

**COLORADO GENERAL ASSEMBLY  
JOINT BUDGET COMMITTEE**



**FY 2015-16 STAFF BUDGET BRIEFING  
TOBACCO MASTER SETTLEMENT AGREEMENT**

**JBC Working Document - Subject to Change  
Staff Recommendation Does Not Represent Committee Decision**

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November 13, 2014**

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## **TOBACCO MASTER SETTLEMENT AGREEMENT**

### **Overview**

The Tobacco Master Settlement Agreement (MSA) provides Colorado with an annual revenue stream which is directed via statutory formulas to a wide variety of programs, primarily in the area of public health. The revenue is the product of 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 treating smoking related illnesses. The current flow of Tobacco MSA receipts to the State includes the following major components:

- *The Base Settlement Agreement Payment:* The base payment represents the core settlement agreement payment. Colorado's April 2014 base payment (prior to "withholding" described below) was \$99.7 million. The MSA indicates that base payments continue in perpetuity, but adjust annually based on tobacco sales and inflationary factors. Projections for the next several years by the National Association of Attorneys General (NAAG) reflect an estimated annual decline in base payments of 1.0 percent per year.
- *The Strategic Contribution Payment:* The Strategic Contribution Payment is allocated among states based on their level of participation in the original Tobacco Lawsuit. These payments are for a ten year period only (April 2007 through April 2016). Colorado's Strategic Contribution Payment received April 2014 (prior to "withholding" described below) was \$17.6 million.
- *Disputed Payments:* Pursuant to the Non-Manufacturers Dispute, Participating Manufacturers have been withholding a portion of their annual payments to states. A total of \$10.7 million was withheld from the April 2014 payment.

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## General Factors Driving the Budget

### **Base Settlement Agreement**

Annual MSA payments by participating manufactures are primarily driven by three factors:

- The number of units sold<sup>1</sup> nationwide (a manufactures base payment is based on the number of units sold nationwide and distribution to states is based on the distribution formula);
- The amount of disputed payments withheld by participating manufactures; and
- The inflation adjustment as prescribed in the MSA which is a cumulative adjustment starting in 2000 with a minimum annual adjustment of 3.0 percent (i.e. if inflation is lower than 3.0 percent the inflation adjustment for that year is 3.0 percent).

The table below reflects the payment history. Amounts received in the prior year (e.g., FY 2013-14) drive total funding allocations for the current year (e.g., FY 2014-15). However, special ("disputed") payments received as legal issues are resolved are not allocated to programs and are used to reduce the share of MSA expenditures made from current year revenue.

<b>Tobacco MSA Payment History FY 2003-04 to FY 2013-14</b>						
<b>Fiscal Year Payment Is Received</b>	<b>This Payment Determines Allocations in FY:</b>	<b>Full Payment</b>	<b>Amount Withheld (Disputed)</b>	<b>Amount Received Excluding Special Payments</b>	<b>Percent Change Excluding Special Payments</b>	<b>Special Payments</b>
<b>Actual Payments (in millions of \$):</b>						
2003-04	2004-05	\$86.1	\$0.0	\$86.1	n/a	\$0.0
2004-05	2005-06	87.4	0.0	87.4	1.5%	0
2005-06	2006-07	91.1	(10.9)	80.2	(8.2)%	0
2006-07	2007-08	92.7	(8.8)	83.9	4.6%	0
2007-08	2008-09	111.4	(7.7)	103.7	23.6%	0
2008-09 <sup>1</sup>	2009-10	112.5	(7.1)	105.4	1.6%	7.4
2009-10	2010-11	103.3	(8.7)	94.6	(10.3)%	0
2010-11	2011-12	102.7	(13.6)	89.1	(5.8)%	0
2011-12	2012-13	102.4	(11.6)	90.8	1.9%	0
2012-13	2013-14	103.1	(12.3)	90.8	0.0%	0
2013-14 <sup>1</sup>	2014-15	99.7	(10.7)	89.0	(1.9)%	11.4

<sup>1</sup>Total receipts in FY 2008-09 were \$112.8 million and total receipts in FY 2013-14 were \$100.4 million, if additional special payments are included.

<sup>1</sup> Pursuant to Section 39-28-202 (10), C.R.S., "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 containers of roll-your-own tobacco, and on packs of cigarettes bearing the excise tax stamp of the state.

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Based on amounts received in FY 2013-14, a total of \$89.0 million will be distributed in FY 2014-15 consistent with Colorado's MSA funding allocation formula. Virtually all of this sum will be allocated to programs for use in FY 2014-15, with a small percentage retained in the Tobacco Litigation Settlement Cash Fund. The first issue includes an in-depth discussion about logistics and details of the MSA and associated state distribution formula.

**Future MSA Revenue Factors**

*Strategic Contribution Payment.* The only *certain* future adjustment to Colorado's portion of MSA funding is that the Strategic Contribution Fund payments will not be received after April 2017, leading to a reduction in funds available for appropriation of \$15 to \$17 million effective FY 2017-18.

*Annual Adjustments.* The base payment amount is driven by the number of units sold each year and the annual inflation adjustment. Cigarette shipments have been declining at a rate of 3.0 to 4.0 percent per year. The impact of this may be partially or entirely offset by the compounding inflation adjustment (minimum annual increase of 3.0 percent). The nominal receipts are projected to decline at a rate of 1.0 percent or less per year.

*Legal Disputes and Negotiation.* The Non-Participating Manufacturers' dispute, described in the first briefing issue, will likely to continue to affect the flow of tobacco settlement revenue. To the extent the State is successful in arbitration proceedings for calendar years 2004 and beyond, as it was for the 2003 arbitration, Colorado should ultimately receive funds withheld from the base payment by the participating manufactures. Current statutory language requires such funds to be deposited to the General Fund.

## **Issue: Master Settlement Agreement Overview**

The 1998 Tobacco Master Settlement Agreement provides Colorado with an annual revenue stream from participating tobacco manufacturers as a result of legal action taken by states to recover state healthcare related expenditures for illness resulting from tobacco use. Colorado has enacted a statutory distribution formula for revenues from the Master Settlement Agreement. This issue provides an overview of the Master Settlement Agreement including revenues, disputed payments, and the distribution formula.

### **SUMMARY:**

- The Master Settlement Agreement required participating manufactures to make perpetual payments to states for past and future healthcare costs for treatment of tobacco related illnesses, and limited marketing efforts by the tobacco industry while releasing participating manufactures from future claims by the settling states.
- Master Settlement Agreement (MSA) payments are driven by the number of units sold, the inflationary adjustments, and the amount of disputed payments withheld by the participating manufactures. Colorado's annual revenue from MSA payments range from approximately \$83.0 million to \$100.0 million.
- The dispute between the original settling states and the participating manufactures regarding diligent enforcement of tobacco laws on Non-Participating Manufacturers in 2003 was resolved through multi-state arbitration proceedings concluding in September 2013. In September 2013, an arbitration panel that Colorado had diligently enforced its escrow statue and that resulted in payments of the 2003 disputed payments.
- There are seventeen state programs which receive a portion of the Master Settlement Agreement revenue. These programs are divided into statutorily defined Tier 1 and Tier 2 programs.

### **RECOMMENDATION**

Staff recommends the Attorney General's Office discuss at their hearing the merits of using disputed payments to eliminate the accelerated payments and the merits of distributing the disputed payments according to the statutory formula verses depositing those funds in the General Fund.

### **DISCUSSION:**

#### **The Basics of the Tobacco Master Settlement Agreement**

In 1995 Colorado and six other states sued major tobacco companies to recover, among other things, health-care costs attributed to smoking-related illnesses. After four years, and tobacco company losses in similar lawsuits, the states and tobacco companies agreed to a settlement on

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November 28, 1998 (this is called the Master Settlement Agreement or MSA). The MSA was signed by forty-six states<sup>2</sup>, the District of Columbia, five U.S. territories (collectively the states and territories are called the Settling States), and the original participating manufactures (Philip Morris, R.J. Reynolds Tobacco Company, and Lorillard Tobacco Company) and went into effect in April 2000.

The MSA settled and released past and future claims by Settling States and required the participating manufactures to make substantial annual payments in perpetuity based upon their annual nationwide cigarette sales, and to be subject to an array of advertising, marketing and other restrictions.

**Subsequent Participating Manufactures and Non-Participating Manufactures**

Current there are over fifty manufactures who have agreed to be bound to the terms of the MSA. The manufactures who signed the MSA after the original three are called Subsequent Participating Manufactures. Manufactures who have not signed the MSA are called Non-Participating Manufactures.

Each participating manufactures makes a single annual payment based on that manufacture's nationwide annual cigarette sales volume. Payments are calculated by an independent auditor and are due on April 15 of the following year. Payments are adjusted by an inflation adjustments and sales volume adjustment. The following table summarizes the total payments by participating manufactures since 2003 and the total non-participating manufacture (NPM) adjustments (i.e. disputed payments withheld by participating manufactures).

<b>National Tobacco MSA Payments and NPM Adjustments</b>				
<b>Sales Year</b>	<b>Payment Year</b>	<b>Total Payment Without NPM</b>	<b>Total NPM Adjustment</b>	<b>NPM adjustments as % Total</b>
2003	2004	\$6,436,152,916	\$1,147,566,065	17.83%
2004	2005	\$6,480,888,462	1,137,395,925	17.55%
2005	2006	\$6,567,965,458	753,345,638	11.47%
2006	2007	\$6,740,562,252	700,344,418	10.39%
2007	2008	\$7,554,018,770	749,358,662	9.92%
2008	2009	\$7,580,287,756	888,409,725	11.72%
2009	2010	\$7,070,579,984	859,075,468	12.15%
2010	2011	\$6,957,329,944	873,144,908	12.55%
2011	2012	\$6,921,173,317	726,031,081	10.49%
2012	2013	\$6,979,173,039	783,063,215	11.22%
2013	2014	\$6,832,992,299	808,342,989	11.83%
<b>Total</b>		<b>\$76,121,124,198</b>	<b>\$9,426,078,094</b>	

Information from National Association of Attorneys General, April 28 2014 "Tobacco Product Manufactures Market Shares and Potential NPM Adjustment Amounts"

<sup>2</sup> Florida, Minnesota, Mississippi, and Texas did not sign the MSA because they had entered into separate settlements prior to the MSA.

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The MSA added about \$5.50 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 who had not joined the agreement. In an effort to level the playing field, the agreement required states to enact a statute (based on a model statute provided as part of the MSA) that forced non-participating manufactures to make payments into escrow accounts that were comparable to what they would have paid to the states had they participated in the agreement.

The escrow payments by non-participating manufactures remain in escrow for twenty-five years. Non-participating manufactures control the interest earnings from the escrow payments, and the escrow can only be access if states sued non-participating manufactures and won. Twenty-five years from the date of each escrow payments, the moneys are returned to the non-participating manufactures. It is unclear what happens to funds paid by non-participating manufactures that have gone out of business during the twenty year time frame.

To ensure states enforced the model statute which protected participating manufacturer interests, the MSA included a non-participating manufacture adjustment clause to reduce manufacturer payments to states when three conditions are satisfied in the following for a given calendar year:

- #1 the market share of Participating Manufacturers declines by 2.0 percent or more relative to the market share prior to the enactment of the MSA;
- #2 an independent economic consultant finds that the agreement significantly contributed to this decline, and
- #3 an arbitration panel finds that a given state failed to diligently enforce the non-participating manufacture statute.

The determination if condition number one applies to a specific calendar year is done by a market analysis and applies to all settling states. Therefore regardless what happens on a state level, if the national market share of the participating manufactures declines by 2.0 percent or more, the first condition is satisfied.

If the market share for a specific calendar year has decline by 2.0 percent or more, an independent auditor evaluates if the MSA was a significate factor in the decline. As for condition one, the finding for the second condition is applicable to all settling states regardless of what the contributing factors were on a state specific level.

If the MSA was a significant factor in the market share decline, the settling states and Participating Manufactures will enter into arbitration. The arbitration panel makes rules specific to each state.



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For states the arbitration panel finds to have not diligently enforced the model statute, the total non-participating manufacture adjustment is applied to those states. Therefore if only one state is determined to have failed in diligently enforcing the non-participating manufactures provisions, that one state will be held financially responsible for Participating Manufacturers' loss of market share nationwide. The maximum non-participating manufactures adjustment penalty faced by a state cannot exceed the total amount of tobacco settlement funds the state was due in the year in question.

The structure of the NPM penalty increases the stakes for all states related to "diligent enforcement". Further, because of the way the NPM reduction penalty is allocated, diligent enforcement determinations must be made for all the participating states before the aggregate adjustment can be distributed.

Some diligent enforcement issues arose but were settled for the years 1999 through 2002. However, whether Participating Manufacturers were entitled to a non-participating manufacture adjustment for calendar year 2003 and each subsequent year has been disputed by the manufactures.

**2003 Disputed Payments**

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 manufacturer's 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. This left only the final requirement that an arbitrator determine whether any states had failed to diligently enforce their NPM statute.

Following the decision of the economic consultant, two of the major tobacco manufacturers, Reynolds and Lorillard, joined by some smaller manufacturers, decided to reduce their April 2006 distribution to the states by the amount of the potential 2003 NPM adjustment. Another large firm, Philip Morris, decided to pay in full, though it also asserted that it was entitled to the adjustment. In response, the accounting firm that oversees the distribution of settlement payments reduced each state's 2006 payment by a proportionate share of the \$800 million that had been placed in escrow by Reynolds and Lorillard related to the dispute. Colorado's share of the reduction for 2003 equaled \$9.9 million.

For calendar year 2004 and subsequent years the participating manufactures have continued to assert that they are entitled to the NPM adjustment, and Reynolds and Lorillard, again joined by some smaller manufacturers, have continued to withhold payments. Starting with the April 2011 payment, Phillip Morris also began to withhold payments.

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Although the withholdings have been proportionately allocated among states, the final NPM adjustment and its allocation to states for 2003 and subsequent years is reallocated to state that are determined by an arbitration panel that one or more states failed to “diligently enforce” the non-participating manufacture state laws.

**Arbitration Panel Ruling: Colorado “culture of compliance”**

Beginning in June 2012, a three-member arbitration panel began state-specific hearing on whether states had “diligently enforced” their NPM statutes. As noted above, these statutes, based on a national model, required Non-Participating Manufacturers to place into escrow amounts that were equivalent to the settlement payments they would have made had they participated in the in the MSA. For the states, the stakes were high. For example, for Colorado, the potential outcome related solely to 2003 disputed payments ranged from:

- receipt of amounts withheld for 2003 (\$9.9 million); to
- loss of the entire 2003 tobacco allocation for the state (\$88.2 million) plus interest.

On September 11, 2013, the panel issued its ruling on the Colorado case. Because the original MSA did not define “diligent enforcement”, the arbitration panel had to make various determinations regarding what constituted diligent enforcement and how certain provision of the model NPM statute in use in all states should be interpreted. In general, the panel found that various interpretations of the model statute were acceptable as long as they appeared rational based on the plain language of the statute. The panel then outlined the various factors it would consider in determining diligent enforcement, such as a state’s collection rate from the Non-Participating Manufacturers, enforcement efforts, etc. Based on the specific facts in Colorado, the panel concluded as follows:

*The PMs criticize Colorado for the amount of turnover in the Office of the Attorney General, the lack of a formal planning process, and the fact that no one in the Office of the Attorney General was exclusively assigned to MSA enforcement, or spent enough time on escrow matters. The panel agrees that more could have, and possibly should have, been done regarding injunctions and audits. For example, Colorado could have gone after General (Sun) Tobacco sooner; however, it did reach a settlement for all prior years in 2003.*

*Balancing those criticisms, the record as a whole indicates that Colorado was aware of its obligations beginning in 1999, that it passed appropriate legislation and regulations, established reasonable spheres of responsibility between the Department of Revenue and the office of the Attorney General, generally met those responsibilities, and dramatically reduced non-compliant sales during calendar year 2003. In sum, there was a culture of compliance. The civil burden of proof requires only a tipping of the evidentiary balance, and Colorado has achieved that.*

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As a result of this ruling, Colorado should ultimately be entitled to amounts previously withheld due to the 2003 NPM adjustment (now estimated at \$9.9 million, as shown in the table). Pursuant to S.B. 12-114, disputed payments received are deposited to the General Fund. Staff understands that Colorado might see a small amount of the 2003 disputed payment this year (\$2.0-\$3.0 million), but the timing and amount are uncertain, due to anticipated ongoing litigation. The reasons for this are described further below.

**The National Context: Winners and Losers in the NPM Dispute**

Although Colorado proceeded to arbitration on the NPM dispute and ultimately won, the outcomes for states varied, and the majority never received an arbitration panel ruling.

- In December 2012, 19 of the states, districts and territories in the original tobacco settlement agreement signed on to a multi-year settlement agreement with the Participating Manufacturers. Of the nineteen states all but two states had hearings schedule, and four of them completed the hearings. Three additional states joined the settlement during 2013 for a total of 22 settling states and districts, and two states that were found non-diligent for 2003 (Indiana and Kentucky) joined the settlement in 2014. This group represents about 4.06 percent of annual tobacco MSA payment “allocable shares”.
- The District of Columbia and fourteen states, including Colorado, completed the arbitration process outlined in the original Tobacco MSA. Of these fifteen, four (Kansas, South Carolina, Connecticut, and the District of Columbia) completed the arbitration hearings but settled before rulings were issued.
- Of those states that completed arbitration, nine, including Colorado, have now been found to have diligently enforced their NPM laws in 2003. These states represent about 29 percent of the “allocable shares” of tobacco revenue.
- Six states had arbitration panel findings against them. These states represent about 15 percent of the “allocable shares” of annual tobacco revenue.
- For the remaining states and territories, the Participating Manufacturers never contested that these states and territories were diligent in enforcing their NPM statutes. Note that New Jersey and Wyoming were not contested but chose to join the settlement. These states and territories represent about 10 percent of the “allocable shares” of annual tobacco revenue.

*For states that settled*, under the terms of the agreement, the manufacturers receive 46 percent of disputed non-participating manufacturer adjustments for 2003 through 2012, and the settling states receive 54 percent. The participating states receive a large one-time payment out of the disputed payments account totaling approximately half of each state’s annual receipts in 2013, but in the subsequent four years (2014 through 2017) have their annual receipts reduced by close to 10 percent per year related to the settlement/prior year disputed payments. These reductions are in addition to reductions for more recent non-participating manufacturer adjustments. The

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settlement also modifies how the non-participating manufacturer adjustments are calculated going forward and required increased enforcement oversight on behalf of these states.

*For states like Colorado that did not settle*, the original terms of the agreement are in effect. Specifically, if they won or if they were not contested, they should not be subject to any NPM adjustment and should thus receive funds that were withheld from their annual tobacco payments, based on the NPM adjustment. A total of \$9.9 million was withheld from Colorado associated with the 2003 NPM adjustment, and Colorado should be entitled to receive that amount back.

All *losing states* are collectively responsible for the NPM adjustment for all the other states and territories that were found to have “diligently enforced” NPM escrow requirements, up to the total of each losing state’s total tobacco allocation for the year. The total of 2003 payments originally due to the losing states exceeds the total NPM adjustment for 2003 of \$1.1 billion. Thus, the tobacco manufacturers and the states that won through arbitration should be able to collect what is owed to them out of escrow accounts and future payments to losing states. However, this is not the end of the legal contest. Because the number of losing states is relatively small, the calculated loss to each losing state is large. Barring further legal developments, each losing states will need to repay over 70 percent of tobacco MSA funds they received in 2003. These states will likely continue to litigate to reduce their liability and spread financial responsibility to additional states, such as those that settled or those that were not contested. The table below summarizes which states fall into which resolution categories and also identify the “allocable shares” of the total annual settlement payment assigned to these states. Note that Florida, Minnesota, Mississippi, Texas are not part of the MSA because they reached a settlement prior to the MSA

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<b>Diligence contested - did not settle - <u>won</u> 2003 arbitration (9 states)</b>	<b>Diligence contested - did not settle - <u>lost</u> 2003 arbitration (6 states)</b>	<b>Diligence <u>not</u> contested - did <u>not</u> settle (11 states; 4 territories)</b>	<b><u>Settled</u> NPM dispute with the manufacturers (20 states; 2 districts/territories)</b>
Colorado	Missouri	Alaska	Alabama
Illinois	Indiana*	Delaware	Arizona
Iowa	Kentucky*	Hawaii	Arkansas
Maine	Maryland	Idaho	California
New York	New Mexico	Massachusetts	Connecticut
North Dakota	Pennsylvania	Montana	District of Columbia
Ohio		Rhode Island	Georgia
Oregon		Vermont	Kansas
Washington		Wisconsin	Louisiana
		South Dakota	Michigan
		Utah	Nebraska
		American Samoa	Nevada
		US Virgin Islands	New Hampshire
		Northern Mariana Islands	New Jersey
		Guam	North Carolina
			Oklahoma
			Puerto Rico
			South Carolina
			Tennessee
			Virginia
			West Virginia
			Wyoming
Share of Total Annual Tobacco Allocations (“allocable shares”)			
29%	15%	10%	46%
*Indiana and Kentucky were found non-diligent for 2003 and later joined the settlement.			

**Future Year Disputed Payments**

Colorado’s success in the 2003 dispute bodes well for future years, but the NPM dispute will be separately decided for each year by an arbitration panel. Staff’s understanding is that:

- The current arbitration panel will be dissolved and a new arbitration panel will be constituted for the next affected year (2004);
- The findings of the 2003 arbitration panel do not create a legal precedent for the findings of subsequent arbitration panels. Nonetheless, a new panel may adopt many of the prior panel’s decisions related to how certain terms in the NPM model statute are defined and the factors to be considered when determining whether a state has “diligently enforced” the model NPM statute.

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- Colorado’s win in the 2003 arbitration ruling seems fairly clear-cut. Thus, it seems well-positioned for the NPM disputes for subsequent years. However, the 2003 win does not mean that the Participating Manufactures will not contest Colorado and does not guarantee a win for future years.
- Although the 2004 arbitration proceedings will likely take less time than the 2003 proceedings, it will likely be multiple years before the 2004 dispute is resolved.
- The resolution for 2003 is not expected to have any impact on whether or not funds are withheld from Colorado related to future-year NPM adjustments.

Any disputed payments received will be deposited to the General Fund. Pursuant to H.B. 13-1305, in the event Colorado were to lose in a future arbitration proceeding, statutory provisions provide a “stop gap” mechanism for addressing a resulting reduction in tobacco revenue if the General Assembly is not in session. However, when back in session, the General Assembly would need to take action to cut funding to tobacco programs or otherwise address the loss in tobacco receipts.

**Distribution of MSA Revenue**

Section 24-75-1104.5, C.R.S., divides tobacco-settlement programs into two tiers. Settlement moneys are first allocated among the tier 1 programs, which will use approximately two thirds of the total. The remainder is allocated among the tier 2 programs. The tables below list the tier 1 and tier 2 settlement programs and provide an overview of each program's statutory funding rule. Note that the Children's Basic Health Plan receives allocations from both tier 1 and tier 2.

<b>Tier 1 Programs</b>	
<b>Recipient</b>	<b>Portion of the Total Amount Distributed</b>
Children's Basic Health Plan	27.0%, not to exceed \$33.0 million and not less than \$17.5 million
Nurse Home Visitor (NHV) Program and the General Fund (GF)	17.0% less \$1.0 million in FY 2013-14, 18.0% less \$1.0 million in FY 2014-15, 19.0% less \$1.0 million in FY 2015-16, and 19.0% in FY 2016-17 and thereafter, not to exceed \$19.0 million in any year
Fitzsimons lease purchase	8.0%, not to exceed the lesser of \$8.0 million or the actual lease purchase payment
Early Literacy Program (H.B. 12-1238)	5.0%, not to exceed \$8.0 million
Tony Gramscas Youth Services Program	4.0%, not to exceed \$5.0 million
HIV/AIDS Drug Assistance Program	3.5%, not to exceed \$5.0 million
HIV and AIDS Prevention Grant Program	2.0%, not to exceed \$2.0 million
State Veterans Trust Fund	1.0%, not to exceed \$1.0 million (10.0% of the state veterans allocation is retained in the State Veterans Trust Fund and the remaining 90.0%, plus interest earned by the trust, is expended)
Litigation Settlement Defense Account	\$1,000,000 (fixed) in FY 2013-14, FY 2014-15, and FY 2015-16

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<b>Tier 1 Programs</b>	
<b>Recipient</b>	<b>Portion of the Total Amount Distributed</b>
Autism Treatment Fund	\$1,000,000 annually (fixed)
Child Mental Health Treatment Act	\$300,000 annually (fixed)
Dental Loan Repayment Program	\$200,000 annually (fixed)

<b>Tier 2 Programs</b>	
<b>Recipient</b>	<b>Portion of the Residual Distributed after Tier 1 Program Allocations</b>
University of Colorado Health Sciences Center	49.0%
Children's Basic Health Plan	14.5%
Mental health services for juvenile and adult offenders	12.0%
Local public health services	7.0%
Supplemental state contribution for state employee group benefit plans	4.5%
Colorado Immunization Program	4.0%
Alcohol and drug abuse and treatment programs	3.0%
Health Services Corps (Health Care Professional Loan Forgiveness Program)	\$250,000 (fixed)
State Auditor's Office	\$89,000 (fixed)
Retained in Tobacco Litigation Settlement Cash Fund	6.0% less fixed Tier 2 allocations
<b>Total</b>	<b>100.0%</b>

The table below summarizes the combined total allocations by department and program from tier 1 and tier 2 for FY 2013-14 and FY 2014-15.

<b>Tobacco Settlement Allocations - FY 2013-14 AND FY 2014-15 <sup>/1</sup></b>		
	<b>FY 2013-14</b>	<b>FY 2014-15</b>
<b>EDUCATION</b>		
Early Literacy Grant Program	\$4,538,500	\$4,451,853
<b>HEALTH CARE POLICY AND FINANCING</b>		
Children's Basic Health Plan Trust	28,567,935	27,889,272
Children with Autism	<u>1,000,000</u>	<u>1,000,000</u>
Subtotal – Health Care Policy and Financing	29,567,935	28,889,272
<b>HIGHER EDUCATION</b>		
University of Colorado Health Sciences Center	13,720,122	13,007,869

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<b>Tobacco Settlement Allocations - FY 2013-14 AND FY 2014-15 <sup>1</sup></b>		
	<b>FY 2013-14</b>	<b>FY 2014-15</b>
<b>HUMAN SERVICES</b>		
Nurse Home Visitor Program	14,430,900	15,026,670
Tony Gramscas Youth Services Program	3,630,800	3,561,482
Offender Mental Health Services	3,360,030	3,185,601
Treatment, Detoxification, and Prevention Contracts	840,007	796,400
Residential Mental Health Treatment for Youth	<u>300,000</u>	<u>300,000</u>
Subtotal – Human Services	22,561,737	22,870,153
<b>LAW</b>		
Defense Account of the Tobacco Litigation Settlement Cash Fund	1,000,000	1,000,000
<b>LEGISLATURE</b>		
Office of the State Auditor	89,000	89,000
<b>MILITARY AND VETERANS AFFAIRS</b>		
State Veterans Trust Fund	907,700	890,371
<b>PERSONNEL</b>		
Supplemental State Contribution Fund	1,260,011	1,194,600
<b>PUBLIC HEALTH AND ENVIRONMENT</b>		
AIDS Drug Assistance Program (ADAP; Ryan White)	3,176,950	3,116,297
Local, District and Regional Health Department Distributions	1,960,017	1,858,267
AIDS and HIV Prevention Grants (CHAPP)	1,815,400	1,780,741
Immunizations	1,120,010	1,061,867
Health Services Corps Fund	250,000	250,000
Dental Loan Repayment Program	<u>200,000</u>	<u>200,000</u>
Subtotal – Public Health and Environment	8,522,377	8,267,172
<b>CAPITAL CONSTRUCTION</b>		
Department of Higher Education - Fitzsimons Lease Purchase Payments	7,261,600	7,122,964
<b>OTHER</b>		
Amount not allocated (used to reduce accelerated payments)	1,341,015	1,253,799
<b>TOTAL ALLOCATION TO TOBACCO-SUPPORTED PROGRAMS</b>	<b>\$90,769,997</b>	<b>\$89,037,053</b>



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Amounts shown in the table represent actual and anticipated allocations to program cash funds supported with Tobacco Settlement revenue based on statutory formulas and settlement payments received in April 2013 and April 2014. Appropriations for individual programs from program cash funds typically differ from these amounts, in part because actual revenue is not known at the time appropriations are enacted. Program spending is limited by the lesser of total funds available in program cash funds or appropriated amounts; however, with limited exceptions, programs are authorized to carry forward revenue that exceeds their appropriation into the next fiscal year. In FY 2013-14, actual receipts exceeded January 2013 projections by 0.7 percent. In FY 2014-15, receipts fell below January 2014 projections by 1.8 percent.

**"Accelerated" Use of Revenue**

Annual settlement payments arrive April 15 of each year.<sup>3</sup> Prior to FY 2008-09, funds received in April of the prior year supported all state tobacco expenditures for the next fiscal year, i.e., revenues received in April 2007 supported expenditures in FY 2007-08. However, beginning in FY 2008-09, and increasing in FY 2009-10, the General Assembly began to "accelerate" the use of tobacco revenues so that a large portion of annual tobacco expenditures relies on the payment received in April of that fiscal year.

Because most expenditures are made prior to the receipt of funds, programs are effectively "loaned" the necessary working capital from the General Fund for approximately nine months each year. House Bill 14-104 requires that disputed tobacco litigation settlement moneys received be credited to the Tobacco Litigation Settlement Cash Fund and be used to reduce the annual amount of accelerated payments.

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<sup>3</sup>The April 15 payment is based on the base and strategic contribution tobacco company payments for the prior calendar year. Amounts withheld, however, may be for earlier years. For example, 2011 withholding is related to CY 2008 disputed payments.

## **Issue: Department of Laws FY 2014-15 Request**

The Department of Law has requested for FY 2015-16 \$80,389 cash funds from the Tobacco Defense Account and 1.0 FTE to support the effort and workload needs for Tobacco Litigation support.

### **SUMMARY:**

- The Tobacco Settlement Enforcement Unit in the Attorney General's Office is responsible for ensuring Tobacco Product Manufactures are in compliance with statutory and regulatory requirements of the Master Settlement Agreement and associated statutes, enforcing escrow payments by non-participating manufactures, enforcing advertising, marketing and other restrictions against Participating Manufactures, and protecting Colorado's interests during Master Settlement Agreement payment calculations.
- The Attorney General's Office is anticipating the arbitrations of disputed payments for each calendar year since 2004 will continue for the foreseeable future (the underlying state court cases, negotiation, and actual arbitration for calendar year 2003 alone took eight years).
- It is in the General Assembly's interest to ensure Colorado has sufficient resources to ensure continued diligent enforcement of the terms of the Master Settlement Agreement because the cost of losing a disputed payments arbitration could be equal to the State's annual revenue from the Master Settlement Agreement (\$83 million to \$100 million per year).

### **RECOMMENDATION:**

Staff recommends the Attorney General's Office discuss the merit of adding an enforcement/coordinator position to the Department of Revenue to complement the additional staff in the Attorney General's Office.

### **DISCUSSION:**

Since the settlement of the tobacco litigation, the Attorney General has monitored compliance with the numerous requirements and payment obligations under the agreement, consistent with the provisions of Section 24-31-402 (1), C.R.S. The Antitrust, Tobacco and Consumer Protection Unit (Unit) in the Attorney General's Office:

- Monitors the MSA marketing restrictions in Colorado;
- Ensures Colorado's interests are protected in the calculation of Master Settlement Agreement payments;

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- Enforces state statutes requiring non-participating manufactures to pay into the escrow account, the amount, based on their sales, they would have been required to pay under the Master Settlement Agreement;
- Enforces the State's Certified Brand Director which is the listing of all cigarette and roll-your-own tobacco brands legal for sale in Colorado; and
- Is the liaison between the outside council representing the State during arbitration hearings and the Attorney General's Office.

The Tobacco Settlement Enforcement Unit, along with outside counsel, represents Colorado in the arbitration proceedings related to the non-participating manufactures adjustment. This includes representing Colorado at all multi-state meetings and arbitration hearings, negotiating with counsel for Participating Manufacturers, and monitoring all contested state arbitration to prepare for the arbitration hearing scheduled for December 2012 and future arbitrations. The Department of Law's efforts are essentially "on trial" before the arbitrators, so attorneys from the Department are likely to be called to testify during the arbitration proceeding. Thus, the Department is required to utilize outside counsel.

The Colorado Department of Revenue (DOR) also has enforcement responsibilities with regard to distributors and tracking "units sold", the measure for determining Non-Participating Manufacture escrow requirements. The Tobacco Settlement Enforcement Unit works closely with DOR on this enforcement. The structure of DOR is such that the enforcement activities are spread among multiple staff in different units of the Department.

Every tobacco product manufacturer must file an annual certification with the Unit for review, and several will file additional supplemental certifications throughout the year. In addition, Non-Participating Manufacturers also file certifications verifying compliance with the Escrow Funds Act. Review of more than 45 annual manufacturer certifications and 20 escrow certifications can take months under normal circumstances. With increased demands in other areas, this annual review is often extended for a greater amount of time. Tobacco Settlement Enforcement currently consists of one Assistant Attorney General and partial support from a Legal Assistant. In the past, a temporary legal assistant has been engaged to provide short-term assistance in review of certifications and escrow compliance.

The request is for a full time Legal Assistant II, more tasks would be handled in a timely and efficient manner and potentially new investigations, multi-state activities, and assistance to other agencies would not be delayed or hindered.

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**Staff recommends the Attorney General's Office discuss the merits of adding one full time enforcement and coordination position to the Department of Revenue in conjunction with the addition of a legal assistant to the Attorney General's office who would be able to do a number of functions including: (1) be a coordinator of all the employees in the Department of Revenue working on tobacco enforcement, (2) be a dedicated liaison between the Department of Revenue and the Attorney General's Office, and (3) be a dedicated resource for the additional enforcement/investigative work that will be generated by the new Legal Assistant via review of certifications and escrow compliance.**

Defense Account of the Tobacco Litigation Settlement Cash Fund

The Tobacco Settlement Defense Account OF the Tobacco Litigation Settlement Cash Fund [created in Section 24-22-115 (2) (a), C.R.S.] is to be used by the Department of Law “to defend the state in lawsuits arising out of challenges or arising under the provisions of the master settlement agreement...to enforce and defend all rights and obligations of the state under said settlement agreements...and to resolve any dispute with any participating manufacturer...or nonparticipating manufacturer...”. The statute specifies that any moneys received to compensate the state for attorney fees, court costs, or other expenses incurred by the State in obtaining the settlement, and all interest earned on these funds, is deposited in this account.

The Department’s legal efforts have been funded by the Tobacco Settlement Defense Account. In FY House Bill 13-1180 required \$1.8 million in FY 2012-13 and \$1.0 million each year thereafter until FY 2015-16 of revenue from the Master Settlement Agreement be deposited into the Defense Account of the Tobacco Litigation Settlement Cash Fund. The following table summarizes the impact of the request (excluding the option of adding a full time enforcement/investigator to the Department of Revenue) on the balance of the Tobacco Settlement Defense Account.

<b>Tobacco Settlement Defense Account</b>	
FY 2014-15 Starting Balance	\$2,355,974
Estimated Interest	\$14,462
\$1M deposit via HB 13-1180	\$1,000,000
<b>FY 14-15 Total Revenue</b>	<b>\$3,370,436</b>
Expenditures	
Consumer Protection Personal Services and Operating	\$176,596
Common Policies	9,521
Tobacco Litigation Expenses	\$1,250,000
<b>Total Expenses</b>	<b>\$1,436,117</b>
<b>Est FY 14-15 Ending Balance</b>	<b>\$1,934,319</b>

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<b>Tobacco Settlement Defense Account</b>	
FY 2015-16 Estimated Starting Balance	\$1,934,319
Estimated Interest	\$14,462
\$1M deposit via HB 13-1180	\$1,000,000
<b>FY 15-16 Total Revenue</b>	<b>\$2,948,781</b>
FY 15-16 Est Expenses by Line Item	
Consumer Protection Personal Services and Operating	\$243,798
Common Policies	10,902
Tobacco Litigation Expenses	\$1,250,000
<b>Total Expenses</b>	<b>\$1,504,700</b>
<b>Est FY 15-16 Ending Balance</b>	<b>\$1,444,081</b>

FY 16 is the last year for the \$1.0 million transfer into the Tobacco Defense Account. The above chart table reflects the Department's conservation assumption of expenditures. If the General Assembly decides to not continue the transfer, the Attorney General's Office will require General Fund to continue the enforcement of the Master Settlement provisions. The Department anticipates the need for legislation to continue the transfer of funds to the Tobacco Defense Account during the 2016 or 2017 Session.

## Recent Legislation - Tobacco Settlement Funds

### 2013 Session Bills

**H.B. 13-1117 (Alignment of Child Development Programs):** Consolidates several child development programs in the Department of Human Services, including, among others, the Nurse Home Visitor Program and the Tony Grampsas Youth Services Program, both of which receive funding from the Tobacco Master Settlement Agreement (MSA). Results in the transfer of Tobacco MSA appropriations for both of these programs from the Department of Public Health and Environment to the Department of Human Services. For additional information, see the Recent Legislation section for the Department of Human Services.

**H.B. 13-1180 (Allocation of Tobacco Litigation Settlement Moneys):** Pursuant to S.B. 11-224, a portion of the Tobacco Master Settlement Agreement (MSA) funding that was initially directed to the Nurse Home Visitor (NHV) Program was temporarily redirected to the General Fund. This bill restores these funds back to the NHV Program, less \$1.8 million in FY 2012-13 and \$1.0 million per year in FY 2013-14 through FY 2015-16 that is directed to the Defense Account of the Tobacco Settlement Cash Fund (Defense Account). The table below compares projected allocations before and after the enactment of this bill.

<b>Allocation of Tobacco MSA Revenue: Changes to Nurse Home Visitor Program, Defense Account of Tobacco Litigation Settlement Cash Fund, and General Fund</b>						
Projected Tobacco MSA Allocation Prior to H.B. 13-1180 <sup>1</sup>				Projected Tobacco MSA Allocation After H.B. 13-1180		
Fiscal Year	Nurse Home Visitor Program Fund (MSA Percent)	Transfer to General Fund (MSA Percent)	Transfer to General Fund (Amount)	Nurse Home Visitor Program Fund (MSA Percent)	Increase to Nurse Home Visitor Fund (Amount)	Transfer to Defense Account* (Amount)
2012-13	\$12,737,350	16% less NHV allocation	\$1,792,244	\$12,737,350	\$0	\$1,792,244
2013-14	15%	2%	1,803,330	17% less \$1,000,000	803,330	1,000,000
2014-15	16%	2%	1,820,072	18% less \$1,000,000	820,072	1,000,000
2015-16	17%	2%	1,802,274	19% less \$1,000,000	802,274	1,000,000
2016-17	18%	1%	909,221	19%	909,221	0
2017-18	19%	0%	0	19%	0	0
<b>Total</b>			<b>\$8,127,141</b>		<b>\$3,334,897</b>	<b>\$4,792,244</b>

<sup>1</sup> There were no allocations to the Defense Account prior to H.B. 13-1180

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**H.B. 13-1181 (Tobacco Program Cash Funds):** Enables various programs that receive Tobacco Master Settlement Agreement (MSA) funds to carry forward funds to the next fiscal year in program-specific cash funds in amounts not to exceed 5.0 percent of the prior year's program appropriation. Previously, the programs affected by the bill had no capacity to carry forward funds between fiscal years, and unspent amounts reverted at the end of the year to either the General Fund or the Tobacco Litigation Settlement Cash Fund. Modifies provisions related to existing cash funds and creates new program cash funds for two programs that did not previously have them: Tony Grampsas Youth Services and AIDS Drug Assistance. Specifies that if an end-of-year fund balance exceeds the 5.0 percent limit, the excess reverts to the Tobacco Litigation Settlement Cash Fund.

Due to the bill, Tobacco Settlement revenues that were allocated to programs in FY 2012-13 based on statutory formulas but that were in excess of the January 2012 tobacco settlement projections (and thus FY 2012-13 Long Bill appropriations) could be carried forward in program cash funds and appropriated in the FY 2013-14 Long Bill. The moneys carried forward to FY 2013-14 due to the bill are reflected in the table below.

	<b>Tobacco Allocation Reflected in FY 2012-13 Long Bill (based on January 2012 Projection)</b>	<b>FY 2012-13 Final Tobacco Settlement Allocation</b>	<b>Excess Cash Funds Allowed to be Carried to FY 2013-14 per H.B. 13-1181 that Would Otherwise Have Reverted</b>
<b>PUBLIC HEALTH AND ENVIRONMENT</b>			
Local, District and Regional Health Department Distributions	\$1,989,030	\$2,024,494	\$35,464
Immunizations	1,136,590	1,156,854	20,264
Nurse Home Visitor Program <sup>1</sup>	12,737,350	12,737,350	0
Tony Grampsas Youth Services Program <sup>1</sup>	3,571,900	3,632,399	60,499
AIDS Drug Assistance Program ( Ryan White)	3,125,420	3,178,349	<u>52,929</u>
Subtotal – Public Health and Environment			\$169,156
<b>HIGHER EDUCATION</b>			
University of Colorado Health Sciences Center	13,923,200	14,171,456	\$248,256
<b>HUMAN SERVICES*</b>			
Treatment, Detoxification, and Prevention Contracts	852,440	867,640	15,200
Offender Mental Health Services	3,409,760	3,470,561	<u>60,801</u>
Subtotal – Human Services			\$76,001

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Tobacco Allocation Reflected in FY 2012-13 Long Bill (based on January 2012 Projection)	FY 2012-13 Final Tobacco Settlement Allocation	Excess Cash Funds Allowed to be Carried to FY 2013-14 per H.B. 13-1181 that Would Otherwise Have Reverted
<b>TOTAL carry forward FY 2012-13 to FY 2013-14</b>		<b>\$493,413</b>

<sup>1</sup>The Nurse Home Visitor Program and Tony Grampsas Youth Services Program were moved to the Department of Human Services in FY 2013-14 pursuant to H.B. 13-1117.

A total of \$591,892 will be carried forward in program funds from FY 2013-14 to FY 2014-15 because April 2013 receipts exceeded projections for FY 2013-14. However, there will be no carry-forward from FY 2014-15 to FY 2015-16, because April 2014 receipts fell below the amount projected for FY 2014-15.

**H.B. 13-1305 (Address Possible Tobacco Settlement Payment):** Requires the Attorney General to immediately notify various elected officials if an arbitration panel makes any findings regarding the failure of the State to diligently enforce state laws that require that tobacco manufacturers either participate in the Tobacco Master Settlement Agreement or place specified revenues into escrow. If such notification is provided, the Governor may instruct the State Treasurer to transfer a specific amount up to \$40.0 million from the General Fund to the Tobacco Litigation Settlement Cash Fund and from the Tobacco Litigation Settlement Cash Fund to the appropriate programs and program cash funds if the General Assembly is not in regular session and certain other conditions are met. The amount to be transferred is to be based on: (1) the amount required to cover working-capital advanced from the General Fund for programs funded with the Tobacco Litigation Settlement Cash Fund prior to the arbitration panel finding; and (2) any additional amount required to enable programs to meet critical state obligations and to reduce program expenditures in an orderly manner through the end of the next January.

## 2014 Session Bills

**S.B. 14-104 (Tobacco Settlement Disputed Payments):** Requires that disputed tobacco litigation settlement moneys received be credited to the Tobacco Litigation Settlement Cash Fund and be used to reduce the annual amount of accelerated payments from the fund. Previously, disputed tobacco litigation settlement moneys were credited to the General Fund. A total of \$11,367,403 in disputed payments was received in April 2014 and was subject to this change.

**H.B. 14-1394 (Allocation of Tobacco Settlement Disputed Payments):** Makes technical corrections to the statutory changes in S.B. 14-104.