

MEMORANDUM

TO: Joint Budget Committee

FROM: Amanda Bickel, JBC Staff

SUBJECT: Tobacco Master Settlement Agreement – Arbitration Panel Ruling

DATE: September 20, 2013

On September 11, 2013, Colorado won an important victory in an ongoing dispute with tobacco manufacturers regarding funds due to the state under the Tobacco Master Settlement Agreement (MSA). An arbitration panel has ruled in Colorado's favor in the dispute over the 2003 non-participating manufacturers' (NPM) adjustment. The panel considered whether Colorado had "diligently enforced" its statutes that required non-participating manufacturers to place funds in escrow in 2003. The panel concluded that Colorado had a "culture of compliance".

The benefits of this ruling include:

- Colorado may receive a payout in the coming year (possibly \$2-\$3 million from amounts previously withheld), and it could ultimately receive over \$10 million in additional funds related to this ruling for 2003. Under current statute, any amounts received will be deposited to the General Fund.
- The ruling eliminates any immediate risk of a "worst case scenario" in which Colorado would lose an entire year's worth of tobacco MSA revenue based on an adverse panel ruling.
- The decision increases the odds that Colorado will win disputes over subsequent years' payments (the NPM disputes for 2004 to the present year).

Additional background and detail on the Tobacco MSA and NPM adjustment dispute is attached. Copies of the arbitration panel ruling are also available for any interested legislators.

Background on the Tobacco MSA, NPM Adjustment, and Disputed Payments

The Tobacco MSA: The Tobacco MSA is a 1998 settlement between tobacco manufacturers and states, which sued tobacco manufacturers in the mid-1990s to recover Medicaid and other health-related costs incurred as a result of smoking. In recent years, Colorado has received \$90 to \$95 million per year from its share of the Tobacco MSA, but this is net of \$10 to \$12 million per year withheld by participating manufacturers pursuant to the NPM adjustment described below. The funds Colorado does receive are distributed to a large number of programs based on statutory allocation formulas.

The NPM Adjustment: The Tobacco MSA added about \$4.30 to the cost of a carton of cigarettes purchased from participating manufacturers. The settlement costs were expected to place participating manufacturers at a competitive disadvantage when compared with the "non-participating manufacturers" (NPMs) who had not joined the agreement. In an effort to level the playing field, the agreement required states to enact a model statute that forced NPMs to make payments into escrow accounts that were comparable to what they would have paid to the states had they participated in the agreement.

To ensure states enforced the model statute and protected participating manufacturer interests, the agreement included an NPM adjustment clause to reduce manufacturer payments to states under certain circumstances. This adjustment comes into play when three conditions are satisfied for a given year:

- the market share of participating manufacturers declines by 2 percent or more;
- an independent economic consultant finds that the agreement significantly contributed to this decline, and
- an arbitrator finds that a given state failed to diligently enforce its NPM statute.

If all three conditions occur, then an aggregate NPM adjustment is proportionately allocated among those states that are found to have failed to have diligently enforce their NPM laws. If only one state is found to have failed to diligently enforce NPM provisions, that one state can be held financially responsible for participating manufacturers' loss of market share nationwide; however, the maximum NPM adjustment penalty faced by a state cannot exceed the total amount of tobacco settlement funds the state received in the year in question.

The NPM Adjustment Dispute and Arbitration: By the time that the 2003 settlement payment was due in 2004, the market share of the major tobacco manufacturers had declined 8.2 percent relative to 1997. The participating firms made the 2003 payment but also set in motion the process for review by an independent economic consultant.

The consultant concluded that the tobacco settlement agreement significantly contributed to the participating manufacturers' decline in market share. Based on the consultants' finding, two of the three criteria for participating manufacturers to claim an NPM adjustment had been met.

Following the decision of the economic consultant, some tobacco companies decided to reduce their 2006 April MSA payments based on the estimated 2003 NPM adjustment. In response, the accounting firm that oversees the distribution of settlement payments reduced each state's 2006 payment by a proportionate share. For calendar year 2004 and subsequent years the participating manufacturers have continued to assert that they are entitled to the NPM adjustment, and manufacturers have continued to withhold a portion of payments. These reductions have been proportionately allocated among states, with most of the withheld funds deposited into a disputed payments account.

Nonetheless, the final NPM adjustment and its allocation to states for 2003 and subsequent years has been pending a determination by an arbitration panel that one or more states failed to “diligently enforce” their state laws.

Beginning in June 2012, a three-member arbitration panel began state-specific hearings on this topic for 35 states (including Colorado) whose diligence in 2003 was challenged by the manufacturers. In December 2012, 19 of the 52 states, districts and territories in the tobacco settlement agreement, including many of the states in state-specific arbitration proceedings, signed on to a multi-year settlement agreement with the participating manufacturers. The agreement apportions withheld funds between the manufacturers and the states and makes various other changes to how future NPM adjustments will be calculated for states that participate. The arbitration panel allowed the agreement to proceed.

Ultimately, 15 states, including Colorado, proceeded with the arbitration process outlined in the original Tobacco MSA. *Of those 15 states, 9, including Colorado, have now been found to have diligently enforced their NPM laws in 2003, while 6 had arbitration panel findings against them.*

Next Steps: There will be ongoing legal disputes and negotiations about how moneys that were withheld by tobacco manufacturers for the 2003 NPM adjustment are distributed between the participating manufacturers, states whose diligence in enforcing state laws was not contested, states which had arbitration panel rulings in their favor, and states which settled the NPM dispute with the manufacturers. Thus, it remains unclear when Colorado will be fully compensated for its share of the 2003 Tobacco MSA funds that were withheld. Further, each year after 2003 is still subject to a separate arbitration panel decision.