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Memorandum

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TO: Interested Persons

FROM: Elizabeth Ramey, Principal Economist, 303-866-3522

SUBJECT: 2022 Tobacco MSA Forecast

Summary

Colorado receives annual payments from tobacco manufacturers as part of the Tobacco Master Settlement Agreement (MSA). In April 2021, the state received $86.6 million, which was used to determine distributions to MSA-funded programs for the Current FY 2021-22.

This document presents a forecast for annual receipts from the Tobacco MSA through FY 2023-24. The state is expected to receive $86.9 million in 2022; the actual amount received in 2022 will determine disbursements to MSA-funded programs in FY 2022-23. Payments are expected to be $87.8 million in 2023 and $83.6 million in 2024.

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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 have driven decreases in MSA revenue. This trend has been disrupted by the COVID-19 pandemic, which has been 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 disputes; 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.

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 starting in 2019 are governed by the NPM Settlement, the amount that the state receives differs from what would otherwise be expected under the original MSA. Annual payments to Colorado increase because manufacturers do not withhold from these payments. This effect is offset, however, because portions of the lump sum amount received in 2018 are required to be credited back to manufacturers over several years.

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 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 2019. The NPM Settlement includes provisions governing the disbursement of future funds that would otherwise be 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, respectively. Approximately 25 percent of these amounts will be credited back to manufacturers via subtractions from the annual payments received in 2022 and 2023, respectively.

Settlement for future years. Net payments received will be slightly less than if the state had not joined the NPM Settlement for 2021 and 2022, because credits back for a portion of the 2018 lump sum payment will slightly exceed the state's receipt of about 70 percent of the amount that would otherwise be withheld. Beginning in 2023, 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

Table 1 presents actual Tobacco MSA receipts for FY 2020-21 and estimated receipts for FY 2021-22 through FY 2023-24. Payments are expected to increase in 2022 and 2023, before declining toward pre-pandemic levels in 2024.

Table 1
2022 Tobacco MSA Payment Forecast
Dollars in Millions

Payment Source	FY 2020-21 Actual	FY 2021-22 Estimate	FY 2022-23 Estimate	FY 2023-24 Estimate
Annual MSA Payment	$86.6	$86.9	$87.8	$83.6
Net Funds Received	**$86.6**	**$86.9**	**$87.8**	**$83.6**

Allocation of Received Funds	FY 2021-22 Preliminary	FY 2022-23 Estimate	FY 2023-24 Estimate	FY 2024-25 Estimate
MSA-Funded State Programs (see Table 2)	$85.3	$85.6	$86.5	$82.3
Unallocated Portion[1]	$1.3	$1.3	$1.3	$1.3

Sources: 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.

The expected fluctuation in annual payments is partially attributable to pandemic-related disruptions, including an uptick in cigarette sales, which are expected to hold steady or decline more slowly than pre-pandemic rates over the next three years. The pandemic has also been accompanied by historically high inflation rates. Both of these trends are expected to keep upward pressure on MSA revenue from its elevated 2021 level, before beginning to abate, placing downward pressure on payments starting in 2024.

Additionally, the largest manufacturers that participate in the MSA, Philip Morris and R.J. Reynolds, are changing their business strategies. Specifically, the manufacturers are moving toward higher-priced premium products and non-cigarette tobacco products, and away from high-volume products. This trend is expected to put downward pressure on MSA payments as the quantity of cigarettes sold declines. This downward pressure may be offset by upward adjustments to MSA payments as manufacturer profits increase. Manufacturer profits, along with an uptick in cigarette consumption, contributed to an increase in the 2021 MSA payment, and are expected to continue to elevate payments throughout the forecast period.

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 subtract from the 2022 payment, and to subtract less from the 2023 and 2024 payments.

Risks to the forecast. Annual payments are sensitive to cigarette consumption, U.S. inflation, and manufacturer profits. This forecast assumes that consumption will hold steady or decline slowly throughout the forecast period and that inflation will remain elevated in 2022 before moderating in 2023. Manufacturer profits are expected to remain elevated. Deviations from these assumptions will affect the amount received. 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

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. 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 2024-25 under the payment forecast scenarios 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 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 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 2020 budget-balancing measure enacted in House Bill 20-1380 in response to the COVID-19 pandemic, the General Assembly had 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.[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 2020-21, $17.5 million was paid from the state's April 2020 payment, and the remaining $60.0 million is expected to be paid from the April 2021 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. For FY 2020-21, this amount was supplemented by additional unallocated funding of approximately $2 million under House Bill 20-1380.

[1]Senate Bill 09-269.

Table 2
2022 Tobacco MSA Distribution Forecast
Dollars in Millions

Program	FY 2021-22 Preliminary	FY 2022-23 Estimate	FY 2023-24 Estimate	FY 2024-25 Estimate
Department of Law				
Tobacco Settlement Defense Account	$2.2	$2.2	$2.2	$2.1
Department of Human Services				
Nurse Home Visitors	$23.1	$23.2	$23.5	$22.3
Tony Grampsas Youth Services	$6.5	$6.5	$6.6	$6.3
Department of Health Care Policy and Financing				
Children's Basic Health Plan Trust	$15.6	$15.6	$15.8	$15.0
Children with Autism	$1.7	$1.7	$1.8	$1.7
Department of Higher Education				
CU Health Sciences Center[1]	$15.2	$15.2	$15.4	$14.6
Department of Public Health and Environment				
AIDS Drug Assistance	$4.3	$4.3	$4.4	$4.2
HIV Prevention	$3.0	$3.0	$3.1	$2.9
Immunizations	$2.2	$2.2	$2.2	$2.1
Health Services Corps	$0.9	$0.9	$0.9	$0.8
Dental Loan Repayment	$0.9	$0.9	$0.9	$0.8
Capital Construction				
Fitzsimons Trust Fund	$6.9	$7.0	$7.0	$6.7
Department of Personnel and Administration				
Supplement State Employee Insurance Plans	$2.0	$2.0	$2.0	$1.9
Department of Military and Veterans Affairs				
Veterans Trust Fund	$0.9	$0.9	$0.9	$0.8
Total Funds Distributed	**$85.3**	**$85.6**	**$86.5**	**$82.3**

Sources: Department of the Treasury and Legislative Council Staff Forecast.
[1]A share of this amount is required to be spent for tobacco-related in-state cancer research.

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.