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M E M O R A N D U M

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TO: Interested Persons
FROM: Greg Sobetski, Economist, 303-866-4105
SUBJECT: 2017 Tobacco MSA Payment Forecast

Summary

Colorado receives annual payments from tobacco manufacturers as part of the Tobacco Master Settlement Agreement. In April 2016, the state received \$92.3 million. This memorandum presents the distribution of the 2016 payment and forecasts payments through 2019. House Bill 16-1408 made significant changes to the distribution of settlement revenue for FY 2016-17 and future years; most of the payment is used to fund health care programs across the state.

After manufacturer withholding, payments are estimated at \$95.4 million in 2017, \$79.1 million in 2018, and \$80.3 million in 2019.

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. Colorado receives a fixed portion of the national MSA payment each year. As a damage award, MSA revenue is exempt from TABOR.

The states and tobacco manufacturers must 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. Since 2003, a portion of the MSA payment has been disputed each year.

MSA Payment History and Forecast

Colorado began receiving MSA payments in 1999. The payments are calculated from a base amount in the MSA that is adjusted annually for inflation and changes in cigarette consumption. Until 2015, consumption had fallen faster than the rate of inflation, so the nominal base payment had decreased over time. Available data suggest that cigarette consumption is flattening, and payments are expected to be driven by inflation adjustments in the current forecast period. The payment received in 2016 exceeded the payment received in 2015, the first year-over-year increase since 2012. Payments are due each year in 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 agreement" (NPM). In order for manufacturers to lower their obligations under the framework of 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. Since 2011, all of the largest manufacturers and most of the smaller manufacturers have annually withheld disputed payment amounts. This forecast assumes that participating tobacco manufacturers will withhold an increasing share of annual payments in 2017 and future years.

Litigation concerning disputed payments for 2003, which were withheld in 2006, was resolved in 2014. Colorado was found to have complied with the NPM agreement and received \$11.4 million in NPM adjustment arbitration money, of which \$2.2 million was paid from the disputed payments account and \$9.2 million was reallocated to Colorado from the annual payments of states that did not comply.

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. Colorado's share of the nationwide payment withheld by manufacturers based on alleged 2004 noncompliance is \$9.7 million. States involved in the 2004 dispute are expected to present their cases beginning in October 2017, and the arbitration panel is expected to rule on the question of compliance prior to the 2019 payment at the earliest. Given the slow pace of legal proceedings, this forecast assumes that the 2004 dispute will not impact payments during the current forecast period.

Table 1
2017 Tobacco MSA Payment Forecast
Dollars in Millions

| Payment Source | FY 2014-15 Actual | FY 2015-16 Actual | FY 2016-17 Estimate | FY 2017-18 Estimate | FY 2018-19 Estimate |
|---|------------------------------|------------------------------|--------------------------------|--------------------------------|--------------------------------|
| Annual MSA Payment (Gross of Withholding) | \$83.4 | \$85.7 | \$89.1 | \$91.8 | \$93.4 |
| Strategic Contribution Fund Payment (Gross of Withholding) ¹ | 17.1 | 17.6 | 18.3 | - | - |
| Manufacturer Withholding | (12.5) | (11.2) | (12.1) | (12.8) | (13.1) |
| Release of Prior Year Withholdings | - | - | - | - | - |
| Net Funds Received | \$88.1 | \$92.3 | \$95.4 | \$79.1 | \$80.3 |

| Allocation of Received Funds | FY 2015-16 Actual | FY 2016-17 Estimate | FY 2017-18 Estimate | FY 2018-19 Estimate | FY 2019-20 Estimate |
|---|------------------------------|--------------------------------|--------------------------------|--------------------------------|--------------------------------|
| MSA-Funded State Programs (see Table 2) | \$86.9 | \$90.9 | \$79.2 | \$77.9 | \$79.1 |
| Unallocated Portion ² | 1.2 | 1.4 | 16.2 | 1.2 | 1.2 |

Source: Department of Law, Department of the Treasury, and Legislative Council Staff Forecast.

¹Under the terms of the settlement, Strategic Contribution Fund payments end after April 2017.

²Unallocated amounts for each fiscal year remain in the Tobacco Litigation Settlement Cash Fund, thereby reducing future accelerated payments from the fund. Section 24-75-1104.5 (1.3)(a.5)(II), C.R.S., requires that \$15 million be reserved from the April 2017 payment for this purpose.

Forecast. In 2016, Colorado received an MSA payment totaling \$92.2 million after withholding, 5.3 percent more than the \$87.6 million expected in the 2016 Tobacco MSA Payment Forecast. The difference was attributable to cigarette consumption, which did not decrease as had been anticipated in last year's forecast. After accounting for adjustments to previous payments, the total amount received by the state in 2016 increased by a net \$120,829. Manufacturers withheld \$11.2 million, below forecast expectations. Expected MSA receipts have been revised upward in each of 2017 and 2018 to reflect increased expectations for cigarette consumption.

The MSA payment is expected to rise to \$95.4 million in 2017 before falling to \$79.1 million in 2018 and \$80.3 million in 2019. The one-time drop in collections in 2018 reflects the scheduled termination of payments from the Strategic Contribution Fund (SCF). Through 2017, this secondary payment from tobacco manufacturers each year is distributed to states based on their level of contribution toward final resolution of state lawsuits against tobacco companies. Net of withholding, Colorado received about \$15.5 million from the SCF in April 2016, in line with payments in prior years. This year's SCF payment will be the last.

Table 1 presents MSA payments since 2015 and the estimated payments for 2017 through 2019.

Risks to the 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. The forecast for the base payment reflects flattening cigarette sales and inflation rates below 3 percent.
- Manufacturers may change their pattern of withholding payments. Consistent with the 2011 and subsequent payments, it is assumed that the largest cigarette manufacturers will withhold payments through the forecast period. If this pattern changes, annual payments received could be higher than forecast.
- 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

The MSA payment that the state receives in April dictates the allocation of moneys to MSA-funded programs for the fiscal year beginning in the following July. The bottom section of Table 1 shows the amounts of payments received each year that are expected to be spent on programs versus the amounts reserved each year to reduce the accelerated payments described below. Table 2 shows the amount that each MSA-funded program is projected to receive through FY 2019-20.

Table 2
2017 Tobacco MSA Distribution Forecast
Dollars in Millions

| Program | FY 2015-16 Actual | FY 2016-17 Estimate | FY 2017-18 Estimate | FY 2018-19 Estimate | FY 2019-20 Estimate |
|--|----------------------|------------------------|------------------------|------------------------|------------------------|
| Department of Law | | | | | |
| Tobacco Settlement Defense Account | \$1.0 | \$2.3 | \$2.0 | \$2.0 | \$2.0 |
| Department of Human Services | | | | | |
| Nurse Home Visitors | \$15.7 | \$24.6 | \$21.5 | \$21.1 | \$21.4 |
| Tony Gramscas Youth Services | 3.5 | 6.9 | 6.0 | 5.9 | 6.0 |
| Offender Mental Health Services ¹ | 3.0 | - | - | - | - |
| Alcohol and Drug Abuse Services ¹ | 0.8 | - | - | - | - |
| Children's Mental Health Treatment ¹ | 0.3 | - | - | - | - |
| Dep't of Health Care Policy and Financing | | | | | |
| Children's Basic Health Plan Trust | \$27.5 | \$16.6 | \$14.5 | \$14.2 | \$14.4 |
| Children with Autism | 1.0 | 1.8 | 1.6 | 1.6 | 1.6 |
| Department of Higher Education | | | | | |
| CU Health Sciences Center ² | \$12.4 | \$16.2 | \$14.1 | \$13.8 | \$14.0 |
| Department of Public Health and Environment | | | | | |
| AIDS Drug Assistance | \$3.1 | \$4.6 | \$4.0 | \$4.0 | \$4.0 |
| HIV Prevention | 1.8 | 3.2 | 2.8 | 2.8 | 2.8 |
| Immunizations | 1.0 | 2.3 | 2.0 | 2.0 | 2.0 |
| Health Services Corps | 0.3 | 0.9 | 0.8 | 0.8 | 0.8 |
| Dental Loan Repayment | 0.2 | 0.9 | 0.8 | 0.8 | 0.8 |
| Public Health Services ¹ | 1.8 | - | - | - | - |
| Capital Construction | | | | | |
| Fitzsimons Trust Fund | \$7.0 | \$7.4 | \$6.4 | \$6.3 | \$6.4 |
| Department of Personnel and Administration | | | | | |
| Supplement State Employee Insurance Plans | \$1.1 | \$2.1 | \$1.8 | \$1.8 | \$1.8 |
| Department of Military and Veterans Affairs | | | | | |
| Veterans Trust Fund | \$0.9 | \$0.9 | \$0.8 | \$0.8 | \$0.8 |
| Department of Education | | | | | |
| Early Literacy Fund ¹ | \$4.4 | - | - | - | - |
| Legislative Branch | | | | | |
| Audit of MSA-Funded Programs ³ | \$0.1 | - | - | - | - |
| Total Funds Distributed | \$86.9 | \$90.9 | \$79.2 | \$77.9 | \$79.1 |

Source: Department of the Treasury and Legislative Council Staff Forecast.

¹For FY 2016-17, these programs received appropriations from the Marijuana Tax Cash Fund under House Bill 16-1408. The General Assembly may choose to fund these programs from marijuana tax revenue in coming years.

²For FY 2016-17 and subsequent years, a share of this amount is required to be spent for tobacco-related in-state cancer research.

³For FY 2016-17 and subsequent years, the audit is no longer funded pursuant to House Bill 16-1408.

Accelerated payments. While the amount allocated to MSA programs for a fiscal year is determined by the payment the state receives in the previous April, each payment funds programs in both the fiscal year it is received and the following fiscal year. In FY 2009-10, \$65.0 million was transferred from the state's 2010 MSA payment to the General Fund.¹ Had the transfer not been made, this amount would have been used to fund programs for FY 2010-11; to compensate, \$65.0 million from the state's 2011 MSA payment was allocated to programs in the then-current FY 2010-11. The ongoing shift in pay dates, called an "accelerated payment," has occurred in every year since. For programs funded in FY 2016-17, \$31.7 million was paid from the state's April 2016 payment, and the remaining \$60.7 million is expected to be paid from the April 2017 payment.

Because the state fiscal year begins in July and payments do not arrive until April, expenditures to MSA-funded programs are paid out of the General Fund between the date when the previous fiscal year's MSA revenue is exhausted and the arrival of the current fiscal year's MSA payment in April. To decrease the amount advanced annually from the General Fund, any unallocated amount remaining in the Tobacco Litigation Settlement Cash Fund after programs are funded is retained in the fund and used to reduce the following year's accelerated payment. Additionally, statute requires that \$15 million from the 2017 payment not be used to drive the FY 2017-18 MSA distribution and instead remain in the fund to reduce the accelerated payment.² This essentially saves this money so that it can be distributed to programs one year later, in FY 2018-19. For FY 2017-18, the amount of the accelerated payment is expected to fall to \$44.3 million, a decrease of 27 percent. This amount is expected to fall by a further \$1.2 million in each of FY 2018-19 and FY 2019-20, based on the unallocated amounts expected for those years.

Under Senate Bill 14-104 and House Bill 14-1394, any released disputed payments that the state receives in future years will not be distributed to MSA-funded programs and will instead reduce the amount of the accelerated payment. The state is not expected to receive any disputed payments during the current forecast period.

House Bill 16-1408. The state's MSA payment will fall in 2018 as the supplemental payment from the Strategic Contribution Fund ends. In anticipation of this reduction, the General Assembly enacted HB 16-1408. The bill eliminated funding from MSA revenue for six programs beginning in FY 2016-17:

- the Offender Mental Health Services Program in the Department of Human Services (DHS);
- the Alcohol and Drug Abuse Services Program in DHS;
- the Children's Mental Health Treatment Program in DHS;
- the Public Health Services Program in the Department of Public Health and Environment;
- the Early Literacy Fund in the Department of Education; and
- the Office of the State Auditor's annual audit of MSA-funded programs.

All of these programs except the audit received appropriations from the Marijuana Tax Cash Fund for operations during FY 2016-17. For FY 2017-18 and subsequent years, none of the programs will receive funding from the annual MSA payment.

¹Senate Bill 09-269.

²Section 24-75-1104.5 (1.3)(a.5)(II), C.R.S.

The bill made significant changes to the statutory formula used to allocate MSA revenue. It removed the two-tier distribution previously in statute and, beginning in FY 2016-17, allocates 98.5 percent of the annual MSA payment to 14 programs in the shares listed in Table 3.

Table 3
Distribution of Tobacco MSA Payment under HB16-1408
Effective FY 2016-17 under Section 24-75-1104.5 (1.7), C.R.S.

| Program | Distribution |
|---|---------------------|
| Department of Law | |
| Tobacco Settlement Defense Account | 2.5% |
| Department of Human Services | |
| Nurse Home Visitors | 26.7% |
| Tony Grampas Youth Services | 7.5% |
| Department of Health Care Policy and Financing | |
| Children's Basic Health Plan Trust | 18.0% |
| Children with Autism | 2.0% |
| Department of Higher Education | |
| CU Health Sciences Center ¹ | 17.5% |
| Department of Public Health and Environment | |
| AIDS Drug Assistance | 5.0% |
| HIV Prevention | 3.5% |
| Immunizations | 2.5% |
| Health Services Corps | 1.0% |
| Dental Loan Repayment | 1.0% |
| Capital Construction | |
| Fitzsimons Trust Fund | 8.0% |
| Department of Personnel and Administration | |
| Supplement State Employee Insurance Plans | 2.3% |
| Department of Military and Veterans Affairs | |
| Veterans Trust Fund | 1.0% |
| Total Funds Distributed | 98.5% |

¹Of this share, 2.0 percent must be expended for tobacco-related in-state cancer research.

Table 2 reflects distributions of future payments in the percentages listed in Table 3. The remaining 1.5 percent of each year's MSA payment remains in the Tobacco Litigation Settlement Cash Fund and is used to reduce the following year's accelerated payment.