Primer
From the House Appropriations Committee
JOE MARKOSEK, DEMOCRATIC CHAIRMAN December 16, 2013

Tobacco Settlement Fund

Pennsylvania is one of 46 states that joined the 1998 Master Settlement Agreement (MSA) with the nation's major tobacco companies. Under the MSA, state lawsuits against cigarette manufacturers are dismissed in exchange for annual payments to states totaling billions of dollars.

The Tobacco Settlement Act (Act 77 of 2001) governs the deposit, investment and spending of Pennsylvania's share of the MSA payments. Act 77 established the Tobacco Settlement Fund for the deposit of payments received by the commonwealth and established health-related programs to be financed with the money. It also created two accounts within the Tobacco Settlement Fund: the Health Venture Investment Account to fund venture capital investments in health-related businesses and an endowment account to preserve a portion of tobacco revenues for future health care needs.

The Tobacco Settlement Fund is invested and managed by the Tobacco Settlement Investment Board. This 11-member board is comprised of the governor, the Secretary of the Budget, the State Treasurer, four members appointed by the General Assembly (one each by the four caucuses), three members appointed by the governor, and one member appointed by the State Treasurer.

As part of the 2013/14 budget, the General Assembly made changes to the Act 77 provisions related to the deposit and spending of tobacco funds, including changes to the funding formula used for appropriating the annual MSA payments made by tobacco manufacturers. As in previous fiscal years, the General Assembly used the Fiscal Code to amend Act 77 so that tobacco money could be redirected to help pay for other health-related programs in the General Fund budget; however, unlike prior years, the 2013 legislation (Act 71) made the new provisions permanent.

Master Settlement Agreement (MSA)

On Nov. 23, 1998, the Attorneys General from 46 states signed an agreement negotiated with the nation's largest tobacco manufacturers – Philip Morris, R.J. Reynolds, Brown & Williamson and Lorillard Tobacco Company. The four remaining states - Florida, Minnesota, Mississippi and Texas - had previously settled with tobacco manufacturers in separate agreements.

The MSA settled state claims filed against the tobacco industry to recover Medicaid costs associated with treating smoking-related illnesses. It also resolved all other lawsuits (such as antitrust and consumer protection) filed by the Attorneys General against the tobacco industry and protected the manufacturers from future state suits.

In exchange, the tobacco companies agreed to make annual payments to the states that will continue in perpetuity. The companies also agreed to change their marketing and advertising practices, which were largely aimed at youth.

In addition to the original participating manufacturers, the MSA allows other tobacco manufacturers to join the agreement. All companies that adhere to the terms of the MSA are protected from future lawsuits. Currently, about 65 tobacco companies are MSA signatories – the companies are referred to as "participating manufacturers". Companies that have not signed the agreement are known as "non-participating manufacturers".

The MSA required each of the 46 states to enact a model statute to ensure fair competition between participating and non-participating manufacturers. This statute included a per-pack fee on non-participating manufacturers, designed to neutralize the cost disadvantages that participating manufacturers experience as a result of provisions in the MSA.

Pennsylvania enacted its model statute, the Tobacco Settlement Agreement Act, in June 2000. This act requires all tobacco manufacturers doing

business in Pennsylvania to either become participating manufacturers in the MSA, adhering to its financial obligations, or place funds in a qualified escrow account so non-participating manufactures can pay future claims that may arise from suits brought by the commonwealth.

MSA Payments

The MSA requires tobacco companies to make various payments to the states. The three major payments – initial, annual and strategic contribution – are summarized below:

- The original participating manufacturers were required to make five **initial payments** between 1998 and 2003 – these "up-front" payments did not apply to subsequent participants to the agreement. The first payment (known as the "jurisdictional payment") was dispersed to the specific states after they attained "finality" on the settlement – that is, after a state court settled or dismissed all legal challenges to the MSA.
- **Annual payments** began in 2000 and are to be made by April 15 each year in perpetuity.
- **Strategic contribution payments** began April 15, 2008, and are to be made by April 15 each year thereafter through 2017.

The MSA commits the tobacco companies to make annual payments totaling $206 billion through 2025. The amount allocated to each state is in accordance with a distribution formula developed by the state Attorneys General – this formula is based on the estimated tobacco-related Medicaid expenditures and the number of smokers in each state. Pennsylvania's allocable share of the settlement is approximately 5.75 percent (or $11.3 billion of the estimated annual payments through 2025).

The schedule of annual payments provided in the MSA is subject to upward and downward adjustments depending upon criteria specified in the agreement. In particular, tobacco payments to states are affected by the following three adjustment factors:

- **Inflation adjustment.** Payments are adjusted each year based on an inflation factor, which is the greater of 3 percent or the Consumer Price Index.
- **Volume-of-sales adjustment.** Payments are adjusted each year based on the number of cigarettes shipped within the United States by the participating manufacturers. Declining cigarette sales decrease state payments, while rising sales increase the payments.
- **Non-Participating Manufacturer (NPM) adjustment.** Because of the numerous restrictions on participating tobacco manufacturers, companies are allowed to adjust their payments to address market share losses attributable to provisions in the agreement. If in any year the participating manufacturers lose market share to non-participating manufacturers and an economic consulting firm determines that the provisions of the MSA were a significant factor contributing to the market share loss, the annual payment to states may be reduced. However, no NPM adjustment may be made to any state that has passed the model statute and has diligently enforced it.

The MSA provides for complex methods and formulas to calculate the annual state payments made by the participating tobacco companies. Each year, an independent auditor calculates the aggregate payments due under the agreement, determines how the aggregate payment is to be allocated among the individual participating manufacturers, and authorizes disbursement of the payment to the states in accordance with each state's allocable share.

Through June 2013, Pennsylvania has received more than $5.2 billion in MSA payments.

Pennsylvania MSA Payments

Year	$ Millions
1999	$123.6
2000	$452.3
2001	$348.5
2002	$410.9
2003	$338.3
2004	$361.3
2005	$366.4
2006	$335.2
2007	$348.8
2008	$382.0
2009	$419.2
2010	$349.8
2011	$330.8
2012	$337.4
2013	$337.2
TOTAL	**$5,241.8**

Pennsylvania's payments have been less than the base amounts estimated in the MSA, reflecting the affect of an overall decrease in tobacco sales and the declining market share of manufacturers participating in the settlement.

Beginning in 2003, an independent auditor determined that participating manufacturers started losing market share to non-participating manufacturers. Pursuant to this finding, tobacco companies applied the downward NPM adjustment to annual state payments, contending that their market share loss is attributable to the MSA and paying a portion of their settlement payments into a dispute account. Under the agreement, withheld amounts are not to be distributed to the states until the dispute is resolved. The PA Attorney General has pursued legal proceedings to get the disputed funds back, arguing that Pennsylvania diligently enforced its model statute and is therefore entitled to full payment.

In September 2013, a three-judge arbitration panel ruled that Pennsylvania had not adequately enforced the MSA escrow provisions involving "non-participating" manufacturers and reduced the state's tobacco settlement payments for 2003 by 60 percent, or approximately $180 million. The reduction will occur with the annual payment due in April 2014.

The Attorney General is appealing the arbitration panel's decision, which applied only to 2003 disputed payments. The tobacco companies are still disputing how much they should pay Pennsylvania for subsequent years, 2004 through 2012.

Tobacco-Funded Programs

In June 2001, Pennsylvania enacted legislation governing the deposit, investment and spending of MSA funds. The Tobacco Settlement Act (Act 77 of 2001) established the Tobacco Settlement Fund for the deposit of payments received by the commonwealth. It also established two accounts within the Tobacco Settlement Fund: the Health Venture Investment Account to fund venture capital investments in health-related businesses and the Health Endowment Account to preserve a portion of tobacco revenues for future health care needs.

Act 77 established the following health-related programs to be financed with Pennsylvania's tobacco payments:

- Home and community-based services for seniors (Chapter 5)
- Tobacco use prevention and cessation programs (Chapter 7)
- Health research grant program (Chapter 9)
- Hospital uncompensated care payment program (Chapter 11)
- Basic coverage insurance program for low-income adults, known as adultBasic (Chapter 13)
- Medical Assistance purchase program for workers with disabilities, known as MAWD (Chapter 15)
- Regional biotechnology research centers (Chapter 17)
- Medical and surgical equipment grant program (Chapter 19)
- Community-based health care assistance grant program (Chapter 21)
- Expansion of the PACENET program (Chapter 23)
- Medical education loan assistance program (Chapter 25)

Some programs were designated to receive annual appropriations, beginning with fiscal year 2001/02, based on funding formulas in state statute that distribute each year's payments. Note: a brief description of each program is provided in this section. Other programs received one-time appropriations in 2001/02, using the MSA payments that Pennsylvania received prior to June 2000. Note: Information for these programs is provided in Appendix A.

The table on the following page shows the percentages set forth in Section 1712-A.1 of the Fiscal Code (as amended by Act 71 of 2013) for allocating annual tobacco payments to those programs designated to receive ongoing funding. These percentages replace those initially established in the Tobacco Settlement Act under Section 306, which was repealed by Act 71 of 2013. For purposes of comparison, the table below identifies the annual appropriation percentages initially established in the 2001 Tobacco Settlement Act (Act 77) and the replacement percentages established in Act 71. Of

particular note, Act 71 of 2013 made the following changes to the annual funding formula in Act 77:

- Eliminated the annual allocation to the Health Endowment Account and to the adultBasic program.
- Reduced the annual allocations for tobacco use prevention and cessation programs, broad-based health research, and the hospital uncompensated care program.
- Added a new allocation to be separately appropriated for health-related purposes – this represents the funding that has been redirected in prior budgets to help pay for Medical Assistance Long Term Care and Life Sciences Greenhouses.

Program Receiving Annual Appropriations	Act 77 of 2001	Act 71 of 2013
Home and Community-Based Services	13%	13%
Tobacco Use Prevention and Cessation Programs	12%	4.5%
CURE - Broad-Based Health Research	18%	12.6%
CURE - Cancer Research	1%	1%
Hospital Uncompensated Care Payment Program	10%	8.18%
Medical Assistance for Workers with Disabilities*	30%	30%
PACENET Program for Seniors	8%	8%
Health Endowment Account	8%	n/a
Health-Related Purposes	n/a	22.72%

*Act 77 stipulated that these funds be used for MAWD (established in Chapter 15 of Act 77) and the adultBasic program (established in Chapter 13 of Act 77).

Additionally, Act 71 of 2013 requires that all other payments and revenues received in the Tobacco Settlement Fund shall be appropriated for health-related purposes. Examples of "other payments" include strategic contribution payments and investment earnings – Section 303 of Act 77 had previously required these monies be deposited into the endowment account.

In nine of the budgets enacted subsequent to 2001/02, the General Assembly modified the various funding provisions in Act 77 of 2001, through amendments to the Fiscal Code, so that tobacco funds could be redirected to other health related programs in the state budget.

Appendix A provides a summary of how Pennsylvania used its MSA payments for the 12 budgets that cover fiscal years 2001/02 through 2012/13.

Home and Community-Based Services

The allocated tobacco funds are used to provide home- and community-based services, as an alternative to nursing home care, for seniors. Prior to 2012/13, this allocation was shared between the Department of Public Welfare (DPW) and the Department of Aging.

DPW used its allocation to pay for services provided through the Aging Waiver to seniors, age 60 or older, who are eligible for Medical Assistance.

The Department of Aging used its allocation to pay for the administrative costs associated with the Aging Waiver and the Nursing Home Transition program which assists individuals who want to move from a nursing facility back into the community.

The 2012/13 enacted budget moved the entire allocation to DPW, together with the expenditures associated with administrating the Aging Waiver program and the Nursing Home Transition program.

Tobacco Use Prevention & Cessation Programs

The Department of Health uses this allocation to administer a comprehensive tobacco control program that is based on best practices for effective intervention from the national Centers for Disease Control.

At least 70 percent of this funding is designated for grants to local programs and services. The balance may be used for statewide efforts.

Health Research

The Department of Health uses this allocation to administer the Commonwealth Universal Research Enhancement (CURE) program, which awards grants to Pennsylvania-based researchers, universities, medical schools and other institutions.

Of the 19 percent in Tobacco Settlement Funds allocated for health research, Act 77 designates 18 percent for broad-based health research and one percent for cancer research.

Hospital Uncompensated Care

DPW uses this allocation to provide payments to hospitals as partial reimbursement for the costs incurred in treating patients with inadequate or no insurance.

- 85 percent of funding is designated for Uncompensated Care payments to hospitals for the cost of care provided to individuals who are uninsured or unable to pay for services.
- 15 percent of funding is designated for Extraordinary Expense payments to hospitals for treating uninsured patients whose cost of care exceeds twice the hospital's average cost per stay.

Eligible hospitals may choose to receive either the Uncompensated Care payment or the Extraordinary Expense payment, but cannot receive both.

Health Insurance for Adults

These funds initially supported two programs: adultBasic in the Department of Insurance and Medical Assistance for Workers with Disabilities (MAWD) in the Department of Public Welfare.

- adultBasic provided basic health insurance to uninsured adults, age 19 to 64, with income less than 200 percent of the federal poverty level. The Insurance Department contracted with private insurers, and enrollees were required to contribute toward the cost of the health insurance (the monthly premium was $36 for 2010).
- MAWD is a Medical Assistance purchase program for working Pennsylvanians, age 16 to 64, who have a disability and whose income is less than 250 percent of the federal poverty level. Act 77 stipulates that MAWD enrollees pay DPW a monthly premium, equal to five percent of their monthly premium, to purchase Medical Assistance coverage.

With the termination of adultBasic in February 2011 and in accordance with the new funding formula in Act 71 of 2013, these funds now exclusively support MAWD

PACENET

This allocation is transferred to the PACE Fund to help support provisions in the Tobacco Settlement Act which expanded PACENET, a pharmaceutical assistance program for seniors.

The Act increased income eligibility for PACENET by $1,000 in 2001, raising the annual income limit to $17,000 for single individuals and $20,200 for married couples. (Note: Because of subsequent legislation, the current PACENET income limit is $23,500 for single individuals and $31,500 for married couples.)

adultBasic Court Challenge

After adultBasic was terminated, a group of former recipients filed suit in Commonwealth Court alleging the redirection of the monies that had supported adultBasic and MAWD violated the Tobacco Settlement Agreement. They asked the court to rule that Act 46 of 2010 and Act 26 of 2011 were unconstitutional. Both acts were omnibus amendments to the Fiscal Code that *inter alia*, redirected the monies from adultBAsic and MAWD. (Sears v. Corbett, Docket No. 121 M.D. 2011).

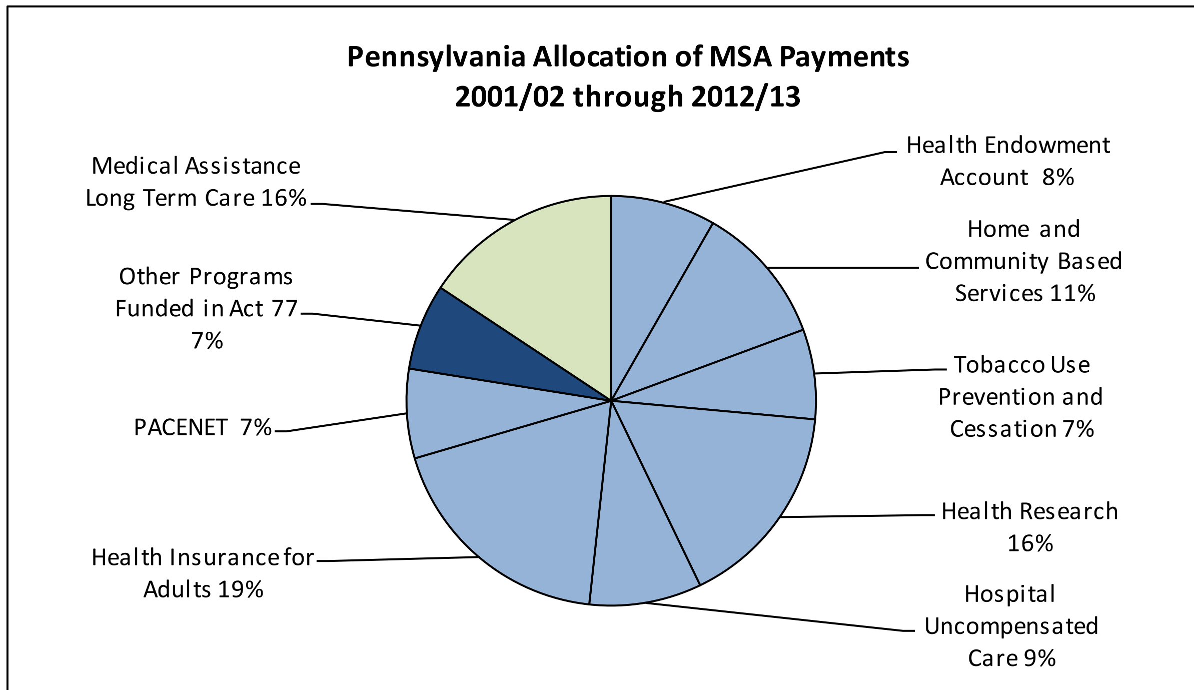
On March 4, 2013, the court ruled the acts were unconstitutional because they violated Article III, Sections 3 and 6 of the PA Constitution. (Single subject and prohibition on amending, including repealing, a law by reference to its title only). The court permanently enjoined the provisions of the acts from being enforced, but it did not require the monies be repaid to the Fund.

The court decision requires that, in the future, monies for adultBasic (or a similar program) and MAWD be distributed according to the formula set forth in section 306(b)(1)(vi) of the Tobacco Settlement Act. Please note: The final outcome of the lawsuit is unclear because the court decision can be appealed, and the appeal period has not expired as of the date of this publication.

Appendix A.

Utilization of MSA Payments, 2001/02 through 2012/13

The chart below shows how Pennsylvania allocated the $4.9 billion of MSA payments received through June 2012. The table on Page 7 details funding by specific program.



More than three-fourths of MSA payments ($3.8 billion) were allocated to the programs designated to receive ongoing allocations under Section 306 of Act 77, led by health insurance for adults followed by health research.

Seven percent of payments ($335 million) were appropriated to 11 other programs that received funding in 2001/02, as provided in Section 1501 of Act 77. Funding went to the following:

- The Health Venture Investment Account (established in Section 305 of Act 77), for authorized venture capital investments by the Tobacco Settlement Investment Board in health care, biotechnology or any other health-related businesses.
- Three regional biotechnology research centers established by the Department of Community and Economic Development. In addition to the $100 million appropriated in Act 77 to provide start-up funding, the centers have received annual funding in seven fiscal years (2006/07 through 2012/13) as the result of redirected MSA payments (see Page 7).
- The HealthLink Program, which was administered by the Department of Health, provided grants to rural hospitals for the purchase of medical and surgical equipment.
- The Community-Based Health Care Assistance Program, which was administered by the Department of Health, provided two grants to nonprofit health care centers: Coordination and Outreach Grants were available to support locating, assessing, and managing health care for low-income and chronically-ill people; Resource Grants were available to nonprofit health care centers to improve delivery and quality of care for these individuals.
- The Medical Education Loan Assistance Program, which was administered by PHEAA to assist individuals who acquire the required degree in medicine, professional nursing, biomedicine or life sciences and to recruit these individuals to practice their professions in Pennsylvania.

- Other health-related programs in the state budget, pursuant to Section 5101(D) of Act 77 which transferred $68.5 million to the General Fund in 2001/02. Subsequent transfers to the General Fund were executed in 2009/10 and 2010/11 as the result of redirected MSA payments.

Sixteen percent of MSA payments ($769 million) were used for Medical Assistance Long-Term Care in the Department of Public Welfare, helping to pay the cost of nursing home care provided to elderly and disabled Medical Assistance recipients. This funding for Medical Assistance Long-Term Care was the result of redirected MSA payments (see explanation on Page 8).

Allocation of MSA Payments, 2001/02 through 2012/13

($ in Millions)

Programs Receiving Annual Allocations (Under Section 306 of Act 77)		
Health Endowment Account*		$408
Home and Community Based Services		$549
Tobacco Use Prevention and Cessation		$352
CURE Health Research		$809
Hospital Uncompensated Care**		$439
Health Insurance for Adults		$923
Adult Basic	$579	
MAWD	$344	
PACENET		$348
Programs Receiving Appropriations for 2001/02 (Under Section 5101 of Act 77)		
Health Venture Investment Account		$60
Regional Biotechnology Research Centers***		$121
HealthLink Grant Program		$20
Community Based Health Care Assistance		$25
Medical Education Loan Assistance		$8
Transfer to General Fund for Health-Related Programs ****		$101
Other Programs Receiving Redirected MSA Payments		
Medical Assistance Long-Term Care		$769

Note: Allocations for home and community-based services, adultBasic, MAWD, and tobacco use prevention and cessation were adjusted to reflect the amounts lapsed in 2001/02 and 2002/03.

*Includes $25.783 million of supplemental funding in 2001/02, as the result of a one-time appropriation under Section 5101 of Act 77.

**Includes $15.0 million of supplemental funding in 2001/02, as the result of a one-time appropriation under Section 5101 of Act 77.

***Includes annual appropriations totaling $21 million from 2006/07 through 2012/13, as the result of redirected MSA payments.

****Includes additional transfers in 2009/10 ($17.4 million) and 2010/11 ($14.7 million), as the result of redirected MSA payments.

Redirected MSA Payments

Beginning with 2002/03, and over the course of nine budgets, the various funding provisions in Sections 303 and 306 of Act 77 were altered so that **MSA payments totaling $822 million** could be redirected to other health-related programs.

Through amendments to the Fiscal Code, the percentages used to allocate annual payments to programs were reduced. The amendments also modified provisions governing the deposit of monies into the Health Endowment Account and the treatment of lapses (unspent allocations).

Specifically, the following MSA payments were redirected:

- Annual allocations to:
  - Adult insurance programs were reduced in six budgets, 2005/06 through 2012/13 ($231 million). All of the funds were redirected from adultBasic.
  - Tobacco use prevention and cessation programs were reduced in six budgets, 2005/06 through 2012/13 ($143 million).
  - Health Endowment Account was reduced in four budgets, 2009/10 through 2012/13 ($108 million).
  - Hospital uncompensated care payments were reduced in two budgets, 2011/12 and 2012/13 ($11 million).
  - CURE research program was reduced in the 2012/13 budget ($17 million).
- Lapses from 2001/02 and 2002/03 ($193.5 million):
  - These unspent allocations were due primarily to delays in implementing the following programs established in Act 77: adultBasic ($97.5 million), Medical Assistance for Workers with Disabilities ($52.7 million), home and community-based services ($16.5 million) and tobacco use prevention and cessation programs ($26.5 million). Act 77 required lapses from the adult insurance programs and the home and community-based services be reallocated to these programs for use in succeeding years, with all other lapses to be deposited in the Health Endowment Account.
- The strategic contribution payments received in 2008 through 2012 ($117.6 million). These payments otherwise would have been deposited into the Health Endowment Account.

The **$822 million of redirected MSA payments** were used as follows:

- A total of **$769 million was redirected to Medical Assistance Long-Term Care**. In addition to MSA payments, $326 million of interest, earnings and fund balances were also redirected, bringing total tobacco fund monies redirected for Medical Assistance Long-Term Care to nearly $1.1 billion over the course of nine budgets. The redirected amounts, which varied from year to year, were included in the annual appropriations act as a specific appropriation under the Tobacco Settlement Fund.
- A total of **$21 million was redirected to Life Sciences Greenhouses** over the course of seven budgets; $3 million was redirected each year, appearing in the annual appropriations act as a specific appropriation under the Tobacco Settlement Fund.
- A total of **$32 million was redirected to the General Fund** to pay for other health-related programs. The redirected amounts were transferred from the Tobacco Settlement Fund to the General Fund, as provided in the Fiscal Code.

House Appropriations Committee (D)

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