Audit Report

CITY OF AUSTIN
TOBACCO SETTLEMENT PROCEEDS

May 2002

City Auditor
Stephen L. Morgan

Deputy City Auditor
Colleen Waring

Office of the City Auditor
Austin, Texas

Audit Team

Susan L. Wynne, Auditor-In-Charge

University of Texas Student Team

Amy M. Bell
Clint Macha
Kara Schirmer

Additional Contributor

Roger Williams

Assistant City Auditor

Page Graves, CPA, CIA

For additional copies of this report, please request Audit No. AU02301

Printed on recycled paper

City of Austin MEMO

Office of the City Auditor
206 E. 9th Street, Suite 16.122
P. O. Box 1088
Austin, Texas 78767-8808
(512) 974-2805, Fax: (512) 974-2078
email: oca_auditor@ci.austin.tx.us, web site: http://www.ci.austin.tx.us/auditor

May 30, 2002

To: Mayor and Council Members

From: Stephen L. Morgan, City Auditor

Subject: City of Austin Tobacco Settlement Proceeds Report

I am pleased to present this report on the City of Austin's tobacco settlement proceeds. Per our fiscal year 2002 service plan, we reviewed the City of Austin's participation in the State of Texas' process for the disbursement of litigation settlement funds received as a result of the Texas Attorney General's suit against several large tobacco companies filed in 1996. Our objectives for this audit were to

- determine how much the City of Austin has received in tobacco settlement proceeds as a participant in the State of Texas' tobacco settlement,
- determine what process the City uses to obtain the funds, and
- determine how the City of Austin is using or planning to use its share of the tobacco settlement funds.

Through its participation in the State's tobacco settlement distribution process, the City has received almost $13.3 million in tobacco settlement proceeds and interest earnings since calendar year 1999. The State of Texas has placed no restrictions on how the City must spend its portion of the tobacco settlement proceeds.

The City has not spent, nor does it have immediate plans to spend, the funds accumulated from tobacco settlement disbursements. According to City financial officials, the funds are being held in reserve within the City's Hospital Fund in case the federal government discontinues or substantially reduces funding for the Disproportionate Share Revenue (Dispro) program, which is one of the key funding sources for the City's Federally Qualified Health Clinics (FQHC).

This report was presented to City management for review and comment. We received minor comments and revisions that were agreed upon and incorporated; however, management submitted no formal response for publication with the report.

This report is presented as information to assist Mayor and Council in policy-making decisions; therefore, it contains no recommendations to management.

We appreciate the cooperation and assistance we received from the City's Financial and Administrative Services and Health and Human Services staff during this audit.

Stephen L. Morgan

Stephen L. Morgan, CIA, CGAP, CFE, CGFM
City Auditor

CITY OF AUSTIN
TOBACCO SETTLEMENT PROCEEDS

This report contains information about two types of funds received by the City: proceeds from the State of Texas' tobacco settlement and funds from the State's Medicaid Disproportionate Share Hospital program. These funds are linked because they are distributed by the State of Texas and the objectives are to provide remuneration for indigent healthcare expenses incurred by the City. Specifically, the City of Austin receives funds as an eligible participant in the State of Texas' disbursement of tobacco settlement proceeds. These funds were intended by the State as recompense for unreimbursed healthcare costs of treating indigent patients for tobacco-related illnesses. In addition, the City receives funds via the State of Texas' Health and Human Services Commission for the federally based Medicaid Disproportionate Share Hospital (Dispro) program, which provides partial reimbursement for indigent healthcare costs to hospitals that provide a disproportionate amount of charity care.

BACKGROUND

In 1996, the Texas Attorney General sued the tobacco industry under fraud, consumer protection, racketeering, and other federal and state statutes. The lawsuit alleged that for decades the tobacco industry deliberately and deceitfully caused the addiction of millions of persons to tobacco products through the manipulation of nicotine levels. The tobacco industry also targeted advertising at children to create new users of cigarettes and smokeless tobacco products to replace those adult users dying from various tobacco-related diseases. According to the Attorney General, the result of the industry's activities has been millions of deaths and debilitating diseases. Thus, through the lawsuit, the Attorney General sought changes in the tobacco industry's deceptive marketing practices. Further, the Attorney General sought compensation for the State of Texas and other political subdivisions for tobacco-related health care costs incurred by Texans who received treatment under the Medicaid program or other indigent care program.

On January 16, 1998, the tobacco companies settled the lawsuit brought by the Attorney General for $15.3 billion. Nearly $2.3 billion of that total was set aside by the State for allocation to certain political subdivisions with the intended purpose of reimbursing these entities for a portion of their unreimbursed health care expenditures incurred for treatment of tobacco-related illnesses under Medicaid or other indigent care program. The State created two accounts for the $2.3 billion: a lump sum trust account and a permanent trust account. The Office of Policy and Planning of the Texas Department of Health (TDH) is responsible for the distribution of the funds in the lump sum account and the interest earnings from the permanent trust account to the eligible political subdivisions.

In the *Rules for the Distribution of Tobacco Settlement Proceeds to Political Subdivisions* (the Rules), the State defined the types of political subdivisions that are eligible for a portion of settlement proceeds and described the method to be used to distribute the funds. Under the Rules, the term political subdivision refers to a hospital district; a local political subdivision owning or maintaining a public hospital; or a county of the State of Texas responsible for providing indigent health care to the general public, per the *Texas Health and Safety Code.* Political subdivisions are eligible for tobacco settlement proceeds if they fall into one (or more) of the following four categories.

- Counties not wholly within a hospital district
- Hospital districts
- Non-hospital district public hospitals
- Political subdivisions that have sold or leased a public health care facility

The City of Austin (the City) is an eligible political subdivision only by virtue of its relationship with Brackenridge hospital. The City owns Brackenridge; however, it leases the hospital to Daughters of Charity (d.b.a. Seton Healthcare Network). Under this arrangement both the City and Seton incur eligible unreimbursed health care costs. Therefore, the City's annual claim for tobacco proceeds includes expenditures from both the City and Seton. After receiving the combined annual distribution of tobacco settlement proceeds from the State, the City gives Seton its pro-rata share.

OBJECTIVES, SCOPE, & METHODOLOGY

Objectives

This project had the following objectives and sub objectives:

- Determine what the City of Austin's annual entitlement as a participant in the State of Texas' tobacco settlement is and what process it goes through to obtain the funds.
  - Determine how much the City has received in tobacco settlement funds since the first disbursements in 1999 through 2002.
  - Describe how the City's portion of the tobacco settlement proceeds is calculated by the State.
  - Describe the application process the City must follow to obtain its entitlement.

- Determine how the City of Austin is using or planning to use its share of the State of Texas' tobacco settlement funds.
  - Determine the restrictions placed on the use of the funds and whether there are incentives to use the funds for a particular purpose.
  - Determine how the City has used or is planning to use the funds.

Scope

The scope of this project included information related to City of Austin's portion of the tobacco settlement fund received in 1999, 2000, 2001, and 2002.

Methodology

To determine the amount of money the City of Austin ("the City") has received and how much it is projected to receive as a participant in the State of Texas' tobacco litigation settlement, we obtained data from the City's accounting system, AFS2, and reviewed the City's approved budgets for fiscal years 1999-2002. We also researched the Texas Department of Health's (TDH) website tables, which depict amounts disbursed by the State of Texas annually for expenditures in calendar years 1999, 2000, and 2001. In addition, we interviewed City financial officials to determine how proposed tobacco revenues are calculated; how much interest has been earned on the money received to date; and what, if anything, is being done with the amount earned.
To determine how the City's portion of the tobacco settlement proceeds is calculated by the State, we reviewed the State of Texas' settlement agreement with the tobacco companies and the *Rules for Distribution of*

Tobacco Settlement Proceeds to Political Subdivisions. We also conducted interviews with officials of TDH's Office of Policy and Planning to determine how TDH calculates each eligible political subdivision's portion of the funds.

To determine the application process the City must follow to obtain its entitlement, we interviewed the City's Deputy Controller and the financial manager of the City's Health and Human Services Department. We also reviewed the settlement agreement, the *Rules for Disbursement of Tobacco Settlement Proceeds to Political Subdivisions*, and the TDH website link to application for the funds. In addition, we analyzed the calendar year 2001 claim submitted to the State of Texas by the City.

To analyze the restrictions and determine the incentives regarding the use of the City's share of the tobacco settlement funds, we reviewed the *Rules for Disbursement of Tobacco Settlement Proceeds to Political Subdivisions* and interviewed TDH staff. To obtain information about the State's Disproportionate Share Hospital program we interviewed officials of the Texas Health and Human Services Commission.

To determine how the City has used or is planning to use the funds, we interviewed high-level City financial officials. Also, we reviewed the City's budget for fiscal year 1999 through 2002 for evidence of usage of the funds. Last, we queried the City's accounting system (AFS2) to determine if (and to whom) expenditures or transfers had been made out of the tobacco settlement account.

This audit was conducted in accordance with generally accepted government auditing standards.

AUDIT FINDINGS

Through its participation in the State's tobacco settlement distribution process, the City has received almost $13.3 million in tobacco settlement proceeds and interest earnings since calendar year 1999. Because Seton also participates in the disbursement process through the lease of Brackenridge from the City, Seton has also received tobacco settlement funds which total just under $1.3 million.

There are no restrictions on how the City or other political subdivisions must spend their portion of the tobacco settlement proceeds. Neither the State of Texas' settlement agreement with tobacco companies nor the Texas Department of Health rules and regulations stipulate that the proceeds must be spent on healthcare expenditures or for any other specific purpose. However, there is incentive built into the annual claim submission process to spend the proceeds on unreimbursed healthcare expenditures.

The City has not spent, nor does it have immediate plans to spend, the funds accumulated from tobacco settlement disbursements. According to City financial officials, the funds are being held in reserve within the City's Hospital Fund. This reserve has been set aside in case the federal government discontinues or substantially reduces funding for the Disproportionate Share Revenue (Dispro) program. City financial officials report that revenue received through the Dispro program is one of the key funding sources for the City's Federally Qualified Health Clinics (FQHC). The City's revenue from the Dispro program has decreased over the past 10 years; however, according to State officials responsible for managing Texas' Dispro program, there is currently no indication that the federal government intends to discontinue the program.

The City has received $13,279,490 in tobacco settlement disbursements and interest earned from 1999 through 2002. In January 1999, the City received its first tobacco settlement disbursement of $8,180,221. In calendar year 1999, the City and Brackenridge hospital together incurred just over $27.4 million in claimable unreimbursed health care expenditures. In May 2000 the City received $1,806,124 in tobacco proceeds based on that claim. The City's 2001 expenditure claim, based on both the City's and Seton's incurred costs during calendar year 2000, totaled just over $36.6 million; and the City recouped $1,400,968 of that in April 2001 tobacco settlement funds. Finally, for calendar year 2001, the combined Seton and City claimable costs totaled $35.7 million, and the City regained $302,252 in April of 2002 as a tobacco disbursement participant.

According to the City's accounting system (AFS2), interest earned for the Tobacco Fund through April 30th, 2002 totaled $1,586,539 bringing the total proceeds to the City attributable to the tobacco settlement process to $13,279,490.

Through its operation of Brackenridge hospital, Seton has received $1,285,452 in tobacco proceeds based on the hospital's pro rata portion of the City's total 1999, 2000, and 2001 expenditure claims. As noted above, the City and Brackenridge hospital both incur eligible unreimbursed health care costs, which are combined in the annual expenditure claim submitted to the State. For this reason, the City reimburses Seton for its pro rata share of the proceeds received based on the combined claim. Based on the State's decision to use a per capita formula to disburse the first year's settlement funds (see the State's distribution methodology below), Seton did not receive any of the $8.18 million received by the City. However, in 2000, 2001, and 2002 Seton received 26.4 percent ($646,525), 26.7 percent ($511,355), and 29.7 percent ($127,572) of the City's total disbursements for those years, respectively.

Exhibit 1 below shows the breakdown of fund receipts from 1999-2002 as well as the total amount of interest earned on these receipts.

EXHIBIT 1
City of Austin's Tobacco Proceeds
(with Seton's Portion), CY 99-02

	1999	2000	2001	2002	Interest through 04/30/02	Total to Date
City	$8,180,220.66	$1,806,124.42	$1,400,967.61	$302,252.19	$1,589,925.47	**$13,279,490.35**
Seton		$646,525.28	$511,355.09	$127,571.74		**$1,285,452.11**
TOTAL	**$8,180,220.66**	**$2,452,649.70**	**$1,912,322.70**	**$429,823.93**		

Source: City Controller's Office, AFS2, and TDH (October 2001 – May 2002)

The City's portion of the tobacco settlement proceeds is based on the ratio of the City's submitted expenditures compared to the total submitted expenditures from all eligible political subdivisions. The first disbursement of tobacco proceeds to eligible political subdivisions was made in January 1999 based on a per capita formula used by the Texas Department of Health (TDH) for all eligible entities. This formula essentially apportioned the first payment made by the tobacco companies per the settlement agreement of $300 million to eligible counties and municipalities based on 1990 census data. According to officials of TDH, this initial disbursement amounted to approximately $18 per capita.

After the first year, however, according to *the Rules* disbursements are based on the eligible entities' prior year annual claimable unreimbursed health care costs. The TDH's Office of Policy and Planning sums the total expenditure amounts for all claims received from about 300 eligible political subdivisions and calculates the relative proportion of each subdivision's claim to that sum. Thus, beginning in calendar year 1999, the City's portion of the annual tobacco proceeds for expenditures incurred can be represented by the following formula.

$$\textbf{City's portion} = \frac{\text{Austin's total claimable expenditures (City + Seton)}}{\text{Sum of expenditures claimed by all political subdivisions}}$$

The proceeds the City actually receives is based on the calculated proportion, and, of course, depends on the amount available to distribute to eligible subdivisions varies from year to year based on the funds available in the State's tobacco settlement trust accounts. The following represents the ratio:

$$\frac{\text{City's annual proceeds}}{\begin{array}{c}\text{Total funds available for distribution}\\ \text{In State's the tobacco trust accounts}\end{array}} = \frac{\text{City's expenditures}}{\begin{array}{c}\text{Sum of total expenditures}\\ \text{from all political subdivisions}\end{array}}$$

Beginning in 2002, the City's tobacco proceeds will be significantly less than prior years because disbursements will begin to be funded solely by interest earned on the corpus of the State's tobacco permanent trust account. Tobacco settlement disbursements prior to 2002 were paid from both the State's lump sum trust and permanent trust accounts, which were created solely for the settlement money received from the tobacco companies. As originally set forth in the settlement agreement, the State used funds from both the lump sum trust and permanent trust accounts for the first three tobacco settlement disbursements. As planned, these disbursements consumed all of the funds in the lump sum account; thus, as noted in the settlement agreement, beginning with disbursements in 2002, proceeds will be paid only from interest earned on the State's permanent trust account. This resulted in a significant decrease in the City's total disbursement from $1.9 million in 2001 to just under $430,000 in 2002.

The City's Health and Human Services Department (HHSD) is responsible for coordinating the city's annual claim to the state for tobacco settlement funds. The HHSD financial manager gathers information from the City's accounting system, AFS2, for expenditure information related to the City's portion of unreimbursed healthcare costs. Several City programs incur these unreimbursed costs, such as those that arrange for payments to Seton for "charity care" (per the hospital lease agreement). According to HHSD financial officials, since relatively few accounting funds are involved in this process, gathering the information from AFS2 is not a complicated process. In fact, reportedly the most difficult step in the process involved the initial determination of the kind of expenses that would be considered claimable according to the TDH rules and regulations.

The City Controller's Office is responsible for collecting information from Seton regarding Brackenridge's portion of claimable expenses. The Seton information is routed to the HHSD, where financial officials organize it and then use it to complete the City's Annual Expenditure Statement that is submitted to TDH annually.

Upon receipt and verification of a claim from a political subdivision, the State sends the subdivisions their respective amount of tobacco settlement money. The State has audited the City's claims for the past two years, and no problems have been found.

There are no restrictions on the use of the distributed tobacco settlement funds. Neither the State's settlement agreement with the tobacco companies nor the TDH's Rules for distribution specify any restrictions or limitations on the use of the funds distributed to each political subdivision. Staff of the TDH's Office of Policy and Planning confirmed this fact in an interview. In addition, TDH explained that the intent was to give the political subdivisions complete freedom with the money to compensate them for having to sacrifice funding for other programs to provide health care to their indigent populations under State statute.

Spending the funds on unreimbursed health care expenditures is the only incentive for use. There is an implicit incentive for spending the distributions according to the TDH Rules: any portion expended for “unreimbursed health care expenditures…may be counted toward the political subdivision’s pro rata share of the annual distribution in the subsequent year.” By spending the distribution on these expenditures, the political subdivision can slightly increase its distribution in the following year.

Officials of TDH reported that because there are no restrictions on the use of tobacco proceeds, TDH does not formally survey participating political subdivisions regarding how the money is used. Despite this, the officials were aware from information discussions that other political subdivisions have spent the money in a variety of ways. Some have spent the settlement money on helicopters and prisons, others have simply deposited the proceeds into general funds accounts, and still others have used the monies to cover unreimbursed health care costs.

The City has not spent or allocated, nor does the City have immediate plans to spend, the $13.3 million that has accumulated through tobacco settlement disbursements. The City’s tobacco funds are held in the Tobacco Litigation account, which is within the Hospital Fund. As of May 6, 2002, the City had a cash balance of approximately $13.3 million dollars in the Tobacco Litigation account, all attributable to tobacco settlement disbursements and interest earnings on the disbursement amounts. According to the City’s accounting records, none of the funds that have been deposited into the Tobacco Litigation account have been withdrawn or transferred for any purpose. Further, according to City financial officials, there are no immediate plans to spend the money within the Tobacco Litigation fund.

The tobacco funds are being held in reserve in case the federal government discontinues or substantially reduces funding for the Disproportionate Share Hospital Revenue program. The Disproportionate Share Hospital (Dispro) program is based on a state-federal relationship that supplements Medicaid. Medicaid, the state and federal cooperative venture that provides medical coverage to eligible needy persons, covers some of the costs of indigent medical care through federal and state reimbursements to care-providing entities. However, the Dispro program supplements Medicaid reimbursements for hospitals designated as ‘disproportionate share hospitals’ (i.e., hospitals that serve a disproportionate share of low-income patients). The City’s Brackenridge hospital qualifies under state and federal criteria as a Medicaid disproportionate share hospital.

Currently, according to City financial officials, the Dispro revenue and additional hospital lease payments received by virtue of the City’s ongoing relationship with Seton, account for approximately one-third of the funding for the FQHC system. Prior to fiscal year (FY) 1996, the City owned and operated Brackenridge hospital; therefore, the City received 100 percent of the Dispro revenue. However, after the hospital was leased to Seton Healthcare Network in 1996, Seton, not the City, became the primary participant in the Dispro program. According to the terms of the lease, the City receives 16 percent of the total Dispro revenue to help fund the City's federally qualified health clinics (FQHC) system. Further, an additional portion (55 percent of the remaining 84 percent) is paid to the City as additional lease payments.

According to City financial officials, indications that the Dispro program would be terminated were evident in the mid 1990's; however, after almost 10 years, the current status of the program is unclear. Based on this uncertainty and declining Dispro revenues during the last 10 years, City financial officials feel that it is necessary and prudent to hold the proceeds from the tobacco disbursement in reserve in case this federal funding source is discontinued or substantially reduced. City officials noted that in the event Dispro is altered and is no longer a viable funding source for the FQHC system, the reserve in the Hospital Fund would be tapped to support the system until alternative funding sources could be secured. Further, in this scenario, if the reserve were to be exhausted before an alternative FQHC support source is secured, officials report that they will turn to the General Fund to sustain the clinics.

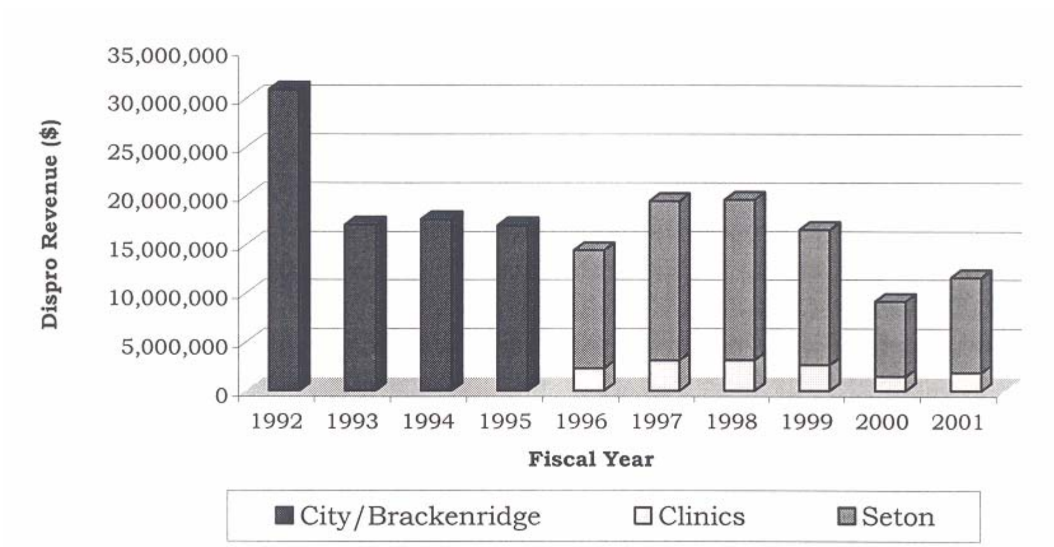
While the City's Dispro revenue has decreased over the past 10 years, State of Texas Medicaid officials report that there are currently no indications that the Dispro program will be cut. In fact, two factors may lead to slight increases in the City's Dispro revenue over the next few years. According to the State's manager of the Dispro program, discussions of the termination of the program were indeed prevalent in the mid-1990's. However, with the federal Balanced Budget Act of 1997, significant changes were made to the program that made it less of a target for federal and state officials to cut. As a result, State officials have not heard discussions or projections indicating that the program is in line for elimination.

State Dispro program officials report recent federal budget shortfalls may result in fewer total Dispro dollars to distribute to hospitals across the state. In fact, for 2003, State officials predict an 11 percent reduction in total Dispro revenue received by Seton for services performed at Brackenridge. For subsequent years, officials expect federal funding to generally remain steady; however, the portion received by large public hospitals such as Brackenridge may actually increase. This is due to anticipated changes in the formulas used to apportion state Dispro funds. Large urban public hospitals tend to provide an even greater share of the indigent care than others classified as disproportionate share hospitals. Thus, representatives for these hospitals are lobbying to change the existing disbursement formulas to favor more Dispro revenue for those hospitals that provide an even greater share of indigent care.

Further, the City's plan to develop the hospital within a hospital for certain reproductive services on the fifth floor of Brackenridge, will likely result in more Dispro revenue disbursed directly to the City. In fact, according to City financial officials, estimates are that indigent care offered via the new City-run services at Brackenridge will result in about $400,000 more in Dispro revenue. However, according to City management (in Council transcripts regarding the new initiative), all direct revenues, including Dispro revenues received by the new hospital, will be used to offset the expenses of the new hospital, which are expected to run between $6 and $7 million. Thus, unlike current Dispro revenue, additional Dispro funds attributable to these City services will not be used to fund the FQHC system.

Exhibit 2 is a graphical representation of the history of the City's Disproportionate Share Revenue from fiscal years 1992 through 2001:

EXHIBIT 2
City of Austin's
History of Disproportionate Share Revenues, FY 92- FY 01



SOURCE: City Controller's Office, December 2001