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## MEMORANDUM

January 23, 2014

**TO:** Interested Persons  
**FROM:** Greg Sobetski, Economist, (303) 866-4105  
**SUBJECT:** 2014 Tobacco MSA Payment Forecast

### Summary

Colorado receives annual payments from tobacco manufacturers as part of the Tobacco Master Settlement Agreement. In April 2013, the state received \$90.8 million, most of which will be used to fund healthcare programs across the state.

A participating tobacco manufacturer can withhold a portion of its required payment if its market share decreases. The amount withheld is paid into an escrow account until an arbitration panel can rule on the cause of the decrease in market share. Many manufacturers have been doing so since 2006, and this forecast assumes a similar pattern. In September 2013, the arbitration panel ruled that Colorado had been in compliance with the terms of the settlement agreement in 2003, the year for which money was withheld from payments in 2006. The state could receive up to \$9.9 million of withheld 2006 payments in April 2014. However, developments in certain legal proceedings may delay Colorado's receipt of these withholdings. Payments withheld in 2007 and subsequent years are not expected to arrive during the forecast period.

### The Tobacco Master Settlement Agreement

The Tobacco Master Settlement Agreement (MSA) was signed in 1998 by 46 states, including Colorado, the District of Columbia, and five U.S. territories. As part of the agreement, states consented to release participating tobacco manufacturers from health-related claims associated with the use, manufacture, and marketing of tobacco products in return for perpetual annual payments from the manufacturers.

The states and tobacco manufacturers have to meet certain requirements to maintain the present level of payments. An arbitration process was established in the MSA to hear any disputes between the participating states and tobacco manufacturers. Colorado receives a fixed portion of the national MSA payment.

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## MSA Payment History and Forecast

Colorado began receiving MSA payments in 1999. The payments are calculated from a base amount that was agreed to in the MSA and is adjusted annually for inflation and changes in cigarette consumption. Consumption has fallen faster than the rate of inflation, so the base payment has decreased over time. In addition to the inflation and consumption adjustments, receipts have been reduced because tobacco manufacturers have disputed a portion of the payment. The payments are due each April.

***MSA dispute and withholding of payments.*** The MSA allows a participating manufacturer to reduce its payments to a state if the following conditions are met:

- the manufacturer is found to have lost market share to manufacturers that do not participate in the MSA;
- the MSA is determined to have been a significant contributing factor in the manufacturer's market share loss; and
- the state in which the market share loss occurred has not upheld its legal obligations to participating manufacturers under the MSA.

This is called the "nonparticipating manufacturers adjustment" (NPM). In order for manufacturers to lower their obligations under the NPM, they must dispute the amount owed at the time of the payment.

Since 2003, tobacco manufacturers have been claiming losses in market share resulting from states' failure to comply with the MSA. Some manufacturers began withholding a portion of their annual payments in 2006. Payments have been withheld despite the fact that the full legal process that must occur for the manufacturers to lower their payments has not run its course. Withheld payments either have not been paid by manufacturers or have been deposited into a separate disputed payments account. Starting with the 2011 payment, all of the largest manufacturers and most of the smaller manufacturers have annually withheld disputed payment amounts. This forecast assumes all tobacco manufacturers will continue to withhold disputed payments in 2014 and future years.

There are two ongoing legal proceedings concerning disputed payments. One is an arbitration process that dates back to the 2003 dispute. The other is a December 2012 settlement reached between tobacco manufacturers and a group of 20 states that had previously participated in the arbitration hearings. Because Colorado is not a party to the second settlement, only the arbitration process is discussed in this memorandum.

Legal progress toward resolving the payment dispute has been slow. Alleged state violations of the NPM in 2003, which resulted in the 2006 withholdings, were not directly addressed by the arbitration panel until September 2013. Because it was determined that Colorado upheld its legal responsibilities under the MSA in 2003, Colorado is eligible to receive the amount that was withheld from its 2006 payment due to the NPM adjustment, approximately \$9.9 million. This figure is less than the total of \$10.9 million withheld from Colorado's 2006 payment because manufacturers withhold money each year for both the NPM dispute and several much smaller disputes each.

Colorado is expected to receive this \$9.9 million distribution payment along with its annual payment at some point during the next three years. It is unknown exactly when the payment will be received, because the timeline for distribution of withheld payments is complicated. As part of the agreement to arbitrate, states conceded that the tobacco manufacturers, not the states, would collect the first disbursements from the disputed payments account if any state were determined to have violated the NPM agreement in 2003. Six states were found to have been in violation.<sup>1</sup> The

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<sup>1</sup>Indiana, Kentucky, Maryland, Missouri, New Mexico, and Pennsylvania.

remaining balance of the disputed payments account for 2006 is less than the amount to be refunded to manufacturers for state NPM violations, so the account will be emptied.

Nine states were found to have met their NPM obligations in 2003,<sup>2</sup> and will receive an amount of money equivalent to their share of manufacturer withholdings in 2006. The money owed to compliant states is supposed to be paid by states that lost in arbitration, but these states are seeking court orders to stop their payments until they can protest the panel's ruling. Should a court issue such an order before payments are due in April, Colorado and the other compliant states will not receive their share of the 2006 disputed amount this year. Instead, the payment would be received in April of the year after the legal proceedings have been resolved.

Developments related to the 2003 and later disputes will impact future payments received by Colorado. Between 2014 and 2016, Colorado will see one annual payment increase of \$9.9 million when its share of the 2006 NPM withholdings are distributed. Once this payment is received, payments are projected to return to 2013 levels as manufacturers are expected to continue withholding. At some future date, Colorado's MSA payment will increase or decrease when the arbitration panel rules on the state's compliance in 2004 and subsequent years. Given the slow pace of legal proceedings, these developments are not expected to impact any payment in the forecast period.

**Table 1**  
**Colorado Tobacco Master Settlement Agreement**  
**Payments and Disputed Payments**  
**2005 to 2016**

Year	Colorado Annual Payment After Withholdings	Disputed Amount Withheld	Release of Prior Withholdings
2005	\$87,367,598	(\$0)	2006 amount withheld due to NPM dispute will be released in April 2014 or after legal proceedings have been resolved.
2006	\$80,367,598	(\$10,942,921)	
2007	\$82,005,568	(\$12,113,579)	
2008	\$103,640,385	(\$7,711,843)	2007 and subsequent withholdings will be distributed after arbitration if Colorado is found to have complied.
2009	\$105,419,647	(\$7,062,223)	
2010	\$95,709,303	(\$8,714,641)	
2011	\$89,065,763	(\$13,614,015)	
2012	\$90,809,964	(\$11,574,809)	
2013	\$90,769,997	(\$12,362,477)	
<b>Forecast</b>			
2014	\$90,616,611	(\$12,341,586)	One time release of \$9,923,353, in a year to be determined.
2015	\$90,467,138	(\$12,321,229)	
2016	\$90,320,774	(\$12,301,295)	

<sup>2</sup>Colorado, Illinois, Iowa, Maine, New York, North Dakota, Ohio, Oregon, and Washington.

Table 1 shows MSA payments since 2005 and the estimated payments for 2014 through 2016. The large increase in payments in 2008 is from a separate strategic contribution fund payment made in addition to the base payment in the MSA. The payment from the strategic contribution fund is an additional payment intended to reflect the level of contribution each state made toward final resolution of the state lawsuits against the tobacco companies. Colorado will receive this secondary payment through 2016. The increase in disputed payments in 2011 is a result of the three largest tobacco manufacturers withholding disputed payments. Between 2008 and 2010, only two of the three largest manufacturers disputed payment amounts.

**Risks to the MSA forecast.** In addition to the NPM dispute, several factors could alter the amount the state receives from future payments, resulting in either larger or smaller amounts than forecast. These are described below.

- MSA base payments are adjusted depending on the volume of cigarettes consumed nationwide and on inflation rates, which are difficult to predict. The forecast for the base payment reflects projected decreases in cigarette sales and continued low inflation rates.
- Manufacturers may change their pattern of withholding payments. Consistent with the 2011 payment, it is assumed that the largest cigarette manufacturers will withhold payments throughout the forecast period. Once the legal disputes are resolved, the manufacturers' withholding patterns may change.
- Additional smaller adjustments occur when manufacturers withhold payments in disputes unrelated to the NPM, or when manufacturers release payments withheld in prior disputes of this type. These are difficult to forecast.
- Some manufacturers may go out of business or file bankruptcy, and some manufacturers may not pay what is due each year.

### **Distribution of MSA Payments**

Table 3 on page 6 shows the state's actual MSA receipts in FY 2010-11 through FY 2012-13 and the Legislative Council Staff forecast of the state's receipts for FY 2013-14 through FY 2015-16. Table 3 also summarizes how the money is distributed among the General Fund, Tobacco Settlement Litigation Fund, and MSA-funded programs. Table 4 on page 7 shows the amount that each MSA-funded program is projected to receive through FY 2016-17. The table includes a description of the funds that receive MSA revenue and the funding formula used to allocate those funds. State law distinguishes between two tiers of programs, which is why that distinction is made in Tables 3 and 4.

Currently, most of the payments go to programs in the Department of Health Care Policy and Financing, the Department of Human Services, the Department of Higher Education, and the Department of Public Health and Environment, though other departments receive payments as well. Each annual MSA payment funds programs in both the fiscal year the payment is received and the following fiscal year.

Senate Bill 09-269 transferred \$65.0 million in tobacco MSA payments to the state General Fund in FY 2009-10. These funds would have been appropriated to healthcare programs in FY 2010-11. To make up for this transfer, \$65.0 million in tobacco MSA payments received in April 2011 were used to fund healthcare programs in FY 2010-11. This accelerated payment has occurred each year since FY 2010-11, as a portion of MSA payments are used to fund programs in the fiscal year they are received.

Because the state fiscal year begins in July but MSA payments do not arrive until April, expenditures to programs funded by MSA revenue are paid out of the General Fund between the date when the previous fiscal year's MSA revenue is exhausted, usually in August, and the arrival of the current fiscal year's MSA payment in April. In order to decrease the amount advanced annually from the General Fund, House Bill 12-1247 reduced the size of the accelerated payment by about \$1.5 million and prevents it from increasing in any fiscal year after FY 2012-13.

Finally, state law distinguishes between annual payments and disputed payments for the purposes of distribution. When Colorado receives disputed payments withheld in 2006 and subsequent years, these funds will not be distributed following the formula in statute but instead credited directly to the General Fund.

**2011, 2012, and 2013 legislative adjustments to allocations of MSA payments.** Laws passed in recent legislative sessions adjusted the allocations of MSA payments to certain programs. Table 2 shows a summary of bills passed in the 2011 through 2013 sessions and their effects on the distribution of MSA payments.

**Table 2  
Recent Bills Affecting MSA Distributions**

<b>2011 Session</b>	
SB 11-216	Increased funding for the Children's Basic Health Plan by redistributing MSA funding from other programs.
HB 11-1281	Transferred \$250,000 annually from the Short-term Innovative Health Programs Grant Fund to the Colorado Health Services Corps.
<b>2012 Session</b>	
HB 12-1238	Eliminated the Read-to-Achieve program and transferred its funding to the Early Literacy Fund.
HB 12-1247	Eliminated the Short-term Innovative Health Programs Grant Fund and used the savings to offset General Fund accelerated payments to MSA-funded programs.
HB 12-1249	Requires the Office of the State Auditor to review MSA programs and allocates \$89,000 annually for this purpose.
<b>2013 Session</b>	
HB 13-1180	Redirected MSA funds from the General Fund to the Nurse Home Visitor program and to the Defense Account of the Tobacco Litigation Cash Fund.
HB 13-1305	Allows the Governor to transfer General Fund money into the Tobacco Litigation Cash Fund if the General Assembly is not in session and the arbitration panel rules that Colorado is not entitled to its share of the disputed payment amounts.

**Table 3. Tobacco Master Settlement Agreement Payments**

*(In Millions)*

*Fiscal Years 2010-11 to 2012-13 Payments Actual*

<b>Received from Tobacco MSA Settlement</b>		<b>2010-11</b>	<b>2011-12</b>	<b>2012-13</b>	<b>2013-14</b>	<b>2014-15</b>	<b>2015-16</b>
Annual MSA Payment Received (Payments provide funding for programs both in the fiscal year received and in the following year)		<b>\$89.1</b>	<b>\$90.8</b>	<b>\$90.8</b>	<b>\$90.6</b>	<b>\$90.5</b>	<b>\$90.3</b>
<b>General Fund</b>		<b>2010-11</b>	<b>2011-12</b>	<b>2012-13</b>	<b>2013-14</b>	<b>2014-15</b>	<b>2015-16</b>
General Fund	Diversion of reduced transfers to tobacco programs (SBs 11-224 and 11-225; HB 12-1247) <sup>1</sup>	\$2.9	\$2.3	\$1.3	\$1.3	\$1.2	\$1.2
	Release of withheld payments from prior years (not included in the Annual MSA Payment Received) <sup>2</sup>	\$0.0	\$0.0	\$0.0	One-time receipt of \$9.9 million in a year to be determined.		
	<b>Total to General Fund</b>	<b>\$2.9</b>	<b>\$2.3</b>	<b>\$1.3</b>	<b>\$1.3</b>	<b>\$1.2</b>	<b>\$1.2</b>
<b>Attorney General</b>		<b>2010-11</b>	<b>2011-12</b>	<b>2012-13</b>	<b>2013-14</b>	<b>2014-15</b>	<b>2015-16</b>
Tobacco Litigation Settlement Fund	Reallocation of General Fund MSA share in FY 2012-13; \$1 million annually between FY 2013-14 and FY 2015-16 <sup>3</sup>	\$0.0	\$0.0	\$1.8	\$1.0	\$1.0	\$1.0
<b>State Agencies</b>		<b>2011-12</b>	<b>2012-13</b>	<b>2013-14</b>	<b>2014-15</b>	<b>2015-16</b>	<b>2016-17</b>
Allocations to MSA-Funded Programs	Tier 1 Programs (pursuant to 24-75-1104.5 (1), C.R.S.)	\$59.0	\$60.1	\$61.8	\$62.6	\$63.4	\$64.3
	Tier 2 Programs (pursuant to 24-75-1104.5 (1.5), C.R.S.)	\$27.8	\$27.4	\$26.7	\$25.8	\$24.9	\$24.8
	<b>Total; See Table 4 on page 7</b>	<b>\$86.8</b>	<b>\$87.5</b>	<b>\$88.4</b>	<b>\$88.3</b>	<b>\$88.2</b>	<b>\$89.1</b>

<sup>1</sup>SB 11-224 established an annual transfer from the Nurse Home Visitor Fund to the General Fund; this ended with the passage of HB 13-1180. SB 11-225 established an annual transfer from the Short-term Innovative Health Programs Grant fund to the General Fund; this ended with the passage of HB 12-1247. HB 12-1247 eliminated the Short-term Innovative Health Programs Grant Fund and used the 6% of second tier MSA revenue that had been allocated to that fund to offset a portion of the annual General Fund loans used to make accelerated payments to tobacco programs. General Fund savings from HB 12-1247 is reported as General Fund revenue in this table.

<sup>2</sup>SB 09-269 requires that all disputed payments received after June 1, 2009, be credited to the General Fund. These payments are not a part of the sum distributed according to the formula in statute.

<sup>3</sup>HB 13-1180 transferred money that had been allocated to the general fund under SB 11-224 to the Tobacco Litigation Settlement Fund in FY 2012-13; between FY 2013-14 and FY 2015-16, \$1 million is transferred to the Tobacco Litigation Settlement Fund annually.

**Table 4. Tobacco Master Settlement Agreement Distribution**

*(In Millions)*

*Fiscal Years 2010-11 to 2012-13 Distribution Actual; Pursuant to 24-75-1104.5, C.R.S.*

<b>Total MSA Payment Distributed (Excluding General Fund and Tobacco Litigation Settlement Fund)</b>			<b>\$86.8</b>	<b>\$87.5</b>	<b>\$88.4</b>	<b>\$88.3</b>	<b>\$88.2</b>	<b>\$89.1</b>
<b>First Tier Program Allocations</b>			<b>2011-12</b>	<b>2012-13</b>	<b>2013-14</b>	<b>2014-15</b>	<b>2015-16</b>	<b>2016-17</b>
Health Care Policy and Financing	Children's Basic Health Plan Trust	27% of MSA payment up to \$33 million	\$24.1	\$24.5	\$24.5	\$24.5	\$24.4	\$24.4
	Children with Autism	\$1 million annually	\$1.0	\$1.0	\$1.0	\$1.0	\$1.0	\$1.0
Public Health and Environment	Dental Loan Repayment	\$200,000 annually	\$0.2	\$0.2	\$0.2	\$0.2	\$0.2	\$0.2
	HIV Prevention	2% of MSA payment up to \$2 million	\$1.8	\$1.8	\$1.8	\$1.8	\$1.8	\$1.8
	AIDS Drug Assistance	3.5% of MSA payment up to \$5 million	\$3.1	\$3.2	\$3.2	\$3.2	\$3.2	\$3.2
Human Services <sup>1</sup>	Nurse Home Visitors	Varies; see footnote <sup>2</sup>	\$12.4	\$12.7	\$14.4	\$15.3	\$16.2	\$17.2
	Tony Grampsas Youth Services	4% of MSA payment up to \$5 million	\$3.6	\$3.6	\$3.6	\$3.6	\$3.6	\$3.6
	Children's Mental Health Treatment	\$300,000 annually	\$0.3	\$0.3	\$0.3	\$0.3	\$0.3	\$0.3
Capital Construction	Fitzsimons Trust Fund	8% of MSA payment up to \$8 million, or Fitzsimons debt service requirement under HB 03-1256 if less	\$7.1	\$7.3	\$7.3	\$7.2	\$7.2	\$7.2
Military Affairs and Veterans	Veterans Trust Fund	1% of MSA payment up to \$1 million	\$0.9	\$0.9	\$0.9	\$0.9	\$0.9	\$0.9
Education	Read to Achieve	5% of MSA payment up to \$8 million <sup>3</sup>	\$4.5	\$0.0	\$0.0	\$0.0	\$0.0	\$0.0
	Early Literacy Fund	5% of MSA payment up to \$8 million <sup>3</sup>	\$0.0	\$4.5	\$4.5	\$4.5	\$4.5	\$4.5
<b>Second Tier Program Allocations</b>			<b>2011-12</b>	<b>2012-13</b>	<b>2013-14</b>	<b>2014-15</b>	<b>2015-16</b>	<b>2016-17</b>
Health Care Policy and Financing	Children's Basic Health Plan Trust	14.5% of MSA payment remaining after first tier	\$4.3	\$4.2	\$4.1	\$3.9	\$3.8	\$3.8
Higher Education	CU Health Sciences Center	49% of MSA payment remaining after first tier	\$14.4	\$14.2	\$13.7	\$13.3	\$12.8	\$12.8
Human Services	Offender Mental Health Services	12% of MSA payment remaining after first tier	\$3.5	\$3.5	\$3.4	\$3.2	\$3.1	\$3.1
	Alcohol and Drug Abuse Programs	3% of MSA payment remaining after first tier	\$0.9	\$0.9	\$0.8	\$0.8	\$0.8	\$0.8
Personnel and Administration	Supplement State Employee Insurance Plans	4.5% of MSA payment remaining after first tier	\$1.3	\$1.3	\$1.3	\$1.2	\$1.2	\$1.2
Public Health and Environment	Public Health Services	7% of MSA payment remaining after first tier	\$2.1	\$2.0	\$2.0	\$1.9	\$1.8	\$1.8
	Immunizations	4% of MSA payment remaining after first tier	\$1.2	\$1.1	\$1.1	\$1.1	\$1.0	\$1.0
	Health Services Corps	\$250,000 annually <sup>4</sup>	\$0.3	\$0.3	\$0.3	\$0.3	\$0.3	\$0.3
Office of the State Auditor	Reviews of Tobacco Settlement Programs	\$89,000 annually beginning in FY 2012-13 <sup>5</sup>	\$0.0	\$0.1	\$0.1	\$0.1	\$0.1	\$0.1

<sup>1</sup>SB 10-175 relocated the Children's Mental Health Treatment program from the Department of Health Care Policy and Financing to the Department of Human Services. HB 13-1117 relocated the Nurse Home Visitors fund and Tony Grampsas Youth Services Fund from the Department of Public Health and Environment to the Department of Human Services.

<sup>2</sup>HB 13-1180 made substantial changes to the funding formula for the Nurse Home Visitors Program. In FY 2011-12 and FY 2012-13, the fund received the greater of 14% of the MSA payment and \$12,727,350; in FY 2013-14, 2014-15, and 2015-16, it receives 17%, 18%, and 19% of the MSA payment, respectively, less \$1 million annual transfer to the Tobacco Litigation Settlement Fund; in FY 2016-17, it receives 19% of the MSA payment

<sup>3</sup>HB 12-1238 replaced the Read to Achieve program with the Early Literacy Fund beginning in FY 2012-13.

<sup>4</sup>HB 11-1281 appropriated \$250,000 from the Short-term Innovative Health Programs Grant Fund. After the passage HB 12-1247, Health Services Corps money comes from the 6% of second tier revenue not allocated to other programs.

<sup>5</sup>HB 12-1249 requires the Office of the State Auditor to review the performance of programs receiving MSA funding. It appropriated \$89,000 from the 6% of unallocated second tier revenue, the balance of which is transferred to the General Fund.