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Memorandum

January 29, 2019

TO: Interested Persons

FROM: Greg Sobetski, Senior Economist, 303-866-4105

SUBJECT: 2019 Tobacco MSA Payment Forecast

Summary

Colorado receives annual payments from tobacco manufacturers as part of the Tobacco Master Settlement Agreement (MSA). In April 2018, the state received $177.3 million, including a one-time payment of $113.3 million pursuant to the Nonparticipating Manufacturers Adjustment Settlement Agreement, a supplementary legal agreement that Colorado signed in 2018.

Contents

This memorandum presents the anticipated effects of the new settlement on future payments. The state is expected to receive $85.8 million in 2019 and $85.5 million in 2020; these receipts will drive disbursements to MSA-funded programs in FY 2019-20 and FY 2020-21, respectively.

Tobacco Master Settlement Agreement

The Tobacco MSA was reached in 1998 between tobacco manufacturers and the governments of 46 states (including Colorado), the District of Columbia, and five U.S. territories. Under the MSA, the states and other governments consented to release participating manufacturers from health-related claims associated with the use, manufacture, and marketing of tobacco products in return for perpetual annual payments from manufacturers.

Colorado receives a fixed portion of the national MSA payment each year. Following a formula in the MSA, the dollar amount received grows with inflation but falls as fewer cigarettes are consumed. Historically, these adjustments have counteracted one another, keeping nominal MSA revenue relatively flat. MSA revenue is exempt from TABOR as a damage award.

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

- the participating 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 participating manufacturer's market share loss; and
- a 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 agreement (NPM agreement). In order for manufacturers to lower their obligation under the NPM agreement, they must dispute the amount owed at the time of payment.

Beginning in 2003, participating manufacturers complained that they had lost market share resulting from governments' failure to comply with the MSA. These allegations were renewed each year, creating a series of disputes. Under the framework of the MSA, each dispute triggered an arbitration proceeding to determine whether governments had failed to comply. Beginning in 2006, some manufacturers withheld a portion of their annual payments, either by reducing the amount paid or by depositing the disputed amounts in an escrow account ("Disputed Payments Account") pending resolution of the arbitration proceedings. Payments were withheld even though the arbitration process had not run its course. Withholding continued annually, such that the amount withheld from the 2006 payment is associated with the 2003 dispute; the amount withheld in 2007 is associated with the 2004 dispute, and so on.

Arbitration proceedings have taken years to resolve. Arbitration 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 money, 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 that did not comply.

Nonparticipating Manufacturers Adjustment Settlement Agreement

The NPM Adjustment Settlement Agreement (NPM Settlement) is a supplementary legal agreement within the MSA framework to expedite resolution of the NPM disputes for a subset of MSA states and territories. Under the settlement, governments immediately receive a percentage of previously withheld payments while the remaining share is returned to manufacturers. Additionally, future annual payments to these governments are not subject to withholding, though the additional amount paid to signatory states is about 70 percent of the total amount that would otherwise be withheld.

Colorado signed the NPM Settlement in March 2018. This section presents information on the fiscal impact of Colorado's assent to the settlement and explains how the settlement addresses the NPM disputes for particular years.

Impacts on future payments. With its April 2018 payment, the state received a lump sum amount reflecting previous NPM withholding and a share of the amounts that would otherwise be withheld in future years. Because payments for 2019 and 2020 are governed by the NPM Settlement, the amount that the state receives will differ from what would otherwise be projected. Annual payments to Colorado will increase because no further amounts will be withheld by manufacturers. This effect will be offset, however, because portions of the lump sum amount received in 2018 are required to be credited back to manufacturers over several years. On net, the settlement is expected to modestly increase Colorado's receipts in 2019 and 2020.

This assessment assumes that the state would not receive released disputed payments in either year. Had the state not signed the NPM Settlement, active arbitration proceedings would continue. If the state was determined to have complied with the NPM agreement in earlier years, it would have received released arbitration moneys in lump sum amounts at irregular intervals.

Settlement for 2004 through 2014. In 2018, Colorado received its full share of the amounts withheld by manufacturers between 2007 and 2017, which reflect NPM disputes for 2004 through 2014. The state is authorized to retain 54 percent of the disputed amounts for 2004 through 2012 and 66 percent of the disputed amounts for 2013 and 2014. The remaining share is required to be credited back to manufacturers as a subtraction from the state's annual payments over five years, in 2018 through 2022. Credits to the manufacturers were frontloaded in 2018 so as to maintain relatively constant annual payment amounts in future years.

Settlement for 2015 through 2017. Participating manufacturers had disputed governments' compliance with the NPM agreement in 2015 through 2017, with withholding scheduled to occur in 2018 through 2020. In 2018, Colorado received its full share of the amounts scheduled to be withheld for these years. The state will retain 75 percent of these amounts; the remaining share is required to be credited back to manufacturers as a subtraction from the state's annual payments over three years, in 2019 through 2021.

Settlement for 2018 and subsequent years. The NPM Settlement includes provisions governing the disbursement of future funds that would otherwise be subject to NPM withholding. For 2019 and 2020, Colorado will receive 100 percent of what otherwise would have been withheld, consistent with the NPM Settlement. Approximately 25 percent of these amounts will be credited back to manufacturers via subtractions from the annual payments received in 2022 and 2023, respectively.

Pending legal question. Implementation of the NPM Settlement for 2021 and future years is currently on hold pending the resolution of a tax-related legal question submitted by participating manufacturers to the Internal Revenue Service (IRS). The forecast in the following section of this document is presented as if the NPM Settlement will not govern withholding for the April 2021 payment. In this circumstance, the payment received will decrease in this year, because deductions will continue to be made from the payment to credit back portions of the lump sum amount received in 2018, while disputed payments will once again be withheld via the Disputed Payments Account. Adjustments will be made to future forecast documents if and when this legal question is resolved.

Table 1
2019 Tobacco MSA Payment Forecast
Dollars in Millions

Payment Source	FY 2017-18 Actual	FY 2018-19 Estimate	FY 2019-20 Estimate	FY 2020-21 Estimate
Annual MSA Payment (Gross of Withholding)[1]	$64.0	$85.8	$85.5	$86.4
Manufacturer Withholding	-	-	-	($11.6)
Release of Prior Year Withholdings	$113.3	-	-	-
Net Funds Received	**$177.3**	**$85.8**	**$85.5**	**$74.9**

Allocation of Received Funds	FY 2018-19 Preliminary	FY 2019-20 Estimate	FY 2020-21 Estimate	FY 2021-22 Estimate
MSA-Funded State Programs (see Table 2)	$63.1	$84.5	$84.2	$73.8
Unallocated Portion[2]	$1.0	$1.3	$1.3	$1.1
General Fund	$113.3	-	-	-

Source: Department of Law, Department of the Treasury, and Legislative Council Staff Forecast.

[1]For FY 2018-19 and FY 2019-20, this amount is presented net of credits and debits associated with the NPM Settlement. It is assumed that, under current law, these funds will be subject to the annual MSA payment distribution in HB 16-1408. Section 24-75-1104.5, C.R.S., requires that received disputed payments be expended differently, and it is assumed that no receipts attributable to the NPM Settlement will constitute disputed payments for this purpose beyond FY 2017-18.

[2]Unallocated amounts for each fiscal year remain in the Tobacco Litigation Settlement Cash Fund, thereby reducing future accelerated payments from the fund. For FY 2018-19, the total unallocated amount is estimated at $1.3 million and includes $0.3 million from transferred funds, which are omitted here.

Forecast

Table 1 presents actual Tobacco MSA receipts for FY 2017-18 and estimated receipts for FY 2018-19 through FY 2020-21.

Estimates for receipts in FY 2018-19 and FY 2019-20 are largely based upon the terms of the NPM Settlement described above. Relative to the 2018 forecast, these projections have been revised downward modestly based on a slight decrease in expectations for cigarette consumption. For these years, the effects of the NPM Settlement are included in the "Annual MSA Payment Amount" line in the top part of Table 1, based on the assumption that these moneys will be subject to the statutory allocation formula in House Bill 16-1408. Independent from the NPM Settlement, the state no longer receives an allocation from the Strategic Contribution Fund, as these allocations ended after 2017.

Estimates for receipts in FY 2020-21 subtract manufacturer withholding amounts that may potentially be paid to the Disputed Payments Account. Implementation of the NPM Settlement for purposes of the April 2021 payment is contingent upon resolution of the legal question described in the previous section. If this question is resolved in a manner allowing for continuation of the NPM Settlement, the net amount received in April 2021 is projected to exceed this forecast by about $8.1 million. Under this scenario, the net amount would still be expected to fall relative to April 2020 receipts because the state would receive about 70 percent of the amount that would otherwise be withheld in 2021 and subsequent years, versus 100 percent of the amount that would otherwise be withheld in 2019 and 2020.

Risks to the forecast. The Tobacco MSA remains an area of ongoing legal uncertainty. Any changes to the legal landscape resulting from government or manufacturer legal strategy, arbitration proceedings, or court orders will have an effect on the amounts received. Colorado's arbitration proceedings for the 2004 through 2017 NPM disputes have been permanently settled; however, resolution of these disputes will not be concluded entirely until arbitration proceedings for all states have been closed. Annual payments are sensitive to cigarette consumption and U.S. inflation. This forecast assumes declining consumption and moderate inflation, and deviations from either assumption will affect the amount received. Finally, receipts will fall if participating manufacturers cease operations, file bankruptcy, or otherwise fail to pay what is due each year.

Distribution of MSA Payments

Payments that the state receives under the Tobacco MSA are allocated in percentage shares to specific programs identified in statute. The statutory allocation formula dictates only the distribution of annual MSA payments. Per statute, revenue from the release of disputed payments is credited to the General Fund.[1] Thus, disputed payments released when Colorado agreed to the NPM Settlement were credited to the General Fund and not disbursed using the statutory distribution formula.

[1] Section 24-75-1104.5 (5), C.R.S.

The MSA payment that the state receives each April dictates the allocation of moneys to MSA-funded programs for the fiscal year beginning in the following July. The bottom section of Table 1 shows the amounts of payments received each year that are spent on programs versus the unallocated portion reserved each year to reduce the amount of the annual accelerated payment, described below. Table 2 shows the amount that each MSA-funded program is projected to receive through FY 2021-22.

Senate Bill 18-280. Under the NPM Settlement, total 2018 state revenue from the MSA was greater than anticipated, but the annual MSA payment amount credited to the Tobacco Litigation Settlement Cash Fund fell short of expectations. Since only annual MSA cash fund revenue is distributed using the statutory formula, agreement to the NPM Settlement would have caused reductions in FY 2018-19 allocations to all MSA-funded programs. To offset this effect, the General Assembly adopted SB 18-280, which made a one-time transfer of $20.0 million from the General Fund to the Tobacco Litigation Settlement Cash Fund to boost FY 2018-19 allocations.

FY 2018-19 allocations were further supplemented by a transfer of $0.2 million from the Department of Law to the Tobacco Litigation Settlement Cash Fund in conjunction with the 2014 NPM dispute.

Table 2
2019 Tobacco MSA Distribution Forecast
Dollars in Millions

Program	FY 2018-19 Preliminary	FY 2019-20 Estimate	FY 2020-21 Estimate	FY 2021-22 Estimate
Department of Law				
Tobacco Settlement Defense Account	$2.1	$2.1	$2.1	$1.9
Department of Human Services				
Nurse Home Visitors	$22.5	$22.9	$22.8	$20.0
Tony Grampsas Youth Services	$6.3	$6.4	$6.4	$5.6
Department of Health Care Policy and Financing				
Children's Basic Health Plan Trust	$15.2	$15.4	$15.4	$13.5
Children with Autism	$1.7	$1.7	$1.7	$1.5
Department of Higher Education				
CU Health Sciences Center[1]	$14.7	$15.0	$15.0	$13.1
Department of Public Health and Environment				
AIDS Drug Assistance	$4.2	$4.3	$4.3	$3.7
HIV Prevention	$2.9	$3.0	$3.0	$2.6
Immunizations	$2.1	$2.1	$2.1	$1.9
Health Services Corps	$0.8	$0.9	$0.9	$0.7
Dental Loan Repayment	$0.8	$0.9	$0.9	$0.7
Capital Construction				
Fitzsimons Trust Fund	$6.7	$6.9	$6.8	$6.0
Department of Personnel and Administration				
Supplement State Employee Insurance Plans	$1.9	$2.0	$2.0	$1.7
Department of Military and Veterans Affairs				
Veterans Trust Fund	$0.8	$0.9	$0.9	$0.7
Total Funds Distributed[2]	**$82.9**	**$84.5**	**$84.2**	**$73.8**

Source: Department of the Treasury and Legislative Council Staff Forecast.

[1]*For FY 2016-17 and subsequent years, a share of this amount is required to be spent for tobacco-related in-state cancer research.*
[2]*For FY 2018-19 only, includes $19.7 million of $20.0 million transferred from the General Fund pursuant to SB 18-280, and $0.2 million transferred from the Department of Law in conjunction with the 2014 NPM dispute.*

Accelerated payments. The amount allocated to MSA programs for a fiscal year is determined by the payment that the state receives in the previous April. However, due to a budget-balancing measure enacted in 2009 following the Great Recession, the annual payment received each April funds programs in both the fiscal year it is received and the following fiscal year. This creates an annual General Fund obligation for a bridge loan, or "accelerated payment," made to fund MSA programs between the date when the prior year's payment is exhausted and the date when the current year's payment arrives. The General Assembly has taken steps to gradually reduce the size of this obligation on the General Fund.

As a budget-balancing measure in FY 2009-10, $65.0 million was transferred from the state's 2010 MSA payment to the General Fund.[2] Had the transfer not been made, this amount would have been used to fund programs for FY 2010-11; to compensate, $65.0 million from the state's 2011 MSA payment was allocated to programs in the then-current FY 2010-11. This measure created an ongoing obligation on the General Fund, and the accelerated payment has occurred in every year since. For programs funded in FY 2017-18, $31.3 million was paid from the state's April 2017 payment, and the remaining $43.7 million was paid from the April 2018 payment.

To decrease the amount advanced annually from the General Fund, any unallocated amount remaining in the Tobacco Litigation Settlement Cash Fund after programs are funded is retained in the fund and used to reduce the following year's accelerated payment. This amount is currently set at 1.5 percent of the annual payment received. Under House Bill 16-1408, the amount allocated to fund programs in FY 2016-17 was reduced by $15 million relative to the actual MSA payment received in April 2016.[3] Reducing this allocation correspondingly reduced the portion of the April 2017 payment required to be accelerated to pay program costs in FY 2016-17, with ongoing impacts on the accelerated payment amount in future fiscal years.

Statutory distribution formula. Independent of the NPM Settlement, the state's MSA payment would have fallen in 2018 due to the scheduled termination of a supplementary payment, called the Strategic Contribution Fund payment, which the state received over ten years ending in 2017. In anticipation of this reduction, the General Assembly enacted HB 16-1408 to rewrite the MSA distribution formula in statute. HB 16-1408 directs the distribution of 98.5 percent of the annual MSA payment as shown in Table 3. The bill eliminated funding from MSA revenue for six programs beginning in FY 2016-17:

- the Offender Mental Health Services Program in the Department of Human Services (DHS);
- the Alcohol and Drug Abuse Services Program in DHS;
- the Children's Mental Health Treatment Program in DHS;
- the Public Health Services Program in the Department of Public Health and Environment;
- the Early Literacy Fund in the Department of Education; and
- the Office of the State Auditor's annual audit of MSA-funded programs.

With the exception of the audit, these programs continue to exist and are funded using other revenue streams, including retail marijuana special sales tax revenue credited to the Marijuana Tax Cash Fund.

[2] Senate Bill 09-269.
[3] Section 24-75-1104.5 (1.3)(a.5)(II), C.R.S.

Table 3
Distribution of Tobacco MSA Payment under HB 16-1408
Effective beginning in FY 2016-17 under Section 24-75-1104.5 (1.7), C.R.S.

Program	Distribution
Department of Law	
Tobacco Settlement Defense Account	2.5%
Department of Human Services	
Nurse Home Visitors	26.7%
Tony Grampsas Youth Services	7.5%
Department of Health Care Policy and Financing	
Children's Basic Health Plan Trust	18.0%
Children with Autism	2.0%
Department of Higher Education	
CU Health Sciences Center[1]	17.5%
Department of Public Health and Environment	
AIDS Drug Assistance	5.0%
HIV Prevention	3.5%
Immunizations	2.5%
Health Services Corps	1.0%
Dental Loan Repayment	1.0%
Capital Construction	
Fitzsimons Trust Fund	8.0%
Department of Personnel and Administration	
Supplement State Employee Insurance Plans	2.3%
Department of Military and Veterans Affairs	
Veterans Trust Fund	1.0%
Total Funds Distributed	**98.5%**

[1]Of this share, 2.0 percent must be expended for tobacco-related in-state cancer research.

The remaining 1.5 percent of each year's MSA payment remains in the Tobacco Litigation Settlement Cash Fund and is used to reduce the following year's accelerated payment.