

THE HONORABLE CURTIS M. LOFTIS, JR.

State Treasurer

October 12, 2012

Mr. R. Les Boles
Director, Office of State Budget
1205 Pendleton Street
Edgar A. Brown Building, Suite 529
Columbia, South Carolina 29201

Dear Les:

A number of interested parties have requested information concerning the payments due the State of South Carolina under the Tobacco Master Settlement Agreement ("MSA"). As you know, the bonds securitized by these payments were retired on June 1, 2012, thereby releasing MSA payments for appropriation, subject to certain remaining conditions.

Bond Covenants and Current Status of Funds. On refinancing the Tobacco bonds in 2008, the Authority determined to utilize all but a portion of funds available in the Healthcare Tobacco Settlement Trust Fund to effect the refinancing of the Series 2001 Bonds, with approximately \$30 million reserved to continue making available \$10 million annually which to that point had been appropriated by proviso to Medicaid. At September 28, 2012, there remained in that fund \$11,244,523. Proviso 90.3 of the Fiscal Year 2012-13 Appropriation Act directs \$8,481,912 of that amount to the Department of Health and Human Services to be expended for Medicaid. Following transfer pursuant to that direction, there will remain in the Healthcare Trust Fund approximately \$2,762,611.¹

Following retirement of the Series 2008 bonds, the bond trustee held at June 30, 2012, approximately \$10,703,642 which will be released from the Authority's covenants and become available for expenditure after June 2, 2013.²

Likewise, the State's share of payments under the Master Settlement Agreement will no longer be pledged to the payment of bonds after June 2, 2013, and will thereafter be available for expenditure as appropriated by the General Assembly. Under the MSA, the State receives its share of annual payments in mid-April based on domestic cigarette shipments in the preceding calendar year.

¹ Of the difference in the Healthcare Trust Fund balance and the appropriation act, \$2,349,390 is the result of an investment gain realized from a bond repurchase on June 21, 2012, within the escrow fund held by the trustee. This gain was realized after *Sine Die* adjournment of the General Assembly and therefore was not as a practical matter available to be appropriated for Fiscal Year 2012-13.

² The Authority's enabling act provides a covenant for the irrevocable assignment of these assets during any time bonds are outstanding, plus one year and one day thereafter. See SC Code Sec. 11-49-50.

Historical MSA Payments. Over time, MSA payments to the State have been declining for two principal reasons – (1) declines in consumption and (2) deposits by Participating Manufacturers (“PMs”) into a disputed payments account of certain amounts otherwise due to the states, under assertions by the PMs that the States have not diligently enforced certain provisions of the MSA. The Authority has estimated the financial impact of these disputed payments at approximately \$51.2 million for the fiscal years 2006 through 2012, generally ranging from \$8 – 10 million annually.

The following table reflects the State’s actual receipts under the MSA for each of the Fiscal Years 2006 - 2012:

Fiscal Year Ending	
June 30	Actual Receipts
2006	\$ 68,612,916
2007	71,406,465
2008	83,474,567
2009	84,866,705
2010	76,308,650
2011	72,001,411
2012	73,416,493

The timing of payments and variables presented by consumption declines and disputed payments has proven to be a challenge in forecasting revenues available for expenditure.³ The Authority followed a practice in setting its budget by using the latest year’s payment as a baseline and making an adjustment for prior year differences. In developing its revenue forecasts for appropriation, the State will likely need to develop a similar methodology because predicting these revenues against these variables will continue to present inherent imprecision throughout a significant period of time during the State’s annual budgeting process.

The Expenditure Act. Under current law, unless otherwise amended by legislation or proviso, the provisions of SC Code Sec. 11-11-170 will apply to the expenditure of any future payments received under the MSA, generally:

1. Pursuant to Sec. 11-11-170(B)(1), 73% of the revenues must be deposited to the Healthcare Tobacco Settlement Trust Fund to be used for healthcare programs;
2. Pursuant to Sec. 11-11-170(B)(2), 15% of the revenues received after June 30, 2012, which were initially allocated to reimburse tobacco growers, quota holders and warehousemen, must be redirected to the Healthcare Tobacco Settlement Trust Fund;
3. Pursuant to Sec. 11-11-170(B)(3), 10% of the revenues must be deposited to the Tobacco Settlement Economic Development Fund, generally to fund the South Carolina Water and Wastewater Infrastructure Fund; and

³ Inasmuch as the payments are not finalized until April 15-17 (with timing subject to adjustment for non-business days), the General Assembly will not know until midway through the budget process the exact amount that will be available for appropriation.

4. Pursuant to Sec. 11-11-170(B)(4), 2% of the revenues must be deposited to the Tobacco Settlement Local Government Fund to fund the operation of and grants distributed by the Office of Local Government.

Inasmuch as twelve years have passed since original enactment, the General Assembly may wish to revisit these priorities.

Moreover, Act 170 of 2010, codified at SC Code Sec. 11-49-55, redirected to the Department of Agriculture for the SC branding program and for the purpose of natural disaster relief \$1 million in tobacco funds for five fiscal years, beginning with the first fiscal year in which funds are available. To date, the Office of State Treasurer has transferred the following amounts to the Department of Agriculture pursuant to this provision:

Fiscal Year Ending	Transfers pursuant to
June 30	SC Code Sec. 11-49-55
2011	\$ 500,000
2012	1,000,000
Total	\$ 1,500,000

In view of the foregoing, the provisions of SC Code Sec. 11-49-55 need to be harmonized with the provisions of SC Code Sec. 11-11-170.

Diligent Enforcement. The Office of Attorney General has statutory responsibilities under Title 11, Chapters 47 (Tobacco Escrow Fund), 48 (Tobacco Qualified Escrow Fund Enforcement) and 49 (Tobacco Settlement Revenue Management Authority Act) to administer the MSA. Inherent in these responsibilities is the duty to diligently enforce the statutes enacted to maintain compliance with the terms of the MSA and state law, which until the time of bond retirement, included contractual obligations and covenants to the Authority's bondholders.

To meet these requirements, the Attorney General maintains a staff of designated personnel including two attorneys and other support staff to among other things coordinate all MSA compliance activities, maintain the South Carolina Tobacco Directory, and prosecute violations. The Office of Attorney General also monitors developments and amendments to the MSA and manages the disputed payments arbitration and litigation processes.

Moreover, in coordination with and under the oversight of the Office of Attorney General, the South Carolina Law Enforcement Division conducts field inspections to ensure compliance with the statutes noted above. Over time, SLED has implemented changes to the tobacco enforcement process by increasing the number of agents from two agents dedicated solely to tobacco enforcement to ten agents under a geographically based inspection approach, with tobacco inspections conducted in conjunction with other retail inspections. The Department of Revenue employs four field auditors whose concentrations are committed solely to auditing tobacco tax and MSA issues.

In compliance with its covenants to enforce the terms of the MSA, the Authority has in each year provided funding for this program of diligent enforcement from MSA payments, including in its Fiscal Year 2012-13 budget a total of \$1.2 million for reimbursements to the Office of Attorney General, the

Department of Revenue, and SLED. The General Assembly may wish to consider an approach similar to that previously followed by the Authority to provide for the annual funding of the enforcement programs necessary to protect the payments due the State under the MSA.

Arbitration. Under the provisions of the MSA, PMs are potentially entitled to an adjustment of their required payments under the MSA in the event that all of the PMs, in the aggregate, lose more than two percentage points of market share compared to the market share of the PMs in 1997. However, the adjustment cannot be applied against settling states that have enacted and diligently enforced an escrow fund statute under the MSA. Nevertheless, as noted above, a number of PMs over time have deposited a portion of their tobacco settlement payments into a disputed payments account, incidental to a finding by an independent arbitrator that MSA disadvantages were a significant factor in market share losses experienced by the PMs in calendar years 2003 through 2008. The Authority estimates that South Carolina's share of these disputed payments is \$51.2 million.⁴

At the request of the state's Attorney General, a portion of the State's MSA payments have been set aside to fund the costs of legal action to determine whether the state has diligently enforced its escrow fund statutes. To date, the Authority has provided for a total of \$6.1 million to fund the state's share of costs, expert testimony, and associated legal fees in connection with the arbitration, and the Authority has expended approximately \$3.3 million toward these costs. The State presented its case to the arbitration panel in June, 2012, which dealt with disputed payments for calendar year 2003. Arbitration proceedings remain unscheduled for calendar years 2004-2008. Legal costs to date have averaged \$828 thousand annually.

The Office of Attorney General has recommended that the State continue to fund the diligent enforcement program in order to protect the State's share of future payments due under the MSA, and to vigorously pursue recovery of previously withheld amounts. The arbitration matter is particularly important not only to potentially recover past disputed amounts, but also to protect the State against the provision in the MSA permitting full recovery against settling states that are determined not to have diligently enforced their escrow fund statute.

Summary and Recommendations.

Revenue. The State presently holds \$13,466,253, comprised of \$10,703,642 in deposits held by the bond trustee following discharge of the Series 2008 Tobacco Bonds, and \$2,762,611 held in the Healthcare Tobacco Settlement Trust Fund. The funds held by the bond trustee are available for appropriation now but cannot be expended until after June 2, 2013. Of the funds held in the Healthcare Trust Fund, which are available for appropriation and expenditure now, we believe that \$1,000,000 is likely committed to be transferred to the Department of Agriculture under the provisions of SC Code Sec.11-49-55.

Based entirely on historical collections, we estimate that the State will receive in mid-April, 2013, approximately \$70 million in annual payments under the MSA; however, we caution that a number of factors influence these payments and recommend that the General Assembly appropriate those amounts with that fact in mind.⁵

⁴ Estimated by applying the State's allocation percentage to the amounts reported by the MSA Independent Auditor as deposited into the disputed payments account.

⁵ Our estimate is based on historical experience and is not the result of application of empirical data. The Board of Economic Advisors may have observations and recommendations for a better methodology of revenue forecasting.

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Expenditures. As noted above, unless the General Assembly otherwise provides through amendment or proviso, we believe that the provisions of the existing expenditure act at SC Code Sec. 11-11-170(B) will dictate the allocation of expenditures from MSA payments, viz.:

Healthcare Trust Fund	
SC Code Sec. 11-11-170(B)(1)	73%
SC Code Sec. 11-11-170(B)(2) after June 30, 2012	15%
Economic Development Fund	10%
SC Code Sec. 11-11-170(B)(3)	
Local Government Fund	2%
SC Code Sec. 11-11-170(B)(4)	

However, we recommend that the General Assembly give appropriate consideration to the protection of the future MSA payment stream by providing as a first priority from MSA payments funds to support diligent enforcement and, until settled, funds to support expenses of the ongoing arbitration matter. We also recommend that any appropriation of the MSA payments reflect the legislative intent of the provisions of SC Code Sec. 11-49-55 with respect to remaining payments to be made to the Department of Agriculture. Finally, there may be benefit to organizing a meeting with representatives of the Office of the Governor, the State Treasurer, the Attorney General and the Chairmen of the legislative finance committees to identify and assist in the resolution of present ambiguities in funding priorities. We would be happy to facilitate and host such a meeting.

We have attached for your information the statutory references on which our observations and recommendations are based, and hope that this information will be helpful in planning the expenditures associated with this repatriated revenue source.

Very truly yours,



F. Richard Harmon, Jr.
Senior Assistant State Treasurer

- c: ✓ The Honorable Nikki R. Haley
The Honorable Curtis M. Loftis, Jr.
The Honorable Richard A. Eckstrom
The Honorable Hugh K. Leatherman, Sr.
The Honorable W. Brian White
The Honorable Alan M. Wilson
The Honorable Hugh E. Weathers
Mr. Frank A. Rainwater

South Carolina General Assembly
119th Session, 2011-2012

H. 4813

General Appropriations Bill for fiscal year 2012-2013
As Ratified by the General Assembly

PART IB
OPERATION OF STATE GOVERNMENT

89.53. (GP: Tobacco Funds) The Tobacco Settlement Revenue Management Authority may determine by resolution that some or all of the amounts on deposit in the Healthcare Tobacco Settlement Trust Fund established pursuant to Section 11-11-170, whether in the form of principal or interest, may be used to refund bonds issued pursuant to Chapter 49, Title 11, to purchase such bonds, directly or indirectly, and/or to secure bonds issued to refund such bonds. Any amounts received by the Authority pursuant to the preceding clause in excess of the amount required to refund or purchase such bonds and all tobacco settlement receipts received by the State pursuant to Section 11-49-130 must be deposited directly with the Department of Health and Human Services for health care expenditures to achieve the maximum Medicaid match.

90.3. (SR: Tobacco Settlement) Contingent upon the approval of the Tobacco Settlement Revenue Management Authority and parties to the trust agreement, the State Treasurer shall transfer an amount equal to \$8,481,912 from the unrestricted taxable proceeds portion of the principal of the Healthcare Tobacco Settlement Trust Fund established pursuant to Section 11-11-170(B)(1) of the 1976 Code to the Department of Health and Human Services to be expended for Medicaid. The State Treasurer is authorized and directed to transfer to the Office of the Attorney General from funds available to the Tobacco Settlement Management Authority such amounts as shall be necessary for the enforcement of Chapter 47 of Title 11, The Tobacco Escrow Fund Act, which will protect the payments to the State under the Master Settlement Agreement.

STATUTORY REFERENCES

TITLE 11, CHAPTER 11

SECTION 11-11-170. Use of revenues payable pursuant to Master Settlement Agreement.

(A) All revenues payable to this State pursuant to the Master Settlement Agreement as described in Section 11-47-20(e) must be used in the manner specified in this section.

(B)(1) Seventy-three percent of the revenues must be used for healthcare programs. These revenues, or the funds obtained pursuant to Chapter 49, Title 11, must be deposited in a fund separate and distinct from the general fund and all other funds, which is hereby established in the State Treasury styled the Healthcare Tobacco Settlement Trust Fund. Earnings on this fund must be credited to the fund. The principal must remain in the fund and only the interest earnings may be appropriated and used for the following purposes:

(a) for fiscal year 2000-2001 only, the first twenty million dollars available from the principal derived from securitization must be used for hospital base increase;

(b) the South Carolina Seniors' Prescription Drug Program, as provided in Chapter 130, Title 44;

(c) home and community-based programs for seniors coordinated by the Department of Health and Human Services;

(d) youth smoking cessation and prevention programs coordinated by the Department of Health and Environmental Control and the Department of Alcohol and Other Drug Abuse Services;

(e) newborn infants hearing screening initiatives coordinated by the Department of Health and Environmental Control;

(f) disease prevention and elimination of health disparities: diabetes, HIV/AIDS, hypertension, and stroke, particularly in minority populations;

(g) other health related issues as determined by the General Assembly.

(2) Fifteen percent of the revenues, or the funds obtained pursuant to Chapter 49, Title 11, must be deposited in a fund separate and distinct from the general fund and all other funds, which is hereby established in the State Treasury styled the Tobacco Community Trust Fund. Earnings on the fund must be credited to the fund. This fund must be used to reimburse:

(a) tobacco growers, tobacco quota holders, and tobacco warehousemen for actual losses due to reduced quotas since 1998. For purposes of this subitem, "tobacco quota owner" and "tobacco grower" have the meaning provided in Section 46-30-210, and the reimbursement is for losses incurred in reduced cultivation of tobacco in this State. Reimbursements must be made pursuant to eligibility requirements established by the South Carolina Tobacco Community Development Board created pursuant to Section 46-30-230;

(b) after the reimbursement provided pursuant to subitem (a), the balance must be held in an escrow account through June 30, 2012, and used as provided in subitem (a). After June 30, 2012, any account balance must be transferred to the Healthcare Tobacco Settlement Trust Fund.

(3) Ten percent of the revenues, or the funds obtained pursuant to Chapter 49, Title 11, must be deposited in a fund separate and distinct from the general fund and all other funds, which is hereby established in the State Treasury styled the Tobacco Settlement Economic Development Fund. Earnings on the fund must be credited to the fund. This fund must be used for the following programs:

(a) the first eighty million dollars credited to the fund is set aside to be used for the purposes specified in this item except for subitem (b);

(b) for Fiscal Year 2000-2001 only, the next ten million dollars credited to the fund must be set aside to be available to be appropriated and used in accordance with the provisions of Section 12-37-2735; and

(c) the remaining revenue credited to the fund must be used to fund the South Carolina Water and Wastewater Infrastructure Fund as provided in Section 13-1-45.

(4) Two percent of the revenues, or the funds obtained pursuant to Chapter 49, Title 11, must be deposited in a fund separate and distinct from the general fund and all other funds, which is hereby established in the State Treasury styled the Tobacco Settlement Local Government Fund. Earnings on the fund must be credited to the fund. This fund must be used to fund the operation of and grants distributed by the Office of Local Government of the Division of Regional Development of the Budget and Control Board, or its successor in interest.

(C) In addition to those investments allowed pursuant to Section 11-9-660, the State Treasurer may invest and reinvest the revenues payable to the State pursuant to the Tobacco Master Settlement Agreement or funds raised pursuant to the provisions of Chapter 49 of this title and credited to the funds established by this section in any obligations of a corporation, state, or political subdivision denominated in United States dollars if the obligations bear an investment grade rating of at least two nationally recognized rating services.

HISTORY: 2000 Act No. 387, Part II, Section 69B; 2001 Act No. 7, Section 1.

TITLE 11, CHAPTER 49

SECTION 11-49-50. Tobacco receipts; assignment to authority.

The State's tobacco receipts due to the State after June 30, 2001, and the right to receive them as they are distributed from the escrow are assigned to the authority. On and after the date these revenues are pledged, the State shall have no right, title, or interest in or to the state's tobacco receipts; and the state's tobacco receipts are property of the authority and not of the State, and must be owned, received, held, and disbursed by the authority or the trustee for the holders of bonds and not by the State. The State directs the independent auditor and the escrow agent to make all these payments to the authority in accordance with instructions that may be given by the authority from time to time. The assignment and direction made in this subsection are irrevocable during any time when bonds are outstanding under this chapter plus one year and one day thereafter and are a part of the contractual obligation owed to the bond holders. On or before the date of delivery of any bonds, the State through the State Treasurer shall notify the independent auditor and the escrow agent that the State's tobacco receipts have been assigned to the authority and shall instruct the independent auditor and the escrow agent that, subsequent to the delivery date for bonds and irrevocably during the time when any bonds are outstanding, the State's tobacco receipts are to be paid directly to the authority or its designee.

HISTORY: 2000 Act No. 387, Part II, Section 69A.2.

SECTION 11-49-55. State-grown crops; marketing, branding, and natural disaster relief assistance.

Notwithstanding any other provision of law, and to the extent that funds are available and not otherwise committed or restricted by law or by contract, from the trust fund created pursuant to this chapter, the State Treasurer shall direct one million dollars annually for five fiscal years beginning with the first fiscal year in which funds are available, to the Department of Agriculture to cause the marketing and branding of South Carolina agricultural crops or produce as being grown in South Carolina when offered for sale in retail establishments and to assist in relief from natural disasters affecting state-grown crops.

HISTORY: 2010 Act No. 170, Section 4, eff May 13, 2010.

SECTION 11-49-130. Excess tobacco receipts.

All of the state's tobacco receipts not needed to pay (1) expenses of the authority during the next twelve months, or (2) debt service on bonds during the next twelve months, or fully to fund reserve accounts established by the board with respect to bonds, not less frequently than annually and at a time determined by the board in its resolutions authorizing the issuance of bonds, must be transferred to the funds as identified in Section 11-11-170. The determination by the board of the amount to be transferred is final and is not reviewable by any court or other body.

HISTORY: 2000 Act No. 387, Part II, Section 69A.2.