COLORADO GENERAL ASSEMBLY
JOINT BUDGET COMMITTEE

FY 2012-13 STAFF BUDGET BRIEFING

TOBACCO MASTER SETTLEMENT AGREEMENT FUNDING

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

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FY 2012-13 Joint Budget Committee Staff Budget Briefing
Tobacco Master Settlement Agreement Funding

BRIEFING ISSUE

ISSUE: Tobacco Settlement Agreement Update and Recommendations for Statutory Change

This issue provides background on the Tobacco Master Settlement Agreement, the current Non Participating Manufacturers legal dispute, and the complex allocation of Tobacco Settlement funds in Colorado. It includes various options for statutory changes to the current allocation formulas.

SUMMARY:

- ❏ Pursuant to the Tobacco Master Settlement Agreement reached between states and tobacco manufacturers in the late 1990s, Colorado receives an annual allocation of tobacco settlement funds, currently estimated at $89 million. Recent year receipts have been significantly affected by funds withheld by manufacturers due to a dispute over whether states are diligently enforcing provisions of the settlement agreement related to "non-participating manufacturers". Legal proceedings related to this dispute are ongoing.

- ❏ Tobacco revenue has been unstable and this, in combination with extremely complex allocation formulas, can interfere with program management.

RECOMMENDATION:

Staff recommends that the Committee sponsor legislation to: (1) direct all Tobacco Settlement revenues to the General Fund; (2) replace current Tobacco Settlement allocations with General Fund appropriations; and (3) establish statutory procedures for special review of the funding levels for any programs created or expanded with Tobacco Settlement funds if Tobacco Settlement revenue falls below a set level.

If the Committee is not comfortable pursuing a change this dramatic, staff would recommend various other statutory changes addressing disputed payments, accelerated payments, the Short Term Innovative Health Grant Program Grant Fund, the Autism Fund, and the State Auditor's Office Tobacco Settlement funding.

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

1. Abide by a variety of public health restrictions on the advertising and marketing of cigarettes,

2. Create and fund the American Legacy Foundation, which conducts youth-targeted anti-tobacco advertising, and
3. 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.

Tobacco Revenue Structure
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 estimated base payment for FY 2011-12 (prior to "withholding" described below) is estimated at $84.3 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 estimated Strategic Contribution Payment for FY 2011-12 (prior to "withholding" described below) is $17.3 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. An estimated $12.6 million is projected to be withheld in FY 2011-12, assuming full withholding, *i.e.,* the most recent projection from NAAG indicates that Colorado would receive $101.6 million without withholding but $89.1 million with withholding.

The Non-Participating-Manufacturer Dispute
The Tobacco MSA added about $4.30 to the cost of a carton of cigarettes purchased from participating manufacturers. From the outset, it was recognized that the extra costs the settlement imposes would place participating manufacturers at a competitive disadvantage when compared with

[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.

the "non participating manufacturers" (NPMs) who have not joined the agreement. In an effort to level the playing field, the agreement required states to enact a model statute that forced non participating manufacturers to make payments into escrow accounts that are comparable to what they would have paid to the states had they participated in the agreement.

Concern that the agreement would cause participating manufacturers to lose market share led to the inclusion of an NPM adjustment clause in the agreement, which reduces payments that the participating manufacturers make to the states. This adjustment comes into play when three conditions are satisfied for a given year:

1. the market share of participating manufacturers declines by 2 percent of more,
2. an independent economic consultant finds that the agreement significantly contributed to this decline, and
3. 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". At the same time, 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. Thus, the process for determining whether there should be an NPM-related adjustment and who should bear the penalty can be (and has been) lengthily.

Participating manufacturers first began assert that their payments should be reduced by an NPM adjustment related to the 2003 settlement payment. 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 went ahead and made the 2003 payment but, believing that the payment should be reduced by an NPM adjustment, they also set in motion a process that led an independent economic consultant to conclude that the agreement significantly contributed to this decline.

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. However, identifying qualified arbitrators and establishing the process for the arbitration has taken many years.

The Department of Law provided the following update on the case on November 28, 2011:

> The 2003 NPM Adjustment/Diligent Enforcement Arbitration began in July 2010. Most preliminary legal issues have been decided or have been briefed and deferred by the Arbitration Panel. The Panel has scheduled April for the beginning of the Common Case, a background and educational component for the Panel. Shortly after

> the Common Case presentation, State specific hearings will begin. Colorado is one of the remaining 35 states whose diligence is being contested by the Participating Manufacturers. State specific hearings are scheduled to begin in June 2012. At this time, there is no procedure for determining the order of State specific hearings. When the Panel approves a procedure, we will know the timing of Colorado's specific hearing. At this time, there are no substantive discussions between the States and Participating Manufacturers regarding settlement.

Following a decision for the 2003 adjustment, the arbitration process would then be repeated for 2004 and following years. However, the process for subsequent years would presumably be much accelerated.

Withholding of Disputed Payments. Following the decision of the economic consultant that the Tobacco MSA significantly contributed to participating manufacturers' decline in market share, 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, leading to a significant additional reduction in Colorado's allocation.*

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-$12 million (payout of amounts withheld); to
- Loss of the entire 2003 tobacco allocation for the state.

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

Recent Settlement Revenues

The following table presents the actual tobacco-settlement revenues in recent years. The column titled "Full payment" is the amount Colorado should have received had no withholding occurred.

FY Payment Is Received	This Payment Determines Approps in FY:	Full Payment	Amount Withheld	Total Received, Excluding Special Payments	% Change of Total Received Before Special Payments	Special Payments
Actual Payments:						
2003-04	2004-05	$86.1	$0.0	$86.1		$0.0
2004-05	2005-06	87.4	0.0	87.4	1.5%	0.0
2005-06	2006-07	91.1	(10.9)	80.2	-8.2%	0.0
2006-07	2007-08	92.7	(8.8)	83.9	4.6%	0.0
2007-08	2008-09	111.4	(7.7)	103.7	23.6%	0.0
2008-09	2009-10	112.5	(7.1)	105.4	1.6%	7.4
2009-10	2010-11	102.5	(7.9)	94.6	-10.2%	0.0
2010-11	2011-12	101.3	(12.2)	89.1	-5.8%	0.0

Amounts are in millions of dollars.

A review of the "Total Received Excluding Special Payments" column in this table shows that tobacco settlement revenues have been fairly volatile.

- The FY 2005-06 decline of settlement revenues was due to the start of withholding by participating manufacturers related to the Non Participating Manufacturers dispute.[2]
- The Special payment received in FY 2008-09 was also related to this ongoing dispute.
- The FY 2007-08 surge was due to the start of the Strategic Contribution Payments, which the Tobacco MSA requires manufacturers to make for ten years.
- The FY 2009-10 decline appears to have been due to the effects of the recession and the 61.6¢ per pack federal excise tax that was placed on cigarettes in April 2009.
- The FY 2010-11 decline is primarily due to a decision by the last of the major Participating Manufacturers (Phillip Morris) to withhold distributions related to the NPM dispute, as the other major manufacturers have done for a number of years.

"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

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[2]Note that amounts withheld were actually related to funds disputed 2003 funds, rather than tied to the FY 2005-06 amount that was due.

[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.

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 large portion of annual tobacco expenditures relies on the payment received in April of that year, *i.e.*, over $80 million of FY 2011-12 Tobacco expenditures will be supported by the April 2012 payment. [4]

Fiscal Year	Total Distributed to Settlement-supported Programs and Funds
2007-08 and earlier	Payments received during the prior fiscal year
2008-09	Payments received during the prior fiscal year (FY 2007-08) − $15.4 million of Strategic Contribution Fund (SCF) payments received during FY 2007-08 or minus the actual SCF payment if less + $15.4 million of the SCF payments received during FY 2008-09 or plus the actual SCF payment if less
2009-10	$100.0 million of the payments received during the prior fiscal year (FY 2008-09) − $15.4 million of SCF payments received during FY 2007-08 or minus the actual SCF payment if less + $15.4 million of the SCF payments received during FY 2009-10 or plus the actual SCF payment if less (Payments received during FY 2008-09 in excess of $100.0 million were transferred to the General Fund (GF) to augment FY 2008-09 GF revenues.)
2010-11 to 2016-17	Payments received during the prior fiscal year − $15.4 million of SCF payments received during the prior year or minus the actual SCF payment if + less − $15.4 million of SCF payments received during the current year or plus the actual SCF payment if + less $65.0 million of base payments received during the prior year or minus the actual base payment if less $65.0 million of base payments received during the current year or plus the actual base payment if less
2017-18	Payments received during the prior fiscal year (FY 2016-17) − $15.4 million of SCF payments received during FY 2016-17 or minus the actual SCF payment if less − $65.0 million of base payments received during FY 2016-17 or minus the actual base payment if less + $65.0 million of base payments received during FY 2017-18 or plus the actual base payment if less (There is no SCF payment in FY 2017-18 or subsequent years.)
2017-18 and later	Payments received during the prior fiscal year − $65.0 million of base payments received during the prior fiscal year or minus the actual base payment + if less $65.0 million of base payments received during the current fiscal year or plus the actual base payment if less

[4]These adjustments, included in H.B. 07-1359 and S.B. 09-269, enabled the General Assembly to allocate $80.4 million between FY 2008-09 and FY 2009-10 *in addition to* the usual Tobacco allocations distributed to Tobacco-funded programs.

Allocation of Tobacco Revenues in Colorado

The allocation of settlement revenues in Colorado follows complex statutorily-directed formulas. The revenue is first divided among what are commonly called Tier 1 programs, which collectively utilize about two thirds of the total, and the remainder is then allocated among the Tier 2 programs. Statute also sets aside a percentage from other allocations for audits by the State Auditor's Office, directs how interest on the fund is spent (Breast and Cervical Cancer Treatment) and what happens to unspent revenue (which varies by program).

Tier 1 Program	Portion of the Total Allocation
Children's Basic Health Plan	27%, not to exceed $33 million and not less than $17.5 million.
Nurse Home Visitor Program	15% in FY 2011-12, rising 1% annually to 19% in FY 2014-15, not to exceed $19 million in any year. However, for the years FY 2011-12 through FY 2014-15, a portion of the allocation is redirected to the General Fund, so that the actual NHV funding is 14% in FY 2011-12 increasing to 16% in FY 2014-15; and 19% for NHV is not reached until FY 2017-18.
Fitzsimons lease purchase	8%, not to exceed $8 million
Read-to-achieve Grant Program, Reading Assistance Grant Program (Section 22-88-102, C.R.S.), and Reimbursements to school districts for costs of educating juvenile offenders in adult detention facilities (Section 22-32-141, C.R.S.)	5%, not to exceed $8 million
Tony Grampsas Youth Services Program	4%, not to exceed $5 million
HIV/AIDS Drug Assistance Program	3.5%, not to exceed $5 million
HIV and AIDS Prevention Grant Program	2%, not to exceed $2 million
State Veterans	1%, not to exceed $1 million.
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)

Tobacco-settlement revenue that is not allocated to tier 1 programs (the "remainder") by the above table is allocated among tier 2 programs in the percentages detailed. As the share of revenue allocated to the Nurse Home Visitor Program in tier 1 increases over time, the total revenue available for tier 2 programs decreases.

Tier 2 Program	Percentage of Remainder
University of Colorado Health Sciences Center	49.0%
Mental health services for juvenile and adult offenders	12.0%
Local public health services	7.0%

Tier 2 Program	Percentage of Remainder
Children's Basic Health Plan	14.5%
Supplemental state contribution for group benefit plans	4.5%
Colorado Immunization Program	4.0%
Alcohol and drug abuse and treatment programs	3.0%
Short-term Grants for Innovative Health Programs (transferred to General Fund in recent years)	6.0%
Total	**100.0%**

The table below reflects the final FY 2010-11 allocation and the most recent estimate of the FY 2011-12 allocation. This estimate is slightly lower than the estimate included in the annual Appropriations Report based on revised estimates from the National Association of Attorneys General.

Tier 1 Program	FY 2010-11 Allocation Actual	FY 2011-12 Allocation Projected
Legislative Department		
Office of the State Auditor	**$112,831**	**$94,587**
Department of Education		
Read-to-achieve Grant Program and other education programs	**4,706,694**	**4,445,074**
Department of Health Care Policy and Financing		
Comprehensive Primary and Preventive Care Grant Program *(FY 2010-11 allocation of $2.8 million was transferred to the General Fund)*	*0*	0
Children's Basic Health Plan Trust (program receives Tier 1 AND Tier 2 allocations)	22,592,132	24,003,399
State share of funding required for the Children with Autism Act	1,000,000	1,000,000
Subtotal - Department of Health Care Policy and Financing	**23,592,132**	**25,003,399**
Department of Higher Education		
Fitzsimons lease purchase	**7,546,687**	**7,125,278**
Department of Military and Veterans Affairs		
Colorado State Veterans	**941,339**	**889,015**
Department of Human Services		
Child Mental Health Treatment Act	**300,000**	**300,000**
Department of Public Health and Environment		
Dental Loan Repayment Program	200,000	200,000
AIDS and HIV Prevention Grant Program	1,882,678	1,778,030
AIDS Drug Assistance Program	3,294,686	3,111,552

Tier 1 Program	FY 2010-11 Allocation Actual	FY 2011-12 Allocation Projected
Tony Grampsas Youth Services Program	3,765,355	3,556,059
Nurse Home Visitor Program *(the FY 2011-12 allocation excludes amounts redirected to the General Fund)*	13,178,744	12,737,347
Subtotal - Department of Public Health and Environment	**22,321,463**	**21,382,988**
Other		
Transferred to the General Fund instead of allocated to Nurse Home Visitor	**0**	**597,872**
Total	**$59,521,146**	**$59,838,213**

Tier 2 Program	FY 2010-11 Allocation	FY 2011-12 Allocation
Department of Higher Education		
University of Colorado, Health Sciences Center	**$15,674,327**	**$14,321,603**
Department of Health Care Policy and Financing		
Comprehensive Primary and Preventive Care Grant Program (redirected to Children's Basic Health Plan in FY 2010-11)	0	0
Medicaid shortfalls at Children's Hospital	307,000	0
Children's Basic Health Plan Trust	4,318,437	4,238,025
Subtotal - Department of Health Care Policy and Financing	**4,625,437**	**4,238,025**
Department of Human Services		
Mental Health Services for juvenile and adult offenders	3,838,611	3,507,331
Alcohol and drug abuse programs	959,653	876,833
Subtotal - Department of Human Services	**4,798,264**	**4,384,164**
Department of Personnel and Administration		
Supplemental state contribution for group benefit plans	**1,439,479**	**1,315,249**
Department of Public Health and Environment		
Local public health agencies	2,239,190	2,045,943
Colorado Immunization Program	1,279,537	1,169,110
Health Services Corps Fund (Health Care Professional Loan Repayment)	0	250,000
Short-term Grants for Innovative Health Programs *(FY 2010-11 amount transferred to the General Fund/other; assumption that same will occur in FY 2011-12)*	0	*1,503,666*
Subtotal - Department of Public Health and Environment	**3,518,727**	**4,968,719**
Total	**$30,056,234**	**$29,227,760**

Two appendices at the back of this packet provide additional contextual information.

- The first appendix organizes program allocations from largest to smallest and includes additional information such as whether the program is solely funded with Tobacco revenue and whether it is allowed to hold unexpended tobacco funds in a program fund.

- The second appendix attempts to graphically display Tobacco allocations among programs.

Problems with the Current Structure.

- Tobacco settlement revenue has fluctuated. As reflected in tables above, over the last eight years, Tobacco MSA revenue received has ranged from a low of $80.2 million to a high of $105.4 million -- a variance of 31 percent from the low-point to the high point. Further, much of the fluctuation has not been possible to predict. In particular, decisions regarding withholding funds due to legal disputes and release of funds as issues are resolved has not been predictable. For the upcoming year, staff will operate on the assumption that all companies will withhold amounts related to the Non Participating Manufacturers dispute. However as various disputes are settled either in the State's favor or not, revenue will continue to adjust.

- For the majority of programs, which rely on a set percentage of Tobacco funding, rather than a set amount of dollars, the funding variation can be difficult to manage. This situation can be particularly challenging for programs that rely exclusively on Tobacco funding and that have no capacity to cushion revenue fluctuations because they are not able to retain reserves. Realistically, fluctuations present a problem both in bad times, when revenues are smaller than an anticipated, and also in good times. Any program that provides ongoing services needs time to grow or shrink in a thoughtful fashion. The Tobacco revenue stream is not conducive to any kind of planning.

- It can be particularly difficult for programs to manage Tobacco revenue due to the timing of key information. First, a good estimate of the next year's funding levels only becomes available after April 15 (*i.e.*, a good estimate of FY 2011-12 funding only became available after April 15, 2011). It has not been possible to incorporate related late adjustments into the Long Bill before it is finalized (*i.e.*, figures incorporated in the FY 2011-12 Long Bill were known to be out-of-date by April 15, 2011). Further, under the current formula, additional adjustments may occur very late in the year being funded (*i.e.*, FY 2010-11 funding was reduced in April 2011 and FY 2011-12 funding is likely to be reduced in April 2012).

- The complex Tobacco funding structure exacerbates planning-problems. The complex formulas make ultimate funding levels opaque to the departments and programs that benefit from the funding, increases the risk that there will be errors in allocations (or in legislation that creates these allocations), and drives workload for executive and legislative branch staff, legislators, and anyone interested in how individual programs are faring. Further, because the Tobacco formulas are so complicated, individual programs cannot tell how changes to statewide Tobacco funding will affect them until they are informed by the Treasurer's Office or JBC staff.

- A final concern about the current system is that it relies so heavily on receipts that arrive late in the year to finance the majority of current year activities (*i.e.*, payments received April 15, 2012 support over $80 million of the FY 2010-12 expenditures of approximately $89 million). The decision to use current-year revenue (rather than prior year revenue) to support current-year programs enabled the General Assembly to capture over $80 million in one-time savings between FY 2008-09 and FY 2009-10 that could be redirected to meet other state needs. However, as projected Tobacco receipts decline, the risk grows of a year in which the General Assembly learns in April that it has not received a significant portion of the $80.4 million on which it was relying for the current year. At that point, the majority of the dollars will already have been spent. *Any major adjustment to revenue -- for example if Colorado were to lose in the current Non Participating Manufacturer dispute -- could leave the General Fund with tens of millions in unrecoverable bad debt.*

Staff Recommendation: Exchange Tobacco Allocations for General Fund Appropriations
Staff believes one way to address the problems described above would be to change statute to deposit all Tobacco revenue in the General Fund and replace current Tobacco allocations with General Fund appropriations. Decisions about funding for these programs would be made as they are for other programs with the exception that funding levels would be subject to special review at points when Tobacco revenues are expected to fall (*i.e.*, when Strategic Contribution Payments end in 2017) or if total Tobacco revenue falls below a specified amount. This would involve an array of statutory changes and would doubtless involve delicate political negotiations. However, staff believes such a change would offer significant benefits.

Benefits

- New programs and expanded programs that the General Assembly authorized when Tobacco revenues began to flow to the State would continue. The General Assembly's intent with respect to funding (*i.e.*, that Tobacco settlement funds be used to enable the State to add and expand various health-related programs) could still be reflected in statute. The mechanism for funding these new and expanded programs would simply change.

- The programs that receive Tobacco revenue would have a predictable funding stream that would be set in the Long Bill and would not typically change mid-year based on unforeseen revenue adjustments.

- Variations in the Tobacco funding stream would be cushioned within the structure of the much larger General Fund. The current risk--that Tobacco receipts will decline sharply and that this will not be apparent until April-- would not disappear. However the risk to the General Fund would be no greater than it is now, since the General Fund is currently used to "loan" Tobacco programs operating revenue for most of the year pending receipt of annual Tobacco MSA dollars in April.

- The current byzantine funding formulas could be eliminated, enabling legislative and executive staff, as well as legislators, to focus on the merits of particular programs rather than the details of Tobacco formulas.

Weaknesses

- A clear risk of adopting this proposal--as well as a benefit-- is that new General Fund appropriations for programs would not generally adjust up or down based on changes in

Tobacco funding.

Ongoing Slow Revenue Decline: The National Association of Attorneys General (NAAG) is currently projecting an annual decline in Tobacco revenues of 1.0 percent per year. This excludes adjustments related to legal disputes. Thus, the General Assembly may not wish to lock in fixed funding for these programs in an environment of declining revenue. That said, the General Assembly could consider absorbing a modest funding decline for a few years given that: (1) a share of Tobacco revenue is being directed to the General Fund at present (a portion of Nurse Home Visitor funding); (2) a larger share could be directed there (*e.g.*, by permanently eliminating the Short-term Innovative Grants program); and (3) If funding is set at approximately the current level, any additional funds received related to disputed payments (*i.e.*, any lawsuit "wins") would effectively go into the General Fund.

Potential for Large Reductions In Funding: This includes both anticipated and unanticipated adjustments. With respect to anticipated changes, April 2017 will be the State's final Strategic Contribution Payment. When this ends, total annual revenues will fall by about $15 million. Programs that were created or expanded with Tobacco MSA funds will be significantly affected under the current formulas and, in staff's opinion, most should also expect to face a reduction if the current structure is replaced with General Fund appropriations. In addition to this anticipated adjustment, there is also the risk that the State could lose in the Non-participating Manufacturer dispute, leading to an unanticipated financial penalty that could be as great as loss of the State's full Tobacco allocation for a year.

Staff therefore recommends that a significant decline or elimination of Tobacco revenue (projected or actual) trigger a special review of those programs created or expanded with Tobacco dollars. The General Assembly could, for example, consider a mechanism whereby if actual or projected Tobacco revenue fell below a set figure ($80 to $85 million) based on a report from the Treasurer or the Legislative Council projection, programs that benefitted from creation or expansion due to the Tobacco MSA would face an automatic, proportionate reduction in appropriations unless the Governor proposed, and the General Assembly approved, an alternative method for addressing the shortfall. Staff assumes that, at the very latest, such a review would be triggered during the 2017 legislative session, since Strategic Contribution Payments end in FY 2016-17.

- Advocates for programs now supported with Tobacco dollars are likely to be threatened by the loss of a legislatively-authorized, dedicated funding stream. However, as discussed above, this dedicated stream is a two-edged sword, and many programs may actually find that a more stable, General Fund appropriation will be in their favor.

- One challenge in converting Tobacco formulas to General Fund appropriation is that, pursuant to current statute, the funding formulas change over time. Specifically, the Nurse Home Visitor Program is scheduled to absorb a larger share of total revenue over the next several years at the expense of "Tier 2" programs. Under current formulas (and assuming total funding is unchanged), by FY 2015-16, the total funding for Tier 2 programs such as funding for the University of Colorado Health Sciences Center and Human Services mental health and alcohol and drug abuse programs will have decreased by 12.2 percent from the FY 2011-12 level (a decline of $3.6 million in total for these programs), while funding for the Nurse Home Visitor Program plus a diversion from Nurse Home Visitor to the General Fund will have increased by $3.6 million. Further, the amount of the Nurse Home Visitor funding that is diverted to the General Fund continues to adjust through FY 2017-08.

The table below shows how the total percentage of Tobacco MSA revenue that goes to the Nurse Home Visitor Program, the Nurse Home Visitor diversion to the General Fund (a provision added in response to a large multi-year grant received by Nurse Home Visitor), and all Tier 2 programs changes over time based on current statute.

If the General Assembly wished to retain the impact of current formulas while converting funding to General Fund, it would need to actively adjust funding for the affected programs over the next several years. *It might be possible to include multi-year assumed program growth/decline in the fiscal note for bill, thus enabling these changes to be treated as "annualization" in the budget process rather than "decision items."*

Nurse Home Visitor and Tier 2 Programs: Share of Annual Tobacco Allocation
Based on Statutory Formula

	FY 12	FY 13	FY 14	FY 15	FY 16	FY 17	FY 18
Nurse Home Visitor (NHV)	14.3%	14.3%	15.0%	16.0%	17.0%	18.0%	19.0%
NHV Diversion to GF	0.7%	1.7%	2.0%	2.0%	2.0%	1.0%	0.0%
Tier 2 programs	32.8%	31.8%	30.8%	29.8%	28.8%	28.8%	28.5%

Nurse Home Visitor and Tier 2 Programs: Approximate Change in Funding
Assumes Total Ongoing Revenue at FY 2011-12 level until $15 million decline FY 2017-18 due to expiry of Strategic Contribution Payments

	FY 12	FY 13	FY 14	FY 15	FY 16	FY 17	FY 18
Nurse Home Visitor (NHV)	$12,740,000	$12,740,000	$13,360,000	$14,250,000	$15,140,000	$16,030,000	$14,040,000
Change from Prior Year	*0*	*0*	*620,000*	*890,000*	*890,000*	*890,000*	*(1,990,000)*
Percent change		*0.0%*	*4.9%*	*6.7%*	*6.3%*	*5.9%*	*-12.4%*
NHV Diversion to GF	$600,000	$1,490,000	$1,750,000	$1,750,000	$1,750,000	$860,000	$0
Tier 2 programs	$29,230,000	$28,340,000	$27,450,000	$26,560,000	$25,670,000	$25,670,000	$21,050,000
Change from Prior Year	*0*	*(890,000)*	*(890,000)*	*(890,000)*	*(890,000)*	*0*	*(4,620,000)*
Percent change		*-3.0%*	*-3.1%*	*-3.2%*	*-3.4%*	*0.0%*	*-18.0%*

Alternative: Modest Changes to Current Statute
Staff realizes that the political obstacles to staff's preferred option, as well as some of the technical challenges outlined, may be daunting. In light of this, staff has also outlined below some more limited changes to current statute that the Committee may wish to consider.

Provisions Related to Disputed Payments. A statutory provision at Section 24-75-1104.5 (5), C.R.S., previously specified that any receipt of disputed payments by the State would be deposited to the General Fund. This provision expired July 1, 2011. Staff believes this should be reinstated, given: (1) the current need for General Fund revenue; and (2) the difficulty most Tobacco MSA-funded programs are likely to have in effectively managing a sudden payment "windfall". If the General Assembly does not wish to simply extend the provision that expired, it could establish a threshold above which receipts would go to the General Fund, *e.g.*, disputed payments that increase total annual receipts above $90 million will be deposited to the General Fund.

It is very unlikely there will be any disputed payments payouts during FY 2011-12, given that legal proceeding will be commencing during the summer of 2012. However, in the event the 2003 dispute were resolved in the state's favor, Colorado would receive a payout in the $10 to $12 million range, and this could conceivably occur in FY 2012-13. Additional amounts might ultimately become available related to the disputed payments for subsequent years, if arbitrators find in Colorado's favor.

Provisions Related to Accelerated Payments. Pursuant to Section 24-75-1104.5 (1), C.R.S., accelerated payments are based on the lesser of $15,400,000 in Strategic Contribution Fund (SCF) moneys or actual SCF receipts plus $65.0 million of other settlement moneys or actual other settlement receipts. The segregation of SCF receipts from other receipts has been a problem in recent years because actual SCF receipts have been coming in below $15.4 million. *Staff therefore recommends modifying the statutory component that treats "Strategic Contribution" revenues separately from base funding revenues when determining total funds available for expenditure.* With this change, a total of $80.4 million in current year revenues would be applied to current year expenses, rather than applying $65 million in base funding revenues and $15.4 million in Strategic Contribution revenues separately. *This modification would apply only through FY 2016-17*. At the point, the Strategic Contributions are projected to end, and the formula should be restored to approximately its current format (with the Strategic Contribution component reduced from $15.4 to $15.0 million). This would eliminate a problem of the last several years that funding for programs has adjusted downward very late in the year (April 2011 for FY 2010-11) based on actual Strategic Contribution receipts that are lower than $15.4 million.

The General Assembly might also consider reversing at least a portion of the accelerated payment structure. Tobacco revenues are currently projected at around $89 million and falling and accelerated payments now represent over 90 percent of total Tobacco expenditures. This should only be considered acceptable if the General Assembly is prepared to write off "bad debt" to the General Fund of up to $60 million (the amount likely to be advance-spent by mid-April) if the State were to lose in the current NPM dispute. That said, any action to reverse the accelerated payments structure bears a one-time cost in the amount to be reversed.

Short-term Innovative Health Program Grant Fund. Pursuant to Section 24-75-1104.5 (1.5) (a) (IX), C.R.S., the Short-term Innovative Health Program Grant Fund receives 6.0 percent of Tier 2 allocations, which translates into 1.7 percent of allocations or about $1.5 million in FY 2011-12. Pursuant to the program's statutory authorizing state at Section 25-36-101 (2), C.R.S., the Department of Public Health and Environment may use this fund to make short-term grants of no more than one fiscal year in duration to fund innovative health programs designed to improve the health of Coloradans. However, in practice, the Fund has rarely been used for this purpose. Instead, amounts in the Fund have been statutorily directed to other programs or, most recently, Fund amounts have simply been transferred to the General Fund. Pursuant to Section 24-75-1104.5 (8), C.R.S., at the end of FYs 2010-11 and 2011-12, amounts in the Fund are to be transferred to the

General Fund. No grants were provided in FY 2010-11 or are expected to be provided in FY 2011-12. However, it is presently unclear what might happen in FY 2012-13. *The staff recommendation would be to modify statute so that, for FY 2012-13 and several years into the future, this amount is deposited to the General Fund instead of the Short-term Innovative Health Program Grant Fund*[5]. *Staff does not believe re-activating these grants is presently the best use of these funds.* At a minimum, staff would recommend extending provisions that revert any unused funds to the General Fund at the end of FY 2012-13 and future years.

Autism Fund. Pursuant to Section 24-75-1104.5 (1) (l), C.R.S., the Autism Treatment Fund in the Department of Health Care Policy and Financing receives an annual Tier 1 allocation of $1,000,000. This Fund supports a Medicaid Home- and Community-based Waiver Program for 75 children with autism. Tobacco MSA funds may only be spent on autism waiver services, and the program is allowed to retain unspent Tobacco MSA moneys in the Autism Fund. The Department of Health Care Policy and Financing reported $2.1 million in cash fund balance for the program at the beginning of FY 2011-12 and anticipated annual expenditures of $920,454. The fund balance has grown due to the slow growth of the program (annual expenditures were under $600,000 in actual FY 2010-11). Regardless, *the fund balance represents a one-time source of dollars which staff does not believe it would be reasonable to use in an unsustainable program expansion above the $1.0 million available in ongoing annual revenue. In light of this, staff would suggest that the General Assembly consider a one-year suspension of new payments to the Autism Fund to enable it to spend down a portion of its fund balance. A smaller Autism Fund allocation might also be considered for the subsequent year, depending upon the size of fund balance the General Assembly believes should be retained.* Amounts not allocated to the Autism Fund could be redirected to the General Fund.

State Auditor's Office. Pursuant to Section 2-3-113 (7), C.R.S., the State Auditor's Office receives 0.1 percent of the total Tobacco funding received in the prior *calendar year* for the purpose of conducting audits of tobacco-funded programs. This allocation is supported via a proportionate reduction in the allocations to selected Tier I tobacco programs. Staff believes this statutory provision creates an unnecessarily level of complexity, particularly given that this is the very smallest of all Tobacco allocations. *Staff therefore recommends that this portion of statute be modified to provide the State Auditor's Office a fixed-dollar allocation. Staff would propose a dollar amount that is no more than 0.1 percent of the payment received during the prior fiscal year (about $89,000, based on the projected FY 2011-12 receipts).* This fixed dollar amount could be added to Tier 2 programs and reduced out of the Short-term Innovative Health Programs Grant Fund/ amount to be transferred to the General Fund. This would avoid any negative impact on Tier 2 programs and would reflect the likelihood that in many years this funding would revert to the General Fund.

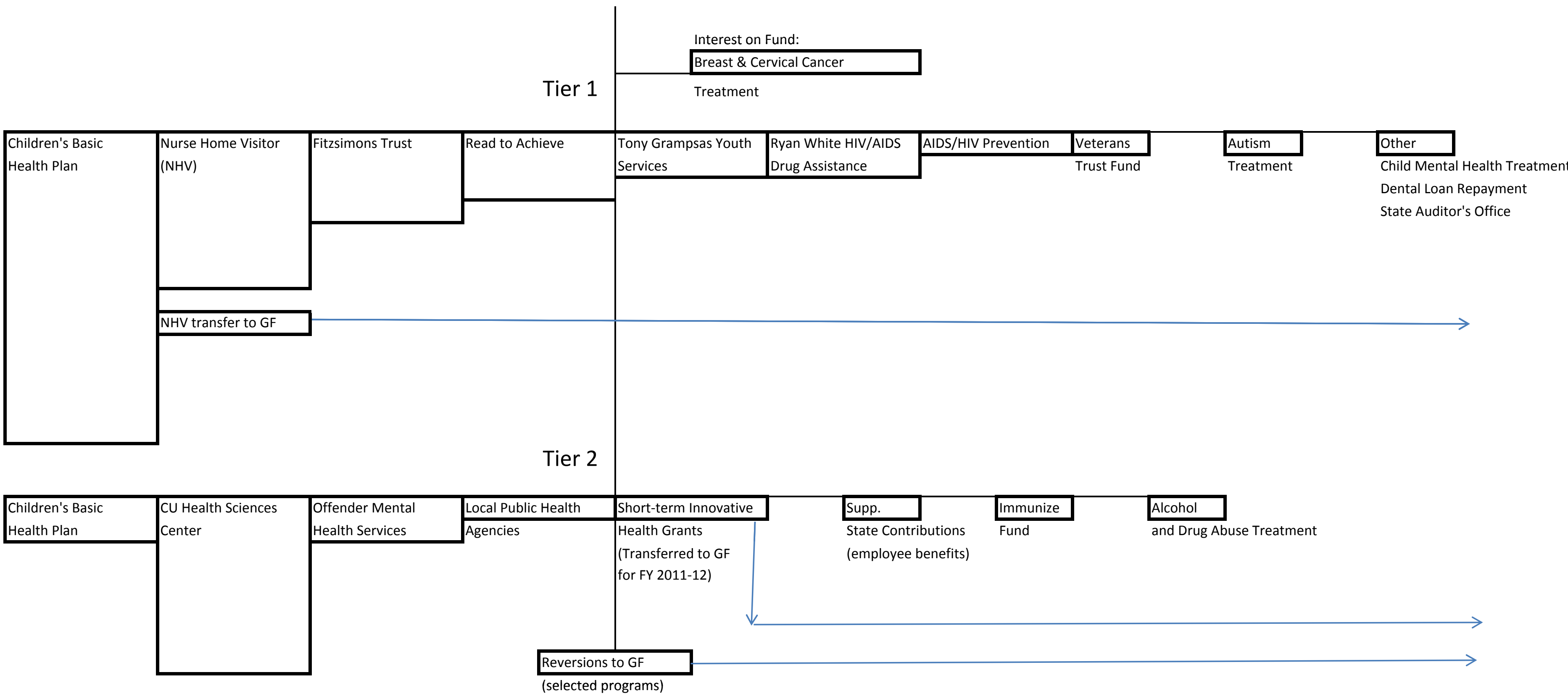
In recent years the Auditor's Office has reverted much of its Tobacco funding, as it only uses the funding if it audits a tobacco program. In FY 2010-11, in spent only $5,728 of its $112,831 allocation, and the balance reverted to the General Fund. In response to a staff question, the State Auditor indicated that the Office would nonetheless like to retain a Tobacco allocation.

[5]Staff notes that, among other demands on the General Fund, there may be a need for additional ongoing funding for the Attorney General's Office related to Tobacco Settlement litigation.

Additional Background on Tobacco MSA Allocations

Program	FY 2011-12 Tobacco Allocation	Percent Total Tobacco Allocation	FY 2011-12 Appropriation/ Estimated Total Program Funding	Tobacco Funding as Percent Total Program Funding	General Fund Appropriation FY 2011-12	Does excess revert or is it carried forward?
Children's Basic Health Plan Trust	$28,241,424	31.7%	$213,086,149	13.25%	29,997,908	Stays in Program Fund
CU Health Sciences Center	14,321,603	16.1%	193,782,226	7.39%	50,007,827	Reverts to General Fund
Nurse Home Visitor Program	12,737,350	14.3%	16,829,547	75.68%	0	Reverts to Tobacco Fund & then transferred to General Fund
Fitzsimons Trust Fund	7,125,278	8.0%	13,000,000	54.81%	0	Stays in Program Fund (but allocation reduced before this)
Read to Achieve	4,445,074	5.0%	4,445,074	100.00%	0	Stays in Program Fund
Tony Grampsas Youth Services	3,556,059	4.0%	3,556,059	100.00%	0	Reverts to Tobacco Fund & then transferred to General Fund
Offender Mental Health Services	3,507,331	3.9%	3,507,331	100.00%	0	Reverts to General Fund
Ryan White HIV/AIDS Drug Assistance Program	3,111,552	3.5%	17,784,843	17.50%	1,379,025	Reverts to Tobacco Fund & then transferred to General Fund
Support for Local Public Health Agencies	2,045,943	2.3%	8,013,294	25.53%	5,935,190	Reverts to General Fund
AIDS & HIV Prevention	1,778,030	2.0%	8,406,248	21.15%	0	Stays in Program Fund
Short Term Innovative Health Grants Program	1,503,666	1.7%	1,503,666	100.00%	0	Stays in Program Fund
Supplemental State Contribution	1,315,249	1.5%	1,315,249	100.00%	0	Stays in Program Fund
CO Immunization Fund	1,169,110	1.3%	7,798,474	14.99%	1,472,463	Reverts to General Fund
Autism Treatment	1,000,000	1.1%	1,727,250	57.90%	0	Stays in Program Fund
State Veterans Trust Fund	889,015	1.0%	889,015	100.00%	0	Stays in Program Fund
Alcohol & Drug Abuse Treatment	876,833	1.0%	47,486,313	1.85%	15,516,633	Reverts to General Fund
Transfer to General Fund	597,872	0.7%	n/a	n/a	n/a	Stays in Program Fund
Child Mental Health Treatment Act	300,000	0.3%	976,994	30.71%	618,574	Reverts to Tobacco Fund & then transferred to General Fund
Health Services Corps (Loan Repayment)	250,000	0.3%	2,836,227	8.81%	0	Stays in Program Fund
Dental Loan Repayment	200,000	0.2%	203,225	98.41%	0	Stays in Program Fund
State Auditor's Office	94,587	0.1%	7,992,279	1.18%	7,047,692	Reverts to Tobacco Fund & then transferred to General Fund
Total	**$89,065,978**					

Tobacco Litigation Settlement Trust Fund - Estimated FY 2011-12 Allocations - $89 Million



=Approximately 1% of annual allocation

JOINT BUDGET COMMITTEE BILL

SUMMARY OF H.B. 12-XXXX:
CONCERNING ANNUAL REDUCTIONS IN THE AMOUNT OF TOBACCO LITIGATION SETTLEMENT MONEYS THAT ARE ALLOCATED IN THE FISCAL YEAR IN WHICH THE STATE RECEIVES THEM, AND, IN CONNECTION THEREWITH, OFFSETTING THE REDUCTIONS WITH TOBACCO LITIGATION SETTLEMENT CASH FUND MONEYS MADE AVAILABLE BY THE REPEAL OF THE SHORT-TERM INNOVATIVE HEALTH PROGRAM GRANT FUND.

Bill Summary

This bill 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 Program Grant Fund.

Specifically, this bill makes the following changes:

- **Section 1, Pages 2-4: Establishes in statute the mechanism for reducing 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 would be allocated in the year received, with the balance derived from the prior year's Tobacco MSA revenue.

This bill modifies statute to specify that beginning in FY 2012-13, $80.4 million less unexpended funds in the Tobacco Litigation Settlement Cash Fund will be allocated in the year received. Each subsequent year, the amount allocated from current-year funds is further reduced by the amount remaining in the Tobacco Litigation Settlement Cash Fund at the end of the prior year.

Tobacco programs are held harmless in this process (i.e., they receive no less than they would have under the previous formula) because amounts remaining in the Tobacco Litigation Settlement Cash Fund are also distributed to them. The only exception is in FY 2016-17, when Strategic Contribution Payments are expected to end, and the amount allocated from current year funds is further reduced by $15.0 million. Current statute also incorporated this Strategic Contribution Payment reduction.

The table below provides a *simplified example* of how the process would work.

		FY 2011-12	FY 2012-13	FY 2013-14	FY 2014-15
A	Balance in Tobacco Settlement Cash Fund June 30 of prior year	0.0	1.2	1.2	1.1
B	Tobacco MSA funds Received April 15 of prior year	90.0	89.0	88.0	87.0
C	Tobacco MSA funds distributed in the prior year from the April 15 prior year revenue	80.4	80.4	79.2	78.0
D	Funds remaining after distribution above (B-C)	9.6	8.6	8.8	9.0
	Program Allocations				
E	Prior year balance (row D)	9.6	8.6	8.8	9.0
F	Tobacco MSA funds distributed in the current year from April 15 revenue	80.4	79.2	78.0	76.9
G	Funds from Tobacco Settlement CF balance	n/a	1.2	1.2	1.1
	Total Program Allocation	**90.0**	**89.0**	**88.0**	**87.0**

- **Section 1, Page 4:** Requires an annual report on November 1 from the Treasurer's Office to the JBC specifying the amount of Tobacco MSA funds spent and anticipated to be spent from current year revenue, *i.e.*, a report describing the impact of the process above on accelerated payments.

- **Section 1, Pages 6-7:** Eliminates the Tobacco MSA allocation to the Short-term Innovative Health Program Grant Fund.

- **Section 2, Pages 8-9:** Enables the Tobacco Litigation Settlement Cash Fund to carry a balance to the next fiscal year, beginning in FY 2011-12, rather than having the balance swept to the General Fund, for the purpose of reducing accelerated payments.

- **Section 5, Page 11-16:** Requires that, at the end of FY 2011-12, the balance in the Short-term Innovative Health Programs Grant Fund is transferred to the Tobacco Litigation Settlement Cash Fund. Repeals the Short-term Innovative Health Programs Grant Fund.

- **Sections 9 and 10, Page 19:** Makes the act effective upon passage, except the introductory portion related to accelerated payments, which takes effect July 1, 2012, and adds a safety clause.

- **All other sections of the bill:** Technical clean-up to eliminate historic references to the Short-term Innovative Health Programs Grant Fund.