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Memorandum

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TO: Interested Persons

FROM: Emily Dohrman, Economist, 303-866-3687

SUBJECT: 2023 Tobacco Master Settlement Agreement Payment Forecast

Summary

Colorado receives annual payments from tobacco manufacturers as part of the Tobacco Master Settlement Agreement (MSA). In April 2022, the state received $88.2 million, which was used to determine distributions to MSA-funded programs for the current FY 2022-23.

This document presents a forecast for annual receipts from the Tobacco MSA through FY 2024-25. The state is expected to receive $92.3 million in 2023; the actual amount received in 2023 will determine disbursements to MSA-funded programs in FY 2023-24. Payments are expected to be $89.8 million in 2024 and $86.8 million in 2025.

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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 and profits of participating manufacturers, but falls as fewer cigarettes are consumed. In recent years, faster declines in consumption alongside persistently low inflation had driven decreases in MSA revenue. This trend was disrupted by the COVID-19 pandemic, which was accompanied by an uptick in cigarette sales for the first time in 20 years, as well as historically high inflation rates, both driving a bump up in MSA revenue. 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 diligently enforced its legal obligations 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 claimed that they had lost market share resulting from governments' failure to diligently enforce the requirements of 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 was associated with the 2003 dispute, the amount withheld in 2007 was 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. Arbitration between states and manufacturers concerning disputed payments for subsequent years remains ongoing.

Nonparticipating Manufacturers Adjustment Settlement Agreement

To expedite resolution of payment disputes, participating manufacturers and states negotiated the NPM Adjustment Settlement Agreement (NPM Settlement), a supplementary legal agreement within the MSA framework. 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 amount that would otherwise be withheld.

Colorado signed the NPM Settlement in March 2018. This section explains how the settlement addresses the NPM disputes for particular years, including its expected fiscal impact for Colorado.

Lump sum 2018 payment. 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. After 2018, annual payments to Colorado increased because manufacturers do not withhold from these payments. This effect was offset between 2019 and 2022, however, because portions of the lump sum amount received in 2018 were credited back to manufacturers, reducing annual payments received.

Settlement for 2004 through 2017. In 2018, Colorado received its full share of the amounts supposed to be withheld by manufacturers between 2004 and 2017. The state is authorized to retain 54 percent of the disputed amounts for 2004 through 2012, 66 percent of the disputed amounts for 2013 and 2014, and 75 percent for 2015 through 2017. The remaining share was 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 to maintain relatively constant annual payment amounts in future years.

Settlement for 2019 through 2022. The NPM Settlement includes provisions governing the disbursement of funds that would otherwise have been subject to NPM withholding. With its 2019 payment, Colorado received 100 percent of what otherwise would have been withheld for 2018 and disputes with its 2019 and 2020 payments. Approximately 25 percent of the amounts received are being credited back to manufacturers via subtractions from the annual payments received in 2022 and 2023, respectively.

Settlement for later years. Beginning in 2023, the credits to manufacturers from the 2018 lump sum payment will be paid back. Therefore, continued participation in the NPM Settlement is expected to increase annual receipts relative to what would be expected if the state had not joined the NPM Settlement.

Revenue Forecast

Payments that the state receives under the Tobacco MSA are allocated in percentage shares to specific programs identified in statute. The MSA payment that the state receives each April dictates the allocations to MSA-funded programs for the fiscal year that begins the following July.

Table 1 presents actual Tobacco MSA receipts for FY 2021-22 and estimated receipts for FY 2022-23 through FY 2024-25. The bottom section 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 in the next section.

Table 1
2023 Tobacco MSA Payment Forecast
Dollars in Millions

Payment	FY 2021-22 Actual	FY 2022-23 Estimate	FY 2023-24 Estimate	FY 2024-25 Estimate
Annual MSA Payment	$88.2	$92.3	$89.8	$86.8
Allocation of Received Funds	**FY 2022-23 Actual**	**FY 2023-24 Estimate**	**FY 2024-25 Estimate**	**FY 2025-26 Estimate**
MSA-Funded State Programs (see Table 2)	$86.9	$91.0	$88.5	$85.5
Unallocated Portion[1]	$1.3	$1.4	$1.3	$1.3
Net Funds Received	**$88.2**	**$92.3**	**$89.8**	**$86.8**

Source: Department of Law, Department of the Treasury, and Legislative Council Staff Forecast.
[1]*Unallocated amounts for each fiscal year remain in the Tobacco Litigation Settlement Cash Fund, thereby reducing future accelerated payments from the fund.*

Variables that impact MSA payments. The size of the annual MSA base payment is largely determined by U.S. inflation, U.S. cigarette consumption, and cigarette manufacturers' income. Inflation generally has a positive impact on the size of payments, particularly over the past two years, while the volume of cigarette sales tends to decline year over year, putting downward pressure on payments. Lastly, if the income collected by cigarette manufacturers in a given year exceeds a certain inflation-adjusted threshold, then the payments will be increased.

Some fluctuation in annual payments is also attributable to a schedule of payments and credits that was established when Colorado joined the NPM Settlement in 2018. The NPM Settlement governs the share that the state receives from the amount that manufacturers would have withheld had Colorado not joined the NPM Settlement. Additionally, subtractions are made from the state's annual payment through 2023 to credit back a portion of the lump sum payment that the state received in 2018. On net, these changes are expected to have subtracted from the 2022 payment.

Recent payments and expectations. The payment received in FY 2021-22 came in higher than recent years due to an uptick in inflation, cigarette sales, and manufacturers' income during the COVID-19 pandemic. The inflation adjustment for the payment received in FY 2021-22 corresponds to the inflation that occurred during calendar year 2021, which was higher than normal due to demand for goods outpacing the supply following the pandemic. The pandemic also increased demand for cigarettes, disrupting the decades long trend of declining sales. Lastly, the largest manufacturers that participate in the MSA began moving toward higher-priced premium products and non-cigarette tobacco products, and away from lower-cost products, resulting in higher incomes for tobacco manufacturers.

Payments are expected to peak in FY 2022-23 due to even higher inflation and manufacturers' incomes recorded in calendar year 2022. Payments are then expected to decline through the forecast period as inflation moderates and cigarette sales return to their pre-pandemic trend of steady decline.

Risks to the forecast. Annual payments are sensitive to cigarette consumption, U.S. inflation, and manufacturers' income. This forecast assumes that consumption will decline throughout the forecast period and that inflation will begin moderating in 2023. Manufacturer profits are expected to remain elevated. Deviations from these assumptions will affect the amount received.

Additionally, 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 2022 NPM disputes have been settled; however, resolution of these disputes will not be concluded entirely until arbitration proceedings for all states have been closed. Receipts will also fall if participating manufacturers cease operations, file bankruptcy, or otherwise fail to pay what is due each year.

Distribution of MSA Payments

Table 2 shows the amount that each MSA-funded program is projected to receive through FY 2024-25 under the payment forecast estimates presented in Table 1.

Accelerated payments. The amount allocated to MSA programs for a fiscal year is determined by the payment that the state receives in April of the previous fiscal year. 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 in which 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. Prior to the COVID-19 pandemic, the General Assembly had taken steps to gradually reduce the size of this obligation on the General Fund. However, the General Assembly again increased the accelerated payment in House Bill 20-1380 as a budget-balancing measure during the pandemic-induced recession.

In FY 2009-10, $65.0 million was transferred from the state's 2010 MSA payment to the General Fund.[1] 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 FY 2010-11. This measure created an ongoing obligation on the General Fund, and the accelerated payment has occurred in every year since. Similarly, House Bill 20-1380 transferred $20 million from the state's 2020 MSA payment to the General Fund. To compensate, an additional $20 million from the state's 2021 MSA payment was allocated to programs in FY 2020-21.

As a result, for programs funded in FY 2022-23, $29.5 million was paid from the state's April 2022 payment, and the remaining $58.7 million is expected to be paid from the April 2023 payment.

[1]Senate Bill 09-269.

Table 2
2023 Tobacco MSA Distribution Forecast
Dollars in Millions

Program	FY 2022-23 Estimate	FY 2023-24 Estimate	FY 2024-25 Estimate	FY 2025-26 Estimate
Department of Law				
Tobacco Settlement Defense Account	$2.2	$2.3	$2.2	$2.2
Department of Human Services				
Nurse Home Visitors	$23.5	$24.7	$24.0	$23.2
Tony Grampsas Youth Services	$6.6	$6.9	$6.7	$6.5
Department of Health Care Policy and Financing				
Children's Basic Health Plan Trust	$15.9	$16.6	$16.2	$15.6
Children with Autism	$1.8	$1.8	$1.8	$1.7
Department of Higher Education				
CU Health Sciences Center[1]	$15.4	$16.2	$15.7	$15.2
Department of Public Health and Environment				
AIDS Drug Assistance	$4.4	$4.6	$4.5	$4.3
HIV Prevention	$3.1	$3.2	$3.1	$3.0
Immunizations	$2.2	$2.3	$2.2	$2.2
Health Services Corps	$0.9	$0.9	$0.9	$0.9
Dental Loan Repayment	$0.9	$0.9	$0.9	$0.9
Capital Construction				
Fitzsimons Trust Fund	$7.1	$7.4	$7.2	$6.9
Department of Personnel and Administration				
Supplement State Employee Insurance Plans	$2.0	$2.1	$2.1	$2.0
Department of Military and Veterans Affairs				
Veterans Trust Fund	$0.9	$0.9	$0.9	$0.9
Total Funds Distributed	**$86.9**	**$91.0**	**$88.5**	**$85.5**

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

[1]A portion of this amount is required to be spent for tobacco-related in-state cancer research.

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.

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.

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.