of *Freedom Holdings*. Any final decision by the U.S. Supreme Court on the substantive merits of *Freedom Holdings* would be binding everywhere in the U.S., including in the State.

*Other Litigation Challenging the MSA, Qualifying Statutes and Related Legislation.* In addition to *Freedom Holdings* and *Grand River*, other cases remain pending in federal courts that challenge the MSA, the Qualifying Statute, the Complementary Legislation and/or the Allocable Share Release Amendment in California, Louisiana, Oklahoma, Kentucky, Tennessee, Arkansas and Kansas. The issues raised in *Freedom Holdings* or *Grand River* are also raised in many of these other cases, as briefly described below, by way of example only, and not as an exclusive or complete list.

On March 28, 2005, the District Court for the Northern District of California in the California case, *Sanders v. Lockyer*, dismissed an antitrust challenge to the MSA and California's Qualifying Statute and Complementary Legislation brought by a class of California consumers against the State of California and the OPMs. The District Court, expressly unpersuaded by *Freedom Holdings*, found the MSA to be the sovereign act of the state and further found California's Qualifying Statute and Complementary Legislation to be direct legislative activity entitled to *Parker* immunity without the need for any additional *MidCal* analysis. The District Court also found the MSA and California's Qualifying Statute and Complementary Legislation to be entitled to *NP* immunity. The plaintiffs have appealed the dismissal to the Ninth Circuit Court of Appeals. On September 26, 2007, the Ninth Circuit affirmed the District Court ruling that *Sanders* had failed (i) to show that the MSA implementing statutes are per se illegal under the Sherman Act, (ii) to show that any of the defendants are liable under either the Sherman Act or California antitrust law or (iii) to state a claim entitling him to relief. In upholding the district court's dismissal of the plaintiff's claims challenging the MSA, the Ninth Circuit expressly agreed with the Sixth Circuit's reasoning in *Tritent* and expressly declined to follow either the Second Circuit's approach in *Freedom Holdings* or the Third Circuit's "hybrid restraint" analysis of the MSA in *Bedell*. A petition for a writ of certiorari to the U.S. Supreme Court was filed in February 2008; California's opposition is due to be filed on April 2, 2008.

Two cases are currently pending in Louisiana that challenge the MSA, Qualifying Statutes, and/or related legislation. In *Xcaliber International Limited, LLC v. Ieyoub*, certain NPMs have challenged the state's Allocable Share Release Amendment on both federal and state constitutional grounds. In March 2006, the Fifth Circuit Court of Appeals vacated the District Court's earlier dismissal of the action and remanded the case for further proceedings to review the plaintiffs' allegations that the Louisiana Allocable Share Release Amendment violates the rights of free speech, due process of law, and equal protection of the laws guaranteed under the U.S. Constitution and the Louisiana Constitution. On July 5, 2006, the plaintiff filed an Amended Complaint, which is now pending before U.S. District Court for the Eastern District of Louisiana. The Amended Complaint also alleges that the Louisiana Allocable Share Release Amendment violates federal antitrust laws. On July 19, 2006, defendant filed a motion to dismiss certain claims of the Amended Complaint, which the court denied on October 18, 2006. On October 30, 2006, the defendant filed its answer to the Amended Complaint. A settlement conference was held on February 5, 2007. A final pre-trial conference had been set for September 6, 2007, with a bench trial to follow on September 24, 2007. This schedule, however, has been suspended pending the resolution of certain discovery issues. The court has ordered that dates for a final pre-trial conference and trial be set at a scheduling conference set for April 10, 2008. In *A.B. Coker v. Foti*, filed in August 2005, certain NPMs and cigarette distributors brought an action in a federal district court in Louisiana, seeking, among other relief: (1) a declaration that the MSA and Louisiana's Qualifying Statute and Complementary Legislation are invalid under various federal laws; and (2) an injunction barring the enforcement of the MSA and Louisiana's Qualifying Statute and Complementary Legislation. On November 2, 2005, the state defendant filed a motion to dismiss the complaint for lack of jurisdiction. On November 9, 2006, the U.S. District Court for the Western District of Louisiana granted in part and denied in part the defendant's motion to dismiss. The court allowed the case to proceed on claims that the MSA and Louisiana's Complementary Legislation are violations of the Commerce Clause, Due Process Clause and First Amendment of the U.S. Constitution, and the Federal Cigarette Labeling and Advertising Act. The court dismissed the claims that alleged violation of the Tenth Amendment of the U.S. Constitution. On December 12, 2006, the state defendant filed its answer to the complaint. The judge has ordered all dispositive motions due by June 13, 2008. A trial date will be set thereafter.

In the Oklahoma case, *Xcaliber International Limited, LLC v. Edmondson*, certain NPMs have challenged Oklahoma's enforcement of its Allocable Share Release Amendment under federal antitrust laws. On May 20, 2005,

the District Court granted summary judgment in favor of defendant, holding that the Oklahoma Allocable Share Release Amendment constituted unilateral state action that is directly protected from preemption by the *Parker* immunity doctrine. The plaintiffs have requested that the District Court reconsider its summary judgment order and appealed the order to the U.S. Court of Appeals for the Tenth Circuit. On August 31, 2005, the District Court denied the motion to reconsider. On October 28, 2005, the Tenth Circuit referred the case for mediation conferencing. Mediation conferencing was subsequently terminated, and appellate briefing was completed in February 2006. Oral argument on the appeal was held on September 25, 2006 and a decision remains pending.

In the Kentucky case, *Tritent International Corp. v. Commonwealth of Kentucky*, the plaintiffs seek a declaratory judgment that Kentucky's Qualifying Statute and Complementary Legislation conflict with federal antitrust laws and certain provisions of the U.S. Constitution. On September 8, 2005, the District Court granted Kentucky's motion to dismiss the complaint, and on October 24, 2005, the District Court denied the plaintiffs' subsequent motion for reconsideration. The plaintiffs appealed the dismissal to the Sixth Circuit Court of Appeals. Oral argument occurred on September 20, 2006, and on October 30, 2006, the Sixth Circuit affirmed the District Court's dismissal. On November 13, 2006, the plaintiffs filed a petition for en banc rehearing, which petition was denied in February 2007. The Sixth Circuit's October 30, 2006 decision is controlling law within the Sixth Circuit and is not subject to appeal as of right to the U.S. Supreme Court. Plaintiffs did not file within the prescribed time period a petition for a writ of certiorari with the U.S. Supreme Court with respect to the Sixth Circuit's rulings in this case and those rulings are final.

Similarly, in the Tennessee case, *S&M Brands, Inc. v. Summers*, the plaintiffs filed suit in the U.S. District Court for the Middle District of Tennessee seeking a declaratory judgment that the Tennessee Qualifying Statute (including the Allocable Share Release Amendment) and Complementary Legislation also conflict with federal antitrust laws and certain provisions of the U.S. Constitution. On June 1, 2005, the Sixth Circuit affirmed the District Court's denial of plaintiffs' motion for a preliminary injunction with respect to the enforcement of Tennessee's Allocable Share Release Amendment. On October 6, 2005, the District Court granted Tennessee's motion to dismiss the complaint except that portion of the complaint that alleges that the state's retroactive enforcement of the state's Allocable Share Release Provision violates plaintiff's constitutional rights, which issue was not raised by the state in its motion and was therefore not addressed by the court. In its opinion, the District Court expressly rejected the Second Circuit's reasoning in sustaining antitrust challenges in the *Freedom Holdings* case and the Third Circuit's rationale for denying state action immunity in the *Bedell* and *Mariana* cases. Instead, *S&M Brands* followed the *Sanders* and *PTI* line of cases and held that Qualifying Statute and Complementary Legislation are direct state action, entitled to *Parker* immunity without the need for *MidCal* analysis. On December 13, 2005, and in accordance with its October 6, 2005 decision, the District Court entered a final judgment dismissing the claims seeking a declaration that the Tennessee Qualifying Statute violated federal antitrust laws and certain provisions of the U.S. Constitution. On January 3, 2006, plaintiffs filed a notice of appeal of that judgment. On April 19, 2007, the Sixth Circuit Court of Appeals affirmed the District Court's December 12, 2005 final judgment of dismissal. The Sixth Circuit's April 19, 2007 decision is controlling law within the Sixth Circuit and is not subject to appeal as of right to the U.S. Supreme Court. Plaintiffs did not file within the prescribed period a petition for a writ of certiorari with the U.S. Supreme Court with respect to the Sixth Circuit's April 19, 2007 decision and that decision is final. By separate decision filed November 28, 2005, the District Court also held that the state's retroactive application of its Allocable Share Release Amendment, which was effective as of April 20, 2004, to 2003 cigarette sales was unconstitutional. Defendants' appeal of the District Court's November 28, 2005 decision regarding retroactivity of Tennessee's Allocable Share Release Amendment was argued before the Sixth Circuit on April 26, 2007 and remains pending.

Similar cases were brought in Arkansas. In three cases in the U.S. District Court for the Western District of Arkansas (*Grand River Enterprises Six Nations Ltd. v. Beebe*, *International Tobacco Partners Ltd. v. Beebe*, and *Dos Santos v. Beebe*), the plaintiffs sought to enjoin, preliminarily and permanently, Arkansas's enforcement of its Allocable Share Release Amendment as preempted by the federal antitrust laws and certain provisions of the U.S. Constitution and the Arkansas Constitution. In *International Tobacco Partners Ltd.*, the plaintiffs also sought a declaratory judgment that the MSA and Arkansas's Qualifying Statute and Complementary Legislation are preempted by federal antitrust laws and certain provisions of the U.S. Constitution. The District Court preliminarily enjoined, as against the plaintiffs only, the enforcement of Arkansas's Allocable Share Release Amendment. On August 8, 2005, the court ordered Arkansas to reimburse certain amounts it withheld pursuant to the Allocable Share Release Amendment to *International Tobacco Partners Ltd.* On March 6, 2006, the District Court issued orders in all



three cases: (1) denying Arkansas's motion to dismiss the complaint with respect to the plaintiffs' claim that the retroactive application of the Allocable Share Release Amendment violates the plaintiffs' right to due process of law under the Fourteenth Amendment of the U.S. Constitution; and (2) granting Arkansas's motion to dismiss the complaint in all other respects. Both the *Dos Santos* and *International Tobacco Partners Ltd.* cases have been settled by the parties, and orders dismissing those cases have been entered. On March 14, 2006, the District Court in *Grand River v. Beebe* denied the plaintiffs' motion to preliminarily enjoin the Allocable Share Release Amendment. On April 12, 2006, the plaintiffs filed an appeal to the U.S. Court of Appeals for the Eighth Circuit. On December 4, 2006, the Eighth Circuit affirmed the District Court's decision to deny an injunction.

Two cases are currently pending in Kansas. In the first case filed, *Xcaliber International Limited, LLC v. Kline*, the plaintiffs seek to enjoin, preliminarily and permanently, Kansas's enforcement of its Allocable Share Release Amendment as preempted by the federal antitrust laws, expressly based on the same facts that were before the District Court in the *Freedom Holdings* case in New York. The complaint challenges only the Allocable Share Amendment but purports to reserve the right to challenge the Kansas Qualifying Statute in its entirety. On February 7, 2006, the District Court granted the state's motion for summary judgment and dismissed the case on its merits and denied the plaintiffs' motion to supplement the record with additional facts. On February 16, 2006, the plaintiffs appealed to the Court of Appeals for the Tenth Circuit. On March 8, 2006, the Tenth Circuit granted *Xcaliber's* motion to consolidate this case with *Xcaliber v. Edmondson* (described above) for oral argument, and oral argument was held in September 2006. In the second case, *International Tobacco Partners Ltd. v. Kline*, the plaintiff seeks a declaratory judgment that the Allocable Share Release Amendment is preempted by federal antitrust laws and certain provisions of the U.S. Constitution and preliminary and permanent injunctions against the enforcement of the Allocable Share Release Amendment. On January 30, 2006, the plaintiff amended the complaint, which now seeks to enjoin the enforcement of Kansas's Complementary Legislation and Kansas's Qualifying Statute in their entirety. Although the complaint asserts that the MSA is also preempted by federal antitrust laws and certain provisions of the U.S. Constitution, it does not specifically seek to enjoin the enforcement thereof. Both parties filed motions for summary judgment, which were dismissed by the court. Kansas filed a motion to dismiss on February 28, 2006. On April 24, 2006, plaintiff filed a new motion for summary judgment. On February 8, 2007, the court granted Kansas' motion and dismissed the case. On March 9, 2007, the plaintiff appealed this dismissal. The Tenth Circuit has put briefing in this case on hold pending its decision in the appeals of *Xcaliber International Limited, LLC v. Kline* and *Xcaliber v. Edmondson*.

The plaintiffs in *Freedom Holdings* filed a motion with the federal Judicial Panel on Multidistrict Litigation (the "MDL Panel") requesting that the Tennessee, Kentucky, and Oklahoma cases described above, together with *Grand River*, be transferred to the Southern District of New York for coordinated and consolidated pretrial proceedings with *Freedom Holdings*. On June 16, 2005, the MDL Panel denied this motion. The MDL Panel's denial of this motion is not subject to appeal.

If there is an adverse ruling in one or more of the cases discussed above, it could have a material adverse effect on the amount and/or timing of Pledged Settlement Payments available to the Corporation, could lead to a decrease in the market value and/or the liquidity of the Series 2008 Bonds and, in certain circumstances, could lead to a complete loss of the Series A Pledged Settlement Payments and the Series B Pledged Settlement Payments. For a description of the opinions of Transaction Counsel addressing such matters, see "LEGAL CONSIDERATIONS RELATING TO SERIES A PLEDGED SETTLEMENT PAYMENTS AND SERIES B PLEDGED SETTLEMENT PAYMENTS –MSA Enforceability" and "–Qualifying Statute Constitutionality" herein.

### **Litigation Seeking Monetary Relief from Tobacco Industry Participants**

The tobacco industry has been the target of litigation for many years. Both individual and class action lawsuits have been brought by or on behalf of smokers alleging that smoking has been injurious to their health, and by non-smokers alleging harm from environmental tobacco smoke ("ETS"), also known as "secondhand smoke." Plaintiffs in these actions seek compensatory and punitive damages aggregating billions of dollars. Philip Morris, for example, has reported that, as of February 15, 2008, there were nine cases on appeal in which verdicts were returned against Philip Morris, including: (1) a \$74 billion punitive damages judgment against Philip Morris in the *Engle* class action, which has been overturned on appeal by the Florida Supreme Court; and (2) a compensatory and punitive damages verdict totaling approximately \$10.1 billion in the *Price* case in Illinois. On December 15, 2005, however, the Illinois Supreme Court reversed the judgment against Philip Morris in *Price* and remanded the case to

the trial court with instructions to dismiss the case in its entirety. In its decision, the court held that the defendant's conduct alleged by the plaintiffs to be fraudulent under the Illinois Consumer Fraud Act was specifically authorized by the Federal Trade Commission, and that the Illinois Consumer Fraud Act specifically exempts conduct so authorized by a regulatory body acting under the authority of the U.S. The court declined to review the case on the merits, concluding that the action was barred entirely by the Illinois Consumer Fraud Act. In January 2006, the plaintiffs filed a motion asking the court to reconsider its decision in *Price*. On May 5, 2006, the Supreme Court of Illinois denied this motion. In October 2006, plaintiffs filed a petition for certiorari with the U.S. Supreme Court. On November 27, 2006, the U.S. Supreme Court denied plaintiff's petition for certiorari. The trial court then entered an order of dismissal in December 2006. In January 2007, the plaintiff filed a motion to vacate the dismissal, which motion was dismissed on August 30, 2007. It has been reported that on May 2, 2007 the state trial court judge in the *Price* case asked the Illinois Fifth District Appellate Court whether he has the authority to reopen the *Price* case, citing possible new evidence presented in a case pending before the U.S. Supreme Court. It has also been reported that on May 17, 2007, Philip Morris petitioned the Illinois Supreme Court for an order that would prevent the trial court judge from reopening the *Price* case. On October 1, 2007, the U.S. Supreme Court denied defendants' petition for certiorari and on October 26, 2007, defendants filed a motion for rehearing of the U.S. Supreme Court's denial of defendants' petition. See "APPENDIX F—CERTAIN INFORMATION RELATING TO THE TOBACCO INDUSTRY –Civil Litigation" herein.

There are a number of other proposed federal class action suits against manufacturers of "light" cigarettes alleging that the manufacturers falsely represented the cigarettes as "light" to mislead smokers into believing that the cigarettes delivered lower tar and nicotine and therefore were safer than regular cigarettes. For example, on August 31, 2007, the First Circuit issued an opinion in *Good v. Altria Group Inc.* holding that plaintiffs' claims, although similar to those in *Price*, are not preempted by the Federal Cigarette Labeling and Advertising Act (the "FCLAA"). The court reasoned that plaintiffs' claims of fraudulent misrepresentation under a Maine fraud statute are neither expressly nor implicitly preempted by the FCLAA. The court also disagreed with those courts, including the *Price* court, which have held that "lights" advertising is authorized by the FTC and therefore beyond the reach of state consumer protection statutes. The First Circuit denied defendant's summary judgment motion and remanded the case to the U.S. District Court for the District of Maine. The U.S. District Court for the District of Maine has stayed proceedings pending the ruling of the U.S. Supreme Court on defendant's petition for writ of certiorari, which the court granted on January 18, 2008.

The MSA does not release PMs from liability in either individual or class action cases. Healthcare cost recovery cases have also been brought by governmental and non-governmental healthcare providers seeking, among other things, reimbursement for healthcare expenditures incurred in connection with the treatment of medical conditions allegedly caused by smoking. The PMs are also exposed to liability in these cases, because the MSA only settled healthcare cost recovery claims of the Settling States. Litigation has also been brought against certain PMs and their affiliates in foreign countries.

Pending claims related to tobacco products generally fall within four categories: (1) smoking and health cases alleging personal injury and purporting to be brought on behalf of a class of individual plaintiffs, including cases brought pursuant to a 1997 settlement agreement involving claims by flight attendants on U.S. airlines alleging injury from exposure to ETS in aircraft cabins; (2) smoking and health cases alleging personal injury brought on behalf of individual plaintiffs; (3) health care cost recovery cases brought by governmental (both domestic and foreign) and non-governmental plaintiffs seeking reimbursement for health care expenditures allegedly caused by cigarette smoking and/or disgorgement of profits; and (4) other tobacco-related litigation, including class action suits alleging that the use of the terms "Lights" and "Ultra Lights" constitute deceptive and unfair trade practices, suits by former asbestos manufacturers seeking contribution or reimbursement for amounts expended in connection with the defense and payment of asbestos claims that were allegedly caused in whole or in part by cigarette smoking, and various antitrust suits and suits by foreign governments seeking to recover damages for taxes lost as a result of the allegedly illegal importation of cigarettes into their jurisdictions. Plaintiffs seek various forms of relief, including compensatory and punitive damages, treble/multiple damages and other statutory damages and penalties, creation of medical monitoring and smoking cessation funds, disgorgement of profits, legal fees, and injunctive and equitable relief. Defenses raised in these cases include lack of proximate cause, statutes of limitation and preemption by the Federal Cigarette Labeling and Advertising Act. A February 2007 California Supreme Court decision (*Grisham v. Philip Morris*) regarding a statute of limitations issue in an individual case has held that the plaintiff need not have

filed suit when she realized she was addicted, thus permitting her lawsuit to go forward after a lower court had held her claim to be time-barred. This decision could lead to an increase in individual lawsuits in California.

The ultimate outcome of these and any other pending or future lawsuits is uncertain. Verdicts of substantial magnitude that are enforceable as to one or more PMs, if they occur, could encourage commencement of additional litigation, or could negatively affect perceptions of potential triers of fact with respect to the tobacco industry, possibly to the detriment of pending litigation. An unfavorable outcome or settlement or one or more adverse judgments could result in a decision by the affected PMs to substantially increase cigarette prices, thereby reducing cigarette consumption beyond what is forecast in the Global Insight Report. In addition, the financial condition of any or all of the PM defendants could be materially and adversely affected by the ultimate outcome of pending litigation, including bonding and litigation costs or a verdict or verdicts awarding substantial compensatory or punitive damages. Depending upon the magnitude of any such negative financial impact (and irrespective of whether the PM is thereby rendered insolvent), an adverse outcome in one or more of the lawsuits could substantially impair the affected PM's ability to make payments under the MSA, could lead to a decrease in the market value and/or the liquidity of the Series 2008 Bonds and could have a material adverse effect on the amount and/or timing of Pledged Settlement Payments available to the Corporation. See "APPENDIX F—CERTAIN INFORMATION RELATING TO THE TOBACCO INDUSTRY –Civil Litigation" and "LEGAL CONSIDERATIONS RELATING TO SERIES A PLEDGED SETTLEMENT PAYMENTS AND SERIES B PLEDGED SETTLEMENT PAYMENTS" herein.

### **Decline in Cigarette Consumption Materially Beyond Forecasted Levels May Adversely Affect Payments**

*Smoking Trends.* As discussed in the Global Insight Report, cigarette consumption in the U.S. has declined since its peak in 1981 of 640 billion cigarettes to an estimated 368 billion cigarettes in 2007. Adult per capita cigarette consumption (total consumption divided by the number of people 18 years and older) has been declining since 1964. The Global Insight Report forecasts a continued decline in total cigarette consumption at an average annual rate of 1.85% to 273 billion cigarettes in 2023 under the Global Insight Base Case Forecast, as defined herein, which represents a decline in per capita consumption at an average rate of 2.67% per year. These consumption declines are based on historical trends, which may not be indicative of future trends, as well as other factors which may vary significantly from those assumed or forecasted by Global Insight. For a more detailed discussion of the Global Insight methodology, see "SUMMARY OF THE GLOBAL INSIGHT REPORT" herein and "APPENDIX E – GLOBAL INSIGHT REPORT" attached hereto.

According to the Global Insight Report, the pharmaceutical industry is seeking approval from the U.S. Food and Drug Administration (the "FDA") for two new smoking cessation products possibly more effective than those now in existence, such as gum and patch nicotine replacement products, and other smoking cessation products such as NicoBloc or Zyban. In June 2006, the FDA has approved Varenicline, a Pfizer product to be marketed as Chantix, for use as a prescription medicine. It is intended to satisfy nicotine cravings without being pleasurable or addictive. The drug binds to the same brain receptor as nicotine. Tests indicate that it is more effective as a cessation aid than Zyban. Pfizer has introduced Chantix with a novel marketing program, GETQUIT, an integrated consumer support system which emphasizes personalized treatment advice with regular phone and email contact. Pfizer reports that approximately 3.5 million U.S. prescriptions have been filled since Chantix' introduction.

Several new drugs may also appear on the market in the near future. On May 14, 2005, Cytos Biotechnology AG, announced that it had successfully completed Phase II testing of a virus based vaccine, which is genetically engineered to cause an immune system response against nicotine and its effects. Novartis has acquired the license to the vaccine and has reported positive results toward Phase III trials. Nabi Biopharmaceuticals has successfully completed its Phase IIB clinical trials for NicVAX, a vaccine to prevent and treat nicotine addiction. It triggers antibodies that bind with nicotine molecules. In 2006, NicVAX received Fast Track Designation from the FDA, which is intended to expedite its review process. Phase III trials are the remaining step before a license application. The Xenova Group is set to begin Phase II testing of its similar vaccine, Ta Nic. Positive results were also reported in July 2006 by Somaxon Pharmaceuticals from a pilot Phase II study of Nalmefene. Nalmefene has been used for over 10 years for the reversal of opioid drug effects. Somaxon Pharmaceuticals is seeking to develop it as a treatment for impulse control disorders. In 2008, Evotec AG announced it would launch a Phase II study of EVT 302, a drug intended to ease smoker's cravings and nicotine withdrawal symptoms after cigarette deprivation. Global Insight expects that products such as these will continue to be developed and that their introduction and use

will contribute to the trend decline in smoking. One SPM has also introduced a cigarette with reportedly little or no nicotine. Future FDA regulation could also include regulation of nicotine content in cigarettes to non-addictive levels. Such new products or similar products, if successful, or such FDA regulation, if enacted, could have a material adverse effect on cigarette consumption.

*Smokeless Tobacco Products.* Smokeless tobacco products have been available for centuries. As cigarette consumption expanded in the last century, the use of smokeless products declined. Chewing tobacco and snuff are the most significant components. Snuff is a ground or powdered form of tobacco that is placed under the lip to dissolve. It delivers nicotine effectively to the body. Moist snuff is both smoke-free and can be spit free. According to the Global Insight Report, chewing tobacco and dry snuff consumption has been declining in the U.S. in this decade, but moist snuff consumption has increased at an annual rate of more than 5% since 2002, and by 10.4% in 2006, when over 5 million consumers purchased 1.1 billion cans. Snuff is now being marketed to adult cigarette smokers as an alternative to cigarettes. UST Inc., the largest producer of moist smokeless tobacco, is explicitly targeting adult smoker conversion in its growth strategy. The industry is responding to both the proliferation of indoor smoking bans and to a perception that smokeless use is a less harmful mode of tobacco and nicotine usage than cigarettes. In 2006, the three largest U.S. cigarette manufacturers entered the market. Philip Morris introduced a snuff product, Taboka, Reynolds American acquired Conwood Company, L.P., the nation's second largest smokeless tobacco manufacturer, and introduced Camel Snus, a snuff product, and Lorillard entered into an agreement with Swedish Match North America to develop smokeless tobacco product in the U.S. Product development has continued in 2007, with the introduction by Philip Morris of a Marlboro snus product. In October 2007, Altria announced that it would accelerate the development of snuff and less-harmful cigarettes to counter a decline in smoking. In 2008, Liggett announced it would introduce Grand Prix snus.

Advocates of the use of snuff as part of a tobacco harm reduction strategy point to Sweden, where 'snus,' a moist snuff manufactured by Swedish Match, use has increased sharply since 1970, and where cigarette smoking incidence among males has declined to levels well below that of other countries. A review of the literature on the Swedish experience concludes that snus, relative to cigarettes, delivers lower concentrations of some harmful chemicals, and does not appear to cause cancer or respiratory diseases. They conclude that snus use appears to have contributed to the unusually low rates of smoking among Swedish men. The Sweden experience is unique, even with respect to its Northern European neighbors. It is not clear whether it could be replicated elsewhere. Public health advocates in the U.S. emphasize that smokeless use results in both nicotine dependence and to increased risks of oral cancer among other health concerns. Snuff use is also often criticized as a gateway to cigarette use. See "APPENDIX F – CERTAIN INFORMATION RELATING TO THE TOBACCO INDUSTRY—Regulatory Issues—*Smokeless Tobacco Products*" herein and "APPENDIX E – GLOBAL INSIGHT REPORT". In 2008 a new firm, Fuisz Tobacco, was formed to commercialize a film-based smokeless tobacco product. The thin film strip would be spitless and would dissolve entirely in the cheek.

A decline in the overall consumption of cigarettes beyond the levels forecasted in the Global Insight Report could have a material adverse effect on the payments by PMs under the MSA and the amount and/or timing of Pledged Settlement Payments available to the Corporation.

*Regulatory Restrictions and Legislative Initiatives.* The tobacco industry is subject to a wide range of laws and regulations regarding the marketing, sale, taxation and use of tobacco products imposed by local, state, federal and foreign governments. Various state governments have adopted or are considering, among other things, legislation and regulations that would increase their excise taxes on cigarettes, restrict displays and advertising of tobacco products, establish ignition propensity standards for cigarettes, raise the minimum age to possess or purchase tobacco products, ban the sale of "flavored" cigarette brands, require the disclosure of ingredients used in the manufacture of tobacco products, impose restrictions on smoking in public and private areas, restrict the sale of tobacco products directly to consumers or other unlicensed recipients, including over the Internet, and charge state employees who smoke higher health insurance premiums than non-smoking state employees. Five states, Alabama, Georgia, Idaho, Kentucky, and West Virginia, charge higher health insurance premiums to smokers than non-smokers, and a number of states have implemented legislation that allows employers to provide incentives to employees who do not smoke. Several large corporations, including Meijer Inc., Gannett Co., American Financial Group Inc., PepsiCo Inc., and Northwest Airlines, are now charging smokers higher health insurance premiums. In addition, the U.S. Congress may consider legislation further increasing the federal excise tax, regulation of cigarette manufacturing and sale by the FDA, amendments to the Federal Cigarette Labeling and Advertising Act to require

additional warnings, reduction or elimination of the tax deductibility of advertising expenses, implementation of a national standard for “fire safe” cigarettes, regulation of the retail sale of cigarettes over the Internet and in other non face to face retail transactions, such as by mail order and telephone, and banning the delivery of cigarettes by the U.S. Postal Service. In March 2005, for example, bipartisan legislation was reintroduced in the U.S. Congress, which would provide the FDA with broad authority to regulate tobacco products. A bipartisan group of lawmakers, Massachusetts Senator Edward M. Kennedy, Texas Senator John Cornyn, California Representative Henry Waxman and Virginia Representative Tom Davis, on February 15, 2007 introduced the Family Smoking Prevention and Tobacco Control Act, legislation aimed at placing tobacco products under the authority of the FDA. The bill would give the FDA broad regulatory authority over the sale, distribution, and advertising of tobacco products. Such legislation would, among other anticipated changes, permit the FDA to regulate tar and other ingredients in cigarettes, permit the FDA to strengthen warning labels, reduce nicotine levels in tobacco products, police false or misleading advertising and marketing aimed at children and would require manufacturers to provide the FDA with lists of ingredients and additives in their products, including nicotine. Philip Morris has indicated its strong support for this legislation. The Senate Health Committee approved the legislation on August 1, 2007 by a 13 to 8 vote, including an amendment requiring that all cigarette packages be half covered by warning labels with colored graphic. A committee of the House of Representatives began holding hearings on October 3, 2007 on whether the FDA should be given the power to regulate tobacco products. On October 12, 2007, the House of Representatives passed a tax bill containing new tax breaks for corporations and a buyout for tobacco farmers, but omitting the FDA broad authority to regulate tobacco products. It has been recently reported that various states have requested the Alcohol Tax and Trade Bureau to categorize “little cigars” as another form of cigarettes that require federal regulation. No assurance can be given that future legislation or administrative regulations will not seek to further regulate, restrict or discourage the manufacture, sale and use of cigarettes.

Cigarettes are also currently subject to substantial excise taxes in the U.S. The federal excise tax has remained constant, at \$0.39 per pack, since 2002. The U.S. Congress has adopted legislation which would raise the federal excise tax. In August, the Senate and House of Representatives passed bills with \$0.61 and \$0.45 increases to the tax, respectively. The increase to the federal excise tax is designed to provide funding for the State Children’s Health Insurance Program (“**SCHIP**”). On September 25, 2007, the House of Representatives passed a new bill with a \$0.61 increase by a vote of 265 to 159. On September 27, 2007, the Senate voted 67 to 29 to reauthorize and expand SCHIP funded in part by a \$0.61 increase in the federal excise tax on cigarettes. On October 3, 2007, the President vetoed the bill, and on October 18, 2007, the House of Representatives failed to override the Presidential veto. Subsequent override attempts in November and in January 2008 also failed. It is not possible at this time to predict with certainty the outcome of this legislation or any future legislative action or its effect upon the level of federal excise taxes on cigarettes.

All states, the District of Columbia, and the Commonwealth of Puerto Rico currently impose taxes at levels ranging from \$0.07 per pack in South Carolina to \$2.575 per pack in New Jersey. In addition, certain municipalities also impose an excise tax on cigarettes ranging up to \$1.50 per pack in New York City and \$2.68 per pack in Chicago, which includes the Cook County tax of \$2.00 per pack. According to the Global Insight Report, excise tax increases were enacted in 20 states and in New York City in 2002, in 13 states in 2003, in 11 states in 2004, and in 8 states (Kentucky, Maine, Minnesota, New Hampshire, North Carolina, Ohio, Virginia, and Washington) in 2005. The increase in Minnesota was not a tax increase, but rather the imposition of a “Health Impact Fee,” which has the same effect on consumer prices. The Global Insight Report considers any such fees as equivalent to excise taxes.

In 2006, Texas passed a budget that raised the state excise tax by \$1.00 in January 2007, and Hawaii, New Jersey, North Carolina, and Vermont enacted legislation which raised excise taxes. In the November 2006 elections, referenda passed in Arizona and South Dakota raising excise taxes. In 2007, Connecticut, Delaware, Iowa, Indiana, New Hampshire and Tennessee each increased its excise taxes. These actions increased the average state excise tax to \$1.074 per pack in July 2007. In October, Wisconsin enacted a \$1.25 increase, and in November Maryland enacted a \$1.00 increase. These actions will push the average state excise tax to \$1.116 in 2008. It is expected that other states will also enact increases in 2008 and in future years. Georgia, Illinois, Kansas, Kentucky, Massachusetts, Mississippi, Pennsylvania, South Carolina and Utah are now considering excise tax increases. Though California voters rejected a ballot initiative on November 7, 2006 that would have raised the tax from \$0.87 to \$3.47 per pack, California lawmakers have introduced a bill which would raise the tax by \$2.00 per pack.

As mentioned above, at least one state, Minnesota, currently imposes a 75 cent “health impact fee” on tobacco manufacturers for each pack of cigarettes sold. The purpose of this fee is to recover the state’s health costs related to or caused by tobacco use. The imposition of this fee was contested by Philip Morris and upheld by the Minnesota Supreme Court as not in violation of Minnesota’s settlement with the tobacco companies. On February 20, 2007, the U.S. Supreme Court declined to hear Philip Morris’ appeal of that decision. See “Other Potential Payment Decreases Under the Terms of the MSA–*NPM Adjustment*” below.

According to the Global Insight Report, all of the states and the District of Columbia now require smoke-free indoor air to some degree or in some public places. The most comprehensive bans have been enacted since 1998 in 28 states and a number of large cities. In 1998, California imposed a comprehensive smoking ban for all indoor workplaces, including restaurants and bars. Delaware followed suit in 2002, and in 2003, Connecticut, Maine, New York, and Florida passed similar comprehensive bans, as did the cities of Boston and Dallas. Since then, Arizona, Arkansas, Colorado, the District of Columbia, Hawaii, Illinois, Louisiana, Maryland, Massachusetts, Minnesota, Montana, Nebraska, Nevada, New Hampshire, New Jersey, New Mexico, Ohio, Oregon, Rhode Island, Tennessee, Utah, Vermont, Washington, and Puerto Rico established similar bans, as did the cities of Baltimore, Chicago, Houston, and Philadelphia. The New Mexico, Washington State and Chicago restrictions are stronger than those in other states as they include a ban on outdoor smoking within 25 feet of the entrances of restaurants and other public places. It is expected that these restrictions will continue to proliferate. For example, in 2008, at least 11 states, Alabama, Iowa, Kansas, Michigan, Missouri, North Carolina, Pennsylvania, South Carolina, Tennessee, West Virginia and Wisconsin, are considering legislation which would enact comprehensive bans.

The American Nonsmokers’ Rights Foundation documents clean indoor air ordinances by local governments throughout the U.S. As of January 2, 2008, there were 2,671 municipalities with local laws that restrict where smoking is allowed, including 1,134 municipalities that restrict smoking in one or more outdoor areas. Of these, 524 local governments required workplaces to be 100% smoke free, and 100% smoke free conditions were required for restaurants by 488 governments, and for bars by 366. The number of such ordinances grew rapidly beginning in the 1980s, from less than 200 in 1985 to over 1,000 by 1993, and 1,500 by 2001. The ordinances completely restricting smoking in restaurants and bars have generally appeared in the past decade. In 1993 only 13 municipalities prohibited all smoking in restaurants, and 6 in bars. These numbers grew to 49 for restaurants and 32 for bars in 1998, and doubled again by 2001, to 100 and 74, respectively.

The first extensive outdoor smoking restrictions were instituted in March 2006 in Calabasas, California. The City of Oakland and California municipalities of Belmont, Beverly Hills, Dublin, El Cajon, Emeryville and Santa Monica have also established extensive outdoor restrictions, as have Davis County and the City of Murray in Utah. Burbank, California, is expected to follow suit. In the most restrictive version to date, the California cities, Belmont, and Calabasas have approved ordinances which restrict smoking anywhere in the city except for single-family detached homes. Many landlords and condominium associations have also established smoke-free apartment policies. The Massachusetts Department of Public Health is conducting a survey of landlords, tenants, and condominium associations to assess the feasibility of making residences smoke-free.

In the past year, San Diego City and Los Angeles, Santa Cruz and San Mateo Counties have banned smoking at beaches and parks, joining over 30 other Southern California cities in prohibiting smoking on the beach. The beach restrictions may soon become statewide. Chicago approved beach and parkground smoking restrictions in October 2007. Sarasota County, Florida has banned smoking on its beaches, and Nassau County, New York and Volusia County, Florida are also considering park and beach bans. At least 50 colleges nationwide now prohibit smoking everywhere on campus. California, Illinois, Michigan and Nevada have banned smoking in state prisons. Arkansas, California, Louisiana, Puerto Rico, Texas and Rockland County, New York now prohibit smoking in a car where there are children present, and similar legislation has been proposed in Arizona, California, Connecticut, Illinois, Indiana, Iowa, Kansas, Massachusetts, Montana, New Jersey, New York, Oregon, Rhode Island, South Carolina, Utah, West Virginia, and in Bangor, Maine.

In June 2006, the Office of the Surgeon General released a report, “The Health Consequences of Involuntary Exposure to Tobacco Smoke.” It is a comprehensive review of health effects of involuntary exposure to tobacco smoke. It concludes definitively that secondhand smoke causes disease and adverse respiratory effects. It also concludes that policies creating completely smoke-free environments are the most economical and efficient approaches to providing protection to non-smokers. On September 18, 2007, the Office of the Surgeon General

released the report, “Children and Secondhand Smoke Exposure,” which concludes that many children are exposed to secondhand smoke in the home and that establishing a completely smoke-free home is the only way to eliminate secondhand smoke exposure in that setting. These reports are expected to strengthen arguments in favor of further smoking restrictions across the country. Further, the California Environmental Protection Agency Air Resources Board declared environmental tobacco smoke to be a toxic air contaminant in 2006.

The attorneys general of the Settling States have obtained agreements from Philip Morris, Reynolds Tobacco and B&W that they will remove product advertisements from various magazines that are circulated in schools for educational purposes.

No assurance can be given that future legislation or administrative regulations will not seek to further regulate, restrict or discourage the manufacture, sale and use of cigarettes. Excise tax increases and other legislative or regulatory measures could severely increase the cost of cigarettes, limit or prohibit the sale of cigarettes, make cigarettes less appealing to smokers or reduce the addictive qualities of cigarettes. As a result of these types of initiatives and other measures, the overall consumption of cigarettes nationwide may decrease materially more than forecasted in the Global Insight Report and thereby could have a material adverse effect on the payments by PMs under the MSA, could lead to a decrease in the market value and/or the liquidity of the Series 2008 Bonds, and could have a material adverse effect on the amount and/or timing of Pledged Settlement Payments available to the Corporation. See “APPENDIX F – CERTAIN INFORMATION RELATING TO THE TOBACCO INDUSTRY–Regulatory Issues” herein.

#### **Other Potential Payment Decreases Under the Terms of the MSA**

*Adjustments to MSA Payments.* The MSA provides that the amounts payable by the PMs are subject to numerous adjustments, offsets and recalculations, some of which are material. Such adjustments, offsets and recalculations, could reduce the Series A Pledged Settlement Payments and the Series B Pledged Settlement Payments available to the Corporation below the respective amounts required to pay principal of and interest on the Series 2008 Bonds and could lead to a decrease in the market value and/or the liquidity of the Series 2008 Bonds, which in certain circumstances could lead to a complete loss of the Series A Pledged Settlement Payments and the Series B Pledged Settlement Payments. Both the Settling States and one or more of the PMs are disputing or have disputed the calculations of some of the Initial Payments for the years 2000 through 2003, and some Annual Payments for the years 2000 through 2007. No assurance can be given as to the magnitude of the adjustments that may result upon resolution of those disputes. Any such adjustments could trigger the Offset for Miscalculated or Disputed Payments. For additional information regarding the MSA and the payment adjustments, see “SUMMARY OF THE MASTER SETTLEMENT AGREEMENT” herein.

The assumptions used to project collections (the source of the payments on the Series 2008 Bonds) are based on the premise that certain adjustments will occur as set forth under “SUMMARY OF SERIES A AND SERIES B PLEDGED SETTLEMENT PAYMENTS METHODOLOGY AND BOND STRUCTURING ASSUMPTIONS” herein. Actual adjustments could be materially different from what has been assumed and described herein.

*Growth of NPM Market Share and Other Factors.* The assumptions used to project collections and structure the Series 2008 Bonds contemplate declining consumption of cigarettes in the U.S. combined with a static relative market share of 5.14%\* for the NPMs. See “SUMMARY OF SERIES A AND SERIES B PLEDGED SETTLEMENT PAYMENTS METHODOLOGY AND BOND STRUCTURING ASSUMPTIONS” herein. Should the forecasted decline in consumption occur, but be accompanied by a material increase in the relative aggregate market share of the NPMs, shipments by PMs would decline at a rate greater than the decline in consumption. This would result in greater reductions of Annual Payments and Strategic Contribution Fund Payments by the PMs due to application of the Volume Adjustment, even for Settling States (including the State) that have adopted enforceable Qualifying Statutes and are diligently enforcing such statutes and are thus exempt from the NPM Adjustment. One SPM has introduced a cigarette with reportedly no nicotine. If consumers used this product to quit smoking, it could reduce the size of the cigarette market. The capital costs required to establish a

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\* The aggregate market share of NPMs utilized in the Collection Methodology and Assumptions may differ materially from the market share information utilized by the MSA Auditor when calculating the NPM Adjustments.

profitable cigarette manufacturing facility are relatively low, and new cigarette manufacturers, whether SPMs or NPMs, are less likely than OPMs to be subject to frequent litigation.

The Model Statute in its original form had required each NPM to make escrow deposits approximately in the amount that the NPM would have had to pay had it been a PM, but entitled the NPM to a release, from each Settling State in which the NPM had made an escrow deposit, of the amount by which the escrow deposit exceeds that Settling State's allocable share of the total payments that the NPM would have been required to make had it been a PM. At least 44 Settling States, including the State, have enacted, and other states are considering enacting, legislation that amends this provision in their Model/Qualifying Statutes, by eliminating the reference to the allocable share and limiting the possible release an NPM may obtain to the excess above the total payment that the NPM would have paid had it been a PM (so called "**Allocable Share Release Legislation**"). The National Association of Attorneys General ("**NAAG**") has endorsed these legislative efforts. A majority of the PMs, including all OPMs, have indicated their agreement in writing that in the event a Settling State enacts legislation substantially in the form of the Allocable Share Release Legislation, such Settling State's previously enacted Model Statute or Qualifying Statute will continue to constitute a Model Statute or Qualifying Statute within the meaning of the MSA. Following a challenge by NPMs, the U.S. District Court for the Southern District of New York in September 2004 enjoined New York from enforcing its Allocable Share Release Legislation. NPMs are also currently challenging Allocable Share Release Legislation in the states of California, Arkansas, Kansas, Kentucky, Louisiana, Oklahoma, and Tennessee. It is possible that NPMs will challenge such legislation in other states. See "**Litigation Challenging the MSA, the Qualifying Statutes and Related Legislation**" herein. To the extent that either: (1) other jurisdictions do not enact or enforce Allocable Share Release Legislation; or (2) a jurisdiction's Allocable Share Release Legislation is invalidated, NPMs could concentrate sales in such jurisdiction to take advantage of the absence of Allocable Share Release Legislation by limiting the amount of its escrow payment obligations to only a fraction of the payment it would have been required to make had it been a PM. Because the price of cigarettes affects consumption, NPM cost advantage is one of the factors that has resulted and could continue to result in increases in market share for the NPMs.

A significant loss of market share by PMs to NPMs could have a material adverse effect on the payments by PMs under the MSA, could lead to a decrease in the market value and/or the liquidity of the Series 2008 Bonds, and could have a material adverse effect on the amount and/or timing of Pledged Settlement Payments available to the Corporation. See "**SUMMARY OF THE MASTER SETTLEMENT AGREEMENT—Adjustments to Payments**" and "**APPENDIX E - GLOBAL INSIGHT REPORT.**"

### *NPM Adjustment*

Description of the NPM Adjustment. The NPM Adjustment, measured by domestic sales of cigarettes by NPMs, operates in certain circumstances to reduce the payments of the PMs under the MSA in the event of losses in market share to NPMs during a calendar year as a result of the MSA. Three conditions must be met in order to trigger an NPM Adjustment for one or more Settling States: (1) a Market Share Loss (as defined in the MSA) for the applicable year must exist, which means that the aggregate market share of the PMs in any year must fall more than 2% below the aggregate market share held by those same PMs in 1997 (a condition that has existed for every year since 2000); (2) a nationally recognized firm of economic consultants must determine that the disadvantages experienced as a result of the provisions of the MSA were a significant factor contributing to the market share loss for the year in question; and (3) the Settling States in question must be found to not have diligently enforced their Qualifying Statutes.<sup>†</sup> The Settling States and the PMs selected The Brattle Group in May 2004 as current economic consultants responsible for making the significant factor determinations for sales years 2003-2005. A new economic consultant will be selected jointly by the Settling States and the PMs for the 2006 significant factor determination.

Application of the NPM Adjustment. The entire NPM Adjustment is ultimately applied to a subsequent year's Annual Payment and Strategic Contribution Fund Payment due to those Settling States: (1) that have been found to have not diligently enforced their Qualifying Statutes throughout the year; or (2) that have enacted a Model Statute or Qualifying Statute that is declared invalid or unenforceable by a court of competent jurisdiction. The

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<sup>†</sup> The NPM Adjustment does not apply at all if the number of cigarettes shipped in or to the United States in the year prior to the year in which the payment is due by all manufacturers that were PMs prior to December 7, 1998 exceeds the number of cigarettes shipped in or to the United States by all such PMs in 1997.



1997 market share percentage for the PMs, less 2%, is defined in the MSA as the “**Base Aggregate Participating Manufacturer Market Share.**” If the PMs’ actual aggregate market share is between 0% and 16⅔% less than the Base Aggregate Participating Manufacturer Market Share, the amounts paid by the PMs would be decreased by three times the percentage decrease in the PMs’ actual aggregate market share. If, however, the PMs’ market share loss is greater than 16⅔%, then the NPM Adjustment will equal 50% plus an amount determined by formula as set forth in the footnote below.<sup>†</sup>

The MSA further provides that in no event shall the amount of an NPM Adjustment applied to any Settling State in any given year exceed the amount of Annual Payments and Strategic Contribution Fund Payments to be received by such Settling State in such year.

Regardless of how the NPM Adjustment is calculated, it is always subtracted from the total Annual Payments and Strategic Contribution Fund Payments due from the PMs and then ultimately allocated on a Pro rata (as defined in the MSA) basis only among those Settling States: (1) that have been proven to have not diligently enforced their Qualifying Statute; or (2) that have enacted a Model Statute or Qualifying Statute that is declared invalid or unenforceable by a court of competent jurisdiction.<sup>††</sup> However, the practical effect of a decision by a PM to claim an NPM Adjustment for a given year and pay its portion of the amount of such claimed NPM Adjustment into the Disputed Payments Account, or withhold payment of such amount, would be to reduce the payments to all Settling States on a pro rata basis until, for any particular Settling State, a resolution is reached regarding the diligent enforcement dispute for such state for such year or until, for all Settling States, a global settlement is reached for all such disputes for such year. If the PMs make a claim for an NPM Adjustment for any particular year and the State is determined to be one of a few states (or the only state) not to have diligently enforced its Model Statute or Qualifying Statute in such year, the amount of the NPM Adjustment applied to the State in the year following such determination could be as great as the amount of Annual Payments and Strategic Contribution Fund Payments that could otherwise have been received by the State in such year, and could have a material adverse effect on the amount and/or timing of Pledged Settlement Payments available to the Corporation. In the view of the Attorney General of the State, the State has been and is diligently enforcing its Qualifying Statute. The State has also covenanted in the Act to diligently enforce its Qualifying Statute.

Settlement of Calendar 1999 through 2002 NPM Adjustment Claims. In June 2003, the OPMs and the Settling States settled all NPM Adjustment claims for the years 1999 through 2002, subject, however, under limited circumstances, to the reinstatement of an OPM’s right to an NPM Adjustment for the years 2001 and 2002. In connection therewith, the OPMs and the Settling States agreed prospectively that OPMs claiming an NPM Adjustment for any year will not make such a deposit into the Disputed Payments Account or withhold payment with respect thereto unless and until the selected economic consultants determine that the disadvantages of the MSA were a significant factor contributing to the market share loss giving rise to the alleged NPM Adjustment. If the selected economic consultants make such a “significant factor” determination regarding a year for which one or more OPMs have claimed an NPM Adjustment, such OPMs may, in fact, either make a deposit into the Disputed Payments Account or withhold payment reflecting the claimed NPM Adjustment. See “SUMMARY OF THE MASTER SETTLEMENT AGREEMENT—Adjustments to Payments” herein.

The State has indicated that the 2005 Annual Payments by the OPMs were made without a diversion of any portion thereof into the Disputed Payments Account for the Settling States. According to the State, however, it has been reported that 11 SPMs paid approximately \$84 million of their 2005 Annual Payments into the Disputed Payments Account for the Settling States as a result of alleged disputes, including disputes related to NPM Adjustments. Unlike the OPMs, the SPMs had not agreed, as part of their settlement of calendar 1999 through 2002 NPM Adjustment Claims, to await the finding of a significant factor determination before taking such action. Of this \$84 million, approximately \$44 million represented payments by six SPMs relating to cigarettes sold in 2003. Following litigation brought by the State of New York challenging such actions, the six SPMs released such

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<sup>†</sup> If the aggregate market share loss from the Base Aggregate Participating Manufacturer Share is greater than 16⅔%, the NPM Adjustment will be calculated as follows:

$$\text{NPM Adjustment} = 50\% + \\ \left[ \frac{50\%}{(\text{Base Aggregate Participating Manufacturer Market Share} - 16\frac{2}{3}\%)} \right] \\ \times [\text{market share loss} - 16\frac{2}{3}\%]$$

<sup>††</sup> If a court of competent jurisdiction declares a Settling State’s Qualifying Statute to be invalid or unenforceable, then the NPM Adjustment for such state is limited to no more, on a yearly basis, than 65% of the amount of such state’s allocated payment.

\$44 million to the Settling States. Such release of money, however, does not represent final settlement of any alleged disputes. In addition, more than \$18 million due from various SPMs was withheld on April 15, 2005.

Significant Factor Determination for Calendar Year 2003. On March 27, 2006, The Brattle Group made its final determination, which final determination is publicly available, that the disadvantages experienced as a result of the MSA were a significant factor contributing to the Market Share Loss for calendar year 2003. The MSA Auditor had previously determined that the Market Share Loss in 2003 was 5.95%, reflecting the difference between the PMs' 99.58% 1997 market share and their 91.63% 2003 market share less 2%. Of the total 7.95% differential, The Brattle Group determined that 3% to 3.5% was attributable to the MSA and then compared 3% to 3.5% to 7.95% in making its significant factor determination. In a statement dated March 28, 2006, the Attorneys General of Iowa and Idaho, the co-chairs of the NAAG Tobacco Committee, stated, among other things, that the Settling States believe it would not be appropriate for a PM to withhold any portion of the April 2006 Annual Payment. According to the statement, the Settling States believe that the PMs must still prove to a court that the Settling States have not diligently enforced their Model Statutes and also believe that every Settling State will be found to have diligently enforced its Model Statute in 2003. It has been reported, however, that the general counsel of Reynolds American stated that he believes not all jurisdictions were diligently enforcing their Model Statutes.

Effect of Calendar 2003 NPM Adjustment Claim on 2006 Annual Payments. Philip Morris and Reynolds American believe that the size of the NPM Adjustment attributable to 2003 is approximately \$1.2 billion (representing a \$1.14 billion NPM Adjustment of approximately 17.85% of the 2004 Annual Payment, with interest). On March 31, 2006, Philip Morris made its full \$3.4 billion payment, even though it believes that payment should eventually be subject to downward adjustment by operation of the calendar 2003 NPM Adjustment, and it intends to continue to negotiate with the Settling States' Attorneys General for, and reserved its right to claim, a reduction of its payment. Lorillard paid approximately \$558 million of its 2006 Annual Payment on March 31, 2006 and deposited the balance of the 2006 Annual Payment, \$108 million, into the Disputed Payments Account pending final non appealable resolution of the diligent enforcement issue with respect to 2003. Additionally, Reynolds American paid approximately \$2.016 billion of its Annual Payment obligation for 2006, of which \$647 million was deposited in the Disputed Payment Account pending resolution of the diligent enforcement issue in 2003. According to the co-chairs of the NAAG Tobacco Committee, in a statement released on April 18, 2006, the Annual Payments paid by Lorillard and Reynolds American to the Settling States constitute about 82% of the amount that was due. The three SPMs from whom the largest payments were due made substantial payments. However, one of the three paid a portion of its payment to the Disputed Payments Account, and the other two each withheld a portion of the payment due from them. A majority of the Settling States have given notice to the PMs of each such Settling State's intent to commence enforcement proceedings under the MSA, compelling the PMs to make the 2006 Annual Payment without diminution for any NPM Adjustment so long as there has not yet been a final non-appealable resolution of the diligent enforcement issue for such Settling State for the year in question.

Vibo Corporation d/b/a General Tobacco, an SPM, paid \$96 million of its 2006 Annual Payment in April 2006 and paid the balance, \$11.5 million, in June 2006. General Tobacco reportedly maintains that it is entitled to a reduction based on the market share loss it experienced after joining the MSA, but has elected to make the full payments pending final adjudication regarding the actual final payments due.

In their April 18, 2006 statement, the co-chairs of the NAAG Tobacco Committee restated that the Settling States believe that no NPM Adjustment would be found to apply and, thus, the Settling States are entitled to receive the full payment due under the MSA. They stated that each Settling State has enacted a Model Statute, that the Settling States all believe they have diligently enforced their Model Statute, and that they will ultimately receive the money in dispute. The statement further stated that the issues of diligent enforcement are not subject to arbitration and will be litigated in the courts of each Settling State. Many of the Settling States have initiated legal action in their state courts to ensure full payment. On September 13, 2006, Reynolds American and certain other PMs sent letters to the Settling States that had not yet objected to arbitration of the NPM Adjustment or that had not yet filed legal proceedings relating to the dispute regarding a claimed NPM Adjustment for 2003 in their respective state courts. These letters stated that unless the Settling States indicated otherwise, it would be assumed that these Settling States would not object to such arbitration. All but one of the Settling States that received these letters responded that they would not agree to submit the dispute to arbitration and would oppose any effort to compel arbitration of the dispute. PMs have filed motions in the courts of each of these Settling States (except certain of the Territories) to compel arbitration.

Altria has reported that 38 states have instituted legal proceedings in their respective state courts against the PMs. They each claim that they diligently enforced their Qualifying Statute and request that the respective court enter a declaratory order finding that the 2006 Annual Payment is not subject to a 2003 NPM Adjustment, and that the PMs are not entitled to withhold or pay into the Disputed Payments Account any portion of the 2006 Annual Payment. They also assert that in June 2003, the OPMs unconditionally released the Settling States from all claims that they may have with respect to cigarettes sold or shipped from 1999 through 2002. As previously noted, the OPMs and the Settling States entered into agreements that resolved a variety of disputes relating to cigarette sales and MSA payments from 1999 through 2002. The Settling States maintain that, since an NPM Adjustment for 2003 would be based upon cigarettes sold or shipped in 2002, the release in the June 2003 agreements bars the OPMs from claiming an NPM Adjustment for 2003.

Calendar 2004 NPM Adjustment. In April 2006, the OPMs initiated NPM Adjustment proceedings seeking a downward adjustment of their annual payments under the MSA for 2004. It has been reported that the Brattle Group rendered its final determination on February 12, 2007 to the effect that the disadvantages experienced as a result of the MSA were a “significant factor” contributing to the Market Share Loss for calendar year 2004. Each Settling State may nonetheless avoid a downward adjustment to its share of the PMs’ annual payment for 2004 if it establishes that it diligently enforced a qualifying escrow statute during the entirety of 2004. Any downward adjustment is then potentially re-allocated to states that do not establish such diligent enforcement. It has been reported that the calendar year 2004 NPM Adjustment for the OPMs is approximately \$1.14 billion. There is no certainty that the PMs will ultimately receive any adjustment as a result of these proceedings. If the PMs do receive such an adjustment, the adjustment may be applied as a credit against future MSA payments and would be allocated among the PMs pursuant to the MSA’s provisions for allocation of the NPM Adjustment among the PMs. On March 30, 2007, Philip Morris reported that it made its full \$3.5 billion payment, which amount includes approximately \$400 million that Philip Morris disputes it owes by operation of the calendar 2004 NPM Adjustment. Philip Morris stated that it hoped that its full payment will facilitate an expeditious resolution of NPM Adjustment disputes, whether by settlement or by arbitration. Reynolds American and Lorillard, on the other hand, collectively paid approximately \$672 million of their aggregate 2007 annual payment into the Disputed Payments Account based on a claim of entitlement to an NPM Adjustment for 2004. Settlement discussions are currently ongoing between the Attorneys General of the Settling States and the OPMs in an attempt to effect a national settlement of both outstanding and subsequent NPM Adjustment claims, with the goal of replacing the current NPM Adjustment dispute resolution methodology with one that is more predictable and less subjective. Any such settlement in a given Settling State would have to be approved by such Settling State. Pursuant to the Act, the State has covenanted not to amend the MSA in any manner that may materially alter the rights of Bondholders.

Calendar 2005 NPM Adjustment. The PMs have reported that the Brattle Group on February 7, 2008 made its final “significant factor” determination to the effect that the disadvantages experienced as a result of the MSA were a “significant factor” contributing to the Market Share Loss for calendar year 2005. The Brattle Group determined that the MSA was a significant factor in explaining 3.9% points of a 5.6% point market share loss experienced by the PMs.

Resolution of Diligent Enforcement Disputes. As previously noted, any Settling State that adopts, maintains and diligently enforces its Qualifying Statute is exempt from the NPM Adjustment. The State has adopted the Model Statute (which is a Qualifying Statute under the MSA). No provision of the MSA, however, attempts to define what activities, if undertaken by a Settling State, would constitute diligent enforcement. Furthermore, the MSA does not explicitly state which party bears the burden of proving or disproving whether a Settling State has diligently enforced its Qualifying Statute, or whether any diligent enforcement dispute would be resolved in state courts or through arbitration. As of March 5, 2008, 47 of 48 state courts that have thus far considered the issue of whether a diligent enforcement dispute should be resolved in state courts or through arbitration have held in favor of the arbitration process. Thirty-three states have final orders compelling arbitration and 12 states have orders to compel arbitration that are at various stages of appellate review, including writs and appeals. Some of these courts have suggested that such an arbitration proceeding should be before a single national panel. On June 7, 2007, the North Dakota Supreme Court reversed the decision of the lower court and ruled that a diligent enforcement dispute should be resolved through arbitration. On the other hand, on May 31, 2007, a Louisiana trial court has concluded that such a dispute is not subject to arbitration. Certain of these decisions are the subject of appeals and, because the time period for taking appeals has not yet expired in all cases, further appeals can be expected. The State had initiated a proceedings against the PMs seeking, among other things, resolution of the diligent enforcement dispute

in the State. The trial court judge in that proceeding has ruled that the State is entitled to its own, separate arbitration on its diligent enforcement dispute with the PMs. The PMs have appealed the state court ruling approving a New York-specific arbitration and instead are seeking to have a single nationwide arbitration panel to determine a resolution of the diligent enforcement dispute between the PMs and all Settling States. As of February 16, 2008, 19 Settling States, not including the State, had reportedly agreed to a multi-state arbitration.

The MSA provides that arbitration, if required by the MSA, will be governed by the United States Federal Arbitration Act. The decision of an arbitration panel under the Federal Arbitration Act may only be overturned under limited circumstances, including a showing of a manifest disregard of the law by the panel. At the present time, there are hearings pending in many other states regarding whether arbitration is the appropriate forum for these disputes. Regardless of the forum in which a diligent enforcement dispute is heard, no assurance can be given as to how long it will take to resolve such a dispute with finality.

Effect of Complementary Legislation. At least 45 of the Settling States, including the State, have passed legislation (often termed “**Complementary Legislation**”) to further ensure that NPMs are making required escrow payments under the Qualifying Statutes.

Pursuant to the State’s Complementary Legislation, every tobacco product manufacturer whose cigarettes are sold directly or indirectly in the State is required to certify annually that it is either (a) a PM and is in full compliance with the terms of the MSA or (b) an NPM and is in full compliance with the State’s Qualifying Statute.

All of the OPMs and other PMs have provided written assurances that the Settling States have no duty to enact Complementary Legislation, that the failure to enact such a legislation will not be used in determining whether a Settling State has diligently enforced its Qualifying Statute pursuant to the terms of the MSA, and that the diligent enforcement obligations under the MSA shall not apply to the Complementary Legislation. In addition, the written assurances contain an agreement that the Complementary Legislation will not constitute an amendment to a Settling State’s Qualifying Statute. However, a determination that a Settling State’s Complementary Legislation is invalid may make enforcement of its Qualifying Statute more difficult, which could lead to an increase in the market share of NPMs, resulting in a reduction of Annual Payments and Strategic Contribution Fund Payments under the MSA. The Qualifying Statutes and related Complementary Legislation in many Settling States have been challenged on various constitutional grounds, including claims based on preemption by the federal antitrust laws. See “–Litigation Challenging the MSA, the Qualifying Statutes and Related Legislation” herein. See “SUMMARY OF THE MASTER SETTLEMENT AGREEMENT–MSA Provisions Relating to Model/Qualifying Statutes”.

Conclusion. Future NPM Adjustment claims remain possible for calendar year 2005, and all future years. Philip Morris, Reynolds American, and Lorillard have filed an NPM Adjustment claim for the year 2005. The PMs have reported that the Brattle Group on February 7, 2008 made its final “significant factor” determination to the effect that the disadvantages experienced as a result of the MSA were a “significant factor” contributing to the Market Share Loss for calendar year 2005. In addition, the “diligent enforcement” exemption afforded a Settling State is based on actual enforcement efforts for the calendar year preceding each Annual Payment, and could be disputed by a PM even after the final resolution of a diligent enforcement dispute related to a prior year. If the other preconditions to an NPM Adjustment exist for a given year, disputes regarding diligent enforcement for such year may be expected if the market share of the NPMs results in an NPM Adjustment that, absent the protection of the Qualifying Statutes, would apply.

Future NPM Adjustments could be as large as, or larger than, the reported potential \$1.2 billion calendar 2003 NPM Adjustment and \$1.14 billion calendar 2004 NPM Adjustment. Although a Settling State that diligently enforces its Qualifying Statute is exempt from the NPM Adjustment, many procedural uncertainties, as described above, still remain regarding the resolution of a dispute regarding diligent enforcement. A decision by the PMs to pay the amount of a claimed NPM Adjustment into the Disputed Payments Account or to withhold payment of such an amount pending the resolution of the dispute could lead to a decrease in the market value and/or the liquidity of the Series 2008 Bonds and could have a material adverse effect on the amounts of Pledged Settlement Payments available to the Corporation to make payments on the Series 2008 Bonds during such period. Should a PM be determined with finality to be entitled to an NPM Adjustment in a future year due to an absence of diligent enforcement of the Qualifying Statute by the State, the application of the NPM Adjustment could lead to a decrease

in the market value and/or the liquidity of the Series 2008 Bonds, and could also have a material adverse effect on the amount and/or timing of Pledged Settlement Payments available to the Corporation.

Altria has reported that a resolution of the NPM Adjustment disputes for the calendar years 2003, 2004 and 2005 are unlikely to occur prior to late 2008. Settlement discussions are currently ongoing between the Attorneys General of the Settling States and the OPMs in an attempt to effect a national settlement of both outstanding and subsequent NPM Adjustment claims, with the goal of replacing the current NPM Adjustment dispute resolution methodology with one that is more predictable and less subjective. Any such settlement in a given Settling State would have to be approved by such Settling State. Pursuant to the Act, the State has covenanted not to amend the MSA in any manner that may in any way impair the rights and remedies of the Bondholders or the security for the Bonds, until the Bonds, together with the interest thereon and all costs and expenses in connection with any action or proceedings by or on behalf of the Bondholders, are fully paid and discharged (provided, that nothing in the Act, the Series A Indenture or the Series B Indenture shall be construed to preclude the State's regulation of smoking and taxation and regulation of the sale of cigarettes or the like or to restrict the right of the State to amend, modify, repeal or otherwise alter statutes imposing or relating to the taxes). The structuring assumptions for the Series 2008 Bonds do not include any NPM Adjustments, nor do they include withholdings or Disputed Payment Account deposits relating to PM claims of entitlement to NPM Adjustments or any settlement of NPM Adjustment claims. See "SUMMARY OF SERIES A AND SERIES B PLEDGED SETTLEMENT PAYMENTS METHODOLOGY AND BOND STRUCTURING ASSUMPTIONS" herein.

*Disputed or Recalculated Payments and Disputes under the Terms of the MSA.* Miscalculations or recalculations by the MSA Auditor or disputed calculations by any of the parties to the MSA, such as those described above under "NPM Adjustment," have resulted and could in the future result in offsets to, or delays in disbursements of, payments to the Settling States pending resolution of the disputed item in accordance with the provisions of the MSA. By way of example, on August 30, 2004, one of the SPMs (Liggett) announced that it had notified the attorneys general of 46 states that it intended to initiate proceedings against the attorneys general for violating the terms of the MSA. It alleged that the attorneys general violated its rights and the MSA by extending unauthorized favorable financial terms to Miami-based Vibo Corporation d/b/a General Tobacco when, on August 19, 2004, the attorneys general entered into an agreement with General Tobacco allowing it to become an SPM. General Tobacco imports discount cigarettes manufactured in Colombia, South America. In the notice sent to the attorneys general, Liggett indicated that it would seek to enforce the terms of the MSA, void the agreement with General Tobacco and enjoin the Settling States and NAAG from listing General Tobacco as a PM on their websites. On August 18, 2005, Liggett and an additional four SPMs filed a motion to enforce the MSA in Kentucky. The Commonwealth of Kentucky filed its opposition, and the SPMs replied. General Tobacco intervened in the case and filed its opposition to the other SPMs' motion. The SPMs replied, and a hearing was held on the issue on November 8, 2005. On January 26, 2006 the court upheld the agreement by which General Tobacco became an SPM. An appeal was filed to the Kentucky Court of Appeals on February 14, 2006, and oral arguments were heard in March 2006. The Kentucky Court of Appeals, on August 24, 2007, upheld a lower court decision denying a motion that sought to void the 2004 Agreement that permitted General Tobacco to join the MSA.

Disputes concerning payments and their calculations may be raised up to four years after the respective Payment Due Date (as defined in the MSA). The resolution of disputed payments may result in the application of an offset against subsequent Annual Payments or Strategic Contribution Fund Payments. The diversion of disputed payments to the Disputed Payments Account, the withholding of all or a portion of any disputed amounts or the application of offsets against future payments could lead to a decrease in the market value and/or the liquidity of the Series 2008 Bonds, and could also have a material adverse effect on the amount and/or timing of Pledged Settlement Payments available to the Corporation. Amounts held in the Disputed Payments Account could be released to those Settling States which, in the future, are found to have diligently enforced their Model Statutes, or pursuant to a settlement of the disputes among the Settling States and the PMs. The structuring assumptions for the Series 2008 Bonds do not factor in an offset for miscalculated or disputed payments or any release of funds currently held in the Disputed Payments Account. See "SUMMARY OF THE MASTER SETTLEMENT AGREEMENT—Adjustments to Payments—*Offset for Miscalculated or Disputed Payments*" herein.

On June 3, 2005, the State of California filed an application in San Diego County Superior Court seeking an enforcement order against Bekenton USA, Inc. ("**Bekenton**"), to compel Bekenton to comply with its full payment obligations under the MSA. On June 29, 2005, Bekenton filed a motion to file a suit, alleging that the State

of California breached the Most Favored Nation (“MFN”) provisions of the MSA by allowing three other SPMs (Farmer’s Tobacco Co., General Tobacco, and Premier Manufacturing Incorporated) to join the MSA under more favorable terms. In a tentative ruling dated November 1, 2005, the Superior Court granted Bekenton’s motion to file suit based on this allegation. In its initial complaint, Bekenton had further alleged that: (1) California’s agreements with Farmer’s Tobacco, General Tobacco and Premier (the “**Three Agreements**”), which required them to make certain back payments (as required by the MSA) as a precondition to joining the MSA, permitted such back payments to be made on an extended time frame; and (2) this time frame effectively “relieved” Farmer’s Tobacco, General Tobacco and Premier of certain payment obligations as PMs. Bekenton claimed that it was entitled to a similar relief under another clause of the MSA (the “**Relief Clause**”), which requires that if any PM is relieved of a payment obligation, such relief becomes applicable to all of the PMs. In its November 1, 2005 tentative ruling, the Superior Court denied Bekenton’s motion to file suit under the Relief Clause, ruling that: (1) because the Three Agreements were preconditions to allowing Farmer’s Tobacco, General Tobacco and Premier to become PMs, these companies were not “PMs” for purposes of the Relief Clause; and (2) even if Farmer’s Tobacco, General Tobacco and Premier are PMs for purposes of the Relief Clause, the payment schedules in the Three Agreements did not relieve them of any obligations. On March 15, 2006, the Superior Court adopted the November 1, 2005 tentative ruling as its final order.

Bekenton is involved in similar disputes in Kentucky and Iowa. In the Kentucky case, Bekenton failed to make its full MSA payment of approximately \$7.7 million in April 2005, and, instead, paid only \$198,000, less than 3% of the total payment due. The Commonwealth of Kentucky commenced an action against Bekenton in which Bekenton claimed that under the Relief Clause it was entitled to reduce its payment as a consequence of Kentucky’s agreement with General Tobacco, which was similar to the agreement described above between the State of California and General Tobacco. On April 14, 2006, the court dismissed Bekenton’s claim for a reduction, holding that the Relief Clause was not applicable since the General Tobacco agreement did not relieve General Tobacco of any payment obligations.

In the Iowa case, the State of Iowa sought to de-list Bekenton as a PM for failing to comply with the MSA payment provisions and to prohibit Bekenton from doing business in Iowa for failing to comply with the escrow payment provisions of the Iowa Qualifying Statute. On August 11, 2005 an Iowa state court, finding that the MSA itself provides procedures for the resolution of disputes regarding MSA payments and that such procedures should be followed in this case, enjoined Iowa from “de-listing” Bekenton, permitting Bekenton to continue selling cigarettes in Iowa. In 2005, Bekenton also filed for bankruptcy relief.

“*Nicotine-Free*” Cigarettes. The MSA contemplates that the manufacturers of cigarettes will be either a PM or an NPM. The term “cigarette” is defined in the MSA to mean any product that contains tobacco and nicotine, is intended to be burned and is likely to be offered to, or purchased by, consumers as a cigarette and includes “roll-your-own” tobacco. Should a manufacturer develop a “nicotine-free” tobacco product (intended to be burned and likely to be offered to, or purchased by, consumers as a cigarette), such manufacturer would not be a manufacturer for purposes of the MSA. Sales of such a product could cause a reduction in Annual Payments and Strategic Contribution Fund Payments. In addition, if consumers used the product to quit smoking, it could reduce the size of the cigarette market. The capital costs required to establish a profitable cigarette manufacturing facility are relatively low and new cigarette manufacturers are less likely to be subject to frequent litigation than OPMs. Furthermore, the Qualifying Statutes would not cover a manufacturer of such “nicotine-free” products and such manufacturer would not be required to make escrow deposits in the same manner as the NPMs are so required. Vector Group has introduced QUEST, a tobacco product that is reportedly nicotine-free.

#### **Other Risks Relating to the MSA and Related Statutes**

*Severability.* Most of the major provisions of the MSA are not severable. If a court materially modifies, renders unenforceable or finds unlawful any non-severable provision, the attorneys general of the Settling States and the OPMs are required by the MSA to attempt to negotiate substitute terms. If, however, any OPM does not agree to the substitute terms, the MSA terminates in all Settling States affected by the court’s ruling. See “SUMMARY OF THE MASTER SETTLEMENT AGREEMENT–Severability” herein.

*Amendments, Waivers and Termination.* As a settlement agreement between the PMs and the Settling States, the MSA is subject to amendment in accordance with its terms, and may be terminated upon consent of the

parties thereto. Parties to the MSA, including the State, may waive the performance provisions of the MSA. The Corporation is not a party to the MSA; accordingly, the Corporation has no right to challenge any such amendment, waiver or termination. While the economic interests of the State and the Bondholders will presumably be the same in many circumstances, no assurance can be given that such an amendment, waiver or termination of the MSA would not have a material adverse effect on the Corporation's ability to make payments to the Bondholders. The State has agreed, pursuant to the Act, that it shall neither amend the MSA nor the Consent Decree or take any other action in any way that would materially adversely in any way impair the rights and remedies of the Bondholders or the security for the Bonds, until the Bonds, together with the interest thereon and all costs and expenses in connection with any action or proceedings by or on behalf of the Bondholders, are fully paid and discharged (provided, that nothing in the Act, the Series A Indenture or the Series B Indenture shall be construed to preclude the State's regulation of smoking and taxation and regulation of the sale of cigarettes or the like or to restrict the right of the State to amend, modify, repeal or otherwise alter statutes imposing or relating to the taxes). See "SUMMARY OF THE MASTER SETTLEMENT AGREEMENT—Amendments and Waivers" herein.

*Reliance on State Enforcement of the MSA and State Non-Impairment.* The State may not convey and has not conveyed to the Corporation or the Bondholders any right to enforce the terms of the MSA. Pursuant to its terms, the MSA, as it relates to the State, can only be enforced by the State. The State has agreed, pursuant to the Act, that it shall neither amend the MSA nor the Consent Decree or take any other action in any way that would materially adversely alter, limit or impair the Corporation's right to receive Series A Pledged Settlement Payments and Series B Pledged Settlement Payments; however, no assurance can be given that the State will enforce any particular provision of the MSA. Failure to do so may have a material adverse effect on the Corporation's ability to make payments to the Bondholders. It is also possible that the State could attempt to claim some or all of the Series A Pledged Settlement Payments and the Series B Pledged Settlement Payments for itself or otherwise interfere with the security for the Series 2008 Bonds. In that event, the Bondholders, the Trustee or the Corporation may assert claims based on contractual, fiduciary or constitutional rights, but no prediction can be made as to the disposition of such claims. See "LEGAL CONSIDERATIONS RELATING TO SERIES A PLEDGED SETTLEMENT PAYMENTS AND SERIES B PLEDGED SETTLEMENT PAYMENTS" herein.

### **Bankruptcy of a PM May Delay, Reduce, or Eliminate Payments of Pledged Settlement Payments**

The only significant source of payment for the Bonds is the Series A Pledged Settlement Payments and the Series B Pledged Settlement Payments that are paid by the PMs. Therefore, if one or more PMs were to become a debtor in a case under Title 11 of the United States Code (the "**Bankruptcy Code**"), there could be delays in or reductions or elimination of payments on the Series 2008 Bonds, and Bondholders and beneficial owners of the Series 2008 Bonds could incur losses on their investments. Philip Morris, by way of example, prior to the resolution of the dispute in the *Price* case in Illinois in the spring of 2003 over the size of the required appeal bond, had publicly stated that it would not have been possible for it to post the \$12 billion bond initially ordered by the trial judge. Philip Morris also publicly stated at that time that there was a risk that immediate enforcement of the judgment would force a bankruptcy. Certain SPMs, including Cutting Edge Enterprises, Inc. and Carolina Tobacco Company have filed for bankruptcy relief. In the case of *Cutting Edge Enterprises Inc. v. National Association of Attorneys General*, several state attorneys general were defendants in an action in federal court in the Southern District of New York where Cutting Edge, a PM, sought to cause the National Association of Attorneys General and the respective states to list the PM's brands which had been purchased from a NPM on their respective web sites, alleging that their refusal to do so violates federal antitrust laws, the Commerce Clause, and laws prohibiting tortious interference with business relations. The court dismissed this case on March 6, 2007 for lack of personal jurisdiction and the appeal period has expired. Having filed a voluntary petition in bankruptcy on April 16, 2007, Cutting Edge as debtor-in-possession has filed similar claims that are now pending against the same defendants in the U.S. Bankruptcy Court for the Middle District of North Carolina. In the bankruptcy case of Carolina Tobacco Company, the court temporarily stayed the enforcement of the states' claims against Carolina Tobacco Company and required that it not be eliminated from the states' Attorney General's list of approved manufacturers. The bankruptcy court has given Carolina Tobacco Company an extension of time to make its past due and current NPM Payments.

In the event of the bankruptcy of a PM, unless approval of the bankruptcy court is obtained, the automatic stay provisions of the Bankruptcy Code could prevent any action by the State, the Corporation, the Trustee, the Bondholders, or the beneficial owners of the Series 2008 Bonds to collect any Pledged Settlement Payments or any

other amounts owing by the bankrupt PM. In addition, even if the bankrupt PM wanted to continue paying Pledged Tobacco Assets, it could be prohibited as a matter of law from making such payments. In particular, if it were to be determined that the MSA was not an “executory contract” under the Bankruptcy Code, then the PM may be unable to make further payments of Pledged Settlement Payments. If the MSA is determined in a bankruptcy case to be an “executory contract” under the Bankruptcy Code, the bankrupt PM may be able to repudiate the MSA and stop making payments under it. Furthermore, payments previously made to the Bondholders or the beneficial owners of the Bonds could be avoided as preferential payments, so that the Bondholders and the beneficial owners of the Bonds would be required to return such payments to the bankrupt PM. Also, the bankrupt PM may have the power to alter the terms of its payment obligations under the MSA without the consent, and even over the objection of the State, the Corporation, the Trustee, the Bondholders, or the beneficial owners of the Bonds. Finally, while there are provisions of the MSA that purport to deal with the situation when a PM goes into bankruptcy (including provisions regarding the termination of that PM’s obligations – see “SUMMARY OF THE MASTER SETTLEMENT AGREEMENT–Termination of Agreement”), such provisions may be unenforceable. There may be other possible effects of a bankruptcy of a PM that could result in delays or reductions or elimination of payments to the Bondholders or the beneficial owners of the Bonds. Regardless of any specific adverse determination in a PM bankruptcy proceeding, the fact of a PM bankruptcy proceeding could have an adverse effect on the timing of receipt, amount and value of the Series A Pledged Settlement Payments and the Series B Pledged Settlement Payments, could have an adverse effect on the liquidity and value of the Series 2008 Bonds. For a further discussion of certain bankruptcy issues, see “LEGAL CONSIDERATIONS RELATING TO SERIES A PLEDGED SETTLEMENT PAYMENTS AND SERIES B PLEDGED SETTLEMENT PAYMENTS” herein.

### **The Obligations of the State Pursuant to each of the Series A Contract and the Series B Contract**

Each of the Series A Contract and the Series B Contract contains the agreement of the Director of the Budget on behalf of the State, subject to the making of annual appropriations therefor by the State Legislature, to make payments to the Corporation in an amount equal to the amount of the principal of and interest on the Series 2008 Bonds, as the same shall become due in the event that amounts on deposit in each of the Series A Pledged Accounts and the Series B Pledged Accounts are insufficient therefor. The obligation of the State to fund or to pay the amounts provided for by each of the Series A Contract and the Series B Contract: (i) is subject to and dependent upon annual appropriations being made by the State Legislature for such purpose, (ii) shall not constitute a debt of the State within the meaning of any constitutional or statutory provision, and (iii) shall be deemed executory only to the extent of moneys available to the State therefor; and no liability shall be incurred by the State beyond the moneys available for the purposes thereof. The State Legislature is not obligated to make appropriations to satisfy the State’s obligations under each of the Series A Contract and the Series B Contract and there can be no assurance that the State Legislature will make any such appropriations. See “SUMMARY OF THE SERIES A CONTRACT” and “SUMMARY OF THE SERIES B CONTRACT” above.

### **Limited Resources of the Corporation**

The Series 2008A Bonds are payable only from the assets of the Corporation, including Series A Contract Payments, pledged under the Series A Indenture. In the event that such assets of the Corporation have been exhausted, no amounts will thereafter be available to be paid on the Series 2008A Bonds. The Series 2008A Bonds are not legal or moral obligations of the State, and no recourse may be had with respect thereto for payment of amounts owing on the Series 2008A Bonds. Investors in the Series 2008A Bonds must look solely to the assets of the Corporation pledged under the Series A Indenture for repayment of their investment. The Corporation’s only sources of funds for payments on the Series 2008A Bonds are the Series A Pledged Revenues. The proceeds of the Series 2008A Bonds will be applied to establish an irrevocable escrow to refund the Series 2003A Refunded Bonds, and will not be available to pay debt service on Series 2008A Bonds. The Corporation has no taxing power and no assets are available to pay Series 2008A Bonds other than the assets acquired pursuant to the Series A Sale Agreement, pledged under the Series A Indenture and payments received under the Series A Contract. No assets of the State are pledged to secure or will be available to pay debt service on the Series 2008A Bonds. The Series 2008B Bonds are payable only from the assets of the Corporation, including Series B Contract Payments, pledged under the Series B Indenture. In the event that such assets of the Corporation have been exhausted, no amounts will thereafter be available to be paid on the Series 2008B Bonds. The Series 2008B Bonds are not legal or moral obligations of the State, and no recourse may be had with respect thereto for payment of amounts owing on the Series 2008B Bonds. Investors in the Series 2008B Bonds must look solely to the assets of the Corporation



pledged under the Series B Indenture for repayment of their investment. The Corporation's only sources of funds for payments on the Series 2008B Bonds are the Series B Pledged Revenues. The proceeds of the Series 2008B Bonds will be applied to establish an irrevocable escrow to refund the Series 2003B Refunded Bonds, and will not be available to pay debt service on Series 2008B Bonds. The Corporation has no taxing power and no assets are available to pay Series 2008B Bonds other than the assets acquired pursuant to the Series B Sale Agreement, pledged under the Series B Indenture and payments received under the Series B Contract. No assets of the State are pledged to secure or will be available to pay debt service on the Series 2008B Bonds.

### **Limited Remedies**

The Trustee is limited under the terms of the Series A Sale Agreement to enforcing the terms of the agreement and to receiving the Series A Pledged Settlement Payments and applying them in accordance with the Series A Indenture. If a Series A Event of Default occurs, the Trustee cannot sell its rights under the Series A Sale Agreement. The Corporation is not a party to the MSA and has not made any representation or warranty that the MSA is enforceable. Remedies under the Series A Sale Agreement do not include the repurchase by the State of the Series A Pledged Settlement Payments under any circumstances, including unenforceability of the MSA, the Model Statute or breach of any representation or warranty. The remedies of the Series 2008A Bondholders are no greater than those afforded to the Trustee. The Trustee is limited under the terms of the Series B Sale Agreement to enforcing the terms of the agreement and to receiving the Series B Pledged Settlement Payments and applying them in accordance with the Series B Indenture. If a Series B Event of Default occurs, the Trustee cannot sell its rights under the Series B Sale Agreement. The Corporation is not a party to the MSA and has not made any representation or warranty that the MSA is enforceable. Remedies under the Series B Sale Agreement do not include the repurchase by the State of the Series B Pledged Settlement Payments under any circumstances, including unenforceability of the MSA, the Model Statute or breach of any representation or warranty. The remedies of the Series 2008B Bondholders are no greater than those afforded to the Trustee.

### **IRS Audit**

The Internal Revenue Service (the "IRS") examined several outstanding tax-exempt bond issues secured by tobacco settlement revenues. The IRS closed its examinations of the three earliest tax-exempt bond issues of this type with no change in the tax-exempt status of the interest on such bonds under Section 103 of the Code. Other pending or future IRS audits of tax-exempt bonds of this type or others, however, could have an adverse effect on the market for or the market price of the Series 2008 Bonds. See "TAX MATTERS."

### **LEGAL CONSIDERATIONS RELATING TO SERIES A PLEDGED SETTLEMENT PAYMENTS AND SERIES B PLEDGED SETTLEMENT PAYMENTS**

The following discussion summarizes some, but not all, of the possible legal issues that could affect the Series 2008 Bonds. The discussion does not address every possible legal challenge that could result in a decision that would cause the Series A Pledged Settlement Payments and the Series B Pledged Settlement Payments to be reduced or eliminated. References in the discussion to various opinions of Hawkins Delafield & Wood LLP are incomplete summaries of such opinions and are qualified in their entirety by reference to the actual opinions.

#### **Bankruptcy of a PM May Delay or Reduce Payments**

Because a significant source of payment for the Series 2008 Bonds (other than amounts in the Series A Debt Service Reserve Accounts, the Series B Debt Service Reserve Accounts and interest earnings) are the Series A Pledged Settlement Payments and the Series B Pledged Settlement Payments paid by the PMs, if one or more PMs were to become a debtor in a case under the Bankruptcy Code, there could be delays or reductions in or elimination of the Series A Pledged Settlement Payments and the Series B Pledged Settlement Payments. See "BONDHOLDERS' RISKS — Bankruptcy of a PM May Delay, Reduce, or Eliminate Payments of Pledge Settlement Revenue" herein.

In the event of a bankruptcy of a PM, the automatic stay provisions of the Bankruptcy Code could prevent (unless approval of the bankruptcy court was obtained) any action by the State, the Corporation, the Trustee, the

Bondholders, or the beneficial owners of the Bonds to collect any Series A Pledged Settlement Payments or Series B Pledged Settlement Payments or any other amounts owing by the bankrupt PM. In addition, even if the bankrupt PM wanted to continue making the required payments to the State pursuant to the MSA, it could be prohibited as a matter of law from making such payments. In particular, if it were to be determined that the MSA was not an “executory contract” under the Bankruptcy Code, then the PM may be unable to make such further payments. Hawkins Delafield & Wood LLP will render an opinion to each Rating Agency that, subject to all the assumptions, qualifications, and limitations set forth therein, if an OPM were to become the debtor in a case under the Bankruptcy Code, and the matter were properly briefed and presented to a federal court with jurisdiction over such bankruptcy case, the court, exercising reasonable judgment after full consideration of all relevant factors, would hold that the MSA is an “executory contract” under Section 365 of the Bankruptcy Code. Certain of the assumptions contained in this opinion will be assumptions that certain facts or circumstances will exist or occur, and Hawkins Delafield & Wood LLP cannot provide any assurance that such facts or circumstances will exist or occur as assumed in the opinion. This opinion will be based on an analysis of existing laws and court decisions, and will cover certain matters not directly addressed by such authorities. There are no court decisions directly on point, there are court decisions that could be viewed as contrary to the conclusions expressed in the opinion, and the matter is not free from doubt. Accordingly, no assurance can be given that a particular court would not hold that the MSA is not an executory contract, thus resulting in delays or reductions in, or elimination of, the Series A Pledged Settlement Payments and the Series B Pledged Settlement Payments.

If the MSA is an “executory contract” under the Bankruptcy Code, the bankrupt PM may be able to repudiate the MSA and stop making payments under it, thus resulting in delays or reductions in, or elimination of, the Series A Pledged Settlement Payments and the Series B Pledged Settlement Payments.

Furthermore, payments previously made to the Bondholders and the beneficial owners of the Bonds could be avoided as preferential payments, so that the Bondholders and the beneficial owners of the Bonds would be required to return such payments to the bankrupt PM. Also, the bankrupt PM may have the power to alter the terms of its payment obligations under the MSA without the consent, and even over the objection, of the State, the Corporation, the Trustee, the Bondholders or the beneficial owners of the Bonds. Finally, while there are provisions of the MSA that purport to deal with the situation when a PM goes into bankruptcy (see “SUMMARY OF THE MASTER SETTLEMENT AGREEMENT- Termination of Agreement”), such provisions may be unenforceable. There may be other possible effects of a bankruptcy of a PM that could result in delays or reductions in, or elimination of, the Series A Pledged Settlement Payments and the Series B Pledged Settlement Payments. Regardless of any specific adverse determination in a PM bankruptcy proceeding, the fact of a PM bankruptcy proceeding could have an adverse effect on the liquidity or value of the Series 2008 Bonds.

### **MSA Enforceability**

Most of the major provisions of the MSA are not severable. If a court materially modifies, renders unenforceable or finds unlawful any nonseverable provision, the attorneys general of the Settling States and the OPMs are required by the MSA to attempt to negotiate substitute terms. However, if any OPM does not agree to the substitute terms, the MSA would terminate in all Settling States affected by the court’s ruling. Even if substitute terms are agreed upon, payments under such terms may be less than payments under the MSA and could reduce the amount available to pay the principal of and interest on the Series 2008 Bonds.

Certain cigarette manufacturers, cigarette importers, cigarette distributors, Native American tribes and smokers’ rights organizations have filed actions against some, and in certain cases all, of the signatories to the MSA alleging, among other things, that the MSA violates provisions of the United States Constitution, federal antitrust laws, federal civil rights laws, state constitutions, state consumer protection laws and unfair competition laws, which actions, if ultimately successful, could result in a determination that the MSA is void or unenforceable. The lawsuits seek, among other things, an injunction against one or more of the Settling States from collecting any money under the MSA and barring the PMs from collecting cigarette price increases related to the MSA or a determination that the MSA is void or unenforceable. To date, such challenges have not been ultimately successful, although four cases (*Grand River*, *Freedom Holdings*, *Xcaliber* and *A.B. Coker*) have survived pre-trial motions to dismiss and have proceeded to a stage of litigation where the ultimate outcome may be determined in part by findings of fact based on extrinsic evidence as to the operation and impact of the MSA and appeals are pending or still possible in certain other cases. The terms of the MSA are currently being challenged and may continue to be challenged in the

future. A determination by a court that a non-severable provision of the MSA is void or voidable would, in the absence of an agreement to a substitute term as described above, result in the termination of the MSA in any Settling States affected by the court's ruling. Accordingly, an adverse court ruling could lead to a complete loss of the Series A Pledged Settlement Payments and the Series B Pledged Settlement Payments. See "BONDHOLDERS' RISKS — Litigation Challenging the MSA, the Qualifying Statutes and Related Legislation" herein.

In rendering the opinions described below, Hawkins Delafield & Wood LLP considered the claims asserted in the federal and state actions described above under the caption "BONDHOLDERS' RISKS — Litigation Challenging the MSA, the Qualifying Statutes and Related Legislation" that it believes are representative of the legal theories that an opponent of the MSA would advance in an attempt to invalidate the MSA. Subject to the assumptions and qualifications set forth below, Hawkins Delafield & Wood LLP will render an opinion to each Rating Agency that, subject to all the assumptions, qualifications and limitations set forth therein, and although there can be no assurances that a court applying existing legal principles would not hold otherwise, a court applying existing legal principles to the facts would find the MSA to be a valid and enforceable agreement among the states and the tobacco companies who are parties thereto. This opinion as to the enforceability of the MSA and the obligations of the aforementioned signatories is also subject to the effect of bankruptcy, insolvency, and other laws affecting creditors' rights or remedies and general principles of equity, regardless of whether such enforceability is considered in a proceeding in equity or at law.

### **Qualifying Statute Constitutionality**

The Qualifying Statutes and related legislation, like the MSA, have also been the subject of litigation in cases alleging that the Qualifying Statutes and related legislation violate certain provisions of the federal and state constitutions or are preempted by federal antitrust laws. The lawsuits seek, among other things, injunctions against the enforcement of the Qualifying Statutes and related legislation. To date such challenges have not been ultimately successful, although the enforcement of Allocable Share Release Amendments has been preliminarily enjoined in New York and certain other states. Appeals are pending or still possible in certain cases. The Qualifying Statutes and related legislation may also continue to be challenged in the future. Although a determination that the Qualifying Statute is unconstitutional would have no effect on the enforceability of the MSA, such a determination could have an adverse effect on payments to be made under the MSA if an NPM were to gain market share in the future and there occurred the requisite impact on the market share of PMs under the MSA. See "BONDHOLDERS' RISKS — Litigation Challenging the MSA, the Qualifying Statutes and Related Legislation" herein.

In rendering the opinion described below, Hawkins Delafield & Wood LLP considered the claims asserted in the federal and state actions described above under the caption "BONDHOLDERS' RISKS - Litigation Challenging the MSA, the Qualifying Statutes and Related Legislation" that it believes are representative of the legal theories that an opponent of the State's Qualifying Statute would advance in an attempt to invalidate the State's Qualifying Statute. Subject to the assumptions and qualifications set forth below, Hawkins Delafield & Wood LLP will render an opinion to each Rating Agency to the effect that, subject to all the facts, assumptions and qualifications set forth therein, and although there can be no assurance that a court applying existing legal principles would not hold otherwise, if the matter were properly briefed and presented to a court, the court applying existing legal principles to the facts would find the State's Qualifying Statute to be valid, enforceable and constitutional in all material respects. In rendering its opinion, Hawkins Delafield & Wood LLP will rely upon a letter from counsel to the OPMs confirming that the OPMs would not dispute that the State's Qualifying Statute constitutes a "model statute" under the MSA.

### **Limitations on Opinions of Counsel; No Assurance as to Outcome of Litigation**

A court's decision regarding the matters upon which a lawyer is opining would be based on such court's own analysis and interpretation of the factual evidence before it and of applicable legal principles. Thus, if a court reached a result different from that expressed in an opinion, such as that the MSA is void or voidable or that the State's Qualifying Statute is unenforceable, it would not necessarily constitute reversible error or be inconsistent with that opinion. An opinion of counsel is not a prediction of what a particular court (including any appellate court) that reached the issue on the merits would hold, but, instead, is the opinion of such counsel as to the proper result to be reached by a court applying existing legal rules to the facts as properly found after appropriate briefing and argument and, in addition, is not a guarantee, warranty or representation, but rather reflects the informed

professional judgment of such counsel as to specific questions of law. Opinions of counsel are not binding on any court or party to a court proceeding. The descriptions of the opinions set forth herein are summaries, do not purport to be complete and are qualified in their entirety by the opinions themselves.

### **Enforcement of Rights to Series A Pledged Settlement Payments and Series B Pledged Settlement Payments**

It is possible that the State could in the future attempt to claim some or all of the Series A Pledged Settlement Payments and the Series B Pledged Settlement Payments for itself, or otherwise interfere with the security for the Series 2008 Bonds. In that event, the Series 2008 Bondholders, the Trustee, or the Corporation, could assert claims based on contractual, fiduciary or constitutional rights, but no prediction can be made as to the disposition of such claims.

*Contractual Remedies.* The State, in each of the Series A Sale Agreement and the Series B Sale Agreement, has covenanted and agreed with the Corporation that it shall: (i) irrevocably direct, through the Attorney General, the independent auditor and the escrow agent under the MSA to transfer all Pledged Settlement Payments directly to the Trustee, (ii) enforce, at the expense of the State, its right to collect all monies due from the PMs under the MSA, (iii) diligently enforce, at the expense of the State, the Qualifying Statute as contemplated in section IX(d)(2)(B) of the MSA against all tobacco product manufacturers selling tobacco products in the State that are not in compliance with the Qualifying Statute, in each case in the manner and to the extent deemed necessary in the judgment of the Attorney General, provided, however, as stated in each of the Series A Sale Agreement and the Series B Sale Agreement, (a) that the remedies available to the Corporation and the Bondholders for any breach of the pledges and agreements of the State set forth in this clause (iii) shall be limited to injunctive relief, and (b) that the State shall be deemed to have diligently enforced the Qualifying Statute so long as there has been no judicial determination by a court of competent jurisdiction in the State, in an action commenced by a PM under the MSA, that the State has failed to diligently enforce the Qualifying Statute for the purposes of section IX(d)(2)(B) of the MSA, (iv) neither amend the MSA nor the Consent Decree or take any other action in any way that would materially adversely (a) alter, limit or impair the Corporation's right to receive Series A Pledged Settlement Payments and Series B Pledged Settlement Payments, or (b) limit or alter the rights vested by the Act, the Series A Indenture and the Series B Indenture in the Corporation to fulfill the terms of its agreements with the Bondholders, or (c) in any way impair the rights and remedies of the Bondholders or the security for the Bonds, until the Bonds, together with the interest thereon and all costs and expenses in connection with any action or proceedings by or on behalf of the Bondholders, are fully paid and discharged (provided, that nothing in the Act, the Series A Indenture or the Series B Indenture shall be construed to preclude the State's regulation of smoking and taxation and regulation of the sale of cigarettes or the like or to restrict the right of the State to amend, modify, repeal or otherwise alter statutes imposing or relating to the taxes), and (v) not amend, supersede or repeal the Qualifying Statute and the Complementary Legislation in any way that would materially adversely affect the rights of, the Corporation or the Bondholders. Notwithstanding these pledges and agreements by the State, the Attorney General may in his or her discretion enforce any and all provisions of the MSA without limitation. The Trustee, as assignee under the Indenture of certain of the Corporation's rights under each of the Series A Sale Agreement and the Series B Sale Agreement, could seek to compel the State to enforce its payment rights under the MSA if the State failed to do so contrary to its covenant in each of the Series A Sale Agreement and the Series B Sale Agreement to cause each of the Series A Pledged Settlement Receipts and the Series B Pledged Settlement Receipts, respectively, to be collected. The Act authorizes the inclusion of these covenants in each of the Series A Sale Agreement and the Series B Sale Agreement and in the Indenture.

*Constitutional Claims.* The Series 2008 Bondholders are further entitled to the benefit of the prohibitions in the United States Constitution's Contract Clause (the "**Contract Clause**") against any state's impairment of the obligation of contracts. This prohibition, although not absolute, is particularly strong when applied to a state's attempt to evade its own obligations.

Generally, based on the U.S. Supreme Court's standard of review for Contract Clause challenges in *Energy Reserves Group, Inc. v. Kansas Power & Light Co.*, 459 U.S. 400 (1983), a state must justify the exercise of its inherent police powers to safeguard the vital interests of its people before it may enact legislation that substantially impairs contractual relationships. In those instances, however, where a state's own contractual obligations involving financing will be substantially impaired, the U.S. Supreme Court applies a stricter standard of judgment to a state's actions due to the risk that a state's self interest rather than any public necessity will be the motivation for its actions.

Indeed, in *United States Trust Company of New York v. New Jersey*, 431 U.S. 1 (1977), the U.S. Supreme Court noted that only once in an entire century had the U.S. Supreme Court upheld the alteration of a municipal bond contract. Thus, in order for the State to justify legislation that substantially impairs the contractual rights of the Series 2008 Bondholders to be paid from the Series A Pledged Settlement Payments and the Series B Pledged Settlement Payments, respectively, the State not only must demonstrate a significant and legitimate public purpose, such as the remedying of a broad and general social or economic problem, but must also demonstrate that its actions under such circumstances satisfy the U.S. Supreme Court's strict standard of judgment employed in *United States Trust Company*.

### **No Assurance as to the Outcome of Litigation**

With respect to all matters of litigation that have been brought and may in the future be brought against the PMs, or involving the enforceability or constitutionality of the MSA and/or the State's related legislation or the enforcement of the right to the Series A Pledged Settlement Payments and the Series B Pledged Settlement Payments or otherwise filed in connection with the tobacco industry, the outcome of such litigation, in general, cannot be determined with certainty and depends, among other things, on (i) the issues being appropriately presented and argued before the courts (including the applicable appellate courts) and (ii) on the courts, having been presented with such issues, correctly applying applicable legal principles in reaching appropriate decisions regarding the merits. In addition, the courts may, in their exercise of equitable jurisdiction, reach judgments based not upon the legal merits but upon a balancing of the equities among the parties. Accordingly, no assurance can be given as to the outcome of any such litigation and any adverse outcome in any such litigation could have a material and adverse impact on the amounts available to the Corporation to pay the principal of and interest on the Series 2008 Bonds.

### **SUMMARY OF THE MASTER SETTLEMENT AGREEMENT**

*The following is a brief summary of certain provisions of the MSA. This summary is not complete and is subject to, and qualified in its entirety by reference to, the copy of the MSA which is attached hereto as APPENDIX C.*

#### **General**

The MSA is an industry wide settlement of litigation between the Settling States including the State and the OPMs and was entered into between the attorneys general of the Settling States and the OPMs on November 23, 1998. The MSA provides for other tobacco companies (the "SPMs") to become parties to the MSA. The three OPMs together with the 53 SPMs are referred to as the "PMs." The settlement represents the resolution of a large potential financial liability of the PMs for smoking related injuries, the costs of which have been borne and will likely continue to be borne by cigarette consumers. Pursuant to the MSA, the Settling States agreed to settle all their past, present and future smoking related claims against the PMs in exchange for agreements and undertakings by the PMs concerning a number of issues. These issues include, among others, making payments to the Settling States, abiding by more stringent advertising restrictions and funding educational programs, all in accordance with the terms and conditions set forth in the MSA. Distributors of PMs' products are also covered by the settlement of such claims to the same extent as the PMs.

#### **Parties to the MSA**

The Settling States are all of the states, territories and the District of Columbia, except for the four states (Florida, Minnesota, Mississippi and Texas) that separately settled with the OPMs prior to the adoption of the MSA (the "Previously Settled States"). According to the National Association of Attorneys General ("NAAG"), as of March 7, 2008, 56 PMs were parties to the MSA. The chart below identifies each of the PMs which was a party to the MSA as of March 7, 2008:

OPMs	SPMs	
Lorillard Tobacco Company Philip Morris, USA (formerly Philip Morris Incorporated) Reynolds American, Inc. (formerly R.J. Reynolds Tobacco Company and Brown & Williamson Tobacco Corporation)	Bekenton, S.A.† Canary Islands Cigar Co. Caribbean-American Tobacco Corp. (CATCORP) Chancellor Tobacco Company, UK Ltd. Commonwealth Brands, Inc. Cutting Edge Enterprises, Inc. † Daughters & Ryan, Inc. M/s. Dhanraj International† Eastern Company S.A.E. Ets L Lacroix Fils NV S.A. (Belgium) Farmer’s Tobacco Co. of Cynthiana, Inc. General Jack’s Incorporated General Tobacco (Vibo Corporation d/b/a General Tobacco) House of Prince A/S Imperial Tobacco Limited/ITL (USA) Limited Imperial Tobacco Limited/ITL (UK) Imperial Tobacco Mullingar (Ireland) Imperial Tobacco Polska S.A. (Poland) Imperial Tobacco Production Ukraine Imperial Tobacco Sigara ve Tutunculuk Sanayi Ve Ticaret S.A. (Turkey) International Tobacco Group (Las Vegas), Inc. Japan Tobacco International USA, Inc. King Maker Marketing Konci G&D Management Group (USA) Inc. Kretek International Lane Limited Liberty Brands, LLC† Liggett Group, Inc.	Lignum-2, Inc. Mac Baren Tobacco Company A/S Monte Paz (Compania Industrial de Tabacos Monte Paz S.A.) NASCO Products Inc. OOO Tabaksfacrik Reemtsma Wolga (Russia) P.T. Djarum Pacific Stanford Manufacturing Corporation Peter Stokkebye Tobaksfabrik A/S Planta Tabak-manufaktur GmbH & Co. Poschl Tabak GmbH & Co. KG Premier Manufacturing Incorporated Reemtsma Cigarettenfabriken GmbH (Reemtsma) Santa Fe Natural Tobacco Company, Inc. Sherman’s 1400 Broadway N.Y.C. Inc. Societe National d’Exploitation Industrielle des Tabacs et Allumettes (SEITA) Tabacalera del Este, S.A. (TABESA) Top Tobacco, LP U.S. Flue-Cured Tobacco Growers, Inc. Van Nelle Tabak Nederland B.V. (Netherlands) Vector Tobacco Inc. (formerly Vector Tobacco Inc. and Medallion Company, Inc.) Virginia Carolina Corporation, Inc. Von Eicken Group Wind River Tobacco Company, LLC VIP Tobacco USA, LTD. (formerly Winner Sales Company) ZNF International, LLC (no current brands)

The MSA restricts PMs from transferring their tobacco product brands, cigarette product formulas and cigarette businesses (unless they are being transferred exclusively for use outside the United States) to any entity that is not a PM under the MSA, unless the transferee agrees to assume the obligations of the transferring PM under the MSA related to such brands, formulas or businesses. The MSA expressly provides that the payment obligations of each PM are not the obligation or responsibility of any affiliate of such PM and, further, that the remedies, penalties or sanctions that may be imposed or assessed in connection with a breach or violation of the MSA will only apply to the PMs and not against any other person or entity. Obligations of the SPMs, to the extent that they differ from the obligations of the OPMs, are described below under “Subsequent Participating Manufacturers” herein.

### Scope of Release

Under the MSA, the PMs and the other Released Parties, as defined below, are released from:

- claims based on past conduct, acts or omissions (including any future damages arising therefrom) in any way relating to the use, sale, distribution, manufacture, development, advertising,

† Has filed for bankruptcy relief.

marketing or health effects of, or exposure to, or research statements or warnings regarding, tobacco products; and

- monetary claims based on future conduct, acts or omissions in any way relating to the use of or exposure to tobacco products manufactured in the ordinary course of business, including future claims for reimbursement of healthcare costs.

This release is binding upon each Settling State and any of its past, present and future agents, officials acting in their official capacities, legal representatives, agencies, departments, commissions and divisions. The MSA is further stated to be binding on the following persons, to the full extent of the power of the signatories to the MSA to release past, present and future claims on their behalf: (i) any Settling State's subdivisions (political or otherwise, including, but not limited to, municipalities, counties, parishes, villages, unincorporated districts and hospital districts), public entities, public instrumentalities and public educational institutions; and (ii) persons or entities acting in a *parens patriae*, sovereign, quasi sovereign, private attorney general, *qui tam*, taxpayer, or any other capacity, whether or not any of them participate in the MSA (a) to the extent that any such person or entity is seeking relief on behalf of or generally applicable to the general public in such Settling State or the people of such Settling State, as opposed solely to private or individual relief for separate and distinct injuries, or (b) to the extent that any such entity (as opposed to an individual) is seeking recovery of healthcare expenses (other than premium or capitation payments for the benefit of present or retired state employees) paid or reimbursed, directly or indirectly, by a Settling State. All such persons or entities are referred to collectively in the MSA as "**Releasing Parties.**"

To the extent that the Attorney General of the State does not have the power or authority to bind any of the State Releasing Parties, the release of claims contemplated by the MSA may be ineffective as to the Releasing Parties and any amounts that become payable by the PMs on account of their claims, whether by way of settlement, stipulated judgment or litigated judgment, will trigger the Litigating Releasing Parties Offset. See "Adjustments to Payments" below.

The release inures to the benefit of all PMs and their past, present and future affiliates, and the respective divisions, officers, directors, employees, representatives, insurers, lenders, underwriters, tobacco-related organizations, trade associations, suppliers, agents, auditors, advertising agencies, public relations entities, attorneys, retailers and distributors of any PM or any such affiliate (and the predecessors, heirs, executors, administrators, successors and assigns of each of the foregoing). They are referred to in the MSA individually as a "**Released Party**" and collectively as the "**Released Parties.**" However, the term "Released Parties" does not include any person or entity (including, but not limited to, an affiliate) that is an NPM at any time after the MSA execution date, unless such person or entity becomes a PM.

### **Overview of Payments by the Participating Manufacturers; MSA Escrow Agent**

The MSA requires that the PMs make several types of payments, including Initial Payments, Annual Payments and Strategic Contribution Fund Payments.<sup>†</sup> See "Initial Payments," "Annual Payments" and "Strategic Contribution Fund Payments" below. These payments (with the exception of the up front Initial Payment) are subject to various adjustments and offsets, some of which could be material. See "Adjustment to Payments" and "—Subsequent Participating Manufacturers" below. SPMs were not required to make Initial Payments. Thus far, the OPMs have made all of the Initial Payments, and the PMs have made the Annual Payments for 2000, 2001, 2002, 2003, 2004, 2005, 2006 and 2007 (subject to certain withholdings described in "BONDHOLDERS' RISKS—Other Potential Payment Decreases Under the Terms of the MSA" herein). See "Payments Made to Date" below. Strategic Contribution Fund Payments are scheduled to begin April 15, 2008 and continue through April 15, 2017.

Payments required to be made by the OPMs are calculated by reference to the OPM's domestic shipments of cigarettes, with the amount of the payments adjusted annually roughly in proportion to the changes in total volume of cigarettes shipped by the OPMs in the United States in the preceding year. Payments to be made by the

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<sup>†</sup> Other payments that are required to be made by the PMs, such as payments of attorneys' fees and payments to a national foundation established pursuant to the MSA, are not allocated to the Settling States and are not available to the Bondholders, and consequently are not described herein.

PMs are recalculated each year, based on the United States market share of each individual PM for the prior year, with consideration under certain circumstances, for the profitability of each OPM. The Annual Payments and Strategic Contribution Fund Payments required to be made by the SPMs are based on increases in their shipment market share. See “—Subsequent Participating Manufacturers.” Pursuant to an escrow agreement (the “**MSA Escrow Agreement**”) established in conjunction with the MSA, remaining Annual Payments and Strategic Contribution Fund Payments are to be made to Citibank, N.A., as escrow agent (the “**MSA Escrow Agent**”), which in turn will disburse the funds to the Settling States.

Beginning with the payments due in the year 2000, the MSA Auditor has, among other things, calculated and determined the amount of all payments owed pursuant to the MSA, the adjustments, reductions and offsets thereto (and all resulting carry forwards, if any), the allocation of such payments, adjustments, reductions, offsets and carry forwards among the PMs and among the Settling States. This information is not publicly available and, the MSA Auditor has agreed to maintain the confidentiality of all such information, except that the MSA Auditor may provide such information to PMs and the Settling States as set forth in the MSA.

### **Initial Payments**

Initial Payments were made only by the OPMs. In December 1998, the OPMs collectively made an up front Initial Payment of \$2.40 billion. The 2000 Initial Payment, which had a scheduled base amount of \$2.47 billion, was paid in December 1999 in the approximate amount of \$2.13 billion due to various adjustments. The 2001 Initial Payment, which had a scheduled base amount of \$2.55 billion, was paid in December 2000 in the approximate amount of \$2.04 billion after taking into account various adjustments and an earlier overpayment. The 2002 Initial Payment, which had a scheduled base amount of \$2.62 billion, was paid in December 2001, in the approximate amount of \$1.89 billion after taking into account various adjustments and a deposit made to the Disputed Payments Account. Approximately \$204 million, which was substantially all of the money previously deposited in the Disputed Payments Account for payment to the Settling States, was distributed to the Settling States with the Annual Payment due April 15, 2002. The 2003 Initial Payment, which had a scheduled base amount of \$2.70 billion, was paid in December 2002 and January 2003, in the approximate aggregate amount of \$2.14 billion after taking into account various adjustments.

### **Annual Payments**

The OPMs and the other PMs are required to make Annual Payments on each April 15 in perpetuity. The PMs made the first eight Annual Payments due April 15 in each of the years 2000 through 2007, the scheduled base amounts of which (before adjustments discussed below) were \$4.5 billion, \$5.0 billion, \$6.5 billion, \$6.5 billion, \$8.0 billion, \$8.0 billion, \$8.0 billion and \$8.0 billion, respectively. After application of the adjustments, the Annual Payment made (i) in April 2000 was approximately \$3.5 billion, (ii) in April 2001 was approximately \$4.1 billion, (iii) in April 2002 was approximately \$5.2 billion, (iv) in April 2003 was approximately \$5.1 billion, (v) in April 2004 was approximately \$6.2 billion, (vi) in April 2005 was approximately \$6.3 billion, (vii) in April 2006 was approximately \$5.8 billion, and (viii) in April 2007 was approximately \$6.0 billion. The scheduled base amount (before adjustments discussed below) of each Annual Payment, subject to adjustment, is set forth below:



## Annual Payments

<u>Year</u>	<u>Base Amount</u>	<u>Year</u>	<u>Base Amount</u>
2000*	\$4,500,000,000	2010	\$8,139,000,000
2001*	5,000,000,000	2011	8,139,000,000
2002*	6,500,000,000	2012	8,139,000,000
2003*	6,500,000,000	2013	8,139,000,000
2004*	8,000,000,000	2014	8,139,000,000
2005*	8,000,000,000	2015	8,139,000,000
2006*	8,000,000,000	2016	8,139,000,000
2007*	8,000,000,000	2017	8,139,000,000
2008	8,139,000,000	Thereafter	9,000,000,000
2009	8,139,000,000		

\* The 2000 through 2007 Annual Payments have been made. However, subsequent adjustments to these Annual Payments may impact subsequent Annual Payments and Strategic Contribution Fund Payments.

The respective portion of each base amount applicable to each OPM is calculated by multiplying the base amount by the OPM's Relative Market Share during the preceding calendar year. The base annual payments in the above table will be increased by at least the minimum 3% Inflation Adjustment, adjusted by the Volume Adjustment, reduced by the Previously Settled States Reduction, and further adjusted by the other adjustments described below. The SPMs are required to make Annual Payments if their respective market share increases above the higher of their respective 1998 Market Share or 125% of their 1997 Market Share. See "Subsequent Participating Manufacturers" herein.

"**Relative Market Share**" is defined as an OPM's percentage share of the number of cigarettes shipped by all OPMs in or to the 50 states, the District of Columbia and Puerto Rico (defined hereafter as the "**United States**"), as measured by the OPM's reports of shipments to Management Science Associates, Inc. (or any successor acceptable to all the OPMs and a majority of the attorneys general of the Settling States who are also members of the NAAG executive committee). The term "**cigarette**" is defined in the MSA to mean any product that contains nicotine, is intended to be burned, contains tobacco and is likely to be offered to, or purchased by, consumers as a cigarette and includes "roll your own" tobacco.

The base amounts shown in the table above are subject to the following adjustments applied in the following order:

- the Inflation Adjustment,
- the Volume Adjustment,
- the Previously Settled States Reduction,
- the Non Settling States Reduction,
- the NPM Adjustment,
- the Offset for Miscalculated or Disputed Payments,
- the Litigating Releasing Parties Offset, and
- the Offset for Claims Over.

Application of these adjustments resulted in a material reduction of Pledged Tobacco Assets from the scheduled base amounts of the Annual Payments made by the PMs in April of the years 2000 through 2007, as discussed under "**Payments Made to Date**" below.

## Strategic Contribution Fund Payments

The OPMs are also required to make Strategic Contribution Fund Payments on April 15, 2008 and on April 15 of each year thereafter through 2017. The base amount of each Strategic Contribution Fund Payment is \$861 million. The respective portion of each base amount applicable to each OPM is calculated by multiplying the base amount by the OPM's Relative Market Share during the preceding calendar year. The SPMs will be required to make Strategic Contribution Fund Payments if their market share increases above the higher of their respective 1998 market share or 125% of their 1997 market share. See “—Subsequent Participating Manufacturers” herein.

The base amounts of the Strategic Contribution Fund Payments are subject to the following adjustments applied in the following order:

- the Inflation Adjustment,
- the Volume Adjustment,
- the Non Settling States Reduction,
- the NPM Adjustment,
- the Offset for Miscalculated or Disputed Payments,
- the Litigating Releasing Parties Offset, and
- the Offset for Claims Over.

## Adjustments to Payments

The base amounts of the Initial Payments were, and the Annual Payments and Strategic Contribution Fund Payments shown in the tables above are, subject to certain adjustments to be applied sequentially and in accordance with formulas contained in the MSA.

*Inflation Adjustment.* The base amounts of the Annual Payments and Strategic Contribution Fund Payments are increased each year to account for inflation. The increase in each year will be 3% or a percentage equal to the percentage increase in the Consumer Price Index for All Urban Consumers (the “**CPI**”) (or such other similar measures as may be agreed to by the Settling States and the PMs) for the preceding year, whichever is greater (the “**Inflation Adjustment**”). The inflation adjustment percentages are compounded annually on a cumulative basis beginning in 1999 and were first applied in 2000.

*Volume Adjustment.* Each of the Initial Payments was, and each of the Annual Payments and Strategic Contribution Fund Payments is, increased or decreased by an adjustment which accounts for fluctuations in the number of cigarettes shipped by the OPMs in or to the United States (the “**Volume Adjustment**”).

If the aggregate number of cigarettes shipped in or to the United States by the OPMs in any given year (the “**Actual Volume**”) is greater than 475,656,000,000 cigarettes (the “**Base Volume**”), the base amount allocable to the OPMs is adjusted to equal the base amount (in the case of Annual Payments and Strategic Contribution Fund Payments after application of the Inflation Adjustment) multiplied by a ratio, the numerator of which is the Actual Volume and the denominator of which is the Base Volume.

If the Actual Volume in a given year is less than the Base Volume, the base amount due from the OPMs (in the case of Annual Payments and Strategic Contribution Fund Payments, after application of the Inflation Adjustment) is decreased by 98% of the percentage by which the Actual Volume is less than the Base Volume, multiplied by such base amount. If, however, the aggregate operating income of the OPMs from sales of cigarettes in the United States during the year (the “**Actual Operating Income**”) is greater than \$7,195,340,000, as adjusted

for inflation in accordance with the Inflation Adjustment (the “**Base Operating Income**”), all or a portion of the volume reduction is added back (the “**Income Adjustment**”). The amount by which the Actual Operating Income of the OPMs exceeds the Base Operating Income is multiplied by the percentage of the allocable shares under the MSA represented by Settling States in which State-Specific Finality has been reached and divided by four, then added to the payment due. However, in no case will the amount added back due to the increase in operating income exceed the amount deducted due to the decrease in domestic volume. Any add back due to an increase in Actual Operating Income will be allocated among the OPMs on a Pro rata basis in accordance with their respective increases in Actual Operating Income over 1997 Base Operating Income.

*Previously Settled States Reduction.* The base amounts of the Annual Payments (as adjusted by the Inflation Adjustment and the Volume Adjustment, if any) are subject to a reduction reflecting the four states that had settled with the OPMs prior to the adoption of the MSA (Mississippi, Florida, Texas and Minnesota) (the “**Previously Settled States Reduction**”). The Previously Settled States Reduction reduces by 12.4500000% each applicable payment on or before December 31, 2007, by 12.2373756% each applicable payment between January 1, 2008 and December 31, 2017, and by 11.0666667% each applicable payment on or after January 1, 2018. The SPMs are not entitled to any reduction pursuant to the Previously Settled States Reduction. Initial Payments were not and Strategic Contribution Fund Payments are not subject to the Previously Settled States Reduction.

*Non Settling States Reduction.* In the event that the MSA terminates as to any Settling State, the remaining Annual Payments and Strategic Contribution Fund Payments due from the PMs shall be reduced to account for the absence of such state. This adjustment has no effect on the amounts to be collected by states which remain a party to the MSA, and the reduction is therefor not detailed.

*Non-Participating Manufacturers Adjustment.* The NPM Adjustment is based upon market share increases, measured by domestic sales of cigarettes by NPMs, and operates to reduce the payments of the PMs under the MSA in the event that the PMs incur losses in market share to NPMs during a calendar year as a result of the MSA. Three conditions must be met in order to trigger an NPM adjustment; (1) the aggregate market share of the PMs in any year must fall more than 2% below the aggregate market share held by those same PMs in 1997, (2) a firm of nationally recognized economic consultants must determine that the disadvantages experienced as a result of the provisions of the MSA were a significant factor contributing to the market share loss for the year in question, and (3) the Settling States in question must be proven to not have diligently enforced their Model Statutes. The “**NPM Adjustment**” is applied to the subsequent year’s Annual Payment and Strategic Contribution Fund Payment and the decrease in total funds available as a result of the NPM Adjustment is then allocated on a Pro rata basis among those Settling States that have been found (i) to not diligently enforce their Qualifying Statutes or (ii) to have enacted a Model Statute or Qualifying Statute that is declared invalid or unenforceable by a court of competent jurisdiction. The 1997 market share percentage for the PMs, less 2%, is defined in the MSA as the “**Base Aggregate Participating Manufacturer Market Share.**” If the PMs’ actual aggregate market share is between 0% and 16 ⅔% less than the Base Aggregate Participating Manufacturer Market Share, the amounts paid by the PMs would be decreased by three times the percentage decrease in the PMs’ actual aggregate market share. If, however, the aggregate market share loss from the Base Aggregate Participating Manufacturer Market Share is greater than 16 ⅔%, the NPM Adjustment will be calculated as follows:

$$\text{NPM Adjustment} = 50\% + [50\% / (\text{Base Aggregate Participating Manufacturer Market Share} - 16 \frac{2}{3}\%)] \times [\text{market share loss} - 16 \frac{2}{3}\%]$$

Regardless of how the NPM Adjustment is calculated, it is always subtracted from, and may not exceed, the total Annual Payments and Strategic Contribution Fund Payments due from the PMs in any given year. The NPM Adjustment applies only to the Annual Payments and Strategic Contribution Fund Payments, and does not apply at all if the number of cigarettes shipped in or to the United States in the year prior to the year in which the payment is due by all manufacturers that were PMs prior to December 7, 1998 exceeds the number of cigarettes shipped in or to the United States by all such PMs in 1997.

The NPM Adjustment is also state specific, in that a Settling State may avoid or mitigate the effects of an NPM Adjustment by enacting and diligently enforcing the Model Statute or a Qualifying Statute, as defined herein. Any Settling State that adopts and diligently enforces a Model Statute or Qualifying Statute is exempt from the

NPM Adjustment. The State has adopted the Model Statute. The decrease in total funds available due to the NPM Adjustment is allocated on a Pro rata basis among those Settling States that either (i) did not enact and diligently enforce the Model Statute or Qualifying Statute, or (ii) enacted a Model Statute or Qualifying Statute that is declared invalid or unenforceable by a court of competent jurisdiction. If a Settling State enacts and diligently enforces a Qualifying Statute that is the Model Statute but it is declared invalid or unenforceable by a court of competent jurisdiction, the NPM Adjustment for any given year will not exceed 65% of the amount of such state's allocated payment for the subsequent year. If a Qualifying Statute that is not the Model Statute is held invalid or unenforceable, however, such state is not entitled to any protection from the NPM Adjustment. Moreover, if a state adopts a Model Statute or a Qualifying Statute but then repeals it or amends it in such fashion that it is no longer a Qualifying Statute, then such state will no longer be entitled to any protection from the NPM Adjustment. At all times, a state's protection from the NPM Adjustment is conditioned upon the diligent enforcement of its Model Statute or Qualifying Statute, as the case may be. See "BONDHOLDERS' RISKS—Other Potential Payment Decreases Under the Terms of the MSA" above and "—MSA Provisions Relating to Model/Qualifying Statutes" below.

The MSA provides that if any Settling State resolves claims against any NPM that are comparable to any of the claims released in the MSA on overall terms more favorable to such NPM than the MSA does to the PMs, or relieves in any respect the obligation of any PM to make payments under the MSA, the terms of the MSA will be deemed modified to match the NPM settlement or such payment terms, but only with respect to the particular Settling State.

*Offset for Miscalculated or Disputed Payments.* If the MSA Auditor receives notice of a miscalculation of an Initial Payment made by an OPM, an Annual Payment made by a PM within four years or a Strategic Contribution Fund Payment made by a PM within four years, the MSA Auditor will recalculate the payment and make provisions for rectifying the error (the "**Offset for Miscalculated or Disputed Payments**"). There are no time limits specified for recalculations although the MSA Auditor is required to determine amounts promptly. Disputes as to determinations by the MSA Auditor may be submitted to binding arbitration governed by the Federal Arbitration Act. In the event that mispayments have been made, they will be corrected through payments with interest (in the event of underpayments) or withholdings with interest (in the event of overpayments). Interest will be at the prime rate, except where a party fails to pay undisputed amounts or fails to provide necessary information readily available to it, in which case a penalty rate of prime plus 3% applies. If a PM disputes any required payment, it must determine whether any portion of the payment is undisputed and pay that amount for disbursement to the Settling States. The disputed portion is required to be paid into the Disputed Payments Account pending resolution of the dispute. Failure to pay such disputed amounts into the Disputed Payments Account can result in liability for interest at the penalty rate if the disputed amount was in fact properly due and owing. See "BONDHOLDERS' RISKS—Other Potential Decreases Under the Terms of the MSA" herein.

*Litigating Releasing Parties Offset.* If any Releasing Party initiates litigation against a PM for any of the claims released in the MSA, the PM may be entitled to an offset against such PM's payment obligation under the MSA (the "**Litigating Releasing Parties Offset**"). A defendant PM may offset dollar for dollar any amount paid in settlement, stipulated judgment or litigated judgment against the amount to be collected by the applicable Settling State under the MSA only if the PM has taken all ordinary and reasonable measures to defend that action fully and only if any settlement or stipulated judgment was consented to by the state attorney general. The Litigating Releasing Parties Offset is state specific. Any reduction in MSA payments as a result of the Litigating Releasing Parties Offset would apply only to the Settling State of the Releasing Party.

*Offset for Claims Over.* If a Releasing Party pursues and collects on a released claim against an NPM or a retailer, supplier or distributor arising from the sale or distribution of tobacco products of any NPM or the supply of component parts of tobacco products to any NPM (collectively, the "**Non Released Parties**"), and the Non Released Party in turn successfully pursues a claim for contribution or indemnification against a Released Party, as defined herein, the Releasing Party must (i) reduce or credit against any judgment or settlement such Releasing Party obtains against the Non Released Party the full amount of any judgment or settlement such Non Released Party may obtain against the Released Party, and (ii) obtain from such Non Released Party for the benefit of such Released Party a satisfaction in full of such Non Released Party's judgment or settlement against the Released Party. In the event that such reduction or satisfaction in full does not fully relieve the Released Party of its duty to pay to the Non Released Party, the PM is entitled to a dollar for dollar offset from its payment to the applicable Settling State (the "**Offset for**

**Claims Over**”). For purposes of the Offset for Claims Over, any person or entity that is enumerated in the definition of Releasing Party set forth above is treated as a Releasing Party without regard to whether the applicable attorney general had the power to release claims of such person or entity. The Offset for Claims Over is state specific and would apply only to MSA payments owed to the Settling State of the Releasing Party.

### **Subsequent Participating Manufacturers**

SPMs are obligated to make Annual Payments and Strategic Contribution Fund Payments which are made at the same times as the Annual Payments and Strategic Contribution Fund Payments to be made by OPMs. Annual Payments and Strategic Contribution Fund Payments for SPMs are calculated differently, however, from Annual Payments and Strategic Contribution Fund Payments for OPMs. Each SPM’s payment obligation is determined according to its market share if, and only if, its “**Market Share**” (defined in the MSA to mean a manufacturer’s share, expressed as a percentage, of the total number of cigarettes sold in the United States in a given year, as measured by excise taxes (or similar taxes, in the case of Puerto Rico)), for the year preceding the payment exceeds its “**Base Share**,” defined as the higher of its 1998 Market Share or 125% of its 1997 Market Share. If an SPM executes the MSA after February 22, 1999, its 1997 or 1998 Market Share, as applicable, is deemed to be zero. Fourteen of the current 53 SPMs signed the MSA on or before the February 22, 1999 deadline.

For each Annual Payment and Strategic Contribution Fund Payment, each SPM is required to pay an amount equal to the base amount of the Annual Payment and the Strategic Contribution Fund Payment owed by the OPMs, collectively, adjusted for the Volume Adjustment described above but prior to any other adjustments, reductions or offsets, multiplied by (i) the difference between that SPM’s Market Share for the preceding year and its Base Share, divided by (ii) the aggregate Market Share of the OPMs for the preceding year. Other than the application of the Volume Adjustment, payments by the SPMs are subject to the same adjustments (including the Inflation Adjustment), reductions and offsets as are the payments made by the OPMs, with the exception of the Previously Settled States Reduction.

Because the Annual Payments and Strategic Contribution Fund Payments to be made by the SPMs are calculated in a manner different from the calculations for Annual Payments and Strategic Contribution Fund Payments to be made by the OPMs, a change in market share between the OPMs and the SPMs could cause the amount of Annual Payments and Strategic Contribution Fund Payments required to be made by the PMs in the aggregate to be greater or less than the amount that would be payable if their market share remained the same. In certain circumstances, an increase in the market share of the SPMs could increase the aggregate amount of Annual Payments and Strategic Contribution Fund Payments because the Annual Payments and Strategic Contribution Fund Payments to be made by the SPMs are not adjusted for the Previously Settled States Reduction. However, in other circumstances, an increase in the market share of the SPMs could decrease the aggregate amount of Annual Payments and Strategic Contribution Fund Payments because the SPMs are not required to make any Annual Payments or Strategic Contribution Fund Payments unless their market share increases above their Base Share, or because of the manner in which the Inflation Adjustment is applied to each SPM’s payments.

### **Payments Made to Date**

As required, the OPMs have made all of the Initial Payments, the PMs have made Annual Payments since 2000 and the MSA Escrow Agent has disbursed to the State its allocable portions thereof totaling approximately \$3,299,000,000 to date. Some of these payments were not sold to the Corporation and therefore were not pledged to payment of the Series A Bonds and the Series B Bonds, and were paid directly to the State, free and clear of the lien of the Series A Indenture and the Series B Indenture. Under the MSA, the computation of Initial Payments, Annual Payments and Strategic Contribution Fund Payments by the MSA Auditor is confidential and may not be used for purposes other than those stated in the MSA.

**Payments Made to Date**

	<b>State Unadjusted Allocable Share of MSA Base Amount*</b>	<b>State Actual Payment**†</b>
Up-Front Initial Payment	157,000,000	\$ 161,000,000
January 10, 2000 Initial Payment	161,000,000	140,000,000
January 10, 2001 Initial Payment	166,000,000	127,000,000
January 10, 2002 Initial Payment	171,000,000	127,000,000
January 10, 2003 Initial Payment	176,000,000	140,000,000
April 15, 2000 Annual Payment	294,000,000	226,000,000
April 15, 2001 Annual Payment	327,000,000	266,000,000
April 15, 2002 Annual Payment	425,000,000	358,000,000
April 15, 2003 Annual Payment	425,000,000	334,000,000
April 15, 2004 Annual Payment	522,000,000	229,000,000
April 15, 2005 Annual Payment	522,000,000	414,000,000
April 15, 2006 Annual Payment	522,000,000	377,000,000
April 15, 2007 Annual Payment	522,000,000	400,000,000

\* Rounded to the nearest millionth.

† As reported by the State, to the best of the State’s knowledge, amounts reflect the State’s actual receipts after applicable adjustments or disputes.

The terms of the MSA relating to such payments and various adjustments thereto are described above under the headings “Initial Payments,” “Annual Payments” and “Adjustment to Payments.”

The State has advised the Issuer that both the Settling States and one or more of the PMs are disputing or have disputed the calculations of some of the Initial Payments for the years 2000 through 2003, and some Annual Payments for the years 2000 through 2007.

In addition, subsequent revisions in the information delivered to the MSA Auditor (on which the MSA Auditor’s calculations of the Initial and Annual Payments are based) have in the past and may in the future result in a recalculation of the payments shown above. Such revisions may also result in routine recalculation of future payments. No assurance can be given as to the magnitude of any such recalculation and such recalculation could trigger the Offset for Miscalculated or Disputed Payments.

**“Most Favored Nation” Provisions**

In the event that any non foreign governmental entity other than the federal government should reach a settlement of released claims with PMs that provides more favorable terms to the governmental entity than does the MSA to the Settling States, the terms of the MSA will be modified to match those of the more favorable settlement. Only the non economic terms may be considered for comparison.

In the event that any Settling State should reach a settlement of released claims with NPMs that provides more favorable terms to the NPMs than the MSA does to the PMs, or relieves in any respect the obligation of any PM to make payments under the MSA the terms of the MSA will be deemed modified to match the NPM settlement or such payment terms, but only with respect to the particular Settling State. In no event will the adjustments discussed in this paragraph modify the MSA with regard to other Settling States.

**State-Specific Finality and Final Approval**

The MSA provides that payments could not be disbursed to the individual Settling States until the occurrence of each of two events: State-Specific Finality and Final Approval.

**“State-Specific Finality”** means, with respect to an individual Settling State, that (i) such state has settled its pending or potential litigation against the tobacco companies with a consent decree, which decree has been approved and entered by a court within the Settling State and (ii) the time for all appeals against the consent decree has expired. All Settling States have achieved State-Specific Finality.

**“Final Approval”** marks the approval of the MSA by the Settling States and means the earlier of (i) the date on which at least 80% of the Settling States, both in terms of number and dollar volume entitlement to the proceeds of the MSA, have reached State-Specific Finality, or (ii) June 30, 2000. Final Approval was achieved on November 12, 1999.

### **Disbursement of Funds from Escrow**

The MSA Auditor makes all calculations necessary to determine the amounts to be paid by each PM, as well as the amounts to be disbursed to each of the Settling States. Not less than 40 days prior to the date on which any payment is due, the MSA Auditor must provide copies of the disbursement calculations to all parties to the MSA, who must within 30 days prior to the date on which such payment is due advise the other parties if it questions or challenges the calculations. The final calculation is due from the MSA Auditor not less than 15 days prior to the payment due date. The calculation is subject to further adjustments if previously missing information is received. In the event of a challenge to the calculations, the non-challenged part of a payment shall be processed in the normal course. Challenges will be submitted to binding arbitration. The information provided by the MSA Auditor to the State with respect to calculations of amounts to be paid by PMs is confidential under the terms of the MSA and may not be disclosed to the Corporation or the Bondholders.

Disbursement of the funds by the MSA Escrow Agent from the escrow accounts shall occur within 10 business days of receipt of the particular funds. The MSA Escrow Agent will disburse the funds due to, or as directed by, each Settling State in accordance with instructions received from that state.

### **Advertising and Marketing Restrictions; Educational Programs**

The MSA prohibits the PMs from certain advertising, marketing and other activities that may promote the sale of cigarettes and smokeless tobacco products (**“Tobacco Products”**). Under the MSA, the PMs are generally prohibited from targeting persons under 18 years of age within the Settling States in the advertising, promotion or marketing of Tobacco Products and from taking any action to initiate, maintain or increase smoking by underage persons within the Settling States. Specifically, the PMs may not (i) use any cartoon characters in advertising, promoting, packaging or labeling Tobacco Products; (ii) distribute any free samples of Tobacco Products except in a restricted facility where the operator thereof is able to ensure that no underage persons are present; or (iii) provide to any underage person any item in exchange for the purchase of Tobacco Products or for the furnishing of proof of purchase coupons. The PMs are also prohibited from placing any new outdoor and transit advertising, and are committed to remove any existing outdoor and transit advertising for Tobacco Products in the Settling States. Other examples of prohibited activities include, subject to limited exceptions, the sponsorship of any athletic, musical, artistic or other social or cultural event in exchange for the use of tobacco brand names as part of the event; the making of payments to anyone to use, display, make reference to or use as a prop any Tobacco Product or item bearing a tobacco brand name in any motion picture, television show, theatrical production, music performance, commercial film or video game; the sale or distribution in the Settling States of any non tobacco items containing tobacco brand names or selling messages; and the sale of packs of cigarettes containing fewer than 20 cigarettes until at least December 31, 2001.

In addition, the PMs have agreed under the MSA to provide funding for the organization and operation of a charitable foundation (the **“Foundation”**) and educational programs to be operated within the Foundation. The main purpose of the Foundation will be to support programs to reduce the use of Tobacco Products by underage persons and to prevent diseases associated with the use of Tobacco Products. On March 31, 1999, and on March 31 of each subsequent year for a period of nine years thereafter, each OPM is required to pay its Relative Market Share of \$25,000,000 (which is not subject to any adjustments, offsets or reductions pursuant to the MSA) to fund the Foundation. In addition, each OPM is required to pay its Relative Market Share of \$250,000,000 on March 31, 1999, and \$300,000,000 on March 31 of each of the subsequent four years to fund the Foundation. Furthermore, each PM may be required to pay its Relative Market Share of \$300,000,000 on April 15, 2004, and on April 15 of each year

thereafter in perpetuity if, during the year preceding the year when payment is due, the sum of the Market Shares of the PMs equals or exceeds 99.05%. The Foundation may also be funded by contributions made by other entities.

### **Remedies upon the Failure of a PM to Make a Payment**

Each PM is obligated to pay when due the undisputed portions of the total amount calculated as due from it by the MSA Auditor's final calculation. Failure to pay such portion shall render the PM liable for interest thereon from the date such payment is due to (but not including) the date paid at the prime rate published from time to time by *The Wall Street Journal* or, in the event *The Wall Street Journal* is no longer published or no longer publishes such rate, an equivalent successor reference to rate determined by the MSA Auditor, plus three percentage points. In addition, any Settling State may bring an action in court to enforce the terms of the MSA. Before initiating such proceeding, the Settling State is required to provide thirty (30) days' written notice to the attorney general of each Settling State, to NAAG and to each PM of its intent to initiate proceedings.

### **Termination of Agreement**

The MSA is terminated as to a Settling State if (i) the MSA or consent decree in that jurisdiction is disapproved by a court and the time for an appeal has expired, the appeal is dismissed or the disapproval is affirmed or (ii) the representations and warranties of the attorney general of that jurisdiction relating to the ability to release claims are breached or not effectively given. In addition, in the event that a PM enters bankruptcy and fails to perform its financial obligations under the MSA, the Settling States, by vote of at least 75% of the Settling States, both in terms of number and of entitlement to the proceeds of the MSA, may terminate certain financial obligations of that particular manufacturer under the MSA.

The MSA provides that if it is terminated, then the statute of limitations with respect to released claims will be tolled from the date the Settling State signed the MSA until the later of the time permitted by applicable law or one year from the date of termination and the parties will jointly move for the reinstatement of the claims and actions dismissed pursuant to the MSA. The parties will return to the positions they were in prior to the execution of the MSA.

### **Severability**

By its terms, most of the major provisions of the MSA are not severable from its other terms. If a court materially modifies, renders unenforceable or finds unlawful any nonseverable provision, the attorneys general of the Settling States and the OPMs are to attempt to negotiate substitute terms. If any OPM does not agree to the substitute terms, the MSA terminates in all Settling States affected by the court's ruling.

### **Amendments and Waivers**

The MSA may be amended by all PMs and Settling States affected by the amendment. The terms of any amendment will not be enforceable against any Settling State which is not a party to the amendment. The MSA provides that any waiver will be effective only against the parties to such waiver and only with respect to the breach specifically waived, although this provision may not be enforceable.

### **MSA Provisions Relating to Model/Qualifying Statutes**

*General.* The MSA sets forth the schedule and calculation of payments to be made by OPMs to the Settling States. As described above, the Annual Payments and Strategic Contribution Fund Payments are subject to, among other adjustments and reductions, the NPM Adjustment, which may reduce the amount of money that a Settling State receives pursuant to the MSA. The NPM Adjustment will reduce payments of a PM if such PM experiences certain losses of market share in the United States as a result of participation in the MSA.

Settling States may eliminate or mitigate the effect of the NPM Adjustment by taking certain actions, including the adoption and diligent enforcement of a statute, law, regulation or rule (a "**Qualifying Statute**") which eliminates the cost disadvantages that PMs experience in relation to NPMs as a result of the provisions of the MSA.



“Qualifying Statute,” as defined in Section IX(d)(2)(E) of the MSA, means a statute, regulation, law, and/or rule adopted by a Settling State that “effectively and fully neutralizes the cost disadvantages that PMs experience vis à vis NPMs within such Settling State as a result of the provisions of the MSA.” Exhibit T to the MSA sets forth the model form of Qualifying Statute (the “**Model Statute**”) that will qualify as a Qualifying Statute so long as the statute is enacted without modification or addition (except for particularized state procedural or technical requirements) and is not enacted in conjunction with any other legislative or regulatory proposal. The MSA also provides a procedure by which a Settling State may enact a statute that is not the Model Statute and receive a determination from a nationally recognized firm of economic consultants that such statute is a Qualifying Statute. See “BONDHOLDERS’ RISKS – Other Potential Payment Decreases under the Terms of the MSA – *NPM Adjustment*” and “– Litigation Challenging the MSA, the Qualifying Statute and Related Legislation” herein.

If a Settling State continuously has a Qualifying Statute in full force and effect and diligently enforces the provisions of such statute, the MSA states that the payments allocated to such Settling State will not be subject to a reduction due to the NPM Adjustment. Furthermore, the MSA dictates that the aggregate amount of the NPM Adjustment is to be allocated, in a pro rata manner, among all Settling States that do not adopt and enforce a Qualifying Statute. In addition, if the NPM Adjustment allocated to a particular Settling State exceeds its allocated payment, that excess is to be reallocated equally among the remaining Settling States that have not adopted and enforced a Qualifying Statute. Thus, Settling States that do not adopt and enforce a Qualifying Statute will receive reduced allocated payments if an NPM Adjustment is in effect. The State has enacted a Model Statute, which is a Qualifying Statute.

The MSA provides that if a Settling State enacts a Qualifying Statute that is a Model Statute and uses its best efforts to keep the Model Statute in effect, but a court invalidates the statute, then, although that state remains subject to the NPM Adjustment, the NPM Adjustment is limited to no more, on a yearly basis, than 65% of the amount of such state’s allocated payment (including reallocations described above). The determination from a nationally recognized firm of economic consultants that a statute constitutes a Qualifying Statute is subject to reconsideration in certain circumstances and such statute may later be deemed not to constitute a Qualifying Statute. In the event that a Qualifying Statute that is not a Model Statute is invalidated or declared unenforceable by a court, or, upon reconsideration by a nationally recognized firm of economic consultants, is determined not to be a Qualifying Statute, the Settling State that adopted such statute will become fully subject to the NPM Adjustment. Moreover, if a state adopts a Model Statute or a Qualifying Statute but then repeals it or amends it in such fashion that it is no longer a Qualifying Statute, then such state will no longer be entitled to any protection from the NPM Adjustment. At all times, a state’s protection from the NPM Adjustment is conditioned upon the diligent enforcement of its Model Statute or Qualifying Statute, as the case may be.

*Summary of the Qualifying Statute.* One of the objectives of the MSA (as set forth in the Findings and Purpose section of the Model Statute) is to shift the financial burdens of cigarette smoking from the Settling States to the tobacco product manufacturers. The Model Statute provides that any tobacco manufacturer that does not join the MSA would be subject to the provisions of the Model Statute because

[i]t would be contrary to the policy of the state if tobacco product manufacturers who determine not to enter into such a settlement could use a resulting cost advantage to derive large, short term profits in the years before liability may arise without ensuring that the state will have an eventual source of recovery from them if they are proven to have acted culpably. It is thus in the interest of the state to require that such manufacturers establish a reserve fund to guarantee a source of compensation and to prevent such manufacturers from deriving large, short term profits and then becoming judgment proof before liability may arise.

Accordingly, pursuant to the Model Statute, a tobacco manufacturer that is an NPM under the MSA must deposit an amount for each cigarette it sells into an escrow account (which amount increases on a yearly basis, as set forth in the Model Statute).

The amounts deposited into the escrow accounts by the NPMs may only be used in limited circumstances. Although the NPM receives the interest or other appreciation on such funds, the principal may only be released (i) to pay a judgment or settlement on any claim of the type that would have been released by the MSA brought against

such NPM by the applicable Settling State or any Releasing Party located within such state; (ii) with respect to Settling States that have enacted and have in effect Allocable Share Release Amendments (described below in the next paragraph), to the extent that the NPM establishes that the amount it was required to deposit into the escrow account was greater than the total payments that such NPM would have been required to make if it had been a PM under the MSA (as determined before certain adjustments or offsets) or, with respect to Settling States that do not have in effect such Allocable Share Release Amendments, to the extent that the NPM establishes that the amount it was required to deposit into the escrow account was greater than such state's allocable share of the total payments that such NPM would have been required to make if it had been a PM under the MSA (as determined before certain adjustments or offsets); or (iii) 25 years after the date that the funds were placed into escrow (less any amounts paid out pursuant to (i) or (ii)).

In recent years legislation has been enacted in at least 44 of the Settling States to amend the Qualifying or Model Statutes in those states by eliminating the reference to the allocable share and limiting the possible release an NPM may obtain under a Model Statute to the excess above the total payment that the NPM would have paid for its cigarettes had it been a PM (each an "**Allocable Share Release Amendment**"). The State has enacted an Allocable Share Release Amendment.

If the NPM fails to place funds into escrow as required, the attorney general of the applicable Settling State may bring a civil action on behalf of the state against the NPM. If a court finds that an NPM violated the statute, it may impose civil penalties as follows: (i) an amount not to exceed 5% of the amount improperly withheld from escrow per day of the violation and in an amount not to exceed 100% of the original amount improperly withheld from escrow; (ii) in the event of a knowing violation, an amount not to exceed 15% of the amount improperly withheld from escrow per day of the violation and, in any event, not to exceed 300% of the original amount improperly withheld from escrow; and (iii) in the event of a second knowing violation, the court may prohibit the NPM from selling cigarettes to consumers within such state (whether directly or through a distributor, retailer or similar intermediary) for a period not to exceed two years. NPMs include foreign tobacco manufacturers that intend to sell cigarettes in the United States that do not themselves engage in an activity in the United States but may not include the wholesalers of such cigarettes. However, enforcement of the Model Statute against such foreign manufacturers that do not do business in the United States may be difficult. See "**BONDHOLDERS' RISKS—Litigation Challenging the MSA, the Qualifying Statutes and Related Legislation**" herein.

*New York Qualifying Statute.* Both houses of the New York State Legislature passed a Qualifying Statute, codified as Article 13-G of the Public Health Law, which was signed by the Governor on September 28, 1999 and became effective 60 days after such date. By letter dated August 4, 1999, as affected by a letter dated September 27, 1999, counsel to the OPMs confirmed that the OPMs will not dispute that the New York State Qualifying Statute constitutes a Model Statute under the MSA.

In October 2003, the State enacted an Allocable Share Release Amendment to amend Article 13-G by eliminating the provision authorizing an NPM to obtain the release of the amount by which its annual escrow deposit exceeds 12.7620310% of the total payments that the NPM would have made as a PM for that year. Under the State's Allocable Share Release Amendment, an NPM would have been entitled to the release of its escrow deposit only to the extent that it exceeded the total amount that the NPM would have paid as a PM. A majority of the PMs, including all three OPM's had indicated in writing that in the event a Settling State enacted legislation substantially in the form of the Allocable Share Release Amendment, the Settling State's previously enacted Qualifying Statute would continue to constitute a Model Statute and a Qualifying Statute within the meaning of the MSA.

As discussed above under the caption "**BONDHOLDERS' RISKS—Litigation Challenging the MSA, the Qualifying Statute and Related Legislation—Grand River, Freedom Holdings and Related Cases,**" the Southern District granted the plaintiffs' request for an injunction to enjoin the State from enforcing its Allocable Share Release Amendment.

### **Complementary Legislation**

Pursuant to the provisions of Sections 480-b, 481(i)(c) and 1846(a-1) of the State Tax Law (collectively, the "**Complementary Legislation**"), tobacco product manufacturers whose cigarettes are sold in the State are required to annually certify that either (i) they are PMs that have complied with requirements of the MSA or (ii) they

have complied with the Public Health Law requirement to deposit money in a qualified escrow fund. No cigarette tax stamps may be affixed to the cigarettes of any tobacco product manufacturers that do not make such certification. In addition to any other penalties that may be imposed by law, a civil penalty can be imposed on any tobacco product manufacturer who files a false certification or any cigarette tax agent who affixes a cigarette tax stamp in violation of the Complementary Legislation, and such cigarettes can be seized and are subject to forfeiture.

## **NEW YORK CONSENT DECREE**

There follows a brief description of the Consent Decree. This description is not complete and is subject to, and qualified in its entirety by reference to the Consent Decree which is attached hereto as APPENDIX D.

### **Introduction and Overview**

On December 23, 1998, the Consent Decree and Final Judgment (as corrected on April 14, 1999, the “**Consent Decree**”), which governs the class action portion of New York State’s action against the tobacco companies, was entered in the Supreme Court of the State of New York for New York County. The Consent Decree contains provisions governing, among other things: (i) the jurisdiction of the court over the parties; (ii) the scope of the Consent Decree; (iii) the required monetary payments by the PMs; (iv) the marketing restrictions and other equitable relief; and (v) the mechanism for enforcing the provisions of the MSA and the Consent Decree. With respect to the intra-state matters, the Consent Decree provides for: (i) the allocation of the amounts in the New York state specific account among the State, The City of New York (the “**City**”) and the other counties of New York (the “**Counties**”); (ii) limitations on the rights of the City and the Counties to enforce the provisions of the Consent Decree; and (iii) the release and dismissal of claims by the City and the Counties. The Consent Decree was affirmed by the Appellate Division and is not subject to further appeal.

### **Calculating the State’s Share of the Accounts and Flow of Funds**

Pursuant to the allocation percentages set forth in the MSA, the State is entitled to 12.7620310% of the total amount of Annual Payments (prior to adjustments). In addition, pursuant to the procedures agreed to in the MSA, the State is entitled to receive 5.4873402% of the total amount of Strategic Contribution Fund Payments (prior to adjustments). The allocation of the “**State’s Share**” of the Annual Payments to be made pursuant to the MSA to the State, the City and the Counties is set forth in the Consent Decree, which provides that the State is to receive 51.176% of the State’s share of the Annual Payments (which represents 6.5310970% of the Annual Payments payable under the MSA) and 100% of the Strategic Contribution Fund Payments.

### **Rights to Enforce Provisions of the Consent Decree**

In addition to allocating the Annual Payments among the State, the City and the Counties, the Consent Decree defines who may enforce the provisions of the Consent Decree. The Consent Decree expressly states that it only confers rights upon, and may be enforced only by, the State or a PM (or other Released Party under the MSA). As a result, only the State is entitled to enforce the PMs’ payment obligations, and the State is prohibited expressly from assigning or transferring its enforcement rights. The Consent Decree does provide, however, that the City or the Counties may enforce their payment rights against the State, the City or the Counties.

### **Release and Dismissal of Claims**

The Consent Decree further provides that, effective upon the occurrence of State Specific Finality in the State, the City and the Counties unconditionally will release and discharge all released claims against all Released Parties to the same extent that the State released its claims pursuant to the MSA. The City and Counties have agreed that, after the occurrence of State Specific Finality, they will not seek to establish civil liability against any Released Party upon any released claim and that such agreement will be a complete defense to any such civil action or proceeding.

## SUMMARY OF THE GLOBAL INSIGHT REPORT

*The following is a brief summary of the Global Insight Report, a copy of which is attached hereto as APPENDIX E. This summary does not purport to be complete and the Global Insight Report should be read in its entirety for an understanding of the assumptions on which it is based and the conclusions it reaches. The Global Insight Report forecasts future United States domestic cigarette consumption. The MSA payments are based in part on cigarettes shipped in and to the United States. Cigarette shipments and cigarette consumption may not match as a result of various factors such as inventory adjustments, but are substantially the same when compared over a period of time. .*

### General

Global Insight (USA), Inc. (“**Global Insight**”), formerly known as DRI•WEFA, Inc., has prepared a report dated March 19, 2008 on the consumption of cigarettes in the United States from 2008 through 2023 entitled, “*A Forecast of U.S. Cigarette Consumption (2008-2023) for the Tobacco Settlement Financing Corporation (State of New York)*.” Global Insight is an internationally recognized econometric and consulting firm of over 325 economists in 23 offices worldwide. Global Insight is a privately held company, which is a provider of financial, economic and market research information.

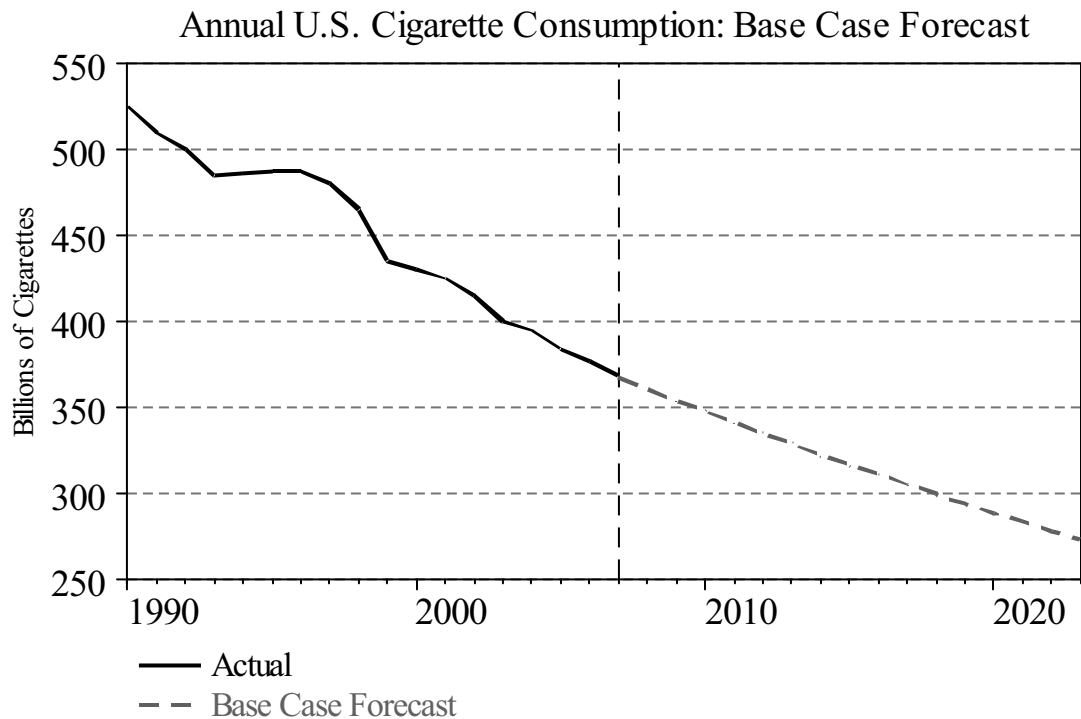
Global Insight has developed a cigarette consumption model based on historical United States data between 1965 and 2003. Global Insight constructed this cigarette consumption model after considering the impact of demographics, cigarette prices, disposable income, employment and unemployment, industry advertising expenditures, the future effect of the incidence of smoking among underage youth and qualitative variables that captured the impact of anti-smoking regulations, legislation, and health warnings. After determining which variables were effective in building this cigarette consumption model (real cigarette prices, real per capita disposable personal income, the impact of restrictions on smoking in public places, and the trend over time in individual behavior and preferences), Global Insight employed standard multivariate regression analysis to determine the nature of the economic relationship between these variables and adult per capita cigarette consumption in the United States. The multivariate regression analysis showed: (i) long run price elasticity of demand of -0.33; (ii) income elasticity of demand of 0.27; and (iii) a trend decline in adult per capita cigarette consumption of 2.40% per year holding other recognized significant factors constant.

Global Insight’s model, coupled with its long term forecast of the United States economy, was then used to project total United States cigarette consumption from 2008 through 2023 (the “**Base Case Forecast**”). The Base Case Forecast indicates that the total United States cigarette consumption in 2023 will be 273 billion cigarettes (approximately 13.7 billion packs), a 26% decline from the 2007 level. After 2007, the rate of decline in total cigarette consumption is projected to moderate and average less than 2% per year. From 2007 through 2023 the average annual rate of decline is projected to be 1.85%. On a per capita basis, consumption is forecast to fall at an average annual rate of 2.67%. Total consumption of cigarettes in the United States is forecast to fall from an estimated 384 billion in 2005 to 368 billion in 2007, to 361 billion in 2008, and to under 300 billion by 2018, as set forth in the following table. The Global Insight Report states that Global Insight believes that the assumptions on which the Base Case Forecast is based are reasonable.

### Global Insight Base Case Forecast of Cigarette Consumption

Year	Cigarettes (billions)	Year	Cigarettes (billions)
2008	360.59	2016	310.82
2009	353.96	2017	305.06
2010	347.62	2018	299.41
2011	341.27	2019	293.71
2012	334.93	2020	288.43
2013	328.54	2021	283.17
2014	322.14	2022	278.11
2015	316.45	2023	273.09

The following graph displays the projected time trend of cigarette consumption in the United States:



The Tobacco Consumption Report also presents alternative forecasts that project higher and lower paths of cigarette consumption, predicting that by 2023, total United States consumption could be as low as 262 billion or as high as 281 billion cigarettes. In addition, the Tobacco Consumption Report presents scenarios with more extreme variations in assumptions for the purposes of illustrating alternative paths of consumption. In one such scenario, Global Insight projects that assuming a 4% decline per year total United States consumption could be as low as 192 billion cigarettes by 2023.

#### Comparison with Prior Forecasts

In November 2003 Global Insight presented a similar study, “A Forecast of U.S. Cigarette Consumption (2002-2023).” Its long run conclusions were similar to this study. The current forecast of consumption for the year 2023 is 3.9% less than that of the original study, 273.1 billion vs. 284.1 billion. In February 2006 full year data on industry shipments for 2005 were reported by the manufacturers and by the Alcohol and Tobacco Tax and Trade Bureau. From this data Global Insight estimates that consumption in 2005 was 381 billion cigarettes, 4 billion fewer than it had projected in 2005. This new data has been incorporated into its revised forecast.

## Historical Cigarette Consumption

The USDA, which has compiled data on cigarette consumption since 1900, reports that consumption (which is defined as taxable United States consumer sales, plus shipments to overseas armed forces, ship stores, Puerto Rico and other United States possessions, and small tax-exempt categories, as reported by the Bureau of Alcohol, Tobacco and Firearms) grew from 2.5 billion in 1900 to a peak of 640 billion in 1981. Consumption declined in the 1980's and 1990's, reaching a level of 465 billion cigarettes in 1998, and decreasing to less than 400 billion cigarettes in 2003.

The following table sets forth United States domestic cigarette consumption for the ten years ended December 31, 2007.<sup>†</sup> The data in this table vary from statistics on cigarette shipments in the United States. While the Tobacco Consumption Report is based on consumption, payments under the MSA are computed based in part on shipments in or to the 50 states of the United States, the District of Columbia and Puerto Rico. The quantities of cigarettes shipped and cigarettes consumed may not match at any given point in time as a result of various factors such as inventory adjustments, but are substantially the same when compared over a period of time.

### U.S. Cigarette Consumption

Year Ended December 31	Consumption (Billions of Cigarettes)	Percentage Change
2007	368	-2.28%
2006	377	-1.93
2005	384	-2.69
2004	395	-2.28
2003	400	-3.66
2002	415	-2.35
2001	425	-1.16
2000	430	-1.15
1999	435	-6.45
1998	465	-3.13

### Factors Affecting Cigarette Consumption

Most empirical studies have found a common set of variables that are relevant in building a model of cigarette demand. These conventional analyses usually evaluate one or more of the following factors: (i) general population growth, (ii) price increases, (iii) changes in disposable income, (iv) youth consumption, (v) trends over time, (vi) smoking bans in public places, (vii) nicotine dependence, and (viii) health warnings. While some of these factors were not found to have a measurable impact on changes in demand for cigarettes, all of these factors are thought to affect smoking in some manner and to be incorporated into current levels of consumption. Since 1964 there has been a significant decline in United States adult per capita cigarette consumption. The 1964 Surgeon General's health warning and numerous subsequent health warnings, together with the increased health awareness of the population over the past 30 years, may have contributed to decreases in cigarette consumption levels. If, as assumed by Global Insight, the awareness of the adult population continues to change in this way, overall consumption of cigarettes will decline gradually over time. Global Insight's analysis includes a time trend variable in order to capture the impact of these changing health trends and the effects of other such variables which are difficult to quantify.

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<sup>†</sup> Source: USDA-ERS; 2004, 2005, 2006, estimates by Global Insight. USDA estimates for 2004, 2005 and 2006 diverge significantly from estimates based on independent data from the industry and from the U.S. Tobacco and Tax Bureau ("TTB"). In 2004, the manufacturers report domestic shipments of 394.5 billion, and the TTB reports a total of 397.7 billion. These contrast with a USDA estimate of 388 billion. In 2005, the manufacturers report 381.7 billion, TTB reports 381.1 billion and USDA 376 billion. In 2006, the manufacturers report 372.5 billion, TTB reports 380.9 billion and USDA 371 billion, subject to revision.

## SUMMARY OF SERIES A AND SERIES B PLEDGED SETTLEMENT PAYMENTS METHODOLOGY AND BOND STRUCTURING ASSUMPTIONS

### Introduction

The following discussion describes the methodology and assumptions used to calculate a forecast of Series A Pledged Settlement Payments and Series B Pledged Settlement Payments to be received by the Corporation (the “**Collection Methodology and Assumptions**”), as well as the methodology and assumptions used to structure the schedule of principal for the bonds (the “**Structuring Assumptions**”). The assumptions are only assumptions and no guarantee can be made as to the ultimate outcome of certain events assumed here. If actual results are different from those assumed, it could have a material effect on the forecast of Series A Pledged Settlement Payments and Series B Pledged Settlement Payments.

### Collection Methodology and Assumptions

In calculating a forecast of Series A Pledged Settlement Payments and Series B Pledged Settlement Payments to be received by the Corporation, the forecast of cigarette consumption in the United States developed by Global Insight and described as the Base Case Forecast was applied to calculate Annual Payments and Strategic Contribution Fund Payments to be made by the PMs pursuant to the MSA. The calculation of payments required to be made was performed in accordance with the terms of the MSA; however, as described below, certain assumptions were made with respect to consumption of cigarettes in the United States and the applicability of certain adjustments and offsets to such payments set forth in the MSA. In addition, it was assumed that the PMs make all payments required to be made by them pursuant to the MSA, and that the relative market share for each of the PMs remains constant throughout the collection forecast period at 84.87% for the OPMs, 9.99% for the SPMs and 5.14% for the NPMs.<sup>†</sup> It was further assumed that each company that is currently a PM remains such throughout the term of the Series A Bonds and the Series B Bonds.

In applying the consumption forecast from the Global Insight Report, it was assumed that United States consumption, which was forecasted by Global Insight, was equal to the number of cigarettes shipped in and to the United States, the District of Columbia and Puerto Rico, which is the number that is applied to determine the Volume Adjustment. The Global Insight Report states that the quantities of cigarettes shipped and cigarettes consumed may not match at any given point in time as a result of various factors such as inventory adjustments, but are substantially the same when compared over a period of time. Global Insight’s Base Case Forecast for United States cigarette consumption is set forth herein under “SUMMARY OF THE GLOBAL INSIGHT REPORT.” See APPENDIX E for a discussion of the assumptions underlying the projections of cigarette consumption contained in the Global Insight Report.

### Annual Payments

In accordance with the Collection Methodology and Assumptions, the amount of Annual Payments to be made by the PMs was calculated by applying the adjustments applicable to the Annual Payments in the order, and in the amounts, set out in the MSA, as follows:

*Inflation Adjustment.* First, the Inflation Adjustment was applied to the schedule of base amounts for the Annual Payments set forth in the MSA, using a rate of 3.4% for 2000, 3.0% for 2001 through 2003, 3.256% for 2004, 3.416% for 2005, 3.0% for 2006, and 4.08% for 2007. Thereafter, the inflation adjustment was assumed to be the minimum provided in the MSA, at a rate of 3% per year, compounded annually, for the rest of the collection forecast period.

*Volume Adjustment.* Next, the annual amounts calculated for each year after application of the Inflation Adjustment were adjusted for the Volume Adjustment by applying the Global Insight Base Case Forecast for United States cigarette consumption to the market share of the OPMs for the prior year. No add back or benefit was

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<sup>†</sup> The aggregate market share information utilized in the bond structuring assumptions may differ materially from the market share information utilized by the MSA Auditor in calculating adjustments to Initial Payments, Annual Payments and Strategic Contribution Fund Payments. See “SUMMARY OF THE MASTER SETTLEMENT AGREEMENT — Adjustments to Payments.”

assumed from any Income Adjustment. See “SUMMARY OF THE MASTER SETTLEMENT AGREEMENT – Adjustments to Payments – *Volume Adjustment*” for a description of the formula used to calculate the Volume Adjustment.

*Previously-Settled States Reduction.* Next, the annual amounts calculated for each year after application of the Inflation Adjustment and the Volume Adjustment were reduced by the Previously-Settled States Reduction which applies only to the payments owed by the OPMs. The Previously-Settled States Reduction is as follows for each year of the following period:

In or prior to 2007	12.4500000%
2008 through 2017	12.2373756%
2018 and after	11.0666667%

*Non-Settling States Reduction.* The Non-Settling States Reduction was not applied to the Annual Payments because such reduction has no effect on the amount of payments to be received by states that remain parties to the MSA. Thus, the Collection Methodology and Assumptions include an assumption that the State will remain a party to the MSA.

*NPM Adjustment.* The NPM Adjustment will not apply to the Annual Payments payable to any state that enacts and diligently enforces a Qualifying Statute so long as such statute is not held to be unenforceable. The Collection Methodology and Assumptions include an assumption that the State will diligently enforce a Qualifying Statute that is not held to be unenforceable. For a discussion of the State Model Statute, see “SUMMARY OF THE MASTER SETTLEMENT AGREEMENT – MSA Provisions Relating to Model/Qualifying Statutes.”

*Offset for Miscalculated or Disputed Payments.* The Collection Methodology and Assumptions include an assumption that there will be no adjustments to the Annual Payments due to miscalculated or disputed payments.

*Litigating Releasing Parties Offset.* The Collection Methodology and Assumptions include an assumption that the Litigating Releasing Parties Offset will have no effect on payments.

*Offset for Claims-Over.* The Collection Methodology and Assumptions include an assumption that the Offset for Claims-Over will not apply.

*Subsequent Participating Manufacturers.* The Collection Methodology and Assumptions assume that the relative market share of the SPMs remains constant at 9.99%. Because the 9.99% market share is greater than 3.125% (125% of 2.5%, the SPMs’ estimated 1997 market share), Collection Methodology and Assumptions assume that the SPMs will be required to make Annual Payments in each year.

*State’s Share.* The amount of Annual Payments payable to the State pursuant to the Consent Decree, after application of the Inflation Adjustment, the Volume Adjustment and the Previously-Settled States Reduction for each year was multiplied by the State’ Share (6.5310970%) in order to determine the amount of Annual Payments to be made by the PMs in each year to be allocated to the State. The Consent Decree allocates 51.176% of the Annual Payments (which represents 6.5310970% of the Annual Payments payable under the MSA) to the State and the remaining 48.824% of the Annual Payments to the City of New York and all other counties located within the State. Series A Pledged Settlement Payments and Series B Pledged Settlement Payments each include fifty percent (50%) of the State’s Share of the Annual Payments.

The following table shows the projection of Annual Payments to be received by the Trustee through the year 2023, calculated in accordance with the Collection Methodology and Assumptions.



## Projection of Annual Payments to be Received by Trustee

Year	Global Insight Base Case Consumption Forecast	OPM Adjusted Consumption	Base Annual Payments	Inflation Adjustment	Volume Adjustment	Previously Settled States Reduction	Subtotal	State's Allocation	Annual Payments to State	Pledged Settlement Payments Allocation*	Total OPM Payments to Trustee	SPM Payments to Trustee	Total Annual Payments to Trustee
2007	366,860,000,000	311,354,082,000	-	-	-	-	-	-	-	-	-	-	-
2008	360,590,000,000	306,032,733,000	\$8,139,000,000	\$2,703,964,282	(\$3,670,487,562)	(\$877,722,916)	\$6,294,753,804	6.5310970%	\$411,116,477	50.00%	\$205,558,238	\$18,945,742	\$224,503,981
2009	353,960,000,000	300,405,852,000	8,139,000,000	3,029,253,211	(3,903,046,917)	(889,070,582)	6,376,135,711	6.5310970	416,431,608	50.00%	208,215,804	19,190,683	227,406,487
2010	347,620,000,000	295,025,094,000	8,139,000,000	3,364,300,807	(4,153,497,623)	(899,423,021)	6,450,380,162	6.5310970	421,280,585	50.00%	210,640,293	19,414,141	230,054,434
2011	341,270,000,000	289,635,849,000	8,139,000,000	3,709,399,831	(4,409,454,421)	(910,331,690)	6,528,613,719	6.5310970	426,390,095	50.00%	213,195,047	19,649,606	232,844,654
2012	334,930,000,000	284,255,091,000	8,139,000,000	4,064,851,826	(4,677,243,874)	(921,059,285)	6,605,548,667	6.5310970	431,414,791	50.00%	215,707,395	19,881,162	235,588,558
2013	328,540,000,000	278,831,898,000	8,139,000,000	4,430,967,381	(4,956,912,389)	(931,638,134)	6,681,416,858	6.5310970	436,369,816	50.00%	218,184,908	20,109,508	238,294,416
2014	322,140,000,000	273,400,218,000	8,139,000,000	4,808,066,402	(5,250,283,448)	(941,884,239)	6,754,898,715	6.5310970	441,168,987	50.00%	220,584,494	20,330,671	240,915,165
2015	316,450,000,000	268,571,115,000	8,139,000,000	5,196,478,394	(5,557,028,732)	(951,878,101)	6,826,571,561	6.5310970	445,850,010	50.00%	222,925,005	20,546,390	243,471,395
2016	310,820,000,000	263,792,934,000	8,139,000,000	5,596,542,746	(5,860,400,845)	(963,710,694)	6,911,431,208	6.5310970	451,392,276	50.00%	225,696,138	20,801,798	246,497,936
2017	305,060,000,000	258,904,422,000	8,139,000,000	6,008,609,029	(6,175,489,658)	(975,578,191)	6,996,541,180	6.5310970	456,950,891	50.00%	228,475,446	21,057,959	249,533,404
2018	299,410,000,000	254,109,267,000	9,000,000,000	7,113,568,706	(7,195,932,807)	(986,885,042)	7,930,750,856	6.5310970	517,965,031	50.00%	258,982,516	23,555,494	282,538,009
2019	293,710,000,000	249,271,677,000	9,000,000,000	7,596,975,767	(7,575,780,908)	(998,345,567)	8,022,849,291	6.5310970	523,980,069	50.00%	261,990,035	23,829,040	285,819,074
2020	288,430,000,000	244,790,541,000	9,000,000,000	8,094,885,040	(7,973,438,151)	(1,009,440,125)	8,112,006,764	6.5310970	529,803,030	50.00%	264,901,515	24,093,851	288,995,366
2021	283,170,000,000	240,326,379,000	9,000,000,000	8,607,731,591	(8,375,205,390)	(1,021,732,903)	8,210,793,298	6.5310970	536,254,875	50.00%	268,127,437	24,387,261	292,514,698
2022	278,110,000,000	236,031,957,000	9,000,000,000	9,135,963,539	(8,793,268,323)	(1,033,924,940)	8,308,770,275	6.5310970	542,653,846	50.00%	271,326,923	24,678,267	296,005,190
2023	-	-	9,000,000,000	9,680,042,445	(9,222,344,611)	(1,046,651,897)	8,411,045,937	6.5310970	549,333,569	50.00%	274,666,784	24,982,041	299,648,825

\* The Series A Bonds and the Series B Bonds are each pledged 50% the State's Pledged Settlement Payments.

## Strategic Contribution Fund Payments

In accordance with the Collection Methodology and Assumptions, the amount of Strategic Contribution Fund Payments to be made by the PMs was calculated by applying the adjustments applicable to the Strategic Contribution Fund Payments in the amounts, set out in the MSA, as follows:

*Inflation Adjustment.* First, the Inflation Adjustment was applied to the schedule of base amounts for the Strategic Contribution Fund Payments set forth in the MSA, using a rate of 3.4% for 2000, 3.0% for 2001 through 2003, 3.256% for 2004, 3.416% for 2005, 3.0% for 2006, and 4.08% for 2007. Thereafter, the Inflation Adjustment was assumed to be the minimum provided in the MSA, 3% per year, compounded annually, for the entire collection forecast period.

*Volume Adjustment.* Next, the Strategic Contribution Fund Payments calculated for each year after application of the Inflation Adjustment were adjusted for the Volume Adjustment by applying the Global Insight Base Case Forecast for United States cigarette consumption to the market share of the OPMs for the prior year. No add back or benefit was assumed from any Income Adjustment. See “SUMMARY OF THE MASTER SETTLEMENT AGREEMENT – Adjustments to Payments – *Volume Adjustment*” for a description of the formula used to calculate the Volume Adjustment.

*NPM Adjustment.* The NPM Adjustment will not apply to the Strategic Contribution Fund Payments payable to any state that enacts and diligently enforces a Qualifying Statute so long as such statute is not held to be unenforceable. The Collection Methodology and Assumptions include an assumption that the State will diligently enforce a Qualifying Statute that it is not held to be unenforceable. For a discussion of the State Model Statute, see “SUMMARY OF THE MASTER SETTLEMENT AGREEMENT – MSA Provisions Relating to Model/Qualifying Statutes.”

*Offset for Miscalculated or Disputed Payments.* The Collection Methodology and Assumptions include an assumption that there will be no adjustments to the Strategic Contribution Fund Payments due to miscalculated or disputed payments.

*Litigating Releasing Parties Offset.* The Collection Methodology and Assumptions include an assumption that the Litigating Releasing Parties Offset will have no effect on payments.

*Offset for Claims-Over.* The Collection Methodology and Assumptions include an assumption that the Offset for Claims-Over will not apply.

*Non-Settling States Reduction.* For the reasons described above under “– Annual Payments,” the Non-Settling States Reduction was not applied to the Strategic Contribution Fund Payments.

*Subsequent Participating Manufacturers.* The Collection Methodology and Assumptions assume that the relative market share of the SPMs remains constant at 9.99%. Because the 9.99% market share is greater than 3.125% (125% of 2.5%, the SPM’s estimated 1997 market share), Collection Methodology and Assumptions assume that the SPMs will be required to make Strategic Contribution Fund Payments in each year.

*State’s Share.* The amount of Strategic Contribution Fund Payments, after application of the Inflation Adjustment, the Volume Adjustment and the Previously-Settled States Reduction for each year was multiplied by the State’s Share (5.4873402%) in order to determine the amount of Strategic Contribution Fund Payments to be made by the PMs in each year to be allocated to the State. The Consent Decree allocates 100% of the Strategic Contribution Fund Payments (which represents 5.4873402% of the Strategic Contribution Fund Payments under the MSA) to the State and 0% of the Strategic Contribution Fund Payments to the City of New York and all other counties located within the State. Series A Pledged Settlement Payments and Series B Pledged Settlement Payments each include fifty percent (50%) of the State’s Share of the Strategic Settlement Payments.

The following table shows the projection of Strategic Contribution Fund Payments and total payments (including Annual Payments) to be received by the Series A Trustee and the Series B Trustee through the year 2023, calculated in accordance with the Collection Methodology and Assumptions.

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## Projection of Strategic Contribution Fund and Total Payments to be Received by Trustee

Year	Strategic Contribution Fund Payments										Total Payments			
	Global Insight Base Case Consumption Forecast	OPM-Adjusted Consumption	Base Strategic Contribution Payments	Inflation Adjustment	Volume Adjustment	Subtotal	State's Allocation	Strategic Contribution Payments to State	Pledged Settlement Payments Percentage*	Strategic Contribution Payments to Trustee	SPM Payments to Trustee	Total Annual Payments to Trustee	Total Strategic Contribution Payments to Trustee	Total Payments to Trustee
2007	366,860,000,000	311,354,082,000	861,000,000	-	-	-	-	-	-	-	-	-	-	-
2008	360,590,000,000	306,032,733,000	861,000,000	\$286,044,139	(\$388,289,690)	\$758,754,448	5.4873402%	\$41,635,438	50.00%	\$20,817,719	\$1,683,912	\$224,503,981	\$22,501,631	\$247,005,612
2009	353,960,000,000	300,405,852,000	861,000,000	320,455,463	(412,891,436)	768,564,027	5.4873402	42,173,723	50.00%	21,086,861	1,705,683	227,406,487	22,792,544	250,199,031
2010	347,620,000,000	295,025,094,000	861,000,000	355,899,127	(439,385,853)	777,513,274	5.4873402	42,664,798	50.00%	21,332,399	1,725,544	230,054,434	23,057,943	253,112,377
2011	341,270,000,000	289,635,849,000	861,000,000	392,406,101	(466,462,742)	786,943,359	5.4873402	43,182,259	50.00%	21,591,130	1,746,472	232,844,654	23,337,602	256,182,255
2012	334,930,000,000	284,255,091,000	861,000,000	430,008,284	(494,791,372)	796,216,912	5.4873402	43,691,131	50.00%	21,845,565	1,767,053	235,588,558	23,612,619	259,201,176
2013	328,540,000,000	278,831,898,000	861,000,000	468,738,532	(524,376,652)	805,361,881	5.4873402	44,192,946	50.00%	22,096,473	1,787,349	238,294,416	23,883,822	262,178,238
2014	322,140,000,000	273,400,218,000	861,000,000	508,630,688	(555,411,482)	814,219,207	5.4873402	44,678,978	50.00%	22,339,489	1,807,006	240,915,165	24,146,495	265,061,660
2015	316,450,000,000	268,571,115,000	861,000,000	549,719,609	(587,861,130)	822,858,479	5.4873402	45,153,044	50.00%	22,576,522	1,826,179	243,471,395	24,402,701	267,874,096
2016	310,820,000,000	263,792,934,000	861,000,000	592,041,197	(619,953,941)	833,087,256	5.4873402	45,714,332	50.00%	22,857,166	1,848,880	246,497,936	24,706,046	271,203,982
2017	305,060,000,000	258,904,422,000	861,000,000	635,632,433	(653,286,226)	843,346,207	5.4873402	46,277,275	50.00%	23,138,638	1,871,648	249,533,404	25,010,286	274,543,690
2018	299,410,000,000	254,109,267,000	-	-	-	-	5.4873402	-	50.00%	-	-	282,538,009	-	282,538,009
2019	293,710,000,000	249,271,677,000	-	-	-	-	5.4873402	-	50.00%	-	-	285,819,074	-	285,819,074
2020	288,430,000,000	244,790,541,000	-	-	-	-	5.4873402	-	50.00%	-	-	288,995,366	-	288,995,366
2021	283,170,000,000	240,326,379,000	-	-	-	-	5.4873402	-	50.00%	-	-	292,514,698	-	292,514,698
2022	278,110,000,000	236,031,957,000	-	-	-	-	5.4873402	-	50.00%	-	-	296,005,190	-	296,005,190
2023	-	-	-	-	-	-	5.4873402	-	50.00%	-	-	299,648,825	-	299,648,825

\* The Series A Bonds and the Series B Bonds are each pledged 50% the State's Pledged Settlement Payments.

## Interest Earnings

The Collection Methodology and Assumptions assume that each of the Series A Trustee and the Series B Trustee will receive ten days after April 15 its respective entitlement of the Annual Payments owed by the PMs in 2008 and each year thereafter. It is further assumed each of the Series A Trustee and the Series B Trustee will receive ten days after April 15 its respective entitlement of the Strategic Contribution Fund Payments owed by the PMs in the years 2008 through 2017. Interest is assumed to be earned on the Annual Payments and Strategic Contribution Fund Payments received by each of the Series A Trustee and the Series B Trustee at the rate of 3% per annum until the next Distribution Date. No interest earnings have been assumed on the Annual Payments and Strategic Contribution Fund Payments prior to the time they are received by the applicable Trustee.

Interest is assumed to be earned on amounts on deposit in the Series A Debt Service Reserve Account at the rate of 3.74% per annum and the Series B Debt Service Reserve Account at the rate of 4.687% per annum. Moneys deposited in each of the Series A Debt Service Reserve Account and the Series B Debt Service Reserve Account are invested in a guaranteed investment contract.

## Structuring Assumptions

### *General*

The Structuring Assumptions for the Series 2008 Bonds and Global Insight Base Case Forecast were applied to the projections of Pledged Settlement Payments described above. **The Global Insight Report also contains several alternative forecasts of cigarette consumption. See “SUMMARY OF THE GLOBAL INSIGHT REPORT” and APPENDIX E.**

The Structuring Assumptions are described below:

*Issue Size.* The objective in issuing the Series 2008 Bonds is to receive proceeds in an amount sufficient to: (i) refund (A) its Asset-Backed Revenue Bonds, Series 2003A-2 through 2003A-4 (State Contingency Contract Secured) (Auction Rate), of which \$217,500,000 are outstanding, and (B) its Asset Backed Revenue Bonds, Series 2003B-2 through 2003B-5 (State Contingency Contract Secured) (Auction Rate), of which \$225,000,000 are outstanding (items (A) and (B), collectively, the “Refunded Bonds”), and (ii) pay the costs of issuance incurred in connection with the issuance of the Series 2008 Bonds.

*Debt Service Reserve Account.* The Series A Debt Service Reserve Account was established with an initial deposit of \$227,545,572. The Series A Debt Service Reserve Account must be maintained, to the extent of available funds, at \$227,545,572. The Series B Debt Service Reserve Account was established with an initial deposit of \$221,582,343.75. The Series B Debt Service Reserve Account must be maintained, to the extent of available funds, at \$221,582,343.75.

*Debt Service Coverage Ratios.* The debt service coverage ratios in 2009 through 2012 were structured to produce coverage levels of Series A Pledged Settlement Payments to debt service on the Series A Bonds, including the Series 2008A Bonds, of approximately 1.30x or greater. For purposes of calculating the debt service coverage ratio, Series A Pledged Settlement Payments were calculated based upon the Global Insight Base Case Forecast. The debt service coverage ratios in 2009 through 2012 were structured to produce coverage levels of Series B Pledged Settlement Payments to estimated debt service on the Series B Bonds, including the Series 2008B Bonds, of approximately 1.30x or greater. For purposes of calculating the debt service coverage ratio, Series B Pledged Settlement Payments were calculated based upon the Global Insight Base Case Forecast.

*Operating Expense Assumptions.* Operating expenses of the Corporation have been assumed at the Series A Operating Cap of \$562,754 inflated at 3.00% per year starting in 2008. No arbitrage rebate expense was assumed. No Junior Payments have been assumed. Operating expenses of the Corporation have been assumed at the Series B Operating Cap of \$562,754 inflated at 3.00% per year starting in 2008. The Series B State Fee attributable to the issuance of the Series 2008B Bonds is assumed to be paid in full on June 1, 2008 from the Series B Pledged Revenues. No arbitrage rebate expense was assumed. No Junior Payments have been assumed.

*Issuance Date.* The Series 2008 Bonds were assumed to be issued on March 27, 2008.

*Interest Rates.* The Bonds were assumed to bear interest at the rates set forth on the inside front cover hereof.

*Principal Amortization.* Principal amortization for the Series 2008 Bonds was structured to repay the Series 2008 Bonds within approximately 4 years from the date of issuance thereof.

***No assurance can be given that actual cigarette consumption in the United States during the term of the Series 2008 Bonds will be as assumed, or that the other assumptions underlying the Collection Methodology and Assumptions and Structuring Assumptions, including that certain adjustments and offsets will not apply to payments due under the MSA, will be consistent with future events. If actual events deviate from one or more of the assumptions underlying the Collection Methodology and Assumptions or Structuring Assumptions, the amount of Series A Pledged Settlement Payments and Series B Pledged Settlement Payments available to the Corporation to pay the principal of and interest on the Series 2008A Bonds and the Series 2008B Bonds, respectively, and the amount of Series A Surplus Pledged Revenues and Series B Surplus Pledged Revenues to pay the redemption price or purchase price of the Series 2008A Bonds and the Series 2008B Bonds, respectively, could be adversely affected. See “BONDHOLDERS’ RISKS” herein.***

## CONTINUING DISCLOSURE AGREEMENTS

### General

To the extent that Rule 15c2-12 (the “**Rule**”) of the SEC promulgated under the Securities Exchange Act of 1934, as amended (the “**1934 Act**”) requires the Underwriters to determine, as a condition to purchasing the respective Series 2008 Bonds, that the Corporation and the State will make such covenants, each of the Corporation and the State (each an “**Obligated Party**”) will enter into a separate undertaking with respect to each Series of the Series 2008 Bonds (each an “**Undertaking**”) with the Trustee pursuant to which the Obligated Party will covenant for the sole benefit of the Holders of the applicable Series of the Series 2008 Bonds to provide the Corporation Annual Information or the State Annual Information, as applicable, to each nationally recognized municipal securities information repository (each a “**NRMSIR**”) and to any State information depository (the “**SID**”). No SID was in existence as of the date of the Undertakings.

Corporation Annual Information shall mean (A) the audited financial statements, if any, of the Corporation, prepared in accordance with generally accepted accounting principles in effect from time to time, (B) financial information or operating data of the type included in this Official Statement under “TABLE OF PROJECTED PLEDGED SETTLEMENT PAYMENTS AND DEBT SERVICE”; together with (C) such narrative explanation as may be necessary to avoid misunderstanding and to assist the reader in understanding the presentation of financial information and operating data and in judging the financial condition of the Corporation and (D) any additional information pursuant to a supplement to the applicable Corporation Undertaking.

Listed Event shall mean any of the following with respect to the applicable Series of the Series 2008 Bonds:

- (A) principal and interest payment delinquencies;
- (B) non payment related defaults;
- (C) unscheduled draws on debt service reserves reflecting financial difficulties;
- (D) unscheduled draws on credit enhancements reflecting financial difficulties;
- (E) substitution of credit or liquidity providers, or their failure to perform;

- (F) adverse tax opinions or events affecting the tax exempt status of the applicable Series of the Series 2008 Bonds;
- (G) modifications to rights of holders of the applicable Series of the Series 2008 Bonds;
- (H) calls and purchases of applicable Series of the Series 2008 Bonds by the Corporation;
- (I) defeasances;
- (J) release, substitution, or sale of property securing repayment of the applicable Series of the Series 2008 Bonds; and
- (K) rating changes.

MSRB shall mean the Municipal Securities Rulemaking Board established pursuant to Section 15B(b)(1) of the Securities Exchange Act of 1934.

State Annual Information shall mean financial information and operating data of the type included in the Annual Information Statement of the State set forth in APPENDIX B hereto, under the headings or sub-headings “Prior Fiscal Years,” “Debt and Other Financing Activities,” “State Government Employment,” “State Retirement Systems,” and “Authorities and Localities,” including, more specifically, information consisting of (i) for prior fiscal years, an analysis of cash-basis results for the State’s three most recent fiscal years, and a presentation of the State’s results in accordance with GAAP for at least the two most recent fiscal years for which that information is currently available; (ii) for debt and other financing activities, a description of the types of financings the State is authorized to undertake, a presentation of the outstanding debt issued by the State and certain public authorities, as well as information concerning debt service requirements on that debt; (iii) for authorities and localities, information on certain public authorities and local entities whose financial status may have a material impact on the financial status of the State; and (iv) material information regarding State government employment and retirement systems; together with (v) such narrative explanation as may be necessary to avoid misunderstanding and to assist the reader in understanding the presentation of financial information and operating data and in judging the financial condition of the State.

### **Corporation Undertaking**

*Obligations of the Corporation.* The Corporation shall provide, by no later than 180 days after the end of each fiscal year, (a) the Corporation Annual Information with respect to such fiscal year to each NRMSIR and the SID, and copies of such Corporation Annual Information to the Trustee and (b) notice of any change in its fiscal year or any failure by it to provide the Corporation Annual Information to each NRMSIR and the SID to (i) either the MSRB or each NRMSIR, and (ii) the SID. In addition, the Corporation shall provide, in a timely manner, to (i) either the MSRB or each NRMSIR, and (ii) the SID, notice of any of the Listed Events with respect to any outstanding Bonds, if material.

The Corporation shall, for each Distribution Date, cause to be provided to each NRMSIR and the SID information as to the aggregate principal amount that has been applied to the defeasance or purchase of the subject Series 2008 Bonds of each Series, pursuant to either the Series A Indenture or the Series B Indenture, during the period ending on such Distribution Date and commencing on the day after the preceding Distribution Date.

*Enforcement.* The obligation of the Corporation to comply with the provisions of the Corporation Undertaking is enforceable (i) in the case of enforcement of obligations to provide financial statements, financial information, operating data and notices, by any Beneficial Owner of outstanding Series 2008A Bonds or Series 2008B Bonds, as applicable, or by the Trustee on behalf of the Holders of outstanding Series 2008A Bonds or Series 2008B Bonds, as applicable, or (ii), in the case of challenges to the adequacy of the financial statements, financial information and operating data so provided, by the Trustee on behalf of the Holders of outstanding Series 2008 Bonds or by any Beneficial Owner thereof. A Beneficial Owner may not take any enforcement action pursuant to clause (ii) without the consent of the respective Holders of not less than 25% in aggregate principal amount of the

Series 2008A Bonds or the Series 2008B Bonds, as applicable, at the time outstanding. The Trustee shall not be required to take any enforcement action except at the direction of the respective Holders of not less than 25% in aggregate principal amount of the Series 2008A Bonds or the Series 2008B Bonds, as applicable, at the time outstanding who shall have provided the Trustee with adequate security and indemnity.

The Beneficial Owners', the Holders', and the Trustee's right to enforce the provisions of the Corporation Undertaking is limited to a right, by action in mandamus or for specific performance, to compel performance of the Corporation's obligations under each Corporation Undertaking. Any failure by the Corporation or the Trustee to perform in accordance with the terms of each Corporation Undertaking will not constitute a default or any Event of Default under the applicable Series of the Series A Indenture and the Series B Indenture, and the rights and remedies provided by the Series A Indenture and the Series B Indenture, as applicable, upon the occurrence of a default or an Event of Default shall not apply to any such failure.

*Amendments.* Each Corporation Undertaking may be amended, by written agreement of the parties, and any provision thereof may be waived, without the consent of the Holders or Beneficial Owners of the applicable Series of the Series 2008 Bonds, except to the extent required by clause 4(ii) below, if all of the following conditions are satisfied: (1) such amendment or waiver is made in connection with a change in circumstances that arises from a change in legal (including regulatory) requirements, a change in law (including rules or regulations) or in interpretations thereof, or a change in the identity, nature or status of the Corporation or the type of business conducted thereby, (2) each Corporation Undertaking as so amended or waived would have complied with the requirements of the Rule as of the date of each primary offering of the applicable Series of the Series 2008 Bonds affected by such amendment or waiver, after taking into account any amendments or interpretations of the Rule, as well as any change in circumstances, (3) the Corporation shall have delivered to the Trustee an opinion of Bond Counsel, addressed to the Corporation and the Trustee, to the same effect as set forth in clause (2) above, (4) either (i) a party unaffiliated with the Corporation (such as the Trustee or bond counsel), acceptable to the Corporation and the Trustee, has determined that the amendment or waiver does not materially impair the interests of the Beneficial Owners, or (ii) the Holders consent to the amendment or waiver of a Corporation Undertaking pursuant to the same procedures as are required for amendments to the Series A Indenture and the Series B Indenture, as applicable, with consent of Holders, and (5) the Corporation shall have delivered copies of such amendment or waiver to the SID and to either each NRMSIR or the MSRB.

In addition, the Corporation and the Trustee may amend a Corporation Undertaking, and any provision thereof may be waived, if the Trustee shall have received an opinion of bond counsel, addressed to the Corporation and the Trustee, to the effect that the adoption and the terms of such amendment or waiver would not, in and of themselves, cause the undertakings herein to violate the Rule, taking into account any subsequent change in or official interpretation of the Rule.

*Termination.* The Corporation's and the Trustee's obligations under a Corporation Undertaking shall terminate upon the legal defeasance pursuant to the applicable Series A Indenture and the Series B Indenture, prior redemption, or payment in full of all of the applicable Series of the Series 2008 Bonds. The Corporation shall give notice of any such termination to the SID and to either each NRMSIR or the MSRB.

The Corporation Undertaking, or any provision thereof, shall be null and void to the extent set forth in the opinion of bond counsel described in clause (1) in the event that the Corporation (1) delivers to the Trustee an opinion of bond counsel, addressed to the Corporation and the Trustee, to the effect that those portions of the Rule which require the provisions of the applicable Corporation Undertaking, or any of such provisions, do not or no longer apply to any or all of the applicable Series of the Series 2008 Bonds, whether because such portions of the Rule are invalid, have been repealed, or otherwise, as shall be specified in such opinion, and (2) delivers notice to such effect to the SID and to either each NRMSIR or the MSRB.

## **State Undertaking**

*Obligations of the State.* The State shall provide, by no later than 120 days after the end of each fiscal year, commencing with the fiscal year ending March 31, 2008 to each NRMSIR and to the SID (a) the State Annual Information with respect to such fiscal year and (b) audited financial statements of the State for such fiscal year, when available. In addition, the State shall provide, in timely manner, to (i) either the MSRB or each NRMSIR, and



(ii) the SID, notice of any of the Listed Events with respect to any outstanding Series 2008 Bonds of an applicable Series, if material.

*Enforcement.* The sole and exclusive remedy for breach of a State Undertaking is an action to compel specific performance of the obligations of the State. No person or entity shall be entitled to recover any monetary damages under any circumstances. The State may be compelled to comply with its obligations under a State Undertaking (i) in the case of enforcement of its obligations to provide information required thereunder, by any Holder of Outstanding Series 2008 Bonds of the applicable Series or by the Trustee on behalf of the Holders of Outstanding Series 2008 Bonds of the applicable Series or (ii) in the case of challenges to the adequacy of the information provided, by the Trustee on behalf of the Holders of Outstanding Series 2008 Bonds of the applicable Series; provided, however, that the Trustee shall not be required to take any enforcement action except at the direction of the respective Holders of not less than 25% in aggregate principal amount of the Series 2008A Bonds or the Series 2008B Bonds, as applicable, at the time Outstanding. Failure by the State to perform its obligations under the State Undertaking shall not constitute an Event of Default under the Series A Indenture or the Series B Indenture or any other agreement executed and delivered in connection with the issuance of the Series 2008 Bonds of the applicable Series.

*Amendments.* Without the consent of any Holders of Series 2008 Bonds of the applicable Series, the State at any time and from time to time may amend the applicable State Undertaking for any of the following purposes: (i) to comply with or conform to any changes in Rule 15c2-12 or any formal authoritative interpretations thereof by the Securities and Exchange Commission or its staff (whether required or optional), which are applicable to the applicable State Undertaking; (ii) to add or change a dissemination agent for the information required to be provided thereby and to make any necessary or desirable provisions with respect thereto; (iii) to evidence the succession of another person to the State, and the assumption by any such successor of the covenants of the State under the applicable State Undertaking; (iv) to add to the covenants of the State for the benefit of the Holders of the Series 2008 Bonds of the applicable Series, or to surrender any right or power therein conferred upon the State; (v) for any purposes for which, and subject to the conditions pursuant to which, amendments may be made under Rule 15c2-12, as amended or modified from time to time, or any formal authoritative interpretations thereof by the Securities and Exchange Commission or its staff, which are applicable to the applicable State Undertaking; or (vi) for any other purpose, if (a) the amendment is made in connection with a change in circumstances that arise from a change in legal requirements, change in law, or change in identity or nature, or status of the State or any type of business or affairs conducted by it; (b) the undertakings set forth in the applicable State Undertaking, as amended, would have complied with the requirements of Rule 15c2-12 at the time of the primary offering of the Series 2008 Bonds of the applicable Series, after taking into account any amendments, or formal authoritative interpretations by the Securities and Exchange Commission of Rule 15c2-12 as well as any change in circumstances; and (c) the amendment does not materially impair the interests of the Holders, as determined either by the Trustee or by nationally recognized bond counsel. (In determining whether or not there is such an adverse effect, the Trustee may rely upon an opinion of nationally recognized bond counsel.)

*Termination.* The State Undertaking will remain in full force and effect until such time as all principal, redemption premiums, if any, and interest on the Series 2008 Bonds of the applicable Series will have been paid in full or such Bonds shall have been defeased pursuant to the Series A Indenture and the Series B Indenture, as applicable; provided, however, that if Rule 15c2-12 (or successor provision) shall be amended, modified or changed so that all or any part of the information currently required to be provided thereunder shall no longer be required to be provided thereunder, then such information shall no longer be required to be provided under the State Undertaking; and provided, further, that if to the extent Rule 15c2-12 (or successor provision), or any provision thereof, shall be declared by a court of competent and final jurisdiction to be, in whole or in part, invalid, unconstitutional, null and void, or otherwise inapplicable to the Bonds, then the information required to be provided thereunder, insofar as it was required to be provided by a provision of Rule 15c2-12 so declared, shall no longer be required to be provided thereunder.

## LITIGATION

There is no litigation pending or threatened in any court (either in State or federal court) to restrain or enjoin the issuance or delivery of the Series 2008 Bonds or questioning the creation, organization or existence of the Corporation, the validity or enforceability of the Act, the Series A Sale Agreement, the Series B Sale Agreement, the

Series A Indenture, the Series B Indenture, the Series A Contract, the Series B Contract, the sale of each of the Series A Pledged Settlement Payments and the Series B Pledged Settlement Payments by the State to the Corporation, the proceedings for the authorization, execution, authentication and delivery of the Series 2008 Bonds or the validity of the Series 2008 Bonds. For a discussion of other legal matters, including certain pending litigation involving the MSA and the PMs, see “BONDHOLDERS’ RISKS,” “LEGAL CONSIDERATIONS RELATING TO SERIES A PLEDGED SETTLEMENT PAYMENTS AND SERIES B PLEDGED SETTLEMENT PAYMENTS” and “APPENDIX F- CERTAIN INFORMATION RELATING TO THE TOBACCO INDUSTRY.”

## TAX MATTERS

*Opinion of Bond Counsel.* In the opinion of Bond Counsel, under existing statutes and court decisions and assuming continuing compliance with certain tax covenants described herein (i) interest on the Series 2008 Bonds is excluded from gross income for Federal income tax purposes pursuant to Section 103 of the Code, and (ii) interest on the Series 2008 Bonds is not treated as a preference item in calculating the alternative minimum tax imposed on individuals and corporations under the Code; such interest, however, is included in the adjusted current earnings of certain corporations for purposes of calculating the alternative minimum tax imposed on such corporations.

In rendering its opinion, Bond Counsel has relied on certain representations, certifications of fact, and statements of reasonable expectations made by the Corporation and the State in connection with the Series 2008 Bonds, and Bond Counsel has assumed compliance by the Corporation and the State with certain ongoing covenants to comply with applicable requirements of the Code to assure the exclusion of interest on the Series 2008 Bonds from gross income under Section 103 of the Code.

In addition, in the opinion of Bond Counsel, under the Act interest on the Series 2008 Bonds is exempt from personal income taxes imposed by the State of New York and its political subdivisions thereof, including The City of New York.

Bond Counsel expresses no opinion regarding any other Federal or state tax consequences with respect to the Series 2008 Bonds. Bond Counsel renders its opinion under existing statutes and court decisions as of the issue date, and assumes no obligation to update its opinion after the issue date to reflect any future action, fact or circumstance, or change in law or interpretation, or otherwise. Bond Counsel expresses no opinion on the effect of any action hereafter taken or not taken in reliance upon an opinion of other counsel on the exclusion from gross income for Federal income tax purposes of interest on the Series 2008 Bonds, or under state or local tax law.

*Certain Ongoing Federal Tax Requirements and Covenants.* The Code establishes certain ongoing requirements that must be met subsequent to the issuance and delivery of the Series 2008 Bonds in order that interest on the Series 2008 Bonds be and remain excluded from gross income under Section 103 of the Code. These requirements include, but are not limited to, requirements relating to use and expenditure of gross proceeds of the Series 2008 Bonds, yield and other restrictions on investments of gross proceeds, and the arbitrage rebate requirement that certain excess earnings on gross proceeds be rebated to the Federal government. Noncompliance with such requirements may cause interest on the Series 2008 Bonds to be included in gross income for Federal income tax purposes retroactive to their issue date, irrespective of the date on which such noncompliance occurs or is discovered. The Corporation has covenanted in each of the Series A Indenture and the Series B Indenture, and the State has covenanted in each of the Series A Sale Agreement and the Series B Sale Agreement to comply with certain applicable requirements of the Code to assure the exclusion of interest on the Series 2008 Bonds from gross income under Section 103 of the Code.

*Certain Collateral Federal Tax Consequences.* The following is a brief discussion of certain collateral Federal income tax matters with respect to the Series 2008 Bonds. It does not purport to address all aspects of Federal taxation that may be relevant to a particular owner of a Series 2008 Bond. Prospective investors, particularly those who may be subject to special rules, are advised to consult their own tax advisors regarding the Federal tax consequences of owning and disposing of the Series 2008 Bonds.

Prospective owners of the Bonds should be aware that the ownership of such obligations may result in collateral Federal income tax consequences to various categories of persons, such as corporations (including S Corporations and foreign corporations), financial institutions, property and casualty and life insurance companies,

individual recipients of Social Security or Railroad Retirement benefits, individuals otherwise eligible for the earned income tax credit, and to taxpayers deemed to have incurred or continued indebtedness to purchase or carry obligations the interest on which is not included in gross income for Federal income tax purposes. Interest on the Series 2008 Bonds may be taken into account in determining the tax liability of foreign corporations subject to the branch profits tax imposed by Section 884 of the Code.

*Original Issue Discount.* Original issue discount (“**OID**”) is the excess of the sum of all amounts payable at the stated maturity of a Series 2008 Bond (excluding certain “qualified stated interest” that is unconditionally payable at least annually at prescribed rates) over the issue price of that maturity. In general, the “issue price” of a maturity means the first price at which a substantial amount of the Series 2008 Bonds of that maturity was sold (excluding sales to bond houses, brokers, or similar persons acting in the capacity as underwriters, placement agents, or wholesalers). In general, the issue price for each maturity of Series 2008 Bonds is expected to be the initial public offering price set forth on the inside front cover page of this Official Statement. Bond Counsel further is of the opinion that, for any Series 2008 Bonds having OID (a “**Discount Bond**”), OID that has accrued and is properly allocable to the owners of the Discount Bonds under Section 1288 of the Code is excludable from gross income for Federal income tax purposes to the same extent as other interest on the Series 2008 Bonds.

In general, under Section 1288 of the Code, OID on a Discount Bond accrues under a constant yield method, based on periodic compounding of interest over prescribed accrual periods using a compounding rate determined by reference to the yield on that Discount Bond. An owner’s adjusted basis in a Discount Bond is increased by accrued OID for purposes of determining gain or loss on sale, exchange, or other disposition of such Bond. Accrued OID may be taken into account as an increase in the amount of tax-exempt income received or deemed to have been received for purposes of determining various other tax consequences of owning a Discount Bond even though there will not be a corresponding cash payment.

Owners of Discount Bonds should consult their own tax advisors with respect to the treatment of original issue discount for Federal income tax purposes, including various special rules relating thereto, and the state and local tax consequences of acquiring, holding, and disposing of Discount Bonds.

*Bond Premium.* In general, if an owner acquires a Series 2008 Bond for a purchase price (excluding accrued interest) or otherwise at a tax basis that reflects a premium over the sum of all amounts payable on the Series 2008 Bond after the acquisition date (excluding certain “qualified stated interest” that is unconditionally payable at least annually at prescribed rates), that premium constitutes “bond premium” on that Series 2008 Bond (a “**Premium Bond**”). In general, under Section 171 of the Code, an owner of a Premium Bond must amortize the bond premium over the remaining term of the Premium Bond, based on the owner’s yield over the remaining term of the Premium Bond, determined based on constant yield principles. An owner of a Premium Bond must amortize the bond premium by offsetting the qualified stated interest allocable to each interest accrual period under the owner’s regular method of accounting against the bond premium allocable to that period. In the case of a tax-exempt Premium Bond, if the bond premium allocable to an accrual period exceeds the qualified stated interest allocable to that accrual period, the excess is a nondeductible loss. Under certain circumstances, the owner of a Premium Bond may realize a taxable gain upon disposition of the Premium Bond even though it is sold or redeemed for an amount less than or equal to the owner’s original acquisition cost. Owners of any Premium Bonds should consult their own tax advisors regarding the treatment of bond premium for Federal income tax purposes, including various special rules relating thereto, and state and local tax consequences, in connection with the acquisition, ownership, amortization of bond premium on, sale, exchange, or other disposition of Premium Bonds.

*Information Reporting and Backup Withholding.* Information reporting requirements apply to interest paid on tax-exempt obligations, including the Series 2008 Bonds. In general, such requirements are satisfied if the interest recipient completes, and provides the payor with, a Form W-9, “Request for Taxpayer Identification Number and Certification,” or unless the recipient is one of a limited class of exempt recipients, including corporations. A recipient not otherwise exempt from information reporting who fails to satisfy the information reporting requirements will be subject to “backup withholding,” which means that the payor is required to deduct and withhold a tax from the interest payment, calculated in the manner set forth in the Code. For the foregoing purpose, a “payor” generally refers to the person or entity from whom a recipient receives its payments of interest or who collects such payments on behalf of the recipient.

If an owner purchasing a Series 2008 Bond through a brokerage account has executed a Form W-9 in connection with the establishment of such account, as generally can be expected, no backup withholding should occur. In any event, backup withholding does not affect the excludability of the interest on the Series 2008 Bonds from gross income for Federal income tax purposes. Any amounts withheld pursuant to backup withholding would be allowed as a refund or a credit against the owner's Federal income tax once the required information is furnished to the Internal Revenue Service.

*Miscellaneous Tax Matters.* Tax legislation, administrative action taken by tax authorities, and court decisions, whether at the Federal or state level, may adversely affect the tax-exempt status of interest on the Series 2008 Bonds under Federal or state law and could affect the market price or marketability of the Series 2008 Bonds.

Prospective purchasers of the Series 2008 Bonds should be aware that the United States Supreme Court is in the process of reviewing *Davis v. Dep't. of Revenue of the Finance and Admin. Cabinet*, 197 S.W. 3d 557 (Ky. App. 2006), *cert. granted* 127 S.Ct. 2451 (2007) (mem.), a decision of a Kentucky appellate court, which held that provisions of Kentucky tax law that provided more favorable income tax treatment for holders of bonds issued by Kentucky municipal bond issuers than for holders of non-Kentucky municipal bonds violated the Commerce Clause of the United States Constitution. New York statutes provide more favorable New York income tax treatment for holders of bonds issued by the New York State and its political subdivisions, including the Series 2008 Bonds, than for bonds issued by other states and their political subdivisions. If the United States Supreme Court affirms the holding of the Kentucky appellate court, subsequent New York judicial decisions or legislation designed to ensure the constitutionality of New York tax law could, among other alternatives, adversely affect the New York State tax exemption of outstanding bonds, including the Series 2008 Bonds, to the extent constitutionally permissible, or result in the exemption from personal income taxes imposed by the New York State and its political subdivisions, including The City of New York, of interest on certain bonds issued by other states and their political subdivisions, either of which actions could affect the market price or marketability of the Series 2008 Bonds.

Prospective purchasers of the Series 2008 Bonds should consult their own tax advisors regarding the foregoing matters.

#### **STATE NOT LIABLE ON THE SERIES 2008A BONDS**

PURSUANT TO THE ACT, THE SERIES A BONDS, INCLUDING THE SERIES 2008A BONDS, SHALL NOT CONSTITUTE A DEBT OR MORAL OBLIGATION OF THE STATE OR A STATE SUPPORTED OBLIGATION WITHIN THE MEANING OF ANY CONSTITUTIONAL OR STATUTORY PROVISION OR A PLEDGE OF THE FAITH AND CREDIT OF THE STATE OR OF THE TAXING POWER OF THE STATE, AND THE STATE SHALL NOT BE LIABLE TO MAKE ANY PAYMENTS THEREON NOR SHALL ANY SERIES 2008A BONDS, INCLUDING ANY SERIES 2008A BONDS, BE PAYABLE OUT OF ANY FUNDS OR ASSETS OTHER THAN THE SERIES A PLEDGED REVENUES. THE CORPORATION HAS NO TAXING POWER.

#### **STATE NOT LIABLE ON THE SERIES 2008B BONDS**

PURSUANT TO THE ACT, THE SERIES 2008B BONDS, INCLUDING THE SERIES 2008B BONDS, SHALL NOT CONSTITUTE A DEBT OR MORAL OBLIGATION OF THE STATE OR A STATE SUPPORTED OBLIGATION WITHIN THE MEANING OF ANY CONSTITUTIONAL OR STATUTORY PROVISION OR A PLEDGE OF THE FAITH AND CREDIT OF THE STATE OR OF THE TAXING POWER OF THE STATE, AND THE STATE SHALL NOT BE LIABLE TO MAKE ANY PAYMENTS THEREON NOR SHALL ANY SERIES 2008B BONDS, INCLUDING ANY SERIES 2008B BONDS, BE PAYABLE OUT OF ANY FUNDS OR ASSETS OTHER THAN THE SERIES B PLEDGED REVENUES. THE CORPORATION HAS NO TAXING POWER.

#### **RATINGS**

S&P has assigned a rating of AA- to the Series 2008 Bonds. Fitch has assigned a rating of A+ to the Series 2008 Bonds.

Such ratings will reflect only the view of such Rating Agencies, and an explanation of the significance of such ratings may be obtained from the Rating Agency furnishing the same. There is no assurance that any initial rating assigned to the Series 2008 Bonds will continue for any given period of time or that such rating will not be revised downward, suspended or withdrawn entirely by the Rating Agencies. Any such downward revision, suspension or withdrawal of a rating may have an adverse effect on the availability of a market for or the market price of the Series 2008 Bonds.

### **VERIFICATION OF MATHEMATICAL COMPUTATIONS**

Upon delivery of the Series 2008A Bonds, the arithmetical accuracy of certain computations included in the schedules provided by the Underwriters on behalf of the Corporation relating to the: (i) adequacy of forecasted receipts of principal and interest on the Series A Defeasance Collateral and cash to be held pursuant to the Series A Refunding Escrow Agreement; (ii) forecasted payments of principal and interest with respect to the Series A Refunded Bonds on and prior to their maturities and/or redemption dates; and (iii) yields with respect to the Series 2008A Bonds and on the obligations and other securities to be deposited pursuant to the Series A Refunding Escrow Agreement upon delivery of the Series 2008A Bonds, will be verified by Causey Demgen & Moore Inc., independent certified public accountants (the “**Verification Agent**”). Such verification shall be based solely upon information and assumptions supplied to the Verification Agent by the Underwriters. The Verification Agent has not made a study or evaluation of the information and assumptions on which such computations are based and, accordingly, has not expressed an opinion on the data used, the reasonableness of the assumptions or the achievability of the forecasted outcome.

Upon delivery of the Series 2008B Bonds, the arithmetical accuracy of certain computations included in the schedules provided by the Underwriters on behalf of the Corporation relating to the: (i) adequacy of forecasted receipts of principal and interest on the Series B Defeasance Collateral and cash to be held pursuant to the Series B Refunding Escrow Agreement; (ii) forecasted payments of principal and interest with respect to the Series B Refunded Bonds on and prior to their maturities and/or redemption dates; and (iii) yields with respect to the Series 2008B Bonds and on the obligations and other securities to be deposited pursuant to the Series B Refunding Escrow Agreement upon delivery of the Series 2008B Bonds, will be verified by the Verification Agent. Such verification shall be based solely upon information and assumptions supplied to the Verification Agent by the Underwriters. The Verification Agent has not made a study or evaluation of the information and assumptions on which such computations are based and, accordingly, has not expressed an opinion on the data used, the reasonableness of the assumptions or the achievability of the forecasted outcome.

### **LEGAL INVESTMENTS**

The Act provides that the Series 2008 Bonds are securities in which all public officers and bodies of the State and all municipalities and political subdivisions, all insurance companies and associations and other persons carrying on an insurance business, all banks, bankers, trust companies, savings banks and savings associations, including savings and loan associations, building and loan associations, investment companies and other persons carrying on a banking business, all administrators, guardians, executors, trustees and other fiduciaries, and all other persons whatsoever who are now or may hereafter be authorized to invest in bonds or in other obligations of the State, may properly and legally invest funds, including capital, in their control or belonging to them. The Act also provides that the Series 2008 Bonds are securities which may be deposited with and may be received by all public officers and bodies of the State and all municipalities, political subdivisions and public corporations for any purpose for which the deposit of bonds or other obligations of the State is now or hereafter may be authorized.

### **UNDERWRITING**

The Underwriters have agreed, subject to certain conditions, to purchase the Series 2008 Bonds from the Corporation for a purchase price of \$456,310,966.11 (representing the principal amount of the Series 2008 Bonds, plus net original issue premium of \$14,596,321.50 and less an underwriting discount of \$2,160,355.39). The Underwriters will be obligated to purchase all Series 2008 Bonds if any such Series 2008 Bonds are purchased.

The Series 2008 Bonds may be offered and sold to certain dealers (including dealers depositing the Series 2008 Bonds into investment trusts) and institutional purchasers at prices lower than such public offering prices, and such public offering prices may be changed, from time to time, by the Underwriters.

Citigroup Global Markets Inc. is an affiliate of Citibank, N.A. which is acting as MSA Escrow Agent under the MSA. The firm and its affiliates also serve as an investment advisor to the MSA Escrow Agent.

### **LEGAL MATTERS**

Hawkins Delafield & Wood LLP, New York, New York, as Bond Counsel to the Corporation, will render the opinions with respect to the validity of the Series 2008A Bonds and the Series 2008B Bonds in substantially the forms set forth in APPENDIX H hereto.

The State Attorney General will render the opinion simultaneously with the delivery of the Series 2008 Bonds. The State Attorney General will deliver an opinion that (i) the Act has been duly enacted by the State and is in full force and effect and (ii) the each of the Series A Contract and the Series B Contract has been duly authorized, executed and delivered by the State, and assuming the due execution and delivery by the Corporation, each of the Series A Contract and the Series B Contract constitutes a legal, valid and binding obligation of the State, enforceable in accordance with its terms.

Certain legal matters will be passed upon for the Corporation by its Counsel.

Certain legal matters will be passed upon for the Underwriters by Sidley Austin LLP, New York, New York, as Underwriters' Counsel.

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**OTHER PARTIES**

**Financial Advisor**

DEPFA First Albany Securities LLC (the “**Financial Advisor**”), has been retained to act as financial advisor for the Corporation in connection with the issuance of the Series 2008 Bonds.

The following sentence has been provided by the Financial Advisor. Although the Financial Advisor has assisted in the preparation of this Official Statement, the Financial Advisor is not obligated to undertake, and have not undertaken to make, an independent verification or to assume responsibility for the accuracy, completeness or fairness of the information contained in this Official Statement.

**Global Insight**

Global Insight has been retained by the Corporation as an independent econometric expert. The Global Insight Report attached as APPENDIX E hereto is included herein in reliance on Global Insight as experts in such matters. Global Insight’s fees for acting as the Corporation’s independent econometric consultant are not contingent upon the issuance of the Series 2008 Bonds. The Global Insight Report should be read in its entirety.

**TOBACCO SETTLEMENT FINANCING CORPORATION**

By: \_\_\_\_\_ /s/ Marian Zucker  
Authorized Representative

March 19, 2008

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**APPENDIX A**

**THE SERIES 2008A CONTINGENCY CONTRACT AND  
THE SERIES 2008B CONTINGENCY CONTRACT  
BETWEEN THE STATE OF NEW YORK AND THE CORPORATION**

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**TOBACCO SETTLEMENT FINANCING CORPORATION CONTINGENCY CONTRACT**, dated as of June 1, 2003 (the "Contract"), by and between the Tobacco Settlement Financing Corporation, created and established as a subsidiary of the State of New York Municipal Bond Bank Agency and as a public benefit corporation, separate and apart from the State of New York (the "Corporation"), and the State of New York (the "State"), acting by and through the Director of the Budget of the State.

**WHEREAS**, pursuant to Part D3 of Assembly. 2106-B, a Chapter of the Laws of 2003 (the Tobacco Settlement Financing Corporation Act) (the "Act"), the Corporation is authorized to purchase, for cash or other consideration, all or a portion of the State's Share (as defined in the Act), but the Act placed limitations upon the amount of bonds and other indebtedness which the Corporation was authorized to issue or incur for such purposes;

**WHEREAS**, in order to assist the Corporation in the undertaking and financing of the purchase of a certain portion of the State's Share through the issuance of its bonds, and in consideration of the undertaking thereof and the benefits to be derived therefrom by the people of the State, the Act authorizes the Director of the Budget, acting on behalf of the State, to enter into one or more contingency contracts with the Corporation whereunder the State would agree, subject to the making of annual appropriations therefor by the State Legislature, to provide to the Corporation the amount, if any, as necessary to meet the debt service requirements on one or more series of bonds of the Corporation in any year if the receipts from pledged tobacco revenues (as defined in the Act) or from an ancillary bond facility (as defined in the Act), if any, are inadequate and after, to the extent required by the Act, application of all other collateral pledged therefor, including any debt service and debt service reserve fund;

**WHEREAS**, this Contingency Contract is executed pursuant to the Act;

**WHEREAS**, pursuant to the Act, the Corporation entered into its Indenture dated as of June 1, 2003, between the Corporation and The Bank of New York, as Trustee (together with its permitted successors and assigns, the "Trustee"), as supplemented by its Series 2003 Supplement dated as of June 1, 2003, between the Corporation and said Trustee (as amended and supplemented, the "Indenture"), for the purpose of providing for the issuance of its Series 2003A Bonds or Refunding Bonds (as defined in the Indenture and, collectively, the "Bonds") and the securing of the repayment of said Bonds, including by a pledge under the Indenture of the Corporation's rights under this Contract; and

**WHEREAS**, terms not otherwise defined herein shall have the definitions assigned thereto under the Indenture;

**NOW, THEREFORE**, the parties mutually agree as follows:

**I. Payments by the State**

1.1. Subject to the provisions of Section 1.3 and Section 1.4, the State agrees to pay to the Corporation, on or before each Distribution Date of any year for which the Corporation shall have outstanding Bonds secured by this Contract, the amount of money, if any, certified by the Chairman of the Corporation to the Director of the Budget and to the State Comptroller no later than five (5) business days prior to each such Distribution Date as the amount which is

necessary, after taking into account application of all amounts of Collateral pledged therefor under the Indenture, including receipts from pledged tobacco revenues or from any ancillary bond facility or amounts in the Debt Service Account, the Debt Service Reserve Account or the Supplemental Account on the date of such certification to pay the scheduled principal (as to which the failure to make payment thereof constitutes a default under the Indenture, including mandatory sinking fund payments, if any) of and interest on the Bonds coming due on such next succeeding Distribution Date (herein "Scheduled Debt Service").

1.2. The State agrees that, subject to the provisions of Section 1.3 and Section 1.4, its obligations to make the payments provided for in this Article I shall be absolute and unconditional, without any rights of set-off, recoupment or counterclaim the State may have against the Corporation or any other person or entity having an interest in this Contract or the payments made hereunder.

1.3. Notwithstanding anything in this Contract to the contrary, (i) the obligation of the State to fund or to pay the amounts herein provided for is subject to annual appropriation by the State Legislature, (ii) the obligation of the State, to fund or to pay the amounts herein provided for shall not constitute a debt of the State, or pursuant to the Act, State supported debt, within the meaning of any constitutional or statutory provision and shall be deemed executory only to the extent of moneys available and no liability shall be incurred by the State beyond the moneys available and appropriated for such purpose, and (iii) the amounts paid to the Corporation pursuant to this Contract shall be applied by the Corporation solely for deposit under the Indenture to pay the Scheduled Debt Service.

1.4. Pursuant to the Act, the following is stated: this Contingency Contract shall not constitute a debt or moral obligation of the State or a State supported obligation within the meaning of any constitutional or statutory provision or a pledge of the faith and credit of the State or of the taxing power of the State, and the State shall not be liable to make any payments thereon nor shall this Contingency Contract be payable out of any funds or assets other than those received from the State under this Contingency Contract and pledged therefor under the Indenture.

1.5. To the extent that the Corporation shall obtain bond insurance for the Series 2003A Bonds (which provides for payment to bondholders in the event that Series 2003A Bonds are not paid from Collateral held under the Indenture), such bond insurance shall not be pledged as Collateral to the payment of the Series 2003A Bonds or otherwise considered an ancillary bond facility under the Indenture, amounts payable by the bond insurer shall not be Pledged Revenues under the Indenture, and the bond insurer shall not be a Beneficiary under the Indenture (except to the extent payments are made on the bond insurance). As a result, payments required to be made by the State pursuant to Section 1.1 hereof shall not take into account amounts due for payment under any such bond insurance policy.

## **II. Duties of the Corporation**

2.1. The Corporation agrees to apply the net proceeds (as defined in the Act) from the sale of its Series 2003A Bonds to finance the purchase of a certain portion of the State's Share in accordance with the applicable provisions of the Act and the Indenture.

2.2. The Corporation agrees to deposit under the Indenture all amounts received pursuant to the Contract, which amounts shall be held, administered and applied by the Trustee, as provided in the Indenture, and shall not be commingled with any other funds of the Corporation.

### **III. Pledge and Assignment**

3.1. The State hereby consents to the pledge and assignment by the Corporation under the Indenture for the benefit of the owners of any of its Bonds of all or any part of the benefits or rights of the Corporation herein and of the payments by the State as provided herein.

### **IV. Special Covenants**

4.1. In accordance with the Act, the Corporation agrees to request from the State annually by certification of an authorized officer thereof to the Director of the Budget, by October 31<sup>st</sup> in each year, but in any event not later than December 15<sup>th</sup> of each year, an appropriation of an amount equal to the Scheduled Debt Service (provided that with respect to Auction Rate Bonds the amount of interest thereon shall be at the Maximum Rate of fifteen percent (15%) per annum as set forth in the Indenture or with respect to other Bonds, if any, for which the interest thereon is subject to variation between Distribution Dates, the amount of interest thereon shall be at the maximum rate as set forth or as provided for in the Indenture) coming due during such next succeeding fiscal year.

4.2. In accordance with the Act, the State agrees that the Director of the Budget on behalf of the State shall include, as a requested appropriation item in the State's budget for such fiscal year, an amount equal to such certified amount.

4.3. The State agrees that whenever requested by the Corporation with reasonable advance notification it shall provide and certify, or cause to be provided and certified, in form satisfactory to the Corporation, such information concerning (A)(i) the State and various public authorities, or (ii) the operations and finances of the State and such other matters, that the Corporation considers necessary to enable it to complete and publish an official statement, placement memorandum or other similar document relating to the sale or issuance of Bonds, and (B) the payments to be made by the State as provided herein or any funds established under the Indenture, or information necessary to enable the Corporation to make any reports required by law or governmental regulations (including Rule 15c2-12, as amended, promulgated by the Securities and Exchange Commission under the Securities Exchange Act of 1934) in connection with any Bonds.

4.4. Neither the Corporation nor the State shall terminate this Contract for any reason whatsoever including, without limiting the generality of the foregoing, any acts or circumstances which may constitute failure of consideration or frustration of purpose or the failure of either party to perform and observe any duty, liability or obligation arising out of or connected with this Contract.

4.5. This Contract may not be amended, changed, modified or altered so as to adversely affect the rights of the owners of any Bonds, the payments to be made by the State as

provided herein or the funds required by the Indenture without the consent of such owners or the Trustee given in accordance with the provisions of the Indenture.

**V. Events of Default by the State and Remedies**

5.1. If, for any reason (other than a failure by the State Legislature to appropriate moneys for such purpose), the State shall fail to pay when due any of the payments provided for in Section 1.1 or shall fail to observe or perform any other covenant, condition or agreement on its part to be observed or performed, the Corporation shall, if such default has not been cured, have the right to institute any action in the nature of mandamus or take whatever action at law or in equity may appear necessary or desirable to collect the payments then due or thereafter to become due or to enforce performance and observance of any obligation, agreement or covenant of the State hereunder.

5.2. The remedies conferred upon or reserved to the Corporation under Section 5.1 in respect of any default described therein are not intended to be exclusive of any other available remedy or remedies and shall be in addition to every other remedy now or hereafter existing at law or in equity; provided, however, that such remedy or remedies may in no event include a termination of this Contract, nor may they include any amendment, change, modification or alteration that is referred to in Sections 4.4 or 4.5.

**VI. Events of Default by the Corporation and Remedies**

6.1. If the Corporation shall fail to observe or perform any covenant, condition or agreement on its part to be observed or performed and such failure to observe or perform shall have continued for 60 days after written notice, specifying such failure and requesting that it be remedied, is given to the Corporation by the State, the State shall, if the default has not been cured, have the right to institute any action in the nature of mandamus or take whatever action at law or in equity may appear necessary or desirable to enforce the performance and observance of any obligation, agreement or covenant of the Corporation hereunder.

6.2. The remedies conferred upon or reserved to the State under Section 6.1 in respect of any default described therein are not intended to be exclusive of any other available remedy or remedies and shall be in addition to every other remedy now or hereafter existing at law or in equity; provided, however, that such remedy or remedies may in no event include a termination of this Contract or of the obligations of the State to make the payments provided for in Article I, nor may they include any amendment, change, modification or alteration of this Contract that is prohibited by Sections 4.4 or 4.5.

**VII. Miscellaneous**

7.1. This Contract shall be construed and interpreted in accordance with the laws of the State of New York.

7.2. This Contract may be executed in several counterparts, each of which shall be deemed to be an original, but such counterparts together shall constitute one and the same instrument.

EXECUTION COPY

7.3. In the event any provision of this Contract shall be held invalid or unenforceable by any court of competent jurisdiction, such holding shall not invalidate or render unenforceable any other provision hereof.

7.4. This Contract shall have a term ending on such date as there are no Bonds Outstanding under the Indenture.

7.5. The waiver by either party of a breach by the other shall not be deemed to waive any other breach hereunder nor shall any delay or omission to exercise any right or power upon any default impair any such right or power or be construed as a waiver thereof.

7.6. All notices for in this Contract shall be in writing and shall be delivered personally to be sent by certified or registered mail to the respective offices of the State and the Corporation as follows:

If to the State:

Director of the Budget  
State of New York  
Executive Department  
Division of the Budget  
State Capitol, Room 113  
Albany, New York 12224

If to the Corporation:

Tobacco Settlement Financing Corporation  
c/o State of New York  
Municipal Bond Bank Agency  
641 Lexington Avenue  
New York, New York 10022

Attention: Robert Drillings, Esq.  
Senior Vice President and Counsel

The Corporation or the State may from time to time designate in writing other representatives with respect to receipt of notices.

7.7. This Contract represents the entire agreement between the parties. It may not be amended or modified otherwise than by a written instrument executed by each of the parties. Such amendments shall not be contrary to the provisions of Sections 4.3 or 4.4.

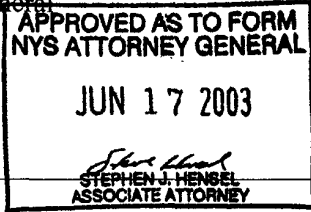
7.8. Nothing in this Contract shall be construed to confer upon or to give notice to any person or entity other than the State, the Corporation, and the owners of any Bonds, the Trustee or any other trustee acting on their behalf, any right, remedy or claim under or by reason of this Contract or any provision thereof.

7.9. In accordance with the Act, neither the members of the Corporation nor any other person executing the Contract shall be subject to any personal liability or accountability by reason of the issuance or execution and delivery thereof.

[Signature Page for Contingency Contract]

IN WITNESS WHEREOF, the State has caused this Contract to be executed in its name by the Director of the Budget and the Corporation has caused this instrument to be signed by its Executive Director as its duly authorized officer all as of the 1st day of June, 2003.

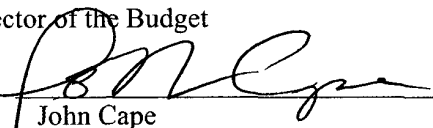
Approved as to form:  
Attorney General



By: \_\_\_\_\_  
Date: \_\_\_\_\_

STATE OF NEW YORK

Carole E. Stone  
Director of the Budget

By:   
John Cape  
First Deputy Director

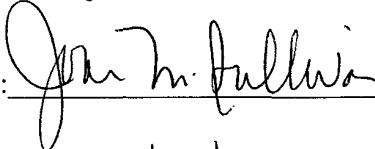
Approved as to form:  
Counsel

TOBACCO SETTLEMENT  
FINANCING CORPORATION

By: \_\_\_\_\_  
Date: \_\_\_\_\_

\_\_\_\_\_  
Authorized Officer

Approved:  
State Comptroller

By:   
\_\_\_\_\_

Date: 6/17/03



[Signature Page for Contingency Contract]

IN WITNESS WHEREOF, the State has caused this Contract to be executed in its name by the Director of the Budget and the Corporation has caused this instrument to be signed by its Executive Director as its duly authorized officer all as of the 1st day of June, 2003.

Approved as to form:  
Attorney General

STATE OF NEW YORK

Carole E. Stone  
Director of the Budget

By: \_\_\_\_\_  
Date: \_\_\_\_\_

By: \_\_\_\_\_  
John Cape  
First Deputy Director

Approved as to form:  
Counsel

TOBACCO SETTLEMENT  
FINANCING CORPORATION

By: \_\_\_\_\_  
Date: 6/18/03

\_\_\_\_\_  
Authorized Officer

Approved:  
State Comptroller

By: \_\_\_\_\_

Date: \_\_\_\_\_

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**TOBACCO SETTLEMENT FINANCING CORPORATION CONTINGENCY  
CONTRACT**

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between the

**STATE OF NEW YORK**

and the

**TOBACCO SETTLEMENT FINANCING CORPORATION**

Dated as of December 1, 2003

**THIS TOBACCO SETTLEMENT FINANCING CORPORATION CONTINGENCY CONTRACT**, dated as of December 1, 2003 (the "Contract"), is by and between the Tobacco Settlement Financing Corporation, created and established as a subsidiary of the State of New York Municipal Bond Bank Agency and as a public benefit corporation, separate and apart from the State of New York (the "Corporation"), and the State of New York (the "State"), acting by and through the Director of the Budget of the State.

**WHEREAS**, pursuant to Part D3 of Chapter 62 of the Laws of 2003 (the Tobacco Settlement Financing Corporation Act) (the "Act"), the Corporation is authorized to purchase, for cash or other consideration, all or a portion of the State's Share (as defined in the Act), but the Act placed limitations upon the amount of bonds and other indebtedness which the Corporation was authorized to issue or incur for such purposes;

**WHEREAS**, in order to assist the Corporation in the undertaking and financing of the purchase of a certain portion of the State's Share through the issuance of its bonds, and in consideration of the undertaking thereof and the benefits to be derived therefrom by the people of the State, the Act authorizes the Director of the Budget, acting on behalf of the State, to enter into one or more contingency contracts with the Corporation whereunder the State would agree, subject to the making of annual appropriations therefor by the State Legislature, to provide to the Corporation the amount, if any, as necessary to meet the debt service requirements on one or more series of bonds of the Corporation in any year if the receipts from pledged tobacco revenues (as defined in the Act) or from an ancillary bond facility (as defined in the Act), if any, are inadequate and after, to the extent required by the Act, application of all other collateral pledged therefor, including any debt service and debt service reserve fund;

**WHEREAS**, this Contingency Contract is executed pursuant to the Act;

**WHEREAS**, pursuant to the Act, the Corporation entered into its Indenture dated as of December 1, 2003, between the Corporation and The Bank of New York, as Trustee (together with its permitted successors and assigns, the "Trustee"), as supplemented by its Series 2003B Supplement dated as of December 1, 2003, between the Corporation and said Trustee (as amended and supplemented, the "Indenture"), for the purpose of providing for the issuance of its Series 2003B Bonds or Refunding Bonds (as defined in the Indenture and, collectively, the "Bonds") and the securing of the repayment of said Bonds, including by a pledge under the Indenture of the Corporation's rights under this Contract; and

**WHEREAS**, terms not otherwise defined herein shall have the definitions assigned thereto under the Indenture;

**NOW, THEREFORE**, the parties mutually agree as follows:

**I. Payments by the State**

1.1. Subject to the provisions of Section 1.3 and Section 1.4, the State agrees to pay to the Corporation, on or before each Distribution Date of any year for which the Corporation shall have outstanding Bonds secured by this Contract, the amount of money, if any, certified by the Chairman of the Corporation to the Director of the Budget and to the State Comptroller no later than five (5) business days prior to each such Distribution Date as the amount which is

necessary, after taking into account application of all amounts of Collateral pledged therefor under the Indenture, including receipts from pledged tobacco revenues or from any ancillary bond facility or amounts in the Debt Service Account, the Debt Service Reserve Account or the Supplemental Account on the date of such certification to pay the scheduled principal (as to which the failure to make payment thereof constitutes a default under the Indenture, including mandatory sinking fund payments, if any) of and interest on the Bonds coming due on such next succeeding Distribution Date (herein "Scheduled Debt Service").

1.2. The State agrees that, subject to the provisions of Section 1.3 and Section 1.4, its obligations to make the payments provided for in this Article I shall be absolute and unconditional, without any rights of set-off, recoupment or counterclaim the State may have against the Corporation or any other person or entity having an interest in this Contract or the payments made hereunder.

1.3. Notwithstanding anything in this Contract to the contrary, (i) the obligation of the State to fund or to pay the amounts herein provided for is subject to annual appropriation by the State Legislature, (ii) the obligation of the State, to fund or to pay the amounts herein provided for shall not constitute a debt of the State, or pursuant to the Act, State supported debt, within the meaning of any constitutional or statutory provision and shall be deemed executory only to the extent of moneys available and no liability shall be incurred by the State beyond the moneys available and appropriated for such purpose, and (iii) the amounts paid to the Corporation pursuant to this Contract shall be applied by the Corporation solely for deposit under the Indenture to pay the Scheduled Debt Service.

1.4. Pursuant to the Act, the following is stated: this Contingency Contract shall not constitute a debt or moral obligation of the State or a State supported obligation within the meaning of any constitutional or statutory provision or a pledge of the faith and credit of the State or of the taxing power of the State, and the State shall not be liable to make any payments thereon nor shall this Contingency Contract be payable out of any funds or assets other than those received from the State under this Contingency Contract and pledged therefor under the Indenture.

1.5. To the extent that the Corporation shall obtain bond insurance for the Series 2003B Bonds (which provides for payment to bondholders in the event that Series 2003B Bonds are not paid from Collateral held under the Indenture), such bond insurance shall not be pledged as Collateral to the payment of the Series 2003B Bonds or otherwise considered an ancillary bond facility under the Indenture, amounts payable by the bond insurer shall not be Pledged Revenues under the Indenture, and the bond insurer shall not be a Beneficiary under the Indenture (except to the extent payments are made on the bond insurance). As a result, payments required to be made by the State pursuant to Section 1.1 hereof shall not take into account amounts due for payment under any such bond insurance policy.

## **II. Duties of the Corporation**

2.1. The Corporation agrees to apply the net proceeds (as defined in the Act) from the sale of its Series 2003B Bonds to finance the purchase of a certain portion of the State's Share in accordance with the applicable provisions of the Act and the Indenture.

2.2. The Corporation agrees to deposit under the Indenture all amounts received pursuant to the Contract, which amounts shall be held, administered and applied by the Trustee, as provided in the Indenture, and shall not be commingled with any other funds of the Corporation.

### **III. Pledge and Assignment**

3.1. The State hereby consents to the pledge and assignment by the Corporation under the Indenture for the benefit of the owners of any of its Bonds of all or any part of the benefits or rights of the Corporation herein and of the payments by the State as provided herein.

### **IV. Special Covenants**

4.1. In accordance with the Act, the Corporation agrees to request from the State annually by certification of an authorized officer thereof to the Director of the Budget, by October 31<sup>st</sup> in each year, but in any event not later than December 15<sup>th</sup> of each year, an appropriation of an amount equal to the Scheduled Debt Service (provided that with respect to Auction Rate Bonds the amount of interest thereon shall be at the Maximum Rate of fifteen percent (15 %) per annum as set forth in the Indenture or with respect to other Bonds, if any, for which the interest thereon is subject to variation between Distribution Dates, the amount of interest thereon shall be at the maximum rate as set forth or as provided for in the Indenture) coming due during such next succeeding fiscal year.

4.2. In accordance with the Act, the State agrees that the Director of the Budget on behalf of the State shall include, as a requested appropriation item in the State's budget for such fiscal year, an amount equal to such certified amount.

4.3. The State agrees that whenever requested by the Corporation with reasonable advance notification it shall provide and certify, or cause to be provided and certified, in form satisfactory to the Corporation, such information concerning (A)(i) the State and various public authorities, or (ii) the operations and finances of the State and such other matters, that the Corporation considers necessary to enable it to complete and publish an official statement, placement memorandum or other similar document relating to the sale or issuance of Bonds, and (B) the payments to be made by the State as provided herein or any funds established under the Indenture, or information necessary to enable the Corporation to make any reports required by law or governmental regulations (including Rule 15c2-12, as amended, promulgated by the Securities and Exchange Commission under the Securities Exchange Act of 1934) in connection with any Bonds.

4.4. Neither the Corporation nor the State shall terminate this Contract for any reason whatsoever including, without limiting the generality of the foregoing, any acts or circumstances which may constitute failure of consideration or frustration of purpose or the failure of either party to perform and observe any duty, liability or obligation arising out of or connected with this Contract.

4.5. This Contract may not be amended, changed, modified or altered so as to adversely affect the rights of the owners of any Bonds, the payments to be made by the State as

provided herein or the funds required by the Indenture without the consent of such owners or the Trustee given in accordance with the provisions of the Indenture.

#### **V. Events of Default by the State and Remedies**

5.1. If, for any reason (other than a failure by the State Legislature to appropriate moneys for such purpose), the State shall fail to pay when due any of the payments provided for in Section 1.1 or shall fail to observe or perform any other covenant, condition or agreement on its part to be observed or performed, the Corporation shall, if such default has not been cured, have the right to institute any action in the nature of mandamus or take whatever action at law or in equity may appear necessary or desirable to collect the payments then due or thereafter to become due or to enforce performance and observance of any obligation, agreement or covenant of the State hereunder.

5.2. The remedies conferred upon or reserved to the Corporation under Section 5.1 in respect of any default described therein are not intended to be exclusive of any other available remedy or remedies and shall be in addition to every other remedy now or hereafter existing at law or in equity; provided, however, that such remedy or remedies may in no event include a termination of this Contract, nor may they include any amendment, change, modification or alteration that is referred to in Sections 4.4 or 4.5.

#### **VI. Events of Default by the Corporation and Remedies**

6.1. If the Corporation shall fail to observe or perform any covenant, condition or agreement on its part to be observed or performed and such failure to observe or perform shall have continued for 60 days after written notice, specifying such failure and requesting that it be remedied, is given to the Corporation by the State, the State shall, if the default has not been cured, have the right to institute any action in the nature of mandamus or take whatever action at law or in equity may appear necessary or desirable to enforce the performance and observance of any obligation, agreement or covenant of the Corporation hereunder.

6.2. The remedies conferred upon or reserved to the State under Section 6.1 in respect of any default described therein are not intended to be exclusive of any other available remedy or remedies and shall be in addition to every other remedy now or hereafter existing at law or in equity; provided, however, that such remedy or remedies may in no event include a termination of this Contract or of the obligations of the State to make the payments provided for in Article I, nor may they include any amendment, change, modification or alteration of this Contract that is prohibited by Sections 4.4 or 4.5.

#### **VII. Miscellaneous**

7.1. This Contract shall be construed and interpreted in accordance with the laws of the State of New York.

7.2. This Contract may be executed in several counterparts, each of which shall be deemed to be an original, but such counterparts together shall constitute one and the same instrument.

7.3. In the event any provision of this Contract shall be held invalid or unenforceable by any court of competent jurisdiction, such holding shall not invalidate or render unenforceable any other provision hereof.

7.4. This Contract shall have a term ending on such date as there are no Bonds Outstanding under the Indenture.

7.5. The waiver by either party of a breach by the other shall not be deemed to waive any other breach hereunder nor shall any delay or omission to exercise any right or power upon any default impair any such right or power or be construed as a waiver thereof.

7.6. All notices for in this Contract shall be in writing and shall be delivered personally to be sent by certified or registered mail to the respective offices of the State and the Corporation as follows:

If to the State:

Director of the Budget  
State of New York  
Executive Department  
Division of the Budget  
State Capitol, Room 113  
Albany, New York 12224

If to the Corporation:

Tobacco Settlement Financing Corporation  
c/o State of New York  
Municipal Bond Bank Agency  
641 Lexington Avenue  
New York, New York 10022

Attention: Robert Drillings, Esq.  
Senior Vice President and Counsel

The Corporation or the State may from time to time designate in writing other representatives with respect to receipt of notices.

7.7. This Contract represents the entire agreement between the parties. It may not be amended or modified otherwise than by a written instrument executed by each of the parties. Such amendments shall not be contrary to the provisions of Sections 4.4 or 4.5.

7.8. Nothing in this Contract shall be construed to confer upon or to give notice to any person or entity other than the State, the Corporation, and the owners of any Bonds, the Trustee or any other trustee acting on their behalf, any right, remedy or claim under or by reason of this Contract or any provision thereof.

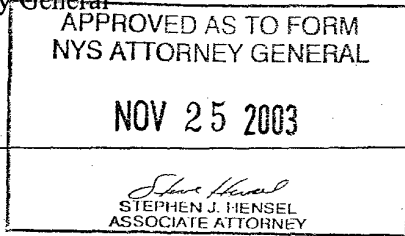
7.9. In accordance with the Act, neither the members of the Corporation nor any other person executing the Contract shall be subject to any personal liability or accountability by reason of the issuance or execution and delivery thereof.

[Signature Page for Contingency Contract]

IN WITNESS WHEREOF, the State has caused this Contract to be executed in its name by the Director of the Budget and the Corporation has caused this instrument to be signed by its Executive Director as its duly authorized officer all as of the 1st day of December, 2003.

Approved as to form:  
Attorney General

By:  
Date:



STATE OF NEW YORK

*Carole E. Stone*  
Carole E. Stone  
Director of the Budget

Approved as to form:  
Counsel

By: *[Signature]*  
Robert M. Drillings  
Senior Vice President and Counsel  
Date: 12/2/2003

TOBACCO SETTLEMENT  
FINANCING CORPORATION

*[Signature]*  
Stephen J. Hunt  
Executive Director

Approved:  
State Comptroller

By: *Richard C. Hill*

Date: 11/26/2003



**APPENDIX B**  
**INFORMATION CONCERNING THE**  
**STATE OF NEW YORK**

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## APPENDIX B

### INFORMATION CONCERNING THE STATE OF NEW YORK

The State Legislature is not legally obligated to appropriate amounts for the payment of principal of, sinking fund installments, if any, or interest on the obligations to which this Official Statement relates. For information about the sources of payment of such obligations, the foregoing Official Statement to which this Appendix B is attached should be read in its entirety. The continued willingness and ability of the State, however, to make the appropriations and otherwise provide for the payments contemplated in the foregoing Official Statement, and the market for and market prices of the obligations, may depend in part upon the financial condition of the State.

Appendix B contains the Annual Information Statement of the State of New York ("Annual Information Statement" or "AIS"), as updated or supplemented to the date specified therein. The State intends to update and supplement that Annual Information Statement as described therein. It has been supplied by the State to provide information about the financial condition of the State in the Official Statements of all issuers, including public authorities of the State, that may depend in whole or in part on State appropriations as sources of payment of their respective bonds, notes or other obligations.

The AIS set forth in this Appendix B is dated May 8, 2007. It was updated on January 30, 2008 and supplemented on February 14, 2008. The AIS was also filed with each Nationally Recognized Municipal Securities Information Repository (NRMSIR). An official copy of the AIS may be obtained by contacting a NRMSIR, or the Division of the Budget, State Capitol, Albany, NY 12224, Tel: (518) 473-8705. An informational copy of the AIS is available on the Internet at <http://www.budget.state.ny.us>.

The Basic Financial Statements and Other Supplementary Information for the State fiscal year ended March 31, 2007 were prepared by the State Comptroller in accordance with accounting principles generally accepted in the United States of America and independently audited in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. The Basic Financial Statements and Other Supplementary Information were issued on July 27, 2007 and have been referred to or set forth thereafter in appendices of information concerning the State in Preliminary Official Statements and Official Statements of the State and certain of its public authorities. The Basic Financial Statements and Other Supplementary Information, which are included in the Comprehensive Annual Financial Report, for the State fiscal year ended March 31, 2007 may be obtained by contacting the Office of the State Comptroller, 110 State Street, Albany, NY 12236 Tel: (518) 474-4015.

**The Annual Information Statement of the State of New York (including any and all updates and supplements thereto) may not be included in an Official Statement or included by reference in an Official Statement without the express written authorization of the State of New York, Division of the Budget, State Capitol, Albany, NY 12224.**

# **Supplement to the Annual Information Statement (AIS)**

## **State of New York**

*February 14, 2008*

### ***Introduction***

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On February 12, 2008, the Governor submitted amendments to the 2008-09 Executive Budget (the "21-day Amendments"), as authorized by the State Constitution. On the same day, the Division of the Budget issued an updated Executive Budget Financial Plan (the "Updated Executive Financial Plan") that reflects the fiscal impact of (a) the Governor's 21-day amendments and (b) revisions to the revenue and spending forecasts based on actual operating results through January 2008 and updated information on economic, revenue, and spending trends. The Updated Executive Financial Plan for 2008-09 is balanced on a cash basis in the General Fund, as required by the State Constitution. Except as noted herein, the current projections (and the assumptions upon which they are based) are consistent with the Financial Plan projections set forth in the Governor's Executive Budget of January 22, 2008. This Supplement should be read in conjunction with the Update to the Annual Information Statement dated January 30, 2008 for a complete explanation of the receipts and disbursements projections for the 2007-08 through 2011-12 fiscal years.

### ***Impact of Recent Economic Events on Financial Plan***

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Since the Division of the Budget (DOB) finalized its Executive Budget forecast in January, the national economic situation has continued to deteriorate and the risk of a recession has increased. A weaker national economy and more severe financial sector woes are projected to negatively affect the New York State economy as well. In light of recent events, DOB has lowered its U.S. forecasts for corporate profits, equity market prices, employment growth, and wages in calendar year 2008. DOB has also modified its forecast for the State economy, based on continuing write-downs related to mortgage-backed securities, credit tightening, and other events that are likely to affect the State's financial services industry. In particular, DOB now projects finance and insurance sector bonuses will remain essentially flat in 2008-09 (compared to 8.6 percent growth at the time of the Executive Budget) and that the volume of taxable capital gains realized by State taxpayers in 2008 will decline by 9.4 percent from 2007 levels (compared to 1.8 percent growth projected at the time of the Executive Budget).

DOB does not expect the impact of revisions to the economic outlook to materially affect the overall General Fund revenue forecast in the current year, based on tax collections to-date and the relatively strong economic performance over much of calendar year 2007 (on which certain tax payments are based). In 2008-09, however, DOB has reduced its General Fund revenue forecast from \$56.3 billion to \$56.0 billion, a reduction of \$358 million, with the most significant reductions taken in the projections for the personal income tax and business taxes. The revenue forecasts for subsequent years have also been lowered by roughly \$500 million annually, from \$58.7 billion to \$58.2 billion in 2009-10, from \$61.3 billion to \$60.8 billion in 2010-11, and from \$64.5 billion to \$64.0 billion in 2011-12.

### ***2008-09 Executive Budget***

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In response to the deterioration in the revenue forecast, the Governor is recommending a package of savings actions that, along with reestimates in certain program spending based on updated information, will maintain a balanced budget in 2008-09 without the use of additional reserves and hold the projected future budget gaps at manageable levels. General Fund spending in 2008-09 is now recommended to

total \$56.4 billion, a reduction of \$358 million from the Executive Budget. The table below and the following paragraphs summarize the revisions to the Executive Budget forecast.

<b>General Fund Projections Updated for 21-Day Revisions</b>					
<b>Savings/(Costs)</b>					
<b>(millions of dollars)</b>					
	<b>2007-08</b>	<b>2008-09</b>	<b>2009-10</b>	<b>2010-11</b>	<b>2011-12</b>
<b>Executive Budget Gaps</b>	<b>0</b>	<b>0</b>	<b>(3,287)</b>	<b>(5,687)</b>	<b>(6,821)</b>
<b>Revenue Reestimates</b>	<b>(1)</b>	<b>(384)</b>	<b>(519)</b>	<b>(523)</b>	<b>(527)</b>
Personal Income Tax*	(150)	(275)	(450)	(450)	(450)
Corporate Franchise Tax	0	(50)	(56)	(60)	(64)
Other Revenue Reestimates	149	(59)	(13)	(13)	(13)
<b>21-Day Actions/Savings Plan</b>	<b>(88)</b>	<b>237</b>	<b>130</b>	<b>129</b>	<b>129</b>
Covered Lives Assessment	0	50	50	50	50
EPIC Mandatory Generic and Prior-Drug Authorization	0	19	45	45	45
Medicaid Trend Factor Reductions	0	18	21	21	21
Finance Health Programs from Insurance Assessments	0	25	25	25	25
Sweep Excess EPF Fund Balance (revenue)	0	25	25	25	25
State Operations/Management Efficiencies	4	36	28	28	28
Pension Prepayment	(86)	88	0	0	0
NYRA Land Acquisition/MLT Facility Construction	0	(6)	(47)	(47)	(47)
State Support for Federal Reduction in Byrne/JAG Funding	0	(6)	(6)	(6)	(6)
NYC School Cafeteria Ventilation Projects	0	(5)	0	0	0
High-Need Nursing Program	0	(2)	(3)	(3)	(3)
Roosevelt School District	(6)	(4)	(6)	(6)	(6)
Local Government Efficiency Grants	0	(1)	(2)	(3)	(3)
<b>Reestimates:</b>	<b>89</b>	<b>147</b>	<b>100</b>	<b>(58)</b>	<b>39</b>
Medicaid	50	50	50	50	50
Family Health Plus Enrollment	10	0	0	0	0
Drug Rebate Revenue	0	60	62	64	66
Berger Commission	0	10	14	14	14
HCRA Spending Revisions	40	40	0	(137)	(18)
Lottery/MLT	(20)	5	(9)	(32)	(53)
Dedicated Highway Fund Subsidy	0	(16)	(15)	(15)	(15)
All Other	9	(2)	(2)	(2)	(5)
<b>Net Savings/(Costs)</b>	<b>0</b>	<b>0</b>	<b>(289)</b>	<b>(452)</b>	<b>(359)</b>
<b>21-Day Surplus/(Gaps)</b>	<b>0</b>	<b>0</b>	<b>(3,576)</b>	<b>(6,139)</b>	<b>(7,180)</b>

\*Excludes STAR and Debt Service Reestimates

The downward revision to personal income tax receipts largely reflects lower withholdings. The downward revision to corporate franchise taxes, beginning in 2008-09, reflects the expected impact of lower projected corporate profits. Other revenue revisions, which include upward revisions in 2007-08 and lower revenue projections beginning in 2008-09, largely reflect year-to-date operating results and the reevaluation of certain assumptions.

Savings actions reflected with the 21-day amendments to the 2008-09 Executive Budget include a proposed increase in the covered lives assessment (a regionally calculated assessment on insurance carriers), requiring the use of generic drugs where available and prior authorization of certain prescription drugs that are not covered by Medicare Part D, revised assumptions with respect to Medicaid trend factors, financing certain health programs by assessments on the insurance industry, additional environmental protection fund balances available to the General Fund, and a range of management efficiencies. The State will also prepay a portion of the 2008-09 pension bill in 2007-08, resulting in interest savings of \$1.4 million.

## ***Out-Year Budget Gaps***

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In the Updated Executive Financial Plan, DOB projects General Fund budget gaps of \$3.6 billion in 2009-10, \$6.1 billion in 2010-11, and \$7.2 billion in 2011-12, assuming enactment of all proposed Executive Budget recommendations. Since the January 30, 2008 Update to the AIS, DOB has increased its gap estimates by \$289 million in 2009-10, \$452 million in 2010-11 and \$359 million in 2011-12.

## ***General Fund Closing Balances***

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DOB projects the State will end the 2007-08 fiscal year with a General Fund balance of \$2.6 billion, unchanged from the Executive Budget. The balance consists of \$1.0 billion in the Tax Stabilization Reserve (to cover unanticipated operating deficits), \$175 million in the new Rainy Day Reserve (after a planned deposit at the end of fiscal year 2007-08), \$21 million in the Contingency Reserve for litigation, \$1.0 billion to finance new labor settlements and \$354 million in the Community Projects Fund to support existing spending commitments. In 2008-09, DOB projects to end the fiscal year with a balance of \$2.2 billion in the General Fund, also unchanged from the Executive Budget estimate. The projected closing balance for 2008-09 is \$400 million below the level estimated for 2007-08, which reflects the partial use of planned reserves set aside for labor settlements (\$337 million) and the partial use of the Community Projects Fund (\$63 million).

## ***General Fund Operating Results to Date***

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Through January 2008 preliminary results, General Fund receipts, including transfers from other funds, totaled \$44.0 billion, \$142 million higher than the Executive Budget forecast. The largest component of this variance was in the personal income tax (\$103 million), which is timing-related and primarily due to later-than-expected payment of personal income tax refunds. General Fund disbursements through January 2008 preliminary results totaled \$40.2 billion, \$47 million higher than projected in the Executive Budget. Higher spending in Welfare, Mental Retardation, and Capital Projects was substantially offset by lower spending in other programs. The impact of cash-flow experience to date is reflected in the Updated Executive Financial Plan.

## ***Budget Process: Next Steps***

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Pursuant to State law, the Legislature and the Executive must meet in February with the purpose of reaching a consensus by March 1 on the tax revenues, lottery receipts, and miscellaneous receipts that are expected to be available in 2007-08 and 2008-09. In the event the Executive and Legislature fail to reach consensus by March 1, 2008, the State Comptroller must provide a revenue forecast by March 5, 2008 for the current and the ensuing State fiscal year. The State's new fiscal year begins on April 1, 2008.

## **Special Consideration**

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In recent days, a significant number of auction rate municipal bonds have failed to attract buyers, including certain bonds backed by the State, resulting in "failed auctions" and a resetting of the periodic rates to rates in excess of that which would otherwise prevail in the short term market. The auction failures have affected municipal issuers throughout the nation and it is important to note that the failed auctions generally do not reflect the credit strength of individual issuers, but reflect concerns relating to bond insurers that have insured such auction rate bonds as well as changes in the operation of the auction rate market itself. As an outcome of these failed auctions, governmental issuers are experiencing significantly higher debt service costs on auction rate bonds and bondholders are experiencing significantly less liquidity than had been anticipated. The likely duration of the disruption in the auction rate securities market cannot be predicted at this time.

The State is evaluating the financial impact of the recent failed auctions and related increased debt service costs on its Financial Plan projections. On the basis of preliminary estimates, the State is not projecting that the higher interest rate costs on its auction rate bonds arising from failed auctions will have a material adverse impact on the Financial Plan in the current year. Furthermore, in 2008-09, DOB estimates that the State could incur higher debt service costs if (a) all of the approximately \$4 billion of auction rate bonds constituting State-supported and State-related debt reset at the maximum auction rate in every upcoming auction, (b) offsetting savings in other parts of the State's debt portfolio are not realized, and (c) the State took no steps to mitigate its exposure to auction rate bonds. However, the State believes that these conditions are not likely to exist throughout 2008-09, particularly since it is initiating steps to limit its exposure to auction rate bonds. Accordingly, at this time, DOB does not expect that any increased debt service costs arising from failed auctions will materially and adversely affect current Financial Plan projections for 2008-09. DOB is continuing to evaluate the impact of current market events on the State debt service costs and plans to update its debt service forecast as part of the Enacted Budget for 2008-09.

**CASH FINANCIAL PLAN  
GENERAL FUND  
UPDATED FOR 21-DAY REVISIONS  
2007-2008  
(millions of dollars)**

	<u>Executive</u>	<u>Change</u>	<u>21-Day</u>
<b>Opening fund balance</b>	<u>3,045</u>	<u>0</u>	<u>3,045</u>
<b>Receipts:</b>			
Taxes:			
Personal income tax	22,735	(97)	22,638
User taxes and fees	8,503	(14)	8,489
Business taxes	6,300	0	6,300
Other taxes	1,030	51	1,081
Miscellaneous receipts	2,444	46	2,490
Federal Grants	71	0	71
Transfers from other funds:			
PIT in excess of Revenue Bond debt service	8,441	(38)	8,403
Sales tax in excess of LGAC debt service	2,305	0	2,305
Real estate taxes in excess of CW/CA debt service	667	50	717
All other	673	0	673
<b>Total receipts</b>	<u>53,169</u>	<u>(2)</u>	<u>53,167</u>
<b>Disbursements:</b>			
Grants to local governments	36,667	(93)	36,574
State operations	9,677	(4)	9,673
General State charges	4,487	76	4,563
Transfers to other funds:			
Debt service	1,557	0	1,557
Capital projects	93	0	93
Other purposes	1,107	19	1,126
<b>Total disbursements</b>	<u>53,588</u>	<u>(2)</u>	<u>53,586</u>
<b>Change in fund balance</b>	<u>(419)</u>	<u>0</u>	<u>(419)</u>
<b>Closing fund balance</b>	<u>2,626</u>	<u>0</u>	<u>2,626</u>
<b>Reserves</b>			
Tax Stabilization Reserve Fund	1,031	0	1,031
Statutory Rainy Day Reserve Fund	175	0	175
Contingency Reserve Fund	21	0	21
Community Projects Fund	354	0	354
Debt Reduction Reserve Fund	0	0	0
Labor Settlement Reserve/Other Risks	<u>1,045</u>	<u>0</u>	<u>1,045</u>
<i>Prior Year Reserves</i>	<i>1,063</i>	<i>0</i>	<i>1,063</i>
<i>Increase/(Decrease) From Current Year Operations</i>	<i>(18)</i>	<i>0</i>	<i>(18)</i>

Source: NYS DOB



**CASH FINANCIAL PLAN  
GENERAL FUND  
UPDATED FOR 21-DAY REVISIONS  
2008-2009  
(millions of dollars)**

	<u>Executive</u>	<u>Change</u>	<u>21-Day</u>
<b>Receipts:</b>			
Taxes:			
Personal income tax	24,391	(186)	24,205
User taxes and fees	8,832	0	8,832
Business taxes	7,254	(127)	7,127
Other taxes	1,194	0	1,194
Miscellaneous receipts	2,238	4	2,242
Federal Grants	41	0	41
Transfers from other funds:			
PIT in excess of Revenue Bond debt service	8,769	(75)	8,694
Sales tax in excess of LGAC debt service	2,314	(4)	2,310
Real estate taxes in excess of CW/CA debt service	615	0	615
All other	694	30	724
<b>Total receipts</b>	<u>56,342</u>	<u>(358)</u>	<u>55,984</u>
<b>Disbursements:</b>			
Grants to local governments	41,860	(252)	41,608
State operations	8,863	(12)	8,851
General State charges	3,136	(103)	3,033
Transfers to other funds:			
Debt service	1,692	0	1,692
Capital projects	366	15	381
Other purposes	825	(6)	819
<b>Total disbursements</b>	<u>56,742</u>	<u>(358)</u>	<u>56,384</u>
<b>Deposit to/(use of) Community Projects Fund</b>	<u>(63)</u>	<u>0</u>	<u>(63)</u>
<b>Deposit to/(use of) Prior Year Reserves</b>	<u>(337)</u>	<u>0</u>	<u>(337)</u>
<b>Margin</b>	<u>0</u>	<u>0</u>	<u>0</u>

Source: NYS DOB

**CASH FINANCIAL PLAN  
GENERAL FUND  
UPDATED FOR 21-DAY REVISIONS  
2009-2010  
(millions of dollars)**

	<u>Executive</u>	<u>Change</u>	<u>21-Day</u>
<b>Receipts:</b>			
Taxes:			
Personal income tax	25,897	(317)	25,580
User taxes and fees	8,913	0	8,913
Business taxes	7,816	(94)	7,722
Other taxes	1,325	0	1,325
Miscellaneous receipts	2,186	7	2,193
Federal Grants	0	0	0
Transfers from other funds:			
PIT in excess of Revenue Bond debt service	9,199	(160)	9,039
Sales tax in excess of LGAC debt service	2,331	0	2,331
Real estate taxes in excess of CW/CA debt service	596	0	596
All other	461	25	486
<b>Total receipts</b>	<u>58,724</u>	<u>(539)</u>	<u>58,185</u>
<b>Disbursements:</b>			
Grants to local governments	45,919	(245)	45,674
State operations	9,236	(9)	9,227
General State charges	3,806	(15)	3,791
Transfers to other funds:			
Debt service	1,680	0	1,680
Capital projects	574	15	589
Other purposes	858	4	862
<b>Total disbursements</b>	<u>62,073</u>	<u>(250)</u>	<u>61,823</u>
<b>Deposit to/(use of) Community Projects Fund</b>	<u>(62)</u>	<u>0</u>	<u>(62)</u>
<b>Margin</b>	<u>(3,287)</u>	<u>(289)</u>	<u>(3,576)</u>

Source: NYS DOB

**CASH FINANCIAL PLAN  
GENERAL FUND  
UPDATED FOR 21-DAY REVISIONS  
2010-2011  
(millions of dollars)**

	<u>Executive</u>	<u>Change</u>	<u>21-Day</u>
<b>Receipts:</b>			
Taxes:			
Personal income tax	27,415	(317)	27,098
User taxes and fees	9,251	0	9,251
Business taxes	7,866	(97)	7,769
Other taxes	1,408	0	1,408
Miscellaneous receipts	2,261	7	2,268
Federal Grants	0	0	0
Transfers from other funds:			
PIT in excess of Revenue Bond debt service	9,647	(160)	9,487
Sales tax in excess of LGAC debt service	2,436	0	2,436
Real estate taxes in excess of CW/CA debt service	599	0	599
All other	460	25	485
<b>Total receipts</b>	<u>61,343</u>	<u>(542)</u>	<u>60,801</u>
<b>Disbursements:</b>			
Grants to local governments	49,833	(88)	49,745
State operations	9,780	(9)	9,771
General State charges	4,087	(15)	4,072
Transfers to other funds:			
Debt service	1,706	0	1,706
Capital projects	930	16	946
Other purposes	845	6	851
<b>Total disbursements</b>	<u>67,181</u>	<u>(90)</u>	<u>67,091</u>
<b>Deposit to/(use of) Community Projects Fund</b>	<u>(151)</u>	<u>0</u>	<u>(151)</u>
<b>Margin</b>	<u>(5,687)</u>	<u>(452)</u>	<u>(6,139)</u>

Source: NYS DOB

**CASH FINANCIAL PLAN  
GENERAL FUND  
UPDATED FOR 21-DAY REVISIONS  
2011-2012  
(millions of dollars)**

	<u>Executive</u>	<u>Change</u>	<u>21-Day</u>
<b>Receipts:</b>			
Taxes:			
Personal income tax	29,315	(317)	28,998
User taxes and fees	9,620	0	9,620
Business taxes	8,218	(102)	8,116
Other taxes	1,498	0	1,498
Miscellaneous receipts	2,060	6	2,066
Federal Grants	0	0	0
Transfers from other funds:			
PIT in excess of Revenue Bond debt service	10,154	(159)	9,995
Sales tax in excess of LGAC debt service	2,556	0	2,556
Real estate taxes in excess of CW/CA debt service	608	0	608
All other	498	26	524
<b>Total receipts</b>	<u>64,527</u>	<u>(546)</u>	<u>63,981</u>
<b>Disbursements:</b>			
Grants to local governments	53,013	(187)	52,826
State operations	10,046	(9)	10,037
General State charges	4,386	(15)	4,371
Transfers to other funds:			
Debt service	1,673	0	1,673
Capital projects	997	17	1,014
Other purposes	1,312	7	1,319
<b>Total disbursements</b>	<u>71,427</u>	<u>(187)</u>	<u>71,240</u>
<b>Deposit to/(use of) Community Projects Fund</b>	<u>(79)</u>	<u>0</u>	<u>(79)</u>
<b>Margin</b>	<u>(6,821)</u>	<u>(359)</u>	<u>(7,180)</u>

Source: NYS DOB

Annual Information Statement Supplement, February 14, 2008

CASHFLOW  
GENERAL FUND  
UPDATED FOR 21-DAY REVISIONS  
2007-2008  
(dollars in millions)

	2008												
	2007 April Actuals	May Actuals	June Actuals	July Actuals	August Actuals	September Actuals	October Actuals	November Actuals	December Actuals	January Preliminary Actuals	February Projected	March Projected	Total
<b>OPENING BALANCE</b>	3,045	6,903	3,136	2,881	3,448	2,854	4,142	2,836	1,320	1,677	6,843	6,651	3,945
<b>RECEIPTS:</b>													
Personal Income Tax	4,017	748	2,414	1,396	1,376	1,971	745	91	1,152	5,322	1,490	1,916	22,638
User Taxes and Fees	679	623	877	671	645	872	632	673	868	662	543	744	8,489
Business Taxes	58	146	1,103	98	139	1,209	123	63	1,145	113	563	1,540	6,300
Other Taxes	81	80	107	100	64	81	80	82	118	105	92	91	1,081
Total Taxes	4,835	1,597	4,501	2,265	2,224	4,133	1,580	909	3,283	6,202	2,688	4,291	38,508
Licenses, fees, etc.	37	98	20	45	66	50	33	70	45	55	40	103	662
Abandoned Property	5	0	0	19	9	33	22	135	25	190	53	193	684
Reimbursement	6	7	25	11	10	20	14	6	22	11	14	38	184
Investment income	70	7	25	22	(11)	6	53	15	3	23	5	7	225
Other transactions	13	15	167	41	45	47	27	30	216	33	31	70	735
Total Miscellaneous Receipts	131	127	237	138	119	156	149	256	311	312	143	411	2,490
Federal Grants	0	12	22	1	5	0	10	10	0	5	6	0	71
PIT in excess of Revenue Bond Debt Service	1,338	198	886	499	401	951	593	79	879	1,597	130	852	8,403
Sales Tax in Excess of LGAC Debt Service	137	41	360	232	196	270	192	205	269	198	1	204	2,305
Real Estate Taxes in Excess of CW/CA Debt Service	55	61	95	62	75	66	44	60	38	41	41	79	717
All Other	3	1	120	29	8	1	19	1	35	146	0	310	673
Total Transfers from Other Funds	1,533	301	1,461	822	680	1,288	848	345	1,221	1,982	172	1,445	12,098
<b>TOTAL RECEIPTS</b>	6,499	2,037	6,221	3,226	3,028	5,577	2,587	1,520	4,815	8,501	3,009	6,147	53,167
<b>DISBURSEMENTS:</b>													
School Aid	236	2,143	1,512	17	504	1,284	511	961	1,365	605	648	6,458	16,244
Higher Education	18	10	335	100	186	77	458	30	214	57	332	507	2,324
All Other Education	26	124	345	161	72	112	175	21	137	68	184	312	1,737
Medicaid - DOH	869	1,267	918	538	1,040	710	673	587	370	754	606	606	8,938
Public Health	16	35	117	32	35	23	131	45	52	5	92	99	682
Mental Hygiene	45	58	62	153	67	135	251	62	180	226	205	394	1,838
Children and Families	5	130	91	223	98	125	73	72	252	68	108	364	1,609
Temporary & Disability Assistance	55	252	248	150	152	184	140	(142)	207	134	40	(29)	1,391
Transportation	0	14	45	1	13	1	0	15	7	0	8	2	106
All Other	22	70	444	50	56	135	63	57	265	81	27	435	1,705
Total Local Assistance Grants	1,292	4,103	4,117	1,425	2,223	2,786	2,475	1,708	3,049	1,996	2,250	9,148	36,574
Personal Service	633	814	599	589	749	546	699	546	417	541	297	380	6,810
Non-Personal Service	203	239	275	208	255	209	219	181	222	252	247	353	2,863
Total State Operations	836	1,053	874	797	1,004	755	918	727	639	793	544	733	9,673
General State Charges	262	430	1,218	258	269	268	285	319	260	367	337	290	4,563
Debt Service	45	144	210	49	40	292	60	163	360	3	26	165	1,557
Capital Projects	89	55	8	51	56	66	133	105	24	152	25	(671)	93
Other Purposes	117	19	49	79	30	122	22	14	126	22	19	507	1,126
Total Transfers to Other Funds	251	218	267	179	126	480	215	282	510	177	70	1	2,776
<b>TOTAL DISBURSEMENTS</b>	2,641	5,804	6,476	2,659	3,622	4,289	3,893	3,036	4,458	3,335	3,201	10,172	53,586
Excess/(Deficiency) of Receipts over Disbursements	3,858	(3,767)	(255)	567	(594)	1,288	(1,306)	(1,516)	357	5,166	(192)	(4,025)	(419)
<b>CLOSING BALANCE</b>	6,903	3,136	2,881	3,448	2,854	4,142	2,836	1,320	1,677	6,843	6,651	2,626	2,626

Source: NYS DOB

**CASHFLOW  
GENERAL FUND  
UPDATED FOR 21-DAY REVISIONS  
2008-2009  
(dollars in millions)**

	2008		2009												Total
	April	May	June	July	August	September	October	November	December	January	February	March			
	Projected	Projected	Projected	Projected	Projected	Projected	Projected	Projected	Projected	Projected	Projected	Projected	Projected	Projected	
<b>OPENING BALANCE</b>	2,626	6,263	1,792	2,872	2,876	2,783	4,044	2,615	1,126	1,505	6,518	6,020	2,826		
<b>RECEIPTS:</b>															
Personal Income Tax	4,570	687	2,372	1,559	1,598	2,102	660	245	1,489	5,371	1,613	1,939	24,205		
User Taxes and Fees	672	647	908	694	665	905	658	702	901	667	559	854	8,832		
Business Taxes	284	50	1,237	183	150	1,283	220	76	1,331	206	236	1,891	7,127		
Other Taxes	99	99	100	100	101	101	99	99	99	99	99	99	1,194		
Total Taxes	5,605	1,483	4,617	2,536	2,514	4,391	1,637	1,122	3,820	6,343	2,507	4,783	41,358		
Licenses, fees, etc.	28	61	44	26	61	41	51	48	32	37	49	60	538		
Abandoned Property	20	0	18	12	8	53	9	167	34	41	39	249	650		
Reimbursement	4	11	24	5	14	13	13	10	23	7	12	27	172		
Investment income	60	7	25	22	(11)	6	53	15	3	14	0	6	200		
Other transactions	26	32	151	43	53	54	34	30	53	34	30	138	682		
Total Miscellaneous Receipts	138	111	262	108	125	176	164	270	145	133	130	480	2,242		
Federal Grants	0	11	4	0	4	0	9	9	0	4	0	0	41		
PIT in excess of Revenue Bond Debt Service	1,522	158	920	539	366	960	620	136	919	1,545	160	849	8,694		
Sales Tax in Excess of LGAC Debt Service	196	24	448	207	200	212	197	211	273	200	1	141	2,310		
Real Estate Taxes in Excess of CW/CA Debt Service	65	57	45	49	59	59	55	40	53	55	41	37	615		
All Other	0	0	96	3	1	5	8	5	122	3	1	480	724		
Total Transfers from Other Funds	1,783	239	1,509	798	626	1,236	880	392	1,367	1,803	203	1,507	12,343		
<b>TOTAL RECEIPTS</b>	7,526	1,844	6,392	3,442	3,269	5,803	2,890	1,793	5,332	8,283	2,840	6,770	55,984		
<b>DISBURSEMENTS:</b>															
School Aid	175	2,320	1,670	135	430	1,790	675	763	1,251	463	635	7,133	17,440		
Higher Education	17	11	483	118	113	95	468	24	287	42	349	466	2,473		
All Other Education	86	100	92	189	141	143	127	66	79	223	141	318	1,705		
Medicaid - DOH	1,608	1,357	1,148	949	1,056	666	1,097	1,006	1,001	948	784	859	12,479		
Public Health	16	38	63	68	34	54	53	42	38	103	28	92	629		
Mental Hygiene	129	127	132	141	131	249	136	127	240	244	124	274	2,054		
Children and Families	79	85	98	291	87	127	79	86	307	83	83	356	1,761		
Temporary & Disability Assistance	157	157	258	157	157	176	157	(135)	176	(143)	106	(54)	1,169		
Transportation	0	11	45	0	14	0	0	17	10	0	8	0	105		
All Other	15	37	414	39	48	204	4	50	402	57	71	452	1,793		
Total Local Assistance Grants	2,282	4,243	4,403	2,087	2,211	3,504	2,796	2,046	3,791	2,020	2,329	9,896	41,808		
Personal Service	685	566	535	619	533	488	630	463	480	542	447	460	6,428		
Non-Personal Service	178	182	177	193	207	246	169	167	178	227	217	282	2,423		
Total State Operations	863	748	712	812	740	734	799	630	638	769	664	742	8,851		
General State Charges	355	1,115	(80)	442	294	(121)	408	284	(64)	325	144	(69)	3,033		
Debt Service	228	139	201	36	46	278	22	175	404	3	19	141	1,692		
Capital Projects	29	33	30	31	30	42	64	77	136	123	157	(371)	381		
Other Purposes	132	37	46	30	41	105	30	70	48	30	25	225	819		
Total Transfers to Other Funds	389	209	277	97	117	425	116	322	588	166	201	(5)	2,892		
<b>TOTAL DISBURSEMENTS</b>	3,889	6,315	5,312	3,438	3,362	4,542	4,119	3,282	4,953	3,270	3,338	10,564	56,384		
Excess/(Deficiency) of Receipts over Disbursements	3,637	(4,471)	1,080	4	(93)	1,261	(1,429)	(1,489)	379	5,013	(498)	(3,794)	(400)		
<b>CLOSING BALANCE</b>	6,263	1,792	2,872	2,876	2,783	4,044	2,615	1,126	1,505	6,518	6,020	2,226	2,226		

Source: NYS DOB

State-Related Debt Outstanding, 1998-99 through 2006-07 (millions of dollars)					
	1998-99	1999-00	2000-01	2001-02	2002-03
Personal Income	\$591,847	\$619,659	\$663,005	\$679,886	\$677,605
State-Related Debt Outstanding	\$37,699	\$38,582	\$38,661	\$38,601	\$40,531
State-Related Debt Outstanding as a % of Personal Income	6.4%	6.2%	5.8%	5.7%	6.0%
		2003-04	2004-05	2005-06	2006-07
Personal Income		\$693,533	\$739,795	\$790,330	\$848,745
State-Related Debt Outstanding		\$46,773	\$46,744	\$46,927	\$48,095
State-Related Debt Outstanding as a % of Personal Income		6.7%	6.3%	5.9%	5.7%

Projected State-Related Debt Outstanding, 2007-08 through 2012-13 (millions of dollars)						
	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13
Personal Income	\$912,373	\$951,766	\$991,266	\$1,041,136	\$1,094,735	\$1,151,470
State-Related Debt Outstanding	\$49,991	\$53,681	\$56,657	\$58,985	\$60,270	\$61,184
State-Related Debt Outstanding as a % of Personal Income	5.5%	5.6%	5.7%	5.7%	5.5%	5.3%

State-Related Debt Per Capita, 1998-99 through 2006-07 (millions of dollars)					
	1998-99	1999-00	2000-01	2001-02	2002-03
State-Related Debt Outstanding	\$37,699	\$38,582	\$38,661	\$38,601	\$40,531
State Population (millions)	18.8	18.9	19.0	19.1	19.2
State-Related Debt Per Capita	\$2,008	\$2,042	\$2,033	\$2,021	\$2,114
		2003-04	2004-05	2005-06	2006-07
State-Related Debt Outstanding		\$46,773	\$46,744	\$46,927	\$48,095
State Population (millions)		19.2	19.3	19.3	19.3
State-Related Debt Per Capita		\$2,430	\$2,423	\$2,429	\$2,491

Projected State-Related Debt Per Capita, 2007-08 through 2012-13 (millions of dollars)						
	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13
State-Related Debt Outstanding	\$49,991	\$53,681	\$56,657	\$58,985	\$60,270	\$61,184
State Population (millions)	19.3	19.3	19.3	19.3	19.3	19.3
State-Related Debt Per Capita	\$2,590	\$2,779	\$2,932	\$3,050	\$3,116	\$3,165

State-Related Debt Service, 1998-99 through 2006-07 (millions of dollars)					
	1998-99	1999-00	2000-01	2001-02	2002-03
All Funds Budget	\$72,551	\$76,804	\$83,527	\$84,312	\$88,274
State-Related Debt Service	\$3,738	\$3,887	\$4,368	\$4,437	\$3,358
State-Related Debt Service as a % All Funds Budget	5.2%	5.1%	5.2%	5.3%	3.8%
		2003-04	2004-05	2005-06	2006-07
All Funds Budget		\$99,698	\$101,381	\$107,027	\$112,396
State-Related Debt Service		\$3,847	\$4,412	\$4,264	\$5,004
State-Related Debt Service as a % All Funds Budget		3.9%	4.4%	4.0%	4.5%

Projected State-Related Debt Service, 2007-08 through 2012-13 (millions of dollars)						
	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13
All Funds Budget	\$117,183	\$123,498	\$128,281	\$133,406	\$138,220	\$143,639
State-Related Debt Service	\$4,880	\$5,287	\$5,830	\$6,450	\$6,784	\$7,102
State-Related Debt Service as a % All Funds Budget	4.2%	4.3%	4.5%	4.8%	4.9%	4.9%

Source: NYS DOB

**STATE DEBT OUTSTANDING  
SUMMARIZED BY FUNCTION AND FINANCING PROGRAM  
2007-2008 THROUGH 2012-2013  
(thousands of dollars)**

	<u>2007-2008</u>	<u>2008-2009</u>	<u>2009-2010</u>	<u>2010-2011</u>	<u>2011-2012</u>	<u>2012-2013</u>
<b>GENERAL OBLIGATION BONDS</b>						
Economic Development & Housing	120,741	105,526	90,240	77,497	65,364	55,259
Environment	1,879,698	1,733,963	1,606,498	1,487,853	1,377,311	1,271,573
Transportation	1,250,226	1,517,700	1,910,716	2,325,869	2,581,345	2,773,508
<b>REVENUE BONDS</b>						
<b>Personal Income Tax</b>						
Economic Development & Housing	2,387,182	3,306,565	4,149,967	4,818,161	5,245,924	5,342,675
Education	4,332,365	5,842,632	7,382,029	8,461,868	9,544,209	10,727,650
Environment	675,275	983,300	1,159,809	1,277,551	1,384,904	1,471,277
Health Care	66,045	153,191	256,621	392,243	347,295	309,002
State Facilities & Equipment	1,908,085	2,758,665	3,088,774	3,445,543	3,715,922	3,960,257
Transportation	1,645,285	1,921,440	2,183,016	2,429,754	2,661,065	2,875,742
<b>Other Revenue</b>						
<b>Education</b>						
SUNY Dorms	873,355	964,725	1,032,870	1,075,981	1,124,986	1,162,641
<b>Health &amp; Mental Hygiene</b>						
Health Income	339,800	327,055	313,740	299,760	285,095	270,440
Mental Health Services	3,920,705	4,267,222	4,601,516	4,835,826	5,081,234	5,307,549
<b>Local Government Assistance</b>						
Sales Tax	4,036,522	3,874,183	3,678,375	3,474,183	3,244,248	3,003,183
<b>Transportation</b>						
Dedicated Highway	6,559,957	7,071,192	7,633,637	8,306,956	8,815,892	9,337,295
<b>SERVICE CONTRACT &amp; LEASE-PURCHASE BONDS</b>						
Economic Development & Housing	1,260,130	1,167,544	1,075,626	969,328	868,850	801,075
Education	6,017,394	5,715,991	5,363,212	5,048,655	4,625,972	4,203,791
Environment	193,412	171,662	148,817	126,427	107,721	92,992
Health & Mental Hygiene	53,645	50,570	47,365	44,000	40,485	36,970
State Facilities & Equipment	3,395,470	3,226,003	3,045,236	2,852,018	2,652,271	2,437,247
Transportation	3,936,350	3,764,935	3,554,825	3,356,500	3,107,705	2,870,160
<b>TOTAL STATE-SUPPORTED</b>						
Economic Development & Housing	3,768,053	4,579,635	5,315,833	5,864,987	6,180,138	6,199,009
Education	11,223,114	12,523,347	13,778,110	14,586,504	15,295,167	16,094,082
Environment	2,748,385	2,888,925	2,915,124	2,891,831	2,869,936	2,835,842
Health & Mental Hygiene	4,380,195	4,798,039	5,219,242	5,571,830	5,754,109	5,923,961
LGAC	4,036,522	3,874,183	3,678,375	3,474,183	3,244,248	3,003,183
State Facilities & Equipment	5,303,555	5,984,668	6,134,010	6,297,561	6,368,193	6,397,504
Transportation	13,391,818	14,275,267	15,282,193	16,419,079	17,166,007	17,856,704
<b>SUBTOTAL STATE-SUPPORTED</b>	<u>44,851,641</u>	<u>48,924,064</u>	<u>52,322,887</u>	<u>55,105,973</u>	<u>56,877,798</u>	<u>58,310,285</u>
<b>OTHER STATE DEBT OBLIGATIONS</b>						
Tobacco	3,839,480	3,521,110	3,178,205	2,809,835	2,414,020	1,988,710
All Other	1,300,286	1,236,098	1,156,314	1,069,612	978,520	884,565
<b>SUBTOTAL OTHER STATE</b>	<u>5,139,766</u>	<u>4,757,208</u>	<u>4,334,519</u>	<u>3,879,447</u>	<u>3,392,540</u>	<u>2,873,275</u>
<b>GRAND TOTAL STATE-RELATED</b>	<u>49,991,407</u>	<u>53,681,272</u>	<u>56,657,406</u>	<u>58,985,420</u>	<u>60,270,338</u>	<u>61,183,560</u>

Source: NYS DOB



# Update to Annual Information Statement (AIS)

## State of New York

*January 30, 2008*

This quarterly update (the "AIS Update") is the third quarterly update to the Annual Information Statement of the State of New York, dated May 8, 2007 (the "AIS") and contains information only through January 30, 2008. This AIS Update should be read in its entirety, together with the AIS and the first and second quarterly updates to the AIS dated August 3, 2007 (the "First Quarterly Update") and November 15, 2007 (the "Mid-Year Update").

In this AIS Update, readers will find:

1. Extracts from the Governor's Executive Budget Financial Plan for 2008-09 (the "Current State Financial Plan") presented to the Legislature on January 22, 2008. The Current State Financial Plan includes estimates for the State's current fiscal year (2007-08) and detailed projections for fiscal years 2008-09 through 2011-12, which reflect the Executive Budget recommendations. The entire 2008-09 Executive Budget, including the Current State Financial Plan, a detailed forecast of the State's economy and revenues, and the proposed Capital Program and Financing Plan, is available on the Division of the Budget (DOB) website, [www.budget.state.ny.us](http://www.budget.state.ny.us).
2. A discussion of special considerations related the Current State Financial Plan.
3. The status of significant litigation that has the potential to adversely affect the State's finances.

DOB is responsible for preparing the State's Financial Plan and presenting the information that appears in this AIS Update on behalf of the State. In preparing the AIS Update, DOB has utilized significant portions of the Current State Financial Plan, but has also relied on information drawn from other sources, such as the Office of the State Comptroller ("OSC"). Information relating to matters described in the section entitled "Litigation" is furnished by the State Office of the Attorney General.

During the current fiscal year, the Governor, the State Comptroller, State legislators, and others may issue statements or reports that contain predictions, projections or other information relating to the State's financial condition, including potential operating results for the current fiscal year and projected baseline gaps for future fiscal years that may vary materially from the information provided in the AIS. Investors and other market participants should, however, refer to the AIS, as revised, updated, or supplemented, for the most current official information regarding the financial condition of the State.

The State may issue AIS supplements or other disclosure notices to this AIS Update as events warrant. The State intends to announce publicly whenever an update or a supplement is issued. The State may choose to incorporate by reference all or a portion of this AIS Update in Official Statements or related disclosure documents for State or State-supported debt issuance. Readers may obtain informational copies of the AIS, updates and supplements by contacting Mr. Louis A. Raffaele, Chief Budget Examiner, New York State Division of the Budget, State Capitol, Albany, NY 12224, (518) 473-8705. The State has filed this AIS Update directly with Nationally Recognized Municipal Securities Information Repositories (NRMSIRs) and with the Central Post Office, Disclosure USA. The Municipal Advisory Council of Texas (Texas MAC) has established this internet-based disclosure filing system approved by the Securities and Exchange Commission to facilitate the transmission of disclosure-related information to the NRMSIRs. [An official copy of this AIS](#)

Update may be obtained from the Division of the Budget, State Capitol, Albany, NY 12224, Tel: (518) 473-8705 or from any NRMSIR.

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## Current State Financial Plan

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*Note:* DOB issued the Current State Financial Plan, extracts of which are set forth below, on January 22, 2008. The Current State Financial Plan includes updated estimates for 2007-08 and projections for 2008-09 through 2011-12. As such, it contains estimates and projections of future results that should not be construed as statements of fact. These estimates and projections are based upon various assumptions that may be affected by numerous factors, including future economic conditions in the State and nation and potential litigation. There can be no assurance that actual results will not differ materially and adversely from the estimates and projections contained in the Current State Financial Plan.

The State accounts for all of its spending and revenues by the fund in which the activity takes place (such as the General Fund), and the broad category or purpose of that activity (such as State Operations). The Financial Plan tables sort all State projections and results by fund and category. The State Constitution requires the Governor to submit an Executive Budget that is balanced on a cash basis in the General Fund—the Fund that receives the majority of State taxes, and all income not earmarked for a particular program or activity. Since this is the fund that is required to be balanced, the focus of the State’s budget discussion is often weighted toward the General Fund.

In addition to the General Fund, the State reports spending and revenue activity by other broad measures, including State Operating Funds, which includes the General Fund and funds specified for dedicated purposes, but excludes capital project funds and Federal Funds; and All Governmental Funds ("All Funds"), which includes both State and Federal Funds and provides the most comprehensive view of the financial operations of the State.

Fund types of the State include: the General Fund; State special revenue funds ("SRFs"), which receive certain dedicated taxes, fees and other revenues that are used for a specified purpose; Federal SRFs, which receive Federal grants; State and Federal Capital Projects Funds, which account for costs incurred in the construction and reconstruction of roads, bridges, prisons, and other infrastructure projects; and Debt Service Funds, which pay principal, interest and related expenses on long-term bonds issued by the State and its public authorities.

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# Update to Annual Information Statement State of New York

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## SUMMARY

The national and State economies have continued to perform below expectations in the second half of 2007. The slowdown in economic activity, which DOB expects to persist until at least the end of calendar year 2008, has begun to affect the State's revenue outlook. Since enactment of the Budget for 2007-08, DOB has reduced its General Fund revenue forecast by over \$500 million for the current year and by over \$700 million for 2008-09.

In the current year, the General Fund is kept in balance through offsetting reductions in spending, which reflect revised estimates for a number of programs based on actual results, as well as by the planned use of reserves to finance collective bargaining costs that have been added since budget enactment. The Financial Plan also includes a planned deposit of \$175 million to the State's new rainy day reserve, as authorized in the Enacted Budget. At this time, DOB believes that any deterioration from the Financial Plan forecast in the remaining months of the current year would likely be manageable without the use of additional reserves, based on the best available information on tax collections and spending through the first week of January 2008.

In 2008-09, the revenue shortfall has widened the current services budget gap (the imbalance between expected receipts and disbursements assuming no change in current law) to \$4.4 billion, up by roughly \$1.3 billion from the Enacted Budget forecast. The current services gap is the largest that must be closed by an Executive Budget since 2005-06. And, unlike 2005, when the direction of the economy was favorable, the current Budget proposal is presented in a volatile economic environment that poses substantial risks to State revenues.

## 2008-09 Executive Budget Recommendations

The Executive Budget for 2008-09 eliminates the entire potential imbalance for fiscal year 2008-09, responding to the current fiscal uncertainties with a plan that emphasizes recurring savings. If enacted as proposed, the Executive Budget would cut the gap that must be addressed in 2009-10 by nearly one-half and reduce the combined structural imbalance by nearly \$12 billion through 2011-12. The table below summarizes the multi-year impact of the Executive Budget recommendations.

General Fund Budget-Balancing Plan: 2008-09 Executive Budget (millions of dollars)				
	2008-09	2009-10	2010-11	2011-12
<b>Current Services Gaps</b>	<b>(4,422)</b>	<b>(6,154)</b>	<b>(7,697)</b>	<b>(9,454)</b>
Savings Plan:	4,838	3,741	3,507	4,071
Savings Actions	2,253	2,495	2,274	2,832
Revenue Initiatives	1,109	1,267	1,254	1,260
Non-recurring Actions	1,139	(21)	(21)	(21)
Use of Reserves for Labor Settlements	337	0	0	0
New Initiatives:	<b>(416)</b>	<b>(874)</b>	<b>(1,497)</b>	<b>(1,438)</b>
<b>Executive Budget Gaps</b>	<b>0</b>	<b>(3,287)</b>	<b>(5,687)</b>	<b>(6,821)</b>

The Budget proposals address the structural imbalance by restraining growth in health care, adjusting the phase-in of the School Tax Relief (STAR) program, realigning program financing with the governmental entities responsible for service delivery, and instituting broad controls on State operations spending.

Additional revenues would be raised through a combination of tax equity and audit initiatives, including the classification of for-profit health maintenance organizations as insurance companies for Tax Law purposes, an increase in audits and recoveries, the elimination of certain tax loopholes, and modifications to the Quick Draw lottery game.

The Budget relies on \$1.1 billion in resources that are not counted on to recur in future years, the largest of which are an expected payment for development rights at Belmont Park and a phased-in restoration of general aid to New York City. Non-recurring resources account for roughly one-quarter of the gap-closing plan. Consistent with the current year, the Financial Plan uses \$337 million in reserves, as planned, to finance certain labor settlements that have been, or are expected to be, ratified in 2007-08.

The Budget finances just over \$400 million in new initiatives in 2008-09, including aid for education; investments in health care, including rate increases for ambulatory care clinics and physicians; and extension through 2011-12 of the cost-of-living adjustment (COLA) for human service providers that is set to expire next year.

DOB projects the State will end the 2008-09 fiscal year with a General Fund balance of \$2.2 billion (3.9 percent of General Fund spending) if the Legislature enacts the Executive Budget recommendations in their entirety. The balance consists of \$1.2 billion in undesignated reserves and \$1.0 billion in reserves designated to finance existing or planned commitments, including potential new labor settlements. The projected closing balance is \$400 million below the level estimated for 2007-08, which reflects primarily the partial use of planned reserves set aside for existing collective bargaining agreements.

### ***Discussion of the Current Services Forecast***

The current services forecast for the General Fund formed the starting point for developing the 2008-09 Executive Budget, and therefore determined the scope of the recommendations that had to be advanced to achieve a balanced budget.

Since the Mid-Year Update, DOB has reviewed emerging data and trends and met with legislative fiscal committees in a public “Quick Start” process. As a result, DOB has revised its current services forecast for receipts and disbursements for 2008-09, 2009-10 and 2010-11 and calculated an estimate for 2011-12. The revised forecast reflects the impact of a slowing economy on State revenues, updated expenditure estimates for programs based on a review of actual operating results and trends, and the costs of tentative labor settlements with several of the large unions representing State employees.

<b>Summary of Changes to General Fund Current Services Forecast Since the Mid-Year Update</b>				
<b>Savings/(Costs)</b>				
<b>(millions of dollars)</b>				
	<u>2008-09</u>	<u>2009-10</u>	<u>2010-11</u>	<u>2011-12*</u>
<b>Mid-Year Current Services Surplus/(Gap)</b>	<b>(4,265)</b>	<b>(6,178)</b>	<b>(7,931)</b>	
<b>Change Since Mid-Year</b>	<b>(157)</b>	<b>24</b>	<b>234</b>	
Revenue Revisions	(381)	(322)	(337)	
Spending Revisions	224	346	571	
School Aid/Lottery	188	390	679	
Medicaid	228	399	484	
Welfare	65	(2)	(2)	
Collective Bargaining Costs	(337)	(510)	(756)	
All Other	80	69	166	
<b>CURRENT BUDGET SURPLUS/(GAP) ESTIMATE</b>	<b>(4,422)</b>	<b>(6,154)</b>	<b>(7,697)</b>	<b>(9,454)</b>

\* The 2011-12 gap estimates are published for the first time in the 2008-09 Executive Budget.

DOB has decreased its estimate of General Fund revenues over the multi-year Financial Plan, based on actual results to date, and on slower than expected growth in the State economy and the financial services sector. Base receipts are now forecast to grow by 4.2 percent in 2008-09. Tax receipts are expected to be lower and account for most of the downward revision in estimated growth. The forecast for miscellaneous receipts has remained virtually unchanged.

Since the Mid-Year Update, DOB has decreased the General Fund current services spending forecast. The updated estimates include downward revisions to spending estimates in several areas including: School Aid, based on updated enrollment and other data reported by school districts to the State Education Department (SED) and revisions to estimated lottery revenues, which have been reduced by \$24 million in 2008-09, but increased in later years to reflect game-cycle innovations and marketing improvements; Medicaid, reflecting price and utilization trends and lower costs for the cap on local Medicaid costs, and welfare, based on public assistance claiming trends (\$65 million in 2008-09). Other significant changes include an updated spending estimate for the Judiciary, which submitted a budget request for 2008-09 that was \$18 million higher than planned, but had lower-than-expected costs in subsequent years, and adjustments to estimated cash disbursements for several other programs, including summer school special education and the aid and incentives program for local governments.

The updated current services forecast includes the estimated costs of tentative labor settlements with the Civil Service Employees Association, United University Professions, District Council 37, and comparable pay and benefits changes extended to Management/Confidential employees. The contracts provide for a 3 percent annual salary increase in 2007-08, 2008-09, and 2009-10, and a 4 percent increase in 2010-11. A full discussion of the status of labor settlements and the impact on the Financial Plan appears later in this section.

### **Sources of the 2008-09 General Fund Budget Gap ("Zero-Based" Perspective)**

The State is projected to move from a balanced General Fund budget in 2007-08 to an imbalance of \$4.4 billion in 2008-09, prior to the impact of Executive Budget recommendations. Current services spending is projected to grow by \$5.3 billion over 2007-08 compared to estimated net revenue growth of \$1.3 billion. At this time, the State plans to use \$370 million less in reserves in 2008-09 than in 2007-08 to help balance the budget. The following chart provides a "zero-based" look at the sources of the 2008-09 General Fund budget gap, followed by a brief summary of the assumptions behind the projections.

For a detailed explanation of the specific assumptions supporting the revenue and spending projections, see “2008-09 Financial Plan” and “General Fund Financial Plan Out-Year Projections” herein.

<b>2008-09 General Fund "Current Services" Annual Change</b>	
<b>Savings/(Costs)</b>	
<b>(millions of dollars)</b>	
<b>RECEIPTS</b>	<b>1,301</b>
Base Tax Receipts - "Constant Law" Growth	2,584
Change in STAR	(388)
Change in Debt Service	(295)
Miscellaneous Receipts/Federal Grants	(406)
Non-tax Transfers from Other Funds (primarily non-recurring fund sweeps)	(255)
All Other	61
<b>DISBURSEMENTS</b>	<b>(5,353)</b>
<b>Local Assistance</b>	<b>(4,033)</b>
Medicaid	(1,736)
<i>Base Program Growth</i>	(1,370)
<i>Change in HCRA and Other Financing</i>	(366)
School Aid	(1,363)
Local Government Assistance	(358)
City University	(199)
Mental Hygiene	(202)
Children and Family Services	(182)
All Other Local Assistance	7
<b>State Operations</b>	<b>(825)</b>
Personal Service	(568)
<i>Collective Bargaining Settlement Costs</i>	(197)
<i>Judicial Salary Increase (in Judiciary's Budget Request)</i>	(143)
<i>All Other Salary Growth</i>	(228)
Non-personal Service	(257)
<b>General State Charges</b>	<b>(281)</b>
Health Insurance	(209)
Pensions	(71)
All Other	(1)
<b>Transfers to Other Funds</b>	<b>(214)</b>
Debt Service	(135)
Capital Projects	(341)
All Other	262
<b>Change in Planned Use of Reserves (net)</b>	<b>(370)</b>
<b>CURRENT SERVICES BUDGET GAP FOR 2008-09</b>	<b>(4,422)</b>

The forecast for 2008-09 is based on assumptions of economic performance, revenue collections, spending patterns, and the estimated costs to maintain programs and activities at the level required by current law. DOB believes the estimates of annual change in revenues and spending that create the 2008-09 current services gap forecast are based on reasonable assumptions and methodologies.



## Explanation of the 2008-09 Gap-Closing Plan

The General Fund Executive Budget savings plan is valued at \$4.8 billion in 2008-09. The plan is sufficient to eliminate the current services gap of \$4.4 billion and finance new initiatives of just over \$400 million.

The gap-closing actions can be grouped into four categories: actions that reduce overall State current services spending on a recurring basis; actions that increase revenues on a recurring basis; transactions that increase revenues or lower spending in 2008-09, but that are not expected to recur; and the use of reserves. The section below provides details on the actions under each category that are recommended for 2008-09. It is followed by a discussion of the new initiatives and their impact on the General Fund Financial Plan. Additional information on the Budget recommendations for major programs and activities appears in the sections entitled "2008-09 Financial Plan" and "General Fund Financial Plan Outyear Projections" later in this AIS Update.

2008-09 Executive Budget -- General Fund Budget-Balancing Plan				
(millions of dollars)				
	2008-09	2009-10	2010-11	2011-12
<b>Current Services Gaps</b>	<b>(4,422)</b>	<b>(6,154)</b>	<b>(7,697)</b>	<b>(9,454)</b>
<b>Savings Plan</b>	<b>4,838</b>	<b>3,741</b>	<b>3,507</b>	<b>4,071</b>
<b>Savings Actions</b>	<b>2,253</b>	<b>2,495</b>	<b>2,274</b>	<b>2,832</b>
Health Care <sup>1</sup>	826	957	895	1,418
STAR	354	380	165	175
Welfare/TANF	204	204	204	204
Mental Hygiene	212	243	277	280
Criminal Justice	101	131	136	139
General State Charges	89	61	66	67
Higher Education	67	99	101	103
Other Education	66	73	76	79
Transportation/Transit	64	45	47	48
All Other	270	302	307	319
<b>Revenue Actions</b>	<b>1,109</b>	<b>1,267</b>	<b>1,254</b>	<b>1,260</b>
Improve Audit and Compliance Efforts	280	250	250	250
Conforming HMOs Taxation	215	250	250	250
LLC Minimum Partner Fees	75	75	75	75
Capital Base Rate Reduction/Cap Elimination	73	58	58	58
Modify Quick Draw Restrictions	36	60	60	60
All Other	430	574	561	567
<b>Non-Recurring Actions</b>	<b>1,139</b>	<b>(21)</b>	<b>(21)</b>	<b>(21)</b>
Belmont Development Rights	250	0	0	0
Phase in AIM Restoration for NYC	164	0	0	0
Bond Finance Certain Eligible Capital Costs	173	(21)	(21)	(21)
All Other	552	0	0	0
Use of Reserves to Finance Labor Settlements	337	0	0	0
<b>New Initiatives:</b>	<b>416</b>	<b>874</b>	<b>1,497</b>	<b>1,438</b>
School Aid	126	207	512	178
Health Care	120	281	373	443
Human Services COLA	0	88	180	278
All Other	170	298	432	539
<b>Executive Budget Gaps</b>	<b>0</b>	<b>(3,287)</b>	<b>(5,687)</b>	<b>(6,821)</b>

<sup>1</sup> Includes Medicaid, Health, and Aging. Excludes certain non-recurring resources and HCRA savings.

## ***Recurring Savings (Spending)***

Actions in this category total \$2.3 billion in 2008-09, comprising slightly less than 50 percent of the overall gap-closing plan. The savings plan recommends continuing efforts to restrain health care costs; slowing the phase-in of the basic middle-class STAR rebate program; realigning costs, where appropriate, to the level of government responsible for service delivery; and enhancing operational controls on State agencies.

### ***Health Care***

The 2008-09 savings plan marks another step in a multi-year plan to reform the State's health care system that began in 2007-08. Recommended State-financed savings, including savings in Medicaid, HCRA programs, and Aging, total \$980 million in 2008-09 from all sources, before accounting for reinvestments. In the General Fund, recurring savings total \$826 million in 2008-09 and grow to over \$1.4 billion by 2011-12. Proposals include intensifying audit activities to reduce fraud, expanding controls on pharmaceutical programs, adjusting reimbursement rates for prescription drugs, and enhancing management of high-cost beneficiaries. Other savings include a program to authorize the use of coordinated transportation services, a Diabetes Care Improvement Project in which Medicaid would reimburse for diabetes self-management education, and the implementation of payment auditing to deny ambulatory care claims submitted without the required procedure or diagnosis codes. Outside of Medicaid, health care savings include elimination of the planned COLA for Early Intervention (EI) providers and certain initiatives enacted in 2007-08.

### ***School Tax Relief Program***

The Executive Budget recommends a slower phase-in of the basic middle-class STAR rebate; a reduction in the STAR credit for New York City resident personal income taxpayers with incomes above \$250,000; a change in the adjustment that limits annual reductions in the STAR exemption amount from 5 percent to 10 percent; and authorization for the State to offset middle-class STAR rebates owed to individuals who are delinquent on their taxes, child support, or other legal debt obligations. After recommendations, the State will finance \$4.7 billion in total property tax relief in 2008-09 (nearly \$5 billion on a commitment basis), growing to \$6.2 billion over the next few years.

### ***Welfare/Temporary Assistance for Needy Families***

Savings in welfare take several forms. First, the level of the Temporary Assistance for Needy Families (TANF) resources available to offset the State's Earned Income Tax Credit (EITC) would be increased by proposed conversion of certain TANF-funded programs to a cash rather than commitment basis, a reduction of TANF funding to reflect 2004-05 program commitments that cost less than originally contemplated to complete, and elimination of several 2007-08 initiatives that are not essential to the agencies' core missions. The Budget also proposes altering the current financing shares for public assistance benefits, requiring local governments to finance more of the costs for certain categories of assistance.

### ***Other Savings***

These cover a broad range of State activities and agencies, including nearly \$300 million in recurring savings in State Operations in the General Fund, with reductions in both personal service and non-personal service spending. Operational savings include hiring controls, including not filling vacancies for non-essential positions; overtime management; and energy and other utility savings. Other significant recommendations include closing three under-utilized correctional camps (Pharsalia, Mt. McGregor, and Gabriels) and the medium-security facility at Hudson; assessing a security fee on nuclear power plant operators for State costs; auditing activities to eliminate ineligible dependents from receiving health insurance coverage from the State; and eliminating certain initiatives enacted in 2007-08.

## **Recurring Savings (Revenues)**

The Executive Budget recommends several tax law and administrative reforms to promote equity and ensure compliance, which will generate \$1.1 billion in additional revenue in the General Fund. These include improving audit capabilities, reclassifying HMOs as insurance taxpayers, and other changes.

## **Non-Recurring Resources**

The State typically uses some non-recurring resources each year to support its operations. The Executive Budget uses approximately \$1.1 billion of non-recurring resources to balance the General Fund Financial Plan and another \$337 million in labor reserves to finance expected collective bargaining costs. There are two significant non-recurring transactions in 2008-09. The first is a potential payment for the development rights at Belmont Park. The second is a partial restoration of an aid payment to New York City under the Aid and Incentives to Municipalities (AIM) program. The 2008-09 current services budget had included a full restoration of the payment that had been reduced to \$20 million in 2007-08. Other one-time actions consist of bonding certain capital projects originally planned to be cash financed, and sweeps of excess balances from other funds. A complete list of the items included in this category is provided later in this AIS Update under the "2008-09 Financial Plan" section.

## **Recommended Initiatives**

The Executive Budget proposes new initiatives totaling over \$400 million in 2008-09, growing to \$1.4 billion in 2011-12. The initiatives include additional School Aid, the re-investment of health care savings in ambulatory and primary care, and extension of COLA for human service providers through 2011-12.

In School Aid, the Budget recommends increasing aid to New York City and maintaining the total funding level for High Tax Aid. Additional resources are also recommended for the Healthy Schools Act. As part of the overall aid package, adjustments are proposed to the minimum guaranteed aid increase under Foundation Aid and the timing of reimbursement for certain expense-based aids.

Health care investments total over \$100 million in 2008-09, annualizing to over \$400 million by 2011-12. The most significant proposals would reinvest hospital savings to improve health care, particularly in primary care and increased physicians fees. Additional funding is also recommended for an array of programs, including the creation of a State Enrollment Portal to authorize the State to directly enroll individuals in Medicaid, Family Health Plus, and Child Health Plus (CHP); a three-year extension of COLA which was set to expire in 2008-09; and tobacco control initiatives intended to minimize tobacco use.

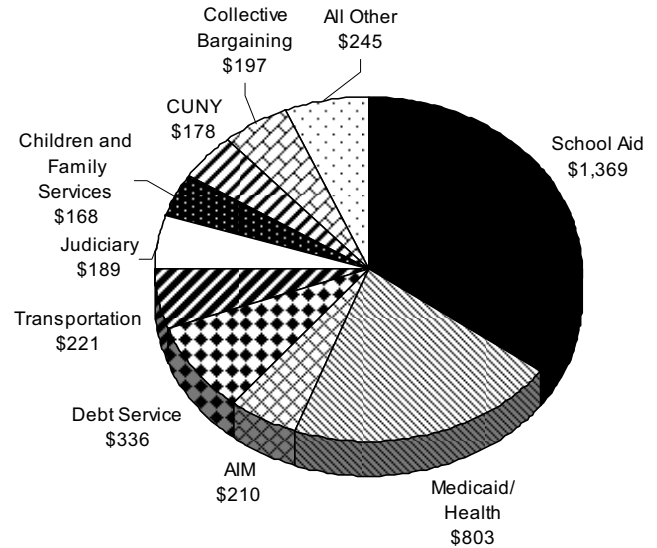
In social services, the Budget also recommends extending the COLA for human service providers through 2011-12. Other investments are made in economic development, Agriculture and Markets, Mental Hygiene, local government aid, and tax credits.

## Executive Budget Impact on Spending Growth

In 2008-09, the Executive set a goal of holding State Operating Funds spending to less than the long-term growth rate in State personal income of 5.3 percent. Achieving a spending growth rate at or below the target rate is important because, in the long run, it should permit the State to increase reserves in economic expansions when State tax receipts tend to grow faster than personal income. In difficult years, when personal income and revenue growth is below the historical trend or even negative, sufficient reserves would be available to smooth the impact on spending and provide for a more stable long-term fiscal environment.

In 2008-09, the Executive Budget holds State Operating Funds spending to 5.0 percent, below the target rate of 5.3 percent. State Operating Funds spending, which excludes Federal operating aid and capital spending, is projected to total \$81.8 billion in 2008-09, an increase of \$3.9 billion over the current-year forecast. This growth is for local aid to public schools, Medicaid costs, support for transportation, local government aid programs and debt service, as well as roughly \$800 million for agency operational costs (including fringe benefit costs).

**State Operating Funds Spending Growth  
\$3.9 billion  
(dollars in millions)**



Total Disbursements (millions of dollars)				
	2007-08 Current	2008-09 Proposed	Annual \$ Change	Annual % Change
<b>State Operating Funds</b>	<b>77,909</b>	<b>81,825</b>	<b>3,916</b>	<b>5.0%</b>
General Fund *	50,831	53,859	3,028	6.0%
Other State Funds	22,728	23,276	548	2.4%
Debt Service Funds	4,350	4,690	340	7.8%
<b>All Governmental Funds</b>	<b>118,314</b>	<b>124,329</b>	<b>6,015</b>	<b>5.1%</b>
State Operating Funds	77,909	81,825	3,916	5.0%
Capital Projects Funds	6,645	7,927	1,282	19.3%
Federal Operating Funds	33,760	34,577	817	2.4%

\*Excludes transfers.

State Operating Funds spending growth in 2008-09 is the product of numerous budget choices. The following table shows that growth is concentrated in a relatively small number of major programs, most significantly in School Aid and Medicaid. Outside of these major agencies, growth in overall State programs is nearly flat in the aggregate.

<b>Main Sources of State Operating Funds Growth</b>						
<b>State Fiscal Year Basis</b>						
<b>(millions of dollars)</b>						
	<b>2007-08 Revised</b>	<b>2008-09</b>			<b>Annual Change</b>	
		<b>Current Services</b>	<b>Chg from Curr. Serv.</b>	<b>Exec. Proposed</b>	<b>Dollar</b>	<b>Percent</b>
<b>STATE OPERATING FUNDS</b>	<b>77,909</b>	<b>83,830</b>	<b>(2,005)</b>	<b>81,825</b>	<b>3,916</b>	<b>5.0%</b>
School Aid	19,025	20,269	125	20,394	1,369	7.2%
Medicaid (excluding Local Cap)*	15,139	16,235	(544)	15,691	552	3.6%
Medicaid: Takeover Initiatives	235	486	0	486	251	106.8%
Debt Service	4,292	4,657	(29)	4,628	336	7.8%
Transportation	2,932	3,133	20	3,153	221	7.5%
Judiciary	1,821	2,010	0	2,010	189	10.4%
Children and Families	1,871	2,095	(56)	2,039	168	9.0%
CUNY	1,134	1,334	(22)	1,312	178	15.7%
AIM	707	1,076	(159)	917	210	29.7%
Collective Bargaining	140	337	0	337	197	140.7%
All Other	30,613	32,198	(1,340)	30,858	245	0.8%

\* Medicaid spending total is for all State agencies including those outside of the Department of Health. This total does not include local cap payments. See further discussion in section entitled "Medicaid Transparency" later in this report.

General Fund spending, which now accounts for roughly 65 percent of State-financed spending, is projected to grow at 6 percent (5.9 percent when transfers are included). The General Fund is important because it must, by law, be balanced, but it is not as comprehensive a view of spending paid for by State taxpayers as State Operating Funds.

Capital Projects Funds spending, which includes Federal and State support, is expected to increase by \$1.3 billion or 19.3 percent over the current 2007-08 forecast, which is in part a result of spending on various projects delayed from 2007-08, as well as recommended new initiatives for transportation, economic development, higher education and parks and recreation. This reflects spending reported in actual cash-basis reports. Additional information on capital spending is provided later in this AIS Update and in the 2008-09 Executive Budget Five-Year Capital Program and Financing Plan available on the DOB website.

All Governmental Funds<sup>1</sup> spending, which includes Federal aid, is estimated at \$124.3 billion in 2008-09, an increase of \$6.0 billion (5.1 percent) from 2007-08.

### **Risks to the Financial Plan**

DOB believes the overall Financial Plan estimates and projected out-year budget gaps are based on reasonable assumptions. In any year, however, the Financial Plan is subject to risks that, if they were to materialize, could affect operating results. In DOB's judgment, the three most significant short-term risks, as measured by their potential fiscal impact and the probability that may occur, are that: (a) economic performance will fall below projected levels and perhaps even lapse into a recession at some point in calendar

<sup>1</sup> Hereafter "All Funds." Comprises the General Fund, Special Revenue Funds, Capital Projects Funds, and Debt Service Funds.

year 2008, which could have a potentially severe impact on State finances; (b) labor settlements will be reached with the remaining State employee unions, the costs of which have not been completely financed in the Financial Plan after 2008-09; and (c) specific transactions included as part of the Executive Budget may not occur as planned. Other risks include potential Federal disallowances arising from audits related to Medicaid claims under the School Supportive Health Services program and proposed Federal rule changes concerning Medicaid payments. See "Financial Plan Reserves and Risks," later in this AIS Update for additional information.

### **Labor Settlements**

The State has reached tentative labor settlements with three labor unions, the Civil Service Employees Association, United University Professions (UUP), and District Council 37, and will extend similar changes in pay and benefits to "management/confidential" employees. Under terms of the tentative four-year contracts, which run from April 2, 2007 through April 1, 2011 (July 2, 2007 through July 1, 2011 for UUP), employees will receive pay increases of 3 percent annually in 2007-08, 2008-09, and 2009-10 and 4 percent in 2010-11. The Civil Service Employees Association ratified its contract on January 3, 2008. The UUP and District Council 37 are expected to vote on their contracts before the end of the current State fiscal year.

The State's Financial Plan funds the costs of these tentative contract agreements in 2007-08 and 2008-09 through the use of \$477 million of the \$1.18 billion in existing reserves set aside for this purpose. DOB estimates the General Fund costs of the tentative agreements at \$140 million in the current year, \$337 million in 2008-09, \$510 million in 2009-10, and \$756 million in both 2010-11 and 2011-12. The current Financial Plan includes these costs.

The unions representing uniformed officers (i.e., Police Benevolent Association, New York State Correctional Officers and Police Benevolent Association) and the Public Employees Federation have not reached settlements with the State at this time. The earliest any costs for these contracts could be paid would be in 2008-09. These costs are not included in the current Financial Plan spending forecast, but a reserve is set aside to partially fund them. The State currently has \$708 million in labor reserves remaining (i.e., not programmed in the Financial Plan) to help finance the costs of potential new settlements.

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## 2007-08 FINANCIAL PLAN UPDATE

The Executive Budget Financial Plan includes the third quarterly update to the 2007-08 Enacted Budget Financial Plan. The following describes the substantive revisions to Financial Plan estimates for the current year since the last update to the AIS in November 2007. Please refer to the AIS Updates issued in August 2007 and November 2007, which are available on-line, for detailed explanations of the earlier revisions.

Since the Mid-Year Update, DOB has revised its revenue and spending estimates based on operating results through the end of the 2007-08 fiscal year, and a review of factors affecting the long-term current services forecast. In addition, DOB has added costs for collective bargaining agreements reached with several of the State's major employee unions that have fiscal implications for 2007-08 and beyond. The revisions result in net General Fund costs in 2007-08 of \$137 million, which will be funded by existing reserves.

Despite the continued slowdown in economic growth reflected in the updated revenue forecast, DOB projects the General Fund will remain in balance in 2007-08. Lower-than-expected local aid payments and operational savings across all State agencies, along with the use of reserves as planned to finance labor settlements, are expected to be sufficient to cover the expected revenue decline. As summarized in the table below, since the beginning of the fiscal year, the roughly \$500 million decline in expected General Fund receipts has been almost entirely offset by a decline in projected growth in Medicaid spending, resulting in no material change (down \$17 million) in net operations.

2007-08 General Fund Quarterly Financial Plan Revisions From Enacted Budget Increase/(Decrease) (millions of dollars)						
	Enacted Estimate	Revisions			Current Estimate	Change From Enacted
		First Quarter	Mid-Year	Executive		
<b>Opening Balance</b>	<b>3,045</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>3,045</b>	<b>0</b>
<b>Revenue Revisions</b>	<b>53,672</b>	<b>324</b>	<b>(609)</b>	<b>(218)</b>	<b>53,169</b>	<b>(503)</b>
<b>Spending Revisions</b>	<b>53,684</b>	<b>311</b>	<b>(326)</b>	<b>(81)</b>	<b>53,588</b>	<b>(96)</b>
Medicaid	9,496	80	(555)	16	9,037	(459)
School Aid	16,170	0	60	8	16,238	68
Children and Families	1,787	70	7	0	1,864	77
Higher Education	3,706	10	(74)	1	3,643	(63)
Mental Hygiene	3,113	5	0	1	3,119	6
State	81	(28)	2	0	55	(26)
Legislature/Judiciary	1,834	0	3	(9)	1,828	(6)
Transportation	107	0	0	0	107	0
Debt Service	1,579	(1)	(27)	6	1,557	(22)
General State Charges	4,530	(6)	(29)	(8)	4,487	(43)
Transfers to Other Funds	2,375	204	3	(75)	2,507	132
Use of Debt Reduction Reserve	0	0	250	0	250	250
All Other	8,906	(23)	34	(21)	8,896	(10)
<b>Planned Use of Reserves For Specified Purposes</b>	<b>0</b>	<b>0</b>	<b>250</b>	<b>140</b>	<b>390</b>	<b>390</b>
Debt Reduction Reserve	0	0	250	0	250	250
Labor Reserve	0	0	0	140	140	140
<b>Net Change from Operations</b>	<b>(12)</b>	<b>13</b>	<b>(33)</b>	<b>3</b>	<b>(29)</b>	<b>(17)</b>
<b>Projected Year-End Reserve Levels</b>	<b>3,033</b>	<b>13</b>	<b>(283)</b>	<b>(137)</b>	<b>2,626</b>	<b>(407)</b>
General Reserves	1,203	12	(33)	(137)	1,045	(158)
Tax Stabilization Reserve	1,031	0	0	0	1,031	0
Rainy Day Reserve Fund (assumed deposit)	175	0	0	0	175	0
Community Projects Fund Reserve	353	1	0	0	354	1
Contingency Reserve	21	0	0	0	21	0
Debt Reduction Reserve	250	0	(250)	0	0	(250)

Since the Mid-Year Update, General Fund receipts, including transfers from other funds, have been revised downward by \$218 million. The slowdown in economic activity is the main reason for the revision. In addition, recent stresses on Wall Street suggest modest declines in bonus payouts over the remainder of the fiscal year.

General Fund disbursements, including transfers to other funds, are expected to total \$53.6 billion in 2007-08, \$81 million lower than the Mid-Year Update estimate. Lower General Fund spending in School Aid based on higher than expected lottery revenues, a reduction in the General Fund subsidy to the Dedicated Highway and Bridge Trust Fund, and adjustments to cash disbursements in other areas based on results to date are offset, in part, by expected spending for tentative labor contracts that will be financed from designated reserves (\$140 million).

**2007-08 Closing Balance**

<b>General Fund Estimated Closing Balance</b> (millions of dollars)			
	<b>2007-08 Mid-Year Estimate</b>	<b>2007-08 Current Estimate</b>	<b>Change</b>
<b>Projected Year-End Fund Balance</b>	<b>2,763</b>	<b>2,626</b>	<b>(137)</b>
<i>Undesignated Reserves</i>			
Tax Stabilization Reserve Fund	1,031	1,031	0
Rainy Day Reserve Fund	175	175	0
Contingency Reserve Fund	21	21	0
<i>Designated Reserves</i>			
Labor Settlement Reserve/Likely Risks	1,182	1,045	(137)
Community Projects Fund	354	354	0

DOB projects the State will end the 2007-08 fiscal year with a General Fund balance of \$2.6 billion, consisting of \$1.2 billion in undesignated reserves and \$1.4 billion in designated reserves. The projected closing balance is \$137 million lower than the balance projected at the time of the Mid-Year Update and is due primarily to the use of the labor reserve as planned.

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## 2007-08 OPERATING RESULTS THROUGH DECEMBER 2007

The table below compares actual results for the period from April 2007 through December 31, 2007 to the estimates included in the Mid-Year Update to the Financial Plan and the Enacted Budget Financial Plans, as well as actual results for the same nine-month period in 2006.

### General Fund

2007-08 Fiscal Year-to-Date Results						
Actual Year-to-Date Results: April through December 2007						
General Fund Results vs. Projections; Year-to-Year Comparison						
(millions of dollars)						
	Enacted Budget	Mid-Year Update Projection	Actual Results	Actuals vs. Estimates Favorable/ (Unfavorable) vs. Plan		Increase/ (Decrease) from Prior Year
				Enacted Budget	Mid-Year Update Projection	
Opening Balance (April 1, 2007)	3,045	3,045	3,045	N/A	N/A	(212)
<b>Receipts</b>	<b>36,041</b>	<b>35,616</b>	<b>35,513</b>	<b>(528)</b>	<b>(103)</b>	<b>448</b>
Personal Income Tax	13,889	13,915	13,910	21	(5)	(695)
User Taxes and Fees	6,543	6,521	6,540	(3)	19	276
Business Taxes	4,589	4,378	4,086	(503)	(292)	(433)
All Other Taxes, Receipts & Grants	2,536	2,345	2,478	(58)	133	(109)
Transfers From Other Funds	8,484	8,457	8,499	15	42	1,409
<b>Disbursements</b>	<b>36,637</b>	<b>36,897</b>	<b>36,881</b>	<b>(244)</b>	<b>16</b>	<b>926</b>
Local Assistance	22,827	22,936	23,179	(352)	(243)	1,028
State Operations						
Personal Service	5,690	5,644	5,592	98	52	(78)
Non-Personal Service	1,986	1,995	2,011	(25)	(16)	206
General State Charges	3,829	3,605	3,569	260	36	(52)
Transfers To Other Funds	2,305	2,717	2,530	(225)	187	(178)
<b>Change in Operations</b>	<b>(596)</b>	<b>(1,281)</b>	<b>(1,368)</b>	<b>(772)</b>	<b>(87)</b>	<b>(478)</b>
Closing Balance (December 31, 2007)	2,449	1,764	1,677	N/A	N/A	(690)

The following describes the difference between estimates and actual results. All comparisons are for the nine-month period for April 1 through December 31, 2007 and, in discussions of annual change, for the comparable nine-month period in 2006.

### General Fund Comparison to Mid-Year Update Projections

The General Fund ended December 2007 with a cash balance of \$1.7 billion, \$87 million lower than projected in the Mid-Year Update. Through December 2007, General Fund receipts, including transfers from other funds, totaled \$35.5 billion, \$103 million lower than the public forecast, mainly due to higher-than-expected refunds of personal income tax and lower-than-expected business tax collections, offset by higher-than-expected real estate transfer tax collections and miscellaneous receipts collections.

General Fund disbursements through December 2007 totaled \$36.9 billion, \$16 million lower than projected as described below. The relatively minor variance is the result of several offsetting factors:

- **School Aid (\$102 million higher than planned):** Largely attributable to the timing of general aid and categorical aid payments.
- **Public Health (\$69 million higher than planned):** Largely due to the timing of EI program payments.

- **Medicaid, including Administration (\$76 million higher than planned):** Largely reflects faster-than-anticipated administrative payments to local governments for the cost of administering Medicaid programs.
- **General State Charges (\$36 million lower than planned):** Primarily attributable to the timing of taxes paid on State-owned lands to certain municipalities and lower-than-projected Workers' Compensation payments.
- **Transfers to Other Funds (\$187 million lower than planned):** The decrease is due to the timing of the expected transfer from the General Fund to the Debt Reduction Reserve Fund, which was originally projected to occur in December 2007 and is now projected to be completed in March 2008.

### **General Fund Comparison to Enacted Budget Projections**

General Fund receipts totaled \$35.5 billion, \$528 million lower than the Enacted Budget forecast. This variance is due in large part to lower-than-expected collections in the corporation franchise tax (\$388 million), which were below expectations due to the timing of large audit collections originally expected in December, and now expected in the last quarter of 2007-08.

General Fund disbursements totaled \$36.9 billion, \$244 million higher than projected in the Enacted Budget. The most significant spending variances include:

- **School Aid (\$188 million higher than planned):** Largely attributable to earlier-than-anticipated payments which are non-statutory and largely based on the execution of contracts and the submission of claims by school districts.
- **Other Education Aid (\$77 million higher than planned):** Attributable to earlier-than-anticipated payments for library aid, case services to individuals with disabilities, community projects funds, workforce education, and various other education programs.
- **Medicaid (\$146 million lower than planned):** Lower than projected Medicaid spending is driven largely by a moderation in caseload and the timing of certain payments and offsets, which has resulted in lower overall utilization of Medicaid services.
- **Children and Family Services (\$77 million higher than planned):** Due to variations from the anticipated spending patterns across all programs.
- **Special Education (\$96 million higher than planned):** Primarily attributable to earlier-than-projected claiming for preschool special education, following administrative accelerations.
- **General State Charges (\$260 million lower than planned):** Underspending was primarily driven by earlier than expected escrow payments which reduce General Fund costs, as well as various timing issues mostly related to Workers' Compensation Claims.
- **Transfers to Other Funds (\$225 million higher than planned):** Driven primarily by earlier than anticipated spending for economic development and higher education projects.

## General Fund Annual Change

On a year-over-year basis, General Fund receipts through December 2007 were up \$448 million, or 1.3 percent, compared to the same period in 2006-07. Increases in transfers from other funds, user taxes and fees and miscellaneous receipts, slightly offset by declines in the personal income tax, business taxes, other taxes and Federal Grants, account for the growth.

General Fund spending was \$926 million higher than actual results through the same period for fiscal year 2006-07. Significant changes in spending levels from the same period last year include:

- **School Aid (\$674 million growth):** Reflects growth associated with increased tail payments for the final three months of the 2006-07 school year (\$239 million) and increased payments for the first six months of the 2007-08 school year as authorized in the Enacted Budget for 2007-08 (\$429 million).
- **Special Education (\$196 million growth):** Annual growth primarily reflects the accelerated submission of claims by counties and accelerated processing of claims by SED in 2007-08 compared to 2006-07.
- **Children and Family Services (\$200 million growth):** Higher spending is primarily attributable to growth in child welfare services (\$93 million), growth in Foster Care Block Grant payments (\$31 million) and payments made for residential education placements for children with needs that cannot be accommodated by public school districts (\$23 million).
- **Medicaid, including Administration (\$315 million decline):** Consistent with current year reestimates in Medicaid, the year-over-year decline is primarily due to a moderation in enrollment and the timing of certain payments and offsets, which has resulted in lower overall utilization of Medicaid services.
- **Public Health (\$112 million growth):** Higher spending is largely attributable to the timing of local public health program payments, as well as additional health care investments included in the 2007-08 Enacted Budget.
- **Local Government Aid (\$257 million decline):** Largely reflects a one-time reduction in New York City's unrestricted local government assistance in 2007-08.
- **Welfare (\$170 million growth):** Reflects a return to the traditional pattern of local district advances.
- **Non-Personal Service (\$206 million growth):** Reflects inflationary growth in non-personal service spending primarily in the State University of New York (SUNY) (\$77 million), Corrections (\$57 million), and the Judiciary (\$19 million).
- **Transfers to Other Funds (\$178 million decline):** Transfers to Capital Projects Funds increased by \$224 million, primarily due to increased spending for authority bonded economic development programs and General Obligation bonded transportation and environment programs, as well as the timing of authority bond receipts. The growth in transfers to Capital Project Funds was offset by a decline in transfers to Debt Service Funds (\$172 million), due mainly to the payment of debt service on certain SUNY construction bonds in March 2007 rather than April 2007, and the decline in transfers to other funds (\$230 million), due mainly to a delay in the expected transfer to the Debt Reduction Reserve Fund.

**State Operating Funds**

2007-08 Fiscal Year-to-Date Results						
Actual Year-to-Date Results: April through December 2007						
State Operating Funds Results vs. Projections; Year-to-Year Comparison						
(millions of dollars)						
	Enacted Budget	Mid-Year Update Projection	Actual Results	Actuals vs. Estimates		Increase/ (Decrease) from Prior Year
				Favorable/ (Unfavorable) vs. Plan		
				Enacted Budget	Mid-Year Update Projection	
<b>Total Receipts</b>	<b>53,420</b>	<b>53,341</b>	<b>53,072</b>	<b>(348)</b>	<b>(269)</b>	<b>1,571</b>
Personal Income Tax	24,825	24,859	24,855	30	(4)	1,500
User Taxes and Fees	9,896	9,806	9,816	(80)	10	367
Business Taxes	5,705	5,455	5,143	(562)	(312)	(466)
Other Taxes	1,378	1,427	1,446	68	19	(140)
Miscellaneous Receipts	11,571	11,721	11,738	167	17	372
Federal Grants	45	73	74	29	1	(62)
<b>Total Disbursements</b>	<b>55,797</b>	<b>55,636</b>	<b>55,231</b>	<b>566</b>	<b>405</b>	<b>2,741</b>
Local Assistance						
Medicaid, including admin	9,245	8,986	9,143	102	(157)	233
School Aid	11,095	11,101	11,162	(67)	(61)	960
STAR	4,730	4,730	4,622	108	108	989
Transportation	2,665	2,642	2,604	61	38	552
Temporary and Disability Assistance	1,203	1,231	1,249	(46)	(18)	142
Public Health	2,079	1,977	1,908	171	69	(179)
Higher Education	1,460	1,411	1,430	30	(19)	21
Children and Family Services	991	1,083	1,069	(78)	14	201
Mental Hygiene	1,165	1,202	1,215	(50)	(13)	169
All Other Education	1,005	1,202	1,185	(180)	17	243
All Other	1,449	1,320	1,288	161	32	(640)
State Operations	11,714	11,721	11,603	111	118	364
General State Charges	4,306	4,062	4,025	281	37	(35)
Capital Projects	3	4	6	(3)	(2)	(2)
Debt Service Funds	2,687	2,964	2,722	(35)	242	(277)

**State Operating Funds Comparison to Second Quarterly Update Projections**

State Operating Funds receipts totaled \$53.1 billion or \$269 million less than the last forecast. Tax receipts totaled \$41.3 billion, \$287 million below the Mid-Year Update estimate. The decrease is the result of lower-than-anticipated collections in business taxes, slightly offset by higher-than-anticipated collections in the other tax categories.

Disbursements totaled \$55.2 billion, \$405 million below the Second Quarterly Update forecast. The largest variances outside the General Fund include the timing of HCRA-supported public health spending, particularly in the HCRA Program Account and in CHP (\$158 million); and lower-than-projected STAR payments (\$108 million). These variances are believed to be timing related and are not expected to result in lower spending for the fiscal year.

**State Operating Funds Comparison to Enacted Budget Projections**

Through December 2007, State Operating Funds receipts totaled \$53.1 billion or \$348 million less than the Enacted Budget projection. Tax receipts totaled \$41.3 billion, \$544 million less than the Enacted Budget estimate. The variance is due in large part to lower-than-expected collections in the corporate franchise tax (\$456 million) reflecting a delayed audit settlement payment, slightly offset by higher than expected

collections in personal income tax (\$30 million) due to higher than expected receipts from withholding and estimated payments.

State Operating Funds disbursements totaled \$55.2 billion, \$566 million below the Enacted Budget. The largest variances outside the General Fund include the timing of HCRA-supported public health spending (\$122 million); lower-than-projected STAR payments (\$108 million), and lower than projected EPIC spending (\$86 million).

### State Operating Funds Annual Change

Total taxes increased by \$1.3 billion, or 3.2 percent, compared to the same period in 2006-07. This increase is largely attributable to two factors. First, there were large one-time audit recoveries in business taxes in 2006. Second, the child credit enacted in 2006 significantly increased income tax refunds during the April-May period. Annual miscellaneous receipts growth is largely driven by lottery revenue growth (\$230 million).

Compared to the same period in 2006-07, State Operating Funds disbursements were \$2.7 billion higher in the current year. The largest increases were for School Aid, reflecting growth in payments of general aid (\$960 million); transportation programs, largely Mass Transportation Operating Assistance (\$552 million); STAR, driven by middle-class STAR property tax rebates (\$989 million); State Operations (\$364 million), largely reflecting salary increases, workforce growth and non-personal service inflation; and Welfare (\$142 million); Special Education (\$196 million); and Children and Family Services (\$201 million).

### Capital Projects Funds

2007-08 Fiscal Year-to-Date Results						
Actual Year-to-Date Results: April through December 2007						
Capital Projects Funds Results vs. Projections; Year-to-Year Comparison						
(millions of dollars)						
	Enacted Budget	Mid-Year Update Projection	Actual Results	Actuals vs. Estimates Favorable/ (Unfavorable) vs. Plan		Increase/ (Decrease) from Prior Year
				Enacted Budget	Mid-Year Update Projection	
<b>Total Receipts</b>	<b>4,540</b>	<b>4,326</b>	<b>4,288</b>	<b>(252)</b>	<b>(38)</b>	<b>178</b>
Taxes	1,584	1,488	1,519	(65)	31	70
Miscellaneous Receipts	1,452	1,607	1,498	46	(109)	82
Federal Grants	1,504	1,231	1,271	(233)	40	26
<b>Total Disbursements</b>	<b>5,105</b>	<b>4,548</b>	<b>4,507</b>	<b>598</b>	<b>41</b>	<b>399</b>
Transportation	2,572	2,560	2,703	(131)	(143)	(55)
Economic Development	225	295	279	(54)	16	172
Public Protection	250	230	190	60	40	22
Mental Hygiene	163	155	158	5	(3)	28
Environment	400	380	371	29	9	64
Higher Education	490	462	454	36	8	(20)
All Other	1,005	466	352	653	114	188

### Capital Projects Funds Comparison to Mid-Year Financial Plan Projections

Receipts totaled \$4.3 billion or \$38 million less than the Mid-Year Update forecast. Total tax receipts were \$31 million higher than anticipated. Lower-than-anticipated reimbursements for bond-financed programs resulted in lower-than-projected miscellaneous receipts. Federal grants exceeded the estimated forecast. Disbursements totaled \$4.5 billion, \$41 million below the Mid-Year projection, largely driven by lower-than-anticipated spending for economic development, health, and public protection projects offset by higher than anticipated spending for transportation projects.

### Capital Projects Funds Comparison to Enacted Budget Projections

Through December 2007, Capital Projects Funds receipts totaled \$4.3 billion or \$252 million less than the Enacted Budget forecast. Higher than anticipated reimbursements for transportation projects resulted in higher than projected miscellaneous receipts. Federal grant reimbursements for spending lagged behind the estimated forecast, as did related disbursements.

Through December 2007, Capital Projects Funds disbursements totaled \$4.5 billion, \$598 million below the Enacted Budget projection, largely driven by slower than anticipated spending for environmental projects financed with general obligation bonds (\$29 million), and higher education, public protection, and health projects financed with authority bonds (\$276 million).

### Capital Projects Funds Annual Change

Total taxes increased by \$70 million, or 4.8 percent, compared to the same period in 2006-07, driven by growth in other taxes and business taxes, offset slightly by declines in user taxes and fees. Annual miscellaneous receipts growth is largely driven by an increase in bond proceeds used to finance capital projects. Disbursements were \$399 million higher primarily driven by increased spending for economic development (\$172 million), environmental (\$64 million) and health (\$35 million) projects.

### Federal Operating Funds

2007-08 Fiscal Year-to-Date Results						
Actual Year-to-Date Results: April through December 2007						
Federal Operating Fund Results vs. Projections; Year-to-Year Comparison						
(millions of dollars)						
	Enacted Budget	Mid-Year Update Projection	Actual Results	Actuals vs. Estimates		
				Favorable/ (Unfavorable) vs. Plan		
				Enacted Budget	Mid-Year Update Projection	Increase/ (Decrease) from Prior Year
<b>Total Receipts</b>	<b>24,981</b>	<b>22,918</b>	<b>23,406</b>	<b>(1,575)</b>	<b>488</b>	<b>(670)</b>
Miscellaneous Receipts	128	145	157	29	12	6
Federal Grants	24,853	22,773	23,249	(1,604)	476	(676)
<b>Total Disbursements</b>	<b>24,902</b>	<b>23,727</b>	<b>23,315</b>	<b>1,587</b>	<b>412</b>	<b>(734)</b>
Local Assistance						
Medicaid, Including admin	15,193	14,497	14,141	1,052	356	(669)
School Aid	1,693	1,558	1,508	185	50	(339)
Temporary and Disability Assistance	1,944	1,920	2,012	(68)	(92)	(63)
Children and Family Services	768	645	665	103	(20)	111
Public Health	823	823	758	65	65	55
All Other	2,415	2,331	2,274	141	57	115
State Operations	1,905	1,790	1,794	111	(4)	43
General State Charges	161	163	163	(2)	0	13

### Federal Operating Funds Comparison to Mid-Year Financial Plan Projections

Federal Operating Funds receipts totaled \$23.4 billion or \$488 million more than the Mid-Year forecast due to Federal grants exceeding the estimated forecast. Disbursements totaled \$23.3 billion, \$412 million below the Mid-Year Update Budget projection largely attributable to lower Federal spending for Medicaid (\$356 million), lower-than-projected Federal School Aid payments (\$50 million), lower public health spending (\$65 million), and partially offset by higher-than-projected Federal spending for social services (\$112 million).

### Federal Operating Funds Comparison to Enacted Budget Projections

Federal Operating Funds receipts totaled \$23.4 billion or \$1.6 billion less than the Mid-Year Update due to Federal grants falling below the Enacted Budget forecast. Disbursements totaled \$23.3 billion, \$1.6 billion below the Enacted Budget projection largely attributable to lower than anticipated Federal spending for Medicaid (\$1.0 billion), Children and Family Services (\$103 million), and School Aid (\$185 million).

### Federal Operating Funds Annual Change

Total receipts decreased by \$670 million compared to the same period in 2006-07. The annual decline is driven by the timing of Federal aid. Total disbursements were \$734 million lower, due primarily to lower Federal Medicaid spending (\$669 million), the timing of the federally supported School Aid spending, including free and reduced-price meals (\$339 million), and partially offset by higher Federal spending for adoption and child care.

### All Funds Summary

2007-08 Fiscal Year-to-Date Results						
Actual Year-to-Date Results: April through December 2007						
All Funds Results vs. Projections; Year-to-Year Comparison						
(millions of dollars)						
	Enacted Budget	Mid-Year Update Projection	Actual Results	Actuals vs. Estimates Favorable/ (Unfavorable) vs. Plan		
				Enacted Budget	Mid-Year Update Projection	Increase/ (Decrease) from Prior Year
<b>Total Receipts</b>	<b>83,371</b>	<b>80,584</b>	<b>80,765</b>	<b>(2,606)</b>	<b>181</b>	<b>803</b>
Personal Income Tax	24,825	24,859	24,855	30	(4)	1,341
User Taxes and Fees	10,823	10,674	10,694	(129)	20	323
Business Taxes	6,201	5,928	5,636	(565)	(292)	(421)
Other Taxes	1,514	1,574	1,594	80	20	(90)
Miscellaneous Receipts	13,631	13,472	13,392	(239)	(80)	363
Federal Grants	26,377	24,077	24,594	(1,783)	517	(713)
<b>Total Disbursements</b>	<b>85,804</b>	<b>83,887</b>	<b>83,053</b>	<b>2,751</b>	<b>834</b>	<b>2,406</b>
General Fund*	34,332	34,180	34,351	(19)	(171)	1,104
Special Revenue Funds	43,680	42,195	41,473	2,207	722	1,180
Capital Projects Funds	5,105	4,548	4,507	598	41	399
Debt Service Funds	2,687	2,964	2,722	(35)	242	(277)

\* Excludes Transfers

## **2008-09 FINANCIAL PLAN**

### **Introduction**

This section describes (1) the economic forecast that served as the basis for developing the Executive Budget and (2) the State's Financial Plan projections for receipts and disbursements based on the 2008-09 Executive Budget recommendations. The receipts forecast describes estimates for the State's principal taxes, miscellaneous receipts, and transfers from other funds. The spending projections summarize the annual growth in current services spending and the impact of Executive Budget recommendations on each of the State's major categories of spending (Local Assistance, State Operations, General State Charges, Debt Service and Capital Projects).

Financial Plan projections are presented on an All Funds basis, which encompasses activity in the General Fund, State Operating Funds, Capital Projects Funds, and Federal Operating Funds, thus providing the most comprehensive view of the financial operations of the State.

### **Economic Outlook**

#### ***The U.S. Economy***

The U.S. economy has continued to lose momentum since the summer. Large declines in residential construction and reduced demand for autos and housing-related durable goods, combined with past energy price increases and credit market tightening, continue to generate a significant drag on economic growth. The uncertainty associated with the still unfolding subprime mortgage problem has substantially increased financial market volatility, reduced financial sector profits, and diminished the accessibility of credit to the nation's households and businesses. In addition, labor market growth has decelerated since the early part of 2007. In response to these developments, the Federal Reserve has lowered its short-term interest rate target 100 basis points to 4.25 percent since August 2007 and has intervened in credit markets to enhance liquidity several times.

On the positive side, robust global growth and a weak dollar have produced strong demand for U.S. exports. In addition, the Federal government, in concert with the banking community, is developing a plan under which subprime borrowers whose rates are due to reset at much higher levels over the next several years can arrange more favorable terms with their lenders. Some states and private lenders are offering their own initiatives to forestall a rising foreclosure rate. In combination with Federal Reserve actions, these interventions are expected to allow the economy to gradually rebound to its long-term trend growth rate over the course of 2008, after bottoming out below 2 percent in the fourth quarter of 2007 and first quarter of 2008. DOB projects growth of 2.2 percent for 2008, following growth of about the same magnitude for 2007. Though DOB is not forecasting a recession at this time, the risk of a recession is judged to have increased significantly since the fall.

The risks notwithstanding, there are good reasons to believe that the economy will experience a period of low growth, but elude recession. The global economy overall is strong and should be able to sustain solid growth even in the face of a U.S. slowdown. Moreover, a falling dollar increases U.S. competitiveness in the global marketplace. Though the labor market has slowed, initial unemployment insurance claims are still low by historical standards and employee earnings growth remains healthy. Though credit markets are tight, interest rates are also low by historical standards. Finally, government spending has been strong and, perhaps more importantly, both the Federal government and the Federal Reserve are playing active roles in trying to keep the economy out of recession. As a result of all of these factors, following two quarters of very low growth in the fourth quarter of 2007 and the first quarter of 2008, the national economy is expected to improve with each subsequent quarter, until reaching growth of 3.0 percent by the fourth quarter of 2008.



## **The New York State Economy**

The national economic slowdown is having a significant impact on the New York State economy. Indeed, the New York State Leading Index is signaling a mild downturn in the State economy starting in early 2008. The impact of the current credit market crisis on State wages is projected to be greatest in the first quarter 2008, during the height of the financial sector bonus season. Indeed, the current credit crisis could have a more deleterious effect on the New York State economy than on the nation as a whole given New York City's status as an international financial center. Though State economic growth is expected to slow in 2008, conditions are not expected to approach those of a recession. The State's large education and health sectors are expected to continue exhibiting robust growth. In addition, tourism and trade are expected to continue to be bolstered by the weak dollar, particularly in New York City and those areas bordering Canada.

The credit crunch and expected decline in finance and insurance sector bonuses, combined with slowing job growth, will result in significantly lower wage growth in 2008. DOB projects total wage growth of 3.3 percent for 2008, following an estimated increase of 7.6 percent for 2007. Slower growth in both the wage and non-wage components of income will result in total personal income growth of 4.3 percent for 2008, following 7.4 percent growth for 2007. The low growth in 2008 is due largely to a projected decline in finance and insurance sector bonuses for the first quarter 2008 and generally weak bonus growth for the other sectors due to the overall economic slowdown.

Consistent with flat securities industry profits for 2007, DOB is projecting a decline in finance and insurance sector bonuses of 2.8 percent for the 2007-08 bonus season now in progress. However, there is considerable risk to this forecast. Though bonus payouts have historically been evenly split between cash and stock incentive payments, the split is expected to be more heavily weighted toward stocks for the current bonus season. This shift could have substantial implications for Federal, State, and local tax revenues since income derived from stock options is not taxed until the option is exercised.

Though there are parallels between State and national labor market trends, there are differences as well. As at the national level, State private sector job growth is expected to be greatest in education and health care and social assistance services, with healthy gains expected for leisure, hospitality, and other services and professional, scientific, and technical services. Similarly, both the State and the nation are projected to see large declines in the manufacturing and mining sector. However, trends appear to diverge dramatically for the construction sector. DOB projects national construction employment to decline for 2008, consistent with the national housing market contraction. However, State construction employment is projected to grow in 2008, albeit at a slower rate than in 2007. The continued strength of the New York City real estate market and the absence of a significant housing boom in much of upstate New York explain most of this difference. As for the nation, the State's average annual unemployment rate is expected to rise in 2008, from 4.4 percent for 2007 to 4.9 percent this year.

## **Receipts Forecast**

Financial Plan receipts comprise a variety of taxes, fees, charges for State-provided services, Federal grants, and other miscellaneous receipts. The receipts estimates and projections have been prepared by DOB on a multi-year basis with the assistance of the Department of Taxation and Finance and other agencies responsible for the collection of State receipts. See the Executive Budget volume entitled, "Economic and Revenue Outlook" available at the DOB website for detailed information on the economic and receipts projections underlying the Executive Budget.

## **Overview of the Revenue Situation**

- Base receipt growth over the period 2004-05 to 2006-07, supported by a strong financial services sector and real estate market, averaged over 11 percent. However, the current slowdown in

economic activity is estimated to negatively impact receipt growth for 2007-08 and 2008-09. As a result, base tax receipt growth (correcting for law changes) falls to 4.2 percent in 2008-09 from 6.5 percent in 2007-08.

- The negative impact of the subprime mortgage situation on the financial services industry is expected to result in declines in bonus payouts over the remainder of the current fiscal year (5.5 percent decline) and reduced growth in business tax receipts over the remaining years of the Financial Plan.
- The financial sector is expected to slowly recover in 2008 and bonus growth levels return to roughly 10 percent per year over the 2008-09 to 2010-11 period.
- The risks stemming from the volatile real estate and financial markets represent even greater risks to revenues due to the high concentration of taxable income among a relatively small segment of the taxpaying population.
- The slowdown in the residential housing market is projected to largely eliminate the recent surge in taxable capital gains realizations associated with real estate sales.
- The economy is expected to slow but not enter recession, and as a result, it is expected that personal income tax withholding (6.2 percent) and sales tax collections (2.7 percent) will continue to grow but at a more modest pace in 2008-09.
- The combined impact of slowing real estate and financial markets and weakening profitability in the financial sector projected for 2008 results in estimated personal income tax liability growth of only 3.9 percent in 2008, rebounding to 6.5 percent in 2009.
- The large audit settlements associated with financial service industry firms continued into 2007-08 but are expected to be largely concluded before 2008-09, and this loss of resources represents another negative to the receipts forecast.

All Funds receipts are projected to total \$123.1 billion, an increase of \$6.3 billion over 2007-08 projections. The following table summarizes the receipts projections for 2007-08 and 2008-09.

<b>Total Receipts</b> (millions of dollars)				
	<b>2007-08</b> <b>Current</b>	<b>2008-09</b> <b>Proposed</b>	<b>Annual \$</b> <b>Change</b>	<b>Annual %</b> <b>Change</b>
<b>State Operating Funds</b>	<b>75,692</b>	<b>80,040</b>	<b>4,348</b>	<b>5.7%</b>
General Fund *	41,083	43,950	2,867	7.0%
Other State Funds	21,391	22,283	892	4.2%
Debt Service Funds	13,218	13,807	589	4.5%
<b>All Governmental Funds</b>	<b>116,834</b>	<b>123,105</b>	<b>6,271</b>	<b>5.4%</b>
State Operating Funds	75,692	80,040	4,348	5.7%
Capital Projects Funds	7,087	8,084	997	14.1%
Federal Operating Funds	34,055	34,981	926	2.7%

\*Excludes transfers.

The following table provides historical and projected data on the growth of actual and base receipts compared to personal income.

<b>Governmental Funds</b> <b>Actual and Base Tax Receipts Growth</b> (percent growth)				
<b>State</b> <b>Fiscal</b> <b>Year</b>	<b>Actual</b> <b>Receipts</b>	<b>Base</b> <b>Receipts</b>	<b>Personal</b> <b>Income</b> <b>Growth</b>	
2000-01	7.9	10.1	6.1	
2001-02	(4.9)	(4.2)	(0.2)	
2002-03	(6.7)	(8.0)	0.2	
2003-04	8.2	5.8	4.2	
2004-05	13.4	11.4	6.5	
2005-06	10.2	9.5	8.7	
2006-07	9.6	12.9	7.2	
2007-08	3.7	6.5	5.6	
2008-09	6.5	4.2	4.6	
2009-10	6.0	6.1	4.9	
2010-11	4.8	5.2	5.2	
2011-12	5.5	5.5	5.1	
	<b>Actual</b> <b>Receipts</b>	<b>Base</b> <b>Receipts</b>	<b>Inflation Adjusted</b> <b>Base Change</b>	<b>Personal</b> <b>Income</b> <b>Growth</b>
Historical Average (87-88 to 06-07)	4.6	4.4	1.3	5.2
Forecast Average (07-08 to 11-12)	5.3	5.5	2.9	5.1
Recessions	1.5	(0.6)	(3.3)	2.6
Expansions	4.5	5.3	2.1	6.3

Base growth, adjusted for law changes, in tax receipts for fiscal year 2007-08 is estimated at 6.5 percent and 4.2 percent for 2008-09. Overall base growth in tax receipts is dependent on many factors. Over the past several fiscal years the most important factors explaining tax receipt growth have been related to:

- improvements in overall economic activity, especially in New York City and surrounding counties;

- continued profitability and compensation gains of financial services companies;
- continued growth in the downstate commercial real estate market; and
- continued positive impact of high-income taxpayers on personal income tax growth.

Each of these factors is expected to become a negative drag on receipts over the next fiscal year. The same factors that spurred economic and tax receipt growth in recent fiscal years are now expected to retard growth in 2007-08 and 2008-09.

## Personal Income Tax

Personal Income Tax (millions of dollars)					
	2006-07	2007-08	Annual	2008-09	Annual
	<u>Actual</u>	<u>Estimated</u>	<u>Change</u>	<u>Projected</u>	<u>Change</u>
<b>General Fund</b>	<b>22,940</b>	<b>22,735</b>	<b>(205)</b>	<b>24,391</b>	<b>1,656</b>
Gross Collections	40,090	43,123	3,033	45,861	2,738
Refunds	(5,510)	(6,572)	(1,062)	(7,056)	(484)
STAR	(3,994)	(4,678)	(684)	(4,713)	(35)
RBTF	(7,646)	(9,138)	(1,492)	(9,701)	(563)
<b>State/All Funds</b>	<b>34,580</b>	<b>36,551</b>	<b>1,971</b>	<b>38,805</b>	<b>2,254</b>
Gross Collections	40,090	43,123	3,033	45,861	2,738
Refunds	(5,510)	(6,572)	(1,062)	(7,056)	(484)

All Funds personal income tax (PIT) receipts, which reflects the net of gross payments minus refunds, for 2007-08 are estimated at \$36.6 billion, an increase of nearly \$2.0 billion or 5.7 percent over the prior year. The increase is primarily attributable to moderately strong growth in withholding of \$1.6 billion, or 6 percent, and solid growth in estimated taxes for tax year 2007 liabilities of \$1.0 billion (13.2 percent). In addition, reflecting taxpayer uncertainty with the expiration of the temporary surcharge, final settlement payments for the 2006 tax year were mixed. The strongest component was a 12.3 percent (\$342 million) increase in extension payments. The \$64 million (3.3 percent) growth in payments accompanying final returns was relatively weak, and the 19.3 increase (roughly \$1.1 billion) in refunds reflected in large part some \$650 million of claims for the Empire State child credit effective in tax year 2006. The following table summarizes, by component, actual receipts for 2006-07 and forecast amounts through 2011-12.

Personal Income Tax Fiscal Year Collection Components						
All Funds						
(millions of dollars)						
	2006-07 (Actual)	2007-08 (Estimated)	2008-09 (Projected)	2009-10 (Projected)	2010-11 (Projected)	2011-12 (Projected)
<b>Receipts</b>						
Withholding	26,802	28,401	30,176	32,093	33,795	36,283
Estimated Payments	10,355	11,697	12,527	13,481	14,751	15,455
Current Year	7,572	8,572	9,152	9,726	10,576	11,030
Prior Year*	2,783	3,125	3,375	3,755	4,175	4,425
Final Returns	2,102	2,116	2,211	2,359	2,516	2,682
Current Year	194	145	180	180	180	180
Prior Year*	1,907	1,971	2,031	2,179	2,336	2,502
Delinquent Collections	831	909	947	986	1027	1065
Gross Receipts	40,090	43,123	45,861	48,919	52,089	55,485
<b>Refunds</b>						
Prior Year*	3,231	4,248	4,412	4415	4765	5163
Previous Years	257	315	290	310	330	330
Current Year*	1,500	1500	1,750	1,750	1,750	1,750
State-City Offset*	522	509	604	684	758	842
Total Refunds	5,510	6,572	7,056	7,159	7,603	8,085
Net Receipts	34,580	36,551	38,805	41,760	44,486	47,400

\* These components, collectively, are known as the "settlement" on the prior year's tax liability.

All Funds income tax receipts for 2008-09 of \$38.8 billion are projected to increase \$2.3 billion or 6.2 percent over the prior year. Gross receipts are projected to increase 6.3 percent and reflect projected withholding growth of 6.2 percent (\$1.8 billion), while the growth in estimated taxes for tax year 2008 liabilities is expected to reach 6.8 percent (\$580 million). Payments from extensions and final returns for tax year 2007 are projected to increase by 8.0 percent and 4.5 percent, respectively. Receipts from delinquencies are projected to increase \$38 million over the prior year. Growth in total refunds is estimated at \$484 million or 7.4 percent.

General Fund income tax receipts are net of deposits to the STAR Fund, which provides property tax relief, and the Revenue Bond Tax Fund (RBTF), which supports debt service payments on State Personal Income Tax Revenue bonds. General Fund income tax receipts for 2007-08 of \$22.7 billion are expected to decrease by \$205 million or 0.9 percent from the prior year. This decline reflects both a large increase in STAR deposits of \$685 million associated with the middle-class rebate program, and a \$1,492 million increase in deposits to the RBTF. The latter reflects Enacted Budget legislation that provides that deposits to the RBTF be calculated before the deposit of income tax receipts to the STAR Fund; in previous fiscal years this transfer was calculated after the STAR transfer, so the RBTF transfer was changed by 25 percent of the amount of the STAR deposit.

General Fund income tax receipts for 2008-09 of \$24.4 billion are projected to increase by \$1.7 billion or 7.3 percent over the prior year. The increase reflects a slight reduction in the STAR transfer which in turn is attributable to a one-time delay of a \$250 million payment to New York City until June 2009. Deposits to the RBTF are expected to increase by 6.2 percent, the same percentage increase as projected for net collections since the transfer equals 25 percent of net collections.

Personal Income Tax Change From Mid-Year Update Estimates & Projections (millions of dollars)								
	2007-08	2007-08	Change	Percent	2008-09	2008-09	Change	Percent
	Mid-Year	Executive		Change	Mid-Year	Executive		Change
	Update	Budget			Update	Budget		
<b>General Fund</b>	<b>22,697</b>	<b>22,735</b>	<b>38</b>	<b>0.2</b>	<b>23,940</b>	<b>24,391</b>	<b>451</b>	<b>1.9</b>
Gross Collections	42,933	43,123	190	0.4	45,896	45,861	(35)	(0.1)
Refunds	(6,363)	(6,572)	(209)	3.3	(6,832)	(7,056)	(224)	3.3
STAR	(4,730)	(4,678)	52	(1.1)	(5,358)	(4,713)	645	(12.0)
RBTF	(9,143)	(9,138)	5	(0.1)	(9,766)	(9,701)	65	(0.7)
<b>State/All Funds</b>	<b>36,570</b>	<b>36,551</b>	<b>(19)</b>	<b>(0.1)</b>	<b>39,064</b>	<b>38,805</b>	<b>(259)</b>	<b>(0.7)</b>
Gross Collections	42,933	43,123	190	0.4	45,896	45,861	(35)	(0.1)
Refunds	(6,363)	(6,572)	(209)	3.3	(6,832)	(7,056)	(224)	3.3

Compared to the Mid-Year Update, 2007-08 All Funds income tax receipts are revised down by \$19 million. The decrease reflects a modest decrease in withholding of \$100 million, and higher-than-projected estimated and final return payments for tax year 2007 of \$250 million and \$40 million, respectively, offset by higher-than-expected refunds of \$209 million (\$164 million for tax year 2006 and \$45 million for prior tax years).

Compared to the Mid-Year Update, 2008-09 All Funds income tax receipts are revised downward by \$259 million. This reflects lower withholding of \$200 million, additional estimated tax payments related to tax year 2008 of \$130 million, an increase in current return payments of \$35 million related to legislation proposed with this Budget, and a \$224 million increase in total refunds. The increase in refunds is the net of a \$500 million upward re-estimate for current tax year 2007 refunds, \$250 million of which is the one-time impact of increasing the January-March refund cap from \$1,500 million to \$1,750 million, a \$100 million downward revision in the State-city offset, and a \$176 million reduction in refunds due to legislation intended to promote improved tax compliance.

Personal Income Tax (millions of dollars)							
	2008-09	2009-10	Annual	2010-11	Annual	2011-12	Annual
	Projected	Projected	Change	Projected	Change	Projected	Change
<b>General Fund</b>	<b>24,391</b>	<b>25,897</b>	<b>1,506</b>	<b>27,415</b>	<b>1,518</b>	<b>29,315</b>	<b>1,900</b>
Gross Collections	45,861	48,919	3,058	52,089	3,170	55,485	3,396
Refunds	(7,056)	(7,159)	(103)	(7,603)	(444)	(8,085)	(482)
STAR	(4,713)	(5,423)	(710)	(5,949)	(526)	(6,235)	(286)
RBTF	(9,701)	(10,440)	(739)	(11,122)	(682)	(11,850)	(728)
<b>State/All Funds</b>	<b>38,805</b>	<b>41,760</b>	<b>2,955</b>	<b>44,486</b>	<b>2,726</b>	<b>47,400</b>	<b>2,914</b>
Gross Collections	45,861	48,919	3,058	52,089	3,170	55,485	3,396
Refunds	(7,056)	(7,159)	(103)	(7,603)	(444)	(8,085)	(482)

All Funds income tax receipts for 2009-10 of \$41.8 billion are projected to increase \$2.95 billion or 7.6 percent over the prior year. Gross receipts are projected to increase 6.7 percent and reflect withholding that is projected to grow by 6.4 percent (\$1.9 billion). Total estimated taxes on prior and current year liabilities reflect the expectation of continued growth in incomes of wealthy taxpayers and will increase by an estimated 7.6 percent (\$954 million). Payments from final returns are expected to increase 6.7 percent (\$148 million). Delinquencies are projected to increase \$39 million or 4.1 percent over the prior year. Growth in total refunds

is projected at \$103 million or 1.5 percent over the prior year. This low growth reflects the one-time \$250 million increase in 2008-09 refunds noted above.

General Fund income tax receipts for 2009-10 of \$25.9 billion are projected to increase by \$1.5 billion, or 6.2 percent. General Fund receipts for 2009-10 reflect an increase in STAR deposits of \$710 million due to the resumption of the middle-class rebate program as well as the fact that 2008-09 transfers were reduced by \$250 million for the New York City timing change noted above, and a \$739 million increase in deposits to the RBTF.

All Funds income tax receipts for 2010-11 and 2011-12 are projected to reach \$44.5 billion and \$47.4 billion, respectively. General Fund receipts are projected at \$27.4 billion and \$29.3 billion, respectively.

## User Taxes and Fees

User Taxes and Fees (millions of dollars)					
	2006-07	2007-08	Annual	2008-09	Annual
	<u>Actual</u>	<u>Estimated</u>	<u>Change</u>	<u>Projected</u>	<u>Change</u>
<b>General Fund</b>	<b>8,186</b>	<b>8,503</b>	<b>317</b>	<b>8,832</b>	<b>329</b>
Sales Tax	7,539	7,865	326	8,080	215
Cigarette and Tobacco Taxes	411	407	(4)	437	30
Motor Vehicle Fees	(16)	(21)	(5)	47	68
Alcoholic Beverage Taxes	194	200	6	220	20
ABC License Fees	58	52	(6)	48	(4)
<b>State/All Funds</b>	<b>13,456</b>	<b>13,903</b>	<b>447</b>	<b>14,217</b>	<b>314</b>
Sales Tax	10,738	11,199	461	11,504	305
Cigarette and Tobacco Taxes	985	973	(12)	1,052	79
Motor Fuel	513	511	(2)	351	(160)
Motor Vehicle Fees	769	772	3	830	58
Highway Use Tax	153	148	(5)	162	14
Alcoholic Beverage Taxes	194	200	6	219	19
ABC License Fees	58	51	(7)	48	(3)
Auto Rental Tax	46	49	3	51	2

All Funds user taxes and fees receipts for 2007-08 are estimated to be \$13.9 billion, an increase of \$447 million or 3.3 percent from 2006-07. Sales tax receipts are expected to increase by \$461 million from the prior year due to a base growth of 3.5 percent before the impact of law changes. This is due largely to projected modest increases in employment, income and overall taxable consumption. Non-sales tax user taxes and fees are estimated to decrease by \$14 million from 2006-07 mainly due a decrease in cigarette tax and highway use tax collections.

General Fund user taxes and fees receipts are expected to total \$8.5 billion in 2007-08, an increase of \$317 million or 3.9 percent from 2006-07. The increase reflects an increase in sales tax receipts of \$326 million due to base growth.

All Funds user taxes and fees receipts for 2008-09 are projected to be \$14.2 billion, an increase of \$314 million, or 2.3 percent from 2007-08. General Fund user taxes and fees receipts are projected to total \$8.8 billion in 2008-09, an increase of \$329 million, or 3.9 percent from 2007-08. This increase largely reflects a projected increase in sales tax and motor vehicle fee receipts. Motor vehicle fee receipts are projected to increase due to a proposal to offer a "Western Hemisphere Travel Initiative" compliant driver's license in New York State. The large decline in motor fuel tax receipts reflects the proposal in this Budget to combine the motor fuel tax into the petroleum business tax.

User Taxes and Fees Change From Mid-Year Update Estimates & Projections (millions of dollars)								
	2007-08		Change	Percent Change	2008-09		Change	Percent Change
	Mid-Year Update	Executive Budget			Mid-Year Update	Executive Budget		
<b>General Fund</b>	<b>8,506</b>	<b>8,503</b>	<b>(3)</b>	<b>(0.0)</b>	<b>8,805</b>	<b>8,832</b>	<b>27</b>	<b>0.3</b>
Sales Tax	7,865	7,865	0	0.0	8,103	8,080	(23)	(0.3)
Cigarette and Tobacco Taxes	407	407	0	0.0	436	437	1	0.2
Motor Vehicle Fees	(18)	(21)	(3)	16.7	13	47	34	261.5
Alcoholic Beverage Taxes	200	200	0	0.0	205	220	15	7.3
ABC License Fees	52	52	0	0.0	48	48	0	0.0
<b>State/All Funds</b>	<b>13,906</b>	<b>13,903</b>	<b>(3)</b>	<b>(0.0)</b>	<b>14,369</b>	<b>14,217</b>	<b>(152)</b>	<b>(1.1)</b>
Sales Tax	11,199	11,199	0	0.0	11,546	11,504	(42)	(0.4)
Cigarette and Tobacco Taxes	973	973	0	0.0	1,048	1,052	4	0.4
Motor Fuel	511	511	0	0.0	523	351	(172)	(32.9)
Motor Vehicle Fees	775	772	(3)	(0.4)	794	830	36	4.5
Highway Use Tax	148	148	0	0.0	154	162	8	5.2
Alcoholic Beverage Taxes	200	200	0	0.0	205	219	14	6.8
ABC License Fees	51	51	0	0.0	48	48	0	0.0
Auto Rental Tax	49	49	0	0.0	51	51	0	0.0

All Funds user taxes and fees in 2007-08 are revised down by \$3 million from the Mid-Year Update. All Funds user taxes and fees are revised down by \$152 million for 2008-09; this revision is mainly due to the proposed combination of the State sales tax on motor fuel and diesel motor fuel and the motor fuel tax with the petroleum business tax effective December 1, 2008. This will be offset by an increase in the petroleum business tax rate.

User Taxes and Fees (millions of dollars)							
	2008-09	2009-10	Annual	2010-11	Annual	2011-12	Annual
	Projected	Projected	Change	Projected	Change	Projected	Change
<b>General Fund</b>	<b>8,832</b>	<b>8,912</b>	<b>80</b>	<b>9,251</b>	<b>339</b>	<b>9,620</b>	<b>369</b>
Sales Tax	8,080	8,125	45	8,438	313	8,778	340
Cigarette and Tobacco Taxes	437	432	(5)	428	(4)	428	0
Motor Vehicle Fees	47	76	29	105	29	126	21
Alcoholic Beverage Taxes	220	227	7	232	5	236	4
ABC License Fees	48	52	4	48	(4)	52	4
<b>State/All Funds</b>	<b>14,217</b>	<b>14,017</b>	<b>(200)</b>	<b>14,470</b>	<b>453</b>	<b>15,006</b>	<b>536</b>
Sales Tax	11,504	11,597	93	12,044	447	12,527	483
Cigarette and Tobacco Taxes	1,052	1,040	(12)	1,027	(13)	1,025	(2)
Motor Fuel	351	0	(351)	0	0	0	0
Motor Vehicle Fees	830	870	40	883	13	919	36
Highway Use Tax	162	178	16	181	3	188	7
Alcoholic Beverage Taxes	219	227	8	232	5	236	4
ABC License Fees	48	52	4	48	(4)	53	5
Auto Rental Tax	51	53	2	55	2	58	3

All Funds user taxes and fees in 2009-10 are projected to decrease by \$200 million and then increase by \$453 million in 2010-11 and \$536 million in 2011-12. Again, the 2009-10 decrease reflects the proposed consolidation of the motor fuel tax, and sales tax on motor fuel and diesel motor fuel into the petroleum business tax.



## Business Taxes

Business Taxes (millions of dollars)					
	2006-07	2007-08	Annual	2008-09	Annual
	<u>Actual</u>	<u>Estimated</u>	<u>Change</u>	<u>Projected</u>	<u>Change</u>
<b>General Fund</b>	<b>6,468</b>	<b>6,300</b>	<b>(168)</b>	<b>7,254</b>	<b>954</b>
Corporate Franchise Tax	3,676	3,575	(101)	4,138	563
Corporation & Utilities Tax	626	618	(8)	589	(29)
Insurance Tax	1,142	1,176	34	1,405	229
Bank Tax	1,024	931	(93)	942	11
Petroleum Business Tax	0	0	0	180	180
<b>State/All Funds</b>	<b>8,606</b>	<b>8,437</b>	<b>(169)</b>	<b>9,721</b>	<b>1,284</b>
Corporate Franchise Tax	4,228	4,106	(122)	4,745	639
Corporation & Utilities Tax	820	816	(4)	787	(29)
Insurance Tax	1,258	1,292	34	1,555	263
Bank Tax	1,210	1,094	(116)	1,096	2
Petroleum Business Tax	1,090	1,129	39	1,538	409

All Funds business tax receipts for 2007-08 are estimated at over \$8.4 billion, a decrease of \$169 million, or 2.0 percent from the prior year. The decrease is primarily due to decreases in corporate franchise tax receipts of 2.9 percent and bank tax receipts of 9.6 percent. The decrease in corporate franchise tax receipts is attributable to reduced audit and compliance payments and high refund payments, more than offsetting current-year receipts growth in the ongoing base. In addition, current year receipts were supplemented by the closing of several loopholes in the 2007-08 Enacted Budget. The change in current year bank tax receipts reflects a significant decrease in audit receipts and a modest increase in the payments on current year estimated liability. In addition, an overall 0.5 percent decrease in corporation and utilities taxes reflects growth of 4.6 percent in non-audit receipts and a decline of 40 percent in audit receipts from 2006-07 levels. Year-to-date trends suggest that increases in receipts from electric utilities will be offset by decreases in receipts from the telecommunications industry.

All Funds Business Tax Audit and Non Audit Receipts (millions of dollars)					
	2003-04	2004-05	2005-06	2006-07	2007-08
	<u>Actual</u>	<u>Actual</u>	<u>Actual</u>	<u>Actual</u>	<u>Estimated</u>
<b>Corporate Franchise Tax</b>	<b>1,701</b>	<b>2,110</b>	<b>3,053</b>	<b>4,228</b>	<b>4,106</b>
Audit	232	397	653	1,133	1,020
Non-Audit	1,470	1,713	2,400	3,095	3,086
<b>Corporation and Utilities Taxes</b>	<b>882</b>	<b>827</b>	<b>832</b>	<b>820</b>	<b>816</b>
Audit	30	43	101	52	20
Non-Audit	852	784	731	768	796
<b>Insurance Taxes</b>	<b>1,031</b>	<b>1,108</b>	<b>1,083</b>	<b>1,258</b>	<b>1,292</b>
Audit	28	32	33	56	41
Non-Audit	1,003	1,076	1,050	1,202	1,251
<b>Bank Tax</b>	<b>342</b>	<b>675</b>	<b>975</b>	<b>1,210</b>	<b>1,094</b>
Audit	39	24	330	299	116
Non-Audit	303	651	645	911	978

The decreases in All Funds corporate franchise and bank tax receipts are partially offset by increases in the All Funds receipts from the insurance tax of 2.7 percent and the petroleum business tax of 3.6 percent. The overall increase in insurance tax receipts reflects modest growth in the ongoing base of insurance tax receipts of 4.1 percent over the prior year and a 27 percent decline in audit receipts from the prior year. The

increase in petroleum business tax receipts is primarily due to the increase of 5.0 percent in the petroleum business tax rate index effective January 1, 2007, offset by an expected 1.2 percent decrease in January 2008. The petroleum business tax increase also reflects the impact of proposed legislation to consolidate the motor fuel and petroleum business taxes.

All Funds business tax receipts for 2008-09 of \$9.7 billion are projected to increase by nearly \$1.3 billion, or 15.2 percent over the prior year. Proposed legislation that would reclassify receipts from the motor fuel tax and sales tax on motor fuel and diesel motor fuel as petroleum business tax receipts accounts for \$358 million of the increase. This increase will be offset by a comparable decrease in the sales tax and motor fuel tax receipts in the user taxes and fees category. (See “User Taxes and Fees” above.)

Non-audit business tax receipts before these Executive Budget initiatives are projected to increase by just 0.2 percent. The overall increase reflects a projected increase in the growth of non-audit corporate franchise tax receipts of 4.3 percent, a decrease of 16.0 percent in non-audit bank tax receipts, an increase in non-audit corporation and utilities taxes of 0.6 percent, and a 4.4 percent increase in the petroleum business tax receipts. Non-audit receipts from the insurance taxes are projected to decrease by 1.3 percent. Audit receipts related to All Funds business taxes are projected to increase by approximately 5.3 percent or roughly \$58 million from 2007-08.

General Fund business tax receipts for 2007-08 of \$6.3 billion are estimated to decrease by \$168 million, or 2.6 percent below 2006-07. Business tax receipts deposited to the General Fund reflect the All Funds trends discussed above.

General Fund business tax receipts for 2008-09 of nearly \$7.3 billion are projected to increase \$954 million, or 15 percent over the prior year. Business tax receipts deposited to the General Fund reflect the All Funds trends and the Executive Budget initiatives discussed above.

Business Taxes Change From Mid-Year Update Estimates & Projections (millions of dollars)								
	2007-08		Change	Percent Change	2008-09		Change	Percent Change
	Mid-Year Update	Executive Budget			Mid-Year Update	Executive Budget		
<b>General Fund</b>	<b>6,500</b>	<b>6,300</b>	<b>(200)</b>	<b>(3.1)</b>	<b>6,669</b>	<b>7,254</b>	<b>585</b>	<b>8.8</b>
Corporate Franchise Tax	3,675	3,575	(100)	(2.7)	3,966	4,138	172	4.3
Corporation & Utilities Tax	618	618	0	0.0	623	589	(34)	(5.5)
Insurance Tax	1,176	1,176	0	0.0	1,161	1,405	244	21.0
Bank Tax	1,031	931	(100)	(9.7)	919	942	23	2.5
Petroleum Business Tax	0	0	0	0.0	0	180	180	-
<b>State/All Funds</b>	<b>8,652</b>	<b>8,437</b>	<b>(215)</b>	<b>(2.5)</b>	<b>8,881</b>	<b>9,721</b>	<b>840</b>	<b>9.5</b>
Corporate Franchise Tax	4,206	4,106	(100)	(2.4)	4,531	4,745	214	4.7
Corporation & Utilities Tax	816	816	0	0.0	821	787	(34)	(4.1)
Insurance Tax	1,292	1,292	0	0.0	1,276	1,555	279	21.9
Bank Tax	1,209	1,094	(115)	(9.5)	1,073	1,096	23	2.1
Petroleum Business Tax	1,129	1,129	0	0.0	1,180	1,538	358	30.3

Compared to the Second Quarterly Update, 2007-08 All Funds business tax receipts are revised down by \$215 million, or 2.5 percent to \$8.4 billion. The decrease in the estimate reflects year-to-date results in the business taxes, which suggest lower growth in the corporate franchise tax receipts and bank tax receipts than anticipated.

All Funds business tax receipts for 2008-09 are revised up by \$840 million, or 9.5 percent from the Mid-Year Update. The increase reflects a downward revision in the base of \$235 million, more than offset by the first-year impact of initiatives proposed with the 2008-09 Executive Budget.

<b>Business Taxes</b> (millions of dollars)							
	<b>2008-09</b>	<b>2009-10</b>	<b>Annual</b>	<b>2010-11</b>	<b>Annual</b>	<b>2011-12</b>	<b>Annual</b>
	<b>Projected</b>	<b>Projected</b>	<b>Change</b>	<b>Projected</b>	<b>Change</b>	<b>Projected</b>	<b>Change</b>
<b>General Fund</b>	<b>7,254</b>	<b>7,816</b>	<b>562</b>	<b>7,866</b>	<b>50</b>	<b>8,218</b>	<b>352</b>
Corporate Franchise Tax	4,138	4,265	127	4,258	(7)	4,497	239
Corporation & Utilities Tax	589	599	10	608	9	612	4
Insurance Tax	1,405	1,466	61	1,505	39	1,549	44
Bank Tax	942	928	(14)	935	7	997	62
Petroleum Business Tax	180	558	378	560	2	563	3
<b>State/All Funds</b>	<b>9,721</b>	<b>10,700</b>	<b>979</b>	<b>10,763</b>	<b>63</b>	<b>11,171</b>	<b>408</b>
Corporate Franchise Tax	4,745	4,891	146	4,883	(8)	5,156	273
Corporation & Utilities Tax	787	797	10	807	10	812	5
Insurance Tax	1,555	1,625	70	1,668	43	1,716	48
Bank Tax	1,096	1,076	(20)	1,084	8	1,156	72
Petroleum Business Tax	1,538	2,311	773	2,321	10	2,331	10

All Funds business tax receipts for 2009-10, 2010-11 and 2011-12 reflect trend growth that is determined in part by the expected level of corporate profits, the projected increase in taxable insurance premiums, estimated increases in electric utility consumption prices and the consumption of telecommunications services. In addition, the fully effective impact of the Executive Budget initiatives supplements out-year growth. Business tax receipts will increase to \$10.7 billion (10.1 percent) in 2009-10, \$10.8 billion (0.6 percent) in 2010-11, and \$11.2 billion (3.8 percent) in 2011-12. Projected General Fund business tax receipts reflect the factors outlined above and the out-year impact of Executive Budget initiatives. General Fund business tax receipts over this period are expected to increase to \$7.8 billion (7.7 percent) in 2009-10, \$7.9 billion (0.6 percent) in 2010-11, and \$8.2 billion (4.5 percent) in 2011-12.

### Other Taxes

<b>Other Taxes</b> (millions of dollars)					
	<b>2006-07</b>	<b>2007-08</b>	<b>Annual</b>	<b>2008-09</b>	<b>Annual</b>
	<b>Actual</b>	<b>Estimated</b>	<b>Change</b>	<b>Projected</b>	<b>Change</b>
<b>General Fund</b>	<b>1,075</b>	<b>1,030</b>	<b>(45)</b>	<b>1,194</b>	<b>164</b>
Estate Tax	1,063	1,006	(57)	1,170	164
Gift Tax	(10)	0	10	0	0
Real Property Gains Tax	0	0	0	0	0
Pari-mutuel Taxes	21	23	2	23	0
All Other Taxes	1	1	0	1	0
<b>State/All Funds</b>	<b>2,097</b>	<b>2,036</b>	<b>(61)</b>	<b>2,169</b>	<b>133</b>
Estate Tax	1,063	1,006	(57)	1,170	164
Gift Tax	(10)	0	10	0	0
Real Property Gains Tax	0	0	0	0	0
Real Estate Transfer Tax	1,022	1,006	(16)	975	(31)
Pari-mutuel Taxes	21	23	2	23	0
All Other Taxes	1	1	0	1	0

All Funds other tax receipts for 2007-08 are estimated to be more than \$2.0 billion, down \$61 million or 2.9 percent from 2006-07 receipts, reflecting declines in estate tax receipts and the real estate transfer tax. General Fund other tax receipts are expected to total \$1.0 billion in fiscal year 2007-08, a decrease of \$45 million.

All Funds other tax receipts in 2008-09 are projected to be nearly \$2.2 billion, up \$133 million or 6.5 percent from 2007-08, reflecting modest retrenchment in real estate transfer tax receipts as well as a return to a normal estate tax collection pace. General Fund receipts for 2008-09 are projected to total nearly \$1.2 billion, an increase of \$164 million.

Other Taxes Change From Mid-Year Update Estimates & Projections (millions of dollars)								
	2007-08 Mid-Year Update	2007-08 Executive Budget	Change	Percent Change	2008-09 Mid-Year Update	2008-09 Executive Budget	Change	Percent Change
<b>General Fund</b>	<b>1,102</b>	<b>1,030</b>	<b>(72)</b>	<b>(6.5)</b>	<b>1,211</b>	<b>1,194</b>	<b>(17)</b>	<b>(1.4)</b>
Estate Tax	1,081	1,006	(75)	(6.9)	1,190	1,170	(20)	(1.7)
Gift Tax	0	0	0	0.0	0	0	0	0.0
Real Property Gains Tax	0	0	0	0.0	0	0	0	0.0
Pari-mutuel Taxes	20	23	3	15.0	20	23	3	15.0
All Other Taxes	1	1	0	0.0	1	1	0	0.0
<b>State/All Funds</b>	<b>2,077</b>	<b>2,036</b>	<b>(41)</b>	<b>(2.0)</b>	<b>2,186</b>	<b>2,169</b>	<b>(17)</b>	<b>(0.8)</b>
Estate Tax	1,081	1,006	(75)	(6.9)	1,190	1,170	(20)	(1.7)
Gift Tax	0	0	0	0.0	0	0	0	0.0
Real Property Gains Tax	0	0	0	0.0	0	0	0	0.0
Real Estate Transfer Tax	975	1,006	31	3.2	975	975	0	0.0
Pari-mutuel Taxes	20	23	3	15.0	20	23	3	15.0
All Other Taxes	1	1	0	0.0	1	1	0	0.0

All Funds other tax receipt estimates for 2007-08 have been revised down \$41 million from the Mid-Year Update estimate. Receipts estimates for the estate tax have been reduced reflecting the decline in collections from larger estates while the real estate transfer tax estimate has been increased modestly as the strength of the Downstate commercial real estate market continues.

Other Taxes (millions of dollars)							
	2008-09 Projected	2009-10 Projected	Annual Change	2010-11 Projected	Annual Change	2011-12 Projected	Annual Change
<b>General Fund</b>	<b>1,194</b>	<b>1,325</b>	<b>131</b>	<b>1,408</b>	<b>83</b>	<b>1,498</b>	<b>90</b>
Estate Tax	1,170	1,301	131	1,384	83	1,474	90
Gift Tax	0	0	0	0	0	0	0
Real Property Gains Tax	0	0	0	0	0	0	0
Pari-mutuel Taxes	23	23	0	23	0	23	0
All Other Taxes	1	1	0	1	0	1	0
<b>State/All Funds</b>	<b>2,169</b>	<b>2,325</b>	<b>156</b>	<b>2,408</b>	<b>83</b>	<b>2,498</b>	<b>90</b>
Estate Tax	1,170	1,301	131	1,384	83	1,474	90
Gift Tax	0	0	0	0	0	0	0
Real Property Gains Tax	0	0	0	0	0	0	0
Real Estate Transfer Tax	975	1,000	25	1,000	0	1,000	0
Pari-mutuel Taxes	23	23	0	23	0	23	0
All Other Taxes	1	1	0	1	0	1	0

General Fund other taxes receipts projections for 2008-09 are revised down by \$17 million from the Mid-Year Update, reflecting slightly slower growth in estate tax collections.

The 2009-10 All Funds receipts projection for other taxes is just over \$2.3 billion, up \$156 million or 7.2 percent from 2008-09 receipts. Growth in the estate tax is projected to follow expected increases in household net worth and receipts from the real estate transfer tax continue to reflect the slowdown in the housing market.

The 2010-11 All Funds receipts projection for other taxes is approximately \$2.4 billion, up \$83 million or 3.6 percent from 2009-10 receipts. The forecast reflects continued increases in household net worth as well as in the value of real property transfers.

The 2011-12 All Funds receipts projection for other taxes is nearly \$2.5 billion, up \$90 million (3.7 percent) from 2010-11 as continued moderate growth in estate tax collections is expected.

### **Miscellaneous Receipts and Federal Grants**

<b>Miscellaneous Receipts and Federal Grants</b>					
<b>(millions of dollars)</b>					
	<b>2006-07</b>	<b>2007-08</b>	<b>Annual</b>	<b>2008-09</b>	<b>Annual</b>
	<b>Actual</b>	<b>Estimated</b>	<b>Change</b>	<b>Projected</b>	<b>Change</b>
<b>General Fund</b>	<b>2,420</b>	<b>2,515</b>	<b>95</b>	<b>2,279</b>	<b>(236)</b>
Miscellaneous Receipts	2,268	2,444	176	2,238	(206)
Federal Grants	152	71	(81)	41	(30)
<b>State Funds</b>	<b>18,015</b>	<b>19,994</b>	<b>1,979</b>	<b>21,206</b>	<b>1,212</b>
Miscellaneous Receipts	17,863	19,922	2,059	21,164	1,242
Federal Grants	152	72	(80)	42	(30)
<b>All Funds</b>	<b>53,657</b>	<b>55,908</b>	<b>2,251</b>	<b>58,193</b>	<b>2,285</b>
Miscellaneous Receipts	18,078	20,067	1,989	21,310	1,243
Federal Grants	35,579	35,841	262	36,883	1,042

All Funds miscellaneous receipts include moneys received from the Health Care Reform Act (HCRA) financing sources, SUNY tuition and patient income, lottery receipts for education, assessments on regulated industries, and a variety of fees and licenses. All Funds miscellaneous receipts are projected to total \$20.1 billion in 2007-08, an increase of \$2.0 billion from 2006-07 largely driven by growth in: HCRA surcharge revenues (\$689 million); lottery revenues, including video lottery terminals (VLTs) (\$256 million); and children and family services restructuring of the Youth Facility Per Diem Account (\$114 million.)

Federal grants help pay for State spending on Medicaid, temporary and disability assistance, mental hygiene, School Aid, public health, and other activities. Annual changes to Federal grants generally correspond to changes in federally-reimbursed spending. Accordingly, DOB typically plans that Federal reimbursement will be received in the State fiscal year in which spending occurs, but timing sometimes varies. All Funds Federal grants are projected to total \$35.8 billion in 2007-08, an increase of \$262 million from 2006-07. Federal spending is expected to increase for Public Health (\$315 million), mental hygiene (\$147 million), transportation (\$129 million), homeland security (\$141 million) and temporary and disability assistance (\$80 million). These increases are partially offset by a reduction in Federal Medicaid (\$593 million).

General Fund miscellaneous receipts collections are estimated to be approximately \$2.4 billion in 2007-08, up \$176 million from 2006-07 receipts. This increase is primarily due to a New York Power Authority payment, an ESDC property sale, a Driver's Responsibility Program portion dedicated to the General Fund

and the Hartford Financial Services Settlement. General Fund Federal grants are expected to decline by \$81 million from the prior-year, reflecting the loss of the Medicare Part D subsidy.

All Funds miscellaneous receipts are projected to total \$21.3 billion in 2008-09, an increase of more than \$1.2 billion from the current year, driven by: growth in programs financed with authority bond proceeds (\$706 million), including spending for economic development, environment, education and mental health; projected first year receipts for the proposal to redirect all unclaimed bottle deposits to support spending in the Environmental Protection Fund (\$25 million); growth in lottery revenues, including VLTs (\$340 million); SUNY revenue (\$68 million); and statewide Civil Legal Services funding (\$53 million.) All Funds Federal grants are projected to total \$36.9 billion in 2008-09, an increase of \$1.0 billion from the current year. Federal spending is expected to increase for Medicaid (\$471 million), social services (\$160 million), and homeland security (\$76 million). These increases would be slightly offset by a decrease of approximately \$14 million due to the potential loss of the Medicare Part D Subsidy should a conversion occur. Such a conversion would have no negative impact on retirees while potentially reducing State spending. In most cases, the grant levels reflect projected changes in State spending levels and a corresponding change in estimated Federal reimbursement, not changes in aid levels for New York authorized by Congress.

General Fund miscellaneous receipts collections in 2008-09 are projected to reach approximately \$2.2 billion, down \$206 million from 2007-08 estimates, due to the loss of revenue from the New York Power Authority, and decreases in indirect costs revenue and abandoned property transfers, partially offset by increases in receipts due to the Monroe County Medicaid sales tax intercept payments.

<b>Miscellaneous Receipts &amp; Federal Grants Change From Mid-Year Update Estimates &amp; Projections</b>								
<b>(millions of dollars)</b>								
	<b>2007-08</b>	<b>2007-08</b>			<b>2008-09</b>	<b>2008-09</b>		
	<b>Mid-Year</b>	<b>Executive</b>	<b>Percent</b>		<b>Mid-Year</b>	<b>Executive</b>	<b>Percent</b>	
	<b>Update</b>	<b>Budget</b>	<b>Change</b>	<b>Change</b>	<b>Update</b>	<b>Budget</b>	<b>Change</b>	<b>Change</b>
<b>General Fund</b>	<b>2,515</b>	<b>2,515</b>	<b>0</b>	<b>0.0</b>	<b>2,107</b>	<b>2,279</b>	<b>172</b>	<b>8.2</b>
Miscellaneous Receipts	2,444	2,444	0	0.0	2,052	2,238	186	9.1
Federal Grants	71	71	0	0.0	55	41	(14)	(25.5)
<b>State Funds</b>	<b>19,983</b>	<b>19,994</b>	<b>11</b>	<b>0.1</b>	<b>19,928</b>	<b>21,206</b>	<b>1,278</b>	<b>6.4</b>
Miscellaneous Receipts	19,911	19,922	11	0.1	19,872	21,164	1,292	6.5
Federal Grants	72	72	0	0.0	56	42	(14)	(25.0)
<b>All Funds</b>	<b>56,075</b>	<b>55,908</b>	<b>(167)</b>	<b>(0.3)</b>	<b>57,850</b>	<b>58,193</b>	<b>343</b>	<b>0.6</b>
Miscellaneous Receipts	20,059	20,067	8	0.0	20,015	21,310	1,295	6.5
Federal Grants	36,016	35,841	(175)	(0.5)	37,835	36,883	(952)	(2.5)

All Funds miscellaneous receipts are projected to total \$20.1 billion in 2007-08, virtually unchanged from the Mid-Year Update. All Funds Federal grants are projected to total \$35.8 billion in 2007-08, a downward revision of \$175 million. This results from slower than expected spending against Federal homeland security grants and delayed implementation of the Federal Help Americans Vote Act mandate.

General Fund miscellaneous receipts and Federal grants in 2007-08 have not been revised from the Mid-Year Update.

All Funds Federal grants are projected to total \$36.9 billion in 2008-09, a downward revision of nearly \$1.0 billion from the Mid-Year Update. Federal aid is expected to decrease for Medicaid (\$620 million), homeland security (\$202 million) and elections (\$103 million).

General Fund miscellaneous receipts and Federal grants projections for 2008-09 are revised up by \$172 million from the Mid-Year Update, primarily due to a larger than expected payment from the State of New York Mortgage Agency and increases in investment income, abandoned property and bond issuance charges.

Miscellaneous Receipts and Federal Grants (millions of dollars)							
	2008-09 Projected	2009-10 Projected	Annual Change	2010-11 Projected	Annual Change	2011-12 Projected	Annual Change
<b>General Fund</b>	<b>2,279</b>	<b>2,186</b>	<b>(93)</b>	<b>2,261</b>	<b>75</b>	<b>2,060</b>	<b>(201)</b>
Miscellaneous Receipts	2,238	2,186	(52)	2,261	75	2,060	(201)
Federal Grants	41	0	(41)	0	0	0	0
<b>State Funds</b>	<b>21,206</b>	<b>21,166</b>	<b>(40)</b>	<b>21,681</b>	<b>515</b>	<b>21,408</b>	<b>(273)</b>
Miscellaneous Receipts	21,164	21,165	1	21,680	515	21,407	(273)
Federal Grants	42	1	(41)	1	0	1	0
<b>All Funds</b>	<b>58,193</b>	<b>59,405</b>	<b>1,212</b>	<b>61,186</b>	<b>1,781</b>	<b>62,220</b>	<b>1,034</b>
Miscellaneous Receipts	21,310	21,305	(5)	21,826	521	21,547	(279)
Federal Grants	36,883	38,100	1,217	39,360	1,260	40,673	1,313

In 2009-10, General Fund miscellaneous receipts and Federal grants are projected to be nearly \$2.2 billion, down \$52 million from 2008-09. This decrease primarily results from the loss of the SONYMA payment and reduced transfers from abandoned property and a possible conversion of a Medicare D (Prescription Drug) Plan for retirees to a contracted Medicare D plan.

General Fund miscellaneous receipts in 2010-11 are projected to be almost \$2.3 billion, up \$75 million from the prior year. This increase is primarily due to projected collections from other transactions.

In 2011-12, General Fund receipts are projected to be nearly \$2.1 billion, a decrease of approximately \$201 million from 2010-11. This decrease is almost solely due to reduced collections from other transactions.

### **Proposed Law Changes**

The 2008-09 Budget contains no tax increases. Measures are included to ensure that taxpayers are properly reflecting New York taxable income and that unintended and anachronistic tax statutes are changed to eliminate tax loopholes. In addition, given the current fiscal stress caused by the slowdown in national economic activity, measures are proposed to delay certain already enacted STAR provisions. Other actions reform existing provisions of Tax Law to make them operate more effectively and equitably. This Budget proposes several modest tax reduction initiatives. The tax policy changes proposed with this Budget are reported in summary below and in detail in the tax-by-tax write-ups contained in the separate “Economic and Revenue Outlook” report provided with the Executive Budget.

<b>All Funds Legislation</b> (millions of dollars)				
	<u>2008-09</u>	<u>2009-10</u>	<u>2010-11</u>	<u>2011-12</u>
<b>Revenue Enhancements</b>	<b>1,519</b>	<b>1,588</b>	<b>1,350</b>	<b>1,365</b>
<b>Personal Income Tax</b>	<b>211</b>	<b>247</b>	<b>247</b>	<b>247</b>
Amend Definitions of Temporary Stay	0	15	15	15
Amend Definition of Presence in New York	0	5	5	5
Tax Gain from Sale of Partnerships	0	10	10	10
Refund Offsets	1	1	1	1
Improve Audit and Compliance Efforts	175	175	175	175
LLC Minimum Partner Fees	35	35	35	35
Make Permanent Reporting of Tax Shelters	0	6	6	6
<b>STAR</b>	<b>354</b>	<b>380</b>	<b>165</b>	<b>175</b>
Increase STAR Exemption Floor from 5 percent to 10 percent	110	115	120	125
Delay Basic Middle Class Rebates	169	175	0	0
Authorize Tax Department to Offset Debts Against STAR Rebates	15	15	15	15
Restructure New York City STAR	60	75	30	35
<b>User Taxes and Fees</b>	<b>192</b>	<b>200</b>	<b>177</b>	<b>182</b>
Voluntary Disclosure and Compliance Program	30	0	0	0
Repeal Bad Debt Provisions	7	9	9	9
Limit Tax Exemptions for Sales by Non-Profits	8	15	15	15
Close Loophole on Tax Avoidance	4	6	6	6
Require Sales Tax Vendors to Re-register	12	37	12	4
Conform Tax Treatment of Little Cigars	4	5	5	5
Conform Tax Treatment of Flavored Malt Beverages	15	18	18	18
Require Tax Stamp on Illegal Drugs	13	17	17	17
Western Hemisphere Travel Initiative	53	20	10	10
Sales Tax Nexus	47	73	85	98
<b>Business Taxes</b>	<b>762</b>	<b>761</b>	<b>761</b>	<b>761</b>
Improve Audit and Compliance Efforts	55	75	75	75
Voluntary Disclosure and Compliance Program	20	0	0	0
LLC Minimum Partner Fees	40	40	40	40
Make Permanent Reporting of Tax Shelters	0	11	11	11
Credit Card Nexus	95	75	75	75
Conforming HMOs Taxation	247	288	288	288
Capital Base	98	70	70	70
Decoupling from Federal QPAI Regulations	56	56	56	56
Expiration of ITC for Financial Services	35	75	75	75
Simplify Taxation of Motor Fuel	13	56	56	56
License Reader Enforcement	8	15	15	15
Modify Pre-Payment Requirements	95	0	0	0
<b>Tax Reductions</b>	<b>(24)</b>	<b>(23)</b>	<b>(23)</b>	<b>(20)</b>
Encourage Alternative Fuel Production - Biofuel	0	(1)	(1)	(1)
Expand the New York State Film Credit	(5)	(10)	(15)	(15)
Low Income Housing Credit	(4)	(4)	(4)	(4)
Handicapped Accessible Taxicab Credit	0	(3)	(3)	0
Power for Jobs Program	(15)	(5)	0	0
<b>All Funds Legislation Change With STAR</b>	<b>1,495</b>	<b>1,565</b>	<b>1,327</b>	<b>1,345</b>
<b>All Funds Legislation Change Without STAR</b>	<b>1,141</b>	<b>1,185</b>	<b>1,162</b>	<b>1,170</b>



## **School Tax Relief**

- Postpone for one year scheduled increases in Basic Middle-Class STAR Rebates and New York City personal income tax credits.
- Increase the "floor" in STAR exemption amounts from 5 percent to 10 percent.
- Authorize the Tax Department to offset tax and other debts against STAR rebates.
- Eliminate the New York City STAR credit to taxpayers with income over \$250,000.

## **Personal Income Tax**

- Create a tax credit for purchases of clean heating fuel ("bioheat") used for residential purposes.
- Restructure and reform the fees and minimum taxes imposed on limited liability companies, other partnerships, and corporations.
- Amend the definition of "presence in New York" for determining the residency of taxpayers.
- Require inclusion of the gain from the sale of partnership interests as NY-source income to non-resident taxpayers to the extent that these gain are from sales of real property located in New York.
- Require taxpayers to pay the fees charged by the Federal government and other states for offsetting refunds for New York State income tax debts owed by those taxpayers.
- Enact a tax enforcement and compliance reform program.
- Reform the Brownfields Tax Credit program.
- Make tax shelter reporting requirements permanent.
- Authorize the Department of Taxation and Finance to conduct a study of the taxation of nonresidents with limited work presence in New York (administrative).

## **Business Taxes**

- Increase the aggregate amount of low-income housing tax credits that the Commissioner of Housing and Community Renewal may allocate.
- Continue to deter the use of tax shelters by making permanent the provisions allowing the Department of Taxation and Finance to require the reporting and disclosure of Federal and New York reportable and listed transactions that may be improper tax avoidance practices.
- Conform to the practices of 18 other states that have decoupled from the Federal deduction related to qualified production activities and require taxpayers to add back income from this deduction for New York tax purposes.
- Make statutory technical corrections and structural alterations necessary to eliminate real estate investment trust (REIT) and regulated investment company (RIC) loopholes that remained after legislation was enacted in 2007 to address REIT and RIC loopholes.
- Restructure and reform the fees and minimum taxes imposed on limited liability companies, other partnerships, and corporations.
- Reduce the corporation franchise tax capital base rate, eliminate the tax liability cap on this base for non-manufacturers, and conform the definition of "manufacturer" under the capital base to the definition under the entire net income base.

- Reclassify for-profit health maintenance organizations (HMOs) as insurance taxpayers so that these HMOs would be subject to the premiums tax of Tax Law section 1502-a instead of the business corporation tax of Article 9-A and would be treated like traditional health insurers for tax purposes.
- Classify credit card companies doing a specified level of business in the State as taxpayers under the Article 32 bank tax.
- Reform the Brownfields tax credit program.
- Extend MTA surcharges on business taxes by four years.
- Change the mandatory first estimated tax payment for all business taxes from 25 percent to 30 percent.
- Extend for two years the credit for taxicabs and livery service vehicles that are accessible by individuals with disabilities.
- Expand the New York State film credit.
- Extend the Power for Jobs program by one year, through June 30, 2009.
- Create a new personal income and corporate franchise tax credit for purchases of clean heating fuel ("bioheat") used for residential purposes.
- Enact a tax enforcement and compliance reform program.
- Combine the Petroleum Business Tax, the Motor Fuel Tax and the State sales tax on fuel into one Petroleum Business Tax.
- Allow the Commissioner of Taxation and Finance to use new technologies to help combat bootlegging of fuels into the State and provide a level playing field.

### ***Other Actions***

- Require non-profit tax-exempt organizations to collect sales tax on certain sales, rentals and leases.
- Narrow the sales tax exemption for commercial aircraft and the use tax exemption for motor vehicle, vessels, and aircraft in order to curtail certain abusive sales and use tax avoidance schemes.
- Institute a re-registration program that would be applicable to new registrations and re-registrations of vendors.
- Create an evidentiary presumption that certain sellers using New York State residents to solicit sales in the State are vendors required to collect sales and use tax.
- Institute a voluntary disclosure and compliance program.
- Extend the seven day liquor sales law.
- Eliminate the sunset of Quick Draw and remove the location restrictions.
- Reclassify little cigars as cigarettes.
- Modify the tax treatment of flavored malt beverages.
- Repeal the private label credit card provision.
- Require a tax stamp on illegal drugs.
- Authorize VLT facility at Belmont Park.

**Disbursements Forecast**

<b>Total Disbursements (millions of dollars)</b>				
	<b>2007-08 Current</b>	<b>2008-09 Proposed</b>	<b>Annual \$ Change</b>	<b>Annual % Change</b>
<b>State Operating Funds</b>	<b>77,909</b>	<b>81,825</b>	<b>3,916</b>	<b>5.0%</b>
General Fund *	50,831	53,859	3,028	6.0%
Other State Funds	22,728	23,276	548	2.4%
Debt Service Funds	4,350	4,690	340	7.8%
<b>All Governmental Funds</b>	<b>118,314</b>	<b>124,329</b>	<b>6,015</b>	<b>5.1%</b>
State Operating Funds	77,909	81,825	3,916	5.0%
Capital Projects Funds	6,645	7,927	1,282	19.3%
Federal Operating Funds	33,760	34,577	817	2.4%

\*Excludes transfers.

State Operating Funds spending, which includes both the General Fund and spending from other operating funds supported by assessments, tuition, HCRA resources and other non-Federal revenues, is projected to total \$81.8 billion in 2008-09. All Funds spending, which includes capital spending and Federal aid in addition to State Operating Funds, is projected to total \$124.3 billion in 2008-09. The Financial Plan projections assume that the 2008-09 Executive Budget is enacted in its entirety.

The major sources of annual spending change between 2007-08 and 2008-09 (after Executive Budget recommendations) are summarized in the table below.

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Executive Budget Spending Projections -- After Executive Budget Recommendations						
Major Sources of Annual Change						
(millions of dollars)						
	General Fund *	Other State Funds**	Total State Operating Funds	Capital Projects Funds	Federal Operating Funds	Total All Funds
<b>2007-08 Revised Estimate***</b>	<b>50,831</b>	<b>27,078</b>	<b>77,909</b>	<b>6,645</b>	<b>33,760</b>	<b>118,314</b>
<b>Major Functions</b>						
<i>Public Health:</i>						
Medicaid	1,038	(207)	831	0	471	1,302
Public Health/Aging	(21)	22	1	63	(7)	57
<i>K-12 Education:</i>						
School Aid	1,203	166	1,369	0	11	1,380
All Other Education Aid	(42)	5	(37)	66	16	45
STAR	0	34	34	0	0	34
Higher Education	109	29	138	93	5	236
<i>Social Services:</i>						
Temporary and Disability Assistance	(246)	1	(245)	0	62	(183)
Children and Family Services	167	1	168	0	98	266
Mental Hygiene	84	30	114	83	56	253
Transportation	0	221	221	389	0	610
General State Charges	155	22	177	0	10	187
Debt Service	135	201	336	0	0	336
<b>All Other Changes</b>						
Economic Development	(27)	23	(4)	304	0	300
Judiciary	186	3	189	14	(1)	202
Local Government Aid	199	0	199	0	0	199
Collective Bargaining	197	0	197	0	0	197
Correctional Services	16	5	21	45	30	96
Empire State Stem Cell Trust Fund	0	85	85	0	0	85
Homeland Security	0	(1)	(1)	(7)	76	68
Parks and Recreation	(3)	(3)	(6)	69	0	63
State Equipment Financing	0	0	0	61	0	61
Elections	0	(7)	(7)	0	47	40
State Police	(41)	42	1	27	1	29
Interest on Lawyer Account	0	28	28	0	0	28
Department of State	(10)	7	(3)	(47)	0	(50)
Military and Naval Affairs	(65)	18	(47)	17	(72)	(102)
All Other	(6)	163	157	105	14	276
<b>2008-09 Executive Budget Estimate</b>	<b>53,859</b>	<b>27,966</b>	<b>81,825</b>	<b>7,927</b>	<b>34,577</b>	<b>124,329</b>
<i>Annual Dollar Change</i>	<i>3,028</i>	<i>888</i>	<i>3,916</i>	<i>1,282</i>	<i>817</i>	<i>6,015</i>
<i>Annual Percent Change</i>	<i>6.0%</i>	<i>3.3%</i>	<i>5.0%</i>	<i>19.3%</i>	<i>2.4%</i>	<i>5.1%</i>

\*Excludes Transfers

\*\*Includes State Special Revenue and Debt Service Funds

\*\*\*Adjusted to reflect a Medicaid Transparency initiative described later.

The spending forecast for each of the State's major Financial Plan categories follows. In general, the forecasts are described in two parts: the current services estimate for each functional area or activity; and the Executive Budget recommendations and resulting annual change in spending.

Projected current services disbursements are based on agency staffing levels, program caseloads, formulas contained in State and Federal law, inflation and other factors. The factors that affect spending estimates vary by program. For example, welfare spending is based primarily on anticipated caseloads that are estimated by analyzing historical trends, projected economic conditions, and changes in Federal law. All projections account for the timing of payments, since not all the amounts appropriated in the Budget are disbursed in the same fiscal year.

Major assumptions used in preparing the spending projections for the State's major programs and activities are summarized in the following tables.

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Forecast for Selected Program Measures Affecting Local Assistance						
(millions of dollars, where applicable)						
	Actual		Forecast			
	2006-07	2007-08	2008-09	2009-10	2010-11	2011-12
<b>Medicaid</b>						
Medicaid Enrollment	3,608,075	3,581,311	3,665,541	3,746,047	3,994,438	4,149,548
Family Health Plus Enrollment	514,058	525,596	545,996	563,084	605,390	605,390
Child Health Plus Enrollment	388,187	396,375	460,614	494,112	499,053	504,043
Medicaid Inflation	2.4%	2.0%	2.9%	3.0%	3.0%	3.0%
Medicaid Utilization	1.1%	-3.3%	1.6%	3.3%	3.7%	4.0%
State Takeover of County/NYC Costs (Total)	\$622	\$677	\$939	\$1,198	\$1,539	\$1,920
- Family Health Plus	\$424	\$442	\$453	\$467	\$484	\$484
- Medicaid*	\$198	\$235	\$486	\$731	\$1,055	\$1,436
<b>Education</b>						
School Aid (School Year)	\$17,800	\$19,600	\$21,000	\$23,100	\$25,600	\$27,200
K-12 Enrollment	2,783,153	2,758,856	2,758,856	2,758,856	2,758,856	2,758,856
Public Higher Education Enrollment (FTEs)	499,082	512,362	518,431	525,408	529,133	528,780
TAP Recipients	320,930	312,779	309,436	310,936	312,686	314,861
<b>Welfare</b>						
Family Assistance Caseload	402,348	348,901	339,686	344,328	331,340	329,517
Single Adult/No Children Caseload	158,513	158,576	166,597	172,876	179,708	186,053
<b>Mental Hygiene</b>						
Mental Hygiene Community Beds	81,737	85,058	87,731	90,520	92,614	95,332

\*Includes the State's costs associated with Monroe County's Medicaid payments, which are offset by General Fund Revenue

Forecast of Selected Program Measures Affecting State Operations						
	Actual		Forecast			
	2006-07	2007-08	2008-09	2009-10	2010-11	2011-12
<b>State Operations</b>						
Prison Population (Corrections)	63,577	62,800	62,200	61,800	61,600	61,400
Negotiated Salary Increases <sup>(1)</sup>	3.0%	3.0%	3.0%	3.0%	4.0%	0.0%
Personal Service Inflation	0.8%	1.0%	1.0%	1.0%	1.0%	1.0%
State Workforce	195,526	199,424	201,270	202,388	202,388	202,388

(1) Negotiated salary increases reflect recent labor settlements included in the Financial Plan estimates

Forecast of Selected Program Measures Affecting General State Charges						
	Actual		Forecast			
	2006-07	2007-08	2008-09	2009-10	2010-11	2011-12
<b>General State Charges</b>						
Pension Contribution Rate as % of Salary	10.2%	9.7%	8.8%	9.0%	9.0%	9.3%
Employee/Retiree Health Insurance Growth Rates	10.3%	5.5%	5.5%	9.5%	9.5%	9.5%

Forecast of Selected Program Measures Affecting Debt Service						
	Actual		Forecast			
	2006-07	2007-08	2008-09	2009-10	2010-11	2011-12
<b>State Debt</b>						
Interest on Variable Rate Debt	3.50%	3.55%	3.15%	3.20%	3.15%	2.80%
Interest on Fixed Rate 30-Year Bonds	4.55%	4.75%	4.75%	4.90%	5.10%	5.25%

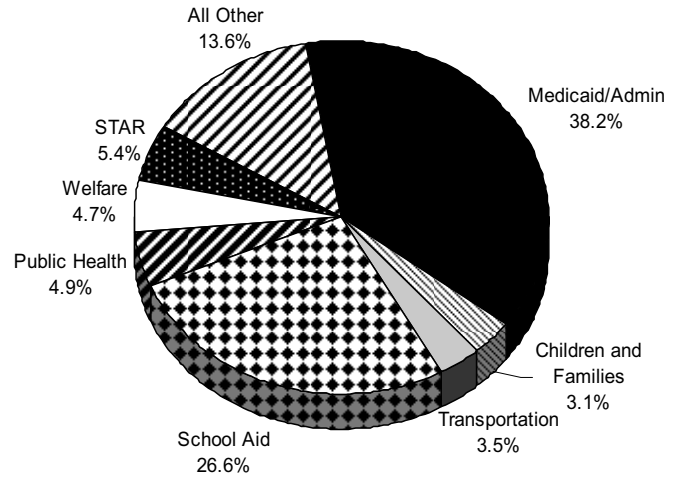
The following sections provide a summary of the 2008-09 Executive Budget by purpose of spending. The presentation summarizes the annual growth in current services spending and the impact of Executive Budget recommendations for each purpose on an All Funds basis, which encompasses activity in the General Fund, State Operating Funds, Capital Projects Funds, and Federal Operating Funds, thus providing the most comprehensive view of the financial operations of the State.

### Grants to Local Governments

Grants to Local Governments (Local Assistance) include payments to local governments, school districts, healthcare providers, and other local entities, as well as certain financial assistance to, or on behalf of, individuals, families, and nonprofit organizations. Local Assistance comprises 70 percent of All Funds spending.

In 2008-09, All Funds spending for local assistance is expected to total \$87.4 billion. Total spending comprises State aid to medical assistance providers and public health programs (\$37.7 billion); State aid to school districts, universities, and tuition assistance (\$33.0 billion); temporary and disability assistance (\$4.1 billion); mental hygiene programs (\$3.7 billion); transportation (\$3.1 billion); children and family services (\$2.7 billion); and local government assistance (\$1.1 billion). Other local assistance programs include criminal justice, economic development, housing, parks and recreation, and environmental quality.

**2008-09 All Funds Local Assistance Spending  
\$87.4 Billion**



The following chart highlights proposed local assistance annual spending changes from 2007-08 to 2008-09 by major program and/or agency.

Local Assistance Spending Projections (millions of dollars)						
	2007-08 Revised	Medicaid Transparency	2007-08 Adjusted	2008-09 Proposed	Annual Change	Percent Change
<b>General Fund</b>	<b>36,667</b>	<b>2,753</b>	<b>39,420</b>	<b>41,860</b>	<b>2,440</b>	<b>6.2%</b>
Other State Support	16,440	(1,971)	14,469	14,811	342	2.4%
<b>State Operating Funds</b>	<b>53,107</b>	<b>782</b>	<b>53,889</b>	<b>56,671</b>	<b>2,782</b>	<b>5.2%</b>
Capital Project Funds	603	0	603	615	12	2.0%
Federal Operating Funds	30,256	0	30,256	30,141	(115)	-0.4%
<b>All Funds</b>	<b>83,966</b>	<b>782</b>	<b>84,748</b>	<b>87,427</b>	<b>2,679</b>	<b>3.2%</b>

<b>Local Assistance Spending Projections</b>			
<b>Major Sources of Annual Change</b>			
(millions of dollars)			
	<b>General Fund</b>	<b>State Operating Funds</b>	<b>All Governmental Funds</b>
<b>2007-08 Revised</b>	<b>36,667</b>	<b>53,107</b>	<b>83,966</b>
Medicaid Transparency Adjustment	2,753	782	782
<b>2007-08 Adjusted</b>	<b>39,420</b>	<b>53,889</b>	<b>84,748</b>
School Aid	1,203	1,369	1,380
Medicaid (incl Admin)	1,038	830	1,301
Children and Families	152	153	252
Mental Hygiene	112	142	214
Transportation	(1)	213	213
Local Government Assistance	198	198	198
City University	178	178	178
Temporary and Disability Assistance	(226)	(226)	(192)
Economic Development	(133)	(134)	(153)
Other Education Aid	(36)	(36)	(26)
All Other	(46)	95	(686)
<b>2008-09 Executive Budget</b>	<b>41,860</b>	<b>56,671</b>	<b>87,427</b>
<i>Annual Dollar Change</i>	<i>2,440</i>	<i>2,782</i>	<i>2,679</i>
<i>Annual Percent Change</i>	<i>6.2%</i>	<i>5.2%</i>	<i>3.2%</i>

For 2008-09, All Funds local assistance spending is projected to total \$87.4 billion, an increase of \$3.5 billion (4.1 percent) over the current year. The growth is primarily driven by projected increases in School Aid (\$1.4 billion) and Medicaid (\$1.3 billion).

These annual changes in local assistance, as further categorized by current service requirements and Executive Budget savings and initiatives, are outlined in more detail below. For more information on specific local programs, see the narratives by function in the complete 2008-09 Executive Budget Financial Plan available on the DOB website.



Local Assistance Sources of Annual Spending Increase/(Decrease) (millions of dollars)						
	General Fund	Other State Funds	Total State Operating Funds	Capital Projects	Federal Funds	All Funds
<b>2007-08 Revised</b>	<b>36,667</b>	<b>16,440</b>	<b>53,107</b>	<b>603</b>	<b>30,256</b>	<b>83,966</b>
Medicaid Transparency Adjustment	2,753	(1,971)	782	0	0	782
<b>2007-08 Adjusted</b>	<b>39,420</b>	<b>14,469</b>	<b>53,889</b>	<b>603</b>	<b>30,256</b>	<b>84,748</b>
<b>Current Services:</b>	<b>4,033</b>	<b>273</b>	<b>4,307</b>	<b>12</b>	<b>1,140</b>	<b>5,459</b>
Medicaid (incl Admin)	1,735	(272)	1,463	0	1,072	2,535
School Aid	1,363	(120)	1,243	0	11	1,254
STAR	0	388	388	0	0	388
Local Government Assistance	358	0	358	0	0	358
Mental Hygiene	202	30	232	78	(5)	304
Children and Families	182	1	183	0	99	282
City University	200	0	200	0	0	200
Transportation	(1)	193	192	0	0	192
Public Health	45	68	113	24	6	143
Economic Development	(104)	(0)	(104)	(19)	0	(123)
Temporary and Disability Assistance	(16)	0	(16)	0	(100)	(116)
Other Education Aid	(24)	(0)	(24)	0	10	(14)
All Other	93	(14)	79	(70)	47	55
<b>Recommended Savings:</b>	<b>(1,940)</b>	<b>22</b>	<b>(1,918)</b>	<b>0</b>	<b>(562)</b>	<b>(2,480)</b>
Medicaid Actions	(787)	64	(723)	0	(691)	(1,414)
STAR	0	(354)	(354)	0	0	(354)
Local Government Assistance	(165)	0	(165)	0	0	(165)
Public Health	(93)	(36)	(129)	0	(12)	(141)
Mental Hygiene	(112)	0	(112)	0	0	(112)
Temporary and Disability Assistance	(216)	0	(216)	0	134	(82)
Other Education Aid	(68)	0	(68)	0	0	(68)
Economic Development	(53)	(1)	(54)	0	0	(54)
Higher Education Services	(35)	0	(35)	0	0	(35)
Criminal Justice/Parole	(39)	0	(39)	0	8	(31)
City University	(23)	0	(23)	0	0	(23)
Children and Families	(30)	0	(30)	0	0	(30)
Transportation	0	3	3	0	0	3
School Aid	(286)	286	0	0	0	0
All Other	(33)	60	27	0	(1)	26
<b>New Initiatives:</b>	<b>346</b>	<b>47</b>	<b>393</b>	<b>0</b>	<b>89</b>	<b>482</b>
Medicaid	89	0	89	0	89	178
School Aid	126	0	126	0	0	126
Other Education	56	0	56	0	0	56
Judiciary/IOLA	0	28	28	0	0	28
Economic Development	24	0	24	0	0	24
Mental Hygiene	22	0	22	0	0	22
Transportation	0	18	18	0	0	18
Public Health	8	1	9	0	0	9
Temporary and Disability Assistance	6	0	6	0	0	6
Local Government Assistance	5	0	5	0	0	5
City University	1	0	1	0	0	1
Children and Families	0	0	0	0	0	0
All Other	9	0	9	0	0	9
<b>2008-09 Executive Budget</b>	<b>41,860</b>	<b>14,811</b>	<b>56,671</b>	<b>615</b>	<b>30,141</b>	<b>87,427</b>
<b>Total Annual Change</b>	<b>2,440</b>	<b>342</b>	<b>2,782</b>	<b>12</b>	<b>(115)</b>	<b>2,679</b>

## **Current Services**

For 2008-09, on an All Funds basis, current service requirements increase by \$5.5 billion above revised 2007-08 estimates. Most of this increase is concentrated in School Aid and Medicaid (\$3.8 billion). The annual decrease in economic development largely reflects a shift in spending categories, from local assistance to State operations, for State payments made pursuant to “Timothy’s Law” to reimburse employers for costs associated with providing mental health insurance coverage. The decrease in Temporary and Disability Assistance largely reflects a decrease in the level of Federal TANF disbursements. The program areas with the greatest growth in current services are described in more detail below.

- **Medicaid:** Medicaid spending is growing due to several factors, including the increasing cost of providing health care services, particularly nursing home services, a projected rise in the number of recipients, and increases in medical service utilization, particularly in managed care and home care programs. Other changes affecting growth include increases in managed care programs and escalating hospital and prescription drug costs. The number of Medicaid recipients is projected to reach over 3.6 million in 2008-09, an increase of 2.4 percent over the current fiscal year.
- **School Aid:** Growth reflects the balance of the 2007-08 school year increase and the level of spending growth which was already projected in the State’s current services plan. School aid commitments are made on a July 1 starting school-year basis, thus, each fiscal year, there is a “tail” of payments related to the prior school year increase (roughly 30 percent of the prior-year total).
- **STAR:** Reflects an increase in tax rebates to local property owners, and other school tax relief to taxpayers across New York.

## **Recommended Savings**

More than half of the Executive Budget’s All Funds local assistance savings plan relies on Medicaid actions. Significant savings initiatives are described in more detail below.

- **Medicaid Actions:** Largely reflects pharmaceutical savings, savings from reduced Medicaid fraud, greater efficiencies in hospital and ambulatory care spending, and a reconfiguration in funding for nursing homes.
- **STAR:** The Executive Budget recommends a slower phase-in of the basic middle-class STAR rebate; a reduction in the STAR credit for New York City resident personal income taxpayers with incomes above \$250,000; a change in the adjustment that limits annual reductions in the STAR exemption amount from 5 percent to 10 percent; and authorization for the State to offset middle-class STAR rebates owed to individuals who are delinquent on their taxes, child support, or other legal debt obligations.
- **Local Government Assistance:** Reflects the partial restoration of New York City funding from the Aid and Incentives for Municipalities program (AIM).
- **Public Health:** Largely reflects savings associated with the Early Intervention program through the recovery of an overpayment made to New York City, and the elimination of the cost of living adjustment for Early Intervention providers authorized in the 2006-07 Enacted Budget.
- **Mental Hygiene:** Largely reflects proposed actions to implement various cash management and revenue maximization initiatives in several program areas, including for Intermediate Care Facility Day Services, Home and Community-Based Services Waiver, NY/NY III Supportive Housing agreement and Day Habilitation services.
- **Temporary and Disability Assistance:** Largely reflects the reprogramming of TANF funding.

## New Initiatives

The largest areas of investment in local assistance are described below.

- **Medicaid:** Reflects investments in hospitals, including ambulatory surgery, emergency room services, and outpatient services.
- **School Aid:** Reflects increased aid to New York City schools.
- **Other Education:** Largely reflects additional resources for preschool special education and non-public schools.

## State Operations

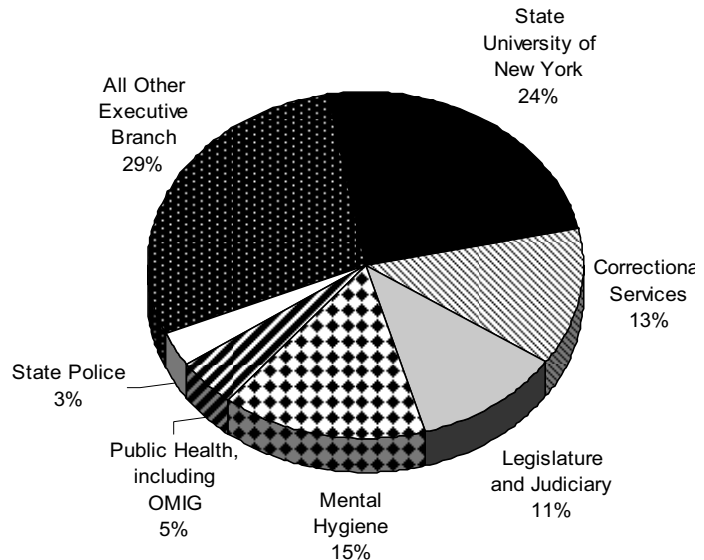
State Operations spending is for personal service and non-personal service costs. Personal service costs, which account for approximately two-thirds of State Operations spending, includes salaries of State employees of the Executive Branch, Legislature, and Judiciary, as well as overtime payments and costs for temporary employees. Non-personal service costs, which account for the remaining one-third of State Operations, represent other operating costs of State agencies, including real estate rental, utilities, contractual payments (i.e., consultants, information technology and professional business services), supplies and materials, equipment, telephone service and employee travel.

All Funds State Operations spending is projected at \$19.4 billion in 2008-09, which finances the costs of Executive agencies (\$17.3 billion) and the Legislature and Judiciary (\$2.1 billion). The largest agencies include SUNY (\$4.7 billion; 40,632 Full Time Equivalent Employees (FTEs)), Correctional Services (\$2.5 billion; 31,603 FTEs), Mental Hygiene (\$3.0 billion; 40,907 FTEs), Public Health, including Office of the Medicaid Inspector General (\$875 million; 6,793 FTEs), and State Police (\$637 million; 5,989 FTEs).

Approximately 93 percent of the State workforce is unionized. The largest unions include the Civil Service Employees Association, which primarily represents office support staff and administrative personnel, machine operators, skilled trade workers, and therapeutic and custodial care staff; the Public Employees Federation which primarily represents professional and technical personnel (i.e., attorneys, nurses, accountants, social workers, and institution teachers); United University Professions which represents faculty and non-teaching professional staff within the State University system; and the New York State Correctional Officers and Police Benevolent Association which represents security personnel (correction officers, safety and security officers).

The State workforce, which reflects full-time employees of the Executive branch, excluding the Legislature, Judiciary, and contractual labor, is projected to total 201,270 in 2008-09, an increase of 1,846 FTEs over 2007-08 levels. Increases are expected in Transportation (322 FTEs) primarily for bridge maintenance; Mental Hygiene agencies (335 FTEs) primarily due to staffing related to the Sex Offender

**2008-09 All Funds State Operations  
Spending  
\$19.4 Billion**



Management and Treatment Act and the NYS-CARES II program; Office of the Medicaid Inspector General (227 FTEs), reflecting staffing growth needed for Medicaid audit and fraud prevention activities; Motor Vehicles (114 FTEs) driven by the Federal Western Hemisphere Travel Initiative; and Health (256 FTEs), CUNY (140 FTEs) and Education (113 FTEs) reflecting authorized fill levels for 2008-09. Declines in Children and Family Services (243 FTEs) and Correctional Services (153 FTEs) are expected mainly through attrition as a result of facility closures.

State Operations Spending Projections (millions of dollars)						
	2007-08 Revised	Medicaid Transparency	2007-08 Adjusted	2008-09 Proposed	Annual Change	Percent Change
<b>General Fund</b>	<b>9,677</b>	<b>(1,247)</b>	<b>8,430</b>	<b>8,863</b>	<b>433</b>	<b>5.1%</b>
Other State Support	5,693	1,135	6,828	7,018	190	2.8%
<b>State Operating Funds</b>	<b>15,370</b>	<b>(112)</b>	<b>15,258</b>	<b>15,881</b>	<b>623</b>	<b>4.1%</b>
Capital Projects Funds	0	0	0	0	0	N/A
Federal Operating Funds	3,260	112	3,372	3,511	139	4.1%
<b>Total All Funds</b>	<b>18,630</b>	<b>0</b>	<b>18,630</b>	<b>19,392</b>	<b>762</b>	<b>4.1%</b>

All Funds State Operations spending is expected to total \$19.4 billion in 2008-09, comprising Personal Service (\$12.6 billion) and Non-Personal Service (\$6.8 billion). The majority of State Operations spending is for SUNY (\$4.7 billion), Correctional Services (\$2.5 billion), Judiciary (\$2.1 billion), OMRDD (\$1.5 billion) and OMH (\$1.4 billion).

State Operations spending by category, based upon historical spending trends, is allocated among employee base salaries (62 percent), overtime payments (3 percent), contractual services (24 percent), supplies and materials (6 percent), equipment (3 percent), employee travel (1 percent) and other operational costs (1 percent).

State Operations Spending Projections Major Sources of Annual Change -- State Operating Funds (millions of dollars)			
	Personal Service	Non-Personal Service	State Operations
<b>2007-08 Revised</b>	<b>9,935</b>	<b>5,435</b>	<b>15,370</b>
Medicaid Transparency Adjustment	(21)	(91)	(112)
<b>2007-08 Adjusted</b>	<b>9,914</b>	<b>5,344</b>	<b>15,258</b>
Collective Bargaining*	197	0	197
Judiciary	177	5	182
Insurance	1	109	110
Stem Cell Research	0	85	85
Correctional Services	(14)	35	21
Mental Health	(18)	35	17
Health, including OMIG	12	4	16
All Other	50	(55)	(5)
<b>2008-09 Executive Budget</b>	<b>10,319</b>	<b>5,562</b>	<b>15,881</b>
<i>Annual Dollar Change</i>	<i>405</i>	<i>218</i>	<i>623</i>
<i>Annual Percent Change</i>	<i>4.1%</i>	<i>4.1%</i>	<i>4.1%</i>

\* Not allocated by agency at this time.

The All Funds State Operations spending increase of \$762 million (4.1 percent) is primarily driven by projected increases for collective bargaining agreements (\$197 million), the Judiciary (\$181 million),

Insurance (\$110 million), Stem Cell Research (\$85 million), Correctional Services (\$51 million), OMH (\$28 million), and Public Health (\$26 million). The annual changes are described in more detail below.

## Personal Service

Personal Service						
Sources of Annual Spending Increase/(Decrease)						
from 2007-08 to 2008-09						
(millions of dollars)						
	General Fund	Other State Funds	Total State Operating Funds	Capital Projects Funds	Federal Operating Funds	Total All Funds
<b>2007-08 Revised</b>	<b>6,813</b>	<b>3,122</b>	<b>9,935</b>	<b>0</b>	<b>2,169</b>	<b>12,104</b>
Medicaid Transparency Adjustment	(688)	667	(21)	0	0	(21)
<b>2007-08 Adjusted</b>	<b>6,125</b>	<b>3,789</b>	<b>9,914</b>	<b>0</b>	<b>2,169</b>	<b>12,083</b>
<b>Current Services:</b>	<b>568</b>	<b>33</b>	<b>601</b>	<b>0</b>	<b>(22)</b>	<b>579</b>
Current Collective Bargaining	197	0	197	0	0	197
Judiciary	175	1	176	0	0	176
Agency Salary Adjustments	93	31	124	0	22	146
Workforce Changes	45	1	46	0	14	60
Offsets	58	0	58	0	(58)	0
<b>Recommended Savings:</b>	<b>(281)</b>	<b>60</b>	<b>(221)</b>	<b>0</b>	<b>121</b>	<b>(100)</b>
Maximize Revenues	(136)	8	(128)	0	121	(7)
Auto Insurance Surcharge	(44)	44	0	0	0	0
Homeland Security	(17)	0	(17)	0	0	(17)
Mental Hygiene	(22)	0	(22)	0	0	(22)
DOCS Facility Closures	(9)	0	(9)	0	0	(9)
Youth Facility Closures	(2)	0	(2)	0	0	(2)
Power Plant Security	0	12	12	0	0	12
All Other	(51)	(4)	(55)	0	0	(55)
<b>New Initiatives:</b>	<b>22</b>	<b>3</b>	<b>25</b>	<b>0</b>	<b>10</b>	<b>35</b>
All Other	22	3	25	0	10	35
<b>2008-09 Executive Budget</b>	<b>6,434</b>	<b>3,885</b>	<b>10,319</b>	<b>0</b>	<b>2,278</b>	<b>12,597</b>
<i>Total Annual Change</i>	<i>309</i>	<i>96</i>	<i>405</i>	<i>0</i>	<i>109</i>	<i>514</i>

## Current Services

**Current Collective Bargaining:** Reflects tentative labor settlements for the Civil Service Employees Association, United University Professions, District Council 37, and the extension of those increases to Management/Confidential State employees that provide a 3 percent salary increase each year beginning on April 1, 2007 and a 4 percent increase in the final year (2010-11).

**Judiciary:** Reflects the Judiciary's budget request for a salary increase (\$143 million), as well as the annualization of prior-year Judiciary actions, including increasing the number of full-time judges and adding Court of Claims and Family judges. The Governor must submit the Judiciary's budget request to the Legislature without modification.

**Agency Salary Adjustments:** Includes performance advances which systematically raise an employee's salary annually until the "job rate" is reached, longevity payments which increase salary for employees at their job rate for more than five years, merit awards and other promotional factors.

**Workforce Changes:** Reflects payroll increases driven by workforce changes.

**Offsets:** A reduction in Federal revenue available to offset General Fund costs, primarily resulting from the rate methodology change in the Medicaid Service Coordination program.

### **Recommended Savings**

**Maximize Revenues:** Proposed Mental Hygiene Patient Income Account actions are expected to increase the amount of patient care revenues available to support State costs (\$121 million). In addition, an increase in Federal revenues earned in various OTDA programs and an increase in Federal funding for the State Criminal Alien Assistance Program lowers General Fund costs (\$8 million and \$5 million, respectively)

**Auto Insurance Surcharge:** Reflects an increase in the auto insurance surcharge from \$5 to \$10 in the portion of the fee used to support State Police highway and public safety activities.

**Homeland Security:** Recommendations include implementation of a security assessment on nuclear power plants to recover costs of National Guard activities at those sites (\$11.7 million) and consolidation of National Guard missions in the New York City area. In addition, a projected increase in Federal funds resulting from the State's use of all available Office of Homeland Security Federal funding will result in one-time General Fund savings of \$5 million.

**Mental Hygiene:** Primarily reflects adjusted estimates of Sex Offender Management and Treatment Act related costs, driven by assessment differences, procedural delays and a backlog in court reviews.

**Correctional Services Facility Closures:** Savings would be generated by the closure of three minimum security correctional camps at Pharsalia, Mt. McGregor, and Gabriels (\$5 million) and the Hudson medium security correctional facility (\$4 million).

**Youth Facility Closures:** Savings would be generated by the previously announced closure of seven underutilized youth facilities and the downsizing of one facility.

**All Other:** Primarily reflects reductions in workforce driven by attrition, consolidation of services and overtime savings.

### **New Initiatives**

**All Other:** Includes additional funding for the Office of the Medicaid Inspector General staffing (\$1 million).

## Non-Personal Service

Non-Personal Service Sources of Annual Spending Increase/(Decrease) from 2007-08 to 2008-09 (millions of dollars)						
	General Fund	Other State Funds	Total State Operating Funds	Capital Projects Funds	Federal Operating Funds	All Funds
<b>2007-08 Revised</b>	<b>2,864</b>	<b>2,571</b>	<b>5,435</b>	<b>0</b>	<b>1,091</b>	<b>6,526</b>
Medicaid Transparency Adjustment	(559)	468	(91)	0	112	21
<b>2007-08 Adjusted</b>	<b>2,305</b>	<b>3,039</b>	<b>5,344</b>	<b>-</b>	<b>1,203</b>	<b>6,547</b>
<b>Current Services:</b>	<b>257</b>	<b>93</b>	<b>350</b>	<b>0</b>	<b>8</b>	<b>358</b>
Correctional Services	52	1	53	0	(1)	52
Mental Hygiene	35	1	36	0	(5)	31
State University	(17)	28	11	0	5	16
Children and Family Services	27	0	27	0	7	34
Environmental Conservation	1	(23)	(22)	0	0	(22)
Insurance	92	4	96	0	0	96
Stem Cell Research	0	85	85	0	0	85
All Other	67	(3)	64	0	2	66
<b>Recommended Savings:</b>	<b>(163)</b>	<b>(6)</b>	<b>(169)</b>	<b>0</b>	<b>10</b>	<b>(159)</b>
Software Bonding	(43)	0	(43)	0	0	(43)
Education	(5)	0	(5)	0	0	(5)
General Services	(10)	0	(10)	0	0	(10)
Maximize Revenues	(9)	6	(3)	0	9	6
Medical Parole	(5)	0	(5)	0	0	(5)
Auto Insurance Surcharge	(4)	4	0	0	0	0
HESC Student Default Fee	0	(32)	(32)	0	0	(32)
Efficiencies	(87)	16	(71)	0	1	(70)
<b>New Initiatives:</b>	<b>30</b>	<b>7</b>	<b>37</b>	<b>0</b>	<b>12</b>	<b>49</b>
Economic Development	10	0	10	0	0	10
Public Health	10	1	11	0	1	12
OMIG	4	0	4	0	4	8
Cook Chill Expansion	0	5	5	0	0	5
HAVA	0	0	0	0	5	5
All Other	6	1	7	0	2	9
<b>2008-09 Executive Budget</b>	<b>2,429</b>	<b>3,133</b>	<b>5,562</b>	<b>-</b>	<b>1,233</b>	<b>6,795</b>
<i>Total Annual Change</i>	<i>124</i>	<i>94</i>	<i>218</i>	<i>0</i>	<i>30</i>	<i>248</i>

### Current Services

**Correctional Services:** Growth is driven primarily by the escalating costs of food, fuel, utilities and providing health care services and prescription drugs to inmates.

**Mental Hygiene:** Primarily reflects overall inflationary increases, including assumed 4 percent increases for energy costs; roughly 10 percent for pharmacy costs driven by increased drug costs and higher utilization (\$29 million); and additional costs resulting from the Sex Offender Management and Treatment Act (\$3 million).

**State University:** Primarily reflects funding for inflationary increases.

**Children and Family Services:** Growth is driven by the exhaustion of prior-year Federal revenues supporting development costs of the child welfare computer system (\$5 million), the modernization of the child welfare computer system (\$17 million), general inflation (\$3 million), and projected Office for Technology rate increases for services provided to the agency (\$1 million).

**Environmental Conservation:** Primarily reflects non-recurring spending in the oil spill compensation program.

**Insurance:** Reflects payments to be made to insurance companies in accordance with Timothy's Law.

**Stem Cell Research:** Growth is from additional funding for stem cell research which was included in the 2007-08 Enacted Budget.

### ***Recommended Savings***

**Software Bonding:** Recommends bonding software development costs for CONNECTIONS (\$20 million), the Medicaid Management Information System (\$10 million), the statewide Welfare Management System (\$5 million), and the School Aid Management System (\$2 million).

**Education:** Reflects a reduction in planned growth associated with the implementation of SED accountability measures.

**General Services:** Proposals include shifting maintenance costs to capital (\$3 million), a planned reduction in energy consumption (\$1 million) and replacing certain contractors with State employees (\$1 million).

**Maximize Revenues:** Reflects a projected increase in Federal revenues earned in various OTDA programs which is used to lower General Fund costs, as well as the use of available Federal funding to support the New York Alert initiative.

**Medical Parole:** Establishes an expedited release process for inmates with terminal or incapacitating illnesses, leading to savings in pharmaceutical costs and outside hospital costs.

**Auto Insurance Surcharge:** Reflects an increase in the auto insurance surcharge from \$5 to \$10 in the portion of the fee used to support State Police highway and public safety activities.

**Higher Education Services Corporation (HESC) Student Default Fees:** HESC will discontinue coverage of the 1 percent default fee. The savings will be used to offset TAP expenses.

**Efficiencies:** Non-personal service spending efficiencies across nearly all State agencies including Mental Hygiene (\$19 million), DOCS (\$13 million) and SUNY (\$9 million) are expected to generate savings in energy, utilities, and travel costs.

### ***New Initiatives***

**Economic Development:** Increased funding for the "I Love New York" and international trade programs, and funding for a new business marketing program.

**Public Health:** Authorizes funding for the State to directly enroll individuals in Medicaid, CHP and FHP.

**Office of Medicaid Inspector General:** Reflects investment in equipment, including data mining tools and cardswipe terminals.



**Cook/Chill Expansion:** This proposal recommends increasing DOCS Cook-Chill food production to provide county jails outside of NYC with food for their inmates. These additional costs are expected to be offset by the revenue generated by the activity.

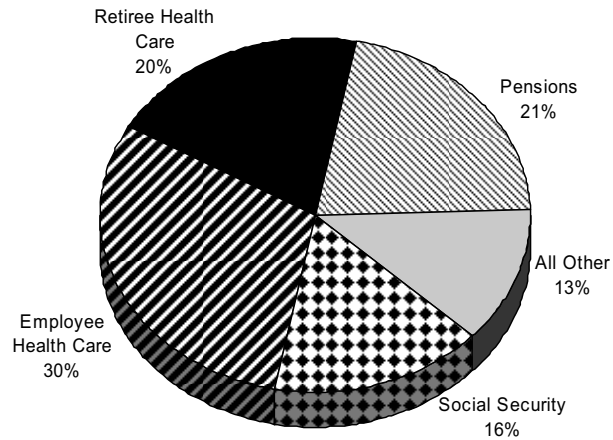
**Help America Vote Act:** Additional funding for the implementation of the Help America Vote Act to ensure compliant voting machines are available in the State.

## General State Charges

General State Charges account for the costs of fringe benefits provided to State employees and retirees of the Executive, Legislative and Judicial branches, and certain fixed costs paid by the State. Fringe benefit payments, many of which are mandated by statute or collective bargaining agreements, include employer contributions for pensions, Social Security, health insurance, workers' compensation and unemployment insurance. Fixed costs include State taxes paid to local governments for certain State-owned lands, and payments related to lawsuits against the State and its public officers.

For most agencies, employee fringe benefit costs are paid centrally from appropriations made to General State Charges. These centrally-paid fringe benefit costs represent the majority of General State Charges spending. However, certain agencies, such as the Judiciary and the State University of New York, directly pay all or a portion of their employees' fringe benefit costs from their respective budgets. Employee fringe benefits paid through the General State Charges account are paid from the General Fund in the first instance and then partially reimbursed by revenue collected from fringe benefit assessments on Federal funds and other special revenue accounts. The funding source of fringe benefit costs directly paid by certain agencies is dependent on the respective agencies' funding sources. Fixed costs are paid in full by General Fund revenues from the General State Charges account.

**General State Charges**  
2008-09 All Funds Spending - \$5.6 billion



General State Charges Spending Projections (millions of dollars)						
	2007-08 Revised	Medicaid Transparency*	2007-08 Adjusted	2008-09 Proposed	Annual Change	Percent Change
General Fund	4,487	(1,506)	2,981	3,136	155	5.2%
Other State Support	639	835	1,474	1,496	22	1.5%
<b>State Operating Funds</b>	<b>5,126</b>	<b>(671)</b>	<b>4,455</b>	<b>4,632</b>	<b>177</b>	<b>4.0%</b>
Federal Operating Funds	243	671	914	924	10	1.1%
<b>Total All Funds</b>	<b>5,369</b>	<b>0</b>	<b>5,369</b>	<b>5,556</b>	<b>187</b>	<b>3.5%</b>

\* For detailed discussion please see the "Medicaid Transparency" discussion earlier.

All Funds spending on GSCs is expected to total \$5.6 billion in 2008-09, and includes health insurance spending for employees (\$1.7 billion) and retirees (\$1.0 billion), pensions (\$1.2 billion) and Social Security (\$889 million). The annual changes are described in more detail below.

General State Charges						
Sources of Annual Spending Increase/(Decrease)						
from 2007-08 to 2008-09						
(millions of dollars)						
	General Fund	Other State Funds	Total State Operating Funds	Capital Projects Funds	Federal Operating Funds	Total All Funds
<b>2007-08 Revised Estimate</b>	<b>4,487</b>	<b>639</b>	<b>5,126</b>	<b>0</b>	<b>243</b>	<b>5,369</b>
<b>Medicaid Transparency Adjustment</b>	<b>(1,506)</b>	<b>835</b>	<b>(671)</b>	<b>0</b>	<b>671</b>	<b>0</b>
<b>2007-08 Adjusted Estimate</b>	<b>2,981</b>	<b>1,474</b>	<b>4,455</b>	<b>0</b>	<b>914</b>	<b>5,369</b>
<b>Current Services:</b>	<b>281</b>	<b>20</b>	<b>301</b>	<b>0</b>	<b>9</b>	<b>310</b>
Employee and Retiree Health Care	209	0	209	0	0	209
Pension Contribution	71	0	71	0	0	71
All Other	1	20	21	0	9	30
<b>Recommended Savings:</b>	<b>(126)</b>	<b>2</b>	<b>(124)</b>	<b>0</b>	<b>1</b>	<b>(123)</b>
Audit Savings	(17)	0	(17)	0	0	(17)
Pensions	(24)	0	(24)	0	0	(24)
Health Dividends	(50)	0	(50)	0	0	(50)
Waiver Savings	(18)	0	(18)	0	0	(18)
All Other	(17)	2	(15)	0	1	(14)
<b>2008-09 Proposed</b>	<b>3,136</b>	<b>1,496</b>	<b>4,632</b>	<b>0</b>	<b>924</b>	<b>5,556</b>
Annual Change	155	22	177	0	10	187

### Current Services

**Employee/Retiree Health Care:** Spending for the State health plan is projected to increase by 5.0 percent in 2008-09, or by a total of \$209 million for active employees and retirees.

**Pension Contribution:** Projected contributions to the New York State and Local Retirement Systems for fiscal year 2008-09 are based on estimated pension contribution rates provided by the State Comptroller. Baseline projections from the Comptroller show an employer pension contribution rate of 8.8 percent of payroll in 2008-09 compared to 9.7 percent in 2007-08. The increase of \$71 million (6 percent) in 2008-2009 reflects large reconciliation charges in 2008-09 associated with larger-than-expected salary growth in 2006-07.

**All Other:** General Fund spending increases in employee benefit programs are driven by additional costs incurred as a result of planned workforce growth, primarily for Social Security costs (\$16 million) and increases for taxes on public lands (\$12 million). These increases are partially offset by higher escrow payments made by State agencies that reduce General Fund spending (\$21 million).

### Recommended Savings

**Audit Savings:** The Executive Budget recommends an eligibility audit to eliminate ineligible dependents from receiving health insurance coverage from the State (\$16 million), as well as increasing audit recoveries through the addition of five audit staff (\$1 million).

**Pensions:** Savings are derived from accelerating the State’s pension payment from September 1, 2008 to May 1, 2008, resulting in interest savings.

**Health Insurance Dividends:** One-time use of health insurance dividends to pay for health care spending in 2008-09.

**Waiver Savings:** Savings are expected from efforts to ensure all non-General Fund State programs are paying their appropriate share of fringe benefit costs. In 2008-09, approximately \$18 million in savings will be realized from the cessation of certain fringe benefit waivers which had previously been granted.

## Debt Service

The State pays debt service on all outstanding State-supported bonds. These include general obligation bonds, for which the State is constitutionally obligated to pay debt service, as well as bonds issued by State public authorities (i.e., Empire State Development Corporation (ESDC), the Dormitory Authority of the State of New York (DASNY), and the Thruway Authority (TA) for which the State is contractually obligated to pay debt service, subject to an appropriation. Depending on the credit structure, debt service is financed through transfers from the General Fund, dedicated taxes and fees, and other resources, such as patient income revenues.

For a more complete discussion on State debt levels, debt service costs and debt management initiatives, please refer to the 2008-09 Executive Budget Five-Year Capital Program and Financing Plan available on the DOB website.

Debt Service Spending Projections (millions of dollars)				
	2007-08 Revised	2008-09 Proposed	Annual Change	Percent Change
<b>General Fund</b>	1,557	1,692	135	8.7%
Other State Support	2,735	2,936	201	7.3%
<b>State Operating Funds</b>	<b>4,292</b>	<b>4,628</b>	<b>336</b>	<b>7.8%</b>
Capital Projects Funds	0	0	0	0.0%
<b>Total All Funds</b>	<b>4,292</b>	<b>4,628</b>	<b>336</b>	<b>7.8%</b>

All Funds debt service is projected at \$4.6 billion in 2008-09, of which \$1.7 billion is paid from the General Fund through transfers and \$2.9 billion from other State funds. Debt service is paid on revenue credits supported by dedicated taxes and fees and patient income, including Personal Income Tax Revenue bonds, Dedicated Highway and Bridge Trust Fund bonds and Mental Health facilities bonds, as well as service contract bonds that are secured mainly by the General Fund.

<b>Debt Service</b>					
<b>Sources of Annual Spending Increase/(Decrease)</b>					
<b>from 2007-08 to 2008-09</b>					
<b>(millions of dollars)</b>					
	<u>General Fund</u>	<u>Other State Funds</u>	<u>Total State Operating Funds</u>	<u>Capital Projects Funds</u>	<u>Total All Funds</u>
<b>2007-08 Revised Estimates</b>	1,557	2,735	4,292	0	4,292
<b>Current Services:</b>	135	232	367	0	367
<b>Recommended Savings:</b>	0	(31)	(31)	0	(31)
<b>2008-09 Proposed</b>	1,692	2,936	4,628	0	4,628
Annual Change	135	201	336	0	336

### **Current Services**

**Underlying Growth:** Primarily reflects increases in debt service costs to support ongoing capital spending. The increased spending is for education purposes (\$158 million, of which \$68 million is for EXCEL), transportation (\$112 million), health and mental hygiene (\$65 million), and economic development and housing (\$63 million), as offset by slightly reduced spending for State facilities and equipment (\$18 million) and the \$250 million Debt Reduction Reserve Fund spending in 2007-08. In addition, spending for SUNY educational facilities and the Local Government Assistance Corporation (LGAC) increased by \$222 million due to the timing of debt service payments made during 2006-07. Variable interest rates are projected at 3.15 percent for 2008-09, slightly lower than 2007-08 levels of 3.55 percent.

The State continues to implement measures to reduce growth in debt service costs, such as using highly rated personal income tax revenue bonds (in lieu of more costly service contract bonds) to finance a variety of capital programs.

### **Recommended Savings**

Reflects \$31 million in savings from a variety of debt management actions, including continuing increased competitive processes for bond sales, maximizing savings opportunities through consolidated service contract refunding structures and more flexible personal income tax new money structures, and – if market conditions become more favorable – further diversifying the State’s debt portfolio with variable rate obligations and interest rate exchange agreements. The State will also continue to use less costly AAA-rated (by Standard and Poor’s) personal income tax bonds to reduce borrowing costs.

### **New Initiatives**

A number of new capital initiatives are proposed to be bond-financed with the Executive Budget. These include increased capital programs for SUNY and CUNY (\$2.9 billion), over \$1 billion for various economic development initiatives and capital enhancements at State parks, \$75 million of bond-eligible capital spending from the Environmental Protection Fund (EPF), and \$65 million of software development costs.

The newly recommended bond-financed capital programs are expected to have a minimal impact on 2008-09 debt service spending, although they will produce higher costs in later years. The recommended additions are explained in detail in the 2008-09 Executive Budget Five-Year Capital Program and Financing Plan available on the DOB website.

## Capital Projects

The following section briefly summarizes activity in Capital Projects Funds. A complete explanation of the State's capital programs is contained in the Five-Year Capital Program and Financing Plan.

Capital Projects account for spending across all functional areas to finance costs related to the acquisition, construction, repair or renovation of fixed assets. Spending from appropriations made from over 30 capital projects funds are financed from four sources: annual State taxes or dedicated miscellaneous receipts, grants from the Federal government, the proceeds of notes or bonds issued pursuant to General Obligation Bond Acts which are approved by the State voters, and the proceeds of notes or bonds issued by public authorities pursuant to legal authorization for State capital spending.

<b>Capital Projects Spending Projections</b> (millions of dollars)				
	<b>2007-08</b> <b>Revised</b>	<b>2008-09</b> <b>Proposed</b>	<b>Annual</b> <b>Change</b>	<b>Percent</b> <b>Change</b>
<b>General Fund</b>	<b>93</b>	<b>366</b>	<b>272</b>	<b>291.7%</b>
Other State Support	4,666	5,589	923	19.8%
<b>State Funds</b>	<b>4,759</b>	<b>5,955</b>	<b>1,195</b>	<b>25.1%</b>
Federal Funds	1,885	1,973	87	4.6%
<b>All Funds</b>	<b>6,645</b>	<b>7,927</b>	<b>1,282</b>	<b>19.3%</b>

All Funds capital spending is projected at \$6.6 billion in 2007-08 and \$7.9 billion in 2008-09. In fiscal year 2008-09, transportation spending, primarily for improvements and maintenance to the State's highways and bridges, continues to account for the largest share (51 percent) of this total. The balance of projected spending will support capital investments in the areas of economic development and government oversight (12 percent), education (10 percent), mental hygiene and public protection (9 percent), and parks and the environment (8 percent). The remainder of projected capital projects spending will be spread across health and social welfare, general government and other areas (10 percent).

<b>Capital Projects</b>				
<b>Sources of Annual Spending Increase/(Decrease)</b>				
<b>(millions of dollars)</b>				
	<b>General Fund</b>	<b>State Funds</b>	<b>Federal Funds</b>	<b>All Funds</b>
<b>Current Services:</b>	<b>271</b>	<b>567</b>	<b>87</b>	<b>925</b>
Transportation	118	119	106	343
Economic Development	112	88	0	200
Higher Education/Education	0	94	0	94
All Other Reestimates	41	266	(19)	288
<b>Recommended Savings:</b>	<b>(3)</b>	<b>0</b>	<b>0</b>	<b>(3)</b>
All Agencies	(3)	0	0	(3)
<b>New Initiatives:</b>	<b>4</b>	<b>356</b>	<b>0</b>	<b>360</b>
Economic Development	0	90	0	90
Environment	0	75	0	75
Transportation	0	74	0	74
Higher Education/Education	4	55	0	59
All Other Additions	0	62	0	62
<b>Annual Change</b>	<b>272</b>	<b>923</b>	<b>87</b>	<b>1,282</b>

### **Current Services**

The projected \$200 million spending increase for economic development reflects the cumulative impacts of initiatives begun over the previous several years. They include projects at State University facilities and its Research Foundation and private universities; various local projects across the State; cultural facilities needs, and energy-related projects. The \$343 million increase for transportation reflects spending for ongoing commitments, including \$106 million in Federal grants and \$181 million for spending from the 2005 Rebuild and Renew New York General Obligation Bond Act, as those projects begin to spend more fully. The \$403 million increase for other spending is spread across all other program areas, including \$163 million for mental hygiene and public protection projects, \$86 million for higher education projects, and \$90 million for DOH projects (primarily HEAL-NY).

### **Recommended Savings**

Approximately \$3 million has been identified as savings for shifting environmental spending to bond financing.

### **New Initiatives**

Please see the 2008-09 Executive Budget Capital Program and Financing Plan for a complete discussion of Capital investments recommended in the Executive Budget.

## Non-Recurring Resources

The State typically uses some non-recurring resources each year to support its operations. The Executive Budget uses approximately \$1.1 billion of non-recurring resources to balance the General Fund Financial Plan and another \$337 million in labor reserves to finance expected collective bargaining costs. The following table summarizes the non-recurring actions.

<b>General Fund Non-Recurring Resources</b> (millions of dollars)	
	<b>2008-09</b>
Belmont Development Rights	250
Partial Restoration of NYC AIM	164
Bonding Capital projects Originally Planned to be Cash Financed	110
Transfer SONYMA Excess Balances to the General Fund	100
Additional 5 Percent Tax Prepayment	95
Sweep Excess EPF Fund Balances to General Fund	80
Recovery of Early Intervention Overpayments to New York City	60
Bond Eligible Software Costs	63
Abandoned Property	50
Mental Hygiene: Federal PIA revenues/Cash Managemnt	66
Student Loan Default Fee	27
Interest Savings for Pension Bill Prepayment	24
Sweep Excess Motor Vehicle Fund Balances to General Fund	16
All other	34
<b>Total One-Time Resources</b>	<b>1,139</b>
Use of Reserves to Finance Labor Settlements	337
<b>Total Non-Recurring Resources</b>	<b>1,476</b>

There are two significant non-recurring transactions in 2008-09. The first is a potential payment for development rights at Belmont Park. The second is a partial restoration of an aid payment to New York City under the AIM program. The 2008-09 current services budget included a full restoration of the payment that had been reduced to \$20 million in 2007-08. Other one-time actions include:

- Bonding certain costs related to the Environmental Protection Fund, the Department of Education, the Office General Services, and software development capital projects originally planned to be cash financed;
- Recovering overpayments made to New York City for Early Intervention claims;
- Accelerating the payment of certain tax liabilities within the calendar year;
- Using one-time Federal revenues that are expected as a result of accelerated Disproportionate Share and Prepaid Mental Health Program claiming for services provided to mental hygiene consumers, revenue maximization in Day Habilitation services, increased Medicare enrollments, residential conversions, and measured bed development; and
- Assigning financial responsibility for the payment of a 1 percent student loan default fee from the State to the actual borrowers.

The remaining actions generally consist of routine sweeps and fund balances.

## GENERAL FUND FINANCIAL PLAN OUT-YEAR PROJECTIONS (2009-10 Through 2011-12)

The State Constitution requires the Governor to submit an Executive Budget that is balanced on a cash basis in the General Fund - the fund that receives the majority of State taxes, and all income not earmarked for a particular program or activity. The following discussion of out-year projections focuses on the State's General Fund, since that is the fund that is required to be balanced.

### **Current Services Gaps**

The current services gaps, which form the starting point for developing the Executive Budget projections, are calculated at \$6.2 billion in 2009-10, \$7.7 billion in 2010-11, and \$9.5 billion in 2011-12. Since the Mid-Year Update, DOB has revised its current services forecasts for receipts and disbursements for 2009-10 and 2010-11 and calculated an estimate of the 2011-12 gap.

### **Executive Budget Impact on the Out-Year Gaps**

The recommendations set forth in the Budget result in a balanced General Fund Financial Plan in 2008-09 and reduce projected out-year budget gaps to \$3.3 billion in 2009-10, \$5.7 billion in 2010-11, and \$6.8 billion in 2011-12. The projections assume that the Legislature will enact the 2008-09 Executive Budget recommendations in their entirety.

The following tables summarize the impact of the 2008-09 Budget recommendations on the 2009-10 through 2011-12 budget gaps, as well as the annual changes in projected receipts, disbursements, and the use of reserves.

<b>General Fund Budget-Balancing Plan: 2008-09 Executive Budget</b>				
<b>(millions of dollars)</b>				
	<b>2008-09</b>	<b>2009-10</b>	<b>2010-11</b>	<b>2011-12</b>
<b>Current Services Gaps</b>	<b>(4,422)</b>	<b>(6,154)</b>	<b>(7,697)</b>	<b>(9,454)</b>
Savings Plan:	4,838	3,741	3,507	4,071
Savings Actions	2,253	2,495	2,274	2,832
Revenue Initiatives	1,109	1,267	1,254	1,260
Non-recurring Actions	1,139	(21)	(21)	(21)
Use of Reserves for Labor Settlements	337	0	0	0
New Initiatives:	<b>(416)</b>	<b>(874)</b>	<b>(1,497)</b>	<b>(1,438)</b>
<b>Executive Budget Gaps</b>	<b>0</b>	<b>(3,287)</b>	<b>(5,687)</b>	<b>(6,821)</b>

After recommendations, General Fund spending is projected to grow at an average annual rate of 8.0 percent. The spending is driven by School Aid investments, rising costs for education, public health care, the State-financed cap on local Medicaid spending, employee and retiree health benefits, local government aid and child welfare programs, and the recommended initiatives for health care and human services cost-of-living-adjustment. Over the same period, General Fund receipts are estimated to grow at approximately 5 percent a year, consistent with the DOB's forecast of moderating economic growth. The following table summarizes the General Fund projections by major tax and Financial Plan category.



<b>General Fund Executive Budget Forecast</b>				
<b>(millions of dollars)</b>				
	<b>2008-09</b>	<b>2009-10</b>	<b>2010-11</b>	<b>2010-12</b>
<b>Receipts</b>				
Taxes	41,671	43,951	45,940	48,651
Personal Income Tax	24,391	25,897	27,415	29,315
User Taxes and Fees	8,832	8,913	9,251	9,620
Business Taxes	7,254	7,816	7,866	8,218
Other Taxes	1,194	1,325	1,408	1,498
Miscellaneous Receipts	2,238	2,186	2,261	2,060
Federal Grants	41	0	0	0
Transfers from Other Funds	12,392	12,587	13,142	13,816
PIT in Excess of Revenue Bond Debt Service	8,769	9,199	9,647	10,154
Sales Tax in Excess of LGAC Debt Service	2,314	2,331	2,436	2,556
Real Estate Taxes in Excess of CW/CA Debt Service	615	596	599	608
All Other	694	461	460	498
<b>Total Receipts</b>	<b>56,342</b>	<b>58,724</b>	<b>61,343</b>	<b>64,527</b>
<b>Disbursements</b>				
Grants to Local Governments	41,860	45,919	49,833	53,013
State Operations	8,863	9,236	9,780	10,046
General State Charges	3,136	3,806	4,087	4,386
Transfers to Other Funds	2,883	3,112	3,481	3,982
Debt Service	1,692	1,680	1,706	1,673
Capital Projects	366	574	930	997
Other Purposes	825	858	845	1,312
<b>Total Disbursements</b>	<b>56,742</b>	<b>62,073</b>	<b>67,181</b>	<b>71,427</b>
<b>Change in Reserves</b>				
Prior Year Reserves	(337)	0	0	0
Community Projects Fund	(63)	(62)	(151)	(79)
<b>Deposit to/(Use of) Reserves</b>	<b>(400)</b>	<b>(62)</b>	<b>(151)</b>	<b>(79)</b>
<b>Revised Budget Surplus/(Gap) Estimate</b>	<b>0</b>	<b>(3,287)</b>	<b>(5,687)</b>	<b>(6,821)</b>

In evaluating the State's out-year operating forecast, it should be noted that the reliability of the estimates as a predictor of the State's future fiscal condition is likely to diminish as one moves further from the current year and budget year estimates. Accordingly, the 2008-09 forecast is perhaps the most relevant from a planning perspective, since any gap in that year must be closed with the next budget and the variability of the estimates is likely to be less than in later years. The State will provide quarterly revisions to its multi-year estimates.

The following chart provides a "zero-based" look at the causes of the 2009-10 General Fund budget gap, followed by a brief summary of the assumptions behind the projections. For a detailed explanation of the assumptions underlying the out-year revenue and spending projections, see "Out-year General Fund Receipt Projections" and "Out-year General Fund Disbursement Projections" later in this AIS Update.

<b>2009-10 General Fund Annual Change Savings/(Costs) (millions of dollars)</b>	
	<b>2009-10</b>
<b>RECEIPTS</b>	<b>2,382</b>
Constant Law Growth	3,394
Change in STAR Deposits	(710)
Change in Debt Service (RBTF/LGAC/CWCA)	(302)
<b>DISBURSEMENTS</b>	<b>(5,331)</b>
<b>Local Assistance</b>	<b>(4,059)</b>
Medicaid (incl. admin)	(1,488)
<i>Program Growth/Other</i>	(1,229)
<i>Medicaid Cap/Family Health Plus Takeover</i>	(259)
School Aid	(1,793)
Other Education Aid	(132)
Children and Family Services	(133)
Local Government Aid	(239)
All Other Local Assistance	(274)
<b>State Operations</b>	<b>(373)</b>
Personal Service	(246)
Non-personal Service	(127)
<b>General State Charges</b>	<b>(670)</b>
Health Insurance	(228)
Pensions	(71)
All Other	(371)
<b>Transfers to Other Funds</b>	<b>(229)</b>
<b>Change in Reserves Used for Operations</b>	<b>(338)</b>
<b>"CURRENT SERVICES" BUDGET GAP FOR 2009-10</b>	<b>(3,287)</b>

The forecast for 2009-10 is based on assumptions of economic performance, revenue collections, spending patterns, and projections for the current services costs of program activities, and assumes enactment of the Executive Budget in its entirety. DOB believes the estimates of annual change in revenues and spending that create the 2009-10 current services gap forecast are based on reasonable assumptions and methodologies. Significant assumptions that affect the forecast include:

- **The Executive Budget will be enacted without modification.** The estimates assume that any legislative changes to the 2008-09 Executive Budget would be matched with a corresponding amount of recurring resources.
- **Economic growth will continue during the forecast period.** DOB's forecast calls for moderate expansion in the economy. The momentum of the State's expansion appears to have peaked in 2005, and the forecast calls for positive, but below average, growth through calendar year 2008 and a return to trend growth in the out-years.
- **Revenues, adjusting for tax law changes, will grow in the range of 5.2 percent to 6.1 percent annually.** The growth rate is consistent with DOB's forecast for the economy but, as in any year,

is subject to significant volatility. Changes in the economic growth rate, Federal law, and taxpayer behavior all have a significant influence on receipts collections.

- **The Federal government will not make substantive funding changes** to major aid programs or make substantive regulatory changes that adversely affect the State.
- **The projections do not include any extra costs for unsettled labor settlements.** The Financial Plan projections do not include spending for unions that have not yet reached tentative labor settlements with the State. These include unions representing uniformed officers and the Public Employees Federation. DOB estimates that if all the unsettled unions were to agree to the same terms that have been ratified by the Civil Service Employees Association, it would result in added costs of \$144 million in 2007-08, \$303 million in 2008-09, \$444 million in 2009-10, and \$636 million in 2010-11. Financial Plan reserves set aside for this purpose are sufficient to cover all but \$183 million of these costs through 2009-10.
- **The projections do not assume the use of one-time resources.** In a typical year, however, the Financial Plan usually includes some such resources.

Changes to these or other assumptions have the potential to materially alter the size of the budget gaps for 2009-10 and beyond.

### **Out-Year General Fund Receipts Projections**

General Fund Receipts Projections (millions of dollars)							
	2008-09	2009-10	Annual \$ Change	2010-11	Annual \$ Change	2011-12	Annual \$ Change
<b>Receipts</b>							
Personal Income Tax	24,391	25,897	1,506	27,415	1,518	29,315	1,900
User Taxes and Fees	8,832	8,913	81	9,251	338	9,620	369
Business Taxes	7,254	7,816	562	7,866	50	8,218	352
Other Taxes	1,194	1,325	131	1,408	83	1,498	90
Miscellaneous Receipts	2,238	2,186	(52)	2,261	75	2,060	(201)
Federal Grants	41	0	(41)	0	0	0	0
Transfers from Other Funds	12,392	12,587	195	13,142	555	13,816	674
PIT in Excess of Revenue Bond Debt Service	8,769	9,199	430	9,647	448	10,154	507
Sales Tax in Excess of LGAC Debt Service	2,314	2,331	17	2,436	105	2,556	120
Real Estate Taxes in Excess of CW/CA Debt Service	615	596	(19)	599	3	608	9
All Other	694	461	(233)	460	(1)	498	38
<b>Total Receipts</b>	<b>56,342</b>	<b>58,724</b>	<b>2,382</b>	<b>61,343</b>	<b>2,619</b>	<b>64,527</b>	<b>3,184</b>

### **Fiscal Years 2009-10, 2010-11 and 2011-12 Overview**

Overall, tax receipts growth in the three fiscal years following 2008-09 is expected to remain in the range of 4.8 to 6.0 percent. This is consistent with a projected return to trend economic growth in the U.S. and New York economies in the second half of 2008. Receipt growth is supported by proposals contained with this Budget that eliminate unintended tax loopholes, reform and simplify the Tax Law, and supplement Department of Taxation and Finance efforts to find non-compliant and fraudulent taxpayers. These factors are expected to continue to enhance expected receipt growth through 2011-12.

- Total General Fund receipts are projected to reach nearly \$59 billion in 2009-10, over \$61 billion in 2010-11 and nearly \$65 billion in 2011-12.
- Total State Funds receipts are projected to be approximately \$85 billion in 2009-10, over \$88 billion in 2010-11 and nearly \$92 billion in 2011-12.

- Total All Funds receipts in 2009-10 are projected to reach over \$128 billion, an increase of \$5.0 billion, or 4.1 percent from 2008-09 estimates. All Funds receipts in 2010-11 are expected to increase by nearly \$5.1 billion (4.0 percent) over the prior year. In 2011-12, receipts are expected to increase by nearly \$5.0 billion (3.7 percent) over 2010-11 projections.
- All Funds tax receipts are expected to increase by 6.0 percent in 2009-10, 4.8 percent in 2010-11 and 5.5 percent in 2011-12. Again, the growth pattern is consistent with an economic forecast of continued, but slower, economic growth.

### Out-Year General Fund Disbursement Projections

DOB forecasts General Fund spending of \$62.1 billion in 2009-10, an increase of \$5.3 billion (9.4 percent) over recommended 2008-09 levels. Growth in 2010-11 is projected at \$5.1 billion (8.2 percent) and in 2011-12 at \$4.2 billion (6.4 percent). The growth levels are based on current services projections, as modified by the recommendations contained in the 2008-09 Executive Budget. They do not incorporate any estimate of potential new actions to control spending, that would likely result from the constitutional requirement for the Governor to submit balanced budgets annually. The main sources of annual spending growth for 2009-10, 2010-11, and 2011-12 are itemized in the table below.

### Grants to Local Governments

Out-year Disbursement Projections - General Fund (millions of dollars)							
	2008-09	2009-10	Annual \$ Change	2010-11	Annual \$ Change	2011-12	Annual \$ Change
<b>Grants to Local Governments:</b>	<b>41,860</b>	<b>45,919</b>	<b>4,059</b>	<b>49,833</b>	<b>3,914</b>	<b>53,013</b>	<b>3,180</b>
School Aid	17,441	19,234	1,793	21,273	2,039	22,789	1,516
Medicaid (including administration)	11,785	13,014	1,229	13,872	858	14,765	893
Medicaid: Takeover Initiatives	939	1,198	259	1,539	341	1,920	381
Mental Hygiene	2,057	2,115	58	2,320	205	2,496	176
Children and Family Services	1,760	1,893	133	2,065	172	2,213	148
Local Government Assistance	1,137	1,376	239	1,440	64	1,410	(30)
Higher Education	2,470	2,540	70	2,602	62	2,623	21
Public Health	644	747	103	796	49	817	21
Other Education Aid	1,702	1,834	132	1,936	102	2,043	107
Temporary and Disability Assistance	1,167	1,240	73	1,240	0	1,242	2
Transportation	105	105	0	105	0	105	0
All Other	653	623	(30)	645	22	590	(55)
<b>State Operations:</b>	<b>8,863</b>	<b>9,236</b>	<b>373</b>	<b>9,780</b>	<b>544</b>	<b>10,046</b>	<b>266</b>
Personal Service	6,434	6,680	246	7,114	434	7,293	179
Non-Personal Service	2,429	2,556	127	2,666	110	2,753	87
<b>General State Charges</b>	<b>3,136</b>	<b>3,806</b>	<b>670</b>	<b>4,087</b>	<b>281</b>	<b>4,386</b>	<b>299</b>
Pensions	1,216	1,287	71	1,285	(2)	1,342	57
Health Insurance (Active Employees)	1,652	1,790	138	1,950	160	2,127	177
Health Insurance (Retired Employees)	1,039	1,129	90	1,233	104	1,347	114
Medicaid Adjustment	(1,506)	(1,136)	370	(1,135)	1	(1,207)	(72)
All Other	735	736	1	754	18	777	23
<b>Transfers to Other Funds:</b>	<b>2,883</b>	<b>3,112</b>	<b>229</b>	<b>3,481</b>	<b>369</b>	<b>3,982</b>	<b>501</b>
Debt Service	1,692	1,680	(12)	1,706	26	1,673	(33)
Capital Projects	366	574	208	930	356	997	67
All Other	825	858	33	845	(13)	1,312	467
<b>TOTAL DISBURSEMENTS</b>	<b>56,742</b>	<b>62,073</b>	<b>5,331</b>	<b>67,181</b>	<b>5,108</b>	<b>71,427</b>	<b>4,246</b>

Annual growth in local assistance is driven primarily by School Aid, Medicaid, local government assistance, other education aid and children and family services. The following table summarizes some of the factors that affect the local assistance projections over the Financial Plan period.

Forecast for Selected Program Measures Affecting Local Assistance						
(millions of dollars, where applicable)						
	Actual	Forecast				
	2006-07	2007-08	2008-09	2009-10	2010-11	2011-12
<b>Medicaid</b>						
Medicaid Enrollment	3,608,075	3,581,311	3,665,541	3,746,047	3,994,438	4,149,548
Family Health Plus Enrollment	514,058	525,596	545,996	563,084	605,390	605,390
Child Health Plus Enrollment	388,187	396,375	460,614	494,112	499,053	504,043
Medicaid Inflation	2.4%	2.0%	2.9%	3.0%	3.0%	3.0%
Medicaid Utilization	1.1%	-3.3%	1.6%	3.3%	3.7%	4.0%
State Takeover of County/NYC Costs (Total)	\$622	\$677	\$939	\$1,198	\$1,539	\$1,920
- Family Health Plus	\$424	\$442	\$453	\$467	\$484	\$484
- Medicaid*	\$198	\$235	\$486	\$731	\$1,055	\$1,436
<b>Education</b>						
School Aid (School Year)	\$17,800	\$19,600	\$21,000	\$23,100	\$25,600	\$27,200
K-12 Enrollment	2,783,153	2,758,856	2,758,856	2,758,856	2,758,856	2,758,856
Public Higher Education Enrollment (FTEs)	499,082	512,362	518,431	525,408	529,133	528,780
TAP Recipients	320,930	312,779	309,436	310,936	312,686	314,861
<b>Welfare</b>						
Family Assistance Caseload	402,348	348,901	339,686	344,328	331,340	329,517
Single Adult/No Children Caseload	158,513	158,576	166,597	172,876	179,708	186,053
<b>Mental Hygiene</b>						
Mental Hygiene Community Beds	81,737	85,058	87,731	90,520	92,614	95,332

### Medicaid

General Fund spending for Medicaid is expected to grow by \$1.5 billion in 2009-10, \$1.1 billion in 2010-11, and another \$1.3 billion in 2011-12.

Medicaid growth results, in part, from the combination of projected increases in recipients, service utilization, and medical care cost inflation that impact nearly all categories of service (i.e., hospitals, nursing homes, etc.). The State cap on local Medicaid costs and takeover of local FHP costs, which are included in base categories of service, are projected to increase spending by \$262 million in 2008-09, \$259 million in 2009-10, and \$341 million in 2010-11. In 2009-10, an extra weekly payment to providers adds \$300 million in base spending across all categories of service. The remaining growth is primarily attributed to the available resources in other State Funds which are used to lower General Fund costs, including certain nursing home delinquent payor assessment collections in 2007-08 that are not expected to recur in 2008-09, and lower levels of HCRA financing beginning in 2008-09.

The average number of Medicaid recipients is expected to grow to 3.7 million in 2008-09, an increase of 2.4 percent from the estimated 2007-08 caseload of more than 3.6 million. FHP enrollment is estimated to grow to approximately 546,000 individuals in 2008-09, an increase of 3.8 percent over projected 2007-08 enrollment of almost 526,000 individuals.

## School Aid

Multi-Year School Aid Projection -- School-Year Basis (millions of dollars)									
	2007-08	2008-09	Annual \$ Change	2009-10	Annual \$ Change	2010-11	Annual \$ Change	2011-12	Annual \$ Change
Foundation Aid	13,644	14,543	899	16,000	1,457	17,900	1,900	18,800	900
Universal Pre-kindergarten	373	452	79	542	90	632	90	657	25
High Tax Aid	100	100	0	100	0	100	0	100	0
Supplemental Public Excess Cost	20	0	(20)	0	0	0	0	0	0
New York City Academic Achievement Grant	89	179	90	179	0	179	0	179	0
EXCEL Building Aid	70	135	65	179	44	191	12	191	0
Expense-Based Aids (Building, Transportation, High Cost and Private Excess Cost, BOCES)	4,634	4,961	327	5,400	439	5,800	400	6,300	500
Other Aid Categories/Initiatives	628	645	17	700	55	798	98	973	175
<b>Total School Aid</b>	<b>19,558</b>	<b>21,015</b>	<b>1,457</b>	<b>23,100</b>	<b>2,085</b>	<b>25,600</b>	<b>2,500</b>	<b>27,200</b>	<b>1,600</b>
<b>Cumulative Increase since 2006-07</b>	<b>1,723</b>		<b>3,180</b>		<b>5,265</b>		<b>7,765</b>		<b>9,365</b>

On a school-year basis, School Aid is projected at \$23.1 billion in 2009-10, \$25.6 billion in 2010-11, and \$27.2 billion in 2011-12. On a State fiscal-year basis, General Fund School Aid spending is projected to grow by \$1.8 billion in 2009-10, \$2.0 billion in 2010-11, and \$1.5 billion in 2011-12. Outside the General Fund, revenues from core lottery sales are projected to increase by \$161 million in 2009-10, \$74 million in 2010-11, and \$108 million in 2011-12 (totaling \$2.5 billion in 2011-12). Revenues from VLTs are projected to total \$764 million in 2008-09, then decrease by \$120 million in 2009-10 following the expected one-time receipt of \$250 million in revenues during 2008-09 for the sale of development rights. They are then projected to increase by \$243 million in 2010-11 and \$229 million in 2011-12. VLTs are expected to total \$1.1 billion in 2011-12. The VLT estimates assume the start of operations at Aqueduct in 2009-10 and Belmont in 2010-11.

Projected School Aid increases are primarily due to increases in Foundation Aid; Universal Pre-kindergarten expansion; and increases in expense-based aids such as building aid and transportation aid.

## Mental Hygiene

Mental Hygiene spending is projected at \$2.1 billion in 2009-10, \$2.3 billion in 2010-11, and \$2.5 billion in 2011-12. Sources of growth include: increases in the projected State share of Medicaid costs; cost-of-living increases, including a proposed three-year extension of the human services COLA; and projected expansions of the various mental hygiene service systems including the OMH's children's services; increases in the NYS-CARES program and in the development of children's beds in OMRDD to bring children back from out-of-state placements; the NY/NY III Supportive Housing agreement and community bed expansion in OMH; and several new chemical dependence treatment and prevention initiatives in OASAS.

## Children and Family Services

Children and Family Services local assistance spending is projected to grow by \$133 million in 2009-10, \$172 million in 2010-11 and \$148 million in 2011-12. The increases are driven primarily by expected growth in local child welfare claims, the implementation of the OCFS Medicaid waiver, and cost-of-living increases for human services providers through 2011-12.

## Temporary and Disability Assistance

Spending is projected at \$1.2 billion in 2009-10, an increase of \$73 million from 2008-09, and is expected at the same level through 2011-12. Although public assistance caseload is projected to increase marginally between 2009-10 and 2011-12, this spending is countered by an increase in Federal offsets, which decrease the level of General Fund resources needed.

### Other Local Assistance

All other local assistance programs total \$4.7 billion in 2009-10, an increase of \$444 million over 2008-09 levels. This growth in spending primarily reflects increases in local government assistance including a full restoration of unrestricted aid to New York City (\$164 million), and additional AIM funding (\$75 million), various public health program costs, and other education aid.

### State Operations

Forecast of Selected Program Measures Affecting State Operations						
	Actual			Forecast		
	2006-07	2007-08	2008-09	2009-10	2010-11	2011-12
<b>State Operations</b>						
Prison Population (Corrections)	63,577	62,800	62,200	61,800	61,600	61,400
Negotiated Salary Increases <sup>(1)</sup>	3.0%	3.0%	3.0%	3.0%	4.0%	0.0%
Personal Service Inflation	0.8%	1.0%	1.0%	1.0%	1.0%	1.0%
State Workforce	195,526	199,424	201,270	202,388	202,388	202,388

(1) Negotiated salary increases reflect recent labor settlements included in the Financial Plan estimates

State Operations spending is expected to total \$9.2 billion in 2009-10, an annual increase of \$373 million (4.2 percent). In 2010-11, spending is projected to grow by another \$544 million (5.9 percent) to a total of \$9.8 billion, followed by another \$266 million (2.7 percent) for a total of \$10.0 billion in 2011-12. The personal service portion of these increases reflects the impact of the settled labor contracts; salary adjustments for performance advances, longevity payments and promotions; and increased staffing levels, primarily in the Judiciary and Mental Hygiene. Inflationary increases for non-personal service costs result in higher spending in all years. Additional growth is driven by spending for ongoing initiatives, including the civil commitment program for sexual offenders, and medical and pharmacy costs in the areas of mental hygiene and corrections.

The agencies experiencing the most significant personal service and non-personal service growth are depicted in the charts below, followed by brief descriptions.

### Personal Service

General Fund - Personal Service (millions of dollars)							
	2008-09	2009-10	Annual \$		Annual \$		Annual \$
			Change	2010-11	Change	2011-12	Change
<b>Total</b>	<b>6,434</b>	<b>6,680</b>	<b>246</b>	<b>7,114</b>	<b>434</b>	<b>7,293</b>	<b>179</b>
Collective Bargaining	336	510	174	756	246	756	0
Correctional Services	1,804	1,821	17	1,847	26	1,866	19
Judiciary	1,498	1,511	13	1,640	129	1,777	137
Environmental Conservation	99	107	8	107	0	107	0
All Other	2,697	2,731	34	2,764	33	2,787	23

- Collective Bargaining:** Reflects the impact of settled labor negotiations which provide a 3 percent salary increase each year beginning in 2007-08 and a 4 percent increase in the final year (2010-11). The settled unions represent roughly one-half of total costs.

- **Correctional Services:** Growth is attributable primarily to the Sex Offender Management and Treatment Act and the restricted use of special housing units for mentally ill inmates, which are expected to result in an increased need for correction officers, thus driving higher workforce levels and costs.
- **Judiciary:** Reflects Office of Court Administration (OCA) projections for non-judicial OCA employees, as well as the annualization of prior-year Judiciary actions, including increasing the number of full-time judges and adding Court of Claims and Family Judges.
- **Environmental Conservation:** Out-year General Fund personal service increases stem from the continued impact of the Administrative Law Enforcement Settlement (ALES) and out-year impacts of 2008-09 Executive Budget recommendations.

**Non-Personal Service**

General Fund - Non-Personal Service (millions of dollars)							
	2008-09	2009-10	Annual \$ Change	20010-11	Annual \$ Change	2011-12	Annual \$ Change
<b>Total</b>	<b>2,429</b>	<b>2,556</b>	<b>127</b>	<b>2,666</b>	<b>110</b>	<b>2,753</b>	<b>87</b>
Correctional Services	627	660	33	698	38	741	43
State Police	56	78	22	77	(1)	77	0
Public Health	127	146	19	165	19	169	4
Temporary and Disability Assistance	37	55	18	56	1	59	3
State University	443	453	10	471	18	491	20
All Other	1,139	1,164	25	1,199	35	1,216	17

- **Correctional Services:** Growth is primarily driven by the escalating costs of food, fuel, utilities, and providing health care services and prescription drugs to inmates.
- **State Police:** Spending growth reflects costs previously supported by cellular surcharge revenues in other State funds that will be supported by General Fund revenues in 2009-10.
- **Public Health:** Growth is largely driven by the annualization in the Executive Budget recommendation providing funding for the State to directly enroll individuals into Medicaid, Child Health Plus and Family Health Plus.
- **Temporary and Disability Assistance:** Spending will increase in 2009-10 as one-time actions, including Federal revenue maximization and bonding of software development costs, do not recur.
- **State University:** Primarily reflects funding for inflationary increases in non-personal service at SUNY.



**General State Charges**

Forecast of Selected Program Measures Affecting General State Charges						
	Actual	Forecast				
	2006-07	2007-08	2008-09	2009-10	2010-11	2011-12
<b>General State Charges</b>						
Pension Contribution Rate as % of Salary	10.2%	9.7%	8.8%	9.0%	9.0%	9.3%
Employee/Retiree Health Insurance Growth Rates	10.3%	5.5%	5.5%	9.5%	9.5%	9.5%

General State Charges are projected to total \$3.8 billion in 2009-10, \$4.1 billion in 2010-11 and \$4.4 billion in 2011-12. The annual increases are due mainly to anticipated cost increases in pensions and health insurance for State employees and retirees. Additional growth is projected in 2009-10 resulting from the Medicaid adjustment transaction described earlier.

The State’s pension contribution rate to the New York State and Local Retirement System, which is 8.8 percent of payroll for 2008-09, is expected to increase to 9.0 percent for 2009-10 and 2010-11 and to 9.3 percent in 2011-12. Pension costs in 2009-10 are projected to total \$1.3 billion, an increase of \$71 million over 2008-09 due to projected growth in the salary base. In 2010-11, pension costs are expected to remain virtually unchanged. In 2011-12, they are expected to increase by \$57 million due to an anticipated increase in the State contribution rate.

Forecast of New York State Employee Health Insurance Costs (millions of dollars)			
Health Insurance			
Year	Active Employees	Retirees	Total State
2006-07	1,518	913	2,431
2007-08	1,572	992	2,564
2008-09	1,652	1,039	2,691
2009-10	1,790	1,129	2,919
2010-11	1,950	1,233	3,183
2011-12	2,127	1,347	3,474

All numbers reflect the cost of health insurance for General State Charges (Executive and Legislative branches) and the Office of Court Administration.

Spending for employee and retiree health care costs is expected to increase by \$228 million in 2009-10, \$264 million in 2010-11, and another \$291 million in 2011-12 and assumes an average annual premium increase of roughly 9.5 percent. Health insurance is projected at \$2.9 billion in 2009-10 (\$1.8 billion for active employees and \$1.1 billion for retired employees), \$3.2 billion in 2010-11 (\$2.0 billion for active employees and \$1.2 billion for retired employees) and \$3.4 billion in 2011-12 (\$2.1 billion for active employees and \$1.3 billion for retired employees).

See discussion of the Governmental Accounting Standards Board (GASB) 45, later in this AIS Update under the “Special Considerations” section, for the valuation of future State health insurance costs for State employees.

**Transfers to Other Funds**

Out-Year Disbursement Projections - Transfers to Other Funds (millions of dollars)							
	2008-09	2009-10	Annual Change	2010-11	Annual Change	2011-12	Annual Change
<b>Transfers to Other Funds:</b>	<b>2,883</b>	<b>3,112</b>	<b>229</b>	<b>3,481</b>	<b>369</b>	<b>3,982</b>	<b>501</b>
Debt Service	1,692	1,680	(12)	1,706	26	1,673	(33)
Capital Projects	366	574	208	930	356	997	67
Dedicated Highway and Bridge Trust Fund	119	212	93	586	374	689	103
All Other Capital	247	362	115	344	(18)	308	(36)
All Other Transfers	825	858	33	845	(13)	1,312	467
Medicaid Payments for State Facility Patients	174	174	0	174	0	174	0
Judiciary Funds	156	167	11	177	10	184	7
HCRA	0	0	0	0	0	464	464
SUNY- Hospital Operations	141	159	18	167	8	167	0
Banking Services	63	63	0	63	0	63	0
Empire State Stem Cell Trust Fund	50	35	(15)	0	(35)	0	0
Statewide Financial System	6	25	19	30	5	25	(5)
All Other	235	235	0	234	(1)	235	1

In 2009-10, transfers to other funds are estimated at \$3.1 billion, an increase of \$229 million over 2008-09. This increase includes potential transfers to the Dedicated Highway and Bridge Trust Fund aimed at reducing fund gaps and an increase in other capital transfers of \$115 million.

All other transfers are expected to increase by \$33 million from 2008-09. The most significant changes include an increase in the State's SUNY subsidy to hospitals and a decline in General Fund transfers to support stem cell research, as support is transitioned from the General Fund to the Health Care Resources Fund beginning in 2009-10.

In 2010-11, transfers to other funds are expected to increase by \$369 million. This reflects expected growth in General Fund support to the Dedicated Highway and Bridge Trust Fund, partially offset by the shift in stem cell research support described above. In 2011-12 transfers are expected to increase by \$501 million, mainly to provide subsidies to HCRA and the Dedicated Highway and Bridge Trust Fund.

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## **FINANCIAL PLAN RESERVES AND RISKS**

### **Reserves**

In January 2007, the State created a new statutory Rainy Day Reserve that has an authorized balance of 3 percent of General Fund spending. The new Rainy Day Reserve may be used to respond to an economic downturn or catastrophic event. The State plans to make its first deposit of \$175 million by the end of 2007-08. When combined with the existing Tax Stabilization Reserve, which has an authorized balance of 2 percent of General Fund spending and can be used only to cover unforeseen year-end deficits, the State's rainy day reserve authorization now totals 5 percent of General Fund spending.

The State projects that General Fund reserves will total \$2.2 billion at the end of 2008-09, with \$1.2 billion in undesignated reserves available to deal with unforeseen contingencies and \$1.0 billion designated for subsequent use.

The \$1.2 billion of undesignated reserves includes a balance of \$1 billion in the Tax Stabilization Reserve, \$175 million in the new Rainy Day Reserve, and \$21 million in the Contingency Reserve Fund for litigation risks.

The designated reserves consist of \$708 million set aside for potential labor settlements (after the use of \$477 million for existing settlements) and \$291 million in the Community Projects Fund to finance existing initiatives.

Aside from the amounts noted above, the 2008-09 Financial Plan does not have specific reserves to cover potential costs that could materialize as a result of Federal disallowances or other Federal actions that could adversely affect the State's projections of receipts and disbursements.

### **Risks**

Many complex political, social, and economic forces influence the State's economy and finances. Such forces may affect the State Financial Plan unpredictably from fiscal year to fiscal year. For example, the Financial Plan is necessarily based on forecasts of national and State economic activity. Economic forecasts have frequently failed to accurately predict the timing and magnitude of specific and cyclical changes to the national and State economies. The Financial Plan also relies on estimates and assumptions concerning Federal aid, law changes, and audit activity.

In any year, the Financial Plan is subject to risks that, if they were to materialize, could affect operating results. The most significant current risks include the following:

#### ***Risks to the Economic Forecast***

At the national level, the DOB outlook calls for a slowdown in growth for much of 2008 but does not anticipate a recession at this time. However, there are a number of risks to the forecast. Larger financial sector write-downs associated with the subprime mortgage debacle could result in a more severe credit situation than anticipated and result in lower business investment in plant and equipment than projected. Should the housing market contraction be even deeper than reflected in the current forecast, residential investment could take even longer to recover. Moreover, if housing prices fall further than anticipated, the rate of foreclosure could jump even higher than expected, impacting both construction spending and household net worth, which in turn could result in less consumption spending than anticipated. A resurgence in the growth in energy and food prices could serve to disrupt inflation expectations and result in even higher inflation than expected. That risk could be compounded by lower productivity growth or a weaker dollar than

currently projected. Higher inflation, in turn, would further impinge upon the Federal Reserve's ability to stimulate the economy by lowering interest rates. Higher interest rates could result in weaker equity prices and further delay the recovery of the financial sector from the subprime mortgage problem. On the other hand, lower energy prices or stronger global growth than anticipated could result in stronger economic growth than is reflected in the forecast.

All of the risks to the U.S. forecast apply to the State forecast as well, although as the nation's financial capital, the current credit tightening poses a particularly large degree of uncertainty for New York. Although the failure of a major Wall Street institution is not anticipated and the large volume of write-downs has been revealing, the full extent of the losses associated with the subprime mortgage problem remains to be seen. Higher losses than anticipated could result in even lower bonuses than projected, reducing household spending. Should the State's commercial real estate market cool more rapidly than anticipated, taxable capital gains realizations could be negatively affected. These effects could ripple through the economy, depressing both employment and wage growth. In contrast, should the national and world economies grow faster than expected, a stronger upturn in stock prices, along with even stronger activity in mergers and acquisitions and other Wall Street activities, could result in higher wage and bonuses growth than projected for 2008 and the 2008-09 bonus season.

### **Labor Settlements**

The State has reached tentative labor settlements with three labor unions, the Civil Service Employees Association, United University Professions (UUP), and District Council 37, and will extend comparable changes in the pay and benefits to "management/confidential" employees. Under terms of the tentative four-year contracts, which run from April 2, 2007 through April 1, 2011 (July 2, 2007 through July 1, 2011 for UUP), employees will receive pay increases of 3 percent annually in 2007-08, 2008-09, and 2009-10 and 4 percent in 2010-11. The Civil Service Employees Association ratified its contract on January 3, 2008. The United University Professions and District Council 37 are expected to vote on their contracts before the end of the current State fiscal year.

The State's Financial Plan funds the costs of these tentative contract agreements in 2007-08 and 2008-09 through the use of \$476 million of the \$1.18 billion in existing reserves set aside for this purpose. DOB estimates the General Fund costs of the tentative agreements at \$140 million in the current year, \$336 million in 2008-09, \$510 million in 2009-10, and \$756 million in both 2010-11 and 2011-12. The current Financial Plan includes these costs.

The unions representing uniformed officers (i.e., Police Benevolent Association, New York State Correctional Officers and Police Benevolent Association) and the Public Employees Federation have not reached settlements with the State at this time. DOB estimates that if all the unsettled unions were to agree to the same terms that have been ratified by the Civil Service Employees Association, it would result in added costs of \$144 million in 2007-08, \$303 million in 2008-09, \$444 million in 2009-10, and \$636 million in both 2010-11 and 2011-12. The earliest any costs for these contracts could be paid would be in 2008-09. These costs are not included in the current Financial Plan spending forecast, but a reserve is set aside to partially fund them. The State currently has \$708 million in labor reserves remaining (i.e., not programmed in the Financial Plan) to help finance the costs of potential new settlements, which is sufficient to cover all costs of a Civil Service Employees Association-type settlement through 2008-09, and all but \$183 million of the \$444 million of potential costs in 2009-10.

### **School Supportive Health Services**

The Office of the Inspector General (OIG) of the United States Department of Health and Human Services is conducting six audits of aspects of New York State's School Supportive Health Services program with regard to Medicaid reimbursement. The audits cover \$1.4 billion in claims submitted between 1990 and

2001. To date, OIG has issued four final audit reports, which cover claims submitted by upstate and New York City school districts for speech pathology and transportation services. The final audits recommend that the Centers for Medicare and Medicaid Services (CMS) disallow \$173 million of the \$362 million in claims for upstate speech pathology services, \$17 million of \$72 million for upstate transportation services, \$436 million of the \$551 million in claims submitted for New York City speech pathology services, and \$96 million of the \$123 million for New York City transportation services. New York State disagrees with the audit findings on several grounds and has requested that they be withdrawn. If the recommended disallowances are not withdrawn, the State expects to appeal.

While CMS has not taken any action with regard to the disallowances recommended by OIG, CMS is deferring 25 percent of New York City claims and 9.7 percent of claims submitted by the rest of the State, pending completion of the audits.

### ***Proposed Federal Rule on Medicaid Funding***

On May 25, 2007, CMS issued a final rule that, if implemented, would significantly curtail Federal Medicaid funding to public hospitals (including New York City's Health and Hospital Corporation (HHC)) and programs operated by both the State OMRDD and the State OMH.

The rule seeks to restrict State access to Federal Medicaid resources by changing the upper payment limit for certain rates to actual facility reported costs. It is estimated that this rule could result in a loss of \$350 million annually in Federal funds for HHC and potentially larger losses in aid for the State Mental Hygiene System.

On May 23, 2007, CMS issued another rule that would eliminate Medicaid funding for graduate medical education (GME). The proposed rule clarifies that costs and payments associated with GME programs are not expenditures of Medicaid for which Federal reimbursement is available. This rule could result in a Financial Plan impact of up to \$600 million since the State would be legally obligated to pay the lost non-Federal share.

The states affected by these regulations are challenging such adoption on the basis that CMS is overstepping its authority and ignoring the intent of Congress. As a result, Congress passed a one-year moratorium barring implementation of these proposed rule changes which expires on May 29, 2008.

CMS has proposed other regulations that could pose a risk to the State's Financial Plan beyond the moratorium. On May 23, 2007, CMS proposed changes to the rules that regulate State taxation of healthcare entities. It is anticipated that this rule could be finalized shortly. The proposal would essentially undo current authorized State flexibility and render a tax invalid if there is any "linkage" between the tax and a Medicaid payment. The State currently uses a substantial amount of provider tax receipts to finance various healthcare programs that serve the State's most vulnerable populations. While the State strongly believes that our imposed taxes are in full compliance, the vagueness of the new rules provides no assurance that these funding streams are adequately protected.

Further, CMS proposes to restrict Medicaid reimbursement for hospital outpatient services and restrict coverage to rehabilitative services, which could pose a risk to the Financial Plan and result in hundreds of millions in lost Federal Share. However, the State argues that the proposed regulation regarding outpatient services is in direct violation of the current moratorium.

The State is actively lobbying the Federal government to be held harmless, either through an extension/modification of the current moratorium or through other administrative or statutory means. The State continues to believe that these risks will be minimized and not realized.

## FUND BALANCES AND CASH FLOW FORECAST

### General Fund

General Fund Estimated Closing Balance (millions of dollars)			
	2007-08	2008-09	Change
<b>Projected Year-End Fund Balance</b>	<b>2,626</b>	<b>2,226</b>	<b>(400)</b>
<u>Undesignated Reserves</u>	1,227	1,227	0
Tax Stabilization Reserve Fund	1,031	1,031	0
Rainy Day Reserve Fund	175	175	0
Contingency Reserve Fund	21	21	0
<u>Designated Reserves</u>	1,399	999	(400)
Labor Settlement Reserve/Likely Risks	1,045	708	(337)
Community Projects Fund	354	291	(63)

DOB projects the State will end the 2008-09 fiscal year with a General Fund balance of \$2.2 billion if the Legislature enacts the Executive Budget recommendations in their entirety. The balance consists of \$1.2 billion in undesignated reserves and \$1.0 billion in reserves designated to finance existing or planned commitments, including potential new labor settlements. The projected closing balance is \$400 million below the level estimated for 2007-08, which primarily reflects the partial use of planned reserves set aside for collective bargaining.

The undesignated reserves include \$1.0 billion in the State's Tax Stabilization Reserve, \$175 million in the new Rainy Day Reserve after an initial deposit planned in 2007-08, and \$21 million in the Contingency Reserve Fund for litigation risks. The new Rainy Day Reserve is authorized to have a maximum balance of 3 percent of General Fund spending and may be used to respond to an economic downturn or catastrophic event.

The designated reserves include \$291 million in the Community Projects Fund to finance existing legislative initiatives, and \$708 million remaining from prior-year reserves designated for potential collective bargaining agreements and Financial Plan risks.

**State Operating Funds**

<b>State Operating Funds Estimated Closing Balance</b> (millions of dollars)			
	<u>2007-08</u>	<u>2008-09</u>	<u>Change</u>
<b>Projected Year-End Fund Balance</b>	<b>5,754</b>	<b>4,892</b>	<b>(862)</b>
General Fund	2,626	2,226	(400)
Special Revenue Funds	2,850	2,359	(491)
Miscellaneous Special Revenue	898	639	(259)
<i>Industry Assessments</i>	152	138	(14)
<i>Health and Social Welfare</i>	241	134	(107)
<i>General Government</i>	244	165	(79)
<i>All Other</i>	261	202	(59)
State University Income	644	636	(8)
Mass Transportation Operating Assistance	407	199	(208)
Health Care Resources Fund	515	453	(62)
Lottery Fund	101	96	(5)
All Other	285	336	51
Debt Service Funds	278	307	29

The combined balances in State Operating Funds are projected to total \$4.9 billion in 2008-09, a decrease of \$864 million from the level estimated for 2007-08. The balances held in State Special Revenue Funds include moneys designated to finance existing or planned commitments, or funds that are restricted or dedicated for specified statutory purposes. The largest balances in the State Special Revenue Funds include moneys on hand to finance future costs for State University programs, operating assistance for transportation programs, various health care programs financed from the Health Care Resources Fund, and lottery revenues used for School Aid. The remaining fund balances are held in numerous funds, primarily the Miscellaneous Special Revenue Fund, and accounts that support a variety of programs including industry regulation, public health, general government, and public safety. See the Financial Plan tables for a comprehensive list of balances for All Governmental Funds and accounts.

**Monthly Cash Flow Forecast**

In 2008-09, the General Fund is projected to have quarterly-ending balances of \$2.8 billion in June 2008, \$3.9 billion in September 2008, \$1.4 billion in December 2008, and \$2.2 billion at the end of March 2009. The lowest projected month-end cash flow balance is \$893 million in November 2008. The 2008-09 General Fund cash flow estimates assume on time enactment of all Executive Budget recommendations.

The Office of the State Comptroller (OSC) invests General Fund moneys, bond proceeds, and other funds not immediately required to make payments through the Short-Term Investment Pool (STIP), which is comprised of joint custody funds (Governmental Funds, Internal Service Funds, Enterprise Funds and Private Purpose Trust Funds), as well as several sole custody funds including the Tobacco Settlement Fund.

OSC is authorized to make short-term loans from STIP to cover temporary cash shortfalls in certain funds and accounts resulting from the timing of receipts and disbursements. The Legislature authorizes the funds and accounts that may receive loans each year, based on legislation submitted with the Executive Budget. Loans may be granted only for amounts that the Director of the Budget certifies are “receivable on account” or can be repaid from the current operating receipts of the fund (i.e., loans cannot be granted in expectation of future revenue enhancements).

## **GAAP-BASIS FINANCIAL PLANS**

In addition to the cash-basis Financial Plans, DOB prepares the General Fund and All Funds Financial Plans on a Generally Accepted Accounting Principles (GAAP)-basis in accordance with the Governmental Accounting Standards Board (GASB) regulations. Tables summarizing the GAAP Financial Plan and comparing the cash basis and GAAP basis General Fund Financial Plans are provided at the end of this AIS Update. The GAAP projections are based on the accounting principles applied by the State Comptroller in the financial statements issued for 2006-07.

In 2007-08, the General Fund GAAP Financial Plan reflects total revenues of \$44.0 billion, total expenditures of \$55.0 billion, and net other financing sources of \$9.9 billion, resulting in an operating deficit of roughly \$1.1 billion. The accumulated surplus at the end of 2007-08 is projected to total \$1.2 billion. The operating results primarily reflect the impact of enacted tax reductions and economic conditions on revenue accruals and a partial use of reserves to support 2007-08 operations.

In 2008-09, the General Fund GAAP Financial Plan shows total revenues of \$47.4 billion, total expenditures of \$60.8 billion, and net other financing sources of \$12.9 billion, resulting in an operating deficit of \$521 million and a projected accumulated surplus of \$712 million. These changes are due primarily to the use of a portion of reserves to support 2008-09 operations.

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## **SPECIAL CONSIDERATIONS**

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Many complex political, social, and economic forces influence the State's economy and finances. Such forces may affect the State Financial Plan unpredictably from fiscal year to fiscal year. For example, the Financial Plan is necessarily based on forecasts of national and State economic activity. Economic forecasts have frequently failed to accurately predict the timing and magnitude of specific and cyclical changes to the national and State economies. For a discussion of the DOB economic forecasts, see the section entitled "Economic Forecast" in this AIS Update. The Financial Plan also relies on estimates and assumptions concerning Federal aid, law changes, and audit activity. For a discussion of additional risks to the Financial Plan, including revenue and economic risks, see the sections entitled "Financial Plan Reserves and Risks" and "Litigation" in this AIS Update.

### *Financial Plan Update*

The Governor is expected to submit amendments to his Executive Budget by February 12, 2008, as authorized by law. At that time, the DOB will issue a revised update to the Current Financial Plan that reflects the fiscal impact of any amendments, as well as updated economic, revenue, and spending forecasts through January 2008. DOB is currently evaluating the potential Financial Plan impact of recent financial market events, and the economic data, tax collection information, and other data that have become available. As a result, the DOB expects to issue a Supplement to this AIS Update in February 2008 that will reflect potential updated forecasts, as well as the fiscal impact of the Governor's amendments.

### *Recent Events in the Municipal Bond Market*

The State is monitoring events in the municipal bond market related to the impact that actual and potential credit rating downgrades to certain bond insurers is having on variable rate debt, as well as changes in investor demand for auction rate securities (ARS) and variable rate demand bonds (VRDBs). The resulting volatility has affected interest rates and the spreads among different variable rate products and has been a concern to governmental issuers of bonds across the country.

At this time, DOB believes that current market events are not likely to have a material adverse effect on the State's Current Financial Plan. The State has entered into interest rate exchange agreements ("swaps") (based on an index equal to 65 percent of LIBOR) that have hedged \$6 billion of its approximately \$8 billion in variable rate debt into "synthetic" fixed rate debt. In October 2007, one of the State's swap counterparties was downgraded to below AA, a level that could trigger the counterparty to comply with enhanced collateral provisions (swap agreements and State law require that collateral be posted at 102 percent of the mark-to-market value if the State is due money upon termination). No collateral is currently required to be posted on the \$323 million of swaps with this counterparty since the State is not in a positive mark-to-market position. Plans are already underway to transition these swaps to an entity that is rated AAA, which is expected to be completed within the current fiscal year.

The State is, however, paying higher costs on certain variable rate products than it is receiving under its swap agreements on certain hedged variable rate debt, and for Auction Rate Securities (ARS) in general, due in part to the events concerning bond insurers. The State is unable to predict how long the higher costs will continue but it does not expect that the additional payments will, in the aggregate, be materially adverse to the State's Current Financial Plan. Currently, overall variable rate costs are slightly below current Financial Plan projections. DOB is evaluating a range of potential options that could be taken to reduce costs, including transitioning out of ARS products.

### *Davis v. Kentucky*

On May 21, 2007, the United States Supreme Court agreed to review the decision of the Court of Appeals of Kentucky in *Davis v. Kentucky Dep't of Revenue of the Finance and Admin. Cabinet*, 197 S.W.<sup>3d</sup> 557 (Ky. App. 2006) *cert. granted* 2007 U.S. Lexis 5914 (May 21, 2007), which held that the disparate state tax treatment of interest income on obligations issued by the State of Kentucky or its political subdivisions and obligations issued by other states or their political subdivisions violated the Commerce Clause of the United States Constitution. Currently, the vast majority of states employ a tax system that provides a preferential treatment that exempts the interest income earned on in-state municipal bonds from state taxation while subjecting the interest income earned on extraterritorially-issued bonds to state taxation.

If the Kentucky decision is affirmed by the United States Supreme Court, a state, including New York State, could be required to eliminate any disparity between the tax treatment of obligations issued by such state and its political subdivisions or instrumentalities and the tax treatment of obligations issued by other states and their respective political subdivisions or instrumentalities. The Supreme Court decision could result in an estimated potential impact of up to \$200 million in claims for tax refunds arising out of income tax payments made in prior years. The preliminary estimate of the financial impact on the State of New York of discontinuing the practice of subjecting extraterritorially-issued municipal bonds to state income taxation is approximately \$70 million of lost tax revenues annually.

On Monday, November 5, 2007, the Supreme Court heard oral arguments in the *Davis* case.

### **GASBS 45**

The GAAP basis results for 2006-07 showed the State having total net assets of \$48.9 billion. The net positive asset condition is before the State reflects the impact of GASBS 45 "Accounting and Financial Reporting by Employers for Post-employment Benefits Other than Pensions." GASBS 45 requires State and local governments to reflect the value of post-employment benefits, predominantly health care, for current employees and retirees beginning with the financial statements for the 2008-09 fiscal year.

The State used an independent actuarial consulting firm to calculate retiree health care liabilities. Assuming there is no pre-funding of this liability, the analysis indicates that the present value of the actuarial accrued total liability for benefits to date would be roughly \$49.7 billion, using the level percentage of projected payroll approach under the Frozen Entry Age actuarial cost method. This is the actuarial methodology recommended to be used to implement GASBS 45 by the Office of the State Comptroller. The actuarial accrued liability was calculated using a 4.155 percent annual discount rate.

The State's total unfunded liability will be disclosed in the 2008-09 basic financial statements. While the total liability is substantial, GASB rules indicate it may be amortized over a 30-year period; therefore, only the annual amortized liability above the current pay-as-you-go costs would be recognized in the financial statements. Assuming no pre-funding, the 2008-09 liability would total roughly \$3.8 billion under the Frozen Entry Age actuarial cost method amortized based on a level percent of salary, or \$2.7 billion above the current pay-as-you-go retiree costs. This difference between the State's pay-as-you-go costs and the actuarially determined annual required contribution under GASBS 45 would reduce the State's currently positive net asset condition.

GASB does not require the additional costs to be funded on the State's budgetary basis, and no funding is assumed for this purpose in the Financial Plan. On a budgetary (cash) basis, the State continues to finance these costs, along with all other employee health care expenses, on a pay-as-you-go basis. Anticipated increases in these costs are reflected in the State's multi-year Financial Plan as detailed below.

<b>History and Forecast of New York State Employee Health Insurance (millions of dollars)</b>			
<b>Health Insurance</b>			
<b>Year</b>	<b>Active Employees</b>	<b>Retirees</b>	<b>Total State</b>
<b>2002-03</b>	1,023	634	1,657
<b>2003-04</b>	1,072	729	1,801
<b>2004-05</b>	1,216	838	2,054
<b>2005-06</b>	1,331	885	2,216
<b>2006-07</b>	1,518	913	2,431
<b>2007-08</b>	1,572	992	2,564
<b>2008-09</b>	1,652	1,039	2,691
<b>2009-10</b>	1,790	1,129	2,919
<b>2010-11</b>	1,950	1,233	3,183
<b>2011-12</b>	2,127	1,347	3,474

All numbers reflect the cost of Health Insurance for General State Charges (Executive and Legislative branches) and the Office of Court Administration.

As noted, the Current Financial Plan does not assume pre-funding of the GASBS 45 liability. If such liability were pre-funded, the additional cost above the pay-as-you-go amounts would be \$2.7 billion in 2008-09. The State's Health Insurance Council, which consists of the Governor's Office of Employee Relations, Civil Service, and DOB will continue to review this matter, seek input from the State Comptroller, the legislative fiscal committees and outside parties, and provide options for consideration.

DOB's detailed GAAP Financial Plans are provided in the tables at the end of this AIS Update.

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## GAAP-Basis Results for Prior Fiscal Years

(Reprinted from August 3, 2007 Update to the AIS)

The Comptroller prepares Basic Financial Statements on a GAAP basis for governments as promulgated by GASB. The Basic Financial Statements, released in July each year, include the Statement of Net Assets and Activities, the Balance Sheet and Statement of Revenues, Expenditures and Changes in Fund Balances for the Governmental Funds, the Statements of Net Assets, Revenues, Expenses and Changes in Fund Net Assets and Cash Flows for the Enterprise Funds, the Statements of Fiduciary Net Assets and Changes in Fiduciary Net Assets and the Combining Statements of Net Assets and Activities for Discretely Presented Component Units. These statements are audited by independent certified public accountants. The Comptroller also prepares and issues a Comprehensive Annual Financial Report, which includes a financial overview, the Basic Financial Statements, other supplementary information which includes individual fund combining statements, and a statistical section. For information regarding the State's accounting and financial reporting requirements, see the section in the AIS dated May 8, 2007 entitled "State Organization—Accounting, Financial Reporting and Budgeting."

Both the Basic Financial Statements and Comprehensive Annual Financial Reports for prior fiscal years can be obtained from the Office of the State Comptroller, 110 State Street, Albany, NY 12236 or at the OSC website at [www.osc.state.ny.us](http://www.osc.state.ny.us). The following table summarizes recent governmental funds results on a GAAP basis.

### Comparison of Actual GAAP-Basis Operating Results Surplus/(Deficit) (millions of dollars)

<u>Fiscal Year Ended</u>	<u>General Fund</u>	<u>Special Revenue Funds</u>	<u>Debt Service Funds</u>	<u>Capital Projects Funds</u>	<u>All Governmental Funds</u>	<u>Accum. General Fund Surplus/(Deficit)</u>
March 31, 2007	202	(840)	92	501	(45)	2,384
March 31, 2006	1,636	3,142	(664)	(265)	3,849	2,182
March 31, 2005	827	833	361	89	2,110	546

Beginning with the fiscal year ended March 31, 2003, statements have been prepared in accordance with GASBS 34. GASBS 34 has significantly affected the accounting and financial reporting for all state and local governments. The financial reporting model redefined the financial reporting model by changing its focus to major funds, rather than fund types, requiring a new section called management discussion and analysis (the "MD&A"), and containing new government-wide financial statements which includes all revenues and all costs of providing services each year. The new Basic Financial Statements and the MD&A are issued in place of the general purpose financial statements. The new statements also report on all current assets and liabilities and also long-term assets and liabilities, such as capital assets, including infrastructure (e.g., roads and bridges).

### Summary of Net Assets (millions of dollars)

<u>Fiscal Year Ended</u>	<u>Governmental Activities</u>	<u>Business-Type Activities</u>	<u>Total Primary Government</u>
March 31, 2007	45,327	3,599	48,926
March 31, 2006	45,997	3,136	49,133
March 31, 2005	41,190	2,645	43,835

## State Organization

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(Reprinted from November 15, 2007 Update to the AIS)

### State Retirement Systems

#### General

The New York State and Local Retirement Systems (the "Systems") provide coverage for public employees of the State and its localities (except employees of New York City and teachers, who are covered by separate plans). The Systems comprise the New York State and Local Employees' Retirement System and the New York State and Local Police and Fire Retirement System. The Comptroller is the administrative head of the Systems. State employees made up about 33 percent of the membership during the 2006-07 fiscal year. There were 3,009 other public employers participating in the Systems, including all cities and counties (except New York City), most towns, villages and school districts (with respect to non-teaching employees) and a large number of local authorities of the State.

As of March 31, 2007, 662,633 persons were members and 350,066 pensioners or beneficiaries were receiving benefits. The State Constitution considers membership in any State pension or retirement system to be a contractual relationship, the benefits of which shall not be diminished or impaired. Members cannot be required to begin making contributions or make increased contributions beyond what was required when membership began.

#### Contributions

Funding is provided in large part by employer and employee contributions. Employers contribute on the basis of the plan or plans they provide for members. Members joining since mid-1976, other than police and fire members, are required to contribute 3 percent of their salaries for their first 10 years of membership.

Legislation enacted in May 2003 realigned the Retirement Systems billing cycle to match governments' budget cycles and also instituted a minimum annual payment. The employer contribution for a given fiscal year will be based on the value of the pension fund and its liabilities on the prior April 1. In addition, employers are required to make a minimum contribution of at least 4.5 percent of payroll every year.

The State paid, in full, its employer contributions for the fiscal year ending March 31, 2008. The payment of \$1,032.7 million was paid on June 1, 2007. This amount included the Judiciary bill and the amortization payments for the 2005 and 2006 bills.

The State bill for the fiscal year ending March 31, 2009 is estimated to be \$1,087.8 million, assuming a payment date of September 1, 2008.

#### Assets and Liabilities

Assets are held exclusively for the benefit of members, pensioners and beneficiaries. Investments for the Systems are made by the Comptroller as trustee of the Common Retirement Fund, a pooled investment vehicle. OSC reports that the net assets available for benefits as of March 31, 2007 were \$156.6 billion (including \$2.7 billion in receivables), an increase of \$14.0 billion or 9.8 percent from the 2005-06 level of \$142.6 billion, reflecting, in large part, equity market performance. OSC reports that the present value of anticipated benefits for current members, retirees, and beneficiaries increased from \$153.7 billion on April 1, 2006 to \$163.1 billion (including \$61.9 billion for current retirees and beneficiaries) on April 1, 2007. The funding method used by the Systems anticipates that the net assets, plus future actuarially determined contributions, will be sufficient to pay for the anticipated benefits of current members, retirees and

beneficiaries. Actuarially determined contributions are calculated using actuarial assets and the present value of anticipated benefits. Actuarial assets differed from net assets on April 1, 2007 in that amortized cost was used instead of market value for bonds and mortgages and the non-fixed investments utilized a smoothing method which recognized 20 percent of unexpected gain for the 2007 fiscal year, 40 percent of the unexpected gain for the 2006 fiscal year and 60 percent of the unexpected gain for the 2005 fiscal year. Actuarial assets increased from \$132.1 billion on April 1, 2006 to \$142.6 billion on April 1, 2007. The funded ratio, as of April 1, 2006, using the entry age normal funding method, was 104%. The table that follows shows the actuarially determined contributions that have been made over the last nine years. See also "Contributions" above.

**Net Assets Available for Benefits of the  
New York State and Local Retirement Systems (1)  
(millions of dollars)**

Fiscal Year Ended		Percent Increase/ (Decrease) From Prior Year
<u>March 31</u>	<u>Total Assets(2)</u>	
1999	112,723	6.0
2000	128,889	14.3
2001	114,044	(11.5)
2002	112,725	(1.2)
2003	97,373	(13.6)
2004	120,799	24.1
2005	128,038	6.0
2006	142,620	11.4
2007	156,625	9.8

Sources: State and Local Retirement Systems.

(1) Includes relatively small amounts held under Group Life Insurance Plan. Includes some employer contribution receivables. Fiscal year ending March 31, 2007 includes approximately \$2.7 billion of receivables.

(2) Includes certain accrued employer contributions to be paid with respect to service rendered during fiscal years other than the year shown.

**Contributions and Benefits  
New York State and Local Retirement Systems  
(millions of dollars)**

Fiscal Year Ended March 31	Contributions Recorded				Total Benefits Paid(2)
	All Participating Employers(1)	Local Employers(1)	State(1)	Employees	
1999	292	156	136	400	3,570
2000	165	11	154	423	3,787
2001	215	112	103	319	4,267
2002	264	199	65	210	4,576
2003	652	378	274	219	5,030
2004	1,287	832	455	222	5,424
2005	2,965	1,877	1,088	227	5,691
2006	2,782	1,714	1,068	241	6,073
2007	2,718	1,730	988	250	6,432

(1) Includes employer premiums to Group Life Insurance Plan.

(2) Includes payments from Group Life Insurance Plan.

# Authorities and Localities

(Reprinted from November 15, 2007 Update to the AIS)

## Public Authorities

For the purposes of this disclosure, public authorities refer to certain of its public benefit corporations, created pursuant to State law. Public authorities are not subject to the constitutional restrictions on the incurrence of debt that apply to the State itself and may issue bonds and notes within the amounts and restrictions set forth in legislative authorization. The State's access to the public credit markets could be impaired and the market price of its outstanding debt may be materially and adversely affected if certain of its public authorities were to default on their respective obligations, particularly those using the financing techniques referred to as State-supported or State-related debt under the section entitled "Debt and Other Financing Activities" in this statement. As of December 31, 2006, each of the 19 public authorities below had outstanding debt of \$100 million or more, and the aggregate outstanding debt, including refunding bonds, of these public authorities was approximately \$129 billion, only a portion of which constitutes State-supported or State-related debt. The table below summarizes the outstanding debt of these public authorities.

**Outstanding Debt of Certain Public Authorities (1) (2) (3)**  
**As of December 31, 2006**  
 (millions of dollars)

<b>Public Authority</b>	<b>State- Related Conduit (4)</b>	<b>Authority Revenue Bonding</b>	<b>Other Conduit Bonding</b>	<b>Total</b>
Dormitory Authority (5)	15,319	0	18,421	<b>33,740</b>
Metropolitan Transportation Authority	2,289	14,343	0	<b>16,632</b>
Port Authority of NY & NJ	0	12,330	0	<b>12,330</b>
Thruway Authority	8,942	1,861	0	<b>10,803</b>
Housing Finance Agency	1,365	6,485	0	<b>7,850</b>
Environmental Facilities Corporation	689	6,647	250	<b>7,586</b>
Triborough Bridge and Tunnel Authority	181	7,026	0	<b>7,207</b>
Long Island Power Authority (6)	0	7,117	0	<b>7,117</b>
UDC/ESDC	5,771	457	0	<b>6,228</b>
Local Government Assistance Corporation	4,204	0	0	<b>4,204</b>
Tobacco Settlement Financing Corporation	4,084	0	0	<b>4,084</b>
Energy Research and Development Authority (6)	9	0	3,655	<b>3,664</b>
State of New York Mortgage Agency	0	2,902	0	<b>2,902</b>
Power Authority	0	2,142	0	<b>2,142</b>
Battery Park City Authority	0	1,041	0	<b>1,041</b>
Convention Center Development Corporation	0	700	0	<b>700</b>
Municipal Bond Bank Agency	484	50	0	<b>534</b>
Niagara Frontier Transportation Authority	0	185	0	<b>185</b>
United Nations Development Corporation	0	128	0	<b>128</b>
<b>TOTAL OUTSTANDING</b>	<b>43,337</b>	<b>63,414</b>	<b>22,326</b>	<b>129,077</b>

Source: Office of the State Comptroller. Debt Classifications are estimated by Budget Division.

(1) Includes only certain of the public authorities which have more than \$100 million in outstanding debt.

(2) Reflects original par amounts for bonds and financing arrangements or original gross proceeds in the case of capital appreciation bonds. Amounts outstanding do not reflect accretion of capital appreciation bonds or premiums received.

(3) Includes short-term and long-term debt.

(4) Reflects debt for which the primary repayment source is from State appropriations or assigned revenues of the State.

(5) Includes debt previously issued by New York State Medical Care Facilities Finance Agency, which was consolidated with the Dormitory Authority on September 1, 1995.

(6) Includes \$155 million in bonds issued by the New York State Energy Research and Development Authority and included in amounts reported for both NYSERDA and LIPA.

## The City of New York

The fiscal demands on the State may be affected by the fiscal condition of the City, which relies in part on State aid to balance its budget and meet its cash requirements. It is also possible that the State's finances may be affected by the ability of the City, and certain entities issuing debt for the benefit of the City, to market securities successfully in the public credit markets. The official financial disclosure of The City of New York and the financing entities issuing debt on its behalf is available by contacting Raymond J. Orlando, City Director of Investor Relations, (212) 788-5875 or contacting the City Office of Management and Budget, 75 Park Place, 6<sup>th</sup> Floor, New York, NY 10007. The State assumes no liability or responsibility for any financial information reported by The City of New York. The following table summarizes the debt of New York City.

**Debt of New York City**  
**as of June 30 of each year**  
**(millions of dollars)**

<u>Year</u>	<u>General Obligation Bonds</u>	<u>Obligations of TFA (1)</u>	<u>Obligations of MAC</u>	<u>Obligations of STAR Corp. (2)</u>	<u>Obligations of TSASC, Inc.</u>	<u>HYIC (3)</u>	<u>Other(4) Obligations</u>	<u>Treasury Obligations</u>	<u>Total</u>
1980	6,179	—	6,116	--	--	--	995	(295)	12,995
1990	13,499	—	7,122	--	--	--	1,077	(1,671)	20,027
1995	24,992	—	4,882	--	--	--	1,299	(1,243)	29,930
1996	26,627	—	4,724	--	--	--	1,394	(1,122)	31,623
1997	27,549	—	4,424	--	--	--	1,464	(391)	33,046
1998	27,310	2,150	4,066	--	--	--	1,529	(365)	34,690
1999	27,834	4,150	3,832	--	--	--	1,835	(299)	37,352
2000	27,245	6,438 (5)	3,532	--	709	--	2,065	(230)	39,759
2001	27,147	7,386	3,217	--	704	--	2,019	(168)	40,305
2002	28,465	10,489 (6)	2,880	--	740	--	2,463	(116)	44,921
2003	29,679	13,134 (7)	2,151	--	1,258	--	2,328	(64)	48,486
2004	31,378	13,364	1,758	--	1,256	--	2,561	(52)	50,265
2005	33,903	12,977	--	2,551	1,283	--	3,746	(39)	54,421
2006	35,844	12,233	--	2,470	1,334	--	3,500	--	55,381
2007	34,506	14,607	--	2,368	1,317	2,100	3,394	--	58,292

Source: Office of the State Comptroller.

(1) Includes amounts for Building Aid Revenue Bonds (BARBS), the debt service on which will be funded solely from future State Building Aid payments that are subject to appropriation by the State and have been assigned by the City of New York to the TFA.

(2) A portion of the proceeds of the Sales Tax Asset Receivable Corporation (STARC) Bonds were used to retire outstanding Municipal Assistance Corporation bonds. The debt service on STARC bonds will be funded from annual revenues to be provided by the State, subject to annual appropriation. These revenues have been assigned to the Corporation by the Mayor of The City of New York.

(3) Includes a \$100 million obligation to the MTA.

(4) Includes bonds issued by the Fiscal Year 2005 Securitization Corporation, the Industrial Development Agency and the Samurai Funding Corporation. Also included are bonds issued by the Dormitory Authority of the State of New York for education, health, and court capital projects and other long-term leases which will be repaid from revenues of the City or revenues that would otherwise be available to the City if not needed for debt service.

(5) Includes \$515 million of bond anticipation notes issued to finance the City's capital expenditures.

(6) Includes \$2.2 billion of bond anticipation notes used to finance the City's capital expenditures in the amount of \$1.2 billion and Recovery notes for costs related to and arising from events on September 11, 2001 at the World Trade Center in the amount of \$1 billion.

(7) Includes \$1.11 billion of bond anticipation notes issued to finance the City's capital expenditures.



The staffs of the Financial Control Board for the City of New York (FCB), the Office of the State Deputy Comptroller (OSDC), the City Comptroller and the Independent Budget Office, issue periodic reports on the City's financial plans. Copies of the most recent reports are available by contacting: FCB, 123 William Street, 23rd Floor, New York, NY 10038, Attention: Executive Director; OSDC, 59 Maiden Lane, 29th Floor, New York, NY 10038, Attention: Deputy Comptroller; City Comptroller, Municipal Building, 6th Floor, One Centre Street, New York, NY 10007-2341, Attention: Deputy Comptroller for Budget; and IBO, 110 William Street, 14th Floor, New York, NY 10038, Attention: Director.

## **Other Localities**

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Certain localities outside New York City have experienced financial problems and have requested and received additional State assistance during the last several State fiscal years. While a relatively infrequent practice, deficit financing has become more common in recent years. Between 2004 and 2007, the State Legislature authorized 14 bond issuances to finance local government operating deficits. The potential impact on the State of any future requests by localities for additional oversight or financial assistance is not included in the projections of the State's receipts and disbursements for the State's 2007-08 fiscal year or thereafter.

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## Litigation

(Reprinted from November 15, 2007 Update to the AIS)

### Real Property Claims

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In *Oneida Indian Nation of New York v. State of New York*, 74-CV-187 (NDNY), the alleged successors-in-interest to the historic Oneida Indian Nation seek a declaration that they hold a current possessory interest in approximately 250,000 acres of lands that the tribe sold to the State in a series of transactions that took place beginning in 1795 and ending in 1846, and ejection of the State and Madison and Oneida Counties from all publicly-held lands in the claim area. This case remained dormant while the Oneidas pursued an earlier action which sought limited relief relating to a single 1795 transaction and the parties engaged in intermittent, but unsuccessful, efforts to reach a settlement. In 1998, the United States filed a complaint in intervention in *Oneida Indian Nation of New York*. In December 1998, both the United States and the tribal plaintiffs moved for leave to amend their complaints to assert claims for 250,000 acres, including both monetary damages and ejection, to add the State as a defendant, and to certify a class made up of all individuals who currently purport to hold title within the affected 250,000 acre area. On September 25, 2000, the District Court granted the motion to amend the complaint to the extent that it sought to add the State as a defendant and to assert money damages with respect to the 250,000 acres and denied the motion to certify a class of individual landowners and to seek the remedy of ejection.

In a decision dated March 29, 2002, the District Court granted, in part, plaintiffs' motion to strike the State's defenses and counterclaims. The District Court also denied the State's motion to dismiss for failure to join indispensable parties.

Further efforts at settlement of this action failed to reach a successful outcome. While such discussions were underway, two significant decisions were rendered by the Supreme Court and the Second Circuit Court of Appeals which changed the legal landscape pertaining to ancient land claims: *City of Sherrill v. Oneida Indian Nation of New York*, 544 U.S. 197 (2005), and *Cayuga Indian Nation of New York v. Pataki*, 413 F.3d 266 (2d Cir. 2005), *cert. denied*, 126 S.Ct. 2021, 2022 (2006). Taken together, these cases have made clear that the equitable doctrines of laches, acquiescence, and impossibility can bar ancient land claims. These decisions prompted the District Court to reassess its 2002 decision, which in part had struck such defenses, and to permit the filing of a motion for summary judgment predicated on the *Sherrill* and *Cayuga* holdings. On August 11, 2006, the defendants moved for summary judgment dismissing the action, based on the defenses of laches, acquiescence, and impossibility. By order dated May 21, 2007, the District Court dismissed plaintiffs' claims to the extent that they asserted a possessory interest, but permitted plaintiffs to pursue a claim seeking the difference between the amount paid and the fair market value of the lands at the time of the transaction. The District Court certified the May 21, 2007 order for interlocutory appeal and, on July 13, 2007, the Second Circuit granted motions by both sides seeking leave to pursue interlocutory appeals of that order.

Other Indian land claims include *Cayuga Indian Nation of New York v. Cuomo, et al.*, and *Canadian St. Regis Band of Mohawk Indians, et al., v. State of New York, et al.*, both in the United States District Court for the Northern District of New York and *The Onondaga Nation v. The State of New York, et al.*

In the *Canadian St. Regis Band of Mohawk Indians* case, plaintiffs seek ejection and monetary damages with respect to their claim that approximately 15,000 acres in Franklin and St. Lawrence Counties were illegally transferred from their predecessors-in-interest. By decision dated July 28, 2003, the District Court granted, in most respects, a motion by plaintiffs to strike defenses and dismiss counterclaims contained in defendants' answers. By decision dated October 20, 2003, the District Court denied the State's motion for

reconsideration of that portion of the July 28, 2003 decision which struck a counterclaim against the United States for contribution. On February 10, 2006, after renewed efforts at settlement failed to resolve this action, and recognizing the potential significance of the *Sherrill* and *Cayuga* appeals, the District Court stayed all further proceedings in this case until 45 days after the United States Supreme Court issued a final decision in the *Cayuga Indian Nation of New York* Case. On November 6, 2006, after certiorari was denied in *Cayuga*, the defendants moved for judgment on the pleadings.

In *The Onondaga Nation v. The State of New York, et al.*, plaintiff seeks a judgment declaring that certain lands allegedly constituting the aboriginal territory of the Onondaga Nation within the State are the property of the Onondaga Nation and the Haudenosaunee, or "Six Nations Iroquois Confederacy," and that conveyances of portions of that land pursuant to treaties during the period 1788 to 1822 are null and void. The "aboriginal territory" described in the complaint consists of an area or strip of land running generally north and south from the St. Lawrence River in the north, along the east side of Lake Ontario, and south as far as the Pennsylvania border, varying in width from about 10 miles to more than 40 miles, including the area constituting the City of Syracuse. On August 15, 2006, based on *Sherrill* and *Cayuga*, the defendants moved for an order dismissing this action, based on laches.

## **West Valley Litigation**

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In *State of New York, et al. v. The United States of America, et al.*, 06-CV-810 (WDNY), the State and the New York State Energy Research and Development Authority have filed suit seeking (1) a declaration that defendants are liable under CERCLA for the State's response costs and for damages to the State's natural resources resulting from releases from the site in Cattaraugus County, New York, and a judgment reimbursing the State for these costs and damages, (2) a declaration of defendants' responsibilities under the West Valley Demonstration Project Act to decontaminate and decommission the site and for future site monitoring and maintenance, and (3) a declaration that the defendants are responsible for paying the fees for disposal of solidified high level radioactive waste at the West Valley site. The parties have agreed to stay the litigation and submit the issues in (1) and (2) to non-binding arbitration and early neutral evaluation. The parties are currently engaged in mediation.

**CASH FINANCIAL PLAN  
GENERAL FUND  
2007-2008  
(millions of dollars)**

	<u>Mid-Year</u>	<u>Change</u>	<u>Executive</u>
<b>Opening fund balance</b>	<u>3,045</u>	<u>0</u>	<u>3,045</u>
<b>Receipts:</b>			
Taxes:			
Personal income tax	22,697	38	22,735
User taxes and fees	8,506	(3)	8,503
Business taxes	6,500	(200)	6,300
Other taxes	1,102	(72)	1,030
Miscellaneous receipts	2,444	0	2,444
Federal Grants	71	0	71
Transfers from other funds:			
PIT in excess of Revenue Bond debt service	8,445	(4)	8,441
Sales tax in excess of LGAC debt service	2,305	0	2,305
Real estate taxes in excess of CW/CA debt service	636	31	667
All other	681	(8)	673
<b>Total receipts</b>	<u>53,387</u>	<u>(218)</u>	<u>53,169</u>
<b>Disbursements:</b>			
Grants to local governments	36,763	(96)	36,667
State operations	9,579	98	9,677
General State charges	4,496	(9)	4,487
Transfers to other funds:			
Debt service	1,551	6	1,557
Capital projects	112	(19)	93
Other purposes	1,168	(61)	1,107
<b>Total disbursements</b>	<u>53,669</u>	<u>(81)</u>	<u>53,588</u>
<b>Change in fund balance</b>	<u>(282)</u>	<u>(137)</u>	<u>(419)</u>
<b>Closing fund balance</b>	<u>2,763</u>	<u>(137)</u>	<u>2,626</u>
<b>Reserves</b>			
Tax Stabilization Reserve Fund	1,031	0	1,031
Statutory Rainy Day Reserve Fund	175	0	175
Contingency Reserve Fund	21	0	21
Community Projects Fund	354	0	354
Debt Reduction Reserve Fund	0	0	0
Labor Settlement Reserve/Other Risks	<u>1,182</u>	<u>(137)</u>	<u>1,045</u>
<i>Prior Year Reserves</i>	1,203	(140)	1,063
<i>Increase/(Decrease) From Current Year Operations</i>	(21)	3	(18)

Source: NYS DOB

**CASH FINANCIAL PLAN  
GENERAL FUND  
2008-2009  
(millions of dollars)**

	<u>Mid-Year</u>	<u>Change</u>	<u>Executive</u>
<b>Receipts:</b>			
Taxes:			
Personal income tax	23,939	452	24,391
User taxes and fees	8,805	27	8,832
Business taxes	6,669	585	7,254
Other taxes	1,211	(17)	1,194
Miscellaneous receipts	2,052	186	2,238
Federal Grants	55	(14)	41
Transfers from other funds:			
PIT in excess of Revenue Bond debt service	8,793	(24)	8,769
Sales tax in excess of LGAC debt service	2,327	(13)	2,314
Real estate taxes in excess of CW/CA debt service	614	1	615
All other	386	308	694
<b>Total receipts</b>	<u>54,851</u>	<u>1,491</u>	<u>56,342</u>
<b>Disbursements:</b>			
Grants to local governments	41,332	528	41,860
State operations	10,015	(1,152)	8,863
General State charges	4,808	(1,672)	3,136
Transfers to other funds:			
Debt service	1,687	5	1,692
Capital projects	452	(86)	366
Other purposes	885	(60)	825
<b>Total disbursements</b>	<u>59,179</u>	<u>(2,437)</u>	<u>56,742</u>
<b>Deposit to/(use of) Community Projects Fund</b>	<u>(63)</u>	<u>0</u>	<u>(63)</u>
<b>Deposit to/(use of) Prior Year Reserves</b>	<u>0</u>	<u>(337)</u>	<u>(337)</u>
<b>Margin</b>	<u>(4,265)</u>	<u>4,265</u>	<u>0</u>

Source: NYS DOB

**CASH FINANCIAL PLAN  
GENERAL FUND  
2009-2010  
(millions of dollars)**

	<u>Mid-Year</u>	<u>Change</u>	<u>Executive</u>
<b>Receipts:</b>			
Taxes:			
Personal income tax	25,463	434	25,897
User taxes and fees	9,150	(237)	8,913
Business taxes	6,854	962	7,816
Other taxes	1,342	(17)	1,325
Miscellaneous receipts	2,163	23	2,186
Federal Grants	55	(55)	0
Transfers from other funds:			
PIT in excess of Revenue Bond debt service	9,152	47	9,199
Sales tax in excess of LGAC debt service	2,425	(94)	2,331
Real estate taxes in excess of CW/CA debt service	595	1	596
All other	358	103	461
<b>Total receipts</b>	<u>57,557</u>	<u>1,167</u>	<u>58,724</u>
<b>Disbursements:</b>			
Grants to local governments	45,156	763	45,919
State operations	10,415	(1,179)	9,236
General State charges	5,097	(1,291)	3,806
Transfers to other funds:			
Debt service	1,676	4	1,680
Capital projects	561	13	574
Other purposes	892	(34)	858
<b>Total disbursements</b>	<u>63,797</u>	<u>(1,724)</u>	<u>62,073</u>
<b>Deposit to/(use of) Community Projects Fund</b>	<u>(62)</u>	<u>0</u>	<u>(62)</u>
<b>Margin</b>	<u>(6,178)</u>	<u>2,891</u>	<u>(3,287)</u>

Source: NYS DOB

**CASH FINANCIAL PLAN  
GENERAL FUND  
2010-2011  
(millions of dollars)**

	<u>Mid-Year</u>	<u>Change</u>	<u>Executive</u>
<b>Receipts:</b>			
Taxes:			
Personal income tax	27,203	212	27,415
User taxes and fees	9,508	(257)	9,251
Business taxes	6,889	977	7,866
Other taxes	1,425	(17)	1,408
Miscellaneous receipts	2,233	28	2,261
Federal Grants	55	(55)	0
Transfers from other funds:			
PIT in excess of Revenue Bond debt service	9,641	6	9,647
Sales tax in excess of LGAC debt service	2,534	(98)	2,436
Real estate taxes in excess of CW/CA debt service	598	1	599
All other	392	68	460
<b>Total receipts</b>	<u>60,478</u>	<u>865</u>	<u>61,343</u>
<b>Disbursements:</b>			
Grants to local governments	48,909	924	49,833
State operations	10,729	(949)	9,780
General State charges	5,386	(1,299)	4,087
Transfers to other funds:			
Debt service	1,703	3	1,706
Capital projects	966	(36)	930
Other purposes	867	(22)	845
<b>Total disbursements</b>	<u>68,560</u>	<u>(1,379)</u>	<u>67,181</u>
<b>Deposit to/(use of) Community Projects Fund</b>	<u>(151)</u>	<u>0</u>	<u>(151)</u>
<b>Margin</b>	<u>(7,931)</u>	<u>2,244</u>	<u>(5,687)</u>

Source: NYS DOB

**CASH FINANCIAL PLAN  
GENERAL FUND  
2008-2009 through 2011-2012  
(millions of dollars)**

	<u>2008-2009</u> <u>Projected</u>	<u>2009-2010</u> <u>Projected</u>	<u>2010-2011</u> <u>Projected</u>	<u>2011-2012</u> <u>Projected</u>
<b>Receipts:</b>				
Taxes:				
Personal income tax	24,391	25,897	27,415	29,315
User taxes and fees	8,832	8,913	9,251	9,620
Business taxes	7,254	7,816	7,866	8,218
Other taxes	1,194	1,325	1,408	1,498
Miscellaneous receipts	2,238	2,186	2,261	2,060
Federal grants	41	0	0	0
Transfers from other funds:				
PIT in excess of Revenue Bond debt service	8,769	9,199	9,647	10,154
Sales tax in excess of LGAC debt service	2,314	2,331	2,436	2,556
Real estate taxes in excess of CW/CA debt service	615	596	599	608
All other transfers	694	461	460	498
<b>Total receipts</b>	<u>56,342</u>	<u>58,724</u>	<u>61,343</u>	<u>64,527</u>
<b>Disbursements:</b>				
Grants to local governments	41,860	45,919	49,833	53,013
State operations	8,863	9,236	9,780	10,046
General State charges	3,136	3,806	4,087	4,386
Transfers to other funds:				
Debt service	1,692	1,680	1,706	1,673
Capital projects	366	574	930	997
Other purposes	825	858	845	1,312
<b>Total disbursements</b>	<u>56,742</u>	<u>62,073</u>	<u>67,181</u>	<u>71,427</u>
<b>Deposit to/(use of) Community Projects Fund</b>	<u>(63)</u>	<u>(62)</u>	<u>(151)</u>	<u>(79)</u>
<b>Deposit to/(use of) Prior Year Reserves</b>	<u>(337)</u>	<u>0</u>	<u>0</u>	<u>0</u>
<b>Margin</b>	<u>0</u>	<u>(3,287)</u>	<u>(5,687)</u>	<u>(6,821)</u>

Source: NYS DOB



**CASH FINANCIAL PLAN  
GENERAL FUND  
2006-2007 and 2007-2008  
(millions of dollars)**

	<u>2006-2007</u> <u>Actuals</u>	<u>2007-2008</u> <u>Current</u>	<u>Annual</u> <u>Change</u>
<b>Opening fund balance</b>	<u>3,257</u>	<u>3,045</u>	<u>(212)</u>
<b>Receipts:</b>			
Taxes:			
Personal income tax	22,939	22,735	(204)
User taxes and fees	8,186	8,503	317
Business taxes	6,468	6,300	(168)
Other taxes	1,075	1,030	(45)
Miscellaneous receipts	2,268	2,444	176
Federal Grants	151	71	(80)
Transfers from other funds:			
PIT in excess of Revenue Bond debt service	7,136	8,441	1,305
Sales tax in excess of LGAC debt service	2,093	2,305	212
Real estate taxes in excess of CW/CA debt service	753	667	(86)
All other	310	673	363
<b>Total receipts</b>	<u>51,379</u>	<u>53,169</u>	<u>1,790</u>
<b>Disbursements:</b>			
Grants to local governments	34,302	36,667	2,365
State operations	9,319	9,677	358
General State charges	4,403	4,487	84
Transfers to other funds:			
Debt service	1,906	1,557	(349)
Capital projects	389	93	(296)
Other purposes	1,272	1,107	(165)
<b>Total disbursements</b>	<u>51,591</u>	<u>53,588</u>	<u>1,997</u>
<b>Change in fund balance</b>	<u>(212)</u>	<u>(419)</u>	<u>(207)</u>
<b>Closing fund balance</b>	<u>3,045</u>	<u>2,626</u>	<u>(419)</u>
<b>Reserves</b>			
Tax Stabilization Reserve Fund	1,031	1,031	0
Statutory Rainy Day Reserve Fund	0	175	175
Contingency Reserve Fund	21	21	0
Community Projects Fund	278	354	76
Debt Reduction Reserve Fund	0	0	0
Labor Settlement Reserve/Other Risks	<u>1,715</u>	<u>1,045</u>	<u>(670)</u>
Prior Year Reserves	1,715	1,063	(652)
Increase/(Decrease) From Current Year Operations	0	(18)	(18)

Source: NYS DOB

**CASH FINANCIAL PLAN  
GENERAL FUND  
2007-2008 and 2008-2009  
(millions of dollars)**

	<u>2007-2008 Current</u>	<u>2008-2009 Recommended</u>	<u>Annual Change</u>
<b>Opening fund balance</b>	<u>3,045</u>	<u>2,626</u>	<u>(419)</u>
<b>Receipts:</b>			
Taxes:			
Personal income tax	22,735	24,391	1,656
User taxes and fees	8,503	8,832	329
Business taxes	6,300	7,254	954
Other taxes	1,030	1,194	164
Miscellaneous receipts	2,444	2,238	(206)
Federal grants	71	41	(30)
Transfers from other funds:			
PIT in excess of Revenue Bond debt service	8,441	8,769	328
Sales tax in excess of LGAC debt service	2,305	2,314	9
Real estate taxes in excess of CW/CA debt service	667	615	(52)
All other transfers	673	694	21
<b>Total receipts</b>	<u>53,169</u>	<u>56,342</u>	<u>3,173</u>
<b>Disbursements:</b>			
Grants to local governments	36,667	41,860	5,193
State operations	9,677	8,863	(814)
General State charges	4,487	3,136	(1,351)
Transfers to other funds:			0
Debt service	1,557	1,692	135
Capital projects	93	366	273
Other purposes	1,107	825	(282)
<b>Total disbursements</b>	<u>53,588</u>	<u>56,742</u>	<u>3,154</u>
<b>Change in fund balance</b>	<u>(419)</u>	<u>(400)</u>	<u>19</u>
<b>Closing fund balance</b>	<u>2,626</u>	<u>2,226</u>	<u>(400)</u>
<b>Reserves</b>			
Tax Stabilization Reserve Fund	1,031	1,031	0
Statutory Rainy Day Reserve Fund	175	175	0
Contingency Reserve Fund	21	21	0
Community Projects Fund	354	291	(63)
Labor Settlement Reserve/Other Risks	1,045	708	(337)

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Source: NYS DOB

**CURRENT STATE RECEIPTS  
GENERAL FUND  
2007-2008 and 2008-2009  
(millions of dollars)**

	<u>2007-2008 Current</u>	<u>2008-2009 Recommended</u>	<u>Annual Change</u>
<b>Personal income tax</b>	22,735	24,391	1,656
<b>User taxes and fees</b>	8,503	8,832	329
Sales and use tax	7,865	8,080	215
Cigarette and tobacco taxes	407	437	30
Motor vehicle fees	(21)	47	68
Alcoholic beverages taxes	200	220	20
Alcoholic beverage control license fees	52	48	(4)
<b>Business taxes</b>	6,300	7,254	954
Corporation franchise tax	3,575	4,138	563
Corporation and utilities tax	618	589	(29)
Insurance taxes	1,176	1,405	229
Bank tax	931	942	11
Petroleum business tax	0	180	180
<b>Other taxes</b>	1,030	1,194	164
Estate tax	1,006	1,170	164
Gift tax	0	0	0
Real property gains tax	0	0	0
Pari-mutuel taxes	23	23	0
Other taxes	1	1	0
<b>Total taxes</b>	38,568	41,671	3,103
<b>Miscellaneous receipts</b>	2,444	2,238	(206)
<b>Federal Grants</b>	71	41	(30)
<b>Total</b>	41,083	43,950	2,867

Source: NYS DOB

**CASH RECEIPTS  
GENERAL FUND  
2008-2009 THROUGH 2011-2012  
(millions of dollars)**

	<b>2008-2009 Projected</b>	<b>2009-2010 Projected</b>	<b>2010-2011 Projected</b>	<b>2011-2012 Projected</b>
<b>Personal income tax</b>	<u>24,391</u>	<u>25,897</u>	<u>27,415</u>	<u>29,315</u>
<b>User taxes and fees</b>	<u>8,832</u>	<u>8,913</u>	<u>9,251</u>	<u>9,620</u>
Sales and use tax	8,080	8,125	8,438	8,778
Cigarette and tobacco taxes	437	433	428	428
Motor fuel tax	0	0	0	0
Motor vehicle fees	47	76	105	126
Alcoholic beverages taxes	220	227	232	236
Alcoholic beverage control license fees	48	52	48	52
Auto rental tax	0	0	0	0
<b>Business taxes</b>	<u>7,254</u>	<u>7,816</u>	<u>7,866</u>	<u>8,218</u>
Corporation franchise tax	4,138	4,265	4,258	4,497
Corporation and utilities tax	589	599	608	612
Insurance taxes	1,405	1,466	1,505	1,549
Bank tax	942	928	935	997
Petroleum business tax	180	558	560	563
<b>Other taxes</b>	<u>1,194</u>	<u>1,325</u>	<u>1,408</u>	<u>1,498</u>
Estate tax	1,170	1,301	1,384	1,474
Gift tax	0	0	0	0
Real property gains tax	0	0	0	0
Pari-mutuel taxes	23	23	23	23
Other taxes	1	1	1	1
<b>Total Taxes</b>	<u>41,671</u>	<u>43,951</u>	<u>45,940</u>	<u>48,651</u>
<b>Miscellaneous receipts</b>	<u>2,238</u>	<u>2,186</u>	<u>2,261</u>	<u>2,060</u>
Licenses, fees, etc.	538	537	549	551
Abandoned property	650	600	600	600
Reimbursements	172	170	170	170
Investment income	200	200	200	200
Other transactions	678	679	742	539
<b>Federal Grants</b>	<u>41</u>	<u>0</u>	<u>0</u>	<u>0</u>
<b>Total</b>	<u><u>43,950</u></u>	<u><u>46,137</u></u>	<u><u>48,201</u></u>	<u><u>50,711</u></u>

Source: NYS DOB

**CASH FINANCIAL PLAN  
STATE FUNDS  
2006-2007  
(millions of dollars)**

	<u>General Fund</u>	<u>Special Revenue Funds</u>	<u>Capital Projects Funds</u>	<u>Debt Service Funds</u>	<u>(MEMO) Total</u>
<b>Opening fund balance</b>	3,257	3,791	(450)	221	6,819
<b>Receipts:</b>					
Taxes	38,668	7,109	1,929	11,033	58,739
Miscellaneous receipts	2,268	12,502	2,246	848	17,864
Federal grants	151	1	0	0	152
<b>Total receipts</b>	<u>41,087</u>	<u>19,612</u>	<u>4,175</u>	<u>11,881</u>	<u>76,755</u>
<b>Disbursements:</b>					
Grants to local governments	34,302	15,216	359	0	49,877
State operations	9,319	5,151	0	44	14,514
General State charges	4,403	594	0	0	4,997
Debt service	0	0	0	4,451	4,451
Capital projects	0	9	3,463	0	3,472
<b>Total disbursements</b>	<u>48,024</u>	<u>20,970</u>	<u>3,822</u>	<u>4,495</u>	<u>77,311</u>
<b>Other financing sources (uses):</b>					
Transfers from other funds	10,292	1,587	454	5,600	17,933
Transfers to other funds	(3,567)	(349)	(766)	(12,974)	(17,656)
Bond and note proceeds	0	0	181	0	181
<b>Net other financing sources (uses)</b>	<u>6,725</u>	<u>1,238</u>	<u>(131)</u>	<u>(7,374)</u>	<u>458</u>
<b>Change in fund balance</b>	<u>(212)</u>	<u>(120)</u>	<u>222</u>	<u>12</u>	<u>(98)</u>
<b>Closing fund balance</b>	<u>3,045</u>	<u>3,671</u>	<u>(228)</u>	<u>233</u>	<u>6,721</u>

Source: NYS DOB

**CASH FINANCIAL PLAN  
STATE FUNDS  
2007-2008  
(millions of dollars)**

	<u>General Fund</u>	<u>Special Revenue Funds</u>	<u>Capital Projects Funds</u>	<u>Debt Service Funds</u>	<u>(MEMO) Total</u>
<b>Opening fund balance</b>	3,045	3,671	(228)	233	6,721
<b>Receipts:</b>					
Taxes	38,568	7,794	2,017	12,547	60,926
Miscellaneous receipts	2,444	13,596	3,211	671	19,922
Federal grants	71	1	0	0	72
<b>Total receipts</b>	<u>41,083</u>	<u>21,391</u>	<u>5,228</u>	<u>13,218</u>	<u>80,920</u>
<b>Disbursements:</b>					
Grants to local governments	36,667	16,440	461	0	53,568
State operations	9,677	5,635	0	58	15,370
General State charges	4,487	639	0	0	5,126
Debt service	0	0	0	4,292	4,292
Capital projects	0	14	4,299	0	4,313
<b>Total disbursements</b>	<u>50,831</u>	<u>22,728</u>	<u>4,760</u>	<u>4,350</u>	<u>82,669</u>
<b>Other financing sources (uses):</b>					
Transfers from other funds	12,086	1,311	252	5,680	19,329
Transfers to other funds	(2,757)	(795)	(930)	(14,503)	(18,985)
Bond and note proceeds	0	0	298	0	298
<b>Net other financing sources (uses)</b>	<u>9,329</u>	<u>516</u>	<u>(380)</u>	<u>(8,823)</u>	<u>642</u>
<b>Change in fund balance</b>	<u>(419)</u>	<u>(821)</u>	<u>88</u>	<u>45</u>	<u>(1,107)</u>
<b>Closing fund balance</b>	<u>2,626</u>	<u>2,850</u>	<u>(140)</u>	<u>278</u>	<u>5,614</u>

Source: NYS DOB

**CASH FINANCIAL PLAN  
STATE FUNDS  
2008-2009  
(millions of dollars)**

	<u>General Fund</u>	<u>Special Revenue Funds</u>	<u>Capital Projects Funds</u>	<u>Debt Service Funds</u>	<u>(MEMO) Total</u>
<b>Opening fund balance</b>	<u>2,626</u>	<u>2,850</u>	<u>(140)</u>	<u>278</u>	<u>5,614</u>
<b>Receipts:</b>					
Taxes	41,671	8,023	2,095	13,123	64,912
Miscellaneous receipts	2,238	14,259	3,979	684	21,160
Federal grants	41	1	0	0	42
<b>Total receipts</b>	<u>43,950</u>	<u>22,283</u>	<u>6,074</u>	<u>13,807</u>	<u>86,114</u>
<b>Disbursements:</b>					
Grants to local governments	41,860	14,811	449	0	57,120
State operations	8,863	6,956	0	62	15,881
General State charges	3,136	1,496	0	0	4,632
Debt service	0	0	0	4,628	4,628
Capital projects	0	13	5,505	0	5,518
<b>Total disbursements</b>	<u>53,859</u>	<u>23,276</u>	<u>5,954</u>	<u>4,690</u>	<u>87,779</u>
<b>Other financing sources (uses):</b>					
Transfers from other funds	12,392	1,292	607	5,764	20,055
Transfers to other funds	(2,883)	(790)	(1,195)	(14,852)	(19,720)
Bond and note proceeds	0	0	457	0	457
<b>Net other financing sources (uses)</b>	<u>9,509</u>	<u>502</u>	<u>(131)</u>	<u>(9,088)</u>	<u>792</u>
<b>Deposit to/(use of) Community Projects Fund</b>	<u>(63)</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>(63)</u>
<b>Change in fund balance</b>	<u>(337)</u>	<u>(491)</u>	<u>(11)</u>	<u>29</u>	<u>(810)</u>
<b>Closing fund balance</b>	<u>2,226</u>	<u>2,359</u>	<u>(151)</u>	<u>307</u>	<u>4,804</u>

Source: NYS DOB

**CASH FINANCIAL PLAN  
STATE FUNDS  
2009-2010  
(millions of dollars)**

	<u>General Fund</u>	<u>Special Revenue Funds</u>	<u>Capital Projects Funds</u>	<u>Debt Service Funds</u>	<u>(MEMO) Total</u>
<b>Opening fund balance</b>	0	2,359	(151)	307	2,515
<b>Receipts:</b>					
Taxes	43,951	8,797	2,199	13,855	68,802
Miscellaneous receipts	2,186	14,136	4,155	687	21,164
Federal grants	0	1	0	0	1
<b>Total receipts</b>	<u>46,137</u>	<u>22,934</u>	<u>6,354</u>	<u>14,542</u>	<u>89,967</u>
<b>Disbursements:</b>					
Grants to local governments	45,919	15,707	481	0	62,107
State operations	9,236	7,225	0	62	16,523
General State charges	3,806	1,116	0	0	4,922
Debt service	0	0	0	5,106	5,106
Capital projects	0	3	5,962	0	5,965
<b>Total disbursements</b>	<u>58,961</u>	<u>24,051</u>	<u>6,443</u>	<u>5,168</u>	<u>94,623</u>
<b>Other financing sources (uses):</b>					
Transfers from other funds	12,587	1,327	784	5,897	20,595
Transfers to other funds	(3,112)	(662)	(1,125)	(15,261)	(20,160)
Bond and note proceeds	0	0	608	0	608
<b>Net other financing sources (uses)</b>	<u>9,475</u>	<u>665</u>	<u>267</u>	<u>(9,364)</u>	<u>1,043</u>
<b>Deposit to/(use of) Community Projects Fund</b>	<u>(62)</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>(62)</u>
<b>Change in fund balance</b>	<u>(3,287)</u>	<u>(452)</u>	<u>178</u>	<u>10</u>	<u>(3,551)</u>
<b>Closing fund balance</b>	<u>(3,287)</u>	<u>1,907</u>	<u>27</u>	<u>317</u>	<u>(1,036)</u>

Source: NYS DOB



**CASH FINANCIAL PLAN  
STATE FUNDS  
2010-2011  
(millions of dollars)**

	<u>General Fund</u>	<u>Special Revenue Funds</u>	<u>Capital Projects Funds</u>	<u>Debt Service Funds</u>	<u>(MEMO) Total</u>
<b>Opening fund balance</b>	<u>0</u>	<u>1,907</u>	<u>27</u>	<u>317</u>	<u>2,251</u>
<b>Receipts:</b>					
Taxes	45,940	9,348	2,196	14,642	72,126
Miscellaneous receipts	2,261	14,651	4,087	687	21,686
Federal grants	0	1	0	0	1
<b>Total receipts</b>	<u>48,201</u>	<u>24,000</u>	<u>6,283</u>	<u>15,329</u>	<u>93,813</u>
<b>Disbursements:</b>					
Grants to local governments	49,833	16,496	452	0	66,781
State operations	9,780	7,311	0	62	17,153
General State charges	4,087	1,075	0	0	5,162
Debt service	0	0	0	5,737	5,737
Capital projects	0	2	6,065	0	6,067
<b>Total disbursements</b>	<u>63,700</u>	<u>24,884</u>	<u>6,517</u>	<u>5,799</u>	<u>100,900</u>
<b>Other financing sources (uses):</b>					
Transfers from other funds	13,142	1,309	1,219	6,327	21,997
Transfers to other funds	(3,481)	(749)	(1,465)	(15,861)	(21,556)
Bond and note proceeds	0	0	655	0	655
<b>Net other financing sources (uses)</b>	<u>9,661</u>	<u>560</u>	<u>409</u>	<u>(9,534)</u>	<u>1,096</u>
<b>Deposit to/(use of) Community Projects Fund</b>	<u>(151)</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>(151)</u>
<b>Change in fund balance</b>	<u>(5,687)</u>	<u>(324)</u>	<u>175</u>	<u>(4)</u>	<u>(5,840)</u>
<b>Closing fund balance</b>	<u>(5,687)</u>	<u>1,583</u>	<u>202</u>	<u>313</u>	<u>(3,589)</u>

Source: NYS DOB

**CASH FINANCIAL PLAN  
STATE FUNDS  
2011-2012  
(millions of dollars)**

	<u>General Fund</u>	<u>Special Revenue Funds</u>	<u>Capital Projects Funds</u>	<u>Debt Service Funds</u>	<u>(MEMO) Total</u>
<b>Opening fund balance</b>	0	1,583	202	313	2,098
<b>Receipts:</b>					
Taxes	48,651	9,719	2,221	15,483	76,074
Miscellaneous receipts	2,060	14,964	3,695	686	21,405
Federal grants	0	1	0	0	1
<b>Total receipts</b>	<u>50,711</u>	<u>24,684</u>	<u>5,916</u>	<u>16,169</u>	<u>97,480</u>
<b>Disbursements:</b>					
Grants to local governments	53,013	17,392	472	0	70,877
State operations	10,046	7,376	0	62	17,484
General State charges	4,386	1,109	0	0	5,495
Debt service	0	0	0	6,064	6,064
Capital projects	0	2	5,488	0	5,490
<b>Total disbursements</b>	<u>67,445</u>	<u>25,879</u>	<u>5,960</u>	<u>6,126</u>	<u>105,410</u>
<b>Other financing sources (uses):</b>					
Transfers from other funds	13,816	1,767	1,245	6,428	23,256
Transfers to other funds	(3,982)	(759)	(1,549)	(16,511)	(22,801)
Bond and note proceeds	0	0	514	0	514
<b>Net other financing sources (uses)</b>	<u>9,834</u>	<u>1,008</u>	<u>210</u>	<u>(10,083)</u>	<u>969</u>
<b>Deposit to/(use of) Community Projects Fund</b>	<u>(79)</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>(79)</u>
<b>Change in fund balance</b>	<u>(6,821)</u>	<u>(187)</u>	<u>166</u>	<u>(40)</u>	<u>(6,882)</u>
<b>Closing fund balance</b>	<u>(6,821)</u>	<u>1,396</u>	<u>368</u>	<u>273</u>	<u>(4,784)</u>

Source: NYS DOB

**CASH FINANCIAL PLAN  
ALL GOVERNMENTAL FUNDS  
2006-2007  
(millions of dollars)**

	<u>General Fund</u>	<u>Special Revenue Funds</u>	<u>Capital Projects Funds</u>	<u>Debt Service Funds</u>	<u>(MEMO) Total</u>
<b>Opening fund balance</b>	3,257	4,238	(648)	221	7,068
<b>Receipts:</b>					
Taxes	38,668	7,109	1,929	11,033	58,739
Miscellaneous receipts	2,268	12,715	2,247	848	18,078
Federal grants	151	33,690	1,738	0	35,579
<b>Total receipts</b>	<u>41,087</u>	<u>53,514</u>	<u>5,914</u>	<u>11,881</u>	<u>112,396</u>
<b>Disbursements:</b>					
Grants to local governments	34,302	45,693	730	0	80,725
State operations	9,319	8,164	0	44	17,527
General State charges	4,403	820	0	0	5,223
Debt service	0	0	0	4,451	4,451
Capital projects	0	9	4,829	0	4,838
<b>Total disbursements</b>	<u>48,024</u>	<u>54,686</u>	<u>5,559</u>	<u>4,495</u>	<u>112,764</u>
<b>Other financing sources (uses):</b>					
Transfers from other funds	10,292	3,857	454	5,600	20,203
Transfers to other funds	(3,567)	(2,916)	(774)	(12,974)	(20,231)
Bond and note proceeds	0	0	181	0	181
<b>Net other financing sources (uses)</b>	<u>6,725</u>	<u>941</u>	<u>(139)</u>	<u>(7,374)</u>	<u>153</u>
<b>Change in fund balance</b>	<u>(212)</u>	<u>(231)</u>	<u>216</u>	<u>12</u>	<u>(215)</u>
<b>Closing fund balance</b>	<u>3,045</u>	<u>4,007</u>	<u>(432)</u>	<u>233</u>	<u>6,853</u>

Source: NYS DOB

**CASH RECEIPTS**  
**ALL GOVERNMENTAL FUNDS**  
**2006-2007**  
(millions of dollars)

	<u>General Fund</u>	<u>Special Revenue Funds</u>	<u>Capital Projects Funds</u>	<u>Debt Service Funds</u>	<u>Total</u>
<b>Personal income tax</b>	22,939	3,994	0	7,647	34,580
<b>User taxes and fees</b>	8,186	1,598	1,161	2,511	13,456
Sales and use tax	7,539	688	0	2,511	10,738
Cigarette and tobacco taxes	411	574	0	0	985
Motor fuel tax	0	108	406	0	514
Motor vehicle fees	(16)	228	557	0	769
Alcoholic beverages taxes	194	0	0	0	194
Highway Use tax	0	0	153	0	153
Alcoholic beverage control license fees	58	0	0	0	58
Auto rental tax	0	0	45	0	45
<b>Business taxes</b>	6,468	1,517	621	0	8,606
Corporation franchise tax	3,676	551	0	0	4,227
Corporation and utilities tax	626	178	17	0	821
Insurance taxes	1,142	116	0	0	1,258
Bank tax	1,024	186	0	0	1,210
Petroleum business tax	0	486	604	0	1,090
<b>Other taxes</b>	1,075	0	147	875	2,097
Estate tax	1,063	0	0	0	1,063
Gift tax	(10)	0	0	0	(10)
Real property gains tax	0	0	0	0	0
Real estate transfer tax	0	0	147	875	1,022
Pari-mutuel taxes	21	0	0	0	21
Other taxes	1	0	0	0	1
<b>Total Taxes</b>	38,668	7,109	1,929	11,033	58,739
<b>Miscellaneous receipts</b>	2,268	12,715	2,247	848	18,078
<b>Federal grants</b>	151	33,690	1,738	0	35,579
<b>Total</b>	41,087	53,514	5,914	11,881	112,396

Source: NYS DOB

**CASH FINANCIAL PLAN  
ALL GOVERNMENTAL FUNDS  
2007-2008  
(millions of dollars)**

	<u>General Fund</u>	<u>Special Revenue Funds</u>	<u>Capital Projects Funds</u>	<u>Debt Service Funds</u>	<u>(MEMO) Total</u>
<b>Opening fund balance</b>	3,045	4,007	(432)	233	6,853
<b>Receipts:</b>					
Taxes	38,568	7,794	2,017	12,547	60,926
Miscellaneous receipts	2,444	13,741	3,211	671	20,067
Federal grants	71	33,911	1,859	0	35,841
<b>Total receipts</b>	<u>41,083</u>	<u>55,446</u>	<u>7,087</u>	<u>13,218</u>	<u>116,834</u>
<b>Disbursements:</b>					
Grants to local governments	36,667	46,696	603	0	83,966
State operations	9,677	8,895	0	58	18,630
General State charges	4,487	882	0	0	5,369
Debt service	0	0	0	4,292	4,292
Capital projects	0	15	6,042	0	6,057
<b>Total disbursements</b>	<u>50,831</u>	<u>56,488</u>	<u>6,645</u>	<u>4,350</u>	<u>118,314</u>
<b>Other financing sources (uses):</b>					
Transfers from other funds	12,086	3,804	252	5,680	21,822
Transfers to other funds	(2,757)	(3,653)	(943)	(14,503)	(21,856)
Bond and note proceeds	0	0	298	0	298
<b>Net other financing sources (uses)</b>	<u>9,329</u>	<u>151</u>	<u>(393)</u>	<u>(8,823)</u>	<u>264</u>
<b>Change in fund balance</b>	<u>(419)</u>	<u>(891)</u>	<u>49</u>	<u>45</u>	<u>(1,216)</u>
<b>Closing fund balance</b>	<u>2,626</u>	<u>3,116</u>	<u>(383)</u>	<u>278</u>	<u>5,637</u>

Source: NYS DOB

**CASH RECEIPTS**  
**ALL GOVERNMENTAL FUNDS**  
**2007-2008**  
(millions of dollars)

	<b>General Fund</b>	<b>Special Revenue Funds</b>	<b>Capital Projects Funds</b>	<b>Debt Service Funds</b>	<b>Total</b>
<b>Personal income tax</b>	22,735	4,678	0	9,138	36,551
<b>User taxes and fees</b>	8,503	1,621	1,163	2,615	13,902
Sales and use tax	7,865	718	0	2,615	11,198
Cigarette and tobacco taxes	407	565	0	0	972
Motor fuel tax	0	107	405	0	512
Motor vehicle fees	(21)	231	562	0	772
Alcoholic beverages taxes	200	0	0	0	200
Highway Use tax	0	0	147	0	147
Alcoholic beverage control license fees	52	0	0	0	52
Auto rental tax	0	0	49	0	49
<b>Business taxes</b>	6,300	1,495	642	0	8,437
Corporation franchise tax	3,575	531	0	0	4,106
Corporation and utilities tax	618	181	17	0	816
Insurance taxes	1,176	116	0	0	1,292
Bank tax	931	163	0	0	1,094
Petroleum business tax	0	504	625	0	1,129
<b>Other taxes</b>	1,030	0	212	794	2,036
Estate tax	1,006	0	0	0	1,006
Gift tax	0	0	0	0	0
Real property gains tax	0	0	0	0	0
Real estate transfer tax	0	0	212	794	1,006
Pari-mutuel taxes	23	0	0	0	23
Other taxes	1	0	0	0	1
<b>Total Taxes</b>	38,568	7,794	2,017	12,547	60,926
<b>Miscellaneous receipts</b>	2,444	13,741	3,211	671	20,067
<b>Federal grants</b>	71	33,911	1,859	0	35,841
<b>Total</b>	41,083	55,446	7,087	13,218	116,834

Source: NYS DOB

**CASH FINANCIAL PLAN  
ALL GOVERNMENTAL FUNDS  
2008-2009  
(millions of dollars)**

	<u>General Fund</u>	<u>Special Revenue Funds</u>	<u>Capital Projects Funds</u>	<u>Debt Service Funds</u>	<u>(MEMO) Total</u>
<b>Opening fund balance</b>	2,626	3,116	(383)	278	5,637
<b>Receipts:</b>					
Taxes	41,671	8,023	2,095	13,123	64,912
Miscellaneous receipts	2,238	14,409	3,979	684	21,310
Federal grants	41	34,832	2,010	0	36,883
<b>Total receipts</b>	<u>43,950</u>	<u>57,264</u>	<u>8,084</u>	<u>13,807</u>	<u>123,105</u>
<b>Disbursements:</b>					
Grants to local governments	41,860	44,952	615	0	87,427
State operations	8,863	10,467	0	62	19,392
General State charges	3,136	2,420	0	0	5,556
Debt service	0	0	0	4,628	4,628
Capital projects	0	14	7,312	0	7,326
<b>Total disbursements</b>	<u>53,859</u>	<u>57,853</u>	<u>7,927</u>	<u>4,690</u>	<u>124,329</u>
<b>Other financing sources (uses):</b>					
Transfers from other funds	12,392	3,854	607	5,764	22,617
Transfers to other funds	(2,883)	(3,758)	(1,213)	(14,852)	(22,706)
Bond and note proceeds	0	0	457	0	457
<b>Net other financing sources (uses)</b>	<u>9,509</u>	<u>96</u>	<u>(149)</u>	<u>(9,088)</u>	<u>368</u>
<b>Deposit to/(use of) Community Projects Fund</b>	<u>(63)</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>(63)</u>
<b>Deposit to/(use of) Prior Year Reserves</b>	<u>(337)</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>(337)</u>
<b>Change in fund balance</b>	<u>0</u>	<u>(493)</u>	<u>8</u>	<u>29</u>	<u>(456)</u>
<b>Closing fund balance</b>	<u>2,226</u>	<u>2,623</u>	<u>(375)</u>	<u>307</u>	<u>5,181</u>

Source: NYS DOB

**CASH RECEIPTS**  
**ALL GOVERNMENTAL FUNDS**  
**2008-2009**  
(millions of dollars)

	<u>General Fund</u>	<u>Special Revenue Funds</u>	<u>Capital Projects Funds</u>	<u>Debt Service Funds</u>	<u>Total</u>
<b>Personal income tax</b>	24,391	4,713	0	9,701	38,805
<b>User taxes and fees</b>	8,832	1,660	1,042	2,684	14,218
Sales and use tax	8,080	742	0	2,684	11,506
Cigarette and tobacco taxes	437	614	0	0	1,051
Motor fuel tax	0	74	277	0	351
Motor vehicle fees	47	230	553	0	830
Alcoholic beverages taxes	220	0	0	0	220
Highway Use tax	0	0	161	0	161
Alcoholic beverage control license fees	48	0	0	0	48
Auto rental tax	0	0	51	0	51
<b>Business taxes</b>	7,254	1,650	816	0	9,720
Corporation franchise tax	4,138	607	0	0	4,745
Corporation and utilities tax	589	181	17	0	787
Insurance taxes	1,405	150	0	0	1,555
Bank tax	942	154	0	0	1,096
Petroleum business tax	180	558	799	0	1,537
<b>Other taxes</b>	1,194	0	237	738	2,169
Estate tax	1,170	0	0	0	1,170
Gift tax	0	0	0	0	0
Real property gains tax	0	0	0	0	0
Real estate transfer tax	0	0	237	738	975
Pari-mutuel taxes	23	0	0	0	23
Other taxes	1	0	0	0	1
<b>Total Taxes</b>	41,671	8,023	2,095	13,123	64,912
<b>Miscellaneous receipts</b>	2,238	14,409	3,979	684	21,310
<b>Federal grants</b>	41	34,832	2,010	0	36,883
<b>Total</b>	<u>43,950</u>	<u>57,264</u>	<u>8,084</u>	<u>13,807</u>	<u>123,105</u>

Source: NYS DOB



**CASH FINANCIAL PLAN  
ALL GOVERNMENTAL FUNDS  
2009-2010  
(millions of dollars)**

	<b>General Fund</b>	<b>Special Revenue Funds</b>	<b>Capital Projects Funds</b>	<b>Debt Service Funds</b>	<b>(MEMO) Total</b>
<b>Opening fund balance</b>	<u>0</u>	<u>2,623</u>	<u>(375)</u>	<u>307</u>	<u>2,555</u>
<b>Receipts:</b>					
Taxes	43,951	8,797	2,199	13,855	68,802
Miscellaneous receipts	2,186	14,277	4,155	687	21,305
Federal grants	0	36,031	2,044	0	38,075
<b>Total receipts</b>	<u>46,137</u>	<u>59,105</u>	<u>8,398</u>	<u>14,542</u>	<u>128,182</u>
<b>Disbursements:</b>					
Grants to local governments	45,919	47,123	647	0	93,689
State operations	9,236	10,561	0	62	19,859
General State charges	3,806	2,067	0	0	5,873
Debt service	0	0	0	5,106	5,106
Capital projects	0	4	7,795	0	7,799
<b>Total disbursements</b>	<u>58,961</u>	<u>59,755</u>	<u>8,442</u>	<u>5,168</u>	<u>132,326</u>
<b>Other financing sources (uses):</b>					
Transfers from other funds	12,587	3,867	784	5,897	23,135
Transfers to other funds	(3,112)	(3,647)	(1,143)	(15,261)	(23,163)
Bond and note proceeds	0	0	608	0	608
<b>Net other financing sources (uses)</b>	<u>9,475</u>	<u>220</u>	<u>249</u>	<u>(9,364)</u>	<u>580</u>
<b>Deposit to/(use of) Community Projects Fund</b>	<u>(62)</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>(62)</u>
<b>Change in fund balance</b>	<u>(3,287)</u>	<u>(430)</u>	<u>205</u>	<u>10</u>	<u>(3,502)</u>
<b>Closing fund balance</b>	<u>(3,287)</u>	<u>2,193</u>	<u>(170)</u>	<u>317</u>	<u>(947)</u>

Source: NYS DOB

**CASH RECEIPTS**  
**ALL GOVERNMENTAL FUNDS**  
**2009-2010**  
(millions of dollars)

	<u>General Fund</u>	<u>Special Revenue Funds</u>	<u>Capital Projects Funds</u>	<u>Debt Service Funds</u>	<u>Total</u>
<b>Personal income tax</b>	25,897	5,423	0	10,440	41,760
<b>User taxes and fees</b>	8,913	1,607	794	2,702	14,016
Sales and use tax	8,125	769	0	2,702	11,596
Cigarette and tobacco taxes	433	607	0	0	1,040
Motor fuel tax	0	0	0	0	0
Motor vehicle fees	76	231	563	0	870
Alcoholic beverages taxes	227	0	0	0	227
Highway Use tax	0	0	178	0	178
Alcoholic beverage control license fees	52	0	0	0	52
Auto rental tax	0	0	53	0	53
<b>Business taxes</b>	7,816	1,767	1,118	0	10,701
Corporation franchise tax	4,265	626	0	0	4,891
Corporation and utilities tax	599	181	17	0	797
Insurance taxes	1,466	159	0	0	1,625
Bank tax	928	148	0	0	1,076
Petroleum business tax	558	653	1,101	0	2,312
<b>Other taxes</b>	1,325	0	287	713	2,325
Estate tax	1,301	0	0	0	1,301
Gift tax	0	0	0	0	0
Real property gains tax	0	0	0	0	0
Real estate transfer tax	0	0	287	713	1,000
Pari-mutuel taxes	23	0	0	0	23
Other taxes	1	0	0	0	1
<b>Total Taxes</b>	43,951	8,797	2,199	13,855	68,802
<b>Miscellaneous receipts</b>	2,186	14,277	4,155	687	21,305
<b>Federal grants</b>	0	36,031	2,044	0	38,075
<b>Total</b>	46,137	59,105	8,398	14,542	128,182

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Source: NYS DOB

**CASH FINANCIAL PLAN  
ALL GOVERNMENTAL FUNDS  
2010-2011  
(millions of dollars)**

	<u>General Fund</u>	<u>Special Revenue Funds</u>	<u>Capital Projects Funds</u>	<u>Debt Service Funds</u>	<u>(MEMO) Total</u>
<b>Opening fund balance</b>	<u>0</u>	<u>2,193</u>	<u>(170)</u>	<u>317</u>	<u>2,340</u>
<b>Receipts:</b>					
Taxes	45,940	9,348	2,196	14,642	72,126
Miscellaneous receipts	2,261	14,791	4,087	687	21,826
Federal grants	0	37,347	1,989	0	39,336
<b>Total receipts</b>	<u>48,201</u>	<u>61,486</u>	<u>8,272</u>	<u>15,329</u>	<u>133,288</u>
<b>Disbursements:</b>					
Grants to local governments	49,833	49,034	618	0	99,485
State operations	9,780	10,756	0	62	20,598
General State charges	4,087	2,082	0	0	6,169
Debt service	0	0	0	5,737	5,737
Capital projects	0	3	7,830	0	7,833
<b>Total disbursements</b>	<u>63,700</u>	<u>61,875</u>	<u>8,448</u>	<u>5,799</u>	<u>139,822</u>
<b>Other financing sources (uses):</b>					
Transfers from other funds	13,142	3,895	1,219	6,327	24,583
Transfers to other funds	(3,481)	(3,795)	(1,479)	(15,861)	(24,616)
Bond and note proceeds	0	0	655	0	655
<b>Net other financing sources (uses)</b>	<u>9,661</u>	<u>100</u>	<u>395</u>	<u>(9,534)</u>	<u>622</u>
<b>Deposit to/(use of) Community Projects Fund</b>	<u>(151)</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>(151)</u>
<b>Change in fund balance</b>	<u>(5,687)</u>	<u>(289)</u>	<u>219</u>	<u>(4)</u>	<u>(5,761)</u>
<b>Closing fund balance</b>	<u>(5,687)</u>	<u>1,904</u>	<u>49</u>	<u>313</u>	<u>(3,421)</u>

Source: NYS DOB

**CASH RECEIPTS**  
**ALL GOVERNMENTAL FUNDS**  
**2010-2011**  
(millions of dollars)

	<u>General Fund</u>	<u>Special Revenue Funds</u>	<u>Capital Projects Funds</u>	<u>Debt Service Funds</u>	<u>Total</u>
<b>Personal income tax</b>	27,415	5,949	0	11,122	44,486
<b>User taxes and fees</b>	9,251	1,625	786	2,807	14,469
Sales and use tax	8,438	798	0	2,807	12,043
Cigarette and tobacco taxes	428	599	0	0	1,027
Motor fuel tax	0	0	0	0	0
Motor vehicle fees	105	228	550	0	883
Alcoholic beverages taxes	232	0	0	0	232
Highway Use tax	0	0	181	0	181
Alcoholic beverage control license fees	48	0	0	0	48
Auto rental tax	0	0	55	0	55
<b>Business taxes</b>	7,866	1,774	1,123	0	10,763
Corporation franchise tax	4,258	625	0	0	4,883
Corporation and utilities tax	608	182	17	0	807
Insurance taxes	1,505	163	0	0	1,668
Bank tax	935	149	0	0	1,084
Petroleum business tax	560	655	1,106	0	2,321
<b>Other taxes</b>	1,408	0	287	713	2,408
Estate tax	1,384	0	0	0	1,384
Gift tax	0	0	0	0	0
Real property gains tax	0	0	0	0	0
Real estate transfer tax	0	0	287	713	1,000
Pari-mutuel taxes	23	0	0	0	23
Other taxes	1	0	0	0	1
<b>Total Taxes</b>	45,940	9,348	2,196	14,642	72,126
<b>Miscellaneous receipts</b>	2,261	14,791	4,087	687	21,826
<b>Federal grants</b>	0	37,347	1,989	0	39,336
<b>Total</b>	48,201	61,486	8,272	15,329	133,288

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Source: NYS DOB

**CASH FINANCIAL PLAN  
ALL GOVERNMENTAL FUNDS  
2011-2012  
(millions of dollars)**

	<u>General Fund</u>	<u>Special Revenue Funds</u>	<u>Capital Projects Funds</u>	<u>Debt Service Funds</u>	<u>(MEMO) Total</u>
<b>Opening fund balance</b>	<u>0</u>	<u>1,904</u>	<u>49</u>	<u>313</u>	<u>2,266</u>
<b>Receipts:</b>					
Taxes	48,651	9,719	2,221	15,483	76,074
Miscellaneous receipts	2,060	15,106	3,695	686	21,547
Federal grants	0	38,703	1,945	0	40,648
<b>Total receipts</b>	<u>50,711</u>	<u>63,528</u>	<u>7,861</u>	<u>16,169</u>	<u>138,269</u>
<b>Disbursements:</b>					
Grants to local governments	53,013	51,204	638	0	104,855
State operations	10,046	10,858	0	62	20,966
General State charges	4,386	2,171	0	0	6,557
Debt service	0	0	0	6,064	6,064
Capital projects	0	3	7,216	0	7,219
<b>Total disbursements</b>	<u>67,445</u>	<u>64,236</u>	<u>7,854</u>	<u>6,126</u>	<u>145,661</u>
<b>Other financing sources (uses):</b>					
Transfers from other funds	13,816	4,375	1,245	6,428	25,864
Transfers to other funds	(3,982)	(3,819)	(1,563)	(16,511)	(25,875)
Bond and note proceeds	0	0	514	0	514
<b>Net other financing sources (uses)</b>	<u>9,834</u>	<u>556</u>	<u>196</u>	<u>(10,083)</u>	<u>503</u>
<b>Deposit to/(use of) Community Projects Fund</b>	<u>(79)</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>(79)</u>
<b>Change in fund balance</b>	<u>(6,821)</u>	<u>(152)</u>	<u>203</u>	<u>(40)</u>	<u>(6,810)</u>
<b>Closing fund balance</b>	<u>(6,821)</u>	<u>1,752</u>	<u>252</u>	<u>273</u>	<u>(4,544)</u>

Source: NYS DOB

**CASH RECEIPTS**  
**ALL GOVERNMENTAL FUNDS**  
**2011-2012**  
(millions of dollars)

	<b>General Fund</b>	<b>Special Revenue Funds</b>	<b>Capital Projects Funds</b>	<b>Debt Service Funds</b>	<b>Total</b>
<b>Personal income tax</b>	29,315	6,235	0	11,850	47,400
<b>User taxes and fees</b>	9,620	1,658	807	2,920	15,005
Sales and use tax	8,778	829	0	2,920	12,527
Cigarette and tobacco taxes	428	598	0	0	1,026
Motor fuel tax	0	0	0	0	0
Motor vehicle fees	126	231	562	0	919
Alcoholic beverages taxes	236	0	0	0	236
Highway Use tax	0	0	188	0	188
Alcoholic beverage control license fees	52	0	0	0	52
Auto rental tax	0	0	57	0	57
<b>Business taxes</b>	8,218	1,826	1,127	0	11,171
Corporation franchise tax	4,497	659	0	0	5,156
Corporation and utilities tax	612	183	17	0	812
Insurance taxes	1,549	167	0	0	1,716
Bank tax	997	159	0	0	1,156
Petroleum business tax	563	658	1,110	0	2,331
<b>Other taxes</b>	1,498	0	287	713	2,498
Estate tax	1,474	0	0	0	1,474
Gift tax	0	0	0	0	0
Real property gains tax	0	0	0	0	0
Real estate transfer tax	0	0	287	713	1,000
Pari-mutuel taxes	23	0	0	0	23
Other taxes	1	0	0	0	1
<b>Total Taxes</b>	48,651	9,719	2,221	15,483	76,074
<b>Miscellaneous receipts</b>	2,060	15,106	3,695	686	21,547
<b>Federal grants</b>	0	38,703	1,945	0	40,648
<b>Total</b>	50,711	63,528	7,861	16,169	138,269

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Source: NYS DOB

**CASHFLOW**  
**GENERAL FUND**  
**2007-2008**  
**(dollars in millions)**

	2007		2008		2008		2008		2008		2008	
	April	May	June	July	August	September	October	November	December	January	February	March
	Actuals	Actuals	Actuals	Actuals	Actuals	Actuals	Actuals	Actuals	Actuals	Projected	Projected	Projected
<b>OPENING BALANCE</b>	3,045	6,903	3,136	2,881	3,448	2,854	4,142	2,836	1,320	1,678	6,782	6,438
<b>RECEIPTS:</b>												
Personal Income Tax	4,017	748	2,414	1,396	1,376	1,971	745	91	1,152	5,219	1,678	1,928
User Taxes and Fees	679	623	877	671	645	872	632	673	868	648	547	768
Business Taxes	58	146	1,103	98	139	1,209	123	82	1,145	378	173	1,665
Other Taxes	81	80	107	100	64	81	80	82	118	79	79	79
Total Taxes	4,835	1,597	4,501	2,265	2,224	4,133	1,580	909	3,283	6,324	2,477	4,440
Licenses, fees, etc.	37	98	20	45	66	50	33	70	45	25	35	113
Abandoned Property	5	0	0	19	9	33	22	135	25	71	53	312
Reimbursement	6	7	25	11	10	20	14	6	22	10	16	53
Investment Income	70	7	25	22	(11)	6	53	15	3	14	(4)	0
Other transactions	13	15	167	41	45	47	27	30	217	30	27	64
Total Miscellaneous Receipts	131	127	237	138	119	156	149	256	312	150	127	542
Federal Grants	0	12	22	1	5	0	10	10	0	5	6	0
PIT in excess of Revenue Bond Debt Service	1,338	198	886	489	401	951	593	79	879	1,657	133	827
Sales Tax in Excess of LGAC Debt Service	137	41	360	232	196	270	192	205	269	197	3	203
Real Estate Taxes in Excess of CW/CA Debt Service	55	61	95	62	75	66	44	60	38	25	25	61
All Other	3	1	120	29	8	1	19	1	35	0	0	456
Total Transfers from Other Funds	1,533	301	1,461	822	680	1,288	848	345	1,221	1,879	161	1,547
<b>TOTAL RECEIPTS</b>	6,499	2,037	6,221	3,226	3,028	5,577	2,587	1,520	4,816	8,358	2,771	6,529
<b>DISBURSEMENTS:</b>												
School Aid	236	2,143	1,512	17	504	1,284	511	961	1,365	581	494	6,631
Higher Education	18	10	335	100	186	77	458	30	214	38	334	524
All Other Education	26	124	345	161	72	112	175	21	137	110	143	312
Medicaid - DOH	869	1,267	918	538	1,040	710	673	587	370	819	626	621
Public Health	16	35	117	32	35	23	131	45	52	54	53	89
Mental Hygiene	45	58	62	153	67	135	251	62	180	237	180	408
Children and Families	5	130	91	223	98	125	73	72	252	99	90	350
Temporary & Disability Assistance	55	252	248	150	152	184	140	(142)	207	10	138	(2)
Transportation	0	14	45	1	13	1	0	15	7	0	8	2
All Other	22	70	444	50	56	135	63	57	265	81	27	432
Total Local Assistance Grants	1,292	4,103	4,117	1,425	2,223	2,786	2,475	1,708	3,049	2,029	2,093	9,367
Personal Service	633	814	599	589	749	546	699	546	417	513	317	391
Non-Personal Service	203	239	275	208	255	209	219	181	222	247	253	353
Total State Operations	836	1,053	874	797	1,004	755	918	727	639	760	570	744
General State Charges	262	430	1,218	258	269	268	285	319	260	389	235	294
Debt Service	45	144	210	49	40	292	60	110	413	4	26	164
Capital Projects	89	55	8	51	56	66	133	105	24	50	124	(688)
Other Purposes	117	19	49	79	30	122	22	67	73	22	67	440
Total Transfers to Other Funds	251	218	267	179	126	480	215	282	510	76	217	(64)
<b>TOTAL DISBURSEMENTS</b>	2,641	5,804	6,476	2,659	3,622	4,289	3,893	3,036	4,458	3,254	3,115	10,341
Excess/(Deficiency) of Receipts over Disbursements	3,858	(3,767)	(255)	567	(594)	1,288	(1,306)	(1,516)	358	5,104	(344)	(3,812)
<b>CLOSING BALANCE</b>	6,903	3,136	2,881	3,448	2,854	4,142	2,836	1,320	1,678	6,782	6,438	2,626

Source: NYS DOB

**CASHFLOW  
GENERAL FUND  
2008-2009  
(dollars in millions)**

	2008		2009		2008		2009		2008		2009		2008		2009	
	April	May	June	July	August	September	October	November	December	January	February	March	April	May	June	July
	Projected	Projected	Projected	Projected	Projected	Projected	Projected	Projected	Projected	Projected	Projected	Projected	Projected	Projected	Projected	Projected
<b>OPENING BALANCE</b>	2,626	6,289	1,713	2,773	2,742	2,655	3,856	2,384	893	1,368	6,448	5,924	2,626			
<b>RECEIPTS:</b>																
Personal Income Tax	4,576	683	2,387	1,556	1,595	2,114	656	248	1,506	5,395	1,716	1,959	24,391			
User Taxes and Fees	672	647	908	694	665	905	658	702	901	667	559	854	8,832			
Business Taxes	266	50	1,214	185	151	1,260	223	77	1,427	232	204	1,965	7,254			
Other Taxes	99	99	100	100	101	101	99	99	99	99	99	99	1,194			
Total Taxes	5,613	1,479	4,609	2,535	2,512	4,380	1,636	1,126	3,933	6,393	2,578	4,877	41,671			
Licenses, fees, etc.	28	61	44	26	61	41	51	48	32	37	49	60	538			
Abandoned Property	20	0	18	12	8	53	9	167	34	41	39	249	650			
Reimbursement	4	11	24	5	14	22	13	10	23	7	12	27	172			
Investment income	60	7	25	22	(11)	6	53	15	3	14	0	6	200			
Other transactions	26	32	151	43	53	54	38	30	53	34	30	134	678			
Total Miscellaneous Receipts	138	111	262	108	125	176	164	270	145	133	130	476	2,238			
Federal Grants	0	11	4	0	4	0	9	9	0	4	0	0	41			
PI in excess of Revenue Bond Debt Service	1,525	157	925	539	366	966	622	136	926	1,593	160	854	8,769			
Sales Tax in Excess of LGAC Debt Service	196	24	448	207	200	212	197	211	273	200	2	144	2,314			
Real Estate Taxes in Excess of CW/CA Debt Service	65	57	45	49	59	59	55	40	53	55	41	37	615			
All Other	0	0	96	3	1	5	8	5	122	3	1	450	694			
Total Transfers from Other Funds	1,786	238	1,514	798	626	1,242	882	392	1,374	1,851	204	1,485	12,392			
<b>TOTAL RECEIPTS</b>	7,537	1,839	6,389	3,441	3,267	5,798	2,691	1,797	5,452	8,381	2,912	6,838	56,342			
<b>DISBURSEMENTS:</b>																
School Aid	175	2,320	1,670	135	430	1,790	675	763	1,251	463	635	7,134	17,441			
Higher Education	17	11	483	118	113	95	468	24	287	42	348	464	2,470			
All Other Education	86	100	92	189	141	143	127	66	79	223	141	315	1,702			
Medicaid - DOH	1,608	1,357	1,172	974	1,080	890	1,145	1,031	1,026	973	808	859	12,723			
Public Health	16	38	63	68	34	54	53	42	46	111	28	92	645			
Mental Hygiene	129	127	132	141	131	249	136	127	240	244	124	274	2,054			
Children and Families	79	85	98	291	87	127	79	86	307	83	83	356	1,761			
Temporary & Disability Assistance	157	157	258	157	157	176	157	(135)	176	(143)	106	(54)	1,169			
Transportation	0	11	45	0	14	0	0	17	10	0	8	0	105			
All Other	15	37	415	38	49	205	5	50	402	56	73	445	1,790			
Total Local Assistance Grants	2,282	4,243	4,428	2,111	2,236	3,529	2,845	2,071	3,824	2,052	2,354	9,885	41,860			
Personal Service	686	566	535	619	533	488	631	463	460	542	447	463	6,433			
Non-Personal Service	178	182	177	193	207	246	169	167	178	227	217	289	2,430			
Total State Operations	864	748	712	812	740	734	800	630	638	769	664	752	8,863			
General State Charges	339	1,215	(86)	452	261	(91)	402	265	(73)	324	217	(87)	3,136			
Debt Service	228	139	201	36	46	278	22	175	404	3	19	141	1,692			
Capital Projects	29	33	30	31	30	42	64	77	136	123	157	(386)	366			
Other Purposes	132	37	46	30	41	105	30	70	48	30	25	231	825			
Total Transfers to Other Funds	389	209	277	97	117	425	116	322	588	156	201	(14)	2,883			
<b>TOTAL DISBURSEMENTS</b>	3,874	6,415	5,929	3,472	3,354	4,597	4,163	3,288	4,977	3,301	3,436	10,536	56,742			
Excess/(Deficiency) of Receipts over Disbursements	3,663	(4,576)	1,060	(31)	(87)	1,201	(1,472)	(1,491)	475	5,080	(524)	(3,698)	(400)			
<b>CLOSING BALANCE</b>	6,289	1,713	2,773	2,742	2,655	3,856	2,384	893	1,368	6,448	5,924	2,226	2,626			

Source: NYS DOB



**CASH DISBURSEMENTS BY FUNCTION**  
**ALL GOVERNMENTAL FUNDS**  
(thousands of dollars)

	2006-2007 Actuals	2007-2008 January	Medicaid Transparency	2007-2008 Adjusted	2008-2009 Recommended	2009-2010 Projected	2010-2011 Projected	2011-2012 Projected
<b>ECONOMIC DEVELOPMENT AND GOVERNMENT OVERSIGHT</b>								
Agriculture and Markets, Department of	94,987	103,857	0	103,857	131,524	99,241	99,843	100,618
Alcoholic Beverage Control	11,696	13,012	0	13,012	13,719	14,125	14,187	14,380
Banking Department	57,224	61,413	0	61,413	62,337	63,549	64,347	62,977
Consumer Protection Board	2,792	3,055	0	3,055	3,703	3,747	3,790	3,677
Economic Development Capital Programs	45,777	134,010	0	134,010	103,405	269,980	224,430	66,077
Economic Development, Department of	42,681	53,968	0	53,968	59,377	60,006	60,025	59,824
Empire State Development Corporation	169,786	471,955	0	471,955	811,885	676,285	455,545	376,869
Energy Research and Development Authority	28,865	28,623	0	28,623	29,413	29,597	29,795	29,997
Housing and Community Renewal, Division of	272,073	315,865	0	315,865	285,417	268,637	269,553	266,312
Insurance Department	145,590	250,421	0	250,421	262,999	263,604	264,748	264,748
Olympic Regional Development Authority	8,250	14,126	0	14,126	9,009	9,217	9,437	9,663
Public Service, Department of	50,931	56,484	0	56,484	59,887	61,572	63,363	65,212
Science, Technology and Innovation, Foundation for	52,263	52,576	0	52,576	44,232	40,800	41,312	37,187
Strategic Investment	4,840	28,000	0	28,000	10,000	14,000	14,000	10,376
<b>Functional Total</b>	<b>987,735</b>	<b>1,587,365</b>	<b>0</b>	<b>1,587,365</b>	<b>1,886,907</b>	<b>1,874,360</b>	<b>1,615,375</b>	<b>1,367,917</b>
<b>PARKS AND THE ENVIRONMENT</b>								
Adirondack Park Agency	4,599	5,740	0	5,740	5,929	5,935	5,942	5,942
Environmental Conservation, Department of	818,004	913,498	0	913,498	893,889	912,210	909,813	917,109
Environmental Facilities Corporation	8,416	16,160	0	16,160	11,815	6,760	6,760	6,760
Hudson River Park Trust	26,284	20,000	0	20,000	20,682	15,000	10,000	0
Parks, Recreation and Historic Preservation, Office of	257,877	256,888	0	256,888	319,996	289,627	256,158	254,800
<b>Functional Total</b>	<b>1,115,180</b>	<b>1,212,286</b>	<b>0</b>	<b>1,212,286</b>	<b>1,252,311</b>	<b>1,229,532</b>	<b>1,188,673</b>	<b>1,184,611</b>
<b>TRANSPORTATION</b>								
Motor Vehicles, Department of	257,839	285,613	0	285,613	316,215	305,133	311,759	319,602
Thruway Authority	1,775	1,734	0	1,734	1,734	1,804	1,876	1,951
Metropolitan Transportation Authority	0	93,700	0	93,700	188,550	258,700	278,922	262,600
Transportation, Department of	5,553,463	6,291,418	0	6,291,418	6,777,123	6,969,066	7,177,524	7,246,077
<b>Functional Total</b>	<b>5,813,077</b>	<b>6,672,465</b>	<b>0</b>	<b>6,672,465</b>	<b>7,283,622</b>	<b>7,534,703</b>	<b>7,770,081</b>	<b>7,830,230</b>
<b>HEALTH AND SOCIAL WELFARE</b>								
Aging, Office for the	197,862	229,194	0	229,194	240,097	245,042	253,378	257,524
Children and Family Services, Office of	2,711,049	2,910,937	0	2,910,937	3,175,932	3,318,432	3,498,975	3,651,761
OCFS	2,711,049	2,910,937	(33,505)	2,877,432	3,132,462	3,252,565	3,387,181	3,519,160
OCFS - Medicaid	0	0	33,505	33,505	43,505	65,867	111,794	132,601
Health, Department of	37,770,678	37,313,545	0	37,313,545	38,671,751	41,366,769	43,804,199	46,452,940
Medical Assistance	32,388,167	31,233,203	0	31,233,203	32,500,763	34,987,577	37,233,503	39,921,945
Medicaid Administration	745,408	820,000	0	820,000	853,000	887,000	922,500	959,250
DOH - Other	4,637,103	5,260,342	0	5,260,342	5,317,988	5,492,192	5,648,196	5,571,745
Human Rights, Division of	16,226	15,816	0	15,816	17,068	17,819	17,791	17,850
Labor, Department of	518,146	511,893	0	511,893	511,053	501,096	501,096	506,055
Medicaid Inspector General, Office of	34,842	74,017	0	74,017	91,603	94,148	95,267	95,942
Prevention of Domestic Violence, Office for	2,315	2,556	0	2,556	2,563	2,575	2,587	2,597
Stem Cell and Innovation	0	15,000	0	15,000	100,000	85,000	50,000	50,000

**CASH DISBURSEMENTS BY FUNCTION**  
**ALL GOVERNMENTAL FUNDS**  
(thousands of dollars)

	2006-2007 Actuals	2007-2008 January	Medicaid Transparency	2007-2008 Adjusted	2008-2009 Recommended	2009-2010 Projected	2010-2011 Projected	2011-2012 Projected
<b>HEALTH AND SOCIAL WELFARE (Continued)</b>								
Temporary and Disability Assistance, Office of Welfare Assistance	4,458,278	4,664,522	0	4,664,522	4,481,508	4,564,415	4,570,869	4,578,495
Welfare Administration	3,016,154	3,189,923	0	3,189,923	3,005,309	3,074,568	3,073,881	3,074,381
All Other	380,349	376,933	0	376,933	371,233	373,233	373,233	373,233
Welfare Inspector General, Office of	1,061,775	1,097,666	0	1,097,666	1,104,966	1,116,614	1,123,755	1,130,881
Workers' Compensation Board	1,074	1,181	0	1,181	1,243	1,261	1,279	1,297
<b>Functional Total</b>	<b>448,277</b>	<b>162,246</b>	<b>0</b>	<b>162,246</b>	<b>152,828</b>	<b>154,944</b>	<b>157,199</b>	<b>157,199</b>
	45,858,747	45,900,907	0	45,900,907	47,445,881	50,351,501	52,952,640	55,771,660
<b>MENTAL HEALTH</b>								
Mental Health, Office of	2,335,339	2,543,085	478,586	3,021,671	2,644,468	2,865,799	2,998,123	3,087,952
OMH	2,335,339	2,543,085	(1,492,746)	1,050,339	1,139,723	1,409,358	1,541,682	1,631,511
OMH - Medicaid	0	0	1,971,332	1,971,332	1,504,745	1,456,441	1,456,441	1,456,441
Mental Hygiene, Department of	8,473	7,800	0	7,800	7,800	7,800	7,800	7,800
Mental Retardation and Developmental Disabilities, Office of	3,168,254	3,421,345	1,002,750	4,424,095	3,515,663	3,675,618	3,789,062	3,828,490
OMRDD	3,168,254	3,421,345	(2,550,379)	870,966	492,105	486,346	611,831	669,976
OMRDD - Medicaid	0	0	3,553,129	3,553,129	3,023,558	3,189,272	3,177,231	3,158,514
Alcoholism and Substance Abuse Services, Office of	521,906	592,931	24,423	617,354	649,878	732,923	722,331	758,665
OASAS	521,906	592,931	(46,580)	546,351	603,298	686,343	675,751	712,085
OASAS - Medicaid	0	0	71,003	71,003	46,580	46,580	46,580	46,580
Developmental Disabilities Planning Council	4,129	3,621	0	3,621	3,617	3,617	3,617	3,617
Quality of Care for the Mentally Disabled, Commission on	12,605	15,592	0	15,592	16,414	16,715	16,768	16,802
<b>Functional Total</b>	<b>6,060,706</b>	<b>6,584,374</b>	<b>1,505,759</b>	<b>8,090,133</b>	<b>6,837,840</b>	<b>7,302,472</b>	<b>7,537,701</b>	<b>7,703,326</b>
<b>PUBLIC PROTECTION</b>								
Capital Defenders Office	1,568	1,300	0	1,300	368	0	0	0
Correction, Commission of	2,621	2,629	0	2,629	2,753	2,784	2,814	2,846
Correctional Services, Department of	2,736,338	2,702,380	0	2,702,380	2,797,864	2,852,013	2,927,428	2,995,137
Crime Victims Board	60,073	62,709	0	62,709	62,483	62,537	62,591	62,647
Criminal Justice Services, Division of	267,326	248,655	0	248,655	259,754	249,809	245,474	237,867
Homeland Security	29,562	230,148	0	230,148	298,782	460,327	559,052	559,832
Investigation, Temporary State Commission of	3,551	3,929	0	3,929	4,076	0	0	0
Judicial Commissions	2,785	4,785	0	4,785	5,139	5,221	5,283	5,386
Military and Naval Affairs, Division of	401,627	462,207	0	462,207	360,263	150,619	171,438	186,481
Parole, Division of	194,729	206,318	0	206,318	208,482	221,011	237,792	242,593
Probation and Correctional Alternatives, Division of	72,752	74,649	0	74,649	78,931	81,157	81,196	80,886
State Police, Division of	644,506	613,303	0	613,303	641,595	643,161	636,979	627,256
<b>Functional Total</b>	<b>4,417,428</b>	<b>4,613,012</b>	<b>0</b>	<b>4,613,012</b>	<b>4,720,490</b>	<b>4,728,639</b>	<b>4,930,047</b>	<b>5,000,931</b>

**CASH DISBURSEMENTS BY FUNCTION**  
**ALL GOVERNMENTAL FUNDS**  
(thousands of dollars)

	2006-2007 Actuals	2007-2008 January	Medicaid Transparency	2007-2008 Adjusted	2008-2009 Recommended	2009-2010 Projected	2010-2011 Projected	2011-2012 Projected
<b>EDUCATION</b>								
Arts, Council on the	49,244	55,766	0	55,766	55,662	55,842	55,823	55,923
City University of New York Education, Department of	1,064,544	1,143,206	0	1,143,206	1,321,507	1,375,671	1,441,356	1,467,236
<i>School Aid</i>	26,657,044	29,344,857	0	29,344,857	30,763,488	33,440,853	36,459,421	38,681,129
<i>School Aid - Medicaid Assistance</i>	20,088,579	21,848,418	(80,000)	21,768,418	23,148,155	24,982,432	27,337,670	29,191,350
<i>Special Education Categorical Programs</i>	0	0	80,000	80,000	80,000	80,000	80,000	80,000
<i>STAR Property Tax Relief</i>	1,620,800	1,719,600	0	1,719,600	1,752,690	1,863,590	1,946,590	2,052,090
<i>All Other</i>	3,983,970	4,678,570	0	4,678,570	4,712,899	5,423,170	5,949,569	6,235,582
Higher Education Services Corporation	953,695	1,098,269	0	1,098,269	1,069,744	1,091,661	1,145,592	1,122,107
Higher Education Capital grants	956,737	954,454	0	954,454	914,493	932,715	932,239	931,795
State University Construction Fund	0	10,000	0	10,000	50,000	30,000	30,000	30,000
State University of New York	13,157	12,478	0	12,478	13,680	13,822	13,966	14,112
<b>Functional Total</b>	<b>5,447,926</b>	<b>5,774,221</b>	<b>0</b>	<b>5,774,221</b>	<b>5,872,410</b>	<b>6,011,760</b>	<b>6,161,001</b>	<b>6,210,428</b>
	<b>34,188,652</b>	<b>37,294,982</b>	<b>0</b>	<b>37,294,982</b>	<b>38,991,240</b>	<b>41,860,663</b>	<b>45,093,806</b>	<b>47,390,623</b>
<b>GENERAL GOVERNMENT</b>								
Audit and Control, Department of	244,078	251,534	0	251,534	258,612	261,688	265,560	267,913
Budget, Division of the	54,817	73,362	0	73,362	91,000	86,243	94,614	91,563
Civil Service, Department of	24,363	23,653	0	23,653	23,922	24,102	24,335	24,571
Elections, State Board of	13,037	29,119	0	29,119	68,917	184,442	9,716	9,833
Employee Relations, Office of	14,517	4,000	0	4,000	4,134	4,119	4,160	4,200
Executive Chamber	255,060	229,724	0	229,724	233,381	228,087	239,644	238,089
General Services, Office of	5,933	6,908	0	6,908	7,153	7,327	7,447	7,529
Inspector General, Office of	193,461	205,763	0	205,763	229,081	232,610	235,554	240,536
Law, Department of	360	1,378	0	1,378	1,420	1,460	1,500	1,550
Lieutenant Governor, Office of the	177,360	182,527	0	182,527	180,147	184,318	188,393	188,393
Lottery, Division of	0	0	0	0	5,432	5,459	5,502	5,860
Commission on Public Integrity	16,899	18,754	0	18,754	18,178	18,622	18,803	18,803
Racing and Wagering Board, State	47,620	51,651	0	51,651	52,655	54,202	55,040	56,032
Real Property Services, Office of	3,509	3,781	0	3,781	3,480	3,526	3,550	3,550
Regulatory Reform, Governor's Office of	3,376	4,077	0	4,077	4,207	4,243	4,284	4,331
Public Employment Relations Board	148,140	210,303	0	210,303	159,916	156,199	156,162	152,338
State, Department of	3,228	3,233	0	3,233	3,273	3,308	3,343	3,343
Tax Appeals, Division of	355,452	367,658	0	367,658	367,454	374,708	378,963	379,018
Taxation and Finance, Department of	19,258	28,309	0	28,309	94,073	144,605	239,775	156,264
Technology, Office for	2,338	0	0	0	0	0	0	(332)
Lobbying, Temporary State Commission on	14,117	15,568	0	15,568	17,820	16,844	16,508	16,071
Veterans Affairs, Division of	1,600,775	1,731,422	0	1,731,422	1,845,185	2,017,672	1,975,053	1,892,325
<b>Functional Total</b>	<b>112,763,918</b>	<b>118,313,828</b>	<b>0</b>	<b>118,313,828</b>	<b>124,329,336</b>	<b>132,325,901</b>	<b>139,821,760</b>	<b>145,661,106</b>
<b>ALL OTHER CATEGORIES</b>								
Legislature	213,118	220,319	0	220,319	226,879	229,531	229,574	229,574
Judiciary (excluding fringe benefits)	1,731,791	1,829,753	0	1,829,753	2,032,399	2,072,858	2,217,176	2,347,564
World Trade Center	37,020	50,000	0	50,000	70,000	70,000	35,000	32,500
Local Government Assistance	1,156,176	938,461	0	938,461	1,136,649	1,376,151	1,440,247	1,410,278
Long-Term Debt Service	4,450,737	4,291,999	0	4,291,999	4,628,094	5,106,458	5,737,221	6,063,808
General State Charges	5,222,834	5,368,881	(1,505,759)	3,863,122	5,555,509	5,873,099	6,168,791	6,556,793
Miscellaneous	(80,058)	17,602	0	17,602	416,330	698,262	930,375	878,966
<b>Functional Total</b>	<b>12,731,618</b>	<b>12,717,015</b>	<b>(1,505,759)</b>	<b>11,211,256</b>	<b>14,065,860</b>	<b>15,426,359</b>	<b>16,758,384</b>	<b>17,519,483</b>
<b>TOTAL ALL GOVERNMENTAL FUNDS SPENDING</b>	<b>112,763,918</b>	<b>118,313,828</b>	<b>0</b>	<b>118,313,828</b>	<b>124,329,336</b>	<b>132,325,901</b>	<b>139,821,760</b>	<b>145,661,106</b>

Source: NYS DOB

**GAAP FINANCIAL PLAN  
GENERAL FUND  
2007-2008 and 2008-2009  
(millions of dollars)**

	<u>2007-2008</u> <u>Current</u>	<u>2008-09</u> <u>Recommended</u>	<u>Annual</u> <u>Change</u>
<b>Revenues:</b>			
Taxes:			
Personal income tax	22,245	24,802	2,557
User taxes and fees	8,581	8,831	250
Business taxes	6,604	7,229	625
Other taxes	1,118	1,272	154
Miscellaneous revenues	5,357	5,262	(95)
Federal grants	71	41	(30)
<b>Total revenues</b>	<u>43,976</u>	<u>47,437</u>	<u>3,461</u>
<b>Expenditures:</b>			
Grants to local governments	38,998	43,986	4,988
State operations	12,139	12,888	749
General State charges	3,891	3,962	71
Debt service	0	0	0
Capital projects	10	11	1
<b>Total expenditures</b>	<u>55,038</u>	<u>60,847</u>	<u>5,809</u>
<b>Other financing sources (uses):</b>			
Transfers from other funds	15,085	18,295	3,210
Transfers to other funds	(5,504)	(5,736)	(232)
Proceeds from financing arrangements/ advance refundings	330	330	0
<b>Net other financing sources (uses)</b>	<u>9,911</u>	<u>12,889</u>	<u>2,978</u>
<b>(Excess) deficiency of revenues and other financing sources over expenditures and other financing uses</b>	<u>(1,151)</u>	<u>(521)</u>	<u>630</u>
<b>Accumulated Surplus/(Deficit)</b>	<u>1,233</u>	<u>712</u>	<u>(521)</u>

Source: NYS DOB

**GAAP FINANCIAL PLAN  
ALL GOVERNMENTAL FUNDS  
EXECUTIVE BUDGET  
2007-2008  
(millions of dollars)**

	<b>General Fund</b>	<b>Special Revenue Funds</b>	<b>Capital Projects Funds</b>	<b>Debt Service Funds</b>	<b>(MEMO) Total</b>
<b>Revenues:</b>					
Taxes	38,548	7,786	2,017	12,596	60,947
Patient fees	0	0	0	326	326
Miscellaneous revenues	5,357	5,119	312	24	10,812
Federal grants	71	36,416	1,859	0	38,346
<b>Total revenues</b>	<b>43,976</b>	<b>49,321</b>	<b>4,188</b>	<b>12,946</b>	<b>110,431</b>
<b>Expenditures:</b>					
Grants to local governments	38,998	46,602	602	0	86,202
State operations	12,139	1,802	0	58	13,999
General State charges	3,891	339	0	0	4,230
Debt service	0	0	0	3,606	3,606
Capital projects	10	5	7,455	0	7,470
<b>Total expenditures</b>	<b>55,038</b>	<b>48,748</b>	<b>8,057</b>	<b>3,664</b>	<b>115,507</b>
<b>Other financing sources (uses):</b>					
Transfers from other funds	15,085	2,865	217	5,680	23,847
Transfers to other funds	(5,504)	(3,872)	(960)	(14,861)	(25,197)
Proceeds of general obligation bonds	0	0	298	0	298
Proceeds from financing arrangements/ advance refundings	330	0	3,689	0	4,019
<b>Net other financing sources (uses)</b>	<b>9,911</b>	<b>(1,007)</b>	<b>3,244</b>	<b>(9,181)</b>	<b>2,967</b>
<b>(Excess) deficiency of revenues and other financing sources over expenditures and other financing uses</b>					
	<b>(1,151)</b>	<b>(434)</b>	<b>(625)</b>	<b>101</b>	<b>(2,109)</b>

Source: NYS DOB

**GAAP FINANCIAL PLAN  
ALL GOVERNMENTAL FUNDS  
EXECUTIVE BUDGET  
2008-2009  
(millions of dollars)**

	<b>General Fund</b>	<b>Special Revenue Funds</b>	<b>Capital Projects Funds</b>	<b>Debt Service Funds</b>	<b>(MEMO) Total</b>
<b>Revenues:</b>					
Taxes	42,134	8,023	2,095	13,123	65,375
Patient fees	0	0	0	330	330
Miscellaneous revenues	5,262	5,246	373	25	10,906
Federal grants	41	37,394	2,010	0	39,445
<b>Total revenues</b>	<b>47,437</b>	<b>50,663</b>	<b>4,478</b>	<b>13,478</b>	<b>116,056</b>
<b>Expenditures:</b>					
Grants to local governments	43,986	47,853	614	0	92,453
State operations	12,888	1,870	0	62	14,820
General State charges	3,962	347	0	0	4,309
Debt service	0	0	0	3,704	3,704
Capital projects	11	3	8,607	0	8,621
<b>Total expenditures</b>	<b>60,847</b>	<b>50,073</b>	<b>9,221</b>	<b>3,766</b>	<b>123,907</b>
<b>Other financing sources (uses):</b>					
Transfers from other funds	18,295	3,192	579	5,764	27,830
Transfers to other funds	(5,736)	(3,930)	(1,230)	(15,440)	(26,336)
Proceeds of general obligation bonds	0	0	457	0	457
Proceeds from financing arrangements/ advance refundings	330	0	4,570	0	4,900
<b>Net other financing sources (uses)</b>	<b>12,889</b>	<b>(738)</b>	<b>4,376</b>	<b>(9,676)</b>	<b>6,851</b>
<b>(Excess) deficiency of revenues and other financing sources over expenditures and other financing uses</b>					
	(521)	(148)	(367)	36	(1,000)

Source: NYS DOB

## NOTES ON MEDICAID FINANCIAL PLAN PRESENTATION

### Medicaid Transparency

The 2008-09 Financial Plan reflects a cost-neutral restructuring of the reporting of certain spending that is intended to improve transparency and assist in analysis of the State's largest program. Specifically, and as explained in detail below, the Financial Plan is adjusted to:

- Provide more budgeting transparency for the State's Medicaid Program such that the Financial Plan will clearly identify the total amount of Medicaid spending for every agency.
- Allocate employee fringe benefit costs to Mental Hygiene agencies, to provide a more accurate depiction of the total costs of providing services in these agencies.

Previously, the State's Medicaid appropriations and spending had been dispersed among various agencies, with the Federal share of Medicaid generally appropriated in DOH, and the State share of Medicaid appropriated through various agencies participating in the Medicaid program, including: the Office of Mental Health (OMH), the Office of Mental Retardation and Developmental Disabilities (OMRDD), the Office of Alcoholism and Substance Abuse Services (OASAS), the State Education Department (SED), and the Office of Children and Family Services (OCFS). For 2008-09, transparency is advanced by consolidating and recognizing for the first time in DOH's appropriations, the State share of Medicaid for OMRDD, OMH and OASAS State Operations.

As a result of these changes, for the first time ever, readers of the State's Financial Plan will be able to easily see the total costs of the State's Medicaid program (excluding the share provided by local governments) for each agency that provides Medicaid services. The following table summarizes this Medicaid information that is now provided in the Financial Plan tables.

2008-09 Statewide Medicaid Program				
Total Disbursements*				
(millions of dollars)				
	General Fund	Special Revenue	Federal Funds	All Government
DOH - Medicaid	12,724	475	20,156	33,355
Mental Hygiene - Medicaid	1,693	1,163	2,703	5,559
OCFS - Medicaid	43	0	0	43
SED - Medicaid	80	0	0	80
<b>State and Federal Share Total</b>	<b>14,540</b>	<b>1,638</b>	<b>22,859</b>	<b>39,037</b>
Local Share	0	0	0	7,221
<b>Grand Total</b>	<b>14,540</b>	<b>1,638</b>	<b>22,859</b>	<b>46,258</b>

\*Includes Local Assistance, State Operations, and General State Charges

A second component of budgeting transparency and rationalizing reimbursement involves charging OMH, OMRDD and OASAS their appropriate share of employee fringe benefits as is currently the practice with other State agencies whose revenue is partially or totally derived from non-General Fund sources.

As summarized in the following tables, this results in appropriation restructurings and cost-neutral spending adjustments which generally reflect a roughly \$2.7 billion increase in General Fund State Medicaid share resources in DOH and a concomitant decrease in General Fund fringe benefits spending in the General State Charges (GSCs) budget and in the Mental Hygiene agencies. Corresponding adjustments are also made in State Funds and All Funds reporting. Accordingly, this initiative has no impact on the State's Financial Plan, but is recommended with the goal of achieving greater transparency in the budgeting of Medicaid and a more accurate reporting of fringe benefit responsibilities.

To facilitate comparable reporting of spending trends and annual growth, the Financial Plan tables for 2007-08 provide projections on an actual basis and on an adjusted basis (with details on each adjustment) by agency for each financial plan category of spending and by fund. The multi-year adjustments are summarized in the following tables.

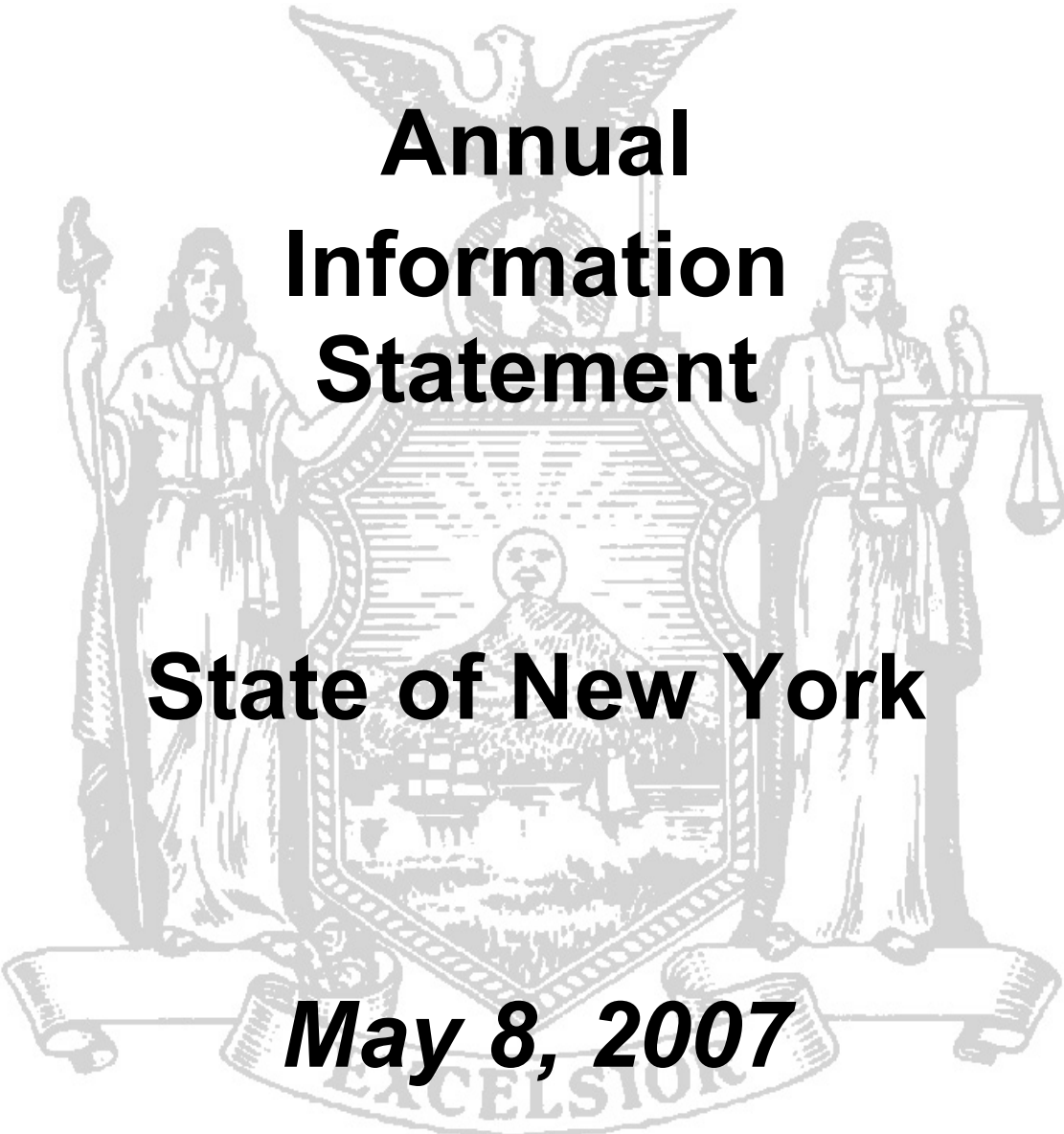
<b>General Fund Medicaid Transparency Increase/(Decrease) in Spending (millions of dollars)</b>					
	<u>2007-08<sup>(1)</sup></u>	<u>2008-09</u>	<u>2009-10</u>	<u>2010-11</u>	<u>2011-12</u>
DOH - Medicaid	2,649	2,649	2,636	2,646	2,656
OMH	(1,249)	(1,249)	(1,477)	(1,381)	(1,296)
OMRDD	377	377	277	184	178
OASAS	(271)	(271)	(300)	(314)	(331)
Central GSCs	<u>(1,506)</u>	<u>(1,506)</u>	<u>(1,136)</u>	<u>(1,135)</u>	<u>(1,207)</u>
<b>Total</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>0</b>

<b>State Funds Medicaid Transparency Increase/(Decrease) in Spending (millions of dollars)</b>					
	<u>2007-08<sup>(1)</sup></u>	<u>2008-09</u>	<u>2009-10</u>	<u>2010-11</u>	<u>2011-12</u>
DOH - Medicaid	-	-	-	-	-
OMH	226	226	254	307	327
OMRDD	1,262	1,262	862	807	858
OASAS	18	18	20	21	22
Central GSCs	<u>(1,506)</u>	<u>(1,506)</u>	<u>(1,136)</u>	<u>(1,135)</u>	<u>(1,207)</u>
<b>Total</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>0</b>

<b>All Funds Medicaid Transparency Increase/(Decrease) in Spending (millions of dollars)</b>					
	<u>2007-08<sup>(1)</sup></u>	<u>2008-09</u>	<u>2009-10</u>	<u>2010-11</u>	<u>2011-12</u>
DOH - Medicaid	-	-	-	-	-
OMH	479	479	503	568	602
OMRDD	1,003	1,003	607	540	576
OASAS	24	24	26	27	29
Central GSCs	<u>(1,506)</u>	<u>(1,506)</u>	<u>(1,136)</u>	<u>(1,135)</u>	<u>(1,207)</u>
<b>Total</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>0</b>

<sup>(1)</sup> For purposes of the 2007-08 adjustment, the 2008-09 amounts were used to ensure reports on annual spending growth were not impacted by the adjustment, and because actual 2007-08 adjusted results will not be reflected in the State's accounting system for this transaction.



The seal of the State of New York is centered in the background. It features an eagle with wings spread at the top, perched on a globe. Below the eagle is a shield with a landscape scene, including a sun, a plow, and a sheaf of wheat. On either side of the shield stand two female figures: Liberty on the left holding a torch and a scroll, and Justice on the right holding a scale. At the bottom of the shield is a banner with the word "EXCELSIOR".

**Annual  
Information  
Statement**

**State of New York**

***May 8, 2007***

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# Annual Information Statement

## State of New York

*Dated: May 8, 2007*

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# Annual Information Statement of the State of New York

## Introduction

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This Annual Information Statement (“AIS”) is dated May 8, 2007 and contains information only through that date. This AIS constitutes the official disclosure information regarding the financial condition of the State of New York (the “State”) and replaces the Annual Information Statement dated June 12, 2006 and all updates and supplements thereto. The AIS is scheduled to be updated on a quarterly basis (in August 2007, November 2007, and February 2008) and is subject to being supplemented from time to time as developments may warrant. This AIS, including the Exhibits attached hereto, should be read in its entirety, together with any update or supplement issued during the fiscal year.

In this AIS, readers will find:

1. A section entitled the “Current Fiscal Year” that contains (a) extracts from the 2007-08 Enacted Budget Financial Plan dated April 19, 2007 (the “Financial Plan”) prepared by the Division of the Budget (“DOB”), including the State’s official Financial Plan projections, and (b) a discussion of potential risks that may affect the Financial Plan during the State’s current fiscal year under the heading “Special Considerations.” The first part of the section entitled “Current Fiscal Year” summarizes the major components of the 2007-08 Enacted Budget and the projected impact on operations, annual spending growth, and the magnitude of future potential budget gaps; the second part provides detailed information on projected total receipts and disbursements in the State’s governmental funds in 2007-08.
2. Information on other subjects relevant to the State’s fiscal condition, including: (a) operating results for the three prior fiscal years, (b) the State’s revised economic forecast and a profile of the State economy, (c) debt and other financing activities, (d) governmental organization, and (e) activities of public authorities and localities.
3. The status of significant litigation that has the potential to adversely affect the State’s finances.

DOB is responsible for organizing and presenting the information that appears in this AIS on behalf of the State. In preparing the AIS, DOB relies on information drawn from other sources, such as the Office of the State Comptroller (“OSC”). Information relating to matters described in the section entitled “Litigation” is furnished by the State Office of the Attorney General.

During the fiscal year, the Governor, the State Comptroller, State legislators, and others may issue statements or reports that contain predictions, projections or other information relating to the State’s financial condition, including potential operating results for the current fiscal year and projected baseline gaps for future fiscal years, that may vary materially from the information provided in this AIS. Investors and other market participants should, however, refer to this AIS, as updated or supplemented, for official information regarding the financial condition of the State.

The State intends to announce publicly whenever an update or a supplement is issued. The State may choose to incorporate by reference all or a portion of this AIS in Official Statements or related disclosure documents for State or State-supported debt issuance. The State has filed this AIS directly

with the Nationally Recognized Municipal Securities Information Repositories (NRMSIRs) and with the Central Post Office, Disclosure USA. The Municipal Advisory Council of Texas established this internet-based disclosure filing system, approved by the Securities and Exchange Commission, to facilitate the transmission of disclosure-related information to the NRMSIRs. An official copy of this AIS may be obtained by contacting Mr. Louis Raffaele, Chief Budget Examiner, New York State Division of the Budget, State Capitol, Albany, NY 12224, Tel: (518) 473-8705 or from any NRMSIR. OSC expects to issue the Basic Financial Statements for the 2006-07 fiscal year in July 2007. Copies may be obtained by contacting the Office of the State Comptroller, 110 State Street, Albany, NY 12236 and will be available on its website at [www.osc.state.ny.us](http://www.osc.state.ny.us).

## Usage Notice

The AIS has been supplied by the State to provide updated information about the financial condition of the State in connection with financings of certain issuers, including public authorities of the State, that may depend in whole or in part on State appropriations as sources of payment of their respective bonds, notes or other obligations and for which the State has contractually obligated itself to provide such information pursuant to an applicable continuing disclosure agreement (a “CDA”).

An informational copy of this AIS is available on the DOB website ([www.budget.state.ny.us](http://www.budget.state.ny.us)). The availability of this AIS in electronic form at DOB’s website is being provided solely as a matter of convenience to readers and does not create any implication that there have been no changes in the financial condition of the State at any time subsequent to its release date. Maintenance of the AIS on the website is not intended as a republication of the information therein on any date subsequent to its release date.

**Neither this AIS nor any portion thereof may be (i) included in a Preliminary Official Statement, Official Statement, or other offering document, or incorporated by reference therein, unless DOB has expressly consented thereto following a written request to the State of New York, Division of the Budget, State Capitol, Albany, NY 12224 or (ii) considered to be continuing disclosure in connection with any offering unless a CDA relating to the series of bonds or notes has been executed by DOB. Any such use, or incorporation by reference, of this AIS or any portion thereof in a Preliminary Official Statement, Official Statement, or other offering document or continuing disclosure filing without such consent and agreement by DOB is unauthorized and the State expressly disclaims any responsibility with respect to the inclusion, intended use, and updating of this AIS if so misused.**

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## Current Fiscal Year

*The 2007-08 Enacted Budget Financial Plan, extracts of which are set forth below, was prepared by the DOB and reflects the actions of the Legislature and Governor.*

*The 2007-08 Enacted Budget Financial Plan contains estimates for 2007-08 and projections for 2008-09 through 2010-11. As such, it contains estimates and projections of future results that should not be construed as statements of fact. These estimates and projections are based upon various assumptions, including future economic conditions in the State and nation and potential litigation. There can be no assurance that actual results will not differ materially and adversely from the estimates and projections contained in the 2007-08 Enacted Budget Financial Plan set forth below.*

*The State accounts for all of its spending and revenues by the fund in which the activity takes place (such as the General Fund), and the broad category or purpose of that activity (such as State Operations). The Financial Plan tables sort all State projections and results by fund and category. The State Constitution requires the Governor to submit an Executive Budget that is balanced on a cash basis in the General Fund — the Fund that receives the majority of State taxes, and all income not earmarked for a particular program or activity. Since this is the fund that is statutorily required to be balanced, the focus of the State's budget discussion is often weighted toward the General Fund.*

*The State also reports spending and revenue activity by two other broad measures: State Funds, which includes the General Fund and funds specified for dedicated purposes, but excludes Federal Funds; and All Governmental Funds, which includes both State and Federal Funds and provides the most comprehensive view of the financial operations of the State.*

*Fund types of the State include: the General Fund; State special revenue funds (SRFs), which receive certain dedicated taxes, fees and other revenues that are used for a specified purpose; Federal SRFs, which receive Federal grants; State and Federal Capital Projects Funds, which account for costs incurred in the construction and reconstruction of roads, bridges, prisons, and other infrastructure projects; and Debt Service Funds, which pay principal, interest and related expenses on long-term bonds issued by the State and its public authorities.*

### **2007-08 Enacted Budget Financial Plan Overview**

Governor Spitzer submitted his \$120.6 billion Executive Budget for fiscal year 2007-08 to the Legislature on January 31, 2007. During budget negotiations, the Executive and Legislature reached agreement that a total of \$1 billion in resources above the Executive Budget forecast were available to finance legislative changes to the Governor's Executive Budget. The Executive, Senate, and Assembly negotiated a budget agreement that culminated with enactment of the budget on April 1, 2007, in time for the start of the State's fiscal year. As in past years, the Legislature enacted the debt service bill in March prior to taking final action on the entire budget. The Governor did not veto any legislative additions.

<b>2007-08 Enacted Budget at a Glance: Impact on Key Measures</b>			
	<b>2006-07 Results*</b>	<b>2007-08 Executive</b>	<b>2007-08 Enacted</b>
<b>Size of the Budget (millions)</b>			
General Fund	\$51,591	\$53,248	\$53,684
State Funds	\$77,311	\$83,545	\$83,779
All Funds	\$112,764	\$120,635	\$120,675
<b>Annual Spending Growth</b>			
General Fund	11.0%	4.2%	4.1%
State Funds	10.9%	7.8%	8.4%
All Funds	8.1%	6.3%	7.0%
<b>Capital Spending</b>			
Capital Projects State Funds	\$3,822	\$5,628	\$5,354
Capital Projects All Funds	\$5,559	\$7,604	\$7,352
State Funds Growth (excl. Capital)	10.8%	6.2%	6.7%
All Funds Growth (excl. Capital)	8.1%	5.1%	5.7%
<b>Receipts (All Funds) (millions)</b>			
Taxes	\$58,739	\$60,961	\$61,960
Miscellaneous Receipts	\$18,078	\$20,058	\$20,402
Federal Grants	\$35,579	\$37,313	\$37,128
Underlying Tax Growth	12.8%	6.5%	7.8%
<b>Outyear Gap Forecast (billions)</b>			
2008-09	n/ap	\$2.3	\$3.1
2009-10	n/ap	\$4.5	\$4.8
2010-11	n/ap	\$6.3	\$6.6
<b>Total General Fund Reserves (billions)</b>	\$3.0	\$3.0	\$3.0
<b>State Workforce</b>	195,526	197,068	198,413
<b>Debt (billions)</b>			
Debt Service as % All Funds	4.4%	4.2%	4.0%
State Related Debt Outstanding	\$48.1	\$52.6	\$52.0

\* Preliminary, unaudited results.

The Enacted Budget Financial Plan for 2007-08 is balanced on a cash basis in the General Fund, based on DOB's current estimates. Annual spending in the General Fund is projected to grow by \$2.1 billion (4.1 percent) from 2006-07 levels, which includes substantial increases in aid to public schools. The growth in spending is moderated by cost containment initiatives that reduce the overall rate of growth in health care spending. All Governmental Funds<sup>1</sup> spending, which includes Federal aid, is estimated at \$120.7 billion in 2007-08, an increase of \$7.9 billion (7.0 percent) from 2006-07. Consistent with the Executive Budget recommendations, the Enacted Budget establishes \$1.2 billion in flexible reserves that are planned to help balance future budgets. The General Fund is projected to have a closing balance of

<sup>1</sup> Hereafter "All Funds." Comprises the General Fund, Special Revenue Funds, Capital Projects Funds, and Debt Service Funds.

\$3.0 billion in 2007-08, comparable to the level at the close of 2006-07. The balance consists of \$1.2 billion in undesignated reserves and \$1.8 billion in reserves for designated purposes.

The Enacted Budget Financial Plan projects potential General Fund budget gaps in future years in the range of \$3.1 billion in 2008-09 growing to \$4.8 billion in 2009-10 and \$6.6 billion in 2010-11. State law requires that the annual budget submitted by the Governor and enacted by the Legislature be in balance.

The table below summarizes the multi-year General Fund fiscal impact of the 2007-08 Enacted Budget.

<b>Changes to General Fund Operating Forecast for 2007-08 Through 2010-11</b>				
	<b>Savings/(Costs)</b>			
	<b>(millions of dollars)</b>			
	<b>2007-08</b>	<b>2008-09</b>	<b>2009-10</b>	<b>2010-11</b>
<b>Executive Budget "Current Services" Gap Estimates (Before Actions)</b>	<b>(1,540)</b>	<b>(2,965)</b>	<b>(5,060)</b>	<b>(5,331)</b>
Proposed Savings Actions	3,850	3,774	4,851	5,050
Proposed Initiatives	(1,885)	(3,101)	(4,274)	(5,964)
Proposed Deposit to Debt Reduction Reserve	(250)	0	0	0
Proposed Deposit to New Rainy Day Reserve	(175)	0	0	0
<b>Executive Budget Surplus/(Gap) Estimate</b>	<b>0</b>	<b>(2,292)</b>	<b>(4,483)</b>	<b>(6,245)</b>
Net Legislative Additions	(1,215)	(1,719)	(1,649)	(1,750)
Net Available Resources	1,215	906	1,361	1,370
<b>Enacted Budget Surplus/(Gap) Estimate</b>	<b>0</b>	<b>(3,105)</b>	<b>(4,771)</b>	<b>(6,625)</b>

Entering the 2007-08 budget cycle, the State estimated a General Fund budget imbalance of \$1.6 billion in 2007-08 and gaps in the range of \$3 billion to \$6 billion in future years. The Enacted Budget Financial Plan, which incorporates both the Legislature's modifications to Executive recommendations and revisions to current service receipts and spending estimates, is also balanced in 2007-08, with gaps somewhat greater than those forecast at the time of the Executive Budget.

During budget negotiations, the Executive and Legislature agreed that additional net resources were available to finance changes to the 2007-08 Executive Budget. The resources included \$1 billion in higher projected tax revenues; \$50 million in additional abandoned property receipts; \$50 million in savings in State programs based on updated information on program trends; new spending cuts and proposed spending not accepted by the Legislature totaling roughly \$92 million in addition to \$69 million in savings (such as retroactive Judicial salary increases) that affected 2006-07 estimated disbursements; and approximately \$187 million in available fund balances. Planned payments from New York City of \$428 million in 2007-08 and \$350 million in 2008-09, which were originally added to the State's receipts forecast in 2005, have been removed from the Financial Plan, partially offsetting the increase in available



resources. New York City did not make similar planned payments in 2005-06 or 2006-07 and, accordingly, any such payments in the current or future years are no longer counted in the Financial Plan.

The Enacted Budget Financial Plan includes a number of substantive fiscal and policy initiatives:

- **School Aid:** A new Foundation Aid formula is enacted in permanent law that bases the amount of School Aid on a district's educational needs and its ability to provide local support for education. Under the Foundation Aid formula, approximately 72 percent of the aid increase will go to high-needs districts.
- **School Tax Relief (STAR):** The Enacted Budget expands the STAR program, providing a new benefit that is targeted to middle class taxpayers.
- **Expanded access to health care for children:** Access to health insurance coverage is made available for the 400,000 children that are without coverage in New York State.
- **Investment in stem cell research:** Provides initial funding for stem cell research.
- **Increased deposits in reserves:** The Enacted Budget finances deposits of \$250 million to the Debt Reduction Reserve and \$175 million to the new Rainy Day Reserve.

To finance the initiatives and eliminate the "current services" imbalance, the Enacted Budget Financial Plan includes \$3.5 billion in savings and the use of prior-year surpluses:

- Savings of \$2.0 billion in spending restraint of which more than \$1 billion will slow growth in Health, Medicaid and Mental Hygiene spending.
- Approximately \$450 million in loophole-closing revenue actions, which is partially offset by \$150 million in revenue reductions from broad-based business tax cuts.
- About \$1.0 billion from the use of prior year surplus moneys.

The Enacted Budget Financial Plan maintains reserves of \$3.0 billion in 2007-08, comparable to the level at the close of 2006-07. Reserves equal roughly 5.7 percent of projected General Fund spending. The Budget includes an initial deposit of \$175 million to the new Rainy Day Reserve that may be used to respond to an economic downturn or catastrophic event and a \$250 million deposit to the State's Debt Reduction Reserve that will be used to eliminate high-cost debt. The reserves also include \$1.0 billion in the Tax Stabilization Reserve Fund, \$1.2 billion in a flexible reserve that is planned to lower the outyear budget gaps, and \$353 million in the Community Projects Fund to finance existing legislative "member item" appropriations.

## Size of the Enacted Budget and impact by major program

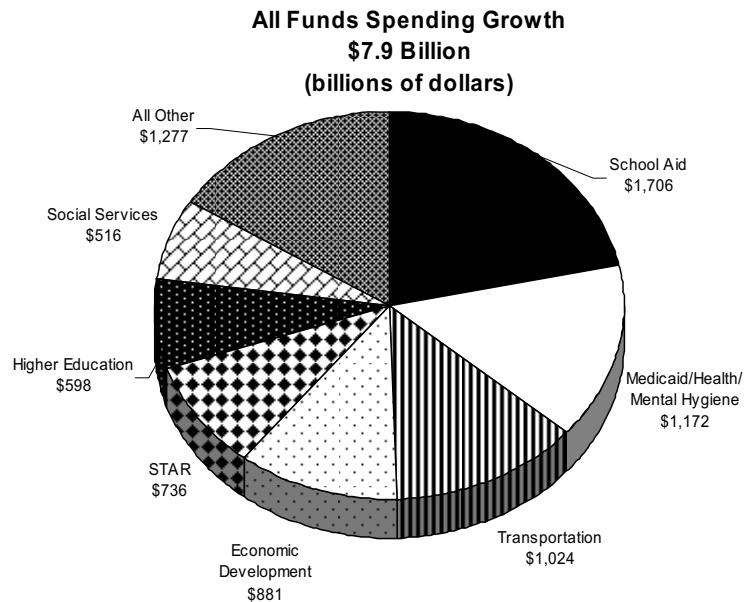
Total Disbursements (millions of dollars)					
	2006-07 Results*	2007-08 Enacted	Annual \$ Change	Annual % Change	Adjusted % Change**
General Fund	51,591	53,684	2,093	4.1%	n/a
State Funds	77,311	83,779	6,468	8.4%	6.7%
All Funds	112,764	120,675	7,911	7.0%	5.7%

\* Unaudited year-end results.

\*\* Reflects operational spending growth which excludes Capital Projects Funds spending.

General Fund spending, including transfers to other funds, is projected to total \$53.7 billion in 2007-08, an increase of \$2.1 billion over the 2006-07 forecast (4.1 percent). State Funds spending, which includes both the General Fund and spending from other funds supported by State revenues, is projected to increase by \$6.5 billion (8.4 percent) and total \$83.8 billion in 2007-08. All Funds spending, the broadest measure of spending, is projected to total \$120.7 billion in 2007-08, an increase of \$7.9 billion (7.0 percent).

The major sources of annual spending from 2006-07 to 2007-08 are presented in the following table, and are explained in detail later in this section.



<b>Enacted Budget Disbursement Projections</b>			
<b>Major Sources of Annual Change</b>			
<b>(millions of dollars)</b>			
	<b>General Fund</b>	<b>State Funds</b>	<b>All Funds</b>
<b>2006-07 Year-End Results</b>	<b>51,591</b>	<b>77,311</b>	<b>112,764</b>
School Aid	1,506	1,660	1,706
Transportation	46	867	1,024
Economic Development	148	876	881
Public Health	145	410	731
STAR	0	736	736
Higher Education	266	556	598
Social Services	322	336	516
Mental Hygiene	261	332	461
Homeland Security	47	47	378
Other Education Aid	182	212	265
General State Charges	127	147	163
Medicaid (inc. takeover)	161	21	(20)
Capital/Other Transfers	(865)	0	0
All Other	(253)	268	472
<b>2007-08 Enacted Budget Estimate</b>	<b>53,684</b>	<b>83,779</b>	<b>120,675</b>
<i>Dollar Change</i>	<i>2,093</i>	<i>6,468</i>	<i>7,911</i>
<i>Percent Change</i>	<i>4.1%</i>	<i>8.4%</i>	<i>7.0%</i>
<i>Percent Change Excluding Capital Spending</i>	<i>n/a</i>	<i>6.7%</i>	<i>5.7%</i>

## Projected 2007-08 Year-End Balances

DOB projects the State will end the 2007-08 fiscal year with a General Fund balance of \$3.0 billion (5.7 percent of spending). The balance consists of \$1.2 billion in undesignated reserves and \$1.8 billion in reserves designated to finance existing or planned commitments. The projected closing balance is \$12 million lower than the 2006-07 year-end results.

<b>General Fund Estimated Closing Balance</b>			
<b>(millions of dollars)</b>			
	<b>2006-07 Results*</b>	<b>2007-08 Enacted</b>	<b>Change</b>
<b>Year-End Fund Balance</b>	<b>3,045</b>	<b>3,033</b>	<b>(12)</b>
<i>Undesignated Reserves</i>	<i>1,052</i>	<i>1,227</i>	<i>175</i>
Tax Stabilization Reserve Fund	1,031	1,031	0
Rainy Day Reserve Fund	0	175	175
Contingency Reserve Fund	21	21	0
<i>Designated Reserves</i>	<i>1,993</i>	<i>1,806</i>	<i>(187)</i>
Debt Reduction Reserve Fund	0	250	250
Remaining 2005-06 Surplus	787	0	(787)
Remaining 2006-07 Surplus	1,493	1,203	(290)
2006-07 Timing Related Changes	(565)	0	565
Community Projects Fund	278	353	75

\* Unaudited year-end results.

The undesignated reserves include \$1.0 billion in the State's Tax Stabilization Reserve, after a deposit of \$87 million in 2006-07 that maintained the balance at the statutory maximum of 2 percent of General Fund spending, \$175 million in the new Rainy Day Reserve after an initial planned deposit in 2007-08, and \$21 million in the Contingency Reserve Fund for litigation risks. The new Rainy Day Reserve can have a statutory maximum balance of 3 percent of General Fund spending and may be used to respond to an economic downturn or catastrophic event.

The designated reserves include \$353 million in the Community Projects Fund to finance existing "member item" initiatives for the Legislature, \$1.2 billion remaining from the 2006-07 surplus that is planned to be used in three equal amounts to lower the projected outyear budget gaps, and \$250 million to reduce State debt levels. The 2006-07 closing balance is affected by the timing of \$565 million in certain transactions across fiscal years. Specifically, certain revenues that were expected in late 2006-07 are now expected in 2007-08, and certain payments that were originally planned in 2007-08 were made in 2006-07. These transactions have no net impact over the two fiscal years, but do have the effect of decreasing the 2006-07 fund balance.

## **Risks to the Financial Plan**

In any year, the Financial Plan is subject to risks that, if they were to materialize, could affect operating results. The most significant short-term risks include the potential cost of collective bargaining agreements and salary increases for the Judiciary (and possibly other elected officials) in 2007-08 and beyond; potential Federal disallowances arising from audits related to Medicaid claims under the School Supportive Health Services program; proposed Federal rule changes concerning Medicaid payments; and under-performance of the national and State economies that can affect State revenues and increase the demand for means-tested programs such as Medicaid and welfare. For more information, see the "Financial Plan Reserves and Risks" section later in this AIS. A full discussion of risks to the State Financial Plan appears in the sections entitled "Special Considerations" and "Litigation" later in this AIS.

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## Changes to the Executive Budget

### Recap of Multi-Year General Fund Operating Forecast: Initial Budget through Enactment

Since the 2007-08 Executive Budget forecast, the operating forecast for 2007-08 has remained in balance from the combined impact of enacted cost containment, new spending initiatives and new resources. At the same time, the gap between spending and revenues for 2008-09 and beyond has widened slightly.

The table below summarizes the evolution of the General Fund operating forecast for 2007-08 through 2010-11 from the Executive Budget forecast through enactment.

Changes to General Fund Operating Forecast for 2007-08 Through 2010-11				
(millions of dollars)				
	2007-08	2008-09	2009-10	2010-11
<b>"Current Services" Gap Estimates (Before Executive Recommendations)</b>	<b>(1,548)</b>	<b>(2,971)</b>	<b>(5,066)</b>	<b>(5,337)</b>
Savings Plan	3,858	3,780	4,857	5,056
New Initiatives	(2,310)	(3,101)	(4,274)	(5,964)
<b>Executive Budget Surplus/(Gap) Estimate</b>	<b>0</b>	<b>(2,292)</b>	<b>(4,483)</b>	<b>(6,245)</b>
Additional Resources Available:	<u>1,215</u>	<u>906</u>	<u>1,361</u>	<u>1,370</u>
Additional Revenues	1,039	900	900	900
New York City Payment	(428)	(358)	0	0
Abandoned Property	50	0	0	0
STAR	218	242	288	280
Current Service Revisions	101	73	114	104
Spending Cuts	48	49	59	86
Fund Balances	187	0	0	0
<b>Additions:</b>	<u>(1,215)</u>	<u>(1,719)</u>	<u>(1,649)</u>	<u>(1,750)</u>
Education	(436)	(429)	(491)	(683)
Higher Education	(39)	(55)	(55)	(55)
Health and Medicaid	(328)	(385)	(310)	(316)
Human Services	(55)	(70)	(70)	(70)
Criminal Justice	(59)	(81)	(72)	(64)
Mental Hygiene	(15)	(15)	(15)	(15)
Agriculture/Environment/Housing	(61)	(45)	(45)	(45)
Economic Development	(23)	(25)	(25)	(25)
Transportation	(11)	(10)	(10)	(10)
Local/General Government	(39)	(368)	(368)	(368)
Member Items	0	(85)	(85)	0
Net Tax Changes	(149)	(151)	(103)	(99)
<b>Enacted Budget Surplus/(Gap) Estimate</b>	<b>0</b>	<b>(3,105)</b>	<b>(4,771)</b>	<b>(6,625)</b>

## Executive Budget Proposals vs. Enacted Budget

The Enacted Budget savings plan in 2007-08 includes \$3.5 billion of the \$3.9 billion in savings actions recommended in the Executive Budget.

The Enacted Budget also includes \$2.9 billion for new initiatives, including most of the \$2.3 billion recommended in the Executive Budget. Legislative adds, excluding restorations of Executive savings proposals, total roughly \$485 million in higher spending for school aid, health care and other areas. In addition, the Enacted Budget includes \$170 million for discretionary legislative “member items,” with additional funding beginning in 2008-09. One important distinction in 2007-08 is that the Governor did not choose to receive any “member item” funding. The table below compares the proposed savings and initiatives to the Enacted Plan.

<b>General Fund Budget-Balancing Plan: Executive Proposals vs. Enacted Budget</b>				
<b>(millions of dollars)</b>				
	<b>2007-08</b>	<b>2008-09</b>	<b>2009-10</b>	<b>2010-11</b>
<b>Value of Savings Plan:</b>				
<u>Proposed</u>	<u>3,858</u>	<u>3,780</u>	<u>4,857</u>	<u>5,056</u>
Medicaid/Health/Mental Hygiene	1,301	954	1,920	1,734
VLT Expansion <sup>(1)</sup>	0	150	357	766
All Other Savings	1,062	1,708	1,642	1,618
Use of Prior-Year Surplus	1,046	401	401	401
Revenue Loophole Closers	449	567	537	537
<u>Enacted</u>	<u>3,512</u>	<u>3,085</u>	<u>4,166</u>	<u>4,357</u>
Medicaid/Health/Mental Hygiene	1,057	667	1,686	1,493
VLT Expansion <sup>(1)</sup>	0	150	357	766
All Other Savings	959	1,331	1,171	1,146
Use of Prior-Year Surplus	1,046	401	401	401
Revenue Loophole Closers	450	536	551	551
<b>Value of New Initiatives:</b>				
<u>Proposed</u>	<u>2,311</u>	<u>3,101</u>	<u>4,274</u>	<u>5,964</u>
STAR	1,211	1,688	2,038	2,152
Additional School Aid	371	851	1,670	3,069
Health Care	103	193	173	192
Increase Reserves	425	0	0	0
All Other New Initiatives	201	369	393	551
<u>Enacted</u>	<u>2,945</u>	<u>3,581</u>	<u>4,754</u>	<u>6,528</u>
STAR	1,011	1,284	1,531	1,590
Additional School Aid	738	1,236	2,151	3,742
Health Care	170	264	245	264
Increase Reserves	425	0	0	0
New Tax Cuts	150	150	150	150
All Other New Initiatives	451	647	677	782

<sup>(1)</sup> VLT expansion legislation was not a part of the Enacted Budget, but is assumed to be addressed at a later date.

Additional detail is provided in the following tables that compare the actions approved in the Enacted Budget against those proposed in the Executive Budget.

## New Initiatives

The Enacted Budget includes new initiatives totaling \$2.9 billion in 2007-08, growing to \$3.6 billion in 2008-09. Initiatives for increased school aid, STAR, tax cuts, health care, and increasing reserves account for roughly 85 percent of the total.

In addition to the school aid, STAR, and health care proposals described above, the Budget includes several other initiatives to reduce taxes or increase investments. These include a \$150 per student increase in community college base aid, an increase in low-income housing tax credits, initial funding for stem cell research, additional resources to fight upstate crime, increased subsidies to upstate transit systems, and increased funding for mental hygiene programs.

In addition, the Enacted Budget includes \$150 million in business tax cuts, including a tax cut for businesses with an emphasis on manufacturing and high technology, a reduction to the entire net income tax rate imposed on corporations, banks, and insurance companies from 7.5 percent to 7.1 percent. Other business tax cuts include a reduction to the alternative minimum tax rate imposed under the corporate franchise tax from 2.5 percent to 1.5 percent, a reduction to the entire net income tax rate imposed on certain manufacturers and qualified emerging technology companies from 7.5 percent to 6.5 percent, and an acceleration in the phase-in of the change in the computation of corporation's business allocation percentage.

## Savings

The Enacted Budget contains a set of health care, local aid, and operational reforms that will provide over \$2.0 billion in savings in both 2007-08 and 2008-09.

## Health Care

The 2007-08 savings plan includes the first step in a multi-year plan to reform the State's health care system. Savings are projected to total more than \$1 billion in the aggregate. The plan reduces the growth in reimbursement rates paid to most providers; strengthens statewide anti-fraud activities; reduces costs of prescription drugs; and enhances management of high-cost beneficiaries.

Specific savings initiatives include:

- **Reduce Rates/Redirect Subsidies:** The Enacted Budget reduces the automatic inflationary rate increases for hospitals and nursing homes by 25 percent, freezes managed care premium payments, and revises subsidy payments to redirect funding to high-need facilities.
- **Pharmaceutical Savings:** Reduces reimbursement rates for pharmacies; increases enrollment in the Medicare Part D program; and expands the applicability of the Preferred Drug Program to the Elderly Pharmaceutical Insurance Coverage (EPIC) program.
- **Enhanced Management of High-Cost Beneficiaries:** Implements a series of new demonstration projects to help provide cost-effective and coordinated care to high-cost beneficiaries.

- **Anti-Fraud:** Enactment of a False Claims Act covering Medicaid, audit staffing increases, greater use of technology, and stepped-up audit procedures will be put into place to generate overall financial savings.

Other savings include maximizing Federal aid, an increase in the covered lives assessment paid by insurance carriers, and additional health care conversion proceeds. The Enacted Budget does not continue the 0.35 percent assessment on hospital revenues beyond March 31, 2007.

## Other Savings

Outside of health care, other enacted savings include reducing certain State aid to New York City, instituting strict controls on spending by State agencies, enhancing savings opportunities in the State's debt management, and maximizing Federal aid.

The key Enacted Budget actions include the following initiatives:

**Local Government Aid:** Restructure local government aid to significantly increase aid to distressed municipalities over four years and reduce Aid and Incentives to Municipalities (AIM) funding to New York City in 2007-08 only.

**Economic Development/Regulation:** Generate savings from increasing New York City's tax processing assessment, and reducing certain economic development initiatives. It also includes a sweep of excess funds from the State of New York Mortgage Agency (SONYMA).

**Social Services/Labor:** Increase the amount of the Temporary Assistance for Needy Families (TANF) public assistance offset through proposed reductions in the TANF funded commitment to several operational programs and several 2006-07 initiatives. In addition, a one-time transfer of \$16 million will be made from Department of Labor interest assessment account funds to the General Fund, and the rates charged to local governments for youth in the Office of Children and Family Services (OCFS) facilities will be adjusted to reflect actual costs and to reconcile prior-year billings.

**Public Safety/Homeland Security:** Improve the parole violation process and continue State Operations efficiencies to generate savings. In addition, savings are generated by using non-General Fund resources to fund State Police public safety communications projects and certain Department of Criminal Justice Services (DCJS) programs.

**Education/Arts:** Includes funding for educational accountability initiatives, as well as increases for public libraries and public broadcasting.

**Transportation:** Includes savings from the transfer of transit operating assistance from the Metropolitan Mass Transportation Operating Assistance Fund (MMTOA) to Public Mass Transportation Operating Assistance (PTOA) rather than from the General Fund to PTOA, and reducing General Fund transfers to the Dedicated Highway and Bridge Trust Fund (DHBTF).

**Debt Service:** Savings are expected from an increase to the interest rate exchange and variable rate caps from 15 percent to 20 percent of debt outstanding, increased refunding opportunities from consolidated structures, and increased efficiencies in the bond sale process. In addition, \$250 million is appropriated to reduce high-cost debt, which will lower future debt service costs.



**Higher Education:** Tuition Assistance Program (TAP) reforms have been enacted to promote the wise investment of taxpayer funds and more effectively determine TAP eligibility, including the use of an ability to benefit test that is approved by the Commissioner of Education.

**STAR Rebate:** The existing STAR Property Tax Rebate program is replaced by the new Middle Class STAR rebate program.

**Video Lottery Terminal (VLT) Expansion:** Legislation to authorize the expansion of a number of VLT facilities is expected to be enacted sometime in 2007-08 to generate additional revenue to support school aid funding.

**All Other Savings:** Includes State Operations savings, primarily in non-personal service costs (part of a statewide total of \$85 million in non-personal service savings).

## Revenue Loophole Closing Initiatives

State tax law currently contains a number of loopholes that enable certain taxpayers to shelter income in unintended ways. The Executive Budget proposed the elimination of a number of such loopholes.

The Enacted Budget loophole closing initiatives, which were used in part to finance \$150 million of new business tax cuts described earlier, include:

- Continue to deter the use of tax shelters by extending for two years the authorization for the Department of Taxation and Finance to require the reporting and disclosure of Federal and New York tax planning strategies that might be contrary to proper compliance with tax law.
- Require certain corporations that are Federal S Corporations to also be New York S corporations. This provision will close a loophole that allows State taxpayers to avoid tax by taking advantage of the preferential investment allocation provision under the corporate franchise tax.
- Provide the Commissioner of Taxation and Finance with authority similar to that now provided to the Federal Secretary of Treasury to end practices used by New York partnerships that allow nonresidents to avoid paying personal income tax on New York source income.
- Require closely affiliated corporations which conduct substantial inter-corporate transactions across the affiliated group to file a combined, rather than separate, corporate franchise tax return.
- Phase out over five years the deduction for certain subsidiary dividends received by a parent company from a real estate investment trust (REIT) or regulated investment company (RIC). This will ensure that the shareholders of the REIT or RIC pay tax on the income earned by the REIT or RIC. Banking corporations with taxable assets of \$8 billion or less will not be subject to the phase out.
- Close a loophole that allows banks to shelter income by using subsidiaries that were grandfathered as corporate taxpayers when the bank tax was changed in 1985.

## Non-Recurring Resources

The State typically uses some non-recurring resources each year to support its operations. In many cases, the resources may occur each year, but are not included in the current services estimates since there is some uncertainty in timing and amounts that may be available. The following table summarizes the non-recurring resources included in the Enacted Budget.

<b>General Fund 2007-08 Non-Recurring Resources</b> (millions of dollars)	
Transfer SONYMA Excess Balances to the General Fund	100
Sweep other excess balances	100
Medicaid: Obtain Federal Share for the Home Care Insurance Demonstration Initiative	82
Use excess balances in Lottery Fund to finance school aid costs	76
Additional Abandoned Property Revenue	50
Medicaid: Waive Statutory Reconciliation of Prior Year Hospital Assessment Collections	44
Medicaid: Drug Rebate Revenue	40
Mental Hygiene: Federal PIA revenues (Part B settlement; Accelerated DSH payments)	61
Mental Hygiene: Audit-Fraud Recoveries; Federal Recovery for OMH Children's Facilities	18
Sweep cash for Cultural Education Storage Facility	20
Sweep Balance in the Unemployment Insurance Interest Assessment Account	16
Sweep Funds from Revenue Arrearage Account	15
DMV Compulsory Insurance Sweep	16
Sweep Funds from Motor Vehicle Law Enforcement Account	11
Sweep Additional Funds from various Public Health Accounts	10
Use Cellular Surcharge to Fund State Police Statewide Wireless Network	10
Sweep Excess EPF Fund Balances to General Fund	10
Finance National Guard Costs with Federal Funds	5
Sell Vacant Building Planned for Youth Opportunity Center	3
Sweep Cash from Several Welfare/OCFS Special Revenue Accounts	3
Utilize Federal Funds for Certain Welfare costs	2
<b>Total One-Time Resources</b>	<b>692</b>
Net Use of Prior-Year Surpluses (after deposit to reserves)	671
<b>Total Non-Recurring Resources</b>	<b>1,363</b>

The approved one-time actions consist mainly of routine transfers of available cash balances from other funds, time-specific transactions, and additional Federal aid including:

- Medicaid: Savings from several actions help finance Medicaid costs that would otherwise be paid by the General Fund. These include obtaining Federal aid for the Health Care Insurance Demonstration initiative, a waiver of prior-year reconciliations of hospital assessment collections, and maximizing drug rebate revenues;
- Mental Hygiene: Federal revenues are expected to increase as a result of one-time benefits including accelerated Medicaid claiming for services provided to mental hygiene consumers, a Federal Medicare settlement, retroactive billings for children's residential facilities and expansion of quality assurance activities; and

- Routine sweeps of fund balances and increased Federal aid account for the majority of the remaining non-recurring actions.

## 2007-08 Receipts and Disbursements Forecast

### Introduction

This section describes the State’s Financial Plan projections for receipts and disbursements based on the 2007-08 Enacted Budget. The receipts forecast describes estimates for the State’s principal taxes, miscellaneous receipts, and transfers from other funds. The spending projections summarize the annual growth in current services spending and the impact of Enacted Budget actions on each of the State’s major areas of spending (e.g., Medicaid, school aid, mental hygiene).

The 2007-08 Financial Plan projections are presented on an All Funds basis, which encompasses activity in the General Fund, other State-supported Funds, and Federal Funds, thus providing the most comprehensive view of the financial operations of the State.

### Receipts Forecast

Financial Plan receipts comprise a variety of taxes, fees, charges for State-provided services, Federal grants, and other miscellaneous receipts. The receipts estimates and projections have been prepared by DOB with the assistance of the Department of Taxation and Finance and other agencies responsible for the collection of State receipts.

Total Receipts (millions of dollars)				
	2006-07	2007-08	Annual Change	
	Results	Enacted	Dollars	Percent
General Fund	51,379	53,672	2,293	4.5%
State Funds	76,755	82,267	5,512	7.2%
All Funds	112,396	119,490	7,094	6.3%

### 2007-08 Receipts Overview

All Funds receipts are projected to total \$119.5 billion, an increase of \$7.1 billion over 2006-07 results. The total comprises tax receipts (\$62.0 billion), Federal grants (\$37.1 billion) and miscellaneous receipts (\$20.4 billion). The following table summarizes the receipts actuals for 2006-07 and projections for 2007-08.

Total Receipts (millions of dollars)							
	2006-07 Actual	2007-08 Estimated	Annual Change	Percent Change	2008-09 Projected	Annual Change	Percent Change
<b>General Fund</b>	<b>51,379</b>	<b>53,672</b>	<b>2,293</b>	<b>4.5</b>	<b>55,179</b>	<b>1,507</b>	<b>2.8</b>
Taxes	38,668	39,264	596	1.5	41,046	1,782	4.5
Miscellaneous Receipts	2,268	2,485	217	9.6	2,054	(431)	(17.3)
Federal Grants	151	59	(92)	-	59	0	0.0
Transfers	10,292	11,864	1,572	15.3	12,020	156	1.3
<b>State Funds</b>	<b>76,755</b>	<b>82,267</b>	<b>5,512</b>	<b>7.2</b>	<b>85,777</b>	<b>3,510</b>	<b>4.3</b>
Taxes	58,739	61,960	3,221	5.5	65,237	3,277	5.3
Miscellaneous Receipts	17,864	20,247	2,383	13.3	20,480	233	1.2
Federal Grants	152	60	(92)	(60.5)	60	0	0
<b>All Funds</b>	<b>112,396</b>	<b>119,490</b>	<b>7,094</b>	<b>6.3</b>	<b>125,117</b>	<b>5,627</b>	<b>4.7</b>
Taxes	58,739	61,960	3,221	5.5	65,237	3,277	5.3
Miscellaneous Receipts	18,078	20,402	2,324	12.9	20,628	226	1.1
Federal Grants	35,579	37,128	1,549	4.4	39,252	2,124	5.7

## 2007-08

- Total All Funds receipts in 2007-08 are expected to reach \$119.5 billion, an increase of \$7.1 billion, or 6.3 percent from 2006-07 results. All Funds tax receipts are projected to grow by more than \$3.2 billion. All Funds Federal grants are expected to increase by more than \$1.5 billion, or 4.4 percent. All Funds Miscellaneous receipts are projected to increase by approximately \$2.3 billion, or 12.9 percent.
- After controlling for the impact of all policy changes, base tax revenue growth is estimated to be 7.8 percent for fiscal year 2007-08.
- Total State Funds receipts are projected at \$82.3 billion, an increase of \$5.5 billion, or 7.2 percent from 2006-07 receipts.
- Total General Fund receipts are projected at \$53.7 billion, an increase of \$2.3 billion, or 4.5 percent from 2006-07 results. General Fund tax receipt growth is projected to be 1.5 percent over 2006-07 results and General Fund miscellaneous receipts are projected to increase by \$217 million. The relatively small growth in General Fund tax receipts largely reflects non-tax and non-economy related factors including proposals increasing STAR benefits and earmarking additional funds to debt service funds. Federal grants decline due to the loss of one-time Federal reimbursement for emergency costs related to delays in implementation of the Federal Medicare Part D program.

## Fiscal Years 2007-08 through 2010-11

Total Receipts (millions of dollars)										
	2007-08 Estimated	2008-09 Projected	Annual Change	Percent Change	2009-10 Projected	Annual Change	Percent Change	2010-11 Projected	Annual Change	Percent Change
<b>General Fund</b>	<b>53,672</b>	<b>55,179</b>	<b>1,507</b>	<b>2.8</b>	<b>58,258</b>	<b>3,079</b>	<b>5.6</b>	<b>60,868</b>	<b>2,610</b>	<b>4.5</b>
Taxes	39,264	41,046	1,782	4.5	43,244	2,198	5.4	45,335	2,091	4.8
<b>State Funds</b>	<b>82,267</b>	<b>85,777</b>	<b>3,510</b>	<b>4.3</b>	<b>89,385</b>	<b>3,608</b>	<b>4.2</b>	<b>92,912</b>	<b>3,527</b>	<b>3.9</b>
Taxes	61,960	65,237	3,277	5.3	68,840	3,603	5.5	72,024	3,184	4.6
<b>All Funds</b>	<b>119,490</b>	<b>125,117</b>	<b>5,627</b>	<b>4.7</b>	<b>129,903</b>	<b>4,786</b>	<b>3.8</b>	<b>135,310</b>	<b>5,407</b>	<b>4.2</b>
Taxes	61,960	65,237	3,278	5.3	68,840	3,603	5.5	72,024	3,184	4.6

Overall, receipts growth through fiscal year 2010-11 is expected to remain strong consistent with projected continued growth in the U.S. and New York economies. In addition, actions contained with this Budget eliminate unintended tax loopholes and supplement Department of Taxation and Finance efforts to find non-compliant taxpayers; these actions are expected to enhance receipt growth through 2010-11.

- Total All Funds receipts in 2008-09 are projected to reach \$125.1 billion, an increase of \$5.6 billion, or 4.7 percent from 2007-08 estimates. All Funds receipts in 2009-10 are expected to increase to nearly \$130 billion, or 3.8 percent over the prior year. In 2010-11, receipts are expected to increase by more than \$5.4 billion over 2009-10.
- All Funds tax receipts are expected to increase by 5.3 percent in 2008-09, 5.5 percent in 2009-10 and 4.6 percent in 2010-11. Again, the growth pattern is consistent with an economic forecast of continued but modest economic growth.
- Total State Funds receipts are projected to be nearly \$85.8 billion in 2008-09, nearly \$89.4 billion in 2009-10 and almost \$93.0 billion in 2010-11.
- Total General Fund receipts are projected to be \$55.2 billion in 2008-09, nearly \$58.3 billion in 2009-10 and roughly \$60.9 billion in 2010-11.

Change From Executive Budget Estimates & Projections (millions of dollars)								
	2007-08 21-Day Amendments	2007-08 Enacted Budget	Change	Percent Change	2008-09 21-Day Amendments	2008-09 Enacted Budget	Change	Percent Change
<b>General Fund</b>	<b>41,194</b>	<b>41,808</b>	<b>614</b>	<b>1.5</b>	<b>42,695</b>	<b>43,159</b>	<b>464</b>	<b>1.1</b>
Taxes	38,284	39,264	980	2.6	40,223	41,046	823	2.0
Miscellaneous Receipts	2,851	2,485	(366)	(12.8)	2,413	2,054	(359)	(14.9)
Federal Grants	59	59	0	0.0	59	59	0	0.0
<b>State Funds</b>	<b>80,923</b>	<b>82,267</b>	<b>1,344</b>	<b>1.7</b>	<b>85,255</b>	<b>85,777</b>	<b>522</b>	<b>0.6</b>
Taxes	60,961	61,960	999	1.6	64,388	65,237	849	1.3
Miscellaneous Receipts	19,902	20,247	345	1.7	20,807	20,480	(327)	(1.6)
Federal Grants	60	60	0	0.3	60	60	0	0.3
<b>All Funds</b>	<b>118,331</b>	<b>119,490</b>	<b>1,159</b>	<b>1.0</b>	<b>124,400</b>	<b>125,117</b>	<b>717</b>	<b>0.6</b>
Taxes	60,961	61,960	999	1.6	64,388	65,237	849	1.3
Miscellaneous Receipts	20,057	20,402	345	1.7	20,955	20,628	(327)	(1.6)
Federal Grants	37,313	37,128	(185)	(0.5)	39,057	39,252	195	0.5

## Base Tax Receipts Growth

Governmental Funds Actual and Base Tax Receipts Growth (percent growth)			
State Fiscal Year	Actual Receipts	Base Receipts	Personal Income Growth
2006-07	9.5	12.8	5.4
2007-08	5.5	7.8	5.0
2008-09	5.3	5.3	5.0
2009-10	5.5	5.6	5.2
2010-11	4.6	4.7	5.1

Base growth, adjusted for law changes, in tax receipts for fiscal year 2006-07 was a strong 12.8 percent. This was the third consecutive year of double digit growth in base tax receipts. The recent strong performance in the tax receipts base has benefited from several factors including:

- improvements in overall economic activity, especially in New York City;
- continued profitability and compensation gains of financial services companies;
- continued growth in the downstate commercial real estate market; and
- continued positive impact of high-income taxpayers on personal income tax growth.

Strong economic growth, especially concentrated in Downstate New York over the past several years, has driven large gains in receipts. It is expected that the rapid expansion in base revenue will stay strong in 2007-08 at 7.8 percent and moderate in 2008-09 and beyond. Base growth is expected to remain at or slightly above 5 percent throughout the forecast period. Actual receipts are expected to grow more slowly than the underlying base in 2007-08, reflecting the impact of tax actions taken with this Budget. As the above table indicates, non-adjusted receipts growth closely matches expected growth in personal income over the forecast period.

## Personal Income Tax

Personal Income Tax (millions of dollars)					
	2006-07 Actual	2007-08 Estimated	Annual Change	2008-09 Projected	Annual Change
<b>General Fund</b>	<b>22,940</b>	<b>22,885</b>	<b>(55)</b>	<b>24,128</b>	<b>1,243</b>
Gross Collections	40,090	43,083	2,993	46,046	2,963
Refunds	(5,510)	(6,263)	(753)	(6,732)	(469)
STAR	(3,994)	(4,730)	(736)	(5,358)	(628)
RBTF	(7,647)	(9,205)	(1,558)	(9,828)	(623)
<b>State/All Funds</b>	<b>34,580</b>	<b>36,820</b>	<b>2,240</b>	<b>39,314</b>	<b>2,494</b>
Gross Collections	40,090	43,083	2,993	46,046	2,963
Refunds	(5,510)	(6,263)	(753)	(6,732)	(469)

All Funds income tax receipts for 2007-08 are projected to increase \$2.2 billion over the prior-year to total \$36.8 billion. Gross receipts are projected to increase 7.5 percent and reflect projected growth for tax year 2007 liabilities in withholding of 6.7 percent (\$1.8 billion) and in estimated taxes of 9.9 percent (\$750 million). Estimated taxes also include \$6 million of receipts from Enacted Budget legislation that

will extend statutory tools used by the Tax Department to address the use of abusive tax shelters. Payments from extensions and final returns for tax year 2006 are projected to increase in total by 8.4 percent, or by \$242 million and \$169 million, respectively. Receipts from delinquencies are projected to increase by 9.3 percent or \$77 million over the prior year. Net receipts, which include refunds on tax year 2006 payments and liabilities, are projected to grow 6.5 percent. Refunds, which are projected to increase by a robust 13.7 percent or \$753 million, reflect the impact of the Empire State Child Credit (a refundable credit for resident taxpayers with children ages 4 to 16) that was enacted in 2006 and is applicable to tax years beginning in 2006 and thereafter.

General Fund income tax receipts for 2007-08, which are net of deposits to the STAR Fund and the Revenue Bond Tax Fund (RBTF), are estimated to remain almost flat at \$22.9 billion. Deposits to the STAR Fund, which will increase by \$736 million to \$4.7 billion in 2007-08, reflect Enacted Budget legislation that will increase the current STAR program by providing property tax relief rebates to middle-class homeowners and seniors. Deposits to the RBTF of over \$9.2 billion reflect Enacted Budget legislation that requires RBTF deposits to be calculated before the deposit of income tax receipts to the STAR Fund. Although this has the impact of decreasing General Fund receipts by nearly \$1.2 billion (25 percent of STAR), deposits in excess of debt service requirements are transferred back to the General Fund.

<b>Personal Income Tax Change From Executive Budget Estimates</b>				
<b>(millions of dollars)</b>				
	<b>2007-08</b>	<b>2007-08</b>		<b>Percent</b>
	<b>Executive Budget</b>	<b>Enacted Budget</b>	<b>Change</b>	<b>Change</b>
<b>General Fund</b>	<b>22,258</b>	<b>22,885</b>	<b>627</b>	<b>2.8</b>
Gross Collections	42,588	43,083	495	1.2
Refunds	(6,314)	(6,263)	51	(0.8)
STAR	(4,948)	(4,730)	218	(4.4)
RBTF	(9,068)	(9,205)	(137)	1.5
<b>State/All Funds</b>	<b>36,274</b>	<b>36,820</b>	<b>546</b>	<b>1.5</b>
Gross Collections	42,588	43,083	495	1.2
Refunds	(6,314)	(6,263)	51	(0.8)

All Funds personal income tax receipts for 2007-08 are projected to be \$546 million, or 1.5 percent, higher than projected in the Executive Budget with 21-Day Amendments. The increase is primarily due to stronger growth in withholding (\$225 million), estimated payments (\$200 million), and final return payments (\$70 million). The net increase in final return payments reflects Enacted Budget legislation that does not include an Executive Budget recommendation to extend and restructure the higher level of fees imposed on limited liability company fees. The Enacted Budget also projects refunds to be \$51 million below the Executive Budget forecast.

General Fund receipts are projected to be \$627 million above the Executive Budget with 21-Day Amendments. This includes \$546 million in additional net receipts, offset by a higher deposit to the RBTF of \$137 million. As a result of amendments made to the STAR proposal submitted with the Executive Budget, deposits to STAR will be \$218 million less than projected in the Executive Budget.

<b>Personal Income Tax</b>					
<b>(millions of dollars)</b>					
	<b>2008-09</b>	<b>2009-10</b>	<b>Annual</b>	<b>2010-11</b>	<b>Annual</b>
	<b>Projected</b>	<b>Projected</b>	<b>Change</b>	<b>Projected</b>	<b>Change</b>
<b>General Fund</b>	<b>24,128</b>	<b>25,576</b>	<b>1,448</b>	<b>26,979</b>	<b>1,402</b>
Gross Collections	46,046	49,004	2,958	51,824	2,820
Refunds	(6,732)	(7,120)	(388)	(7,664)	(544)
STAR	(5,358)	(5,838)	(480)	(6,141)	(304)
RBTF	(9,828)	(10,470)	(642)	(11,040)	(570)
<b>State/All Funds</b>	<b>39,314</b>	<b>41,884</b>	<b>2,570</b>	<b>44,160</b>	<b>2,276</b>
Gross Collections	46,046	49,004	2,958	51,824	2,820
Refunds	(6,732)	(7,120)	(388)	(7,664)	(544)

In general, income tax growth for 2008-09 and 2009-10 is governed by projections of growth in taxable personal income and its major components, including wages, interest and dividend earnings, realized taxable capital gains, and business net income and income derived from partnerships and S corporations, and the impact of tax law changes. Projections for 2008-09 and 2009-10 reflect the impact of Enacted Budget legislation that will close loopholes that allow nonresidents of New York partnerships and certain residents to use corporate status to avoid New York personal income taxes. The legislation applies to tax years beginning on and after January 1, 2007 and is estimated to increase All Funds income tax receipts by \$115 million annually beginning in 2008-09. In addition, receipts for 2008-09 reflect the second year impact of enacted legislation that extended the tax shelter legislation for two years.

All Funds PIT projected receipts for 2008-09 of \$39.3 billion reflect an increase of 6.7 percent or \$2.5 billion above the estimate for 2007-08. The forecast reflects continued solid economic growth and the impact of Enacted Budget legislation described above. All Funds receipts for 2009-10 continue to reflect relatively strong growth in tax liability, and are estimated at \$41.9 billion, an increase of \$2.6 billion or 6.5 percent above 2008-09.

General Fund income tax receipts are projected to increase by \$1.2 billion to just over \$24.1 billion in 2008-09. The change from 2007-08 reflects the growth in net receipts discussed above, a \$600 million increase in transfers to the RBTF and a \$650 million increase in transfers to the STAR Fund. The additional transfers to the STAR Fund will support an increase in the Middle Class STAR rebate program scheduled for 2008-09. General Fund PIT receipts for 2009-10 are projected to increase over 2008-09 by \$1.4 billion to \$25.5 billion. Receipts reflect the 2009-10 increase in the Middle Class STAR program and deposits to the RBTF that are consistent with growth in All Funds receipts discussed above.



## User Taxes and Fees

User Taxes and Fees (millions of dollars)					
	2006-07 Actual	2007-08 Estimated	Annual Change	2008-09 Projected	Annual Change
<b>General Fund</b>	<b>8,185</b>	<b>8,566</b>	<b>381</b>	<b>8,901</b>	<b>335</b>
Sales Tax	7,539	7,867	328	8,205	338
Cigarette and Tobacco Taxes	411	447	36	443	(4)
Motor Vehicle Fees	(17)	0	17	0	0
Alcoholic Beverage Taxes	194	200	6	205	5
ABC License Fees	58	52	(6)	48	(4)
<b>State/All Funds</b>	<b>13,457</b>	<b>14,187</b>	<b>730</b>	<b>14,680</b>	<b>493</b>
Sales Tax	10,739	11,215	476	11,692	477
Cigarette and Tobacco Taxes	985	1,078	93	1,068	(10)
Motor Fuel	513	536	23	539	3
Motor Vehicle Fees	769	900	131	913	13
Highway Use Tax	153	157	4	164	7
Alcoholic Beverage Taxes	194	200	6	205	5
ABC License Fees	58	52	(6)	48	(4)
Auto Rental Tax	46	49	3	51	2

All Funds user taxes and fees receipts for 2007-08 are projected to be \$14.2 billion, an increase of \$730 million or 5.4 percent from 2006-07. General Fund user taxes and fees receipts are projected to total \$8.6 billion in 2007-08, an increase of \$381 million or 4.7 percent from 2006-07. This increase largely reflects the projected growth in the sales tax base (4.1 percent), the collection of taxes on sales to non-Native Americans on New York reservations and a reclassification of motor vehicle fees.

User Taxes And Fees Change From Executive Budget Estimates (millions of dollars)				
	2007-08 Executive Budget	2007-08 Enacted Budget	Change	Percent Change
<b>General Fund</b>	<b>8,633</b>	<b>8,566</b>	<b>(67)</b>	<b>(0.8)</b>
Sales Tax	7,934	7,867	(67)	(0.8)
Cigarette and Tobacco Taxes	447	447	0	0
Motor Vehicle Fees	0	0	0	0
Alcoholic Beverage Taxes	200	200	0	0
ABC License Fees	52	52	0	0
<b>State/All Funds</b>	<b>14,278</b>	<b>14,187</b>	<b>(91)</b>	<b>(0.6)</b>
Sales Tax	11,306	11,215	(91)	(0.8)
Cigarette and Tobacco Taxes	1,078	1,078	0	0
Motor Fuel	536	536	0	0
Motor Vehicle Fees	900	900	0	0
Highway Use Tax	157	157	0	0
Alcoholic Beverage Taxes	200	200	0	0
ABC License Fees	52	52	0	0
Auto Rental Tax	49	49	0	0

<b>User Taxes and Fees</b> (millions of dollars)					
	<b>2008-09</b>	<b>2009-10</b>	<b>Annual</b>	<b>2010-11</b>	<b>Annual</b>
	<b>Projected</b>	<b>Projected</b>	<b>Change</b>	<b>Projected</b>	<b>Change</b>
<b>General Fund</b>	<b>8,901</b>	<b>9,212</b>	<b>311</b>	<b>9,540</b>	<b>328</b>
Sales Tax	8,205	8,514	309	8,845	331
Cigarette and Tobacco Taxes	443	437	(6)	432	(5)
Motor Vehicle Fees	0	0	0	0	0
Alcoholic Beverage Taxes	205	209	4	214	5
ABC License Fees	48	52	4	49	(3)
<b>State/All Funds</b>	<b>14,680</b>	<b>15,181</b>	<b>501</b>	<b>15,683</b>	<b>502</b>
Sales Tax	11,692	12,133	441	12,604	471
Cigarette and Tobacco Taxes	1,068	1,054	(14)	1,038	(16)
Motor Fuel	539	542	3	544	2
Motor Vehicle Fees	913	971	58	1,008	37
Highway Use Tax	164	167	3	171	4
Alcoholic Beverage Taxes	205	209	4	214	5
ABC License Fees	48	52	4	49	(3)
Auto Rental Tax	51	53	2	55	2

General Fund receipts from user taxes and fees are estimated to total \$8.9 billion in 2008-09, an increase of \$335 million from 2007-08. Receipts are projected to grow by an additional \$300 million annually in 2009-10 and 2010-11 to \$9.2 billion and \$9.5 billion, respectively. The increase is due almost exclusively to the projected growth in the sales tax base. The underlying growth in the sales tax base is expected to be in the range of 3 to 4 percent.

## Business Taxes

<b>Business Taxes</b> (millions of dollars)					
	<b>2006-07</b>	<b>2007-08</b>	<b>Annual</b>	<b>2008-09</b>	<b>Annual</b>
	<b>Actual</b>	<b>Estimated</b>	<b>Change</b>	<b>Projected</b>	<b>Change</b>
<b>General Fund</b>	<b>6,468</b>	<b>6,679</b>	<b>211</b>	<b>6,807</b>	<b>128</b>
Corporate Franchise Tax	3,677	3,904	228	4,104	200
Corporation & Utilities Tax	626	618	(8)	623	5
Insurance Tax	1,142	1,176	34	1,161	(15)
Bank Tax	1,024	981	(43)	919	(62)
<b>State/All Funds</b>	<b>8,606</b>	<b>8,919</b>	<b>313</b>	<b>9,084</b>	<b>166</b>
Corporate Franchise Tax	4,228	4,476	248	4,701	226
Corporation & Utilities Tax	820	816	(4)	821	5
Insurance Tax	1,258	1,292	34	1,276	(16)
Bank Tax	1,210	1,150	(60)	1,073	(78)
Petroleum Business Tax	1,090	1,185	94	1,213	29

All Funds business tax receipts for 2007-08 of more than \$8.9 billion are estimated to increase by nearly \$313 million or 3.6 percent over the prior year. The estimates reflect a net increase in receipts of \$362 million from enacted provisions that will close corporate tax loopholes that have allowed bank and corporate franchise taxpayers to use complex tax shelter techniques to avoid tax (\$516 million) and certain business tax cuts. The loophole provisions include: a five-year phase out of the deduction for subsidiary capital received by certain corporations from closely-held real estate investment trusts (\$102

million), combined filing requirements for corporations which conduct substantial inter-corporate transactions with one another to file a combined corporate franchise tax return (\$381 million), eliminating the use of certain grandfathered corporations by banks to shelter income from tax (\$22 million), and extending for two years the authorization for the Department of Taxation and Finance to require the reporting of abusive tax shelters (\$17 million).

The Enacted Budget also reflects legislation that will reduce taxes by \$154 million in 2007-08. That legislation reduces the entire net income tax rate imposed on corporations, banks, and insurance companies from 7.5 percent to 7.1 percent and the alternative minimum tax imposed under the corporate franchise tax from 2.5 percent to 1.5 percent (effective January 1, 2007). In addition, effective January 31, 2007, the entire net income tax rate imposed on certain manufacturers and qualified emerging technology companies is reduced from 7.5 percent to 6.5 percent. Enacted legislation also accelerates the effective date of the phase-in of the change in the computation of a corporation's business allocation percentage from a three factor formula of payroll, property and receipts to a single receipts factor from January 1, 2008 to January 1, 2007, and increases the amount of low income housing credits the Commissioner of Housing and Community Renewal may allocate by \$4 million.

All Funds non-audit business tax receipts before these enacted tax initiatives are estimated to increase 6.6 percent in 2007-08. This overall increase reflects a moderation in the growth of non-audit corporate franchise tax receipts to roughly 8.4 percent. This estimated rate of growth follows two consecutive years of extraordinary growth in non-audit corporate tax receipts of 40 percent in 2005-06 and 29 percent in 2006-07. Total corporate franchise tax receipts for 2007-08 of \$4.5 billion reflect the enacted budget tax legislation described above and a moderation in audit receipts from last year's historic levels.

All Funds non-audit bank tax receipts before enacted tax initiatives are projected to increase by 4.5 percent. Receipts from the bank tax also reflect a moderation in the growth of non-audit receipts of more than 40 percent in 2006-07. Total bank tax receipts for 2007-08 of \$1.2 billion reflect the enacted budget tax legislation described above and a reduction in audit receipts from last year's high levels.

Projected All Funds non-audit business tax receipts for 2007-08 also reflect growth in corporation and utilities taxes receipts of 3.6 percent, the insurance tax receipts of 4.1 percent and petroleum business tax receipts of 8 percent. All Funds audit receipts from all business taxes are projected to decline by 33 percent, or roughly \$515 million, from the historical level of the prior year. Large declines in audit receipts are expected in all business taxes except the petroleum business taxes.

General Fund business tax receipts for 2007-08 of \$6.7 billion are estimated to increase \$211 million, or 3.3 percent over the prior year. Business tax receipts deposited to the General Fund reflect the All Funds trends and the enacted tax initiatives discussed above.

<b>Business Taxes</b> (millions of dollars)					
	<b>2008-09</b> <b>Projected</b>	<b>2009-10</b> <b>Projected</b>	<b>Annual</b> <b>Change</b>	<b>2010-11</b> <b>Projected</b>	<b>Annual</b> <b>Change</b>
<b>General Fund</b>	<b>6,807</b>	<b>7,113</b>	<b>306</b>	<b>7,392</b>	<b>279</b>
Corporate Franchise Tax	4,104	4,342	238	4,578	236
Corporation & Utilities Tax	623	628	5	632	4
Insurance Tax	1,161	1,197	36	1,236	39
Bank Tax	919	946	27	946	0
<b>State/All Funds</b>	<b>9,084</b>	<b>9,435</b>	<b>351</b>	<b>9,757</b>	<b>323</b>
Corporate Franchise Tax	4,701	4,975	273	5,245	270
Corporation & Utilities Tax	821	826	5	831	5
Insurance Tax	1,276	1,315	39	1,358	43
Bank Tax	1,073	1,100	27	1,100	0
Petroleum Business Tax	1,213	1,220	6	1,224	4

All Funds business tax receipts for 2008-09 are projected to increase \$166 million, or 1.9 percent, to nearly \$9.1 billion. The projected receipts reflect the impact of the loophole-closing and business tax rate reduction initiatives enacted in 2007. Without these law changes, business tax receipts are expected to increase by 2.3 percent from comparable 2007-08 receipts. This change reflects modest increases in corporate franchise tax, corporation and utilities taxes, and petroleum business taxes receipts, partially offset by modest decreases in bank tax and insurance taxes receipts.

For 2009-10, All Funds business tax receipts are projected to increase by 3.9 percent, to more than \$9.4 billion. The projected receipts continue to reflect the loophole-closing and business tax rate reduction initiatives enacted in 2007. Without these law changes, business tax receipts are expected to increase by 3.7 percent from comparable 2008-09 receipts. This increase reflects minimal increases in corporation and utilities taxes and petroleum business tax receipts, with modest increases in receipts from each of the other business taxes.

## Other Taxes

<b>Other Taxes</b> (millions of dollars)					
	<b>2006-07</b> <b>Actual</b>	<b>2007-08</b> <b>Estimated</b>	<b>Annual</b> <b>Change</b>	<b>2008-09</b> <b>Projected</b>	<b>Annual</b> <b>Change</b>
<b>General Fund</b>	<b>1,075</b>	<b>1,135</b>	<b>60</b>	<b>1,211</b>	<b>75</b>
Estate Tax	1,063	1,115	51	1,190	75
Gift Tax	(10)	0	10	0	0
Real Property Gains Tax	0	0	(0)	0	0
Pari-mutuel Taxes	21	20	(1)	20	0
All Other Taxes	1	1	0	1	0
<b>State/All Funds</b>	<b>2,097</b>	<b>2,036</b>	<b>(62)</b>	<b>2,161</b>	<b>125</b>
Estate Tax	1,063	1,115	51	1,190	75
Gift Tax	(10)	0	10	0	0
Real Property Gains Tax	0	0	0	0	0
Real Estate Transfer Tax	1,022	900	(122)	950	50
Pari-mutuel Taxes	21	20	(1)	20	0
All Other Taxes	1	1	0	1	0

All Funds other tax receipts in 2007-08 are projected to be roughly \$2 billion, down \$62 million or 3.0 percent from 2006-07, reflecting retrenchment in real estate transfer tax receipts and a slight increase in estate tax collections. General Fund receipts for 2007-08 are projected to total more than \$1.1 billion or a \$60 million increase with estate tax collections expected to grow modestly.

<b>Other Taxes</b> (millions of dollars)					
	<b>2008-09</b> <b>Projected</b>	<b>2009-10</b> <b>Projected</b>	<b>Annual</b> <b>Change</b>	<b>2010-11</b> <b>Projected</b>	<b>Annual</b> <b>Change</b>
<b>General Fund</b>	<b>1,211</b>	<b>1,342</b>	<b>131</b>	<b>1,425</b>	<b>83</b>
Estate Tax	1,190	1,321	131	1,404	83
Gift Tax	0	0	0	0	0
Real Property Gains Tax	0	0	0	0	0
Pari-mutuel Taxes	20	20	0	20	0
All Other Taxes	1	1	0	1	0
<b>State/All Funds</b>	<b>2,161</b>	<b>2,342</b>	<b>181</b>	<b>2,425</b>	<b>83</b>
Estate Tax	1,190	1,321	131	1,404	83
Gift Tax	0	0	0	0	0
Real Property Gains Tax	0	0	0	0	0
Real Estate Transfer Tax	950	1,000	50	1,000	0
Pari-mutuel Taxes	20	20	0	20	0
All Other Taxes	1	1	0	1	0

General Fund receipts from other taxes are expected to grow modestly in the outyears, primarily reflecting modest growth in estate tax collections. All Funds other tax receipts are projected to increase moderately in future years, primarily due to positive change in the estate tax as well real estate transfer tax collections.

## Miscellaneous Receipts

<b>Miscellaneous Receipts and Federal Grants</b> (millions of dollars)					
	<b>2006-07</b> <b>Actual</b>	<b>2007-08</b> <b>Estimated</b>	<b>Annual</b> <b>Change</b>	<b>2008-09</b> <b>Projected</b>	<b>Annual</b> <b>Change</b>
<b>General Fund</b>	<b>2,419</b>	<b>2,545</b>	<b>125</b>	<b>2,113</b>	<b>(431)</b>
Miscellaneous Receipts	2,268	2,485	218	2,054	(431)
Federal Grants	152	59	(92)	59	0
<b>State Funds</b>	<b>17,117</b>	<b>20,307</b>	<b>3,190</b>	<b>20,539</b>	<b>232</b>
Miscellaneous Receipts	16,964	20,247	3,283	20,480	232
Federal Grants	153	60	(93)	60	0
<b>All Funds</b>	<b>53,901</b>	<b>58,212</b>	<b>4,311</b>	<b>60,556</b>	<b>2,344</b>
Miscellaneous Receipts	17,775	21,059	3,285	21,279	220
Federal Grants	36,126	37,153	1,026	39,277	2,124

General Fund miscellaneous receipts collections in 2007-08 are projected to reach approximately \$2.5 billion, up \$218 million from 2006-07 results, reflecting license and fee collections and expected

receipts from the New York Power Authority, partially offset by decreases in receipts from investment income.

<b>Miscellaneous Receipts and Federal Grants</b>					
<b>(millions of dollars)</b>					
	<b>2008-09</b>	<b>2009-10</b>	<b>Annual</b>	<b>2010-11</b>	<b>Annual</b>
	<b>Projected</b>	<b>Projected</b>	<b>Change</b>	<b>Projected</b>	<b>Change</b>
<b>General Fund</b>	<b>2,113</b>	<b>2,516</b>	<b>402</b>	<b>2,518</b>	<b>2</b>
Miscellaneous Receipts	2,054	2,456	402	2,459	2
Federal Grants	59	59	0	59	0
<b>State Funds</b>	<b>20,539</b>	<b>20,545</b>	<b>6</b>	<b>20,887</b>	<b>342</b>
Miscellaneous Receipts	20,480	20,486	6	20,827	342
Federal Grants	60	60	0	60	0
<b>All Funds</b>	<b>60,556</b>	<b>61,742</b>	<b>1,187</b>	<b>63,995</b>	<b>2,253</b>
Miscellaneous Receipts	21,279	21,287	8	21,656	369
Federal Grants	39,277	40,456	1,179	42,339	1,883

General Fund miscellaneous receipts in 2008-09 are projected to be \$2.1 billion, down \$419 million from 2007-08. This decrease is primarily the result of the loss of certain receipts from the Power Authority and a decrease in abandoned property collections. General Fund miscellaneous receipts are projected to be up \$402 million from 2008-09. Receipts are expected to remain relatively constant in 2010-11.

## 2007-08 DISBURSEMENTS FORECAST

<b>Total Disbursements</b>					
<b>(millions of dollars)</b>					
	<b>2006-07</b>	<b>2007-08</b>	<b>Annual \$</b>	<b>Annual %</b>	<b>Adjusted %</b>
	<b>Results*</b>	<b>Enacted</b>	<b>Change</b>	<b>Change</b>	<b>Change**</b>
General Fund	51,591	53,684	2,093	4.1%	n/a
State Funds	77,311	83,779	6,468	8.4%	6.7%
All Funds	112,764	120,675	7,911	7.0%	5.7%

\* Unaudited year-end results.

\*\* Reflects operational spending growth which excludes Capital Projects Funds spending.

In 2007-08, General Fund spending, including transfers to other funds, is projected to total \$53.7 billion. State Funds spending, which includes both the General Fund and spending from other funds supported by assessments, tuition, HCRA resources and other non-Federal revenues, is projected to total \$83.8 billion in 2007-08. All Funds spending, the broadest measure which includes Federal aid, is projected to total \$120.7 billion in 2007-08.

The major sources of annual spending change between 2006-07 and 2007-08 are summarized in the following table.

<b>Enacted Budget Spending Projections</b>					
<b>Major Sources of Annual Change from 2006-07 to 2007-08</b>					
(millions of dollars)					
	<u>General Fund</u>	<u>Other State Funds</u>	<u>State Funds</u>	<u>Federal Funds</u>	<u>All Funds</u>
<b>2006-07 Results</b>	<b>51,591</b>	<b>25,720</b>	<b>77,311</b>	<b>35,453</b>	<b>112,764</b>
<b>Major Functions</b>					
<i>Public Health:</i>					
Medicaid	(43)	(140)	(183)	(41)	(224)
Medicaid Cap/FHP Takeover	204	0	204	0	204
Public Health	145	265	410	321	731
<i>K-12 Education:</i>					
School Aid	1,506	154	1,660	46	1,706
All Other Education Aid	182	30	212	53	265
STAR	0	736	736	0	736
Higher Education	266	290	556	42	598
<i>Social Services:</i>					
Temporary and Disability Assistance	128	6	134	95	229
Children and Family Services	194	8	202	85	287
Mental Hygiene	261	71	332	129	461
Transportation	46	821	867	157	1,024
General State Charges	127	20	147	16	163
Debt Service	(327)	10	(317)	0	(317)
<b>All Other Changes</b>					
Economic Development	148	728	876	5	881
Homeland Security	47	0	47	331	378
Judiciary	84	42	126	1	127
World Trade Center	0	0	0	98	98
Elections	4	7	11	66	77
Environmental Conservation	13	69	82	(3)	79
Local Government Aid	(213)	0	(213)	0	(213)
Criminal Justice Services	30	26	56	(69)	(13)
Capital/Other Transfers	(865)	865	0	0	0
All Other	156	367	523	111	634
<b>2007-08 Enacted Budget</b>	<b>53,684</b>	<b>30,095</b>	<b>83,779</b>	<b>36,896</b>	<b>120,675</b>
<i>Annual Dollar Change</i>	2,093	4,375	6,468	1,443	7,911
<i>Annual Percent Change</i>	4.1%	17.0%	8.4%	4.1%	7.0%
<i>Adjusted Annual Change excluding Capital Projects spending growth</i>					
<i>Dollar Change</i>	n/a	2,843	4,936	1,182	6,118
<i>Percent Change</i>	n/a	13.0%	6.7%	3.5%	5.7%

In general, the forecasts are described in two parts: the first describes the current services estimate for the 2007-08 fiscal year for major programs or activities; the second summarizes the Enacted Budget actions. The combination of current services spending growth and Enacted Budget actions produce the resulting annual change in spending.

The current services estimates are based on agency staffing levels, program caseloads, formulas contained in State and Federal law, inflation and other factors. The factors that affect spending estimates vary by program. For example, welfare spending is based primarily on anticipated caseloads that are estimated by analyzing historical trends, projected economic conditions, and changes in Federal law. In correctional services, spending estimates are based in part on estimates of the State's prison population, which in turn depend on forecasts of incarceration rates, release rates, and conviction rates. All

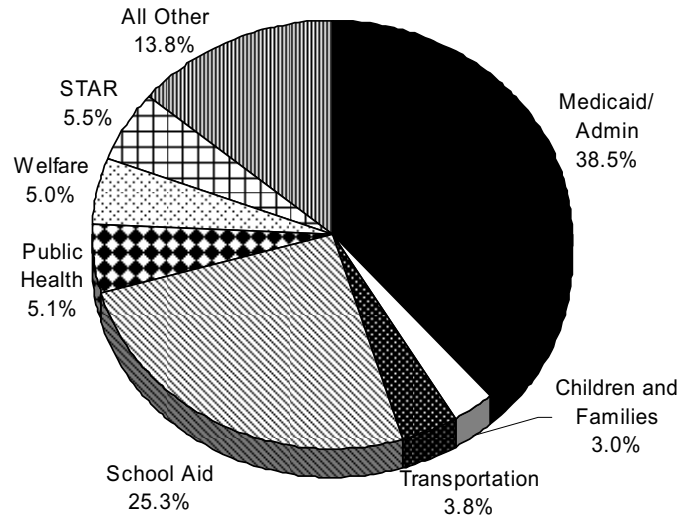
projections account for the timing of payments, since not all the amounts appropriated in the budget are disbursed in the same fiscal year.

## Grants to Local Governments

Grants to Local Governments (Local Assistance) includes payments to local governments, school districts, healthcare providers, and other local entities, as well as certain financial assistance to, or on behalf of, individuals, families, and nonprofit organizations. Local Assistance comprises 71 percent of All Funds spending.

In 2007-08, All Funds spending for local assistance is expected to total \$85.7 billion. Total spending comprises State aid to medical assistance providers and public health programs (\$37.5 billion), State aid to school districts, universities, and TAP (\$31.5 billion), Temporary and Disability Assistance (\$4.3 billion), mental hygiene programs (\$3.5 billion), transportation (\$2.9 billion), children and family services (\$2.6 billion), and local government assistance (\$943 million). Other local assistance programs include criminal justice, economic development, housing, parks and recreation, and environmental quality.

**2007-08 All Funds Local Assistance Spending  
\$85.7 Billion**



Local Assistance Spending Projections (millions of dollars)				
	2006-07 Results	2007-08 Enacted	Annual Change	Percent Change
<b>General Fund</b>	<b>34,302</b>	<b>37,158</b>	<b>2,856</b>	<b>8.3</b>
Other State Support	15,575	16,984	1,409	8.9
<b>State Funds</b>	<b>49,877</b>	<b>54,142</b>	<b>4,265</b>	<b>8.5</b>
Federal Funds	30,848	31,512	664	2.2
<b>All Funds</b>	<b>80,725</b>	<b>85,654</b>	<b>4,929</b>	<b>6.1</b>

The following chart highlights local assistance annual spending changes from 2006-07 to 2007-08 by major program and/or agency.



<b>Local Assistance Spending Projections</b>			
<b>Major Sources of Annual Change</b>			
<b>(millions of dollars)</b>			
	<u>General Fund</u>	<u>State Funds</u>	<u>All Funds</u>
<b>2006-07 Results (unaudited)</b>	<b>34,302</b>	<b>49,877</b>	<b>80,725</b>
School Aid	1,506	1,659	1,706
STAR	0	736	736
Public Health	138	93	393
Mental Hygiene	253	325	326
Homeland Security	0	0	325
Children and Families	174	175	267
Transportation	46	541	261
Temporary and Disability Assistance	118	123	203
Environmental Conservation	7	96	161
Medicaid (incl Admin)	161	22	(21)
All Other	453	495	572
<b>2007-08 Enacted Budget</b>	<b>37,158</b>	<b>54,142</b>	<b>85,654</b>
<i>Annual Dollar Change</i>	2,856	4,265	4,929
<i>Annual Percent Change</i>	8.3%	8.6%	6.1%

For 2007-08, All Funds local assistance spending is projected to total \$85.7 billion, an increase of \$4.9 billion (6.1 percent) over 2006-07 results. The growth is primarily driven by projected increases in School Aid (\$1.7 billion), STAR spending (\$736 million) which includes the expanded Middle Class STAR program, Public Health (\$393 million), Mental Hygiene (\$326 million), and Homeland Security (\$325 million).

These annual changes in local assistance, as further categorized by current service requirements in addition to Enacted Budget savings and new initiatives, are outlined in more detail below.

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<b>Local Assistance</b>				
<b>Sources of Annual Spending Increase/(Decrease) from 2006-07 to 2007-08</b>				
<b>(millions of dollars)</b>				
	<u>General Fund</u>	<u>Other State Funds</u>	<u>Federal Funds</u>	<u>All Funds</u>
<b>Current Services:</b>	<b>2,902</b>	<b>36</b>	<b>852</b>	<b>3,790</b>
Medicaid (incl Admin)	938	(383)	459	1,014
School Aid	768	154	46	968
Homeland Security	0	0	325	325
Mental Hygiene	255	30	1	286
Public Health	88	205	19	312
Children and Families	173	1	92	266
Temporary and Disability Assistance	156	6	95	257
Other Education	108	13	53	174
Transportation	45	237	(280)	2
STAR	0	(275)	0	(275)
All Other	371	48	42	461
<b>Enacted Savings:</b>	<b>(1,206)</b>	<b>15</b>	<b>(581)</b>	<b>(1,772)</b>
Medicaid Actions	(834)	219	(574)	(1,189)
Public Health	(49)	(185)	0	(234)
Local Government Assistance	(213)	0	0	(213)
Temporary and Disability Assistance	(37)	0	0	(37)
Children and Families	(27)	0	0	(27)
All Other	(46)	(19)	(7)	(72)
<b>New Initiatives:</b>	<b>1,160</b>	<b>1,358</b>	<b>393</b>	<b>2,911</b>
Middle Class STAR	0	1,011	0	1,011
School Aid	738	0	0	738
Public Health/F-SHRP	93	24	311	428
MTA/Transit Assistance	1	297	0	298
Other Education	97	0	0	97
Medicaid	57	24	74	73
Mental Hygiene	37	5	0	42
Children and Families	29	0	0	29
Community College Base Aid	26	0	0	26
All Other	82	(3)	8	87
<b>Total Annual Change</b>	<b>2,856</b>	<b>1,409</b>	<b>664</b>	<b>4,929</b>

## **Current Services**

For 2007-08, on an All Funds basis, current service requirements increase by \$3.8 billion above 2006-07 results. Over half of this increase is concentrated in School Aid and Medicaid (\$1.0 billion each). Specific initiatives are described in more detail below.

**Medicaid Program Growth:** General Fund Medicaid spending is growing due to several factors, including the increasing cost of providing health care services, the rising number of recipients, and increases in medical service utilization in nursing homes and managed care programs. Other changes affecting growth include increases in managed care premiums and escalating prescription drug costs. Program growth in 2007-08 is partially offset in the General Fund by the prepayment in 2006-07 of expenses for Supplemental Medical Insurance and a Medicare Part D payment to the Federal government and by the timing of the use of certain assessment and drug rebate revenues. In Federal Funds, growth is partially reduced by the payment in 2006-07 instead of 2007-08 of certain Federal disproportionate share aid to hospitals. The number of Medicaid recipients is projected to reach 3.8 million in 2007-08, an increase of 4.0 percent over the current fiscal year.

**School Aid:** Growth reflects the balance of the 2006-07 school year increase and the level of spending growth which was already projected in the State's current services plan. School aid commitments are made on a July 1 starting school-year basis, thus, each fiscal year, there is a "tail" of payments related to the prior-school year increase (roughly 30 percent of the prior-year total).

**Homeland Security:** As a result of the continued centralization of all "homeland security" grants, Federal grants previously budgeted in Criminal Justice Services have been transferred to the Office of Homeland Security (roughly \$100 million). In addition, delays in Federal Homeland Security spending resulted in approximately \$131 million of this spending being shifted from 2006-07 to 2007-08.

**Mental Hygiene:** Reflects increases in existing program commitments and mandates for the Office of Mental Retardation and Developmental Disabilities (OMRDD), the Office of Mental Health (OMH), and the Office for Alcohol and Substance Abuse Services (OASAS).

**Public Health:** Reflects increases in existing program commitments for Elderly Pharmaceutical Insurance Coverage (EPIC), the Early Intervention Program, and other reimbursements to local governments for the cost of providing local public health services.

**Children and Families:** Largely reflects the human services cost of living adjustment (COLA) and other legislative additions to services provided to children and families.

**Temporary and Disability Assistance:** Temporary Assistance for Needy Families (TANF) and Supplemental Security Income (SSI) are expected to increase over the prior year.

**Other Education:** Aid to non-public schools and special education costs are expected to increase over the prior year.

**Transportation:** Largely reflects timing of transit aid.

**STAR:** Reflects the replacement of the 2006-07 property tax rebate program with the new Middle Class STAR rebate program, partly offset by program growth in other STAR tax exemptions and Personal Income Tax (PIT) relief.

## **Enacted Savings**

Nearly two-thirds of the Enacted Budget's All Funds and General Fund local assistance savings plan relies on Medicaid actions (\$1.2 billion). Other significant savings actions are described in more detail below.

**Medicaid Actions:** Largely reflects a strengthening of anti-fraud capabilities, a change in 2007 rates, pharmaceutical savings, and a reduction in workforce recruitment and retention.

**Public Health:** Reflects program reductions and other savings initiatives in public health programs, particularly in EPIC, Early Intervention, and programs financed by the Health Care Reform Act (HCRA).

**Local Government Assistance:** Largely reflects a one-time reduction in New York City's unrestricted local government assistance, part of which is invested in funding for distressed municipalities.

**Temporary and Disability Assistance:** Reflects the reprogramming of TANF funding.

**Children and Families:** Largely reflects a cap on the rate of reimbursable growth for certain services and implementation delays in certain programs.

## **New Initiatives**

The largest areas of investment in local assistance are described in detail below.

**Middle Class STAR:** Reflects an increased fiscal year cash impact of \$1.0 billion in 2007-08. Middle Class STAR is targeted to benefit homeowners with incomes of \$250,000 or less, based on a sliding scale increase in benefits. Under the 2007-08 STAR program, homeowners will get an increase of approximately 60 percent in their STAR savings via a rebate check if their household income is \$90,000 or less (\$120,000 or less in the New York City metropolitan region).

**School Aid:** This amount represents the new school year commitments related to the 2007-08 school year increase of \$1.8 billion, approximately 70 percent of which is payable in the State's 2007-08 fiscal year. The school aid growth reflects increased funding for a new Foundation Aid Program (which represents \$13.6 billion of total school aid funding of \$19.6 billion), an expansion in the Universal Prekindergarten program (\$146 million) and an increase in Transportation Aid (\$81 million).

**Public Health/F-SHRP:** Reflects the disbursement of Federal aid pursuant to the Federal-State Health Reform Partnership Program (F-SHRP), and other public health investments.

**MTA/Transit Assistance:** Largely reflects State aid increases to the Metropolitan Transit Authority (MTA), which will be financed with existing dedicated fund balances.

**Other Education:** Includes additional aid for non-public schools to comply with State attendance-taking requirements, additional funding for a variety of legislative initiatives, and other additional aid.

**Medicaid:** New initiatives include the simplification of enrollment, long-term care initiatives, demonstration projects for high-cost users, and additional hospital funding.

**Mental Hygiene:** Reflects Enacted Budget initiatives at OMH, OMRDD, and OASAS.

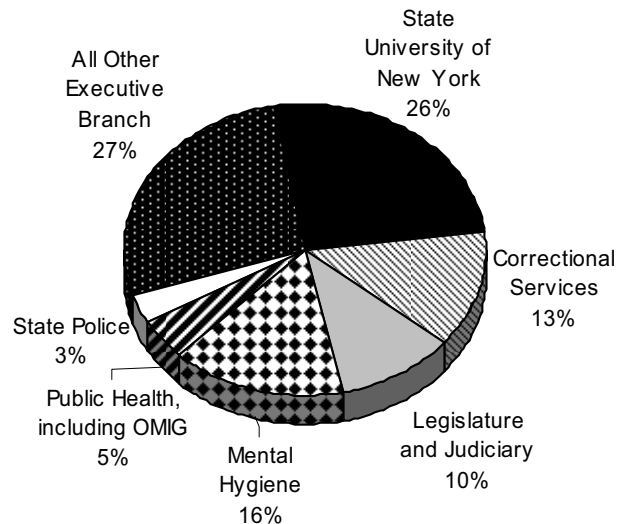
**Children and Families:** The Enacted Budget provides additional funding for programs serving children and families.

**Community College Base Aid:** For the 2007-08 academic year, base operating aid for SUNY and CUNY community colleges will be raised by \$150 per full-time student to a total of \$2,675 per full-time student.

## State Operations

State Operations spending is for personal service (PS) and non-personal service (NPS) costs. Personal service costs, which account for approximately two-thirds of State Operations spending, includes salaries of State employees of the Executive Branch, Legislature, and Judiciary, as well as overtime payments and costs for temporary employees. Non-personal service costs, which account for the remaining one-third of State Operations, represent the operating costs of State agencies, including real estate rental, utilities, contractual payments (e.g., consultants, information technology and professional business services), supplies and materials, equipment, telephone service and employee travel.

**2007-08 All Funds State Operations Spending - \$18.7 Billion**



All Funds State Operations spending is projected at \$18.7 billion in 2007-08, which finances the costs of Executive Branch agencies (\$16.7 billion) and the Legislature and Judiciary (\$1.9 billion). The largest executive branch agencies include SUNY (\$4.8 billion; 39,834 Full Time Equivalent Employees (FTEs)), Correctional Services (\$2.4 billion; 31,756 FTEs), Mental Hygiene (\$2.9 billion; 40,422 FTEs), Public Health, including Office of the Medicaid Inspector General (OMIG) (\$842 million; 6,674 FTEs), and State Police (\$627 million; 5,927 FTEs).

Approximately 93 percent of the State workforce is unionized. The largest unions include the Civil Service Employees Association, which primarily represents office support staff and administrative personnel, machine operators, and therapeutic and custodial care staff; the Public Employees Federation which primarily represents professional and technical personnel (e.g., attorneys, nurses, accountants, social workers, and institution teachers); United University Professions which represents faculty and non-teaching professional staff within the State University system; and the New York State Correctional Officers and Police Benevolent Association comprised of security personnel (e.g., correction officers, safety and security officers).

The State workforce, which reflects full-time employees of the Executive Branch, excluding the Legislature, Judiciary, and contractual labor, is projected to total 198,413 in 2007-08, an increase of 2,887 FTEs over 2006-07 levels. Increases are expected in Mental Hygiene agencies (504 FTEs) primarily due to staffing related to the Sex Offender Management and Treatment Act and the NYS-CARES II program; the Office of the Medicaid Inspector General (284 FTEs), reflecting staffing growth needed for Medicaid audit and fraud prevention activities; Health (427 FTEs) and Labor (415 FTEs) reflecting authorized fill levels for 2007-08; Law (277 FTEs) due to several initiatives including Medicaid Fraud Investigation, the

sex offender initiative, and Project Sunlight; Tax and Finance (158 FTEs) for enhanced compliance; and OCFS (215 FTEs) primarily for the addition of direct-care staff to improve the health and safety of youth and staff at youth facilities, offset by other changes.

<b>State Operations Spending Projections</b>				
<b>(millions of dollars)</b>				
	<b>2006-07 Results</b>	<b>2007-08 Enacted</b>	<b>Annual Change</b>	<b>Percent Change</b>
<b>General Fund</b>	<b>9,319</b>	<b>9,620</b>	<b>301</b>	<b>3.2%</b>
Other State Support	5,195	5,821	626	12.1%
<b>State Funds</b>	<b>14,514</b>	<b>15,441</b>	<b>927</b>	<b>6.4%</b>
Federal Funds	3,013	3,285	272	9.0%
<b>All Funds</b>	<b>17,527</b>	<b>18,726</b>	<b>1,199</b>	<b>6.8%</b>

All Funds State Operations spending is expected to total \$18.7 billion in 2007-08, comprised of Personal Services PS (\$12.0 billion) and Non-Personal Service NPS (\$6.7 billion). The majority of State Operations spending is for SUNY (\$4.8 billion), Correctional Services (\$2.4 billion), Judiciary (\$1.9 billion), OMRDD (\$1.5 billion) and OMH (\$1.3 billion).

State Operations spending by category, based upon historical spending trends, is allocated among employee base salaries (62 percent), overtime payments (3 percent), contractual services (23 percent), supplies and materials (6 percent), employee travel (1 percent) and other operational costs (5 percent).

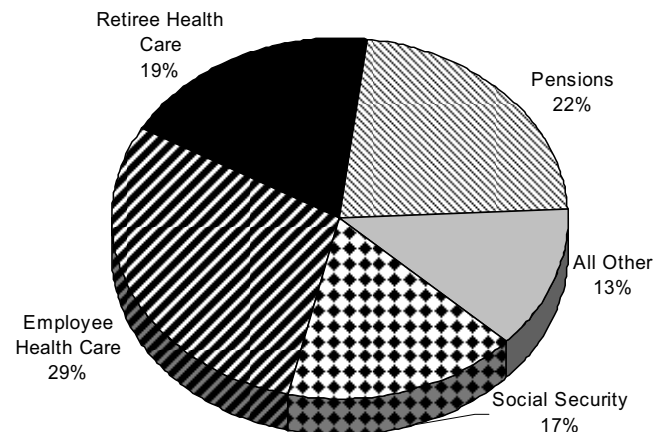
<b>All Funds State Operations Spending Projections</b>			
<b>Major Sources of Annual Change</b>			
<b>(millions of dollars)</b>			
	<b>Personal Service</b>	<b>Non-Personal Service</b>	<b>State Operations</b>
<b>2006-07 Results (unaudited)</b>	<b>11,555</b>	<b>5,972</b>	<b>17,527</b>
State University of New York	168	187	355
Insurance Department	(19)	137	118
Health, including OMIG	51	63	114
Judiciary	66	27	93
Mental Retardation	45	27	72
Mental Health	85	(28)	57
Homeland security	35	18	53
City University of New York	45	8	53
Tribal State Compact	0	40	40
Wireless Network	1	33	34
Correctional Services	(125)	53	(72)
All Other	107	169	276
<b>2007-08 Enacted Budget</b>	<b>12,023</b>	<b>6,703</b>	<b>18,726</b>
<i>Annual Dollar Change</i>	<i>468</i>	<i>731</i>	<i>1,199</i>
<i>Annual Percent Change</i>	<i>4.1%</i>	<i>12.2%</i>	<i>6.8%</i>

All Funds State Operations spending increase of \$1.2 billion (6.8 percent) is primarily driven by projected increases in SUNY (\$355 million), the Insurance Department (\$118 million), Public Health (\$114 million), Judiciary (\$93 million), OMRDD (\$72 million), OMH (\$57 million), Homeland Security (\$53 million), and CUNY (\$53 million), partially offset by a projected decline in DOCS (\$72 million).

## General State Charges

General State Charges account for the costs of fringe benefits provided to State employees and retirees of the Executive, Legislative and Judicial branches, tax payments to municipalities related to public lands, and certain litigation against the State. Fringe benefit payments, many of which are mandated by statute or collective bargaining agreements, include employer contributions for pensions, social security, health insurance, workers' compensation and unemployment insurance. Other costs include State taxes paid to local governments for certain State-owned lands, and payments related to lawsuits against the State and its public officers.

**General State Charges**  
2007-08 All Funds Spending - \$5.4 billion



General State Charges Spending Projections (millions of dollars)				
	2006-07 Results	2007-08 Enacted	Annual Change	Percent Change
<b>General Fund</b>	<b>4,403</b>	<b>4,530</b>	<b>127</b>	<b>2.9%</b>
Other State Support	594	614	20	3.4%
<b>State Funds</b>	<b>4,997</b>	<b>5,144</b>	<b>147</b>	<b>2.9%</b>
Federal Funds	226	242	16	7.1%
<b>All Funds</b>	<b>5,223</b>	<b>5,386</b>	<b>163</b>	<b>3.1%</b>

Employee fringe benefits are paid mostly from the General Fund (84 percent), supplemented with revenue from fringe benefit assessments on Federal funds and other dedicated revenue programs (16 percent). Other General State Charges costs are paid in full by General Fund revenues.

All Funds spending on General State Charges is expected to total \$5.4 billion in 2007-08, and comprises health insurance spending for employees (\$1.6 billion) and retirees (\$1.0 billion), pensions (\$1.2 billion) and social security (\$873 million).

## Debt Service

The State pays debt service on all outstanding State-supported bonds. These include general obligation bonds, for which the State is constitutionally obligated to pay debt service, as well as bonds issued by State public authorities (e.g., Empire State Development Corporation, Dormitory Authority of the State of New York, Thruway Authority) for which the State is contractually obligated to pay debt service, subject to an appropriation. Depending on the credit structure, debt service is financed through

transfers from the General Fund, dedicated taxes and fees, and other resources, such as patient income revenues.

<b>Debt Service Spending Projections</b> (millions of dollars)				
	<b>2006-07 Results</b>	<b>2007-08 Enacted</b>	<b>Annual Change</b>	<b>Percent Change</b>
<b>General Fund</b>	<b>1,906</b>	<b>1,579</b>	<b>(327)</b>	<b>-17.2%</b>
Other State Support	2,545	2,555	10	0.4%
<b>State Funds</b>	<b>4,451</b>	<b>4,134</b>	<b>(317)</b>	<b>-7.1%</b>
<b>All Funds</b>	<b>4,451</b>	<b>4,134</b>	<b>(317)</b>	<b>-7.1%</b>

All Funds debt service is projected at \$4.1 billion in 2007-08, of which \$1.58 billion is paid from the General Fund through transfers and \$2.6 billion from other State funds, primarily dedicated taxes. The year-to-year decrease is due to the timing of payments which were made at the end of 2006-07 (absent such payments, 2007-08 debt service would have increased by an estimated 4.3 percent). Debt service is paid on revenue credits supported by dedicated taxes and fees and patient income, including Personal Income Tax Revenue Bonds, DHBTf bonds and Mental Health facilities bonds, as well as service contract bonds that are secured mainly by the General Fund. For more information, see the "Debt and Other Financing Activities" section later in this AIS.

## Capital Projects

The Capital Projects Fund group accounts for spending across all functional areas to finance costs related to the acquisition, construction, repair or renovation of fixed assets. Spending from appropriations made from over 30 capital projects funds are financed from four sources: annual State taxes or dedicated miscellaneous receipts, grants from the Federal government, the proceeds of notes or bonds issued pursuant to General Obligation Bond Acts which are approved by the State voters, and the proceeds of notes or bonds issued by public authorities pursuant to legal authorization for State capital spending.

<b>Capital Projects Spending Projections</b> (millions of dollars)				
	<b>2006-07 Results</b>	<b>2007-08 Enacted</b>	<b>Annual Change</b>	<b>Percent Change</b>
<b>General Fund</b>	<b>389</b>	<b>82</b>	<b>(307)</b>	<b>-78.9%</b>
Other State Support	3,432	5,271	1,839	53.6%
<b>State Funds</b>	<b>3,821</b>	<b>5,353</b>	<b>1,532</b>	<b>40.1%</b>
Federal Funds	1,737	1,999	262	15.1%
<b>All Funds</b>	<b>5,558</b>	<b>7,352</b>	<b>1,794</b>	<b>32.3%</b>

All Funds capital spending of \$5.6 billion in 2006-07 is projected to increase to \$7.3 billion in 2007-08. In fiscal year 2007-08, transportation spending, primarily for improvements and maintenance to the State's highways and bridges, continues to account for the largest share (57 percent) of this total. The balance of projected spending will support capital investments in the areas of education (9 percent), mental hygiene and public protection (9 percent), economic development and government oversight (8 percent), parks and the environment (8 percent), and health and social welfare, general government, and



other areas (9 percent). For more information, see the "Debt and Other Financing Activities" section later in this AIS

## **Other Financing Sources/(Uses)**

Every year, the State authorizes the transfer of resources among funds and accounts. All Funds transfers from other funds are expected to total \$21.3 billion and comprise of \$11.9 billion in the General Fund, \$3.7 billion in the Special Revenue Funds, \$5.5 billion in the Debt Service Funds and \$293 million in the Capital Projects Funds.

All Funds transfers to other funds are also expected to total \$21.3 billion and comprise \$2.4 billion in the General Fund, \$3.6 billion in the Special Revenue Funds, \$14.4 billion in the Debt Service Funds and \$947 million in the Capital Projects Funds.

The most significant General Fund transfer to other funds is for general debt service (\$1.6 billion). Other significant General Fund transfers to other funds include Judiciary transfers to the Court Facilities Incentive Aid Fund, New York City County Clerks Fund, and Judiciary Data Processing Fund (\$211 million, total) and transfers representing payments for patients residing in State-operated Health, Mental Hygiene and State University facilities (\$174 million), SUNY hospital subsidy payments (\$110 million), and to the Capital Projects fund for pay-as-you-go projects (\$82 million). All other transfers to other funds totaled \$219 million; the most significant include \$69 million for the payment of banking services, \$33 million for transit, \$25 million for stem cell research, and \$20 million for OMRDD.

Of the \$11.9 billion General Fund transfer from other funds, \$11.3 billion results from dedicated Personal Income, Sales and Real Estate Transfer taxes above required debt service. All other fund/account sweeps total \$537 million, the largest of which include \$133 million from the Tribal-State Compact, \$100 million in miscellaneous special revenue sweeps, \$28 million from DMV, \$27 million from the Hazardous Waste Fund, and \$21 million from the Cultural Education account.

## **General Fund Financial Plan Outyear Projections**

### **Impact of Enacted Budget on Gap Forecast**

The actions included in the 2007-08 Enacted Budget result in a balanced General Fund Financial Plan in 2007-08 and projected outyear gaps of \$3.1 billion in 2008-09, \$4.8 billion in 2009-10, and \$6.6 billion in 2010-11.

The projected spending increases are driven by rising costs for public health care, the State-financed cap on local Medicaid spending, employee and retiree health benefits, mental hygiene services, child welfare programs, as well as the new initiatives for school aid and health care. Over the same period, General Fund receipts are estimated to grow at just over 4 percent a year (after tax cuts), consistent with the DOB's forecast of moderating economic growth.

The following table summarizes the Financial Plan projections on the 2008-09 through 2010-11 budget gaps, as well as the annual changes in projected receipts, disbursements, the use of reserves, and changes in fund balances.

<b>General Fund Enacted Budget Forecast</b> (millions of dollars)				
	<u>2007-2008</u>	<u>2008-2009</u>	<u>2009-2010</u>	<u>2010-2011</u>
<b>Receipts:</b>				
Taxes:				
Personal income tax	22,885	24,128	25,576	26,979
User taxes and fees	8,565	8,900	9,213	9,539
Business taxes	6,679	6,807	7,113	7,392
Other taxes	1,135	1,211	1,342	1,425
Miscellaneous receipts	2,485	2,054	2,456	2,459
Federal grants	59	59	59	59
Transfers from other funds	11,864	12,020	12,499	13,015
PIT in excess of Revenue Bond debt service	8,445	8,765	9,133	9,505
Sales tax in excess of LGAC debt service	2,320	2,363	2,469	2,579
Real estate taxes in excess of CW/CA debt service	561	614	670	672
All other	538	278	227	259
<b>Total receipts</b>	<b>53,672</b>	<b>55,179</b>	<b>58,258</b>	<b>60,868</b>
<b>Disbursements:</b>				
Grants to local governments	37,158	40,951	44,762	48,347
State operations	9,620	9,999	10,398	10,644
General State Charges	4,530	4,949	5,342	5,646
Transfers to other funds	2,376	2,851	2,993	3,408
Debt service	1,579	1,709	1,706	1,740
Capital projects	82	277	489	862
Other purposes	715	865	798	806
<b>Total disbursements</b>	<b>53,684</b>	<b>58,750</b>	<b>63,495</b>	<b>68,045</b>
<b>Change in Reserves:</b>				
Debt Reduction Reserve Fund	250	0	0	0
Rainy Day Reserve Fund	175	0	0	0
Community Projects Fund	75	(65)	(65)	(151)
Prior Year Surpluses	(512)	(401)	(401)	(401)
<b>Deposit to/(Use of Gap)</b>	<b>(12)</b>	<b>(466)</b>	<b>(466)</b>	<b>(552)</b>
<b>Enacted Budget Surplus/(Gap) Estimate</b>	<b>0</b>	<b>(3,105)</b>	<b>(4,771)</b>	<b>(6,625)</b>

In evaluating the State's outyear operating forecast, it should be noted that the reliability of the estimates as a predictor of the State's future fiscal condition is likely to diminish as one moves further from the current-year and budget-year estimates. Accordingly, the 2008-09 forecast is perhaps the most relevant from a planning perspective, since any gap in that year must be closed with the next budget and the variability of the estimates is likely to be less than in later years.

The following chart provides a "zero-based" look at the causes of the 2008-09 General Fund budget gap, followed by a brief summary of the assumptions behind the projections. Detailed explanation of the assumptions underlying the outyear revenue and spending projections appear elsewhere in this section.

<b>2008-09 General Fund Annual Change</b>	
<b>Savings/(Costs)</b>	
<b>(millions of dollars)</b>	
	<b>2008-09</b>
<b>RECEIPTS</b>	<b>1,507</b>
Constant Law Growth	3,267
Existing Tax Reductions	(130)
Uncommon Audit Collections	(117)
Change in STAR Tax Cuts	(650)
Change in Debt Service (RBTF/LGAC/CWCA)	(370)
Non-recurring 2007-08 Payments (NYPA; SONYMA; Hurricane Katrina)	(299)
Non-recurring Abandoned Property	(84)
All Other	(110)
<b>DISBURSEMENTS</b>	<b>(5,066)</b>
<b>Local Assistance</b>	<b>(3,793)</b>
Medicaid	(2,104)
<i>Program Growth/Other</i>	(1,255)
<i>Medicaid Cap/Family Health Plus Takeover</i>	(374)
<i>Change in HCRA/Provider Assessment Financing</i>	(475)
School Aid	(876)
Local Government Assistance	(380)
Mental Hygiene	(219)
Children and Family Services	(149)
All Other Local Assistance	(65)
<b>State Operations</b>	<b>(379)</b>
Personal Service	(215)
Non-personal Service	(164)
<b>General State Charges</b>	<b>(419)</b>
Health Insurance	(363)
Pensions	(41)
All Other	(15)
<b>Transfers to Other Funds</b>	<b>(475)</b>
Debt Service	(130)
Capital Projects	(195)
All Other	(150)
<b>Use of Reserves (net)</b>	<b>454</b>
<b>CURRENT SERVICES BUDGET GAP FOR 2008-09</b>	<b>(3,105)</b>

The forecast for 2008-09 is based on assumptions of economic performance, revenue collections, spending patterns, and projections for the current services costs of program activities. DOB believes the estimates of annual change in revenues and spending that create the 2008-09 current services gap forecast are based on reasonable assumptions and methodologies. Significant assumptions that affect the forecast include:

- **Economic growth will continue during the forecast period.** DOB's forecast calls for moderate expansion in the economy. The momentum of the State's expansion appears to have peaked in 2005, and the forecast calls for positive, but slowing, growth in 2007 and a return to trend growth in the outyears.

- **Revenues, adjusting for tax law changes, will grow in the range of 5 percent to 6 percent annually.** The growth rate is consistent with DOB's forecast for the economy, but, as in any year, is subject to significant volatility. Changes in the economic growth rate, Federal law, and taxpayer behavior all have a significant influence on receipts collections.
- **The Federal government will not make substantive funding changes** to major aid programs or make substantive regulatory changes that adversely affect the State.
- **The projections do not include any extra costs for new labor settlements** or pay increases for judges or elected officials. Current labor contracts expired on April 1, 2007. Each 1 percent salary increase is valued at \$86 million in the General Fund and \$134 million in All Funds.
- **The projections do not assume the use of one-time resources.** In a typical year, the Financial Plan will include in the range of \$500 million in such resources and DOB expects similar levels could be achieved in the future.

Changes to these or other assumptions have the potential to materially alter the size of the budget gaps for 2008-09 and beyond.

## **Outyear General Fund Disbursement Projections**

DOB forecasts General Fund spending of \$58.8 billion in 2008-09, an increase of \$5.1 billion (9.4 percent) over projected 2007-08 levels. Growth in 2009-10 is projected at \$4.7 billion (8.1 percent) and in 2010-11 at \$4.6 billion (7.2 percent). The growth levels are based on current services projections, as modified by the actions contained in the 2007-08 Enacted Budget. **The State Constitution requires the Governor to annually submit a balanced budget to the Legislature. The current estimates do not incorporate any proposals to control spending that are likely to be part of any balanced budget submission in 2008-09 and in future years.** The main sources of annual spending growth for 2008-09, 2009-10, and 2010-11 are itemized in the following table.

<b>General Fund Disbursement Projections</b>							
<b>(millions of dollars)</b>							
	<b>2007-08</b>	<b>2008-09</b>	<b>Annual \$ Change</b>	<b>2009-10</b>	<b>Annual \$ Change</b>	<b>2010-11</b>	<b>Annual \$ Change</b>
<b>Grants to Local Governments:</b>	<b>37,158</b>	<b>40,951</b>	<b>3,793</b>	<b>44,762</b>	<b>3,811</b>	<b>48,347</b>	<b>3,585</b>
School Aid	16,170	17,046	876	18,576	1,530	20,358	1,782
Medicaid	8,081	9,811	1,730	11,166	1,355	11,893	727
Medicaid: Takeover Initiatives	974	1,348	374	1,898	550	2,453	555
Higher Education	2,388	2,460	72	2,515	55	2,542	27
Mental Hygiene	1,858	2,077	219	2,244	167	2,349	105
Children and Families Services	1,530	1,679	149	1,782	103	1,875	93
Temporary and Disability Assistance	1,394	1,438	44	1,434	(4)	1,429	(5)
Special Education - Categorical	1,025	1,083	58	1,145	62	1,210	65
Local Government Assistance	943	1,323	380	1,364	41	1,420	56
Public Health	719	771	52	756	(15)	766	10
Transportation	106	105	(1)	105	0	104	(1)
All Other	1,970	1,810	(160)	1,777	(33)	1,948	171
<b>State Operations:</b>	<b>9,620</b>	<b>9,999</b>	<b>379</b>	<b>10,398</b>	<b>399</b>	<b>10,644</b>	<b>246</b>
Personal Service	6,709	6,924	215	7,156	232	7,268	112
Non-Personal Service	2,911	3,075	164	3,242	167	3,376	134
<b>General State Charges</b>	<b>4,530</b>	<b>4,949</b>	<b>419</b>	<b>5,342</b>	<b>393</b>	<b>5,646</b>	<b>304</b>
Pensions	1,185	1,226	41	1,330	104	1,332	2
Health Insurance (Active Employees)	1,586	1,808	223	1,972	164	2,152	180
Health Insurance (Retired Employees)	1,007	1,148	141	1,255	107	1,373	118
All Other	752	769	17	785	16	789	4
<b>Transfers to Other Funds:</b>	<b>2,376</b>	<b>2,851</b>	<b>475</b>	<b>2,993</b>	<b>142</b>	<b>3,408</b>	<b>415</b>
Debt Service	1,579	1,709	130	1,706	(3)	1,740	34
Capital Projects	82	277	195	489	212	862	373
All Other	715	865	150	798	(67)	806	8
<b>Total Disbursements</b>	<b>53,684</b>	<b>58,750</b>	<b>5,066</b>	<b>63,495</b>	<b>4,745</b>	<b>68,045</b>	<b>4,550</b>

## Grants to Local Governments

Annual growth in local assistance is driven primarily by Medicaid, school aid and welfare. The following table summarizes some of the factors that affect the local assistance projections over the forecast period.

<b>Forecast for Selected Program Measures Affecting Local Assistance</b>					
<b>(millions of dollars)</b>					
	<b>Actual</b>	<b>Forecast</b>			
	<b>2006-07 *</b>	<b>2007-08</b>	<b>2008-09</b>	<b>2009-10</b>	<b>2010-11</b>
<b>Medicaid</b>					
Medicaid Coverage (excl. FHP)	3,690,578	3,854,312	4,008,484	4,168,824	4,335,577
Medicaid Inflation	1.4%	1.8%	4.4%	4.7%	4.3%
Medicaid Utilization	1.1%	1.4%	3.4%	3.5%	3.3%
State Takeover of County/NYC Costs					
- Family Health Plus	\$438	\$477	\$518	\$530	\$547
- Medicaid	\$332	\$497	\$830	\$1,368	\$1,906
<b>Education</b>					
School Aid (School Year)	\$17,900	\$19,600	\$21,000	\$23,200	\$25,500
K-12 Enrollment	2,794,393	2,761,450	2,761,450	2,761,450	2,761,450
Public Higher Education Enrollment (FTEs)	503,538	515,178	515,178	515,178	515,178
TAP Recipients	323,000	318,000	318,000	318,000	318,000
<b>Welfare</b>					
Family Assistance Caseload	415,200	397,600	393,000	391,900	391,400
Single Adult/No Children Caseload	150,600	155,400	155,400	154,100	152,600
<b>Mental Hygiene</b>					
Mental Hygiene Community Beds	84,465	87,409	90,196	92,462	94,271

## School Aid

On a school year basis, school aid is projected at \$21.0 billion in 2008-09, \$23.2 billion in 2009-10, and \$25.5 billion in 2010-11. On a State fiscal year basis, General Fund school aid spending is projected to grow by \$875 million in 2008-09, \$1.5 billion in 2009-10, and \$1.8 billion in 2010-11. Outside the General Fund, revenues from lottery sales are projected to increase by \$63 million in 2008-09, \$97 million in 2009-10, and \$27 million in 2010-11, to a total of \$2.2 billion in 2008-09 growing to \$2.3 billion in 2010-11. In addition, VLT revenues are projected to increase by \$476 million in 2008-09, \$286 million in 2009-10, and \$430 million in 2010-11, to a total of \$1.1 billion in 2008-09 and growing to \$1.8 billion in 2010-11. The VLT estimates assume the start of operations at Aqueduct by April 2008 and the approval of a proposed expansion plan in 2007-08, which is expected to provide \$150 million of the increase planned in 2008-09, growing to \$766 million in additional revenue provided in 2010-11.

The Financial Plan assumes that certain school aid initiatives included in the 2007-08 Enacted Budget are non-recurring. Specifically, High Tax Aid (\$100 million); Supplemental Public Excess Cost Aid (\$21 million) and the New York City Academic Achievement Grant (\$89 million). In future years, projected school aid increases are primarily due to increases in Foundation Aid; Universal Prekindergarten expansion; and increases in expense-based aids such as Building Aid and Transportation Aid as detailed in the following table.

<b>Four Year School Aid Projection -- School Year</b>				
<b>Cumulative Increase</b>				
<b>(millions of dollars)</b>				
	<b>Enacted</b>		<b>Forecast</b>	
	<b>2007-08</b>	<b>2008-09</b>	<b>2009-10</b>	<b>2010-11</b>
Foundation Aid	1,092	2,343	3,858	5,512
Universal Prekindergarten	103	200	300	350
Additional Prekindergarten	43	0	0	0
High Tax Aid	100	0	0	0
Supplemental Public Excess Cost	21	0	0	0
New York City Academic Achievement Grant	89	0	0	0
EXCEL Building Aid	112	184	197	197
Expense-Based Aids (Building, Transportation, High Cost and Private Excess Cost, BOCES)	142	332	785	1,280
Other Aid Categories/Initiatives/Miscellaneous Growth	63	63	200	300
<b>School Aid Subtotal</b>	<b>1,765</b>	<b>3,122</b>	<b>5,340</b>	<b>7,639</b>
Other: SED State Operations--Accountability Initiative	15	20	20	20
<b>Total Cumulative Increase</b>	<b>1,780</b>	<b>3,142</b>	<b>5,360</b>	<b>7,659</b>

## Medicaid

The Financial Plan projects that General Fund spending for Medicaid will grow by roughly \$2.1 billion in 2008-09, \$1.9 billion in 2009-10, and another \$1.3 billion in 2010-11.

<b>Major Sources of Annual Change in Medicaid Growth</b>			
<b>General Fund</b>			
<b>(billions of dollars)</b>			
	<b>Increase from Prior Year</b>		
	<b>2008-09</b>	<b>2009-10</b>	<b>2010-11</b>
Price/Utilization/Admin Growth	1.1	1.0	1.0
Timing	0.2	0.0	0.0
Extra Weekly Payment	0.0	0.3	(0.3)
Medicaid Cap/FHP Takeover	0.4	0.6	0.6
Provider Assessments	0.1	0.0	0.0
HCRA Financing	0.3	0.0	0.0
<b>Total</b>	<b>2.1</b>	<b>1.9</b>	<b>1.3</b>

This growth results, in part, from the combination of modest growth in recipients, service utilization, and medical care cost inflation. These factors are projected to add roughly \$1.1 billion in costs annually. In 2009-10, an extra weekly payment to providers adds \$300 million in spending. In addition, the State cap on local Medicaid costs and takeover of local FHP costs is projected to increase spending by \$374 million in 2008-09, \$550 million in 2009-10, and \$555 million in 2010-11. The remaining growth is primarily attributed to certain nursing home delinquent payor assessment collections in 2007-08 that are

not expected to recur in 2008-09 and lower levels of HCRA financing beginning in 2008-09, both of which are used to lower General Fund costs.

The average number of Medicaid recipients is expected to grow to 4 million in 2008-09, an increase of 4.0 percent from the estimated 2007-08 caseload of more than 3.8 million. FHP enrollment is estimated to grow to approximately 556,000 in 2008-09, an increase of 3 percent over projected 2007-08 enrollment of 540,000.

## **Mental Hygiene**

Mental Hygiene spending is projected at \$2.1 billion in 2008-09, \$2.2 billion in 2009-10, and \$2.3 billion in 2010-11. The growth is largely attributable to increases in the projected State share of Medicaid costs, cost-of-living increases, projected expansions of the various mental hygiene service systems including OMH's Children's Services, increases in the NYS-CARES program and in the development of children's beds for out-of-state placements in OMRDD, the NY/NY III Supportive Housing agreement and community bed expansion in OMH, and several new chemical dependence treatment and prevention initiatives.

## **Children and Family Services**

Children and Family Services spending is projected to grow by roughly \$100 million annually in the outyears. The increases are driven primarily by expected growth in the open-ended child welfare services program, the impact of the OCFS Medicaid waiver, and cost-of-living increases for workers in foster care, and foster and adoptive parents enacted in 2006-07.

## **Temporary and Disability Assistance**

Spending is projected at \$1.4 billion in 2008-09, an increase of \$44 million (3.2 percent) from 2007-08, and is expected to remain at virtually the same level in 2009-10 and 2010-11. Caseloads for family assistance and single adult/childless couples are projected to decline marginally. This reduction is more than countered by the reduced availability of Federal TANF to support public assistance costs, thereby increasing General Fund spending growth.

## **Other Local**

All other local assistance programs total \$7.6 billion in 2008-09, an increase of approximately \$400 million over 2007-08 Enacted levels. This growth in spending results primarily from increases in local government assistance (\$380 million) as unrestricted aid to New York City is expected to return to prior-year levels (\$308 million increase) and additional AIM funding for "high need" municipalities increases another \$50 million above 2007-08 levels.



## State Operations

Forecast of Selected Program Measures Affecting State Operations					
	Actual	Forecast			
	2006-07	2007-08	2008-09	2009-10	2010-11
<b>State Operations</b>					
Prison Population (Corrections)	63,577	63,400	63,400	63,400	63,400
Negotiated Salary Increases <sup>(1)</sup>	3.00%	0.0%	0.0%	0.0%	0.0%
Personal Service Inflation	0.8%	0.8%	0.8%	0.8%	0.8%
State Workforce	195,526	198,413	199,184	199,184	199,184

(1) Negotiated salary increases include a recurring \$800 base salary adjustment effective April 1, 2007.

State Operations spending is expected to total \$10.0 billion in 2008-09, an annual increase of \$379 million (3.9 percent). In 2009-10, spending is projected to grow by another \$399 million to a total of \$10.4 billion (3.9 percent). Spending in 2010-11 is projected to total \$10.6 billion, \$246 million above 2009-10 levels (2.4 percent). In all years, normal salary adjustments and increased staffing levels, primarily in mental health and corrections, drive higher personal service costs. Inflationary increases for non-personal service costs result in higher spending in all years. Additional growth is driven by spending for ongoing initiatives, including the civil commitment program Sexually Violent Offender and increasing medical and pharmacy costs in the areas of mental hygiene and corrections. The projections do not include any reserve for labor settlements after the current round of contracts, which expired on April 1, 2007 (United University Professions will expire on July 1, 2007).

## General State Charges (GSCs)

Forecast of Selected Program Measures Affecting General State Charges					
	Actual	Forecast			
	2006-07	2007-08	2008-09	2009-10	2010-11
<b>General State Charges</b>					
Pension Contribution Rate	10.2%	9.5%	9.9%	11.0%	11.0%
Employee/Retiree Health Insurance Rate	10.4%	6.6%	14.0%	9.2%	9.2%

GSCs are projected to total \$5.0 billion in 2008-09, \$5.3 billion in 2009-10 and \$5.6 billion in 2010-11. The annual increases are due mainly to anticipated cost increases in pensions and health insurance for State employees and retirees.

The State's pension contribution rate to the New York State and Local Retirement System is expected to increase from 9.5 percent of salary in 2007-08 to 9.9 percent in 2008-09 and 11.0 percent in 2009-10 and 2010-11. Pension spending in 2008-09 is projected to increase by \$41 million over 2007-08 due to anticipated increases in the employer contribution rate. In 2009-10, spending is projected to grow by another \$104 million to a total of \$1.3 billion, and remains virtually unchanged in 2010-11. Spending for employee and retiree health care costs is expected to increase by \$364 million in 2008-09, \$271 million in 2009-10, and another \$298 million in 2010-11 and assumes an average annual premium increase of roughly 10 percent. Health insurance is projected at \$3.0 billion in 2008-09 (\$1.8 billion for

active employees and \$1.2 billion for retired employees), \$3.3 billion in 2009-10 (\$2.0 billion for active employees and \$1.3 billion for retired employees), and \$3.5 billion in 2010-11 (\$2.1 billion for active employees and \$1.4 billion for retired employees).

<b>Forecast of New York State Employee Health Insurance</b> (millions of dollars)			
<b>Health Insurance</b>			
<b>Year</b>	<b>Active Employees</b>	<b>Retirees</b>	<b>Total State</b>
<b>2006-07</b>	1,492	940	2,432
<b>2007-08</b>	1,586	1,007	2,593
<b>2008-09</b>	1,808	1,148	2,956
<b>2009-10</b>	1,972	1,255	3,227
<b>2010-11</b>	2,152	1,373	3,525

All numbers reflect the cost of Health Insurance for General State Charges (Executive and Legislative branches) and the Office of Court Administration

## Transfers to Other Funds

In 2008-09, transfers to other funds are estimated at \$2.9 billion, an increase of \$480 million over 2006-07. This increase is primarily attributed to the first in a series of annual transfers to the Dedicated Highway Fund (\$37 million) aimed at reducing fund gaps, annual transfers of \$50 million to support development of a single State financial management system, annual transfers of \$50 million for stem cell research, and a return to normal patterns for SUNY Hospital State subsidy payments (\$42 million increase) and debt service requirements (\$130 million increase) after an acceleration of 2007-08 payments into 2006-07. In 2009-10 and 2010-11, transfers to other funds are expected to increase by \$141 million and \$415 million, respectively, as capital transfers to the Dedicated Highway Fund rise by an additional \$209 million and \$364 million in each of those years.

## Financial Plan Reserves

Pursuant to a new State law, the State created a new Rainy Day Reserve in January 2007 that has an authorized balance of 3 percent of General Fund spending. The new Rainy Day Reserve may be used to respond to an economic downturn or catastrophic event. The Enacted Budget for 2007-08 authorizes the first deposit of \$175 million. When combined with the existing Tax Stabilization Reserve, which has a balance of 2 percent of General Fund spending and can be used only to cover unforeseen year-end deficits, the State's Rainy Day Reserve authorization totals 5 percent of General Fund spending.

The State projects that General Fund reserves will total \$3.0 billion at the end of 2007-08 (5.6 percent of General Fund Spending) with \$1.2 billion in undesignated reserves available to deal with unforeseen contingencies and \$1.8 billion designated for subsequent use.

<b>2007-08 General Fund Estimated Closing Balance (millions of dollars)</b>	
<b>Year-End Fund Balance</b>	<b><u>3,033</u></b>
<i>Undesignated Reserves</i>	
	<u>1,227</u>
Tax Stabilization Reserve Fund	1,031
Rainy Day Reserve Fund	175
Contingency Reserve Fund	21
<i>Designated Reserves</i>	
	<u>1,806</u>
Remaining 2006-07 Surplus	1,203
Debt Reduction Reserve Fund	250
Community Projects Fund	353

The \$1.2 billion of undesignated reserves includes a balance of \$1 billion in the Tax Stabilization Reserve, which is at its statutory maximum balance of 2 percent of General Fund spending, \$175 million in the new Rainy Day Reserve, and \$21 million in the Contingency Reserve Fund for litigation risks.

The Enacted Budget reserves another \$1.8 billion designated for future use, including \$1.2 billion remaining from the projected 2006-07 surplus (the Financial Plan projects that the reserve will be used in equal installments in each of the outyears). In addition, \$250 million is set aside for debt reduction and \$353 million is reserved in the Community Projects Fund to finance existing initiatives.

Aside from the amounts noted above, the 2007-08 Enacted Financial Plan does not set aside specific reserves to cover potential costs that could materialize as a result of Federal disallowances or other Federal actions that could adversely affect the State's projections of receipts and disbursements.

## Cash Flow Forecast

Current projections continue to show relatively healthy monthly balances through the end of 2007-08. In 2007-08, the General Fund is projected to have quarterly-ending balances of \$4.2 billion in June 2007, \$5.0 billion in September 2007, \$2.4 billion in December 2007, and \$3.1 billion at the end of March 2008. The lowest projected month-end cash flow balance is \$2.4 billion in December 2007. DOB's detailed monthly cash flow projections for 2007-08 are provided later in this section.

OSC invests General Fund moneys, bond proceeds, and other funds not immediately required to make payments through the Short-Term Investment Pool (STIP), which comprises joint custody funds (Governmental Funds, Internal Service Funds, Enterprise Funds and Private Purpose Trust Funds), as well as several sole custody funds including the Tobacco Settlement Fund.

OSC is authorized to make short-term loans from STIP to cover temporary cash shortfalls in certain funds and accounts resulting from the timing of receipts and disbursements. The Legislature authorizes the funds and accounts that may receive loans each year, based on legislation submitted with the Executive Budget. Loans may be granted only for amounts that the Director of the Budget certifies are "receivable on account" or can be repaid from the current operating receipts of the fund (i.e., loans cannot be granted in expectation of future revenue enhancements).

**CASH FINANCIAL PLAN  
GENERAL FUND  
2006-2007 and 2007-2008  
(millions of dollars)**

	<u>2006-2007 Year-End</u>	<u>Change</u>	<u>2007-2008 Enacted</u>
<b>Opening fund balance</b>	<u>3,257</u>	<u>(212)</u>	<u>3,045</u>
<b>Receipts:</b>			
Taxes:			
Personal income tax	22,939	(54)	22,885
User taxes and fees	8,186	379	8,565
Business taxes	6,468	211	6,679
Other taxes	1,075	60	1,135
Miscellaneous receipts	2,268	217	2,485
Federal grants	151	(92)	59
Transfers from other funds:			
PIT in excess of Revenue Bond debt service	7,136	1,309	8,445
Sales tax in excess of LGAC debt service	2,093	227	2,320
Real estate taxes in excess of CW/CA debt service	753	(192)	561
All other transfers	310	228	538
<b>Total receipts</b>	<u>51,379</u>	<u>2,293</u>	<u>53,672</u>
<b>Disbursements:</b>			
Grants to local governments	34,302	2,856	37,158
State operations	9,319	301	9,620
General State charges	4,403	127	4,530
Transfers to other funds:			
Debt service	1,906	(327)	1,579
Capital projects	389	(307)	82
Other purposes	1,272	(557)	715
<b>Total disbursements</b>	<u>51,591</u>	<u>2,093</u>	<u>53,684</u>
<b>Change in fund balance</b>	<u>(212)</u>	<u>200</u>	<u>(12)</u>
<b>Closing fund balance</b>	<u>3,045</u>	<u>(12)</u>	<u>3,033</u>
<b>Reserves</b>			
Tax Stabilization Reserve Fund	1,031	0	1,031
Statutory Rainy Day Reserve Fund	0	175	175
Contingency Reserve Fund	21	0	21
Community Projects Fund	278	75	353
Debt Reduction Reserve Fund	0	250	250
2005-2006 Surplus	787	(787)	0
2006-2007 Surplus	1,493	(290)	1,203
2006-2007 Timing Related Transactions	(565)	565	0

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Source: NYS DOB

\*2006-07 year-end results are preliminary and unaudited.

**CASH FINANCIAL PLAN  
GENERAL FUND  
2007-2008 THROUGH 2010-2011  
(millions of dollars)**

	<u>2007-2008 Enacted</u>	<u>2008-2009 Projected</u>	<u>2009-2010 Projected</u>	<u>2010-2011 Projected</u>
<b>Receipts:</b>				
Taxes:				
Personal income tax	22,885	24,128	25,576	26,979
User taxes and fees	8,565	8,900	9,213	9,539
Business taxes	6,679	6,807	7,113	7,392
Other taxes	1,135	1,211	1,342	1,425
Miscellaneous receipts	2,485	2,054	2,456	2,459
Federal grants	59	59	59	59
Transfers from other funds:				
PIT in excess of Revenue Bond debt service	8,445	8,765	9,133	9,505
Sales tax in excess of LGAC debt service	2,320	2,363	2,469	2,579
Real estate taxes in excess of CW/CA debt service	561	614	670	672
All other	538	278	227	259
<b>Total receipts</b>	<u>53,672</u>	<u>55,179</u>	<u>58,258</u>	<u>60,868</u>
<b>Disbursements:</b>				
Grants to local governments	37,158	40,951	44,762	48,347
State operations	9,620	9,999	10,398	10,644
General State charges	4,530	4,949	5,342	5,646
Transfers to other funds:				
Debt service	1,579	1,709	1,706	1,740
Capital projects	82	277	489	862
Other purposes	715	865	798	806
<b>Total disbursements</b>	<u>53,684</u>	<u>58,750</u>	<u>63,495</u>	<u>68,045</u>
<b>Deposit to/(use of) Community Projects Fund</b>	<u>75</u>	<u>(65)</u>	<u>(65)</u>	<u>(151)</u>
<b>Deposit to/(use of) Rainy Day Reserve Fund</b>	<u>175</u>	<u>0</u>	<u>0</u>	<u>0</u>
<b>Deposit to/(use of) Debt Reduction Reserve Fund</b>	<u>250</u>	<u>0</u>	<u>0</u>	<u>0</u>
<b>Deposit to/(use of) 2005-06 Surplus</b>	<u>(787)</u>	<u>0</u>	<u>0</u>	<u>0</u>
<b>Deposit to/(use of) 2006-07 Surplus</b>	<u>275</u>	<u>(401)</u>	<u>(401)</u>	<u>(401)</u>
<b>Margin</b>	<u>0</u>	<u>(3,105)</u>	<u>(4,771)</u>	<u>(6,625)</u>

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Source: NYS DOB

**CASH FINANCIAL PLAN  
GENERAL FUND  
2007-2008  
(millions of dollars)**

	<u>Executive Proposal</u>	<u>Change</u>	<u>Enacted Budget</u>
<b>Opening fund balance</b>	<u>3,607</u>	<u>(562)</u>	<u>3,045</u>
<b>Receipts:</b>			
Taxes:			
Personal income tax	22,258	627	22,885
User taxes and fees	8,633	(68)	8,565
Business taxes	6,333	346	6,679
Other taxes	1,060	75	1,135
Miscellaneous receipts	2,851	(366)	2,485
Federal grants	59	0	59
Transfers from other funds:			
PIT in excess of Revenue Bond debt service	8,300	145	8,445
Sales tax in excess of LGAC debt service	2,277	43	2,320
Real estate taxes in excess of CW/CA debt service	560	1	561
All other transfers	335	203	538
<b>Total receipts</b>	<u>52,666</u>	<u>1,007</u>	<u>53,673</u>
<b>Disbursements:</b>			
Grants to local governments	36,384	774	37,158
State operations	9,602	18	9,620
General State charges	4,572	(42)	4,530
Transfers to other funds:			
Debt service	1,752	(173)	1,579
Capital projects	255	(173)	82
Other purposes	683	32	715
<b>Total disbursements</b>	<u>53,248</u>	<u>437</u>	<u>53,685</u>
<b>Change in fund balance</b>	<u>(582)</u>	<u>570</u>	<u>(12)</u>
<b>Closing fund balance</b>	<u>3,025</u>	<u>8</u>	<u>3,033</u>
<b>Reserves</b>			
Tax Stabilization Reserve Fund	1,025	6	1,031
Statutory Rainy Day Reserve Fund	175	0	175
Contingency Reserve Fund	21	0	21
Community Projects Fund	351	2	353
Debt Reduction Reserve Fund	250	0	250
2006-2007 Surplus	1,203	0	1,203

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Source: NYS DOB

**CURRENT STATE RECEIPTS**  
**GENERAL FUND**  
**2006-2007 and 2007-2008**  
**(millions of dollars)**

	<u>2006-2007</u>	<u>2007-2008</u>	<u>Annual Change</u>
<b>Personal income tax</b>	22,939	22,885	(54)
<b>User taxes and fees</b>	8,186	8,565	379
Sales and use tax	7,539	7,867	328
Cigarette and tobacco taxes	411	447	36
Motor vehicle fees	(16)	0	16
Alcoholic beverages taxes	194	200	6
Alcoholic beverage control license fees	58	51	(7)
<b>Business taxes</b>	6,468	6,679	211
Corporation franchise tax	3,676	3,904	228
Corporation and utilities tax	626	618	(8)
Insurance taxes	1,142	1,176	34
Bank tax	1,024	981	(43)
<b>Other taxes</b>	1,075	1,135	60
Estate tax	1,063	1,114	51
Gift tax	(10)	0	10
Real property gains tax	0	0	0
Pari-mutuel taxes	21	20	(1)
Other taxes	1	1	0
<b>Total taxes</b>	<u>38,668</u>	<u>39,264</u>	<u>596</u>
<b>Miscellaneous receipts</b>	<u>2,268</u>	<u>2,485</u>	<u>217</u>
<b>Federal Grants</b>	<u>151</u>	<u>59</u>	<u>(92)</u>
<b>Total</b>	<u><u>41,087</u></u>	<u><u>41,808</u></u>	<u><u>721</u></u>

Source: NYS DOB

\*2006-07 year-end results are preliminary and unaudited.

**CASH FINANCIAL PLAN  
STATE FUNDS  
2006-2007  
(millions of dollars)**

	<u>General Fund</u>	<u>Special Revenue Funds</u>	<u>Capital Projects Funds</u>	<u>Debt Service Funds</u>	<u>(MEMO) Total</u>
<b>Opening fund balance</b>	3,257	3,791	(450)	221	6,819
<b>Receipts:</b>					
Taxes	38,668	7,109	1,929	11,033	58,739
Miscellaneous receipts	2,268	12,502	2,246	848	17,864
Federal grants	151	1	0	0	152
<b>Total receipts</b>	<u>41,087</u>	<u>19,612</u>	<u>4,175</u>	<u>11,881</u>	<u>76,755</u>
<b>Disbursements:</b>					
Grants to local governments	34,302	15,216	359	0	49,877
State operations	9,319	5,151	0	44	14,514
General State charges	4,403	594	0	0	4,997
Debt service	0	0	0	4,451	4,451
Capital projects	0	9	3,463	0	3,472
<b>Total disbursements</b>	<u>48,024</u>	<u>20,970</u>	<u>3,822</u>	<u>4,495</u>	<u>77,311</u>
<b>Other financing sources (uses):</b>					
Transfers from other funds	10,292	1,587	454	5,600	17,933
Transfers to other funds	(3,567)	(349)	(766)	(12,974)	(17,656)
Bond and note proceeds	0	0	181	0	181
<b>Net other financing sources (uses)</b>	<u>6,725</u>	<u>1,238</u>	<u>(131)</u>	<u>(7,374)</u>	<u>458</u>
<b>Change in fund balance</b>	<u>(212)</u>	<u>(120)</u>	<u>222</u>	<u>12</u>	<u>(98)</u>
<b>Closing fund balance</b>	<u>3,045</u>	<u>3,671</u>	<u>(228)</u>	<u>233</u>	<u>6,721</u>

Source: NYS DOB

\*2006-07 year-end results are preliminary and unaudited.



**CASH FINANCIAL PLAN  
STATE FUNDS  
2007-2008  
(millions of dollars)**

	<u>General Fund</u>	<u>Special Revenue Funds</u>	<u>Capital Projects Funds</u>	<u>Debt Service Funds</u>	<u>(MEMO) Total</u>
<b>Opening fund balance</b>	3,045	3,671	(228)	233	6,721
<b>Receipts:</b>					
Taxes	39,264	8,009	2,166	12,521	61,960
Miscellaneous receipts	2,485	13,590	3,501	671	20,247
Federal grants	59	1	0	0	60
<b>Total receipts</b>	<u>41,808</u>	<u>21,600</u>	<u>5,667</u>	<u>13,192</u>	<u>82,267</u>
<b>Disbursements:</b>					
Grants to local governments	37,158	16,545	439	0	54,142
State operations	9,620	5,760	0	61	15,441
General State charges	4,530	614	0	0	5,144
Debt service	0	0	0	4,134	4,134
Capital projects	0	3	4,915	0	4,918
<b>Total disbursements</b>	<u>51,308</u>	<u>22,922</u>	<u>5,354</u>	<u>4,195</u>	<u>83,779</u>
<b>Other financing sources (uses):</b>					
Transfers from other funds	11,864	1,168	293	5,453	18,778
Transfers to other funds	(2,376)	(719)	(934)	(14,411)	(18,440)
Bond and note proceeds	0	0	358	0	358
<b>Net other financing sources (uses)</b>	<u>9,488</u>	<u>449</u>	<u>(283)</u>	<u>(8,958)</u>	<u>696</u>
<b>Change in fund balance</b>	<u>(12)</u>	<u>(873)</u>	<u>30</u>	<u>39</u>	<u>(816)</u>
<b>Closing fund balance</b>	<u>3,033</u>	<u>2,798</u>	<u>(198)</u>	<u>272</u>	<u>5,905</u>

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Source: NYS DOB

**CASH FINANCIAL PLAN**  
**STATE FUNDS**  
**2008-2009**  
(millions of dollars)

	<b>General Fund</b>	<b>Special Revenue Funds</b>	<b>Capital Projects Funds</b>	<b>Debt Service Funds</b>	<b>(MEMO) Total</b>
<b>Opening fund balance</b>	0	2,798	(198)	272	2,872
<b>Receipts:</b>					
Taxes	41,046	8,684	2,200	13,307	65,237
Miscellaneous receipts	2,054	14,186	3,560	680	20,480
Federal grants	59	1	0	0	60
<b>Total receipts</b>	<u>43,159</u>	<u>22,871</u>	<u>5,760</u>	<u>13,987</u>	<u>85,777</u>
<b>Disbursements:</b>					
Grants to local governments	40,951	17,255	464	0	58,670
State operations	9,999	5,840	0	61	15,900
General State charges	4,949	628	0	0	5,577
Debt service	0	0	0	4,798	4,798
Capital projects	0	3	5,340	0	5,343
<b>Total disbursements</b>	<u>55,899</u>	<u>23,726</u>	<u>5,804</u>	<u>4,859</u>	<u>90,288</u>
<b>Other financing sources (uses):</b>					
Transfers from other funds	12,020	1,304	530	5,734	19,588
Transfers to other funds	(2,851)	(532)	(1,006)	(14,835)	(19,224)
Bond and note proceeds	0	0	545	0	545
<b>Net other financing sources (uses)</b>	<u>9,169</u>	<u>772</u>	<u>69</u>	<u>(9,101)</u>	<u>909</u>
<b>Deposit to/(use of) Community Projects Fund</b>	<u>(65)</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>(65)</u>
<b>Deposit to/(use of) 2006-07 Surplus</b>	<u>(401)</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>(401)</u>
<b>Change in fund balance</b>	<u>(3,105)</u>	<u>(83)</u>	<u>25</u>	<u>27</u>	<u>(3,602)</u>
<b>Closing fund balance</b>	<u>(3,105)</u>	<u>2,715</u>	<u>(173)</u>	<u>299</u>	<u>(730)</u>

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Source: NYS DOB

**CASH FINANCIAL PLAN  
STATE FUNDS  
2009-2010  
(millions of dollars)**

	<u>General Fund</u>	<u>Special Revenue Funds</u>	<u>Capital Projects Funds</u>	<u>Debt Service Funds</u>	<u>(MEMO) Total</u>
<b>Opening fund balance</b>	0	2,715	(173)	299	2,841
<b>Receipts:</b>					
Taxes	43,244	9,248	2,246	14,102	68,840
Miscellaneous receipts	2,456	14,005	3,342	682	20,485
Federal grants	59	1	0	0	60
<b>Total receipts</b>	<u>45,759</u>	<u>23,254</u>	<u>5,588</u>	<u>14,784</u>	<u>89,385</u>
<b>Disbursements:</b>					
Grants to local governments	44,762	18,201	466	0	63,429
State operations	10,398	5,794	0	61	16,253
General State charges	5,342	640	0	0	5,982
Debt service	0	0	0	5,250	5,250
Capital projects	0	3	5,297	0	5,300
<b>Total disbursements</b>	<u>60,502</u>	<u>24,638</u>	<u>5,763</u>	<u>5,311</u>	<u>96,214</u>
<b>Other financing sources (uses):</b>					
Transfers from other funds	12,499	1,239	672	5,896	20,306
Transfers to other funds	(2,993)	(419)	(1,103)	(15,365)	(19,880)
Bond and note proceeds	0	0	638	0	638
<b>Net other financing sources (uses)</b>	<u>9,506</u>	<u>820</u>	<u>207</u>	<u>(9,469)</u>	<u>1,064</u>
<b>Deposit to/(use of) Community Projects Fund</b>	<u>(65)</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>(65)</u>
<b>Deposit to/(use of) 2006-07 Surplus</b>	<u>(401)</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>(401)</u>
<b>Change in fund balance</b>	<u>(4,771)</u>	<u>(564)</u>	<u>32</u>	<u>4</u>	<u>(5,299)</u>
<b>Closing fund balance</b>	<u>(4,771)</u>	<u>2,151</u>	<u>(141)</u>	<u>303</u>	<u>(2,458)</u>

Source: NYS DOB

**CASH FINANCIAL PLAN  
STATE FUNDS  
2010-2011  
(millions of dollars)**

	<b>General Fund</b>	<b>Special Revenue Funds</b>	<b>Capital Projects Funds</b>	<b>Debt Service Funds</b>	<b>(MEMO) Total</b>
<b>Opening fund balance</b>	0	2,151	(141)	303	2,313
<b>Receipts:</b>					
Taxes	45,335	9,627	2,280	14,782	72,024
Miscellaneous receipts	2,459	14,618	3,068	683	20,828
Federal grants	59	1	0	0	60
<b>Total receipts</b>	<u>47,853</u>	<u>24,246</u>	<u>5,348</u>	<u>15,465</u>	<u>92,912</u>
<b>Disbursements:</b>					
Grants to local governments	48,347	18,932	442	0	67,721
State operations	10,644	5,898	0	61	16,603
General State charges	5,646	647	0	0	6,293
Debt service	0	0	0	5,877	5,877
Capital projects	0	2	4,932	0	4,934
<b>Total disbursements</b>	<u>64,637</u>	<u>25,479</u>	<u>5,374</u>	<u>5,938</u>	<u>101,428</u>
<b>Other financing sources (uses):</b>					
Transfers from other funds	13,015	1,246	918	6,307	21,486
Transfers to other funds	(3,408)	(331)	(1,445)	(15,849)	(21,033)
Bond and note proceeds	0	0	578	0	578
<b>Net other financing sources (uses)</b>	<u>9,607</u>	<u>915</u>	<u>51</u>	<u>(9,542)</u>	<u>1,031</u>
<b>Deposit to/(use of) Community Projects Fund</b>	<u>(151)</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>(151)</u>
<b>Deposit to/(use of) 2006-07 Surplus</b>	<u>(401)</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>(401)</u>
<b>Change in fund balance</b>	<u>(6,625)</u>	<u>(318)</u>	<u>25</u>	<u>(15)</u>	<u>(6,933)</u>
<b>Closing fund balance</b>	<u>(6,625)</u>	<u>1,833</u>	<u>(116)</u>	<u>288</u>	<u>(4,620)</u>

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Source: NYS DOB

**CASH FINANCIAL PLAN**  
**ALL GOVERNMENTAL FUNDS**  
**2006-2007**  
(millions of dollars)

	<b>General Fund</b>	<b>Special Revenue Funds</b>	<b>Capital Projects Funds</b>	<b>Debt Service Funds</b>	<b>(MEMO) Total</b>
<b>Opening fund balance</b>	3,257	4,238	(648)	221	7,068
<b>Receipts:</b>					
Taxes	38,668	7,109	1,929	11,033	58,739
Miscellaneous receipts	2,268	12,715	2,247	848	18,078
Federal grants	151	33,690	1,738	0	35,579
<b>Total receipts</b>	<u>41,087</u>	<u>53,514</u>	<u>5,914</u>	<u>11,881</u>	<u>112,396</u>
<b>Disbursements:</b>					
Grants to local governments	34,302	45,693	730	0	80,725
State operations	9,319	8,164	0	44	17,527
General State charges	4,403	820	0	0	5,223
Debt service	0	0	0	4,451	4,451
Capital projects	0	9	4,829	0	4,838
<b>Total disbursements</b>	<u>48,024</u>	<u>54,686</u>	<u>5,559</u>	<u>4,495</u>	<u>112,764</u>
<b>Other financing sources (uses):</b>					
Transfers from other funds	10,292	3,873	454	5,600	20,219
Transfers to other funds	(3,567)	(2,932)	(774)	(12,974)	(20,247)
Bond and note proceeds	0	0	181	0	181
<b>Net other financing sources (uses)</b>	<u>6,725</u>	<u>941</u>	<u>(139)</u>	<u>(7,374)</u>	<u>153</u>
<b>Change in fund balance</b>	<u>(212)</u>	<u>(231)</u>	<u>216</u>	<u>12</u>	<u>(215)</u>
<b>Closing fund balance</b>	<u>3,045</u>	<u>4,007</u>	<u>(432)</u>	<u>233</u>	<u>6,853</u>

Source: NYS OSC (reflecting amounts published in the Cash Basis Report).

\*2006-07 year-end results are preliminary and unaudited.

\*\*The opening balance cash balances, receipts, disbursements, other financing sources, and ending cash balances in the Special Revenue and Capital Projects Fund groups have been adjusted to reflect the reclassification of the Hazardous Waste Remedial Fund from the Special Revenue Fund to the Capital Projects Fund, pursuant to Section 70 of the State Finance Law.

**CASH FINANCIAL PLAN  
ALL GOVERNMENTAL FUNDS  
2007-2008  
(millions of dollars)**

	<b>General Fund</b>	<b>Special Revenue Funds</b>	<b>Capital Projects Funds</b>	<b>Debt Service Funds</b>	<b>(MEMO) Total</b>
<b>Opening fund balance</b>	3,045	4,007	(432)	233	6,853
<b>Receipts:</b>					
Taxes	39,264	8,009	2,166	12,521	61,960
Miscellaneous receipts	2,485	13,745	3,501	671	20,402
Federal grants	59	35,049	2,020	0	37,128
<b>Total receipts</b>	<u>41,808</u>	<u>56,803</u>	<u>7,687</u>	<u>13,192</u>	<u>119,490</u>
<b>Disbursements:</b>					
Grants to local governments	37,158	47,915	581	0	85,654
State operations	9,620	9,045	0	61	18,726
General State charges	4,530	856	0	0	5,386
Debt service	0	0	0	4,134	4,134
Capital projects	0	4	6,771	0	6,775
<b>Total disbursements</b>	<u>51,308</u>	<u>57,820</u>	<u>7,352</u>	<u>4,195</u>	<u>120,675</u>
<b>Other financing sources (uses):</b>					
Transfers from other funds	11,864	3,666	293	5,453	21,276
Transfers to other funds	(2,376)	(3,573)	(947)	(14,411)	(21,307)
Bond and note proceeds	0	0	358	0	358
<b>Net other financing sources (uses)</b>	<u>9,488</u>	<u>93</u>	<u>(296)</u>	<u>(8,958)</u>	<u>327</u>
<b>Change in fund balance</b>	<u>(12)</u>	<u>(924)</u>	<u>39</u>	<u>39</u>	<u>(858)</u>
<b>Closing fund balance</b>	<u>3,033</u>	<u>3,083</u>	<u>(393)</u>	<u>272</u>	<u>5,995</u>

---

Source: NYS DOB

**CASH FINANCIAL PLAN  
ALL GOVERNMENTAL FUNDS  
2008-2009  
(millions of dollars)**

	<u>General Fund</u>	<u>Special Revenue Funds</u>	<u>Capital Projects Funds</u>	<u>Debt Service Funds</u>	<u>(MEMO) Total</u>
<b>Opening fund balance</b>	0	3,083	(393)	272	2,962
<b>Receipts:</b>					
Taxes	41,046	8,684	2,200	13,307	65,237
Miscellaneous receipts	2,054	14,334	3,560	680	20,628
Federal grants	59	37,156	2,037	0	39,252
<b>Total receipts</b>	<u>43,159</u>	<u>60,174</u>	<u>7,797</u>	<u>13,987</u>	<u>125,117</u>
<b>Disbursements:</b>					
Grants to local governments	40,951	50,599	630	0	92,180
State operations	9,999	9,139	0	61	19,199
General State charges	4,949	875	0	0	5,824
Debt service	0	0	0	4,798	4,798
Capital projects	0	4	7,189	0	7,193
<b>Total disbursements</b>	<u>55,899</u>	<u>60,617</u>	<u>7,819</u>	<u>4,859</u>	<u>129,194</u>
<b>Other financing sources (uses):</b>					
Transfers from other funds	12,020	3,805	530	5,734	22,089
Transfers to other funds	(2,851)	(3,428)	(1,019)	(14,835)	(22,133)
Bond and note proceeds	0	0	545	0	545
<b>Net other financing sources (uses)</b>	<u>9,169</u>	<u>377</u>	<u>56</u>	<u>(9,101)</u>	<u>501</u>
<b>Deposit to/(use of) Community Projects Fund</b>	<u>(65)</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>(65)</u>
<b>Deposit to/(use of) 2006-07 Surplus</b>	<u>(401)</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>(401)</u>
<b>Change in fund balance</b>	<u>(3,105)</u>	<u>(66)</u>	<u>34</u>	<u>27</u>	<u>(3,576)</u>
<b>Closing fund balance</b>	<u>(3,105)</u>	<u>3,017</u>	<u>(359)</u>	<u>299</u>	<u>(614)</u>

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Source: NYS DOB

**CASH FINANCIAL PLAN  
ALL GOVERNMENTAL FUNDS  
2009-2010  
(millions of dollars)**

	<u>General Fund</u>	<u>Special Revenue Funds</u>	<u>Capital Projects Funds</u>	<u>Debt Service Funds</u>	<u>(MEMO) Total</u>
<b>Opening fund balance</b>	0	3,017	(359)	299	2,957
<b>Receipts:</b>					
Taxes	43,244	9,248	2,246	14,102	68,840
Miscellaneous receipts	2,456	14,152	3,342	682	20,632
Federal grants	59	38,348	2,024	0	40,431
<b>Total receipts</b>	<u>45,759</u>	<u>61,748</u>	<u>7,612</u>	<u>14,784</u>	<u>129,903</u>
<b>Disbursements:</b>					
Grants to local governments	44,762	52,693	632	0	98,087
State operations	10,398	9,102	0	61	19,561
General State charges	5,342	888	0	0	6,230
Debt service	0	0	0	5,250	5,250
Capital projects	0	4	7,132	0	7,136
<b>Total disbursements</b>	<u>60,502</u>	<u>62,687</u>	<u>7,764</u>	<u>5,311</u>	<u>136,264</u>
<b>Other financing sources (uses):</b>					
Transfers from other funds	12,499	3,737	672	5,896	22,804
Transfers to other funds	(2,993)	(3,351)	(1,117)	(15,365)	(22,826)
Bond and note proceeds	0	0	638	0	638
<b>Net other financing sources (uses)</b>	<u>9,506</u>	<u>386</u>	<u>193</u>	<u>(9,469)</u>	<u>616</u>
<b>Deposit to/(use of) Community Projects Fund</b>	<u>(65)</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>(65)</u>
<b>Deposit to/(use of) 2006-07 Surplus</b>	<u>(401)</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>(401)</u>
<b>Change in fund balance</b>	<u>(4,771)</u>	<u>(553)</u>	<u>41</u>	<u>4</u>	<u>(5,279)</u>
<b>Closing fund balance</b>	<u>(4,771)</u>	<u>2,464</u>	<u>(318)</u>	<u>303</u>	<u>(2,322)</u>

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Source: NYS DOB



**CASH FINANCIAL PLAN  
ALL GOVERNMENTAL FUNDS  
2010-2011  
(millions of dollars)**

	<b>General Fund</b>	<b>Special Revenue Funds</b>	<b>Capital Projects Funds</b>	<b>Debt Service Funds</b>	<b>(MEMO) Total</b>
<b>Opening fund balance</b>	0	2,464	(318)	303	2,449
<b>Receipts:</b>					
Taxes	45,335	9,627	2,280	14,782	72,024
Miscellaneous receipts	2,459	14,762	3,068	683	20,972
Federal grants	59	40,203	2,052	0	42,314
<b>Total receipts</b>	<u>47,853</u>	<u>64,592</u>	<u>7,400</u>	<u>15,465</u>	<u>135,310</u>
<b>Disbursements:</b>					
Grants to local governments	48,347	55,183	608	0	104,138
State operations	10,644	9,282	0	61	19,987
General State charges	5,646	899	0	0	6,545
Debt service	0	0	0	5,877	5,877
Capital projects	0	3	6,771	0	6,774
<b>Total disbursements</b>	<u>64,637</u>	<u>65,367</u>	<u>7,379</u>	<u>5,938</u>	<u>143,321</u>
<b>Other financing sources (uses):</b>					
Transfers from other funds	13,015	3,744	918	6,307	23,984
Transfers to other funds	(3,408)	(3,278)	(1,459)	(15,849)	(23,994)
Bond and note proceeds	0	0	578	0	578
<b>Net other financing sources (uses)</b>	<u>9,607</u>	<u>466</u>	<u>37</u>	<u>(9,542)</u>	<u>568</u>
<b>Deposit to/(use of) Community Projects Fund</b>	<u>(151)</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>(151)</u>
<b>Deposit to/(use of) 2006-07 Surplus</b>	<u>(401)</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>(401)</u>
<b>Change in fund balance</b>	<u>(6,625)</u>	<u>(309)</u>	<u>58</u>	<u>(15)</u>	<u>(6,891)</u>
<b>Closing fund balance</b>	<u>(6,625)</u>	<u>2,155</u>	<u>(260)</u>	<u>288</u>	<u>(4,442)</u>

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Source: NYS DOB

**CASHFLOW  
GENERAL FUND  
2007-2008  
(dollars in millions)**

	2007						2008						
	April Projected	May Projected	June Projected	July Projected	August Projected	September Projected	October Projected	November Projected	December Projected	January Projected	February Projected	March Projected	Total
<b>OPENING BALANCE</b>	3,045	6,990	3,765	4,185	4,380	3,887	5,045	3,469	2,652	2,449	7,465	7,090	3,045
<b>RECEIPTS:</b>													
Personal Income Tax	4,012	738	2,345	1,493	1,625	1,954	342	474	906	5,387	1,909	1,700	22,885
User Taxes and Fees	629	627	877	671	638	889	647	638	927	678	570	774	8,565
Business Taxes	248	25	1,236	177	136	1,269	167	60	1,271	157	139	1,794	6,679
Other Taxes	94	95	95	95	96	96	94	94	94	94	94	94	1,135
Total Taxes	4,983	1,485	4,553	2,436	2,495	4,208	1,250	1,266	3,198	6,316	2,712	4,362	39,264
Licenses, fees, etc.	64	60	59	140	57	70	57	54	60	54	65	89	829
Abandoned Property	12	20	35	15	16	48	23	190	55	23	27	220	684
Reimbursement	21	14	25	19	21	8	8	8	22	4	5	35	200
Investment income	13	13	12	13	13	12	12	13	12	12	13	14	150
Other transactions	10	29	139	20	20	39	20	20	39	20	20	246	622
Total Miscellaneous Receipts	120	135	270	206	124	190	120	285	188	113	130	604	2,485
Federal Grants	1	1	13	1	1	13	1	1	13	1	0	13	59
PIT in excess of Revenue Bond Debt Service	1,336	195	859	498	384	936	568	238	790	1,740	143	758	8,445
Sales Tax in Excess of LGAC Debt Service	184	20	441	199	191	256	194	190	287	204	2	152	2,320
Real Estate Taxes in Excess of CW/CA Debt Service	64	60	40	40	42	47	42	47	47	42	44	46	561
All Other	0	0	159	5	1	87	10	6	21	0	0	249	538
Total Transfers from Other Funds	1,584	275	1,489	742	618	1,326	814	481	1,145	1,986	189	1,205	11,864
<b>TOTAL RECEIPTS</b>	6,688	1,896	6,335	3,385	3,238	5,737	2,185	2,033	4,544	8,416	3,031	6,184	53,672
<b>DISBURSEMENTS:</b>													
School Aid	127	1,817	1,711	96	410	1,549	601	697	1,336	468	846	6,512	16,170
Higher Education	18	11	228	211	230	87	447	23	198	55	339	541	2,368
All Other Education	32	98	91	220	93	116	137	86	128	240	141	356	1,738
Medicaid	856	1,279	738	746	1,030	609	645	598	593	810	763	829	9,496
Public Health	114	52	16	52	13	31	65	57	36	101	(4)	186	719
Mental Hygiene	63	78	77	135	81	232	115	74	212	259	165	367	1,858
Children and Families	47	62	69	88	226	90	93	96	220	88	84	367	1,530
Temporary & Disability Assistance	139	142	243	156	160	177	156	(143)	176	6	125	56	1,393
Transportation	0	15	45	0	15	0	0	15	7	0	8	1	106
All Other	26	47	414	41	53	157	22	61	317	96	65	461	1,760
Total Local Assistance Grants	1,422	3,601	3,632	1,745	2,311	3,048	2,281	1,564	3,223	2,123	2,532	9,676	37,158
Personal Service	650	819	605	645	750	587	716	537	381	546	306	167	6,709
Non-Personal Service	147	224	205	215	249	244	248	222	232	247	243	435	2,911
Total State Operations	797	1,043	810	860	999	831	964	759	613	793	549	602	9,620
General State Charges	336	281	1,187	450	310	275	414	277	299	345	150	206	4,530
Debt Service	48	144	216	43	38	295	32	141	409	4	24	185	1,579
Capital Projects	33	25	23	53	44	50	41	42	101	90	127	(547)	82
Other Purposes	107	27	47	39	29	80	29	67	102	45	24	119	715
Total Transfers to Other Funds	188	196	286	135	111	425	102	250	612	139	175	(243)	2,376
<b>TOTAL DISBURSEMENTS</b>	2,743	5,121	5,915	3,190	3,731	4,579	3,761	2,850	4,747	3,400	3,406	10,241	53,684
Excess/(Deficiency) of Receipts over Disbursements	3,945	(3,225)	420	195	(493)	1,158	(1,576)	(817)	(203)	5,016	(375)	(4,057)	(12)
<b>CLOSING BALANCE</b>	6,990	3,765	4,185	4,380	3,887	5,045	3,469	2,652	2,449	7,465	7,090	3,033	3,033

Source: NYS DOB

**CASH DISBURSEMENTS BY FUNCTION**  
**ALL GOVERNMENTAL FUNDS**  
(thousands of dollars)

	2005-2006 Actuals	2006-2007 Actuals	2007-2008 Projected	2008-2009 Projected	2009-2010 Projected	2010-2011 Projected
<b>ECONOMIC DEVELOPMENT AND GOVERNMENT OVERSIGHT</b>						
Agriculture and Markets, Department of	85,677	94,967	122,415	132,022	106,183	106,587
Alcoholic Beverage Control	10,286	11,696	12,948	13,287	13,849	13,911
Banking Department	56,278	57,224	60,010	60,798	61,580	62,377
Consumer Protection Board	2,622	2,792	3,055	3,090	3,125	3,159
Economic Development, Department of	225,352	88,458	154,743	412,627	314,556	164,449
Empire State Development Corporation	45,829	169,786	778,720	538,900	335,840	252,981
Energy Research and Development Authority	26,151	28,865	28,623	27,950	27,950	27,950
Housing and Community Renewal, Division of	259,549	272,073	309,562	291,111	276,706	275,759
Insurance Department	124,142	145,590	262,421	262,594	263,718	264,860
Olympic Regional Development Authority	8,550	8,250	14,126	9,009	9,217	9,217
Public Service, Department of	50,453	50,931	56,884	58,427	59,765	61,705
Science, Technology and Academic Research, Office of	61,470	52,054	57,488	48,335	44,403	43,725
University Broadband	2,930	4,840	7,500	8,200	14,000	14,000
<b>Functional Total</b>	<b>959,289</b>	<b>987,526</b>	<b>1,868,495</b>	<b>1,866,350</b>	<b>1,530,892</b>	<b>1,300,680</b>
<b>PARKS AND THE ENVIRONMENT</b>						
Adirondack Park Agency	4,398	4,599	5,731	5,929	5,935	5,942
Environmental Conservation, Department of	816,091	818,004	896,910	875,694	894,001	902,647
Environmental Facilities Corporation	8,034	8,416	11,760	11,815	6,760	6,760
Parks, Recreation and Historic Preservation, Office of	248,425	284,161	272,031	269,640	250,908	242,053
<b>Functional Total</b>	<b>1,076,948</b>	<b>1,115,180</b>	<b>1,186,432</b>	<b>1,163,078</b>	<b>1,157,604</b>	<b>1,157,402</b>
<b>TRANSPORTATION</b>						
Motor Vehicles, Department of	238,186	257,839	288,051	298,568	302,683	337,234
Thruway Authority	1,671	1,775	1,734	1,778	1,822	1,868
Metropolitan Transportation Authority	38,078	0	93,700	188,550	258,700	278,922
Transportation, Department of	5,323,373	5,553,463	6,452,696	6,594,492	6,773,178	6,822,620
<b>Functional Total</b>	<b>5,601,308</b>	<b>5,813,077</b>	<b>6,836,181</b>	<b>7,083,388</b>	<b>7,336,383</b>	<b>7,440,644</b>
<b>HEALTH AND SOCIAL WELFARE</b>						
Advocate for Persons with Disabilities, Office of	18	0	0	0	0	0
Aging, Office for the	185,728	197,862	228,894	237,659	237,604	236,593
Blind, Office for the	0	0	0	0	0	0
Children and Family Services, Office of	3,196,604	2,711,049	2,997,831	3,180,910	3,311,746	3,445,400
Health, Department of	35,203,517	37,706,416	38,480,237	42,217,902	45,771,058	48,739,728
Medical Assistance	30,209,572	32,316,313	32,271,732	35,718,692	39,199,792	42,199,292
Medicaid Administration	575,158	745,398	840,600	859,800	880,200	901,900
All Other	4,418,787	4,644,705	5,367,905	5,639,410	5,691,066	5,638,536
Human Rights, Division of	14,942	16,226	15,166	15,677	15,677	15,677
Labor, Department of	573,213	513,840	583,624	576,803	577,041	574,350
Medicaid Inspector General, Office of	1,049	34,842	81,256	91,816	93,149	94,268
Prevention of Domestic Violence, Office of	1,985	2,315	2,556	2,584	2,584	2,577
Stem Cell Initiatives	0	0	25,000	125,000	50,000	0

**CASH DISBURSEMENTS BY FUNCTION**  
**ALL GOVERNMENTAL FUNDS**  
(thousands of dollars)

	2005-2006 Actuals	2006-2007 Actuals	2007-2008 Projected	2008-2009 Projected	2009-2010 Projected	2010-2011 Projected
<b>HEALTH AND SOCIAL WELFARE (Continued)</b>						
Temporarily and Disability Assistance, Office of <i>Welfare Assistance</i>	4,391,625	4,458,289	4,686,998	4,636,779	4,636,392	4,636,080
<i>Welfare Administration</i>	2,979,052	3,110,913	3,284,923	3,228,074	3,222,743	3,218,456
<i>All Other</i>	368,537	380,495	377,933	377,933	377,933	377,933
Welfare Inspector General, Office of Workers' Compensation Board	1,044,036	966,881	1,024,142	1,030,772	1,035,716	1,039,691
	1,004	1,074	1,295	1,321	1,347	1,374
<b>Functional Total</b>	<b>43,710,577</b>	<b>45,790,190</b>	<b>47,265,103</b>	<b>51,238,461</b>	<b>54,850,724</b>	<b>57,902,428</b>
<b>MENTAL HEALTH</b>						
Mental Health, Office of Mental Hygiene, Department of	2,199,159	2,335,339	2,520,224	2,692,453	2,830,816	2,894,995
Mental Retardation and Developmental Disabilities, Office of Alcohol and Substance Abuse Services, Office of Developmental Disabilities Planning Council	9,370	8,442	7,800	7,800	7,800	7,800
Quality of Care for the Mentally Disabled, Commission on	2,930,056	3,168,254	3,369,167	3,560,454	3,676,258	3,788,938
	484,034	521,906	595,007	655,669	704,897	687,400
	4,081	4,129	3,621	3,617	3,617	3,617
<b>Functional Total</b>	<b>12,770</b>	<b>12,605</b>	<b>15,492</b>	<b>15,373</b>	<b>15,424</b>	<b>15,394</b>
	<b>5,639,470</b>	<b>6,050,675</b>	<b>6,511,311</b>	<b>6,935,366</b>	<b>7,238,812</b>	<b>7,398,144</b>
<b>PUBLIC PROTECTION</b>						
Capital Defenders Office Correction, Commission of Correctional Services, Department of Crime Victims Board Criminal Justice Services, Division of Homeland Security	4,572	1,558	1,300	1,303	1,309	1,315
	2,515	2,621	2,629	2,674	2,674	2,674
	2,316,062	2,736,338	2,715,169	2,782,450	2,849,374	2,922,707
	55,565	60,073	62,709	62,248	62,269	62,294
	193,492	267,326	254,005	265,162	245,525	235,356
	19,586	29,562	407,925	539,937	347,937	354,184
	3,586	3,551	3,929	4,152	4,219	4,242
	2,714	2,785	4,785	4,819	4,850	4,884
	209,562	401,610	396,929	291,930	146,845	166,777
	193,231	194,729	205,978	220,361	233,189	250,269
	72,254	72,752	74,649	74,702	74,726	73,484
	0	0	0	0	0	0
<b>Functional Total</b>	<b>598,904</b>	<b>644,506</b>	<b>635,760</b>	<b>676,038</b>	<b>697,900</b>	<b>691,810</b>
	<b>3,672,043</b>	<b>4,417,411</b>	<b>4,765,787</b>	<b>4,925,776</b>	<b>4,670,817</b>	<b>4,769,996</b>
<b>EDUCATION</b>						
Arts, Council on the City University of New York Education, Department of <i>School Aid (includes EXCEL)</i> <i>STAR Property Tax Relief</i> <i>Handicapped</i> <i>All Other</i>	42,825	49,244	55,766	54,665	54,845	54,826
	619,871	1,064,544	1,186,315	1,245,860	1,301,014	1,332,761
	24,250,119	26,662,215	29,354,589	31,295,132	33,706,912	36,355,352
	18,549,341	20,088,579	21,794,505	23,143,777	25,056,911	27,295,916
	3,213,204	3,993,970	4,730,450	5,358,402	5,837,916	6,141,480
	1,560,076	1,620,800	1,719,600	1,788,490	1,849,790	1,914,590
	927,498	958,866	1,110,034	1,004,463	962,295	1,003,366
	1,018,291	956,737	981,212	975,422	976,822	978,251
	10,013	13,157	12,428	12,628	12,756	12,884
	4,964,540	5,447,926	5,901,289	5,996,243	6,164,116	6,130,560
<b>Functional Total</b>	<b>30,905,659</b>	<b>34,193,823</b>	<b>37,491,664</b>	<b>39,579,950</b>	<b>42,216,465</b>	<b>44,864,634</b>

**CASH DISBURSEMENTS BY FUNCTION**  
**ALL GOVERNMENTAL FUNDS**  
(thousands of dollars)

	2005-2006	2006-2007	2007-2008	2008-2009	2009-2010	2010-2011
	Actuals	Actuals	Projected	Projected	Projected	Projected
<b>GENERAL GOVERNMENT</b>						
Audit and Control, Department of	225,148	244,078	245,462	247,821	252,679	253,678
Budget, Division of the	37,423	54,817	94,137	109,900	112,400	115,800
Civil Service, Department of	26,391	24,363	23,653	23,857	24,037	24,270
Elections, State Board of	4,206	13,037	90,119	171,199	9,215	99,475
Employee Relations, Office of	3,579	3,852	4,000	4,025	4,062	4,103
Executive Chamber	13,937	14,517	20,320	20,930	21,560	22,200
General Services, Office of	260,359	255,060	234,558	236,355	222,064	233,375
Inspector General, Office of	5,336	5,933	6,908	6,980	7,059	7,127
Law, Department of	182,295	193,461	211,763	213,781	216,561	218,744
Lieutenant Governor, Office of the	348	360	1,378	1,420	1,460	1,500
Lottery, Division of	176,524	164,825	182,527	183,147	187,318	191,393
Racing and Wagering Board, State	13,093	16,899	19,489	19,497	19,967	20,148
Real Property Services, Office of	43,830	47,620	52,570	53,407	54,266	55,154
Regulatory Reform, Governor's Office of	3,661	3,509	3,781	3,825	3,871	3,895
State Labor Relations Board	3,508	3,376	4,077	4,118	4,156	4,198
State, Department of	158,651	148,140	193,507	176,781	155,666	141,851
Tax Appeals, Division of	2,958	3,228	3,233	3,228	3,263	3,298
Taxation and Finance, Department of	341,429	355,452	367,658	364,362	368,490	372,691
Technology, Office for	21,018	19,258	33,856	53,362	81,823	25,221
TSC Lobbying	1,572	2,338	2,314	2,324	2,351	2,370
Veterans Affairs, Division of	13,621	14,117	15,368	15,674	15,774	14,351
<b>Functional Total</b>	<b>1,538,887</b>	<b>1,588,240</b>	<b>1,810,678</b>	<b>1,915,993</b>	<b>1,768,042</b>	<b>1,814,842</b>
<b>ALL OTHER CATEGORIES</b>						
Legislature	210,051	213,118	220,258	223,168	225,841	225,887
Judiciary (excluding fringe benefits)	1,618,170	1,731,791	1,859,488	1,980,944	2,134,111	2,129,205
World Trade Center	38,003	37,020	135,450	82,950	55,500	34,150
Local Government Assistance	1,018,896	1,156,176	943,098	1,323,576	1,363,874	1,419,739
Long-Term Debt Service	3,701,385	4,450,737	4,133,998	4,798,128	5,250,500	5,877,446
General State Charges	4,735,317	5,222,834	5,385,856	5,824,962	6,230,090	6,544,433
Miscellaneous	(84,564)	(85,873)	261,566	251,825	234,109	440,996
<b>Functional Total</b>	<b>11,237,258</b>	<b>12,725,803</b>	<b>12,939,714</b>	<b>14,485,553</b>	<b>15,494,025</b>	<b>16,671,856</b>
<b>TOTAL ALL GOVERNMENTAL FUNDS SPENDING</b>	<b>104,341,439</b>	<b>112,681,925</b>	<b>120,675,365</b>	<b>129,193,915</b>	<b>136,263,764</b>	<b>143,320,626</b>

Source: NYS DOB

## GAAP-Basis Financial Plans/GASB Statement 45

In addition to the cash-basis Financial Plans, the General Fund and All Funds Financial Plans are prepared on a basis of GAAP in accordance with Governmental Accounting Standards Board (GASB) regulations. Tables comparing the cash basis and GAAP basis General Fund Financial Plans are provided at the end of this Financial Plan. The GAAP projections are based on the accounting principles applied by the State Comptroller in the financial statements issued for 2005-06.

In 2007-08, the General Fund GAAP Financial Plan shows total revenues of \$45.0 billion, total expenditures of \$55.3 billion, and net other financing sources of \$9.7 billion, resulting in an operating deficit of \$559 million and a projected accumulated surplus of \$1.1 billion. These changes are due primarily to the use of a portion of the prior-and current-year surplus to support 2007-08 operations.

In 2006-07, the General Fund GAAP Financial Plan reflects total revenues of \$43.8 billion, total expenditures of \$51.7 billion, and net other financing sources of \$7.5 billion, resulting in an operating deficit of roughly \$500 million and a projected accumulated surplus of \$1.7 billion. The operating results primarily reflect the 2006-07 cash-basis surplus, offset by the impact of enacted tax reductions on revenue accruals and a partial use of the 2005-06 surplus to support 2006-07 operations.

The GAAP basis results for 2005-06 showed the State in a net positive overall asset condition of \$49.1 billion. The net positive asset condition is before the State reflects the impact of GASB Statement 45 "Accounting and Financial Reporting by Employers for Post-employment Benefits Other than Pensions." GASB Statement 45 requires State and local governments to reflect the value of post-employment benefits, predominantly health care, for current employees and retirees beginning with the financial statements for the 2007-08 fiscal year.

The State used an independent actuarial consulting firm to calculate retiree health care liabilities. Assuming there is no pre-funding of this liability, the analysis performed April 1, 2006 indicates that the present value of the actuarial accrued total liability for benefits would be roughly \$49.7 billion (\$41.4 billion for the State and \$8.3 billion for SUNY), using the level percentage of projected payroll approach under the Frozen Entry Age actuarial cost method. This is the actuarial methodology recommended to be used to implement GASB Statement 45 by OSC.

The actuarial accrued liability was calculated using a 4.155 percent annual discount rate, a payroll growth rate of 3.5 percent annually, an increase of per capita medical costs of 10 percent in 2007-08 declining by 1 percent annually to 5 percent annual growth for 2013-14 and thereafter, and drug costs of 12 percent in 2007-08 declining by 1 percent annually to 5 percent annual growth beginning in 2014-15 and thereafter.

The State's total unfunded liability will be disclosed in the 2007-08 basic financial statements. While the total liability is substantial, GASB rules indicate it may be amortized over a 30-year period; therefore, only the annual amortized liability above the current pay-as-you-go costs would be recognized in the financial statements. Assuming no pre-funding, the 2007-08 liability would total roughly \$3.8 billion under the Frozen Entry Age actuarial cost method amortized based on a level percent of salary, or \$2.8 billion above the current pay-as-you-go retiree costs. This difference between the State's pay-as-you-go costs and the actuarially determined required annual contribution under GASB Statement 45 would reduce the State's currently positive net asset condition.

The current Financial Plan does not assume pre-funding of the GASB 45 liability. The State's Health Insurance Council, which consists of GOER, Civil Service, and DOB will continue to review this

matter, seek input from the State Comptroller, the legislative fiscal committees and outside parties, and provide options for consideration.

GASB does not require the additional costs to be funded on the State’s budgetary basis, and no funding is assumed for this purpose in the Financial Plan. On a budgetary (cash) basis, the State continues to finance these costs, along with all other employee health care expenses, on a pay-as-you-go basis. Anticipated increases in these costs are reflected in the State’s multi-year Financial Plan as detailed below.

<b>History and Forecast of New York State Employee Health Insurance (millions of dollars)</b>			
<b>Health Insurance</b>			
<b>Year</b>	<b>Active Employees</b>	<b>Retirees</b>	<b>Total State</b>
<b>2001-02</b>	937	565	1,502
<b>2002-03</b>	1,023	634	1,657
<b>2003-04</b>	1,072	729	1,801
<b>2004-05</b>	1,216	838	2,054
<b>2005-06</b>	1,331	885	2,216
<b>2006-07</b>	1,492	940	2,432
<b>2007-08</b>	1,586	1,007	2,593
<b>2008-09</b>	1,808	1,148	2,956
<b>2009-10</b>	1,972	1,255	3,227
<b>2010-11</b>	2,152	1,373	3,525

All numbers reflect the cost of Health Insurance for General State Charges (Executive and Legislative branches) and the Office of Court Administration; actuals through 2004-05.

DOB’s detailed GAAP Financial Plans for 2006-07 and 2007-08 are provided below.

**GAAP FINANCIAL PLAN  
GENERAL FUND  
2006-2007 and 2007-2008  
(millions of dollars)**

	<u>2006-2007 Results</u>	<u>2007-2008 Enacted</u>	<u>Annual Change</u>
<b>Revenues:</b>			
Taxes:			
Personal income tax	22,919	23,090	171
User taxes and fees	8,042	8,564	522
Business taxes	6,661	6,654	(7)
Other taxes	1,053	1,187	134
Miscellaneous revenues	4,928	5,476	548
Federal grants	151	59	(92)
<b>Total revenues</b>	<u>43,754</u>	<u>45,030</u>	<u>1,276</u>
<b>Expenditures:</b>			
Grants to local governments	36,644	39,346	2,702
State operations	11,336	12,161	825
General State charges	3,670	3,811	141
Debt service	26	0	(26)
Capital projects	0	1	1
<b>Total expenditures</b>	<u>51,676</u>	<u>55,319</u>	<u>3,643</u>
<b>Other financing sources (uses):</b>			
Transfers from other funds	13,115	14,991	1,876
Transfers to other funds	(6,003)	(5,628)	375
Proceeds from financing arrangements/ advance refundings	347	367	20
<b>Net other financing sources (uses)</b>	<u>7,459</u>	<u>9,730</u>	<u>2,271</u>
<b>(Excess) deficiency of revenues and other financing sources over expenditures and other financing uses</b>	<u>(463)</u>	<u>(559)</u>	<u>(96)</u>
<b>Accumulated Surplus/(Deficit)</b>	<u>1,719</u>	<u>1,160</u>	<u>(559)</u>

Source: NYS DOB

\*2006-07 year-end results are preliminary and unaudited.



**GAAP FINANCIAL PLAN  
ALL GOVERNMENTAL FUNDS  
ENACTED BUDGET  
2007-2008  
(millions of dollars)**

	<b>General Fund</b>	<b>Special Revenue Funds</b>	<b>Capital Projects Funds</b>	<b>Debt Service Funds</b>	<b>(MEMO) Total</b>
<b>Revenues:</b>					
Taxes	39,495	7,969	2,167	12,520	62,151
Patient fees	0	0	0	326	326
Miscellaneous revenues	5,476	4,914	311	24	10,725
Federal grants	59	36,766	2,020	0	38,845
<b>Total revenues</b>	<u>45,030</u>	<u>49,649</u>	<u>4,498</u>	<u>12,870</u>	<u>112,047</u>
<b>Expenditures:</b>					
Grants to local governments	39,346	44,593	579	0	84,518
State operations	12,161	1,750	0	61	13,972
General State charges	3,811	335	0	0	4,146
Debt service	0	0	0	3,386	3,386
Capital projects	1	3	6,341	0	6,345
<b>Total expenditures</b>	<u>55,319</u>	<u>46,681</u>	<u>6,920</u>	<u>3,447</u>	<u>112,367</u>
<b>Other financing sources (uses):</b>					
Transfers from other funds	14,991	281	267	5,453	20,992
Transfers to other funds	(5,628)	(3,930)	(962)	(14,838)	(25,358)
Proceeds of general obligation bonds	0	0	358	0	358
Proceeds from financing arrangements/ advance refundings	367	0	2,702	0	3,069
<b>Net other financing sources (uses)</b>	<u>9,730</u>	<u>(3,649)</u>	<u>2,365</u>	<u>(9,385)</u>	<u>(939)</u>
<b>(Excess) deficiency of revenues and other financing sources over expenditures and other financing uses</b>					
	<u>(559)</u>	<u>(681)</u>	<u>(57)</u>	<u>38</u>	<u>(1,259)</u>

Source: NYS DOB

## Special Considerations

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Many complex political, social, and economic forces influence the State's economy and finances. Such forces may affect the State Financial Plan unpredictably from fiscal year to fiscal year. For example, the Financial Plan is necessarily based on forecasts of national and State economic activity. Economic forecasts have frequently failed to accurately predict the timing and magnitude of specific and cyclical changes to the national and State economies. For a discussion of the DOB economic forecast, see the section entitled "Economics and Demographics," in this AIS. The Financial Plan also relies on estimates and assumptions concerning Federal aid, law changes, and audit activity.

In any year, the Financial Plan is subject to risks that, if they were to materialize, could affect operating results. The most significant current risks include the following:

### Risks to the U.S. Economic Forecast

Although DOB believes that the Federal Reserve has successfully managed a soft landing and that the U.S. economy will avoid a near-term recession, there is considerable risk to the forecast. As always, the forecast is contingent upon the absence of severe shocks to the economy. Unpredictable events, such as a major terrorist attack, remain the biggest risk to continued economic expansion. Such a shock could impair economic growth in many ways, such as causing a plunge in consumer confidence, the stock market, investment spending by firms, or impairing the transportation of goods and services, or causing a large spike in oil prices. A severe and extended downturn could easily materialize from such shocks.

A more severe-than-anticipated downturn in the housing market could derail the national economy from its predicted path. The additional weakness emanating from the housing and manufacturing sectors could result in lower job and income growth than expected, which in turn would produce lower growth in household spending than implied by the forecast. A more abrupt-than-projected increase in energy prices could reduce the ability of consumers and businesses to spend on non-energy related items. Such cutbacks could make firms behave even more cautiously and reduce business capital spending. Persistently high energy prices also raise the possibility that inflationary expectations could ratchet higher, causing the Federal Reserve Board to revert back to a tightening of monetary policy. Higher interest rates would, in turn, further exacerbate the slowdown and raise the likelihood of a recession.

A sharp reduction in the inflow of foreign funds could produce new inflationary pressures by weakening the U.S. dollar, which might also cause the Federal Reserve to resume tightening. Such a development might also produce an imbalance in the market for U.S. Treasury securities, causing long-term rates to rise higher-than-expected in order to fund the Federal budget deficit. Higher-than-anticipated Federal spending on the Iraq war could have a similar effect. Higher interest rates could, in turn, induce households to increase the personal saving rate, resulting in even further cutbacks in consumer spending. This risk would only be exacerbated by lower-than-expected equity or housing prices, particularly if the anticipated easing of home prices happens suddenly rather than gradually, as expected. Again, lower consumption growth could weaken expected future corporate profits and, in turn, lower employment and investment growth.

On the other hand, lower-than-expected inflation, perhaps as a result of an even greater drop in the price of oil or more modest growth in unit labor costs, possibly due to slower growth in wages or stronger productivity growth, could induce the Federal Reserve to reduce its short-term interest rate target, resulting in stronger consumption and investment growth than projected. A more rapid increase in export growth due to either a weakened dollar or faster global growth could generate a somewhat stronger increase in total output than expected. Moreover, stronger employment growth could result in higher real wages, supporting faster growth in consumer spending than currently anticipated.

## **Risks to the New York Forecast**

In addition to the risks described above for the national forecast, there are risks specific to New York. The chief risk remains another attack targeted at New York City that could once again plunge the State economy into a recession, resulting in substantially lower income and employment growth than is reflected in the current forecast. Higher energy prices and the potential for greater pass-through to core inflation, combined with a tightening labor market, raise the probability that the Federal Reserve could tighten one more time. Such an outcome could negatively affect the financial markets, which would also disproportionately affect the New York State economy. In addition, the State's real estate market could decline more than anticipated, which would negatively affect household consumption and taxable capital gains realizations. These effects could ripple through the economy, affecting both employment and wages.

In contrast, should the national and world economies grow faster than expected, a stronger upturn in stock prices, along with even stronger activity in mergers and acquisitions and other Wall Street activities is possible, resulting in higher wage and bonuses growth than projected. It is important to recall that the financial markets, which are so pivotal to the direction of the downstate economy, are notoriously difficult to forecast.

## **Labor Contracts/Salary Increases**

Existing labor contracts with all of the State's major employee unions expired on April 1, 2007 (United University Professionals will expire on July 1, 2007). The Financial Plan does not set aside any reserves for future collective bargaining agreements in 2007-08 or beyond. Each future 1 percent salary increase would cost roughly \$86 million annually in the General Fund and \$134 million in All Funds. The projections do not contain any funding for pay raises for the Judiciary or elected officials.

## **School Supportive Health Services**

The Office of the Inspector General (OIG) of the United States Department of Health and Human Services is conducting six audits of aspects of New York State's School Supportive Health Services program with regard to Medicaid reimbursement. The audits cover \$1.4 billion in claims submitted between 1990 and 2001. To date, OIG has issued four final audit reports, which cover claims submitted by upstate and New York City school districts for speech pathology and transportation services. The final audits recommend that the Centers for Medicare and Medicaid Services (CMS) disallow \$173 million of the \$362 million in claims for upstate speech pathology services, \$17 million of \$72 million for upstate transportation services, \$436 million of the \$551 million in claims submitted for New York City speech pathology services, and \$96 million of the \$123 million for New York City transportation services. New York State disagrees with the audit findings on several grounds and has requested that they be withdrawn.

While CMS has not taken any action with regard to the disallowances recommended by OIG, CMS is deferring 25 percent of New York City claims and 9.7 percent of claims submitted by the rest of the State, pending completion of the audits. Since the State has continued to reimburse school districts for certain costs, these Federal deferrals are projected to drive additional spending that has been reflected in the State's Financial Plan.

## **Proposed Federal Rule on Medicaid Funding**

On January 18, 2007, CMS issued a proposed rule that, if implemented, would significantly curtail Federal Medicaid funding to public hospitals (including New York City's Health and Hospital Corporation (HHC)) and institutions and programs operated by both the State OMRDD and the State OMH.

The rule seeks to restrict State access to Federal Medicaid resources. The provision replacing prospective reimbursement with cost-based methodologies would have the most significant impact on New York's health care system.

The proposed rule could go into effect as soon as September 2007. It is estimated the rule could result in the loss of \$350 million annually in Federal funds for HHC and potentially larger losses in aid for the State Mental Hygiene System.

The states affected by the regulations are expected to challenge their adoption on the basis that CMS is overstepping its authority and ignoring the intent of Congress. In recent years, the Congress has rejected similar proposals in the President's budget.

## **Video Lottery Terminal Expansion**

In developing annual VLT revenue estimates, the State's four-year Financial Plan assumes the approval of an expansion plan sometime in 2007-08, which is expected to provide \$150 million in 2008-09, \$357 million in 2009-10, and \$766 million in 2010-11. Including expansion, VLT revenues are projected to increase by \$476 million in 2008-09, \$286 million in 2009-10, and \$430 million in 2010-11, and are projected to total \$1.1 billion in 2008-09 growing to \$1.8 billion in 2010-11. Additional VLT revenues from the expansion support planned School Aid spending, offsetting General Fund costs. Absent legislative approval for the expansion, General Fund support for School Aid, as well as the estimated General Fund spending gaps, would increase by \$150 million in 2008-09, \$357 million in 2009-10, and \$766 million in 2010-11.

## **School Aid Database Updates**

After enactment of the State Budget, school districts are authorized to submit additional State aid claims for payment in the September following the close of such school year. In some cases, these additional claims have significantly increased the State's liability on a school year basis. Recent database updates increased the State's liability for School Aid by \$222 million (\$176 million net of SED reclassifications) for increases for the 2006-07 school year, \$161 million for 2005-06 and \$119 million for the 2004-05 school year, the vast majority of which was for New York City. If school districts -- particularly New York City -- continue to submit additional claims after enactment of the 2007-08 State Budget, the State will have an increased financial obligation beyond what is currently reflected in the Financial Plan.

**APPENDIX C**

**MASTER SETTLEMENT AGREEMENT**

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**MASTER SETTLEMENT AGREEMENT**

This Master Settlement Agreement is made by the undersigned Settling State officials (on behalf of their respective Settling States) and the undersigned Participating Manufacturers to settle and resolve with finality all Released Claims against the Participating Manufacturers and related entities as set forth herein. This Agreement constitutes the documentation effecting this settlement with respect to each Settling State, and is intended to and shall be binding upon each Settling State and each Participating Manufacturer in accordance with the terms hereof.

**I. RECITALS**

WHEREAS, more than 40 States have commenced litigation asserting various claims for monetary, equitable and injunctive relief against certain tobacco product manufacturers and others as defendants, and the States that have not filed suit can potentially assert similar claims;

WHEREAS, the Settling States that have commenced litigation have sought to obtain equitable relief and damages under state laws, including consumer protection and/or antitrust laws, in order to further the Settling States' policies regarding public health, including policies adopted to achieve a significant reduction in smoking by Youth;

WHEREAS, defendants have denied each and every one of the Settling States' allegations of unlawful conduct or wrongdoing and have asserted a number of defenses to the Settling States' claims, which defenses have been contested by the Settling States;

WHEREAS, the Settling States and the Participating Manufacturers are committed to reducing underage tobacco use by discouraging such use and by preventing Youth access to Tobacco Products;

WHEREAS, the Participating Manufacturers recognize the concern of the tobacco grower community that it may be adversely affected by the potential reduction in tobacco consumption resulting from this settlement, reaffirm their commitment to work cooperatively to address concerns about the potential adverse economic impact on such community, and will, within 30 days after the MSA Execution Date, meet with the political leadership of States with grower communities to address these economic concerns;

WHEREAS, the undersigned Settling State officials believe that entry into this Agreement and uniform consent decrees with the tobacco industry is necessary in order to further the Settling States' policies designed to reduce Youth smoking, to promote the public health and to secure monetary payments to the Settling States; and

WHEREAS, the Settling States and the Participating Manufacturers wish to avoid the further expense, delay, inconvenience, burden and uncertainty of continued litigation (including appeals from any verdicts), and, therefore, have agreed to settle their respective lawsuits and potential claims pursuant to terms which will achieve for the Settling States and their citizens significant funding for the advancement of public health, the implementation of important tobacco-related public health measures, including the enforcement of the mandates and restrictions related to such measures, as well as funding for a national Foundation dedicated to significantly reducing the use of Tobacco Products by Youth;

NOW, THEREFORE, BE IT KNOWN THAT, in consideration of the implementation of tobacco-related health measures and the payments to be made by the Participating Manufacturers, the release and discharge of all claims by the Settling States, and such other consideration as described herein, the sufficiency of which is hereby acknowledged, the Settling States and the Participating Manufacturers, acting by and through their authorized agents, memorialize and agree as follows:

**II. DEFINITIONS**

(a) "Account" has the meaning given in the Escrow Agreement.

(b) "Adult" means any person or persons who are not Underage.

(c) "Adult-Only Facility" means a facility or restricted area (whether open-air or enclosed) where the operator ensures or has a reasonable basis to believe (such as by checking identification as required under state law, or by checking the identification of any person appearing to be under the age of 27) that no Underage person is present. A facility or restricted area need not be permanently restricted to Adults in order to constitute an Adult-Only Facility, provided that the operator ensures or has a reasonable basis to believe that no Underage person is present during the event or time period in question.

(d) "Affiliate" means a person who directly or indirectly owns or controls, is owned or controlled by, or is under common ownership or control with, another person. Solely for purposes of this definition, the terms "owns," "is owned" and "ownership" mean ownership of an equity interest, or the equivalent thereof, of 10 percent or more, and the term "person" means an individual, partnership, committee, association, corporation or any other organization or group of persons.

(e) "Agreement" means this Master Settlement Agreement, together with the exhibits hereto, as it may be amended pursuant to subsection XVIII(j).

(f) "Allocable Share" means the percentage set forth for the State in question as listed in Exhibit A hereto, without regard to any subsequent alteration or modification of such State's percentage share agreed to by or among any States; or, solely for the purpose of calculating payments under subsection IX(c)(2) (and corresponding payments under subsection

IX(f)), the percentage disclosed for the State in question pursuant to subsection IX(c)(2)(A) prior to June 30, 1999, without regard to any subsequent alteration or modification of such State's percentage share agreed to by or among any States.

(g) "Allocated Payment" means a particular Settling State's Allocable Share of the sum of all of the payments to be made by the Original Participating Manufacturers in the year in question pursuant to subsections IX(c)(1) and IX(c)(2), as such payments have been adjusted, reduced and allocated pursuant to clause "First" through the first sentence of clause "Fifth" of subsection IX(f), but before application of the other offsets and adjustments described in clauses "Sixth" through "Thirteenth" of subsection IX(f).

(h) "Bankruptcy" means, with respect to any entity, the commencement of a case or other proceeding (whether voluntary or involuntary) seeking any of (1) liquidation, reorganization, rehabilitation, receivership, conservatorship, or other relief with respect to such entity or its debts under any bankruptcy, insolvency or similar law now or hereafter in effect; (2) the appointment of a trustee, receiver, liquidator, custodian or similar official of such entity or any substantial part of its business or property; (3) the consent of such entity to any of the relief described in (1) above or to the appointment of any official described in (2) above in any such case or other proceeding involuntarily commenced against such entity; or (4) the entry of an order for relief as to such entity under the federal bankruptcy laws as now or hereafter in effect. Provided, however, that an involuntary case or proceeding otherwise within the foregoing definition shall not be a "Bankruptcy" if it is or was dismissed within 60 days of its commencement.

(i) "Brand Name" means a brand name (alone or in conjunction with any other word), trademark, logo, symbol, motto, selling message, recognizable pattern of colors, or any other indicia of product identification identical or similar to, or identifiable with, those used for any domestic brand of Tobacco Products. Provided, however, that the term "Brand Name" shall not include the corporate name of any Tobacco Product Manufacturer that does not alter the MSA Execution Date sell a brand of Tobacco Products in the States that includes such corporate name.

(j) "Brand Name Sponsorship" means an athletic, musical, artistic, or other social or cultural event as to which payment is made (or other consideration is provided) in exchange for use of a Brand Name or Names (1) as part of the name of the event or (2) to identify, advertise, or promote such event or an entrant, participant or team in such event in any other way. Sponsorship of a single national or multi-state series or tour (for example, NASCAR (including any number of NASCAR races)), or of one or more events within a single national or multi-state series or tour, or of an entrant, participant, or team taking part in events sanctioned by a single approving organization (e.g., NASCAR or CART), constitutes one Brand Name Sponsorship. Sponsorship of an entrant, participant, or team by a Participating Manufacturer using a Brand Name or Names in an event that is part of a series or tour that is sponsored by such Participating Manufacturer or that is part of a series or tour in which any one or more events are sponsored by such Participating Manufacturer does not constitute a separate Brand Name Sponsorship. Sponsorship of an entrant, participant, or team by a Participating Manufacturer using a Brand Name or Names in any event (or series of events) not sponsored by such Participating Manufacturer constitutes a Brand Name Sponsorship. The term "Brand Name Sponsorship" shall not include an event in an Adult-Only Facility.

(k) "Business Day" means a day which is not a Saturday or Sunday or legal holiday on which banks are authorized or required to close in New York, New York.

(l) "Cartoon" means any drawing or other depiction of an object, person, animal, creature or any similar caricature that satirizes any of the following criteria:

(1) the use of comically exaggerated features;

(2) the attribution of human characteristics to animals, plants or other objects, or the similar use of anthropomorphic technique; or

(3) the attribution of unnatural or extrahuman abilities, such as imperviousness to pain or injury, X-ray vision, tunneling at very high speeds or transformation.

The term "Cartoon" includes "Joe Camel," but does not include any drawing or other depiction that on July 1, 1998, was in use in any State in any Participating Manufacturer's corporate logo or in any Participating Manufacturer's Tobacco Product packaging.

(m) "Cigarette" means any product that contains nicotine, is intended to be burned or heated under ordinary conditions of use, and consists of or contains (1) any roll of tobacco wrapped in paper or in any substance not containing tobacco; or (2) tobacco, in any form, that is functional in the product, which, because of its appearance, the type of tobacco used in the filler, or its packaging and labeling, is likely to be offered to, or purchased by, consumers as a cigarette; or (3) any roll of tobacco wrapped in any substance containing tobacco which, because of its appearance, the type of tobacco used in the filler, or its packaging and labeling, is likely to be offered to, or purchased by, consumers as a cigarette described in clause (1) of this definition. The term "Cigarette" includes "roll-your-own" (i.e., any tobacco which, because of its appearance, type, packaging, or labeling is suitable for use and likely to be offered to, or purchased by, consumers as tobacco for making cigarettes). Except as provided in subsections II(z) and II(mm), 0.0325 ounces of "roll-your-own" tobacco shall constitute one individual "Cigarette."

(n) "Claims" means any and all manner of civil (i.e., non-criminal) claims, demands, actions, suits, causes of action, damages (whenever incurred), liabilities of any nature including civil penalties and punitive damages, as well as costs, expenses and attorneys' fees (except as to the Original Participating Manufacturers' obligations under section XVII), known or unknown, suspected or unsuspected, accrued or unaccrued, whether legal, equitable, or statutory.

(o) "Consent Decree" means a state-specific consent decree as described in subsection XIII(b)(1)(B) of this Agreement.

(p) "Court" means the respective court in each Settling State to which this Agreement and the Consent Decree are presented for approval and/or entry as to that Settling State.

(q) "Escrow" has the meaning given in the Escrow Agreement.

(r) "Escrow Agent" means the escrow agent under the Escrow Agreement.

(s) "Escrow Agreement" means an escrow agreement substantially in the form of Exhibit B.

(t) "Federal Tobacco Legislation Offset" means the offset described in section X.

(u) "Final Approval" means the earlier of:

- (1) the date by which State-Specific Finality in a sufficient number of Settling States has occurred; or
- (2) June 30, 2000.

For the purposes of this subsection (u), "State-Specific Finality in a sufficient number of Settling States" means that State-Specific Finality has occurred in both:

- (A) a number of Settling States equal to at least 80% of the total number of Settling States; and
- (B) Settling States having aggregate Allocable Shares equal to at least 80% of the total aggregate Allocable Shares assigned to all Settling States.

Notwithstanding the foregoing, the Original Participating Manufacturers may, by unanimous written agreement, waive any requirement for Final Approval set forth in subsections (A) or (B) hereof.

(v) "Foundation" means the foundation described in section VI.

(w) "Independent Auditor" means the firm described in subsection XI(h).

(x) "Inflation Adjustment" means an adjustment in accordance with the formulas for inflation adjustments set forth in Exhibit C.

(y) "Litigating Releasing Parties Offset" means the offset described in subsection XII(b).

(z) "Market Share" means a Tobacco Product Manufacturer's respective share (expressed as a percentage) of the total number of individual Cigarettes sold in the fifty United States, the District of Columbia and Puerto Rico during the applicable calendar year, as measured by excise taxes collected by the federal government and, in the case of sales in Puerto Rico, arbitros de cigarrillos collected by the Puerto Rico taxing authority. For purposes of the definition and determination of "Market Share" with respect to calculations under subsection IX(f), 0.09 ounces of "roll your own" tobacco shall constitute one individual Cigarette; for purposes of the definition and determination of "Market Share" with respect to all other calculations, 0.0325 ounces of "roll your own" tobacco shall constitute one individual Cigarette.

(aa) "MSA Execution Date" means November 23, 1998.

(bb) "NAAC" means the National Association of Attorneys General, or its successor organization that is directed by the Attorneys General to perform certain functions under this Agreement.

(cc) "Non-Participating Manufacturer" means any Tobacco Product Manufacturer that is not a Participating Manufacturer.

(dd) "Non-Settling States Reduction" means a reduction determined by multiplying the amount to which such reduction applies by the aggregate Allocable Shares of those States that are not Settling States on the date 15 days before such payment is due.

(ee) "Notice Parties" means each Participating Manufacturer, each Settling State, the Escrow Agent, the Independent Auditor and NAAC.

(ff) "NPM Adjustment" means the adjustment specified in subsection IX(d).

(gg) "NPM Adjustment Percentage" means the percentage determined pursuant to subsection IX(d).

(hh) "Original Participating Manufacturers" means the following: Brown & Williamson Tobacco Corporation, Lorillard Tobacco Company, Philip Morris Incorporated and R.J. Reynolds Tobacco Company, and the respective successors of each of the foregoing. Except as expressly provided in this Agreement, once an entity becomes an Original Participating Manufacturer, such entity shall permanently retain the status of Original Participating Manufacturer.

(ii) "Outdoor Advertising" means (1) billboards, (2) signs and placards in arenas, stadiums, shopping malls and Video Game Arcades (whether any of the foregoing are open air or enclosed) (but not including any such sign or placard located in an Adult-Only Facility), and (3) any other advertisements placed (A) outdoors, or (B) on the inside surface of a window facing outward. Provided, however, that the term "Outdoor Advertising" does not mean (1) an advertisement on the outside of a Tobacco Product manufacturing facility; (2) an individual advertisement that does not occupy an area larger than 14 square feet (and that neither is placed in such proximity to any other such advertisement so as to create a single "mosaic" type advertisement larger than 14 square feet, nor functions solely as a segment of a larger advertising unit or series), and that is placed (A) on the outside of any retail establishment that sells Tobacco Products (other than solely through a vending machine), (B) outside (but on the property of) any such establishment, or (C) on the inside surface of a window facing

outward in any such establishment; (3) an advertisement inside a retail establishment that sells Tobacco Products (other than solely through a vending machine) that is not placed on the inside surface of a window facing outward; or (4) an outdoor advertisement at the site of an event to be held at an Adult-Only Facility that is placed at such site during the period the facility or enclosed area constitutes an Adult-Only Facility, but in no event more than 14 days before the event, and that does not advertise any Tobacco Product (other than by using a Brand Name to identify the event).

(j) "Participating Manufacturer" means a Tobacco Product Manufacturer that is or becomes a signatory to this Agreement, provided that (1) in the case of a Tobacco Product Manufacturer that is not an Original Participating Manufacturer, such Tobacco Product Manufacturer is bound by this Agreement and the Consent Decree (or, in any Settling State that does not permit amendment of the Consent Decree, a consent decree containing terms identical to those set forth in the Consent Decree) in all Settling States in which this Agreement and the Consent Decree binds Original Participating Manufacturers (provided, however, that such Tobacco Product Manufacturer need only become bound by the Consent Decree in those Settling States in which the Settling State has filed a Released Claim against it), and (2) in the case of a Tobacco Product Manufacturer that signs this Agreement after the MSA Execution Date, such Tobacco Product Manufacturer, within a reasonable period of time after signing this Agreement, makes any payments (including interest thereon at the Prime Rate) that it would have been obligated to make in the intervening period had it been a signatory as of the MSA Execution Date. "Participating Manufacturer" shall also include the successor of a Participating Manufacturer. Except as expressly provided in this Agreement, once an entity becomes a Participating Manufacturer, such entity shall permanently retain the status of Participating Manufacturer. Each Participating Manufacturer shall regularly report its shipments of Cigarettes in or to the fifty United States, the District of Columbia and Puerto Rico to Management Science Associates, Inc. (or a successor entity as set forth in subsection (mm)). Solely for purposes of calculations pursuant to subsection IX(d), a Tobacco Product Manufacturer that is not a signatory to this Agreement shall be deemed to be a "Participating Manufacturer," if the Original Participating Manufacturers unanimously consent in writing.

(kk) "Previously Settled States Reduction" means a reduction determined by multiplying the amount to which such reduction applies by 12.4500000%, in the case of payments due in or prior to 2007; 12.2373756%, in the case of payments due after 2007 but before 2018; and 11.0666667%, in the case of payments due in or after 2018.

(ll) "Prime Rate" shall mean the prime rate as published from time to time by the Wall Street Journal or, in the event the Wall Street Journal is no longer published or no longer publishes such rate, an equivalent successor reference rate determined by the Independent Auditor.

(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.

(nn) "Released Claims" means:

(1) for past conduct, acts or omissions (including any damages incurred in the future arising from such past conduct, acts or omissions), those Claims directly or indirectly based on, arising out of or in any way related, in whole or in part, to (A) the use, sale, distribution, manufacture, development, advertising, marketing or health effects of, (B) the exposure to, or (C) research, statements, or warnings regarding, Tobacco Products (including, but not limited to, the Claims asserted in the actions identified in Exhibit D, or any comparable Claims that were, could be or could have been asserted now or in the future in those actions or in any comparable action in federal, state or local court brought by a Settling State or a Releasing Party (whether or not such Settling State or Releasing Party has brought such action), except for claims not asserted in the actions identified in Exhibit D for outstanding liability under existing licensing (or similar) fee laws or existing tax laws (but not exempting claims for any tax liability of the Tobacco-Related Organizations or of any Released Party with respect to such Tobacco-Related Organizations, which claims are covered by the release and covenants set forth in this Agreement);

(2) for future conduct, acts or omissions, only those monetary Claims directly or indirectly based on, arising out of or in any way related to, in whole or in part, the use of or exposure to Tobacco Products manufactured in the ordinary course of business, including without limitation any future Claims for reimbursement of health care costs allegedly associated with the use of or exposure to Tobacco Products.

(oo) "Released Parties" means all Participating Manufacturers, their past, present and future Affiliates, and the respective divisions, officers, directors, employees, representatives, insurers, lenders, underwriters, Tobacco-Related Organizations, trade associations, suppliers, agents, auditors, advertising agencies, public relations entities, attorneys, retailers and distributors of any Participating Manufacturer or of any such Affiliate (and the predecessors, heirs, executors, administrators, successors and assigns of each of the foregoing). Provided, however, that "Released Parties" does not include any person or entity (including, but not limited to, an Affiliate) that is itself a Non-Participating Manufacturer at any time after the MSA Execution Date, unless such person or entity becomes a Participating Manufacturer.

(pp) "Releasing Parties," means each Settling State and any of its past, present and future agents, officials acting in their official capacities, legal representatives, agencies, departments, commissions and divisions; and also means, to the full extent of the power of the signatories hereto to release past, present and future claims, the following: (1) any Settling State's subdivisions (political or otherwise, including, but not limited to, municipalities, counties, parishes, villages, unincorporated districts and hospital districts), public entities, public instrumentalities and public educational institutions; and (2) persons or entities acting in a parents patriae, sovereign, quasi-sovereign, private attorney general, quit tam, taxpayer, or any other capacity, whether or not any of them participate in this settlement, (A) to the extent that any such person or entity is seeking relief on behalf of generally applicable to the general public in such Settling State or the people of the State, as opposed solely to private or individual relief for separate and distinct injuries, or (B) to the extent that any such entity (as opposed to an individual) is seeking recovery of health-care expenses (other than premium or capitation payments for the benefit of present or retired state employees) paid or reimbursed, directly or indirectly, by a Settling State.

(qq) "Settling State" means any State that signs this Agreement on or before the MSA Execution Date. Provided, however, that the term "Settling State" shall not include (1) the States of Mississippi, Florida, Texas and Minnesota; and (2) any State as to which this Agreement has been terminated.

(rr) "State" means any state of the United States, the District of Columbia, the Commonwealth of Puerto Rico, Guam, the Virgin Islands, American Samoa, and the Northern Marianas.

(ss) "State-Specific Finality" means, with respect to the Settling State in question:

(1) this Agreement and the Consent Decree have been approved and entered by the Court as to all Original Participating Manufacturers, or, in the event of an appeal from or review of a decision of the Court to withhold its approval and entry of this Agreement and the Consent Decree, by the court hearing such appeal or conducting such review;

(2) entry by the Court has been made of an order dismissing with prejudice all claims against Released Parties in the action as provided herein; and

(3) the time for appeal or to seek review of or permission to appeal ("Appeal") from the approval and entry as described in subsection (1) hereof and entry of such order described in subsection (2) hereof has expired; or, in the event of an Appeal from such approval and entry, the Appeal has been dismissed, or the approval and entry described in (1) hereof and the order described in subsection (2) hereof have been affirmed in all material respects by the court of last resort to which such Appeal has been taken and such dismissal or affirmation has become no longer subject to further Appeal (including, without limitation, review by the United States Supreme Court).

(tt) "Subsequent Participating Manufacturer" means a Tobacco Product Manufacturer (other than an Original Participating Manufacturer) that: (1) is a Participating Manufacturer, and (2) is a signatory to this Agreement, regardless of when such Tobacco Product Manufacturer became a signatory to this Agreement. "Subsequent Participating Manufacturer" shall also include the successors of a Subsequent Participating Manufacturer. Except as expressly provided in this Agreement, once an entity becomes a Subsequent Participating Manufacturer such entity shall permanently retain the status of Subsequent Participating Manufacturer, unless it agrees to assume the obligations of an Original Participating Manufacturer as provided in subsection XVIII(c).

(uu) "Tobacco Product Manufacturer" means an entity that after the MSA Execution Date directly (and not exclusively through any Affiliate):

(1) manufactures Cigarettes anywhere that such manufacturer intends to be sold in the States, including Cigarettes intended to be sold in the States through an importer (except where such importer is an Original Participating Manufacturer that will be responsible for the payments under this Agreement with respect to such Cigarettes as a result of the provisions of subsections II(fmm) and that pays the taxes specified in subsection II(fz) on such Cigarettes, and provided that the manufacturer of such Cigarettes does not market or advertise such Cigarettes in the States);

(2) is the first purchaser anywhere for resale in the States of Cigarettes manufactured anywhere that the manufacturer does not intend to be sold in the States; or

(3) becomes a successor of an entity described in subsection (1) or (2) above.

The term "Tobacco Product Manufacturer" shall not include an Affiliate of a Tobacco Product Manufacturer unless such Affiliate itself falls within any of subsections (1) - (3) above.

(vv) "Tobacco Products" means Cigarettes and smokeless tobacco products.

(ww) "Tobacco-Related Organizations" means the Council for Tobacco Research-U.S.A., Inc., The Tobacco Institute, Inc. ("TI"), and the Center for Indoor Air Research, Inc. ("CIAR") and the successors, if any, of TI or CIAR.

(xx) "Transit Advertisements" means advertising on or within private or public vehicles and all advertisements placed at, on or within any bus stop, taxi stand, transportation waiting area, train station, airport or any similar location. Notwithstanding the foregoing, the term "Transit Advertisements" does not include (1) any advertisement placed in, on or outside the premises of any retail establishment that sells Tobacco Products (other than solely through a vending machine) (except if such individual advertisement (A) occupies an area larger than 14 square feet; (B) is placed in such proximity to any other such advertisement so as to create a single "mosaic"-type advertisement larger than 14 square feet; or (C) functions solely as a segment of a larger advertising unit or series); or (2) advertising at the site of an event to be held at an Adult-Only Facility that is placed at such site during the period the facility or enclosed area constitutes an Adult-Only Facility, but in no

event more than 14 days before the event, and that does not advertise any Tobacco Product (other than by using a Brand Name to identify the event).

- (yy) "Underage" means younger than the minimum age at which it is legal to purchase or possess (whichever minimum age is older) Cigarettes in the applicable Settling State.
- (zz) "Video Game Arcade" means an entertainment establishment primarily consisting of video games (other than video games intended primarily for use by persons 18 years of age or older) and/or pinball machines.
- (aaa) "Volume Adjustment" means an upward or downward adjustment in accordance with the formula for volume adjustments set forth in Exhibit E.
- (bbb) "Youth" means any person or persons under 18 years of age.

### III. PERMANENT RELIEF

- (a) Prohibition on Youth Targeting. No Participating Manufacturer may take any action, directly or indirectly, to target Youth within any Settling State in the advertising, promotion or marketing of Tobacco Products, or take any action the primary purpose of which is to initiate, maintain or increase the incidence of Youth smoking within any Settling State.
- (b) Ban on Use of Cartoons. Beginning 180 days after the MSA Execution Date, no Participating Manufacturer may use or cause to be used any Cartoon in the advertising, promoting, packaging or labeling of Tobacco Products.
- (c) Limitation of Tobacco Brand Name Sponsorships.

(1) Prohibited Sponsorships. After the MSA Execution Date, no Participating Manufacturer may engage in any Brand Name Sponsorship in any State consisting of:

- (A) concerts; or
- (B) events in which the intended audience is comprised of a significant percentage of Youth; or
- (C) events in which any paid participants or contestants are Youth; or
- (D) any athletic event between opposing teams in any football, basketball, baseball, soccer or hockey league.

### (2) Limited Sponsorships.

(A) No Participating Manufacturer may engage in more than one Brand Name Sponsorship in the States in any twelve-month period (such period measured from the date of the initial sponsored event).

(B) Provided, however, that

- (i) nothing contained in subsection (2)(A) above shall require a Participating Manufacturer to breach or terminate any sponsorship contract in existence as of August 1, 1998 (until the earlier of (x) the current term of any existing contract, without regard to any renewal or option that may be exercised by such Participating Manufacturer or (y) three years after the MSA Execution Date); and
- (ii) notwithstanding subsection (1)(A) above, Brown & Williamson Tobacco Corporation may sponsor either the GPC country music festival or the Kool jazz festival as its one annual Brand Name Sponsorship permitted pursuant to subsection (2)(A) as well as one Brand Name Sponsorship permitted pursuant to subsection (2)(B)(i).

(3) Related Sponsorship Restrictions. With respect to any Brand Name Sponsorship permitted under this subsection (c):

(A) advertising of the Brand Name Sponsorship event shall not advertise any Tobacco Product (other than by using the Brand Name to identify such Brand Name Sponsorship event);

(B) no Participating Manufacturer may refer to a Brand Name Sponsorship event or to a celebrity or other person in such an event in its advertising of a Tobacco Product;

(C) nothing contained in the provisions of subsection III(e) of this Agreement shall apply to actions taken by any Participating Manufacturer in connection with a Brand Name Sponsorship permitted pursuant to the provisions of subsections (2)(A) or (2)(B)(i); the Brand Name Sponsorship permitted by subsection (2)(B)(ii) shall be subject to the restrictions of subsection III(e) except that such restrictions shall not prohibit use of the Brand Name to identify the Brand Name Sponsorship;

(D) nothing contained in the provisions of subsections III(f) and III(g) shall apply to apparel or other merchandise: (i) marketed, distributed, offered, sold, or licensed at the site of a Brand Name Sponsorship permitted pursuant to subsections (2)(A) and (2)(B)(i); by the person to which the relevant Participating Manufacturer has provided payment in exchange for the use of the relevant Brand Name in the Brand Name Sponsorship or a third-party that does not receive payment from the relevant Participating Manufacturer (or any Affiliate of such Participating Manufacturer) in connection with the marketing, distribution, offer, sale or license of such apparel or other merchandise; or (ii) used at the site of a Brand Name Sponsorship permitted pursuant to subsection (2)(A) or (2)(B)(i) (during such event) that are not distributed (by sale or otherwise) to any member of the general public; and

(E) nothing contained in the provisions of subsection III(d) shall: (i) apply to the use of a Brand Name on a vehicle used in a Brand Name Sponsorship; or (ii) apply to Outdoor Advertising advertising the Brand Name

Sponsorship, to the extent that such Outdoor Advertising is placed at the site of a Brand Name Sponsorship no more than 90 days before the start of the initial sponsored event, is removed within 10 days after the end of the last sponsored event, and is not prohibited by subsection (3)(A) above.

(4) Corporate Name Sponsorships. Nothing in this subsection (c) shall prevent a Participating Manufacturer from sponsoring or causing to be sponsored any athletic, musical, artistic, or other social or cultural event, or any entrant, participant or team in such event (or series of events) in the name of the corporation which manufactures Tobacco Products, provided that the corporate name does not include any Brand Name of domestic Tobacco Products.

(5) Naming Rights Prohibition. No Participating Manufacturer may enter into any agreement for the naming rights of any stadium or arena located within a Settling State using a Brand Name, and shall not otherwise cause a stadium or arena located within a Settling State to be named with a Brand Name.

(6) Prohibition on Sponsoring Teams and Leagues. No Participating Manufacturer may enter into any agreement pursuant to which payment is made (or other consideration is provided) by such Participating Manufacturer to any football, basketball, baseball, soccer or hockey league (or any team involved in any such league) in exchange for use of a Brand Name.

(d) Elimination of Outdoor Advertising and Transit Advertisements. Each Participating Manufacturer shall discontinue Outdoor Advertising and Transit Advertisements advertising Tobacco Products within the Settling States as set forth herein.

(1) Removal. Except as otherwise provided in this section, each Participating Manufacturer shall remove from within the Settling States within 150 days after the MSA Execution Date all of its (A) billboards (to the extent that such billboards constitute Outdoor Advertising) advertising Tobacco Products; (B) signs and placards (to the extent that such signs and placards constitute Outdoor Advertising) advertising Tobacco Products in arenas, stadiums, shopping malls and Video Game Arcades; and (C) Transit Advertisements advertising Tobacco Products.

(2) Prohibition on New Outdoor Advertising and Transit Advertisements. No Participating Manufacturer may, after the MSA Execution Date, place or cause to be placed any new Outdoor Advertising advertising Tobacco Products or new Transit Advertisements advertising Tobacco Products within any Settling State.

(3) Alternative Advertising. With respect to those billboards required to be removed under subsection (1) that are leased (as opposed to owned) by any Participating Manufacturer, the Participating Manufacturer will allow the Attorney General of the Settling State within which such billboards are located to substitute, at the Settling State's option, alternative advertising intended to discourage the use of Tobacco Products by Youth and their exposure to second-hand smoke for the remaining term of the applicable contract (without regard to any renewal or option term that may be exercised by such Participating Manufacturer). The Participating Manufacturer will bear the cost of the lease through the end of such remaining term. Any other costs associated with such alternative advertising will be borne by the Settling State.

(4) Ban on Agreements Inhibiting Anti-Tobacco Advertising. Each Participating Manufacturer agrees that it will not enter into any agreement that prohibits a third party from selling, purchasing or displaying advertising discouraging the use of Tobacco Products or exposure to second-hand smoke. In the event and to the extent that any Participating Manufacturer has entered into an agreement containing any such prohibition, such Participating Manufacturer agrees to waive such prohibition in such agreement.

(5) Designation of Contact Person. Each Participating Manufacturer that has Outdoor Advertising or Transit Advertisements advertising Tobacco Products within a Settling State shall, within 10 days after the MSA Execution Date, provide the Attorney General of such Settling State with the name of a contact person to whom the Settling State may direct inquiries during the time such Outdoor Advertising and Transit Advertisements are being eliminated, and from whom the Settling State may obtain periodic reports as to the progress of their elimination.

(6) Adult-Only Facilities. To the extent that any advertisement advertising Tobacco Products located within an Adult-Only Facility constitutes Outdoor Advertising or a Transit Advertisement, this subsection (d) shall not apply to such advertisement, provided such advertisement is not visible to persons outside such Adult-Only Facility.

(e) Prohibition on Payments Related to Tobacco Products and Media. No Participating Manufacturer may, beginning 30 days after the MSA Execution Date, make, or cause to be made, any payment or other consideration to any other person or entity to use, display, make reference to or use as a prop any Tobacco Product, Tobacco Product package, advertisement for a Tobacco Product, or any other item bearing a Brand Name in any motion picture, television show, theatrical production or other live performance, live or recorded performance of music, commercial film or video, or video game ("Media"); provided, however, that the foregoing prohibition shall not apply to (1) Media where the audience or viewers are within an Adult-Only Facility (provided such Media are not visible to persons outside such Adult-Only Facility); (2) Media not intended for distribution or display to the public; or (3) instructional Media concerning non-conventional cigarettes viewed only by or provided only to smokers who are Adults.

(f) Ban on Tobacco Brand Name Merchandise. Beginning July 1, 1999, no Participating Manufacturer may, within any Settling State, market, distribute, offer, sell, license or cause to be marketed, distributed, offered, sold or licensed (including, without limitation, by catalogue or direct mail), any apparel or other merchandise (other than Tobacco Products, items the sole function of which is to advertise Tobacco Products, or written or electronic publications) which bears a Brand Name. Provided, however, that nothing in this subsection shall (1) require any Participating Manufacturer to breach or

terminate any licensing agreement or other contract in existence as of June 20, 1997 (this exception shall not apply beyond the current term of any existing contract, without regard to any renewal or option term that may be exercised by such Participating Manufacturer); (2) prohibit the distribution to any Participating Manufacturer's employee who is not Underage of any item described above that is intended for the personal use of such an employee; (3) require any Participating Manufacturer to retrieve, collect or otherwise recover any item that prior to the MSA Execution Date was marketed, distributed, offered, sold, licensed, or caused to be marketed, distributed, offered, sold or licensed by such Participating Manufacturer; (4) apply to coupons or other items used by Adults solely in connection with the purchase of Tobacco Products; or (5) apply to apparel or other merchandise used within an Adult-Only Facility that is not distributed (by sale or otherwise) to any member of the general public.

(g) Ban on Youth Access to Free Samples. After the MSA Execution Date, no Participating Manufacturer may, within any Settling State, distribute or cause to be distributed any free samples of Tobacco Products except in an Adult-Only Facility. For purposes of this Agreement, a "free sample" does not include a Tobacco Product that is provided to an Adult in connection with (1) the purchase, exchange or redemption for proof of purchase of any Tobacco Products (including, but not limited to, a free offer in connection with the purchase of Tobacco Products, such as a "two-for-one" offer), or (2) the conducting of consumer testing or evaluation of Tobacco Products with persons who certify that they are Adults.

(h) Ban on Gifts to Underage Persons Based on Proofs of Purchase. Beginning one year after the MSA Execution Date, no Participating Manufacturer may provide or cause to be provided to any person without sufficient proof that such person is an Adult any item in exchange for the purchase of Tobacco Products, or the furnishing of credits, proofs-of-purchase, or coupons with respect to such a purchase. For purposes of the preceding sentence only, (1) a driver's license or other government-issued identification (or legible photocopy thereof), the validity of which is certified by the person to whom the item is provided, shall by itself be deemed to be a sufficient form of proof of age; and (2) in the case of items provided (or to be redeemed) at retail establishments, a Participating Manufacturer shall be entitled to rely on verification of proof of age by the retailer, where such retailer is required to obtain verification under applicable federal, state or local law.

(i) Limitation on Third-Party Use of Brand Names. After the MSA Execution Date, no Participating Manufacturer may license or otherwise expressly authorize any third party to use or advertise within any Settling State any Brand Name in a manner prohibited by this Agreement if done by such Participating Manufacturer itself. Each Participating Manufacturer shall, within 10 days after the MSA Execution Date, designate a person (and provide written notice to NAAG of such designation) to whom the Attorney General of any Settling State may provide written notice of any such third-party activity that would be prohibited by this Agreement if done by such Participating Manufacturer itself. Following such written notice, the Participating Manufacturer will promptly take commercially reasonable steps against any such non-de minimis third-party activity. Provided, however, that nothing in this subsection shall require any Participating Manufacturer to (1) breach or terminate any licensing agreement or other contract in existence as of July 1, 1998 (this exception shall not apply beyond the current term of any existing contract, without regard to any renewal or option term that may be exercised by such Participating Manufacturer); or (2) retrieve, collect or otherwise recover any item that prior to the MSA Execution Date was marketed, distributed, offered, sold, licensed or caused to be marketed, distributed, offered, sold or licensed by such Participating Manufacturer.

(j) Ban on Non-Tobacco Brand Names. No Participating Manufacturer may, pursuant to any agreement requiring the payment of money or other valuable consideration, use or cause to be used as a brand name of any Tobacco Product any nationally recognized or nationally established brand name or trade name of any non-tobacco item or service or any nationally recognized or nationally established sports team, entertainment group or individual celebrity. Provided, however, that the preceding sentence shall not apply to any Tobacco Product brand name in existence as of July 1, 1998. For the purposes of this subsection, the term "other valuable consideration" shall not include an agreement between two entities who enter into such agreement for the sole purpose of avoiding infringement claims.

(k) Minimum Pack Size of Twenty Cigarettes. No Participating Manufacturer may, beginning 60 days after the MSA Execution Date and through and including December 31, 2001, manufacture or cause to be manufactured for sale in any Settling State any pack or other container of Cigarettes containing fewer than 20 Cigarettes (or, in the case of roll-your-own tobacco, any package of roll-your-own tobacco containing less than 0.60 ounces of tobacco). No Participating Manufacturer may, beginning 150 days after the MSA Execution Date and through and including December 31, 2001, sell or distribute in any Settling State any pack or other container of Cigarettes containing fewer than 20 Cigarettes (or, in the case of roll-your-own tobacco, any package of roll-your-own tobacco containing less than 0.60 ounces of tobacco). Each Participating Manufacturer further agrees that following the MSA Execution Date it shall not oppose, or cause to be opposed (including through any third party or Affiliate), the passage by any Settling State of any legislative proposal or administrative rule applicable to all Tobacco Product Manufacturers and all retailers of Tobacco Products prohibiting the manufacture and sale of any pack or other container of Cigarettes containing fewer than 20 Cigarettes (or, in the case of roll-your-own tobacco, any package of roll-your-own tobacco containing less than 0.60 ounces of tobacco).

(l) Corporate Culture Commitments Related to Youth Access and Consumption. Beginning 180 days after the MSA Execution Date each Participating Manufacturer shall:

promulgate or reaffirm corporate principles that express and explain its commitment to comply with the provisions of this Agreement and the reduction of use of Tobacco Products by Youth, and clearly and regularly communicate to its employees and customers its commitment to assist in the reduction of Youth use of Tobacco Products.

designate an executive level manager (and provide written notice to NAAG of such designation) to identify methods to reduce Youth access to, and the incidence of Youth consumption of, Tobacco Products; and encourage its employees to identify additional methods to reduce Youth access to, and the incidence of Youth consumption of, Tobacco Products.

(m) Limitations on Lobbying. Following State-Specific Finality in a Settling State:

(1) No Participating Manufacturer may oppose, or cause to be opposed (including through any third party or Affiliate), the passage by such Settling State (or any political subdivision thereof) of those state or local legislative proposals or administrative rules described in Exhibit F hereto intended by their terms to reduce Youth access to, and the incidence of Youth consumption of, Tobacco Products. Provided, however, that the foregoing does not prohibit any Participating Manufacturer from (A) challenging enforcement of, or suing for declaratory or injunctive relief with respect to, any such legislation or rule on any grounds; (B) continuing, after State-Specific Finality in such Settling State, to oppose or cause to be opposed, the passage during the legislative session in which State-Specific Finality in such Settling State occurs of any specific state or local legislative proposals or administrative rules introduced prior to the time of State-Specific Finality in such Settling State; (C) opposing, or causing to be opposed, any excise tax or income tax provision or user fee or other payments relating to Tobacco Products or Tobacco Product Manufacturers; or (D) opposing, or causing to be opposed, any state or local legislative proposal or administrative rule that also includes measures other than those described in Exhibit F.

(2) Each Participating Manufacturer shall require all of its officers and employees engaged in lobbying activities in such Settling State after State-Specific Finality, contract lobbyists engaged in lobbying activities in such Settling State after State-Specific Finality, and any other third parties who engage in lobbying activities in such Settling State after State-Specific Finality on behalf of such Participating Manufacturer ("lobbyist" and "lobbying activities," having the meaning such terms have under the law of the Settling State in question) to certify in writing to the Participating Manufacturer that they:

(A) will not support or oppose any state, local or federal legislation, or seek or oppose any governmental action, on behalf of the Participating Manufacturer without the Participating Manufacturer's express authorization (except where such advance express authorization is not reasonably practicable);

(B) are aware of and will fully comply with this Agreement and all laws and regulations applicable to their lobbying activities, including, without limitation, those related to disclosure of financial contributions. Provided, however, that if the Settling State in question has in existence no laws or regulations relating to disclosure of financial contributions regarding lobbying activities, then each Participating Manufacturer shall, upon request of the Attorney General of such Settling State, disclose to such Attorney General any payment to a lobbyist that the Participating Manufacturer knows or has reason to know will be used to influence legislative or administrative actions of the state or local government relating to Tobacco Products or their use. Disclosures made pursuant to the preceding sentence shall be filed in writing with the Office of the Attorney General on the first day of February and the first day of August of each year for any and all payments made during the six month period ending on the last day of the preceding December and June, respectively, with the following information: (1) the name, address, telephone number and e-mail address (if any) of the recipient; (2) the amount of each payment; and (3) the aggregate amount of all payments described in this subsection (2)(B) to the recipient in the calendar year; and

(C) have reviewed and will fully abide by the Participating Manufacturer's corporate principles promulgated pursuant to this Agreement when acting on behalf of the Participating Manufacturer.

(3) No Participating Manufacturer may support or cause to be supported (including through any third party or Affiliate) in Congress or any other forum legislation or rules that would preempt, override, abrogate or diminish such Settling State's rights or recoveries under this Agreement. Except as specifically provided in this Agreement, nothing herein shall be deemed to restrain any Settling State or Participating Manufacturer from advocating terms of any national settlement or taking any other positions on issues relating to tobacco.

(n) Restriction on Advocacy Concerning Settlement Proceeds. After the MSA Execution Date, no Participating Manufacturer may support or cause to be supported (including through any third party or Affiliate) the diversion of any proceeds of this settlement or in any subsequent legislative appropriation of settlement proceeds in connection with the approval of this Agreement.

(o) Dissolution of The Tobacco Institute, Inc., the Council for Tobacco Research-U.S.A., Inc. and the Center for Indoor Air Research, Inc.

(1) The Council for Tobacco Research-U.S.A., Inc. ("CTR") (a not-for-profit corporation formed under the laws of the State of New York) shall, pursuant to the plan of dissolution previously negotiated and agreed to between the Attorney General of the State of New York and CTR, cease all operations and be dissolved in accordance with the laws of the State of New York (and with the preservation of all applicable privileges held by any member company of CTR).

(2) The Tobacco Institute, Inc. ("TI") (a not-for-profit corporation formed under the laws of the State of New York) shall, pursuant to a plan of dissolution to be negotiated by the Attorney General of the State of New York and the Original Participating Manufacturers in accordance with Exhibit G hereto, cease all operations and be dissolved in

accordance with the laws of the State of New York and under the authority of the Attorney General of the State of New York (and with the preservation of all applicable privileges held by any member company of TI).

(3) Within 45 days after Final Approval, the Center for Indoor Air Research, Inc. ("CIAR") shall cease all operations, and be dissolved in a manner consistent with applicable law and with the preservation of all applicable privileges (including, without limitation, privileges held by any member company of CIAR).

(4) The Participating Manufacturers shall direct the Tobacco-Related Organizations to preserve all records that relate in any way to issues raised in smoking-related health litigation.

(5) The Participating Manufacturers may not reconstitute CTR or its function in any form.

(6) The Participating Manufacturers represent that they have the authority to and will effectuate subsections (1) through (5) hereof.

(p) **Rescission and Oversight of New Tobacco-Related Trade Associations:**

(1) A Participating Manufacturer may form or participate in new tobacco-related trade associations (subject to all applicable laws), provided such associations agree in writing not to act in any manner contrary to any provision of this Agreement. Each Participating Manufacturer agrees that if any new tobacco-related trade association fails to so agree, such Participating Manufacturer will not participate in or support such association.

(2) Any tobacco-related trade association that is formed or controlled by one or more of the Participating Manufacturers after the MSA Execution Date shall adopt by-laws governing the association's procedures and the activities of its members, board, employees, agents and other representatives with respect to the tobacco-related trade association. Such by-laws shall include, among other things, provisions that:

(A) each officer of the association shall be appointed by the board of the association, shall be an employee of such association, and during such officer's term shall not be a director of or employed by any member of the association or by an Affiliate of any member of the association;

(B) legal counsel for the association shall be independent, and neither counsel nor any member or employee of counsel's law firm shall serve as legal counsel to any member of the association or to a manufacturer of Tobacco Products that is an Affiliate of any member of the association during the time that it is serving as legal counsel to the association; and

(C) minutes describing the substance of the meetings of the board of directors of the association shall be prepared and shall be maintained by the association for a period of at least five years following their preparation.

(3) Without limitation on whatever other rights to access they may be permitted by law, for a period of seven years from the date any new tobacco-related trade association is formed by any of the Participating Manufacturers after the MSA Execution Date the antitrust authorities of any Settling State may, for the purpose of enforcing this Agreement, upon reasonable cause to believe that a violation of this Agreement has occurred, and upon reasonable prior written notice (but in no event less than 10 Business Days):

(A) have access during regular office hours to inspect and copy all relevant non-privileged, non-work-product books, records, meeting agendas and minutes, and other documents (whether in hard copy form or stored electronically) of such association insofar as they pertain to such believed violation; and

(B) interview the association's directors, officers and employees (who shall be entitled to have counsel present) with respect to relevant, non-privileged, non-work-product matters pertaining to such believed violation.

Documents and information provided to Settling State antitrust authorities shall be kept confidential by and among such authorities, and shall be utilized only by the Settling States and only for the purpose of enforcing this Agreement or the criminal law. The inspection and discovery rights provided to the Settling States pursuant to this subsection shall be coordinated so as to avoid repetitive and excessive inspection and discovery.

(4) **Prohibition on Agreements to Suppress Research:** No Participating Manufacturer may enter into any contract, combination or conspiracy with any other Tobacco Product Manufacturer that has the purpose or effect of: (1) limiting competition in the production or distribution of information about health hazards or other consequences of the use of their products; (2) limiting or suppressing research into smoking and health; or (3) limiting or suppressing research into the marketing or development of new products. Provided, however, that nothing in this subsection shall be deemed to (1) require any Participating Manufacturer to produce, distribute or otherwise disclose any information that is subject to (1) require protection; (2) preclude any Participating Manufacturer from entering into any joint defense or joint legal interest agreement or arrangement (whether or not in writing), or from asserting any privilege pursuant thereto; or (3) impose any affirmative obligation on any Participating Manufacturer to conduct any research.

(r) **Prohibition on Material Misrepresentations:** No Participating Manufacturer may make any material misrepresentation of fact regarding the health consequences of using any Tobacco Product, including any tobacco additives, fillers, paper or other ingredients. Nothing in this subsection shall limit the exercise of any First Amendment right or the assertion of any defense or position in any judicial, legislative or regulatory forum.

**IV. PUBLIC ACCESS TO DOCUMENTS**

(a) After the MSA Execution Date, the Original Participating Manufacturers and the Tobacco-Related Organizations will support an application for the dissolution of any protective orders entered in each Settling State's lawsuit identified in Exhibit D with respect only to those documents, indices and privilege logs that have been produced as of the MSA Execution Date to such Settling State and (1) as to which defendants have made no claim, or have withdrawn any claim, of attorney-client privilege, attorney work-product protection, common interest/joint defense privilege (collectively, "privilege"), trade-secret protection, or confidential or proprietary business information; and (2) that are not inappropriate for public disclosure because of personal privacy interests or contractual rights of third parties that may not be abrogated by the Original Participating Manufacturers or the Tobacco-Related Organizations.

(b) Notwithstanding State-Specific Finality, if any order, ruling or recommendation was issued prior to September 17, 1998 rejecting a claim of privilege or trade-secret protection with respect to any document or documents in a lawsuit identified in Exhibit D, the Settling State in which such order, ruling or recommendation was made may, no later than 45 days after the occurrence of State-Specific Finality in such Settling State, seek public disclosure of such document or documents by application to the court that issued such order, ruling or recommendation and the court shall retain jurisdiction for such purposes. The Original Participating Manufacturers and Tobacco-Related Organizations do not consent to, and may object to, appeal from or otherwise oppose any such application for disclosure. The Original Participating Manufacturers and Tobacco-Related Organizations will not assert that the settlement of such lawsuit has divested the court of jurisdiction or that such Settling State lacks standing to seek public disclosure on any applicable ground.

(c) The Original Participating Manufacturers will maintain at their expense their Internet document websites accessible through "TobaccoResolution.com" or a similar website until June 30, 2010. The Original Participating Manufacturers will maintain the documents that currently appear on their respective websites and will add additional documents to their websites as provided in this section IV.

(d) Within 180 days after the MSA Execution Date, each Original Participating Manufacturer and Tobacco-Related Organization will place on its website copies of the following documents, except as provided in subsections IV(e) and IV(f) below:

(1) all documents produced by such Original Participating Manufacturer or Tobacco-Related Organization as of the MSA Execution Date in any action identified in Exhibit D or any action identified in section 2 of Exhibit H that was filed by an Attorney General. Among these documents, each Original Participating Manufacturer and Tobacco-Related Organization will give the highest priority to (A) the documents that were listed by the State of Washington as trial exhibits in the State of Washington v. American Tobacco Co., et al., No. 96-2-15056-8 SEA (Wash. Super. Ct., County of King); and (B) the documents as to which such Original Participating Manufacturer or Tobacco-Related Organization withdrew any claim of privilege as a result of the re-examination of privilege claims pursuant to court order in State of Oklahoma v. RJR Reynolds Tobacco Company, et al., CJ-96-2499-L (Dist. Ct., Cleveland County);

(2) all documents that can be identified as having been produced by, and copies of transcripts of depositions given by, such Original Participating Manufacturer or Tobacco-Related Organization as of the MSA Execution Date in the litigation matters specified in section 1 of Exhibit H; and

(3) all documents produced by such Original Participating Manufacturer or Tobacco-Related Organization as of the MSA Execution Date and listed by the plaintiffs as trial exhibits in the litigation matters specified in section 2 of Exhibit H.

(e) Unless copies of such documents are already on its website, each Original Participating Manufacturer and Tobacco-Related Organization will place on its website copies of documents produced in any production of documents that takes place on or after the date 30 days before the MSA Execution Date in any federal or state court civil action concerning smoking and health. Copies of any documents required to be placed on a website pursuant to this subsection will be placed on such website within the later of 45 days after the MSA Execution Date or within 45 days after the production of such documents in any federal or state court action concerning smoking and health. This obligation will continue until June 30, 2010. In placing such newly produced documents on its website, each Original Participating Manufacturer or Tobacco-Related Organization will identify, as part of its index to be created pursuant to subsection IV(h), the action in which it produced such documents and the date on which such documents were added to its website.

(f) Nothing in this section IV shall require any Original Participating Manufacturer or Tobacco-Related Organization to place on its website or otherwise disclose documents that: (1) it continues to claim to be privileged, a trade secret, confidential or proprietary business information, or that contain other information not appropriate for public disclosure because of personal privacy interests or contractual rights of third parties; or (2) continue to be subject to any protective order, sealing order or other order or ruling that prevents or limits a litigant from disclosing such documents.

(g) Oversized or multimedia records will not be required to be placed on the Website, but each Original Participating Manufacturer and Tobacco-Related Organization will make any such records available to the public by placing copies of them in the document depository established in The State of Minnesota, et al. v. Philip Morris Incorporated, et al., CI-94-8565 (County of Ramsey, District Court, 2d Judicial Cir.).

(4) **Creation and Organization of the Foundation.** NAAAG, through its executive committee, will provide for the creation of the Foundation. The Foundation shall be organized exclusively for charitable, scientific, and educational purposes within the meaning of Internal Revenue Code section 501(c)(3). The organizational documents of the Foundation shall specifically incorporate the provisions of this Agreement relating to the Foundation, and will provide for payment of the Foundation's administrative expenses from the funds paid pursuant to subsection VI(b) or VI(c). The Foundation shall be governed by a board of directors. The board of directors shall be comprised of eleven directors. NAAAG, the National Governors' Association ("NGA"), and the National Conference of State Legislatures ("NCSL") shall each select from its membership two directors. These six directors shall select the five additional directors. One of these five additional directors shall have expertise in public health issues. Four of these five additional directors shall have expertise in medical, child psychology, or public health disciplines. The board of directors shall be nationally geographically diverse.

(e) **Foundation Affiliation.** The Foundation shall be formally affiliated with an educational or medical institution selected by the board of directors.

(f) **Foundation Functions.** The functions of the Foundation shall be:

- (1) carrying out a nationwide sustained advertising and education program to (A) counter the use by Youth of Tobacco Products, and (B) educate consumers about the cause and prevention of diseases associated with the use of Tobacco Products;

- (2) developing and disseminating model advertising and education programs to counter the use by Youth of substances that are unlawful for use or purchase by Youth, with an emphasis on reducing Youth smoking; monitoring and testing the effectiveness of such model programs; and, based on the information received from such monitoring and testing, continuing to develop and disseminate revised versions of such model programs, as appropriate;

- (3) developing and disseminating model classroom education programs and curriculum ideas about smoking and substance abuse in the K-12 school system, including specific target programs for special at-risk populations; monitoring and testing the effectiveness of such model programs and ideas; and, based on the information received from such monitoring and testing, continuing to develop and disseminate revised versions of such model programs or ideas, as appropriate;

- (4) developing and disseminating criteria for effective cessation programs; monitoring and testing the effectiveness of such criteria; and continuing to develop and disseminate revised versions of such criteria, as appropriate;

- (5) commissioning studies, funding research, and publishing reports on factors that influence Youth smoking and substance abuse and developing strategies to address the conclusions of such studies and research;
- (6) developing other innovative Youth smoking and substance abuse prevention programs;
- (7) providing targeted training and information for parents;
- (8) maintaining a library open to the public of Foundation-funded studies, reports and other publications related to the cause and prevention of Youth smoking and substance abuse;

- (9) tracking and monitoring Youth smoking and substance abuse, with a focus on the reasons for any increases or failures to decrease Youth smoking and substance abuse and what actions can be taken to reduce Youth smoking and substance abuse;

- (10) receiving, controlling, and managing contributions from other entities to further the purposes described in this Agreement; and
- (11) receiving, controlling, and managing such funds paid by the Participating Manufacturers pursuant to subsections VI(b) and VI(c) above.

(g) **Foundation Grants-Making.** The Foundation is authorized to make grants from the National Public Education Fund to Settling States and their political subdivisions to carry out sustained advertising and education programs to (1) counter the use by Youth of Tobacco Products, and (2) educate consumers about the cause and prevention of diseases associated with the use of Tobacco Products. In making such grants, the Foundation shall consider whether the Settling State or political subdivision applying for such grant:

- (1) demonstrates the extent of the problem regarding Youth smoking in such Settling State or political subdivision;

- (2) either seeks the grant to implement a model program developed by the Foundation or provides the Foundation with a specific plan for such applicant's intended use of the grant monies, including demonstrating such applicant's ability to develop an effective advertising/education campaign and to assess the effectiveness of such advertising/education campaign;

- (3) has other funds readily available to carry out a sustained advertising and education program to (A) counter the use by Youth of Tobacco Products, and (B) educate consumers about the cause and prevention of diseases associated with the use of Tobacco Products; and

- (4) is a Settling State that has not severed this section VI from its settlement with the Participating Manufacturers pursuant to subsection VI(f) below, or is a political subdivision in such a Settling State.

(b) Each Original Participating Manufacturer will establish an index and other features to improve searchable access to the document images on its website, as set forth in Exhibit I.

(i) Within 90 days after the MSA Execution Date, the Original Participating Manufacturers will furnish NAAAG with a project plan for completing the Original Participating Manufacturers' obligations under subsection IV(b) with respect to documents currently on their websites, and documents being placed on their websites pursuant to subsection IV(d). NAAAG may engage a computer consultant at the Original Participating Manufacturers' expense for a period not to exceed two years and at a cost not to exceed \$100,000. NAAAG's computer consultant may review such plan and make recommendations consistent with this Agreement. In addition, within 120 days after the completion of the Original Participating Manufacturers' obligations under subsection IV(d), NAAAG's computer consultant may make final recommendations with respect to the websites consistent with this Agreement. In preparing these recommendations, NAAAG's computer consultant may seek input from Settling State officials, public health organizations and other users of the websites.

(j) The expenses incurred pursuant to subsection IV(g), and the expenses related to documents of the Tobacco-Related Organizations, will be severally shared among the Original Participating Manufacturers (allocated among them according to their Relative Market Shares). All other expenses incurred under this section will be borne by the Original Participating Manufacturer that incurs such expense.

## V. TOBACCO CONTROL AND UNDERAGE USE LAWS

Each Participating Manufacturer agrees that following State-Specific Finality in a Settling State it will not initiate, or cause to be initiated, a facial challenge against the enforceability or constitutionality of such Settling State's (or such Settling State's political subdivisions') statutes, ordinances and administrative rules relating to tobacco control enacted prior to June 1, 1998 (other than a statute, ordinance or rule challenged in any lawsuit listed in Exhibit M).

## VI. ESTABLISHMENT OF A NATIONAL FOUNDATION

(a) **Foundation Purposes.** The Settling States believe that a comprehensive, coordinated program of public education and study is important to further the remedial goals of this Agreement. Accordingly, as part of the settlement of claims described herein, the payments specified in subsections VI(b), VI(c), and IX(e) shall be made to a charitable foundation, trust or similar organization (the "Foundation") and/or to a program to be operated within the Foundation (the "National Public Education Fund"). The purposes of the Foundation will be to support (1) the study of and programs to reduce Youth Tobacco Product usage and Youth substance abuse in the States, and (2) the study of and educational programs to prevent diseases associated with the use of Tobacco Products in the States.

(b) **Base Foundation Payments.** On March 31, 1999, and on March 31 of each subsequent year for a period of nine years thereafter, each Original Participating Manufacturer shall severally pay its Relative Market Share of \$25,000,000 to fund the Foundation. The payments to be made by each of the Original Participating Manufacturers pursuant to this subsection (b) shall be subject to no adjustments, reductions, or offsets, and shall be paid to the Escrow Agent (to be credited to the Subsection VI(b) Account), who shall disburse such payments to the Foundation only upon the occurrence of State-Specific Finality in at least one Settling State.

## (c) National Public Education Fund Payments

(1) Each Original Participating Manufacturer shall severally pay its Relative Market Share of the following base amounts on the following dates to the Escrow Agent for the benefit of the Foundation's National Public Education Fund to be used for the purposes and as described in subsections VI(b), VI(c), and IX(e) below: \$250,000,000 on March 31, 1999; \$300,000,000 on March 31, 2000; \$300,000,000 on March 31, 2001; \$300,000,000 on March 31, 2002; and \$300,000,000 on March 31, 2003, as such amounts are modified in accordance with this subsection (c). The payment due on March 31, 1999 pursuant to this subsection (c)(1) is to be credited to the Subsection VI(c) Account (First). The payments due on or after March 31, 2000 pursuant to this subsection VI(c)(1) are to be credited to the Subsection VI(c) Account (Subsequent).

(2) The payments to be made by the Original Participating Manufacturers pursuant to this subsection (c), other than the payment due on March 31, 1999, shall be subject to the Inflation Adjustment, the Volume Adjustment and the offset for miscalculated or disputed payments described in subsection XI(f).

(3) The payment made pursuant to this subsection (c) on March 31, 1999 shall be disbursed by the Escrow Agent to the Foundation only upon the occurrence of State-Specific Finality in at least one Settling State. Each remaining payment pursuant to this subsection (c) shall be disbursed by the Escrow Agent to the Foundation only when State-Specific Finality has occurred in Settling States having aggregate Allocable Shares equal to at least 80% of the total aggregate Allocable Shares assigned to all States that were Settling States as of the MSA Execution Date.

(4) In addition to the payments made pursuant to this subsection (c), the National Public Education Fund will be funded (A) in accordance with subsection IX(e), and (B) through monies contributed by other entities directly to the Foundation and designated for the National Public Education Fund ("National Public Education Fund Contributions").

(5) The payments made by the Original Participating Manufacturers pursuant to this subsection (c) and/or subsection IX(e) and monies received from all National Public Education Fund Contributions will be deposited and invested in accordance with the laws of the state of incorporation of the Foundation.

(b) **Foundation Activities.** The Foundation shall not engage in, nor shall any of the Foundation's money be used to engage in, any political activities or lobbying, including, but not limited to, support of or opposition to candidates, ballot initiatives, referenda or other similar activities. The National Public Education Fund shall be used only for public education and advertising regarding the addictiveness, health effects, and social costs related to the use of tobacco products and shall not be used for any personal attack on, or vilification of, any person (whether by name or business affiliation), company, or governmental agency, whether individually or collectively. The Foundation shall work to ensure that its activities are carried out in a culturally and linguistically appropriate manner. The Foundation's activities (including the National Public Education Fund) shall be carried out solely within the States. The payments described in subsections V(f) and V(c) above are made at the direction and on behalf of Settling States. By making such payments in such manner, the Participating Manufacturers do not undertake and expressly disclaim any responsibility with respect to the creation, operation, liabilities, or tax status of the Foundation or the National Public Education Fund.

(i) **Severance of this Section.** If the Attorney General of a Settling State determines that such Settling State may not lawfully enter into this section VI as a matter of applicable state law, such Attorney General may sever this section VI from its settlement with the Participating Manufacturers by giving written notice of such severance to each Participating Manufacturer and NAAAG pursuant to subsection XVIII(k) hereof. If any Settling State exercises its right to sever this section VI, this section VI shall not be considered a part of the specific settlement between such Settling State and the Participating Manufacturers, and this section VI shall not be enforceable by or in such Settling State. The payment obligation of subsections V(b) and V(c) hereof shall apply regardless of a determination by one or more Settling States to sever section VI hereof; provided, however, that if all Settling States sever section VI hereof, the payment obligations of subsections (b) and (c) hereof shall be null and void. If the Attorney General of a Settling State that severed this section VI subsequently determines that such Settling State may lawfully enter into this section VI as a matter of applicable state law, such Attorney General may rescind such Settling State's previous severance of this section VI by giving written notice of such rescission to each Participating Manufacturer and NAAAG pursuant to subsection XVIII(k). If any Settling State rescinds such severance, this section VI shall be considered a part of the specific settlement between such Settling State and the Participating Manufacturers (including for purposes of subsection (g)(4)), and this section VI shall be enforceable by and in such Settling State.

#### VII. ENFORCEMENT

(a) **Jurisdiction.** Each Participating Manufacturer and each Settling State acknowledge that the Court: (1) has jurisdiction over the subject matter of the action identified in Exhibit D in such Settling State and over each Participating Manufacturer; (2) shall retain exclusive jurisdiction for the purposes of implementing and enforcing this Agreement and the Consent Decree; as to such Settling State; and (3) except as provided in subsections IX(d), XI(c) and XVII(d) and Exhibit O, shall be the only court to which disputes under this Agreement or the Consent Decree are presented as to such Settling State. Provided, however, that notwithstanding the foregoing, the Escrow Court (as defined in the Escrow Agreement) shall have exclusive jurisdiction, as provided in section 15 of the Escrow Agreement, over any suit, action or proceeding seeking to interpret or enforce any provision of, or based on any right arising out of, the Escrow Agreement.

(b) **Enforcement of Consent Decree.** Except as expressly provided in the Consent Decree, any Settling State or Released Party may apply to the Court to enforce the terms of the Consent Decree (or for a declaration constraining any such term) with respect to alleged violations within such Settling State. A Settling State may not seek to enforce the Consent Decree of another Settling State; provided, however, that nothing contained herein shall affect the ability of any Settling State to (1) coordinate state enforcement actions or proceedings, or (2) file or join any amicus brief. In the event that the Court determines that any Participating Manufacturer or Settling State has violated the Consent Decree within such Settling State, the party that initiated the proceedings may request any and all relief available within such Settling State pursuant to the Consent Decree.

(c) **Enforcement of this Agreement.**

(1) Except as provided in subsections IX(d), XI(c), XVII(d) and Exhibit O, any Settling State or Participating Manufacturer may bring an action in the Court to enforce the terms of this Agreement (or for a declaration constraining any such term ("Declaratory Order")) with respect to disputes, alleged violations or alleged breaches within such Settling State.

(2) Before initiating such proceedings, a party shall provide 30 days' written notice to the Attorney General of each Settling State, to NAAAG, and to each Participating Manufacturer of its intent to initiate proceedings pursuant to this subsection. The 30-day notice period may be shortened in the event that the relevant Attorney General reasonably determines that a compelling time-sensitive public health and safety concern requires more immediate action.

(3) In the event that the Court determines that any Participating Manufacturer or Settling State has violated and/or ordering compliance within such Settling State (an "Enforcement Order").

(4) If an issue arises as to whether a Participating Manufacturer has failed to comply with an Enforcement Order, the Attorney General for the Settling State in question may seek an order for interpretation or for monetary, civil contempt or criminal sanctions to enforce compliance with such Enforcement Order.

(5) If the Court finds that a good-faith dispute exists as to the meaning of the terms of this Agreement or a Declaratory Order, the Court may in its discretion determine to enter a Declaratory Order rather than an Enforcement Order.

(6) Whenever possible, the parties shall seek to resolve an alleged violation of this Agreement by discussion pursuant to subsection XVIII(m) of this Agreement. In addition, in determining whether to seek an Enforcement Order, or in determining whether to seek an order for monetary, civil contempt or criminal sanctions for any claimed violation of an Enforcement Order, the Attorney General shall give good-faith consideration to whether the Participating Manufacturer that is claimed to have violated this Agreement has taken appropriate and reasonable steps to cause the claimed violation to be cured, unless such party has been guilty of a pattern of violations of like nature.

(d) **Right of Review.** All orders and other judicial determinations made by any court in connection with this Agreement or any Consent Decree shall be subject to all available appellate review, and nothing in this Agreement or any Consent Decree shall be deemed to constitute a waiver of any right to any such review.

(e) **Applicability.** This Agreement and the Consent Decree apply only to the Participating Manufacturers in their corporate capacity acting through their respective successors and assigns, directors, officers, employees, agents, subsidiaries, divisions, or other internal organizational units of any kind or any other entities acting in concert or participation with them. The remedies, penalties and sanctions that may be imposed or assessed in connection with a breach or violation of this Agreement or the Consent Decree (or any Declaratory Order or Enforcement Order issued in connection with this Agreement or the Consent Decree) shall only apply to the Participating Manufacturers, and shall not be imposed or assessed against any employee, officer or director of any Participating Manufacturer, or against any other person or entity as a consequence of such breach or violation, and the Court shall have no jurisdiction to do so.

(f) **Coordination of Enforcement.** The Attorneys General of the Settling States (through NAAAG) shall monitor potential conflicting interpretations by courts of different States of this Agreement and the Consent Decrees. The Settling States shall use their best efforts, in cooperation with the Participating Manufacturers, to coordinate and resolve the effects of such conflicting interpretations as to matters that are not exclusively local in nature.

(g) **Inspection and Discovery Rights.** Without limitation on whatever other rights to access they may be permitted by law, following State-Specific Finality in a Settling State and for seven years thereafter, representatives of the Attorney General of such Settling State may, for the purpose of enforcing this Agreement and the Consent Decree, upon reasonable cause to believe that a violation of this Agreement or the Consent Decree has occurred, and upon reasonable prior written notice (but in no event less than 10 business days): (1) have access during regular office hours to inspect and copy all relevant non-privileged, non-work-product books, records, meeting agenda and minutes, and other documents (whether in hard copy form or stored electronically) of each Participating Manufacturer insofar as they pertain to such believed violation; and (2) interview each Participating Manufacturer's directors, officers and employees (who shall be entitled to have counsel present) with respect to relevant, non-privileged, non-work-product matters pertaining to such believed violation. Documents and information provided to representatives of the Attorney General of such Settling State pursuant to this section VII shall be kept confidential by the Settling States, and shall be utilized only by the Settling States and only for purposes of enforcing this Agreement, the Consent Decree and the criminal law. The inspection and discovery rights provided to such Settling State pursuant to this subsection shall be coordinated through NAAAG so as to avoid repetitive and excessive inspection and discovery.

#### VIII. CERTAIN ONGOING RESPONSIBILITIES OF THE SETTLING STATES

(a) Upon approval of the NAAAG executive committee, NAAAG will provide coordination and facilitation for the implementation and enforcement of this Agreement on behalf of the Attorneys General of the Settling States, including the following:

(1) NAAAG will assist in coordinating the inspection and discovery activities referred to in subsections III(p)(3) and VIII(g) regarding compliance with this Agreement by the Participating Manufacturers and any new tobacco-related trade associations.

(2) NAAAG will convene at least two meetings per year and one major national conference every three years for the Attorneys General of the Settling States, the directors of the Foundation and three persons designated by each Participating Manufacturer. The purpose of the meetings and conference is to evaluate the success of this Agreement and coordinate efforts by the Attorneys General and the Participating Manufacturers to continue to reduce youth smoking.

(3) NAAAG will periodically inform NGA, NCSL, the National Association of Counties and the National League of Cities of the results of the meetings and conferences referred to in subsection (a)(2) above.

(4) NAAAG will support and coordinate the efforts of the Attorneys General of the Settling States in carrying out their responsibilities under this Agreement.

(5) NAAAG will perform the other functions specified for it in this Agreement, including the functions specified in section IV.

(b) Upon approval by the NAAAG executive committee to assume the responsibilities outlined in subsection VIII(a) hereof, each Original Participating Manufacturer shall cause to be paid, beginning on December 31, 1998, and on December 31 of each year thereafter through and including December 31, 2007, its Relative Market Share of \$150,000 per year to the Escrow Agent (to be credited to the Subsection VIII(b) Account), who shall disburse such monies to NAAAG within 10 Business Days, to fund the activities described in subsection VIII(a).

(c) The Attorneys General of the Settling States, acting through NAAAG, shall establish a fund ("The States' Antitrust/Consumer Protection Tobacco Enforcement Fund") in the form attached as Exhibit J, which will be maintained by



such Attorneys General to supplement the Settling States' (1) enforcement and implementation of the terms of this Agreement and the Consent Decrees, and (2) investigation and litigation of potential violations of laws with respect to Tobacco Products, as set forth in Exhibit J. Each Original Participating Manufacturer shall on March 31, 1999, severally pay its Relative Market Share of \$50,000,000 to the Escrow Agent (to be credited to the Subsection VIII(c) Account), who shall disburse such monies to NAAG upon the occurrence of State-Specific Finality in at least one Settling State. Such funds will be used in accordance with the provisions of Exhibit I.

**IX. PAYMENTS**

(a) All Payments Into Escrow. All payments made pursuant to this Agreement (except those payments made pursuant to section XVII) shall be made into escrow pursuant to the Escrow Agreement, and shall be credited to the appropriate Account established pursuant to the Escrow Agreement. Such payments shall be disbursed to the beneficiaries or returned to the Participating Manufacturers only as provided in section XI and the Escrow Agreement. No payment obligation under this Agreement shall arise (1) unless and until the Escrow Court has approved and retained jurisdiction over the Escrow Agreement or (2) if such approval is reversed (unless and until such reversal is itself reversed). The parties agree to proceed as expeditiously as possible to resolve any issues that prevent approval of the Escrow Agreement. If any payment (other than the first initial payment under subsection IX(b)) is delayed because the Escrow Agreement has not been approved, such payment shall be due and payable (together with interest at the Prime Rate) within 10 Business Days after approval of the Escrow Agreement by the Escrow Court.

(b) Initial Payments. On the second Business Day after the Escrow Court approves and retains jurisdiction over the Escrow Agreement, each Original Participating Manufacturer shall severally pay to the Escrow Agent (to be credited to the Subsection IX(b) Account (First)) its Market Capitalization Percentage (as set forth in Exhibit K) of the base amount of \$2,400,000,000. On January 10, 2000, each Original Participating Manufacturer shall severally pay to the Escrow Agent its Relative Market Share of the base amount of \$2,472,000,000. On January 10, 2001, each Original Participating Manufacturer shall severally pay to the Escrow Agent its Relative Market Share of the base amount of \$2,546,160,000. On January 10, 2002, each Original Participating Manufacturer shall severally pay to the Escrow Agent its Relative Market Share of the base amount of \$2,622,544,800. On January 10, 2003, each Original Participating Manufacturer shall severally pay to the Escrow Agent its Relative Market Share of the base amount of \$2,701,221,144. The payments pursuant to this subsection (b) due on or after January 10, 2000 shall be credited to the Subsection IX(b) Account (Subsequent). The foregoing payments shall be modified in accordance with this subsection (b). The payments made by the Original Participating Manufacturers pursuant to this subsection (b) (other than the first such payment) shall be subject to the Volume Adjustment, the Non-Settling States Reduction and the offset for miscalculated or disputed payments described in subsection XI(f). The first payment due under this subsection (b) shall be subject to the Non-Settling States Reduction, but such reduction shall be determined as of the date one day before such payment is due (rather than the date 15 days before).

**(c) Annual Payments and Strategic Contribution Payments:**

(1) On April 15, 2000 and on April 15 of each year thereafter in perpetuity, each Original Participating Manufacturer shall severally pay to the Escrow Agent (to be credited to the Subsection IX(c)(1) Account) its Relative Market Share of the base amounts specified below, as such payments are modified in accordance with this subsection (c)(1):

Year	Base Amount
2000	\$4,500,000,000
2001	\$5,000,000,000
2002	\$6,500,000,000
2003	\$6,500,000,000
2004	\$8,000,000,000
2005	\$8,000,000,000
2006	\$8,000,000,000
2007	\$8,000,000,000
2008	\$8,139,000,000
2009	\$8,139,000,000
2010	\$8,139,000,000
2011	\$8,139,000,000
2012	\$8,139,000,000
2013	\$8,139,000,000
2014	\$8,139,000,000
2015	\$8,139,000,000
2016	\$8,139,000,000
2017	\$8,139,000,000
2018 and each year thereafter	\$9,000,000,000

The payments made by the Original Participating Manufacturers pursuant to this subsection (c)(1) shall be subject to the Inflation Adjustment, the Volume Adjustment, the Previously Settled States Reduction, the Non-Settling States Reduction, the NPM Adjustment, the offset for miscalculated or disputed payments described in subsection XI(f), the Federal

Tobacco Legislation Offset, the Litigating Releasing Parties Offset, and the offsets for claims over described in subsections XI(a)(4)(B) and XII(a)(8).

(2) On April 15, 2008 and on April 15 of each year thereafter through 2017, each Original Participating Manufacturer shall severally pay to the Escrow Agent (to be credited to the Subsection IX(c)(2) Account) its Relative Market Share of the base amount of \$861,000,000, as such payments are modified in accordance with this subsection (c)(2). The payments made by the Original Participating Manufacturers pursuant to this subsection (c)(2) shall be subject to the Inflation Adjustment, the Volume Adjustment, the NPM Adjustment, the offset for miscalculated or disputed payments described in subsection XI(f), the Federal Tobacco Legislation Offset, the Litigating Releasing Parties Offset, and the offsets for claims over described in subsections XI(a)(4)(B) and XII(a)(8). Such payments shall also be subject to the Non-Settling States Reduction; provided, however, that for purposes of payments due pursuant to this subsection (c)(2) (and corresponding payments by Subsequent Participating Manufacturers under subsection IX(f)), the Non-Settling States Reduction shall be derived as follows: (A) the payments made by the Original Participating Manufacturers pursuant to this subsection (c)(2) shall be allocated among the Settling States on a percentage basis to be determined by the Settling States pursuant to the procedures set forth in Exhibit U, and the resulting allocation percentages disclosed to the Escrow Agent, the Independent Auditor and the Original Participating Manufacturers not later than June 30, 1999; and (B) the Non-Settling States Reduction shall be based on the sum of the Allocable Shares as established pursuant to subsection (c)(2)(A) for those States that were Settling States as of the MSA Execution Date and as to which this Agreement has terminated as of the date 15 days before the payment in question is due.

**(d) Non-Participating Manufacturer Adjustment:**

(1) Calculation of NPM Adjustment for Original Participating Manufacturers. To protect the public health gains achieved by this Agreement, certain payments made pursuant to this Agreement shall be subject to an NPM Adjustment. Payments by the Original Participating Manufacturers to which the NPM Adjustment applies shall be adjusted as provided below:

- (A) Subject to the provisions of subsections (d)(1)(C), (d)(1)(D) and (d)(2) below, each Allocated Payment shall be adjusted by subtracting from such Allocated Payment the product of such Allocated Payment amount multiplied by the NPM Adjustment Percentage. The "NPM Adjustment Percentage" shall be calculated as follows:
  - (i) If the Market Share Loss for the year immediately preceding the year in which the payment in question is due is less than or equal to 0 (zero), then the NPM Adjustment Percentage shall equal zero.
  - (ii) If the Market Share Loss for the year immediately preceding the year in which the payment in question is due is greater than 0 (zero) and less than or equal to 16.2/3 percentage points, then the NPM Adjustment Percentage shall be equal to the product of (x) such Market Share Loss and (y) 3 (three).
  - (iii) If the Market Share Loss for the year immediately preceding the year in which the payment in question is due is greater than 16.2/3 percentage points, then the NPM Adjustment Percentage shall be equal to the sum of (x) 50 percentage points and (y) the product of (1) the Variable Multiplier and (2) the result of such Market Share Loss minus 16.2/3 percentage points.

**(B) Definitions:**

- (i) "Base Aggregate Participating Manufacturer Market Share" means the result of (x) the sum of the applicable Market Shares (the applicable Market Share to be that for 1997) of all present and former Tobacco Product Manufacturers that were Participating Manufacturers during the entire calendar year immediately preceding the year in which the payment in question is due minus (y) 2 (two) percentage points.
- (ii) "Actual Aggregate Participating Manufacturer Market Share" means the sum of the applicable Market Shares of all present and former Tobacco Product Manufacturers that were Participating Manufacturers during the entire calendar year immediately preceding the year in which the payment in question is due (the applicable Market Share to be that for the calendar year immediately preceding the year in which the payment in question is due).
- (iii) "Market Share Loss" means the result of (x) the Base Aggregate Participating Manufacturer Market Share minus (y) the Actual Aggregate Participating Manufacturer Market Share.
- (iv) "Variable Multiplier" equals 30 percentage points divided by the result of (x) the Base Aggregate Participating Manufacturer Market Share minus (y) 16.2/3 percentage points.
- (C) On or before February 2 of each year following a year in which there was a Market Share Loss greater than zero, a nationally recognized firm of economic consultants (the "Firm") shall determine whether the disadvantages experienced as a result of the provisions of this Agreement were a significant factor contributing to the Market Share Loss for the year in question. If the Firm determines that the disadvantages experienced as a result of the provisions of this Agreement were a significant factor contributing to the Market Share Loss for the year in question, the NPM Adjustment described in subsection IX(d)(1) shall apply. If the Firm determines that the disadvantages experienced as a result of the provisions of this Agreement were not a significant factor contributing to the Market Share Loss for the year in question, the NPM Adjustment described in subsection IX(d)(1) shall not apply. The Original Participating Manufacturers, the Settling States, and the Attorneys General for the Settling States shall cooperate to ensure that the determination described in this subsection (1)(C) is timely made. The Firm shall be acceptable to (and the principals responsible for this assignment shall be 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 (or in the event no such firm or no such principals shall be acceptable to such parties, National Economic Research Associates, Inc., or its successors by merger, acquisition or otherwise ("NERA"), acting through a principal or principals acceptable to such parties, if such a person can be identified and, if not, acting through a principal or principals identified by NERA, or a successor firm selected by the CPR Institute for Dispute Resolution). As soon as practicable after the MSA Execution Date, the Firm shall be jointly retained by the Settling States and the Original Participating Manufacturers for the purpose of making the foregoing determination, and the Firm shall provide written notice to each Settling State, to NAAG, to the Independent Auditor and to each Participating Manufacturer of such determination. The determination of the Firm with respect to this issue shall be conclusive and binding upon all parties, and shall be final and non-appealable. The reasonable fees and expenses of the Firm shall be paid by the Original Participating Manufacturers according to their Relative Market Shares. Only the Participating Manufacturers and the Settling States, and their respective counsel, shall be entitled to communicate with the Firm with respect to the Firm's activities pursuant to this subsection (1)(C).

(D) No NPM Adjustment shall be made with respect to a payment if the aggregate number of Cigarettes shipped in or to the fifty United States, the District of Columbia and Puerto Rico in the year immediately preceding the year in which the payment in question is due by those Participating Manufacturers that had become Participating Manufacturers prior to 14 days after the MSA Execution Date is greater than the aggregate number of Cigarettes shipped in or to the fifty United States, the District of Columbia, and Puerto Rico in 1997 by such Participating Manufacturers (and any of their Affiliates that made such shipments in 1997, as demonstrated by certified audited statements of such Affiliates' shipments, and that do not continue to make such shipments after the MSA Execution Date because the responsibility for such shipments has been transferred to one of such Participating Manufacturers). Measurements of shipments for purposes of this subsection (D) shall be made in the manner prescribed in subsection II(mm); in the event that such shipment data is unavailable for any Participating Manufacturer for 1997, such Participating Manufacturer's shipment volume for such year shall be measured in the manner prescribed in subsection II(z).

(2) Allocation among Settling States of NPM Adjustment for Original Participating Manufacturers.

(A) The NPM Adjustment set forth in subsection (d)(1) shall apply to the Allocated Payments of all Settling States, except as set forth below.

(B) A Settling State's Allocated Payment shall not be subject to an NPM Adjustment: (i) if such Settling State continuously had a Qualifying Statute (as defined in subsection 2)(B) below) in full force and effect during the entire calendar year immediately preceding the year in which the payment in question is due, and diligently enforced the provisions of such statute during such entire calendar year; or (ii) if such Settling State enacted the Model Statute (as defined in subsection 2)(E) below) for the first time during the calendar year immediately preceding the year in which the payment in question is due; continuously had the Model Statute in full force and effect during the last six months of such calendar year; and diligently enforced the provisions of such statute during the period in which it was in full force and effect.

(C) The aggregate amount of the NPM Adjustments that would have applied to the Allocated Payments of those Settling States that are not subject to an NPM Adjustment pursuant to subsection 2)(B) shall be reallocated among all other Settling States pro rata in proportion to their respective Allocable Shares (the applicable Allocable Shares being those listed in Exhibit A), and such other Settling States' Allocated Payments shall be further reduced accordingly.

(D) This subsection 2)(D) shall apply if the amount of the NPM Adjustment applied pursuant to subsection 2)(A) to any Settling State plus the amount of the NPM Adjustments reallocated to such Settling State pursuant to subsection 2)(C) in any individual year would either (i) exceed such Settling State's Allocated Payment in that year; or (ii) if subsection 2)(F) applies to the Settling State in question, exceed 65% of such Settling State's Allocated Payment in that year. For each Settling State that has an excess as described in the preceding sentence, the excess amount of NPM Adjustment shall be further reallocated among all other Settling States whose Allocated Payments are subject to an NPM Adjustment and that do not have such an excess, pro rata in proportion to their respective Allocable Shares, and such other Settling States' Allocated Payments shall be further reduced accordingly. The provisions of this subsection 2)(D) shall be repeatedly applied in any individual year until either (i) the aggregate amount of NPM Adjustments has been fully reallocated or (ii) the full amount of the NPM Adjustments subject to reallocation under subsection 2)(C) or 2)(D) cannot be fully reallocated in any individual year as described in those subsections because (x) the Allocated Payment in that year of each Settling State that is subject to an NPM Adjustment and to which subsection 2)(F) does not apply has been reduced to zero, and (y) the Allocated Payment in that year of each Settling State to which subsection 2)(F) applies has been reduced to 35% of such Allocated Payment.

(E) A "Qualifying Statute" means a Settling State's statute, regulation, law and/or rule (applicable everywhere the Settling State has authority to legislate) that effectively and fully neutralizes the cost disadvantages that the Participating Manufacturers experience vis-a-vis Non-Participating Manufacturers within such Settling State as a result of the provisions of this Agreement. Each Participating Manufacturer and each Settling State agree that the model statute in the form set forth in Exhibit T (the "Model Statute"), if enacted without modification or addition (except for parallelized state procedural or technical requirements) and not in conjunction with any other legislative or regulatory proposal, shall constitute a Qualifying Statute. Each Participating Manufacturer agrees to support the enactment of such Model Statute if such Model

Statute is introduced or proposed (i) without modification or addition (except for particularized procedural or technical requirements), and (ii) not in conjunction with any other legislative proposal.

(F) If a Settling State (i) enacts the Model Statute without any modification or addition (except for particularized state procedural or technical requirements) and not in conjunction with any other legislative or regulatory proposal, (ii) uses its best efforts to keep the Model Statute in full force and effect by, among other things, defending the Model Statute fully in any litigation brought in state or federal court within such Settling State (including litigating all available appeals that may affect the effectiveness of the Model Statute), and (iii) otherwise complies with subsection 2)(B), but a court of competent jurisdiction nevertheless invalidates or renders unenforceable the Model Statute with respect to such Settling State, and but for such ruling the Settling State would have been exempt from an NPM Adjustment under subsection 2)(B), then the NPM Adjustment (including reallocations pursuant to subsections 2)(C) and 2)(D)) shall still apply to such Settling State's Allocated Payments but in any individual year shall not exceed 65% of the amount of such Allocated Payments.

(G) In the event a Settling State proposes and/or enacts a statute, regulation, law and/or rule (applicable everywhere the Settling State has authority to legislate) that is not the Model Statute and asserts that such statute, regulation, law and/or rule is a Qualifying Statute, the Firm shall be jointly retained by the Settling States and the Original Participating Manufacturers for the purpose of determining whether or not such statute, regulation, law and/or rule constitutes a Qualifying Statute. The Firm shall make the foregoing determination within 90 days of a written request to it from the relevant Settling State (copies of which request the Settling State shall also provide to all Participating Manufacturers and the Independent Auditor), and the Firm shall promptly thereafter provide written notice of such determination to the relevant Settling State, NAAG, all Participating Manufacturers and the Independent Auditor. The determination of the Firm with respect to this issue shall be conclusive and binding upon all parties, and shall be final and non-appealable; provided, however, (i) that such determination shall be of no force and effect with respect to a proposed statute, regulation, law and/or rule that is thereafter enacted with any modification or addition; and (ii) that the Settling State in which the Qualifying Statute was enacted and any Participating Manufacturer may at any time request that the Firm reconsider its determination as to this issue in light of subsequent events (including, without limitation, subsequent judicial review, interpretation, modification and/or disapproval of a Settling State's Qualifying Statute, and the manner and/or the effect of enforcement of such Qualifying Statute). The Original Participating Manufacturers shall severally pay their Relative Market Shares of the reasonable fees and expenses of the Firm. Only the Participating Manufacturers and Settling States, and their respective counsel, shall be entitled to communicate with the Firm with respect to the Firm's activities pursuant to this subsection 2)(G).

(H) Except as provided in subsection 2)(F), in the event a Qualifying Statute is enacted within a Settling State and is thereafter invalidated or declared unenforceable by a court of competent jurisdiction, otherwise rendered not in full force and effect, or, upon reconsideration by the Firm pursuant to subsection 2)(G) determined not to constitute a Qualifying Statute, then such Settling State's Allocated Payments shall be fully subject to an NPM Adjustment unless and until the requirements of subsection 2)(B) have been once again satisfied.

(3) Allocation of NPM Adjustment among Original Participating Manufacturers. The portion of the total amount of the NPM Adjustment to which the Original Participating Manufacturers are entitled in any year that can be applied in such year consistent with subsection IX(d)(2) (the "Available NPM Adjustment") shall be allocated among them as provided in this subsection IX(d)(3).

(A) The "Base NPM Adjustment" shall be determined for each Original Participating Manufacturer in such year as follows:

(i) For those Original Participating Manufacturers whose Relative Market Shares in the year immediately preceding the year in which the NPM Adjustment in question is applied exceed or are equal to their respective 1997 Relative Market Shares, the Base NPM Adjustment shall equal 0 (zero).

(ii) For those Original Participating Manufacturers whose Relative Market Shares in the year immediately preceding the year in which the NPM Adjustment in question is applied are less than their respective 1997 Relative Market Shares, the Base NPM Adjustment shall equal the result of (x) the difference between such Original Participating Manufacturer's Relative Market Share in such preceding year and its 1997 Relative Market Share multiplied by both (y) the number of individual Cigarettes (expressed in thousands of units) shipped in or to the United States, the District of Columbia and Puerto Rico by all the Original Participating Manufacturers in such preceding year (determined in accordance with subsection II(mm)) and (z) \$20 per each thousand units of Cigarettes (as this number is adjusted pursuant to subsection IX(d)(3)(C) below).

(iii) For those Original Participating Manufacturers whose Base NPM Adjustment, if calculated pursuant to subsection (ii) above, would exceed \$300 million (as this number is adjusted pursuant to subsection IX(d)(3)(C) below), the Base NPM Adjustment shall equal \$300 million (or such adjusted number, as provided in subsection IX(d)(3)(C) below).

(B) The share of the Available NPM Adjustment each Original Participating Manufacturer is entitled to shall be calculated as follows:

(i) If the Available NPM Adjustment the Original Participating Manufacturers are entitled to in any year is less than or equal to the sum of the Base NPM Adjustments of all Original Participating

Manufacturers in such year, then such Available NPM Adjustment shall be allocated among those Original Participating Manufacturers whose Base NPM Adjustment is not equal to 0 (zero) pro rata in proportion to their respective Base NPM Adjustments.

(i) If the Available NPM Adjustment the Original Participating Manufacturers are entitled to in any year exceeds the sum of the Base NPM Adjustments of all Original Participating Manufacturers in such year, then (x) the difference between such Available NPM Adjustment and such sum of the Base NPM Adjustments shall be allocated among the Original Participating Manufacturers pro rata in proportion to their Relative Market Shares (the applicable Relative Market Shares to be those in the year immediately preceding such year), and (y) each Original Participating Manufacturer's share of such Available NPM Adjustment shall equal the sum of (1) its Base NPM Adjustment for such year, and (2) the amount allocated to such Original Participating Manufacturer pursuant to clause (x).

(ii) If an Original Participating Manufacturer's share of the Available NPM Adjustment calculated pursuant to subsection IX(d)(3)(B)(i) or IX(d)(3)(B)(ii) exceeds such Original Participating Manufacturer's payment amount to which such NPM Adjustment applies (as such payment amount has been determined pursuant to step B of clause "Seventh" of subsection IX(f)), then (1) such Original Participating Manufacturer's share of the Available NPM Adjustment shall equal such payment amount, and (2) such excess shall be reallocated among the other Original Participating Manufacturers pro rata in proportion to their Relative Market Shares.

(C) Adjustments:

(i) For calculations made pursuant to this subsection IX(d)(3) (if any) with respect to payments due in the year 2000, the number used in subsection IX(d)(3)(A)(i)(2) shall be \$20 and the number used in subsection IX(d)(3)(A)(iii) shall be \$300 million. Each year thereafter, both these numbers shall be adjusted upward or downward by multiplying each of them by the quotient produced by dividing (x) the average revenue per Cigarette of all the Original Participating Manufacturers in the year immediately preceding such year, by (y) the average revenue per Cigarette of all the Original Participating Manufacturers in the year immediately preceding such year.

(ii) For purposes of this subsection, the average revenue per Cigarette of all the Original Participating Manufacturers in any year shall equal (x) the aggregate revenues of all the Original Participating Manufacturers from sales of Cigarettes in the fifty United States, the District of Columbia and Puerto Rico after Federal excise taxes and after payments pursuant to this Agreement and the tobacco litigation Settlement Agreements with the States of Florida, Mississippi, Minnesota and Texas (as such revenues are reported to the United States Securities and Exchange Commission ("SEC") for such year (either independently by the Original Participating Manufacturer or as part of consolidated financial statements reported to the SEC by an Affiliate of the Original 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 United States generally accepted accounting principles and audited by a nationally recognized accounting firm), divided by (y) the aggregate number of the individual Cigarettes shipped in or to the United States, the District of Columbia and Puerto Rico by all the Original Participating Manufacturers in such year (determined in accordance with subsection II(mm)).

(D) In the event that in the year immediately preceding the year in which the NPM Adjustment is applied both (x) the Relative Market Share of Lorillard Tobacco Company (or of its successor ("Lorillard") was less than or equal to 20.00000000%, and (y) the number of individual Cigarettes shipped in or to the United States, the District of Columbia and Puerto Rico by Lorillard (determined in accordance with subsection II(mm)) (for purposes of this subsection (D), "Volume") was less than or equal to 70 billion, Lorillard's and Philip Morris Incorporated's (or its successor's ("Philip Morris") shares of the Available NPM Adjustment calculated pursuant to subsections (3)(A)-(C) above shall be further reallocated between Lorillard and Philip Morris as follows (this subsection (3)(D) shall not apply in the year in which either of the two conditions specified in this sentence is not satisfied):

(i) Notwithstanding subsections (A)-(C) of this subsection (d)(3), but subject to further adjustment pursuant to subsections (D)(ii) and (D)(iii) below, Lorillard's share of the Available NPM Adjustment shall equal its Relative Market Share of such Available NPM Adjustment (the applicable Relative Market Share to be that in the year immediately preceding the year in which such NPM Adjustment is applied). The dollar amount of the difference between the share of the Available NPM Adjustment Lorillard is entitled to pursuant to the preceding sentence and the share of the Available NPM Adjustment it would be entitled to in the same year pursuant to subsections (d)(3)(A)-(C) shall be reallocated to Philip Morris and used to decrease or increase, as the case may be, Philip Morris's share of the Available NPM Adjustment in such year calculated pursuant to subsections (d)(3)(A)-(C).

(ii) In the event that in the year immediately preceding the year in which the NPM Adjustment is applied either (x) Lorillard's Relative Market Share was greater than 15.00000000% (but did not exceed 20.00000000%), or (y) Lorillard's Volume was greater than 50 billion (but did not exceed 70 billion), or both, Lorillard's share of the Available NPM Adjustment calculated pursuant to subsection (d)(3)(D)(i) shall be reduced by a percentage equal to the greater of (1) 10.00000000% for each percentage point (or fraction thereof) of excess of such Relative Market Share over 15.00000000% (if any), or (2) 2.50000000% for each billion (or fraction thereof) of excess of such Volume over 50 billion (if any). The dollar amount by which Lorillard's share of the Available NPM Adjustment is reduced in any year pursuant to this subsection (D)(ii) shall be reallocated to Philip Morris and used to increase Philip Morris's share of the Available NPM Adjustment in such year.

In the event that in any year a reallocation of the shares of the Available NPM Adjustment between Lorillard and Philip Morris pursuant to this subsection (d)(3)(D) results in Philip Morris's share of the Available NPM Adjustment in such year exceeding the greater of (x) Philip Morris's Relative Market Share of such Available NPM Adjustment (the applicable Relative Market Share to be that in the year immediately preceding such year), or (y) Philip Morris's share of the Available NPM Adjustment in such year calculated pursuant to subsections (d)(3)(A)-(C), Philip Morris's share of the Available NPM Adjustment in such year shall be reduced to equal the greater of (x) or (y) above. In such instance, the dollar amount by which Philip Morris's share of the Available NPM Adjustment is reduced pursuant to the preceding sentence shall be reallocated to Lorillard and used to increase Lorillard's share of the Available NPM Adjustment in such year.

(iv) In the event that either Philip Morris or Lorillard is treated as a Non-Participating Manufacturer for purposes of this subsection IX(d)(3) pursuant to subsection XVIII(w)(2)(A), this subsection (3)(D) shall not be applied, and the Original Participating Manufacturers' shares of the Available NPM Adjustment shall be determined solely as described in subsections (3)(A)-(C).

(4) NPM Adjustment for Subsequent Participating Manufacturers: Subject to the provisions of subsection IX(d)(3), a Subsequent Participating Manufacturer shall be entitled to an NPM Adjustment with respect to payments due from such Subsequent Participating Manufacturer in any year during which an NPM Adjustment is applicable under subsection (d)(1) above to payments due from the Original Participating Manufacturers. The amount of such NPM Adjustment shall equal the product of (A) the NPM Adjustment Percentage for such year multiplied by (B) the sum of the payments due in the year in question from such Subsequent Participating Manufacturer that correspond to payments due from Original Participating Manufacturers pursuant to subsection IX(c) (as such payment amounts due from such Subsequent Participating Manufacturer have been adjusted and allocated pursuant to clauses "First" through "Fifth" of subsection IX(f)). The NPM Adjustment to payments by each Subsequent Participating Manufacturer shall be allocated and reallocated among the Settling States in a manner consistent with subsection (d)(2) above.

(e) Supplemental Payments: Beginning on April 15, 2004, and on April 15 of each year thereafter in perpetuity, in the event that the sum of the Market Shares of the Participating Manufacturers that were Participating Manufacturers during the entire calendar year immediately preceding the year in which the payment in question would be due (the applicable Market Share to be that for the calendar year immediately preceding the year in which the payment in question would be due) equals or exceeds 99.05000000%, each Original Participating Manufacturer shall severally pay to the Escrow Agent (to be credited to the Subsection IX(e) Account) for the benefit of the Foundation its Relative Market Share of the base amount of \$300,000,000, as such payments are modified in accordance with this subsection (e). Such payments shall be utilized by the Foundation to fund the national public education functions of the Foundation described in subsection VI(f)(1), in the manner described in and subject to the provisions of subsections VI(g) and VI(h). The payments made by the Original Participating Manufacturers pursuant to this subsection shall be subject to the Inflation Adjustment, the Volume Adjustment, the Non-Settling States Reduction, and the offset for miscalculated or disputed payments described in subsection XI(f).

(f) Payment Responsibility: The payment obligations of each Participating Manufacturer pursuant to this Agreement shall be the several responsibility only of that Participating Manufacturer. The payment obligations of a Participating Manufacturer shall not be the obligation or responsibility of any Affiliate of such Participating Manufacturer. The payment obligations of a Participating Manufacturer shall not be the obligation or responsibility of any other Participating Manufacturer. Provided, however, that no provision of this Agreement shall waive or excuse liability under any state or federal fraudulent conveyance or fraudulent transfer law. Any Participating Manufacturer whose Market Share (or Relative Market Share) in any given year equals zero shall have no payment obligations under this Agreement in the succeeding year.

(g) Corporate Structures: Due to the particular corporate structures of R.J. Reynolds Tobacco Company ("Reynolds") and Brown & Williamson Tobacco Corporation ("B&W") with respect to their non-domestic tobacco operations, Reynolds and B&W shall be severally liable for their respective shares of each payment due pursuant to this Agreement up to (and their liability hereunder shall not exceed) the full extent of their assets used in and earnings derived from, the manufacture and/or sale in the States of Tobacco Products intended for domestic consumption, and no recourse shall be had against any of their other assets or earnings to satisfy such obligations.

(h) Accrual of Interest: Except as expressly provided otherwise in this Agreement, any payment due hereunder and not paid when due (or payments requiring the accrual of interest under subsection XI(d)) shall accrue interest from and including the date such payment is due until (but not including) the date paid at the Prime Rate plus three percentage points.

(i) Payments by Subsequent Participating Manufacturers:

(1) A Subsequent Participating Manufacturer shall have payment obligations under this Agreement only in the event that its Market Share in any calendar year exceeds the greater of (1) its 1998 Market Share or (2) 125 percent of its 1997 Market Share (subject to the provisions of subsection (i)(4)). In the year following any such calendar year, such Subsequent Participating Manufacturer shall make payments corresponding to those due in that same following year from the Original Participating Manufacturers pursuant to subsections VI(c) (except for the payment due on March 31, 1999), IX(c)(1), IX(c)(2) and IX(e). The amount of such corresponding payments by a Subsequent Participating Manufacturer are as described in the corresponding payments that are due from the Original Participating Manufacturers and shall be determined as described in subsections (2) and (3) below. Such payments by a Subsequent Participating Manufacturer shall (A) be due on the same dates as the corresponding payments are due from Original Participating Manufacturers; (B) be for the same

purpose as such corresponding payments; and (C) be paid, allocated and distributed in the same manner as such corresponding payments.

(2) The base amount due from a Subsequent Participating Manufacturer on any given date shall be determined by multiplying (A) the corresponding base amount due on the same date from all of the Original Participating Manufacturers (as such base amount is specified in the corresponding subsection of this Agreement and is adjusted by the Volume Adjustment (except for the provisions of subsection (B)(ii) of Exhibit E), but before such base amount is modified by any other adjustments, reductions or offsets) by (B) the quotient produced by dividing (i) the result of (x) such Subsequent Participating Manufacturer's applicable Market Share (the applicable Market Share being that for the calendar year immediately preceding the year in which the payment in question is due) minus (y) the greater of (j) its 1998 Market Share or (z) 125 percent of its 1997 Market Share, by (ii) the aggregate Market Shares of the Original Participating Manufacturers (the applicable Market Shares being those for the calendar year immediately preceding the year in which the payment in question is due).

(3) Any payment due from a Subsequent Participating Manufacturer under subsections (1) and (2) above shall be subject (up to the full amount of such payment) to the Inflation Adjustment, the Non-Settling States Reduction, the NPM Adjustment, the offset for miscalculated or disputed payments described in subsection X(f), the Federal Tobacco Legislation Offset, the Litigating Releasing Parties Offset and the offsets for claims over described in subsections XI(a)(4)(B) and XII(a)(8), to the extent that such adjustments, reductions or offsets would apply to the corresponding payment due from the Original Participating Manufacturers. Provided, however, that all adjustments and offsets to which a Subsequent Participating Manufacturer is entitled may only be applied against payments by such Subsequent Participating Manufacturer, if any, that are due within 12 months after the date on which the Subsequent Participating Manufacturer becomes entitled to such adjustment or makes the payment that entitles it to such offset, and shall not be carried forward beyond that time even if not fully used.

(4) For purposes of this subsection (i), the 1997 (or 1998, as applicable) Market Share (and 125 percent thereof) of those Subsequent Participating Manufacturers that either (A) became a signatory to this Agreement more than 60 days after the MSA Execution Date or (B) had no Market Share in 1997 (or 1998, as applicable), shall equal zero.

(i) Order of Application of Allocations, Offsets, Reductions and Adjustments. The payments due under this Agreement shall be calculated as set forth below. The "base amount" referred to in clause "First" below shall mean (1) in the case of payments due from Original Participating Manufacturers, the base amount referred to in the subsection establishing the payment obligation in question; and (2) in the case of payments due from a Subsequent Participating Manufacturer, the base amount referred to in subsection (i)(2) for such Subsequent Participating Manufacturer. In the event that a particular adjustment, reduction or offset referred to in a clause below does not apply to the payment being calculated, the result of the clause in question shall be deemed to be equal to the result of the immediately preceding clause. (If clause "First" is inapplicable, the result of clause "First" will be the base amount of the payment in question prior to any offsets, reductions or adjustments.)

**First:** the Inflation Adjustment shall be applied to the base amount of the payment being calculated;  
**Second:** the Volume Adjustment (other than the provisions of subsection (B)(iii) of Exhibit E) shall be applied to the result of clause "First";

**Third:** the result of clause "Second" shall be reduced by the Previously Settled States Reduction;

**Fourth:** the result of clause "Third" shall be reduced by the Non-Settling States Reduction;

**Fifth:** in the case of payments due under subsections IX(c)(1) and IX(c)(2), the results of clause "Fourth" for each such payment due in the calendar year in question shall be apportioned among the Settling States pro rata in proportion to their respective Allocable Shares, and the resulting amounts for each particular Settling State shall then be added together to form such Settling State's Allocated Payment. In the case of payments due under subsection IX(f) that correspond to payments due under subsections IX(c)(1) or IX(c)(2), the results of clause "Fourth" for all such payments due from a particular Subsequent Participating Manufacturer in the calendar year in question shall be apportioned among the Settling States pro rata in proportion to their respective Allocable Shares, and the resulting amounts for each particular Settling State shall then be added together. (In the case of all other payments made pursuant to this Agreement, this clause "Fifth" is inapplicable.);

**Sixth:** the NPM Adjustment shall be applied to the results of clause "Fifth" pursuant to subsections IX(d)(1) and (d)(2) (or, in the case of payments due from the Subsequent Participating Manufacturers, pursuant to subsection IX(d)(4));

**Seventh:** in the case of payments due from the Original Participating Manufacturers to which clause "Fifth" (and therefore clause "Sixth") does not apply, the result of clause "Fourth" shall be allocated among the Original Participating Manufacturers according to their Relative Market Shares. In the case of payments due from the Original Participating Manufacturers to which clause "Fifth" applies: (A) the Allocated Payments of all Settling States determined pursuant to clause "Fifth" (prior to reduction pursuant to clause "Sixth") shall be added together; (B) the resulting sum shall be allocated among the Original Participating Manufacturers according to their Relative Market Shares and subsection (B)(iii) of Exhibit E hereto (if such subsection is applicable); (C) the Available NPM Adjustment (as determined pursuant to clause "Sixth") shall be allocated among the Original Participating Manufacturers pursuant to subsection IX(d)(3); (D) the respective result of step (C) above for each Original Participating Manufacturer shall be subtracted from the respective result of step (B) above

for such Original Participating Manufacturer; and (E) the resulting payment amount due from each Original Participating Manufacturer shall then be allocated among the Settling States in proportion to the respective results of clause "Sixth" for each Settling State. The offsets described in clauses "Eighth" through "Twelfth" shall then be applied separately against each Original Participating Manufacturer's resulting payment shares (on a Settling State by Settling State basis) according to each Original Participating Manufacturer's separate entitlement to such offsets, if any, in the calendar year in question. (In the case of payments due from Subsequent Participating Manufacturers, this clause "Seventh" is inapplicable.)

**Eighth:** the offset for miscalculated or disputed payments described in subsection X(f) (and any carry-forwards arising from such offset) shall be applied to the results of clause "Seventh" (in the case of payments due from the Original Participating Manufacturers) or to the results of clause "Sixth" (in the case of payments due from Subsequent Participating Manufacturers);

**Ninth:** the Federal Tobacco Legislation Offset (including any carry-forwards arising from such offset) shall be applied to the results of clause "Eighth";

**Tenth:** the Litigating Releasing Parties Offset (including any carry-forwards arising from such offset) shall be applied to the results of clause "Ninth";

**Eleventh:** the offset for claims over pursuant to subsection XI(a)(4)(B) (including any carry-forwards arising from such offset) shall be applied to the results of clause "Tenth";

**Twelfth:** the offset for claims over pursuant to subsection XII(a)(8) (including any carry-forwards arising from such offset) shall be applied to the results of clause "Eleventh"; and

**Thirteenth:** in the case of payments to which clause "Fifth" applies, the Settling States' allocated shares of the payments due from each Participating Manufacturer (as such shares have been determined in step (E) of clause "Seventh" in the case of payments from the Original Participating Manufacturers or in clause "Sixth" in the case of payments from the Subsequent Participating Manufacturers, and have been reduced by clauses "Eighth" through "Twelfth") shall be added together to state the aggregate payment obligation of each Participating Manufacturer with respect to the payments in question. (In the case of a payment to which clause "Fifth" does not apply, the aggregate payment obligation of each Participating Manufacturer with respect to the payment in question shall be stated by the results of clause "Eighth.")

#### X. EFFECT OF FEDERAL TOBACCO-RELATED LEGISLATION

(a) If federal tobacco-related legislation is enacted after the MSA Execution Date and on or before November 30, 2002, and if such legislation provides for payment(s) by any Original Participating Manufacturer (whether by settlement payment, tax or any other means), all or part of which are actually made available to a Settling State ("Federal Funds"), each Original Participating Manufacturer shall receive a continuing dollar-for-dollar offset for any and all amounts that are paid by such Original Participating Manufacturer pursuant to such legislation and actually made available to such Settling State (except as described in subsections (b) and (c) below). Such offset shall be applied against the applicable Original Participating Manufacturer's share (determined as described in step E of clause "Seventh" of subsection IX(f)) of such Settling State's Allocated Payment, up to the full amount of such Original Participating Manufacturer's share of such Allocated Payment (as such share had been reduced by adjustment, if any, pursuant to the NPM Adjustment and has been reduced by offset, if any, pursuant to the offset for miscalculated or disputed payments). Such offset shall be made against such Original Participating Manufacturer's share of the first Allocated Payment due after such Federal Funds are first available for receipt by such Settling State. In the event that such offset would in any given year exceed such Original Participating Manufacturer's share of such Allocated Payment: (1) the offset to which such Original Participating Manufacturer is entitled under this section in such year shall be the full amount of such Original Participating Manufacturer's share of such Allocated Payment, and (2) all amounts not offset by reason of subsection (1) shall carry forward and be offset in the following year(s) until all such amounts have been offset.

(b) The offset described in subsection (a) shall apply only to that portion of Federal Funds, if any, that are either unrestricted as to their use, or restricted to any form of health care or to any use related to tobacco (including, but not limited to, tobacco education, cessation, control or enforcement) (other than that portion of Federal Funds, if any, that is specifically applicable to tobacco growers or communities dependent on the production of tobacco or Tobacco Products). Provided, however, that the offset described in subsection (a) shall not apply to that portion of Federal Funds, if any, whose receipt by such Settling State is conditioned upon or appropriately allocable to:

- (1) the relinquishment of rights or benefits under this Agreement (including the Consent Decree); or
- (2) actions or expenditures by such Settling State, unless:

- (A) such Settling State chooses to undertake such action or expenditure;
- (B) such actions or expenditures do not impose significant constraints on public policy choices; or
- (C) such actions or expenditures are both: (i) related to health care or tobacco (including, but not limited to, tobacco education, cessation, control or enforcement) and (ii) do not require such Settling State to expend state matching funds in an amount that is significant in relation to the amount of the Federal Funds made available to such Settling State.

(c) Subject to the provisions of subsection IX(d)(3), Subsequent Participating Manufacturers shall be entitled to the offset described in this section X to the extent that they are required to pay Federal Funds that would give rise to an offset under subsections (a) and (b) if paid by an Original Participating Manufacturer.

(d) Nothing in this section X shall (1) reduce the payments to be made to the Settling States under this Agreement or (2) alter the Allocable Share used to determine each Settling State's share of the payments described in subsection IX(c) or corresponding payments under subsection IX(f) of this Agreement. Nothing in this section X is intended to or shall reduce the total amounts payable by the Participating Manufacturers to the Settling States under this Agreement by an amount greater than the amount of Federal Funds that the Settling States could elect to receive.

#### XI. CALCULATION AND DISBURSEMENT OF PAYMENTS

##### (a) Independent Auditor to Make All Calculations.

(1) Beginning with payments due in the year 2000, an Independent Auditor shall calculate and determine the amount of all payments owed pursuant to this Agreement, the adjustments, reductions and offsets thereto (and all resulting carry-forwards, if any), the allocation of such payments, adjustments, reductions, offsets and carry-forwards among the Participating Manufacturers and among the Settling States, and shall perform all other calculations in connection with the foregoing (including, but not limited to, determining Market Share, Relative Market Share, Base, Aggregate Participating Manufacturer Market Share and Actual Aggregate Participating Manufacturer Market Share). The Independent Auditor shall promptly collect all information necessary to make such calculations and determinations. Each Participating Manufacturer and each Settling State shall provide the Independent Auditor, as promptly as practicable, with information in its possession or readily available to it necessary for the Independent Auditor to perform such calculations. The Independent Auditor shall agree to maintain the confidentiality of all such information, except that the Independent Auditor may provide such information to Participating Manufacturers and the Settling States as set forth in this Agreement. The Participating Manufacturers and the Settling States agree to maintain the confidentiality of such information.

(2) Payments due from the Original Participating Manufacturers prior to January 1, 2000 (other than the first payment due pursuant to subsection IX(b)) shall be based on the 1998 Relative Market Shares of the Original Participating Manufacturers or, if the Original Participating Manufacturers are unable to agree on such Relative Market Shares, on their 1997 Relative Market Shares specified in Exhibit Q.

(b) Identity of Independent Auditor. The Independent Auditor shall be a major, nationally recognized, certified public accounting firm jointly selected by agreement of the Original Participating Manufacturers and those Attorneys General of the Settling States who are members of the NAAG executive committee, who shall jointly retain the power to replace the Independent Auditor and appoint its successor. Fifty percent of the costs and fees of the Independent Auditor (but in no event more than \$500,000 per annum), shall be paid by the Fund described in Exhibit J hereto, and the balance of such costs and fees shall be paid by the Original Participating Manufacturers, allocated among them according to their Relative Market Shares. The agreement retaining the Independent Auditor shall provide that the Independent Auditor shall perform the functions specified for it in this Agreement, and that it shall do so in the manner specified in this Agreement.

(c) Resolution of Disputes. Any dispute, controversy or claim arising out of or relating to calculations performed by, or any determinations made by, the Independent Auditor (including, without limitation, any dispute concerning the operation or application of any of the adjustments, reductions, offsets, carry-forwards and allocations described in subsection IX(j) or subsection XI(f)) shall be submitted to binding arbitration before a panel of three neutral arbitrators, each of whom shall be a former Article III federal judge. Each of the two sides to the dispute shall select one arbitrator. The two arbitrators so selected shall select the third arbitrator. The arbitration shall be governed by the United States Federal Arbitration Act.

##### (d) General Provisions as to Calculation of Payments.

(1) Not less than 90 days prior to the scheduled due date of any payment due pursuant to this Agreement ("Payment Due Date"), the Independent Auditor shall deliver to each other Notice Party a detailed itemization of all information required by the Independent Auditor to complete its calculation of (A) the amount due from each Participating Manufacturer with respect to such payment, and (B) the portion of such amount allocable to each entity for whose benefit such payment is to be made. To the extent practicable, the Independent Auditor shall specify in such itemization which Notice Party is requested to produce which information. Each Participating Manufacturer and each Settling State shall use its best efforts to promptly supply all of the required information that is within its possession or is readily available to it to the Independent Auditor, and in any event not less than 50 days prior to such Payment Due Date. Such best efforts obligation shall be continuing in the case of information that comes within the possession of, or becomes readily available to, any Settling State or Participating Manufacturer after the date 50 days prior to such Payment Due Date.

(2) Not less than 40 days prior to the Payment Due Date, the Independent Auditor shall deliver to each other Notice Party (A) a detailed preliminary calculations ("Preliminary Calculations") of the amount due from each Participating Manufacturer and of the amount allocable to each entity for whose benefit such payment is to be made, showing all applicable offsets, adjustments, reductions and carry-forwards and setting forth all the information on which the Independent Auditor relied in preparing such Preliminary Calculations, and (B) a statement of any information still required by the Independent Auditor to complete its calculations.

(3) Not less than 30 days prior to the Payment Due Date, any Participating Manufacturer or any Settling State that disputes any aspect of the Preliminary Calculations (including, but not limited to, disputing the methodology that the Independent Auditor employed, or the information on which the Independent Auditor relied, in preparing such calculations) shall notify each other Notice Party of such dispute, including the reasons and basis therefor.

(4) Not less than 15 days prior to the Payment Due Date, the Independent Auditor shall deliver to each other Notice Party a detailed recalculation (a "Final Calculation") of the amount due from each Participating Manufacturer, the amount allocable to each entity for whose benefit such payment is to be made, and the Account to which such payment is to be credited, explaining any changes from the Preliminary Calculation. The Final Calculation may include estimates of amounts in the circumstances described in subsection (d)(5).

(5) The following provisions shall govern in the event that the information required by the Independent Auditor to complete its calculations is not in its possession by the date as of which the Independent Auditor is required to provide either a Preliminary Calculation or a Final Calculation.

(A) If the information in question is not readily available to any Settling State, any Original Participating Manufacturer or any Subsequent Participating Manufacturer, the Independent Auditor shall employ an assumption as to the missing information producing the minimum amount that is likely to be due with respect to the payment in question, and shall set forth its assumption as to the missing information in its Preliminary Calculation or Final Calculation, whichever is at issue. Any Original Participating Manufacturer, Subsequent Participating Manufacturer or Settling State may dispute any such assumption employed by the Independent Auditor in its Preliminary Calculation in the manner prescribed in subsection (d)(3) or any such assumption employed by the Independent Auditor in its Final Calculation in the manner prescribed in subsection (d)(6). If the missing information becomes available to the Independent Auditor prior to the Payment Due Date, the Independent Auditor shall promptly revise its Preliminary Calculation or Final Calculation (whichever is applicable) and shall promptly provide the revised calculation to each Notice Party, showing the newly available information. If the missing information does not become available to the Independent Auditor prior to the Payment Due Date, the minimum amount calculated by the Independent Auditor pursuant to this subsection (A) shall be paid on the Payment Due Date, subject to disputes pursuant to subsections (d)(6) and (d)(8) and without prejudice to a later final determination of the correct amount. If the missing information becomes available to the Independent Auditor after the Payment Due Date, the Independent Auditor shall calculate the correct amount of the payment in question and shall apply any overpayment or underpayment as an offset or additional payment in the manner described in subsection (f).

(B) If the information in question is readily available to a Settling State, Original Participating Manufacturer or Subsequent Participating Manufacturer, but such Settling State, Original Participating Manufacturer or Subsequent Participating Manufacturer does not supply such information to the Independent Auditor, the Independent Auditor shall base the calculation on its best estimate of such information, and shall show such estimate in its Preliminary Calculation or Final Calculation, whichever is applicable. Any Original Participating Manufacturer, Subsequent Participating Manufacturer or Settling State (except the entity that withheld the information) may dispute such estimate employed by the Independent Auditor in its Preliminary Calculation in the manner prescribed in subsection (d)(3) or such estimate employed by the Independent Auditor in its Final Calculation in the manner prescribed in subsection (d)(6). If the withheld information is not made available to the Independent Auditor more than 30 days prior to the Payment Due Date, the estimate employed by the Independent Auditor (as revised by the Independent Auditor in light of any dispute filed pursuant to the preceding sentence) shall govern the amounts to be paid on the Payment Due Date, subject to disputes pursuant to subsection (d)(6) and without prejudice to a later final determination of the correct amount. In the event that the withheld information subsequently becomes available, the Independent Auditor shall calculate the correct amount and shall apply any overpayment or underpayment as an offset or additional payment in the manner described in subsection (f).

(6) Not less than five days prior to the Payment Due Date, each Participating Manufacturer and each Settling State shall deliver to each Notice Party a statement indicating whether it disputes the Independent Auditor's Final Calculation and, if so, the disputed and undisputed amounts and the basis for the dispute. Except to the extent a Participating Manufacturer or a Settling State delivers a statement indicating the existence of a dispute by such date, the amounts set forth in the Independent Auditor's Final Calculation shall be paid on the Payment Due Date. Provided, however, that (A) in the event that the Independent Auditor revises its Final Calculation within five days of the Payment Due Date as provided in subsection (5)(A) due to receipt of previously missing information, a Participating Manufacturer or Settling State may dispute such revision pursuant to the procedure set forth in this subsection (6) at any time prior to the Payment Due Date; and (B) prior to the date four years after the Payment Due Date, neither failure to dispute a calculation made by the Independent Auditor nor actual agreement with any calculation or payment to the Escrow Agent or to another payee shall waive any Participating Manufacturer's or Settling State's rights to dispute any payment for the Independent Auditor's calculations with respect to any payment after the Payment Due Date. No Participating Manufacturer and no Settling State shall have a right to raise any dispute with respect to any payment or calculation after the date four years after such payment's Payment Due Date.

(7) Each Participating Manufacturer shall be obligated to pay by the Payment Due Date the undisputed portion of the total amount calculated as due from it by the Independent Auditor's Final Calculation. Failure to pay such portion shall render the Participating Manufacturer liable for interest thereon as provided in subsection IX(h) of this Agreement, in addition to any other remedy available under this Agreement.

(8) As to any disputed portion of the total amount calculated to be due pursuant to the Final Calculation, any Participating Manufacturer that by the Payment Due Date pays such disputed portion into the Disputed Payments Account (as defined in the Escrow Agreement) shall not be liable for interest thereon even if the amount disputed was in fact properly due and owing. Any Participating Manufacturer that by the Payment Due Date does not pay such disputed portion into the Disputed Payments Account shall be liable for interest as provided in subsection IX(b) if the amount disputed was in fact properly due and owing.

(9) On the same date that it makes any payment pursuant to this Agreement, each Participating Manufacturer shall deliver a notice to each other Notice Party showing the amount of such payment and the Account to which such payment is to be credited.

(10) On the first Business Day after the Payment Due Date, the Escrow Agent shall deliver to each other Notice Party a statement showing the amounts received by it from each Participating Manufacturer and the Accounts credited with such amounts.

(e) **General Treatment of Payments.** The Escrow Agent may disburse amounts from an Account only if permitted, and only at such time as permitted, by this Agreement and the Escrow Agreement. No amounts may be disbursed to a Settling State other than funds credited to such Settling State's State-Specific Account (as defined in the Escrow Agreement). The Independent Auditor, in delivering payment instructions to the Escrow Agent, shall specify: the amount to be paid; the Account or Accounts from which such payment is to be disbursed; the payee of such payment (which may be an Account); and the Business Day on which such payment is to be made by the Escrow Agent. Except as expressly provided in subsection (f) below, in no event may any amount be disbursed from any Account prior to Final Approval.

(f) **Disbursements and Charges Not Contingent on Final Approval.** Funds may be disbursed from Accounts without regard to the occurrence of Final Approval in the following circumstances and in the following manner:

(1) **Payments of Federal and State Taxes.** Federal, state, local or other taxes imposed with respect to the amounts credited to the Accounts shall be paid from such amounts. The Independent Auditor shall prepare and file any tax returns required to be filed with respect to the escrow. All taxes required to be paid shall be allocated to and charged against the Accounts on a reasonable basis to be determined by the Independent Auditor. Upon receipt of written instructions from the Independent Auditor, the Escrow Agent shall pay such taxes and charge such payments against the Account or Accounts specified in those instructions.

(2) **Payments to and from Disputed Payments Account.** The Independent Auditor shall instruct the Escrow Agent to credit funds from an Account to the Disputed Payments Account when a dispute arises as to such funds, and shall instruct the Escrow Agent to credit funds from the Disputed Payments Account to the appropriate payee when such dispute is resolved with finality. The Independent Auditor shall provide the Notice Parties not less than 10 Business Days prior notice before instructing the Escrow Agent to disburse funds from the Disputed Payments Account.

(3) **Payments to a State-Specific Account.** Promptly following the occurrence of State-Specific Finality in any Settling State, such Settling State and the Original Participating Manufacturers shall notify the Independent Auditor of such occurrence. The Independent Auditor shall promptly thereafter notify each Notice Party of such State-Specific Finality and of the portions of the amounts in the Subsection IX(b) Account (First), Subsection IX(c)(2) Account (Subsequent), Subsection IX(c)(1) Account and Subsection IX(c)(2) Account, respectively (as such Accounts are defined in the Escrow Agreement), that are at such time held in such Accounts for the benefit of such Settling State, and which are to be transferred to the appropriate State-Specific Account for such Settling State. If neither the Settling State in question nor any Participating Manufacturer disputes such amounts or the occurrence of such State-Specific Finality by notice delivered to the appropriate State-Specific Account for such Settlement State, the Independent Auditor shall promptly instruct the Escrow Agent to credit the amount disputed to the Disputed Payments Account and the undisputed portion to the appropriate State-Specific Account. No amounts may be transferred or credited to a State-Specific Account for the benefit of any State as to which State-Specific Finality has not occurred or as to which this Agreement has terminated.

(4) **Payments to Parties other than Particular Settling States.**

(A) Promptly following the occurrence of State-Specific Finality in one Settling State, such Settling State and the Original Participating Manufacturers shall notify the Independent Auditor of such occurrence. The Independent Auditor shall promptly thereafter notify each Notice Party of the occurrence of State-Specific Finality in at least one Settling State and of the amounts held in the Subsection VI(b) Account, Subsection VI(c) Account (First), and Subsection VIII(c) Account (as such Accounts are defined in the Escrow Agreement), if any. If neither any of the Settling States nor any of the Participating Manufacturers disputes such amounts or disputes the occurrence of State-Specific Finality in one Settling State, by notice delivered to each Notice Party not later than ten Business Days after delivery by the Independent Auditor of the notice described in the preceding sentence, the Independent Auditor shall promptly instruct the Escrow Agent to disburse the funds held in such Accounts to the Foundation or to the Fund specified in subsection VII(c), as appropriate. If any Settling State or Participating Manufacturer disputes such amounts or the occurrence of such State-Specific Finality by notice delivered to each other Notice Party not later than 10 Business Days after delivery by the

Independent Auditor of the notice described in the second sentence of this subsection (4)(A), the Independent Auditor shall promptly instruct the Escrow Agent to credit the amounts disputed to the Disputed Payments Account and to disburse the undisputed portion to the Foundation or to the Fund specified in subsection VIII(c), as appropriate.

(B) The Independent Auditor shall instruct the Escrow Agent to disburse funds on deposit in the Subsection VII(b) Account and Subsection IX(e) Account (as such Accounts are defined in the Escrow Agreement) to NAAAG or to the Foundation, as appropriate, within 10 Business Days after the date on which such amounts were credited to such Accounts.

(C) Promptly following the occurrence of State-Specific Finality in Settling States having aggregate Allocable Shares equal to at least 80% of the total aggregate Allocable Shares assigned to all States that were Settling States as of the MSA Execution Date, the Settling States and the Original Participating Manufacturers shall notify the Independent Auditor of such occurrence. The Independent Auditor shall promptly thereafter notify each Notice Party of the occurrence of such State-Specific Finality and of the amounts held in the Subsection VI(c) Account (Subsequent) (as such Account is defined in the Escrow Agreement), if any. If neither any of the Settling States nor any of the Participating Manufacturers disputes such amounts or disputes the occurrence of such State-Specific Finality, by notice delivered to each Notice Party not later than 10 Business Days after delivery by the Independent Auditor of the notice described in the preceding sentence, the Independent Auditor shall promptly instruct the Escrow Agent to disburse the funds held in such Account to the Foundation. If any Settling State or Participating Manufacturer disputes such amounts or the occurrence of such State-Specific Finality by notice delivered to each other Notice Party not later than 10 Business Days after delivery by the Independent Auditor of the notice described in the second sentence of this subsection (4)(C), the Independent Auditor shall promptly instruct the Escrow Agent to credit the amounts disputed to the Disputed Payments Account and to disburse the undisputed portion to the Foundation.

(5) **Treatment of Payments Following Termination.**

(A) **As to amounts held for Settling States.** Promptly upon the termination of this Agreement with respect to any Settling State (whether or not as part of the termination of this Agreement as to all Settling States) such State or any Participating Manufacturer shall notify the Independent Auditor of such occurrence. The Independent Auditor shall promptly thereafter notify each Notice Party of such termination and of the amounts held in the Subsection IX(b) Account (First), the Subsection IX(b) Account (Subsequent), the Subsection IX(c)(1) Account, the Subsection IX(c)(2) Account, and the State-Specific Account for the benefit of such Settling State. If neither the State in question nor any Participating Manufacturer disputes such amounts or the occurrence of such termination by notice delivered to each other Notice Party not later than 10 Business Days after delivery by the Independent Auditor of the notice described in the preceding sentence, the Independent Auditor shall promptly instruct the Escrow Agent to transfer such amounts to the Participating Manufacturers (on the basis of their respective contributions of such funds). If the State in question or any Participating Manufacturer disputes the amounts held in the Accounts or the occurrence of such termination by notice delivered to each other Notice Party not later than 10 Business Days after delivery by the Independent Auditor of the notice described in the second sentence of this subsection (5)(A), the Independent Auditor shall promptly instruct the Escrow Agent to transfer the amount disputed to the Disputed Payments Account and the undisputed portion to the Participating Manufacturers (on the basis of their respective contributions of such funds).

(B) **As to amounts held for others.** If this Agreement is terminated with respect to all of the Settling States, the Original Participating Manufacturers shall promptly notify the Independent Auditor of such occurrence. The Independent Auditor shall promptly thereafter notify each Notice Party of such termination and of the amounts held in the Subsection VI(b) Account, the Subsection VI(c) Account (First), the Subsection VIII(b) Account, the Subsection VIII(c) Account and the Subsection IX(e) Account. If neither any such State nor any Participating Manufacturer disputes such amounts or the occurrence of such termination by notice delivered to each other Notice Party not later than 10 Business Days after delivery by the Independent Auditor of the notice described in the preceding sentence, the Independent Auditor shall promptly instruct the Escrow Agent to transfer such amounts to the Participating Manufacturers (on the basis of their respective contributions of such funds). If any such State or any Participating Manufacturer disputes the amounts held in the Accounts or the occurrence of such termination by notice delivered to each other Notice Party not later than 10 Business Days after delivery by the Independent Auditor of the notice described in the second sentence of this subsection (5)(B), the Independent Auditor shall promptly instruct the Escrow Agent to credit the amount disputed to the Disputed Payments Account and transfer the undisputed portion to the Participating Manufacturers (on the basis of their respective contributions of such funds).

(C) **As to amounts held in the Subsection VI(c) Account (Subsequent).** If this Agreement is terminated with respect to Settling States having aggregate Allocable Shares equal to more than 20% of the total aggregate Allocable Shares assigned to those States that were Settling States as of the MSA Execution Date, the Original Participating Manufacturers shall promptly notify the Independent Auditor of such occurrence. The Independent Auditor shall promptly thereafter notify each Notice Party of such termination and of the amounts held in the Subsection VI(c) Account (Subsequent) (as defined in the Escrow Agreement). If neither any such State with respect to which this Agreement has terminated nor any Participating Manufacturer disputes such amounts or the occurrence of such termination by notice delivered to each other Notice Party not later than 10 Business Days after delivery by the Independent Auditor of the notice described in the preceding sentence, the Independent Auditor shall promptly instruct the Escrow Agent to transfer such amounts to the Participating Manufacturers (on the basis of their respective contributions of such funds). If any such State or

any Participating Manufacturer disputes the amounts held in the Account or the occurrence of such termination by notice delivered to each other Notice Party not later than 10 Business Days after delivery by the Independent Auditor of the notice described in the second sentence of this subsection (5)(C), the Independent Auditor shall promptly instruct the Escrow Agent to credit the amount disputed to the Disputed Payments Account and transfer the undisputed portion to the Participating Manufacturer (on the basis of their respective contribution of such funds).

(6) Determination of amounts paid or held for the benefit of each individual Settling State. For purposes of subsections (f)(3), (f)(5)(A) and (f)(2), the portion of a payment that is made or held for the benefit of each individual Settling State shall be determined: (A) in the case of a payment credited to the Subsection IX(b) Account (First) or the Subsection IX(b) Account (Subsequent), by allocating the results of clause "Eighth" of subsection IX(j) among those Settling States who were Settling States at the time that the amount of such payment was calculated, pro rata in proportion to their respective Allocable Shares; and (B) in the case of a payment credited to the Subsection IX(c)(1) Account or the Subsection IX(c)(2) Account, by the results of clause "Twelfth" of subsection IX(j) for each individual Settling State. Provided, however, that, solely for purposes of subsection (f)(3), the Settling States may by unanimous agreement agree on a different method of allocation of amounts held in the Accounts identified in this subsection (f)(6).

(g) Payments to be Made Only After Final Approval. Promptly following the occurrence of Final Approval, the Settling States and the Original Participating Manufacturers shall notify the Independent Auditor of such occurrence. The Independent Auditor shall promptly thereafter notify each Notice Party of the occurrence of Final Approval and of the amounts held in the State-Specific Accounts. If neither any of the Settling States nor any of the Participating Manufacturers disputes such amounts, disputes the occurrence of Final Approval or claims that this Agreement has terminated as to any Settling State for whose benefit the funds are held in a State-Specific Account, by notice delivered to each other Notice Party not later than 10 Business Days after delivery by the Independent Auditor of such notice of Final Approval, the Independent Auditor shall promptly instruct the Escrow Agent to credit the amounts disputed to the Disputed Payments Account and to disburse the undisputed portion to (or as directed by) the respective Settling States.

(h) Applicability to Section XVII Payments. This section XI shall not be applicable to payments made pursuant to section XVII; provided, however, that the Independent Auditor shall be responsible for calculating Relative Market Shares in connection with such payments, and the Independent Auditor shall promptly provide the results of such calculation to any Original Participating Manufacturer or Settling State that requests it to do so.

(i) Miscalculated or Disputed Payments.

(1) Underpayments.

(A) If information becomes available to the Independent Auditor not later than four years after a Payment Due Date, and such information shows that any Participating Manufacturer was instructed to make an insufficient payment on such date ("original payment"), the Independent Auditor shall promptly determine the additional payment owed by such Participating Manufacturer and the allocation of such additional payment among the applicable payees. The Independent Auditor shall then reduce such additional payment (up to the full amount of such additional payment) by any adjustments or offsets that were available to the Participating Manufacturer in question against the original payment at the time it was made (and have not since been used) but which such Participating Manufacturer was unable to use against such original payment because such adjustments or offsets were in excess of such original payment (provided that any adjustments or offsets used against such additional payment shall reduce on a dollar-for-dollar basis any remaining carry-forward held by such Participating Manufacturer with respect to such adjustment or offset). The Independent Auditor shall then add interest at the Prime Rate (calculated from the Payment Due Date in question) to the additional payment (as reduced pursuant to the preceding sentence), except that where the additional payment owed by a Participating Manufacturer is the result of an underpayment by such Participating Manufacturer caused by such Participating Manufacturer's withholding of information as described in subsection (d)(5)(B), the applicable interest rate shall be that described in subsection IX(h). The Independent Auditor shall promptly give notice of the additional payment owed by the Participating Manufacturer in question (as reduced and/or increased as described above) to all Notice Parties, showing the new information and all calculations. Upon receipt of such notice, any Participating Manufacturer or Settling State may dispute the Independent Auditor's calculations in the manner described in subsection (d)(3), and the Independent Auditor shall promptly notify each Notice Party of any subsequent revisions to its calculations. Not more than 15 days after receipt of such notice (or, if the Independent Auditor revises its calculations, not more than 15 days after receipt of the revisions), any Participating Manufacturer and any Settling State may dispute the Independent Auditor's calculations in the manner prescribed in subsection (d)(6). Failure to dispute the Independent Auditor's calculations in this manner shall constitute agreement with the Independent Auditor's calculations, subject to the limitations set forth in subsection (d)(6). Payment of the undisputed portion of an additional payment shall be made to the Escrow Agent not more than 20 days after receipt of the notice described in this subsection (A) (or, if the Independent Auditor revises its calculations, not more than 20 days after receipt of the revisions). Failure to pay such portion shall render the Participating Manufacturer liable for interest thereon as provided in subsection IX(h). Payment of the disputed portion shall be governed by subsection (d)(8).

(B) To the extent a dispute as to a prior payment is resolved with finality against a Participating Manufacturer: (i) in the case where the disputed amount has been paid into the Disputed Payments Account pursuant to subsection (d)(8), the Independent Auditor shall instruct the Escrow Agent to transfer such amount to the applicable payee Account(s); (ii) in the case where the disputed amount has not been paid into the Disputed Payments Account and the dispute was identified prior to the Payment Due Date in question by delivery of a statement pursuant to subsection (d)(6) identifying such dispute, the Independent Auditor shall calculate interest on the disputed amount from the Payment Due Date in question (the applicable interest rate to be provided in subsection IX(h)) and the allocation of such amount and interest among the applicable payees, and shall provide notice of the amount owed (and the identity of the payor and payees) to all Notice Parties; and (iii) in all other cases, the procedure described in subsection (ii) shall apply, except that the applicable interest rate shall be the Prime Rate.

(2) Overpayments.

(A) If a dispute as to a prior payment is resolved with finality in favor of a Participating Manufacturer where the disputed amount has been paid into the Disputed Payments Account pursuant to subsection (d)(8), the Independent Auditor shall instruct the Escrow Agent to transfer such amount to such Participating Manufacturer.

(B) If information becomes available to the Independent Auditor not later than four years after a Payment Due Date showing that a Participating Manufacturer made an overpayment on such date, or if a dispute as to a prior payment is resolved with finality in favor of a Participating Manufacturer where the disputed amount has been paid but not into the Disputed Payments Account, such Participating Manufacturer shall be entitled to a continuing dollar-for-dollar offset as follows:

(i) offsets under this subsection (B) shall be applied only against eligible payments to be made by such Participating Manufacturer after the entitlement to the offset arises. The eligible payments shall be: in the case of offsets arising from payments under subsection IX(b) or IX(c)(1), subsequent payments under any of such subsections; in the case of offsets arising from payments under subsection IX(c)(2), subsequent payments under such subsection or, if no subsequent payments are to be made under such subsection, subsequent payments under subsection IX(c)(1); in the case of offsets arising from payments under subsection IX(e), subsequent payments under such subsection or subsection IX(c); in the case of offsets arising from payments under subsection V(c), subsequent payments under such subsection or, if no subsequent payments are to be made under such subsection, subsequent payments under any of subsection IX(c)(1), IX(c)(2) or IX(c); in the case of offsets arising from payments under subsection VIII(b), subsequent payments under such subsection or, if no subsequent payments are to be made under such subsection, subsequent payments under either subsection IX(c)(1) or IX(c)(2); and, in the case of offsets arising from payments under subsection VIII(c), subsequent payments under either subsection IX(c)(1) or IX(c)(2); and, in the case of offsets arising from payments under subsection IX(f), subsequent payments under such subsection (consistent with the provisions of this subsection (B)(i)).

(ii) in the case of offsets to be applied against payments under subsection IX(c), the offset to be applied shall be apportioned among the Settling States pro rata in proportion to their respective shares of such payments, as such respective shares are determined pursuant to step E of clause "Seventh" (in the case of payments due from the Original Participating Manufacturers) or clause "Sixth" (in the case of payments due from the Subsequent Participating Manufacturers) of subsection IX(j) (except where the offset arises from an overpayment applicable solely to a particular Settling State).

(iii) the total amount of the offset to which a Participating Manufacturer shall be entitled shall be the full amount of the overpayment it made, together with interest calculated from the time of the overpayment to the Payment Due Date of the first eligible payment against which the offset may be applied. The applicable interest rate shall be the Prime Rate (except that, where the overpayment is the result of a Settling State's withholding of information as described in subsection (d)(5)(B), the applicable interest rate shall be that described in subsection IX(h)).

(iv) an offset under this subsection (B) shall be applied up to the full amount of the Participating Manufacturer's share (in the case of payments due from Original Participating Manufacturers, determined as described in the first sentence of clause "Seventh" of subsection IX(j) (or, in the case of payments pursuant to subsection IX(c), step D of such clause)) of the eligible payment in question, as such payment has been adjusted and reduced pursuant to clauses "First" through "Sixth" of subsection IX(j), to the extent each such clause is applicable to the payment in question. In the event that the offset to which a Participating Manufacturer is entitled under this subsection (B) would exceed such Participating Manufacturer's share of the eligible payment against which it is being applied (or, in the case where such offset arises from an overpayment applicable solely to a particular Settling State, the portion of such payment that is made for the benefit of such Settling State), the offset shall be the full amount of such Participating Manufacturer's share of such payment and all amounts not offset shall carry forward and be offset against subsequent eligible payments until all such amounts have been offset.

(j) Payments After Affordable Condition. To the extent that a payment is made after the occurrence of all applicable conditions for the disbursement of such payment to the payee(s) in question, the Independent Auditor shall instruct the Escrow Agent to disburse such payment promptly following its deposit.

#### XII. SETTLING STATES' RELEASE, DISCHARGE AND COVENANT

##### (a) Release.

(1) Upon the occurrence of State-Specific Finality in a Settling State, such Settling State shall absolutely and unconditionally release and forever discharge all Released Parties from all Released Claims that the Releasing Parties directly, indirectly, derivatively or in any other capacity ever had, now have, or hereafter can, shall or may have.

(2) Notwithstanding the foregoing, this release and discharge shall not apply to any defendant in a lawsuit settled pursuant to this Agreement (other than a Participating Manufacturer) unless and until such defendant releases the Releasing Parties (and delivers to the Attorney General of the applicable Settling State a copy of such release) from any and all Claims of such defendant relating to the prosecution of such lawsuit.

(3) Each Settling State (for itself and for the Releasing Parties) further covenants and agrees that it (and the Released Parties) shall not after the occurrence of State-Specific Finality sue or seek to establish civil liability against any Released Party based, in whole or in part, upon any of the Released Claims, and further agrees that such covenant and agreement shall be a complete defense to any such civil action or proceeding.

(4) (A) Each Settling State (for itself and for the Releasing Parties) further agrees that, if a Released Claim by a Releasing Party against any person or entity that is not a Released Party (a "non-Released Party") results in or in any way gives rise to a claim-over (on any theory whatsoever other than a claim based on an express written indemnity agreement) by such non-Released Party against any Released Party (and such Released Party gives notice to the applicable Settling State within 30 days of the service of such claim-over (or within 30 days after the MSA Execution Date, whichever is later) and prior to entry into any settlement of such claim-over), the Releasing Party: (i) shall reduce or credit against any judgment or settlement such non-Released Party may obtain against such non-Released Party the full amount of any judgment or settlement with such non-Released Party may obtain against the Released Party on such claim-over; and (ii) shall, as part of any settlement with such non-Released Party, obtain from such non-Released Party for the benefit of such Released Party a satisfaction in full of such non-Released Party's judgment or settlement against the Released Party.

(B) Each Settling State further agrees that in the event that the provisions of subsection (4)(A) do not fully eliminate any and all liability of any Original Participating Manufacturer (or of any person or entity that is a Released Party by virtue of its relationship to any Original Participating Manufacturer) with respect to claims-over (on any theory whatsoever other than a claim based on an express written indemnity agreement) by any non-Released Party to recover in whole or in part any liability (whether direct or indirect, or whether by way of settlement (to the extent that such Released Party has given notice to the applicable Settling State within 30 days of the service of such claim-over (or within 30 days after the MSA Execution Date, whichever is later) and prior to entry into any settlement of such claim-over, judgment or otherwise) of such non-Released Party to any Released Party arising out of any Released Claim, such Original Participating Manufacturer shall receive a continuing dollar-for-dollar offset for any amounts paid by such Original Participating Manufacturer (or by any person or entity that is a Released Party by virtue of its relationship to such Original Participating Manufacturer) on any such liability against such Original Participating Manufacturer's share (determined as described in step E of clause "Seventh" of subsection IX(j)) of the applicable Settling State's Allocated Payment, up to the full amount of such Original Participating Manufacturer's share of such Allocated Payment each year, until all such amounts paid on such liability have been offset. In the event that the offset under this subsection (4) with respect to a particular Settling State would in any given year exceed such Original Participating Manufacturer's share of such Settling State's Allocated Payment (as such share had been reduced by adjustment, if any, pursuant to the NPM Adjustment, and has been reduced by offsets, if any, pursuant to the offset for miscalculated or disputed payments, the Federal Tobacco Legislation Offset and the Litigating Releasing Parties Offset) and the offset for claims-over under subsection XII(h)(4)(B): (i) any person or entity that is a Released Party by virtue of its relationship with such Subsequent Participating Manufacturer has paid on liability that would give rise to an offset under such subsection (4) with respect to a particular Settling State shall create a right to challenge the continuation, after the MSA Execution Date, of any advertising content, claim or slogan (other than use of a Cartoon) that was not unlawful prior to the MSA Execution Date.

(6) The Settling States do not waive or release any criminal liability based on Federal, state or local law.

(7) The Settling States do not waive or release any claims on behalf of Indian tribes.

(8) Notwithstanding the foregoing (and the definition of Released Parties), this release and covenant shall not apply to retailers, suppliers or distributors to the extent of any liability arising from the sale or distribution of Tobacco Products of, or the supply of component parts of Tobacco Products to, any non-Released Party.

(A) Each Settling State (for itself and for the Releasing Parties) agrees that, if a claim by a Releasing Party against a retailer, supplier or distributor that would be a Released Claim but for the operation of the preceding sentence results in or in any way gives rise to a claim-over (on any theory whatever) by such retailer, supplier or distributor against any Released Party (and such Released Party gives notice to the applicable Settling State within 30 days of the service of such claim-over (or within 30 days after the MSA Execution Date, whichever is later) and prior to entry into any settlement of such claim-over), the Releasing Party: (i) shall reduce or credit against any judgment or settlement such Released Party may obtain against such retailer, supplier or distributor the full amount of any judgment or settlement such retailer, supplier or distributor may obtain against the Released Party on such claim-over; and (ii) shall, as part of any settlement with such retailer, supplier or distributor, obtain from such retailer, supplier or distributor for the benefit of such Released Party a satisfaction in full of such retailer's, supplier's or distributor's judgment or settlement against the Released Party.

(B) Each Settling State further agrees that in the event that the provisions of subsection (8)(A) above do not fully eliminate any and all liability of any Original Participating Manufacturer (or any person or entity that is a Released Party by virtue of its relationship to any Original Participating Manufacturer) with respect to claims-over (on any theory whatever) by any such retailer, supplier or distributor to recover in whole or in part any liability (whether direct or indirect, or whether by way of settlement (to the extent that such Released Party has given notice to the applicable Settling State within 30 days of the service of such claim-over (or within 30 days after the MSA Execution Date, whichever is later) and prior to entry into any settlement of such claim-over), judgment or otherwise) of such retailer, supplier or distributor to any Released Party arising out of any claim that would be a Released Claim but for the operation of the first sentence of this subsection (8), such Original Participating Manufacturer shall receive a continuing dollar-for-dollar offset for any amounts paid by such Original Participating Manufacturer (or by any person or entity that is a Released Party by virtue of its relationship to such Original Participating Manufacturer) on any such liability against such Original Participating Manufacturer's share (determined as described in step E of clause "Seventh" of subsection IX(j)) of the applicable Settling State's Allocated Payment, up to the full amount of such Original Participating Manufacturer's share of such Allocated Payment each year, until all such amounts paid on such liability have been offset. In the event that the offset under this subsection (8) with respect to a particular Settling State would in any given year exceed such Original Participating Manufacturer's share of such Settling State's Allocated Payment (as such share had been reduced by adjustment, if any, pursuant to the NPM Adjustment, and has been reduced by offsets, if any, pursuant to the offset for miscalculated or disputed payments, the Federal Tobacco Legislation Offset, the Litigating Releasing Parties Offset and the offset for claims-over under subsection XII(h)(4)(B)): (i) any person or entity that is a Released Party by virtue of its relationship with such Subsequent Participating Manufacturer has paid on liability that would give rise to an offset under such subsection (8) with respect to a particular Settling State shall create a right to challenge the continuation, after the MSA Execution Date, of any advertising content, claim or slogan (other than use of a Cartoon) that was not unlawful prior to the MSA Execution Date.

(C) Each Settling State further agrees that, subject to the provisions of subsection IX(k)(3), each Subsequent Participating Manufacturer shall be entitled to the offset described in subsection (B) above to the extent that it (or any person or entity that is a Released Party by virtue of its relationship with such Subsequent Participating Manufacturer) has paid on liability that would give rise to an offset under such subsection (8) with respect to a particular Settling State.

(9) Notwithstanding any provision of law, statutory or otherwise, which provides that a general release does not extend to claims which the creditor does not know or suspect to exist in its favor at the time of executing the release, which if known by it must have materially affected its settlement with the debtor, the releases set forth in this section XII release all Released Claims against the Released Parties, whether known or unknown, foreseen or unforeseen, suspected or unsuspected, that the Releasing Parties may have against the Released Parties, and the Releasing Parties understood and acknowledge the significance and consequences of waiver of any such provision and hereby assume full responsibility for any injuries, damages or losses that the Releasing Parties may incur.

(b) Released Claims Against Released Parties. If a Releasing Party (or any person or entity enumerated in subsection I(fpp)), without regard to the power of the Attorney General to release claims of such person or entity) nonetheless attempts to maintain a Released Claim against a Released Party, such Released Party shall give written notice of such potential claim to the Attorney General of the applicable Settling State within 30 days of receiving notice of such potential claim (or within 30 days after the MSA Execution Date, whichever is later) (unless such potential claim is being maintained by such Settling State). The Released Party may offer the release and covenant as a complete defense. If it is determined at any point in such action that the release of such claim is unenforceable or invalid for any reason (including, but not limited to, lack of authority to release such claim), the following provisions shall apply:

(1) The Released Party shall take all ordinary and reasonable measures to defend the action fully. The Released Party may settle or enter into a stipulated judgment with respect to the action at any time in its sole discretion, but in such event the offset described in subsection (b)(2) or (b)(3) below shall apply only if the Released Party obtains the relevant Attorney General's consent to such settlement or stipulated judgment, which consent shall not be unreasonably withheld. The Released Party shall not be entitled to the offset described in subsection (b)(2) or (b)(3) below if such Released Party failed to take ordinary and reasonable measures to defend the action fully.



**XIV. PARTICIPATING MANUFACTURERS' DISMISSAL OF RELATED LAWSUITS**

(a) Upon State-Specific Finality in a Settling State, each Participating Manufacturer will dismiss without prejudice (and without costs and fees) the lawsuit(s) listed in Exhibit M pending in such Settling State in which the Participating Manufacturer is a plaintiff. Within 10 days after the MSA Execution Date, each Participating Manufacturer and each Settling State that is a party in any of the lawsuits listed in Exhibit M shall jointly move for a stay of all proceedings in such lawsuit. Such stay of a lawsuit against a Settling State shall be dissolved upon the earlier of the occurrence of State-Specific Finality in such Settling State or termination of this Agreement with respect to such Settling State pursuant to subsection XVII(o)(1).

(b) Upon State-Specific Finality in a Settling State, each Participating Manufacturer will release and discharge any and all monetary Claims against such Settling State and any of such Settling State's officers, employees, agents, administrators, representatives, officials acting in their official capacity, agencies, departments, commissions, divisions and counsel relating to or in connection with the lawsuit(s) commenced by the Attorney General of such Settling State identified in Exhibit D.

(c) Upon State-Specific Finality in a Settling State, each Participating Manufacturer will release and discharge any and all monetary Claims against all subdivisions (political or otherwise, including, but not limited to, municipalities, counties, parishes, villages, unincorporated districts and hospital districts) of such Settling State, and any of their officers, employees, agents, administrators, representatives, officials acting in their official capacity, agencies, departments, commissions, divisions and counsel arising out of Claims that have been waived and released with continuing full force and effect pursuant to section XII of this Agreement.

**XV. VOLUNTARY ACT OF THE PARTIES**

The Settling States and the Participating Manufacturers acknowledge and agree that this Agreement is voluntarily entered into by each Settling State and each Participating Manufacturer as the result of arm's-length negotiations, and each Settling State and each Participating Manufacturer was represented by counsel in deciding to enter into this Agreement. Each Participating Manufacturer further acknowledges that it understands that certain provisions of this Agreement may require it to act or refrain from acting in a manner that could otherwise give rise to state or federal constitutional challenges and that, by voluntarily consenting to this Agreement, it (and the Tobacco-Related Organizations (or any trade associations formed or controlled by any Participating Manufacturer)) waives for purposes of performance of this Agreement any and all claims that the provisions of this Agreement violate the state or federal constitutions. Provided, however, that nothing in the foregoing shall constitute a waiver as to the entry of any court order (or any interpretation thereof) that would operate to limit the exercise of any constitutional right except to the extent of the restrictions, limitations or obligations expressly agreed to in this Agreement or the Consent Decree.

**XVI. CONSTRUCTION**

(a) No Settling State or Participating Manufacturer shall be considered the drafter of this Agreement or any Consent Decree, or any provision of either, for the purpose of any statute, case law or rule of interpretation or construction that would or might cause any provision to be construed against the drafter.

(b) Nothing in this Agreement shall be construed as approval by the Settling States of any Participating Manufacturer's business organizations, operations, acts or practices, and no Participating Manufacturer may make any representation to the contrary.

**XVII. RECOVERY OF COSTS AND ATTORNEYS' FEES**

(a) The Original Participating Manufacturers agree that, with respect to any Settling State in which the Court has approved this Agreement and the Consent Decree, they shall severally reimburse the following "Governmental Entities": (1) the office of the Attorney General of such Settling State; (2) the office of the governmental prosecuting authority for any political subdivision of such Settling State with a lawsuit pending against any Participating Manufacturer as of July 1, 1998 (as identified in Exhibit N) that has released such Settling State and such Participating Manufacturer(s) from any and all Released Claims (a "Litigating Political Subdivision"); and (3) other appropriate agencies of such Settling State and such Litigating Political Subdivision, for reasonable costs and expenses incurred in connection with the litigation or resolution of claims asserted by or against the Participating Manufacturers in the actions set forth in Exhibits D, M and N; provided that such costs and expenses are of the same nature as costs and expenses for which the Original Participating Manufacturers would reimburse their own counsel or agents (but not including costs and expenses relating to lobbying activities).

(b) The Original Participating Manufacturers further agree severally to pay the Governmental Entities in any Settling State in which State-Specific Finality has occurred an amount sufficient to compensate such Governmental Entities for time reasonably expended by attorneys and paralegals employed in such offices in connection with the litigation or resolution of claims asserted against or by the Participating Manufacturers in the actions identified in Exhibits D, M and N (but not including time relating to lobbying activities), such amount to be calculated based upon hourly rates equal to the market rate in such Settling State for private attorneys; and paralegals of equivalent experience and seniority.

(c) Such Governmental Entities seeking payment pursuant to subsection (a) and/or (b) shall provide the Original Participating Manufacturers with an appropriately documented statement of all costs, expenses, and attorney and paralegal time for which payment is sought, and, solely with respect to payments sought pursuant to subsection (b), shall do so no earlier than the date on which State-Specific Finality occurs in such Settling State. All amounts to be paid pursuant to

(2) The following provisions shall apply where the Released Party is an Original Participating Manufacturer (or any person or entity that is a Released Party by virtue of its relationship with an Original Participating Manufacturer):

(A) In the event of a settlement or stipulated judgment, the settlement or stipulated amount shall give rise to a continuing offset as such amount is actually paid against the full amount of such Original Participating Manufacturer's share (determined as described in step E of clause "Seventh" of subsection IX(d)) of the applicable Settling State's Allocated Payment until such time as the settlement or stipulated amount is fully credited on a dollar-for-dollar basis.

(B) Judgments (other than a default judgment) against a Released Party in such an action shall, upon payment of such judgment, give rise to an immediate and continuing offset against the full amount of such Original Participating Manufacturer's share (determined as described in subsection (A)) of the applicable Settling State's Allocated Payment, until such time as the judgment is fully credited on a dollar-for-dollar basis.

(C) Each Settling State reserves the right to intervene in such an action (unless such action was brought by the Settling State) to the extent authorized by applicable law in order to protect the Settling State's interest under this Agreement. Each Participating Manufacturer agrees not to oppose any such intervention.

(D) In the event that the offset under this subsection (b)(2) with respect to a particular Settling State would in any given year exceed such Original Participating Manufacturer's share of such Settling State's Allocated Payment (as such share had been reduced by adjustment, if any, pursuant to the NPM Adjustment, and has been reduced by offsets, if any, pursuant to the Federal Tobacco Legislation Offset and the offset for miscalculated or disputed payments); (i) the offset to which such Original Participating Manufacturer is entitled under this subsection (2) in such year shall be the full amount of such Original Participating Manufacturer's share of such Allocated Payment; and (ii) all amounts not offset by reason of clause (i) shall carry forward and be offset in the following year(s) until all such amounts have been offset.

(3) The following provisions shall apply where the Released Party is a Subsequent Participating Manufacturer (or any person or entity that is a Released Party by virtue of its relationship with a Subsequent Participating Manufacturer): Subject to the provisions of subsection IX(i)(3), each Subsequent Participating Manufacturer shall be entitled to the offset as described in subsections (2)(A)-(C) above against payments it otherwise would owe under section IX(d) to the extent that it (or any person or entity that is a Released Party by virtue of its relationship with such Subsequent Participating Manufacturer) has paid on a settlement, stipulated judgment or judgment that would give rise to an offset under such subsections if paid by an Original Participating Manufacturer.

**XIII. CONSENT DECREES AND DISMISSAL OF CLAIMS**

(a) Within 10 days after the MSA Execution Date (or, as to any Settling State identified in the Additional States provision of Exhibit D, concurrently with the filing of its lawsuit), each Settling State and each Participating Manufacturer that is a party in any of the lawsuits identified in Exhibit D shall jointly move for a stay of all proceedings in such Settling State's lawsuit with respect to the Participating Manufacturers and all other Released Parties (except any proceeding seeking public disclosure of documents pursuant to subsection IV(b)). Such stay of a Settling State's lawsuit shall be dissolved upon the earlier of the occurrence of State-Specific Finality or termination of this Agreement with respect to such Settling State pursuant to subsection XVII(o)(1).

(b) Not later than December 11, 1998 (or, as to any Settling State identified in the Additional States provision of Exhibit D, concurrently with the filing of its lawsuit):

(1) each Settling State that is a party to a lawsuit identified in Exhibit D and each Participating Manufacturer will:

(A) tender this Agreement to the Court in such Settling State for its approval; and

(B) tender to the Court in such Settling State for entry a consent decree conforming to the model consent decree attached hereto as Exhibit L (revisions or changes to such model consent decree shall be limited to the extent required by state procedural requirements to reflect accurately the factual setting of the case in question, but shall not include any substantive revision to the duties or obligations of any Settling State or Participating Manufacturer, except by agreement of all Original Participating Manufacturers); and

(2) each Settling State shall seek entry of an order of dismissal of claims dismissing with prejudice all claims against the Participating Manufacturers and any other Released Party in such Settling State's action identified in Exhibit D. Provided, however, that the Settling State is not required to seek entry of such an order in such Settling State's action against such a Released Party (other than a Participating Manufacturer) unless and until such Released Party has released the Releasing Parties (and delivered to the Attorney General of such Settling State a copy of such release) (which release shall be effective upon the occurrence of State-Specific Finality in such Settling State, and shall recite that in the event this Agreement is terminated with respect to such Settling State pursuant to subsection XVII(o)(1) the Released Party agrees that the order of dismissal shall be null and void and of no effect) from any and all Claims of such Released Party relating to the prosecution of such action as provided in subsection XII(a)(2).

subsections (a) and (b) shall be subject to reasonable verification if requested by any Original Participating Manufacturer; provided, however, that nothing contained in this subsection (c) shall constitute, cause, or require the performance of any act that would constitute any waiver (in whole or in part) of any attorney-client privilege, work product protection or common interests/joint prosecution privilege. All such amounts to be paid pursuant to subsections (a) and (b) shall be subject to an aggregate cap of \$150 million for all Settling States, shall be paid promptly following submission of the appropriate documentation (and the completion of any verification process), shall be paid separately and apart from any other amounts due pursuant to this Agreement, and shall be paid severally by each Original Participating Manufacturer according to its Relative Market Share. All amounts to be paid pursuant to subsection (b) shall be paid to such Governmental Entities in the order in which State-Specific Finality has occurred in such Settling States (subject to the \$150 million aggregate cap).

(d) The Original Participating Manufacturers agree that, upon the occurrence of State-Specific Finality in a Settling State, they will severally pay reasonable attorneys' fees to the private outside counsel, if any, retained by such Settling State (and each Litigating Political Subdivision, if any, within such Settling State) in connection with the respective actions identified in Exhibits D, M and N and who are designated in Exhibit S for each Settling State by the relevant Attorney General (and for each Litigating Political Subdivision, as later certified in writing to the Original Participating Manufacturers by the relevant governmental prosecuting authority of each Litigating Political Subdivision) as having been retained by and having represented such Settling State (or such Litigating Political Subdivision), in accordance with the terms described in the Model Fee Payment Agreement attached as Exhibit O.

#### XVIII. MISCELLANEOUS

(a) Effect of Current or Future Law. If any current or future law includes obligations or prohibitions applying to Tobacco Product Manufacturers related to any of the provisions of this Agreement, each Participating Manufacturer shall comply with this Agreement unless compliance with this Agreement would violate such law.

(b) Limited Most-Favored Nation Provision.

(1) If any Participating Manufacturer enters into any future settlement agreement of other litigation comparable to any of the actions identified in Exhibit D brought by a non-foreign governmental plaintiff other than the federal government ("Future Settlement Agreement"):

(A) before October 1, 2000, on overall terms more favorable to such governmental plaintiff than the overall terms of this Agreement (after due consideration of relevant differences in population or other appropriate factors), then, unless a majority of the Settling States determines that the overall terms of the Future Settlement Agreement are not more favorable than the overall terms of this Agreement, the overall terms of this Agreement will be revised so that the Settling States will obtain treatment with respect to such Participating Manufacturer at least as relatively favorable as the overall terms provided to any such governmental plaintiff; provided, however, that as to economic terms this Agreement shall not be revised based on any such Future Settlement Agreement, if such Future Settlement Agreement is entered into after: (i) the impaneling of the jury (or, in the event of a non-jury trial, the commencement of trial) in such litigation or any severed or bifurcated portion thereof; or (ii) any court order or judicial determination relating to such litigation that (x) grants judgment (in whole or in part) against such Participating Manufacturer; or (y) grants injunctive or other relief that affects the assets or on-going business activities of such Participating Manufacturer in a manner other than as expressly provided for in this Agreement; or

(B) on or after October 1, 2000, on non-economic terms more favorable to such governmental plaintiff than the non-economic terms of this Agreement, and such Future Settlement Agreement includes terms that provide for the implementation of non-economic tobacco-related public health measures different from those contained in this Agreement, then this Agreement shall be revised with respect to such Participating Manufacturer to include terms comparable to such non-economic terms, unless a majority of the Settling States elects against such revision.

(2) If any Settling State resolves by settlement Claims against any Non-Participating Manufacturer after the MSA Execution Date comparable to any Released Claim, and such resolution includes overall terms that are more favorable to such Non-Participating Manufacturer than the terms of this Agreement (including, without limitation, any terms that relate to the marketing or distribution of Tobacco Products and any term that provides for a lower settlement cost on a per pack sold basis), then the overall terms of this Agreement will be revised so that the Original Participating Manufacturers will obtain, with respect to that Settling State, overall terms at least as relatively favorable (taking into account, among other things, all payments previously made by the Original Participating Manufacturers and the timing of any payments) as those obtained by such Non-Participating Manufacturer pursuant to such resolution of Claims. The foregoing shall include but not be limited to: (a) to the treatment by any Settling State of a Future Affiliate, as that term is defined in agreements between any of the Settling States and Brooke Group Ltd., Liggett & Myers Inc. and/or Liggett Group, Inc. ("Liggett"), whether or not such Future Affiliate is merged with, or its operations combined with, Liggett or any Affiliate thereof; and (b) to any application of the terms of any such agreement (including any terms subsequently negotiated pursuant to any such agreement) to a brand of Cigarettes (or tobacco-related assets) as a result of the purchase by or sale to Liggett of such brand or assets or as a result of any combination of ownership among Liggett and any entity that manufactures Tobacco Products. Provided, however, that revision of this Agreement pursuant to this subsection (2) shall not be required by virtue of the subsequent entry into this Agreement by a Tobacco Product Manufacturer that has not become a Participating Manufacturer as of the MSA Execution Date. Notwithstanding the provisions of subsection XVIII(G), the provisions of this subsection XVIII(b)(2) may be waived by (and only by) unanimous agreement of the Original Participating Manufacturers.

(3) The parties agree that if any term of this Agreement is revised pursuant to subsection (b)(i) or (b)(2) above and the substance of such term before it was revised was also a term of the Consent Decree, each affected Settling State and each affected Participating Manufacturer shall jointly move the Court to amend the Consent Decree to conform the terms of the Consent Decree to the revised terms of the Agreement.

(4) If at any time any Settling State agrees to relieve, in any respect, any Participating Manufacturer's obligation to make the payments as provided in this Agreement, then, with respect to that Settling State, the terms of this Agreement shall be revised so that the other Participating Manufacturers receive terms as relatively favorable.

(c) Transfer of Tobacco Brands. No Original Participating Manufacturer may sell or otherwise transfer or permit the sale or transfer of any of its Cigarette brands, Brand Names, Cigarette product formulas or Cigarette businesses (other than a sale or transfer of Cigarette brands or Brand Names to be sold, product formulas to be used, or Cigarette businesses to be conducted, by the acquirer or transferee exclusively outside of the States) to any person or entity unless such person or entity is an Original Participating Manufacturer or prior to the sale or acquisition agrees to assume the obligations of an Original Participating Manufacturer with respect to such Cigarette brands, Brand Names, Cigarette product formulas or businesses. No Participating Manufacturer may sell or otherwise transfer any of its Cigarette brands, Brand Names, Cigarette product formulas or Cigarette businesses (other than a sale or transfer of Cigarette brands or Brand Names to be sold, Cigarette product formulas to be used, or businesses to be conducted, by the acquirer or transferee exclusively outside of the States) to any person or entity unless such person or entity is or becomes prior to the sale or acquisition a Participating Manufacturer. In the event of any such sale or transfer of a Cigarette brand, Brand Name, Cigarette product formula or Cigarette business by a Participating Manufacturer to a person or entity that within 180 days prior to such sale or transfer was a Non-Participating Manufacturer, the Participating Manufacturer shall certify to the Settling States that it has determined that such person or entity has the capability to perform the obligations under this Agreement. Such certification shall not survive beyond one year following the date of any such transfer. Each Original Participating Manufacturer certifies and represents that, except as provided in Exhibit R, it (or a wholly owned Affiliate) exclusively owns and controls in the States the Brand Names of those Cigarettes that it currently manufactures for sale (or sells) in the States and that it has the capacity to enter into an effective agreement concerning the sale or transfer of such Brand Names pursuant to this subsection XVIII(c). Nothing in this Agreement is intended to create any right for a State to obtain any Cigarette product formula that it would not otherwise have under applicable law.

(d) Payments in Settlement. All payments to be made by the Participating Manufacturers pursuant to this Agreement are in settlement of all of the Settling States' antitrust, consumer protection, common law negligence, statutory, common law and equitable claims for monetary, restitutionary, equitable and injunctive relief alleged by the Settling States with respect to the year of payment or earlier years, except that no part of any payment under this Agreement is made in settlement of an actual or potential liability for a fine, penalty (civil or criminal) or enhanced damages or is the cost of a tangible or intangible asset or other future benefit.

(e) No Determination of Admission. This Agreement is not intended to be and shall not in any event be construed or deemed to be, or represented as, an admission or concession or evidence of (1) any liability or any wrongdoing whatsoever on the part of any Released Party or that any Released Party has engaged in any of the activities barred by this Agreement; or (2) personal jurisdiction over any person or entity other than the Participating Manufacturers. Each Participating Manufacturer specifically disclaims and denies any liability or wrongdoing whatsoever with respect to the claims and allegations asserted against it by the Attorneys General of the Settling States and the Litigating Political Subdivisions. Each Participating Manufacturer has entered into this Agreement solely to avoid the further expense, inconvenience, burden and risk of litigation.

(f) Non-Admissibility. The settlement negotiations resulting in this Agreement have been undertaken by the Settling States and the Participating Manufacturers in good faith and for settlement purposes only, and no evidence of negotiations or discussions underlying this Agreement shall be offered or received in evidence in any action or proceeding for any purpose. Neither this Agreement nor any public discussions, public statements or public comments with respect to this Agreement by any Settling State or Participating Manufacturer or its agents shall be offered or received in evidence in any action or proceeding for any purpose other than in an action or proceeding arising under or relating to this Agreement.

(g) Reconsiderations of Parties. Each Settling State and each Participating Manufacturer hereby represents that this Agreement has been duly authorized and, upon execution, will constitute a valid and binding contractual obligation, enforceable in accordance with its terms, of each of them. The signatories hereto on behalf of their respective Settling States expressly represent and warrant that they have the authority to settle and release all Released Claims of their respective Settling States and any of their respective Settling States' past, present and future agents, officials acting in their official capacities, legal representatives, agencies, departments, commissions and divisions, and that such signatories are aware of no authority to the contrary. It is recognized that the Original Participating Manufacturers are relying on the foregoing representation and warranty in making the payments required by and in otherwise performing under this Agreement. The Original Participating Manufacturers shall have the right to terminate this Agreement pursuant to subsection XVIII(u) as to any Settling State as to which the foregoing representation and warranty is breached or not effectively given.

(h) Obligations Several, Not Joint. All obligations of the Participating Manufacturers pursuant to this Agreement (including, but not limited to, all payment obligations) are intended to be, and shall remain, several and not joint.

(i) **Headings.** The headings of the sections and subsections of this Agreement are not binding and are for reference only and do not limit, expand or otherwise affect the contents or meaning of this Agreement.

(j) **Amendment and Waiver.** This Agreement may be amended by a written instrument executed by all Participating Manufacturers affected by the amendment and by all Settling States affected by the amendment. The terms of any such amendment shall not be enforceable in any Settling State that is not a signatory to such amendment. The waiver of any rights conferred hereunder shall be effective only if made by written instrument executed by the waiving party or parties. The waiver by any party of any breach of this Agreement shall not be deemed to be or construed as a waiver of any other breach, whether prior, subsequent or contemporaneous, nor shall such waiver be deemed to be or construed as a waiver by any other party.

(k) **Notices.** All notices or other communications to any party to this Agreement shall be in writing (including, but not limited to, facsimile, telex, teletype or similar writing) and shall be given at the addresses specified in Exhibit P (as it may be amended) to reflect any additional Participating Manufacturer that becomes a party to this Agreement after the MSA Execution Date). Any Settling State or Participating Manufacturer may change or add the name and address of the persons designated to receive notice on its behalf by notice given (effective upon the giving of such notice) as provided in this subsection.

(l) **Cooperation.** Each Settling State and each Participating Manufacturer agrees to use its best efforts and to cooperate with each other to cause this Agreement and the Consent Decrees to become effective, to obtain all necessary approvals, consents and authorizations, if any, and to execute all documents and to take such other action as may be appropriate in connection herewith. Consistent with the foregoing, each Settling State and each Participating Manufacturer agrees that it will not directly or indirectly assist or encourage any challenge to this Agreement or any Consent Decree by any other person, and will support the integrity and enforcement of the terms of this Agreement and the Consent Decrees. Each Settling State shall use its best efforts to cause State-Specific Finality to occur as to such Settling State.

(m) **Disputes to Discuss Disputes.** Within 14 days after the MSA Execution Date, each Settling State's Attorney General and each Participating Manufacturer shall provide written notice of its designation of a senior representative to discuss with the other signatories to this Agreement any disputes and/or other issues that may arise with respect to this Agreement. Each Settling State's Attorney General shall provide such notice of the name, address and telephone number of the person it has so designated to each Participating Manufacturer and to NAAG. Each Participating Manufacturer shall provide such notice of the name, address and telephone number of the person it has so designated to each Settling State's Attorney General, to NAAG and to each other Participating Manufacturer.

(n) **Governing Law.** This Agreement (other than the Escrow Agreement) shall be governed by the laws of the relevant Settling State, without regard to the conflict of law rules of such Settling State. The Escrow Agreement shall be governed by the laws of the State in which the Escrow Court is located, without regard to the conflict of law rules of such State.

(o) **Severability.**

(1) Sections VI, VII, IX, X, XI, XII, XIII, XIV, XVI, XVII(b), (c), (d), (e), (f), (g), (h), (i), (j), (k), (l), (m), (n), (o), (p), (r), (s), (t), (u), (v), (w), (x), (y), and Exhibit A, B, and E hereof ("Nonseverable Provisions") are not severable, except to the extent that severance of section VI is permitted by Settling States pursuant to subsection V(i) hereof. The remaining terms of this Agreement are severable, as set forth herein.

(2) If a court materially modifies, renders unenforceable, or finds to be unlawful any of the Nonseverable Provisions, the NAAG executive committee shall select a team of Attorneys General (the "Negotiating Team") to attempt to negotiate an equivalent or comparable substitute term or other appropriate credit or adjustment (a "Substitute Term") with the Original Participating Manufacturers. In the event that the court referred to in the preceding sentence is located in a Settling State, the Negotiating Team shall include the Attorney General of such Settling State. The Original Participating Manufacturers shall have no obligation to agree to any Substitute Term. If any Original Participating Manufacturer does not agree to a Substitute Term, this Agreement shall be terminated in all Settling States affected by the court's ruling. The Negotiating Team shall submit any proposed Substitute Term negotiated by the Negotiating Team and agreed to by all of the Original Participating Manufacturers to the Attorneys General of all of the affected Settling States for their approval. If any affected Settling State does not approve the proposed Substitute Term, this Agreement in such Settling State shall be terminated.

(3) If a court materially modifies, renders unenforceable, or finds to be unlawful any term of this Agreement other than a Nonseverable Provision:

(A) The remaining terms of this Agreement shall remain in full force and effect.

(B) Each Settling State whose rights or obligations under this Agreement are affected by the court's decision in question (the "Affected Settling State") and the Participating Manufacturers agree to negotiate in good faith a Substitute Term. Any agreement on a Substitute Term reached between the Participating Manufacturers and the Affected Settling State shall not modify or amend the terms of this Agreement with regard to any other Settling State.

(C) If the Affected Settling State and the Participating Manufacturers are unable to agree on a Substitute Term, then they will submit the issue to non-binding mediation. If mediation fails to produce agreement to a Substitute Term, then that term shall be severed and the remainder of this Agreement shall remain in full force and effect.

(4) If a court materially modifies, renders unenforceable, or finds to be unlawful any portion of any provision of this Agreement, the remaining portions of such provision shall be unenforceable with respect to the affected Settling State unless a Substitute Term is arrived at pursuant to subsection (6)(2) or (6)(3) hereof, whichever is applicable.

(f) **Intended Beneficiaries.** No portion of this Agreement shall provide any rights to, or be enforceable by, any person or entity that is not a Settling State or a Released Party. No Settling State may assign or otherwise convey any right to enforce any provision of this Agreement.

(g) **Counterparts.** This Agreement may be executed in counterparts. Facsimile or photocopied signatures shall be considered as valid signatures as of the date affixed, although the original signature pages shall thereafter be appended.

(h) **Applicability.** The obligations and duties of each Participating Manufacturer set forth herein are applicable only to actions taken (or omitted to be taken) within the States. This subsection (f) shall not be construed as extending the territorial scope of any obligation or duty set forth herein whose scope is otherwise limited by the terms hereof.

(i) **Preservation of Privilege.** Nothing contained in this Agreement or any Consent Decree, and no act required to be performed pursuant to any attorney-client privilege, work product protection or common interest/joint defense privilege, (in whole or in part) of any attorney-client privilege, work product protection or common interest/joint defense privilege, and each Settling State and each Participating Manufacturer agrees that it shall not make or cause to be made in any forum any assertion to the contrary.

(j) **Non-Release.** Except as otherwise specifically provided in this Agreement, nothing in this Agreement shall limit, prejudice or otherwise interfere with the rights of any Settling State or any Participating Manufacturer to pursue any and all rights and remedies it may have against any Non-Participating Manufacturer or other non-Released Party.

(k) **Termination.**

(1) Unless otherwise agreed to by each of the Original Participating Manufacturers and the Settling State in question, in the event that (A) State-Specific Finality in a Settling State does not occur in such Settling State on or before December 31, 2001; or (B) this Agreement or the Consent Decree has been disapproved by the Court (or, in the event of an appeal from or review of a decision of the Court to approve this Agreement and the Consent Decree, by the court hearing such appeal or conducting such review), and the time to Appeal from such disapproval has expired, or, in the event of an Appeal from such disapproval, the Appeal has been dismissed or the disapproval has been affirmed by the court of last resort to which such Appeal has been taken and such dismissal or disapproval has become no longer subject to further Appeal (including, without limitation, review by the United States Supreme Court); or (C) this Agreement is terminated in a Settling State for whatever reason (including, but not limited to, pursuant to subsection XVIII(c) of this Agreement), then this Agreement and all of its terms (except for the non-admissibility provisions hereof, which shall continue in full force and effect) shall be canceled and terminated with respect to such Settling State, and it and all orders issued by the courts in such Settling State pursuant hereto shall become null and void of no effect.

(2) If this Agreement is terminated with respect to a Settling State for whatever reason, then (A) the applicable statute of limitation or any similar time requirement shall be tolled from the date such Settling State signed this Agreement until the later of the time permitted by applicable law or for one year from the date of such termination, with the effect that the parties shall be in the same position with respect to the statute of limitation as they were at the time such Settling State filed its action, and (B) the parties shall jointly move the Court for an order reinstating the actions and claims dismissed pursuant to sections XIII and XIV hereof, with the effect that the parties shall be in the same position with respect to those actions and claims as they were at the time the action or claim was stayed or dismissed.

(v) **Freedom of Information Requests.** Upon the occurrence of State-Specific Finality in a Settling State, each Participating Manufacturer will withdraw in writing any and all requests for information, administrative applications, and proceedings brought or caused to be brought by such Participating Manufacturer pursuant to such Settling State's freedom of information law relating to the subject matter of the lawsuits identified in Exhibit D.

(w) **Bankruptcy.** The following provisions shall apply if a Participating Manufacturer both enters Bankruptcy and at any time thereafter is not timely performing its financial obligations as required under this Agreement:

(1) In the event that both a number of Settling States equal to at least 75% of the total number of Settling States and Settling States having aggregate Allocable Shares equal to at least 75% of the total aggregate Allocable Shares assigned to all Settling States, deem (by written notice to the Participating Manufacturers other than the bankrupt Participating Manufacturer) that the financial obligations of this Agreement have been terminated and rendered null and void as to such bankrupt Participating Manufacturer (except as provided in subsection (A) below) due to a material breach by such Participating Manufacturer, whereupon, with respect to all Settling States:

(A) all agreements, all concessions, all reductions of Releasing Parties' Claims, and all releases and covenants not to sue, contained in this Agreement shall be null and void as to such Participating Manufacturer. Provided, however, that (i) all reductions of Releasing Parties' Claims, and all releases and covenants not to sue, contained in this Agreement shall remain in full force and effect as to all persons or entities (other than the bankrupt Participating Manufacturer itself or any person or entity that, as a result of the Bankruptcy, obtains domestic tobacco assets of such

Participating Manufacturer (unless such person or entity is itself a Participating Manufacturer) who (but for the first sentence of this subsection (A)) would otherwise be Released Parties by virtue of their relationship with the bankrupt Participating Manufacturer; and (ii) in the event a Settling State asserts any Released Claim against a bankrupt Participating Manufacturer after the termination of this Agreement with respect to such Participating Manufacturer as described in this subsection (1) and receives a judgment, settlement or distribution arising from such Released Claim, then the amount of any payments such Settling State has previously received from such Participating Manufacturer under this Agreement shall be applied against the amount of any such judgment, settlement or distribution (provided that in no event shall such Settling State be required to refund any payments previously received from such Participating Manufacturer pursuant to this Agreement);

(B) the Settling States shall have the right to assert any and all claims against such Participating Manufacturer in the Bankruptcy or otherwise without regard to any limits otherwise provided in this Agreement (subject to any and all defenses against such claims);

(C) the Settling States may exercise all rights provided under the federal Bankruptcy Code (or other applicable bankruptcy law) with respect to their Claims against such Participating Manufacturer, including the right to initiate and complete police and regulatory actions against such Participating Manufacturer pursuant to the exceptions to the automatic stay set forth in section 362(b) of the Bankruptcy Code (provided, however, that such Participating Manufacturer may contest whether the Settling State's action constitutes a police and regulatory action); and

(D) to the extent that any Settling State is pursuing a police and regulatory action against such Participating Manufacturer as described in subsection (1)(C), such Participating Manufacturer shall not request or support a request that the Bankruptcy court utilize the authority provided under section 105 of the Bankruptcy Code to impose a discretionary stay on the Settling State's action. The Participating Manufacturers further agree that they will not request, seek or support relief from the terms of this Agreement in any proceeding before any court of law (including the federal bankruptcy courts) or an administrative agency or through legislative action, including (without limitation) by way of joinder in or consent to or acquiescence in any such pleading or instrument filed by another.

(2) Whether or not the Settling States exercise the option set forth in subsection (1) (and whether or not such option, if exercised, is valid and enforceable):

(A) In the event that the bankrupt Participating Manufacturer is an Original Participating Manufacturer, such Participating Manufacturer shall continue to be treated as an Original Participating Manufacturer for all purposes under this Agreement except (i) such Participating Manufacturer shall be treated as a Non-Participating Manufacturer (and not as an Original Participating Manufacturer or Participating Manufacturer) for all purposes with respect to subsections IX(d)(1), IX(d)(2) and IX(d)(3) (including, but not limited to, that the Market Share of such Participating Manufacturer shall not be included in Base Aggregate Participating Manufacturer Market Share or Actual Aggregate Participating Manufacturer Market Share, and that such Participating Manufacturer's volume shall not be included for any purpose under subsection IX(d)(1)(DD)); (ii) such Participating Manufacturer's Market Share shall not be included as that of a Participating Manufacturer for the purpose of determining whether the trigger percentage specified in subsection IX(e) has been achieved (provided that such Participating Manufacturer shall be treated as an Original Participating Manufacturer for all other purposes with respect to such subsection); (iii) for purposes of subsection (B)(iii) of Exhibit E, such Participating Manufacturer shall continue to be treated as an Original Participating Manufacturer, but its operating income shall be recalculated by the Independent Auditor to reflect what such income would have been had such Participating Manufacturer made the payments that would have been due under this Agreement but for the Bankruptcy; (iv) for purposes of subsection XVII(c), such Participating Manufacturer shall not be treated as an Original Participating Manufacturer or as a Participating Manufacturer to the extent that after entry into Bankruptcy it becomes the acquirer or transferee of Cigarette brands, Brand Names, Cigarette product formulas or Cigarette businesses of any Participating Manufacturer (provided that such Participating Manufacturer shall continue to be treated as an Original Participating Manufacturer and Participating Manufacturer for all other purposes under such subsection); and (v) as to any action that by the express terms of this Agreement requires the unanimous agreement of all Original Participating Manufacturers.

(B) In the event that the bankrupt Participating Manufacturer is a Subsequent Participating Participating Manufacturer, such Participating Manufacturer shall continue to be treated as a Subsequent Participating Participating Manufacturer for all purposes under this Agreement except (i) such Participating Manufacturer shall be treated as a Non-Participating Participating Manufacturer (and not as a Subsequent Participating Participating Manufacturer) for all purposes with respect to subsections IX(d)(1), (d)(2) and (d)(4) (including, but not limited to, that the Market Share of such Participating Participating Manufacturer shall not be included in Base Aggregate Participating Participating Manufacturer Market Share or Actual Aggregate Participating Participating Manufacturer Market Share, and that such Participating Participating Manufacturer's volume shall not be included for any purpose under subsection IX(d)(1)(DD)); (ii) such Participating Participating Manufacturer's Market Share shall not be included as that of a Participating Participating Manufacturer for the purpose of determining whether the trigger percentage specified in subsection IX(e) has been achieved (provided that such Participating Participating Manufacturer shall be treated as a Subsequent Participating Participating Manufacturer for all other purposes with respect to such subsection); and (iii) for purposes of subsection XVII(c), such Participating Participating Manufacturer shall not be treated as a Subsequent Participating Participating Manufacturer or as a Participating Participating Manufacturer to the extent that after entry into Bankruptcy it becomes the acquirer or transferee of Cigarette brands, Brand Names, Cigarette product formulas or Cigarette businesses of any Participating Participating Manufacturer (provided that such Participating Participating Manufacturer shall

continue to be treated as a Subsequent Participating Participating Manufacturer and Participating Participating Manufacturer for all other purposes under such subsection).

(C) Revision of this Agreement pursuant to subsection XVIII(b)(2) shall not be required by virtue of any resolution on an involuntary basis in the Bankruptcy of Claims against the bankrupt Participating Participating Manufacturer.

(x) Notice of Material Transfers. Each Participating Participating Manufacturer shall provide notice to each Settling State at least 20 days before consummating a sale, transfer of title or other disposition, in one transaction or series of related transactions, of assets having a fair market value equal to five percent or more (determined in accordance with United States generally accepted accounting principles) of the consolidated assets of such Participating Participating Manufacturer.

(y) Entire Agreement. This Agreement (together with any agreements expressly contemplated hereby and any other contemporaneous written agreements) embodies the entire agreement and understanding between and among the Settling States and the Participating Participating Manufacturers relating to the subject matter hereof and supercedes (1) all prior agreements and understandings relating to such subject matter, whether written or oral, and (2) all purportedly contemporaneous oral agreements and understandings relating to such subject matter.

(z) Business Days. Any obligation hereunder that, under the terms of this Agreement, is to be performed on a day that is not a Business Day shall be performed on the first Business Day thereafter.

(aa) Subsequent Signatories. With respect to a Tobacco Product Manufacturer that signs this Agreement after the MSA Execution Date, the timing of obligations under this Agreement (other than payment obligations, which shall be governed by subsection II(i)) shall be negotiated to provide for the institution of such obligations on a schedule not more favorable to such subsequent signatory than that applicable to the Original Participating Participating Manufacturers.

(bb) Decimal Places. Any figure or percentage referred to in this Agreement shall be carried to seven decimal places.

(cc) Regulatory Authority. Nothing in section III of this Agreement is intended to affect the legislative or regulatory authority of any local or State government.

(dd) Successors. In the event that a Participating Participating Manufacturer ceases selling a brand of Tobacco Products in the States that such Participating Participating Manufacturer owned in the States prior to July 1, 1998, and an Affiliate of such Participating Participating Manufacturer thereafter and after the MSA Execution Date intentionally sells such brand in the States, such Affiliate shall be considered to be the successor of such Participating Participating Manufacturer with respect to such brand. Performance by any such successor of the obligations under this Agreement with respect to the sales of such brand shall be subject to court-ordered specific performance.

(ee) Export Packaging. Each Participating Participating Manufacturer shall place a visible indication on each pack of Cigarettes it manufactures for sale outside of the fifty United States and the District of Columbia that distinguishes such pack from packs of Cigarettes it manufactures for sale in the fifty United States and the District of Columbia.

(ff) Actions Within Geographic Boundaries of Settling States. To the extent that any provision of this Agreement expressly prohibits, restricts, or requires any action to be taken "within" any Settling State or the Settling States, the relevant prohibition, restriction, or requirement applies within the geographic boundaries of the applicable Settling State or Settling States, including, but not limited to, Indian country or Indian trust land within such geographic boundaries.

(gg) Notice to Affiliates. Each Participating Participating Manufacturer shall give notice of this Agreement to each of its Affiliates.

IN WITNESS WHEREOF, each Settling State and each Participating Participating Manufacturer, through their fully authorized representatives, have agreed to this Agreement.

[Signatures Intentionally Omitted]

**EXHIBIT A**  
**STATE ALLOCATION PERCENTAGES**

State	Percentage
Alabama	1.6161308%
Alaska	0.3414187%
Arizona	1.4738845%
Arkansas	0.8280661%
California	12.7639554%
Colorado	1.3708614%
Connecticut	1.8565323%
Delaware	0.3954685%
D.C.	0.6071183%
Florida	0.0000000%
Georgia	2.4544575%
Hawaii	0.6018630%
Idaho	0.1632632%
Illinois	4.6542472%
Indiana	2.0398033%
Iowa	0.8696670%
Kansas	0.8336712%
Kentucky	1.7611586%
Louisiana	2.2553531%
Maine	0.1693505%
Maryland	2.2604570%
Massachusetts	4.0389790%
Michigan	4.3519476%
Minnesota	0.0000000%
Mississippi	0.0000000%
Missouri	2.2746011%
Montana	0.2427591%
Nebraska	0.5949833%
Nevada	0.6099351%
New Hampshire	0.6659140%
New Jersey	3.8669963%
New Mexico	0.5963897%
New York	12.7620310%
North Carolina	2.3322850%
North Dakota	0.3660138%
Ohio	5.0375098%
Oklahoma	1.0361370%
Oregon	1.1476582%
Pennsylvania	5.7468588%
Rhode Island	0.7189054%
South Carolina	1.1765319%
South Dakota	0.4489458%
Tennessee	2.4408945%
Texas	0.0000000%
Utah	0.4448869%
Vermont	0.4111851%
Virginia	2.0447451%
Washington	2.0532582%
West Virginia	0.8864604%
Wisconsin	2.0720390%
Wyoming	0.2483449%
American Samoa	0.0152170%
N. Mariana Isl.	0.0084376%
Guam	0.0219371%
U.S. Virgin Isl.	0.013593%
Puerto Rico	1.1212774%
Total	100.0000000%

**EXHIBIT B**  
**FORM OF ESCROW AGREEMENT**

This Escrow Agreement is entered into as of \_\_\_\_\_, 1998 by the undersigned State officials (on behalf of their respective Settling States), the undersigned Participating Manufacturers and \_\_\_\_\_ as escrow agent (the "Escrow Agent").

**WITNESSETH:**

WHEREAS, the Settling States and the Participating Manufacturers have entered into a settlement agreement entitled the "Master Settlement Agreement" (the "Agreement"); and

WHEREAS, the Agreement requires the Settling States and the Participating Manufacturers to enter into this Escrow Agreement.

NOW, THEREFORE, the parties hereto agree as follows:

**SECTION 1. Appointment of Escrow Agent.**

The Settling States and the Participating Manufacturers hereby appoint \_\_\_\_\_ to serve as Escrow Agent under this Agreement on the terms and conditions set forth herein, and the Escrow Agent, by its execution hereof, hereby accepts such appointment and agrees to perform the duties and obligations of the Escrow Agent set forth herein. The Settling States and the Participating Manufacturers agree that the Escrow Agent appointed under the terms of this Escrow Agreement shall be the Escrow Agent as defined in, and for all purposes of, the Agreement.

**SECTION 2. Definitions.**

(a) Capitalized terms used in this Escrow Agreement and not otherwise defined herein shall have the meaning given to such terms in the Agreement.

(b) "Escrow Court" means the court of the State of New York to which the Agreement is presented for approval, or such other court as agreed to by 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 NAAAG executive committee at the time in question.

**SECTION 3. Escrow and Accounts.**

(a) All funds received by the Escrow Agent pursuant to the terms of the Agreement shall be held and disbursed in accordance with the terms of this Escrow Agreement. Such funds and any earnings thereon shall constitute the "Escrow" and shall be held by the Escrow Agent separate and apart from all other funds and accounts of the Escrow Agent, the Settling States and the Participating Manufacturers.

(b) The Escrow Agent shall allocate the Escrow among the following separate accounts (each an "Account" and collectively the "Accounts"):

- SUBSECTION VI(B) ACCOUNT
- SUBSECTION VI(C) ACCOUNT (FIRST)
- SUBSECTION VI(C) ACCOUNT (SUBSEQUENT)
- SUBSECTION VII(B) ACCOUNT
- SUBSECTION VIII(C) ACCOUNT
- SUBSECTION IX(B) ACCOUNT (FIRST)
- SUBSECTION IX(B) ACCOUNT (SUBSEQUENT)
- SUBSECTION IX(C)(1) ACCOUNT
- SUBSECTION IX(C)(2) ACCOUNT
- SUBSECTION IX(E) ACCOUNT
- DISPUTED PAYMENTS ACCOUNT
- STATE-SPECIFIC ACCOUNTS WITH RESPECT TO EACH SETTLING STATE IN WHICH STATE-SPECIFIC FINALITY OCCURS.

(c) All amounts credited to an Account shall be retained in such Account until disbursed therefrom in accordance with the provisions of this Escrow Agreement pursuant to (i) written instructions from the Independent Auditor, or (ii) written instructions from all of the following: all of the Original Participating Manufacturers; all of the Subsequent Participating Manufacturers that contributed to such amounts in such Account; and all of the Settling States (collectively, the "Escrow Parties"). In the event of a conflict, instructions pursuant to clause (ii) shall govern over instructions pursuant to clause (i).

(d) On the first Business Day after the date any payment is due under the Agreement, the Escrow Agent shall deliver to each other Notice Party a written statement showing the amount of such payment (or indicating that no payment was made, if such is the case), the source of such payment, the Account or Accounts to which such payment has been

credited, and the payment instructions received by the Escrow Agent from the Independent Auditor with respect to such payment.

(e) The Escrow Agent shall comply with all payment instructions received from the Independent Auditor unless before 11:00 a.m. (New York City time) on the scheduled date of payment it receives written instructions to the contrary from all of the Escrow Parties, in which event it shall comply with such instructions.

(f) On the first Business Day after disbursing any funds from an Account, the Escrow Agent shall deliver to each other Notice Party a written statement showing the amount disbursed, the date of such disbursement and the payee of the disbursed funds.

#### SECTION 4. *Failure of Escrow Agent to Receive Instructions.*

In the event that the Escrow Agent fails to receive any written instructions contemplated by this Escrow Agreement, the Escrow Agent shall be fully protected in refraining from taking any action required under any section of this Escrow Agreement other than Section 5 until such written instructions are received by the Escrow Agent.

#### SECTION 5. *Investment of Funds by Escrow Agent.*

The Escrow Agent shall invest and reinvest all amounts from time to time credited to the Accounts in either (i) direct obligations of, or obligations the principal and interest on which are unconditionally guaranteed by, the United States of America; (ii) repurchase agreements fully collateralized by securities described in clause (i) above; (iii) money market accounts maturing within 30 days of the acquisition thereof and issued by a bank or trust company organized under the laws of the United States of America or of any of the 50 States thereof (a "United States Bank") and having combined capital, surplus and undistributed profits in excess of \$500,000,000; or (iv) demand deposits with any United States Bank having combined capital, surplus and undistributed profits in excess of \$500,000,000. To the extent practicable, monies credited to any Account shall be invested in such a manner so as to be available for use at the times when monies are expected to be disbursed by the Escrow Agent and charged to such Account. Obligations purchased as an investment of monies credited to any Account shall be deemed at all times to be a part of such Account and the income or interest earned, profits realized or losses suffered with respect to such investments (including, without limitation, any penalty for any liquidation of an investment required to fund a disbursement to be charged to such Account), shall be credited or charged, as the case may be, to, such Account and shall be for the benefit of, or be borne by, the person or entity entitled to payment from such Account. In choosing among the investment options described in clauses (i) through (iv) above, the Escrow Agent shall comply with any instructions received from time to time from all of the Escrow Parties. In the absence of such instructions, the Escrow Agent shall invest such sums in accordance with clause (i) above. With respect to any amounts credited to a State-Specific Account, the Escrow Agent shall invest and reinvest all amounts credited to such Account in accordance with the law of the applicable Settling State to the extent such law is inconsistent with this Section 5.

#### SECTION 6. *Substitute Form W-9; Qualified Settlement Fund.*

Each signatory to this Escrow Agreement shall provide the Escrow Agent with a correct taxpayer identification number on a substitute Form W-9 or if it does not have such a number, a statement evidencing its status as an entity exempt from back-up withholding, within 30 days of the date hereof (and, if it supplies a Form W-9, indicate thereon that it is not subject to backup withholding). The escrow established pursuant to this Escrow Agreement is intended to be treated as a Qualified Settlement Fund for federal tax purposes pursuant to Treas. Reg. § 1.468B-1. The Escrow Agent shall comply with all applicable tax filing, payment and reporting requirements, including, without limitation, those imposed under Treas. Reg. § 1.468B, and if requested to do so shall join in the making of the relation-back election under such regulation.

#### SECTION 7. *Duties and Liabilities of Escrow Agent.*

The Escrow Agent shall have no duty or obligation hereunder other than to take such specific actions as are required of it from time to time under the provisions of this Escrow Agreement, and it shall incur no liability hereunder or in connection herewith for anything whatsoever other than any liability resulting from its own gross negligence or willful misconduct. The Escrow Agent shall not be bound in any way by any agreement or contract between the Participating Manufacturers and the Settling States (whether or not the Escrow Agent has knowledge thereof) other than this Escrow Agreement, and the only duties and responsibilities of the Escrow Agent shall be the duties and obligations specifically set forth in this Escrow Agreement.

#### SECTION 8. *Indemnification of Escrow Agent.*

The Participating Manufacturers shall indemnify, hold harmless and defend the Escrow Agent from and against any and all losses, claims, liabilities and reasonable expenses, including the reasonable fees of its counsel, which it may suffer or incur in connection with the performance of its duties and obligations under this Escrow Agreement, except for those losses, claims, liabilities and expenses resulting solely and directly from its own gross negligence or willful misconduct.

#### SECTION 9. *Resignation of Escrow Agent.*

The Escrow Agent may resign at any time by giving written notice thereof to the other parties hereto, but such resignation shall not become effective until a successor Escrow Agent, selected by the Original Participating Manufacturers and the Settling States, shall have been appointed and shall have accepted such appointment in writing. If an instrument of acceptance by a successor Escrow Agent shall not have been delivered to the resigning Escrow Agent within 90 days after the giving of such notice of resignation, the resigning Escrow Agent may, at the expense of the Participating Manufacturers (to

be shared according to their pro rata Market Shares), petition the Escrow Court for the appointment of a successor Escrow Agent.

#### SECTION 10. *Escrow Agent Fees and Expenses.*

The Participating Manufacturers shall pay to the Escrow Agent its fees as set forth in Appendix A hereto as amended from time to time by agreement of the Original Participating Manufacturers and the Escrow Agent. The Participating Manufacturers shall pay to the Escrow Agent its reasonable fees and expenses, including all reasonable expenses, charges, counsel fees, and other disbursements incurred by it or by its attorneys, agents and employees in the performance of its duties and obligations under this Escrow Agreement. Such fees and expenses shall be shared by the Participating Manufacturers according to their pro rata Market Shares.

#### SECTION 11. *Notices.*

All notices, written instructions or other communications to any party or other person hereunder shall be given in the same manner as, shall be to the same person as, and shall be effective at the same time as provided in subsection XVIII(k) of the Agreement.

#### SECTION 12. *Setoff; Reimbursement.*

The Escrow Agent acknowledges that it shall not be entitled to set off against any funds in, or payable from, any Account to satisfy any liability of any Participating Manufacturer. Each Participating Manufacturer that pays more than its pro rata Market Share of any payment that is made by the Participating Manufacturers to the Escrow Agent pursuant to Section 8, 9 or 10 hereof shall be entitled to reimbursement of such excess from the other Participating Manufacturers according to their pro rata Market Shares of such excess.

#### SECTION 13. *Intended Beneficiaries; Successors.*

No persons or entities other than the Settling States, the Participating Manufacturers and the Escrow Agent are intended beneficiaries of this Escrow Agreement, and only the Settling States, the Participating Manufacturers and the Escrow Agent shall be entitled to enforce the terms of this Escrow Agreement. Pursuant to the Agreement, the Settling States have designated NAAG and the Foundation as recipients of certain payments; for all purposes of this Escrow Agreement, the Settling States shall be the beneficiaries of such payments entitled to enforce payment thereof. The provisions of this Escrow Agreement shall be binding upon and inure to the benefit of the parties hereto and, in the case of the Escrow Agent and Participating Manufacturers, their respective successors. Each reference herein to the Escrow Agent or to a Participating Manufacturer shall be construed as a reference to its successor, where applicable.

#### SECTION 14. *Governing Law.*

This Escrow Agreement shall be construed in accordance with and governed by the laws of the State in which the Escrow Court is located, without regard to the conflicts of law rules of such state.

#### SECTION 15. *Jurisdiction and Venue.*

The parties hereto irrevocably and unconditionally submit to the continuing exclusive jurisdiction of the Escrow Court for purposes of any suit, action or proceeding seeking to interpret or enforce any provision of, or based on any right arising out of, this Escrow Agreement, and the parties hereto agree not to commence any such suit, action or proceeding except in the Escrow Court. The parties hereto hereby irrevocably and unconditionally waive any objection to the laying of venue of any such suit, action or proceeding in the Escrow Court and hereby further irrevocably waive and agree not to plead or claim in the Escrow Court that any such suit, action or proceeding has been brought in an inconvenient forum.

#### SECTION 16. *Amendments.*

This Escrow Agreement may be amended only by written instrument executed by all of the parties hereto that would be affected by the amendment. The waiver of any rights conferred hereunder shall be effective only if made in a written instrument executed by the waiving party. The waiver by any party of any breach of this Agreement shall not be deemed to be or construed as a waiver of any other breach, whether prior, subsequent or contemporaneous, of this Escrow Agreement, nor shall such waiver be deemed to be or construed as a waiver by any other party.

#### SECTION 17. *Counterparts.*

This Agreement may be signed in any number of counterparts, each of which shall be an original, with the same effect as if the signatures thereto and hereto were upon the same instrument. Delivery by facsimile of a signed counterpart shall be deemed delivery for purposes of acknowledging acceptance hereof; however, an original executed Escrow Agreement must promptly thereafter be delivered to each party.

#### SECTION 18. *Captions.*

The captions herein are included for convenience of reference only and shall be ignored in the construction and interpretation hereof.

#### SECTION 19. *Conditions to Effectiveness.*

This Escrow Agreement shall become effective when each party hereto shall have signed a counterpart hereof. The parties hereto agree to use their best efforts to seek an order of the Escrow Court approving, and retaining continuing jurisdiction over, the Escrow Agreement as soon as possible, and agree that such order shall relate back to, and be deemed effective as of, the date this Escrow Agreement became effective.

**SECTION 20. Address for Payments.**

Whenever funds are under the terms of this Escrow Agreement required to be disbursed to a Settling State, a Participating Manufacturer, NAAG or the Foundation, the Escrow Agent shall disburse such funds by wire transfer to the account specified by such payee by written notice delivered to all Notice Parties in accordance with Section 11 hereof at least five Business Days prior to the date of payment. Whenever funds are under the terms of this Escrow Agreement required to be disbursed to any other person or entity, the Escrow Agent shall disburse such funds to such account as shall have been specified in writing by the Independent Auditor for such payment at least five Business Days prior to the date of payment.

**SECTION 21. Reporting.**

The Escrow Agent shall provide such information and reporting with respect to the escrow as the Independent Auditor may from time to time request.

IN WITNESS WHEREOF, the parties have executed this Escrow Agreement as of the day and year first hereinabove written.

[Signature Blocks]

**Appendix A**  
**Schedule Of Fees And Expenses**

**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%	Inflation Adjustment Percentage
2000	2.4%	3.0%
2001	2.1%	3.0%
2002	3.5%	9.8031500%
2003	3.5%	13.6462603%
2004	4.0%	18.1921107%
2005	2.2%	21.7378740%
2006	1.6%	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.

**EXHIBIT D  
LIST OF LAWSUITS**

1. Alabama  
*Blatnick et al. v. American Tobacco Co. et al.*  
Circuit Court, Montgomery County, No. CV-96-1508-PR
2. Alaska  
*State of Alaska v. Philip Morris, Inc., et al.*, Superior Court, First Judicial District of Juneau, No. JIU-97915 CI (Alaska)
3. ARIZONA  
*State of Arizona v. American Tobacco Co., Inc., et al.*, Superior Court, Maricopa County, No. CV-96-14769 (Ariz.)
4. ARKANSAS  
*State of Arkansas v. The American Tobacco Co., Inc., et al.*, Chancery Court, 6<sup>th</sup> Division, Pulaski County, No. JJ 97-2982 (Ark.)
5. California  
*People of the State of California et al. v. Philip Morris, Inc., et al.*, Superior Court, Sacramento County, No. 97-AS-30301
6. Colorado  
*State of Colorado et al. v. R.J. Reynolds Tobacco Co., et al.*, District Court, City and County of Denver, No. 97CV3432 (Colo.)
7. Connecticut  
*State of Connecticut v. Philip Morris, et al.*, Superior Court, Judicial District of Waterbury No. X02 CV96-0148414S (Conn.)
8. Georgia  
*State of Georgia et al. v. Philip Morris, Inc., et al.*, Superior Court, Fulton County, No. CA E-61692 (Ga.)
9. Hawaii  
*State of Hawaii v. Brown & Williamson Tobacco Corp., et al.*, Circuit Court, First Circuit, No. 97-0441-01 (Haw.)
10. Idaho  
*State of Idaho v. Philip Morris, Inc., et al.*, Fourth Judicial District, Ada County, No. CVOC 9703239D (Idaho)
11. Illinois  
*People of the State of Illinois v. Philip Morris et al.*, Circuit Court of Cook County, No. 96-LJ13146 (Ill.)
12. Indiana  
*State of Indiana v. Philip Morris, Inc., et al.*, Marion County Superior Court, No. 49D 07-9702-CT-000236 (Ind.)
13. Iowa  
*State of Iowa v. R.J. Reynolds Tobacco Company et al.*, Iowa District Court, Fifth Judicial District, Polk County, No. CL71048 (Iowa)
14. KANSAS  
*State of Kansas v. R.J. Reynolds Tobacco Company, et al.*, District Court of Shawnee County, Division 2, No. 96-CV-919 (Kan.)
15. Louisiana  
*Ieyouba v. The American Tobacco Company, et al.*, 14th Judicial District Court, Calcasieu Parish, No. 96-1209 (La.)
16. Maine  
*State of Maine v. Philip Morris, Inc., et al.*, Superior Court, Kennebec County, No. CV 97-134 (Me.)
17. Maryland  
*Maryland v. Philip Morris Incorporated, et al.*, Baltimore City Circuit Court, No. 96-122017-CL211487 (Md.)
18. MASSACHUSETTS  
*Commonwealth of Massachusetts v. Philip Morris Inc., et al.*, Middlesex Superior Court, No. 95-7378 (Mass.)
19. Michigan  
*Kelley v. Philip Morris Incorporated, et al.*, Ingham County Circuit Court, 30<sup>th</sup> Judicial Circuit, No. 96-84281-CZ (Mich.)
20. Missouri  
*State of Missouri v. American Tobacco Co., Inc. et al.*, Circuit Court, City of St. Louis, No. 972-1465 (Mo.)
21. MONTANA  
*State of Montana v. Philip Morris, Inc., et al.*, First Judicial Court, Lewis and Clark County, No. CDV 9700306-14 (Mont.)
22. Nebraska  
*State of Nebraska v. R.J. Reynolds Tobacco Co., et al.*, District Court, Lancaster County, No. 573277 (Neb.)



**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 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) [(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 I(f)(mm).

23. Nevada  
*Nevada v. Philip Morris, Incorporated, et al.*, Second Judicial Court, Washoe County, No. CV97-03279 (Nev.)
24. New Hampshire  
*New Hampshire v. R.J. Reynolds Tobacco Co., et al.*, New Hampshire Superior Court, Merrimack County, No. 97-E-165 (N.H.)
25. New Jersey  
*State of New Jersey v. R.J. Reynolds Tobacco Company, et al.*, Superior Court, Chancery Division, Middlesex County, No. C-254-96 (N.J.)
26. New Mexico  
*State of New Mexico v. The American Tobacco Co., et al.*, First Judicial District Court, County of Santa Fe, No. SF-1235 c (N.M.)
27. New York State  
*State of New York et al. v. Philip Morris, Inc., et al.*, Supreme Court of the State of New York, County of New York, No. 40036197 (N.Y.)
28. Ohio  
*State of Ohio v. Philip Morris, Inc., et al.*, Court of Common Pleas, Franklin County, No. 97CV1055114 (Ohio)
29. Oklahoma  
*State of Oklahoma, et al. v. R.J. Reynolds Tobacco Company, et al.*, District Court, Cleveland County, No. CJ-96-1499-L (Okla.)
30. Oregon  
*State of Oregon v. The American Tobacco Co., et al.*, Circuit Court, Multnomah County, No. 9706-04457 (Or.)
31. Pennsylvania  
*Commonwealth of Pennsylvania v. Philip Morris, Inc., et al.*, Court of Common Pleas, Philadelphia County, April Term 1997, No. 2443
32. Puerto Rico  
*Rosado, et al. v. Brown & Williamson Tobacco Corporation, et al.*, U.S. District Court, Puerto Rico, No. 97-1910JAF
33. Rhode Island  
*State of Rhode Island v. American Tobacco Co., et al.*, Rhode Island Superior Court, Providence, No. 97-3058 (R.I.)
34. South Carolina  
*State of South Carolina v. Brown & Williamson Tobacco Corporation, et al.*, Court of Common Pleas, Fifth Judicial Circuit, Richland County, No. 97-CP-40-1686 (S.C.)
35. South Dakota  
*State of South Dakota, et al. v. Philip Morris, Inc., et al.*, Circuit Court, Hughes County, Sixth Judicial Circuit, No. 98-65 (S.D.)
36. Utah  
*State of Utah v. R.J. Reynolds Tobacco Company, et al.*, U.S. District Court, Central Division, No. 96 CV 0829W (Utah)
37. Vermont  
*State of Vermont v. Philip Morris, Inc., et al.*, Chittenden Superior Court, Chittenden County, No. 744-97 (Vt.) and 5816-98 (Vt.)
38. Washington  
*State of Washington v. American Tobacco Co. Inc., et al.*, Superior Court of Washington, King County, No. 96-2-1505608SEA (Wash.)
39. West Virginia  
*McGraw, et al. v. The American Tobacco Company, et al.*, Kanawha County Circuit Court, No. 94-1707 (W. Va.)
40. Wisconsin  
*State of Wisconsin v. Philip Morris Inc., et al.*, Circuit Court, Branch 11, Dane County, No. 97-CV-328 (Wis.)  
Additional States

For each Settling State not listed above, the lawsuit or other legal action filed by the Attorney General or Governor of such Settling State against Participating Manufacturers in the Court in such Settling State prior to 30 days after the MSA Execution Date asserting Released Claims.

**EXHIBIT F**  
**POTENTIAL LEGISLATION NOT TO BE OPPOSED**

1. Limitations on Youth access to vending machines.
2. Inclusion of cigars within the definition of tobacco products.
3. Enhancement of enforcement efforts to identify and prosecute violations of laws prohibiting retail sales to Youth.
4. Encouraging or supporting use of technology to increase effectiveness of age-of-purchase laws, such as, without limitation, the use of programmable scanners, scanners to read drivers' licenses, or use of other age/ID data banks.
5. Limitations on promotional programs for non-tobacco goods using tobacco products as prizes or give-aways.
6. Enforcement of access restrictions through penalties on Youth for possession or use.
7. Limitations on tobacco product advertising in or on school facilities, or wearing of tobacco logo merchandise in or on school property.
8. Limitations on non-tobacco products which are designed to look like tobacco products, such as bubble gum cigars, candy cigarettes, etc.

**EXHIBIT G**  
**OBLIGATIONS OF THE TOBACCO INSTITUTE**  
**UNDER THE MASTER SETTLEMENT AGREEMENT**

- (a) Upon court approval of a plan of dissolution The Tobacco Institute ("TI") will:
  - (1) **Employees.** Promptly notify and arrange for the termination of the employment of all employees; provided, however, that TI may continue to engage any employee who is (A) essential to the wind-down function as set forth in section (g) herein; (B) reasonably needed for the sole purpose of directing and supporting TI's defense of ongoing litigation; or (C) reasonably needed for the sole purpose of performing the Tobacco Institute Testing Laboratory's (the "TITL") industry-wide cigarette testing pursuant to the Federal Trade Commission (the "FTC") method or any other testing prescribed by state or federal law as set forth in section (h) herein.
  - (2) **Employee Benefits.** Fund all employee benefit and pension programs; provided, however, that unless ERISA or other federal or state law prohibits it, such funding will be accomplished through periodic contributions by the Original Participating Manufacturers, according to their Relative Market Shares, into a trust or a like mechanism, which trust or like mechanism will be established within 90 days of court approval of the plan of dissolution. An opinion letter will be appended to the dissolution plan to certify that the trust plan is not inconsistent with ERISA or employee benefit pension contracts.
  - (3) **Leases.** Terminate all leaseholds at the earliest possible date pursuant to the leases; provided, however, that TI may retain or lease anew such space (or lease other space) as needed for its wind-down activities, for TITL testing as described herein, and for subsequent litigation defense activities. Immediately upon execution of this Agreement, TI will provide notice to each of its landlords of its desire to terminate its lease with such landlord, and will request that the landlord take all steps to re-lease the premises at the earliest possible date consistent with TI's performance of its obligations hereunder. TI will vacate such leasehold premises as soon as they are re-leased or on the last day of wind-down, whichever occurs first.
- (b) **Assets/Debts.** Within 60 days after court approval of a plan of dissolution, TI will provide to the Attorney General of New York and append to the dissolution plan a description of all of its assets, its debts, tax claims against it, claims of state and federal governments against it, creditor claims against it, pending litigation in which it is a party and notices of claims against it.
- (c) **Documents.** Subject to the privacy protections provided by New York Public Officers Law §§ 91-99, TI will provide a copy of or otherwise make available to the State of New York all documents in its possession, excluding those that TI continues to claim to be subject to any attorney-client privilege, attorney work product protection, common interest/joint defense privilege or any other applicable privilege (collectively, "privilege") after the re-examination of privilege claims pursuant to court order in *State of Oklahoma v. R.J. Reynolds Tobacco Company, et al.*, CJ-96-2499-L (Dist. Ct., Cleveland County) (the "Oklahoma action").
  - (1) TI will deliver to the Attorney General of the State of New York a copy of the privilege log served by it in the Oklahoma action. Upon a written request by the Attorney General, TI will deliver an updated version of its privilege log, if any such updated version exists.
  - (2) The disclosure of any document or documents claimed to be privileged will be governed by section IV of this Agreement.
  - (3) At the conclusion of the document production and privilege logging process, TI will provide a sworn affidavit that all documents in its possession have been made available to the Attorney General of New York except for documents claimed to be privileged, and that any privilege logs that already exist have been made available to the Attorney General.
- (d) **Remaining Assets.** On mutual agreement between TI and the Attorney General of New York, a not-for-profit health or child welfare organization will be named as the beneficiary of any TI assets that remain after lawful transfers of assets and satisfaction of TI's employee benefit obligations and any other debts, liabilities or claims.
- (e) **Defense of Litigation.** Pursuant to Section 1006 of the New York Not-for-Profit Corporations Law, TI will have the right to continue to defend its litigation interests with respect to any claims against it that are pending or threatened now or that are brought or threatened in the future. TI will retain sole discretion over all litigation decisions, including, without limitation, decisions with respect to asserting any privileges or defenses, having privileged communications and creating privileged documents, filing pleadings, responding to discovery requests, making motions, filing affidavits and briefs, conducting party and non-party discovery, retaining expert witnesses and consultants, preparing for and defending itself at trial, settling any claims asserted against it, intervening or otherwise participating in litigation to protect interests that it deems significant to its defense, and otherwise directing or conducting its defense. Pursuant to existing joint defense agreements, TI may continue to assist its current or former members in defense of any litigation brought or threatened against them. TI also may enter into any new joint defense agreement or agreements that it deems significant to its defense of pending or threatened claims. TI may continue to engage such employees as reasonably needed for the sole purpose of directing and supporting its defense of ongoing litigation. As soon as TI has no litigation pending against it, it will dissolve completely and will cease all functions consistent with the requirements of law.

**EXHIBIT H**  
**DOCUMENT PRODUCTION**

Section 1.

- (a) Philip Morris Companies, Inc., et al., v. American Broadcasting Companies, Inc., et al., 41 Law No. 760CL94X00816-00 (Cir. Ct., City of Richmond)
- (b) Harley-Davidson v. Lorillard Tobacco Co., No. 93-947 (S.D.N.Y.)
- (c) Lorillard Tobacco Co. v. Harley-Davidson, No. 93-6098 (E.D. Wis.)
- (d) Brown & Williamson v. Jacobson and CBS, Inc., No. 82-648 (N.D. Ill.)
- (e) The FTC investigations of tobacco industry advertising and promotion as embodied in the following cites:

- 46 FTC 706
- 48 FTC 82
- 46 FTC 735
- 47 FTC 1393
- 108 F. Supp. 573
- 55 FTC 354
- 56 FTC 96
- 79 FTC 255
- 80 FTC 455
- Investigation #8023069
- Investigation #8323222

Each Original Participating Manufacturer and Tobacco-Related Organization will conduct its own reasonable inquiry to determine what documents or deposition testimony, if any, it produced or provided in the above-listed matters.

Section 2.

- (a) State of Washington v. American Tobacco Co., et al., No. 96-2-15056-8 SEA (Wash. Super. Ct., County of King)
- (b) In re Mike Moore, Attorney General, ex rel. State of Mississippi Tobacco Litigation, No. 94-1429 (Chancery Ct., Jackson, Miss.)
- (c) State of Florida v. American Tobacco Co., et al., No. CL 95-1466 AH (Fla. Cir. Ct., 15<sup>th</sup> Judicial Cir., Palm Beach Co.)
- (d) State of Texas v. American Tobacco Co., et al., No. 5-96CV-91 (E.D. Tex.)
- (e) Minnesota v. Philip Morris et al., No. C-94-8565 (Minn. Dist. Ct., County of Ramsey)
- (f) Brown v. R.J. Reynolds, No. 91-49738 CA (22) (11th Judicial Ct., DuDe County, Florida)

(f) No public statement. Except as necessary in the course of litigation defense as set forth in section (e) above, upon court approval of a plan of dissolution, neither TI nor any of its employees or agents acting in their official capacity on behalf of TI will issue any statements, press releases, or other public statement concerning tobacco.

(g) Wind-down. After court approval of a plan of dissolution, TI will effectuate wind-down of all activities (other than its defense of litigation as described in section (e) above) expeditiously, and in no event later than 180 days after the date of court approval of the plan of dissolution. TI will provide monthly status reports to the Attorney General of New York regarding the progress of wind-down efforts and work remaining to be done with respect to such efforts.

(h) TTTL. Notwithstanding any other provision of this Exhibit G or the dissolution plan, TI may perform TTTL industry-wide cigarette testing pursuant to the FTC method or any other testing prescribed by state or federal law until such function is transferred to another entity, which transfer will be accomplished as soon as practicable but in no event more than 180 days after court approval of the dissolution plan.

(i) Jurisdiction. After the filing of a Certificate of Dissolution, pursuant to Section 1004 of the New York Not-for-Profit Corporation Law, the Supreme Court for the State of New York will have continuing jurisdiction over the dissolution of TI and the winding-down of TI's activities, including any litigation-related activities described in subsection (e) herein.

(j) No Determination of Admission. The dissolution of TI and any proceedings taken hereunder are not intended to be and shall not in any event be construed as, deemed to be, or represented or caused to be represented by any Settling State as, an admission or concession or evidence of any liability or any wrongdoing whatsoever on the part of TI, any of its current or former members or anyone acting on their behalf. TI specifically disclaims and denies any liability or wrongdoing whatsoever with respect to the claims and allegations asserted against it by the Attorney General of the Settling States.

(k) Court Approval. The Attorney General of the State of New York and the Original Participating Manufacturers will prepare a joint plan of dissolution for submission to the Supreme Court of the State of New York, all of the terms of which will be agreed on and consented to by the Attorney General and the Original Participating Manufacturers consistent with this schedule. The Original Participating Manufacturers and their employees, as officers and directors of TI, will take whatever steps are necessary to execute all documents needed to develop such a plan of dissolution and to submit it to the court for approval. If any court makes any material change to any term or provision of the plan of dissolution agreed upon and consented to by the Attorney General and the Original Participating Manufacturers, then:

- (1) the Original Participating Manufacturers may, at their election, nevertheless proceed with the dissolution plan as modified by the court; or
- (2) if the Original Participating Manufacturers elect not to proceed with the court-modified dissolution plan, the Original Participating Manufacturers will be released from any obligations or undertakings under this Agreement or this schedule with respect to TI; provided, however, that the Original Participating Manufacturers will engage in good faith negotiations with the New York Attorney General to agree upon the term or terms of the dissolution plan that the court may have modified in an effort to agree upon a dissolution plan that may be resubmitted for the court's consideration.

**EXHIBIT I  
INDEX AND SEARCH FEATURES FOR DOCUMENT WEBSITE**

(a) Each Original Participating Manufacturer and Tobacco-Related Organization will create and maintain on its website, at its expense, an enhanced, searchable index, as described below, using Alta-Vista or functionally comparable software, for all of the documents currently on its website and all documents being placed on its website pursuant to section IV of this Agreement.

(b) The searchable indices of documents on these websites will include:  
 (1) all of the information contained in the 4(b) indices produced to the State Attorneys General (excluding fields specific only to the Minnesota action other than "request number");

(2) the following additional fields of information (or their substantial equivalent) to the extent such information already exists in an electronic format that can be incorporated into such an index:

- |                        |                        |
|------------------------|------------------------|
| Document ID            | Master ID              |
| Other Number           | Document Date          |
| Primary Type           | Other Type             |
| Person Attending       | Person Noted           |
| Person Author          | Person Recipient       |
| Person Copied          | Person Mentioned       |
| Organization Author    | Organization Recipient |
| Organization Copied    | Organization Mentioned |
| Organization Attending | Organization Noted     |
| Physical Attachment 1  | Physical Attachment 2  |
| Characteristics        | File Name              |
| Site                   | Area                   |
| Verbatim Title         | Old Brand              |
| Primary Brand          | Mentioned Brand        |
| Page Count             |                        |

(c) Each Original Participating Manufacturer and Tobacco-Related Organization will add, if not already available, a user-friendly document retrieval feature on the Website consisting of a "view all pages" function with enhanced image viewer capability that will enable users to choose to view and/or print either "all pages," for a specific document or "page-by-page".

(d) Each Original Participating Manufacturer and Tobacco-Related Organizations will provide at its own expense to NAAG a copy set in electronic form of its website document images and its accompanying subsection IV(h) index in ASCII-delimited form for all of the documents currently on its website and all of the documents described in subsection IV(d) of this Agreement. The Original Participating Manufacturers and Tobacco-Related Organizations will not object to any subsequent distribution and/or reproduction of these copy sets.

**EXHIBIT I  
TOBACCO ENFORCEMENT FUND PROTOCOL**

The States' Antitrust/Consumer Protection Tobacco Enforcement Fund ("Fund") is established by the Attorneys General of the Settling States, acting through NAAG, pursuant to section VIII(c) of the Agreement. The following shall be the primary and mandatory protocol for the administration of the Fund.

**Section A  
Fund Purpose**

**Section 1**

The monies to be paid pursuant to section VIII(c) of the Agreement shall be placed by NAAG in a new and separate interest bearing account, denominated The States' Antitrust/ Consumer Protection Tobacco Enforcement Fund, which shall not then or thereafter be commingled with any other funds or accounts. However, nothing herein shall prevent deposits into the account so long as monies so deposited are then lawfully committed for the purpose of the Fund as set forth herein.

**Section 2**

A committee of three Attorneys General ("Special Committee") shall be established to determine disbursements from the account, using the process described herein. The three shall be the Attorney General of the State of Washington, the Chair of NAAG's antitrust committee, and the Chair of NAAG's consumer protection committee. In the event that an Attorney General shall hold either two or three of the above stated positions, that Attorney General may serve only in a single capacity, and shall be replaced in the remaining positions by first, the President of NAAG, next by the President-Elect of NAAG and if necessary the Vice-President of NAAG.

**Section 3**

The purpose of the Fund is: (1) to enforce and implement the terms of the Agreement, in particular, by partial payment of the monetary costs of the Independent Auditor as contemplated by the Agreement; and (2) to provide monetary assistance to the various states' attorneys general: (A) to investigate and/or litigate suspected violations of the Agreement and/or Consent Decree; (B) to investigate and/or litigate suspected violations of state and/or federal antitrust or consumer protection laws with respect to the manufacture, use, marketing and sales of tobacco products; and (C) to enforce the Qualifying Statute ("Qualifying Actions"). The Special Committee shall entertain requests only from Settling States for disbursement from the fund associated with a Qualifying Action ("Grant Application").

**Section B  
Administration Standards Relative to Grant Applications**

**Section 1**

The Special Committee shall not entertain any Grant Application to pay salaries or ordinary expenses of regular employees of any Attorney General's office.

**Section 2**

The affirmative vote of two or more of the members of the Special Committee shall be required to approve any Grant Application.

**Section 3**

The decision of the Special Committee shall be final and non-appealable.

**Section 4**

The Attorney General of the State of Washington shall be chair of the Special Committee and shall annually report to the Attorneys General on the requests for funds from the Fund and the actions of the Special Committee upon the requests.

**Section 5**

When a Grant Application to the Fund is made by an Attorney General who is then a member of the Special Committee, such member will be temporarily replaced on the Committee, but only for the determination of such Grant Application. The remaining members of the Special Committee shall designate an Attorney General to replace the Attorney General so disqualified, in order to consider the application.

**Section 6**

The Fund shall be maintained in a federally insured depository institution located in Washington, D.C. Funds may be invested in federal government-backed vehicles. The Fund shall be regularly reported on NAAG financial statements and subject to annual audit.

**Section 7**

Withdrawals from and checks drawn on the Fund will require at least two of three authorized signatories. The three persons so authorized shall be the executive director, the deputy director, and controller of NAAG.

**Section 8**

The Special Committee shall meet in person or telephonically as necessary to determine whether a grant is sought for assistance with a Qualifying Action and whether and to what extent the Grant Application is accepted. The chair of the

Special Committee shall designate the times for such meetings, so that a response is made to the Grant Application as expeditiously as practicable.

**Section 10**

The Special Committee may issue a grant from the Fund only when an Attorney General certifies that the monies will be used in connection with a Qualifying Action, to wit: (A) to investigate and/or litigate suspected violations of the Agreement and/or Consent Decree; (B) to investigate and/or litigate suspected violations of state and/or federal antitrust or consumer protection laws with respect to the manufacture, use, marketing and sales of tobacco products; and (C) to enforce the Qualifying Statute. The Attorney General submitting such application shall further certify that the entire grant of monies from the Fund will be used to pay for such investigation and/or litigation. The Grant Application shall describe the nature and scope of the intended action and use of the funds which may be granted.

**Section 11**

To the extent permitted by law, each Attorney General whose Grant Application is favorably acted upon shall promise to pay back to the Fund all of the amounts received from the Fund in the event the state is successful in litigation or settlement of a Qualifying Action. In the event that the monetary recovery, if any, obtained is not sufficient to pay back the entire amount of the grant, the Attorney General shall pay back as much as is permitted by the recovery. In all instances where monies are granted, the Attorney General(s) receiving monies shall provide an accounting to NAAG of all disbursements received from the Fund no later than the 30th of June next following such disbursement.

**Section 12**

In addition to the repayments to the Fund contemplated in the preceding section, the Special Committee may deposit in the Fund any other monies lawfully committed for the precise purpose of the Fund as set forth in section A(3) above. For example, the Special Committee may at its discretion accept for deposit in the Fund a foundation grant or court-ordered award for state antitrust and/or consumer protection enforcement as long as the monies so deposited become part of and subject to the same rules, purposes and limitations of the Fund.

**Section 13**

The Special Committee shall be the sole and final arbiter of all Grant Applications and of the amount awarded for each such application, if any.

**Section 14**

The Special Committee shall endeavor to maintain the Fund for as long a term as is consistent with the purpose of the Fund. The Special Committee will limit the total amount of grants made to a single state to no more than \$500,000.00. The Special Committee will not award a single grant in excess of \$200,000.00, unless the grant involves more than one state, in which case, a single grant so made may not total more than \$300,000.00. The Special Committee may, in its discretion and by unanimous vote, decide to waive these limitations if it determines that special circumstances exist. Such decision, however, shall not be effective unless ratified by a two-thirds majority vote of the NAAG executive committee.

**Section C**

**Grant Application Procedures**

**Section 1**

This Protocol shall be transmitted to the Attorneys General within 90 days after the MSA Execution Date. It may not be amended unless by recommendation of the NAAG executive committee and majority vote of the Settling States. NAAG will notify the Settling States of any amendments promptly and will transmit yearly to the attorneys general a statement of the Fund balance and a summary of deposits to and withdrawals from the Fund in the previous calendar or fiscal year.

**Section 2**

Grant Applications must be in writing and must be signed by the Attorney General submitting the application.

**Section 3**

Grant Applications must include the following:

- (A) A description of the contemplated/pending action, including the scope of the alleged violation and the area (state/regional/multi-state) likely to be affected by the suspected offending conduct.
- (B) A statement whether the action is actively and currently pursued by any other Attorney General or other prosecuting authority.
- (C) A description of the purposes for which the monies sought will be used.
- (D) The amount requested.
- (E) A directive as to how disbursements from the Fund should be made, e.g., either directly to a supplier of services (consultants, experts, witnesses, and the like), to the Attorney General's office directly, or in the case of multi-state action, to one or more Attorneys General's offices designated as a recipient of the monies.

(F) A statement that the applicant Attorney(s) General will, to the extent permitted by law, pay back to the Fund all, or as much as is possible, of the monies received, upon receipt of any monetary recovery obtained in the contemplated/pending litigation or settlement of the action.

(G) A certification that no part of the grant monies will be used to pay the salaries or ordinary expenses of any regular employee of the office of the applicant(s) and that the grant will be used solely to pay for the stated purpose.

(H) A certification that an accounting will be provided to NAAG of all monies received by the applicant(s) by no later than the 30th of June next following any receipt of such monies.

**Section 4**

All Grant Applications shall be submitted to the NAAG office at the following address: National Association of Attorneys General, 750 1st Street, NE, Suite 1100, Washington D.C. 20002.

**Section 5**

The Special Committee will endeavor to act upon all complete and properly submitted Grant Applications within 30 days of receipt of said applications.

**Section D**

**Other Disbursements from the Fund**

**Section 1**

To enforce and implement the terms of the Agreement, the Special Committee shall direct disbursements from the Fund to comply with the partial payment obligations set forth in section XI of the Agreement relative to costs of the Independent Auditor. A report of such disbursements shall be included in the accounting given pursuant to section C(1) above.

**Section E**

**Administrative Costs**

**Section 1**

NAAG shall receive from the Fund on July 1, 1999 and on July 1 of each year thereafter an administrative fee of \$100,000 for its administrative costs in performing its duties under the Protocol and this Agreement. The NAAG executive committee may adjust the amount of the administrative fee in extraordinary circumstances.

**EXHIBIT K  
MARKET CAPITALIZATION PERCENTAGES**

Philip Morris Incorporated	68.00000000%
Brown & Williamson Tobacco Corporation	17.90000000%
Lorillard Tobacco Company	7.30000000%
R.J. Reynolds Tobacco Company	6.80000000%
Total	<u>100.00000000%</u>

**EXHIBIT L  
MODEL CONSENT DECREE**

IN THE [XXXXXX] COURT OF THE STATE OF [XXXXXX]  
IN AND FOR THE COUNTY OF [XXXXX] CAUSE NO. XXXXXX  
----- x

STATE OF [XXXXXXXXXXXXXX],  
Plaintiff,  
v.  
[XXXXXX XXXXX XXXX], et al.,  
Defendants.

**CONSENT DECREE AND FINAL JUDGMENT**

----- x

WHEREAS, Plaintiff, the State of [name of Settling State], commenced this action on [date], [by and through its Attorney General [name]], pursuant to [her/his/its] common law powers and the provisions of [state and/or federal law];  
WHEREAS, the State of [name of Settling State] asserted various claims for monetary, equitable and injunctive relief on behalf of the State of [name of Settling State] against certain tobacco product manufacturers and other defendants;  
WHEREAS, Defendants have contested the claims in the State's complaint [and amended complaints, if any] and denied the State's allegations [and asserted affirmative defenses];

WHEREAS, the parties desire to resolve this action in a manner which appropriately addresses the State's public health concerns, while conserving the parties' resources, as well as those of the Court, which would otherwise be expended in litigating a matter of this magnitude; and  
WHEREAS, the Court has made no determination of any violation of law, this Consent Decree and Final Judgment being entered prior to the taking of any testimony and without trial or final adjudication of any issue of fact or law;

**NOW, THEREFORE, IT IS HEREBY ORDERED, ADJUDGED AND DECREED, AS FOLLOWS:**

**I. JURISDICTION AND VENUE**

This Court has jurisdiction over the subject matter of this action and over each of the Participating Manufacturers. Venue is proper in this [county/district].

**II. DEFINITIONS**

The definitions set forth in the Agreement (a copy of which is attached hereto) are incorporated herein by reference.

**III. APPLICABILITY**

A. This Consent Decree and Final Judgment applies only to the Participating Manufacturers in their corporate capacity acting through their respective successors and assigns, directors, officers, employees, agents, subsidiaries, divisions, or other internal organizational units of any kind or any other entities acting in concert or participation with them. The remedies, penalties and sanctions that may be imposed or assessed in connection with a violation of this Consent Decree and Final Judgment (or any order issued in connection herewith) shall only apply to the Participating Manufacturers, and shall not be imposed or assessed against any employee, officer or director of any Participating Manufacturer, or against any other person or entity as a consequence of such violation, and there shall be no jurisdiction under this Consent Decree and Final Judgment to do so.

B. This Consent Decree and Final Judgment is not intended to and does not vest standing in any third party with respect to the terms hereof. No portion of this Consent Decree and Final Judgment shall provide any rights to, or be enforceable by, any person or entity other than the State of [name of Settling State] or a Released Party. The State of [name of Settling State] may not assign or otherwise convey any right to enforce any provision of this Consent Decree and Final Judgment.

**IV. VOLUNTARY ACT OF THE PARTIES**

The parties hereto expressly acknowledge and agree that this Consent Decree and Final Judgment is voluntarily entered into as the result of arm's-length negotiation, and all parties hereto were represented by counsel in deciding to enter into this Consent Decree and Final Judgment.

**V. INJUNCTIVE AND OTHER EQUITABLE RELIEF**

Each Participating Manufacturer is permanently enjoined from:

sentence shall be deemed to (1) require any Participating Manufacturer to produce, distribute or otherwise disclose any information that is subject to any privilege or protection; (2) preclude any Participating Manufacturer from entering into any joint defense or joint legal interest agreement or arrangement (whether or not in writing), or from asserting any privilege pursuant thereto; or (3) impose any affirmative obligation on any Participating Manufacturer to conduct any research.

I. Making any material misrepresentation of fact regarding the health consequences of using any Tobacco Product, including any tobacco additives, filters, paper or other ingredients. Provided, however, that nothing in the preceding sentence shall limit the exercise of any First Amendment right or the assertion of any defense or position in any judicial, legislative or regulatory forum.

#### VI. MISCELLANEOUS PROVISIONS

A. Jurisdiction of this case is retained by the Court for the purposes of implementing and enforcing the Agreement and this Consent Decree and Final Judgment and enabling the continuing proceedings contemplated herein. Whenever possible, the State of [name of Settling State] and the Participating Manufacturers shall seek to resolve any issue that may exist as to compliance with this Consent Decree and Final Judgment by discussion among the appropriate designees named pursuant to subsection XVIII(m) of the Agreement. The State of [name of Settling State] and/or any Participating Manufacturer may apply to the Court at any time for further orders and directions as may be necessary or appropriate for the implementation and enforcement of this Consent Decree and Final Judgment. Provided, however, that with regard to subsections V(A) and V(I) of this Consent Decree and Final Judgment, the Attorney General shall issue a cease and desist demand to the Participating Manufacturer that the Attorney General believes is in violation of either of such sections at least ten Business Days before the Attorney General applies to the Court for an order to enforce such subsections, unless the Attorney General reasonably determines that either a compelling time-sensitive public health and safety concern requires more immediate action or the Court has previously issued an Enforcement Order to the Participating Manufacturer in question for the same or a substantially similar action or activity. For any claimed violation of this Consent Decree and Final Judgment, in determining whether to seek an order for monetary, civil contempt or criminal sanctions for any claimed violation, the Attorney General shall give good-faith consideration to whether: (1) the Participating Manufacturer that is claimed to have committed the violation has taken appropriate and reasonable steps to cause the claimed violation to be cured, unless that party has been guilty of a pattern of violations of like nature; and (2) a legitimate, good-faith dispute exists as to the meaning of the terms in question of this Consent Decree and Final Judgment. The Court in any case in its discretion may determine not to enter an order for monetary, civil contempt or criminal sanctions.

B. This Consent Decree and Final Judgment is not intended to be, and shall not in any event be construed as, or deemed to be, an admission or concession or evidence of (1) any liability or any wrongdoing whatsoever on the part of any Released Party or that any Released Party has engaged in any of the activities barred by this Consent Decree and Final Judgment; or (2) personal jurisdiction over any person or entity other than the Participating Manufacturers. Each Participating Manufacturer specifically disclaims and denies any liability or wrongdoing whatsoever with respect to the claims and allegations asserted against it in this action, and has stipulated to the entry of this Consent Decree and Final Judgment solely to avoid the further expense, inconvenience, burden and risk of litigation.

C. Except as expressly provided otherwise in the Agreement, this Consent Decree and Final Judgment shall not be modified (by this Court, by any other court or by any other means) unless the party seeking modification demonstrates, by clear and convincing evidence, that it will suffer irreparable harm from new and unforeseen conditions. Provided, however, that the provisions of sections III, V, VI and VII of this Consent Decree and Final Judgment shall in no event be subject to modification without the consent of the State of [name of Settling State] and all affected Participating Manufacturers. In the event that any of the sections of this Consent Decree and Final Judgment enumerated in the preceding sentence are modified by this Court, by any other court or by any other means without the consent of the State of [name of Settling State] and all affected Participating Manufacturers, then this Consent Decree and Final Judgment shall be void and of no further effect. Changes in the economic conditions of the parties shall not be grounds for modification. It is intended that the Participating Manufacturers will comply with this Consent Decree and Final Judgment as originally entered, even if the Participating Manufacturers' obligations hereunder are greater than those imposed under current or future law (unless compliance with this Consent Decree and Final Judgment would violate such law). A change in law that results, directly or indirectly, in more favorable or beneficial treatment of any one or more of the Participating Manufacturers shall not support modification of this Consent Decree and Final Judgment.

D. In any proceeding which results in a finding that a Participating Manufacturer violated this Consent Decree and Final Judgment, the Participating Manufacturer or Participating Manufacturers found to be in violation shall pay the State's costs and attorneys' fees incurred by the State of [name of Settling State] in such proceeding.

E. The remedies in this Consent Decree and Final Judgment are cumulative and in addition to any other remedies the State of [name of Settling State] may have at law or equity, including but not limited to its rights under the Agreement. Nothing herein shall be construed to prevent the State from bringing an action with respect to conduct not released pursuant to the Agreement, even though that conduct may also violate this Consent Decree and Final Judgment. Nothing in this Consent Decree and Final Judgment is intended to create any right for [name of Settling State] to obtain any Cigarette product formula that it would not otherwise have under applicable law.

A. Taking any action, directly or indirectly, to target Youth within the State of [name of Settling State] in the advertising, promotion or marketing of Tobacco Products, or taking any action the primary purpose of which is to initiate, maintain or increase the incidence of Youth smoking within the State of [name of Settling State].

B. After 180 days after the MSA Execution Date, using or causing to be used within the State of [name of Settling State] any Cartoon in the advertising, promoting, packaging or labeling of Tobacco Products.

C. After 30 days after the MSA Execution Date, making or causing to be made any payment or other consideration to any other person or entity to use, display, make reference to or use as a prop within the State of [name of Settling State] any Tobacco Product, Tobacco Product package, advertisement for a Tobacco Product, or any other item bearing a Brand Name in any Media; provided, however, that the foregoing prohibition shall not apply to (1) Media where the audience or viewers are within an Adult-Only Facility (provided such Media are not visible to persons outside such Adult-Only Facility); (2) Media not intended for distribution or display to the public; (3) instructional Media concerning non-conventional cigarettes viewed only by or provided only to smokers who are Adults; and (4) actions taken by any Participating Manufacturer in connection with a Brand Name Sponsorship permitted pursuant to subsections III(c)(2)(A) and III(c)(2)(B)(i) of the Agreement, and use of a Brand Name to identify a Brand Name Sponsorship permitted by subsection III(c)(2)(B)(ii).

D. Beginning July 1, 1999, marketing, distributing, offering, selling, licensing or causing to be marketed, distributed, offered, sold, or licensed (including, without limitation, by catalogue or direct mail), within the State of [name of Settling State], any apparel or other merchandise (other than Tobacco Products, items the sole function of which is to advertise Tobacco Products, or written or electronic publications) which bears a Brand Name. Provided, however, that nothing in this section shall (1) require any Participating Manufacturer to breach or terminate any licensing agreement or other contract in existence as of June 20, 1997 (this exception shall not apply beyond the current term of any existing contract, without regard to any renewal or option term that may be exercised by such Participating Manufacturer); (2) prohibit the distribution to any Participating Manufacturer's employee who is not Underage of any item described above that is intended for the personal use of such an employee; (3) require any Participating Manufacturer to retrieve, collect or otherwise recover any item that prior to the MSA Execution Date was marketed, distributed, offered, sold, licensed or caused to be marketed, distributed, offered, sold or licensed by such Participating Manufacturer; (4) apply to coupons or other items used by Adults solely in connection with the purchase of Tobacco Products; (5) apply to apparel or other merchandise used within an Adult-Only Facility that is not distributed (by sale or otherwise) to any member of the general public; or (6) apply to apparel or other merchandise (a) marketed, distributed, offered, sold, or licensed at the site of a Brand Name Sponsorship permitted pursuant to subsection III(c)(2)(A) or III(c)(2)(B)(i) of the Agreement by the person to which the relevant Participating Manufacturer has provided payment in exchange for the use of the relevant Brand Name in the Brand Name Sponsorship or a third-party that does not receive payment from the relevant Participating Manufacturer (or any Affiliate of such Participating Manufacturer) in connection with the marketing, distribution, offer, sale or license of such apparel or other merchandise, or (b) used at the site of a Brand Name Sponsorship permitted pursuant to subsections III(c)(2)(A) or III(c)(2)(B)(i) of the Agreement (during such event) that are not distributed (by sale or otherwise) to any member of the general public.

E. After the MSA Execution Date, distributing or causing to be distributed within the State of [name of Settling State] any free samples of Tobacco Products except in an Adult-Only Facility. For purposes of this Consent Decree and Final Judgment, a "free sample" does not include a Tobacco Product that is provided to an Adult in connection with (1) the purchase, exchange or redemption for proof of purchase of any Tobacco Products (including, but not limited to, a free offer in connection with the purchase of Tobacco Products, such as a "two-for-one" offer), or (2) the conducting of consumer testing or evaluation of Tobacco Products with persons who certify that they are Adults.

F. Using or causing to be used as a brand name of any Tobacco Product pursuant to any agreement requiring the payment of money or other valuable consideration, any nationally recognized or nationally established brand name or trade name of any non-tobacco item or service or any nationally recognized or nationally established sports team, entertainment group or individual celebrity. Provided, however, that the preceding sentence shall not apply to any Tobacco Product brand name in existence as of July 1, 1998. For the purposes of this provision, the term "other valuable consideration" shall not include an agreement between two entities who enter into such agreement for the sole purpose of avoiding infringement claims.

G. After 60 days after the MSA Execution Date and through and including December 31, 2001, manufacturing or causing to be manufactured for sale within the State of [name of Settling State] any pack or other container of Cigarettes containing fewer than 20 Cigarettes (or, in the case of roll-your-own tobacco, any package of roll-your-own tobacco containing less than 0.60 ounces of tobacco); and, after 150 days after the MSA Execution Date and through and including December 31, 2001, selling or distributing within the State of [name of Settling State] any pack or other container of Cigarettes containing fewer than 20 Cigarettes (or, in the case of roll-your-own tobacco, any package of roll-your-own tobacco containing less than 0.60 ounces of tobacco).

H. Entering into any contract, combination or conspiracy with any other Tobacco Product Manufacturer that has the purpose or effect of: (1) limiting competition in the production or distribution of information about health hazards or other consequences of the use of their products; (2) limiting or suppressing research into smoking and health; or (3) limiting or suppressing research into the marketing or development of new products. Provided, however, that nothing in the preceding

F. No party shall be considered the drafter of this Consent Decree and Final Judgment for the purpose of any statute, case law or rule of interpretation or construction that would or might cause any provision to be construed against the drafter. Nothing in this Consent Decree and Final Judgment shall be construed as approval by the State of [name of Settling State] of the Participating Manufacturers' business organizations, operations, acts or practices, and the Participating Manufacturers shall make no representation to the contrary.

G. The settlement negotiations resulting in this Consent Decree and Final Judgment have been undertaken in good faith and for settlement purposes only, and no evidence of negotiations or discussions underlying this Consent Decree and Final Judgment shall be offered or received in evidence in any action or proceeding for any purpose. Neither this Consent Decree and Final Judgment nor any public discussions, public statements or public comments with respect to this Consent Decree and Final Judgment by the State of [name of Settling State] or any Participating Manufacturer or its agents shall be offered or received in evidence in any action or proceeding for any purpose other than in an action or proceeding arising under or relating to this Consent Decree and Final Judgment.

H. All obligations of the Participating Manufacturers pursuant to this Consent Decree and Final Judgment (including, but not limited to, all payment obligations) are, and shall remain, several and not joint.

I. The provisions of this Consent Decree and Final Judgment are applicable only to actions taken (or omitted to be taken) within the States. Provided, however, that the preceding sentence shall not be construed as extending the territorial scope of any provision of this Consent Decree and Final Judgment whose scope is otherwise limited by the terms thereof.

J. Nothing in subsection V(A) or V(I) of this Consent Decree shall create a right to challenge the continuation, after the MSA Execution Date, of any advertising content, claim or slogan (other than use of a Cartoon) that was not unlawful prior to the MSA Execution Date.

K. If the Agreement terminates in this State for any reason, then this Consent Decree and Final Judgment shall be void and of no further effect.

#### VII. FINAL DISPOSITION

A. The Agreement, the settlement set forth therein, and the establishment of the escrow provided for therein are hereby approved in all respects, and all claims are hereby dismissed with prejudice as provided therein.

B. The Court finds that the person[s] signing the Agreement have full and complete authority to enter into the binding and fully effective settlement of this action as set forth in the Agreement. The Court further finds that entering into this settlement is in the best interests of the State of [name of Settling State].

LET JUDGMENT BE ENTERED ACCORDINGLY

DATED this \_\_\_\_\_ day of \_\_\_\_\_, 1998.

### EXHIBIT M LIST OF PARTICIPATING MANUFACTURERS' LAWSUITS AGAINST THE SETTLING STATES

1. Philip Morris, Inc., et al. v. Muzny Bronster, Attorney General of the State of Hawaii, In Her Official Capacity, Civ. No. 96-00722HG, United States District Court for the District of Hawaii
2. Philip Morris, Inc., et al. v. Bruce Botelho, Attorney General of the State of Alaska, In His Official Capacity, Civ. No. A97-0003CV, United States District Court for the District of Alaska
3. Philip Morris, Inc., et al. v. Scott Harshbarger, Attorney General of the Commonwealth of Massachusetts, In His Official Capacity, Civ. No. 95-12574-GAO, United States District Court for the District of Massachusetts
4. Philip Morris, Inc., et al. v. Richard Blumenthal, Attorney General of the State of Connecticut, In His Official Capacity, Civ. No. 396CV01221 (PCD), United States District Court for the District of Connecticut
5. Philip Morris, et al. v. William H. Sorrell, et al., No. 1:98-ev-132, United States District Court for the District of Vermont



**EXHIBIT N**  
**LITIGATING POLITICAL SUBDIVISIONS**

1. City of New York, et al., v. The Tobacco Institute, Inc., et al., Supreme Court of the State of New York, County of New York, Index No. 406225/96
2. County of Erie v. The Tobacco Institute, Inc., et al., Supreme Court of the State of New York, County of Erie, Index No. 1 1997/359
3. County of Los Angeles v. R.J. Reynolds Tobacco Co., et al., San Diego Superior Court, No. 707651
4. The People v. Philip Morris, Inc., et al., San Francisco Superior Court, No. 980864
5. County of Cook v. Philip Morris, Inc., et al., Circuit Court of Cook County, Ill., No. 97-L-4550

**EXHIBIT O**  
**MODEL STATE FEE PAYMENT AGREEMENT**

This STATE Fee Payment Agreement (the "STATE Fee Payment Agreement") is entered into as of \_\_\_\_\_, between and among the Original Participating Manufacturers and STATE Outside Counsel (as defined herein), to provide for payment of attorneys' fees pursuant to Section XVII of the Master Settlement Agreement (the "Agreement").

WITNESSETH:

WHEREAS, the State of STATE and the Original Participating Manufacturers have entered into the Agreement to settle and resolve with finality all Released Claims against the Released Parties, including the Original Participating Manufacturers, as set forth in the Agreement; and

WHEREAS, Section XVII of the Agreement provides that the Original Participating Manufacturers shall pay reasonable attorneys' fees to those private outside counsel identified in Exhibit S to the Agreement, pursuant to the terms hereof;

NOW, THEREFORE, BE IT KNOWN THAT, in consideration of the mutual agreement of the State of STATE and the Original Participating Manufacturers to the terms of the Agreement and of the mutual agreement of STATE Outside Counsel and the Original Participating Manufacturers to the terms of this STATE Fee Payment Agreement, and such other consideration described herein, the Original Participating Manufacturers and STATE Outside Counsel agree as follows:

**SECTION 1. Definitions.**

All definitions contained in the Agreement are incorporated by reference herein, except as to terms specifically defined herein.

(a) "Action" means the lawsuit identified in Exhibit D, M or N to the Agreement that has been brought by or against the State of STATE for Litigating Political Subdivision(s).

(b) "Allocated Amount" means the amount of any Applicable Quarterly Payment allocated to any Private Counsel (including STATE Outside Counsel) pursuant to section 17 hereof.

(c) "Allocable Liquidated Share" means, in the event that the sum of all Payable Liquidated Fees of Private Counsel as of any date specified in section 8 hereof exceeds the Applicable Liquidation Amount for any payment described therein, a percentage share of the Applicable Liquidation Amount equal to the proportion of (i) the amount of the Payable Liquidated Fee of STATE Outside Counsel to (ii) the sum of Payable Liquidated Fees of all Private Counsel.

(d) "Applicable Liquidation Amount" means, for purposes of the payments described in section 8 hereof —

(i) for the payment described in subsection (a) thereof, \$125 million;

(ii) for the payment described in subsection (b) thereof, the difference between (A) \$250 million and (B) the sum of all amounts paid in satisfaction of all Payable Liquidated Fees of Outside Counsel pursuant to subsection (a) thereof;

(iii) for the payment described in subsection (c) thereof, the difference between (A) \$250 million and (B) the sum of all amounts paid in satisfaction of all Payable Liquidated Fees of Outside Counsel pursuant to subsections (a) and (b) thereof;

(iv) for the payment described in subsection (d) thereof, the difference between (A) \$250 million and (B) the sum of all amounts paid in satisfaction of all Payable Liquidated Fees of Outside Counsel pursuant to subsections (a), (b) and (c) thereof;

(v) for the payment described in subsection (e) thereof, the difference between (A) \$250 million and (B) the sum of all amounts paid in satisfaction of all Payable Liquidated Fees of Outside Counsel pursuant to subsections (a), (b), (c) and (d) thereof;

(vi) for each of the first, second and third quarterly payments for any calendar year described in subsection (f) thereof, \$62.5 million; and

(vii) for each of the fourth calendar quarterly payments for any calendar year described in subsection (f) thereof, the difference between (A) \$250 million and (B) the sum of all amounts paid in satisfaction of all Payable Liquidated Fees of Outside Counsel with respect to the preceding calendar quarters of the calendar year.

(e) "Application" means a written application for a Fee Award submitted to the Panel, as well as all supporting materials (which may include video recordings of interviews).

(f) "Approved Cost Statement" means both (i) a Cost Statement that has been accepted by the Original Participating Manufacturers; and (ii) in the event that a Cost Statement submitted by STATE Outside Counsel is disputed, the determination by arbitration pursuant to subsection (b) of section 19 hereof as to the amount of the reasonable costs and expenses of STATE Outside Counsel.

(g) "Cost Statement" means a signed and attested statement of reasonable costs and expenses of Outside Counsel for any action identified on Exhibit D, M or N to the Agreement that has been brought by or against a Settling State or Litigating Political Subdivision.

(h) "Designated Representative" means the person designated in writing, by each person or entity identified in Exhibit S to the Agreement, by the Attorney General of the State of STATE or as later certified in writing by the governmental prosecuting authority of the Litigating Political Subdivision, to act as their agent in receiving payments from the Original Participating Manufacturers for the benefit of STATE Outside Counsel pursuant to sections 8, 16 and 19 hereof, as applicable.

(i) "Director" means the Director of the Private Adjudication Center of the Duke University School of Law or such other person or entity as may be chosen by agreement of the Original Participating Manufacturers and the Committee described in the second sentence of paragraph (b)(ii) of section 11 hereof.

(j) "Eligible Counsel" means Private Counsel eligible to be allocated a part of a Quarterly Fee Amount pursuant to section 17 hereof.

(k) "Federal Legislation" means federal legislation that imposes an enforceable obligation on Participating Defendants to pay attorneys' fees with respect to Private Counsel.

(l) "Fee Award" means any award of attorneys' fees by the Panel in connection with a Tobacco Case.

(m) "Liquidated Fee" means an attorneys' fee for Outside Counsel for any action identified on Exhibit D, M or N to the Agreement that has been brought by or against a Settling State or Litigating Political Subdivision, in an amount agreed upon by the Original Participating Manufacturers and such Outside Counsel.

(n) "Outside Counsel" means all those Private Counsel identified in Exhibit S to the Agreement.

(o) "Panel" means the three-member arbitration panel described in section 11 hereof.

(p) "Party" means (i) STATE Outside Counsel and (ii) an Original Participating Manufacturer.

(q) "Payable Cost Statement" means the unpaid amount of a Cost Statement as to which all conditions precedent to payment have been satisfied.

(r) "Payable Liquidated Fee" means the unpaid amount of a Liquidated Fee as to which all conditions precedent to payment have been satisfied.

(s) "Previously Settled States" means the States of Mississippi, Florida and Texas.

(t) "Private Counsel" means all private counsel for all plaintiffs in a Tobacco Case (including STATE Outside Counsel).

(u) "Quarterly Fee Amount" means, for purposes of the quarterly payments described in sections 16, 17 and 18 hereof —

(i) for each of the first, second and third calendar quarters of any calendar year beginning with the first calendar quarter of 1999 and ending with the third calendar quarter of 2008, \$125 million;

(ii) for each fourth calendar quarter of any calendar year beginning with the fourth calendar quarter of 1999 and ending with the fourth calendar quarter of 2003, the sum of (A) \$125 million and (B) the difference, if any, between \$125 million and (2) the sum of all amounts paid in satisfaction of all Fee Awards of Private Counsel during such calendar year, if any;

(iii) for each fourth calendar quarter of any calendar year beginning with the fourth calendar quarter of 2004 and ending with the fourth calendar quarter of 2008, the sum of (A) \$125 million; (B) the difference between (i) \$375 million; and (2) the sum of all amounts paid in satisfaction of all Fee Awards of Private Counsel during such calendar year, if any; and (C) the difference, if any, between (i) \$250 million and (2) the product of (a) .2 (two tenths) and (b) the sum of all amounts paid in satisfaction of all Liquidated Fees of Outside Counsel pursuant to section 8 hereof, if any;

(iv) for each of the first, second and third calendar quarters of any calendar year beginning with the first calendar quarter of 2009, \$125 million; and

(v) for each fourth calendar quarter of any calendar year beginning with the fourth calendar quarter of 2009, the sum of (A) \$125 million and (B) the difference, if any, between (i) \$375 million and (2) the sum of all amounts paid in satisfaction of all Fee Awards of Private Counsel during such calendar year, if any.

(v) "Related Persons" means each Original Participating Manufacturer's past, present and future Affiliates, divisions, officers, directors, employees, representatives, insurers, lenders, underwriters, Tobacco-Related Organizations, trade associations, suppliers, agents, auditors, advertising agencies, public relations entities, attorneys, retailers and distributors (and the predecessors, heirs, executors, administrators, successors and assigns of each of the foregoing).

(w) "State of STATE" means the (applicable Settling State or the Litigating Political Subdivision), any of its past, present and future agents, officials acting in their official capacities, legal representatives, agencies, departments, commissions and subdivisions.

(x) "STATE Outside Counsel" means all persons or entities identified in Exhibit S to the Agreement by the Attorney General of State of STATE (or as later certified by the office of the governmental prosecuting authority for the Litigating Political Subdivision) as having been retained by and having represented the STATE in connection with the Action, acting collectively by unanimous decision of all such persons or entities.

(y) "Tobacco Case" means any tobacco and health case (other than a non-class action personal injury case brought directly by or on behalf of a single natural person or the survivor of such person or for wrongful death, or any non-class action consolidation of two or more such cases).

(z) "Unpaid Fee" means the unpaid portion of a Fee Award.

#### SECTION 2. Agreement to Pay Fees.

The Original Participating Manufacturers will pay reasonable attorneys' fees to STATE Outside Counsel for their representation of the State of STATE in connection with the Action, as provided herein and subject to the *Code of Professional Responsibility* of the American Bar Association. Nothing herein shall be construed to require the Original Participating Manufacturers to pay any attorneys' fees other than (i) a Liquidated Fee or a Fee Award and (ii) a Cost Statement, as provided herein, nor shall anything herein require the Original Participating Manufacturers to pay any Liquidated Fee, Fee Award or Cost Statement in connection with any litigation other than the Action.

#### SECTION 3. Exclusive Obligation of the Original Participating Manufacturers.

The provisions set forth herein constitute the entire obligation of the Original Participating Manufacturers with respect to payment of attorneys' fees of STATE Outside Counsel (including costs and expenses) in connection with the Action and the exclusive means by which STATE Outside Counsel or any other person or entity may seek payment of fees by the Original Participating Manufacturers or Related Persons in connection with the Action. The Original Participating Manufacturers shall have no obligation pursuant to Section XVII of the Agreement to pay attorneys' fees in connection with the Action to any counsel other than STATE Outside Counsel, and they shall have no other obligation to pay attorneys' fees to or otherwise to compensate STATE Outside Counsel, any other counsel or representative of the State of STATE or the State of STATE itself with respect to attorneys' fees in connection with the Action.

#### SECTION 4. Release.

(a) Each person or entity identified in Exhibit S to the Agreement by the Attorney General of the State of STATE for as certified by the office of the governmental prosecuting authority for the Litigating Political Subdivision hereby irrevocably releases the Original Participating Manufacturers and all Related Persons from any and all claims that such person or entity ever had, now has or hereafter can, shall or may have in any way related to the Action (including but not limited to any negotiations related to the settlement of the Action). Such release shall not be construed as a release of any person or entity as to any of the obligations undertaken herein in connection with a breach thereof.

(b) In the event that STATE Outside Counsel and the Original Participating Manufacturers agree upon a Liquidated Fee pursuant to section 7 hereof, it shall be a precondition to any payment by the Original Participating Manufacturers to the Designated Representative pursuant to section 8 hereof that each person or entity identified in Exhibit S to the Agreement by the Attorney General of the State of STATE (or as certified by the office of the governmental prosecuting authority for the Litigating Political Subdivision) shall have irrevocably released all entities represented by STATE Outside Counsel in the Action, as well as all persons acting by or on behalf of such entities (including the Attorney General for the office of the governmental prosecuting authority) and each other person or entity identified on Exhibit S to the Agreement by the Attorney General for the office of the governmental prosecuting authority) from any and all claims that such person or entity ever had, now has or hereafter can, shall or may have in any way related to the Action (including but not limited to any negotiations related to the settlement of the Action). Such release shall not be construed as a release of any person or entity as to any of the obligations undertaken herein in connection with a breach thereof.

#### SECTION 5. No Effect on STATE Outside Counsel's Fee Contract.

The rights and obligations, if any, of the respective parties to any contract between the State of STATE and STATE Outside Counsel shall be unaffected by this STATE Fee Payment Agreement except (a) insofar as STATE Outside Counsel grant the release described in subsection (b) of section 4 hereof; and (b) to the extent that STATE Outside Counsel receive any payments in satisfaction of a Fee Award pursuant to section 16 hereof, any amounts so received shall be credited, on a dollar-for-dollar basis, against any amount payable to STATE Outside Counsel by the State of STATE for the Litigating Political Subdivision) under any such contract.

#### SECTION 6. Liquidated Fees.

(a) In the event that the Original Participating Manufacturers and STATE Outside Counsel agree upon the amount of a Liquidated Fee, the Original Participating Manufacturers shall pay such Liquidated Fee, pursuant to the terms hereof.

(b) The Original Participating Manufacturers' payment of any Liquidated Fee pursuant to this STATE Fee Payment Agreement shall be subject to (i) satisfaction of the conditions precedent stated in section 4 and paragraph (c)(ii) of section 7 hereof; and (ii) the payment schedule and the annual and quarterly aggregate national caps specified in sections 8 and 9 hereof, which shall apply to all payments made with respect to Liquidated Fees of all Outside Counsel.

#### SECTION 7. Negotiation of Liquidated Fees.

(a) If STATE Outside Counsel seek to be paid a Liquidated Fee, the Designated Representative shall so notify the Original Participating Manufacturers. The Original Participating Manufacturers may at any time make an offer of a Liquidated Fee to the Designated Representative in an amount set by the unanimous agreement, and at the sole discretion, of the Original Participating Manufacturers and, in any event, shall collectively make such an offer to the Designated Representative no more than 60 Business Days after receipt of notice by the Designated Representative that STATE Outside

Counsel seek to be paid a Liquidated Fee. The Original Participating Manufacturers shall not be obligated to make an offer of a Liquidated Fee in any particular amount. Within ten Business Days after receiving such an offer, STATE Outside Counsel shall either accept the offer, reject the offer or make a counteroffer.

(b) The national aggregate of all Liquidated Fees to be agreed to by the Original Participating Manufacturers in connection with the settlement of those actions indicated on Exhibits D, M and N to the Agreement shall not exceed one billion two hundred fifty million dollars (\$1,250,000,000).

(c) If the Original Participating Manufacturers and STATE Outside Counsel agree in writing upon a Liquidated Fee:

(i) STATE Outside Counsel shall not be eligible for a Fee Award;

(ii) such Liquidated Fee shall not become a Payable Liquidated Fee until such time as (A) State-Specific Finality has occurred in the State of STATE; (B) each person or entity identified in Exhibit S to the Agreement by the Attorney General of the State of STATE for as certified by the office of the governmental prosecuting authority of the Litigating Political Subdivision has granted the release described in subsection (b) of section 4 hereof; and (C) notice of the events described in subparagraphs (A) and (B) of this paragraph has been provided to the Original Participating Manufacturers.

(iii) payment of such Liquidated Fee pursuant to sections 8 and 9 hereof (together with payment by the Original Participating Manufacturers to section 19 hereof), shall be STATE Outside Counsel's total and sole compensation by the Original Participating Manufacturers in connection with the Action.

(d) If the Original Participating Manufacturers and STATE Outside Counsel do not agree in writing upon a Liquidated Fee, STATE Outside Counsel may submit an Application to the Panel for a Fee Award to be paid as provided in sections 16, 17 and 18 hereof.

#### SECTION 8. *Payment of Liquidated Fee.*

In the event that the Original Participating Manufacturers and STATE Outside Counsel agree in writing upon a Liquidated Fee, and until such time as the Designated Representative has received payments in full satisfaction of such Liquidated Fee —

(a) On February 1, 1999, if the Liquidated Fee of STATE Outside Counsel became a Payable Liquidated Fee before January 15, 1999, each Original Participating Manufacturer shall severally pay to the Designated Representative its Relative Market Share of (i) the Payable Liquidated Fee of STATE Outside Counsel, (ii) \$5 million or (iii) in the event that the sum of all Payable Liquidated Fees of all Outside Counsel as of January 15, 1999 exceeds the Applicable Liquidation Amount, the Allocable Liquidated Share of STATE Outside Counsel.

(b) On August 1, 1999, if the Liquidated Fee of STATE Outside Counsel became a Payable Liquidated Fee on or after January 15, 1999 and before July 15, 1999, each Original Participating Manufacturer shall severally pay to the Designated Representative its Relative Market Share of (i) the Payable Liquidated Fee of STATE Outside Counsel, (ii) \$5 million or (iii) in the event that the sum of all Payable Liquidated Fees of all Outside Counsel that became Payable Liquidated Fees on or after January 15, 1999 and before July 15, 1999 exceeds the Applicable Liquidation Amount, the Allocable Liquidated Share of STATE Outside Counsel.

(c) On December 15, 1999, if the Liquidated Fee of STATE Outside Counsel became a Payable Liquidated Fee on or after July 15, 1999 and before December 1, 1999, each Original Participating Manufacturer shall severally pay to the Designated Representative its Relative Market Share of (i) the Payable Liquidated Fee of STATE Outside Counsel, (ii) \$5 million or (iii) in the event that the sum of all Payable Liquidated Fees of all Outside Counsel that became Payable Liquidated Fees on or after July 15, 1999 and before December 1, 1999 exceeds the Applicable Liquidation Amount, the Allocable Liquidated Share of STATE Outside Counsel.

(d) On December 15, 1999, if the Liquidated Fee of STATE Outside Counsel became a Payable Liquidated Fee before December 1, 1999, each Original Participating Manufacturer shall severally pay to the Designated Representative its Relative Market Share of (i) the Payable Liquidated Fee of STATE Outside Counsel, or (ii) \$5 million or (iii) in the event that the sum of all Payable Liquidated Fees of all Outside Counsel that became Payable Liquidated Fees before December 1, 1999 exceeds the Applicable Liquidation Amount, the Allocable Liquidated Share of STATE Outside Counsel.

(e) On December 15, 1999, if the Liquidated Fee of STATE Outside Counsel became a Payable Liquidated Fee before December 1, 1999, each Original Participating Manufacturer shall severally pay to the Designated Representative its Relative Market Share of (i) the Payable Liquidated Fee of STATE Outside Counsel or (ii) in the event that the sum of all Payable Liquidated Fees of all Outside Counsel that became Payable Liquidated Fees before December 1, 1999 exceeds the Applicable Liquidation Amount, the Allocable Liquidated Share of STATE Outside Counsel.

(f) On the last day of each calendar quarter, beginning with the first calendar quarter of 2000 and ending with the fourth calendar quarter of 2003, if the Liquidated Fee of STATE Outside Counsel became a Payable Liquidated Fee at least 15 Business Days prior to the last day of each such calendar quarter, each Original Participating Manufacturer shall severally pay to the Designated Representative its Relative Market Share of (i) the Payable Liquidated Fee of STATE Outside Counsel or (ii) in the event that the sum of all Payable Liquidated Fees of all Outside Counsel as of the date 15 Business Days prior to the date of the payment in question exceeds the Applicable Liquidation Amount, the Allocable Liquidated Share of STATE Outside Counsel.

#### SECTION 9. *Limitations on Payments of Liquidated Fees.*

Notwithstanding any other provision hereof, all payments by the Original Participating Manufacturers with respect to Liquidated Fees shall be subject to the following:

(a) Under no circumstances shall the Original Participating Manufacturers be required to make any payment that would result in aggregate national payments of Liquidated Fees:

(i) during 1999, totaling more than \$250 million;

(ii) with respect to any calendar quarter beginning with the first calendar quarter of 2000 and ending with the fourth calendar quarter of 2003, totaling more than \$62.5 million, except to the extent that a payment with respect to any prior calendar quarter of any calendar year did not total \$62.5 million; or

(iii) with respect to any calendar quarter after the fourth calendar quarter of 2003, totaling more than zero.

(b) The Original Participating Manufacturers' obligations with respect to the Liquidated Fee of STATE Outside Counsel, if any, shall be exclusively as provided in this STATE Fee Payment Agreement, and notwithstanding any other provision of law, such Liquidated Fee shall not be entered as or reduced to a judgment against the Original Participating Manufacturers or considered as a basis for requiring a bond or imposing a lien or any other encumbrance.

#### SECTION 10. *Fee Awards.*

(a) In the event that the Original Participating Manufacturers and STATE Outside Counsel do not agree in writing upon a Liquidated Fee as described in section 7 hereof, the Original Participating Manufacturers shall pay, pursuant to the terms hereof, the Fee Award awarded by the Panel to STATE Outside Counsel.

(b) The Original Participating Manufacturers' payment of any Fee Award pursuant to this STATE Fee Payment Agreement shall be subject to the payment schedule and the annual and quarterly aggregate national caps specified in sections 17 and 18 hereof, which shall apply to:

(i) all payments of Fee Awards in connection with an agreement to pay fees as part of the settlement of any Tobacco Case on terms that provide for payment by the Original Participating Manufacturers or other defendants acting in agreement with the Original Participating Manufacturers (collectively, "Participating Defendants"); of fees with respect to any Private Counsel, subject to an annual cap on payment of all such fees; and

(ii) all payments of attorneys' fees (other than fees for attorneys of Participating Defendants) pursuant to Fee Awards for activities in connection with any Tobacco Case resolved by operation of Federal Legislation.

#### SECTION 11. *Composition of the Panel.*

(a) The first and the second members of the Panel shall both be permanent members of the Panel and, as such, will participate in the determination of all Fee Awards. The third Panel member shall not be a permanent Panel member, but instead shall be a state-specific member selected to determine Fee Awards on behalf of Private Counsel retained in connection with litigation within a single state. Accordingly, the third, state-specific member of the Panel for purposes of determining Fee Awards with respect to litigation in the State of STATE shall not participate in any determination as to any Fee Award with respect to litigation in any other state (unless selected to participate in such determinations by such persons as may be authorized to make such selections under other agreements).

(b) The members of the Panel shall be selected as follows:

(i) The first member shall be the natural person selected by Participating Defendants.

(ii) The second member shall be the person jointly selected by the agreement of Participating Defendants and a majority of the committee described in the fee payment agreements entered in connection with the settlements of the Tobacco Cases brought by the Previously Settled States. In the event that the person so selected is unable or unwilling to continue to serve, a replacement for such member shall be selected by agreement of the Original Participating Manufacturers and a majority of the members of a committee composed of the following members: Joseph F. Rice, Richard F. Scruggs, Steven W. Berman, Walter Umphrey, one additional representative, to be selected in the sole discretion of NAAAG, and two representatives of Private Counsel in Tobacco Cases, to be selected at the sole discretion of the Original Participating Manufacturers.

(iii) The third, state-specific member for purposes of determining Fee Awards with respect to litigation in the State of STATE shall be a natural person selected by STATE Outside Counsel, who shall notify the Director and the Original Participating Manufacturers of the name of the person selected.

#### SECTION 12. *Application of STATE Outside Counsel.*

(a) STATE Outside Counsel shall make a collective Application for a single Fee Award, which shall be submitted to the Director. Within five Business Days after receipt of the Application by STATE Outside Counsel, the Director shall serve the Application upon the Original Participating Manufacturers and the STATE. The Original Participating Manufacturers shall submit all materials in response to the Application to the Director by the later of (i) 60 Business Days after service of the Application upon the Original Participating Manufacturers by the Director, (ii) five Business Days after the date of State-Specific Finality in the State of STATE or (iii) five Business Days after the date on which notice of the name of the third, state-specific panel member described in paragraph (b)(iii) of section 11 hereof has been provided to the Director and the Original Participating Manufacturers.

(b) The Original Participating Manufacturers may submit to the Director any materials that they wish and, notwithstanding any restrictions or representations made in any other agreements, the Original Participating Manufacturers shall be in no way constrained from contesting the amount of the Fee Award requested by STATE Outside Counsel. The Director, the Panel, the State of STATE, the Original Participating Manufacturers and STATE Outside Counsel shall preserve the confidentiality of any attorney work-product materials or other similar confidential information that may be submitted.

(c) The Director shall forward the Application of STATE Outside Counsel, as well as all written materials relating to such Application that have been submitted by the Original Participating Manufacturers pursuant to subsection (b) of this section, to the Panel within five Business Days after the later of (i) the expiration of the period for the Original Participating Manufacturers to submit such materials or (ii) the earlier of (A) the date on which the Panel issues a Fee Award with respect to any Application of other Private Counsel previously forwarded to the Panel by the Director or (B) 30 Business Days after the forwarding to the Panel of the Application of other Private Counsel most recently forwarded to the Panel by the Director. The Director shall notify the Parties upon forwarding the Application (and all written materials relating thereto) to the Panel.

(d) In the event that either Party seeks a hearing before the Panel, such Party may submit a request to the Director in writing within five Business Days after the forwarding of the Application of STATE Outside Counsel to the Panel by the Director, and the Director shall promptly forward the request to the Panel. If the Panel grants the request, it shall promptly set a date for hearing, such date to fall within 30 Business Days after the date of the Panel's receipt of the Application.

#### SECTION 13. *Panel Proceedings.*

The proceedings of the Panel shall be conducted subject to the terms of this Agreement and of the Protocol of Panel Procedures attached as an Appendix hereto.

#### SECTION 14. *Award of Fees to STATE Outside Counsel.*

The members of the Panel will consider all relevant information submitted to them in reaching a decision as to a Fee Award that fairly provides for full reasonable compensation of STATE Outside Counsel. In considering the amount of the Fee Award, the Panel shall not consider any Liquidated Fee agreed to by any other Outside Counsel, any offer of or negotiations relating to any proposed liquidated fee for STATE Outside Counsel or any Fee Award that already has been or yet may be awarded in connection with any other Tobacco Cases. The Panel shall not be limited to an hourly-rate or industry analysis in determining the amount of the Fee Award of STATE Outside Counsel, but shall take into account the totality of the circumstances. The Panel's decisions as to the Fee Award of STATE Outside Counsel shall be in writing and shall report the amount of the fee awarded (with or without explanation or opinion, at the Panel's discretion). The Panel shall determine the amount of the Fee Award to be paid to STATE Outside Counsel within the later of 30 calendar days after receiving the Application (and all related materials) from the Director or 15 Business Days after the last date of any hearing held pursuant to subsection (d) of section 12 hereof. The Panel's decision as to the Fee Award of STATE Outside Counsel shall be final, binding and non-appealable.

#### SECTION 15. *Costs of Arbitration.*

All costs and expenses of the arbitration proceedings held by the Panel, including costs, expenses and compensation of the Director and of the Panel members (but not including any costs, expenses or compensation of counsel making applications to the Panel), shall be borne by the Original Participating Manufacturers in proportion to their Relative Market Shares.

#### SECTION 16. *Payment of Fee Award of STATE Outside Counsel.*

On or before the tenth Business Day after the last day of each calendar quarter beginning with the first calendar quarter of 1999, each Original Participating Manufacturer shall severally pay to the Designated Representative its Relative Market Share of the Allocated Amount for STATE Outside Counsel for the calendar quarter with respect to which such quarterly payment is being made (the "Applicable Quarter").

#### SECTION 17. *Allocated Amounts of Fee Awards.*

The Allocated Amount for each Private Counsel with respect to any payment to be made for any particular Applicable Quarter shall be determined as follows:

(a) The Quarterly Fee Amount shall be allocated equally among each of the three months of the Applicable Quarter. The amount for each such month shall be allocated among those Private Counsel retained in connection with Tobacco Cases settled before or during such month (each such Private Counsel being an "Eligible Counsel" with respect to such month amount), each of which shall be allocated a portion of each such monthly amount up to (or, in the event that the sum of all Eligible Counsel's respective Unpaid Fees exceeds such monthly amount, in proportion to) the amount of such Eligible Counsel's Unpaid Fees. The monthly amount for each month of the calendar quarter shall be allocated among those Eligible Counsel having Unpaid Fees, without regard to whether there may be Eligible Counsel that have not yet been granted or denied a Fee Award as of the last day of the Applicable Quarter. The allocation of subsequent Quarterly Fee Amounts for the calendar year, if any, shall be adjusted, as necessary, to account for any Eligible Counsel that are granted Fee Awards in a subsequent quarter of such calendar year, as provided in paragraph (b)(ii) of this section.

(b) In the event that the amount for a given month is less than the sum of the Unpaid Fees of all Eligible Counsel;

(i) in the case of the first quarterly allocation for any calendar year, such monthly amount shall be allocated among all Eligible Counsel for such month in proportion to the amounts of their respective Unpaid Fees.

(ii) in the case of a quarterly allocation after the first quarterly allocation, the Quarterly Fee Amount shall be allocated among only those Private Counsel, if any, that were Eligible Counsel with respect to any monthly amount for any prior quarter of the calendar year but were not allocated a proportionate share of such monthly amount (either because such Private Counsel's applications for Fee Awards were still under consideration as of the last day of the calendar quarter containing the month in question or for any other reason), until each such Eligible Counsel has been allocated a proportionate share of all such prior monthly payments for the calendar year (each such share of each such Eligible Counsel being a "Payable Proportionate Share"). In the event that the sum of all Payable Proportionate Shares exceeds the Quarterly Fee Amount, the Quarterly Fee Amount shall be allocated among such Eligible Counsel on a monthly basis in proportion to the amounts of their respective Unpaid Fees (without regard to whether there may be other Eligible Counsel with respect to such prior monthly amounts that have not yet been granted or denied a Fee Award as of the last day of the Applicable Quarter). In the event that the sum of all Payable Proportionate Shares is less than the Quarterly Fee Amount, the amount by which the Quarterly Fee Amount exceeds the sum of all such Payable Proportionate Shares shall be allocated among each month of the calendar quarter, each such monthly amount to be allocated among those Eligible Counsel having Unpaid Fees in proportion to the amounts of their respective Unpaid Fees (without regard to whether there may be Eligible Counsel that have not yet been granted or denied a Fee Award as of the last day of the Applicable Quarter).

(c) Adjustments pursuant to subsection (b)(ii) of this section 17 shall be made separately for each calendar year. No amounts paid in any calendar year shall be subject to refund, nor shall any payment in any given calendar year affect the allocation of payments to be made in any subsequent calendar year.

#### SECTION 18. *Credits to and Limitations on Payment of Fee Awards.*

Notwithstanding any other provision hereof, all payments by the Original Participating Manufacturers with respect to Fee Awards shall be subject to the following:

(a) Under no circumstances shall the Original Participating Manufacturers be required to make payments that would result in aggregate national payments and credits by Participating Defendants with respect to all Fee Awards of Private Counsel;

(i) during any year beginning with 1999, totaling more than the sum of the Quarterly Fee Amounts for each calendar quarter of the calendar year, excluding certain payments with respect to any Private Counsel for 1998 that are paid in 1999; and

(ii) during any calendar quarter beginning with the first calendar quarter of 1999, totaling more than the Quarterly Fee Amount for such quarter, excluding certain payments with respect to any Private Counsel for 1998 that are paid in 1999.

(b) The Original Participating Manufacturers' obligations with respect to the Fee Award of STATE Outside Counsel, if any, shall be exclusively as provided in this STATE Fee Payment Agreement, and notwithstanding any other provision of law, such Fee Award shall not be entered as or reduced to a judgment against the Original Participating Manufacturers or considered as a basis for requiring a bond or imposing a lien or any other encumbrance.

#### SECTION 19. *Reimbursement of Outside Counsel's Costs.*

(a) The Original Participating Manufacturers shall reimburse STATE Outside Counsel for reasonable costs and expenses incurred in connection with the Action, provided that such costs and expenses are of the same nature as costs and expenses for which the Original Participating Manufacturers ordinarily reimburse their own counsel or agents. Payment of any Approved Cost Statement pursuant to this STATE Fee Payment Agreement shall be subject to (i) the condition precedent of approval of the Agreement by the Court for the State of STATE and (ii) the payment schedule and the aggregate national caps specified in subsection (c) of this section, which shall apply to all payments made with respect to Cost Statements of all Outside Counsel.

(b) In the event that STATE Outside Counsel seek to be reimbursed for reasonable costs and expenses incurred in connection with the Action, the Designated Representative shall submit a Cost Statement to the Original Participating Manufacturers. Within 30 Business Days after receipt of any such Cost Statement, the Original Participating Manufacturers shall either accept the Cost Statement or dispute the Cost Statement, in which event the Cost Statement shall be subject to a full audit by examiners to be appointed by the Original Participating Manufacturers (in their sole discretion). Any such audit will be completed within 120 Business Days after the date the Cost Statement is received by the Original Participating Manufacturers. Upon completion of such audit, if the Original Participating Manufacturers and STATE Outside Counsel cannot agree as to the appropriate amount of STATE Outside Counsel's reasonable costs and expenses, the Cost Statement and the examiner's audit report shall be submitted to the Director for arbitration before the Panel or, in the event that STATE Outside Counsel and the Original Participating Manufacturers have agreed upon a Liquidated Fee pursuant to section 7 hereof, before a separate three-member panel of independent arbitrators, to be selected in a manner to be agreed to by STATE Outside Counsel and the Original Participating Manufacturers, which shall determine the amount of STATE Outside Counsel's reasonable costs and expenses for the Action. In determining such reasonable costs and expenses, the members of the arbitration panel shall be governed by the Protocol of Panel Procedures attached as an Appendix hereto. The amount of

STATE Outside Counsel's reasonable costs and expenses determined pursuant to arbitration as provided in the preceding sentence shall be final, binding and non-appealable.

(c) Any Approved Cost Statement of STATE Outside Counsel shall not become a Payable Cost Statement until approval of the Agreement by the Court for the State of STATE. Within five Business Days after receipt of notification thereof by the Designated Representative, each Original Participating Manufacturer shall severally pay to the Designated Representative its Relative Market Share of the Payable Cost Statement of STATE Outside Counsel, subject to the following:

(i) All Payable Cost Statements of Outside Counsel shall be paid in the order in which such Payable Cost Statements became Payable Cost Statements.

(ii) Under no circumstances shall the Original Participating Manufacturers be required to make payments that would result in aggregate national payments by Participating Defendants of all Payable Cost Statements of Private Counsel in connection with all of the actions identified in Exhibits D, M and N to the Agreement, totaling more than \$75 million for any given year.

(iii) Any Payable Cost Statement of Outside Counsel not paid during the year in which it became a Payable Cost Statement as a result of paragraph (ii) of this subsection shall become payable in subsequent years, subject to paragraphs (i) and (d), until paid in full.

(d) The Original Participating Manufacturers' obligations with respect to reasonable costs and expenses incurred by STATE Outside Counsel in connection with the Action shall be exclusively as provided in this STATE Fee Payment Agreement, and notwithstanding any other provision of law, any Approved Cost Statement determined pursuant to subsection (b) of this section (including any Approved Cost Statement determined pursuant to arbitration before the Panel or the separate three-member panel of independent arbitrators described therein) shall not be entered as or reduced to a judgment against the Original Participating Manufacturers or considered as a basis for requiring a bond or imposing a lien or any other incumbrance.

#### SECTION 20. *Distribution of Payments among STATE Outside Counsel.*

(a) All payments made to the Designated Representative pursuant to this STATE Fee Payment Agreement shall be for the benefit of each person or entity identified in Exhibit S to the Agreement by the Attorney General of the State of STATE (or as certified by the governmental prosecuting authority of the Litigating Political Subdivision), each of which shall receive from the Designated Representative a percentage of each such payment in accordance with the fee sharing agreement, if any, among STATE Outside Counsel (or any written amendment thereto).

(b) The Original Participating Manufacturers shall have no obligation, responsibility or liability with respect to the allocation among those persons or entities identified in Exhibit S to the Agreement by the Attorney General of the State of STATE (or as certified by the governmental prosecuting authority of the Litigating Political Subdivision), or with respect to any claim of misallocation, of any amounts paid to the Designated Representative pursuant to this STATE Fee Payment Agreement.

#### SECTION 21. *Calculations of Amounts.*

All calculations that may be required hereunder shall be performed by the Original Participating Manufacturers, with notice of the results thereof to be given promptly to the Designated Representative. Any disputes as to the correctness of calculations made by the Original Participating Manufacturers shall be resolved pursuant to the procedures described in Section X(c) of the Agreement for resolving disputes as to calculations by the Independent Auditor.

#### SECTION 22. *Payment Responsibility.*

(a) Each Original Participating Manufacturer shall be severally liable for its share of all payments pursuant to this STATE Fee Payment Agreement. Under no circumstances shall any payment due hereunder or any portion thereof become the joint obligation of the Original Participating Manufacturers or the obligation of any person other than the Original Participating Manufacturer from which such payment is originally due, nor shall any Original Participating Manufacturer be required to pay a portion of any such payment greater than its Relative Market Share.

(b) Due to the particular corporate structures of R. J. Reynolds Tobacco Company ("Reynolds") and Brown & Williamson Tobacco Corporation ("Brown & Williamson") with respect to their non-domestic tobacco operations, Reynolds and Brown & Williamson shall each be severally liable for its respective share of each payment due pursuant to this STATE Fee Payment Agreement up to (and its liability hereunder shall not exceed) the full extent of its assets used in, and earnings and revenues derived from, its manufacture and sale in the United States of Tobacco Products intended for domestic consumption, and no recourse shall be had against any of its other assets or earnings to satisfy such obligations.

#### SECTION 23. *Termination.*

In the event that the Agreement is terminated with respect to the State of STATE pursuant to Section XVIII(a) of the Agreement (or for any other reason) the Designated Representative and each person or entity identified in Exhibit S to the Agreement by the Attorney General of the State of STATE (or as certified by the governmental prosecuting authority of the Litigating Political Subdivision) shall immediately refund to the Original Participating Manufacturers all amounts received under this STATE Fee Payment Agreement.

#### SECTION 24. *Intended Beneficiaries.*

No provision hereof creates any rights on the part of, or is enforceable by, any person or entity that is not a Party or a person covered by either of the releases described in section 4 hereof, except that sections 5 and 20 hereof create rights on the part of, and shall be enforceable by, the State of STATE. Nor shall any provision hereof bind any non-signatory or determine, limit or prejudice the rights of any such person or entity.

#### SECTION 25. *Representations of Parties.*

The Parties hereto hereby represent that this STATE Fee Payment Agreement has been duly authorized and, upon execution, will constitute a valid and binding contractual obligation, enforceable with its terms, of each of the Parties hereto.

#### SECTION 26. *No Admission.*

This STATE Fee Payment Agreement is not intended to be and shall not in any event be construed as, or deemed to be, an admission or concession or evidence of any liability or wrongdoing whatsoever on the part of any signatory hereto or any person covered by either of the releases provided under section 4 hereof. The Original Participating Manufacturers specifically disclaim and deny any liability or wrongdoing whatsoever with respect to the claims released under section 4 hereof and enter into this STATE Fee Payment Agreement for the sole purposes of memorializing the Original Participating Manufacturers' rights and obligations with respect to payment of attorneys' fees pursuant to the Agreement and avoiding the further expense, inconvenience, burden and uncertainty of potential litigation.

#### SECTION 27. *Non-admissibility.*

This STATE Fee Payment Agreement having been undertaken by the Parties hereto in good faith and for settlement purposes only, neither this STATE Fee Payment Agreement nor any evidence of negotiations relating hereto shall be offered or received in evidence in any action or proceeding other than an action or proceeding arising under this STATE Fee Payment Agreement.

#### SECTION 28. *Amendment and Waiver.*

This STATE Fee Payment Agreement may be amended only by a written instrument executed by the Parties. The waiver of any rights conferred hereunder shall be effective only if made by written instrument executed by the waiving Party. The waiver by any Party of any breach hereof shall not be deemed to be or construed as a waiver of any other breach, whether prior, subsequent or contemporaneous, of this STATE Fee Payment Agreement.

#### SECTION 29. *Notices.*

All notices or other communications to any party hereto shall be in writing (including but not limited to telefax, facsimile or similar writing) and shall be given to the notice parties listed on Schedule A hereto at the addresses therein indicated. Any Party hereto may change the name and address of the person designated to receive notice on behalf of such Party by notice given as provided in this section including an updated list conformed to Schedule A hereto.

#### SECTION 30. *Governing Law.*

This STATE Fee Payment Agreement shall be governed by the laws of the State of STATE without regard to the conflict of law rules of such State.

#### SECTION 31. *Construction.*

None of the Parties hereto shall be considered to be the drafter hereof or of any provision hereof for the purpose of any statute, case law or rule of interpretation or construction that would or might cause any provision to be construed against the drafter hereof.

#### SECTION 32. *Captions.*

The captions of the sections hereof are included for convenience of reference only and shall be ignored in the construction and interpretation hereof.

#### SECTION 33. *Execution of STATE Fee Payment Agreement.*

This STATE Fee Payment Agreement may be executed in counterparts. Facsimile or photocopied signatures shall be considered valid signatures as of the date hereof, although the original signature pages shall thereafter be appended to this STATE Fee Payment Agreement.

#### SECTION 34. *Entire Agreement of Parties.*

This STATE Fee Payment Agreement contains an entire, complete and integrated statement of each and every term and provision agreed to by and among the Parties with respect to payment of attorneys' fees by the Original Participating Manufacturers in connection with the Action and is not subject to any condition or covenant, express or implied, not provided for herein.

IN WITNESS WHEREOF, the Parties hereto, through their fully authorized representatives, have agreed to this STATE Fee Payment Agreement as of this \_\_\_th day of \_\_\_\_\_, 1998.

[SIGNATURE BLOCK]

[Intentionally Omitted]

APPENDIX  
to MODEL FEE PAYMENT AGREEMENT  
**PROTOCOL OF PANEL PROCEEDINGS**

This Protocol of procedures has been agreed to between the respective parties to the STATE Fee Payment Agreement, and shall govern the arbitration proceedings provided for therein.

**SECTION 1. Definitions.**

All definitions contained in the STATE Fee Payment Agreement are incorporated by reference herein.

**SECTION 2. Chairman.**

The person selected to serve as the permanent, neutral member of the Panel as described in paragraph (b)(ii) of section 11 of the STATE Fee Payment Agreement shall serve as the Chairman of the Panel.

**SECTION 3. Arbitration Pursuant to Agreement.**

The members of the Panel shall determine those matters committed to the decision of the Panel under the STATE Fee Payment Agreement, which shall govern as to all matters discussed therein.

**SECTION 4. ABA Code of Ethics.**

Each of the members of the Panel shall be governed by the *Code of Ethics for Arbitrators in Commercial Disputes* prepared by the American Arbitration Association and the American Bar Association (the "*Code of Ethics*") in conducting the arbitration proceedings pursuant to the STATE Fee Payment Agreement, subject to the terms of the STATE Fee Payment Agreement and this Protocol. Each of the party-appointed members of the Panel shall be governed by Canon VII of the *Code of Ethics*. No person may engage in any *ex parte* communications with the permanent, neutral member of the Panel selected pursuant to paragraph (b)(ii) of section 11, in keeping with Canons I, II and III of the *Code of Ethics*.

**SECTION 5. Additional Rules and Procedures.**

The Panel may adopt such rules and procedures as it deems necessary and appropriate for the discharge of its duties under the STATE Fee Payment Agreement and this Protocol, subject to the terms of the STATE Fee Payment Agreement and this Protocol.

**SECTION 6. Majority Rule.**

In the event that the members of the Panel are not unanimous in their views as to any matter to be determined by them pursuant to the STATE Fee Payment Agreement or this Protocol, the determination shall be decided by a vote of a majority of the three members of the Panel.

**SECTION 7. Application for Fee Award and Other Materials.**

(a) The Application of STATE Outside Counsel and any materials submitted to the Director relating hereto (collectively, "submissions") shall be forwarded by the Director to each of the members of the Panel in the manner and on the dates specified in the STATE Fee Payment Agreement.

(b) All materials submitted to the Director by either Party (or any other person) shall be served upon all Parties. All submissions required to be served on any Party shall be deemed to have been served as of the date on which such materials have been sent by either (i) hand delivery or (ii) facsimile and overnight courier for priority next-day delivery.

(c) To the extent that the Panel believes that information not submitted to the Panel may be relevant for purposes of determining those matters committed to the decision of the Panel under the terms of the STATE Fee Payment Agreement, the Panel shall request such information from the Parties.

**SECTION 8. Hearing.**

Any hearing held pursuant to section 12 of the STATE Fee Payment Agreement shall not take place other than in the presence of all three members of the Panel upon notice and an opportunity for the respective representatives of the Parties to attend.

**SECTION 9. Miscellaneous.**

(a) Each member of the Panel shall be compensated for his services by the Original Participating Manufacturers on a basis to be agreed to between such member and the Original Participating Manufacturers.

(b) The members of the Panel shall refer all media inquiries regarding the arbitration proceeding to the respective Parties to the STATE Fee Payment Agreement and shall refrain from any comment as to the arbitration proceedings to be conducted pursuant to the STATE Fee Payment Agreement during the pendency of such arbitration proceedings, in keeping with Canon IV(B) of the *Code of Ethics*.

**EXHIBIT Q**  
**EXCLUSION OF CERTAIN BRAND NAMES**

**EXHIBIT Q**  
**1996 AND 1997 DATA**

(1) 1996 Operating Income  
Original Participating Manufacturer  
Brown & Williamson Tobacco Corp.  
Lorillard Tobacco Co.  
Philip Morris Inc.  
R.J. Reynolds Tobacco Co.  
Total (Base Operating Income)

Operating Income  
\$801,640,000  
\$719,100,000  
\$4,206,600,000  
\$1,468,000,000  
\$7,195,340,000

(2) 1997 volume (as measured by shipments of Cigarettes)

Original Participating Manufacturer  
Brown & Williamson Tobacco Corp.\*  
Lorillard Tobacco Co.  
Philip Morris Inc.  
R.J. Reynolds Tobacco Co.  
Total (Base Volume)

Number of Cigarettes  
78,911,000,000  
42,288,000,000  
236,203,000,000  
118,254,000,000  
475,656,000,000

(3) 1997 volume (as measured by excise taxes)

Original Participating Manufacturer  
Brown & Williamson Tobacco Corp.\*  
Lorillard Tobacco Co.  
Philip Morris Inc.  
R.J. Reynolds Tobacco Co.

Number of Cigarettes  
78,758,000,000  
42,315,000,000  
236,326,000,000  
119,099,000,000

\* The volume includes 2,847,595 pounds of "roll your own" tobacco converted into the number of Cigarettes using 0.0325 ounces per Cigarette conversion factor.

Brown & Williamson Tobacco Corporation  
GPC  
State Express 555  
Riviera

Philip Morris Incorporated

Players  
B&H  
Belmont  
Mark Ten  
Viscount  
Accord  
L&M  
Lark  
Rothman's  
Best Buy  
Bronson  
F&L  
Genco  
GPA  
Gridlock  
Money  
No Frills  
Generals  
Premium Buy  
Shenandoah  
Top Choice

Lorillard Tobacco Company

None  
R.J. Reynolds Tobacco Company  
Best Choice  
Cardinal  
Director's Choice  
Jacks  
Rainbow  
Scotch Buy  
Slim Price  
Smoker Friendly  
Valu Time  
Worth

EXHIBIT I  
MODEL STATUTE

Section \_\_\_\_ Findings and Purpose.<sup>1</sup>

- (a) Cigarette smoking presents serious public health concerns to the State and to the citizens of the State. The Surgeon General has determined that smoking causes lung cancer, heart disease and other serious diseases, and that there are hundreds of thousands of tobacco-related deaths in the United States each year. These diseases most often do not appear until many years after the person in question begins smoking.
- (b) Cigarette smoking also presents serious financial concerns for the State. Under certain health-care programs, the State may have a legal obligation to provide medical assistance to eligible persons for health conditions associated with cigarette smoking, and those persons may have a legal entitlement to receive such medical assistance.
- (c) Under these programs, the State pays millions of dollars each year to provide medical assistance for these persons for health conditions associated with cigarette smoking.
- (d) It is the policy of the State that financial burdens imposed on the State by cigarette smoking be borne by tobacco product manufacturers rather than by the State to the extent that such manufacturers either determine to enter into a settlement with the State or are found culpable by the courts.
- (e) On \_\_\_\_\_, 1998, leading United States tobacco product manufacturers entered into a settlement agreement, entitled the "Master Settlement Agreement," with the State. The Master Settlement Agreement obligates these manufacturers, in return for a release of past, present and certain future claims against them as described therein, to pay substantial sums to the State (tied in part to their volume of sales); to fund a national foundation devoted to the interests of public health; and to make substantial changes in their advertising and marketing practices and corporate culture, with the intention of reducing underage smoking.
- (f) It would be contrary to the policy of the State if tobacco product manufacturers who determine not to enter into such a settlement could use a resulting cost advantage to derive large, short-term profits in the years before liability may arise without ensuring that the State will have an eventual source of recovery from them if they are proven to have acted culpably. It is thus in the interest of the State to require that such manufacturers establish a reserve fund to guarantee a source of compensation and to prevent such manufacturers from deriving large, short-term profits and then becoming judgment-proof before liability may arise.

Section \_\_\_\_ Definitions.

- (a) "Adjusted for inflation" means increased in accordance with the formula for inflation adjustment set forth in Exhibit C to the Master Settlement Agreement.
- (b) "Affiliate" means a person who directly or indirectly owns or controls, is owned or controlled by, or is under common ownership or control with, another person. Solely for purposes of this definition, the terms "owns," "is owned," and "ownership" mean ownership of an equity interest, or the equivalent thereof, of ten percent or more, and the term "person" means an individual, partnership, committee, association, corporation or any other organization or group of persons.
- (c) "Allocable share" means Allocable Share as that term is defined in the Master Settlement Agreement.
- (d) "Cigarette" means any product that contains nicotine, is intended to be burned or heated under ordinary conditions of use, and consists of or contains (1) any roll of tobacco wrapped in paper or in any substance not containing tobacco, or (2) tobacco, in any form, that is functional in the product, which, because of its appearance, the type of tobacco used in the filler, or its packaging and labeling, is likely to be offered to, or purchased by, consumers as a cigarette; or (3) any roll of tobacco wrapped in any substance containing tobacco which, because of its appearance, the type of tobacco used in the filler, or its packaging and labeling, is likely to be offered to, or purchased by, consumers as a cigarette described in clause (1) of this definition. The term "cigarette" includes "roll-your-own" (i.e., any tobacco which, because of its appearance, type, packaging, or labeling is suitable for use and likely to be offered to, or purchased by, consumers as tobacco for making cigarettes). For purposes of this definition of "cigarette," 0.09 ounces of "roll-your-own" tobacco shall constitute one individual "cigarette."
- (e) "Master Settlement Agreement" means the settlement agreement (and related documents) entered into on \_\_\_\_\_, 1998 by the State and leading United States tobacco product manufacturers.
- (f) "Qualified escrow fund" means an escrow arrangement with a federally or State chartered financial institution having no affiliation with any tobacco product manufacturer and having assets of at least \$1,000,000,000 where such arrangement requires that such financial institution hold the escrowed funds' principal for the benefit of releasing parties and prohibits the tobacco product manufacturer placing the funds into escrow from using, accessing or directing the use of the funds' principal except as consistent with section \_\_\_\_ (b)-(c) of this Act.
- (g) "Released claims" means Released Claims as that term is defined in the Master Settlement Agreement.
- (h) "Releasing parties" means Released Parties as that term is defined in the Master Settlement Agreement.

<sup>1</sup> [A State may elect to delete the "findings and purposes" section in its entirety. Other changes or substitutions with respect to the "findings and purposes" section (except for particularized state procedural or technical requirements) will mean that the statute will no longer conform to this model.]



(i) "Tobacco Product Manufacturer" means an entity that after the date of enactment of this Act directly (and not exclusively through any affiliate):

(1) manufactures cigarettes anywhere that such manufacturer intends to be sold in the United States, including cigarettes intended to be sold in the United States through an importer (except where such importer is an original participating manufacturer (as that term is defined in the Master Settlement Agreement) that will be responsible for the payments under the Master Settlement Agreement with respect to such cigarettes as a result of the provisions of subsections II(m) of the Master Settlement Agreement and that pays the taxes specified in subsection II(z) of the Master Settlement Agreement, and provided that the manufacturer of such cigarettes does not market or advertise such cigarettes in the United States);

(2) is the first purchaser anywhere for resale in the United States of cigarettes manufactured anywhere that the manufacturer does not intend to be sold in the United States; or

(3) becomes a successor of an entity described in paragraph (1) or (2).

The term "Tobacco Product Manufacturer" shall not include an affiliate of a tobacco product manufacturer unless such affiliate itself falls within any of (1) - (3) above.

(j) "Units sold" means the number of individual cigarettes sold in the State by the applicable tobacco product manufacturer (whether directly or through a distributor, retailer or similar intermediary or intermediaries) during the year in question, as measured by excise taxes collected by the State on packs (or "roll-your-own" tobacco containers) bearing the excise tax stamp of the State. The [fill in name of responsible state agency] shall promulgate such regulations as are necessary to ascertain the amount of State excise tax paid on the cigarettes of such tobacco product manufacturer for each year.

#### Section \_\_\_\_ Requirements.

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 date of enactment of this Act shall do one of the following:

(a) become a participating manufacturer (as that term is defined in section II(j) 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 amount(s) (as such amounts are adjusted for inflation) --

1999: \$ 0094241 per unit sold after the date of enactment of this Act;<sup>2</sup>

2000: \$ 0104712 per unit sold after the date of enactment of this Act;<sup>3</sup>

for each of 2001 and 2002: \$ 0136125 per unit sold after the date of enactment of this Act;

for each of 2003 through 2006: \$ 0167539 per unit sold after the date of enactment of this Act;

for each of 2007 and each year thereafter: \$ 0188482 per unit sold after the date of enactment of this Act.

(2) A tobacco product manufacturer that places funds into escrow pursuant to paragraph (1) 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 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) 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), funds shall be released from escrow and revert back to such tobacco product manufacturer twenty-five 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 [or other State official] that it is in compliance with this subsection. The Attorney General [or other State official] may bring a civil action on behalf of the State against any tobacco product

<sup>2</sup> [All per unit numbers subject to verification]

<sup>3</sup> [The phrase "after the date of enactment of this Act" would need to be included only in the calendar year in which the Act is enacted.]

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 paid to the general fund of the state) in an amount not to exceed 5 percent of the amount improperly withheld from escrow per day of the violation and in a total amount not to exceed 100 percent 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 general fund of the state) in an amount not to exceed 15 percent of the amount improperly withheld from escrow per day of the violation and in a total amount not to exceed 300 percent 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 2 years. Each failure to make an annual deposit required under this section shall constitute a separate violation.<sup>4</sup>

<sup>4</sup> [A State may elect to include a requirement that the violator also pay the State's costs and attorney's fees incurred during a successful prosecution under this paragraph (3).]

EXHIBIT U  
STRATEGIC CONTRIBUTION FUND PROTOCOL

The payments made by the Participating Manufacturers pursuant to section IX(c)(2) of the Agreement ("Strategic Contribution Fund") shall be allocated among the Settling States pursuant to the process set forth in this Exhibit U.

Section 1

A panel committee of three former Attorneys General or former Article III judges ("Allocation Committee") shall be established to determine allocations of the Strategic Contribution Fund, using the process described herein. Two of the three members of the Allocation Committee shall be selected by the NAAG executive committee. Those two members shall choose the third Allocation Committee member. The Allocation Committee shall be geographically and politically diverse.

Section 2

Within 60 days after the MSA Execution Date, each Settling State will submit an itemized request for funds from the Strategic Contribution Fund, based on the criteria set forth in Section 4 of this Exhibit U.

Section 3

The Allocation Committee will determine the appropriate allocation for each Settling State based on the criteria set forth in Section 4 below. The Allocation Committee shall make its determination based upon written documentation.

Section 4

The criteria to be considered by the Allocation Committee in its allocation decision include each Settling State's contribution to the litigation or resolution of state tobacco litigation, including, but not limited to, litigation and/or settlement with tobacco product manufacturers, including Liggett and Myers and its affiliated entities.

Section 5

Within 45 days after receiving the itemized requests for funds from the Settling States, the Allocation Committee will prepare a preliminary decision allocating the Strategic Contribution Fund payments among the Settling States who submitted itemized requests for funds. All Allocation Committee decisions must be by majority vote. Each Settling State will have 30 days to submit comments on or objections to the draft decision. The Allocation Committee will issue a final decision allocating the Strategic Contribution Fund payments within 45 days.

Section 6

The decision of the Allocation Committee shall be final and non-appealable.

Section 7

The expenses of the Allocation Committee, in an amount not to exceed \$100,000, will be paid from disbursements from the Subsection VIII(c) Account.

**APPENDIX D**  
**CONSENT DECREE**

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CONSENT DECREE

At IAS Part 56 of the Supreme Court of the State of New York, held in and for the County of New York, at the Courthouse located at 60 Centre Street, New York, New York, on the 23<sup>rd</sup> day of December, 1998

PRESENT:

HON. STEPHEN G. CRANE, Justice

SUPREME COURT OF THE STATE OF NEW YORK  
COUNTY OF NEW YORK

<hr/>	X	
THE STATE OF NEW YORK and DENNIS C. VACCO,	:	
Attorney General of the State of New York, for and on	:	
behalf of the PEOPLE OF THE STATE OF NEW YORK,	:	
	:	
Plaintiffs,	:	
-against-	:	
	:	
PHILIP MORRIS INCORPORATED; PHILIP MORRIS	:	
COMPANIES, INC.; RJR NABISCO, INC.; RJR	:	CONSENT DECREE AND
NABISCO HOLDINGS CORP.; R.J. REYNOLDS	:	<u>FINAL JUDGMENT</u>
TOBACCO CO.; THE AMERICAN TOBACCO CO.,	:	
INC.; AMERICAN BRANDS, INC.; BROWN &	:	
WILLIAMSON TOBACCO CORP.; LORILLARD	:	
TOBACCO COMPANY; LORILLARD	:	Index No.: 400361/97
INCORPORATED; LOEWS CORPORATION; UNITED	:	Hon. Stephen G. Crane, Justice.
STATES TOBACCO COMPANY; UST, INC.; B.A.T.	:	
INDUSTRIES, P.L.C.; BRITISH AMERICAN	:	
TOBACCO COMPANY, LTD.; BATUS HOLDINGS,	:	
INC.; THE COUNCIL FOR TOBACCO RESEARCH -	:	
U.S.A., INC.; and TOBACCO INSTITUTE, INC.,	:	
	:	
Defendants.	:	
	:	
<hr/>	X	

WHEREAS, Plaintiffs, the State of New York and Attorney General Dennis C. Vacco, commenced this action on January 27, 1997, pursuant to their common law powers and the provisions of N.Y. Executive Law, Public Health Law, General Business Law, Business Corporations Law, Penal Law, Social Services Law, Not-for-Profit Corporations Law, Unconsolidated Law, the Civil Practice Law and Rules, and the State Constitution;

WHEREAS, Plaintiffs asserted various claims for monetary, equitable and injunctive relief, on behalf of the State of New York, including its Counties under GBL §342-b, against certain tobacco product manufacturers and other defendants;

WHEREAS, Defendants have contested the claims in the State's complaint and amended complaint and denied the State's allegations;

WHEREAS, the parties desire to resolve this action in a manner which appropriately addresses the State's public health concerns, while conserving the parties' resources, as well as those of the Court, which would otherwise be expended in litigating a matter of this magnitude; and

WHEREAS, the Court has made no determination of any violation of law, this Consent Decree and Final Judgment being entered prior to the taking of any testimony and without trial or final adjudication of any issue of fact or law;

**NOW, THEREFORE, IT IS HEREBY ORDERED, ADJUDGED AND DECREED, AS FOLLOWS:**

## **I. JURISDICTION AND VENUE**

This Court has jurisdiction over the subject matter of this action and over each of the Participating Manufacturers. Venue is proper in this county.

## **II. DEFINITIONS**

The definitions set forth in the Master Settlement Agreement ("MSA" or "Agreement") (a copy of which is attached hereto as Exhibit 1) are incorporated herein by reference. "County" means a county of the State of New York, including New York City, with New York City to be treated as a single county and none of its constituent counties to be treated separately; "Counties" means the counties of the State of New York, including New York City, with New York City to be treated as a single county and none of its constituent counties to be treated separately; provided, however, that any county that properly excludes itself from the class provisionally certified for settlement purposes only by this Court's Order of November 24, 1998 (the "Class") is not included in the definitions of "County" or "Counties."

## **III. APPLICABILITY**

A. This Consent Decree and Final Judgment applies only to the Participating Manufacturers in their corporate capacity acting through their respective successors and assigns, directors, officers, employees, agents, subsidiaries, divisions, or other internal organizational units of any kind or any other entities acting in concert or participation with them. The remedies, penalties and sanctions that may be imposed or assessed in connection with a violation of this Consent Decree and Final Judgment (or any order issued in connection herewith) shall only apply to the Participating Manufacturers, and shall not be imposed or assessed against any employee, officer or director of any Participating Manufacturer, or against any other person or entity as a consequence of such violation, and there shall be no jurisdiction under this Consent Decree and Final Judgment to do so.

B. This Consent Decree and Final Judgment is not intended to and does not vest standing in any third party with respect to the terms hereof. No portion of this Consent Decree and Final Judgment shall provide any rights to, or be enforceable by, any person or entity other than the State of New York or a Released Party. The State of New York may not assign or otherwise convey any right to enforce any provision of this Consent Decree and Final Judgment. Provided, however, that a County or Counties may enforce the payment rights provided in Article V of this Consent Decree and Final Judgment, but only against other Counties or the State. Only the State may enforce the provisions of Article V against the Participating Manufacturers.

## **IV. VOLUNTARY ACT OF THE PARTIES**

The parties hereto expressly acknowledge and agree that this Consent Decree and Final Judgment is voluntarily entered into as the result of arm's-length negotiation, and all parties hereto were represented by counsel in deciding to enter into this Consent Decree and Final Judgment.

## V. MONETARY RELIEF

A. Under subsections II(r), (s), IX, and XI of the MSA, payments from the Participating Manufacturers will be made to the Escrow Agent for further disbursement, pursuant to an Escrow Agreement executed by the parties and approved by a Court of competent jurisdiction. The State shall instruct the Independent Auditor and the Escrow Agent to disburse funds from the New York State-Specific Account directly to the State of New York and directly to the Counties individually according to the payment schedule annexed hereto as Exhibit 2.

B. The payment schedule set forth in Exhibit 2 shall remain in effect for as long as payments are made from the Participating Manufacturers under the MSA. The portion of those payments credited to the New York State-Specific Account, if any, shall be allocable to the State of New York and the individual Counties as set forth in Exhibit 2.

C. Effective upon the occurrence of State-Specific Finality in the State of New York, and to the extent that such claims may not otherwise be released by operation of the MSA, the Counties (as defined in this Consent Decree and Final Judgment) hereby absolutely and unconditionally release and forever discharge all Released Parties from all Released Claims that the Counties directly, indirectly, derivatively or in any other capacity ever had, now have, or hereafter can, shall, or may have, to the same extent that the Settling States are releasing Released Claims against Released Parties under the MSA.

D. Each County (as defined in this Consent Decree and Final Judgment) further covenants and agrees that it shall not after the occurrence of State-Specific Finality in the State of New York sue or seek to establish civil liability against any Released Party based, in whole or in part, upon any of the Released Claims, and further agrees that such covenant and agreement shall be a complete defense to any such civil action or proceeding.

E. Upon the occurrence of State-Specific Finality in the State of New York, the City of New York (unless it has properly excluded itself from the Class) will move forthwith for a dismissal with prejudice of the action entitled *City of New York et al. v. The Tobacco Institute, Inc. et al.*, Supreme Court of the State of New York, County of New York, Index No. 406225/96, and the County of Erie (unless it has properly excluded itself from the Class) will move forthwith for a dismissal with prejudice of its action entitled *County of Erie v. The Tobacco Institute, Inc. et al.*, Supreme Court of the State of New York, County of Erie, Index No. 1997/359.

F. If a County or Counties properly excludes itself from the Class, such County or Counties shall not receive any funds under the MSA, and the State may, in its sole discretion, place the funds allocated to such County or Counties under Exhibit 2 to this Consent Decree And Final Judgment in escrow.

G. If any funds are recouped from the State of New York by the Federal Government, pursuant to an Act of Congress or otherwise, from monies received or to be received by the State (including its political subdivisions) from the New York State-Specific Account, then the State shall recoup from the Counties the Counties' share of such funds, through offsets or any other mechanisms selected by the State, according to the allocation percentages of the settlement funds in the year or years in question assigned to the respective Counties pursuant to the allocation schedule set forth in Exhibit 2. Nothing herein acknowledges a right of the Federal Government to recoup any such funds.

## VI. INJUNCTIVE AND OTHER EQUITABLE RELIEF

Each Participating Manufacturer is permanently enjoined from:

A. Taking any action, directly or indirectly, to target Youth within the State of New York in the advertising, promotion or marketing of Tobacco Products, or taking any action the primary purpose of which is to initiate, maintain or increase the incidence of Youth smoking within the State of New York.

B. After 180 days after the MSA Execution Date, using or causing to be used within the State of New York any Cartoon in the advertising, promoting, packaging or labeling of Tobacco Products.

C. After 30 days after the MSA Execution Date, making or causing to be made any payment or other consideration to any other person or entity to use, display, make reference to or use as a prop within the State of New York any Tobacco Product, Tobacco Product package, advertisement for a Tobacco Product, or any other item bearing a Brand Name in any Media; provided, however, that the foregoing prohibition shall not apply to (1) Media where the audience or viewers are within an Adult-Only Facility (provided such Media are not visible to persons outside such Adult-Only Facility); (2) Media not intended for distribution or display to the public; (3) instructional Media concerning non-conventional cigarettes viewed only by or provided only to smokers who are Adults; and (4) actions taken by any Participating Manufacturer in connection with a Brand Name Sponsorship permitted pursuant to subsections III(c)(2)(A) and III(c)(2)(B)(i) of the Agreement, and use of a Brand Name to identify a Brand Name Sponsorship permitted by subsection III(c)(2)(B)(ii).

D. Beginning July 1, 1999, marketing, distributing, offering, selling, licensing or causing to be marketed, distributed, offered, sold, or licensed (including, without limitation, by catalogue or direct mail), within the State of New York, any apparel or other merchandise (other than Tobacco Products, items the sole function of which is to advertise Tobacco Products, or written or electronic publications) which bears a Brand Name. Provided, however, that nothing in this section shall (1) require any Participating Manufacturer to breach or terminate any licensing agreement or other contract in existence as of June 20, 1997 (this exception shall not apply beyond the current term of any existing contract, without regard to any renewal or option term that may be exercised by such Participating Manufacturer); (2) prohibit the distribution to any Participating Manufacturer's employee who is not Underage of any item described above that is intended for the personal use of such an employee; (3) require any Participating Manufacturer to retrieve, collect or otherwise recover any item that prior to the MSA Execution Date was marketed, distributed, offered, sold, licensed or caused to be marketed, distributed, offered, sold or licensed by such Participating Manufacturer; (4) apply to coupons or other items used by Adults solely in connection with the purchase of Tobacco Products; (5) apply to apparel or other merchandise used within an Adult-Only Facility that is not distributed (by sale or otherwise) to any member of the general public; or (6) apply to apparel or other merchandise (a) marketed, distributed, offered, sold, or licensed at the site of a Brand Name Sponsorship permitted pursuant to subsection III(c)(2)(A) or III(c)(2)(B)(i) of the Agreement by the person to which the relevant Participating Manufacturer has provided payment in exchange for the use of the relevant Brand Name in the Brand Name Sponsorship or a third-party that does not receive payment from the relevant Participating Manufacturer (or any Affiliate of such Participating Manufacturer) in connection with the marketing, distribution, offer, sale or license of such apparel or other merchandise, or (b) used at the site of a Brand Name Sponsorship permitted pursuant to subsections III(c)(2)(A) or III(c)(2)(B)(i) of the Agreement (during such event) that are not distributed (by sale or otherwise) to any member of the general public.

E. After the MSA Execution Date, distributing or causing to be distributed within the State of New York any free samples of Tobacco Products except in an Adult-Only Facility. For purposes of this Consent Decree and Final Judgment, a "free sample" does not include a Tobacco Product that is provided to an Adult in connection with (1) the purchase, exchange or redemption for proof of purchase of any Tobacco Products (including, but not limited to, a free offer in connection with the purchase of Tobacco Products, such as a "two-for-one" offer), or (2) the conducting of consumer testing or evaluation of Tobacco Products with persons who certify that they are Adults.

F. Using or causing to be used as a brand name of any Tobacco Product pursuant to any agreement requiring the payment of money or other valuable consideration, any nationally recognized or nationally established brand name or trade name of any non-tobacco item or service or any nationally recognized or nationally established sports team, entertainment group or individual celebrity. Provided, however, that the preceding sentence shall not apply to any Tobacco Product brand name in existence as of July 1, 1998. For the purposes of this provision, the term "other valuable consideration" shall not include an agreement between two entities who enter into such agreement for the sole purpose of avoiding infringement claims.

G. After 60 days after the MSA Execution Date and through and including December 31, 2001, manufacturing or causing to be manufactured for sale within the State of New York any pack or other container of Cigarettes containing fewer than 20 Cigarettes (or, in the case of roll-your-own tobacco, any



package of roll-your-own tobacco containing less than 0.60 ounces of tobacco); and, after 150 days after the MSA Execution Date and through and including December 31, 2001, selling or distributing within the State of New York any pack or other container of Cigarettes containing fewer than 20 Cigarettes (or, in the case of roll-your-own tobacco, any package of roll-your-own tobacco containing less than 0.60 ounces of tobacco).

H. Entering into any contract, combination or conspiracy with any other Tobacco Product Manufacturer that has the purpose or effect of: (1) limiting competition in the production or distribution of information about health hazards or other consequences of the use of their products; (2) limiting or suppressing research into smoking and health; or (3) limiting or suppressing research into the marketing or development of new products. Provided, however, that nothing in the preceding sentence shall be deemed to (1) require any Participating Manufacturer to produce, distribute or otherwise disclose any information that is subject to any privilege or protection; (2) preclude any Participating Manufacturer from entering into any joint defense or joint legal interest agreement or arrangement (whether or not in writing), or from asserting any privilege pursuant thereto; or (3) impose any affirmative obligation on any Participating Manufacturer to conduct any research.

I. Making any material misrepresentation of fact regarding the health consequences of using any Tobacco Product, including any tobacco additives, filters, paper or other ingredients. Provided, however, that nothing in the preceding sentence shall limit the exercise of any First Amendment right or the assertion of any defense or position in any judicial, legislative or regulatory forum.

## **VII. MISCELLANEOUS PROVISIONS**

A. Jurisdiction of this case is retained by the Court for the purposes of implementing and enforcing the Agreement and this Consent Decree and Final Judgment and enabling the continuing proceedings contemplated herein. Whenever possible, the State of New York and the Participating Manufacturers shall seek to resolve any issue that may exist as to compliance with this Consent Decree and Final Judgment by discussion among the appropriate designees named pursuant to subsection XVIII(m) of the Agreement. The State of New York and/or any Participating Manufacturer may apply to the Court at any time for further orders and directions as may be necessary or appropriate for the implementation and enforcement of this Consent Decree and Final Judgment. A County may apply for further orders and directions as may be necessary or appropriate for the implementation or enforcement of the fourth sentence of Article III(B) of this Consent Decree and Final Judgment. Provided, however, that with regard to subsections VI(A) and VI(I) of this Consent Decree and Final Judgment, the Attorney General shall issue a cease and desist demand to the Participating Manufacturer that the Attorney General believes is in violation of either of such sections at least ten Business Days before the Attorney General applies to the Court for an order to enforce such subsections, unless the Attorney General reasonably determines that either a compelling time-sensitive public health and safety concern requires more immediate action or the Court has previously issued an Enforcement Order to the Participating Manufacturer in question for the same or a substantially similar action or activity. For any claimed violation of this Consent Decree and Final Judgment, in determining whether to seek an order for monetary, civil contempt or criminal sanctions for any claimed violation, the Attorney General shall give good-faith consideration to whether: (1) the Participating Manufacturer that is claimed to have committed the violation has taken appropriate and reasonable steps to cause the claimed violation to be cured, unless that party has been guilty of a pattern of violations of like nature; and (2) a legitimate, good-faith dispute exists as to the meaning of the terms in question of this Consent Decree and Final Judgment. The Court in any case in its discretion may determine not to enter an order for monetary, civil contempt or criminal sanctions.

B. This Consent Decree and Final Judgment is not intended to be, and shall not in any event be construed as, or deemed to be, an admission or concession or evidence of (1) any liability or any wrongdoing whatsoever on the part of any Released Party or that any Released Party has engaged in any of the activities barred by this Consent Decree and Final Judgment; or (2) personal jurisdiction over any person or entity other than the Participating Manufacturers. Each Participating Manufacturer specifically disclaims and denies any liability or wrongdoing whatsoever with respect to the claims and allegations

asserted against it in this action, and has stipulated to the entry of this Consent Decree and Final Judgment solely to avoid the further expense, inconvenience, burden and risk of litigation.

C. Except as expressly provided otherwise in the Agreement, this Consent Decree and Final Judgment shall not be modified (by this Court, by any other court or by any other means) unless the party seeking modification demonstrates, by clear and convincing evidence, that it will suffer irreparable harm from new and unforeseen conditions. Provided, however, that the provisions of sections III, V, VI, VII and VIII of this Consent Decree and Final Judgment shall in no event be subject to modification without the consent of the State of New York and all affected Participating Manufacturers. In the event that any of the sections of this Consent Decree and Final Judgment enumerated in the preceding sentence are modified by this Court, by any other court or by any other means without the consent of the State of New York and all affected Participating Manufacturers, then this Consent Decree and Final Judgment shall be void and of no further effect. Changes in the economic conditions of the parties shall not be grounds for modification. It is intended that the Participating Manufacturers will comply with this Consent Decree and Final Judgment as originally entered, even if the Participating Manufacturers' obligations hereunder are greater than those imposed under current or future law (unless compliance with this Consent Decree and Final Judgment would violate such law). A change in law that results, directly or indirectly, in more favorable or beneficial treatment of any one or more of the Participating Manufacturers shall not support modification of this Consent Decree and Final Judgment.

D. In any proceeding which results in a finding that a Participating Manufacturer violated this Consent Decree and Final Judgment, the Participating Manufacturer or Participating Manufacturers found to be in violation shall pay the State's costs and attorneys' fees incurred only by the State of New York in such proceeding.

E. The remedies in this Consent Decree and Final Judgment are cumulative and in addition to any other remedies the State of New York may have at law or equity, including but not limited to its rights under the Agreement. Nothing herein shall be construed to prevent the State from bringing an action with respect to conduct not released pursuant to the Agreement, even though that conduct may also violate this Consent Decree and Final Judgment. Nothing in this Consent Decree and Final Judgment is intended to create any right for New York to obtain any Cigarette product formula that it would not otherwise have under applicable law.

F. No party shall be considered the drafter of this Consent Decree and Final Judgment for the purpose of any statute, case law or rule of interpretation or construction that would or might cause any provision to be construed against the drafter. Nothing in this Consent Decree and Final Judgment shall be construed as approval by the State of New York of the Participating Manufacturers' business organizations, operations, acts or practices, and the Participating Manufacturers shall make no representation to the contrary.

G. The settlement negotiations resulting in this Consent Decree and Final Judgment have been undertaken in good faith and for settlement purposes only, and no evidence of negotiations or discussions underlying this Consent Decree and Final Judgment shall be offered or received in evidence in any action or proceeding for any purpose. Neither this Consent Decree and Final Judgment nor any public discussions, public statements or public comments with respect to this Consent Decree and Final Judgment by the State of New York or any Participating Manufacturer or its agents shall be offered or received in evidence in any action or proceeding for any purpose other than in an action or proceeding arising under or relating to this Consent Decree and Final Judgment.

H. All obligations of the Participating Manufacturers pursuant to this Consent Decree and Final Judgment (including, but not limited to, all payment obligations) are, and shall remain, several and not joint.

I. The provisions of this Consent Decree and Final Judgment are applicable only to actions taken (or omitted to be taken) within the States. Provided, however, that the preceding sentence shall not be construed as extending the territorial scope of any provision of this Consent Decree and Final Judgment whose scope is otherwise limited by the terms thereof.



**EXHIBIT 2**

At all times and under all circumstances specified in Section XI of the Master Settlement Agreement that require the Independent Auditor to instruct the Escrow Agent to disburse amounts to the State of New York pursuant to the terms of the Master Settlement Agreement (“New York Disbursal Share”), the Independent Auditor shall allocate all such New York Disbursal Share among the State of New York, the City of New York<sup>1</sup>, and the individual counties of New York according to the schedule set forth below and instruct the Escrow Agent to disburse such allocated amounts directly to the State of New York, the City of New York and the specified counties.

(1) With respect to the New York Disbursal Share of all amounts paid by the Participating Manufacturers pursuant to Section IX(b) of the Master Settlement Agreement, the Independent Auditor shall allocate and instruct the Escrow Agent to disburse such amounts as follows:

<u>Entity</u>	<u>Percentage of Payment</u>
New York State.....	51.176%
New York City .....	26.670%
Albany .....	0.593%
Allegheny .....	0.107%
Broome .....	0.446%
Cattaraugus.....	0.179%
Cayuga.....	0.166%
Chautauqua.....	0.308%
Chemung .....	0.212%
Chenango .....	0.104%
Clinton .....	0.170%
Columbia .....	0.126%
Cortland .....	0.100%
Delaware .....	0.101%
Dutchess .....	0.500%
Erie .....	2.194%
Essex .....	0.075%
Franklin .....	0.098%
Fulton .....	0.121%
Genessee .....	0.118%
Greene .....	0.085%
Hamilton .....	0.013%
Herkimer .....	0.142%
Jefferson .....	0.190%
Lewis .....	0.054%
Livingston .....	0.112%
Madison.....	0.131%
Monroe .....	1.536%
Montgomery.....	0.114%
Nassau .....	2.739%
Niagara .....	0.467%

<sup>1</sup>The City of New York includes the five individual boroughs of Manhattan, Bronx, Brooklyn, Queens and Staten Island, and the New York City Health and Hospitals Corporation.

<u>Entity</u>	<u>Percentage of Payment</u>
Oneida .....	0.544%
Onondaga .....	0.972%
Ontario .....	0.181%
Orange .....	0.564%
Orleans .....	0.078%
Oswego .....	0.239%
Otsego .....	0.122%
Putnam .....	0.152%
Rensselaer .....	0.317%
Rockland .....	0.560%
St. Lawrence .....	0.239%
Saratoga .....	0.304%
Schenectady .....	0.319%
Schoharie .....	0.063%
Schuyler .....	0.038%
Seneca .....	0.069%
Steuben .....	0.211%
Suffolk .....	2.673%
Sullivan .....	0.155%
Tioga .....	0.100%
Tompkins .....	0.170%
Ulster .....	0.334%
Warren .....	0.113%
Washington .....	0.113%
Wayne .....	0.172%
Westchester .....	1.926%
Wyoming .....	0.081%
Yates .....	0.044%

(2) With respect to amounts paid by the Participating Manufacturers pursuant to Section IX(c)(2) of the Master Settlement Agreement, the Independent Auditor shall allocate and instruct the Escrow Agent to disburse the entire proceeds to the State of New York.

SUPREME COURT OF THE STATE OF NEW YORK — NEW YORK COUNTY

PRESENT: HON. STEPHEN G. CRANE  
*Justice*

Part 56

_____x	
THE STATE OF NEW YORK, et al.,	:
	:
<i>Plaintiff,</i>	:
- v -	:
	:
PHILIP MORRIS, INC., et al.,	:
	:
<i>Defendants.</i>	:
_____x	

INDEX NO.: 400361/97  
MOTION DATE: 4/13/99  
MOTION SEQ. NO.: 019  
MOTION CAL. NO.: 139

The following papers, numbered 1 to \_\_\_\_\_ were read on this motion to/for

PAPERS NUMBERED

Notice of Motion/Order to Show Cause — Affidavits — Exhibits \_\_\_\_\_

Answering Affidavits — Exhibits \_\_\_\_\_

Replying Affidavits \_\_\_\_\_

Cross-Motion: [ ] Yes [X] No

The State of New York and defendants Brown & Williamson Tobacco Corporation, Philip Morris Incorporated, R.J. Reynolds Tobacco Company, and Lorillard Tobacco Company, jointly move for an order, pursuant to CPLR 5019(a), correcting Exhibit 2 to the "Consent Decree and Final Judgment" relating to the Master Settlement Agreement, entered on December 23, 1998, so that the "Consent Decree and Final Judgment" accurately reflects the original intention of the parties and the terms of the Master Settlement Agreement with respect to the intra-State allocation of annual payments by the Participating Manufacturers pursuant to Section IX(c)(1) of the Master Settlement Agreement. The motion is granted on default.

Accordingly, it is

ORDERED that the motion is granted on default; and it is further

ORDERED that Paragraph (1) of "Exhibit 2" to the "Consent Decree and Final Judgment" relating to the Master Settlement Agreement, entered on December 23, 1998, shall be amended to read as follows:

(1) With respect to the New York Disbursal Share of all amounts paid by the Participating Manufacturers pursuant to Sections IX(b) or IX(c)(1) of the Master Settlement Agreement, the Independent Auditor shall allocate and instruct the Escrow Agent to disburse such amounts as follows: . . . .

The foregoing constitutes the decision and order of the court.

Dated: April 14, 1999

/s/ SGC  
STEPHEN G. CRANE J.S.C.

Check One: [ ] FINAL DISPOSITION [X] NON-FINAL DISPOSITION  
*/s/ MDAR*

**APPENDIX E**  
**GLOBAL INSIGHT REPORT**

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**A Forecast of  
U.S. Cigarette  
Consumption  
(2008-2023) for the  
Tobacco Settlement Financing Corporation (State of New York)**

Submitted to:

**Tobacco Settlement Financing Corporation (State of New York)**

Prepared by:

**Global Insight (USA), Inc.**

**March 19, 2008**



**Jim Diffley**  
Group Managing Director

**Jeannine Cataldi**  
Senior Economist

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## Executive Summary

Global Insight<sup>1</sup> has developed a cigarette consumption model based on historical U.S. data between 1965 and 2003. This econometric model, coupled with our long term forecast of the U.S. economy, has been used to project total U.S. cigarette consumption from 2008 through 2023. Our Base Case Forecast indicates that total consumption in 2023 will be 273 billion cigarettes (approximately 13.7 billion packs), a 26% decline from the 2007 level. From 2007 through 2023 the average annual rate of decline is projected to be 1.85%. On a per capita basis consumption is projected to fall at an average rate of 2.67% per year.

We also present alternative forecasts that project higher and lower paths of cigarette consumption. Under these, less likely, scenarios we forecast that by 2023 U.S. cigarette consumption could be as low as 262 billion and as high as 281 billion cigarettes. In addition, we also present scenarios with more extreme variations in assumptions for the purposes of illustrating alternative paths of consumption.

Another alternative to the Base Case Forecast will result from a sharp increase in the federal excise tax on cigarettes. In September 2007, the U.S. Congress adopted legislation which would raise the excise tax by \$0.61. In October, the President vetoed the bill and the Congress failed to override the veto. We forecast that, if the tax increase were to be enacted in 2008 or 2009, U.S. cigarette consumption would fall by an additional 4.3%, or 15.5 billion cigarettes, by 2010, and in 2023 will be 261 billion.

Our model was constructed from widely accepted economic principles and Global Insight's long experience in building econometric forecasting models. A review of the economic research literature indicates that our model is consistent with the prevalent consensus among economists concerning cigarette demand. We considered the impact of demographics, cigarette prices, disposable income, employment and unemployment, industry advertising expenditures, the future effect of the incidence of smoking amongst underage youth, and qualitative variables that captured the impact of anti-smoking regulations, legislation, and health warnings. After extensive analysis, we found the following variables to be effective in building an empirical model of adult per capita cigarette consumption: real cigarette prices, real per capita disposable personal income, the impact of restrictions on smoking in public places, and the trend over time in individual behavior and preferences. The projections and forecasts are based on reasonable assumptions regarding the future paths of these factors.

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<sup>1</sup> On November 4, 2002, **DRI•WEFA** was re-named **Global Insight**.

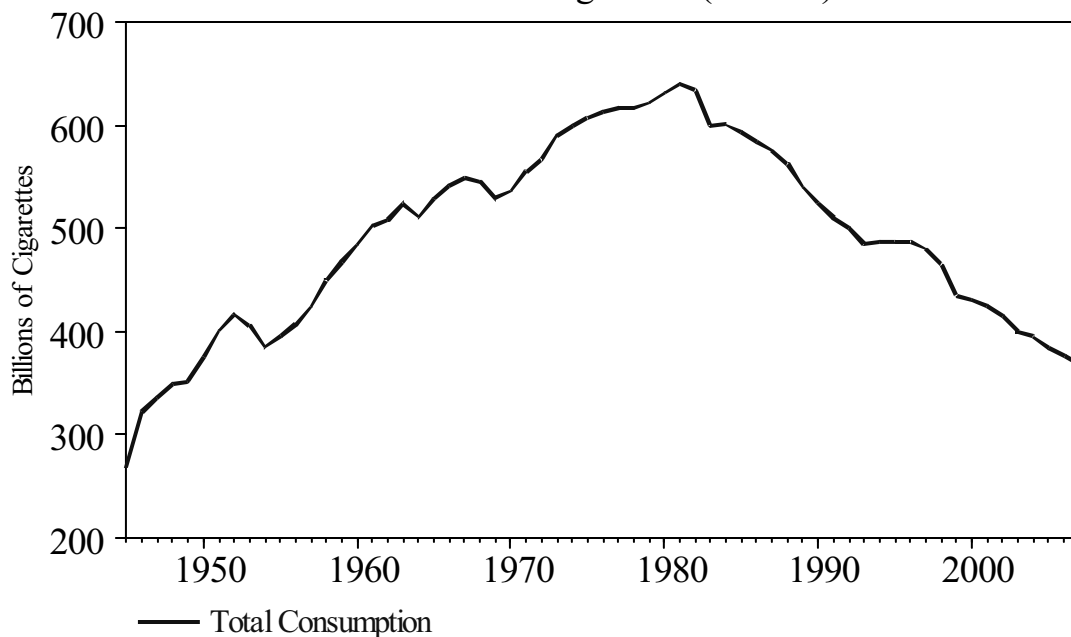
## **Disclaimer**

**The projections and forecasts included in this report, including, but not limited to, those regarding future cigarette consumption, are estimates, which have been prepared on the basis of certain assumptions and hypotheses. No representation or warranty of any kind is or can be made with respect to the accuracy or completeness of, and no representation or warranty should be inferred from, these projections and forecasts. The projections and forecasts contained in this report are based upon assumptions as to future events and, accordingly, are subject to varying degrees of uncertainty. Some assumptions inevitably will not materialize and, additionally, unanticipated events and circumstances may occur. Therefore, for example, actual cigarette consumption inevitably will vary from the projections and forecasts included in this report and the variations may be material and adverse.**

## Historical Cigarette Consumption

People have used tobacco products for centuries. Tobacco was first brought to Europe from America in the late 15<sup>th</sup> century and became America's major cash crop in the 17<sup>th</sup> and 18<sup>th</sup> centuries<sup>2</sup>. Prior to 1900, tobacco was most frequently used in pipes, cigars and snuff. With the widespread production of manufactured cigarettes (as opposed to hand-rolled cigarettes) in the United States in the early 20<sup>th</sup> century, cigarette consumption expanded dramatically. Consumption is defined as taxable United States consumer sales, plus shipments to overseas armed forces, ship stores, Puerto Rico and other United States possessions, and small tax-exempt categories<sup>3</sup> as reported by the Bureau of Alcohol Tobacco and Firearms. The USDA, which has compiled data on cigarette consumption since 1900, reports that consumption grew from 2.5 billion in 1900 to a peak of 640 billion in 1981<sup>4</sup>. Consumption declined in the 1980's and 1990's, reaching a level of 465 billion cigarettes in 1998, and decreasing to less than 400 billion cigarettes in 2003<sup>5</sup>.

**Historical U.S. Cigarette Consumption: 1945-2007**  
Number of Cigarettes (Billions)



While the historical trend in consumption prior to 1981 was increasing, there was a decline in cigarette consumption of 9.8% during the Great Depression between 1931 and 1932. Notwithstanding this steep decline, consumption rapidly increased after 1932, and exceeded previous levels by 1934. Following the release of the Surgeon General's Report

<sup>2</sup> Source: "Tobacco Timeline," Gene Borio (1998).

<sup>3</sup> Bureau of Alcohol, Tobacco and Firearms reports as categories such as transfer to export warehouses, use of the U.S., and personal consumption/experimental.

<sup>4</sup> Source: "Tobacco Situation and Outlook". U.S. Department of Agriculture-Economic Research Service. September 1999 (USDA-ERS).

<sup>5</sup> Source: USDA-ERS. April 2005.

in 1964, cigarette consumption continued to increase at an average annual rate of 1.2% between 1965 and 1981. Between 1981 and 1990, however, cigarette consumption declined at an average annual rate of 2.2%. From 1990 to 1998, the average annual rate of decline in cigarette consumption was 1.5%; but for 1998 the decline increased to 3.1% and increased further to 6.5% for 1999. These recent declines are correlated with large price increases in 1998 and 1999 following the Master Settlement Agreement (“MSA”). In 2000 and 2001, the rate of decline moderated, to 1.2%. More recently, coincident with a large number of state excise tax increases, the rate of decline accelerated in 2002-2007 to an annual rate of 2.4%.

Adult per capita cigarette consumption (total consumption divided by the number of people 18 years and older) began to decline following the Surgeon General’s Report in 1964. Population growth offset this decline until 1981. The adult population grew at an average annual rate of 1.9% for the period 1965 through 1981, 1.2% from 1981 to 1990 and 1.0% from 1990 to 1999. Adult per capita cigarette consumption declined at an average annual rate of 0.7% for the period 1965 to 1981, 3.3% for the period 1981 to 1990 and 2.5% for the period 1990 to 1998. In 1998 the per capita decline in cigarette consumption was 4.2% and in 1999 the decline accelerated to 7.5%. These sharp declines are correlated with large price increases in 1998 and 1999 following the MSA. All percentages are based upon compound annual growth rates.

The following table sets forth United States domestic cigarette consumption for the ten years ended December 31, 2007<sup>6</sup>. The data in this table vary from statistics on cigarette shipments in the United States. While our Report is based on consumption, payments made under the MSA dated November 23, 1998 between certain cigarette manufacturers and certain settling states are computed based in part on shipments in or to the fifty United States, the District of Columbia and Puerto Rico. The quantities of cigarettes shipped and cigarettes consumed may not match at any given point in time as a result of various factors such as inventory adjustments, but are substantially the same when compared over a period of time.

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<sup>6</sup> *Source:* USDA-ERS; 2004, 2005, 2006, estimates by Global Insight. USDA estimates for 2004, 2005, and 2006 diverge significantly from estimates based on independent data from the industry and from the US Tobacco and Tax Bureau. In 2004, the manufacturers report domestic shipments of 394.5 billion, and the TTB reports a total of 397.7 billion. These contrast with a USDA estimate of 388 billion. In 2005, the manufacturers report 381.7 billion, TTB reports 381.1 billion, and USDA 376 billion. In 2006, the manufacturers report 372.5 billion, TTB reports 380.9 billion, and USDA 372 billion. The USDA has discontinued this service, publishing its final report on October 24, 2007.

### U.S. Cigarette Consumption

Year Ended December 31,	Consumption (Billions of Cigarettes)	Percentage Change
2007	368	-2.28
2006	377	-1.93
2005	384	-2.69
2004	395	-2.28
2003	400	-3.66
2002	415	-2.35
2001	425	-1.16
2000	430	-1.15
1999	435	-6.45
1998	465	-3.13

### The U.S. Cigarette Industry

The domestic cigarette market is an oligopoly in which, according to reports of the manufacturers, the three leading manufacturers accounted for 86.7% of U.S. shipments in 2007. These top companies were Philip Morris, Reynolds American Inc. (following the merger of RJ Reynolds and Brown & Williamson in 2004), and Lorillard. These companies commanded 49.0%, 27.4%, and 10.3%, respectively of the domestic market in 2007. The market share of the leading manufacturers has declined from over 96% in 1998 due to inroads by smaller manufacturers and importers following the Master Settlement Agreement.

The United States government has raised revenue through tobacco taxes since the Civil War. Although the federal excise taxes have risen through the years, excise taxes as a percentage of total federal revenue have fallen from 3.4% in 1950 to approximately 0.42% today. In fiscal year 2006, the federal government received \$7.7 billion in excise tax revenue from tobacco sales. In addition, state and local governments also raised significant revenues, \$14.0 billion in 2006, from excise and sales taxes. Cigarettes constitute the majority of these sales, which include cigars and other tobacco products.

### Survey of the Economic Literature on Smoking

Many organizations have conducted studies on United States cigarette consumption. These studies have utilized a variety of methods to estimate levels of smoking, including interviews and/or written questionnaires. Although these studies have tended to produce varying estimates of consumption levels due to a number of factors, including different survey methods and different definitions of smoking, taken together such studies provide

a general approximation of consumption levels and trends. Set forth below is a brief summary of some of the more recent studies on cigarette consumption levels.

## **Incidence of Smoking**

Approximately 45.3 million American adults were current smokers in 2006, representing approximately 20.8% of the population age 18 and older, according to a Centers for Disease Control and Prevention (“CDC”) study<sup>7</sup> released in November, 2007. This survey defines "current smokers" as those persons who have smoked at least 100 cigarettes in their lifetime and who smoked every day or some days at the time of the survey. Although the percentage of adults who smoke (incidence) declined from 42.4% in 1965 to 25.5% in 1990,<sup>8</sup> the incidence rate declined relatively slowly through the following decade. The decline had accelerated between 2002, when the incidence rate was 22.5%, to 2004, when incidence dropped to 20.9%.

## **Youth Smoking**

Certain studies have focused in whole or in part on youth cigarette consumption. Surveys of youth typically define a "current smoker" as a person who has smoked a cigarette on one or more of the 30 days preceding the survey. The CDC's Youth Risk Behavior Survey estimated that from 1991 to 1999 incidence among high school students (grades 9 through 12) rose from 27.5% to 34.8%, representing an increase of 26.5%. By 2003, the incidence had fallen to 21.9%, a decline of 37.1% over four years. The prevalence was unchanged from 2003 to 2005.<sup>9</sup>

In 2004, the CDC's National Youth Tobacco Survey, formerly done by the American Legacy Foundation, reported that the percentage of middle school students who were current users of cigarettes declined from 9.8% in 2002 to 8.1% in 2004. Among high school students there was no significant change, with 22.3% as current users.<sup>10</sup>

According to the Monitoring the Future Study, a school-based study of cigarette consumption and drug use conducted by the Institute for Social Research at the University of Michigan, smoking incidence over the prior 30 days among eighth and tenth graders was lower in 2007 than in 2006, continuing trends that began in 1996. Among those students in twelfth grade, incidence remained unchanged from 2006 after having declined in 2005 and 2006. Smoking incidence in all grades is well below where it was in 1991, having fallen below that mark in 2001 for eighth graders and in 2002 for tenth and twelfth graders.

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<sup>7</sup> *Source:* CDC. Morbidity and Mortality Weekly Report. “Tobacco Use Among Adults – United States, 2005”. October 20, 2006.

<sup>8</sup> *Source:* CDC. Office on Smoking and Health.

<sup>9</sup> *Source:* CDC. Morbidity and Mortality Weekly Report. “Cigarette Use Among High School Students --- United States, 1991-2005”. July 7, 2006.

<sup>10</sup> CDC. Morbidity and Mortality Weekly Report. “Tobacco Use, Access, and Exposure to Tobacco in Media Among Middle and High School Students in the United States, 2004”. April 1, 2005.

### Prevalence of Cigarette Use Among 8<sup>th</sup>, 10<sup>th</sup>, and 12<sup>th</sup> Graders

Grade	1991 (%)	2006 (%)	2007 (%)	'05-'06 Change (%)	'91-'06 Change (%)
8 <sup>th</sup>	14.3	8.7	7.1	-18.4	-50.4
10 <sup>th</sup>	20.8	14.5	14.0	-3.5	-32.7
12 <sup>th</sup>	28.3	21.6	21.6	0.0	-23.7

A report from the New York City Youth Risk Behavior Survey finds that smoking among New York City high school students decreased by 52% from 1997 to 2007.<sup>11</sup> Over this period New York City has raised excise taxes to the highest in the nation and instituted a comprehensive indoor smoking ban. Youth smoking rates also declined sharply in Massachusetts. The Department of Public Health reported in 2008 that smoking rates among high school students fell from 20.5% in 2005 to 17.7% in 2007. It was the first significant drop this decade and came as renewed efforts were announced by the Commonwealth to discourage adolescent tobacco use.

The 2006 National Survey on Drug Use and Health (formerly called National Household Survey on Drug Abuse) conducted by the Substance Abuse and Mental Health Services Administration of the United States Department of Health and Human Services estimated that approximately 61.6 million Americans age 12 and older were current cigarette smokers (defined by this survey to mean they had smoked cigarettes at least once during the 30 days prior to the interview). This estimate represents an incidence rate of 25.0%, unchanged from 2005, but down from 26.0% in 2002. The same survey found that an estimated 10.4% of youths age 12 to 17 were current cigarette smokers in 2006, down from 11.9% in 2004 and 13.0% in 2002.

New Jersey recently raised the minimum legal age to purchase cigarettes from 18 to 19 years. Three states, Alabama, Alaska, and Utah, also set the minimum age at 19.

### Price Elasticity of Cigarette Demand

The price elasticity of demand reflects the impact of changes in price on the demand for a product. Cigarette price elasticities from recent conventional research studies have generally fallen between an interval of -0.3 to -0.5.<sup>12</sup> (In other words, as the price of cigarettes increases by 1.0% the quantity demanded decreases by 0.3% to 0.5%.) A few researchers have estimated price elasticity as high as -1.23. Research focused on youth smoking has found price elasticity levels of up to -1.41.

<sup>11</sup> New York City Department of Health and Mental Hygiene. "Smoking among New York City Public High School Students". NYC Vital Signs. January 2008.

<sup>12</sup> Chaloupka FJ, Warner KE:P.5.



Two studies published by the National Bureau of Economic Research examine the price elasticity of youth smoking. In their study on youth smoking in the United States, Gruber and Zinman estimate an elasticity of smoking participation (defined as smoking any cigarettes in the past 30 days) of  $-0.67$  for high school seniors in the period 1991 to 1997.<sup>13</sup> That is, a 1% increase in cigarette prices would result in a decrease of 0.67% in the number of those seniors who smoked. The study's findings state that the drop in cigarette prices in the early 1990's can explain 26% of the upward trend in youth smoking during the same period. The study also found that price has little effect on the smoking habits of younger teens (8<sup>th</sup> grade through 11<sup>th</sup> grade), but that youth access restrictions have a significant impact on limiting the extent to which younger teens smoke. Tauras and Chaloupka also found an inverse relationship between price and cigarette consumption among high school seniors.<sup>14</sup> The price elasticity of cessation for males averaged 1.12 and for females averaged 1.19 in this study. These estimates imply that a 1% increase in the real price of cigarettes will result in an increase in the probability of smoking cessation for high school senior males and females of 1.12% and 1.19%, respectively. A study utilizing more recent data, from 1975 to 2003, by Grossman, estimated an elasticity of smoking participation of just  $-0.12$ .<sup>15</sup> Nevertheless it concludes that price increases subsequent to the 1998 MSA explain almost all of the 12% drop in youth smoking over that time.

In another study, Czart et al. (2001) looked at several factors which they felt could influence smoking among college students. These factors included price, school policies regarding tobacco use on campus, parental education levels, student income, student marital status, sorority/fraternity membership, and state policies regarding smoking. The authors considered two ways in which smoking behavior could be affected: (1) smoking participation; and (2) the amount of cigarettes consumed per smoker. The results of the study suggest that, (1) the average estimated price elasticity of smoking participation is  $-0.26$ , and (2), the average conditional demand elasticity is  $-0.62$ . These results indicate that a 1% increase in cigarette prices, will reduce smoking participation among college students by 0.26% and will reduce the level of smoking among current college students by 0.62%.<sup>16</sup>

Tauras et al. (2001) conducted a study that looked at the effects of price on teenage smoking initiation.<sup>17</sup> The authors used data from the Monitoring the Future study which examines smoking habits, among other things, of 8<sup>th</sup>, 10<sup>th</sup>, and 12<sup>th</sup> graders. They defined smoking initiation in three different ways: smoking any cigarettes in the last 30 days,

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<sup>13</sup> Source: Gruber, Jonathon and Zinman, Jonathon. "Youth Smoking in the U.S.: Evidence and Implications". Working Paper No. W7780. National Bureau of Economic Research. 2000.

<sup>14</sup> Source: Tauras, John A. and Chaloupka, Frank, J.. "Determinants of Smoking Cessation: An Analysis of Young Adult Men and Women". Working Paper No. W7262. National Bureau of Economic Research. 1999.

<sup>15</sup> Michael Grossman. "Individual Behaviors and Substance Use: The Role of Price". Working Paper No. W10948. National Bureau of Economic Research. December 2004.

<sup>16</sup> Czart et al. "The impact of prices and control policies on cigarette smoking among college students". Contemporary Economic Policy. Western Economic Association. Copyright April 2001.

<sup>17</sup> Tauras et al. "Effects of Price and Access Laws on Teenage Smoking Initiation: A National Longitudinal Analysis". University of Chicago Press. Copyright 2001.

smoking at least one to five cigarettes per day on average, or smoking at least one-half pack per day on average. The results suggest that the estimated price elasticities of initiation are  $-0.27$  for any smoking,  $-0.81$  for smoking at least one to five cigarettes, and  $-0.96$  for smoking at least one-half pack of cigarettes. These results above indicate that a 10% increase in the price of cigarettes will decrease the probability of smoking initiation between approximately 3% and 10% depending on how initiation is defined. In a related study, Powell et al. (2003) estimated a price elasticity of youth smoking participation of  $-0.46$ , implying that a 1% increase in price leads to a 0.46% reduction in smoking participation.<sup>18</sup>

In conclusion, economic research suggests the demand for cigarettes is price inelastic, with an elasticity generally found to be between  $-0.3$  and  $-0.5$ .

## Nicotine Replacement Products

Nicotine replacement products, such as Nicorette Gum and Nicoderm patches, are used to aid those who are attempting to quit smoking. Before 1996, these products were only available with a doctor's prescription. Currently, they are available as over-the-counter products. One study, by Hu et al., examines the effects of nicotine replacement products on cigarette consumption in the United States.<sup>19</sup> One of the results of the study found that, "a 0.076% reduction in cigarette consumption is associated with the availability of nicotine patches after 1992." In October 2002, the FDA approved the Commit lozenge for over-the-counter sale. This product is similar to the gum and patch nicotine replacement products. It is unclear whether it offers a significant advantage over those other products.<sup>20</sup> NicoBloc, a liquid applied to cigarettes which blocks tar and nicotine from being inhaled, is another new cessation product on the market since 2003. Zyban is a non-nicotine drug that has been available since 2000. It has been shown to be effective when combined with intensive behavioral support.<sup>21</sup>

In 2006 the Food and Drug Administration (FDA) approved varenicline, a Pfizer product marketed as Chantix, for use as a prescription medicine. It is intended to satisfy nicotine cravings without being pleasurable or addictive. The drug binds to the same brain receptor as nicotine. Tests indicate that it is more effective as a cessation aid than Zyban. Pfizer introduced Chantix with a novel marketing program, GETQUIT, an integrated consumer support system which emphasizes personalized treatment advice with regular phone and e-mail contact. The company reports that through June 2007, nearly 2.5 million prescriptions have been filled.

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<sup>18</sup> Powell et al. "Peer Effects, Tobacco Control Policies, and Youth Smoking Behavior". *Impacteen*. February 2003.

<sup>19</sup> Hu et al. "Cigarette consumption and sales of nicotine replacement products". *TC Online*. Tobacco Control. <http://tc.bmjournals.com>.

<sup>20</sup> Niaura, Raymond and Abrams, David B. "Smoking Cessation: Progress, Priorities, and Prospectus". *Journal of Consulting and Clinical Psychology*. June 2002.

<sup>21</sup> Roddy, Elin. "Bupropion and Other Non-nicotine Pharmacotherapies". *British Medical Journal*. 28 February 2004.

Several new drugs may also appear on the market in the near future. On May 14, 2005, Cytos Biotechnology AG announced the successful completion of Phase II testing of a virus-based vaccine, genetically engineered to attract an immune system response against nicotine and its effects. Novartis has acquired the license to the vaccine, and has reported positive results toward Phase III trials. Nabi Biopharmaceuticals has successfully completed its Phase IIB clinical trials for NicVAX, a vaccine to prevent and treat nicotine addiction. It triggers antibodies that bind with Nicotine molecules. In 2006, NicVAX received Fast Track Designation from the FDA, which is intended to expedite its review process. Phase III trials are the remaining step before a license application. The Xenova Group is set to begin Phase II testing of its similar vaccine, Ta-Nic. And positive results were reported in July 2006 by Somaxon Pharmaceuticals from a pilot Phase II study of Nalmefene. Nalmefene has been used for over 10 years for the reversal of opioid drug effects. The company is seeking to develop it as a treatment for impulse control disorders. In 2008, Evotec AG announced it would launch a Phase II study of EVT 302, a drug intended to ease smoker's cravings and nicotine withdrawal symptoms after cigarette deprivation. It is expected that products such as these will continue to be developed and that their introduction and use will contribute to the trend decline in smoking. Our forecast includes a strong negative trend in smoking rates which incorporates the influence of these factors.

## **Workplace Restrictions**

In their 1996 study on the effect of workplace smoking bans on cigarette consumption, Evans, Farrelly, and Montgomery found that between 1986 and 1993 smoking participation rates among workers fell 2.6% more than non-workers.<sup>22</sup> Their results suggest that workplace smoking bans reduce smoking prevalence by 5 percentage points and reduce consumption by smokers nearly 10%. The authors also found a positive correlation between hours worked and the impact on smokers in workplaces that have smoking bans. The more hours per day that a smoker spends working in an environment where there are smoking restrictions, the greater is the decline in the quantity of cigarettes consumed by that smoker.

## **Factors Affecting Cigarette Consumption**

Most empirical studies have found a common set of variables that are relevant in building a model of cigarette demand. These conventional analyses usually evaluate one or more of the following factors: (i) general population growth, (ii) price increases, (iii) changes in disposable income, (iv) youth consumption, (v) trend over time, (vi) smoking bans in public places, (vii) nicotine dependence and (viii) health warnings. While some of these factors were not found to have a measurable impact on changes in demand for cigarettes,

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<sup>22</sup> *Source:* Evans, William N.; Farrelly, Matthew C. and Montgomery, Edward. "Do Workplace Smoking Bans Reduce Smoking?". Working Paper No. W5567. National Bureau of Economic Research. 1996.

all of these factors are thought to affect smoking in some manner and to affect current levels of consumption.

**General Population Growth.** Global Insight forecasts that the United States population will increase from 283 million in 2000 to approximately 333 million in 2023. This forecast is consistent with the Bureau of the Census forecast based on the 2000 Census.

**Price Elasticity of Demand & Price Increases.** Cigarette price elasticities from recent conventional research studies have generally fallen within an interval of -0.3 to -0.5. Based on Global Insight's multivariate regression analysis using data from 1965 to 2003, the long run price elasticity of consumption for the entire population is -0.33; a 1.0% increase in the price of cigarettes decreases consumption by 0.33%.

In 1998, the average price of a pack of cigarettes in nominal terms was \$2.20. This increased to \$2.88 per pack in 1999, representing a nominal growth in the price of cigarettes of 30.9% from 1998. During 1999, consumption declined by 6.45%. This was primarily due to a \$0.45 per pack increase in November 1998 which was intended to offset the costs of the MSA and agreements with previously settled states. The cigarette manufacturers then increased wholesale prices on seven occasions between August 1999 and April 2002, with the total change aggregating to \$0.82. In addition to the wholesale price increases, in 1999 New York and California each increased its state excise tax by \$0.50 per pack. In 2001, five states followed suit, and in January 2002, a scheduled increase in the federal excise tax of \$0.05 per pack went into effect. By June 2002 the average price per pack had reached \$3.73.

Severe budget shortfalls following the 2001 recession led at least 30 states to consider cigarette excise tax increases in 2002. Ultimately 20 states and New York City imposed excise tax increases that year. These increases range from \$0.07 per pack in Tennessee to \$1.42 per pack in New York City. They averaged \$0.47 per pack, and, when weighted by the state population boosted the nationwide average retail price by \$0.18. This increased the population-weighted average state excise tax to over \$0.60 per pack. The trend continued in 2003, as state fiscal difficulties persisted. Excise tax increases were enacted in 13 states, pushing the average price per pack to over \$3.80. This was followed by eleven state tax increases in 2004 and eight (Kentucky, Maine, Minnesota, New Hampshire, North Carolina, Ohio, Virginia, and Washington) in 2005. The increase in Minnesota was not a tax increase, but rather the imposition of a "Health Impact Fee" which has the same effect on consumer prices. This report will consider any such fees as equivalent to excise taxes.

In 2006 Texas passed a budget that will raise the state excise tax by \$1.00 in January 2007. Also in 2006 Hawaii, New Jersey, North Carolina, and Vermont enacted legislation which raised excise taxes. As a result the population-weighted average state excise tax increased to \$0.932 per pack. In the November elections referenda passed in Arizona and South Dakota raising excise taxes. Increases in California and Missouri were rejected by voters. As a result of these actions the weighted average state excise tax increased to \$1.038 per pack.

In 2007 Connecticut, Delaware, Iowa, Indiana, New Hampshire, and Tennessee each increased excise taxes. These actions further increased the average state excise tax to \$1.074 in July. In October, Wisconsin enacted a \$1.25 increase, and in November Maryland enacted a \$1.00 increase. These actions will push the average state excise tax to \$1.116 in 2008. It is expected that other states will also enact increases in 2008 and in future years. Georgia, Illinois, Kansas, Kentucky, Massachusetts, Mississippi, Pennsylvania, South Carolina, and Utah are now considering excise tax increases. Though California voters rejected a ballot initiative on November 7, 2006 that would have raised the tax from \$0.87 to \$3.47 per pack, California lawmakers have introduced a bill which would raise the tax by \$2.00 per pack.

The federal excise tax has remained constant, at \$0.39 per pack, since 2002. The U.S. Congress adopted legislation which would have raised the tax by \$0.61. But on October 3, 2007 the President vetoed the bill, and on October 18 the House of Representatives failed to override the veto. Subsequent override attempts in November and in January 2008 also failed. If the tax increase were to be enacted the federal excise tax would equal \$1.00 per pack, and the total state and federal excise tax would exceed \$2.00 per pack.

During much of this period, the major manufacturers refrained from wholesale price increases, and also actively pursued extensive promotional and dealer and retailer discounting programs which served to hold down retail prices. They did this in part due to the state tax increases, but primarily to maintain their market share from its erosion by a deep discount segment which grew rapidly following the MSA. The major manufacturers were finally successful in stemming the increase in the deep discount market share, which has been stable since 2003. As 2004 came to a close, the manufacturers raised list prices for the first time since 2002. The major manufacturers have raised prices or reduced discounts and promotions in each year since 2004. The average price in December 2006 was \$4.24 per pack. Following further wholesale price and excise tax increases it has increased to \$4.63 in February 2008.

Over the longer term our forecast expects price increases to continue to exceed the general rate of inflation due to increases in the manufacturers' prices as well as further increases in excise taxes.

Premium brands are typically \$0.50 to \$1.00 more expensive per pack than discount brands, allowing a margin for consumers to switch to less costly discount brands in the event of price increases. The increasing availability of cigarette outlets on Indian reservations, where sales are exempt from taxes, provides another opportunity for consumers to reduce the cost of smoking. Similarly, Internet sales of cigarettes are growing rapidly, though a recent decision by credit card companies that they would not handle cigarette sales has started to have an impact and will dampen this growth. While these sales are not technically exempt from taxation, states are currently having a difficult time enforcing existing statutes and collecting excise taxes on these sales.<sup>23</sup> Under the MSA, volume adjustments to payments are based on the quantity (and not the price or

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<sup>23</sup> *Source:* United States General Accounting Office. "Internet Cigarette Sales". GAO-02-743. August 2002.

type) of cigarettes shipped. The availability of lower price alternatives lessens the negative impact of price increases on cigarette volume.

**Changes in Disposable Income.** Analyses from many conventional models also include the effect of real personal disposable income. Most studies have found cigarette consumption in the United States increases as disposable income increases.<sup>24</sup> However, a few studies found cigarette consumption decreases as disposable income increases.<sup>25</sup> Based on our multivariate regression analysis the income elasticity of consumption is 0.27; a 1.0% increase in real disposable income per capita increases per capita cigarette consumption by 0.27%.

**Youth Consumption.** The number of teenagers who smoke is another likely determinant of future adult consumption. While this variable has been largely ignored in empirical studies of cigarette consumption,<sup>26</sup> almost all adult smokers first use cigarettes by high school, and very little first use occurs after age 20.<sup>27</sup> One study examines the effects of youth smoking on future adult smoking.<sup>28</sup> The study found that between 25% and 50% of any increase or decrease in youth smoking would persist into adulthood. According to the study, several factors may alter future correlation between youth and adult smoking: there are better means for quitting smoking than in the past, and there are more workplace bans in effect that those who are currently in their teen years will face as they age.

We have compiled data from the CDC which measures the incidence of smoking in the 12-17 age group as the percentage of the population in this category that first become daily smokers. This percentage, after falling since the early 1970s, began to increase in 1990 and increased through the decade. We assume that this recent trend peaked in the late 1990s and youth smoking has resumed its longer-term decline.

**Trend Over Time.** Since 1964 there has been a significant decline in U.S. adult per capita cigarette consumption. The Surgeon General's health warning (1964) and numerous subsequent health warnings, together with the increased health awareness of the population over the past thirty years, may have contributed to decreases in cigarette consumption levels. If, as we assume, the awareness of the adult population continues to change in this way, overall consumption of cigarettes will decline gradually over time. In order to capture the impact of these changing health trends and the effects of other such variables which are difficult to quantify, our analysis includes a time trend variable.

**Health Warnings.** Categorical variables also have been used to capture the effect of different time periods on cigarette consumption. For example, some researchers have identified the United States Surgeon General's Report in 1964 and subsequent mandatory health warnings on cigarette packages as turning points in public attitudes and knowledge of the health effects of smoking. The Cigarette Labeling and Advertising Act of 1965

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<sup>24</sup> Ippolito, et al.; Fuji.

<sup>25</sup> Wasserman, et al.; Townsend et al.

<sup>26</sup> Except for those such as Wasserman, et al. that studied the price elasticity for different age groups.

<sup>27</sup> Source: Surgeon General's 1994 Report, "Preventing Tobacco Use Among Young People."

<sup>28</sup> Source: Gruber, Jonathon and Zinman, Jonathon. "Youth Smoking in the U.S.: Evidence and Implications". Working Paper No. W7780. National Bureau of Economic Research. 2000.

required a health warning to be placed on all cigarette packages sold in the United States beginning January 1, 1966. The Public Health Smoking Act of 1969 required all cigarette packages sold in the United States to carry an updated version of the warning, stating that it was a Surgeon General's warning, beginning November 1, 1970. The Comprehensive Smoking Education Act of 1984 led to even more specific health warnings on cigarette packages. The dangers of cigarette smoking have been generally known to the public for years. Part of the negative trend in smoking identified in our model may represent the cumulative effect of various health warnings since 1966.

Five states, Alabama, Georgia, Idaho, Kentucky and West Virginia, charge higher health insurance premiums to state employee smokers than non-smokers, and a number of states have implemented legislation that allows employers to provide incentives to employees who do not smoke. Several large corporations, including Meijer Inc., Gannett Co., American Financial Group Inc., PepsiCo Inc. and Northwest Airlines, are now charging smokers higher premiums.

***Smoking Bans in Public Places.*** Beginning in the 1970s numerous states have passed laws banning smoking in public places as well as private workplaces. In September 2003 Alabama joined the other 49 states and the District of Columbia in requiring smoke-free indoor air to some degree or in some public places.<sup>29</sup>

The most comprehensive bans have been enacted since 1998 in 28 states and a number of large cities. In 1998, California imposed a comprehensive smoking ban for all indoor workplaces, including restaurants and bars. Delaware followed suit in 2002, and in 2003, Connecticut, Maine, New York, and Florida passed similar comprehensive bans, as did the cities of Boston and Dallas. Since then, Arizona, Arkansas, Colorado, the District of Columbia, Hawaii, Illinois, Louisiana, Maryland, Massachusetts, Minnesota, Montana, Nebraska, Nevada, New Hampshire, New Jersey, New Mexico, Ohio, Oregon, Rhode Island, Tennessee, Utah, Vermont, Washington, and Puerto Rico established similar bans, as did the cities of Baltimore, Chicago, Houston, and Philadelphia. The New Mexico, Washington State and Chicago restrictions are stronger than those in other states as they include a ban on outdoor smoking within 25 feet of the entrances of restaurants and other public places. It is expected that these restrictions will continue to proliferate. For example, in 2008 at least 11 states, Alabama, Iowa, Kansas, Michigan, Missouri, North Carolina, Pennsylvania, South Carolina, Tennessee, West Virginia, and Wisconsin, are considering legislation which would enact comprehensive bans.

The American Nonsmokers' Rights Foundation documents clean indoor air ordinances by local governments throughout the U.S. As of January 2, 2008, there were 2,671 municipalities with indoor smoking restrictions. Of these, 524 local governments required workplaces to be 100% smoke-free, and 100% smoke-free conditions were required for restaurants by 488 governments, and for bars by 366. The number of such ordinances grew rapidly beginning in the 1980s, from less than 200 in 1985 to over 1,000 by 1993, and 1,500 by 2001. The ordinances completely restricting smoking in restaurants and bars

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<sup>29</sup> Source: American Lung Association. "State Legislated Actions on Tobacco Issues". 2002.

have generally appeared in the past decade. In 1993 only 13 municipalities prohibited all smoking in restaurants, and 6 in bars. These numbers grew to 49 for restaurants and 32 for bars in 1998, and doubled again by 2001, to 100 and 74, respectively.<sup>30</sup>

Based on the regression analysis using data from 1965 to 2003, the restrictions on public smoking appear to have an independent effect on per capita cigarette consumption. We estimate that the restrictions instituted beginning in the late 1970's have reduced smoking by about 2%. However, the timing of the restrictions within and across states makes such statistical identification difficult. Bauer, et al. estimate that U.S. workers in smoke-free workplaces from 1993 to 2001 decreased their average daily consumption by 2.6 cigarettes.<sup>31</sup> Research in Canada, by the Ontario Tobacco Research Unit, concludes that consumption drops in workplaces where smoking is banned, by almost five cigarettes per person per day. Tauras, in a study based on a large survey of smokers, found that the more restrictive smoke-free air laws decrease average smoking, but have little influence on prevalence.<sup>32</sup> The study predicts that moving from no smoking restrictions at all to the most restrictive bans reduces average smoking by from 5% to 8%.

The first extensive outdoor smoking restrictions were instituted on March 2006 in Calabasas, California. The city of Oakland, and the California municipalities of Belmont, Beverly Hills, Dublin, El Cajon, Emeryville, and Santa Monica have also established extensive outdoor restrictions, as have Davis County and the city of Murray in Utah. Burbank, CA is expected to follow suit. And in the most restrictive version to date, the California cities, Belmont, and Calabasas have approved ordinances which restrict smoking anywhere in the city except for single-family detached homes. Many landlords and condominium associations have also established smoke-free apartment policies. And the Massachusetts Department of Public Health is conducting a survey of landlords, tenants, and condominium associations to assess the feasibility of making residences smoke-free.

In the past year, San Diego City and Los Angeles, Santa Cruz and San Mateo Counties have banned smoking at beaches and parks, joining over 30 other Southern California cities in prohibiting smoking on the beach. The beach restrictions may soon become statewide. Chicago approved beach and parkground smoking restrictions in October 2007. Sarasota County, Florida has banned smoking on its beaches, and Nassau County, New York and Volusia County, Florida are also considering park and beach bans. At least 43 colleges nationwide now prohibit smoking everywhere on campus. California, Illinois, Michigan, and Nevada have banned smoking in state prisons. Arkansas, California, Louisiana, Puerto Rico, Texas, and Rockland County, NY now prohibit smoking in a car where there are children present, and similar legislation has been proposed in Arizona, California, Connecticut, Illinois, Indiana, Iowa, Kansas,

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<sup>30</sup> *Source:* American Nonsmokers' Rights Foundation. <http://www.no-smoke.org>. January 2008.

<sup>31</sup> Bauer, Hyland, Li, Steger, and Cummings. "A Longitudinal Assessment of the Impact of Smoke-Free Worksite Policies on Tobacco Use". American Journal of Public Health. June 2005

<sup>32</sup> Tauras, John A. "Smoke-Free Air Laws, Cigarette Prices, and Adult Cigarette Demand" Economic Inquiry, April 2006.



Massachusetts, Montana, New Jersey, New York, Oregon, Rhode Island, South Carolina, Utah, West Virginia, and in Bangor, Maine.

In June 2006, the Office of The Surgeon General released a report, "The Health Consequences of Involuntary Exposure to Tobacco Smoke". It is a comprehensive review of health effects of involuntary exposure to tobacco smoke. It concludes definitively that secondhand smoke causes disease and adverse respiratory effects. It also concludes that policies creating completely smoke-free environments are the most economical and efficient approaches to providing protection to non-smokers. We expect that the report will strengthen arguments in favor of further smoking restrictions across the country. Further ammunition for activists for smoke-free environments was provided by the California Environmental Protection Agency Air Resources Board, which in 2006 declared environmental tobacco smoke to be a toxic air contaminant.

The trend variable included in our econometric analysis is likely to incorporate some part of the cumulative impact of the various smoking bans and restrictions. Our forecast assumes that the factors, which have contributed to the negative trend in smoking in the U.S. population, continue to contribute to further declines in smoking rates throughout the forecast horizon. However, should there be a proliferation of the most severe bans, such as those extensively limiting outdoor smoking, or smoking anywhere children might be affected, consumption declines would very likely accelerate.

***Smokeless Tobacco Products.*** Smokeless tobacco products have been available for centuries. As cigarette consumption expanded in the last century, the use of smokeless products declined. Chewing tobacco and snuff are the most significant components. Snuff is a ground or powdered form of tobacco that is placed under the lip to dissolve. It delivers nicotine effectively to the body. Moist snuff is both smoke-free and potentially spit-free. Chewing tobacco and dry snuff consumption has been declining in the U.S. in this decade, but moist snuff consumption has increased at an annual rate of more than 5% since 2002, and by 10.4% in 2006, when over 5 million consumers purchased 1.1 billion cans. Snuff is now being marketed to adult cigarette smokers as an alternative to cigarettes. UST, the largest producer of moist smokeless tobacco is explicitly targeting adult smoker conversion in its growth strategy. The industry is responding to both the proliferation of indoor smoking bans and to a perception that smokeless use is a less harmful mode of tobacco and nicotine usage than cigarettes. In 2006 the three largest U.S. cigarette manufacturers entered the market. Philip Morris introduced a snuff product, Taboka, Reynolds American acquired Conwood Company, the second largest domestic producer, and introduced Camel Snus, a snuff product, and Lorillard entered into an agreement with Swedish Match North America to develop smokeless products in the U.S. Product development has continued in 2007 with the introduction by Philip Morris of a Marlboro snus product. In October 2007, Altria announced that it would accelerate the development of snuff and less-harmful cigarettes to counter a decline in smoking. In 2008, Liggett announced it would introduce Grand Prix snus.

Advocates of the use of snuff as part of a harm reduction strategy point to Sweden, where 'snus', a moist snuff manufactured by Swedish Match, use has increased sharply since

1970, and where cigarette smoking incidence among males has declined to levels well below that of other countries. A review of the literature on the Swedish experience concludes that snus, relative to cigarettes, delivers lower concentrations of some harmful chemicals, and does not appear to cause cancer or respiratory diseases. They conclude that snus use appears to have contributed to the unusually low rates of smoking among Swedish men.<sup>33</sup> The Sweden experience is unique, even with respect to its Northern European neighbors. It is not clear whether it could be replicated elsewhere. Public health advocates in the U.S. emphasize that smokeless use results in both nicotine dependence and to increased risks of oral cancer among other health concerns. Snuff use is also often criticized as a gateway to cigarette use.

In 2008 a new firm, Fuisz Tobacco, was formed to commercialize a film-based smokeless tobacco product. The thin film strip would be spitless and would dissolve entirely in the cheek.

Similar to the case of smoking bans, this report assumes that the trend decline in smoking projected in this forecast is sufficient to incorporate the negative impact that increasing use of snuff may have on cigarette consumption.

***Nicotine Dependence.*** Nicotine is widely believed to be an addictive substance. The Surgeon General<sup>34</sup> and the American Medical Association<sup>35</sup> (AMA) both conclude that nicotine is an addictive drug which produces dependence. The American Psychiatric Association has determined that cigarette smoking causes nicotine dependence in smokers and nicotine withdrawal in those who stop smoking. The American Medical Association Council on Scientific Affairs found that one-third to one-half of all people who experiment with smoking become smokers.

***Other Considerations.*** In August 1999, the CDC published Best Practices for Comprehensive Tobacco Control Programs. Citing the success of programs in California and Massachusetts, the CDC recommends comprehensive tobacco control programs to the states. On August 9, 2000, the Surgeon General issued a report, Reducing Tobacco Use (“Surgeon General’s Report”), that comprehensively assesses the value and efficacy of the major approaches that have been used to reduce tobacco use. The report concludes that a comprehensive program of educational strategies, treatment of nicotine addiction, regulation of advertising, clean air regulations, restriction of minors’ access to tobacco, and increased excise taxation can significantly reduce the prevalence of smoking. The Surgeon General called for increased spending on anti-smoking initiatives by states, up to 25% of their annual settlement proceeds, which is far higher than the approximately 9% allocated from the first year’s settlement payments.

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<sup>33</sup> Foulds, Ramstrom, Burke, and Fagerstrom. "Effect of Smokeless Tobacco (Snus) on Smoking and Public Health in Sweden". Tobacco Control. Vol. 12, 2003.

<sup>34</sup> Source: Surgeon General’s 1988 Report. “The Health Consequences of Smoking – Nicotine Addiction”.

<sup>35</sup> Source: Council on Scientific Affairs. “Reducing the Addictiveness of Cigarettes”. Report to the AMA House of Delegates. June 1998.

The Surgeon General's Report documents evidence of the effectiveness of five major modalities for reducing tobacco use. Educational strategies are shown to be effective in postponing or preventing adolescent smoking. Pharmacologic treatment of nicotine addiction, combined with behavioral support, can enhance abstinence efforts. Regulation of advertising and promotional activities of manufacturers can reduce smoking, particularly among youth. Clean air regulations and restricted minor's access contribute to lessening smoking prevalence. And excise tax increases will reduce cigarette consumption. Further support for the efficacy of such programs is provided in an analysis by Farrelly, Pechacek, and Chaloupka.<sup>36</sup> They estimate that tobacco control program expenditures between 1988 and 1998 resulted in a decline in cigarette sales of 3%. Tauras, et al. estimate that, had state tobacco control spending been maintained at the levels recommended by the CDC, youth smoking rates would have been from 3.3% to 13.5% lower.<sup>37</sup> Also, Farrelly et al. estimate that 22% of the decline in youth smoking from 1999 to 2002 was due to the national "truth" mass media campaign.<sup>38</sup> In 2002, New York City implemented a strategy which sharply increased excise taxes, banned smoking in bars and restaurants, distributed free nicotine patches, and expanded educational efforts. Research by Frieden et al. estimates that smoking prevalence in the City declines by 11% as a result of these measures, an effect consistent with the conclusions of the Surgeon General's Report.<sup>39</sup>

In May 2001 a Commission established by President Clinton in September 2000 released its final report on how to improve economic conditions in tobacco dependent economies while making sure that public health does not suffer in the process.<sup>40</sup> The Commission recommended moving from the current quota system to what would be called a Tobacco Equity Reduction Program (TERP). TERP would allow compensation to be rendered to quota owners for the loss in value of their quota assets as a result of a restructuring to a production permit system where permits would be issued annually to tobacco growers. Also created would be a Center for Tobacco-Dependent Communities, which would address any challenges faced during this period. Three public health proposals that were suggested by the Commission were: that states increase funding on tobacco cessation and prevention programs; that the FDA be allowed to regulate tobacco products in a "fair and equitable" manner; and that funding be included in Medicaid and Medicare coverage for smoking cessation. To be able to fund these recommendations, the Commission called for a 17-cent increase in the excise tax on all packs of cigarettes sold in the United States. The increased revenues would then be deposited into a fund and earmarked for the

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<sup>36</sup> "The Impact of Tobacco Control Program Expenditures on Aggregate Cigarette Sales: 1981-1998." Working Paper No. 8691, National Bureau of Economic Research, 2001.

<sup>37</sup> Tauras, Chaloupka, Farrelly, Giovino, Wakefield, Johnston, O'Malley, Kloska, and Pechacek. "State Tobacco Control Spending and Youth Smoking", *American Journal of Public Health*, February 2005.

<sup>38</sup> Farrelly, Davis, Haviland, Messeri, and Heaton. "Evidence of a Dose-Response Relationship Between "truth" Antismoking Ads and Youth Smoking Prevalence". *American Journal of Public Health*. March 2005.

<sup>39</sup> Frieden, Mostashari, Kerker, Miller, Hajat, and Frankel. "Adult Tobacco Use Levels After Intensive Tobacco Control Measures: New York City, 2002-2003". *American Journal of Public Health*. June 2005.

<sup>40</sup> "Tobacco at a Crossroad: A Call for Action". President's Commission on Improving Economic Opportunity in Communities Dependent on Tobacco Production While Protecting Public Health. May 14, 2001.

recommended programs. On February 13, 2003, the Interagency Committee on Smoking and Health, which reports to the U.S. Department of Health and Human Services, issued recommendations, which included raising the federal excise tax on cigarettes from \$0.39 to \$2.39 per pack. The purpose of the tax increase would be to discourage smoking and to fund anti-tobacco efforts.

Neither the Surgeon General's nor the Presidential Commission's report have resulted in a concerted nationwide program to implement their recommendations, though legislation to establish FDA regulation was re-introduced in 2005 and again on February 15, 2007 as the Family Smoking Prevention and Tobacco Control Act. The bill would give the FDA broad authority over the sale, distribution, and advertising of tobacco products. Such legislation would, among other anticipated changes, permit the FDA to strengthen warning labels, reduce nicotine levels in tobacco products, police false or misleading advertising and marketing aimed at children and would require manufacturers to provide the FDA with lists of ingredients and additives in their products, including nicotine.

Research has indicated, and our model incorporates, a negative impact on cigarette consumption due to tobacco tax increases, and a negative trend decline in levels of smoking since the Surgeon General's 1964 warning, subsequent anti-smoking initiatives, and regulations which restrict smoking. Our model and forecast acknowledges the efficacy of these activities in reducing smoking and assumes that the effectiveness of such anti-smoking efforts will continue. For instance, in 2001, Canada required cigarette labels to include large graphic depictions of adverse health consequences of smoking. Recent research suggests that these warnings have some effectiveness, as one-fifth of the participants in a survey reported smoking less as a result of the labels.<sup>41</sup> Similarly, the Justice Department has indicated that, as part of a lawsuit against the tobacco companies, it may seek to require graphic health warnings covering 50% of cigarette packs. In addition, it would prohibit in-store promotions and require that all advertising and packaging be black-and-white. A similar proposal is part of the World Health Organization's Framework Convention on Tobacco Control, which the U.S. may sign. As the prevalence of smoking declines, it is likely that the achievement of further declines will require either greater levels of spending, or more effective programs. This is the common economic principle of diminishing returns.

In August 2007, the President's Cancer Panel issued a report which included a series of recommendations to reduce American's cancer risk. These included FDA regulation of the tobacco industry, increased federal and state excise taxes on tobacco, increased funding of tobacco prevention and cessation programs, and the enactment in all states of smoke-free laws which cover restaurants and bars.

Also in 2007, the Motion Picture Association of America promised to consider the amount of smoking depicted in a film as a determinant in assigning it an R rating, one which limits youth attendance. Researchers at the University of California at San

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<sup>41</sup> Hammond, Fong, McDonald, Brown, and Cameron. "Graphic Canadian Warning Labels and Adverse Outcomes: Evidence from Canadian Smokers. *American Journal of Public Health*. August 2004.

Francisco have concluded that viewing on-screen smoking is linked to smoking among young adults.

New York State, in 2000, mandated that manufacturers provide, beginning in 2003, only cigarettes that self-extinguish. These standards went into effect in 2004. Similar laws have been enacted in Alaska, California, Connecticut, Delaware, Illinois, Iowa, Kentucky, Louisiana, Maine, Maryland, Massachusetts, Minnesota, Montana, New Hampshire, New Jersey, North Carolina, Oregon, Rhode Island, Texas, Utah, and Vermont. We do not believe that these statutes or a nationwide agreement on such standards will affect consumption noticeably. It will probably raise the cost of manufacture slightly, but we view it as a continuation of a long series of government actions that contribute to the trend decline in consumption, which has been incorporated into our model. The expense and availability of technology required in the manufacture of self-extinguishing cigarettes may put the smaller manufacturers at a slight competitive disadvantage, as their cost per pack would increase more relative to the cost per pack increase for the larger manufacturers. In October 2007 Reynolds American announced that, by 2009, it would sell only fire-safe cigarettes in the U.S.

Similarly, in January 2001, Vector Group Ltd. announced plans for a virtually nicotine-free cigarette. The product, Quest, was introduced on January 27, 2003. This non-addictive product might be used as a tool to quit or reduce smoking. We view this as a continuation of efforts to provide products, such as the nicotine patch, that are supposed to reduce smoking addiction. These products have likely contributed to the trend decline in consumption incorporated into our model. In our forecast, we expect such efforts to continue to reduce per capita cigarette consumption.

## **An Empirical Model of Cigarette Consumption**

An econometric model is a set of mathematical equations which statistically best describes the available historical data. It can be applied, with assumptions on the projected path of independent explanatory variables, to predict the future path of the dependent variable being studied, in this case adult per capita cigarette consumption (CPC). After extensive analysis of available data measuring all of the above-mentioned factors which influence smoking, we found the following variables to be effective in building an empirical model of adult per capita cigarette consumption for the United States:

- 1) the real price of cigarettes (cigprice)
- 2) the level of real disposable income per capita (ydp96pc)
- 3) the impact of restrictions on smoking in public places (smokeban)
- 4) the trend over time in individual behavior and preferences (trend)

We used the tools of standard multivariate regression analysis to determine the nature of the economic relationship between these variables and adult per capita cigarette consumption in the U.S. Then, using that relationship, along with Global Insight's

standard adult population growth, and adjustment for non-adult smoking, we projected actual cigarette consumption (in billions of cigarettes) out to 2023. It should also be noted that since our entire dataset incorporates the effect of the Surgeon General’s health warning (1964), the impact of that variable too is accounted for in the forecast. Similarly the effect of nicotine dependence is incorporated into our entire dataset and influences the trend decline.

Using U.S. data from 1965 through 2003 on the variables described above, we developed the following regression equation. All of the data sources are detailed in Appendix 1 of this Report.

$$\begin{aligned} \log(\text{cpc}) &= 57.7 && - && 0.024 * \text{trend} \\ &- && 0.223 * \log(\text{cigprice}) &- & 0.106 * \log(\text{cigprice})(-1) \\ &+ && 0.270 * \log(\text{ydp96pc}) &- & 0.020 * \text{smokeban} \end{aligned}$$

The model is estimated in logarithmic form, since that allows the easy computation of the responsiveness (or elasticity) of the dependent variable (adult per capita cigarette consumption) to changes in the various explanatory (or the right hand side) variables.

This model has an R-square in excess of 0.99, meaning that it explains more than 99 percent of the variation in U.S. adult per capita cigarette consumption over the 1965 to 2003 period. In terms of explanatory power this indicates a very strong model with a high level of statistical significance.

Our model is completed with two other equations:

(1) Total adult cigarette consumption =

$$\text{cpc} * \text{U.S. adult population.}$$

(2) Total cigarette consumption =

$$\text{total adult cigarette consumption} + \text{total youth cigarette consumption.}$$

We have measured the consumption level of cigarettes in the 12-17 age group by examining the difference between total consumption and total adult consumption. We then use the expected trend of youth smoking incidence to adjust for the volume of cigarette consumption in this age group. Youth incidence is expected to gradually decline, and our estimated consumption levels will fall to 4.4 billion in 2023.

## **Dependent Variable**

### **Adult Per Capita Cigarette Consumption (CPC)**

CPC measures the average annual cigarette consumption of the American adult. It is calculated by dividing total adult cigarette consumption by the size of the population (18 years and above). Of the different measures of cigarette consumption available, this is considered to be the most reliable. It also directly reflects the changing behavior of individual smokers over the historical period. Data were obtained from the U.S. Department of Agriculture's (USDA) Economic Research Service.

## **Explanatory Variables**

### **The Real Price of Cigarettes (CIGPRICE)**

Reliable data on retail cigarette prices from the consumer price index (CPI) are only available since 1997, an inadequate time frame to build our model. However, tobacco CPI, which is available for the entire period of analysis, closely follows cigarette prices, since cigarettes constitute over 95 percent of tobacco products. We have, therefore, used the tobacco CPI in our model, as is standard. Further, we have deflated this price of cigarettes (tobacco) by the overall price level to ensure that any change in cigarette consumption is correctly attributed to a change in the price of cigarettes relative to other goods, rather than an overall change in the price level. The overall, as well as tobacco CPI, were obtained from the Bureau of Labor Statistics (BLS).

The coefficient on CIGPRICE in the regression equation measures the elasticity of cigarette consumption with respect to price. In our model this effect consists of two parts. The coefficient of  $-0.223$  measures the short-run elasticity of cigarette demand. That is, a 1% increase in price reduces consumption by 0.223% in the current year. The second coefficient,  $-0.106$  relates to prices in the previous year. It indicates that, following a 1% increase, an additional decrease in cigarette consumption of 0.106% will occur. Thus, according to the data, a one percent increase in price decreases cigarette consumption by 0.329 percent in the long term. The low value of the elasticity indicates that cigarette consumption is price inelastic, or relatively unresponsive to changes in price. This coefficient is estimated such that a statistical confidence interval of 95% places its value between  $-0.25$  and  $-0.41$ . This implies that there is a probability of 5% that the price elasticity is outside this range.

### **Real Disposable Income Per Capita (YDP96PC)**

Real disposable income per capita measures the average income per person after tax in constant 1996 dollars. Data used were collected by the Bureau of Economic Analysis (BEA). For goods considered "normal", consumption increases as incomes rise. Hence the coefficient is positive. On the other hand if the coefficient is negative, it indicates that the good is "inferior" and less is purchased as incomes rise.

Our analysis indicates that the income elasticity of cigarettes, given by the regression coefficient on YDP96PC, is 0.27. The positive sign on the coefficient indicates that cigarettes are a normal good. Specifically, every percent increase in real disposable income per capita has raised adult per capita cigarette consumption by 0.27%. However, the low value of the elasticity indicates that the demand for cigarettes is income inelastic, or relatively unresponsive to changes in income. This coefficient (0.27) is estimated such that a statistical confidence interval of 95% places its value between 0.03 and 0.52. This implies that there is a probability of 5% that the income elasticity is outside this range.

### **Qualitative Variable**

The qualitative variable that we have explicitly included in our model relates to the restrictions on public smoking since the 1980s (SMOKEBAN). The negative coefficient on the variable implies that smoking decreases as a result of smoking bans. The coefficient on SMOKEBAN is estimated such that a statistical confidence interval of 95% for its value is from 0 to -0.53. This implies that there is a probability of 5% that the coefficient is outside this range.

### **Trend and Constant Term**

According to the regression equation specified above, adult cigarette consumption per capita (CPC) displays a trend decline of 2.40% per year. The trend reflects the impact of a systematic change in the underlying data that is **not** explained by the included explanatory variables. In the case of cigarette consumption, the systematic change is in public attitudes toward smoking. The trend may also reflect the cumulative impact of health warnings, advertising restrictions, and other variables which are statistically insignificant when viewed in isolation. This trend, primarily due to an increase in the health-conscious proportion of the population averse to smoking, would by itself account for 90.3% of the variation in consumption. This coefficient is estimated such that a statistical confidence interval of 95% for its value is from 0.0195 to 0.0269 (1.95% to 2.69%). This implies that there is a probability of 5% that the trend rate of decline is outside this range.

The constant term (57.7) also reflects the impact of excluded variables, those that stay fixed over time (e.g., the health warnings on cigarette packs). It should be noted that the actual decline in CPC in any given year could be above or below the trend, depending on the values of the other explanatory variables.



## Forecast Assumptions

Our forecast is based on assumptions regarding the future path of the explanatory variables in the regression equation. Projections of U.S. population and real per capita personal disposable income are standard Global Insight forecasts. Annual population growth is projected to average 0.8%, and real per capita personal disposable income is projected to increase over the long term at just over 2.1% per year.

The projection of the real price of cigarettes is based upon its past behavior with an adjustment for the shock to prices due to the tobacco settlement. Cigarette prices increased dramatically in November 1998, as manufacturers raised prices by \$0.45 per pack. Subsequent increases by the manufacturers and numerous federal and state hikes in excise taxes brought prices to an average of \$3.84 per pack in 2004, to \$4.04 in 2005, to \$4.18 in 2006, and to \$4.47 in 2007.. After a long period of fighting to maintain market share, the large cigarette manufacturers are expected to reduce discounts and other promotions. Price increases were announced in the fourth quarter of 2006 and again, by \$0.05, in the third quarter of 2007. In addition many states continue to discuss excise tax increases.

Our model, intended for long-term forecasting, uses annual data to describe changes in prices and other variables. When viewed over long intervals of time, the changes will appear to be gradual. The purpose of the model is to capture these broad changes and their influence on consumption. Because cigarette manufacturing is dominated by a few firms, price changes will typically be discrete events, with jumps such as occurred on August 1999 and December 2004, followed by plateaus, rather than small and continuous changes. The exact timing during the year of price changes influences only the short-term path of consumption.

The forecast assumes that average prices will reach \$4.68 per pack in 2008 and \$4.92 in 2009. Our forecast assumptions have incorporated price increases in excess of general inflation in order to meet the requirements of the MSA and offset excise and other taxes. Based upon our general inflation and cost assumptions, we anticipate that the nominal price per pack of cigarettes will rise to \$9.83 by 2023, which is \$6.52 in 2000 dollars. Relative to other goods, cigarette prices will rise by an average of 1.9% per year over the long term. The average real increase over the 30 years ending 1998 was 1.48% per year.

Prior to the MSA, only once, in 1983, have real cigarette prices appreciated at a double digit, or greater than 10%, rate. If a 10% rate of price increase were to continue, the annual rate of decline in cigarette consumption predicted by our model would increase to approximately 4%.

Our Base Case Forecast assumes that the incidence of youth smoking will continue to decline. By 2023 we assume that youth smoking will have declined at an average annual rate of 1.6% since 2001, or by 23% overall.

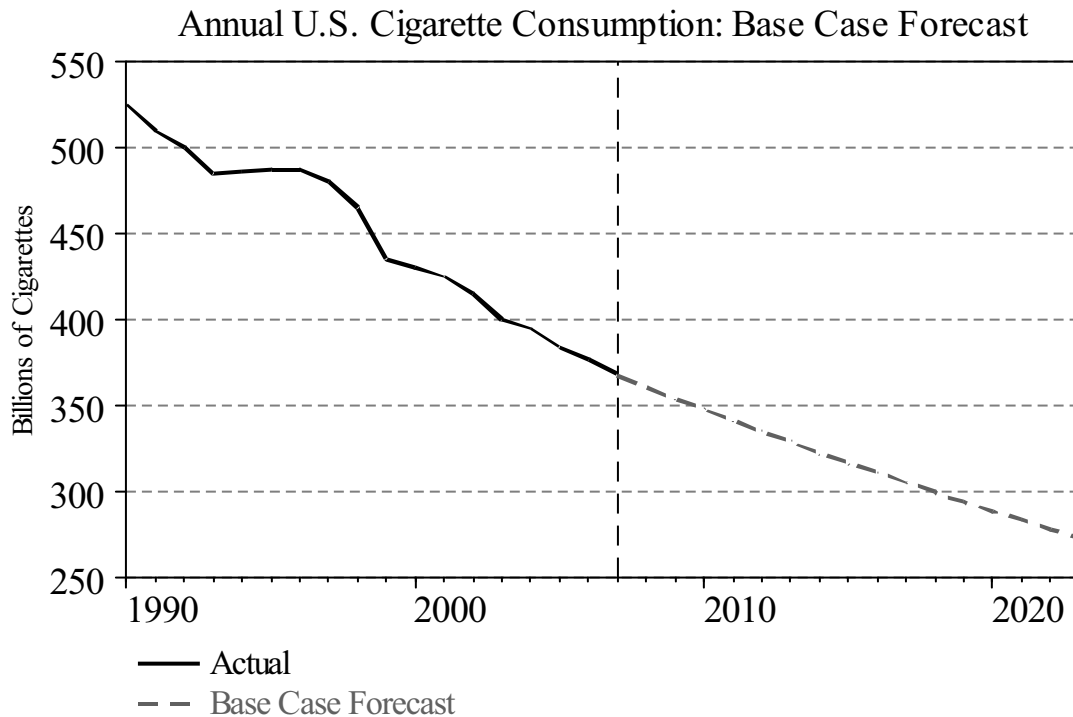
We believe the assumptions on which the Base Case Forecast are based to be reasonable.

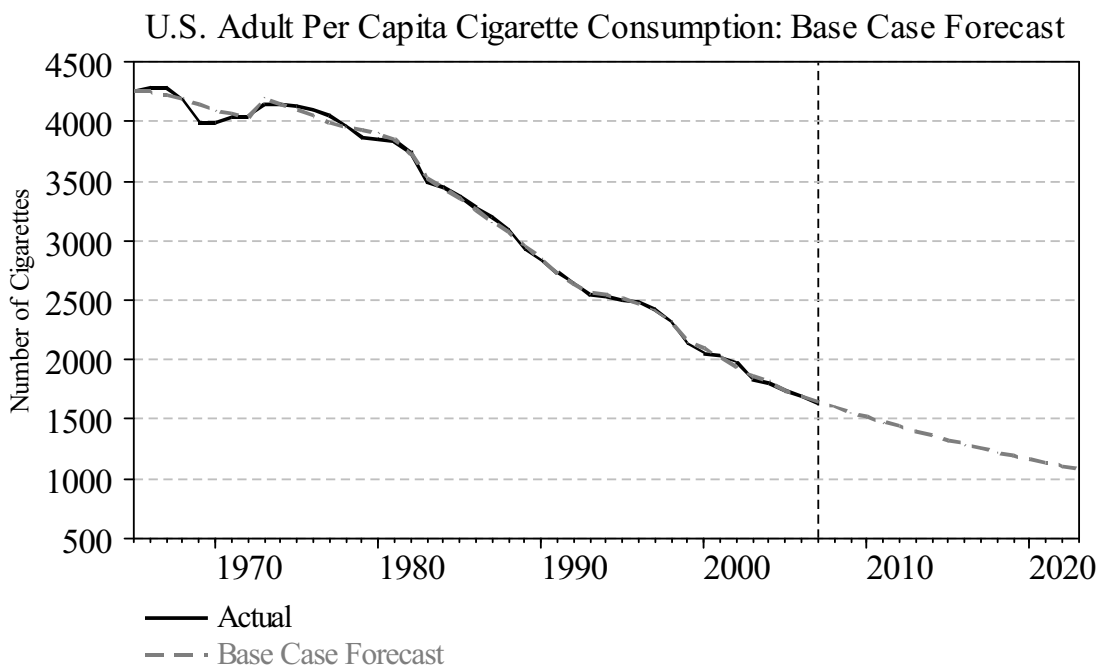
## Forecast of Cigarette Consumption

After developing the regression equation specified above, we used it to project CPC for the period 2004 through 2023. Then using the standard adult population projections of Global Insight's macroeconomic model, we converted per capita consumption to aggregate adult consumption. We then added our estimate of teenage smoking volume going forward.

In using regression equations developed on the basis of historical data to project future values of the dependent variable, we must also assume that the underlying economic structure captured in the equation will remain essentially the same. While past performance is no guarantee of future patterns, it is still the best tool we have to make such projections.

The graphs below display the projected time trend of U.S. cigarette consumption. The first graph illustrates total actual and projected cigarette consumption in the United States. The second graph illustrates actual and projected CPC in the United States. For the period 1965 through 2003 the forecast line on the second graph indicates the value of CPC our model would have projected for those years.





In addition to the expected trend decline in cigarette consumption, the sharp upward shock to cigarette prices in late 1998 and 1999 contributed to a 6.5% reduction in consumption in 1999. The rate of decline has moderated considerably since that time, averaging -2.1% from 1999 to 2007. The deep discount share of the market has been reported by the manufacturers as having stabilized at about 12% since 2003 and 2004. These cigarettes are produced by a large number of manufacturers, including many who participate in the MSA. After significant gains earlier in the decade, imports to the U.S. have declined from a high of 23.1 billion sticks in 2003 to 13.3 billion in 2007.

In 2005 industry shipments of 381 billion cigarettes were 3.4% lower than in 2004.<sup>42</sup> Part of this decline can be attributed to two extra shipping days in the leap year 2004. We also estimate that there was an inventory reduction of 3 billion units in 2005. This leads us to estimate that consumption in 2005 was somewhat higher than shipments, approximately 384 billion. For 2006, industry shipments, as reported by the manufacturers, were 372.5 billion, 2.4% less than the 381.7 billion reported for 2005. The US Tobacco and Tax Bureau (TTB) reported for 2006 that domestic shipments totaled 364.4 billion and that there were 16.2 billion imported cigarettes.<sup>43</sup> The total, 380.7 billion, was only 0.1% fewer than in 2005. The manufacturers note significant inventory increases at the wholesale level in the fourth quarter of 2006 in advance of price and tax increases, most significantly that in Texas of \$1.00 per pack. We estimate that this inventory accumulation equaled 4 billion cigarettes. Thus consumption in 2006 was 377 billion, a decline of 1.9%.

<sup>43</sup> Statistical Report – Tobacco, December 2006. <http://www.ttb.gov>. 26-Feb-2007.

As a result shipments in the first half of 2007 were temporarily depressed as wholesalers reduced the accumulated stock. In addition, the manufacturers report that in the fourth quarter of 2007 that wholesalers moved to reduce the inventory they carry by 2.5 billion sticks. The net result is that shipments by manufacturers in 2007 understate consumption by 6.5 billion cigarettes. TTB reports 2007 shipments of 361.6 billion. The addition of 6.5 billion consumed out of inventories results in a consumption estimate of 368.1 billion.

After 2007, the rate of decline of consumption is projected to moderate and average less than 2% per year. From 2008 through 2023 the average annual rate of decline is projected to be 1.85%. On a per capita basis consumption is projected to fall at an average rate of 2.67% per year. Total consumption of cigarettes in the U.S. is projected to fall from an estimated 368 billion in 2007, to 361 billion in 2008, and to under 300 billion by 2018.

### **Statistical Confidence and Forecast Error**

In addition to potential forecast errors due to incorrect forecast assumptions, there also exists possible error in the statistical estimation. The estimation and development of an econometric model is a statistical exercise. Thus, our parameters are estimated with some degree of error. We have provided confidence intervals for the coefficient (elasticity) estimates. For instance, there is a 2.5% probability ( $5\%/2$ ) that the price elasticity exceeds 0.38. There is similarly a 2.5% chance that the income elasticity is less than 0.03. But if these events were independent, the probability of both would be  $.025 \times .025 = .000625$ , or .0625%, less than one tenth of one percent.

### **Comparison With Prior Forecasts**

In November 2003 Global Insight presented a similar study, "A Forecast of U.S. Cigarette Consumption (2002-2023)." Its long run conclusions were similar to this study. The current forecast of consumption for the year 2023 is 3.9% less than that of the original study, 273.1 billion vs. 284.1 billion.

## Alternative Forecasts

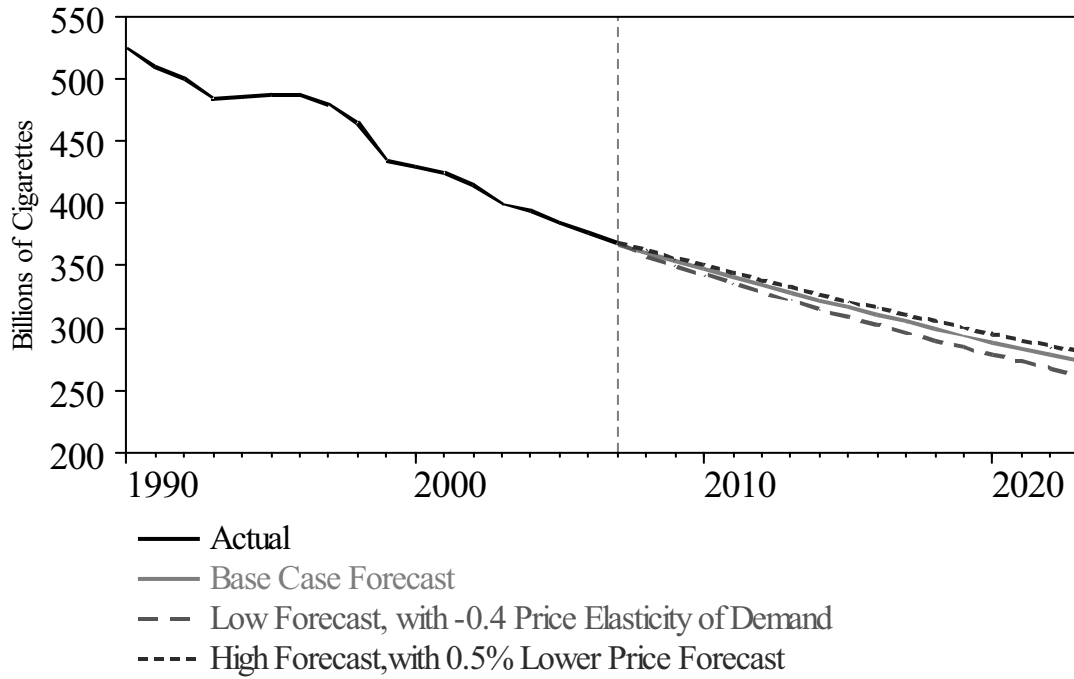
Two sources of variance may appear in the forecast derived by our model. First, as detailed in the Explanatory Variables section, there is some degree of forecast error in the parameters of the model. Second, the time paths of the explanatory variables may differ from our Base Case Forecast assumptions. Alternative forecasts are included in order to provide an interval forecast that, in our opinion, encompasses all of the likely potential realizations over time.

The high and low alternative forecasts are derived as follows. For the high scenario, we use a lower price forecast, under which prices are increasing at an annual rate of 0.5% more slowly than our current base case forecast. Under this scenario, the rate of decline is moderated slightly, from an average rate of 1.85% to 1.68%, resulting in consumption of 281 billion in 2023.

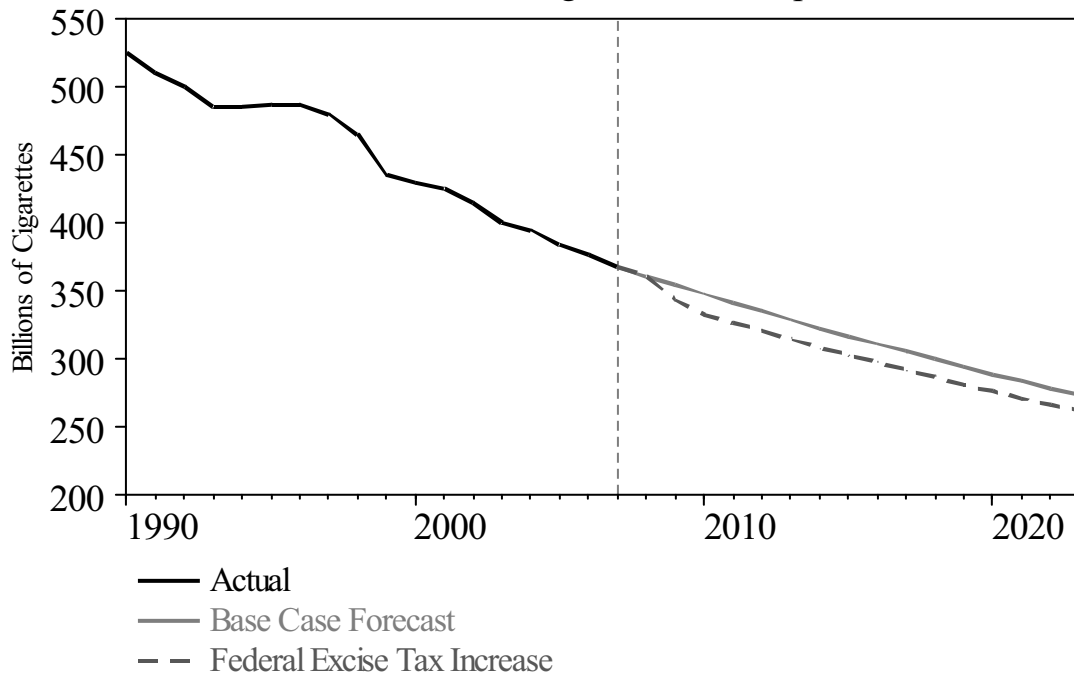
In the low forecast, Low Case 1, we posit a sharper price elasticity of demand. Our estimate of the price elasticity, -0.33, is on the low end of the range when compared to that of certain other economic researchers. Recent economic research has forged a consensus that the elasticity lies between -0.3 and -0.5. We have, therefore, used a higher elasticity of -0.4, to generate the lowest consumption forecast which might be reasonably anticipated by our model. This increases the average rate of decline to 2.10% and results in cigarette consumption of 262 billion in 2023.

Should the federal excise tax increase to \$1.00 per pack in 2009 the resulting price increase would, according to our model, lead to a sharper, one-time, consumption decline of 4.3%, or 15.5 billion cigarettes, by 2010. This is illustrated in FET Increase Case. The difference with our Base Case forecast would be somewhat lower over the longer term, because our base case forecast assumptions incorporate the likelihood of significant excise tax increases over time. By 2023 consumption would equal 261 billion, resulting in an average rate of decline of 2.12%.

Annual U.S. Cigarette Consumption



Annual U.S. Cigarette Consumption



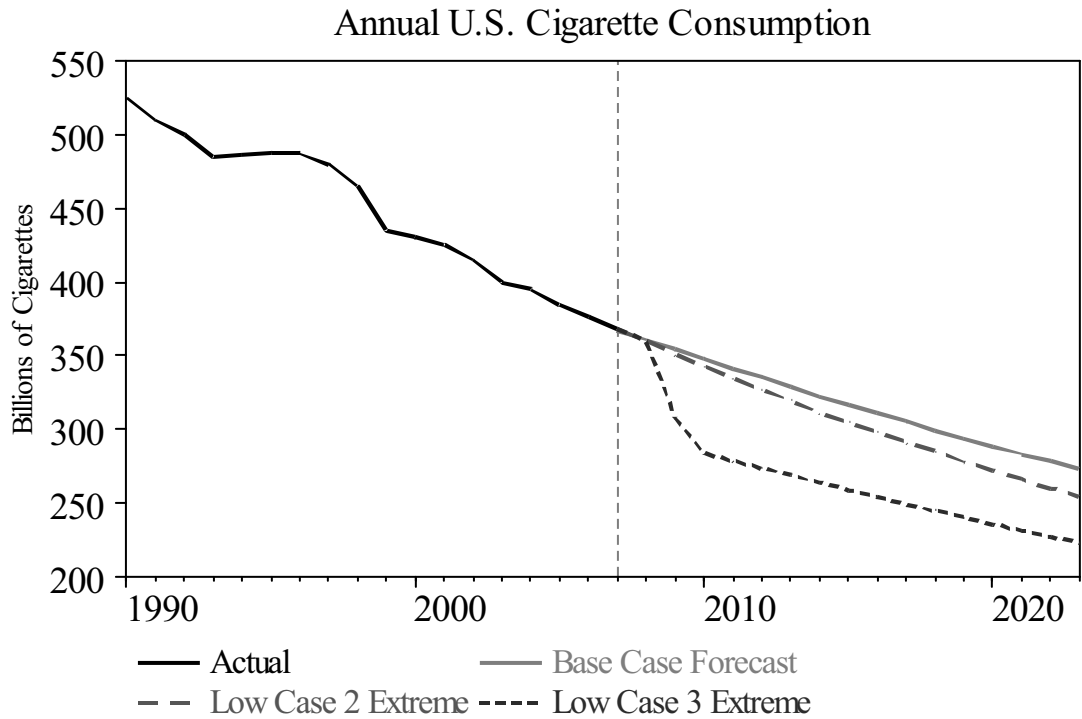
## Hypothetical Stress Scenarios

The model was also tested under more extreme, and concurrently, less likely conditions. These exercises do not represent informed anticipation of possible future conditions. Rather, they are meant only to test the model under extreme conditions. First, we increased the negative response of consumer demand to recent price increases by assuming a much larger, -0.5, elasticity. This sharpens the fall in total consumption to an average annual rate of 2.28%, and results in demand of 254 billion cigarettes in 2023 (Low Case 2). This scenario would also be the result if, instead of a greater price sensitivity of smokers, we postulated an increased rate of cigarette price increase. Indeed, if cigarette prices, instead of averaging increases in real terms of 2.39% per year, accelerated to a pace of 4.19% annually, demand would also fall to 254 billion in 2023.

A second large negative stress is placed by postulating, in 2009, either an adverse federal government settlement, or tort claims of three times the size of this MSA. This would result in a real price increase of 57%, and a large decline, 18% over two years, in consumption. By 2023, consumption will have fallen to 223 billion cigarettes, an average annual rate of decline of 3.09% (Low Case 3).

### Alternative Forecasts

	2023 Consumption Level (Bil.)	Average Annual Decline (%)
Base Case Forecast	273	1.85
FET Increase Case	261	2.12
Low Case 1	262	2.10
High Alternative	281	1.68
Low Case 2	254	2.28
Low Case 3	223	3.09



Finally, for comparative purposes we have calculated the volume of total cigarette consumption under four alternative annual rates of decline, 2.5%, 3%, 3.5% and 4%. Under these scenarios consumption in 2023 falls to 245 billion, 226 billion, 208 billion, and 192 billion respectively. These calculations are simple arithmetic examples, and are neither forecasts nor projections.



**Base Case Forecast: Assumptions for Explanatory Variables**

Year	Real Per Capita Personal Income	Real Price of Cigarettes	U.S. Adult Population	Incidence of Smoking in 12-17 Age Group	Youth Consumption	Average Nominal Price Per Pack
	<i>Growth Rate (%)</i>	<i>Growth Rate (%)</i>	<i>Growth Rate (%)</i>	<i>Fraction</i>	<i>Billions</i>	<i>\$ (Current)</i>
1965	4.84	4.13	1.95	0.04		
1966	4.06	0.92	1.28	0.04		
1967	3.27	0.72	1.39	0.05		
1968	3.50	1.89	1.56	0.05		
1969	2.06	0.00	1.69	0.06		
1970	3.02	2.24	2.00	0.05		
1971	3.28	0.12	2.27	0.06		
1972	3.66	2.08	2.85	0.06		
1973	5.73	-3.29	2.03	0.07		
1974	-1.62	-5.49	2.05	0.07		
1975	1.30	-1.87	2.12	0.05		
1976	2.92	-1.40	2.07	0.05		
1977	2.46	-1.60	1.91	0.07		
1978	3.58	-2.05	1.91	0.06		
1979	1.35	-4.73	2.00	0.05		
1980	0.06	-5.03	1.96	0.05		
1981	1.63	-2.11	1.73	0.06		
1982	1.20	4.80	1.64	0.05		
1983	2.35	15.84	1.46	0.04		
1984	6.63	2.10	1.48	0.05		
1985	2.45	2.31	1.16	0.05		
1986	2.21	4.84	1.38	0.06		
1987	0.83	3.36	1.23	0.05		
1988	3.32	4.83	1.26	0.05		
1989	1.82	7.64	1.35	0.05		
1990	0.72	4.71	0.89	0.06	7.96	
1991	-0.81	7.16	0.96	0.06	7.72	
1992	2.08	5.24	0.99	0.06	7.62	
1993	-0.24	0.91	1.02	0.06	7.12	
1994	1.48	-6.11	0.95	0.07	7.21	
1995	1.58	-0.21	0.85	0.07	7.76	
1996	1.77	0.18	0.89	0.08	7.54	
1997	2.30	2.31	1.27	0.08	6.58	
1998	4.63	11.03	1.15	0.08	6.30	2.20
1999	1.80	26.72	1.13	0.08	5.92	2.88
2000	3.71	7.47	1.14	0.08	5.92	3.20
2001	0.89	4.36	1.10	0.08	5.92	3.45
2002	2.06	5.76	1.02	0.08	5.91	3.71
2003	1.32	-0.64	0.96	0.08	5.87	3.77
2004	2.43	-0.75	0.96	0.08	5.84	3.84
2005	0.48	1.68	0.98	0.08	5.82	4.04
2006	2.24	1.87	0.99	0.08	5.80	4.18
2007	2.14	5.09	1.00	0.08	5.78	4.47
2008	1.73	2.71	1.00	0.08	5.77	4.68
2009	2.20	3.10	1.02	0.07	5.77	4.92
2010	2.17	2.61	1.00	0.07	5.62	5.17
2011	2.10	2.57	0.93	0.07	5.47	5.42
2012	2.02	2.52	0.88	0.07	5.32	5.71
2013	2.02	2.48	0.81	0.07	5.18	6.01
2014	2.02	2.84	0.80	0.07	5.18	6.35
2015	2.04	2.02	0.84	0.07	5.18	6.66
2016	2.04	2.37	0.82	0.07	5.18	7.00
2017	2.05	2.34	0.77	0.07	5.18	7.36
2018	2.05	2.31	0.76	0.07	5.18	7.74
2019	2.06	2.27	0.74	0.06	5.03	8.13
2020	2.08	1.89	0.76	0.06	4.88	8.52
2021	2.09	2.22	0.77	0.06	4.73	8.94
2022	2.10	1.85	0.77	0.06	4.59	9.36
2023	2.11	2.17	0.78	0.06	4.44	9.83

**Historical / Base Case Forecast U.S. Adult Per Capita and Total Consumption of Cigarettes (1965 – 2023)**

	<b>Per Capita Consumption</b>	<b>Growth Rate</b>	<b>Total Consumption</b>	<b>Total Consumption</b>	<b>Growth Rate</b>
		<i>(%)</i>	<i>(billions)</i>	<i>(billions of packs)</i>	<i>(%)</i>
1965	4259	1.53	528.70	26.44	3.42
1966	4287	0.66	541.20	27.06	2.36
1967	4280	-0.16	549.20	27.46	1.48
1968	4186	-2.20	545.70	27.29	-0.64
1969	3993	-4.61	528.90	26.45	-3.08
1970	3985	-0.20	536.40	26.82	1.42
1971	4037	1.30	555.10	27.76	3.49
1972	4043	0.15	566.80	28.34	2.11
1973	4148	2.60	589.70	29.49	4.04
1974	4141	-0.17	599.00	29.95	1.58
1975	4123	-0.43	607.20	30.36	1.37
1976	4092	-0.75	613.50	30.68	1.04
1977	4051	-1.00	617.00	30.85	0.57
1978	3967	-2.07	616.00	30.80	-0.16
1979	3861	-2.67	621.50	31.08	0.89
1980	3849	-0.31	631.50	31.58	1.61
1981	3836	-0.34	640.00	32.00	1.35
1982	3739	-2.53	634.00	31.70	-0.94
1983	3488	-6.71	600.00	30.00	-5.36
1984	3446	-1.20	600.40	30.02	0.07
1985	3370	-2.21	594.00	29.70	-1.07
1986	3274	-2.85	583.80	29.19	-1.72
1987	3197	-2.35	575.00	28.75	-1.51
1988	3096	-3.16	562.50	28.13	-2.17
1989	2926	-5.49	540.00	27.00	-4.00
1990	2826	-3.14	525.00	26.25	-2.78
1991	2727	-3.50	510.00	25.50	-2.86
1992	2647	-2.93	500.00	25.00	-1.96
1993	2542	-3.97	485.00	24.25	-3.00
1994	2524	-0.71	486.00	24.30	0.21
1995	2505	-0.75	487.00	24.35	0.21
1996	2482	-0.84	487.00	24.35	0.00
1997	2423	-2.50	480.00	24.00	-1.44
1998	2320	-4.25	465.00	23.25	-3.13
1999	2136	-7.93	435.00	21.75	-6.45
2000	2056	-3.75	430.00	21.50	-1.15
2001	2026	-1.46	425.00	21.25	-1.16
2002	1979	-2.32	415.00	20.75	-2.35
2003	1837	-7.18	400.00	20.00	-3.61
2004	1799	-2.03	394.70	19.74	-2.28
2005	1733	-3.63	384.10	19.21	-2.69
2006	1686	-2.77	376.70	18.84	-1.93
2007	1631	-3.25	368.10	18.41	-2.28
2008	1581	-3.05	360.59	18.03	-2.04
2009	1537	-2.82	353.96	17.70	-1.84
2010	1494	-2.76	347.62	17.38	-1.79
2011	1454	-2.72	341.27	17.06	-1.83
2012	1414	-2.70	334.93	16.75	-1.86
2013	1376	-2.69	328.54	16.43	-1.91
2014	1338	-2.76	322.14	16.11	-1.95
2015	1303	-2.62	316.45	15.82	-1.77
2016	1269	-2.61	310.82	15.54	-1.78
2017	1236	-2.63	305.06	15.25	-1.85
2018	1203	-2.62	299.41	14.97	-1.85
2019	1172	-2.61	293.71	14.69	-1.90
2020	1142	-2.53	288.43	14.42	-1.80
2021	1113	-2.56	283.17	14.16	-1.83
2022	1085	-2.51	278.11	13.91	-1.79
2023	1058	-2.54	273.09	13.65	-1.81

## Base Case Forecast and Low Case Projections

Year	Base Case Forecast			FET Increase Case: \$0.61 FET Increase			Low Case 1: -0.4 Price Elasticity of Demand			High Forecast: Lower Price Assumption		
	<i>Cigarettes (billions)</i>	<i>Packs (billions)</i>	<i>Growth Rate (%)</i>	<i>Cigarettes (billions)</i>	<i>Packs (billions)</i>	<i>Growth Rate (%)</i>	<i>Cigarettes (billions)</i>	<i>Packs (billions)</i>	<i>Growth Rate (%)</i>	<i>Cigarettes (billions)</i>	<i>Packs (billions)</i>	<i>Growth Rate (%)</i>
2006	376.70	18.84	-1.93	376.70	18.84	-1.93	376.70	18.84	-1.93	376.70	18.84	-1.93
2007	368.10	18.41	-2.28	368.10	18.41	-2.28	368.10	18.41	-2.28	368.10	18.41	-2.28
2008	360.59	18.03	-2.04	360.59	18.03	-2.04	357.81	17.89	-2.80	362.21	18.11	-1.60
2009	353.96	17.70	-1.84	343.45	17.17	-4.75%	350.22	17.51	-2.12	356.09	17.80	-1.69
2010	347.62	17.38	-1.79	332.12	16.61	-3.30%	343.12	17.16	-2.03	350.25	17.51	-1.64
2011	341.27	17.06	-1.83	326.32	16.32	-1.75%	336.05	16.80	-2.06	344.41	17.22	-1.67
2012	334.93	16.75	-1.86	320.26	16.01	-1.86	329.04	16.45	-2.09	338.53	16.93	-1.71
2013	328.54	16.43	-1.91	314.16	15.71	-1.91	322.01	16.10	-2.14	332.58	16.63	-1.76
2014	322.14	16.11	-1.95	308.03	15.40	-1.95	314.92	15.75	-2.20	326.63	16.33	-1.79
2015	316.45	15.82	-1.77	302.59	15.13	-1.77	308.80	15.44	-1.95	321.35	16.07	-1.62
2016	310.82	15.54	-1.78	297.21	14.86	-1.78	302.65	15.13	-1.99	316.12	15.81	-1.63
2017	305.06	15.25	-1.85	291.70	14.58	-1.85	296.41	14.82	-2.06	310.76	15.54	-1.69
2018	299.41	14.97	-1.85	286.30	14.31	-1.85	290.33	14.52	-2.05	305.50	15.28	-1.69
2019	293.71	14.69	-1.90	280.85	14.04	-1.90	284.19	14.21	-2.11	300.15	15.01	-1.75
2020	288.43	14.42	-1.80	275.80	13.79	-1.80	278.57	13.93	-1.98	295.21	14.76	-1.65
2021	283.17	14.16	-1.83	270.77	13.54	-1.83	272.93	13.65	-2.03	290.26	14.51	-1.68
2022	278.11	13.91	-1.79	265.93	13.30	-1.79	267.62	13.38	-1.95	285.54	14.28	-1.63
2023	273.09	13.65	-1.81	261.13	13.06	-1.81	262.28	13.11	-2.00	280.84	14.04	-1.65

### **Base Case Forecast and Low Case Extreme Projections**

<b>Year</b>	<b>Base Case Forecast</b>			<b>Low Case 2: -0.5 Price Elasticity of Demand</b>			<b>Low Case 3: Large MSA in 2007</b>		
	<i>Cigarettes (billions)</i>	<i>Packs (billions)</i>	<i>Growth Rate (%)</i>	<i>Cigarettes (billions)</i>	<i>Packs (billions)</i>	<i>Growth Rate (%)</i>	<i>Cigarettes (billions)</i>	<i>Packs (billions)</i>	<i>Growth Rate (%)</i>
<b>2006</b>	376.70	18.84	-1.93	376.70	18.84	-1.93	376.70	18.84	-1.93
<b>2007</b>	368.10	18.41	-2.28	368.10	18.41	-2.28	368.10	18.41	-2.28
<b>2008</b>	360.59	18.03	-2.04	359.75	17.99	-2.27	359.75	17.99	-2.27
<b>2009</b>	353.96	17.70	-1.84	351.01	17.55	-2.43	307.62	15.38	-14.49
<b>2010</b>	347.62	17.38	-1.79	342.97	17.15	-2.29	283.77	14.19	-7.75
<b>2011</b>	341.27	17.06	-1.83	335.02	16.75	-2.32	278.59	13.93	-1.83
<b>2012</b>	334.93	16.75	-1.86	327.19	16.36	-2.34	273.41	13.67	-1.86
<b>2013</b>	328.54	16.43	-1.91	319.41	15.97	-2.38	268.20	13.41	-1.91
<b>2014</b>	322.14	16.11	-1.95	311.46	15.57	-2.49	262.97	13.15	-1.95
<b>2015</b>	316.45	15.82	-1.77	304.78	15.24	-2.15	258.32	12.92	-1.77
<b>2016</b>	310.82	15.54	-1.78	297.98	14.90	-2.23	253.73	12.69	-1.78
<b>2017</b>	305.06	15.25	-1.85	291.15	14.56	-2.29	249.03	12.45	-1.85
<b>2018</b>	299.41	14.97	-1.85	284.50	14.23	-2.28	244.41	12.22	-1.85
<b>2019</b>	293.71	14.69	-1.90	277.84	13.89	-2.34	239.76	11.99	-1.90
<b>2020</b>	288.43	14.42	-1.80	271.85	13.59	-2.16	235.46	11.77	-1.80
<b>2021</b>	283.17	14.16	-1.83	265.74	13.29	-2.25	231.16	11.56	-1.83
<b>2022</b>	278.11	13.91	-1.79	260.06	13.00	-2.14	227.03	11.35	-1.79
<b>2023</b>	273.09	13.65	-1.81	254.30	12.72	-2.22	222.93	11.15	-1.81

### Alternative Constant Rate Decline Projections

Year	2.5% Decline Per Year			3.0% Decline Per Year		
	<i>Cigarettes (billions)</i>	<i>Packs (billions)</i>	<i>Growth Rate (%)</i>	<i>Cigarettes (billions)</i>	<i>Packs (billions)</i>	<i>Growth Rate (%)</i>
2007	368.10	18.41	-2.28	368.10	18.41	-2.28
2008	358.90	17.94	-2.50	357.06	17.85	-3.00
2009	349.93	17.50	-2.50	346.35	17.32	-3.00
2010	341.18	17.06	-2.50	335.95	16.80	-3.00
2011	332.65	16.63	-2.50	325.88	16.29	-3.00
2012	324.33	16.22	-2.50	316.10	15.80	-3.00
2013	316.22	15.81	-2.50	306.62	15.33	-3.00
2014	308.32	15.42	-2.50	297.42	14.87	-3.00
2015	300.61	15.03	-2.50	288.50	14.42	-3.00
2016	293.09	14.65	-2.50	279.84	13.99	-3.00
2017	285.77	14.29	-2.50	271.45	13.57	-3.00
2018	278.62	13.93	-2.50	263.30	13.17	-3.00
2019	271.66	13.58	-2.50	255.40	12.77	-3.00
2020	264.87	13.24	-2.50	247.74	12.39	-3.00
2021	258.24	12.91	-2.50	240.31	12.02	-3.00
2022	251.79	12.59	-2.50	233.10	11.65	-3.00
2023	245.49	12.27	-2.50	226.11	11.31	-3.00

**Alternative Constant Rate Decline Projections (Cont)**

Year	3.5% Decline Per Year			4.0% Decline Per Year		
	<i>Cigarettes (billions)</i>	<i>Packs (billions)</i>	<i>Growth Rate (%)</i>	<i>Cigarettes (billions)</i>	<i>Packs (billions)</i>	<i>Growth Rate (%)</i>
2007	368.10	18.41	-2.28	368.10	18.41	-2.28
2008	355.22	17.76	-3.50	353.38	17.67	-4.00
2009	342.78	17.14	-3.50	339.24	16.96	-4.00
2010	330.79	16.54	-3.50	325.67	16.28	-4.00
2011	319.21	15.96	-3.50	312.64	15.63	-4.00
2012	308.04	15.40	-3.50	300.14	15.01	-4.00
2013	297.26	14.86	-3.50	288.13	14.41	-4.00
2014	286.85	14.34	-3.50	276.61	13.83	-4.00
2015	276.81	13.84	-3.50	265.54	13.28	-4.00
2016	267.12	13.36	-3.50	254.92	12.75	-4.00
2017	257.77	12.89	-3.50	244.72	12.24	-4.00
2018	248.75	12.44	-3.50	234.94	11.75	-4.00
2019	240.05	12.00	-3.50	225.54	11.28	-4.00
2020	231.64	11.58	-3.50	216.52	10.83	-4.00
2021	223.54	11.18	-3.50	207.86	10.39	-4.00
2022	215.71	10.79	-3.50	199.54	9.98	-4.00
2023	208.16	10.41	-3.50	191.56	9.58	-4.00

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**APPENDIX F**

**CERTAIN INFORMATION RELATING TO THE TOBACCO INDUSTRY**

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## APPENDIX F

### CERTAIN INFORMATION RELATING TO THE TOBACCO INDUSTRY

*The following description of the domestic tobacco industry has been compiled from certain publicly available documents of the tobacco companies and their parent companies, certain publicly available analyses of the tobacco industry and other public sources. Certain of those companies file annual, quarterly and certain other reports with the Securities and Exchange Commission (the "SEC"). Such reports are available on the SEC's website (www.sec.gov) and upon request from the Office of Public Reference of the SEC, 450 5th Street, NW, Room 1300, Washington, D.C. 20549-0102 (phone: (202) 942-8090; fax: (202) 628-9001; e-mail: publicinfo@sec.gov). The following information does not, nor is it intended to, provide a comprehensive description of the domestic tobacco industry, the business, legal and regulatory environment of the participants therein, or the financial performance or capability of such participants. Although the Corporation has no independent knowledge of any facts indicating that the following information is inaccurate in any material respect, the Corporation has not independently verified this information and cannot and does not warrant the accuracy or completeness of this information. Prospective investors in the Series 2008 Bonds should conduct their own independent investigations of the domestic tobacco industry to determine if an investment in the Series 2008 Bonds is consistent with their investment objectives.*

***Retail market share information, based upon shipments or sales as reported by the OPMs for purposes of their filings with the SEC, may be different from Relative Market Share for purposes of the MSA and the respective obligations of the OPMs to contribute to Annual Payments and Strategic Contribution Fund Payments. The Relative Market Share information reported is confidential under the MSA. See "SUMMARY OF THE MASTER SETTLEMENT AGREEMENT – Overview of Payments by the Participating Manufacturers; MSA Escrow Agent." Additionally, aggregate market share information, based upon shipments as reported by Loews and Philip Morris and reflected in the chart below entitled "Manufacturers' Domestic Market Share Based on Shipments," is different from that utilized in the bond structuring assumptions. See "SUMMARY OF SERIES A AND SERIES B PLEDGED SETTLEMENT PAYMENT METHODOLOGY AND BOND STRUCTURING ASSUMPTIONS."***

MSA payments are computed based in part on cigarette shipments in or to the 50 states of the United States, the District of Columbia and Puerto Rico. The Global Insight Report states that the quantities of cigarettes shipped and cigarettes consumed within the United States, the District of Columbia, and Puerto Rico may not match at any given point in time as a result of various factors, such as inventory adjustments, but are substantially the same when compared over a period of time.

#### **Industry Overview**

According to publicly available documents of Loews Corporation, the parent company of Lorillard, Inc., the three leading manufacturers of tobacco products in the U.S. in 2007 collectively accounted for approximately 86.41% of the domestic cigarette retail industry when measured by shipment volume. The market for cigarettes in the U.S. divides generally into premium and discount sales, approximately 72.8% and 27.2%, respectively, measured by volume of all domestic cigarette sales for calendar year 2007, as reported by Loews Corporation.

Philip Morris USA Inc. ("**Philip Morris**"), a wholly-owned subsidiary of Altria Group, Inc. ("**Altria**"), is the largest tobacco company in the U.S. Prior to a name change on January 27, 2003, the Altria Group, Inc. was named Philip Morris Companies Inc. In its Form 10-K filed with the SEC for calendar year 2007, Altria reported that Philip Morris's domestic retail market share for calendar year 2007 was 50.6% (based on sales), which represents an increase of 0.3 share points from its reported domestic retail market share (based on sales) of 50.3% for calendar year 2006. Philip Morris's major premium brands are Marlboro, Virginia Slims and Parliament. Its principal discount brand is Basic. Marlboro is the largest selling cigarette brand in the U.S., with approximately 41.0% of the U.S. domestic retail share for calendar year 2007, up from 40.5% from the calendar year 2006, and has been the world's largest-selling cigarette brand since 1972. Philip Morris's market share information is based on data from the IRI/Capstone Total Retail Panel ("**IRI/Capstone**"), which was designed to measure market share in retail stores selling cigarettes, but was not designed to capture Internet or direct mail sales.

Reynolds American Inc. (“**Reynolds American**”), is the second largest tobacco company in the U.S. Reynolds American became the parent company of R.J. Reynolds Tobacco Company (“**Reynolds Tobacco**”) on July 30, 2004, following a transaction that combined Reynolds Tobacco and the U.S. operations of Brown & Williamson Tobacco Corp. (“**B&W**”), previously the third largest tobacco company in the U.S., under the Reynolds Tobacco name. In connection with this merger, Reynolds American assumed all pre-merger liabilities, costs and expenses of B&W, including those related to the MSA and related agreements and with respect to pre-merger litigation of B&W. Reynolds American is also the parent company of Lane Limited, a manufacturer and marketer of specialty tobacco products, and Santa Fe Natural Tobacco Company, Inc., both of which are SPMs.

In its Form 10-K filed with the SEC for calendar year 2007, Reynolds American reported that its domestic retail market share for calendar year 2007 was 29.0% (measured by sales volume), which represents a decrease of 0.80 share points from the 29.8% for calendar year 2006 combined domestic retail market share of Reynolds Tobacco and B&W. Reynolds American’s major premium brands are Camel, Kool, Winston and Salem. Its discount brands include Doral and Pall Mall. Reynolds American’s market share information is based on IRI/Capstone data.

Lorillard, Inc. (“**Lorillard**”), a wholly-owned subsidiary of Loews Corporation, is the third largest tobacco company in the U.S. On February 6, 2002, in an initial public offering, Loews Corporation issued shares of Carolina Group stock, which is intended to reflect the economic performance of Loews Corporation’s stock in Lorillard. Carolina Group is not a separate legal entity. In its Form 10-K filed with the SEC for calendar year 2007, Loews Corporation reported that Lorillard’s domestic retail market share for calendar year 2007 was 10.0% (measured by shipment volume), which represents an increase of 0.4 share points from its reported domestic retail market share of 9.6% (measured by shipment volume) for calendar year 2006. Lorillard’s principal brands are Newport, Kent, True, Maverick, and Old Gold. Its largest selling brand is Newport, which accounted for approximately 91.8% of Lorillard’s unit sales for the calendar year 2007. Market share data reported by Lorillard is based on data made available by Management Science Associates, Inc. (“**MSAI**”), an independent third-party database management organization that collects wholesale shipment data.

Based on the domestic retail market shares discussed above, the remaining share of the U.S. retail cigarette market for calendar year 2007 was held by a number of other domestic and foreign cigarette manufacturers, including Liggett Group, Inc. (“**Liggett**”), a wholly-owned subsidiary of Vector Group Ltd. (“**Vector**”). Liggett, the operating successor to the Liggett & Myers Tobacco Company, is the fourth largest tobacco company in the U.S. In its Form 10-K filed with the SEC for calendar year 2007, Vector reported that Liggett’s domestic retail market share in 2007 was 2.5% (measured by shipment volume), which represents an increase of 0.1 share points from its self-reported 2006 domestic retail market share of 2.4%. All of Liggett’s unit volume for the calendar year 2007 was in the discount segment. Its brands include Liggett Select, Grand Prix, Eve, Pyramid and USA. In November 2001, Vector Group launched OMNI, which Vector Group claims is the first reduced-carcinogen cigarette that tastes, smokes and burns like other premium cigarettes. Additionally, Vector Group announced that it has introduced three varieties of a low nicotine cigarette in eight states, one of which is reported to be virtually nicotine free, under the brand name QUEST. Vector has determined to postpone the national launch of QUEST indefinitely. Liggett and Vector Group Ltd. are SPMs under the MSA. In February 2008, Liggett announced that it will begin selling a smokeless tobacco product under its Grand Prix brand.

## **Shipment Trends**

The following table sets forth the approximate comparative positions of the leading producers in the U.S. domestic tobacco industry, each of which is an OPM under the MSA, based upon cigarette shipments. Individual domestic OPM shipments are as reported in the publicly available documents of the OPMs. Total industry shipments are based on data made available by MSAI, as reported in publicly available documents of Loews Corporation.

Effective in June of 2004, MSAI changed the way it reports market share information to include actual units shipped by Commonwealth Brands, Inc. (“**CBI**”), an SPM who markets deep discount brands, and implemented a new model for estimating unit sales of smaller, primarily deep discount marketers. MSAI has restated its reports to reflect these changes as of January 1, 2001. As a result of these changes, market shares for the three OPMs are lower than had been reflected under MSAI’s prior methodology and market shares for CBI and



other low volume companies are higher. All industry volume and market share information herein reflects MSAI's revised reporting data. Despite the effects of MSAI's new estimation model for deep discount manufacturers, Lorillard management has indicated that it continues to believe that volume and market share information for the deep discount manufacturers are understated and, correspondingly, market share information for the larger manufacturers are overstated by MSAI.

**Manufacturers' Domestic Market Share Based on Shipments\***

<b>Manufacturer</b>	<b>2004</b>	<b>2005</b>	<b>2006</b>	<b>2007</b>
Philip Morris	47.4%	48.6%	48.7%	49.0%
Reynolds American**	28.8	28.1	27.2	27.4
Lorillard	8.8	9.2	9.6	10.0
Other***	15.0	14.1	14.5	13.6

\* Aggregate market share as reported by Loews Corporation (or as derived from such reports) is different from that utilized in the bond structuring assumptions and may differ from the market share information reported by the OPMs for purposes of their filings with the SEC.

\*\* Prior to July 2004, represents the combined market share of Reynolds Tobacco and B&W.

\*\*\* The market share based on shipments of the tobacco manufacturers, other than the OPMs, has been determined by subtracting the total retail market share percentages of the OPMs as reported in the publicly available documents of Loews Corporation from 100%. Results may not total 100% due to rounding.

The following table sets forth the industry's cigarette shipments in the U.S. for the four years ended December 31, 2007. The MSA payments are calculated in part on shipments by the OPMs in or to the U.S. rather than consumption.

<b>Years Ended December 31</b>	<b>Shipments (Billions of Cigarettes)*</b>
2004	394.5
2005	381.7
2006	376.0
2007	357.2

\* As reported in SEC filings and other publicly available documents of the Loews Corporation, based on MSAI data.

The information in the foregoing tables, which has been obtained from publicly available documents but has not been independently verified, may differ materially from the amounts used by the MSA Auditor for calculating Annual Payments and Strategic Contribution Fund Payments under the MSA.

**Consumption Trends**

According to the October 24, 2007 estimates of the U.S. Department of Agriculture (the "USDA") Economic Research Service ("USDA-ERS"), smokers in the U.S. consumed 372 billion cigarettes in 2006, which represents a decrease of approximately 1.1% from the previous year. USDA-ERS attributes declining cigarette use to a combination of higher consumer costs due to tax and price increases, restrictions on where people can smoke and greater awareness of the health risks associated with smoking. Annual per capita consumption (per adult over 18) has dropped from 2,445 cigarettes in 1996 to 1,691 in 2006 (based on October 24, 2007 USDA-ERS). The following chart sets forth domestic cigarette consumption from 2001 through 2007, according to the USDA:

<b>Years Ended December 31</b>	<b>U.S. Domestic Consumption (Billions of Cigarettes)*</b>
2001	425
2002	415
2003	400
2004	388
2005	376
2006	372
2007	360**

\* USDA-ERS. The MSA Payments are calculated in part based on domestic industry shipments rather than consumption. The Global Insight Report states that the quantities of cigarettes shipped and cigarettes consumed within the 50 states of the U.S., the District of Columbia and Puerto Rico may not match at any given time as a result of various factors, such as inventory adjustments, but are substantially the same when compared over a period of time.

\*\* Estimated.

### **Distribution, Competition and Raw Materials**

Cigarette manufacturers sell tobacco products to wholesalers (including distributors), large retail organizations, including chain stores, and the armed services. They and their affiliates and licensees also market cigarettes and other tobacco products worldwide, directly or through export sales organizations and other entities with which they have contractual arrangements.

The market for tobacco products is highly competitive and is characterized by brand recognition and loyalty, with product quality, price, marketing and packaging constituting the significant methods of competition. Promotional activities include, in certain instances, allowances, the distribution of incentive items, price reductions and other discounts. Considerable marketing support, merchandising display and competitive pricing are generally necessary to maintain or improve a brand's market position. Increased selling prices and taxes on cigarettes have resulted in additional price sensitivity of cigarettes at the consumer level and in a proliferation of discounts and of brands in the discount segment of the market. Generally, sales of cigarettes in the discount segment are not as profitable as those in the premium segment.

The tobacco products of the cigarette manufacturers and their affiliates and licensees are advertised and promoted through various media, although television and radio advertising of cigarettes is prohibited in the U.S. The domestic tobacco manufacturers have agreed to additional marketing restrictions in the U.S. as part of the MSA and other settlement agreements. They are still permitted, however, to conduct advertising campaigns in magazines, at retail cigarette locations, in direct mail campaigns targeted at adult smokers, and in other adult media.

### **Grey Market**

A price differential exists between cigarettes manufactured for sale abroad and cigarettes manufactured for U.S. sale. Consequently, a domestic grey market has developed in cigarettes manufactured for sale abroad, but instead diverted for domestic sales that compete with cigarettes manufactured for domestic sale. The U.S. federal government and all states, except Massachusetts, have enacted legislation prohibiting the sale and distribution of grey market cigarettes. In addition, Reynolds American has reported that it has taken legal action against certain distributors and retailers who engage in such practices.

### **Regulatory Issues**

*Regulatory Restrictions and Legislative Initiatives.* The tobacco industry is subject to a wide range of laws and regulations regarding the marketing, sale, taxation and use of tobacco products imposed by local, state, federal and foreign governments. Various state governments have adopted or are considering, among other things, legislation and regulations that would increase their excise taxes on cigarettes, restrict displays and advertising of tobacco products, establish ignition propensity standards for cigarettes, raise the minimum age to possess or purchase tobacco products, ban the sale of "flavored" cigarette brands, require the disclosure of ingredients used in

the manufacture of tobacco products, impose restrictions on smoking in public and private areas, restrict the sale of tobacco products directly to consumers or other unlicensed recipients, including over the Internet, and charging state employees who smoke higher health insurance premiums than non-smoking state employees. Five states, Alabama, Georgia, Idaho, Kentucky and West Virginia, charge higher health insurance premiums to state employee smokers than non-smokers, and a number of states have implemented legislation that allows employers to provide incentives to employees who do not smoke. Several large corporations, including Meijer Inc., Gannett Co., American Financial Group Inc., PepsiCo Inc. and Northwest Airlines, are now charging smokers higher premiums. In addition, the U.S. Congress may consider legislation further increasing the federal excise tax, regulation of cigarette manufacturing and sale by the U.S. Food and Drug Administration (the “FDA”), amendments to the Federal Cigarette Labeling and Advertising Act to require additional warnings, reduction or elimination of the tax deductibility of advertising expenses, implementation of a national standard for “fire-safe” cigarettes, regulation of the retail sale of cigarettes over the Internet and in other non-face-to-face retail transactions, such as by mail order and telephone, and banning the delivery of cigarettes by the U.S. Postal Service. In March 2005, for example, bipartisan legislation was reintroduced in the U.S. Congress which would provide the FDA with authority to broadly regulate tobacco products. A bi-partisan group of lawmakers, Massachusetts Senator Edward M. Kennedy, Texas Senator John Cornyn, California Representative Henry Waxman and Virginia Representative Tom Davis, on February 15, 2007 introduced the Family Smoking Prevention and Tobacco Control Act, legislation aimed at placing tobacco products under the authority of the FDA. The bill would give the FDA broad regulatory authority over the sale, distribution, and advertising of tobacco products. Such legislation would, among other anticipated changes, permit the FDA to regulate tar and other ingredients in cigarettes, permit the FDA to strengthen warning labels, reduce nicotine levels in tobacco products, police false or misleading advertising and marketing aimed at children and would require manufacturers to provide the FDA with lists of ingredients and additives in their products, including nicotine. Philip Morris has indicated its strong support for this legislation. The Senate Health Committee approved the legislation on August 1, 2007 by a 13 to 8 vote, including an amendment requiring that all cigarette packages be half-covered by warning labels with colored graphic. A committee of the House of Representatives began holding hearings on October 3, 2007 on whether the FDA should be given the power to regulate tobacco products.

In 1964, the Report of the Advisory Committee to the Surgeon General of the U.S. Public Health Service concluded that cigarette smoking was a health hazard of sufficient importance to warrant appropriate remedial action. Since 1966, federal law has required a warning statement on cigarette packaging. Since 1971, television and radio advertising of cigarettes has been prohibited in the U.S. Cigarette advertising in other media in the U.S. is required to include information with respect to the “tar” and nicotine yield of cigarettes, as well as a warning statement.

During the past four decades, various laws affecting the cigarette industry have been enacted. In 1984, Congress enacted the Comprehensive Smoking Education Act. Among other things, the Smoking Education Act:

- establishes an interagency committee on smoking and health that is charged with carrying out a program to inform the public of any dangers to human health presented by cigarette smoking;
- requires a series of four health warnings to be printed on cigarette packages and advertising on a rotating basis;
- increases type size and area of the warning required in cigarette advertisements; and
- requires that cigarette manufacturers provide annually, on a confidential basis, a list of ingredients added to tobacco in the manufacture of cigarettes to the Secretary of Health and Human Services.

Since the initial report in 1964, the Secretary of Health, Education and Welfare (now the Secretary of Health and Human Services) and the Surgeon General have issued a number of other reports that find the nicotine in cigarettes addictive and that link cigarette smoking and exposure to cigarette smoke with certain health hazards, including various types of cancer, coronary heart disease and chronic obstructive lung disease. These reports have recommended various governmental measures to reduce the incidence of smoking. In 1992, the federal Alcohol, Drug Abuse and Mental Health Act was signed into law. This act requires states to adopt a minimum age of 18 for purchases of tobacco products and to establish a system to monitor, report and reduce the illegal sale of tobacco products to minors in order to continue receiving federal funding for mental health and drug abuse programs. Federal law prohibits smoking in scheduled passenger aircraft, and the U.S. Interstate Commerce Commission has

banned smoking on buses transporting passengers interstate. Certain common carriers have imposed additional restrictions on passenger smoking.

*State and Local Regulation; Private Restrictions.* Legislation imposing various restrictions on public smoking also has been enacted in all of the states and many local jurisdictions. A number of states have enacted legislation designating a portion of increased cigarette excise taxes to fund either anti-smoking programs, healthcare programs or cancer research. In addition, educational and research programs addressing healthcare issues related to smoking are being funded from industry payments made or to be made under the MSA.

Several states have enacted or have proposed legislation or regulations that would require cigarette manufacturers to disclose the ingredients used in the manufacture of cigarettes. In September 2003, the Massachusetts Department of Public Health (“**MDPH**”) announced its intention to hold public hearings on amendments to its tobacco regulations. The proposed regulations would delete any ingredients-reporting requirement. (The U.S. Court of Appeals for the Second Circuit previously affirmed a ruling that the Massachusetts ingredient-reporting law was unconstitutional.) MDPH has proposed to inaugurate extensive changes to its regulations requiring tobacco companies to report nicotine yield rating for cigarettes according to methods prescribed by MDPH. Because MDPH withdrew its notice for a public hearing in November 2003, it is impossible to predict the final form any new regulations will take or the effect they will have on the PMs.

On May 21, 1999, the OPMs filed lawsuits in the U.S. District Court for the District of Massachusetts to enjoin implementation of certain Massachusetts attorney general regulations concerning the advertisement and display of tobacco products. The regulations went beyond those required by the MSA, and banned outdoor advertising of tobacco products within 1,000 feet of any school or playground, as well as any indoor tobacco advertising placed lower than five feet in stores within the 1,000-foot zone. The district court ruled against the industry on January 25, 2000, and the U.S. Court of Appeals for the First Circuit affirmed. The U.S. Supreme Court granted the industry’s petition for writ of certiorari on January 8, 2001, and ruled in favor of RJR Tobacco and the rest of the industry on June 28, 2001. The U.S. Supreme Court found that the regulations were preempted by the Federal Cigarette Labeling and Advertising Act, which precludes states from imposing any requirement or prohibition based on smoking and health with respect to the advertising or promotion of cigarettes labeled in conformity with federal law.

In June 2000, the New York state legislature passed legislation charging New York’s Office of Fire Prevention and Control (“**OFPC**”) with developing standards for “fire-safe” or self-extinguishing cigarettes. On December 31, 2003, OFPC issued a final standard with accompanying regulations that requires all cigarettes offered for sale in New York State after June 28, 2004 to achieve specified test results when placed on 10 layers of filter paper in controlled laboratory conditions. Reynolds American’s operating companies that sell cigarettes in New York State have provided written certification to both the OFPC and the Office of the Attorney General for New York that each of their cigarette brand styles currently sold in New York has been tested and has met the performance standards set forth in the OFPC’s regulations. Design and manufacturing changes were made for cigarettes manufactured for sale in New York to comply with the standard. Similar laws have been enacted in Alaska, California, Connecticut, Delaware, Illinois, Iowa, Kentucky, Louisiana, Maine, Maryland, Massachusetts, Minnesota, Montana, New Hampshire, New Jersey, North Carolina, Oregon, Rhode Island, Texas, Utah and Vermont. A number of other states are also considering similar legislation. Varying standards from state to state could have an adverse effect on the PMs.

According to the Global Insight Report, all of the states and the District of Columbia now require smoke-free indoor air to some degree or in some public places. The most comprehensive bans have been enacted since 1998 in 28 states and a number of large cities. In 1998, California imposed a comprehensive smoking ban for all indoor workplaces, including restaurants and bars. Delaware followed suit in 2002, and in 2003, Connecticut, Maine, New York, and Florida passed similar comprehensive bans, as did the cities of Boston and Dallas. Since then, Arizona, Arkansas, Colorado, the District of Columbia, Hawaii, Illinois, Louisiana, Maryland, Massachusetts, Minnesota, Montana, Nebraska, Nevada, New Hampshire, New Jersey, New Mexico, Ohio, Oregon, Rhode Island, Tennessee, Utah, Vermont, Washington, and Puerto Rico established similar bans, as did the cities of Baltimore, Chicago, Houston, and Philadelphia. The New Mexico, Washington State and Chicago restrictions are stronger than those in other states as they include a ban on outdoor smoking within 25 feet of the entrances of restaurants and other public places. It is expected that these restrictions will continue to proliferate. For example, in 2008, at least

10 states, Alabama, Iowa, Michigan, Missouri, North Carolina, Pennsylvania, South Carolina, Tennessee, West Virginia and Wisconsin, are considering legislation which would enact comprehensive bans.

The American Nonsmokers' Rights Foundation documents clean indoor air ordinances by local governments throughout the U.S. As of January 2, 2008, there were 2,671 municipalities with local laws that restrict where smoking is allowed, including 1,109 municipalities that restrict smoking in one or more outdoor areas. Of these, 524 local governments required workplaces to be 100% smoke free, and 100% smoke free conditions were required for restaurants by 488 governments, and for bars by 366. The number of such ordinances grew rapidly beginning in the 1980s, from less than 200 in 1985 to over 1,000 by 1993, and 1,500 by 2001. The ordinances completely restricting smoking in restaurants and bars have generally appeared in the past decade. In 1993 only 13 municipalities prohibited all smoking in restaurants, and 6 in bars. These numbers grew to 49 for restaurants and 32 for bars in 1998, and doubled again by 2001, to 100 and 74, respectively.

The first extensive outdoor smoking restrictions were instituted in March 2006 in Calabasas, California. The City of Oakland and California municipalities of Belmont, Beverly Hills, Dublin, El Cajon, Emeryville and Santa Monica have also established extensive outdoor restrictions, as have Davis County and the City of Murray in Utah. Burbank, California, is expected to follow suit. In the most restrictive version to date, the California cities, Belmont, and Calabasas have approved ordinances which restrict smoking anywhere in the city except for single-family detached homes. Many landlords and condominium associations have also established smoke-free apartment policies. The Massachusetts Department of Public Health is conducting a survey of landlords, tenants, and condominium associations to assess the feasibility of making residences smoke-free.

In the past year, San Diego City and Los Angeles, Santa Cruz and San Mateo Counties have banned smoking at beaches and parks, joining over 30 other Southern California cities in prohibiting smoking on the beach. The beach restrictions may soon become statewide. Chicago approved beach and parkground smoking restrictions in October 2007. Sarasota County, Florida has banned smoking on its beaches, and Nassau County, New York and Volusia County, Florida are also considering park and beach bans. At least 50 colleges nationwide now prohibit smoking everywhere on campus. California, Illinois, Michigan and Nevada have banned smoking in state prisons. Arkansas, California, Louisiana, Puerto Rico, Texas and Rockland County, New York now prohibit smoking in a car where there are children present, and similar legislation has been proposed in Arizona, California, Connecticut, Illinois, Indiana, Iowa, Kansas, Massachusetts, Montana, New Jersey, New York, Oregon, Rhode Island, South Carolina, Utah, West Virginia, and in Bangor, Maine.

In June 2006, the Office of the Surgeon General released a report, "The Health Consequences of Involuntary Exposure to Tobacco Smoke." It is a comprehensive review of health effects of involuntary exposure to tobacco smoke. It concludes definitively that secondhand smoke causes disease and adverse respiratory effects. It also concludes that policies creating completely smoke-free environments are the most economical and efficient approaches to providing protection to non-smokers. On September 18, 2007, the Office of the Surgeon General released the report, "Children and Secondhand Smoke Exposure," which concludes that many children are exposed to secondhand smoke in the home and that establishing a completely smoke-free home is the only way to eliminate secondhand smoke exposure in that setting. These reports are expected to strengthen arguments in favor of further smoking restrictions across the country. Further, the California Environmental Protection Agency Air Resources Board declared environmental tobacco smoke to be a toxic air contaminant in 2006.

In August 2007, the President's Cancer Panel issued a report which included a series of recommendations to reduce Americans' cancer risk. These include FDA regulation of the tobacco industry, increased federal and state excise taxes on tobacco, increased funding of tobacco prevention and cessation programs, and the enactment in all states of smoke free laws which cover restaurants and bars.

*Smokeless Tobacco Products.* Smokeless tobacco products have been available for centuries. As cigarette consumption expanded in the last century, the use of smokeless products declined. Chewing tobacco and snuff are the most significant components. Snuff is a ground or powdered form of tobacco that is placed under the lip to dissolve. It delivers nicotine effectively to the body. Moist snuff is both smoke-free and can be spit-free. According to the Global Insight Report, chewing tobacco and dry snuff consumption has been declining in the U.S. in this decade, but moist snuff consumption has increased at an annual rate of more than 5% since 2002, and by 10.4% in 2006, when over 5 million consumers purchased 1.1 billion cans. Snuff is now being marketed to adult

cigarette smokers as an alternative to cigarettes. UST Inc., the largest producer of moist smokeless tobacco, is explicitly targeting adult smoker conversion in its growth strategy. The industry is responding to both the proliferation of indoor smoking bans and to a perception that smokeless use is a less harmful mode of tobacco and nicotine usage than cigarettes. In 2006, the three largest U.S. cigarette manufacturers entered the market. Philip Morris introduced a snuff product, Taboka, Reynolds American acquired Conwood Company, L.P., the nation's second largest smokeless-tobacco manufacturer, and introduced Camel Snus, a snuff product, and Lorillard entered into an agreement with Swedish Match North America to develop smokeless products in the United States. Product development has continued in 2007, with the introduction by Philip Morris of a Marlboro snus product. In October 2007, Altria announced that it would accelerate the development of snuff and less-harmful cigarettes to counter a decline in smoking. In 2008, Liggett announced it would introduce Grand Prix snus.

Advocates of the use of snuff as part of a tobacco harm reduction strategy point to Sweden, where 'snus,' a moist snuff manufactured by Swedish Match, use has increased sharply since 1970, and where cigarette smoking incidence among males has declined to levels well below that of other countries. A review of the literature on the Swedish experience concludes that snus, relative to cigarettes, delivers lower concentrations of some harmful chemicals, and does not appear to cause cancer or respiratory diseases. They conclude that snus use appears to have contributed to the unusually low rates of smoking among Swedish men. The Sweden experience is unique, even with respect to its Northern European neighbors. It is not clear whether it could be replicated elsewhere. Public health advocates in the U.S. emphasize that smokeless use results in both nicotine dependence and to increased risks of oral cancer among other health concerns. Snuff use is also often criticized as a gateway to cigarette use. In 2008 a new firm, Fuisz Tobacco, was formed to commercialize a film-based smokeless tobacco product. The thin film strip would be spitless and would dissolve entirely in the cheek.

*Voluntary Private Sector Regulation.* In recent years, many employers have initiated programs restricting or eliminating smoking in the workplace and providing incentives to employees who do not smoke, including charging higher health insurance premiums to employees who smoke, and many common carriers have imposed restrictions on passenger smoking more stringent than those required by governmental regulations. Similarly, many restaurants, hotels and other public facilities have imposed smoking restrictions or prohibitions more stringent than those required by governmental regulations, including outright bans.

*International Agreements.* On March 1, 2003, the member nations of the World Health Organization concluded four years of negotiations on an international treaty, the Framework Convention on Tobacco Control (the "FCTC"), aimed at imposing greater legal liability on tobacco manufacturers, banning advertisements of tobacco products (especially to youths), raising taxes and requiring safety labeling and comprehensive listing of ingredients on packaging, among other things. The FCTC entered into force on February 27, 2005 for the first forty countries, including the U.S., that had ratified the treaty prior to November 30, 2004. As of April 27, 2005, 168 countries signed and 64 countries ratified the FCTC. On June 29, 2004 the FCTC was closed for signature, but there is no deadline for ratification. It has been reported that as of December 20, 2006, at least 191 countries had ratified the FCTC.

*Excise Taxes.* Cigarettes are also currently subject to substantial excise taxes in the U.S. The federal excise tax has remained constant, at \$0.39 per pack, since 2002. The U.S. Congress has adopted legislation which would raise the federal excise tax. In August, the Senate and House of Representatives passed bills with \$0.61 and \$0.45 increases to the tax, respectively. The increase to the federal excise tax is designed to provide funding for the State Children's Health Insurance Program ("SCHIP"). On September 25, 2007, the House of Representatives passed a new bill with a \$0.61 increase by a vote of 265 to 159. On September 27, 2007, the Senate voted 67 to 29 to reauthorize and expand SCHIP funded in part by a \$0.61 increase in the federal excise tax on cigarettes. On October 3, 2007, the President vetoed the bill, and on October 18, 2007, the House of Representatives failed to override the Presidential veto. Subsequent override attempts in November and in January 2008 also failed. It is not possible at this time to predict with certainty the outcome of this legislation or any future legislative action or its effect upon the level of federal excise taxes on cigarettes.

All states, the District of Columbia, and the Commonwealth of Puerto Rico currently impose taxes at levels ranging from \$0.07 per pack in South Carolina to \$2.575 per pack in New Jersey. In addition, certain municipalities also impose an excise tax on cigarettes ranging up to \$1.50 per pack in New York City and \$2.68 per pack in Chicago, which includes the Cook County tax of \$2.00 per pack. According to the Global Insight Report, excise tax

increases were enacted in 20 states and in New York City in 2002, in 13 states in 2003, in 11 states in 2004, and in 8 states (Kentucky, Maine, Minnesota, New Hampshire, North Carolina, Ohio, Virginia, and Washington) in 2005. The increase in Minnesota was not a tax increase, but rather the imposition of a “Health Impact Fee,” which has the same effect on consumer prices. Global Insight’s Consumption Report considers any such fees as equivalent to excise taxes.

In 2006, Texas passed a budget that raised the state excise tax by \$1.00 in January 2007, and Hawaii, New Jersey, North Carolina, and Vermont enacted legislation which raised excise taxes. In the November 2006 elections, referenda passed in Arizona and South Dakota raising excise taxes. In 2007, Connecticut, Delaware, Iowa, Indiana, New Hampshire and Tennessee each increased excise taxes. These actions increased the average state excise tax to \$1.074 per pack in July 2007. In October, Wisconsin enacted a \$1.25 increase, and in November Maryland enacted a \$1.00 increase. These actions will push the average state excise tax to \$1.116 in 2008. It is expected that other states will also enact increases in 2008 and in future years. Georgia, Illinois, Kansas, Kentucky, Massachusetts, Mississippi, Pennsylvania, South Carolina and Utah are now considering excise tax increases. Though California voters rejected a ballot initiative on November 7, 2006 that would have raised the tax from \$0.87 to \$3.47 per pack, California lawmakers have introduced a bill which would raise the tax by \$2.00 per pack.

At least one state, Minnesota (a Previously-Settled State), currently imposes a 75-cent “health impact fee” on tobacco manufacturers for each pack of cigarettes sold. The purpose of this fee is to recover the state’s health costs related to or caused by tobacco use. The imposition of this fee was contested by Philip Morris and upheld by the Minnesota Supreme Court as not in violation of Minnesota’s settlement with the tobacco companies. On February 20, 2007, the U.S. Supreme Court declined to hear Philip Morris’ appeal of that decision. See “BONDHOLDERS’ RISKS—Other Potential Payment Decreases Under the Terms of the MSA—NPM Adjustment” herein. These tax increases and other legislative or regulatory measures could severely increase the cost of cigarettes, limit or prohibit the sale of cigarettes, make cigarettes less appealing to smokers or reduce the addictive qualities of cigarettes.

## **Civil Litigation**

The tobacco industry has been the target of litigation for many years. Both individual and class action lawsuits have been brought by or on behalf of smokers alleging that smoking has been injurious to their health, and by non-smokers alleging harm from environmental tobacco smoke, also known as “secondary smoke.” Plaintiffs in these actions seek compensatory and punitive damages aggregating billions of dollars. Philip Morris, for example, has reported that, as of February 15, 2008, there were nine cases on appeal in which verdicts were returned against Philip Morris, including (i) a \$74 billion (out of total a verdict of \$145 billion) punitive damages judgment against Philip Morris in the Engle class action, which has been overturned on appeal by the Florida Supreme Court; and (ii) a compensatory and punitive damages verdict totaling approximately \$10.1 billion in the *Price* case in Illinois. The Supreme Court of Illinois subsequently reversed the verdict in *Price* and instructed the trial court to dismiss the case in its entirety. In January 2006 the plaintiffs filed a motion asking the court to reconsider its decision. On May 5, 2006, the Supreme Court of Illinois denied this motion. In October 2006, plaintiffs filed a petition for certiorari with the U.S. Supreme Court. On November 27, 2006, the U.S. Supreme Court denied plaintiff’s petition for certiorari. In December 2006, the trial court entered an order of dismissal. In January 2007, the plaintiff filed a motion to vacate the dismissal, which motion is pending. It has been reported that on May 2, 2007 the state trial court judge in the *Price* case asked the Illinois Fifth District Appellate Court whether he has the authority to reopen the *Price* case, citing possible new evidence presented in a case pending before the U.S. Supreme Court. It has also been reported that on May 17, 2007, Philip Morris petitioned the Illinois Supreme Court for an order that would prevent the trial court judge from reopening the *Price* case. See “— Class Action Lawsuits” below. The MSA does not release PMs from liability in either individual or class action cases. Healthcare cost recovery cases have also been brought by governmental and non-governmental healthcare providers seeking, among other things, reimbursement for healthcare expenditures incurred in connection with the treatment of medical conditions allegedly caused by smoking. The PMs are also exposed to liability in these cases, because the MSA only settled healthcare cost recovery claims of the Settling States. Litigation has also been brought against certain PMs and their affiliates in foreign countries.

Pending claims related to tobacco products generally fall within four categories: (1) smoking and health cases alleging personal injury and purporting to be brought on behalf of a class of individual plaintiffs, including

cases brought pursuant to a 1997 settlement agreement involving claims by flight attendants alleging injury from exposure to ETS in aircraft cabins (the *Broin II* cases, discussed below); (2) smoking and health cases alleging personal injury brought on behalf of individual plaintiffs; (3) healthcare cost recovery cases brought by governmental (both domestic and foreign) and non-governmental plaintiffs seeking reimbursement for healthcare expenditures allegedly caused by cigarette smoking and/or disgorgement of profits; and (4) other tobacco-related litigation, including class action suits alleging that the use of the terms “Lights” and “Ultra Lights” constitute deceptive and unfair trade practices, suits by former asbestos manufacturers seeking contribution or reimbursement for amounts expended in connection with the defense and payment of asbestos claims that were allegedly caused in whole or in part by cigarette smoking, and various antitrust suits and suits by foreign governments seeking to recover damages for taxes lost as a result of the allegedly illegal importation of cigarettes into their jurisdictions. Plaintiffs seek various forms of relief, including compensatory and punitive damages, treble/multiple damages and other statutory damages and penalties, creation of medical monitoring and smoking cessation funds, disgorgement of profits, legal fees, and injunctive and equitable relief. Defenses raised in these cases include lack of proximate cause, statutes of limitation and preemption by the Federal Cigarette Labeling and Advertising Act. A recent California Supreme Court decision (*Grisham v. Philip Morris*) regarding a statute of limitations issue in an individual case has held that the plaintiff need not have filed suit when she realized she was addicted, thus permitting her lawsuit to go forward after a lower court had held her claim to be time-barred. This decision could lead to an increase in individual lawsuits in California.

According to Altria, since January 1999 and through February 15, 2008, verdicts have been returned in 45 smoking and health cases, Lights/Ultra Lights cases and healthcare cost recovery cases in which Philip Morris was a defendant. Verdicts in favor of Philip Morris and other tobacco industry defendants were returned in 28 of these cases. Verdicts in favor of plaintiffs were returned in 17 cases. Appeals or post-trial motions by defendants and by plaintiffs are pending in many of these cases. Of the 17 cases in which verdicts were returned in favor of plaintiffs, the *Carter* case (discussed below) was the first to reach final resolution in March 2001, when the plaintiff received payments from a trust in the full amount of the judgment and Brown & Williamson’s petition for review of the judgment against it was denied by the U.S. Supreme Court. In addition, eight of the 17 cases have reached final resolution with respect to Philip Morris. A \$17.8 million verdict against defendants in a healthcare cost recovery case in New York was reversed, and all claims were dismissed with prejudice in February 2005 in the *Blue Cross/Blue Shield* case. In October 2004, after exhausting all appeals, Philip Morris paid \$3.3 million in an individual smoking and health case in Florida (the *Eastman* case, discussed below). In March 2005, after exhausting all appeals, Philip Morris paid \$17 million in an individual smoking and health case in California (the *Henley* case, discussed below). Altria has reported that in December 2005, after exhausting all appeals, Philip Morris paid \$328,759 as its share of the judgment amount and interest in a flight attendant ETS case in Florida (the *French* case, discussed below) and will pay attorneys’ fees yet to be determined. In addition, in February 2005, after exhausting all appeals, Reynolds Tobacco, due to its obligation to indemnify B&W, paid approximately \$9.1 million in the *Boerner* case (see below) and on June 17, 2005, after exhausting all appeals, Reynolds Tobacco paid a \$196,416 plus interest and costs judgment in an individual case in Kansas (the *Burton* case, discussed below). In March 2006, after exhausting all appeals, Philip Morris paid approximately \$82.5 million (including interest of approximately \$27 million) in an individual smoking and health case in California (the *Boeken* case, described below). In October 2006, after exhausting all appeals, Philip Morris paid approximately \$1.1 million in judgment, interest and attorneys’ fees in an individual smoking and health case in Florida (the *Arnitz* case described below) and in January 2007, after exhausting all appeals, Philip Morris paid approximately \$1.1 million in judgment and interest in an individual smoking and health case in Missouri (the *Thompson* case described below).

*Class Action Lawsuits.* The MSA does not release the PMs from liability in class action lawsuits. Plaintiffs have brought claims as class actions on behalf of large numbers of individuals for damages allegedly caused by smoking, price fixing and consumer fraud. One OPM (Altria) has reported that, as of February 15, 2008, there were 31 such class actions pending against it in the U.S., as well as two in Brazil, three in Israel, five in Nigeria, one in Canada and one in Spain. Plaintiffs in class action smoking and health lawsuits allege essentially the same theories of liability against the tobacco industry as those in the individual lawsuits. Other class action plaintiffs allege consumer fraud or violations of consumer protection or unfair trade statutes. Plaintiffs historically have had limited success in obtaining class certification, a prerequisite to proceeding as a class action lawsuit, because of the individual circumstances related to each smoker’s election to smoke and the individual nature of the alleged harm. One OPM (Altria) reports that class certification has been denied or reversed in 57 smoking and health class actions involving that OPM.



To date, plaintiffs have successfully maintained class certification in federal and state court class action cases in at least the following states: California, Florida, Illinois, Louisiana, Massachusetts, Minnesota, Missouri, New York, North Carolina, Ohio, Oregon, Washington, and West Virginia. One OPM (Reynolds) reports that 18 federal courts that have considered the issue, including two courts of appeals, have rejected class certification in smoking and health cases. Only two federal district courts have certified a smoker class action. See (*In re Simon (II) Litigation*, and *Schwab v. Philip Morris USA Inc.*, each discussed below). The class in the *Simon* case was subsequently dismissed by the plaintiffs after being decertified by the U.S. Court of Appeals for the Second Circuit.

On September 6, 2000, in *In re Simon (II) Litigation*, lawyers for plaintiffs in ten tobacco-related cases pending in U.S. District Court for the Eastern District of New York filed suit in the same court (before Judge Weinstein) to consolidate the pending cases and seek certification of a class and subclasses to obtain compensatory and punitive damages from the tobacco industry defendants. The pending cases included individual and purported nationwide class action lawsuits alleging tobacco-related personal injuries, as well as healthcare cost recovery cases brought by union trust funds, an insurance plan and an asbestos fund. The suit sought to certify a nationwide class action to consolidate all punitive damage aspects of the pending cases for a single trial and to try the compensatory damage aspects of the pending claims separately. On September 19, 2002, Judge Weinstein certified a class to hear the punitive damages claims. The class consisted of all smokers diagnosed with a variety of illnesses, including lung cancer, emphysema and some forms of heart disease, after April 9, 1993. In May 2005, the U.S. Court of Appeals for the Second Circuit, in a unanimous opinion, decertified the class. Plaintiffs' motion for rehearing en banc was denied on August 8, 2005, and the time for plaintiffs to petition the U.S. Supreme Court for further review has expired. On February 6, 2006, Judge Weinstein dismissed the case upon the plaintiffs' motion. He stayed the order for 30 days to allow potential plaintiffs who expressed interest in the case to receive notices and to protect their interest. On March 22, 2006, a final judgment was entered dismissing the case. Two of the 10 original cases, *Falise v. American Tobacco Co.*, and *H.K. Porter Company, Inc. v. The American Tobacco Company* were dismissed in June 2001 and July 2001, respectively. Other plaintiffs who would have been part of the *Simon II* class remain free to pursue their own individual lawsuits.

On December 14, 2006, in *Donovan v. Philip Morris*, a federal class action complaint was filed by a group of Massachusetts residents who are fifty years of age or older, have smoked a pack of cigarettes a day for at least twenty years, continue to smoke or have quit smoking within one year of filing, have not been diagnosed with lung cancer, and have smoked Marlboro cigarettes within Massachusetts. The class seeks to compel Philip Morris to fund each member's CT scans to support the early detection of lung cancer. The case is pending in the U.S. District Court for the District of Massachusetts.

A number of state courts have rejected class certification. In May 2000, Maryland's highest court ordered the trial court to vacate its certification of a class in *Richardson v. Philip Morris*. The parties agreed to dismiss the case in March 2001. In September 2000, in *Walls v. American Tobacco Co.*, an Oklahoma state court answered a series of state law questions, certified to the state court by the federal court where the purported class was filed, in such a way that led the parties to stipulate that the case should not be certified as a class action in federal court and that the individual plaintiffs would dismiss their federal court cases without prejudice. In October 2000, the federal court issued its order refusing to certify the case as a class action, and dismissed the individual plaintiffs' cases.

In December 2000, in *Geiger v. American Tobacco Co.*, the Appellate Division of the Supreme Court of New York affirmed the trial court's denial of class action status to a purported class defined as all New York residents, including their heirs, representatives, and estates, who contracted lung or throat cancer as a result of smoking cigarettes. Plaintiffs filed a motion for leave to appeal the order denying certification to the New York Court of Appeals, the highest court in the state. The New York Court of Appeals dismissed the plaintiff's appeal in February 2001.

In *Engle v. R.J. Reynolds Tobacco Co.*, a Florida state court certified a class of Florida smokers alleging injury due to their tobacco use. The estimated size of the class ranges from 300,000 to 700,000 members. The court determined that the lawsuit could be tried as a class action because, even though certain factual issues are unique to individual plaintiffs and must be tried separately, certain other factual issues were common to all class members and could be tried in one proceeding for the whole class. In July 1999, in the first phase of a three-phase trial, the jury found against the defendants regarding the issues common to the class, such as whether smoking caused certain diseases, whether tobacco was addictive, and whether the tobacco companies withheld information from the public.

In July 2000, in the second phase of the *Engle* trial, the jury returned a verdict assessing punitive damages totaling approximately \$145 billion against the tobacco industry defendants. Following entry of judgment, the defendants appealed. The defendants posted bonds to stay collection of the final judgment with respect to the punitive damages against them and statutory interest thereon pending the exhaustion of all appeals. In May 2003, the Florida Third District Court of Appeal reversed the judgment entered by the trial court and instructed the trial court to order the decertification of the class. The plaintiffs petitioned the Florida Supreme Court for further review and, in May 2004, the Florida Supreme Court agreed to review the case.

On July 6, 2006, the Florida Supreme Court remanded the *Engle* case to the District Court with directions to decertify the class, and it approved the District Court's reversal of the \$145 billion class action punitive damages award. The court also reinstated the compensatory damages awards to two purported class members of \$2.8 million and \$4 million, and approved the District Court's findings (the "**Findings**") as to the adverse health effects of smoking, that nicotine is addictive, that the defendants placed defective and unreasonably dangerous products in the market, that defendants concealed or omitted information about the health effects and addictive nature of cigarettes, and otherwise that defendants were negligent. The Florida Supreme Court stated that certain individual members of the purported class could bring actions within one year of the court's decision, in which the courts would be bound by the conclusions reached in the Findings, and in which the plaintiffs would be expected to address causation, reliance, and apportionment of fault among the defendants. One result of the court's decision may be an increase in the number of individual plaintiffs' suits in Florida from members of the decertified *Engle* class. One such individual suit was filed in Florida state court on July 10, 2006 against Philip Morris and Reynolds Tobacco (*Pummer v. Philip Morris*). On November 16, 2006, that case was removed to the U.S. District Court for the Southern District of Florida. On December 15, 2006, the court dismissed the case without prejudice, pursuant to stipulation, due to the wrongful joinder of defendant Publix Supermarkets, Inc., a Florida corporation not named in the *Engle* case, and thus not privity to the allowance of one year for plaintiffs to sue (it had been nearly ten years since the initial cause of action, which exceeds Florida's statute of limitations).

On August 7, 2006, the *Engle* defendants filed a motion for rehearing with the Florida Supreme Court, asking the court to reverse its decision to uphold the Findings. On December 21, 2006, the Florida Supreme Court declined to reconsider and clarify its ruling, with the exception of invalidating the conspiracy to misrepresent charge against the tobacco companies. The court withdrew the July 6th opinion, issuing the December 21st opinion in lieu thereof. In January 2007, the Florida Supreme Court issued the mandate from its revised opinion (which begins the one-year period for individual class members to file lawsuits) and defendants filed a motion with the Florida Third District Court of Appeals requesting the court's review of legal errors previously raised but not ruled on. On February 21, 2007, the court denied the defendants' motion. In March 2007, the U.S. Supreme Court granted defendants' motion for an extension of time in which to file a petition for a writ of certiorari, and the *Engle* defendants filed their petition on May 21, 2007. On October 1, 2007, the U.S. Supreme Court denied the petition for a writ of certiorari and in November 2007, the U.S. Supreme Court denied defendants' petition for rehearing from the denial of the petition for writ of certiorari. Reynolds American has stated that it is likely that individual case filings in Florida will increase as a result of the *Engle* case. As of the January 11, 2008 deadline for bringing an action, approximately 1,540 individual smoking and health cases have been brought by or on behalf of the 8,016 plaintiffs in Florida. In addition, on February 14, 2008, the trial court decertified the class and formally vacated the punitive damages award pursuant to the Florida Supreme Court's mandate.

Florida has enacted legislation capping the amount of the appeal bond necessary to stay execution of the punitive judgment pending appeal to the lesser of: (1) the amount of punitive damages, plus twice the statutory rate of interest; or (2) 10% of a defendant's net worth, but in no case more than \$100 million. Forty-one other states have passed and several additional states are considering statutes limiting the amount of bonds required to file an appeal of an adverse judgment in state court. The limitation on the amount of such bonds generally ranges from \$1 million to \$150 million. Such bonding statutes allow defendants that are subject to large adverse judgments, such as cigarette manufacturers, to reasonably bond such judgments and pursue the appellate process. In six jurisdictions — Connecticut, Maine, Massachusetts, New Hampshire, Vermont and Puerto Rico — the filing of a notice of appeal automatically stays the judgment of the trial court.

One *Engle* purported class member has previously received a judgment at trial. In *Lukacs v. Reynolds Tobacco*, a Florida appellate court granted the plaintiff the right to proceed before he died, but stated that any award in favor of the plaintiff would not be enforced until after the *Engle* appeal is decided. On June 11, 2002, a Florida

jury awarded \$37.5 million in compensatory damages to the plaintiff. On April 1, 2003, the Miami-Dade County Circuit Court granted in part the defendants' motion for remittitur, reducing the total award to \$25.125 million. Because the *Engle* appeal is now resolved, subject to motions for rehearing, the defendants' time to appeal the case is expected to begin to run. On August 2, 2006, plaintiff filed a motion for partial judgment on the compensatory damages award, and trial was scheduled to begin on November 27, 2006. However, on September 27, 2006, the trial court granted the defendants' motion to strike as premature the plaintiff's motions and removed the case from the trial calendar. On January 2, 2007, the defendants moved to set aside the June 11, 2002 verdict and to dismiss the plaintiff's punitive damage claim. On January 3, 2007, the plaintiffs filed a motion for entry of judgment. A hearing on the motion was held in March 2007 and on August 1, 2007, the trial court deferred ruling on plaintiffs' motion for entry of judgment until after the U.S. Supreme Court's review of *Engle* is completed and until after further submissions by the parties. One OPM (Vector) reports that it is a defendant in 11 separate cases pending in Florida courts in which the plaintiffs claim that they are members of the *Engle* class, that all liability issues associated with their claims were resolved in the earlier phases of the *Engle* proceedings, and that trials on their claims should proceed immediately. Vector also reported that settlement of the appellate activity in *Engle* would be a prerequisite for those cases proceeding.

On June 6, 2007, a plaintiff representing the estates of her deceased mother and grandmother filed suit against several PMs in Miami-Dade County Circuit Court, Florida, in which she alleges that her mother and grandmother died of health problems related to smoking PMs' tobacco products. In that case, *Gloria Tucker v. Philip Morris U.S.A. et al*, the plaintiff alleges that the PMs engaged in cynical and exploitative marketing that targeted African-American communities and asserts theories of strict liability, negligent design, fraud by concealment and civil conspiracy. The plaintiff in *Tucker* also reportedly is requesting more than \$1 billion in compensatory and punitive damages. This action was removed to federal court and is currently pending in the District Court for the Southern District of Florida.

In October 1997, the tobacco industry defendants settled another class action case, *Broin I*. *Broin I* was brought in Florida state court by flight attendants alleging injuries related to ETS. See "*Individual Plaintiffs' Lawsuits*" below. The *Broin I* settlement established a protocol for the resolution of individual claims by class members against the tobacco companies. In addition to shifting the burden of proof to defendants as to whether ETS causes certain illnesses such as lung cancer and emphysema, the *Broin I* settlement required defendants to pay \$300 million to be used to establish a foundation to sponsor research with respect to the early detection and cure of tobacco-related diseases. Individual members of the *Broin I* class retained the right to bring individual claims, although they are limited to non-fraud type claims and may not seek punitive damages. Altria has reported that as of February 15, 2008, approximately 2,622 of these individual cases (known as *Broin II* cases) are pending against it in Florida. In October 2000, Judge Robert P. Kaye, the presiding judge of the original *Broin I* class action, held that the flight attendants will not be required to prove the substantive liability elements of their claims for negligence, strict liability and breach of implied warranty in order to recover damages, if any. The court also ruled that the trials of these suits will address whether the plaintiffs' alleged injuries were caused by their exposure to ETS and, if so, the amount of damages. The defendants' appeal of these rulings was dismissed by the intermediate appellate court on the basis that the appeal was premature and that the court lacked jurisdiction. On January 23, 2002, the defendants asked the Florida Supreme Court to review the district court's order. That request was denied.

Seven *Broin II* cases have gone to trial since Judge Kaye's ruling in October 2000. Six of these cases have resulted in verdicts for the defendants: *Fontana* in June 2001, *Tucker* in June 2002, *Janoff* in October 2002, *Seal* in February 2003, *Routh* in October 2003 and *Swaty* in May 2005. Appeals are pending in some of these cases. On September 12, 2002, the plaintiff in the *Janoff* case filed a motion for a new trial, which the judge granted on January 8, 2003. The defendants appealed to the Florida Third District Court of Appeal, which, on October 27, 2004, affirmed the trial court's order granting a new trial. The defendants' motion for rehearing was denied. The defendants filed a notice of intent to invoke the discretionary jurisdiction of the Florida Supreme Court on June 17, 2005. On November 1, 2005, the Florida Supreme Court refused to hear the case. In *Swaty*, the plaintiff filed a motion for a new trial on May 12, 2005, which was denied on June 23, 2005. On May 17, 2005, the court entered a final judgment in favor of the defendants. The plaintiff's motion for a new trial was denied on June 23, 2005. The plaintiff's appeal to the Third District Court of Appeal was denied and the Court of Appeal affirmed the trial court's verdict in November 2006. The one plaintiff's verdict was returned in *French v. Philip Morris*. On June 18, 2002, the *French* jury awarded the plaintiff \$5.5 million in damages, finding that the flight attendant's sinus disease was caused by ETS. On September 13, 2002, the judge reduced the award to \$500,000. The defendants appealed the trial

court's final judgment to the Florida Third District Court of Appeal on various grounds, the primary one being that under Judge Kaye's October 2000 ruling, the burden of proof was erroneously shifted and the plaintiff was not required to show that the tobacco companies' cigarettes were defective, that the tobacco company defendants acted negligently or that a warranty was made and breached. In December 2004, the Florida Third District Court of Appeal affirmed the judgment awarding plaintiff \$500,000 and directed the trial court to hold the defendants jointly and severally liable. In April 2005, the appellate court denied defendants' motion for a rehearing. On May 11, 2005, the defendants filed a notice of intent to invoke the discretionary jurisdiction of the Florida Supreme Court. On November 28, 2005, the Florida Supreme Court declined to hear the appeal. The defendants satisfied the judgment on December 6, 2005.

In *Scott v. American Tobacco Company, Inc.*, a Louisiana medical monitoring and smoking cessation case, the court certified a class consisting of smokers desiring to participate in a program designed to assist them in the cessation of smoking and monitor the medical condition of class members to ascertain whether they might be suffering from diseases caused by cigarette smoking. The class members may also choose to bring individual smoking and health lawsuits. On July 28, 2003, following the first phase of a trial, the jury returned a verdict in favor of the tobacco industry defendants on the medical monitoring claim and found that cigarettes were not defective products. The jury found against the defendants, however, on claims relating to fraud, conspiracy, marketing to minors and smoking cessation. On March 31, 2004, phase two of the trial began to address the scope and cost of smoking cessation programs. On May 21, 2004, the jury returned a verdict in the amount of \$591 million (\$590 million plus prejudgment interest accruing from the date the suit commenced) on the class's claim for a smoking cessation program. On July 1, 2004, the judge upheld the jury's verdict and awarded the plaintiffs prejudgment interest, which, as of February 15, 2007, totals approximately \$444 million, as reported by Altria. On August 31, 2004, the defendants' motion for judgment notwithstanding the verdict or, in the alternative, for a new trial was denied. On September 29, 2004, pursuant to a stipulation of the parties, the defendants posted a \$50 million bond (pursuant to legislation that limits the amount of the bond to \$50 million collectively for MSA signatories) and noticed their appeal. Oral argument occurred on April 27, 2006. The defendants filed post-argument briefs on April 28, 2006. Under the terms of the stipulation, the plaintiffs reserved the right to contest the constitutionality of the bond cap law. On February 7, 2007, the state appeals court upheld part of the jury's verdict but reduced the \$591 million by approximately \$312 million, eliminated the award of prejudgment interest, and remanded the case back to the trial court. On March 6, 2007, the state appeals court refused to reconsider its verdict. Plaintiffs' and defendants' petitions for writ of certiorari with the Louisiana Supreme Court were denied in January 2008. The deadline for the defendants to file a writ of certiorari with the U.S. Supreme Court is April 7, 2008.

In August 2000, a West Virginia state court conditionally certified, only to the extent of medical monitoring, in *In re Tobacco Litigation* (formerly known as *Blankenship*), a class of West Virginia residents. The plaintiffs proposed that the class include all West Virginia residents who: (1) on or after January 1, 1995, smoked cigarettes supplied by defendants; (2) smoked at least a pack a day for five years without having developed any of a specified list of tobacco-related illness; and (3) do not receive healthcare paid or reimbursed by the state of West Virginia. Trial began in January 2001. On January 25, 2001, the trial court granted a motion for a mistrial, ruling that the plaintiffs had improperly introduced testimony about addiction to smoking as a basis for claiming damages. In March 2001, the court denied the defendants' motion to decertify the class. The retrial began in September 2001, and on November 14, 2001 the jury returned a verdict that defendants were not liable for funding the medical monitoring program. On July 18, 2002, the plaintiffs petitioned the Supreme Court of West Virginia for leave to appeal, which was granted on February 25, 2003. The Supreme Court of West Virginia affirmed the judgment for the defendants on May 6, 2004. On July 1, 2004, the class's petition for rehearing was denied. The plaintiffs did not seek review by the U.S. Supreme Court.

Altria has reported that approximately 728 cases against Philip Morris and other tobacco industry defendants are pending in a single West Virginia court in a consolidated proceeding. The West Virginia court has scheduled a single trial for these consolidated cases, but it has certified a question to the Supreme Court of Appeals of West Virginia requesting a determination of the extent to which the claims in these individual cases can be consolidated in a single trial. On December 2, 2005, the Supreme Court of Appeals of West Virginia held that the Due Process Clause of the 14th Amendment, as interpreted by *State Farm v. Campbell*, does not preclude a bifurcated trial plan in which a punitive damages multiplier is established prior to compensatory damages. In November 2007, the Supreme Court of Appeals of West Virginia denied defendants' renewal motion for review of

the trial plan. In December 2007, defendants filed a petition for writ of certiorari with the U.S. Supreme Court, which was denied on February 25, 2008. In February 2008, the court granted defendants' motion to stay the case pending the decision in *Good*, described below.

In *Daniels v. Philip Morris* (also known as *In re Tobacco Case II*), a California state court certified a class comprised of individuals who were minors residing in California, who were exposed to defendants' marketing and advertising activities, and who smoked one or more cigarettes within the applicable time period. Certification was granted as to plaintiffs' claims that defendants violated the state's unfair business practice laws. On September 12, 2002, the trial court judge granted the defendants' motion for summary judgment on First Amendment and preemption (Federal Cigarette Labeling and Advertising Act) claims. In November 2002, the court confirmed its earlier rulings granting defendant's motion for summary judgment. The plaintiffs filed a petition for review with the California Supreme Court. On August 2, 2007, the California Supreme Court affirmed the grant of summary judgment. In December 2007, plaintiffs filed a petition for writ of certiorari with the U.S. Supreme Court.

During April 2001, a California state court issued an oral ruling in the case of *Brown v. The American Tobacco Company, Inc.*, in which it granted in part plaintiffs' motion for class certification and certified a class comprised of residents of California who smoked at least one of defendants' cigarettes during the period from June 10, 1993 through April 23, 2001 and who were exposed to defendants' marketing and advertising activities in California. Certification was granted as to plaintiffs' claims that defendants violated California Business and Professions Code Sections 17200 and 17500. The court denied the motion for class certification as to plaintiffs' claims under the California Legal Remedies Act. Defendants' writ with the court of appeals challenging the trial court's class certification was denied on January 16, 2002. The defendants filed a motion for summary judgment on January 31, 2003. On August 4, 2004, the defendants' motion for summary judgment was granted in part and denied in part. Following the November 2004 election, and the passage of a proposition in California that brought about a change in the law regarding the requirements for filing cases of this nature, the defendants filed a motion to decertify the class based on the changes in the law. On March 7, 2005, the court granted the defendants' motion to decertify the class. On March 17, 2005, plaintiffs filed a motion for reconsideration of the court's ruling decertifying the class. The trial judge denied the plaintiffs' motion on April 20, 2005, and the plaintiffs appealed on May 19, 2005. On September 5, 2006, the California Court of Appeals affirmed the judge's order decertifying the class. On October 13, 2006, the plaintiffs filed a petition for review with the California Supreme Court, which review was granted on November 1, 2006.

Altria has reported that, as of February 15, 2008, there are 17 putative class actions pending against Philip Morris in the U.S. on behalf of individuals who purchased and consumed various brands of cigarettes, including Marlboro Lights, Marlboro Ultra Lights, Virginia Slims Lights and Superslims, Merit Lights, and Cambridge Lights. These actions allege, among other things, that the use of the term "Lights" or "Ultra Lights" constitutes deceptive and unfair trade practices and seek injunctive and equitable relief, including restitution. As reported by Altria, trial courts have certified classes in cases pending against Philip Morris in Massachusetts (*Aspinall*), Minnesota (*Curtis*), Missouri (*Craft*), and New York (*Schwab*). Philip Morris has appealed or otherwise challenged these class certification orders. Additionally, an appellate court in Florida has overturned a class certification by the trial court in the "lights" case styled *Hines v. Philip Morris, Inc.*, and the plaintiffs have petitioned the Florida Supreme Court for further review. On December 10, 2004, the Florida Supreme Court stayed further proceedings pending its decision in the *Engle* case, which was entered thereafter on December 21, 2006. On January 8, 2007, the court ordered the plaintiff in *Hines* to respond by January 23, 2007 as to why the decision in *Engle* should not control the outcome in *Hines*. The plaintiffs petitioned the Florida Supreme Court for further review, and on January 14, 2008, the Florida Supreme Court denied the petition.

In August 2004, the Massachusetts Supreme Judicial Court affirmed class certification in the "lights" case *Aspinall v. Philip Morris Cos.* In April 2006, plaintiffs filed a motion to redefine the class to include all persons who after November 25, 1994 purchased packs or cartons of *Marlboro Lights* in Massachusetts that displayed the legend "Lower Tar & Nicotine" (the original class definition did not include a reference to lower tar and nicotine). In August 2006, the trial court denied Philip Morris's motion for summary judgment based on the state consumer protection statutory exemption and federal preemption. On motion of the parties, the trial court subsequently reported its decision to deny summary judgment to the appeals court for review and the trial court proceedings are stayed pending completion of the appellate review. Motions for direct appellate review with the Massachusetts

Supreme Judicial Court were granted in April 2007. Arguments were heard in January 2008. In February 2008, the parties jointly agreed to stay the case pending the U.S. Supreme Court decision in *Good*, described below.

In *Watson v. Philip Morris*, the U.S. District Court for the Eastern District of Arkansas upheld the federal officer removal statute as a basis for removal of “lights” cases from state to federal court, and the U.S. Court of Appeals for the Eighth Circuit affirmed. The U.S. Supreme Court granted plaintiffs a writ of certiorari and requested comment from the U.S. Solicitor General as to whether federal jurisdiction of the matter, based on the involvement of the Federal Trade Commission (“FTC”), was appropriate. The U.S. Solicitor General filed its brief amicus curiae on December 19, 2006, recommending that the petition for writ of certiorari be denied, despite its belief that the Eighth Circuit erred, because the error below (that Philip Morris marketed its cigarettes as “light” pursuant to the FTC’s comprehensive direction and control) was fact-specific and insufficient to warrant review. On January 12, 2007, the U.S. Supreme Court granted the petition for a writ of certiorari. On June 11, 2007, the Supreme Court issued a ruling in which it reversed the trial court’s order and directed that the *Watson* case be remanded and transferred back for further proceedings to the Arkansas state court where it had originally been filed. The Court held that the *Watson* case did not qualify under applicable federal law for removal and transfer from the Arkansas state court to the Arkansas federal court. In December 2007, the court rejected the parties’ proposed stipulation to stay the case pending the U.S. Supreme Court’s decision on defendants’ petition for writ of certiorari in *Good*, which was granted on January 18, 2008. A motion is pending to reconsider this denial.

In April 2005, the Minnesota Supreme Court declined to review the trial court’s class certification order in the “lights” case *Curtis v. Altria*. In September 2005, the case was removed to the U.S. District Court for the District of Minnesota, based on the Eighth Circuit’s decision in *Watson*. In February 2006, the U.S. District Court denied plaintiffs’ motion to remand the case to state court, and the case is pending in federal court. On July 31, 2006, the court stayed all proceedings pending resolution of the appeal in *Dahl* (described below). In February 2007, the U.S. Court of Appeals for the Eighth Circuit issued its ruling in *Dahl*, and reversed the federal district court’s denial of plaintiff’s motion to remand that case to the state trial court. On October 17, 2007, the district court remanded the case to state court. In December 2007, the Minnesota Court of Appeals reversed the trial court’s determination in *Dahl* that the Lights class action was subject to preemption, and defendants have appealed. The *Dahl* case has been stayed pending the U.S. Supreme Court decision in *Good*.

In August 2005, the Missouri Court of Appeals, Eastern District, affirmed the class certification order in *Craft v. Philip Morris Cos.* In September 2005, Philip Morris removed the case to federal court based on *Watson*. In March 2006, the federal trial court granted plaintiffs’ motion and remanded the case to the Missouri state trial court. Philip Morris filed a motion for appellate review of the trial court’s class certification. In May 2006, the Missouri Supreme Court declined to review the class certification decision. Trial is currently scheduled to begin in January 2009.

On May 11, 2004, smokers of “Lights” cigarettes filed a purported class action suit, presently styled *Schwab v. Philip Morris USA, Inc.* (but originally filed as *McLaughlin et al. v. Philip Morris USA, Inc.*), in the U.S. District Court for the Eastern District of New York against the OPMs and their parent companies, Liggett and certain other entities. Plaintiffs allege that the defendants formed an “association-in-fact” enterprise, in violation of the federal RICO statute, to defraud the public into believing that “light” cigarettes were healthier alternatives to regular cigarettes. Plaintiffs seek to certify a nationwide class of smokers comprising all purchasers of “light” cigarettes manufactured by the defendants since the 1970s. Oral argument on the plaintiffs’ motion for class certification occurred on September 12, 2005. The defendants filed a motion to deny class certification and to dismiss the complaint, asserting that the plaintiffs’ request – that any determination as to damages payable to a certified class be allocated among class members on a “fluid recovery” basis – is illegal. On November 14, 2005, the court denied the defendants’ motion, ruling that the plaintiffs’ request for “fluid recovery” is not illegal and does not require denial of class certification or dismissal of the action. The trial judge ordered several months of additional discovery before deciding the class certification issue. On September 25, 2006, the court granted class certification and set a trial date of January 22, 2007. On October 6, 2006, the defendants filed a petition seeking review by the U.S. Court of Appeals for the Second Circuit of the class certification decision along with a motion to stay that decision pending review. On October 24, 2006, the Second Circuit ordered a temporary stay of all pretrial and trial proceedings pending the disposition of the petition for review and motion to stay. In November 2006, the Second Circuit granted the defendants’ petition for review of the class certification order. Oral argument on that

appeal was heard by the Second Circuit on July 10, 2007 and no decision has yet been issued with respect to the appeal.

In *Marrone v. Philip Morris, USA, Inc.*, smokers of “Lights” cigarettes manufactured and sold by Philip Morris, Inc. filed class-action complaints in an Ohio state court against Philip Morris, alleging violations of Ohio’s Consumer Sales Practices Act (“OCSPA”) in that, among other allegations, Philip Morris falsely represented the cigarettes as “light” to mislead smokers into believing that the cigarettes delivered lower tar and nicotine and therefore were safer than their “regular” cigarette counterparts. The trial court certified a limited class of consumers from an area of Ohio on the OCSPA claims and Philip Morris appealed. The Ohio appellate court affirmed the trial court’s judgment certifying the class. In contrast to the above “lights” cases, on June 14, 2006, the Supreme Court of Ohio reversed the judgment of the appellate court and ruled that the plaintiffs did not meet the standard to qualify for class-action certification under the OCSPA, concluding that the plaintiffs had not shown prior rules or court decisions determining that conduct sufficiently similar to the alleged acts of Philip Morris constituted a deceptive act or practice.

Moreover, the Supreme Court of Illinois has overturned a judgment in favor of a plaintiff class in *Price v. Philip Morris Cos., Inc.* (formerly known as *Miles v. Philip Morris, Inc.*). A Madison County Illinois state court certified a class comprised of all residents of Illinois who purchased and consumed Cambridge Lights and Marlboro Lights within a specified time period but who did not have a claim for personal injury resulting from the purchase or consumption of cigarettes. The plaintiffs alleged consumer fraud claims and sought economic damages in the form of a refund of purchase costs of the cigarettes. On March 21, 2003, after a non-jury trial, the trial court judge ruled in favor of the plaintiffs, ordering Philip Morris to pay \$10.1 billion (\$7.1 billion in compensatory damages, \$3.0 billion in punitive damages) to the State of Illinois, and \$1.78 billion in plaintiff lawyer fees to be paid from the \$10.1 billion. The court also stayed execution of the judgment for 30 days. After entry of the judgment on March 21, 2003, Philip Morris had 30 days within which to file a notice of appeal. Under Illinois court rules then-applicable, the enforcement of a trial court’s money judgment may be stayed only if, among other things, an appeal bond in an amount sufficient to cover the amount of the judgment, interest, and costs is posted by a defendant within the 30-day period during which an appeal may be taken. With the approval of the trial court, such 30-day period may be extended for up to an additional 15 days. The trial court judge initially set the bond at \$12 billion. Because of the difficulty of posting a bond of that magnitude, Philip Morris pursued various avenues of relief from the \$12 billion bond requirement. In April 2003, the judge reduced the amount of the appeal bond. He ordered the bond to be secured by \$800 million, payable in four equal quarterly installments beginning in September 2003, and a pre-existing 7.0%, \$6 billion long-term note from Altria Group, Inc. to Philip Morris to be placed in an escrow account pending resolution of the case. The plaintiffs appealed the judge’s order reducing the amount of the bond. On July 14, 2003, the Illinois Fifth District Court of Appeals ruled that the trial court had exceeded its authority in reducing the bond and ordered the trial judge to reinstate the original bond. On September 16, 2003, the Illinois Supreme Court upheld the reduced bond set by the trial court and agreed to hear Philip Morris’s appeal without the need for intermediate appellate court review. On December 15, 2005, the Illinois Supreme Court reversed the trial court’s judgment and remanded the case to the trial court with instructions to dismiss the case in its entirety. In its decision, the court held that the defendant’s conduct alleged by the plaintiffs to be fraudulent under the Illinois Consumer Fraud Act was specifically authorized by the Federal Trade Commission, and that the Illinois Consumer Fraud Act specifically exempts conduct so authorized by a regulatory body acting under the authority of the U.S. The court declined to review the case on the merits, concluding that the action was barred entirely by the Illinois Consumer Fraud Act. The plaintiffs filed a motion asking the court to reconsider its decision, which was denied on May 5, 2006 by the Supreme Court of Illinois. In June 2006, the Illinois Supreme Court ordered the return to Philip Morris of approximately \$2.15 billion held in escrow to secure the appeal bond and terminated Philip Morris’s obligations to pay administrative fees. The pre-existing 7.0%, \$6 billion long-term note from Altria Group, Inc. to Philip Morris was being held in escrow pending the outcome of plaintiffs’ petition for writ of certiorari to the U.S. Supreme Court, filed on October 2, 2006. On November 27, 2006, the U.S. Supreme Court denied plaintiff’s petition for certiorari. In December 2006, the trial court then entered an order of dismissal. In January 2007, the plaintiff filed a motion to vacate the dismissal, which motion is pending. In May 2007, the state trial court judge in the *Price* case asked the Illinois Fifth District Appellate Court whether he has the authority to reopen the *Price* case, citing possible new evidence presented in a case pending before the U.S. Supreme Court. On May 30, 2007, Philip Morris filed a motion to stay the Fifth District proceeding, which motion was granted by the Illinois Fifth District Appellate Court on June 1, 2007. It has also been reported that on May 17, 2007, Philip Morris petitioned the Illinois Supreme Court for an order that would prevent the trial court judge from reopening the *Price* case. In

August 2007, the Illinois Supreme Court granted the motion and the trial court dismissed plaintiffs' motion to vacate or withhold final judgment.

According to Reynolds American, "lights" class-action cases are pending against Reynolds or Brown & Williamson in Illinois (*Turner and Howard*), Missouri (*Collora and Black*), Minnesota (*Dahl and Thompson*), Louisiana (*Harper and Brown*), Florida (*Rios*), Washington (*Huntsberry*), and New York (*Schwab*). Illinois state courts have certified classes in *Turner v. R.J. Reynolds Tobacco Co.* and *Howard v. Brown & Williamson*. In *Turner*, the state court certified a class defined as "[a]ll persons who purchased defendants' Doral Lights, Winston Lights, Salem Lights and Camel Lights, in Illinois, for personal consumption, between the first date that defendants sold Doral Lights, Winston Lights, Salem Lights and Camel Lights through the date the court certifies this suit as a class action...." On June 6, 2003, Reynolds Tobacco filed a motion to stay the case pending Philip Morris's appeal of the *Price* case. On July 11, 2003, the court denied the motion, and Reynolds Tobacco appealed to the Illinois Fifth District Court of Appeals. The Court of Appeals denied this motion on October 17, 2003. On October 20, 2003, the trial judge ordered that the case be stayed for 90 days, or pending the result of the *Price* appeal. The order stated that a hearing would be held at the end of the 90-day period to determine if the stay should be continued. However, on October 24, 2003, the Illinois Supreme Court ordered an emergency stay of all proceedings pending review by the entire Illinois Supreme Court of Reynolds Tobacco's emergency stay order request filed on October 15, 2003. On November 5, 2003, the Illinois Supreme Court granted Reynolds Tobacco's motion for a stay pending the court's final appeal decision in *Price*. On October 11, 2007, the Illinois Fifth District Court of Appeals dismissed Reynolds Tobacco's appeal and remanded the case to the circuit court. The *Howard* case remains stayed by order of the trial judge, although the plaintiffs appealed this stay order to the Illinois Fifth District Court of Appeals, which appeal was denied on August 19, 2005.

On December 31, 2003, a Missouri state court judge certified a similar class in the "lights" case *Collora v. R.J. Reynolds Tobacco Co.* On January 14, 2004, Reynolds Tobacco removed the case to the U.S. District Court for the Eastern District of Missouri. On September 30, 2004, the case was remanded to the Circuit Court for the City of St. Louis. Reynolds Tobacco removed the case once again, and on April 18, 2006, the case was remanded for the second time to the Circuit Court for the City of St. Louis. *Black v. Brown & Williamson Tobacco Corp.* is another "lights" case pending in Missouri. Brown & Williamson removed the case to the U.S. District Court for the Eastern District of Missouri on September 23, 2005. On October 25, 2005, the plaintiffs filed a motion to remand, which was granted on March 17, 2006. The plaintiffs' motion for class certification is scheduled to be heard on April 16, 2008. A consolidated hearing in both *Black* and *Collora* has been set for December 25, 2007. On December 22, 2006, the plaintiffs filed a motion to reassign both *Black* and *Collora* to a single general division, which motion was granted on April 19, 2007.

In May 2005, a Minnesota state court dismissed in its entirety the "lights" case *Dahl v. R.J. Reynolds Tobacco Company*, ruling that the plaintiffs' claims conflicted with the federal Cigarette Labeling and Advertising Act. On July 11, 2005, the plaintiffs appealed. Pending appeal, Reynolds Tobacco removed the case to the U.S. District Court for the District of Minnesota. The plaintiffs filed a motion to remand, which was denied on February 14, 2006. On March 9, 2006, the case was transferred to the U.S. Court of Appeals for the Eighth Circuit. On February 28, 2007, the Eighth Circuit reversed and remanded the case to the Minnesota Court of Appeals and oral argument occurred on September 18, 2007. In December 2007, the Minnesota Court of Appeals reversed the trial court's determination in *Dahl* that the Lights class action was subject to preemption, and defendants' have appealed. The *Dahl* case has been stayed pending the U.S. Supreme Court decision in *Good*. In *Thompson v. R.J. Reynolds Tobacco Co.*, also pending in Minnesota, Reynolds removed the case on September 23, 2005 to the United States District Court for the District of Minnesota. On October 21, 2005, the plaintiffs filed a motion to remand, which was denied on February 14, 2006. On August 7, 2006, the parties filed a stipulation to stay the case, pending resolution of the appeal in *Dahl*. On October 29, 2007, the United States District Court remanded the case to the District Court for Hennepin County. On February 1, 2008, the court stayed the case until the completion of *Dahl*.

On August 31, 2005, a Louisiana federal district court ruled in a proposed class action, *Sullivan v. Philip Morris*, that the Federal Cigarette Labeling and Advertising Act (FCLAA) does not preempt plaintiffs' claims of a breach of express warranty and certain state law remedies with respect to manufacturing defects. On September 14, 2005, the same district court ruled in the proposed class action *Brown v. Brown & Williamson* that the FCLAA does not preempt plaintiffs' fraudulent misrepresentation/concealment and defective product claims. Brown & Williamson filed a petition to the U.S. Court of Appeals for the Fifth Circuit for permission to appeal, which was



granted on February 10, 2006. In February 2007, the Fifth Circuit reversed the judgment and remanded the case with directions to dismiss all claims with prejudice. Philip Morris also filed a petition to the U.S. Court of Appeals for the Fifth Circuit for permission to appeal the Sullivan ruling, which was granted on March 31, 2006. On January 27, 2005, also in Louisiana, a federal judge denied the plaintiffs' motion to remand in *Harper v. R.J. Reynolds Tobacco Co.* The plaintiffs appealed, and on July 17, 2006, the Fifth Circuit Court of Appeals affirmed the district court's order.

Pending in the state of Washington is the "lights" case *Huntsberry v. R.J. Reynolds Tobacco Co.*, in which the plaintiffs' motion for class certification was denied on April 21, 2006. On September 18, 2006, the court denied the plaintiffs' motion for discretionary review. The plaintiffs filed a motion to modify the ruling with the Washington Court of Appeals on October 17, 2006, which motion was denied in December 2006. In January 2007, plaintiffs filed a motion with the Washington Supreme Court, asking the court to review the rulings that denied their motions for class certification, which motion was denied on March 1, 2007. The plaintiffs filed a motion to modify the ruling of that court on April 2, 2007, which motion is set for reconsideration on June 5, 2007. Pending in Florida is the "lights" case *Rios v. R.J. Reynolds Tobacco Co.*, which is currently dormant pending plaintiffs' counsel's attempt to appeal decertification in the Florida case *Hines v. Philip Morris, Inc.* Also pending in Florida is *Rivera v. Brown & Williamson Tobacco Corp.* which was filed in October 2006 and removed by the defendant in November 2006 to the federal District Court for the Southern District of Florida. On September 10, 2007, the court stayed the case until disposition of *Hines*.

On June 9, 2005, a proposed "lights" class action was filed in U.S. District Court for the District of New Mexico (*Mulford v. Altria Group, Inc.*). Philip Morris's motions for summary judgment on preemption and consumer protection statutory exemption grounds are pending resolution of the plaintiffs' amended motion for class certification. In March 2007, the federal district court denied plaintiffs' amended motion for class certification and in June 2007, plaintiffs renewed their motion for class certification. On June 27, 2005, a similar class action was filed in Kansas state court against Philip Morris and its parent, Altria (*Benedict v. Altria Group, Inc.*). The case has been transferred to U.S. District Court for the District of Kansas, where plaintiffs' motion for class certification and Philip Morris's motion for summary judgment are pending.

It is also reported that on August 15, 2005, three individuals filed a "lights" class action in the U.S. District Court for the District of Maine against the same defendants (*Good v. Altria Group, Inc.*). In May 2006, the court granted Philip Morris's motion for summary judgment on the grounds that plaintiffs' claims are preempted by the Federal Cigarette Labeling and Advertising Act (the "FCLAA") and dismissed the case. In June 2006, plaintiffs appealed to the U.S. Court of Appeals for the First Circuit. On August 31, 2007, the First Circuit issued an opinion holding that the plaintiffs' claims are not preempted. The court reasoned that plaintiffs' claims of fraudulent misrepresentation are neither expressly nor implicitly preempted by the FCLAA. The court also disagreed with those courts, including the *Price* court, which have held that "lights" advertising is authorized by the FTC and therefore beyond the reach of state consumer protection statutes. The First Circuit remanded the case to the district court. The district court has stayed proceedings pending the ruling of the United States Supreme Court on defendant's petition for writ of certiorari, which the court granted on January 18, 2008.

On April 3, 2002, in *Deloach v. Philip Morris*, a federal district court in North Carolina granted class certification to a group of tobacco growers and quota-holders from Alabama, Florida, Georgia, North Carolina, South Carolina, and Tennessee. The class accused cigarette manufacturers of conspiring to set prices offered for tobacco in violation of antitrust laws. In June 2002, the defendants' petition to the Fourth Circuit Court of Appeals seeking permission to appeal the class certification was denied. In May 2003, the plaintiffs reached a settlement with all of the tobacco industry defendants other than Reynolds Tobacco. The settling defendants agreed to pay \$210 million to the plaintiffs, to pay plaintiffs' attorney fees of \$75.3 million as set by the court and to purchase a minimum amount of U.S. leaf for ten years. The case continued against Reynolds Tobacco. On April 22, 2004, after the trial began, the parties settled the case. Under the settlement, Reynolds Tobacco has paid \$33 million into a settlement fund, which, after deductions for attorneys' fees and administrative costs, will be distributed to the class pending final settlement approval. Reynolds Tobacco has also agreed to purchase a minimum amount of U.S. leaf for the next ten years. On March 21, 2005, the court approved the settlement and dismissed the suit.

On May 23, 2001, a lawsuit was filed in the U.S. District Court for the District of Columbia styled *Simms v. Philip Morris Incorporated*, which sought class action status for millions of youths who began smoking cigarettes

before they were legally allowed to buy cigarettes. Plaintiffs sought to recover moneys that underage smokers spent on cigarettes before they were legally allowed to buy cigarettes, whether or not they have suffered health problems, and/or profits the tobacco manufacturers have earned from sales to children. The lawsuit alleged that tobacco manufacturers concealed the addictive nature of cigarettes and concealed the health risks of smoking in their advertising. In February 2003, the court denied plaintiffs' motion for class certification. The plaintiffs have filed several motions for reconsideration of the order denying class certification, which motions were denied in December 2006. The case has been stayed pending resolution of the *U.S. Department of Justice* case described below under “–*Healthcare Cost Recovery Lawsuits*”.

On January 19, 2006, a lawsuit styled *Caronia v. Philip Morris USA, Inc.* was filed in the U.S. District Court for the Eastern District of New York to require Philip Morris to pay for low dose CAT scans (on an annual basis) for a class of smokers over the age of 50 who have been smoking at least a pack of Marlboro a day for 20 years and have not been diagnosed with lung cancer. Motions for summary judgment and class certification are pending in district court. On November 3, 2006, plaintiffs filed a Third Amended Complaint, which Philip Morris answered on November 13, 2006. Class certification discovery ended in February 2007, and briefing was due in April. A similar lawsuit, styled *Donovan, et al. v. Philip Morris USA, Inc. et al.*, was filed on March 2, 2007 in the United States District Court in Massachusetts.

On December 2006, a lawsuit styled *Espinosa, et al. v. Philip Morris USA, Inc. et al.* was filed in the Cook County, Illinois circuit court on behalf of individuals from throughout Illinois and/or the United States who purchased cigarettes manufactured by certain defendants from 1996 through the date of any judgment in plaintiffs' favor. Excluded from the class are any individuals who allege personal injury or healthcare costs. The complaint alleges, among other things, that defendants were negligent and violated the Illinois consumer fraud statute by certain defendants' steadily and purposefully increasing the nicotine level and absorption of their cigarettes into the human body, including the brands most popular with young people and minorities. On January 12, 2007, Philip Morris removed the case to the United States District Court for the Northern District of Illinois. In March 2007, the District Court rejected plaintiffs' motion to remand the case to the Circuit Court of Cook County. On June 18, 2007, the District Court granted Philip Morris' motion to dismiss the action.

*Individual Plaintiffs' Lawsuits.* The MSA does not release PMs from liability in individual plaintiffs' cases. Numerous cases have been brought by individual plaintiffs who allege that their cancer or other health effects have resulted from their use of cigarettes, addiction to smoking, or exposure to environmental tobacco smoke. Individual plaintiffs' allegations of liability are based on various theories of recovery, including but not limited to, negligence, gross negligence, strict liability, fraud, misrepresentation, design defect, failure to warn, breach of express and implied warranties, breach of special duty, conspiracy, concert of action, restitution, indemnification, violations of deceptive trade practice laws and consumer protection statutes, and claims under federal and state RICO statutes. The tobacco industry has traditionally defended individual health and smoking lawsuits by asserting, among other defenses, assumption of risk and/or comparative fault on the part of the plaintiff, as well as lack of proximate cause.

Altria has reported that as of February 15, 2008, there were approximately 111 individual plaintiff smoking and health cases and 10 smoking and health class actions and aggregated claims pending in the U.S. against it (many of which cases include other tobacco industry defendants), including 728 cases pending before a single West Virginia state court in a consolidated proceeding. In addition, approximately 2,622 additional individual cases (referred to herein as the *Broin II* cases) are pending in Florida by individual current and former flight attendants claiming personal injury allegedly related to ETS in airline cabins. The individuals in the *Broin II* cases are limited by the settlement of a previous class action lawsuit, *Broin v. Philip Morris* (known as *Broin I*), to the recovery of compensatory damages only, and are precluded from seeking or recovering punitive damages. As a result of the settlement, however, the burden of proof as to whether ETS causes certain illnesses such as lung cancer and emphysema was shifted to the tobacco industry defendants. To date, seven individual *Broin II* flight attendant cases have gone to trial, one of which has resulted in a jury verdict against the tobacco industry defendants. The defendants' appeal in that case is pending. See also “Class Action Lawsuits,” above.

In the last ten years, juries have returned verdicts in individual smoking and health cases against the tobacco industry, including one or more of the PMs. Thus far, a number of those cases have resulted in significant verdicts against the defendants — some have been appealed, some have been overturned, and others have been affirmed.

By way of example only, and not as an exclusive or complete list, the following individual matters are illustrative of individual cases.

- In February 1999, a California jury in *Henley v. Philip Morris* awarded \$1.5 million in compensatory damages and \$50 million in punitive damages. The award was subsequently reduced by the trial judge to \$25 million in punitive damages, and both Philip Morris and the plaintiff appealed. In September 2003, a California Court of Appeal further reduced the punitive damage award to \$9 million, but otherwise affirmed the judgment for compensatory damages, and Philip Morris appealed to the California Supreme Court. In September 2004, the California Supreme Court dismissed Philip Morris's appeal. In October 2004, the California Court of Appeal issued an order allowing the execution of the judgment. In December 2004, Philip Morris filed with the U.S. Supreme Court a petition for a writ of certiorari. On March 21, 2005, the U.S. Supreme Court denied Philip Morris's petition. Philip Morris subsequently satisfied the judgment, paying \$1.5 million in compensatory damages, \$9 million in punitive damages and \$6.4 million in accumulated interest.
- In March 1999, an Oregon jury in *Williams-Branch v. Philip Morris* awarded \$821,500 in actual damages and \$79.5 million in punitive damages. The trial judge subsequently reduced the punitive damages award to \$32 million, but the reduction was overturned and the full amount of the punitive damages award was reinstated by the Oregon Court of Appeals. The Oregon Supreme Court declined to review the reinstated punitive damage award and Philip Morris petitioned the U.S. Supreme Court for further review. In October 2003, the U.S. Supreme Court set aside the Oregon appellate court's ruling and directed the Oregon court to reconsider the case in light of *State Farm v. Campbell*. In June 2004, the Oregon Court of Appeals reinstated the punitive damages award. In December 2004, the Oregon Supreme Court granted Philip Morris's petition for review of the case. On February 2, 2006, the Oregon Supreme Court affirmed the Court of Appeals decision, holding that the punitive damage award does not violate the due process guarantees of the U.S. Constitution. On March 30, 2006, Philip Morris filed a petition for certiorari review with the U.S. Supreme Court challenging the ruling of the Oregon Supreme Court as a violation of the principles set forth in *State Farm v. Campbell* regarding the permissible size of punitive damage awards relative to compensatory damage awards. The U.S. Supreme Court granted Philip Morris's petition for review in May 2006, and oral argument was heard on October 31, 2006. On February 20, 2007, the U.S. Supreme Court ruled that a punitive damage award may not be based on a jury's desire to punish a defendant for harming persons who were not parties to the case in question and held that such an award would amount to an unconstitutional taking of property from a defendant without due process. The Court vacated the judgment of the Oregon Supreme Court and remanded the case for further proceedings not inconsistent with its opinion. On January 31, 2008, the Oregon Supreme Court affirmed the Oregon Court of Appeals' June 2004 decision, which in turn, upheld the jury's compensatory damage award and reinstated the jury's award of \$79.5 million in punitive damages, Phillip Morris intends to seek further review by the U.S. Supreme Court.
- In April 1999, a Maryland jury in *Connor v. Lorillard* awarded \$2.225 million in damages. An appellate court has remanded the case for a determination of the date of injury to determine whether a statutory cap on non-economic damages applies.
- In March 2000, a California jury in *Whiteley v. Raybestos-Manhattan, Inc.* returned a verdict in favor of the plaintiff and found the defendants, including Philip Morris and Reynolds Tobacco, liable for negligent product design and fraud, and awarded \$1.72 million in compensatory damages and \$20 million in punitive damages. Both damage awards were upheld by the trial judge, who denied the defendants' post-verdict challenge. The defendants appealed the verdict. In April 2004, the California Court of Appeal reversed the judgment and remanded the case for a new trial. The plaintiff's motion for rehearing was denied on April 29, 2004. In May 2006, the plaintiff filed an amended consolidated complaint. In September 2006, the trial court granted the plaintiff's motion for a preferential trial date and trial began on January 22, 2007. On May 2, 2007, the jury awarded plaintiffs \$2.46 million in compensatory damages against Philip Morris

and the other defendant in the case. The jury also found that plaintiffs are entitled to punitive damages against the other defendant, but not Philip Morris, in an amount to be determined in a later phase of the trial. Philip Morris has stated it intends to seek review of the compensatory damage verdict. On September 5, 2007, the court denied Reynolds Tobacco's motion for judgment notwithstanding the verdict or, in the alternative, a new trial. On October 3, 2007, Reynolds Tobacco filed for appeal.

- In October 2000, a Tampa, Florida jury in *Jones v. R.J. Reynolds Tobacco Co.* found Reynolds Tobacco liable for negligence and strict liability and returned a verdict in favor of the widower of a deceased smoker, awarding approximately \$200,000 in compensatory damages; the jury rejected the plaintiff's conspiracy claim and did not award punitive damages. Reynolds Tobacco filed a motion for judgment notwithstanding the verdict, or, in the alternative, for a new trial. On December 28, 2000, the court granted the motion for a new trial and on August 30, 2002 the Second District Court of Appeal of Florida affirmed the decision to grant a new trial. The plaintiff has filed for permission to appeal to the Florida Supreme Court. On December 9, 2002, the Supreme Court of Florida issued an order to show cause as to why Jones's notice of appeal should not be treated as a notice to invoke discretionary jurisdiction. On April 27, 2005 the Florida Supreme Court denied the plaintiff's notice of appeal without prejudice. On May 25, 2005 the plaintiff served an amended notice of intent to invoke discretionary jurisdiction. On August 31, 2005, the Florida Supreme Court denied review for lack of jurisdiction. On April 20, 2006, the plaintiff voluntarily dismissed all claims against Reynolds Tobacco.
- In November 2000, the Supreme Court of Florida reinstated the verdict by a Florida jury in *Carter v. Brown & Williamson Tobacco Corporation* to award \$750,000 in damages to the plaintiff. In 1996, the jury had found that cigarettes were a defective product and that B&W was negligent for not warning people of the danger, but an appeals court reversed this decision. In March 2001, the plaintiff received slightly over \$1 million from a trust account that contained the \$750,000 jury award plus interest and became the first smoker to be paid by a tobacco company in an individual lawsuit. On June 29, 2001, the U.S. Supreme Court denied B&W's petition for a writ of certiorari, thus leaving the jury verdict intact.
- In March 2001, a Massachusetts lower court in *Haglund v. Philip Morris* dismissed, without factual inquiries, a claim brought on behalf of a deceased smoker for breach of implied warranty of merchantability, based upon the applicability of a defense as to "unreasonable" use of the product by the smoker and the stipulation by the plaintiff that the defendant would prevail if the defense was made applicable. In May 2006, the Massachusetts Supreme Judicial Court, in reversing and remanding the case for further factual proceedings as to reasonableness of use, noted that such defense will not be available in most cases involving the manufacture and sale of cigarettes, but will only be available in situations where the plaintiff has acted so overwhelmingly unreasonable that imposing liability would be unfair.
- In June 2001, in *Boeken v. Philip Morris Incorporated*, a California state court jury found against Philip Morris on all six claims of fraud, negligence and making a defective product alleged by the plaintiff. The jury awarded the plaintiff \$5.5 million in compensatory damages and \$3 billion in punitive damages. The \$3 billion punitive damages award was reduced to \$100 million post-trial. Philip Morris appealed. In September 2004, the California Second District Court of Appeal further reduced the punitive damage award to \$50 million, but otherwise affirmed the judgment entered in the case. In October 2004 the Court of Appeal granted the parties' motions for rehearing and, in April 2005, reaffirmed the amount of the September 2004 ruling. On August 10, 2005, the California Supreme Court denied Philip Morris's request for review. Philip Morris and the plaintiff have petitioned the U.S. Supreme Court for review. Plaintiff has agreed not to execute on the judgment pending the disposition of Philip Morris's petition. On March 20, 2006, the U.S. Supreme Court denied all parties' petitions for review. After exhausting all appeals, Philip Morris paid approximately \$82.5 million (including interest of approximately \$27 million) to the plaintiffs.

- In December 2001, a Florida state court jury awarded the plaintiff \$165,000 in compensatory damages but no punitive damages in *Kenyon v. R.J. Reynolds Tobacco Co.* Reynolds Tobacco appealed to the Second District Court of Appeal of Florida, which, on May 30, 2003, affirmed per curium (that is, without writing an opinion) the trial court's judgment in favor of the plaintiff. Reynolds Tobacco paid \$196,000, which represents the amount of the judgment plus accrued interest, in order to pursue further appeals. On September 5, 2003, Reynolds Tobacco petitioned the Florida Supreme Court to require the Second District Court of Appeal to write an opinion. On April 22, 2004, the Florida Supreme Court denied the petition. On January 26, 2004, the U.S. Supreme Court denied Reynolds Tobacco's petition for a writ of certiorari, thus leaving the jury verdict intact. Reynolds Tobacco subsequently paid approximately \$1.3 million in attorneys' fees to the plaintiff's counsel.
- In February 2002, a federal jury in Kansas City awarded \$198,000 in compensatory damages to a former smoker in *Burton v. R.J. Reynolds Tobacco Co.* The jury also determined that punitive damages were appropriate and, after a separate hearing was held to address that issue, the court awarded the plaintiff \$15 million in punitive damages. On February 9, 2005, the U.S. Court of Appeals for the Tenth Circuit upheld the compensatory damages award, but unanimously reversed the award of punitive damages in its entirety. On May 17, 2005, the District Court entered a second amended judgment for \$196,416 plus interest and costs. On June 17, 2005, Reynolds Tobacco paid the judgment.
- In March 2002, a Portland, Oregon jury awarded approximately \$168,500 in compensatory damages and \$150 million in punitive damages to the family of a light cigarette smoker in *Schwarz v. Philip Morris Incorporated.* The trial judge subsequently reduced the punitive damages awarded to \$100 million. Philip Morris and the plaintiffs appealed this judgment. In May 2006, the Oregon Court of Appeals affirmed the compensatory damages verdict and reversed the award of punitive damages and remanded the case to the trial court for a second trial to determine the amount of punitive damages, if any. In June 2006, plaintiffs filed a petition to the Oregon Supreme Court to review the portion of the Oregon Court of Appeals decision reversing the punitive damages and remanding the case for a new trial on punitive damages. In October 2006, the Oregon Supreme Court announced that it would hold this petition in abeyance until the U.S. Supreme Court decides the *Williams* case described above. In February 2007, the U.S. Supreme Court vacated the punitive damages judgment in the *Williams* case and remanded the case to the Oregon Supreme Court for proceedings consistent with its decision. The parties have submitted their briefs to the Oregon Supreme Court setting forth their respective views on how the *Williams* decision impacts the plaintiffs pending petition for review.
- In June 2002, in *Lukacs v. Philip Morris, Inc.*, a Florida jury awarded a smoker \$37.5 million in compensatory damages against Philip Morris and other defendants. In March 2003, the trial court reduced the damages award to \$24.9 million. The court has not yet entered the judgment in the jury verdict. In January 2007, defendants petitioned the trial court to set aside the jury's verdict and plaintiff filed a motion for entry of judgment. On August 1, 2007, the trial court deferred ruling on plaintiff's motion until the U.S. Supreme Court reviews *Engle*. Philip Morris has stated it intends to appeal if a judgment is entered in this case.
- In September 2002, in *Figueroa-Cruz v. R.J. Reynolds Tobacco Co.*, a Puerto Rico jury awarded two sons of a deceased smoker \$500,000 each. The trial judge vacated one of the awards on statute of limitations grounds, and granted Reynolds Tobacco's motion for judgment as a matter of law on the other award on October 9, 2002. On October 28, 2003, the U.S. Court of Appeals for the First Circuit affirmed the trial court's ruling. The plaintiffs' petition for a writ of certiorari was denied by the U.S. Supreme Court in November 2004.
- In October 2002, in *Bullock v. Philip Morris, Inc.*, a Los Angeles, California jury awarded a smoker \$850,000 in compensatory damages. In October 2002, the same jury awarded the plaintiff \$28 billion in punitive damages. In December 2002, the trial judge reduced the punitive damage award to \$28 million. Philip Morris and the plaintiff have each appealed and the appeal was argued on January 18, 2006. On April 21, 2006, the California Court of Appeal, Second Appellate

District, Division Three, upheld the \$28 million punitive damages award. In August 2006, the California Supreme Court denied the plaintiff's petition to overturn the trial court's reduction in the punitive damage award and granted Philip Morris's petition for review challenging the punitive damage award, with further action deferred pending the U.S. Supreme Court's decision on punitive damages in the *Williams* case described above. In February 2007, the U.S. Supreme Court vacated the punitive damages judgment in *Williams* and remanded the case to the Oregon Supreme Court for proceedings consistent with its decision. On January 30, 2008, the California Court of Appeals reversed the judgment with respect to the \$28 million punitive damages award, affirmed the judgment in all other respects, and remanded the case to trial court on the amount of punitive damages.

- In April 2003, in *Eastman v. Philip Morris*, a Florida jury awarded a smoker \$3.26 million in damages, after reducing the award to reflect the plaintiff's partial responsibility. Defendants Philip Morris and B&W appealed to the Second District of Florida Court of Appeal. In May 2004, the Second District Court of Appeal rejected the appeal in a per curium decision (that is, without a written opinion). The defendants' petition for a written opinion and rehearing was denied on October 14, 2004, and that ruling is not subject to review by the Florida Supreme Court. On October 29, 2004, Philip Morris and Reynolds Tobacco, due to their obligation to indemnify B&W, satisfied their respective portions of the judgment.
- In May 2003, in *Boerner v. Brown & Williamson*, an Arkansas jury awarded the plaintiff \$15 million in punitive damages and \$4 million in compensatory damages. Following a series of appeals, on January 7, 2005, the U.S. Court of Appeals for the Eighth Circuit affirmed the trial court's May 2003 judgment, but reduced the punitive damages award to \$5 million. Reynolds Tobacco, due to its obligation to indemnify B&W, satisfied the approximately \$9.1 million judgment on February 16, 2005.
- In November 2003, in *Thompson v. Philip Morris, Inc.*, a Missouri jury returned a split verdict, awarding approximately \$1.6 million in compensatory damages to the plaintiff and an additional \$500,000 in damages to his wife. The jury apportioned 40% of fault to Philip Morris, 10% of fault to B&W and the remaining 50% to the plaintiff. Accordingly, under Missouri law, the court must reduce the damages award by half. On March 8, 2004, the defendants appealed to the Missouri Court of Appeals for the Western District, which affirmed the judgment entered in favor of the plaintiffs on August 22, 2006. On September 26, 2006, the Court of Appeals denied the defendants' motion to transfer the case to the Missouri Supreme Court. The defendants filed an application to transfer in the Missouri Supreme Court on October 10, 2006, and on December 19, 2006, the application was denied. In January 2007, Philip Morris and Reynolds Tobacco paid approximately \$1.1 million and \$268,100, respectively, in judgment and interest to the plaintiff.
- In December 2003, in *Frankson v. Brown & Williamson*, a New York jury awarded the plaintiff \$350,000 in compensatory damages and \$20 million in punitive damages. On June 22, 2004, the trial judge granted a new trial unless the parties agree to an increase in compensatory damages to \$500,000 and a decrease in punitive damages to \$5 million. On January 21, 2005, the plaintiff stipulated to the court's reduction in the amount of punitive damages. The defendants' appeal was denied by the appellate division in July 2006. On August 4, 2006, the defendants filed a motion for rehearing, or, in the alternative, for leave to appeal to the New York Court of Appeals. That motion was denied on October 5, 2006. The defendants' motion to stay entry and enforcement of the final judgment pending further appeal was granted in January 2007 and the defendants also appealed the judgment that same month. Judgment was entered against the defendants on March 7, 2007 and they have filed a notice of appeal. The appeals will be consolidated.
- In April 2004, a Florida jury returned a verdict in favor of the plaintiff in *Davis v. Liggett Group, Inc.*, awarding a total of \$540,000 in actual damages. In addition, the jury awarded legal fees of \$752,000. The jury did not award punitive damages. Liggett has appealed.
- In October 2004, in *Arnitz v. Philip Morris, Inc.*, a Florida jury returned a verdict in favor of the plaintiff, who claims that as a result of his smoking he developed lung cancer and emphysema.

The jury awarded a total of \$240,000 in compensatory damages. Philip Morris, the sole defendant in the case, appealed to the Florida Second District Court of Appeals. In July 2006, the appellate court affirmed the judgment of the trial court. In September 2006, the appellate court denied Philip Morris's motion for rehearing. Philip Morris subsequently filed a motion to stay the issuance of the mandate with the appellate court. On October 6, 2006, the appellate court denied this motion, and the mandate was issued. On October 16, 2006, Philip Morris paid \$1,094,352 in judgment, interest, and attorneys' fees. On October 19, 2006, Philip Morris filed a petition for discretionary review with the Florida Supreme Court. The petition was denied on December 20, 2006.

- In February 2005, in *Smith v. Brown & Williamson*, a Missouri state court jury returned a split verdict, finding in favor of the defendant on counts of fraudulent concealment and conspiracy and in favor of the plaintiffs on a negligence count. The jury awarded the plaintiffs \$500,000 in compensatory damages and \$20 million in punitive damages. On March 10, 2005, the defendant filed a motion for judgment notwithstanding the verdict or, in the alternative, for a new trial. On May 23, 2005, the trial court denied defendant's motion, and on June 1, 2005, the defendant appealed. Oral argument occurred on October 5, 2006. On July 31, 2007 a majority of the judges of the Missouri Appeals Court for the Western District issued a decision affirming the jury's finding of negligence and its award of compensatory damages, but reversing the \$20 million punitive damages award based on its determination that plaintiffs had not shown by clear and convincing evidence that B&W had engaged in intentional wrongdoing with respect to that portion of its negligence claim based on theories of negligent failure to warn and negligent product design. However, the majority of the Court also found that plaintiffs had submitted sufficient evidence of B&W's intentional wrongdoing with respect to their strict liability product defect theory, and the majority indicated its intent to remand the case for a new trial on punitive damages on the strict liability product defect claim only. Because one of the justices of the Appeals Court dissented from several of the rulings of the majority opinion, the case has been transferred in accordance with the Missouri Constitution to the Missouri Supreme Court where it remains pending. Oral argument was heard on February 13, 2008.
- In March 2005, in *Rose v. Philip Morris*, a New York jury awarded \$3.42 million in compensatory damages against B&W and Philip Morris. On August 18, 2005, B&W filed a notice of appeal. Pursuant to its agreement to indemnify B&W, on February 7, 2006, Reynolds Tobacco posted a supersedeas bond in the approximate amount of \$2.058 million. The jury also returned a punitive damages award totaling \$17.1 million against Philip Morris. In December 2005, Philip Morris's post-trial motions challenging the verdict were denied by the trial court. Philip Morris has appealed. Oral argument occurred on December 12, 2006, and a decision is pending.
- Also in March 2005, the Ninth Circuit Court of Appeals referred the case *Grisham v. Philip Morris* to the California Supreme Court to determine the statute of limitations in tobacco cases, noting an inconsistency in federal and California state law. The plaintiff, who was diagnosed with severe periodontal disease caused by toxins in cigarette smoke, alleged that Philip Morris and Brown & Williamson deceived her for four decades about the safety of their products. The case had reached the Ninth Circuit after a Los Angeles federal court dismissed the case as being time-barred. On December 6, 2006, the California Supreme Court heard arguments regarding whether long-term smokers who relied on manufacturers' false safety claims are required to file suit when health problems emerge or much earlier, when smokers realize they are addicted. On February 15, 2007, the California Supreme Court ruled that such smokers need not have filed suit when they realized they were addicted, thus permitting the Grisham lawsuit to proceed in federal court in California.

In August 2002, the California Supreme Court issued a decision limiting evidence of wrongdoing between 1988 and 1998 by tobacco companies. One OPM has reported that this decision worked to the advantage of the tobacco industry defendants in the Whiteley case, and it believes that it will have a favorable impact for tobacco industry defendants in other California cases, both at the trial court level and on appeal.

*Healthcare Cost Recovery Lawsuits.* In certain pending proceedings, domestic and foreign governmental entities and non-governmental plaintiffs, including Native American tribes, insurers and self-insurers such as Blue Cross and Blue Shield plans, hospitals and others, are seeking reimbursement of healthcare cost expenditures allegedly caused by tobacco products and, in some cases, of future expenditures and damages as well. Relief sought by some but not all plaintiffs includes punitive damages, multiple damages and other statutory damages and penalties, injunctions prohibiting alleged marketing and sales to minors, disclosure of research, disgorgement of profits, funding of anti-smoking programs, additional disclosure of nicotine yields, and payment of attorney and expert witness fees. The PMs are exposed to liability in these cases, because the MSA only settled healthcare cost recovery claims belonging to the Settling States. Altria has reported that as of February 15, 2008, there were two healthcare cost recovery actions pending against Philip Morris in the U.S. For example, on August 4, 2005, a national senior citizens' organization filed a lawsuit (*United Senior Association, Inc. v. Philip Morris Inc., et al.*) in Boston against cigarette manufacturers under the federal "Medicare as Secondary Payer" statute, which permits Medicare beneficiaries or others to bring actions on behalf of Medicare to recover healthcare costs paid by Medicare for which another party may be liable. The plaintiffs are reportedly seeking to recover more than \$60 billion in alleged Medicare spending on treatment of smoking related illnesses since August 4, 1999. On October 24, 2005, the defendants filed a motion to dismiss, or, in the alternative, to transfer the case to the U.S. District Court for the Middle District of Florida, where a similar lawsuit involving Medicare payments in Florida was dismissed on July 26, 2005. The Boston lawsuit reportedly does not seek to recover Medicare payments in Florida. On August 28, 2006, the defendants' motion to dismiss was granted. On September 7, 2006, the plaintiffs filed a notice of appeal with the U.S. Court of Appeals for the First Circuit. On August 20, 2007, the First Circuit issued an opinion affirming the District Court's dismissal of the action. In November, 2007, plaintiffs filed a petition for writ of certiorari with the U.S. Supreme Court, which was denied on January 22, 2008.

The claims asserted in the healthcare cost recovery actions include the equitable claim that the tobacco industry was "unjustly enriched" by plaintiffs' payment of healthcare costs allegedly attributable to smoking, the equitable claim of indemnity, common law claims of negligence, strict liability, breach of express and implied warranty, violation of a voluntary undertaking or special duty, fraud, negligent misrepresentation, conspiracy, public nuisance, claims under federal and state statutes governing consumer fraud, antitrust, deceptive trade practices and false advertising, and claims under federal Racketeer Influenced and Corrupt Organizations Act ("RICO") and parallel state statutes.

Defenses raised include lack of proximate cause, remoteness of injury, failure to state a valid claim, lack of benefit, adequate remedy at law, "unclean hands" (namely, that plaintiffs cannot obtain equitable relief because they participated in, and benefited from, the sale of cigarettes), lack of antitrust standing and injury, federal preemption, lack of statutory authority to bring suit, and statutes of limitations. In addition, defendants argue that they should be entitled to "set off" any alleged damages to the extent the plaintiff benefits economically from the sale of cigarettes through the receipt of excise taxes or otherwise. Defendants also argue that these cases are improper because plaintiffs must proceed under principles of subrogation and assignment. Under traditional theories of recovery, a payor of medical costs (such as an insurer) can seek recovery of healthcare costs from a third party solely by "standing in the shoes" of the injured party. Defendants argue that plaintiffs should be required to bring any actions as subrogees of individual healthcare recipients and should be subject to all defenses available against the injured party.

Although there have been some decisions to the contrary, most courts that have decided motions in these cases have dismissed all or most of the claims against the industry. In addition, eight federal Courts of Appeals (the Second, Third, Fifth, Seventh, Eighth, Ninth, Eleventh, and District of Columbia Circuits), as well as California, Florida, New York, and Tennessee intermediate appellate courts, relying primarily on grounds that plaintiffs' claims were too remote, have affirmed dismissals of, or reversed trial courts that had refused to dismiss, healthcare cost recovery actions. The U.S. Supreme Court has refused to consider plaintiffs' appeals from the cases decided by the U.S. Courts of Appeals for the Second, Third, Fifth, Ninth, and District of Columbia Circuits.

A number of foreign governmental entities have filed suit in state and federal courts in the U.S. against tobacco industry defendants to recover funds for healthcare and medical and other assistance paid by those foreign governments to their citizens. Such suits have been brought in the U.S. by 13 countries, a Canadian province, 11 Brazilian states and 11 Brazilian cities. All of these suits have been dismissed. In addition to these cases brought in the U.S., healthcare cost recovery actions have also been brought in Israel, the Marshall Islands (where the suit was



dismissed), Canada, France (where the suit was dismissed), Spain and Nigeria. In September 2003, the case pending in France was dismissed and the plaintiff has appealed. Other governmental entities have stated that they are considering filing such actions. On September 29, 2005, the Supreme Court of Canada upheld legislation passed in 1998 by the province of British Columbia allowing the provincial government to seek damages from tobacco companies for healthcare costs incurred during the past 50 years, as well as for future illness-related expenses in connection with tobacco use. The legislation also lightens the required burden of proof and curtails certain traditional defenses in civil suits. Other provinces are reported to have already adopted or are expected to adopt similar legislation. See discussion of HCCR Act, below.

In September 1999, the U.S. government filed a lawsuit (*USA v. Philip Morris USA*) in the U.S. District Court for the District of Columbia against the OPMs, certain related parent companies and two tobacco industry research and lobbying organizations, seeking medical cost recovery for federal funds spent to treat alleged tobacco-related illnesses and asserting violation of RICO. In September 2000, the trial court dismissed the government's medical cost recovery claims, but permitted discovery to proceed on the government's claims for relief under RICO. The government alleged that disgorgement by defendants of approximately \$280 billion is an appropriate remedy. In May 2004, the court issued an order denying defendants' motion for partial summary judgment limiting the disgorgement remedy. In June 2004, the trial court certified that order for immediate appeal, and in July 2004, the U.S. Court of Appeals for the District of Columbia agreed to hear the appeal on an expedited basis. On February 4, 2005, the appeals court, in a 2-1 decision, ruled that disgorgement is not an available remedy in this case. This ruling eliminated the government's claim for \$280 billion and limits the government's potential remedies principally to forward-looking relief, including funding for anti-smoking programs. The government appealed this ruling to seek a rehearing en banc. On April 20, 2005, the appeals court denied the government's appeal. On July 18, 2005, the government appealed the ruling with regard to the \$280 billion disgorgement decision to the U.S. Supreme Court. On October 17, 2005 the U.S. Supreme Court, without comment, denied the appeal.

In addition to the claim for disgorgement, the government sought relief consisting of, among other things: (1) prohibitory injunctions (including prohibitions on committing acts of racketeering, making false or misleading statements about cigarettes, and on youth marketing); (2) disclosure of documents concerning the health risks and addictive nature of smoking, the ability to develop less hazardous cigarettes and youth marketing campaigns; (3) mandatory corrective statements about the health risks of smoking and the addictive properties of nicotine in future marketing campaigns; and (4) funding of remedial programs (including research, public education campaigns, medical monitoring programs, and smoking cessation programs). The trial phase of the case concluded on June 9, 2005. In its closing argument and submissions, the government requested that the tobacco industry be required to fund an up to ten-year, \$14 billion smoking cessation program. The government has reportedly also asked the court to appoint a lawyer as monitor with power to order the defendants to sell off their research and development facilities related to developing so-called safer cigarettes. The monitor would also have power to review the business policies of the defendants. The government has also reportedly requested that restrictions be placed on the defendants' ability to sell their cigarette businesses and that the defendants be compelled to run public advertisements regarding the dangers of smoking. The defendants filed a motion to dismiss the government's request for the \$14 billion award, arguing that the award was barred by the February 4, 2005 appellate decision. On July 22, 2005, the District Court judge granted the motion made under Federal Rule of Civil Procedure 24 by six public interest groups to intervene in this action for the very limited purpose of being heard on the issue of permissible and appropriate remedies in this case, should the government prevail on its claims with respect to smoking cessation programs. On August 15, 2005, the parties filed their proposed findings of fact. Post-trial briefing was completed on October 9, 2005. In August 2006, the District Court entered judgment in favor of the government, finding the defendants liable for the RICO claims, but imposing no direct financial penalties on the defendants, instead ordering the defendants to make certain "corrective communications" in a variety of media and enjoining the defendants from using certain brand descriptors. Both parties appealed — the defendants filed on September 11, 2006, and the government filed on October 16, 2006. In March 2007, the trial court denied defendants' post-trial motion for clarification of those portions of the court's remedial order prohibiting defendants from making certain statements to consumers about their products both within and outside the United States, but granted defendants' post-trial motion for clarification that the court's remedial order requiring corrective statements on display at retail points of sale do not apply outside the United States. The defendants have filed amended notices of appeal. The District Court's stay of the proceedings remains in effect pending appeal to the Court of Appeals. Briefing of the parties' consolidated appeal is scheduled to conclude in May 2008.

In January of 2001, the Canadian Province of British Columbia enacted the Damages and Healthcare Costs Recovery Act (the “HCCR Act”). The HCCR Act authorizes an action by the government of British Columbia against a manufacturer of tobacco products for the recovery by the government of the present value of past and reasonably expected future healthcare expenditures incurred by the government in treating British Columbians with diseases caused by exposure to tobacco products, where such exposure was caused by a manufacturer’s tort in British Columbia or a breach of a duty owed to persons in British Columbia. The HCCR Act allows the government to bring such action for expenditures related to a particular individual or on an aggregate basis for a population of persons. In an action brought on an aggregate basis, the Act does not require the government identify a particular person or to prove particular injury, healthcare costs or causation of harm with respect to any particular person. Where the government proves in an aggregate claim with respect of a type of tobacco product that a manufacturer breached a legal duty owed to persons who have been or might become exposed to the tobacco product and that exposure to the tobacco product can cause or contribute to a disease, the court is required to presume that: (1) the population of persons who were exposed to the tobacco product would not have been exposed to the product but for the breach of duty; and (2) such exposure caused or contributed to disease or risk of disease in such population of persons. In such cases, the court is required to determine on an aggregate basis the cost of healthcare benefits provided after the date of the breach of duty and to assess liability among defendants based on the proportion of the aggregate cost equal to each defendant’s market share in the type of tobacco product. Statistical information and information derived from epidemiological and other relevant studies is admissible as evidence under the HCCR Act to establish causation and for quantifying damages in an action brought by the government under the HCCR Act or in an action brought by a class of persons under Canada’s class action statute.

Subsequently to the enactment of the HCCR Act, the government of British Columbia brought an action under the HCCR Act against certain foreign and domestic tobacco manufacturers, including Philip Morris International, a subsidiary of Altria. The defendants challenged the constitutionality of the HCCR Act, and in a decision dated June 5, 2003, British Columbia’s trial level court held that the HCCR Act was unconstitutional as exceeding the territorial jurisdiction of the Province. On appeal, British Columbia’s highest court reversed the lower court in a decision dated May 20, 2004, holding that the HCCR Act was constitutional. The matter was appealed to the Canadian Supreme Court, Canada’s highest court. By a unanimous decision dated September 29, 2005 the Canadian Supreme Court affirmed the lower court, holding that the HCCR Act was constitutional. In the decision, the court also vacated the stay of proceedings and the action was allowed to continue. On September 15, 2006, the British Columbia Court of Appeal unanimously ruled that the foreign defendants served ex juris are subject to British Columbia law, allowing the government to proceed with its lawsuit against them. On November 10, 2006, the ex juris defendants applied for leave to appeal the judgment to the Supreme Court of Canada. On April 5, 2007, the Supreme Court of Canada dismissed the defendants’ application. While the judgment only applies to British Columbia, it is expected that other provincial governments may follow suit. It has been reported that Newfoundland has enacted, and Saskatchewan and Nova Scotia are considering enacting, legislation similar to the HCCR Act.

*Other Tobacco-Related Litigation.* The tobacco industry is also the target of other litigation. By way of example only, and not as an exclusive or complete list, the following are additional tobacco-related litigation:

- *Asbestos Contribution Cases.* These cases, which have been brought against cigarette manufacturers on behalf of former asbestos manufacturers, their personal injury settlement trusts and insurers, seek, among other things, contribution or reimbursement for amounts expended in connection with the defense and payment of asbestos claims that were allegedly caused in whole or in part by cigarette smoking. Two of the cases were dismissed.
- *Cigarette Price-Fixing Cases.* According to one OPM, as of February 15, 2008, there were two cases pending against domestic cigarette manufacturers in Kansas (*Smith v. Philip Morris*) and New Mexico (*Romero v. Philip Morris*), alleging that defendants conspired to fix cigarette prices in violation of antitrust laws. The plaintiffs’ motions for class certification have been granted in both cases. In February 2005, the New Mexico Court of Appeals affirmed the class certification decision in the *Romero* case. On April 19, 2005, the defendants filed motions for summary judgment. In June 2006, the court granted defendant’s motion, and the plaintiffs appealed on August 14, 2006. In the *Smith* case, on July 14, 2006, the court issued an order confirming that fact discovery is closed, except for such privilege issues that the court determines, based on a Special Master’s report, justify further limited fact discovery. Expert discovery, as necessary, will begin in early 2007.

- Cigarette Contraband Cases.* In May 2001 and August 2001, various governmental entities of Colombia, the European Community and ten member states filed suits in the U.S. against certain PMs, alleging that defendants sold to distributors cigarettes that would be illegally imported into various jurisdictions. The claims asserted in these cases include negligence, negligent misrepresentation, fraud, unjust enrichment, violations of RICO and its state-law equivalents and conspiracy. Plaintiffs in these cases seek actual damages, treble damages and undisclosed injunctive relief. In February 2002, the trial court granted defendants' motions to dismiss all of the actions. Plaintiffs in each case have appealed. In January 2004, the U.S. Court of Appeals for the Second Circuit affirmed the dismissals of the cases. In April 2004, plaintiffs petitioned the U.S. Supreme Court for further review. The European Community and the 10 member states moved to dismiss their petition in July 2004 following an agreement entered into among Philip Morris, the European Commission and 10 member states of the European Community. The terms of this cooperation agreement provide for broad cooperation with European law enforcement agencies on anti-contraband and anti-counterfeit efforts and resolve all disputes between the parties on these issues. In May 2005, the U.S. Supreme Court granted the petitions for review, vacated the judgment of the Second Circuit Court of Appeals and remanded the case to that court for further review in light of the Supreme Court's recent decision in *U.S. v. Pasquantino*. On September 13, 2005, the Second Circuit Court of Appeals found that *Pasquantino* was inapplicable to the case and affirmed its earlier decision that the revenue rule bars foreign sovereigns' civil claims for recovery of lost tax revenue and law enforcement costs related to cigarette smuggling. In January 2006, the U.S. Supreme Court rejected the European Union's petition for review.
- Patent Litigation.* In 2001 and 2002, Star Scientific, Inc. ("**Star**") filed two patent infringement actions against Reynolds Tobacco in the U.S. District Court for the District of Maryland. Such actions have been consolidated. Reynolds Tobacco filed various motions for summary judgment, which were all denied. Reynolds Tobacco has also filed counterclaims seeking a declaration that the claims of the two Star patents in dispute are invalid, unenforceable and not infringed by Reynolds Tobacco. Between January 31, 2005 and February 8, 2005, the District Court held a first bench trial on Reynolds Tobacco's affirmative defense and counterclaim based upon inequitable conduct. The District Court has not yet issued a ruling on this issue. Additionally, in response to the court's invitation, Reynolds Tobacco filed two summary judgment motions on January 20, 2005. The District Court has indicated that it will rule on Reynolds Tobacco's two pending summary judgment motions and the issue of inequitable conduct at the same time. On June 26, 2007, the court ruled that Star's patents are unenforceable. The court also entered final judgment in favor of Reynolds Tobacco, dismissing all of Star's claims with prejudice. On June 27, 2007, Star filed a notice of appeal with the U.S. Court of Appeals for the Federal Circuit. Oral argument is scheduled for March 7, 2008.
- Vermont Litigation.* On July 22, 2005, Vermont announced that it had sued Reynolds Tobacco in the Vermont Superior Court for using false and misleading advertising to promote its "Eclipse" brand of cigarettes. The lawsuit charges that Reynolds Tobacco's advertising, which claims that smoking Eclipse cigarettes is less harmful than smoking other brands of cigarettes, violated Vermont's consumer protection statutes. The State of Vermont is seeking declaratory, injunctive, and monetary relief. Reynolds Tobacco has answered the complaint. Discovery is underway. No trial date has been set. According to the Vermont Attorney General, the offices of Attorneys General across the country, including California, Connecticut, the District of Columbia, Idaho, Illinois, Iowa, Maine, New York, and Tennessee, have actively participated in the investigation leading up to this lawsuit and will continue to assist Vermont in it.
- Foreign Lawsuits.* Lawsuits have been filed in foreign jurisdictions against certain OPMs and/or their subsidiaries and affiliates, including individual smoking and health actions, class actions and healthcare cost recovery suits.

The foregoing discussion of civil litigation against the tobacco industry is not exhaustive and is not based upon the Issuer's examination or analysis of the court records of the cases mentioned or of any other court records. It is based on SEC filings by OPMs and on other publicly available information published by the OPMs or others. Prospective purchasers of the Series 2008 Bonds are referred to the reports filed with the SEC by certain of the OPMs and applicable court records for additional descriptions thereof.

Litigation is subject to many uncertainties. In its SEC filing, one OPM states that it is not possible to predict the outcome of litigation pending against it, and that it is unable to make a meaningful estimate of the amount or range of loss that could result from an unfavorable outcome of pending litigation, and that it is possible that its business, volume, results of operations, cash flows, or financial position could be materially affected by an unfavorable outcome or settlement of certain pending litigation or by the enactment of federal or state tobacco legislation. It can be expected that at any time and from time to time there will be developments in the litigation presently pending and filing of new litigation that could adversely affect the business of the PMs and the market for or prices of securities such as the Series 2008 Bonds payable from tobacco settlement payments made under the MSA.

**APPENDIX G**

**DEFINITIONS AND SUMMARIES OF THE TRANSACTION DOCUMENTS**

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## APPENDIX G

### DEFINITIONS AND SUMMARIES OF THE TRANSACTION DOCUMENTS

#### DEFINITIONS

*In addition to terms defined elsewhere herein, the following terms have the following meanings in this summary, unless the context otherwise requires:*

“**Accounts**” means the Pledged Revenues Account, the Operating Account, the Debt Service Account, the Debt Service Reserve Account, the Supplemental Account, the Costs of Issuance Account, the Rebate Account and any accounts established by Series Supplement, all of which shall be established and held by the Trustee.

“**Ancillary Bond Facility**” means the Contract and any Interest Rate Exchange or Similar Agreement or any bond insurance policy, letter of credit or other credit enhancement facility, liquidity facility, guaranteed investment or reinvestment agreement, or other similar agreement, arrangement or contract pledged as Collateral under the Indenture.

“**Ancillary Contracts**” means the “ancillary bond facilities”, as defined in the Act, constituting contracts entered into by the Corporation pursuant to the provisions of the related Series Supplement or other Supplemental Indenture, for its benefit or the benefit of any of the Beneficiaries, to facilitate the issuance, sale, resale, purchase, repurchase or payment of Bonds, including any bond insurance, letters of credit and liquidity facilities, investment agreements and forward delivery agreements with respect to Eligible Investments, but excluding Swap Contracts.

“**Authorized Officer**” means: (i) in the case of the Corporation, the Chairman, Vice Chairman, Executive Director, any Senior Vice President, their successors in office, and any other person authorized to act under the Indenture by appropriate Written Notice to the Trustee, and (ii) in the case of the Trustee, any officer assigned to the Corporate Trust Office, including any managing director, director, vice president, assistant vice president, associate, assistant secretary, authorized signer or any other officer of the Trustee customarily performing functions similar to those performed by any of the above designated officers and having direct responsibility for the administration of the Indenture, and also, with respect to a particular matter, any other officer, to whom such matter is referred because of such officer’s knowledge of and familiarity with the particular subject.

[**With respect to the Series A Indenture**] “**Beneficiaries**” means Bondholders, the owner of the Residual Certificate and, to the extent specified in the related Series Supplement or other Supplemental Indenture, the party or parties to Swap Contracts, Ancillary Contracts and Subordinate Indebtedness.

[**With respect to the Series B Indenture**] “**Beneficiaries**” means Bondholders, the owner of the Residual Certificate and, to the extent specified in the related Series Supplement or other Supplemental Indenture, the party or parties to Swap Contracts and Ancillary Contracts.

[**With respect to the Series A Indenture**] “**Bond Purchase Agreement**” means collectively the Bond Purchase Agreements by and between the Corporation and the underwriters of the applicable series of the Series A Bonds, relating to the sale of the Series A Bonds, in such form as the parties thereto shall agree.

[**With respect to the Series B Indenture**] “**Bond Purchase Agreement**” means collectively the Bond Purchase Agreements by and between the Corporation and the underwriters of the applicable series of the Series B Bonds, relating to the sale of the Series B Bonds, in such form as the parties thereto shall agree.

“**Bondholders**” or “**Holders**” or similar terms mean the registered owners of the Bonds registered as to principal and interest or as to principal only, as shown on the books of the Trustee.

“**Bonds**” means the applicable obligations issued as summarized in the caption herein entitled “THE INDENTURE – Bonds of the Corporation.”

**“Broker-Dealer Fees”** means the fees paid to the broker-dealers for the Auction Rate Bonds, as set forth in the related Series Supplement.

**“Business Day”** means any day other than (i) a Saturday or a Sunday or (ii) a day on which banking institutions in New York, New York, are required or authorized by law to be closed.

**“Code”** or **“Tax Code”** means the Internal Revenue Code of 1986, as amended.

**“Collateral”** has the meaning as set forth herein under the caption “THE INDENTURE – Security and Pledge.”

**“Complementary Legislation”** means sections 480-b, 481(1)(c) and 1846(a-1) of the Tax Law of the State.

**[With respect to the Series A Indenture] “Contingency Contract”** means (i) with respect to the Series A Bonds, that certain Tobacco Settlement Financing Corporation Contingency Contract, dated as of June 1, 2003, by and between the Corporation and the State, as the same may be amended or supplemented in accordance with its terms, and (ii) with respect to any Series of Refunding Bonds, any Contingency Contract, identified as such in a Series Supplement or other Supplemental Indenture, between the Corporation and the State, pursuant to which the State agrees to pay to the Corporation, under certain circumstances and subject to appropriation by the State Legislature, such amounts as are necessary to meet the debt service requirements on such Refunding Bonds in any year.

**[With respect to the Series B Indenture] “Contingency Contract”** means: (i) with respect to the Series B Bonds, that certain Tobacco Settlement Financing Corporation Contingency Contract, dated as of December 1, 2003, by and between the Corporation and the State, as the same may be amended or supplemented in accordance with its terms, and (ii) with respect to any Series of Refunding Bonds, any Contingency Contract, identified as such in a Series Supplement or other Supplemental Indenture, between the Corporation and the State, pursuant to which the State agrees to pay to the Corporation, under certain circumstances and subject to appropriation by the State Legislature, such amounts as are necessary to meet the debt service requirements on such Refunding Bonds in any year.

**“Costs of Issuance”** means those “costs of issuance”, as defined in the Act, related to the authorization, sale or issuance of Bonds, including but not limited to all fees, costs, expenses and governmental charges for underwriting and transaction structuring, auditors or accountants, printing, reproducing documents, filing and recording of documents, fiduciaries, legal services, financial advisory and professional consultants’ services, credit ratings, credit and liquidity enhancements, execution, and transportation and safekeeping of Bonds; and also includes costs incurred by the State to the extent the same are to be paid by the Corporation in accordance with the Sale Agreement.

**“Debt Service”** means interest, redemption premium, principal and Sinking Fund Installments due on Outstanding Bonds.

**“Default”** means an Event of Default without regard to any declaration, notice or lapse of time.

**“Defeasance Collateral”** means money and, to the extent lawful for investment of funds of the Corporation, any of the following:

(a) non-callable direct obligations of the United States of America, non-callable and non-prepayable direct federal agency obligations the timely payment of principal of and interest on which are fully and unconditionally guaranteed by the United States of America, (which do not include obligations of FNMA or the FHLMC), non-callable direct obligations of the United States of America which have been stripped by the United States Treasury itself or by any Federal Reserve Bank (not including “CATS, TIGRS” and “TRS”) and the interest components of REFCORP bonds for which the underlying bond is non-callable (or non-callable before the due date of such interest component) for which



separation of principal and interest is made by request to the Federal Reserve Bank of New York in book-entry form, and shall exclude investments in mutual funds and unit investment trusts;

(b) non-callable obligations timely maturing and bearing interest (but only to the extent that the full faith and credit of the United States of America are pledged to the timely payment thereof);

(c) certificates rated in one of the two highest long-term rating categories by S&P, Moody's and Fitch (if rated by Fitch) evidencing ownership of the right to the payment of the principal of and interest on obligations described in clause (ii), provided that such obligations are held in the custody of a bank or trust company satisfactory to the Trustee in a segregated trust account in the trust department separate from the general assets of such custodian;

(d) bonds or other obligations of any state of the United States of America or of any agency, instrumentality or local governmental unit of any such state (x) which are not callable at the option of the obligor or otherwise prior to maturity or as to which irrevocable notice has been given by the obligor to call such bonds or obligations on the date specified in the notice, (y) timely payment of which is fully secured by a fund consisting only of cash or obligations of the character described in clause (i), (ii) or (iii) which fund may be applied only to the payment when due of such bonds or other obligations and (z) rated "AAA" by S&P and in one of the two highest long-term rating categories by Moody's and Fitch (if rated by Fitch); and

(e) investment arrangements rated in the highest long-term and short-term rating categories by each Rating Agency.

**"Defeased Bonds"** means Bonds that remain in the hands of their Holders, but are deemed no longer Outstanding as specified under the Indenture.

**"Distribution Date"** means (1) each June 1 and December 1 commencing December 1, 2003, or if such date is not a Business Day, the following Business Day, (2) each additional Distribution Date selected by the Corporation or the Trustee following an Event of Default, and (3) each Distribution Date, to the extent so characterized in a Supplemental Indenture.

**"Eligible Investments"** means, as set forth in the Act, (a) general obligations of, or obligations guaranteed by, any state of the United States of America or political subdivision thereof, or the District of Columbia or any agency or instrumentality of any of them, receiving one of the three highest long-term unsecured debt rating categories available for such securities of at least one independent rating agency, (b) certificates of deposit, savings accounts, time deposits or other obligations or accounts of banks or trust companies in the State, secured, if the Corporation shall so require, in such manner as the Corporation may so determine, and (c) obligations in which the State Comptroller is authorized to invest, pursuant to either Section 98 or 98-a of the State Finance Law, and (d) any of the following:

(i) Defeasance Collateral;

(ii) direct obligations of, or obligations guaranteed as to timely payment of principal and interest by, FHLMC, FNMA, the Federal Farm Credit System or the Federal Home Loan Bank (FHNLB) system;

(iii) demand and time deposits in or certificates of deposit of, or bankers' acceptances issued by, any bank or trust company, savings and loan association or savings bank, payable on demand or on a specified date no more than three months after the date of issuance thereof, if such deposits or instruments are rated at least "F-1" by Fitch (if rated by Fitch), "A-1" by S&P and "P-1" by Moody's;

(iv) general obligations of, or obligations guaranteed by, any state of the United States, territory or possession thereof, the District of Columbia or any political subdivision of any of the foregoing

rated at least “Aa1” by Moody’s and receiving one of the two highest long-term unsecured debt ratings available for such securities by S&P and Fitch (if rated by Fitch);

(v) commercial or finance company paper (including both non-interest-bearing discount obligations and interest bearing obligations payable on demand or on a specified date not more than 190 days after the date of issuance thereof) that is rated at least “F-1” by Fitch (if rated by Fitch), “A-1” by S&P and “P-1” by Moody’s (and, if longer than 100 days but no longer than 190 days, rated at least “A”, “A” and “A1”, respectively);

(vi) repurchase obligations with respect to any security described in clause (i), (ii), (iv) or (v) above entered into with a primary dealer, depository institution or trust company (acting as principal) rated at least “F-1” by Fitch (if rated by Fitch), “A-1” by S&P and “P-1” by Moody’s (if payable on demand or on a specified date no more than three months after the date of issuance thereof) or rated at least “A3” by Moody’s and in one of the three highest long-term rating categories by S&P and Fitch (if rated by Fitch) or collateralized by securities described in clause (i), (ii), (iv) or (v) above with any registered broker/dealer or with any domestic commercial bank whose long-term debt obligations are rated “investment grade” by each Rating Agency, provided that (1) a specific written agreement governs the transaction, (2) the securities are held, free and clear of any lien, by the Trustee or an independent third party acting solely as agent for the Trustee, and such third party is (a) a Federal Reserve Bank, or (b) a member of the Federal Deposit Insurance Corporation that has combined surplus and undivided profits of not less than \$25 million, and the Trustee shall have received written confirmation from such third party that it holds such securities, free and clear of any lien, as agent for the Trustee, (3) the agreement has a term of thirty days or less, or the Trustee will value the collateral securities no less frequently than monthly and will liquidate the collateral securities if any deficiency in the required collateral percentage is not restored with five Business Days of such valuation, and (4) the fair market value of the collateral securities in relation to the amount of the obligation, including principal and interest, is equal to at least 102%;

(vii) securities bearing interest or sold at a discount (payable on demand or on a specified date not more than 190 days after the date of issuance thereof) that are issued by any single corporation incorporated under the laws of the United States of America or any state thereof and rated at least “F-1” by Fitch (if rated by Fitch), “P-1” by Moody’s and “A-1” by S&P at the time of such investment or contractual commitment providing for such investment; provided, that securities issued by any such corporation will not be Eligible Investments to the extent that investment therein would cause the then outstanding principal amount of securities issued by such corporation that are then held to exceed 20% of the aggregate principal amount of all Eligible Investments then held;

(viii) units of taxable money market funds which funds are regulated investment companies and seek to maintain a constant net asset value per share and have been rated at least “Aa1” by Moody’s, in one of the two highest categories by Fitch (if rated by Fitch) and at least “Aam” or “AAM-G” by S&P, including if so rated any such fund which the Trustee or an affiliate of the Trustee serves as an investment advisor, administrator, shareholder, servicing agent and/or custodian or sub-custodian, notwithstanding that (a) the Trustee or an affiliate of the Trustee charges and collects fees and expenses (not exceeding current income) from such funds for services rendered, (b) the Trustee charges and collects fees and expenses for services rendered pursuant to the Indenture, and (c) services performed for such funds and pursuant to the Indenture may converge at any time (the Corporation specifically authorizes the Trustee or an affiliate of the Trustee to charge and collect all fees and expenses from such funds for services rendered to such funds, in addition to any fees and expenses the Trustee may charge and collect for services rendered pursuant to the Indenture);

(ix) investment agreements or guaranteed investment contracts rated, or with any financial institution or corporation whose senior long-term debt obligations are rated, or guaranteed by a financial institution or corporation whose senior long-term debt obligations are rated, at the time such agreement or contract is entered into, at least “F-1” by Fitch (if rated by Fitch), “A3/P1” by Moody’s and in one of the three highest long-term rating categories by S&P if the Corporation has an option to terminate such agreement in the event that any such rating is either withdrawn or downgraded below the rating on the Bonds, or if not so rated, then collateralized by securities described in clause (i), (ii), (iv) or (v) above with

any registered broker/dealer or with any domestic commercial bank whose long-term debt obligations are rated “investment grade” by each Rating Agency, provided that (1) a specific written agreement governs the transaction, (2) the securities are held, free and clear of any lien, by the Trustee or an independent third party acting solely as agent for the Trustee, and such third party is (a) a Federal Reserve Bank, or (b) a member of the Federal Deposit Insurance Corporation that has combined surplus and undivided profits of not less than \$25 million, and the Trustee shall have received written confirmation from such third party that it holds such securities, free and clear of any lien, as agent for the Trustee, (3) the agreement has a term of thirty days or less, or the Trustee will value the collateral securities no less frequently than monthly and will liquidate the collateral securities if any deficiency in the required collateral percentage is not restored with seven Business Days of such valuation, and (4) the fair market value of the collateral securities in relation to the amount of the obligation, including principal and interest, is equal to at least 102%;

(x) with respect to any Series of Bonds, the investment contracts constituting Ancillary Contracts, as set forth in the related Series Supplement or other Supplemental Indenture; and

(xi) solely for investment of money in the Supplemental Account, Non-AMT Tax Exempt Obligations; provided, however, that no Eligible Investment may (a) except for Defeasance Collateral, evidence the right to receive only interest with respect to the obligations underlying such instrument or (b) be purchased at a price greater than par if such instrument may be prepaid or called at a price less than its purchase price prior to its stated maturity.

“**Fiduciary**” means the Trustee, any representative of the Holders of Bonds appointed by Series Supplement, and each Paying Agent, if any.

“**Financing Costs**” means (1) Costs of Issuance, (2) capitalized interest, (3) the capitalization of initial operating expenses of the Corporation, (4) the funding of the debt service reserves, (5) fees and costs for Ancillary Bond Facilities, and (6) any other fees, discounts, expenses and costs of any kind whatsoever related to issuing, securing and marketing the Bonds, including, without limitation, bond insurance premiums, and any net original issue discount.

“**Fiscal Year**” means the twelve (12) month period commencing November 1 of each year and ending on October 31 of the succeeding year.

“**Fitch**” means Fitch, Inc.; references to Fitch under the Indenture are effective so long as Fitch is a Rating Agency.

“**Funds**” means funds or accounts established under the Indenture and by Series Supplement.

“**Majority in Interest**” means as of any particular date of calculation the Holders of a majority of the Outstanding Bonds eligible to act on a matter, measured by Outstanding principal amount, payable at maturity, or, in the case of a Bond specifically designated in a Series Supplement as having Accreted Value, by the Accreted Value of such Outstanding Bonds as of such date.

“**Maximum Rate**” means (1) the highest rate payable on a Bond to Holders other than parties to Ancillary Contracts, as specified by Series Supplement or (2) the rate specified by Series Supplement as the Maximum Rate on a Swap.

“**Moody’s**” means Moody’s Investors Service; references to Moody’s under the Indenture are effective so long as Moody’s is a Rating Agency.

“**Non-AMT Tax-Exempt Obligations**” means a debt obligation the interest on which (i) is excludable from gross income for federal income tax purposes pursuant to Section 103 of the Tax Code and (ii) is not a preference item for purposes of computing alternative minimum tax by reason of Section 57(a)(5) of the Tax Code.

**[With respect to the Series A Indenture]** “**Operating Expenses**” means all operating and administrative expenses incurred by the Corporation, and all operating and administrative expenses incurred by the State of New York Municipal Bond Bank Agency and related (as set forth in a certificate of an Authorized Officer of the Corporation) to such Agency’s activities on behalf of or in assistance to the Corporation, including but not limited to, the cost of preparation of accounting and other reports, costs of maintenance of ratings on the Bonds, arbitrage rebate and penalties, salaries, administrative expenses, insurance premiums, auditing and legal expenses, fees and expenses incurred for the Trustee, any Paying Agents, professional consultants and fiduciaries, the fees of any Auction Agent or Broker-Dealer, costs of any Contract, costs incurred to preserve the tax-exempt status of any Tax-Exempt Bonds, costs related to the enforcement rights with respect to the Indenture, the MSA, the Sale Agreement, the Qualifying Statute, the Complementary Legislation or the Bonds and all other Operating Expenses so identified in the Series A Indenture.

**[With respect to the Series B Indenture]** “**Operating Expenses**” means: (i) all operating and administrative expenses incurred by the Corporation, and all operating and administrative expenses incurred by the State of New York Municipal Bond Bank Agency and related (as set forth in a certificate of an Authorized Officer of the Corporation) to such Agency’s activities on behalf of or in assistance to the Corporation, including but not limited to, the cost of preparation of accounting and other reports, costs of maintenance of ratings on the Bonds, arbitrage rebate and penalties, salaries, administrative expenses, insurance premiums, fees and charges of the State (including the State Fee), auditing and legal expenses, fees and expenses incurred for the Trustee, any Paying Agents, professional consultants and fiduciaries, the fees of any Auction Agent or Broker-Dealer, costs of any Contingency Contract, costs incurred to preserve the tax-exempt status of any Tax-Exempt Bonds, costs related to the enforcement rights with respect to the Series B Indenture, the MSA, the Sale Agreement, the Qualifying Statute, the Complementary Legislation or the Bonds and all other Operating Expenses so identified in the Series B Indenture.

“**Opinion of Counsel**” means one or more written opinions of counsel who may be an employee of or counsel to the Corporation or the State, which counsel shall be acceptable to the Trustee.

**[With respect to the Series A Indenture]** “**Outstanding**” means, with respect to bonds, all Bonds issued under the Series A Indenture, excluding: (i) Series A Bonds that have been exchanged or replaced, or delivered to the Trustee for credit against a principal payment; (ii) Series A Bonds that have been paid; (iii) Bonds that have become due and for the payment of which money has been duly provided; (iv) Bonds for which (A) there has been irrevocably set aside sufficient Defeasance Collateral timely maturing and bearing interest, to pay or redeem them and (B) any required notice of redemption shall have been duly given in accordance with the Indenture or irrevocable instructions to give notice shall have been given to the Trustee; (v) Bonds the payment of which shall have been provided for pursuant to the Indenture; and (vi) for purposes of any consent or other action to be taken by the Holders of a Majority in Interest or specified percentage of Bonds under the Indenture, Bonds held by or for the account of the Corporation, the State or any person controlling, controlled by or under common control with either of them. For the purposes of this definition, “control,” when used with respect to any specified person, means the power to direct the management and policies of such person, directly or indirectly, whether through the ownership of voting securities, by law or contract or otherwise, and the terms “controlling” and “controlled” have meanings correlative to the foregoing.

**[With respect to the Series B Indenture]** “**Outstanding**” means with respect to bonds, all Bonds issued under the Series B Indenture, excluding: (i) Bonds that have been exchanged or replaced, or delivered to the Trustee for credit against a principal payment; (ii) Bonds that have been paid or, as set forth in the applicable Series Supplement, purchased by the Corporation; (iii) Bonds that have become due and for the payment of which money has been duly provided; (iv) Bonds for which (A) there has been irrevocably set aside sufficient Defeasance Collateral timely maturing and bearing interest, to pay or redeem them and (B) any required notice of redemption shall have been duly given in accordance with the Series B Indenture or irrevocable instructions to give notice shall have been given to the Trustee; (v) Bonds the payment of which shall have been provided for pursuant to the Series B Indenture; and (vi) for purposes of any consent or other action to be taken by the Holders of a Majority in Interest or specified percentage of Bonds under the Series B Indenture, Bonds held by or for the account of the Corporation, the State or any person controlling, controlled by or under common control with either of them. For the purposes of this definition, “control,” when used with respect to any specified person, means the power to direct the management and policies of such person, directly or indirectly, whether through the ownership of voting securities,

by law or contract or otherwise, and the terms “controlling” and “controlled” have meanings correlative to the foregoing.

**[With respect to the Series A Indenture] “Permitted Indebtedness”** means (i) Bonds, (ii) borrowings to pay Operating Expenses as described in the Indenture, (iii) bonds or other obligations payable solely from Unsold Settlement Payments, (iv) Subordinate Indebtedness, and (v) specified assets of the Corporation not subject to the lien of the Indenture and the holders of which expressly have no recourse to any other assets of the Corporation pledged under the Indenture in the event of non-payment.

**[With respect to the Series B Indenture] “Permitted Indebtedness”** means: (i) Bonds, (ii) borrowings to pay Operating Expenses as described in the Series B Indenture, (iii) bonds or other obligations payable solely from Previously Purchased and Pledged Settlement Payments and Unsold Settlement Payments, (iv) indebtedness secured by specified assets of the Corporation not subject to the lien of the Series B Indenture and the holders of which expressly have no recourse to any other assets of the Corporation pledged hereunder in the event of non-payment.

**“Portion of the State’s Share”** means fifty percent (50%) of the State’s Share (other than the payment of funds to the State to resolve claims relating to amounts held as of the Closing Date in the Disputed Payments Account as defined in the Escrow Agreement under the MSA).

**“Presumed Auction Rate”** means with respect to any Auction Rate Bonds, the greatest of (a) the actual average rate of interest on the Auction Rate Bonds for the immediately preceding twelve months plus 250 basis points, (b) the actual average rate of interest on the Auction Rate Bonds for the immediately preceding six months plus 250 basis points or (c) the presumed Fixed Rate less the Broker-Dealer Fees.

**“Presumed Fixed Rate”** means with respect to any Auction Rate Bonds, as set forth in the Series Supplement, the hypothetical rate which it is presumed the Auction Rate Bonds would have borne had they been issued at a fixed rate of interest. The Presumed Fixed Rate is assumed to be an all-in rate which includes Broker-Dealer Fees.

**“Rating Agency”** means each nationally recognized statistical rating organization that has, at the request of the Corporation, a rating in effect for any of the Bonds.

**“Record Date”** means the last Business Day of the calendar month preceding a Distribution Date; provided that with regard to Auction Rate Bonds, “Record Date” shall have the meaning set forth in the related Series Supplement, or such other date as may be specified by the Indenture, a Series Supplement or Supplemental Indenture or an Officer’s Certificate; and the Corporation or the Trustee may in its discretion establish special record dates for the determination of the Holders of Bonds for various purposes thereof, including giving consent or direction to the Trustee.

**“Refunding Bonds”** means Bonds issued to renew or refund any Bonds, by exchange, purchase, redemption or payment.

**“Series Supplement”** means a Supplemental Indenture as identified above under the caption: “Bonds of the Corporation.”

**“Sinking Fund Installment”** means a scheduled amount set forth in the applicable Series Supplement for required amortization prior to maturity of a Term Bond.

**“S&P”** means Standard & Poor’s Ratings Services; references to S&P under the Indenture are effective so long as S&P is a Rating Agency.

**“State Lien”** means a security interest, lien, charge, pledge, equity or encumbrance of any kind, attaching to the interests of the State in and to the State’s Share, whether or not as a result of any act or omission by the State.

**“Subordinate Indebtedness”** means any indebtedness of the Corporation secured by a pledge of the Collateral which conforms to the requirements as summarized above under the caption “Subordinate Indebtedness.”

**“Supplemental Indenture”** means a Series Supplement or supplement adopted pursuant to the Indenture and becoming effective in accordance with the terms of the Indenture. Any provision that may be included in a Series Supplement or Supplemental Indenture is also eligible for inclusion in the other subject to the provisions of the Indenture.

**“Swap”** or **“Swap Contract”** means one of the “ancillary bond facilities”, as defined in the Act, constituting an interest rate exchange (in currency of the United States only), cap, collar, hedge or similar agreement entered into by the Corporation, meeting the requirements as summarized above under “Swap Contracts and Ancillary Contracts” and under which all payments required to be made by the Corporation constitute Junior Payments.

**“Transaction Documents”** means the Sale Agreement, the Contract, the Indenture and the Bond Purchase Agreement.

## **THE INDENTURES**

*The following summary describes certain terms of the Series A Indenture pursuant to which the Series 2008A Bonds will be issued and the Series B Indenture pursuant to which the Series 2008B Bonds will be issued. The terms of the Series A Indenture and the Series B Indenture are very alike. Where provisions summarized under this heading are different in each indenture, the alternate text has been set forth. References to “the Indenture” mean the Series A Indenture or the Series B Indenture, as applicable. The terms “Bond” or “Bonds” should be understood as bonds issued under the applicable Indenture. This summary does not purport to be complete and is subject to, and qualified in its entirety by reference to, the provisions of the Indenture and the Series 2008 Bonds. See “SECURITY AND SOURCES OF PAYMENT FOR THE SERIES 2008A BONDS” or “SECURITY AND SOURCES OF PAYMENT FOR THE SERIES 2008B BONDS” for further descriptions of certain terms and provisions of the Series A Bonds or Series B Bonds, as applicable.*

### **Directors and Officers Not Liable on Bonds**

Neither the members, directors or officers of the Corporation nor any person executing Bonds, Ancillary Contracts, Swap Contracts, or other obligations of the Corporation nor any official, employee or agent of the Corporation shall be liable personally thereon or be subject to any personal liability or accountability solely by reason of the issuance or execution and delivery thereof.

PURSUANT TO THE ACT, NEITHER ANY BOND NOR ANY ANCILLARY CONTRACT OF THE CORPORATION SHALL CONSTITUTE A DEBT OR MORAL OBLIGATION OF THE STATE OR A STATE SUPPORTED OBLIGATION WITHIN THE MEANING OF ANY CONSTITUTIONAL OR STATUTORY PROVISION OR A PLEDGE OF THE FAITH AND CREDIT OF THE STATE OR OF THE TAXING POWER OF THE STATE, AND THE STATE SHALL NOT BE LIABLE TO MAKE ANY PAYMENTS THEREON NOR SHALL ANY BOND OR ANY ANCILLARY CONTRACT BE PAYABLE OUT OF ANY FUNDS OR ASSETS OTHER THAN PLEDGED TOBACCO REVENUES AND OTHER ASSETS, IF ANY SOLD TO THE CORPORATION AND OTHER FUNDS AND ASSETS OF OR AVAILABLE TO THE CORPORATION PLEDGED THEREFOR, AND THE BONDS AND ANY ANCILLARY CONTRACT OF THE CORPORATION SHALL CONTAIN ON THE FACE THEREOF OR OTHER PROMINENT PLACE THEREON A STATEMENT TO THE FOREGOING EFFECT. (Section 1.03)

### **Separate Accounts and Records**

The parties to the Indenture represent and covenant, each for itself, that: (a) the Corporation and the Trustee each will maintain its respective books, financial records and accounts (including, without limitation, inter-entity transaction accounts) in a manner so as to identify separately the assets and liabilities of each such entity; each has observed and will observe all applicable corporate or trust procedures and formalities, including, where applicable, the holding of regular periodic and special meetings of governing bodies, the recording and

maintenance of minutes of such meetings and the recording and maintenance of resolutions, if any, adopted at such meetings; and all transactions and agreements between the Corporation and the Trustee have reflected and will reflect the separate legal existence of each entity and have been and will be formally documented in writing; and (b) the Corporation has paid and will pay its liabilities and losses from its separate assets. In furtherance of the foregoing, the Corporation has compensated and will compensate all consultants, independent contractors and agents from its own funds for services provided to it by such consultants, independent contractors and agents. (Section 1.04)

## **Security and Pledge**

Pursuant to the Indenture, the Corporation will assign and pledge to the Trustee and, pursuant to the Act, will grant a first lien on and a first priority security interest in, in trust upon the terms of the Indenture, the “**Collateral**” consisting of (subject to the next two succeeding sentences): (a) the Pledged Revenues (including all Pledged Settlement Payments and payments on Contracts), (b) all rights to receive the Pledged Revenues and the proceeds of such rights, (c) the Pledged Accounts and assets thereof (including Swap Contracts and Ancillary Contracts), including money, contract rights, general intangibles or other personal property, held by the Trustee under the Indenture, (d) subject to the following sentence, all rights and interest of the Corporation under the Sale Agreement and Contracts, including the representations, warranties and covenants of the State in the Sale Agreement and in Contingency Agreements, and (e) any and all other property of every kind and nature from time to time hereafter, by delivery or by writing of any kind, conveyed, pledged, assigned or transferred as and for additional security under the Indenture. Except as specifically provided in the Indenture, this assignment and pledge does not include: (i) the Unsold Settlement Payments, (ii) the rights of the Corporation pursuant to provisions for consent or other action by the Corporation, notice to the Corporation, indemnity or the filing of documents with the Corporation, or otherwise for its benefit and not for that of the Beneficiaries, (iii) any right or power reserved to the Corporation pursuant to the Act or other law, (iv) any Defeasance Collateral held by the Trustee for the benefit of Defeased Beneficiaries in accordance with the Defeasance provisions of the Indenture, (v) as to any Series of Bonds identified in a Series Supplement, any other property or interest explicitly excluded from Collateral pursuant to the terms of the related Series Supplement, and, with respect to the Series B Indenture, (vi) the Previously Purchased and Pledged Settlement Payments, nor do the Security and Pledge provisions of the Indenture preclude the Corporation’s enforcement of its rights under and pursuant to the Sale Agreement for the benefit of the Beneficiaries as provided in the Indenture. The Unsold Settlement Payments, the proceeds of the Bonds, other than the amounts deposited in the Debt Service Reserve Account or the Debt Service Account, and, with respect to the Series B Indenture, the Previously Purchased and Pledged Settlement Payments, do not constitute any portion of the Pledged Revenues, are not pledged to the holders of the Bonds and are not subject to the lien of the Indenture. The right of the Corporation to receive the Pledged Settlement Payments is valid and enforceable and, during the respective periods that Pledged Settlement Payments are payable to the Corporation and pledged under the Indenture, the right of the Corporation to receive the Pledged Settlement Payments is on a parity with and is not inferior or superior to the right of the State to receive the Unsold Settlement Payments and, with respect to the Series B Indenture, the right of the Series A Trustee (or any future assignee or any future successor of the Series A Trustee) to receive the previously Purchased and Pledged Settlement Payments. Neither the Corporation nor the Trustee, any Beneficiary or other person or entity shall have the right to make a claim to make up all or any portion of a perceived deficiency in Pledged Settlement Payments from the Unsold Settlement Payments and with respect to the Series B Indenture, the Previously Purchased and Pledged Settlement Payments, and, likewise, neither the Corporation nor the State nor, with respect to the Series B Indenture, the Series A Trustee (nor any future assignee or future successor of the Series A Trustee) shall have any right to make a claim to make up all or any portion of a perceived deficiency in the Unsold Settlement Payments from the Pledged Settlement Payments or, with respect to the Series B Indenture, the Previously Purchased and Pledged Settlement Payments. The Corporation will implement, protect and defend this assignment and pledge by all appropriate legal action, the cost thereof to be an Operating Expense. The Collateral is to be pledged to secure the payment of Bonds, Swap Contracts, Ancillary Contracts and with respect to the Series A Indenture Subordinate Indebtedness, all with the respective priorities specified in the Indenture. The pledge and assignment made by the Indenture and the covenants and agreements to be performed by or on behalf of the Corporation shall be for the equal and ratable benefit, protection and security of the Holders of any and all of the Outstanding Bonds and all other Beneficiaries, all of which, regardless of the time or times of their issue or maturity, shall be of equal rank without preference, priority or distinction of such Bonds and all other Beneficiaries over any other Bonds or Beneficiaries except as expressly provided in the Indenture or permitted thereby. The lien of such pledge and the obligation to perform the contractual provisions in the Indenture made shall have priority over any or

all other obligations and liabilities of the Corporation secured by the Pledged Revenues. The Corporation shall not incur any obligations, except as authorized in the Indenture, secured by a lien on the Pledged Revenues, or the Pledged Accounts equal or prior to the lien in the Indenture. (Section 2.01).

### **Defeasance**

When (a) there is held by or for the account of the Trustee Defeasance Collateral in such principal amounts, bearing fixed interest at such rates and with such maturities as will provide sufficient funds to pay or redeem all or any portion of Outstanding Bonds in accordance with their terms and all or any portion of obligations to Beneficiaries (including parties to Swap Contracts and Ancillary Contracts) (the holders of said Bonds and such Beneficiaries called the “**Defeased Beneficiaries**”) (to be verified by a nationally recognized firm of independent certified public accountants or other professionals expert in verifying bond defeasance escrows), (b) any required notice of redemption shall have been given in accordance with the Indenture or irrevocable written instructions to give notice shall have been given to the Trustee, (c) all the rights under the Indenture of the Fiduciaries have been provided for, then upon written notice from the Corporation to the Trustee, such Defeased Beneficiaries shall cease to be entitled to any benefit or security under the Indenture except the right to receive payment of the funds so held and other rights which by their nature cannot be satisfied prior to or simultaneously with termination of the lien under the Indenture, the security interests created by the Indenture with respect to such Defeased Beneficiaries (except in such funds and investments) shall terminate, and the Corporation and the Trustee shall execute and deliver such instruments as may be necessary to discharge the Trustee’s lien and security interests created under the Indenture with respect to such Defeased Beneficiaries. Upon such defeasance, the funds and investments required to pay or redeem such Bonds and other obligations to such Defeased Beneficiaries shall be irrevocably set aside for that purpose, subject to certain provisions of the Indenture, and money held for defeasance shall be invested only Defeasance Collateral and applied by the Trustee and other Paying Agents, if any, to the retirement of such Bonds and such other obligations. When provision for payment or redemption is made in accordance under the “Defeasance” provisions of the Indenture for less than all the Bonds of a Series and maturity, the Trustee shall choose by lot the particular Bond or Bonds of such Series and maturity to be so paid or redeemed. Upon defeasance of all Outstanding Bonds and Beneficiaries, any funds or property held by the Trustee and not required for payment or redemption of such Bonds and such other obligations to Defeased Beneficiaries and Fiduciaries in full shall be distributed to the order of the Corporation. (Section 2.02)

### **Bonds of the Corporation**

By Series Supplement complying procedurally and in substance with the Series A Indenture or the Series B Indenture, as applicable, and including with any consent of the State Representative required by the terms of the related Series Supplement, the Corporation may authorize, issue, sell and deliver (1), respectively, the Series A Bonds or Series B Bonds and (2) other Series of Refunding Bonds from time to time in such principal amounts as the Corporation shall determine and establish such escrows therefor as it may determine. Subsequent to the issuance of the Series 2003A Bonds, only Refunding Bonds may be issued and only upon receipt by the Corporation or the Trustee of a Contingency Contract for such Refunding Bonds. See “SECURITY AND SOURCE OF PAYMENTS FOR THE SERIES 2008A BONDS” and “SECURITY AND SOURCE OF PAYMENTS FOR THE SERIES 2008B BONDS.” (Section 3.01)

### **Subordinate Indebtedness**

The Corporation may incur Subordinate Indebtedness, not constituting Bonds under the Indenture for any purpose, pursuant to the terms of any Supplemental Indenture, provided, that (a) payment of principal of and interest on such Subordinate Indebtedness shall be treated under the Indenture as Junior Payments, and (b) failure by the Corporation to pay the principal of or interest on such Subordinate Indebtedness when due shall not constitute an Event of Default under the Indenture so long as there shall be any Bonds Outstanding. (Section 3.05)

### **Accounts**

There is established within the Indenture the Pledged Revenues Account, Operating Account, the Debt Service Account, the Debt Service Reserve Account, the Supplemental Account, the Costs of Issuance Account and the Rebate Account, and such other Accounts as may be established by Supplemental Indenture. (Section 4.01)



## **Swap Contracts and Ancillary Contracts**

The Corporation may enter into, amend or terminate, as it determines to be necessary or appropriate, Swap Contracts or Ancillary Contracts with the approval (as required by the Act) of the State Representative and may by Series Supplement or other Supplemental Indenture provide for the receipt of payments thereunder as Pledged Revenues, and provide for the payment of amounts due from the Corporation thereunder as Junior Payments. (Section 4.05)

## **Redemption of the Bonds**

The Corporation may redeem Bonds at its option in accordance with their terms and the terms of the applicable Series Supplement and, subject to certain provisions in the Indenture, will redeem Bonds in accordance with their terms pursuant to any mandatory redemption established by the Series Supplement. When Bonds are called for redemption, the accrued interest thereon shall become due on the redemption date. To the extent not otherwise provided, the Corporation shall deposit with the Trustee on or prior to the redemption date a sufficient sum to pay principal or Sinking Fund Installments, redemption premium, if any, and accrued interest.

Unless otherwise specified by Series Supplement, there shall, at the option of the Corporation, be applied to or credited against any sinking fund requirement the principal amount of any Bonds subject to redemption therefrom that have been purchased, redeemed or, with respect to the Series A Indenture, defeased, and not previously so applied or credited. With respect to the Series B Indenture, to the extent set forth in the applicable Series Supplement, Bonds purchased by the Corporation shall be promptly tendered to the Trustee for cancellation.

When a Bond is to be redeemed prior to its Maturity Date, the Trustee shall give notice in the name of the Corporation, which notice shall identify the Bonds to be redeemed, state the date fixed for redemption and state that such Bonds will be redeemed at the Corporate Trust Office of the Trustee or a Paying Agent. The notice shall further state that on such date there shall become due and payable upon each Bond to be redeemed the redemption price thereof, together with interest accrued to the redemption date, and that money therefor having been deposited with the Trustee or Paying Agent on or prior to the redemption date, from and after such date, interest thereon shall cease to accrue. The Trustee shall give 15 days' notice by mail, or otherwise transmit the redemption notice in accordance with any appropriate provisions under the Indenture, to the registered owners of any Bonds which are to be redeemed, at their addresses shown on the registration books of the Corporation. Such notice may be waived by any Holder of Bonds to be redeemed. Failure by a particular Holder to receive notice, or any defect in the notice to such Holder, shall not affect the redemption of any other Bond. Any notice of redemption given pursuant to the Indenture may be rescinded by Written Notice by the Corporation to the Trustee no later than 5 days prior to the date specified for redemption. The Trustee shall give notice of such rescission as soon thereafter as practicable in the same manner and to the same persons, as notice of such redemption was given as described above. Subject to the defeasance and redemption and payment provisions of the Indenture or by Series Supplement: (a) if less than all the Outstanding Bonds are to be redeemed pursuant to certain of the redemption provisions of the Indenture, the particular Bonds of a Maturity Date and Series to be redeemed shall be selected by the Trustee by such method as it shall deem fair and appropriate, and the Trustee may provide for the selection for redemption of portions (equal to any authorized denominations) of the principal of Bonds of a denomination larger than the minimum authorized denomination, and (b) the Trustee shall redeem any and all Bonds held by the provider of an Ancillary Contract prior to any other Bonds redeemed under the Indenture unless otherwise directed by an Officer's Certificate of the Corporation. (Section 4.06)

## **Investments**

Pending its application under the Indenture, money in the Funds and Accounts may be invested by the Trustee pursuant to written direction of the Corporation in Eligible Investments maturing or redeemable at the option of the holder at or before the time when such money is expected to be needed. Specifically, Eligible Investments shall mature or be redeemable at the option of the Corporation in an amount and at such times sufficient to make certain payments under the Indenture on the next succeeding Distribution Date. Investments shall be held by the Trustee in the respective Funds and Accounts and shall be sold or redeemed to the extent necessary to make payments or transfers from each Fund or Account. The Trustee shall not be liable for any losses on investments made at the direction of the Corporation.

On the Business Day immediately preceding each Distribution Date, the Trustee shall value the money and investments in the Debt Service Reserve Account according to the methods set forth under the Investments provisions of the Indenture. Any amounts in the Debt Service Reserve Account in excess of the Debt Service Reserve Requirement shall be applied as provided under the Indenture.

In computing the amount in any Fund or Account, the value of Eligible Investments shall be determined by the Trustee at least as frequently as the Business Day preceding each Distribution Date and shall be calculated as follows:

- (i) As to investments the bid and asked prices of which are published on a regular basis in *The Wall Street Journal* (or, if not there, then in *The New York Times*): the average of the bid and asked prices for such investments so published on or most recently prior to such time of determination;
- (ii) As to investments the bid and asked prices of which are not published on a regular basis in *The Wall Street Journal* or *The New York Times*: the average bid price at such time of determination for such investments by any two nationally recognized government securities dealers (selected by the Trustee in its absolute discretion) at the time making a market in such investments or the bid price published by a nationally recognized pricing service;
- (iii) As to certificates of deposit and bankers acceptances: the face amount thereof, plus accrued interest; and
- (iv) As to any investment not specified above: the value thereof established by prior agreement between the Corporation and the Trustee (with written notice to Moody's of such agreement).

The Trustee may hold undivided interests in Eligible Investments for more than one Fund or Account (for which they are eligible) and may make inter-fund transfers in kind.

In respect of Defeasance Collateral held for Defeased Bonds, the provisions of the Indenture summarized under the caption "Investments" shall be effective only to the extent it is consistent with other applicable provisions of the Indenture or any separate escrow agreement. (Section 4.07)

#### **Rebate**

- (a) The Trustee shall establish and maintain an account separate from any other account established and maintained under the Indenture designated as the Rebate Account. Subject to the transfer provisions provided in paragraph (e) below, all money at any time deposited in the Rebate Account shall be held by the Trustee in trust, to the extent required to satisfy the Rebate Requirement (as defined, computed and provided to the Trustee in accordance with the Tax Certificate), for payment to the United States Treasury. Neither the Corporation nor any Bondholder shall have any rights in or claim to such money in the Rebate Account. All amounts deposited into or on deposit in the Rebate Account shall be governed by the rebate provisions and the tax covenants contained in the Indenture and by the Tax Certificate. The Trustee shall be deemed conclusively to have complied with such provisions if it follows such directions of the Corporation, and shall have no liability or responsibility to enforce compliance by the Corporation with the terms of the Tax Certificate.
- (b) Upon the Corporation's written direction, an amount shall be deposited to the Rebate Account by the Trustee from amounts on deposit in the Operating Account so that the balance in the Rebate Account shall equal the Rebate Requirement. Computations of the Rebate Requirement shall be furnished by or on behalf of the Corporation in accordance with the Tax Certificate. The Trustee

shall supply to the Corporation all information required to be provided in the Tax Certificate to the extent such information is reasonably available to the Trustee.

- (c) The Trustee shall have no obligation to rebate any amounts required to be rebated pursuant to the rebate provisions of the Indenture, other than from moneys held in the Operating Account or the Rebate Account created under the Indenture.
- (d) At the written direction of the Corporation, the Trustee shall invest all amounts held in the Rebate Account in Eligible Investments, subject to the restrictions set forth in the Tax Certificate. Moneys shall not be transferred from the Rebate Account except as provided in paragraph (e) below. The Trustee shall not be liable for any consequences arising from such investment.
- (e) Upon receipt of the Corporation's written directions, the Trustee shall remit part or all of the balances in the Rebate Account to the United States, as directed in writing by the Corporation. In addition, if the Corporation so directs, the Trustee will deposit money into or transfer money out of the Rebate Account from or into such Accounts or Funds as directed by the Corporation's written directions; provided, that only moneys in excess of the Rebate Requirement may, at the written direction of the Corporation, be transferred out of the Rebate Account to such other Accounts or Funds or to anyone other than the United States in satisfaction of the arbitrage rebate obligation. Any funds remaining in the Rebate Account after each five year remittance to the United States, redemption and payment of all of the bonds and payment and satisfaction of any Rebate Requirement, or after provision has been made therefor satisfactory to the Trustee, shall be withdrawn and deposited in the Pledged Revenues Account.
- (f) Notwithstanding any other provision of the Indenture, the obligation to remit the Rebate Requirement to the United States and to comply with all other requirements of the Tax Covenants provisions of the Indenture and the Tax Certificate shall survive the defeasance or payment in full of the Tax-Exempt Bonds. (Section 4.09)

#### **Application of Supplemental Account**

In addition to the application of amounts deposited in the Supplemental Account pursuant to the Indenture, and whether or not an Event of Default shall have occurred, the Corporation shall cause amounts in the Supplemental Account to be applied, at the written direction of the State, to the defeasance, purchase (subject to any applicable maximum purchase price limitation set forth in the Act) or optional redemption of Bonds in accordance with one or more Series Supplements. Notwithstanding the requirements of the Indenture described herein under paragraph (B)(vi) under the caption "SECURITY AND SOURCES OF PAYMENT FOR THE SERIES 2008A BONDS – Series A Flow of Funds" and paragraph (B)(vi) under the caption "SECURITY AND SOURCES OF PAYMENT FOR THE SERIES 2008B BONDS – Series B Flow of Funds" or the preceding sentence of this paragraph to the contrary, between April 15 and the next Distribution Date in each year, no amounts in the Supplemental Account shall be applied or set aside to defease Bonds or to pay the optional redemption or purchase price of Bonds unless there is held in the Debt Service Account sufficient amounts to pay all Debt Service scheduled to be paid during the next fiscal year. (Section 4.10)

#### **Contract; Obligations to Beneficiaries**

In consideration of the purchase and acceptance of any or all of the Bonds and Swap Contracts and Ancillary Contracts by those who shall hold the same from time to time, the provisions of the Indenture shall be a part of the contract of the Corporation with the Beneficiaries. The pledge made in the Indenture and the covenants set forth in the Indenture to be performed by the Corporation shall be for the equal benefit, protection and security of the Beneficiaries of the same priority. All of the Bonds, or payments on Swap Contracts or Ancillary Contracts of the same priority, regardless of the time or times of their issuance or maturity, shall be of equal rank without preference, priority or distinction of any thereof over any other except as expressly provided in the Indenture.

Under the Indenture, the Corporation covenants to pay when due all sums payable on the Bonds, but only from the Pledged Revenues and money designated in the Indenture, subject only to (i) the Indenture, and (ii) to the extent permitted by the Indenture, (x) agreements with Holders of Bonds pledging particular collateral for the payment thereof and (y) the rights of Beneficiaries under Swap Contracts, Ancillary Contracts and, with respect to Series A Indenture, Subordinate Indebtedness. The obligation of the Corporation to pay principal or Sinking Fund Installments, interest and redemption premium, if any, to the Holders of Bonds shall be absolute and unconditional, shall be binding and enforceable in all circumstances whatsoever, and shall not be subject to setoff, recoupment or counterclaim. The Corporation shall pay its Operating Expenses (including, without limitation, any Bond insurance premiums payable by the Corporation on or after the Closing Date). The Corporation may borrow money to pay, and repay such borrowings as Operating Expenses.

In addition, the Corporation represents under the Indenture that it is duly authorized pursuant to law, including the Act, to create and issue the Bonds, to enter into the Indenture and to pledge the Pledged Revenues and other collateral purported to be pledged in the manner and to the extent provided in the Indenture. The Pledged Revenues and other collateral so pledged are and will be free and clear of any pledge, lien, charge or encumbrance thereon or with respect thereto prior to, or of equal rank with, the pledge created by the Indenture, and all corporate action on the part of the Corporation to that end has been duly and validly taken. The Bonds and the provisions of the Indenture are and will be the valid and binding obligations of the Corporation in accordance with their terms. (Section 5.01)

### **Enforcement**

Under the Indenture, the Trustee shall enforce, by appropriate legal proceedings, each covenant, pledge or agreement made by the State in the Purchase Agreement for the benefit of any of the Beneficiaries. (Section 5.02)

### **Tax Covenants**

The Corporation will covenant under the Indenture that:

- (a) the Corporation shall at all times do and perform all acts and things permitted by law and necessary or desirable to assure that interest paid by the Corporation on Tax-Exempt Bonds will be excludable from gross income for federal income tax purposes pursuant to Section 103(a) of the Code; and
- (b) no funds of the Corporation shall at any time be used directly or indirectly to acquire securities, obligations or other investment property the acquisition or holding of which would cause any Tax-Exempt Bond to be an arbitrage bond as defined in the Code.

If and to the extent required by the Code, the Corporation shall periodically, at such times as may be required to comply with the Code, pay as an Operating Expense the amount, if any, required by the Code to be rebated or paid as a related penalty. Without limiting the foregoing, the Corporation agrees that it will comply with the provisions of the Tax Certificate which are incorporated in the Indenture. The Corporation's tax covenants shall, notwithstanding any other provisions of the Indenture, survive the defeasance or other payment of the Tax-Exempt Bonds. (Section 5.03)

### **Accounts and Reports**

The Corporation will make the following covenants under the Indenture:

- (a) cause to be kept books of account in which complete and accurate entries shall be made of its transactions relating to all funds and accounts under the Indenture, which books shall at all reasonable times and at the expense of the Corporation be subject to the inspection of the Trustee and the Holders of an aggregate of not less than 25% in principal amount or Accreted Value of Bonds then Outstanding or their representatives duly authorized in writing;

- (b) annually, within 210 days after the close of each Fiscal Year, deliver to the Trustee and each Rating Agency, a copy of its financial statements for such Fiscal Year, as audited by an independent certified public accountant or accountants;
- (c) keep in effect at all times by Officer's Certificate an accurate and current schedule of all Debt Service to be payable over the term of then Outstanding Bonds, Swap Contracts and Ancillary Contracts; certifying for the purpose such estimates as may be necessary; and
- (d) for each Distribution Date, cause the Trustee to provide to the Corporation and each Rating Agency a written statement indicating:
  - (1) the Outstanding Bonds of each Series;
  - (2) the amount of principal and Sinking Fund Installments to be paid to the Holders of the Bonds of each Series on such Distribution Date;
  - (3) the amount of interest to be paid to the Holders of the Bonds of each Series on such Distribution Date;
  - (4) the amount on deposit in each Fund and Account as of that Distribution Date;
  - (5) the Debt Service Reserve Requirement as of that Distribution Date;
  - (6) whether or not there have been any payments received under a Contract since the preceding Distribution Date; and
  - (7) the amount of Junior Payments paid or to be paid to Beneficiaries under each Swap Contract and Ancillary Contract on such Distribution Date. (Section 5.04)

## **Ratings**

Unless otherwise specified by Series Supplement, the Corporation shall pay such reasonable fees and provide such available information as may be necessary to obtain and keep in effect ratings on all the Senior Bonds from at least one Rating Agency. (Section 5.05)

## **Affirmative Covenants**

The Corporation will make the following affirmative covenants under the Indenture:

*Punctual Payment.* The Corporation shall duly and punctually pay the principal or Sinking Fund Installments of and premium, if any, and interest on the Bonds in accordance with the terms of the Bonds and the Indenture.

*Maintenance of Existence.* Unless the Special Conditions described under "Limitations on Consolidation, Merger, Sale of Assets, etc." below are met, the Corporation shall keep in full effect its existence, rights and franchises as a public benefit corporation of the State under the laws of the State.

*Protection of Collateral.* The Corporation shall from time to time execute and deliver all documents and instruments, and will take such other action, as is necessary or advisable to: (i) maintain or preserve the lien and security interest (and the priority thereof) of the Indenture; (ii) perfect, publish notice of or protect the validity of any grant made or to be made by the Indenture; (iii) preserve and defend title to the Pledged Revenues and other collateral pledged under the Indenture and the rights of the Trustee and the Bondholders in such collateral against the claims of all persons and parties, including the challenge by any party to the validity or enforceability of the Consent Decree, the Indenture, the Sale Agreement or the Act or the performance by any party thereunder;

(iv) cause the Trustee to enforce the Sale Agreement; (v) pay any and all taxes levied or assessed upon all or any part of the collateral; or (vi) carry out more effectively the purposes of the Indenture.

*Performance of Obligations.* The Corporation (i) shall diligently pursue any and all actions to enforce its rights under each instrument or agreement included in the collateral and (ii) shall not take any action and will use its best efforts not to permit any action to be taken by others that would release any person from any of such person's covenants or obligations under any such instrument or agreement or that would result in the amendment, hypothecation, subordination, termination or discharge of, or impair the validity or effectiveness of, any such instrument or agreement, except, in each case, as expressly provided in the Indenture, the Sale Agreement or the Consent Decree.

*Notice of Events of Default.* The Corporation will give the Trustee and Rating Agencies prompt written notice of each Event of Default under the Indenture.

*Concerning Payments Under Contracts.* If, on the fifth Business Day preceding any Distribution Date, the sum of the amounts on deposit to the credit of the Debt Service Account, the Debt Service Reserve Account and the Supplemental Account shall be less than the Debt Service to be payable or scheduled to be payable on such Distribution Date, then the Trustee shall cause written notice thereof, and demand for payment of an amount necessary to eliminate any such deficiency, to be promptly submitted on behalf of the Corporation to the Director of the Budget of the State pursuant to the terms of the related Contract, such payment to be received (subject to the terms of the related Contract) in any event on or before such Distribution Date, and any amounts paid pursuant to such Contract shall be deposited directly to the credit of the Debt Service Account for the purposes of making payments on such Distribution date pursuant to certain sections under the Indenture. (Section 5.06)

## **Negative Covenants**

The Corporation will make the following negative covenants under the Indenture:

*Sale of Assets.* Except as expressly permitted by the Indenture, the Corporation shall not sell, transfer, exchange or otherwise dispose of any of its properties or assets that are pledged under the Indenture.

*No Setoff.* The Corporation shall not claim any credit on, or make any deduction from the principal or premium, if any, or interest due in respect of, the Bonds or payments due to other Beneficiaries or assert any claim against any present or former Bondholder or Beneficiary by reason of the payment of taxes levied or assessed upon any part of the collateral.

*Liquidation.* Unless the Special Conditions described under "Limitations on Consolidation, Merger, Sales of Assets, etc" below are met, the Corporation shall not terminate its existence or dissolve or liquidate in whole or in part.

*Limitation of Liens.* The Corporation shall not (i) permit the validity or effectiveness of the Indenture to be impaired, or permit the lien of the Indenture or the Sale Agreement to be amended, hypothecated, subordinated, terminated or discharged, or permit any person to be released from any covenants or obligations with respect to the Bonds under the Indenture except as may be expressly permitted thereby, (ii) permit any lien, charge, excise, claim, security interest, mortgage or other encumbrance (other than the lien of the Indenture and any lien securing Permitted Indebtedness) to be created on or extend to or otherwise arise upon or burden the collateral or any part thereof or any interest therein or the proceeds thereof or (iii) permit the lien of the Indenture not to constitute a valid first priority security interest in the collateral.

*Limitations on Consolidation, Merger, Sale of Assets, etc.* Except as otherwise provided in the Indenture, the Corporation shall not consolidate or merge with or into any other person, or convey or transfer all or substantially all of its properties or assets, unless the following conditions (the "**Special Conditions**") are met:

- (a) an entity shall survive such event, and such entity shall be organized and existing under the laws of the United States, the State or any state and shall expressly assume the due and punctual

payment of all obligations owing to Beneficiaries and the performance or observance of every agreement and covenant of the Corporation in the Indenture;

- (b) immediately after giving effect to such transaction, no Default has occurred under the Indenture;
- (c) the Corporation has received an opinion of Bond Counsel to the effect that such transaction will not adversely affect the exclusion of interest on any Tax-Exempt Bond from gross income for federal income tax purposes;
- (d) any action as is necessary to maintain the lien and security interest created by the Indenture has been taken; and
- (e) the Corporation has delivered to the Trustee an Officer's Certificate and an opinion of Counsel to the effect that such transaction complies with the Indenture and that all conditions precedent to such transaction have been complied with.

*No Other Business.* The Corporation will not engage in any business other than financing, purchasing, owning and managing any portion of the State's Share sold by the State to the Corporation in the manner contemplated by the Indenture, the Sale Agreement and any other sale agreement with the State, and activities incidental thereto.

*No Borrowing.* The Corporation will not issue, incur, assume, guarantee or otherwise become liable, directly or indirectly, for any indebtedness except Permitted Indebtedness, and in the event that the Corporation incurs indebtedness other than issuing the Bonds, the Corporation shall provide the Rating Agency written notice of such indebtedness. Swap Contracts, Ancillary Contracts and, with respect to the Series A Indenture, Subordinate Indebtedness are not indebtedness within the meaning of this covenant.

*Guarantees, Loans, Advances and Other Liabilities.* Except as otherwise contemplated by the Indenture and the Sale Agreement (including the issuance of obligations secured by Unsold Settlement Payments or, with respect to the Series B Indenture, by Previously Purchased and Pledged Settlement Payments), the Corporation will not make any loan or advance of credit to, or guarantee (directly or indirectly or by an instrument having the effect or assuring another's payment or performance on any obligation or capability of so doing or otherwise), endorse or otherwise become contingently liable, directly or indirectly, in connection with the obligations, stock or dividends of, or own, purchase, repurchase or acquire (or agree contingently to do so) any stock, obligations, assets or securities of, or any other interest in, or make any capital contribution to, any other person.

*Restricted Payments.* The Corporation will not, directly or indirectly, make payments to or distributions from the Pledged Revenues Account except in accordance with the Indenture. (Section 5.08)

#### **Prior Notice**

The Corporation will give each Rating Agency thirty days' prior written notice of each issue of Bonds other than the Series A Bonds or Series B Bonds, as applicable, with a copy of the proposed Series Supplement, and of each Supplemental Indenture, amendment to the Sale Agreement, Swap Contract, Ancillary Contract or defeasance or redemption of Bonds. (Section 5.09)

#### **Pledged Settlement Payments.**

Under the Indenture, the Corporation acknowledges that the MSA, the Consent Decree and the Sale Agreement constitute important security provisions of the Bonds and waives any right to assert any claim to the contrary and agrees that it will neither in any manner directly or indirectly assert, nor in any manner directly or indirectly support the assertion by the State or any other person of, any such claim to the contrary.

By acknowledging that the MSA, the Consent Decree and the Sale Agreement constitute important security provisions of the Bonds, the Corporation also acknowledges under the Indenture that, in the event of any failure or

refusal by the State to comply with its agreements included in the MSA, the Consent Decree or the Sale Agreement, the Holders of the Bonds may have suffered damage, the extent of the remedy for which may be, to the fullest extent permitted by applicable federal and State law, determined, in addition to any other remedy available at law or in equity, in the course of any action taken pursuant to the Indenture; and the Corporation will waive any right to assert any claim to the contrary and agrees that it shall neither in any manner directly or indirectly assert, nor in any manner directly or indirectly support the assertion by the State or any other person of, any claim to the effect that no such monetary damages have been suffered. (Section 6.01)

### **Resignation or Removal of the Trustee**

Under the Indenture, the Trustee may resign at any time on not less than 30 days' written notice to the Corporation, the Holders and each of the Rating Agencies. The Trustee will promptly certify to the Corporation that it has sent written notice to all Holders and such certificate will be conclusive evidence that such notice was mailed as required hereby. Upon receiving such notice of resignation, the Corporation shall promptly appoint a successor and, upon the acceptance by the successor of such appointment, release the resigning Trustee from its obligations under the Indenture by written instrument, a copy of which instrument shall be delivered to each of the Holders, the resigning Trustee and the successor Trustee. The Trustee may be removed by the Corporation or by a Majority in Interest of Outstanding Bonds, upon written notice to the Trustee, if the Trustee is or becomes rated below investment grade by Moody's and each successor Trustee will have an investment grade rating from Moody's. The Trustee may also be removed by written notice from the Corporation if no Default has occurred or from a Majority in Interest of the Holders of the Outstanding Bonds to the Trustee and the Corporation. No such resignation or removal will not take effect until a successor has been appointed and has accepted the duties of the Trustee. (Section 7.04)

### **Successor Fiduciaries**

Any corporation or association which succeeds to the municipal corporate trust business of a Fiduciary as a whole or substantially as a whole, whether by sale, merger, consolidation or otherwise, will become vested under the Indenture, with all the property, rights, powers and duties under the Indenture, without any further act or conveyance or without the execution or filing of any paper with any party hereto except where an instrument of transfer or assignment is required by law to effect such succession, anything in the Indenture to the contrary notwithstanding.

In case a Fiduciary resigns or is removed or becomes incapable of acting, or becomes bankrupt or insolvent, or if a receiver, liquidator or conservator of a Fiduciary or of its property is appointed, or if a public officer takes charge or control of a Fiduciary, or of its property or affairs, then such Fiduciary shall with due care terminate its activities under the Indenture and a successor may, or in the case of the Trustee will, be appointed by the Corporation. The Corporation shall notify the Holders and the Rating Agencies of the appointment of a successor Trustee in writing within 20 days from the appointment. The Corporation will promptly certify to the successor Trustee that it has given such notice to all Holders and such certificate will be conclusive evidence that such notice was given as required by the Indenture. If no appointment of a successor Trustee is made within 45 days after the giving of written notice in accordance with the provisions of the Indenture summarized above under the caption "Resignation or Removal of the Trustee" or after the occurrence of any other event requiring or authorizing such appointment, the outgoing Trustee or any Holder may apply to any court of competent jurisdiction for the appointment of such a successor, and such court may thereupon, after such notice, if any, as such court may deem proper, appoint such successor. Any successor Trustee appointed in accordance with the provisions of the Indenture shall be a trust company or a bank having the powers of a trust company, having a capital and surplus of not less than \$50,000,000 and a Moody's rating of Baa3 or higher or otherwise as approved by the Rating Agencies. Any such successor Trustee shall notify the Corporation of its acceptance of the appointment and, upon giving such notice, shall become Trustee, vested with all the property, rights, powers and duties of the Trustee under the Indenture, without any further act or conveyance. Such successor Trustee shall execute, deliver, record and file such instruments as are required to confirm or perfect its succession under the Indenture and any predecessor Trustee will from time to time execute, deliver, record and file such instruments as the incumbent Trustee may reasonably require to confirm or perfect any succession under the Indenture. (Section 7.05)



## **Reports by Trustee to Holders**

The Trustee, on or prior to each Distribution Date for a Series of Bonds, shall deliver to the Holders of such Bonds who, respect to the Series B Indenture, shall have provided written request therefor to the Trustee and to each Rating Agency, a written statement indicating certain items described in the Indenture. The Trustee's responsibility for delivering such information is limited to availability, timeliness and accuracy of the information provided to the Trustee by the Corporation in accordance with the Indenture. (Section 7.06)

## **Nonpetition Covenant**

Notwithstanding any prior termination of the Indenture, no Fiduciary shall, prior to the date that is one year and one day after the termination of the Indenture, acquiesce, petition or otherwise invoke or cause the Corporation to invoke the process of any court of government authority for the purpose of commencing or sustaining a case against the Corporation under any federal or state bankruptcy, insolvency or similar law or appointing a receiver, liquidator, assignee, trustee, custodian, sequestrator or other similar official of the Corporation or any substantial part of its property, or ordering the winding up or liquidation of the affairs of the Corporation. (Section 7.07)

## **Action by Holders**

Any request, authorization, direction, notice, consent, waiver or other action provided by the Indenture to be given or taken by Holders of Bonds may be contained in and evidenced by one or more writings of substantially the same tenor signed by the requisite number of Holders or their attorneys duly appointed in writing. Proof of the execution of any such instrument, or of an instrument appointing any such attorney, will be sufficient for any purpose of the Indenture (except as otherwise expressly provided in the Indenture) if made in the following manner, but the Corporation or the Trustee may nevertheless in its discretion require further or other proof in cases where it deems the same desirable. The fact and date of the execution by any Bondholder or his attorney of such instrument may be proved by the certificate or signature guarantee, which need not be acknowledged or verified, of an officer of a bank, trust company or securities dealer satisfactory to the Corporation or to the Trustee; or of any notary public or other officer authorized to take acknowledgments of deeds to be recorded in the state in which he purports to act, that the person signing such request or other instrument acknowledged to him the execution thereof; or by an affidavit of a witness of such execution, duly sworn to before such notary public or other officer. The authority of the person or persons executing any such instrument on behalf of a corporate Holder may be established without further proof if such instrument is signed by a person purporting to be the president or a vice president of such corporation with a corporate seal affixed and attested by a person purporting to be its clerk or secretary or an assistant clerk or secretary. Any action of the owner of any Bond will be irrevocable and bind all future record and beneficial owners thereof. (Section 8.01)

## **Registered Owners**

Certain provisions of the Indenture applicable to DTC as Holder of immobilized Bonds shall not be construed in limitation of the rights of the Corporation and each Fiduciary to rely upon the registration books in all circumstances and to treat the registered owners of Bonds as the owners thereof for all purposes not otherwise specifically provided for by law or in the Indenture. Notwithstanding any other provisions in the Indenture, any payment to the registered owner of a Bond will satisfy the Corporation's obligations thereon to the extent of such payment. (Section 8.02)

## **Remedies**

If an Event of Default occurs the Trustee may, and upon written request of the Holders of 25% in principal amount or Accreted Value of the Bonds Outstanding shall, in its own name by action or proceeding in accordance with the law:

- (i) enforce all rights of the Holders and require the Corporation or, to the extent permitted by law, the State to carry out its agreements with the Holders and to perform its duties under the Sale Agreement;

- (ii) sue upon such Bonds;
- (iii) require the Corporation to account as if it were the trustee of an express trust for the Holders of such Bonds; and
- (iv) enjoin any acts or things which may be unlawful or in violation of the rights of the Holders of such Bonds.

In no event shall the principal of any Bond be declared due and payable in advance of its stated maturity.

The Trustee shall, in addition to the other provisions of the “Remedies” section of the Indenture, have and possess all of the powers necessary or appropriate for the exercise of any functions incident to the general representation of Holders in the enforcement and protection of their rights.

Upon a failure of the Corporation to pay when due, principal or Sinking Fund Installments of or interest on any Bond or a failure actually known to an Authorized Officer of the Trustee to make any other payment required thereby within seven days after the same becomes due and payable, the Trustee shall give written notice thereof to the Corporation and the Budget Director of the State. The Trustee shall give Default notices under certain provisions of the Indenture when instructed to do so by the written direction of another Fiduciary or the Holders of at least 25% in principal amount or Accreted Value of the Outstanding Bonds. The Trustee shall proceed for the benefit of the Holders in accordance with the written direction of a Majority in Interest of the Outstanding Bonds. The Trustee shall not be required to take any remedial action (other than the giving of notice) unless indemnity satisfactory to the Trustee is furnished for any expense or liability to be incurred therein. Upon receipt of written notice, direction and indemnity, and after making such investigation, if any, as it deems appropriate to verify the occurrence of any event of which it is notified as aforesaid, the Trustee will promptly pursue the remedies provided by the Indenture or any such remedies (not contrary to any such direction) as it deems appropriate for the protection of the Holders, and will act for the protection of the Holders with the same promptness and prudence as would be expected of a prudent person in the conduct of such person’s own affairs. The foregoing provisions of the “Remedies” section of the Indenture to the contrary notwithstanding, the remedies available to the Trustee for any breach of the pledges and assignments of the State relating to the diligent enforcement of the Qualifying Statute as contemplated in section IX(d)(2)(B) of the MSA shall be limited to injunctive relief. (Section 9.02)

#### **Waiver**

If the Trustee determines that a Default has been cured before becoming an Event of Default and before the entry of any final judgment or decree with respect to it, the Trustee may waive the Default and its consequences, by written notice to the Corporation, and shall do so upon written instruction of the Holders of at least 25% principal amount of the Outstanding Bonds. (Section 9.03)

#### **Individual Remedies**

No one or more Holders will by his or their action affect, disturb or prejudice the pledge created by the Indenture, or enforce any right under the Indenture, except in the manner therein provided; and all proceedings at law or in equity to enforce any provision of the Indenture will be instituted, had and maintained in the manner provided therein and for the equal benefit of all Holders of the same class; but nothing in the Indenture will affect or impair the right of any Holder of any Bond to enforce payment of the principal of, premium, if any, or interest thereon at and after the same comes due pursuant to the Indenture, or the obligation of the Corporation to pay such principal, premium, if any, and interest on each of the Bonds to the respective Holders thereof at the time, place, from the source and in the manner expressed in the Indenture and in the Bonds. (Section 9.06)

#### **Venue and Governing Law**

The venue of every action, suit or special proceeding against the Corporation shall be laid in the State and shall be heard and determined in the Supreme Court for the State of New York, County of Albany, and in accordance with the Act. (Section 9.07) The Indenture shall be construed in accordance with the laws of the State,

without reference to its conflict of law provisions, and the obligations, rights and remedies of the parties hereunder shall be determined in accordance with such laws (section 10.05)

### **Supplements and Amendments to the Indenture**

The Indenture may be:

- (i) supplemented by delivery to the Trustee of an instrument certified by an Authorized Officer of the Corporation to (1) provide for earlier or greater deposits into the Funds and Accounts, (2) subject any property to the lien of the Indenture, (3) add to the covenants and agreements of the Corporation or surrender or limit any right or power of the Corporation, (4) identify particular Bonds for purposes not inconsistent with the provisions of the Indenture, including credit or liquidity support, remarketing, serialization and defeasance, (5) cure any ambiguity or defect, (6) protect the exclusion of interest on the Tax-Exempt Bonds from gross income for federal income tax purposes, or the exemption from registration of the Bonds under the Securities Act of 1933, as amended, or of the Indenture under the Trust Indenture Act of 1939, as amended, or (7) authorize Bonds of a Series and in connection therewith determine the matters referred to in the Indenture or, with respect to the Series A Indenture, (8) provide provisions regarding Subordinate Indebtedness, and any other things relative to such Bonds that are not materially adverse to the Holders of Outstanding Bonds, or to modify or rescind any such authorization or determination at any time prior to the first authentication and delivery of such Series of Bonds; or
- (ii) amended in any other respect by the Corporation and the Trustee, (1) to add provisions that are not materially adverse to the Holders, or (2) to adopt amendments that do not take effect unless and until (a) no Bonds Outstanding prior to the adoption of such amendment remain Outstanding or (b) such amendment is consented to by the Holders of such Bonds in accordance with the provisions of subparagraph (iii) below; or
- (iii) otherwise amended only with written notice to the Rating Agencies and the written consent of a Majority in Interest of the Bonds to be Outstanding and affected thereby. However, the Indenture may not be amended so as to (1) extend the maturity of any Bond, (2) reduce the principal or Sinking Fund Installment amount, applicable premium or interest rate of any Bond, (3) make any Bond redeemable other than in accordance with its terms, (4) create a preference or priority of any Bond over any other Bond of the same class, or (5) reduce the percentage of the Bonds required to be represented by the Holders giving their consent to any amendment, unless the Holders of the Bonds affected by such amendment have consented to it in writing.

Any amendment of the Indenture shall be accompanied by a Bond Counsel's opinion addressed to the Trustee to the effect that the amendment is permitted by law and does not adversely affect the exclusion of interest on the Tax-Exempt Bonds from gross income for federal income tax purposes.

When the Corporation determines that the requisite number of consents have been obtained for an amendment to the Indenture which requires consents, it shall file a certificate to that effect in its records and give written notice to the Trustee and the Holders. The Trustee will promptly certify to the Corporation that it has given such notice to all Holders and such certificate will be conclusive evidence that such notice was given in the manner required by the Indenture. (Section 10.01)

### **Supplements and Amendments to the Sale Agreement**

The Sale Agreement may be amended in accordance with the provisions of Section 6.01 thereof, with the consent of the Trustee but without the consent of the Holders of the Bonds (i) to cure any ambiguity, (ii) to correct or supplement any provisions in the Sale Agreement, (iii) to correct or amplify the description of the tobacco settlement payments sold thereunder, (iv) to add additional covenants for the benefit of the Corporation, or (v) for the purpose of adding any provisions to or changing in any manner or eliminating any of the provisions in the Sale Agreement that shall not, adversely affect in any material respect the interest of the Holders of Outstanding Bonds.

The Sale Agreement may also be amended from time to time by the Corporation and the State, with the consent of a Majority in Interest of the Bondholders, for the purpose of adding any provisions to or changing in any manner or eliminating any of the provisions of the Sale Agreement or of modifying in any manner the rights of the Bondholders, but no such amendment shall reduce the aforesaid portion of the Outstanding amount of the Bonds, the Holders of which are required to consent to any such amendment, without the consent of all of the Bondholders. In the event that the Trustee receives a request for a consent or other action under the Sale Agreement, the Trustee may, and if consent or other action by Holders is required shall, transmit a notice of such request to each Holder and request directions with respect thereto; and the Trustee (and the Corporation, if applicable) shall proceed in accordance with such directions (if any), pursuant to the Indenture and the Sale Agreement. (Section 10.02)

### **Supplements and Amendments to Contracts**

A Contract may be amended, changed, modified or altered, with the consent of the Trustee but without the consent of Bondholders, (i) to cure any ambiguity, or to correct or supplement any provisions contained in the Contract that may be defective or inconsistent with any other provisions contained in the Indenture or in such Contract, and (ii) in any other manner that does not materially adversely affect the interest of the Holders of Outstanding Bonds. With the prior written consent of a Majority in Interest of the Bonds then Outstanding, a Contract may also be amended, changed, modified, altered or terminated, provided however, that no such amendment, change, modification, alteration or termination will reduce the percentage of the aggregate principal amount of Outstanding Bonds the consent of the Holders of which is a requirement for any such amendment, change, modification, alteration or termination, or with respect to the Series B Indenture, without the consent of the Bondholders adversely affected thereby, decrease the amount of any payment to be made under any Contract or extend the time allowed for payment thereof; and provided, further, that if such modification or amendment will, by its terms, not take effect so long as any Bonds of any specified series remain Outstanding, the consent of the Holders of such Bonds shall not be required and such Bonds shall not be deemed to be Outstanding for the purpose of any calculation of Outstanding Bonds for purposes of the Indenture. No amendment to a Contract shall become effective until an executed copy thereof certified by an Authorized Officer of the Corporation shall be filed with the Trustee. (Section 10.03)

### **THE SERIES A SALE AGREEMENT AND SERIES B SALE AGREEMENT**

*The following summary describes certain terms of each of the Series A Sale Agreement and the Series B Sale Agreement. This summary does not purport to be complete and is subject to, and qualified in its entirety by reference to the provisions of the Series A Sale Agreement or Series B Sale Agreement, as applicable. The term "Sale Agreement" refers to each individually. References to "Indenture" mean the Series A Indenture or the Series B Indenture, as applicable.*

### **Conveyance of the Portion of the State's Share**

On the Closing Date, the State will sell and convey to the Corporation without recourse (subject to certain continuing obligations set forth in the Sale Agreement) in accordance with and subject to the terms of the Sale Agreement, all of its right, title and interest in and to the Portion of the State's Share. As consideration for such sale and conveyance of the Portion of the State's Share, the Corporation promises to pay and otherwise convey to the State, without recourse, on the Closing Date, the proceeds (net of Financing Costs) of the Series 2008 Bonds and the applicable Residual Certificate in accordance with and subject to the terms and conditions of the applicable Series.

The right of the Corporation to receive the Pledged Settlement Payments, on and after the Closing Date, is valid and enforceable, and, during the respective periods that Pledged Settlement Payments are payable to the Corporation and pledged under the Indenture, the right of the Corporation to receive the Pledged Settlement Payments is equal to and on a parity with, and is not inferior or superior to the right and the claim of the State to receive the Unsold Settlement Payments and, with respect to the Series B Sale Agreement, the Series A Trustee to receive the Previously Purchased and Pledged Settlement Payments. Neither the Corporation nor any Beneficiary, person or entity shall have the right to make a claim to make up all or any portion of a perceived deficiency in Pledged Settlement Payments from the Unsold Settlement Payments or, with respect to the Series A Sale Agreement, the Previously Purchased and Pledged Settlement Payments and, likewise, neither the Corporation, the State nor, with respect to the Series B Sale Agreement, the Series A Trustee shall have any right to make a claim to make up

all or any portion of a perceived deficiency in the Unsold Settlement Payments or, with respect to the Series B Sale Agreement, the Previously Purchased and Pledged Settlement Payments, from the Pledged Settlement Payments. (Section 2.01)

## **Representations of State**

The State makes the following representations on which the Corporation is deemed to have relied in acquiring the Portion of the State's Share. The representations speak as of the Closing Date, and survive the sale of the Portion of the State's Share and the pledge thereof to the Trustee as Pledged Settlement Payments pursuant to the Indenture.

*Power and Authority.* The State is duly authorized through the Act to sell the Portion of the State's Share and has full power and authority to execute and deliver the Sale Agreement and to carry out its terms.

*Binding Obligation.* The Sale Agreement has been duly executed and delivered by the State and, assuming the due authorization, execution and delivery of the Sale Agreement by the Corporation, constitutes a legal, valid and binding obligation of the State enforceable in accordance with its terms.

*No Consents.* No consent, approval, authorization, order, registration or qualification of or with any court or governmental agency or body is required for the consummation of the transactions contemplated by the Sale Agreement, except for those which have been obtained and are in full force and effect.

*No Violation.* The consummation by the State [and the Corporation in the Series B Indenture] of the transactions contemplated by the Transaction Documents and the fulfillment of the terms thereof do not, to the State's knowledge, in any material way conflict with, result in any material breach of any of the material terms and provisions of, or constitute (with or without notice or lapse of time) a material default under the Act or any indenture, agreement or other instrument to which the State is a party (including the MSA) or by which it shall be bound; nor violate any law or, to the State's knowledge, any order, rule or regulation applicable to the State of any court or of any federal or state regulatory body, administrative agency or other governmental instrumentality having jurisdiction over the State or its property.

*No Proceedings.* To the State's knowledge, and except as may be described in a written certificate of the Attorney General on the Closing Date or as may be disclosed in this Official Statement, there are no proceedings pending against the State, before any court, regulatory body, administrative agency or other governmental instrumentality having jurisdiction over the State: (1) asserting the invalidity of any of the Transaction Documents or the Series A Bonds, (2) seeking to prevent the issuance of the Series A Bonds or the consummation of any of the transactions contemplated by any of the Transaction Documents, or (3) seeking any determination or ruling that would materially and adversely affect the validity or enforceability of any of the Act, the Consent Decree, the MSA, the Qualifying Statute, the Complementary Legislation, the Transaction Documents, or the Series A Bonds.

*Title to Portion of the State's Share.* The State is the sole owner of the Portion of the State's Share to be sold to the Corporation under the Sale Agreement. On and after the Closing Date, (1) the State shall have no right, title or interest in or to the Portion of the State's Share, and (2) the Portion of the State's Share shall be the property of the Corporation, and not of the State, and shall be owned, received, held and disbursed by the Corporation or the Trustee and not by the State. Pursuant to the Act and the Sale Agreement, (1) the Pledged Settlement Payments shall be paid directly to the Trustee, and (2) the Pledged Settlement Payments shall not be received by the State.

*True Sale; Absence of Liens on Portion of the State's Share.* The State is irrevocably selling the Portion of the State's Share free and clear of any and all State Liens, pledges, charges, security interests or any other statutory impediments to transfer or conveyance of any nature encumbering the Portion of the State's Share. The sale of the Portion of the State's Share is, and shall be treated as, a true sale and absolute transfer and conveyance of the property, and all of the right, title and interest in and to such property, so transferred and conveyed, and not as a pledge or any other security interest granted by the State for any borrowing. The characterization by the State of such sale as an absolute transfer or conveyance will not be negated or adversely affected by (1) the sale and assignment pursuant to the Sale Agreement of less than all of the State's Share, (2) the issuance and delivery to the

State of the applicable Residual Certificate, (3) any characterization of the Corporation or its bonds for purposes of accounting, taxation or securities regulation, (4) or by the pledge of other funds or assets of the Corporation, including the Contract and the revenues provided by the State and pledged by the Corporation thereunder, or (5) any other factor whatsoever.

*Assignment to the Trustee.* The State acknowledges and consents to the pledge, assignment and grant of a security interest by the Corporation to the Trustee pursuant to the Indenture for the benefit of the Bondholders and certain other Beneficiaries, of any or all right, title and interest of the Corporation in, to and under the Pledged Settlement Payments. The State acknowledges that the Corporation will assign to the Trustee for the benefit of the Bondholders and certain other Beneficiaries, all of its rights and remedies with respect to any breach by the State of any of its obligations, representations and warranties under the Sale Agreement, subject, however, to the limitations and provisions set forth in the following paragraph.

The State's acknowledgments and consents in the foregoing paragraph are subject to the condition that any and all pledges, assignments and grants made or to be made by the Corporation pursuant to the foregoing paragraph shall be limited solely to the Trustee for the benefit of Bondholders and certain other Beneficiaries. The Corporation agrees that any pledge, assignment and grant it makes in accordance therewith will be limited and restricted so that the Trustee may not further assign any such rights, remedies and interest to any other person or entity, including any different or additional assignment thereof to Bondholders or certain other Beneficiaries.

*Redemption of Bonds at Direction of State.* The Corporation grants, assigns and conveys to the State the independent right (in addition to the rights retained by the Corporation under the Indenture), but not any obligation, to exercise the right of the Corporation to cause the optional redemption of the Bonds in accordance with the requirements of the Indenture, from either the Supplemental Account (as defined under the Indenture) in which funds are available therefor under the Indenture or upon the State providing the funds necessary therefor. The State Representative shall file a certificate with the Corporation and Trustee on or before each Distribution Date in the event the State elects to exercise such right with respect to the Supplemental Account on such Distribution Date, and the State Representative shall file a certificate with the Corporation and Trustee at least 30 days before a Distribution Date in the event the State elects to exercise such right with respect to funds other than Supplemental Account on such Distribution Date. The Corporation shall not exercise any right of the Corporation under the Indenture to cause the optional redemption of the Bonds except upon direction of the State Representative. (Section 3.01)

### **Limitation on Liability**

Neither the State nor any person holding a position by election, appointment or employment in the service of the State, any member of the Corporation, or any officer, employee, or agent of the Corporation, while acting within the scope of their authority, shall be subject to any personal liability resulting from exercising or carrying out of any of the State's or the Corporation's purposes or powers.

Members, officers, and employees and agents of the Corporation under the Sale Agreement shall be subject to the provisions of section 17 of the Public Officer's Law of the State. (Section 3.02)

### **Pledges; Protection of Title; Non-Impairment Covenant**

The State covenants and agrees with the Corporation, and the Corporation is authorized to include such covenant and agreement in the Indenture for the benefit of the Beneficiaries, that the State will (i) irrevocably direct, through the Attorney General, the independent auditor and the escrow agent under the MSA to transfer all Pledged Settlement Payments directly to the Trustee, (ii) enforce, at the expense of the State, its right to collect all monies due from the PMs under the MSA, (iii) diligently enforce, at the expense of the State, the Qualifying Statute as contemplated in section IX(d)(2)(B) of the MSA against all tobacco product manufacturers selling tobacco products in the State that are not in compliance with the Qualifying Statute, in each case in the manner and to the extent deemed necessary in the judgment of the Attorney General, provided, however, as stated in the Sale Agreement, (a) that the remedies available to the Corporation and the Bondholders for any breach of the pledges and agreements of the State set forth in this clause (iii) shall be limited to injunctive relief, and (b) that the State shall be deemed to have diligently enforced the Qualifying Statute so long as there has been no judicial determination by a court of

competent jurisdiction in the State, in an action commenced by a PM under the MSA, that the State has failed to diligently enforce the Qualifying Statute for the purposes of section IX(d)(2)(B) of the MSA, (iv) neither amend the MSA nor the Consent Decree or take any other action in any way that would materially adversely (a) alter, limit or impair the Corporation's right to receive Pledged Settlement Payments, or (b) limit or alter the rights vested by the Act and the Indenture in the Corporation to fulfill the terms of its agreements with the Bondholders, or (c) in any way impair the rights and remedies of the Bondholders or the security for the Bonds, until the Bonds, together with the interest thereon and all costs and expenses in connection with any action or proceedings by or on behalf of the Bondholders, are fully paid and discharged (provided, that nothing in this clause (iv) or elsewhere in the Sale Agreement or the Act shall be construed to preclude the State's regulation of smoking and taxation and regulation of the sale of cigarettes or the like or to restrict the right of the State to amend, modify, repeal or otherwise alter statutes imposing or relating to the taxes), and (v) not amend, supersede or repeal the Qualifying Statute and the Complementary Legislation in any way that would materially adversely affect the amount of any payment to, or materially adversely affect the rights of, the Corporation or the Bondholders. Notwithstanding these pledges and agreements by the State, the Attorney General may in his or her discretion enforce any and all provisions of the MSA without limitation.

Notwithstanding these pledges and agreements by the State, the Attorney General may in his or her discretion enforce any and all provisions of the MSA without limitation.

In accordance with the Act, prior to the date that is one year and one day after which the Corporation no longer has any Bonds Outstanding, the Corporation is prohibited from filing a voluntary petition under Chapter 9 of the Bankruptcy Code or such corresponding chapter or section as may, from time to time, be in effect, and a public official or organization, entity, or other person shall not authorize the Corporation to be or become a debtor under Chapter 9 or any successor or corresponding chapter or sections during such period. In accordance with the Act, this contractual obligation will be part of the contractual obligation owed to Bondholders and may not subsequently be modified by State law prior to the date that is one year and one day after which the Corporation no longer has any Bonds Outstanding.

Upon request of the Corporation or the Trustee, the State will execute and deliver such further instruments and do such further acts as the parties reasonably agree are reasonably necessary or proper to carry out more effectively the purposes of the Sale Agreement. (Section 4.01)

## **Tax Covenants**

Pursuant to section 4 of the Act, the State agrees as follows:

The State will at all times do and perform all acts and things permitted by law and necessary or desirable to assure that interest paid by the Corporation on the applicable Series of the Series 2008 Bonds will be excludable from gross income for federal income tax purposes pursuant to Section 103(a) of the Tax Code.

The State will not directly or indirectly use or permit the use of any of the proceeds of the applicable Series of the Series 2008 Bonds that would cause the Bonds to be "private activity bonds" within the meaning of Section 141(a) of the Tax Code or would cause interest on such Bonds to not be excludable from gross income for federal income tax purposes pursuant to Section 103(a) of the Tax Code.

The State agrees that no gross proceeds (as such term is defined in Section 1.148-1 of the Treasury Regulations promulgated under Section 148 of the Tax Code, as such Treasury Regulations and the Tax Code may be amended from time to time) of the applicable Series of the Series 2008 Bonds shall at any time be used directly or indirectly to acquire securities or obligations the acquisition or holding of which would cause any such Bond to be an "arbitrage bond" as defined in the Tax Code and any applicable Treasury Regulations promulgated thereunder.

The State will execute a tax certificate containing all appropriate representations, covenants, statements of intention and certifications of fact and reasonable expectations for bond counsel to the Corporation to render its opinion that interest on the applicable Series of the Series 2008 Bonds is excluded from gross income for federal income tax purposes pursuant to Section 103 of the Tax Code. (Section 4.02)

### **Residual Certificate, Unsold and Previously Purchased and Pledged Settlement Payments**

The Corporation shall determine the amounts of the residual interests represented by the Residual Certificate, and pay and transfer such residual interests to the registered owner of the Residual Certificate. To the extent that the Trustee shall receive an amount not constituting Pledged Settlement Payments or any other Unsold Settlement Payments and Previously Purchased and Pledged Settlement Payments in the Series B Indenture, the Corporation shall cause the Trustee to promptly remit such amount to or upon the order of the State or of the Series A Trustee, as applicable. (Section 5.02)

### **Bonds Not Debt of State**

The applicable Series of the Series 2008 Bonds must be issued in the name of the Corporation. Such Bonds will be obligations only of the Corporation, payable solely from the special fund or funds created by the Corporation and pledged for their payment. Such Bonds and any Ancillary Bond Facility must contain a recital on their face to the effect that, pursuant to the Act, neither any such Bond nor any Ancillary Bond Facility shall constitute a debt or moral obligation of the State or a State supported obligation within the meaning of any constitutional or statutory provision or a pledge of the faith and credit of the State or the taxing power of the State, and the State shall not be liable to make any payments thereon nor shall any such Bond or Ancillary Bond Facility be payable out of any funds or assets other than Pledged Settlement Payments and other assets if any, sold to the Corporation and other funds and assets of or available to the Corporation including those received from the State under the Contract and pledged therefor under the Indenture. (Section 5.03)

### **Amendment**

Except as otherwise provided in the third paragraph under the caption “Pledges; Protection of Title; Non-Impairment Covenant” above, after issuance of the Series 2008A Bonds, the Sale Agreement may be amended by agreement of the State and the Corporation, with the consent of the Trustee but without the consent of any of the Bondholders: (1) to cure any ambiguity; (2) to correct or supplement any provisions in the Sale Agreement; (3) to correct or amplify the description of the Portion of the State’s Share; (4) to add additional covenants for the benefit of the Corporation; or (5) for the purpose of adding any provisions to or changing in any manner or eliminating any of the provisions in the Sale Agreement that shall not adversely affect in any material respect the Bonds.

In addition to the provisions in the preceding paragraph, the Sale Agreement may also be amended from time to time by the Corporation and the State, with the consent of a majority of the Bondholders with respect to the Series A Sale Agreement, and with the consent the holders of a majority of principal amount of outstanding Bonds, with respect to the Series B Sale Agreement, for the purpose of adding any provisions to or changing in any manner or eliminating any of the provisions of the Sale Agreement or of modifying in any manner the rights of the Bondholders, but no such amendment may reduce the aforesaid portion of the Outstanding amount of the Bonds, the Holders of which are required to consent to any such amendment, without the consent of all of the Bondholders.

Prior to the execution of any amendment to the Sale Agreement, the Trustee will be entitled to receive and rely upon an Opinion of Counsel stating that the execution of such amendment is authorized or permitted by the Sale Agreement and will not adversely affect the exclusion of interest on any tax-exempt Bonds from gross income for federal income tax purposes. Without the prior written consent of the Trustee, no amendment, supplement or other modification of the Sale Agreement may be entered into or be effective. (Section 6.01)



**APPENDIX H**

**PROPOSED FORMS OF OPINIONS OF BOND COUNSEL**

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## APPENDIX H

### PROPOSED FORMS OF OPINIONS OF BOND COUNSEL

[LETTERHEAD OF HAWKINS DELAFIELD & WOOD LLP]

March \_\_, 2008

Tobacco Settlement Financing Corporation  
New York, New York

Members:

As Bond Counsel to the Tobacco Settlement Financing Corporation (the "Corporation"), a public benefit corporation of the State, established as a subsidiary of the State of New York Municipal Bond Bank Agency and created and empowered to effectuate the purposes of the Tobacco Settlement Financing Corporation Act (the "Act"), we have examined the Constitution and laws of the State of New York (the "State") and a record of proceedings relating to the issuance of \$219,935,000 aggregate principal amount of its Asset-Backed Revenue Bonds, Series 2008A (State Contingency Contract Secured) (the "Series 2008A Bonds").

In such examinations, we have assumed the genuineness of all signatures, the authenticity of all documents submitted to us as originals and the conformity with originals of all documents submitted to us as copies thereof.

The Series 2008A Bonds are authorized and issued pursuant to the Act and a resolution of the Corporation adopted March 13, 2008, and are issued pursuant to an indenture, dated as of June 1, 2003 (the "General Indenture"), and series supplement thereto, dated as of March 1, 2008 (together with the General Indenture, the "Indenture"), each by and between the Corporation and The Bank of New York, as trustee (the "Trustee"). The Corporation is authorized and has reserved the right to issue one or more additional series of bonds for refunding purposes, secured on a parity with the Series 2008A Bonds and other bonds heretofore issued under the General Indenture, only on the terms and conditions set forth in the General Indenture.

Capitalized terms used herein and not defined herein are used as defined in the Indenture.

In rendering our opinion, we have relied, to the extent we have deemed such reliance proper, on certain representations, certifications of fact, and statements of reasonable expectation made by the Corporation and the State in connection with the issuance of the Series 2008A Bonds, and certain opinions provided to us, and we have assumed compliance by the Corporation and the State with certain ongoing covenants to comply with applicable requirements of the Internal Revenue Code of 1986, as amended (the "Code"), to assure the exclusion of the interest on the Series 2008A Bonds from gross income under Section 103 of the Code.

The Series 2008A Bonds are secured by a pledge of the Contingency Contract dated as of June 1, 2003 by and between the State of New York, acting by and through the Director of the Budget, and the Corporation (the "Contract"), which provides for payments by the State of New York to the Corporation, subject to annual appropriation by the State Legislature, in the event that all other pledged funds (the "Collateral") under the Indenture are not sufficient to pay debt service on the Bonds outstanding under the Indenture. We have relied upon the opinion of the Attorney General as to the enforceability of each of the Sale Agreement and the Contract against the State and upon the opinion of Dorsey & Whitney LLP as to the enforceability of the Indenture against the Trustee, each in accordance with its respective terms.

Subject to the foregoing, we are of the opinion that:

1. Under the laws of the State, including the Constitution of the State, and under the Constitution of the United States, the Act is valid with respect to all provisions thereof material to the subject matters of this opinion letter.

2. The Corporation is duly created and established and validly exists under the Act as a public benefit corporation of the State, with the right and lawful authority and power to enter into the Indenture, the Contract and the Sale Agreement, to perform the duties and obligations of the Corporation under the Indenture, the Contract and the Sale Agreement, and to issue the Series 2008A Bonds.

3. Each of the Sale Agreement, the Contract and the Indenture has been duly and lawfully authorized, executed and delivered by the Corporation, is in full force and effect and is the legal, valid and binding agreement of the Corporation, enforceable against the Corporation in accordance with its terms.

4. The Indenture creates the valid pledge of, and first-priority lien on, the Collateral (including, without limitation, Pledged Revenues received under the Contract and the Sale Agreement) that it purports to create. Pursuant to the Act, the lien of such pledge and security interest is valid and binding as against all parties having claims of any kind in tort, contract or otherwise against the Corporation, irrespective of whether such parties have notice thereof.

5. The claim of the Trustee (as assignee and pledgee of the Corporation) upon the right, title and interest to Pledged Settlement Payments is valid and enforceable and on a parity with the claim of the State or the trustee for the Corporation's Asset-Backed Revenue Bonds, Series 2003B (State Contingency Contract Secured), dated June 19, 2003, and the Corporation's Asset-Backed Revenue Bonds, Series 2008B (State Contingency Contract Secured), dated March \_\_\_, 2008, to Unsold Settlement Payments.

6. The Series 2008A Bonds have been duly and validly authorized and issued by the Corporation in accordance with provisions of the Act and the Indenture and are valid and binding special revenue obligations of the Corporation, payable only out of the Collateral pledged by the Corporation under the Indenture in Section 2.01 thereof.

7. Pursuant to the Act, no Series 2008A Bond shall constitute a debt or moral obligation of the State or a State supported obligation within the meaning of any constitutional or statutory provision or a pledge of the faith and credit of the State or of the taxing power of the State, and the State shall not be liable to make any payments thereon nor shall any Series 2008A Bond be payable out of any funds or assets other than the Collateral pledged therefor.

8. Under existing statutes and court decisions, interest on the Series 2008A Bonds (i) is excluded from gross income for federal income tax purposes pursuant to Section 103 of the Code, and (ii) is not treated as a preference item in calculating the alternative minimum tax imposed on individuals and corporations under the Code; such interest, however, is included in adjusted current earnings of certain corporations for purposes of calculating the alternative minimum tax imposed on such corporations.

9. Under the Act, interest on the Series 2008A Bonds is exempt from personal income taxes imposed by the State and its political divisions, including The City of New York.

We express no opinion regarding any other federal or state tax consequences with respect to the Series 2008A Bonds. We render our opinions under existing statutes and court decisions as of the date hereof, and we assume no obligation to update, revise or supplement our opinions after such date to reflect any future action taken or not taken, or any facts or circumstances that may hereafter come to our attention, or any changes in law or interpretation thereof that may hereafter occur, or for any other reason. We express no opinion on the effect of any action taken or not taken after the date of our opinion in reliance on an opinion of other counsel on the exclusion from gross income for federal income tax purposes of the interest on the Series 2008A Bonds, or under state and local tax law. We undertake no responsibility for the accuracy, completeness or fairness of any official statement or other offering materials relating to the Series 2008A Bonds and we express no opinion herein relating thereto.

In rendering this opinion, we are advising you that the enforceability of rights and remedies with respect to the Series 2008A Bonds, the Indenture and the Sale Agreement may be limited by bankruptcy, insolvency and other laws affecting creditors' rights or remedies heretofore or hereafter enacted, and is subject to general principles of equity (regardless of whether such enforceability is considered in a proceeding in equity or at law).

Very truly yours,

[LETTERHEAD OF HAWKINS DELAFIELD & WOOD LLP]

March \_\_, 2008

Tobacco Settlement Financing Corporation  
New York, New York

Members:

As Bond Counsel to the Tobacco Settlement Financing Corporation (the "Corporation"), a public benefit corporation of the State, established as a subsidiary of the State of New York Municipal Bond Bank Agency and created and empowered to effectuate the purposes of the Tobacco Settlement Financing Corporation Act (the "Act"), we have examined the Constitution and laws of the State of New York (the "State") and a record of proceedings relating to the issuance of \$223,940,000 aggregate principal amount of its Asset-Backed Revenue Bonds, Series 2008B (State Contingency Contract Secured) (the "Series 2008B Bonds").

In such examinations, we have assumed the genuineness of all signatures, the authenticity of all documents submitted to us as originals and the conformity with originals of all documents submitted to us as copies thereof.

The Series 2008B Bonds are authorized and issued pursuant to the Act and a resolution of the Corporation adopted March 13, 2008, and are issued pursuant to an indenture, dated as of December 1, 2003 (the "General Indenture"), and series supplement thereto, dated as of March 1, 2008 (together with the General Indenture, the "Indenture"), each by and between the Corporation and The Bank of New York, as trustee (the "Trustee"). The Corporation is authorized and has reserved the right to issue one or more additional series of bonds for refunding purposes, secured on a parity with the Series 2008B Bonds and other bonds heretofore issued under the General Indenture, only on the terms and conditions set forth in the General Indenture.

Capitalized terms used herein and not defined herein are used as defined in the Indenture.

In rendering our opinion, we have relied, to the extent we have deemed such reliance proper, on certain representations, certifications of fact, and statements of reasonable expectation made by the Corporation and the State in connection with the issuance of the Series 2008B Bonds, and certain opinions provided to us, and we have assumed compliance by the Corporation and the State with certain ongoing covenants to comply with applicable requirements of the Internal Revenue Code of 1986, as amended (the "Code"), to assure the exclusion of the interest on the Series 2008B Bonds from gross income under Section 103 of the Code.

The Series 2008B Bonds are secured by a pledge of the Contingency Contract dated as of December 1, 2003 by and between the State of New York, acting by and through the Director of the Budget, and the Corporation (the "Contract"), which provides for payments by the State of New York to the Corporation, subject to annual appropriation by the State Legislature, in the event that all other pledged funds (the "Collateral") under the Indenture are not sufficient to pay debt service on the Bonds outstanding under the Indenture. We have relied upon the opinion of the Attorney General as to the enforceability of each of the Sale Agreement and the Contract against the State and upon the opinion of Dorsey & Whitney LLP as to the enforceability of the Indenture against the Trustee, each in accordance with its respective terms.

Subject to the foregoing, we are of the opinion that:

1. Under the laws of the State, including the Constitution of the State, and under the Constitution of the United States, the Act is valid with respect to all provisions thereof material to the subject matters of this opinion letter.

2. The Corporation is duly created and established and validly exists under the Act as a public benefit corporation of the State, with the right and lawful authority and power to enter into the Indenture, the Contract and the Sale Agreement, to perform the duties and obligations of the Corporation under the Indenture, the Contract and the Sale Agreement, and to issue the Series 2008B Bonds.

3. Each of the Sale Agreement, the Contract and the Indenture has been duly and lawfully authorized, executed and delivered by the Corporation, is in full force and effect and is the legal, valid and binding agreement of the Corporation, enforceable against the Corporation in accordance with its terms.

4. The Indenture creates the valid pledge of, and first-priority lien on, the Collateral (including, without limitation, Pledged Revenues received under the Contract and the Sale Agreement) that it purports to create. Pursuant to the Act, the lien of such pledge and security interest is valid and binding as against all parties having claims of any kind in tort, contract or otherwise against the Corporation, irrespective of whether such parties have notice thereof.

5. The claim of the Trustee (as assignee and pledgee of the Corporation) upon the right, title and interest to Pledged Settlement Payments is valid and enforceable and on a parity with the claim of the State or the trustee for the Corporation's Asset-Backed Revenue Bonds, Series 2003A (State Contingency Contract Secured), dated June 19, 2003, and the Corporation's Asset-Backed Revenue Bonds, Series 2008A (State Contingency Contract Secured), dated March \_\_, 2008, to Unsold Settlement Payments and to Previously Purchased and Pledged Settlement Payments.

6. The Series 2008B Bonds have been duly and validly authorized and issued by the Corporation in accordance with provisions of the Act and the Indenture and are valid and binding special revenue obligations of the Corporation, payable only out of the Collateral pledged by the Corporation under the Indenture in Section 2.01 thereof.

7. Pursuant to the Act, no Series 2008B Bond shall constitute a debt or moral obligation of the State or a State supported obligation within the meaning of any constitutional or statutory provision or a pledge of the faith and credit of the State or of the taxing power of the State, and the State shall not be liable to make any payments thereon nor shall any Series 2008B Bond be payable out of any funds or assets other than the Collateral pledged therefor.

8. Under existing statutes and court decisions, interest on the Series 2008B Bonds (i) is excluded from gross income for federal income tax purposes pursuant to Section 103 of the Code, and (ii) is not treated as a preference item in calculating the alternative minimum tax imposed on individuals and corporations under the Code; such interest, however, is included in adjusted current earnings of certain corporations for purposes of computing the alternative minimum tax imposed on such corporations.

9. Under the Act, interest on the Series 2008B Bonds is exempt from personal income taxes imposed by the State and its political divisions, including The City of New York.

We express no opinion regarding any other federal or state tax consequences with respect to the Series 2008B Bonds. We render our opinions under existing statutes and court decisions as of the date hereof, and we assume no obligation to update, revise or supplement our opinions after such date to reflect any future action taken or not taken, or any facts or circumstances that may hereafter come to our attention, or any changes in law or interpretation thereof that may hereafter occur, or for any other reason. We express no opinion on the effect of any action taken or not taken after the date of our opinion in reliance on an opinion of other counsel on the exclusion from gross income for federal income tax purposes of the interest on the Series 2008B Bonds, or under state and local tax law. We undertake no responsibility for the accuracy, completeness or fairness of any official statement or other offering materials relating to the Series 2008B Bonds and we express no opinion herein relating thereto.

In rendering this opinion, we are advising you that the enforceability of rights and remedies with respect to the Series 2008B Bonds, the Indenture and the Sale Agreement may be limited by bankruptcy, insolvency and other

laws affecting creditors' rights or remedies heretofore or hereafter enacted, and is subject to general principles of equity (regardless of whether such enforceability is considered in a proceeding in equity or at law).

Very truly yours,



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