COLORADO GENERAL ASSEMBLY
JOINT BUDGET COMMITTEE

FY 2013-14 STAFF BUDGET BRIEFING

TOBACCO MASTER SETTLEMENT AGREEMENT

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

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TOBACCO MASTER SETTLEMENT AGREEMENT

Overview and General Factors Driving the Budget

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 smoking. Since 1999 (over a period of 14 years), Colorado has received a cumulative total of $1.2 billion in Tobacco MSA payments. The payment in FY 2011-12 was $91 million.

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 base payment for FY 2011-12 (prior to "withholding" described below) was $85.0 million. The Settlement agreement indicates that base payments continue in perpetuity, but adjust annually based on tobacco sales and inflationary factors.[1] 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 for FY 2011-12 (prior to "withholding" described below) was $17.4 million.

- *Tobacco Company Withholding:* Pursuant to the Non-participating Manufacturers Dispute (discussed further below), participating manufacturers have been withholding a portion of their annual payments to states. A total of $11.6 million was withheld in FY 2011-12.

The table below reflects recent-year receipts. As shown, revenue has fluctuated significantly, in part due to the ongoing legal dispute.

[1]Although the Tobacco MSA indicates base payments will be provided in perpetuity, the calculations in the agreement are built around a 25-year time-span; thus, staff's understanding is that specific calculations may be subject to renegotiation after 25 years.

Fiscal Year Payment Is Received	This Payment Determines Allocations in FY:	Full Payment	Amount Withheld (Disputed)	Special Payments (Disputed Amounts)	Total Payment
Actual Payments (in millions of $s):					
2003-04	2004-05	$86.1	$0.0	$0.0	$86.1
2004-05	2005-06	87.4	0.0	0	87.4
2005-06	2006-07	91.1	(10.9)	0	80.2
2006-07	2007-08	92.7	(8.8)	0	83.9
2007-08	2008-09	111.4	(7.7)	0	103.7
2008-09	2009-10	112.5	(7.1)	7.4	112.8
2009-10	2010-11	103.3	(8.7)	0	94.6
2010-11	2011-12	102.7	(13.6)	0	89.1
2011-12	2012-13	102.4	(11.6)	0	90.8

Allocation of Tobacco Revenue in Colorado

The allocation of settlement revenues in Colorado follows complex statutorily-directed formulas. The formulas are included in the appendix to this issue. The outcome of the formulas, for FY 2011-12 and FY 2012-13 are reflected in the table below.

Program Allocations (Includes Tier 1 and Tier 2)	FY 2011-12 Distribution	FY 2012-13 Distribution
Department of Education		
Early Literacy Program	**$4,457,736**	**$4,540,498**
Department of Health Care Policy and Financing		
Children's Basic Health Plan Trust	28,322,469	28,712,284
State share of funding for the Children with Autism Act	1,000,000	1,000,000
Subtotal - Department of Health Care Policy and Financing	**29,322,469**	**29,712,284**
Department of Higher Education (includes Capital Construction)		
University of Colorado, Health Sciences Center	14,364,414	14,171,456
Fitzsimons lease purchase	7,145,538	7,264,797
Subtotal - Department of Higher Education	**21,509,952**	**21,436,253**
Department of Human Services		
Mental Health Services for Juvenile and Adult Offenders	3,517,816	3,470,561
Child Mental Health Treatment Act	300,000	300,000

Program Allocations (Includes Tier 1 and Tier 2)	FY 2011-12 Distribution	FY 2012-13 Distribution
Alcohol and drug abuse programs	879,454	867,640
Subtotal - Department of Human Services	**4,697,270**	**4,638,201**
Legislative Department		
Office of the State Auditor	**94,587**	**89,000**
Department of Military and Veterans Affairs		
Colorado State Veterans Trust	**891,547**	**908,100**
Department of Personnel		
Supplemental state contribution for group benefit plans	**1,319,181**	**1,301,460**
Department of Public Health and Environment		
Nurse Home Visitor Program	12,737,350	12,737,350
Tony Grampsas Youth Services Program	3,566,189	3,632,399
AIDS Drug Assistance Program	3,120,415	3,178,349
Local public health agencies	2,052,059	2,024,494
AIDS and HIV Prevention Grant Program	1,783,094	1,816,199
Colorado Immunization Program	1,172,605	1,156,854
Short-term Innovative Health Programs Grant Fund /1	1,508,908	0
Health Services Corps Fund (Health Care Professional Loan Repayment Program)	250,000	250,000
Dental Loan Repayment Program	200,000	200,000
Subtotal - Department of Public Health and Environment	**26,390,620**	**24,995,645**
Allocate to General Fund (statutory diversion from Home Visitor Program)	**635,858**	**1,792,244**
Unallocated (contributes to reserve in Tobacco Litigation Settlement Fund and the H.B. 12-1247 reduction in accelerated payments)	**0**	**1,396,279**
Total	**$89,319,220**	**$90,809,964**

1/ The FY 2011-12 allocation for the Short-term Innovative Health Programs Grant Fund was transferred to the Tobacco Litigation Settlement Cash Fund at the end of FY 2011-12, pursuant to H.B. 12-1247.

Future of the Tobacco Revenue Stream

Tobacco revenue will ultimately decline. However, numerous factors affect the rate of decline.

- *Strategic Contribution Payment.* The only *certain* future adjustment to Tobacco MSA funding is that the Strategic Contribution Fund payments will not be received after April 2016, leading to a reduction in funds available for appropriation of $15 to $17 million effective FY 2017-18.

- *Annual Adjustments for Inflation and Cigarette Sales.* Base payments are subject to annual adjustments for:
  - Inflation, calculated at not less than 3.0 percent;
  - Trends in cigarette consumption/participating manufacturer revenue.

Cigarette shipments have been declining at a rate of 3 to 4 percent per year. The impact of this may be partially or entirely offset by the required 3.0 inflationary adjustment, so that nominal receipts are projected to decline at a rate of 1.0 percent or less per year. ("Real" (inflation-adjusted) funding will decline more rapidly.)

- *Legal Disputes and Negotiation.* If Colorado is successful in the current non-participating manufacturers arbitration proceedings, it will receive one-time payments of funds withheld (withholdings of $7.1 to $13.6 million each year since 2006), and future withholding may decline or be eliminated. If it is not successful, it could face large reductions in annual receipts.

"Accelerated" Use of Revenue

Annual settlement payments arrive April 15 of each year.[3] 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. In FY 2011-12, $80.4 million of the $89.3 million distributed was from revenue received in April 2012. 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. In FY 2012-13, the General Assembly adopted H.B. 12-1247, which is designed to *very gradually* reduce the accelerated payments by about $1.5 million per year. However, in the absence of further changes, the majority of annual tobacco settlement receipts will continue to be spent before they are actually in-hand.

[3]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.

Accelerated Payments Structure as modified by H.B. 12-1247 *(Simplified model assumes $1.5 million increase in Tobacco CF balance each year)*				
	Year in Which Revenue is Allocated/Spent			
	FY 2011-12	**FY 2012-13**	**FY 2013-14**	**FY 2014-15**
Revenue Received in Prior Year: Balance of Funds Received in Prior Year (Tobacco Litigation Settlement Cash Fund balance)	$8.7	$11.9	$12.6	$14.1
Revenue Received During Current Year: MSA funds distributed in the current year from April 15 revenue ("accelerated payments")	80.4	78.9	77.4	75.9
Total Program Allocation	**$89.1**	**$90.8**	**$90.0**	**$90.0**

Issue: Tobacco Litigation Continues – How Should It Be Funded?

The 1998 Tobacco Master Settlement Agreement provides Colorado with an annual revenue stream from participating tobacco manufacturers, but a portion of payments has been withheld each year since 2006 due to a dispute about non-participating manufacturers. To resolve the dispute, Colorado is currently engaged in multi-state arbitration proceedings. Meanwhile, the Tobacco Litigation Settlement Defense Account, that supports related legal work, is projected to run out by the end of FY 2012-13. The Department of Law is therefore requesting $676,952 General Fund to replace Defense Account cash funds for FY 2013-14.

SUMMARY:

- In recent years, tobacco manufacturers have withheld a portion of Tobacco Settlement payments due to a dispute over whether states are diligently enforcing provisions of the settlement agreement related to non-participating manufacturers (NPM's).

- Colorado is one of 35 states moving forward in arbitration proceedings related to the NPM dispute. In December 2012, Colorado will present its case to arbitrators, arguing that it diligently enforced NPM requirements for 2003. The outcome of this dispute could range from payment of funds previously withheld ($10.9 million for 2003) to the complete loss of a year of Tobacco Settlement revenue.

- The Department of Law projects that the Tobacco Litigation Settlement Fund will be exhausted by the end of FY 2012-13, and has therefore submitted an FY 2013-14 General Fund request for $676,952 to sustain its litigation efforts.

RECOMMENDATION:

Staff recommends the Committee approve a General Fund appropriation to the Department of Law for tobacco litigation efforts in FY 2013-14. The Committee should also consider introducing legislation that would direct the first portion of any disputed payments received, up to a specified amount, to the Tobacco Settlement Defense Account of the Tobacco Litigation Settlement Cash Fund to potentially reduce or eliminate the need for additional General Fund support for tobacco litigation efforts. Under current law (JBC bill S.B. 12-144), any disputed payments received are deposited to the General Fund.

If the JBC pursues such a statutory change, it might also consider crediting the balance of any disputed payments to the Tobacco Litigation Settlement Cash Fund, instead of the General Fund, to reduce the amount of tobacco settlement moneys spent before they are received.

DISCUSSION:

Historical Background

In the mid 1990's, various states began litigation against the major tobacco companies, trying to recover Medicaid and other health-care costs that they had incurred as a result of smoking-related diseases. Following separate 1997 settlements with Mississippi, Florida, Texas, and Minnesota, the remaining states agreed to the Tobacco Master Settlement Agreement (Tobacco MSA) in November 1998. In the agreement, the participating tobacco manufacturers agreed to:

- Abide by a variety of public health restrictions on the advertising and marketing of cigarettes,
- Create and fund the American Legacy Foundation, which conducts youth-targeted anti-tobacco advertising, and
- Make specified payments to the settling states in perpetuity.

In return, the settling states agreed to release the participating manufacturers from health-related claims by the states and their local governments related to the use, manufacture and marketing of tobacco products.

A number of smaller tobacco companies subsequently joined the Tobacco MSA, agreeing to abide by its provisions. The tobacco companies that are now parties to the agreement are collectively known as Participating Manufacturers while tobacco companies that have not joined are called Non-participating Manufacturers.

The Non-Participating-Manufacturer 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 of 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 is 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 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. This results in a lengthily process.
Some diligent enforcement issues arose but were settled for the years 1999 through 2002. However, whether participating manufacturers are entitled to an NPM adjustment for 2003 and subsequent years is being disputed.

Current Dispute
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 $10.9 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.

Status of the Arbitration
The Department of Law has reported that:

- The 2003 NPM Adjustment/Diligent Enforcement Arbitration began in July 2010.
- Colorado is one of the remaining 35 states whose diligence is being contested by the Participating Manufacturers.
- Most preliminary legal issues have been decided or have been briefed and deferred by the Arbitration Panel.
- The substantive portion of the arbitration began April 2012 with background and educational presentations. State specific hearings began June 2012. Fourteen states have now completed state-specific hearings. The last state-specific hearings are scheduled for June 2013.
- Colorado's three-day arbitration hearing is scheduled for December 2012.
- The arbitration panel will not issue any final orders on state-specific hearings until six months after all state hearings have been completed. Thus, final resolution of the 2003 arbitration is likely to be in late 2013 or early 2014.
- Following a decision for the 2003 adjustment, the arbitration process will be repeated for 2004 and following years. The process for these later years is expected to be faster.
- There have been substantive discussions between some states and participating manufacturers regarding settlement. However, no long term settlement has been reached.

Depending upon the results of this legal dispute for Colorado, the outcome <u>related solely to 2003 disputed payments</u> could range from:

- Receipt of an additional $10.9 million (payout of amounts withheld); to
- Loss of the entire 2003 tobacco allocation for the state ($86.1 million).

The State faces similar potential additional payouts and financial risks related to 2004 and subsequent years.

- Pursuant to S.B. 12-114, if the dispute is resolved in the State's favor, the additional revenue would be deposited to the General Fund.
- If the State is penalized as a result of the dispute, staff anticipates negotiations on *when* the penalty would be applied. Fiscal impacts could be spread across multiple years.

Tobacco Litigation Settlement Defense Account and Department of Law Request
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 monitors marketing restrictions and ensures that Colorado's interests are protected under the payment calculation provisions. It also enforces the tobacco related statutes enacted as a result of the agreement (the NPM escrow payment provisions) in collaboration with the Department of Revenue.

The Antitrust, Tobacco, and Consumer Protection unit, along with outside counsel, represents Colorado in the arbitration proceedings related to the NPM 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.

Department of Law attorneys helped develop and continue to assist the NPM enforcement program that is operated by the Department of Revenue. 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 Department's legal efforts have traditionally been funded by the Tobacco Settlement Defense Account. Because this account is projected to be exhausted by the end of FY 2012-13, the Department is requesting General Fund to continue to litigation efforts on behalf of the State.

The request components are reflected in the table below. As shown, the request reflects SHIFTING expenditures that previously would have been funded from the Tobacco Settlement Defense Account of the Tobacco Litigation Settlement Cash Fund TO the General Fund. Staff assumes future years would also require General Fund support, although the specific amount would vary, depending upon the specific litigation demands in a given year.

Department of Law – Request R-3	Total Funds	General Fund	Cash Funds
Consumer Protection and Antitrust (1.0 FTE)	$0	$153,795	($153,795)
Centrally-appropriated line items and indirect costs (e.g., salary survey, IT asset maintenance)	$0	$23,157	($23,157)
Tobacco Litigation	$0	$500,000	($500,000)
Total	**$0**	**$676,952**	**($676,952)**

In FY 2011-12, actual expenditures from the Defense Account totaled $898,320, including $745,624 for tobacco litigation. Appropriations for FY 2012-13 total $1,058,603, including $880,000 for tobacco litigation. The high costs for FY 2011-12 and FY 2012-13 are due to the costs associated with the arbitration proceedings, including outside counsel. The lower request for FY 2013-14 is due to the completion of state-specific meetings with the arbitration team. The request indicates that outside counsel will continue to work in FY 2013-14 on either the confirmation of the award the State receives during FY 2012-13 or the challenge of that decision, as well as the continued monitoring of other state proceedings.

Tobacco Litigation Settlement Cash Fund - Defense Account
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 Account initially received $4.0 million in FY 2000-01 (including $3.83 million from the MSA attorney fees plus interest earned), and the Department of Law began to draw on it in FY 2001-02. In subsequent years, the Department of Law spent varying amounts, ranging from a low of $66,096 in FY 2006-07 to a high of $1,139,303 in FY 2010-11. As reflected in the chart below, the Department's request indicates that entire balance of $1,025,710 available at the beginning of FY 2012-13 will be expended this year.

Defense Account of Tobacco Litigation Settlement Cash Fund	
Cummulative FY 00-01 through FY 11-12	
MSA Attorney Fees (FY 00-01)	$3,830,642
Interest (FY 00-01 to FY 11-12)	1,254,168
Open records reimbursement	7,230
Transfer to Dept. of Law (FY 01-02 to FY 11-12)	(4,066,330)
Ending balance	$1,025,710
FY 2012-13	
Beginning Balance FY 12-13	$1,025,710
Interest (projected)	9,220
FY 2012-13 appropriation	(1,058,603)
Projected ending balance (expenditures will be reduced)	($23,673)
Average annual Dept. Law transfer	*($427,077)*
Range for Dept. Law transfer	*($66,096) to ($1,139,303)*

Issues for JBC Consideration

- As reflected in the Defense Account statute, the General Assembly has always anticipated a need for ongoing legal work related to tobacco litigation, given the requirements of the agreement. Even if active litigation were to end, staff anticipates that ongoing funding for the 1.0 FTE in Consumer Protection and Antitrust and related benefits and indirect costs would need to be continued indefinitely ($176,952 requested for FY 2013-14). Based on past history, staff also assumes that future funding for active litigation will also be required, although the specific amount needed in any year can apparently fluctuate from $0 to $1.0 million.

- The current NPM legal dispute has high financial stakes for the State, and ceasing or substantially limiting financial support for litigation efforts at this point appears unwise.

- The JBC may wish to align funding for tobacco litigation with the revenue source it protects, *i.e.*, to fund tobacco litigation through Tobacco Settlement funds. However, all annual tobacco receipts are currently fully allocated in statute. As a result, diverting Tobacco Settlement revenue to litigation costs would either:

  1. reduce funding to one or more other programs;
  2. reduce moneys deposited to the General Fund; or
  3. increase General Fund expenditures for other programs to compensate for reduced Tobacco Settlement revenue.

  For the second and third options, the net impact on the General Fund will be the same whether Tobacco Settlement funds or General Fund moneys are used to fund litigation efforts.

- At present, the tobacco allocation formulas provide all recipients with either a fixed percentage of annual revenue or, for some smaller programs, a fixed dollar amount. This is a poor “fit” with the litigation effort, given that its financial needs fluctuate to such a large extent. For this reason, if the JBC wishes to use Tobacco Settlement revenue for litigation efforts, staff recommends this be accomplished by transferring Tobacco Settlement funds into the Defense Account, and appropriating annually from the Defense Account.

With these factors in mind, staff recommends that the JBC consider the following options.

Option 1: Approve a General Fund appropriation to the Department of Law for tobacco litigation efforts in FY 2013-14. Also, introduce legislation that would direct the first portion of any disputed payments received, up to a specified amount, to the Tobacco Settlement Defense Account of the Tobacco Litigation Settlement Cash Fund. This could potentially reduce or eliminate the need for additional General Fund support for future tobacco litigation efforts. If significant disputed payments are received in FY 2013-14, funding for FY 2014-15 and future years could again be appropriated from the Defense Account.

If the JBC wishes to pursue the statutory change above, it could also consider crediting any funds not allocated to the Defense Account to the Tobacco Litigation Settlement Cash Fund to reduce the amount of tobacco settlement moneys spent before they are received, *i.e.*, to reduce "accelerated payments" structure described in the Overview and General Factors Driving the Budget section.

The JBC sponsored S.B. 12-114 last year to extend in perpetuity a provision directing disputed payments to the General Fund. However, as outlined in this option, funds could instead be used to replenish the Defense Account and, if desired, to reduce accelerated payments. Unfortunately, accelerated payments are most likely to cause a problem for the State if the arbitration panel rules against it in the current NPM dispute. If this occurs, there will not be any disputed payments to deposit into the General Fund, the Defense Account, or the Tobacco Litigation Settlement Cash Fund.

Option 2: Introduce legislation to redirect Tobacco Settlement funds that are currently being deposited to the General Fund into the Defense Account. For FY 2012-13, $1,792,244 is being directed to the General Fund, based on a component in the allocation formulas that diverts moneys that would otherwise go to the Nurse Home Visitor Program. If annual Tobacco Settlement receipts were to remain the same as the amount received in April 2012, amounts to the General Fund would be as follows.

	FY 12-13	FY 13-14	FY 14-15	FY 15-16	FY 16-17	FY 17-18
Deposit to GF	$1,792,244	$1,816,199	$1,816,199	$1,816,199	$908,100	$0

Redirecting all of these funds to the Defense Account seems excessive. However, the Committee could consider directing these funds for next two or three fiscal years or a portion of these funds over multiple years to replenish the Defense Account to a level likely to cover the costs of tobacco litigation and enforcement efforts for at least the next five fiscal years. As for Option 2 or 3 above, if the Committee re-opens this portion of statute, it might also consider depositing funds not needed for the Defense Account into the Tobacco Litigation Settlement Cash Fund, rather than directing the moneys to the General Fund, to reduce the accelerated payments structure.

Questions for the Department of Law

The Committee's decisions on the above options should take into account whether some Tobacco Settlement revenue from disputed moneys might be available in the near future, how much will likely be available (if any), and how much funding will be required in the next few years for litigation activities . In light of this, staff recommends that the Committee ask the Attorney General to discuss the following during his December 4, 2012 hearing with the Committee (in Executive Session, if necessary).

1. The progress on the arbitration, including the likelihood, scale, and timing of any payouts or penalties; and

2. the anticipated funding needs for the Department's tobacco litigation and enforcement efforts in the next five fiscal years, given the status of the arbitration.

Issue: Above Expectations – 2012 Tobacco Settlement Revenue

Tobacco settlement receipts in April 2012 exceeded the January 2012 Legislative Council Staff projection that was used to set program appropriations in the FY 2012-13 Long Bill. Some programs will be unable to access these additional funds without an appropriation or statutory change.

SUMMARY:

- For most programs, Tobacco Settlement revenue must be appropriated in the Long Bill, in addition to allocated through statutory formula.

- Long Bill appropriations for Tobacco Settlement funds are based on projections. For FY 2012-13, the actual revenue anticipated to be available exceeds the initial projection by 1.7 percent.

- In the absence of supplemental budget adjustments or statutory change, many programs will be forced to revert the portion of the their Tobacco Settlement allocation that exceeds appropriations.

RECOMMENDATION:

Staff recommends the Committee introduce legislation to enable Tobacco Settlement-funded programs to expend up to 5.0 percent more than their annual appropriation of Tobacco Settlement funds, if tobacco receipts exceed projections. This change should apply to those Tobacco Settlement-funded programs that are unable to carry forward funds from year-to-year through a program-specific cash fund.

DISCUSSION:

Tobacco Settlement program allocations are driven by statutory formulas, but most programs are unable to spend these funds without associated Long Bill appropriations. These Long Bill appropriations are based on projections, because actual Tobacco Settlement receipts arrive too late for accurate figures to be included in the Long Bill. As a result, the Long Bill appropriations are always slightly off—either too high or too low—compared to the funds that are actually available.

For FY 2012-13, the Long Bill appropriations are too low when compared to the funds that will be available for expenditure this year. The Tobacco Settlement revenue that arrived in April 2012 and that drives funding levels for FY 2012-13 came in higher than the January 2012

Legislative Council Staff projection that was used to set appropriations. The difference was $1.5 million (1.7 percent) of initial allocations.

When actual receipts are higher than appropriation (or when a program under-spends its appropriation) the outcome (where the excess dollars go) depends on the specific statutory guidelines for the program. For programs funded with Tobacco Settlement revenue, there are essentially three major options:

1. amounts are retained in a dedicated program fund that carries forward from year-to-year;
2. amounts revert to the Tobacco Litigation Settlement Cash Fund; or
3. amounts revert to the General Fund.

The table below compares the projected allocations with the final allocations for FY 2012-13, identifies the excess revenue by program, and indicates what happens to the excess based on current law. As shown, a total of $1.5 million above the projected allocations will be allocated in FY 2012-13. Under current law, of this amount:

- $746,578 (six programs) stays in program funds;
- $143,827 (three programs plus direct allocations) goes to the Tobacco Litigation Settlement Cash Fund; and
- $621,959 (four programs plus direct allocations) goes to the General Fund.

	FY 2012-13 Projected Allocation	FY 2012-13 Final Allocation	Difference	Stays in Program Fund/ Reverts to GF/ Reverts to Tobacco Fund
OVERSIGHT				
Office of the State Auditor	$ 89,000	$ 89,000	$ -	Reverts to Tobacco Fund
EDUCATION				
Early Literacy Program	4,464,880	4,540,498	75,618	Stays in Program Fund
HEALTH CARE POLICY AND FINANCING				
Children's Basic Health Plan Trust	28,230,480	28,712,284	481,804	Stays in Program Fund
Children with Autism	1,000,000	1,000,000	0	Stays in Program Fund
SUBTOTAL - HEALTH CARE POLICY AND FINANCING	29,230,480	29,712,284	481,804	
MILITARY AND VETERANS AFFAIRS				
State Veterans Trust	892,980	908,100	15,120	Stays in Program Fund
PUBLIC HEALTH AND ENVIRONMENT				
Local, District and Regional Health Department Distributions	1,989,030	2,024,494	35,464	Reverts to General Fund
Immunizations	1,136,590	1,156,854	20,264	Reverts to General Fund
AIDS and HIV Prevention Grants (CHAPP)	1,785,950	1,816,199	30,249	Stays in Program Fund
Health Services Corps Fund (Provider Loan Repayment)	250,000	250,000	0	Stays in Program Fund
Dental Loan Repayment Program	200,000	200,000	0	Stays in Program Fund
Nurse Home Visitor Program	12,737,350	12,737,350	0	Reverts to Tobacco Fund
Tony Grampsas Youth Services Program	3,571,900	3,632,399	60,499	Reverts to Tobacco Fund
AIDS Drug Assistance Program (ADAP; Ryan White)	3,125,420	3,178,349	52,929	Reverts to Tobacco Fund
SUBTOTAL - PUBLIC HEALTH AND ENVIRONMENT	24,796,240	24,995,645	199,405	
HIGHER EDUCATION				
University of Colorado Health Sciences Center	13,923,200	14,171,456	248,256	Reverts to General Fund
HUMAN SERVICES				
Residential Mental Health Treatment for Youth	300,000	300,000	0	Reverts to Tobacco Fund
Treatment, Detoxification, and Prevention Contracts	852,440	867,640	15,200	Reverts to General Fund
Offender Mental Health Services	3,409,760	3,470,561	60,801	Reverts to General Fund
SUBTOTAL - HUMAN SERVICES	4,562,200	4,638,201	76,001	
PERSONNEL AND ADMINISTRATION				
Supplemental State Contribution Fund	1,278,660	1,301,460	22,800	Stays in Program Fund
CAPITAL CONSTRUCTION				
Fitzsimons Lease Purchase Payments	7,143,810	7,264,797	120,987	Stays in Program Fund
OTHER				
Amount Diverted from Nurse Home Visitor to General Fund	1,550,270	1,792,244	241,974	Goes to General Fund
Retained in Tobacco Fund	1,365,880	1,396,279	30,399	Goes to Tobacco Fund
TOTAL TOBACCO ALLOCATIONS	$ 89,297,600	$ 90,809,964	$ 1,512,364	
In absence of statutory or appropriation change:				
Stays in Program Fund			$ 746,578	
Goes to Tobacco Fund			$ 143,827	
Goes to General Fund			$ 621,959	

The JBC could consider the following three options for responding to the discrepancy between projected and actual allocations.

Option 1: No Change to Appropriations or Statute
The General Assembly could choose to leave appropriations at the level in the FY 2012-13 Long Bill. Programs would be forced to revert the additional Tobacco Settlement revenue if they do not have a dedicated cash fund that enables them to carry funds forward from year-to-year. Depending upon the statute governing the particular program, these amounts would revert to either the Genera; Fund or the Tobacco Litigation Settlement Fund. The amounts deposited to the Tobacco Litigation Settlement Fund would be used to reduce the "accelerated payments" structure, while General Fund reversions would be treated like all other General Fund reversions.

Negatives: This approach could be viewed as inconsistent with current law, since tobacco statutes provide for specific percentage allocations of total tobacco receipts to particular programs. It would also treat programs unequally, since programs that have continuous spending authority or a cash fund would not be forced to revert dollars.

Option 2: Increase appropriations through supplemental budget action
In the past, the General Assembly has provided for supplemental budget adjustments when Tobacco Settlement revenues have come in higher than projected (and, sometimes, when revenues have come in lower).

Negatives: This drives significant workload for both Executive and Legislative Branch budget staff for relatively modest budget adjustments. It also adds many more line items for legislators to examine in supplemental bills and supplemental bill narratives.

Options 3: Statutory change to enable spending above appropriated amounts.
The JBC could introduce a bill to enable Tobacco Settlement-funded programs to expend above the level of their annual appropriations. Staff believes that tobacco settlement funds should continue to be shown in the Long Bill for information and transparency. However, for many programs, it is not clear how much value is added by appropriating funds, and then modifying appropriations, given that allocations are driven by a statutory formula.

At one extreme, the General Assembly could provide all of these programs with "continuous spending authority". This would change all or virtually all Tobacco Settlement amounts in the Long Bill to "(I)" (information only) amounts. Staff does not recommend such an extreme change because: (1) once amounts are truly "information only" the quality of Executive requests and the level of annual legislative oversight tends to decline; and (2) the General Assembly's tools for responding to significant changes in tobacco revenue would decline. For example, if there were a sudden, substantial increase in annual revenue (unlikely, but not impossible), the General Assembly would not be in as strong a position if it wished to do something other than allow the revenue to flow through current allocation formulas.

- **Instead of full continuous authority, staff recommends a middle ground: programs should be allowed to expend up to 5.0 percent above their appropriated funding levels without an adjustment to their appropriation**. If additional tobacco revenue exceeds this 5.0 percent threshold, changes would need to be made to appropriations through supplemental action. **If the JBC wishes to pursue this, it would need to introduce a bill.** (Staff has explored whether this could be accomplished by footnote, but Legislative Legal Services Staff believe this extends beyond the legal purpose of footnotes as outlined in Section 24-75-112 (2), C.R.S.)

As reflected in the table, in the last five years, the variance between the projection and actual funds received has not exceeded 2.8 percent, so 5.0 percent should be more than sufficient to accommodate routine discrepancies between the forecast and actual receipts.

Receipt Year	Distribution Year	Legislative Council Projection Used for Figure Setting	Actual Funds Received	Actual Above/(Below) Projection	Percent Variance from Projection
FY 08	FY 09	$106,653,988	$103,640,385	$ (3,013,603)	-2.8%
FY 09*	FY 10*	103,302,921	105,419,646	2,116,725	2.0%
FY 10	FY 11	96,231,588	94,587,045	(1,644,543)	-1.7%
FY 11	FY 12	90,397,679	89,065,763	(1,331,916)	-1.5%
FY 12**	FY 13**	89,297,600	90,809,964	1,512,364	1.7%

*Actual amounts shown in this year exclude $7.4 million in special payments received related to the non-participating manufacturers dispute.
** The amount in the projection figure reflects the estimated allocations, which were somewhat higher than the Legislative Council
projection due to the formula's allocation of funds between fiscal years.

- **Staff recommends that this change apply only to those programs that do not have program-specific funds in which they can carry forward funds from year-to-year**. Programs with their own cash fund, such as the Children's Basic Health Plan, are not forced to revert excess Tobacco Settlement allocations, and staff typically apply a variety of considerations when setting annual appropriations for these programs and not solely the projected level of tobacco receipts.

Recent Legislation - Tobacco Settlement Funds

2011 Session Bills

S.B. 11-224: Suspends growth of the Nurse Home Visitor Program for two years, transferring the resulting tobacco settlement funds savings to the General Fund.

S.B. 11-225: Redirects certain transfers of tobacco-settlement moneys from the Short-term Innovative Health Program Grant Fund to the General Fund and transfers the balance of the Short-term Innovative Health Program Grant Fund to the General Fund at the end of FY 2011-12. (This provision was subsequently modified by H.B. 12-1347, as described below.)

S.B. 11-226: Transfers the balance of the Health Care Supplemental Appropriations and Overexpenditures Account of the Tobacco Litigation Settlement Cash Fund to the General fund and transfers $1,864,845 from the Read to Achieve Cash Fund to the General Fund. For more information see the corresponding bill description for the Department of Education.

H.B. 11-1281: Increases the annual diversion of tobacco settlement revenue to the Health Care Professional Loan Forgiveness Program from $90,070 to $250,000.

2012 Session Bills

S.B. 12-114: Extends in perpetuity a provision allowing any disputed Tobacco Litigation Settlement payments received by the state to continue to be credited to the General Fund. Previously, this diversion was set to expire on June 30, 2011. No disputed payments are anticipated to be received in FY 2012-13. However, payments may be received in future years depending upon the outcome of ongoing litigation. If Colorado prevails in arbitration proceedings for 2003 disputed payments, it could receive up to an estimated $12 million in FY 2013-14.

H.B. 12-1238: Makes a number of changes to policies, programs, and procedures associated with early literacy skills. Creates the Early Literacy Grant Program in the Department of Education and replaces the Read-to-Achieve Grant Program with the new program. All Tobacco Settlement allocations previously allocated to the Read-to-Achieve Grant Program are transferred to the new program (5.0 percent of Tobacco Settlement moneys up to $8.0 million each year).

H.B. 12-1247: Annually reduces the amount of Tobacco Master Settlement Agreement (MSA) funds that are allocated in the year in which they are received (accelerated payments). The funding for this comes from eliminating allocations to the Short-term Innovative Health Programs Grant Fund.

Short-term Innovative Health Programs Grant Fund: The bill eliminates the Short-term Innovative Health Programs Grant Fund in the Department of Public Health and Environment and the Tobacco MSA allocation to the Grant Fund and makes various conforming amendments. This program previously received 6 percent of tier 2 Tobacco Settlement allocations (about $1.5 million per year). However, the program had not been active since FY 2009-10 due to previous legislative action to direct Grant Fund amounts to the General Fund. The bill also transfers the June 30, 2012 Short-term Innovative Health Programs Grant Fund balance to the Tobacco Litigation Settlement Cash Fund. Because this bill passed before the Long Bill, an FY 2012-13 appropriation of $1,365,880 cash funds and 1.0 FTE for the Department of Public Health and Environment was not included in the Long Bill.

Accelerated Payments: Previously, statute specified that $65.0 million in annual Tobacco MSA revenue plus $15.4 million in Strategic Contribution Payment Tobacco MSA revenue ($80.4 million total) would be allocated in the year received, with the balance derived from the prior year's Tobacco MSA revenue. As modified by the bill, the $80.4 million figure is reduced each year by the amount that would, in the past, have been allocated to the Short-term Innovative Health Programs Grant Fund and any other residual funds in the Tobacco Litigation Settlement Cash Fund (approximately $1.5 million per year total; actual amount will vary by year). With the exception of the Short-term Innovative Health Programs Grant Fund, programs supported by Tobacco MSA revenue receive no less than they would have under the previous formula.

H.B. 12-1249: Changes the mechanism for allocating funding to the State Auditor's Office (SAO) for review of programs funded through the Tobacco Litigation Settlement Cash Fund. Previously, the SAO received one-tenth of one percent of the total funds received pursuant to the Tobacco Master Settlement Agreement (MSA) in the previous calendar year. This amount was proportionately reduced from some of the tier 1 Tobacco Settlement programs. This bill instead provides for a flat tier 2 allocation of $89,000 per year for the SAO. Unspent amounts revert to the Tobacco Litigation Settlement Cash Fund.

Appendix A – Tobacco Settlement Funds Allocation Formulas

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.

Tier 1 Programs

Recipient	Portion of the Total Amount Distributed
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)	• The combined allocation to the NHV program and the GF equals 15.0% of the total amount distributed in FY 2011-12, 16.0% in FY 2012-13, rising 1.0% annually to 19.0% in FY 2015-16, not to exceed $19.0 million in any year. • The NHV allocation equals 14.0% of the total amount distributed in FY 2011-12 and 2012-13, 15.0% in FY 2013-14, 16.0% in FY 2014-15, rising 1.0% annually to 19.0% in FY 2017-18, not to exceed $19.0 million in any year and not less than $12.7 million in FY 2011-12 or FY 2012-13. • The difference between the combined allocation and the NHV allocation is transferred to the GF.
Fitzsimons lease purchase	8.0%, not to exceed $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 Grampsas 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)
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)

Tier 2 Programs

Recipient	Portion of the Residual Distributed after Tier 1 Program Allocations
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	$89,0000 (fixed)
Retained in Tobacco Litigation Settlement Cash Fund	6.0% less fixed Tier 2 allocations
Total	100.0%

The table below summarizes the resulting allocations by program, from largest to smallest, for FY 2012-13.

FY 2012-13 Tobacco Settlement Fund Allocations by Program
Ordered by Percentage of Allocation

Department	Program	Projected Tobacco Allocation	Program Allocation as Percentage All Tobacco Allocations
Health Care Policy	Children's Basic Health Plan Trust	$28,712,284	31.6%
Higher Education	CU Health Sciences Center	14,171,456	15.6%
Public Health	Nurse Home Visitor Program	12,737,350	14.0%
Higher Education	Fitzsimons Trust Fund	7,264,797	8.0%
Education	Early Literacy Program	4,540,498	5.0%
Public Health	Tony Grampsas Youth Services	3,632,399	4.0%
Human Services	Offender Mental Health Services	3,470,561	3.8%
Public Health	Ryan White HIV/AIDS Drug Assistance Program	3,178,349	3.5%
Public Health	Support for Local Public Health Agencies	2,024,494	2.2%
Public Health	AIDS & HIV Prevention	1,816,199	2.0%
n/a	Transfer to General Fund	1,792,244	2.0%
n/a	Retained in Tobacco Fund	1,396,279	1.5%
Personnel	Supplemental State Contribution	1,301,460	1.4%
Public Health	CO Immunization Fund	1,156,854	1.3%

FY 2012-13 Tobacco Settlement Fund Allocations by Program Ordered by Percentage of Allocation			
Department	**Program**	**Projected Tobacco Allocation**	**Program Allocation as Percentage All Tobacco Allocations**
Health Care Policy	Autism Treatment	1,000,000	1.1%
Military Affairs	State Veterans Trust Fund	908,100	1.0%
Human Services	Alcohol & Drug Abuse Treatment	867,640	1.0%
Human Services	Child Mental Health Treatment Act	300,000	0.3%
Public Health	Health Services Corps (Loan Repayment)	250,000	0.3%
Public Health	Dental Loan Repayment	200,000	0.2%
Legislature	State Auditor's Office	89,000	0.1%
	Total	**$90,809,964**	**100.0%**