COLORADO GENERAL ASSEMBLY
JOINT BUDGET COMMITTEE

FY 2014-15 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 15 years), Colorado has received a cumulative total of $1.3 billion in Tobacco MSA payments. The most recent payment, received in April 2013, was $90.8 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 April 2013 base payment (prior to "withholding" described below) was $85.5 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 received April 2013 (prior to "withholding" described below) was $17.6 million.

- *Tobacco Company Withholding:* Pursuant to the Non-participating Manufacturers Dispute, participating manufacturers have been withholding a portion of their annual payments to states. A total of $12.3 million was withheld from the April 2013 payment.

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

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[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.

Payment History FY 2003-04 to FY 2012-13						
Fiscal Year Payment Is Received	**This Payment Determines Allocations in FY:**	**Full Payment**	**Amount Withheld (Disputed)**	**Amount Received Excluding Special Payments**	**Percent Change Excluding Special Payments**	**Special Payments (Disputed Amounts)**
Actual Payments (in millions of $s):						
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*	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

*Total receipts in FY 2008-09 were $112.8 million, if additional special payments are included.

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 2013-14, ordered from largest to smallest, are reflected in the table below. See the appendix to this issue for the allocation formulas and the FY 2012-13 and FY 2013-14 allocations by department.

FY 2013-14 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	28,567,935	31.5%
Human Services	Nurse Home Visitor Program	14,430,900	15.9%
Higher Education	CU Health Sciences Center	13,720,122	15.1%
Higher Education	Fitzsimons Trust Fund (Capital Construction)	7,261,600	8.0%
Education	Early Literacy Program	4,538,500	5.0%
Human Services	Tony Grampsas Youth Services	3,630,800	4.0%
Human Services	Offender Mental Health Services	3,360,030	3.7%
Public Health	Ryan White HIV/AIDS Drug Assistance Program	3,176,950	3.5%
Public Health	Support for Local Public Health Agencies	1,960,017	2.2%
Public Health	AIDS & HIV Prevention	1,815,400	2.0%

FY 2013-14 Tobacco Settlement Fund Allocations by Program Ordered by Percentage of Allocation			
Department	**Program**	**Projected Tobacco Allocation**	**Program Allocation as Percentage All Tobacco Allocations**
n/a	Retained in Tobacco Fund	1,341,015	1.5%
Personnel	Supplemental State Contribution to Employee Health Plans	1,260,011	1.4%
Public Health	Colorado Immunization Fund	1,120,010	1.2%
Law	Tobacco Litigation Defense Account	1,000,000	1.1%
Health Care Policy	Autism Treatment	1,000,000	1.1%
Military Affairs	State Veterans Trust Fund	907,700	1.0%
Human Services	Alcohol & Drug Abuse Treatment	840,007	0.9%
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	**$90,769,997**	**100.0%**

The April 2013 Tobacco payment came in 0.7 percent above the January 2013 forecast of $90,166,340 used to set Long Bill figures. Due largely to the passage of H.B. 13-1181, virtually all excess revenue ($653,657 total) will be deposited into program cash funds and will be available for appropriation to programs for FY 2014-15.

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 2017, 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. The non-participating manufacturers dispute, described further below, will likely to continue to affect the flow of tobacco settlement revenue. To the extent the State is successful in arbitration proceedings, as it has been for the 2003 arbitration, it should ultimately receive funds withheld. Such funds will be deposited to the General Fund. There is no indication at present that future withholding will be affected by the results of the arbitration panel hearings.

"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. 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 gradually reduce accelerated payments. As required by this bill, the Treasurer submitted a report to the JBC on October 1, 2013, identifying the carry-forwards from FY 2011-12 and FY 2012-13 used to reduce the accelerated payment amounts. The impact is reflected in the table below.

	Total	Prior year revenue	Current year revenue	Carry-forward used to reduce use of current-year revenue	Percent Total from Current year revenue
FY 2010-11	$94,333,586	$14,187,045	$80,146,541		85.0%
FY 2011-12	89,319,222	8,919,222	80,400,000		90.0%
FY 2012-13	90,809,964	12,331,836	78,478,128	(1,921,872)	86.4%
FY 2013-14	90,769,997	13,861,284	76,908,713	(1,569,415)	84.7%

[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.

Issue: Colorado Wins in Non-participating Manufacturer Arbitration

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 due to a dispute about non-participating manufacturers. To resolve the dispute, Colorado has engaged in multi-state arbitration proceedings. In September 2013, an arbitration panel ruled in Colorado's favor related to 2003 disputed payments.

SUMMARY:

- In recent years, participating tobacco manufacturers (PMs) have withheld a portion of tobacco settlement payments based on settlement provisions that allow for a "non-participating manufacturers" (NPM) adjustment. The PMs assert that states have not diligently enforced settlement provisions that require NPMs to put funds into escrow. As a result, they assert PMs have lost market share. If states do not diligently enforce NPM requirements, they may be subject to the NPM adjustment (reduced settlement payouts).

- Colorado is one of 35 states whose diligence in enforcing NPM rules was challenged by the PMs for 2003. Colorado chose to move forward in arbitration proceedings to determine whether or not it had been diligent and thus whether it should be subject to the 2003 NPM adjustment. Over the course of 2012-13, some states whose diligence was challenged reached a settlement with the PMs. Colorado did not.

- In September 2013, the arbitration panel ruled that Colorado had a "culture of compliance" and had taken appropriate steps to enforce settlement provisions related to NPMs in 2003.

- Based on this ruling, Colorado should not have been subject to the NPM adjustment for 2003 and is owed $9.9 million in funds previously withheld. However, due to ongoing legal proceeding, it is uncertain when Colorado will receive a related payout. No more than $2.0 to $3.0 million is expected in FY 2013-14.

RECOMMENDATION:

Pursuant to current statute, any moneys received from the dispute will be deposited to the General Fund. Staff believes this is reasonable given the unpredictable nature of the payments. However, the JBC could consider a statutory change to credit some disputed payments to the Tobacco Litigation Settlement Cash Fund, instead of the General Fund, to reduce or eliminate 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 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 an NPM adjustment for 2003 and subsequent years was disputed.

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.

Although the withholdings have been proportionately allocated among states, the final NPM adjustment and its allocation to states for 2003 and subsequent years has been pending a determination by an arbitration panel that one or more states failed to "diligently enforce" state laws.

The table below summarizes the national MSA payments, the NPM adjustments associated with that year of the MSA payments, and the disposition of the associated funds. As reflected in the table, for 2003, Colorado's share of the NPM adjustment was $15.7 million, of which $5.8 million was released to Colorado, leaving $9.9 million in escrow (the "Disputed Payments Account").

		National Tobacco MSA Payments and NPM Adjustments			**Disposition of the NPM Adjustment Prior to NPM Settlement (Percentage of the Adjustment in Each Category)***			**Colorado share of the MSA Payment and NPM Adjustment**				
								Total Payment and NPM Adjustment		Disposition of Colorado's NPM Adjustment*		
Sales Year	Payment Year	Total Payment Without NPM	Total NPM Adjustment	NPM as % Total	DPA	Withheld	Paid	Total Payment Without NPM	Total NPM Adjustment	Disputed Payments Account	Withheld	Paid to CO
2003	2004	$6,434,954,708	$1,147,566,065	17.8%	63%	0%	37%	$88,214,310	$15,731,540	$9,923,353	$0	$5,808,187
2004	2005	6,481,664,045	1,137,395,925	17.5%	62%	0%	37%	88,854,630	15,592,122	9,674,228	72,896	5,844,998
2005	2006	6,569,689,499	753,345,638	11.5%	0%	0%	100%	90,061,337	10,327,325	0	21,923	10,305,402
2006	2007	6,739,926,533	700,344,418	10.4%	14%	59%	28%	92,395,051	9,600,751	1,304,520	5,630,161	2,666,070
2007	2008	6,745,374,259	749,358,662	11.1%	76%	2%	22%	111,463,191	11,675,029	8,840,573	269,198	2,565,258
2008	2009	6,771,926,842	892,674,779	13.2%				111,874,229	13,578,730			
2009	2010	6,315,352,143	849,083,672	13.4%				104,318,064	12,676,468			
2010	2011	6,215,307,710	852,798,330	13.7%				102,680,182	12,601,766			
2011	2012	6,185,767,481	672,734,718	10.9%				102,189,326	9,928,422			
2012	2013	6,235,404,611	768,925,782	12.3%				103,132,475	11,348,196			

*For years after 2003, the percentage allocation between the DPA, amounts withheld, and amounts paid to states may be subject to adjustment, based on additional research.

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).

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.*

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. Three additional states joined the settlement during 2013 for a total of 22 settling states and districts. This group represents about 46 percent of annual tobacco MSA payment “allocable shares”.

- Fifteen states, including Colorado, proceeded with the arbitration process outlined in the original Tobacco MSA.

- Of those states that proceeded with arbitration, 9, 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. 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 escrow 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 in addition to reductions for more recent non-participating manufacturer adjustments. The settlement also modifies how the non-participating manufacturer adjustments are calculated going forward.

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.

- Of the total NPM adjustment for 2003 for states that did not settle, 63 percent is in escrow (the Disputed Payments Account or DPA) and 37 percent was paid out to states (neither placed in the DPA nor withheld). Thus, there may be some competition between winning/no-contest states and the participating manufacturers related to who is paid first (out of escrow) and who is paid later (out of amounts withheld from future year payments to losing states).

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.

Diligence contested - did not settle - <u>won</u> 2003 arbitration (9 states)	**Diligence contested - did not settle - <u>lost</u> 2003 arbitration (6 states)**	**Diligence <u>not contested</u> - did <u>not</u> settle (11 states; 4 territories)**	**<u>Settled</u> NPM dispute with the manufacturers (20 states; 2 districts/territories)**
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
		South Samoa	Nevada
		US Virgin Islands	New Hampshire
		Mariana Islands	New Jersey
		Guam	North Carolina
			Oklahoma
			Puerto Rico
			South Carolina
			Tennessee

Diligence contested - did not settle - won 2003 arbitration (9 states)	**Diligence contested - did not settle - lost 2003 arbitration (6 states)**	**Diligence not contested - did not settle (11 states; 4 territories)**	**Settled NPM dispute with the manufacturers (20 states; 2 districts/territories)**
			Virginia
			West Virginia
			Wyoming
Share of Total Annual Tobacco Allocations ("allocable shares")			
29%	15%	10%	46%

*Florida, Minnesota, Mississippi, Texas are not part of the MSA because they reached a settlement prior to the MSA

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.
- 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 guarantee a win for all future years.
- Although the 2004 arbitration proceedings will likely take less time than the 2003 proceedings, it will likely be multiple additional 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.

JBC Option – Use Payments Received to Reduce Accelerated Payments Structure

During the Great Recession, the General Assembly began to spend tobacco revenues prior to their receipt. This allowed it to access $80.4 million in one-time funds. The net result is that the General Fund "loans" tobacco programs moneys until annual tobacco revenue is received in

April of each year. House Bill 12-1347 gradually reverses this trend by about $1.5 million per year, but the amount is small given the scale of the accelerated payments.

The accelerated payments could present large problems if Colorado were to lose an arbitration panel ruling in the future. Such a loss does not seem too likely, given the recent ruling in Colorado's favor for 2003. Nonetheless, there is always the possibility for such a loss to a future year or some other sudden shock to the tobacco revenue stream. In light of this, it might be prudent for the General Assembly to reduce the scale of tobacco program spending that relies on moneys not yet received. As shown below, staff anticipates that about $57 million in FY 2013-14 will be spent before the funds are received.

FY 2013-14 Monthly Tobacco Settlement Allocations by When Funds are Received

	Prior Year Revenue	Current Year Revenue (April 2014 Payment)		
	(April 2013 Payment)	Allocated Prior to Receipt	Allocated After Receipt	Total Monthly Allocation
July	$ 7,452,415	$ -	$ -	$ 7,452,415
August	6,408,869	1,043,546	-	7,452,415
September	-	7,452,415	-	7,452,415
October	-	7,452,415	-	7,452,415
November	-	7,452,415	-	7,452,415
December	-	7,452,415	-	7,452,415
January	-	7,452,415	-	7,452,415
February	-	7,452,415	-	7,452,415
March	-	7,452,415	-	7,452,415
April	-	3,726,207	3,726,208	7,452,415
May	-	-	7,452,415	7,452,415
June	-	-	7,452,415	7,452,415
TOTAL*	$ 13,861,284	$ 56,936,660	$ 18,631,038	$ 89,428,982
Percent Total	15.5%	63.7%	20.8%	100.0%

*Balance is not allocated and is used to reduce accelerated payments

One option for reducing the accelerated payments structure would be to change statute to direct disputed payments received for the 2003 dispute (or up to a specified amount) into the Tobacco Litigation Settlement Cash Fund, rather than the General Fund.

Recent Legislation - Tobacco Settlement Funds

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, disputed 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 disputed payments in FY 2013-14.

H.B. 12-1202: Allows the General Assembly to annually appropriate moneys in the Tobacco Education Programs Fund to the Department of Health Care Policy and Financing (DHCPF) so that DHCPF can receive additional federal matching funds for the Colorado Quitline Program. For FY 2011-12 appropriates $577,316 to the DHCPF for Medical Services Premiums, comprised of $288,658 cash funds from the Tobacco Education Programs Fund and $288,658 of federal funds. Decreases appropriations to the Department of Public Health and Environment by $288,658, comprised of an increase of $577,316 reappropriated funds from the DHCPF and a decrease of $288,658 cash funds from the Tobacco Education Programs Fund. For more information see the corresponding bill descriptions for the Department of Public Health and Environment and the DHCPF.

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). For additional information, see the bill description in the Department of Education.

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. Also requires an annual report from the State Treasurer on Tobacco MSA accelerated payment amounts.

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.

2013 Session Bills

H.B. 13-1117: 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: 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.

Allocation of Tobacco MSA Revenue: Changes to Nurse Home Visitor Program, Defense Account of Tobacco Litigation Settlement Cash Fund, and General Fund						
	Projected Tobacco MSA Allocation Prior to H.B. 13-1180*			**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

* There were no allocations to the Defense Account prior to H.B. 13-1180

Provides an FY 2013-14 appropriation of $803,330 cash funds to the Department of Human Services for the NHV program (based on the enactment of H.B. 13-1117, which transfers NHV from the Department of Public Health and Environment to the Department of Human Services). Provides an FY 2013-14 appropriation of $1,433,351 cash funds from the Defense Account to the Department of Law and reduces the General Fund appropriation to the Department of Law by the same amount.

H.B. 13-1181: 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.

	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
PUBLIC HEALTH AND ENVIRONMENT			
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*	12,737,350	12,737,350	0
Tony Grampsas Youth Services Program*	3,571,900	3,632,399	60,499
AIDS Drug Assistance Program (Ryan White)	3,125,420	3,178,349	52,929
SUBTOTAL - PUBLIC HEALTH AND ENVIRONMENT			$169,156
HIGHER EDUCATION			
University of Colorado Health Sciences Center	13,923,200	14,171,456	$248,256
HUMAN SERVICES*			
Treatment, Detoxification, and Prevention Contracts	852,440	867,640	15,200
Offender Mental Health Services	3,409,760	3,470,561	60,801
SUBTOTAL - HUMAN SERVICES			$76,001
TOTAL			**$493,413**

*The Nurse Home Visitor Program and Tony Grampsas Youth Services Program are moved to the Department of Human Services in FY 2013-14 pursuant to H.B. 13-1117.

H.B. 13-1305: 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.

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	$12.7 million in FY 2012-13, 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 $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)
Litigation Settlement Defense Account	$1.8 million in FY 2012-13, $1.0 million in FY 2013-14, $1.0 million in FY 2014-15, and $1.0 million in FY 2015-16
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	$89,000 (fixed)
Retained in Tobacco Litigation Settlement Cash Fund	6.0% less fixed Tier 2 allocations
Total	100.0%

The table below reflects the results of these formulas for FY 2012-13 and FY 2013-14 for total program allocations from both Tier I and Tier II.

Tobacco Settlement Allocations - FY 2012-13 and FY 2013-14 /1	FY 2012-13	FY 2013-14
EDUCATION		
Early Literacy Grant Program	$4,540,498	$4,538,500
HEALTH CARE POLICY AND FINANCING		
Children's Basic Health Plan Trust	28,712,284	28,567,935
Children with Autism	1,000,000	1,000,000
Subtotal – Health Care Policy and Financing	29,712,284	29,567,935
HIGHER EDUCATION		
University of Colorado Health Sciences Center	14,171,456	13,720,122
HUMAN SERVICES		
Nurse Home Visitor Program (Transferred from DPHE in FY 13-14)	0	14,430,900
Tony Grampsas Youth Services Program (transferred from DPHE in FY 2013-14)	0	3,630,800
Residential Mental Health Treatment for Youth	300,000	300,000

Tobacco Settlement Allocations - FY 2012-13 and FY 2013-14 [1]	FY 2012-13	FY 2013-14
Treatment, Detoxification, and Prevention Contracts	867,640	840,007
Offender Mental Health Services	3,470,561	3,360,030
Subtotal – Human Services	4,638,201	22,561,737
LAW		
Defense Account of the Tobacco Litigation Settlement Cash Fund	1,792,244	1,000,000
LEGISLATURE		
Office of the State Auditor	89,000	89,000
MILITARY AND VETERANS AFFAIRS		
State Veterans Trust Fund	908,100	907,700
PERSONNEL		
Supplemental State Contribution Fund	1,301,460	1,260,011
PUBLIC HEALTH AND ENVIRONMENT		
Local, District and Regional Health Agency Distributions	2,024,494	1,960,017
Immunizations	1,156,854	1,120,010
AIDS and HIV Prevention Grants (CHAPP)	1,816,199	1,815,400
Health Services Corps Fund	250,000	250,000
Dental Loan Repayment Program	200,000	200,000
Nurse Home Visitor Program (transferred to DHS in FY 2013-14)	12,737,350	0
Tony Grampsas Youth Services Program (transferred to DHS FY 2013-14)	3,632,399	0
AIDS Drug Assistance Program (ADAP; Ryan White)	3,178,349	3,176,950
Subtotal – Public Health and Environment	24,995,645	8,522,377
CAPITAL CONSTRUCTION		
Department of Higher Education - Fitzsimons Lease Purchase Payments	7,264,797	7,261,600
OTHER		
Amount not allocated (used to reduce accelerated payments)	1,396,279	1,341,015
TOTAL ALLOCATION TO TOBACCO-SUPPORTED PROGRAMS	$90,809,964	$90,769,997

[1/] Amounts shown represent actual and anticipated allocations to program cash funds supported with tobacco settlement

Tobacco Settlement Allocations - FY 2012-13 and FY 2013-14 [1]		
	FY 2012-13	**FY 2013-14**

revenue based on statutory formulas and settlement payments received in April 2012 and April 2013. Appropriations for individual programs from program cash funds typically differ from these amounts for various reasons, including because actual revenue is not known at the time appropriations are enacted. Programs are generally authorized to carry forward revenue that exceeds their appropriation into the next fiscal year.