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## MEMORANDUM

January 29, 2015

**TO:** Interested Persons  
**FROM:** Greg Sobetski, Economist, (303) 866-4105  
**SUBJECT:** 2015 Tobacco MSA Payment Forecast

### Summary

Colorado receives annual payments from tobacco manufacturers as part of the Tobacco Master Settlement Agreement. In April 2014, the state received \$100.4 million, including an \$89.0 million annual payment and an \$11.4 million payment in resolution of a legal dispute regarding withholding by manufacturers in 2006. This memorandum presents the distribution of the received payment from 2014, and forecasts payments and distributions through FY 2016-17. Most of this money will be used to fund healthcare programs across the state.

A tobacco manufacturer participating in the settlement can withhold a portion of its required payment if its market share decreases. The amount withheld is paid into an escrow account until an arbitration panel can rule on the cause of the decrease in market share. Most manufacturers have withheld a portion of their payments since 2006; this forecast assumes that withholding will continue. Payments withheld in 2007 and subsequent years remain a subject of legal dispute and are not expected to affect payments during the forecast period.

### Tobacco Master Settlement Agreement

The Tobacco Master Settlement Agreement (MSA) was signed in 1998 by 46 states, including Colorado, the District of Columbia, and five U.S. territories. As part of the agreement, states consented to release participating tobacco manufacturers from health-related claims associated with the use, manufacture, and marketing of tobacco products in return for perpetual annual payments from the manufacturers.

The states and tobacco manufacturers have to meet certain requirements to maintain the present level of payments. An arbitration process was established in the MSA to hear any disputes between the participating states and tobacco manufacturers. Colorado receives a fixed portion of the national MSA payment.

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## MSA Payment History and Forecast

Colorado began receiving MSA payments in 1999. The payments are calculated from a base amount that was agreed to in the MSA and is adjusted annually for inflation and changes in cigarette consumption. Consumption has fallen faster than the rate of inflation, so the base payment has decreased over time. In addition to the inflation and consumption adjustments, receipts have been reduced because tobacco manufacturers have disputed a portion of the payment. The payments are due each April.

***MSA dispute and withholding of payments.*** The MSA allows a participating manufacturer to reduce its payments to a state if the following conditions are met:

- the manufacturer is found to have lost market share to manufacturers that do not participate in the MSA;
- the MSA is determined to have been a significant contributing factor in the manufacturer's market share loss; and
- the state in which the market share loss occurred has not upheld its legal obligations to participating manufacturers under the MSA.

This is called the "nonparticipating manufacturers adjustment" (NPM). In order for manufacturers to lower their obligations under the NPM, they must dispute the amount owed at the time of the payment.

Since 2003, tobacco manufacturers have been claiming losses in market share resulting from states' failure to comply with the MSA. Some manufacturers began withholding a portion of their annual payments in 2006. Payments have been withheld despite the fact that the full legal process that must occur for the manufacturers to lower their payments has not run its course. Withheld payments either have not been paid by manufacturers or have been deposited into a separate disputed payments account. Since 2011, all of the largest manufacturers and most of the smaller manufacturers have annually withheld disputed payment amounts. This forecast assumes all tobacco manufacturers will continue to withhold disputed payments in 2015 and future years.

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

At some future date, Colorado's MSA payment will increase or decrease when the arbitration panel rules on the state's compliance in 2004 and subsequent years. Given the slow pace of legal proceedings, these developments are not expected to impact payments in the forecast period.

Table 1 on page 3 shows MSA payments since 2007 and the estimated payments for 2015 through 2017. The large increase in payments in 2008 is from a separate strategic contribution fund payment made in addition to the base MSA payment. The payment from the strategic contribution fund is an additional payment intended to reflect the level of contribution each state made toward final resolution of the state lawsuits against the tobacco companies. Colorado will receive the final installment of this secondary payment in 2017. The increase in disputed payments in 2011 is a result of the three largest tobacco manufacturers withholding disputed payments. Between 2008 and 2010, only two of the three largest manufacturers disputed payment amounts.

**Table 1**  
**Colorado Tobacco Master Settlement Agreement**  
**Payments and Disputed Payments**  
**2007 to 2017**

Year	Colorado Annual Payment After Withholdings	Disputed Amount Withheld	Release of Prior Withholdings
2007	\$82,005,568	(\$12,113,579)	
2008	\$103,640,385	(\$7,711,843)	
2009	\$105,419,647	(\$7,062,223)	\$7,411,531
2010	\$95,709,303	(\$8,714,641)	
2011	\$89,065,763	(\$13,614,015)	
2012	\$90,809,964	(\$11,574,809)	
2013	\$90,769,997	(\$12,362,477)	
2014	\$89,037,053	(\$11,756,684)	\$11,367,403
Forecast			
2015	\$88,562,575	(\$11,694,032)	
2016	\$88,054,137	(\$11,626,897)	
2017	\$87,430,714	(\$11,544,578)	

Source: Department of Law and Legislative Council Staff.

**Risks to the MSA forecast.** In addition to the NPM dispute, several factors could alter the amount the state receives from future payments, resulting in either larger or smaller amounts than forecast. These are described below.

- MSA base payments are adjusted depending on the volume of cigarettes consumed nationwide and on inflation rates, which are difficult to predict. The forecast for the base payment reflects projected decreases in cigarette sales and continued low inflation rates.
- Manufacturers may change their pattern of withholding payments. Consistent with the 2011 payment, it is assumed that the largest cigarette manufacturers will withhold payments through the forecast period. If this pattern changes, annual payments received could be higher than forecast.
- Additional smaller adjustments occur when manufacturers withhold payments in disputes unrelated to the NPM, or when manufacturers release payments withheld in prior disputes of this type. These are difficult to forecast.
- Some manufacturers may go out of business or file bankruptcy, and some manufacturers may not pay what is due each year.

### Distribution of MSA Payments

Table 2 on page 5 shows the state's actual MSA receipts in FY 2011-12 through FY 2013-14 and the Legislative Council Staff forecast of the state's receipts for FY 2014-15 through

FY 2016-17. Table 2 also summarizes how the money is distributed among the General Fund, Tobacco Settlement Litigation Fund, and MSA-funded programs. Table 3 on page 6 shows the amount that each MSA-funded program is projected to receive through FY 2017-18. The table includes a description of the funds that receive MSA revenue and the funding formula used to allocate those funds. State law distinguishes between two tiers of programs, which is why that distinction is made in Tables 2 and 3.

Currently, most of the payments fund programs in the Department of Health Care Policy and Financing, the Department of Human Services, the Department of Higher Education, and the Department of Public Health and Environment, though other departments receive payments as well. Each annual MSA payment funds programs in both the fiscal year the payment is received and the following fiscal year.

Senate Bill 09-269 transferred \$65.0 million in tobacco MSA payments to the state General Fund in FY 2009-10. These funds would have been appropriated to healthcare programs in FY 2010-11. To make up for this transfer, \$65.0 million in tobacco MSA payments received in April 2011 were used to fund healthcare programs in FY 2010-11. This accelerated payment has occurred each year since FY 2010-11, as a portion of MSA payments are used to fund programs in the fiscal year they are received.

Because the state fiscal year begins in July but MSA payments do not arrive until April, expenditures to programs funded by MSA revenue are paid out of the General Fund between the date when the previous fiscal year's MSA revenue is exhausted, usually in August, and the arrival of the current fiscal year's MSA payment in April. In order to decrease the amount advanced annually from the General Fund, House Bill 12-1247 reduced the size of the accelerated payment by about \$1.5 million and prevents it from increasing in any fiscal year after FY 2012-13.

During the 2014 legislative session, the General Assembly adopted Senate Bill 14-104 and House Bill 14-1394, requiring that any disputed payments received in FY 2013-14 and subsequent years be used to reduce the share of payments disbursed to fund programs in the fiscal year they are received. The \$11.4 million disputed payment received in 2014 was used for this purpose.

***Legislative adjustments to allocations of MSA payments.*** Laws passed in recent legislative sessions adjusted the allocations of MSA payments to certain programs. Table 4 on page 7 shows a summary of bills passed in the 2011 through 2014 sessions and their effects on the distribution of MSA payments.

**Table 2. Tobacco Master Settlement Agreement Payments**

*(In Millions)*

*Fiscal Years 2011-12 to 2013-14 Reflect Actual Payments*

<b>Received from Tobacco MSA Settlement</b>		<b>2011-12</b>	<b>2012-13</b>	<b>2013-14</b>	<b>2014-15</b>	<b>2015-16</b>	<b>2016-17</b>
Annual MSA Payment Received <i>(Payments provide funding for programs both in the fiscal year received and in the following year)</i>		\$90.8	\$90.8	\$89.0	\$88.6	\$88.1	\$87.4
Release of disputed payments from prior years <i>(not included in the Annual MSA Payment Received)<sup>1</sup></i>		\$0.0	\$0.0	\$11.4	\$0.0	\$0.0	\$0.0
<b>General Fund</b>		<b>2011-12</b>	<b>2012-13</b>	<b>2013-14</b>	<b>2014-15</b>	<b>2015-16</b>	<b>2016-17</b>
General Fund	Diversion of reduced transfers to tobacco programs <i>(SBs 11-224 and 11-225; HB 12-1247)<sup>2</sup></i>	\$2.0	\$1.3	\$1.3	\$1.2	\$1.2	\$1.2
<b>Attorney General</b>		<b>2011-12</b>	<b>2012-13</b>	<b>2013-14</b>	<b>2014-15</b>	<b>2015-16</b>	<b>2016-17</b>
Tobacco Litigation Settlement Fund	Reallocation of General Fund MSA share in FY 2012-13; \$1 million annually between FY 2013-14 and FY 2015-16 <sup>3</sup>	\$0.0	\$1.8	\$1.0	\$1.0	\$1.0	\$0.0
<b>State Agencies</b>		<b>2012-13</b>	<b>2013-14</b>	<b>2014-15</b>	<b>2015-16</b>	<b>2016-17</b>	<b>2017-18</b>
Allocations to MSA-Funded Programs	Tier 1 Programs (pursuant to 24-75-1104.5 (1), C.R.S.)	\$60.1	\$60.6	\$61.5	\$62.1	\$62.7	\$62.3
	Tier 2 Programs (pursuant to 24-75-1104.5 (1.5), C.R.S.)	\$27.4	\$27.5	\$25.3	\$24.3	\$24.2	\$24.0
	<b>Total; See Table 3 on page 6</b>	<b>\$87.5</b>	<b>\$88.1</b>	<b>\$86.8</b>	<b>\$86.4</b>	<b>\$86.9</b>	<b>\$86.3</b>

<sup>1</sup>SB 14-104 and HB 14-1394 require that disputed payments received beginning in FY 2013-14 be used to reduce "accelerated payments," which fund settlement programs in the fiscal year that the annual payment is received. Disputed payments are not a part of the sum distributed according to the formula in statute.

<sup>2</sup>SB 11-224 established an annual transfer from the Nurse Home Visitor Fund to the General Fund; this ended with the passage of HB 13-1180. SB 11-225 established an annual transfer from the Short-term Innovative Health Programs Grant fund to the General Fund; this ended with the passage of HB 12-1247. HB 12-1247 eliminated the Short-term Innovative Health Programs Grant Fund and used the 6% of second tier MSA revenue that had been allocated to that fund to offset a portion of the annual General Fund loans used to make accelerated payments to tobacco programs. General Fund savings from HB 12-1247 is reported as General Fund revenue in this table.

<sup>3</sup>HB 13-1180 transferred money that had been allocated to the general fund under SB 11-224 to the Tobacco Litigation Settlement Fund in FY 2012-13; between FY 2013-14 and FY 2015-16, \$1 million is transferred to the Tobacco Litigation Settlement Fund annually.

**Table 3. Tobacco Master Settlement Agreement Distribution**

(In Millions)

Fiscal Years 2012-13 and 2013-14 Reflect Actual Distribution; Pursuant to 24-75-1104.5, C.R.S.

Total MSA Payment Distributed (Excluding General Fund and Tobacco Litigation Settlement Fund)			\$87.5	\$88.1	\$86.8	\$86.4	\$86.9	\$86.3
First Tier Program Allocations			2012-13	2013-14	2014-15	2015-16	2016-17	2017-18
Health Care Policy and Financing	Children's Basic Health Plan Trust	27% of MSA payment up to \$33 million	\$24.5	\$24.0	\$24.0	\$23.9	\$23.8	\$23.6
	Children with Autism	\$1 million annually	\$1.0	\$1.0	\$1.0	\$1.0	\$1.0	\$1.0
Public Health and Environment	Dental Loan Repayment	\$200,000 annually	\$0.2	\$0.2	\$0.2	\$0.2	\$0.2	\$0.2
	HIV Prevention	2% of MSA payment up to \$2 million	\$1.8	\$1.8	\$1.8	\$1.8	\$1.8	\$1.7
	AIDS Drug Assistance	3.5% of MSA payment up to \$5 million	\$3.2	\$2.5	\$3.1	\$3.1	\$3.1	\$3.1
Human Services <sup>1</sup>	Nurse Home Visitors	Varies; see footnote <sup>2</sup>	\$12.7	\$14.4	\$15.0	\$15.8	\$16.7	\$16.6
	Tony Gramscas Youth Services	4% of MSA payment up to \$5 million	\$3.6	\$3.6	\$3.6	\$3.5	\$3.5	\$3.5
	Children's Mental Health Treatment	\$300,000 annually	\$0.3	\$0.3	\$0.3	\$0.3	\$0.3	\$0.3
Capital Construction	Fitzsimons Trust Fund	8% of MSA payment up to \$8 million, or Fitzsimons debt service requirement under HB 03-1256 if less	\$7.3	\$7.3	\$7.1	\$7.1	\$7.0	\$7.0
Military Affairs and Veterans	Veterans Trust Fund	1% of MSA payment up to \$1 million	\$0.9	\$0.9	\$0.9	\$0.9	\$0.9	\$0.9
Education	Early Literacy Fund	5% of MSA payment up to \$8 million <sup>3</sup>	\$4.5	\$4.5	\$4.5	\$4.4	\$4.4	\$4.4
Second Tier Program Allocations			2012-13	2013-14	2014-15	2015-16	2016-17	2017-18
Health Care Policy and Financing	Children's Basic Health Plan Trust	14.5% of MSA payment remaining after first tier	\$4.2	\$4.9	\$3.8	\$3.7	\$3.7	\$3.6
Higher Education	CU Health Sciences Center	49% of MSA payment remaining after first tier	\$14.2	\$13.7	\$13.0	\$12.5	\$12.4	\$12.3
Human Services	Offender Mental Health Services	12% of MSA payment remaining after first tier	\$3.5	\$3.4	\$3.2	\$3.1	\$3.0	\$3.0
	Alcohol and Drug Abuse Programs	3% of MSA payment remaining after first tier	\$0.9	\$0.8	\$0.8	\$0.8	\$0.8	\$0.8
Personnel and Administration	Supplement State Employee Insurance Plans	4.5% of MSA payment remaining after first tier	\$1.3	\$1.3	\$1.2	\$1.1	\$1.1	\$1.1
Public Health and Environment	Public Health Services	7% of MSA payment remaining after first tier	\$2.0	\$2.0	\$1.9	\$1.8	\$1.8	\$1.8
	Immunizations	4% of MSA payment remaining after first tier	\$1.1	\$1.1	\$1.1	\$1.0	\$1.0	\$1.0
	Health Services Corps	\$250,000 annually <sup>4</sup>	\$0.3	\$0.3	\$0.3	\$0.3	\$0.3	\$0.3
Office of the State Auditor	Reviews of Tobacco Settlement Programs	\$89,000 annually beginning in FY 2012-13 <sup>5</sup>	\$0.1	\$0.1	\$0.1	\$0.1	\$0.1	\$0.1

<sup>1</sup>SB 10-175 relocated the Children's Mental Health Treatment program from the Department of Health Care Policy and Financing to the Department of Human Services. HB 13-1117 relocated the Nurse Home Visitors fund and Tony Gramscas Youth Services Fund from the Department of Public Health and Environment to the Department of Human Services.

<sup>2</sup>HB 13-1180 made substantial changes to the funding formula for the Nurse Home Visitors Program. In FY 2011-12 and FY 2012-13, the fund received the greater of 14% of the MSA payment and \$12,727,350; in FY 2013-14, 2014-15, and 2015-16, it receives 17%, 18%, and 19% of the MSA payment, respectively, less \$1 million annual transfer to the Tobacco Litigation Settlement Fund; beginning FY 2016-17, it receives 19% of the MSA payment.

<sup>3</sup>HB 12-1238 replaced the Read to Achieve program with the Early Literacy Fund beginning in FY 2012-13.

<sup>4</sup>HB 11-1281 appropriated \$250,000 from the Short-term Innovative Health Programs Grant Fund. After the passage HB 12-1247, Health Services Corps money comes from the 6% of second tier revenue not allocated to other programs.

<sup>5</sup>HB 12-1249 requires the Office of the State Auditor to review the performance of programs receiving MSA funding. It appropriated \$89,000 from the 6% of unallocated second tier revenue, the balance of which is transferred to the General Fund.

**Table 4  
Recent Bills Affecting MSA Distributions**

<b>2011 Session</b>	
SB 11-216	Increased funding for the Children's Basic Health Plan by redistributing MSA funding from other programs.
HB 11-1281	Transferred \$250,000 annually from the Short-term Innovative Health Programs Grant Fund to the Colorado Health Services Corps.
<b>2012 Session</b>	
HB 12-1238	Eliminated the Read-to-Achieve program and transferred its funding to the Early Literacy Fund.
HB 12-1247	Eliminated the Short-term Innovative Health Programs Grant Fund and used the savings to offset General Fund accelerated payments to MSA-funded programs.
HB 12-1249	Requires the Office of the State Auditor to review MSA programs and allocates \$89,000 annually for this purpose.
<b>2013 Session</b>	
HB 13-1180	Redirected MSA funds from the General Fund to the Nurse Home Visitor program and to the Defense Account of the Tobacco Litigation Cash Fund.
HB 13-1305	Allows the Governor to transfer General Fund money into the Tobacco Litigation Settlement Cash Fund if the General Assembly is not in session and the arbitration panel rules that Colorado is not entitled to its share of the disputed payments.
<b>2014 Session</b>	
SB 14-104	Diverted all disputed payments received in 2014 and subsequent years from the General Fund to the Tobacco Litigation Settlement Cash Fund to reduce the annual amount of accelerated payments to MSA-funded programs.
HB 14-1394	Clarified SB 14-104 to stipulate that disputed payments are not to be included in the calculation of MSA receipts distributed to MSA-funded programs.