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December 26, 2019

The Honorable Ronald D. Kouchi
President of the Senate
and Members of the Senate
Thirtieth State Legislature
State Capitol, Room 409
Honolulu, Hawaii 96813

The Honorable Scott K. Saiki
Speaker and Members of the House of
Representatives
Thirtieth State Legislature
State Capitol, Room 431
Honolulu, Hawaii 96813

Dear President Kouchi and Speaker Saiki:

For your information and consideration, I am transmitting a copy of the Department of the Attorney General's Annual Report on the Tobacco Enforcement Special Fund as required by section 28-15(d), Hawaii Revised Statutes (HRS). In accordance with Section 93-16, HRS, I am also informing you that the report may be viewed electronically at <http://ag.hawaii.gov/publications/reports/reports-to-the-legislature/>.

If you have any questions or concerns, please feel free to call me at 586-1282.

Sincerely,

Clare E. Connors
Attorney General

Enclosure



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REPORT ON THE TOBACCO ENFORCEMENT SPECIAL FUND

Pursuant to Section 28-15(d), Hawaii Revised Statutes

Fiscal Year 2018-2019

Submitted to the Thirtieth State Legislature
Regular Session of 2020

I.	INTRODUCTION	2
II.	TOBACCO MASTER SETTLEMENT AGREEMENT	2
	A. Background	2
	B. Master Settlement Agreement Payments	2
	C. Tobacco Liability Act (Chapter 675, HRS)	4
	D. Enforcement	5
	E. Diligent Enforcement Arbitration	7
III.	CIGARETTE TAX AND TOBACCO TAX LAW (Chapter 245, HRS)	7
	A. Background	7
	B. Cigarette Tax Revenues	8
	C. Enforcement	9
	D. Gray Market	10
	E. Counterfeit Tax Stamps	10
	F. Half-Stamping	10
	G. Sales by Internet and Mail	11
IV.	FY 2018-2019 DEPOSITS TO TOBACCO ENFORCEMENT SPECIAL FUND	11
V.	FY 2018-2019 APPROPRIATIONS AND EXPENDITURES	11

I. INTRODUCTION

Section 28-15(d), Hawaii Revised Statutes (HRS), requires the Department of the Attorney General (the Department) to submit a report to the Legislature, no later than twenty days prior to the convening of each regular session, providing an accounting of the receipts and expenditures of the Tobacco Enforcement Special Fund.

On July 1, 2000, the Department's Tobacco Enforcement Unit (the Unit) was created to enforce the Tobacco Master Settlement Agreement, the state Tobacco Liability Act, Chapter 675, Hawaii Revised Statutes (HRS), the state Cigarette Tax and Tobacco Tax Law, Chapter 245, HRS, and the state Tobacco Products Reporting Law, Chapter 486P, HRS. The Unit is composed of a unit supervisor, a Master Settlement Agreement civil prosecutor, a cigarette tax prosecutor, seven criminal investigators, a legal assistant, and a legal clerk.

II. TOBACCO MASTER SETTLEMENT AGREEMENT

A. Background

On November 23, 1998, leading United States tobacco manufacturers entered into the Tobacco Master Settlement Agreement with forty-six states, including Hawaii. In consideration for a release of past, present, and certain future claims against them, the Master Settlement Agreement obligates these manufacturers to pay substantial sums to the settling states (tied in part to the volume of tobacco product sales). The Attorney General of each settling state is responsible for enforcing the provisions of the Tobacco Master Settlement Agreement (hereinafter "Master Settlement Agreement" or "MSA").

B. Master Settlement Agreement Payments

There are three types of Master Settlement Agreement payments:

- (1) Initial Payments to Hawaii were received annually from January 10, 1999, through January 10, 2003.

<u>Year</u>	<u>Amount of Initial Payment</u>
1999-2000	27,804,177.13
2000-2001	11,659,558.77
2001-2002	12,701,627.03
2002-2003	<u>12,864,378.74</u>
Total	\$ 65,029,741.67

Report on the Tobacco Enforcement Special Fund
Fiscal Year 2018-2019

- (2) Annual Payments to Hawaii began on April 15, 2000, and are scheduled to be received on April 15 of each year in perpetuity.

<u>Year</u>	<u>Amount of Annual Payment</u>
1999-2000	20,811,042.90
2000-2001	24,471,822.21
2001-2002	32,674,220.28
2002-2003	31,845,690.90
2003-2004	37,793,157.48
2004-2005	38,357,998.54
2005-2006	35,212,822.31
2006-2007	36,857,166.01
2007-2008	37,299,996.79
2008-2009	41,132,845.88
2009-2010	34,230,792.73
2010-2011	32,453,603.85
2011-2012	33,096,749.95
2012-2013	33,073,205.78
2013-2014	37,420,086.29
2014-2015	32,022,781.47
2015-2016	33,654,568.07
2016-2017	33,211,083.41
2017-2018	26,149,213.01
2018-2019	<u>34,801,958.14</u>
Total	\$666,570,806.00

- (3) Strategic Contribution Payments to Hawaii began on April 15, 2008, and were received on April 15 of each year through 2017.

<u>Year</u>	<u>Amount of Strategic Contribution Payment</u>
2007-2008	18,762,802.27
2008-2009	19,225,534.21
2009-2010	16,691,299.06
2010-2011	15,211,574.73
2011-2012	15,492,087.49
2012-2013	15,505,806.17
2013-2014	15,238,278.95
2014-2015	15,206,293.27
2015-2016	15,612,254.40
2016-2017	<u>15,538,756.05</u>
Total	\$162,484,686.60

Report on the Tobacco Enforcement Special Fund
Fiscal Year 2018-2019

In fiscal year (FY) 2018-2019, the State received \$34,801,958.14 in Master Settlement Agreement moneys. The total amounts of Master Settlement Agreement payments received by Hawaii as of the end of FY 2018-2019 are as follows:

Initial Payments	65,029,741.67
Annual Payments	666,570,806.00
Strategic Contribution Payments	162,484,686.60
2004 Diligent Enforcement Arbitration Settlement of 2004 to 2017 Diligent Enforcement Arbitration issues	58,600,584.78
Total:	<u>\$ 952,685,819.05</u>

C. Tobacco Liability Act (Chapter 675, HRS)

The Master Settlement Agreement requires the State to diligently enforce the requirements of the “model statute,” which was enacted as the Tobacco Liability Act. The Master Settlement Agreement and the Tobacco Liability Act represent affirmative steps toward holding tobacco manufacturers accountable for the harm caused by the sale of cigarettes to residents of Hawaii. Section 675-1(d), HRS, provides:

It is the policy of the State that financial burdens imposed on the State by cigarette smoking be borne by tobacco product manufacturers rather than by the State to the extent that such manufacturers either determine to enter into a settlement with the State or are found culpable by the courts.

Section 675-1(f), HRS, provides:

It would be contrary to the policy of the State if tobacco product manufacturers who determine not to enter into such a settlement could use a resulting cost advantage to derive large, short-term profits It is thus in the interest of the State to require that such manufacturers establish a reserve fund to guarantee a source of compensation and to prevent such manufacturers from deriving large, short-term profits and then becoming judgment-proof before liability may arise.

The Tobacco Liability Act requires any tobacco product manufacturer selling cigarettes to consumers in Hawaii – whether directly or through a distributor, retailer, or similar intermediary or intermediaries – to either participate in and perform its financial obligations under the Master Settlement Agreement, or place funds in an escrow account to establish a reserve fund to guarantee a source of compensation to the State if the tobacco product manufacturer is found culpable by the courts. A non-participating manufacturer (NPM) is a tobacco product manufacturer who has not entered into the Master Settlement Agreement.

NPMs who fail to comply with the escrow requirements enjoy a price advantage over those who comply. This price advantage lures consumers away from and decreases the market share of participating manufacturers. In a recent Master Settlement Agreement disbursement, the amounts due to the states were reduced because of a national increase in NPM market share.

D. Enforcement

Failure to diligently enforce the Tobacco Liability Act may result in a state losing a significant portion of its Master Settlement Agreement payments. “Diligent enforcement” in the context of the Master Settlement Agreement had not been clearly defined, and was the subject of the lengthy 2003 Diligent Enforcement Arbitration (2003 DE Arbitration), which began in 2010 and concluded in 2013. In the 2003 DE Arbitration, the panel concluded that diligent enforcement was an ongoing and intentional consideration of the requirements of a Settling State’s Qualifying Statute, and a significant attempt by a Settling State to meet those requirements, taking into account a Settling State’s competing laws and policies that may conflict with its MSA contractual obligations. The factors considered by the 2003 panel included: collection rate, lawsuits filed, gathering reliable data, resources allocated to enforcement, preventing non-compliant NPMs from future sales, legislation enacted, actions short of legislation, and efforts to be aware of National Association of Attorneys General and other states’ enforcement efforts.

The 2003 arbitration panel on the issue of what constitutes “Units Sold” determined that, “as a matter of law”, the model statute definition of “Units Sold” is unambiguous and binding.” “Units Sold” is defined in Exhibit T to the MSA as follows:

“Units Sold” means the number of individual cigarettes sold in the State by the applicable tobacco product manufacturer (whether directly or through a distributor, retailer or similar intermediary or intermediaries) during the year in question, as measured by excise taxes collected by the State on packs (or “roll-your-own” tobacco containers) bearing the excise tax stamp of the State [Emphasis added.]

Simply put, the 2003 Arbitration panel held that a state’s obligation to collect escrow was limited to those NPM cigarettes, which could be measured by packs bearing the excise tax stamp of a state.

Hawaii’s diligent enforcement efforts and regulatory scheme includes identifying NPMs and the number of NPM cigarettes sold in Hawaii in each calendar year; notifying NPMs of their obligation to establish and fund an escrow in accordance with chapter 675; and as necessary filing complaints in court against NPMs who fail to comply with chapter 675. Simply put, the Department has developed a system that:

- (1) Identifies NPMs and their products;
- (2) Gathers and tracks information on NPM products;

Report on the Tobacco Enforcement Special Fund
Fiscal Year 2018-2019

- (3) Notifies NPMs of their obligations under the Tobacco Liability Act, Tobacco Products Reporting Law, and related statutes (the Department sends letters to tobacco product manufacturers worldwide to advise them of these obligations);
- (4) Provides assistance to effectuate compliance;
- (5) Has provided the relevant information, that has allowed the Attorney General to file lawsuits as necessary to compel compliance with the escrow statutes; and
- (6) Provides the information-gathering and certification protocols necessary to establish and publish the directory of tobacco product manufacturers whose cigarettes and Roll-Your-Own (RYO) tobacco products are authorized for sale in Hawaii.

In 2003, the Unit created a directory of compliant cigarettes and RYO tobacco products. The directory has been posted on the Department's website since October 31, 2003, and was revised and updated in FY 2018-2019. At the end of FY 2018-2019, 16 compliant tobacco product manufacturers (16 participating manufacturers and 0 NPMs) were listed in the directory, along with a list of 93 authorized brands of cigarettes and RYO tobacco products.

Further, the directory in conjunction with the Tobacco Products Reporting Law facilitates the time-consuming process of identifying individual manufacturers and their respective brands. When a tobacco product manufacturer is identified as having or intending to have sales in Hawaii, the Unit notifies the tobacco product manufacturer that it must comply with chapter 486P, including the requirement to register with the Department pursuant to section 486P-5, HRS.

The Unit provides a reporting form to wholesalers and distributors, and gathers information from the responses and invoices submitted by the wholesalers and distributors. Based on this information, the Unit verifies that only compliant NPMs and their brands are sold (directly or through distributors, retailers, or similar intermediaries) in Hawaii. In addition, the Unit verifies that only compliant NPMs and their authorized brands are stamped and sold in Hawaii by investigating cigarette brands on store shelves.

The Unit sends formal demands to NPMs that have sales in Hawaii, requiring that they place appropriate sums in a qualified escrow fund in compliance with the Tobacco Liability Act. In FY 2018-2019, there were no NPM sales, and therefore no escrow payments were required to be made.

E. 2004 Diligent Enforcement Arbitration

Report on the Tobacco Enforcement Special Fund
Fiscal Year 2018-2019

As noted above, failure to diligently enforce the Tobacco Liability Act may result in a state losing a significant portion of its Master Settlement Agreement payments. After nearly two years of pretrial litigation and extensive discovery, the Participating Manufacturers affirmatively challenged the State of Hawaii's Diligent Enforcement for the calendar year 2004. The State of Hawaii's Arbitration was scheduled to begin in August of 2018. With the assistance of outside counsel the State reached a Settlement with the Participating Manufacturers, on March 6, 2018, which resolved the Diligent Enforcement Arbitration Issues for the years 2004 through and including 2017. The Settlement spared the State the cost and uncertainty of ongoing and protracted arbitrations. It was estimated that had the matter gone to arbitration it could have cost the State approximately \$1.5 million dollars in litigation costs¹.

As mentioned above, the State of Hawaii reached an agreement with the Tobacco Industry that settled the Diligent Enforcement Arbitration Issues for the years 2004 through and including 2017. The Settlement amount of \$58,600,584.78 was received by the State on April 19, 2018. Outside litigation costs totaled approximately, \$189,000.00.

III. CIGARETTE TAX AND TOBACCO TAX LAW (Chapter 245, HRS)

A. Background

In 2000, the Legislature recognized the need for a mandatory cigarette tax stamp system "to assess, collect, and enforce the cigarette and tobacco tax." The Conference Committee on S.B. No. 2486, S.D. 2, H.D. 2, C.D. 1 (2000) (Act 249, Session Laws of Hawaii 2000), reported:

Enforcement of the current system of collecting cigarette and tobacco taxes is sporadic, haphazard, and ineffective, resulting in uncollected potential tax revenue. The current system of filing of returns by licensed dealers is in effect a system of voluntary compliance. Persons may try to sell cigarettes and tobacco products without obtaining a license, or could have a license and not file a return or understate the income on the return.

The Legislature recognized that obtaining proof of large-scale black market cigarette sales is nearly impossible because the activity is surreptitious and the State's resources are limited. Nonetheless, the Legislature concluded, "judging from the anecdotal evidence existing and continuing over a fifteen-year period that a black market exists." With these concerns in mind, chapter 245 was amended by Act 249 to

¹ Had the State prevailed in the 2004 Diligent Enforcement Arbitration, Hawaii would have received \$4,648,059.24, the amount withheld by the industry from the industry's 2004 payment to Hawaii, plus any interest that accrued on the withheld amount.

Report on the Tobacco Enforcement Special Fund
Fiscal Year 2018-2019

require that the tax on the sale or use of cigarettes under section 245-3, HRS, shall be paid by licensees through the use of stamps. Beginning on January 1, 2001, a licensee or its authorized agent or designee is required to affix a stamp to the bottom of each individual package of cigarettes prior to distribution. Beginning on April 1, 2001, no individual package of cigarettes could be sold or offered for sale to the public unless affixed with the stamp as required by chapter 245. Beginning in 2000, the Unit worked closely with licensed wholesalers and dealers and the Department of Taxation to facilitate the implementation of the cigarette stamp program. In January 2001, the Unit began conducting inspections for compliance with the program.

In 2005, the Attorney General proposed a bill to amend chapter 245 to require a permit for the retail sale of cigarettes and other tobacco products, and to require retailers to keep adequate records. These amendments became effective on December 1, 2006 (Act 131, Session Laws of Hawaii 2005). The Retail Tobacco Permit program addresses the problem of cigarettes and other tobacco products being imported to Hawaii by entities other than known wholesalers and distributors; for example, consumers and retail stores often order cigarettes by Internet, telephone, or mail. The record-keeping requirements of the Retail Tobacco Permit program help law enforcement officers determine the sources of cigarettes and other tobacco products sold at retail, and thus these record-keeping requirements help prevent evasion of state taxes.

B. Cigarette Tax Revenues

Since the implementation of the tax stamp program on January 1, 2001, cigarette tax revenues have increased significantly. Cigarette tax revenues increased from \$40,049,539 in FY 1999-2000 to \$51,739,469 in FY 2000-2001 (an increase of \$11,689,930 or approximately 29 percent) even though the tax stamp program was in effect for only half of FY 2000-2001 and effective enforcement began at the retail level only three months before the end of FY 2000-2001. In FY 2018-2019, the Department of Taxation reported cigarette tax collections of \$102,793,761.66.

Cigarette Tax Revenues by Fiscal Year

FY 1999-2000	\$ 40,049,539
FY 2000-2001	\$ 51,739,469
FY 2001-2002	\$ 62,609,477
FY 2002-2003	\$ 70,586,392
FY 2003-2004	\$ 77,541,843
FY 2004-2005	\$ 83,135,360
FY 2005-2006	\$ 85,702,483
FY 2006-2007	\$ 88,771,666
FY 2007-2008	\$ 101,560,051
FY 2008-2009	\$ 104,433,576
FY 2009-2010	\$ 119,926,741
FY 2010-2011	\$ 135,647,918

Report on the Tobacco Enforcement Special Fund
Fiscal Year 2018-2019

FY 2011-2012	\$ 130,994,721
FY 2012-2013	\$ 120,095,909
FY 2013-2014	\$ 114,112,465
FY 2014-2015	\$ 121,629,882
FY 2015-2016	\$ 116,382,902
FY 2016-2017	\$ 114,926,266
FY 2017-2018	\$ 110,762,991
FY 2018-2019	\$ 102,793,762

C. Enforcement

The Unit conducts inspections, including unannounced inspections, of wholesalers and distributors, retail establishments, and cigarette vending machines for compliance with the Cigarette Tax and Tobacco Tax Law. 1,385 retailers hold Retail Tobacco Permits: 890 on Oahu, 203 on Hawaii, 184 on Maui, 90 on Kauai, 14 on Molokai, 4 on Lanai. Inspections have been conducted on all of these islands.

- In FY 2018-2019, 1,506 compliance inspections were conducted statewide: 1,196 on Oahu, 123 on the island of Hawaii, 69 on Kauai, 102 on Maui, 13 on Molokai, and 3 on Lanai.
- Since April 1, 2001, enforcement activities have resulted in more than 160 felony arrests, numerous investigations, and seizure of more than 3,204,448 illegal cigarettes and 267.8 pounds of tobacco leaves. Historically, arrests have been made on Hawaii, Kauai, Maui, Molokai, and Oahu.
- In FY 2018-2019, 27 criminal tobacco investigations were conducted and 301 cartons and 1 pack of cigarettes (the equivalent of 60,220 cigarettes) and 163 pounds of tobacco leaves were seized at the Honolulu International Airport (16 investigations) and at the U.S. Post Office (11 investigations), as a result of cooperative efforts between the Department, United States Customs and Border Protection, and the U.S. Postal Service.
- Since April 1, 2001, the Unit has prosecuted 139 tobacco cases, resulting in criminal fines of \$197,600.
- In total, 75 cigarette prosecutions have resulted in court-ordered forfeiture of cigarettes. In addition, the Department has secured 99 civil administration forfeiture orders for, or stipulations or agreements to, the forfeiture of confiscated cigarettes.
- In FY 2018-2019, 2 criminal tax cases were charged.

D. Gray Market

Gray market cigarettes are American-made or foreign-made cigarettes – usually major American brands – sold by the manufacturers specifically for sale outside of the United States that nevertheless ends up in the United States. Gray market cigarettes cut into the market share of participating manufacturers. Gray market cigarettes include cigarettes that have been imported illegally into the United States in violation of federal law, fail to meet federally mandated labeling requirements, or bear an unauthorized brand or trademark and are considered contraband. Foreign-made gray market cigarettes are manufactured overseas in such places as China, Colombia, the Philippines, Southeast Asia, and Switzerland, representing a multitude of brands and cigarette manufacturers. These cigarettes are often smuggled into Hawaii from Asia (predominantly the Philippines and Southeast Asia), and the South Pacific, and have been found in small grocery and liquor stores. Some mainland distributors attempt to mask or re-label “Tax Exempt” cigarettes to avoid prosecution for sale of gray market cigarettes.

Historically, to address the gray market and other contraband cigarette problem, the Department has established relationships and has shared information with the taxing and regulatory authorities of Alaska, Arizona, California, Florida, Michigan, Oregon, Utah, Vermont, Washington, and Canada. The Department has also historically coordinated with the Bureau of Alcohol, Tobacco, Firearms, and Explosives; Internal Revenue Service; United States Customs and Border Protection; United States Postal Service; and Royal Canadian Mounted Police with regard to gray market cigarettes and other contraband cigarette-related issues.

The Department has worked with United States Customs and Border Protection in joint investigations of persons smuggling contraband cigarettes to Hawaii from foreign countries. This cooperative effort has resulted in 5 investigations of individuals attempting to bring undeclared or under-declared cigarettes to Hawaii in FY 2018-2019. Gray market and other contraband cigarettes have been seized at airports in these joint interdiction efforts.

E. Counterfeit Tax Stamps

Counterfeit tax stamps cost as little as \$0.03 to \$0.50 per stamp and, therefore, create a significant price advantage over vendors who sell properly stamped cigarettes. The Department searches for counterfeit Hawaii tax stamps in order to prevent their circulation.

F. Half-Stamping

Historically vendors have attempted to evade the cigarette tax by placing a half-stamp on the bottom of a package of cigarettes, thus stamping two packs for the price of one. Investigations have resulted in arrests for selling half-stamped or partially

Report on the Tobacco Enforcement Special Fund
Fiscal Year 2018-2019

stamped packs. In November 2001, the Unit made arrests for half-stamping and seized 12,879 packs, of which 2,639 packs were half-stamped and 10,240 packs were unstamped. The Unit continues to ensure that the application of tax stamps conforms with the stamping requirements set forth by rules adopted by the Department of Taxation².

G. Sales by Internet and Mail

Efforts continue in Hawaii and across the nation to address the problem of Internet sales of cigarettes. Significant federal regulation in the form of the Prevent All Cigarette Trafficking Act of 2009 (PACT ACT³) was passed in March 2010. In FY 2018-2019, the Tobacco Unit also initiated 25 investigations into (22) Craigslist and (3) OfferUp internet offerings for the sale of tobacco products without a tobacco retail permit within the State of Hawaii. The investigations resulted in the Craigslist and OfferUp listings being removed from Craigslist and OfferUp within a day or two of the investigations being initiated.

As noted above, interdiction activities also took place in conjunction with United States Customs and the U.S. Postal Service where parcels of cigarettes and loose tobacco were seized as prohibited mailed items and treated as contraband in violation of the PACT ACT.

IV. FY 2018-2019 RECEIPTS INTO TOBACCO ENFORCEMENT SPECIAL FUND

Master Settlement Agreement funds	350,000
Cigarette tax stamp fees/interest/fines/misc.	<u>1,563,872</u>
Total:	\$1,913,872

V. FY 2018-2019 APPROPRIATIONS AND EXPENDITURES

In FY 2018-2019, there was a total appropriation of \$1,572,204 for Master Settlement Agreement and cigarette tax stamp enforcement. The appropriation was funded in part by \$350,000 from moneys received from the Master Settlement Agreement and \$1,563,872 from cigarette tax stamp fees.

Expenses for FY 2018-2019 totaled \$1,525,663.50 which leaves an appropriation balance of \$46,540.50.

TOBACCO ENFORCEMENT SPECIAL FUND
Fiscal Year 2018-2019

² Title 18, Hawaii Administrative Rules, section 18-245-3 provides that stamps or stamping indicia shall be securely affixed to the bottom of each cigarette package in such a manner that the stamps or stamping indicia are clearly visible, legible, and complete.

³ 18 U.S.C. § 1716E (2010).

Report on the Tobacco Enforcement Special Fund
 Fiscal Year 2018-2019

APPROPRIATION			\$1,572,204.00
PERSONNEL COSTS		1,194,611.13	
Salaries and Fringe			
OPERATIONAL EXPENSES & OVERHEAD COSTS			
Supplies	5,182.52		
Membership Dues and Subscriptions	2,153.25		
Computer Network Cabling	7,572.97		
Telephone	6,028.79		
Mileage	4,314.36		
Travel Costs	9,347.05		
Data Service	5,265.42		
Lease Rent	59,005.35		
Rental of Equipment	14,313.74		
Miscellaneous Expenses	2,874.36		
Legal Fees (MSA Data Storage)	675.00		
Investigators' Fees (Monthly Parking)	525.00		
Moving Expenses	9,124.77		
Special Fund Assessments paid to B&F	136,197.67		
Special Fund Assessments for AG Department (Redistribute Expenses)	68,472.12		
TOTAL		331,052.37	
TOTAL COSTS			\$1,525,663.50
APPROPRIATION BALANCE			\$46,540.50