

**MINUTES
of the
FIRST MEETING
of the
TOBACCO SETTLEMENT REVENUE OVERSIGHT COMMITTEE**

**May 24, 2016
Room 321, State Capitol
Santa Fe**

The first meeting of the Tobacco Settlement Revenue Oversight Committee was called to order by Representative John L. Zimmerman, co-chair, on May 24, 2016 at 10:46 a.m. in Room 321 of the State Capitol in Santa Fe.

Present

Sen. Cisco McSorley, Co-Chair
Rep. John L. Zimmerman, Co-Chair
Sen. John C. Ryan
Sen. John Arthur Smith

Absent

Rep. Gail Chasey
Rep. Monica Youngblood

Advisory Members

Sen. Linda M. Lopez
Sen. Mary Kay Papen
Rep. Jim R. Trujillo

Rep. Patricio Ruiloba
Rep. Don L. Tripp

Staff

Celia Ludi, Staff Attorney, Legislative Council Service (LCS)
Jeff Eaton, Research and Fiscal Policy Analyst, LCS
Diego Jimenez, Research Assistant, LCS

Guests

The guest list is in the meeting file.

Handouts

Handouts and other written testimony are on the New Mexico Legislature website and in the meeting file.

Tuesday, May 24

Welcome and Introductions

Representative Zimmerman welcomed everyone and asked members and staff to introduce themselves.

History of the Master Settlement Agreement in New Mexico

Ms. Ludi, referring to a handout at Item 1, presented a brief history of the tobacco litigation Master Settlement Agreement in New Mexico.

In 1994, the attorney general of the State of Mississippi filed suit against major tobacco companies for deceptive and fraudulent marketing, targeting children and conspiracy to conceal the health effects of smoking, arguing that Mississippi should not be forced to pay the costs of treating smoking-related diseases and conditions such as lung cancer, heart disease, emphysema and low-birth-weight babies. Eventually, 45 other states, including New Mexico, filed similar lawsuits against the same defendants, seeking recovery of Medicaid and other public health expenses incurred by the states in the treatment of smoking-related diseases and conditions.

In November 1998, the New Mexico attorney general joined 45 other states' attorneys general in settling the lawsuit with the tobacco companies, which are referred to as the participating manufacturers (PMs). The document that sets out the settlement is called the "Master Settlement Agreement", or MSA.

The MSA requires the PMs to stop deceptive marketing of cigarettes, particularly to children, and to make payments to settling states in perpetuity to compensate for the increased costs to the states because of the use of the tobacco companies' products. In exchange, states gave up any future claims against the PMs based on the tobacco companies' actions at issue in the settled lawsuits.

The PMs were the largest tobacco companies in the country at the time of settlement, but there are smaller tobacco companies that did not participate in the settlement. These companies are referred to as nonparticipating manufacturers (NPMs). The PMs were concerned that, because of the payments they had to make to the settling states, the NPMs would gain an unfair advantage in sales, leading to an increased market share for the NPMs and, therefore, a loss of market share to the PMs as an unintended result of the settlement.

To level the playing field between the PMs and the NPMs, the MSA provided that the annual payment amounts to the settling states could be reduced if it could be shown that the PMs had lost market share to the NPMs as a result of the settlement; these reductions are called "NPM adjustments".

The MSA allowed settling states to avoid reductions in payments because of NPM adjustments by:

(1) passing model escrow statutes that neutralize the cost disadvantages that the PMs experience by requiring NPMs operating in the settling states to either join the MSA and comply with its terms or to establish an escrow account and make regular payments into that account; and

(2) enforcing the escrow legislation.

In the 1999 legislative session, almost immediately after the MSA was signed, the legislature enacted the model escrow statutes.

The annual calculation of the settlement payment to be made by each PM and the amount to be received by each settling state, including any NPM adjustments, is very complex, and the parties can dispute the calculations. Disputes are resolved by arbitration, and the arbitration decisions may be challenged in state court. The calculation of the payments and whether the state has enforced the escrow statutes have been disputed by the PMs, beginning in 2003.

The Attorney General's Office (AGO) manages enforcement of and compliance with the MSA and represents the state in any disputes.

Ms. Ludi concluded her presentation, noting that Ari Biernoff, assistant attorney general, AGO, would later provide an update on the litigation.

Post-Session Update: Tobacco Settlement Permanent and Program Funds

Christine Boerner, senior fiscal analyst, Legislative Finance Committee (LFC), referred to a handout at Item 2, "Tobacco Settlement Fund Revenue and Appropriations", which reviewed the last three fiscal years. She particularly noted the additional transfers from the Tobacco Settlement Permanent Fund (Permanent Fund) to the Tobacco Settlement Program Fund (Program Fund) in fiscal years 2016 and 2017 to cover increases in Medicaid costs.

A committee member asked if the state borrowed money from the Permanent Fund during the great recession. Ms. Boerner responded in the affirmative. The member asked if the money had been repaid, and Ms. Boerner replied that it has not, and she agreed with the member's supposition that the absence of the borrowed money has negatively affected the Permanent Fund's earnings.

Another committee member pointed out that the Permanent Fund, which receives the annual payment from the MSA, was set up with an annual 50% distribution to the Program Fund and opined that the Permanent Fund was not sustainable at that level of distribution.

Another committee member commented that research indicates that \$21 million to \$22 million should be spent annually on smoking cessation efforts, yet only \$5.4 million is currently allocated for smoking cessation. The member pointed out that when not enough is spent on smoking cessation, state Medicaid costs go up and insurance costs go up. By cutting smoking cessation programs, "we are cutting off our nose to spite our face", the member noted. Another member pointed out that actual tobacco usage continues to decrease.

Another committee member expressed concern about whether the current annual appropriations are authorized by statute [Section 6-4-10 NMSA 1978]. The member also

wondered if there is a sunset on any of the current uses of the appropriations and if some of the current uses are real needs.

A member asked Christina Keyes, economist, LFC, to explain where the distributions received from the MSA are coming from, e.g., are the companies making payments from their sales revenues or did they set up their own escrow funds to make the payments from returns on the escrow funds; and what is the LFC seeing in terms of the long-run forecast of investment returns. Ms. Keyes said that the LFC uses the services of a reputable macroeconomic forecasting firm, Global Insight. The firm is taking a more conservative stance with regard to long-run rates of return for institutional investment funds and sovereign wealth funds, she said. The returns for the State Investment Council (SIC) were flat last year, only posting a 0.4% return. Current assumptions are that institutional investment funds will, in the long run, have investment returns of 7.75%. Ms. Keyes said that the SIC is revisiting this assumption and that Global Insight is forecasting institutional returns at around 4% for this fiscal year. She noted that the state retirement agencies (the Public Employees Retirement Association and the Educational Retirement Board) are reviewing their long-run return assumptions this year as well. In response to the committee member's question as to where the money was coming from (tobacco sales, an escrow fund, etc.), Ms. Keyes said that she was unsure and would refer that question to Mr. Biernoff. The member commented that if the settlement payments come from some kind of tobacco escrow fund, the settlement payments might be in danger because of the risk of poor investment performance. Ms. Keyes responded that the Consensus Revenue Estimating Group [a state fiscal advisory group consisting of representatives from the Department of Finance and Administration, the Taxation and Revenue Department, the Department of Transportation and the LFC] sees the Permanent Fund as a declining revenue source because of the overall decline in the use of tobacco products. She observed that last year's forecast settlement payment was \$42 million, but the actual payment was \$37 million.

A member added that another concern is that the state's operating reserve of 5% includes the Permanent Fund.

A discussion ensued about the current state of general fund revenue collections, revealing that gross receipts tax, compensating tax, corporate income tax and personal income tax revenues are all currently well below prior year collections. A member pointed out that volumes of oil and gas extracted are flat, and oil and gas wells using hydraulic fracturing are good producers early but quickly decline in productivity. Another member noted that the production in the Permian Basin is still very good and that the price can fall to \$28.00 to \$32.00 per barrel and New Mexico producers will still pump, but if revenues are off and stay off as they have recently, the Permanent Fund is at risk of being liquidated to balance the state budget.

Update on MSA Litigation

Mr. Biernoff first introduced the attorney general's "tobacco team", Special Projects Coordinator Phil Bachicha, paralegal Jennifer Van Wiel and the new Civil Litigation Division director, Regina Ryzanczak, and then he provided the update.

Basically, he said, a ruling by the district court in the state's appeal of the arbitrator's final award concerning the distribution of the NPM adjustment of the settlement payment for 2003 is still pending; the case has been before the judge for almost two years. A member asked which court and the name of the judge; Mr. Biernoff replied that it is the First Judicial District Court and Judge Raymond Ortiz.

Mr. Biernoff refreshed the committee's recollection that, in 2006, the PMs and the states began disputing the 2003 settlement payment, with the PMs alleging that New Mexico had not adequately enforced the escrow statutes. In September 2013, an arbitration panel issued a decision that New Mexico had not diligently enforced its escrow statute in calendar year 2003. The attorney general appealed the arbitrators' decision by filing a motion to vacate the final award in December 2013 in the district court in Santa Fe. The attorney general also filed a motion to vacate the arbitration panel's "partial award" (which had adopted the term "sheet settlement", a side agreement between certain states and the PMs). Prevailing on that motion could ultimately increase New Mexico's payment distribution by up to \$12 million. Both motions are awaiting a decision by the district court.

A committee member asked if the state can appeal if the district court rules against the state. Mr. Biernoff replied affirmatively. He added that the tobacco companies would also be able to appeal the lower court's ruling if the district court rules against them. The appeal would be to the New Mexico Court of Appeals. Mr. Biernoff informed the committee that the PMs had challenged payments to Maryland and Pennsylvania on similar issues, the arbitrator's decisions were appealed to their trial courts, and the trial court decisions were appealed to their state appeals courts and then their state supreme courts. The Maryland and Pennsylvania supreme courts have recently issued rulings favorable to the states; the PMs have applied to the United States Supreme Court for writs of certiorari in one of those cases, and the applications are pending. Mr. Biernoff noted that it had taken approximately two and one-half years for the Maryland and Pennsylvania appeals to progress from their district courts through their supreme courts, in contrast to New Mexico, where the district court has still not issued a decision, almost two years after the hearing. He declined to predict how long it would be before the 2003 payment dispute is finally resolved.

Mr. Biernoff informed the committee that the PMs' challenge to the 2004 payment is just getting under way in the arbitration process. He is concerned that, as time goes on, it will become more difficult to resolve disputes over diligent enforcement because of the lag time between the time of challenge and the time of resolution; witnesses will retire or otherwise become unavailable.

In response to a question by a committee member, Mr. Biernoff explained that if a state's diligent enforcement is challenged by the PMs and the arbitrator finds for the PMs, money will be debited from the next year's payment; the state never has to return money that has already been paid. So, the 2014 payment was reduced in accordance with the arbitrator's decision rendered in late 2013 in the 2003 case; if the state wins the appeal of the arbitrator's decision, the PMs will

have to pay the amount of the reduction, in addition to the current amount due in whatever year the final decision is issued. Mr. Biernoff warned that the attorney general expects the PMs to challenge New Mexico's and many other states' diligent enforcement in every year, which may result in adjustments to the payment calculation, which will unpredictably affect the payments in years when an arbitration decision is issued and resolved.

A member asked what costs the state has accumulated for the litigation. Mr. Biernoff replied that the state has spent well over \$100,000 for its share of the 2003 arbitration proceeding, which is the most expensive phase; as to the exact amount, Mr. Biernoff said he did not know but would provide the committee with that information. The member opined that it would be important to do a cost-benefit analysis of the litigation, including the cost to the AGO for staff to defend the litigation, to determine if the state will get back more money than it cost to get it, and Mr. Biernoff agreed, adding that New Mexico and all states have a very strong incentive to defend their settlement payments.

A member noted that the "Tobacco Settlement Fund Revenue and Appropriations" handout provided by Ms. Boerner listed an appropriation to the Indian Affairs Department for tobacco cessation programs, yet tribal sales are not included in the settlement payment calculation and are also a source of dispute that is costing the state money to defend. Mr. Biernoff corrected that perception by explaining that anyone who buys cigarettes on or off tribal land contributes to nationwide PM sales. As a result, total tobacco sales go up and that increases the payments to the states; it is just that there is no state cigarette tax on tribal sales.

Mr. Biernoff further explained that one of the issues New Mexico faces in the current case is the sale of tobacco on tribal lands. He said that the MSA does not specifically require regulation of tribal sales, but it does require regulation of sales of cigarettes subject to the imposition of the cigarette excise tax; in New Mexico, tribal sales are not subject to the cigarette excise tax. New Mexico maintains that the tribes are sovereign, and New Mexico has never imposed a state cigarette excise tax on tobacco sales made on tribal land. The arbitrator in the challenge to the 2003 payment agreed with New Mexico that the state does not have to require escrow deposits for NPM tribal sales. However, 23 states have agreed in a side settlement with the PMs to heightened enforcement beyond the requirements of the MSA, including enforcement of the escrow statutes on tribal sales.

In response to questions from the committee, Mr. Biernoff summarized the legislative history of escrow deposits on tribal sales: the 2009 legislature permitted the state to require escrow deposits on tribal sales even in the absence of the cigarette excise tax, but in 2010, it appeared to have reverted to the status quo, i.e., not requiring escrow deposits on tribal sales. The attorney general is currently involved in pending litigation with some NPMs on the issue of whether the NPMs are required to make escrow deposits on tribal sales for 2010. In 2011 and 2012, the legislature passed bills that would have required NPMs to deposit escrow payments for tribal sales, and both bills were vetoed. The same bill was introduced in 2013 but did not pass both houses.

Mr. Biernoff related that another issue in the challenge to the 2003 payment was the state's recordkeeping. A member asked if recordkeeping is better today than it was in 2003. Mr. Biernoff said yes. He noted that in 2003, state government had not yet computerized much of its recordkeeping and email usage in New Mexico was not as ubiquitous as it is today. State agency recordkeeping is much better now for retaining and retrieving information.

A member asked if the concept of the MSA was, if New Mexico reduces smoking more, more money is distributed. Mr. Biernoff replied no — the opposite is true. As tobacco sales go down, settlement payments go down because the payments are calculated based on the total amount of sales. On the other hand, the enforcement of the MSA on NPMs can make states' distributions go up. In 2003, more than 90% of sales were from the PMs. Today, that has dropped to 75% to 83% in some years. The other thing to remember, Mr. Biernoff said, is that state enforcement against NPMs basically offers the NPMs two choices: they can either join the MSA and become PMs, or they can pay money into an escrow fund to offset what they would have paid if they were PMs. A member asked if all arbitration and subsequent appeal litigation is about enforcement of the escrow statute against the NPMs, and Mr. Biernoff replied that it is.

A member asked precisely how the PMs finance their settlement payments — sales or an escrow fund of their own. Mr. Biernoff said that he did not know, but he would look into it and try to find out if that information is publicly available. The member asked whether, if they came from an investment fund, the manufacturers could go to court and ask for the payments to be reduced. Mr. Biernoff said that was not contemplated under the MSA. He stated that the tobacco companies could not claim a financial hardship and request a lower payment, but if a company goes out of business, it will no longer be making payments.

A member recalled that the previous attorney general had proposed legislation to require escrow deposits on NPM tribal sales, and the member asked if the current attorney general was considering proposing similar legislation. Mr. Biernoff said that staff has not been directed to draft any proposed legislation.

Review and Adoption of 2016 Interim Work Plan and Meeting Schedule

Ms. Ludi presented the committee's proposed work plan and meeting schedule. She noted that this committee is one of the few statutory committees, and its responsibilities are set out in the establishing statute, so the items that come before the committee from year to year do not change very much; the recipients of appropriations from the Program Fund review what they have done with the money.

After discussion, it was decided that the three meetings outside of Santa Fe would be in Albuquerque at the University of New Mexico (July 1), in Las Cruces at New Mexico State University (August 5) and in Mescalero (September 26). A motion was made by Senator McSorley and seconded by Representative Zimmerman to approve that schedule, subject to approval by the New Mexico Legislative Council. The motion was adopted unanimously.

Ms. Ludi also proposed a "Tobacco Settlement Revenue (TSR) Funding Request" form for recipients of funds to complete and then provide to the committee for review when the committee considers its recommendations to the legislature. After discussion, the committee directed that the proposed form be amended to include statements of goals and objectives for the programs for which funding was requested.

Permanent Fund Asset Allocation

Steve Moise, state investment officer, SIC, and Charles Wollmann, director of communications and legislative affairs, SIC, referring to a handout at Item 5, presented an update of the investment performance of the Permanent Fund.

Mr. Moise began by noting that the Permanent Fund has approximately \$256.4 million in assets. The one-year return on investment was flat at negative 0.38%. The 10-year return average was 5.3%. Mr. Wollmann explained that the Permanent Fund, as part of the state operating reserve, needs to have more liquid assets relative to the other state investment funds. Mr. Moise added that periodically, and particularly over the last two fiscal years, the legislature has re-allocated statutory distributions to the Permanent Fund; in other words, all settlement payments received by the Permanent Fund were appropriated instead of 50% remaining in the Permanent Fund.

Referring to Slide 4 of the handout, Mr. Wollmann explained that the Permanent Fund is not invested in long-term assets because they are not liquid. The Permanent Fund is the only non-constitutional permanent fund, and, if necessary, its corpus may be transferred to the general fund to avoid an unconstitutional deficit. Because it must be readily available, the Permanent Fund has to be invested in liquid assets.

A committee member asked how the Permanent Fund returns compare with the retirement funds' returns. Mr. Wollmann said that it is hard to compare them because the retirement funds have different approaches to investing because they have different requirements. He said that, in general, the Educational Retirement Board invests its funds in fixed-rate instruments, and the Public Employees Retirement Association invests primarily in equities, while the SIC, because of its expectation of muted economic growth, invests in private equities as well as stocks and bonds.

Mr. Wollmann informed the committee that United States stocks and bonds are valued more highly today than at almost any time in history, which is unusual because, usually, when one is higher, the other is lower. He expects a correction in either or both.

Mr. Wollmann advised that if there were legislative action to remove the "reserve" status of the Permanent Fund [Subsection F of Section 6-4-9 NMSA 1978: "The tobacco settlement permanent fund shall be considered a reserve fund of the state and, as a reserve fund, may be expended in the event that general fund balances ... will not meet the level of appropriations authorized from the general fund for a fiscal year. ..."] and maintain the 50% investment policy

[Subsection B of Section 6-4-9 NMSA 1978: "In fiscal year 2007 and in each fiscal year thereafter, an annual distribution shall be made from the tobacco settlement permanent fund to the tobacco settlement program fund of an amount equal to fifty percent of the total amount of money distributed to the tobacco settlement permanent fund in that fiscal year ..."], it would allow for better fund growth and longer-term investment strategies that have better yields and less volatility. Mr. Moise acknowledged that in the current budget environment, these recommendations may not be feasible.

A member asked if the SIC had considered bifurcating the Permanent Fund, that is, protecting part of the Permanent Fund but not all of it, and if it could be done incrementally, protecting more of it over a period of several years. Mr. Wollmann said that the SIC can and will look at that possibility. He mentioned that the SIC was reassured that the legislature did not appropriate the Permanent Fund corpus even during the financial crises in 2009 and 2010. Mr. Moise informed the committee that New Mexico has the third-largest sovereign wealth fund, composed of the Severance Tax Permanent Fund and the Land Grant Permanent Fund, in the country; there are 11 others. He said that if the Permanent Fund were similarly protected, it could grow slowly over time. The member suggested considering protecting the Permanent Fund by amending the state constitution as well as statutes, and another committee member strongly agreed with that suggestion. A discussion followed regarding possible approaches to protect the Permanent Fund, including requiring a supermajority vote to sweep the Permanent Fund to cover general fund shortfalls; increasing the tobacco tax and directing the revenue to the Permanent Fund; and instituting a new tax on vapor products and directing revenues to the Permanent Fund.

A member commented that other state revenues coming in are falling short of forecasts, and, because it is part of the reserve, the Permanent Fund is at risk of having to transfer balances to make up the difference in general fund expenditures and revenues collected because of the state constitutional requirement of having a balanced budget.

A member commented that the legislature is the biggest threat to the funds: it has expanded utilization of money from the Land Grant Permanent Fund, Severance Tax Permanent Fund and Tobacco Settlement Permanent Fund at the same time as the revenues of those funds are declining. The current permanent fund distributions provide 16% of general fund appropriations. The member said that, on the course the state is on, the revenue streams are being eliminated.

A member observed that the current statute [Section 6-4-10 NMSA 1978] is very flexible on what constitutes appropriate uses of the Program Fund. The member added that when a fund is small, the legislature views it as acceptable to put protections on the fund, but when the fund grows and becomes large, the appetite to "raid" the fund is greater. The member noted that because of the protections put on the Land Grant Permanent Fund and Severance Tax Permanent Fund, the annual distribution from those funds has grown to over 14% of the general fund revenue stream and is a very stabilizing force.

Adjournment

There being no further business before the committee, the first meeting of the Tobacco Settlement Revenue Oversight Committee for the 2016 interim adjourned at 2:49 p.m.