Legislative Fiscal Bureau

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April 26, 2001 Joint Committee on Finance Paper #885

Discussion of Tobacco Securitization (Tobacco Settlement Securitization)

[LFB 2001-03 Budget Summary: Page 637, #1 and Page 638, #2]

This paper provides background information and discusses the issues surrounding payments to the states of monies from the Attorneys General Master Tobacco Settlement Agreement of November, 1998, and the provisions in the Governor's 2001-03 biennial budget bill relating to the sale of the state's rights to the payments under the agreement.

This paper includes four sections. Following this brief introduction is a Table of Contents. The first section provides background information on the tobacco settlement and the projected settlement payments to the state and discusses the various factors that could impact those payments. The second section provides information on tobacco securitizations and the other states or governmental bodies that have sold their tobacco settlement payment revenues. The third section analyzes the Governor's proposal to sell the state's tobacco settlement payments including an outline of the proposed transaction. The last section describes some of the advantages and disadvantages of the proposed securitization of the state's tobacco settlement payments and other issues facing the Legislature relating to the proposal.

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SECTION 1

Background Information on Tobacco Settlement

Master Settlement Agreement

On November 23, 1998, Wisconsin and 45 other states, Puerto Rico, the U.S. Virgin Islands, American Samoa, the Northern Mariana Islands, Guam and the District of Columbia ("settling states") entered into the Master Settlement Agreement with Brown & Williamson Tobacco Corporation, Lorillard Tobacco Company, Philip Morris Incorporated and R.J. Reynolds Tobacco Company. At the time of the agreement, these four companies had over 96% of the retail market share for tobacco products, with Phillip Morris (Marlboro and other brands) having nearly 50% of the total retail market share.

The settlement agreement also allows for tobacco product manufacturers, in addition to the original participating manufacturers (OPMs), to join the master settlement agreement. Such tobacco product manufacturers are known as subsequent participating manufacturers. Only if a subsequent manufacturer's market share in the previous year was larger than its base market share will it have an obligation to make payments under the settlement agreement in a given year. A subsequent manufacturer who signed the agreement no more than 90 days after the agreement's execution date was given the option of either using 125% of its 1997 market share, or its 1998 market share as its base market share. Subsequent participating manufacturers, who did not sign the agreement within 90 days of the execution date or did not have a market share in 1997, are assigned a base market share of zero. For these latter manufacturers, therefore, any market share will trigger payment obligations under the settlement agreement.

The settlement agreement requires the participating manufacturers to make initial payments (OPMS only), annual payments and strategic contribution payments. Settlement payments are allocated to each participating manufacturer based on its market share in the prior year. The first initial payment was made in December, 1998, and will continue to be made every January 10 from 2000 through 2003. The annual payments began in 2000 and are to be paid on April 15 of each year in perpetuity. The agreement for also provides for a series of strategic contribution payments that the participating manufacturers are to pay to the settling states. Beginning April 15, 2008, and on April 15th of each year thereafter through 2017, the participating manufacturers are to make a yearly strategic contribution payment.

The settlement agreement also established each state's allocation percentage for the settlement payments. Wisconsin's allocation percentage was established at 2.07% of the payments for the initial and annual payments and at 2.62% for the strategic contribution payments. As of January, 2001, Wisconsin has received $207.5 million in unrestricted settlement payments. These monies have been deposited to the state's general fund with a portion being transferred to fund the Tobacco Control Board's activities. Under current projections the state expects to receive an additional $84.1 million in 2000-01, $155.5 million in 2001-02 and

$157.6 million in 2002-03 in settlement payments. Currently, it is estimated the state will receive $5.57 billion in payments from 2002 through 2032.

In addition, the agreement provides for a "model statute" to be enacted by the settling states. Under 1999 Act 122, Wisconsin's model statute became effective on May 23, 2000. Under these statutes, manufacturers that are not participating in the settlement agreement would be required to make payments to a state-specific escrow account equal to the amounts they would have to pay if they were participating in the tobacco settlement agreement. The escrow account is to be used to pay any future claims against the non-participating manufacturer. The payments required under these model statutes are designed to level the playing field between participating tobacco manufacturers and non-participating manufacturers by requiring that both make similar payments regardless of settlement status under the settlement agreement. However, because the non-participating manufacturers have the payment liability without insulation from any legal liability, these statutes provide an incentive for the non-participating manufacturers to join the master settlement agreement.

Adjustments and Offsets to Settlement Payments

While the settlement agreement provides for payments to the settling states, no absolute guarantee of payment exists. The degree to which the various adjustments and offsets to the settlement payments outlined in the agreement impact the payments will determine whether or not future settlement payments to the states will be made as currently projected. Each type of tobacco settlement payment is subject to several potential adjustments. After the specific adjustments and offsets are made the total of each type of payment is multiplied by the state allocation percentage to determine each state's share of the payments. The primary adjustments are related to changes in cigarette shipment volume by the OPMs and inflation. Other adjustments include a non-participating manufacturers adjustment, a previous settled states reduction and a non-settling states reduction. In addition, payment amounts are subject to potential offsets for miscalculated or disputed payments, federal tobacco legislation, litigating releasing parties and claims-over, which are described in the following sections.

Volume Adjustment. Each type of settlement payment is subject to the annual volume adjustment established under the agreement. The volume adjustment is based on the aggregate number of cigarettes shipped in or to the fifty states in the U.S., the District of Columbia, and Puerto Rico by the OPMs in a given year compared to the 1997 base year level of 475.7 billion cigarettes. Any increase in the aggregate number of cigarettes shipped in or to the United States, the District of Columbia, and Puerto Rico by the OPMs would result in a volume adjustment that translates into a directly proportional increase in the payment obligations of the OPMs. Conversely, any reduction in the payment obligation due to a decline in the aggregate number of cigarettes shipped compared to the 1997 base year is equal to 98% of the percentage decrease. Downward volume adjustments in tobacco settlements can result from either an overall decline in tobacco consumption which results in reduced shipments by participating manufacturers or from the loss of participating manufacturer market share to nonparticipating manufacturers or to illegal "black market" providers.

For 1998 and 2000, payments to the settling states were reduced by 13.7293% as the result of the volume adjustment of -14.00949% adjusted by a multiplier of 0.98. For 2001, payments to the settling states are being reduced by 15.039041% as a result of the volume adjustment of -15.34596% being adjusted by a multiplier of 0.98. These reductions reflect the cumulative volume adjustments from the 1997 base year, and are not one-year declines. The significant decline in the volume of cigarettes shipped that has occurred since 1997 is believed to be primarily attributable to substantial price increases by manufacturers to meet their settlement payment requirements and increases to state and local taxes on cigarette products.

A second part of the volume adjustment, which only applies to annual and strategic contribution payments made by OPMs, involves changes in those manufacturers' aggregate operating income. If the aggregate operating income for the original manufacturers in the previous year is greater than the aggregate operating income for the manufacturers in 1996, adjusted for inflation, their payments in a given year are adjusted upward by approximately one quarter of the difference between the previous year's aggregate operating income for the manufacturers and the aggregate operating income for those same manufacturers in 1996, adjusted for inflation. The volume adjustment for the 2001 annual payments to the settling states will be modified as a result of this aggregate OPM operating income calculation.

Inflation Adjustment. The annual and strategic contribution payments are subject to an annual inflation adjustment. The inflation adjustment percentage applicable to payments due in the year 2000 was equal to the greater of 3% or the annual percentage change in the consumer price index (CPI). The inflation adjustment percentage applicable to payments due in any year after 2000 will be calculated by applying in each year the greater of 3% or the annual percentage change in the CPI to the inflation adjustment percentage applicable to payments due in the prior year. The annual CPI or inflation adjustments will mitigate declines in annual and strategic payments that result from future annual volume adjustments.

Non-Participating Manufacturers Adjustment. The annual and strategic contribution payments are subject to a non-participating manufacturer adjustment. The non-participating manufacturer adjustment is applied if, in any year, the total aggregate market share of the OPMs (original settling tobacco manufacturers) decreases more than 2% from their total aggregate 1997 market share, and it is determined that the provisions of the settlement agreement were a significant factor contributing to their market share loss. In this case, payments to states may be reduced based on that loss. In addition to the adjustment amount, any loss of market share by participating manufacturers to non-participating manufacturers would also reduce the volume used in the calculation of the volume adjustment. Wisconsin's 2000 annual payment has been reduced by $7.4 million under these provisions because Wisconsin's model statute was not passed by July 1, 1999. If the state properly enforces the statute no further adjustments are likely under these provisions.

Non-Settling States Adjustment. The settlement agreement provides that initial and annual payment amounts be decreased by the amounts that would be allocable to states that have not settled any pending or potential litigation against tobacco manufacturers. All parties have

agreed that all states have settled any pending litigation, so that this adjustment no longer applies.

Previously Settled States Adjustment. Annual payments are subject to a previously settled states reduction. Florida, Texas, Mississippi and Minnesota settled with the major tobacco manufacturers for a total of $40 billion prior to the agreement. This adjustment reduces payments to the settling states and is determined by multiplying the applicable settlement payment by 12.45%, in the case of payments due in or prior to 2007; 12.2373756%, in the case of payments due after 2007 but before 2018; and 11.0666667% in the case of payments due in or after 2018. These reductions are figured into current estimates of state settlement payments.

Offsets for Miscalculated or Disputed Payments. The initial, annual and strategic contribution payments are all subject to an offset for miscalculated or disputed payments. If within four years of a payment due date an independent auditor finds that a participating manufacturer has paid the wrong amount, the manufacturer is due a payment in the case of any overpayment and a payment is owed the escrow account in the case of an underpayment. There is a separate account within the escrow account for disputed payments. Both the 2000 annual and the 2001 initial payments included offsets under this provision.

Federal Tobacco Legislation Offset. The annual and strategic contribution payments are subject to a federal tobacco legislation offset. If federal tobacco legislation is enacted on or before November 30, 2002, that requires participating manufacturers to provide payments to the federal government, with all or part of the funding being passed on to the settling states, each participating manufacturer will receive a dollar-for-dollar reduction in the payment required under the settlement agreement. It is believed that the likelihood of this offset is minimal because the federal government has no incentive to seek moneys from manufacturers for distribution to the states that would result in an offsetting reduction to settlement payments to states. However, some concern does exist that the federal legislation offset could provide the federal government a means to restrict the use of tobacco settlement payments to states. That is, the federal legislation, which would reduce current settlement payments to the states, could also direct states how to spend any funds distributed to the states to replace the funds lost under this offset.

Litigating Releasing Parties Offset. The annual and strategic contribution payments are subject to a litigating releasing parties offset. The agreement provides that participating manufacturers are released from any pending litigation, judgment or settlement claims asserted by the state or its political subdivisions or by private persons seeking relief on behalf of the general public or the state. If such a judgment or settlement is ordered, participating manufacturers would receive a dollar-for-dollar offset to its annual and strategic contribution payments that would otherwise be owed. The Governor's 2001-03 biennial budget contains a provision that prohibits any political subdivision of the state or any officer or agent of a political subdivision from having or seeking to maintain a claim against any party that was released from liability by the state under the settlement agreement. If this provision is enacted, it would

remove any potential offset under these provisions relating to claims of political subdivisions of the state.

Offset for Claims-Over. Original participating manufacturers annual and strategic contribution payments are subject to an offset for claims-over. The offset can occur when a party to a releasing state wins a judgment or settlement on a released claim against a non-settling party, and the non-settling party has a claim-over against an original participating manufacturer in regards to the judgment or settlement on the released claim. If this occurs, the manufacturer receives a dollar-for-dollar offset for any amounts paid by that manufacturer to the non-settling party. As of January, 2001, no offset has been applied under these provisions.

Potential Impacts to Wisconsin's Tobacco Settlement Payments

As indicated, the settlement agreement has several provisions that could impact the amount of tobacco settlement payments that the state will actually receive. While it is unlikely that the payments to the state will be discontinued, the amount of payments the state will receive is not guaranteed. The level of future volume adjustments, the potential of bankruptcy of participating manufacturers and the potential for future litigation involving participating manufacturers appear to be the primary factors that could affect the state's settlement payments.

Future Volume Adjustments. While it is believed the volume of cigarettes shipped will continue a steady decline resulting in continued downward volume adjustments to settlement payments, most forecasters predict that future declines in cigarette shipments and subsequent volume adjustments will be not be as large as the 4.6% decline in 1998 and the 9.0% decrease in 1999. Recent studies indicate that the decline in number of smokers as a percentage of the 18 or older population appears to have leveled off during the 1990s dropping less than one percent from 25.5% in 1990 to 24.7% in 1999. This compares to smokers representing 42.4% of the population in 1965.

Currently, projections of future settlement payments to Wisconsin and other states use a study of United States cigarette consumption from 2000-2042 conducted by WEFA, Inc., an independent econometric forecasting and consulting company. The tobacco settlement agreement bases payment on the number of cigarettes shipped by participating manufacturers rather than the overall cigarette consumption measure contained in the WEFA study. However, many believe that because currently participating manufacturers make up nearly 97% of the cigarette market, and with the requirements placed on non-participating manufacturers under the model statutes, the two quantities will tend to equate over time.

The WEFA forecast projects 204 billion cigarettes will be consumed in the year 2042, which represents a 53% decline (or an approximately 1.7% compounded annual decline), from the 1999 level. Most believe that the decline in cigarette consumption will moderate compared to recent declines. Specifically, the study forecasts two more years of consumption annual declines that will be higher than pre-settlement annual declines before returning to the historical level of declines that existed prior to the agreement. However, future industry, judicial and governmental decisions that impact tobacco product pricing will be important in assessing the

certainty and size of future settlement payments. Some concern does exist that unfavorable rulings in private action or other litigation could require participating manufacturers to make higher than projected future increases in product prices to cover the cost of the rulings. Similarly, there is some concern that state and local governments will continue to look to tobacco product excise taxes as a means to raise additional revenues, to a greater extent than is assumed in the WEFA forecast. Such price increases could result in greater than projected annual declines in overall cigarette demand or could result in loss of market share to non-participating manufacturers or loss of sales to "black market" cigarette providers.

Loss of market share by the original participating manufacturers to non-participating manufacturers could also impact the volume adjustment and reduce annual settlement payments. However, some of the potential losses in volume due to reduced market share of the original manufacturers has been substantially mitigated by the fact that 25 additional tobacco manufacturers have become subsequent participating manufacturers to the settlement agreement and are required to make payments if their market shares increase to levels specified in the agreement. A number of subsequent manufacturers that have joined the settlement agreement have met the criteria for making payments under the agreement.

Also, all settling states, including Wisconsin, have enacted model statutes. These statutes, by requiring non-participating manufacturers to make payments to an escrow fund that are similar to the payments made under the agreement, removes a pricing advantage the non-participating manufacturer would otherwise have. Further, because these non-participating manufacturers are required to make payments as if under the settlement agreement, they may eventually choose to join the settlement agreement to obtain the legal immunity provided under the agreement. In addition, cigarette manufacturers that have subsequently signed onto the agreement are also subject to the same marketing and advertising restrictions outlined in the agreement as the original participating manufacturers. As a result, the ability of non-participating manufacturers to gain market share from participating manufacturers has been somewhat curtailed.

Lastly, the change in aggregate operating income component of the volume adjustment for original participating manufacturers may partially offset the settlement payment reductions associated with any lower volume of cigarettes being shipped by those manufacturers.

Issues Relating to Bankruptcy. Because they have most of the cigarette market share currently, the focus of concerns with bankruptcy is on the four original participating manufacturers. The credit quality of these manufacturers becomes a key factor in analyzing the reliability of future settlement payments or in attempting to securitize those payments. The settlement agreement states that the settlement payment obligations are solely the liability of the U.S. tobacco subsidiaries that sign the agreement. Publicly traded holding company parent companies and sister subsidiaries have no payment obligation and no remedies, penalties or sanctions may be imposed on these affiliates under the agreement. Thus far the courts have generally supported the contention that tobacco settlement liabilities belong to the tobacco subsidiaries and not at the parent corporation level.

Rating agencies currently rate the four major tobacco manufacturers as generally stable. One rating agency indicates that the strengths of the tobacco industry include the fact that the products are relatively inexpensive with strong repeat purchases and brand recognition and they have a strong profit and cash flow capability. Another rating agency gives the tobacco industry as a whole an unsecured credit quality rating of upper medium. Individually, the obligations of the parent companies have credit quality ratings that range from: (1) being adequately protected, but subject to weakened capacity to meet its obligations (BBB-) in the case of R.J. Reynolds Tobacco Holding Co.; to (2) having a strong capacity to meet its obligations (AA-) in the case of Lorillard Tobacco Co.

In the event of bankruptcy, participating manufacturers could file under Chapters 7 or 11 of the federal bankruptcy code. Under a Chapter 7 bankruptcy, the manufacturer would cease operations and its assets would be liquidated. A Chapter 7 filing by a participating manufacturer could interrupt the settlement payments allocated to that manufacturer. However, the risk of an ongoing reduction in payments associated with such a bankruptcy would be limited by the fact that the company would no longer be able to manufacture cigarettes and its market share would likely be absorbed by other participating manufacturers. In that event, that manufacturer's settlement payments would be reallocated to the remaining participating manufacturers based on each remaining participating manufacturer's market share.

Under a Chapter 11 bankruptcy, a participating manufacturer could continue to manufacture and sell cigarettes while undergoing a Chapter 11 reorganization, which could take several years to resolve. Because the company could continue to manufacture cigarettes, it could retain its market share. Thus, unlike a Chapter 7 bankruptcy, the manufacturer's payments would not be reallocated to the remaining participating manufacturers. While it is unknown how a bankruptcy court would rule, bond rating agencies, on opinion of counsel, believe that a bankruptcy court would rule that the settlement payment would be determined to be an executory contract, which would allow the manufacturer the opportunity to assume the settlement agreement obligations and continue to make payments. The rating agencies believe that a bankrupt manufacturer would assume the settlement agreement obligations in order to maintain the liability protections under the settlement and to avoid any claims being filed in bankruptcy by the settling states.

Risk of Further Litigation. While the settlement agreement releases the participating manufacturer from future claims by the states and requires offsets to the settlement payments for other types of litigation, the manufacturers are still facing private litigation and public litigation on the part of the federal government and various local governments. It is believed that most manufacturers could survive additional obligations associated with this litigation if they are allowed to spread the payment of such obligations out over several years. However, such additional obligations could result in larger than projected increases in prices that could lead to larger declines in cigarette consumption and consequently larger volume adjustments to annual state settlement payments.

It is generally believed by legal and financial analysts that concerns related to future litigation involving tobacco manufacturers have subsided. According to the National Conference of State Legislatures, state and federal courts have dismissed more than 24 state and federal class action suits against tobacco manufacturers, with the number of pending cases dropping from 55 in August, 1999 to 35 in August, 2000. In addition, some states are setting statutory limits on awards relating to class action lawsuits. However, these limits may also be challenged through legal action.

Currently, Engle et al. vs. R.J. Reynolds is the most prominent active tobacco litigation case. It is a private class action suit that was filed in Florida state court on behalf of between forty thousand and one million smokers. In the first phase of the trial, a jury issued a judgment against tobacco manufacturers indicating that they conspired to hide the dangers of smoking from the public. In phase two of the trial, the jury determined punitive damages of over $145 billion for the entire class of smokers. The third phase of the trial will involve perhaps thousands of separate trials before separate juries for members of the class action, including each member's claims of causation. A judge has subsequently affirmed the jury’s award of over $145 billion in damages and ordered a final judgment against the tobacco industry. An appeal of that judgment and the jury's verdict awards has been filed. While final action on this appeal may be years away, financial and legal analysts believe that the tobacco manufacturers have strong legal arguments that could overturn the verdict. Further, it is believed that even if the appeal is denied, under Florida law, the separate trial for each class action litigant requirement would continue to be apply. Such trials would likely take several additional years.

In recent years, the U.S. Department of Justice brought a lawsuit to try to recover federal government expenses related to sick smokers under the Medical Care Recovery Act or the medicare secondary payer insurance provisions. In September, 2000, a U.S. District judge ruled against the U.S. Department of Justice claims related to the recovery of these federal program costs. It does not appear that the Department will appeal this ruling. Similar private action health care recovery suits that have been brought by insurance companies have also been rejected by the courts.

Finally, several counties in this state have filed suit against the state and the tobacco industry. The counties claim against the state is that they should share in the state's tobacco settlement payments. Their claim against the industry is similar to the state's claims against the industry which resulted in the master settlement agreement. Under the litigation offset requirements of the tobacco settlement agreement, if the counties prevail in this suit, the tobacco industry payments to the state could be reduced by any amount the industry would be required to pay Wisconsin counties.

The Governor's 2001-03 biennial budget recommendations relating to tobacco securitization include a provision that would prohibit such claims by political subdivisions of the state. Further, the State Attorney General, as well as the industry, have filed a request that the county action be dismissed. Therefore, many believe that the risk to the state's tobacco settlement payments associated with this litigation would be minimal.

SECTION 2

Other Tobacco Securitization Transactions

This section provides a description of tobacco securitization transactions and information on securitization of tobacco settlement payments by other state or local governments. In addition, information on the marketability of these transactions is provided.

Tobacco Securitizations

Tobacco securitizations are similar to a revenue bond borrowing in that a specific revenue stream backs the bonds. However, under the state's revenue bond programs, the state, as the recipient of the revenues backing the bonds, issues the bonds. Therefore, the state's name would be involved in the event the revenues backing the obligations are unable to meet the debt service payments on the bonds.

Securitization of annual tobacco settlement payments involves the current recipients selling or assigning their rights to future tobacco settlement payments to a third party buyer. The buyer of those rights then issues revenue bonds secured by the newly-assigned tobacco payments. In return for its rights to the tobacco settlement payments, the seller or assignor receives an up-front, lump sum payment from the revenue bond proceeds. The lump sum payment amount received by the seller is not the discounted present value of the tobacco settlement payment stream being sold, but rather is the amount of proceeds that can be generated by issuing bonds secured by that revenue stream. Under securitization, the seller retains no right or pledge to any of the revenues until all the obligations associated with the bonds are met. In return, the buyer assumes the risk as to whether the tobacco settlement payments will be adequate to meet the debt service on the bonds backed by those payments.

In addition, under some securitizations, the seller has also received annual tobacco payment revenues (residuals) in excess of those amounts needed to cover debt service on the bonds backed by those payments. Due to the uncertainties as to whether the payment stream will be able to cover debt service on the tobacco revenue obligations, the buyer would not be able to issue bonds that would use the entire amount of the annual tobacco settlement payment as security. As a result, residual amounts, in excess of annual debt service amounts, exist. Under tobacco securitization, the seller generally enters into a contract with the buyer where the seller receives a certificate from the buyer for these annual residual revenues. The risk associated with these residual funds is borne by the seller.

In summary, securitizing the state's tobacco payment would be similar to the state's other revenue bond programs in that the state would essentially be borrowing against a future revenue stream of the state. However, under securitization, the state would limit some risk associated with the current payment stream by transferring that risk to the holders of tobacco revenue bonds.

Existing Tobacco Securitizations

The volume of tobacco securitizations to date has been less than some market analysts expected. However, activity has increased recently, with over 10 securitization transactions having taken place in the last eight months. In addition, several other governmental entities have made the decision to sell their rights to tobacco settlement payments or are considering issuing tobacco revenue bonds. The decline in the volume of cigarettes shipped and consumed in the years immediately following the tobacco settlement led to substantial volume adjustments being made to the settlement payments in recent years. These reductions in payments and the prospects of additional reductions, together with lower than anticipated general sales tax revenues for state and local governments in recent months, could lead state and local governments to consider selling their rights to tobacco settlement payments.

Most tobacco securitization transactions have involved the same basic structure. The state or local government currently receiving the tobacco settlement payment sells and assigns the right to that payment to another entity. Typically these entities are corporations established by the state or local governmental body. In order to shield the state or local government from any liability relating to the issuance of tobacco bonds, the buyer of the settlement payment stream is typically an entity that cannot initiate bankruptcy proceedings in the event the payment stream is not sufficient to pay off the holders of the tobacco obligations. However, under tobacco securitizations, whether the government body is truly remote from any bankruptcy proceeding has not been tested in the courts.

To date, 15 states or local governmental units have issued bonds backed by all, or a portion, of their tobacco settlement payments. New York City issued the first tobacco revenue bonds in November, 1999.

Other entities are considering securitizing or issuing state or local revenue bonds against their tobacco payment streams. However, some states have had proposals to securitize their tobacco payments before their Legislatures for some time. Some of these proposals have been rejected, or failed to come to a vote, others are still pending.

The following table indicates the entities that have securitized all or a portion of the rights to their tobacco settlement payments.

Jurisdictions Which Have Securitized Tobacco Settlement Funds
($ in Millions)

Jurisdiction	Date Issued	Amount of Proceeds	Use of Proceeds
New York City	11/99	$709.0	Capital funding/schools
Nassau Co. (NY)	11/99	294.0	Health care/general expenses (deficits)
Westchester Co. (NY)	12/99	103.0	Advance payment of hospital debt
Tulare Co. (CA)	12/99	45.0	Establish endowment for general expenses
North Dakota	3/00	32.1	Water resource projects
Monroe Co. (NY)	8/00	163.0	Refunding debt/capital projects
Erie Co. (NY)	9/00	246.0	Economic development/county expenses
Alabama	9/00	50.0	Capital projects/economic development
Chautauqua Co. (NY)	9/00	30.0	Capital projects/debt defeasance
State of Alaska	10/00	115.0	School construction/renovation
Puerto Rico	10/00	409.0	Capital projects and equipment
Niagara Co. (NY)	10/00	48.0	Refunding debt/capital projects
NY Co. Tobacco Trust I	11/00	239.0	Refunding debt/capital projects
Washington D.C.	2/01	525.0	Refunding debt/capital projects
South Carolina	3/01	934.0	Capital projects/health care/econ. development

Various reasons have contributed to the decisions of governments to securitize their tobacco payment stream. Some have viewed securitization as an insurance policy against the risk of future reductions in annual tobacco settlement payments. Governments have been willing to take a smaller amount of funds in the near term in exchange for a larger, but potentially riskier, long-term payment stream. Other governmental entities' decisions to securitize have been partially driven by that governmental entity's current financial situation. Some have used the funds to assist in short-term budgetary shortfalls. At least two securitization transactions involved governmental entities that were up against their general obligation debt limit. Securitization of tobacco payments could be used because, while it essentially involves borrowing against a future revenue stream, such a borrowing did not count against their general obligation debt limits. Others have used the transaction as a means of borrowing for needed capital construction projects, or to refinance existing debt, thereby reducing the need for tax-supported borrowing.

More recently, some securitization transactions have involved a governmental entity using the tobacco revenue bond proceeds to establish endowment funds to be used as a "rainy day" fund or to provide investment revenues that could flow back to the governmental entity to be used for health care or other public purposes. This "borrow to save" approach involves the governmental entity borrowing against the current stream of tobacco payments to avoid some

risk associated with that payment stream, and investing the proceeds from that borrowing. However, this approach also carries some risk, because in order for the transaction to pay off, the earnings from investments have to exceed the cost of the funds, including the transaction costs, on the bonds issued under the securitization transaction.

Tax Exempt Versus Taxable Bonds

Tobacco revenue bonds may be issued on a federal tax exempt or taxable basis. Federal tax exempt bonds carry a lower financing rate associated with the federal income tax exemption on the interest earnings on the bonds provided to the holder of the bonds. Therefore, the debt service costs for the issuer tend to be lower and, as a result, lower annual revenues are needed to cover the debt service costs on federal tax exempt bonds. Consequently, assuming the same revenue stream is available to finance a bond issue, that revenue stream will support a larger principal amount under a federal tax exempt borrowing than under a taxable borrowing.

However, federal tax exempt bonds must meet certain federal statutory and regulatory requirements in order to carry tax exempt status. These requirements primarily relate to the allowable uses of the bond proceeds, with the fundamental requirement being that the proceeds be used for a public or allowable private purpose or activity. In addition, bond proceeds that are used for allowable public capital projects can be issued on a tax exempt basis. Tax exempt bonds can also be used for ongoing governmental operations if a need for the funds is imminent or if the funds are used to fund "working capital" projects that would otherwise be cash-funded.

In general, federal tax law requires that tax exempt bond proceeds be expended on a timely schedule to limit arbitrage earnings on those proceeds. Arbitrage earnings are the difference between the investment earnings on bond proceeds and the financing costs of the bonds. The federal arbitrage requirements limit the extent to which tax exempt issuers can invest bond proceeds for the purpose of generating earnings off the difference between the federal tax exempt rate on the bonds and the return on the investment of those proceeds. However, allowable arbitrage earning periods exist for the investment of federal tax exempt bond proceeds in taxable investments for certain bonds before the earnings have to be rebated to the U.S. Treasury. Also, investing the proceeds from tax exempt obligations in other tax exempt obligations is allowable under the arbitrage requirement.

Federal tax law also allows a process called de-allocation of tax exempt principal for proceeds placed in an endowment or other long-term holding. Under this process, as the principal amounts on the tax exempt bond proceeds placed in an endowment fund are repaid, the issuer may allocate that principal amount to the portions of the balance in the endowment fund that may be invested in taxable investments. Eventually an endowment fund that was funded entirely with federal tax exempt bond proceeds could be entirely invested in taxable investments when the tax exempt bonds have been repaid. However, because funds placed in an endowment fund are invested rather than spent, endowments funded with federal tax exempt proceeds are generally required to be repaid more quickly and tend to carry some uncertainty associated with the potential federal tax law questions that could arise from investing those proceeds.

No investment restrictions are placed on the investment of bond proceeds from taxable bonds. Taxable bond proceeds may be invested in other taxable bonds or equities that have the ability to generate higher yields than tax exempt investments. Therefore, while federal tax exempt bonds may allow for a larger amount of principal to be financed from the same revenue stream, the earnings on the principal or proceeds from taxable bonds, if invested, may be larger than the earnings on tax exempt bond proceeds.

To date, most tobacco bonds have been issued on a federal tax exempt basis with the proceeds being used to finance ongoing capital improvements or economic development projects. The decision of whether to issue tax exempt bonds versus taxable obligations is primarily contingent on what the seller intends to do with the proceeds from the obligations. If the bond proceeds are to be used by the seller to fund current or future capital related expenditures, tax exempt borrowing would probably be used. If the proceeds are used to establish an endowment fund, a portion of the transaction may involve taxable bonds. The ability to invest in taxable investments may be necessary in order for investment earnings on the endowment fund to outperform the costs of the funds, including the transaction costs. In creating a fund to which bond proceeds are deposited, state and local governments have to balance the potentially larger amount of proceeds that can be realized from tax exempt bonds against the more limited investment returns allowed under federal tax law that can be generated on tax exempt bond proceeds prior to significant amounts of principal on the bonds being repaid.

In addition, the length of the securitization transaction will likely be determined by the type of bonds issued. In the market, tax exempt and taxable investments have different allowable maturities. Tax exempt bonds are generally issued with maturities of 2 to 30 years. Conversely, marketable taxable bonds are generally limited to maturities of 2 to 20 years, with most lasting 12 years or less.

Amount of Bond Proceeds

In order to determine the amount of proceeds that may be generated by bonds backed by the tobacco settlement payments, it is first necessary to determine the maximum payment stream that may be available for debt service on the bonds. The rating on the bonds and the principal amount of the bonds that can be supported using that payment stream as security can then be determined. Initially, rating agencies review the current credit situation of each of the four original participating manufacturers, including the risk of future litigation and its impact on the financial status of the settling manufacturers and future product pricing decisions. Rating agencies then apply various tests or criteria to current projections of the tobacco payment stream. The more stringent the test that the payment stream backing the tobacco bonds can withstand, the higher the rating on the bonds. This process is similar in concept to the process used by mortgage lenders to determine the size of mortgage a borrower's income could support. Mortgage lenders do not allow a potential borrower to borrow a principal amount for a home that is backed by 100% of that borrower's income. Rather, certain criteria are applied that allow only a percentage of the borrower's income to be used to back a home mortgage. Similarly, in order for tobacco bonds to be marketable, rating agencies apply stress tests that disallow portions of the projected

tobacco settlement payments from being used in determining the amount of debt service that those payments could support.

These tests essentially provide assurance to the bond holders that despite declines or interruptions in the tobacco settlement payment stream, the annual tobacco settlement payments will continue to cover annual debt service on the bonds. The end result of these tests is a reduced tobacco payment stream that constrains the principal size of the transaction that this stressed payment stream can support. However, the constraint is required by the market in order to issue such obligations. In general, due to the stringency of the tests applied, the sizing of tobacco revenue bond issues is considered conservative given the likelihood of the constrained payment stream backing them. For this reason all of the tobacco revenue bonds issued to date have been rated "A" or higher, with some receiving "AA" or "AAA" bond ratings.

Rating agencies start with a baseline scenario of current tobacco settlement payment projections. In the case of tobacco revenue bonds, rating agencies tend to use the projections of tobacco payments that have been derived from the WEFA study of tobacco consumption as the baseline revenue estimates. The agencies then conduct alternative tobacco payment revenue estimates by applying various stress tests to the baseline projections of the projected tobacco payment stream. These tests involve the application of a larger than currently projected downward volume adjustment to the settlement payment stream. The higher the rating desired on the bonds, the larger the volume adjustment applied. One rating agency, Moody's, currently applies the most stringent series of tests to tobacco revenue payments in determining the rating on tobacco obligations. On "A" rated issues, Moody's applies volume adjustments of -6% in 2001, -4% in 2002 and an annual -3.5% decline thereafter to the current payment stream projections. This compares to a volume adjustment of -2.53% in 2001 and an annual volume adjustment of approximately -1.63% thereafter, on average, as projected by WEFA. Other stress tests include assessing the impact that an interruption in payments by one or more original participating manufacturers would have on the tobacco payment stream.

Once the maximum amount of annual debt service that can be covered by the stressed payment stream is known, the amount of obligations that can be supported by those payments can be determined. However, other factors, including the type of bonds issued and the structure of the amortization schedule can also impact the amount of principal that this stressed payment stream could support. Also, the structure of the amortization schedule can be varied to provide the maximum coverage for each year that the bonds are outstanding. For example, if the maximum allowable debt service amount fluctuates annually, the amortization schedule on the bonds may be adjusted to a certain extent to assist in ensuring that the annual tobacco payment revenues will cover those annual debt service amounts.

In order to further enhance the marketability of tobacco revenue bonds, two debt service schedules have been established for tobacco revenue bonds. One schedule is the required debt service mentioned earlier, which is designed to achieve a given rating based on the maximum allowable debt service. The second schedule, termed a "flexible schedule," is the planned repayment schedule, which involves a more aggressive repayment of principal on the obligations so as to reduce the amount of principal outstanding in the later, and potentially less certain, years

of the tobacco settlement payment stream. In the event tobacco settlement payments are not sufficient to meet the planned repayment schedule, the bonds may be extended to the required repayment schedule. This two schedule approach further reduces the risk to holders of long-term tobacco bond maturities, which carry the most risk. Under the flexible repayment schedule, at the time of issuance, the purchaser of the bond is made aware that the issuer intends to pay down the outstanding principal on the bond at a quicker pace than is required during the early years of the issue. The flexible repayment schedule does not require the use of all annual tobacco payments to meet debt service payments on bonds issued. As a result, residual amounts of annual tobacco settlement payments in excess of annual debt service on the bonds continue to exist.

Based on recent issues of tobacco bonds, additional security mechanisms are becoming increasingly necessary to further enhance the creditworthiness of tobacco revenue bonds. Accelerated repayment and "trapping" mechanisms have each been used in recent tobacco revenue bond issues. Under an accelerated repayment mechanism, the annual amount of tobacco settlement payments in excess of the amounts needed to meet the required annual debt service payments are used to redeem outstanding tobacco revenue bonds. Similar to the flexible amortization schedule, failure to make the accelerated payments is not considered a default. Accelerated payments are also seen as a positive credit feature for bond holders in that the payments reduce the risk associated with the uncertainty of tobacco settlement payments. In addition, because accelerated payments repay principal more quickly, the potential for federal tax questions associated with use of tax exempt bond proceeds is more limited. However, fully accelerated payments would prohibit any annual tobacco payment residuals in excess of debt service to flow back to the seller or assignor of the rights during periods that bonds remain outstanding.

Trapping mechanisms involve the holding of annual revenues in excess of debt service payments to assist in meeting future debt service payments. These mechanisms are generally triggered when certain specified events take place. For example, bonds may require revenues in excess of annual debt service to be trapped if the volume of cigarettes shipped drops below a specified percentage. This mechanism further enhances the security of tobacco bonds. However, the mechanism may reduce the annual tobacco settlement payment residuals that flow to the seller or assignor of the tobacco settlement payments.

SECTION 3

Proposed Securitization Transaction

This section of the paper describes the proposed securitization transaction outlined by the Department of Administration capital finance officials. In addition, an analysis of that transaction as well as other possible transactions that could occur is provided.

Current Law

As a participant in the Attorneys General Master Tobacco Settlement Agreement of November, 1998, the state receives settlement payments from tobacco manufacturers participating in the agreement. These settlement payments are estimated to be $155.5 million in 2001-02 and $157.6 million in 2002-03. Through 2032, these payments are projected to total $5.57 billion according to the WEFA, Inc., study, which is the leading study used by state and local governments and financial markets in analyzing the tobacco settlement payments. Effectively, all of these settlement payment revenues are deposited to the general fund, with the first $21.5 million in 1999-00 having been transferred to the tobacco control fund to fund the Tobacco Control Board's activities.

Governor's Proposal

The Governor's 2001-03 budget recommendation would allow the DOA Secretary to use the authority provided under the bill to sell, transfer or assign the state's rights to the tobacco settlement payments to the Wisconsin Health and Educational Facilities Authority (WHEFA) or to a nonstock, nonprofit corporation formed by WHEFA or the state. The bill does not specify the number of years of settlement payments the DOA Secretary would be allowed to sell, transfer or assign to the corporation. The transaction would occur in 2001-02, but would not involve the $155.5 million in 2001-02 and $157.6 million in 2002-03 projected to be received in the biennium. These funds could either be directly deposited into the general fund or flow through the permanent endowment fund and then be deposited to the general fund, depending on when in 2001-02 the proposed sale would occur. The funds provided to the Tobacco Control Board would also be unaffected by the securitization transaction.

After receiving the rights to the state's tobacco settlement payments, the corporation would use the newly-acquired revenue stream to back the issuance of revenue bonds. In return for the tobacco settlement payment revenue, the corporation would provide the state with the proceeds from those bonds. Under the budget bill, $350 million of the proceeds would be deposited to the general fund in 2001-02. Proceeds from the bonds would also be deposited to an endowment fund to be invested by the State of Wisconsin Investment Board (SWIB), if the provisions of the bill would be clarified to accomplish this intent. The bill would also require that a portion of the investment earnings of the endowment fund would flow back to the general fund annually. In

addition, the state could receive any annual residual tobacco settlement payments in excess of the annual debt service on the obligations issued and the ongoing transaction costs.

The specific details of the proposed transaction relating to the sale, transfer or assignment of the state's rights to tobacco settlement agreement revenues are not included in the bill. While the bill would establish the statutory authority necessary for the transaction to occur, the Secretary of Administration would determine the final structure of the transaction. There are many ways the proposed transaction could be structured. DOA capital finance officials provided the information on a potential model of the proposed transaction that is outlined in this section. However, they indicate that it is likely that the actual transaction may differ from this model due to the changing market environment surrounding tobacco securitizations.

According to DOA officials, the proposed securitization is the result of balancing two policy goals: (a) to maximize the amount of proceeds that can be generated from the sale of tobacco settlement revenues; and (b) to create an endowment fund that would be an asset of the state and to maximize the long-term value of that fund. In addition, the transaction would provide $350 million in revenues to the general fund in 2001-02 to meet the proposed expenditure levels under the Governor's 2001-03 biennial budget recommendations.

Tobacco Securitization Transaction. Under the transaction outlined by DOA, the state would sell, assign or transfer 30 years of rights to its annual tobacco settlement payments to a corporation created by DOA or WHEFA. Based on the goals outlined earlier, the corporation would issue a mixture of federal tax exempt and taxable revenue bonds secured by those payments in order to balance the larger proceeds amount associated with tax exempt bonds with the greater investment return potential of taxable bonds. While the exact mixture of tax exempt and taxable bonds is not known, under the transaction outlined by DOA, $676.2 million in taxable bonds and $581.0 million in federal tax exempt bonds could be issued, for a total of $1.257 billion in tobacco revenue bond proceeds. DOA indicates that the proceeds would be available for the purposes shown in Table 1.

TABLE 1

Use of Revenue Bond Proceeds
(In Millions)

Purpose	Amount
Deposit to General Fund	$350.0
Deposit to Endowment Fund	570.0
Interest Paid from Proceeds	187.9
Debt Service Reserve Trust Fund	136.7
Administrative Cost of Issuance	12.6
Total	$1,257.2

As indicated in Table 1, under the proposed transaction the state would receive $920 million in 2001-02, of which $350 million would be deposited to the general fund and $570 million would be deposited to the permanent endowment fund established under the bill. For federal tax law reasons, the $350 million in proceeds deposited to the general fund for expenditure in 2001-02 would be from tax exempt bonds. To maximize the potential investment returns to the endowment fund, proceeds from taxable bonds would make up most of the $570 million deposited to the fund. Approximately $187.9 million in proceeds would be the additional principal borrowed to capitalize the interest costs that would accrue in 2002 and 2003 when only limited debt service payments would be made. Approximately $136.7 million in proceeds would be deposited to a debt service trust fund as a reserve in the event the tobacco settlement revenues are not able to not cover the required debt service in a given year. The annual earnings on this reserve fund would be applied to debt service on the tobacco bonds each year and the remaining principal in the reserve would be applied to the last debt service payments on the bonds. Finally, $12.6 million in proceeds, or 1% of the amount of bonds issued, would be used to cover the cost to issue the bonds and would be paid to one or more financial institutions administering the transaction.

Under the proposed transaction, the state would sell or assign its rights to tobacco payments (2002-2032) to back the issuance of revenue obligations. However, only limited debt service payments would be made until 2004, so the state could continue to receive its 2001-02 and 2002-03 tobacco settlement payments. As mentioned earlier, additional principal would be borrowed to cover the interest during these first two years in which only limited debt service would be paid. The tobacco bonds would have two schedules for the payment of debt service on the obligations, which would be outlined to investors at the time of issuance: (a) a required schedule, which is the repayment schedule that must be met in order for the issuer of the 30-year bonds to avoid default; and (b) a flexible schedule, under which the issuer outlines an anticipated prepayment of outstanding principal, but would not be in default if the payment schedule is not met. Beginning in 2004, under the flexible repayment schedule, substantial prepayment of principal would occur, resulting in the bonds being retired in 2021. At the point all outstanding bonds are retired, the remaining years of tobacco settlement payments that had been sold or assigned as part of the transaction would again flow to the state.

Annual Revenues to the General Fund and Endowment Fund. In securitizing its tobacco settlement payments, the state would be reducing revenues to the general fund by the projected tobacco settlement payment amounts. However, a portion of these revenues would be replaced under the transaction outlined by DOA. In addition to the $350 million in bond proceeds deposited to the general fund in 2001-02, annual deposits to the general fund would also occur under the proposed securitization transaction as follows: (a) any "residual" amounts of tobacco settlement payment revenues in excess of the annual debt service costs on the obligations backed by those revenues and the operating expenses of the debt service reserve trust; and (b) an amount from the permanent endowment fund equal to 8.5% of the balance in the fund, plus additional amounts from investments that could be designated by the DOA Secretary.

Under the proposed securitization transaction, the cost of financing is assumed to be 10.5% on the $676.2 million in taxable bonds and 6.5% on the $581 million in federal tax exempt bonds, which would result in an overall, blended rate of financing of 8.7% on the entire amount of the bonds. The $570 million in proceeds deposited to the endowment fund are assumed to earn 10.5% on the portion associated with taxable bonds, with the portion of proceeds associated with tax exempt bonds earning 4.5%. The overall blended investment rate on bond proceeds deposited to the endowment fund would be 10.3% with most years earning 10.5%. Factored into these investment earnings to the endowment fund is the conversion of tax exempt proceeds to taxable proceeds as allowed under the de-allocation of proceeds process under federal tax law. The difference between the assumed investment rate on the proceeds (10.5% for most years) and the blended rate on the costs of financing on the obligations (8.7%) is the estimated amount that the investments in the endowment fund are expected to out-perform the cost to finance those obligations, including the transaction costs. However, under the proposal, each year 8.5% of the balance in the endowment fund would be transferred to the general fund to mitigate some of the revenue lost due to the fact that the total tobacco settlement payment amount will no longer be available to the general fund. Net of this transfer, the growth in the balance of the endowment fund would be approximately 2.0% per year, under DOA's assumption of a 10.5% annual return on the endowment fund for most years of the transaction.

The proposed transaction also assumes that the funds in the endowment fund would not be appropriated by the Legislature in future years, but rather the balance would be allowed grow. Any reduction in the amount deposited to the endowment fund or additional transfers from the endowment fund for other purposes would reduce the balance and earnings on the fund over the transaction period. Consequently, subsequent transfers equal to 8.5% of the fund balance to the general fund would also be reduced.

Table 2 illustrates the flow of funds under the securitization transaction outlined by DOA. Table 2 contains the following ten columns.

Column 1: Year -- Lists each year of the proposed transaction.

Column 2: Estimated Tobacco Payments -- The current projections of annual tobacco payments under the master settlement agreement.

Column 3: Debt Service -- Equals the annual debt service amount on the bonds issued based on the flexible repayment schedule outlined in the bond resolution.

Column 4: Operating Costs -- Equals the annual administrative costs associated with the management of the debt service reserve trust fund.

Column 5: One-Time Transfer -- Equals the one-time transfer of $350 million in tobacco bond proceeds to the general fund in 2001-02.

Column 6: Residual -- Equals the expected residual amounts of tobacco settlement payments in excess of annual debt service and operating costs associated with securitization to be deposited to the general fund each year.

Column 7: Transfer from Endowment -- Annual transfers to the general fund from the permanent endowment fund equal to 8.5% of the balance in the fund.

Column 8: Total Transfers -- Total revenues deposited to the general fund under the securitization transaction outlined by DOA.

Column 9: Earnings Less Transfers -- Equals the annual investment earnings on the fund balance less the 8.5% of the fund balance transferred to the general fund each year. Under the proposal, the assets of the fund would be invested by the State of Wisconsin Investment Board

Column 10: Fund Balance -- Equals the balance in the endowment fund after the initial deposit of $570 million and annual investment earnings, less the 8.5% annual transfer to the general fund.

Table 2 indicates that the estimated 30-year tobacco settlement payments would total $5.57 billion. Estimated payments decline after year 2003 because initial settlement payments end in that year while annual settlement payments continue. Tobacco settlement payments increase again in 2008 to reflect the receipt of 10 years of strategic settlement payments in addition to annual settlement payment amounts.

As Table 2 indicates, the cost of financing the $1.257 billion in tobacco bonds issued would total $2.423 billion, $2.409 billion in debt service costs under the flexible repayment schedule and $14.1 million in operating costs associated with the administration of the debt service reserve fund. Annual transfers to the general fund would be less than the annual tobacco payments that would otherwise be deposited to the general fund until the bonds are retired in year 2021. However, transfers to the general fund would total $5.63 billion over the 30-year period, which compares to the estimated $5.57 billion in projected tobacco settlement payments. In addition, under the transaction outlined by DOA, in the 30th year of the transaction, if the monies from the fund have not been otherwise appropriated, the state would have an endowment fund balance totaling approximately $1.12 billion.

TABLE 2

Proposed Securitization Plan
(In Millions)

Year	Tobacco Payments	Securitization Costs: Debt Service*	Securitization Costs: Operating Costs	General Fund Revenues: One-Time Transfer	General Fund Revenues: Residuals	General Fund Revenues: Transfer From Endowment	General Fund Revenues: Total Transfer	Endowment Fund: Earnings Less Transfers	Endowment Fund: Fund Balance**
2002	$155.5	$7.3	$0.5	$350.0	$155.5	$0.0	$505.5	$26.7	$596.7
2003	157.6	7.3	0.5	0.0	157.6	0.0	157.6	56.3	653.0
2004	131.6	112.9	0.5	0.0	18.1	56.0	74.2	6.4	659.4
2005	133.0	114.2	0.6	0.0	18.3	56.7	75.0	7.6	667.0
2006	134.8	114.6	0.6	0.0	19.6	57.4	77.0	8.5	675.4
2007	136.6	116.1	0.6	0.0	19.8	58.2	78.1	9.4	684.8
2008	162.6	138.6	0.6	0.0	23.4	59.1	82.5	10.5	695.4
2009	164.9	140.6	0.6	0.0	23.7	60.1	83.9	12.1	707.4
2010	167.1	142.4	0.7	0.0	24.0	61.3	85.3	13.9	721.3
2011	169.5	143.2	0.7	0.0	25.7	62.5	88.2	14.4	735.7
2012	171.9	145.2	0.7	0.0	26.0	63.8	89.8	14.7	750.4
2013	174.2	147.1	0.7	0.0	26.3	65.1	91.4	15.0	765.4
2014	176.4	149.0	0.8	0.0	26.6	66.4	93.0	15.3	780.7
2015	178.6	150.8	0.8	0.0	27.0	67.7	94.6	15.6	796.4
2016	181.1	151.6	0.8	0.0	28.7	69.0	97.7	15.9	812.3
2017	183.6	153.7	0.8	0.0	29.1	70.4	99.5	16.2	828.5
2018	180.9	151.4	0.9	0.0	28.7	71.8	100.5	16.6	845.1
2019	183.4	153.5	0.9	0.0	29.0	73.3	102.3	16.9	862.0
2020	185.7	155.4	0.9	0.0	29.4	74.7	104.1	17.2	879.3
2021	188.2	13.8	0.9	0.0	173.5	76.2	249.7	17.6	896.8
2022	190.8	0.0	0.0	0.0	190.8	77.8	268.5	17.9	914.8
2023	193.4	0.0	0.0	0.0	193.4	79.3	272.7	18.3	933.1
2024	196.1	0.0	0.0	0.0	196.1	80.9	277.0	18.7	951.7
2025	199.0	0.0	0.0	0.0	199.0	82.5	281.5	19.0	970.8
2026	201.9	0.0	0.0	0.0	201.9	84.2	286.1	19.4	990.2
2027	204.9	0.0	0.0	0.0	204.9	85.8	290.7	19.8	1,010.0
2028	207.9	0.0	0.0	0.0	207.9	87.6	295.5	20.2	1,030.2
2029	211.0	0.0	0.0	0.0	211.0	89.3	300.3	20.6	1,050.8
2030	214.2	0.0	0.0	0.0	214.2	91.1	305.3	21.0	1,071.8
2031	217.3	0.0	0.0	0.0	217.3	92.9	310.3	21.4	1,093.2
2032	220.5	0.0	0.0	0.0	220.5	94.8	315.3	21.9	1,115.1
Total	$5,574.3	$2,408.9	$14.1	$350.0	$3,167.0	$2,116.1	$5,633.0	$545.1	$1,115.1

*Limited debt service payments would be made from the debt service reserve fund in the first two years.
**Endowment fund balance in the first year equals $570 million in bond proceeds plus one-half year of earnings.

Comparison of Current Law to Securitization

Cash Flow Comparisons. In analyzing the securitization transaction, a comparison of the total cash flows available to the state under the proposed transaction and under current law is useful. In addition, a comparison of the net present value of the two cash flow streams is also relevant. Table 3 compares the total cash flows and the net present value of those cash flows under the proposed securitization transaction and under current law. For the purposes of calculating the net present value of the two cash flow streams, an annual discount rate of 8.7% is applied. This rate is equal to the blended rate on the taxable and tax exempt bonds backed by the projected tobacco payments, which could be considered the market value of those payments.

TABLE 3

DOA Scenario for Proposed Securitization Plan
Comparison of Cash Flows
(In Millions)

	Total Cash Flow	Net Present Value
Proposal		
Proceeds Deposited to General Fund	$350.0	$350.0
Annual Transfer to General Fund	2,116.1	582.0
Annual Residuals	3,167.0	745.6
Endowment Fund Balance	1,115.1	84.0
Total	$6,748.1	$1,761.6
Current Law		
Tobacco Payments	$5,574.3	$1,743.7
Difference	$1,173.9	$17.9

As indicated in Table 3, the total funds made available to the state after the 30-year transaction would be $1,173.9 million higher than under the current projections of the tobacco payments for that period. The net present value of the proposed securitization would be an estimated $17.9 million greater than the net present value of the current projections of annual tobacco settlement payments. Again, these figures are derived using DOA's assumptions that: (a) SWIB will annually out-perform the 8.7% blended rate cost of financing the tobacco revenue bonds; and (b) that the funds deposited to the endowment fund would not be appropriated by the Legislature in future years, but rather the balance would be allowed to grow to a level of $1.12 billion.

Lower annual investment returns or annual returns on a lower endowment fund balance if funds would be appropriated from the endowment fund would impact this analysis. To illustrate this effect, Table 4 presents a hypothetical example where the endowment fund would be

expended in 2005. As indicated in Table 4, if all of the proceeds derived from securitizing the state's tobacco payments would be expended by 2005, the net present value and total cash flows to the state under the proposed securitization would be significantly less than the net present value and total cash flows to the state under the current tobacco settlement payment stream. Under this example, only two years of transfers from the endowment fund to the general fund would occur, before the endowment fund balance, plus any investment earnings to the fund, would be expended by the end of 2005.

TABLE 4

Hypothetical Example Where Endowment Fund is Expended at End of 2005
Comparison of Cash Flows
(In Millions)

	Total Cash Flow	Net Present Value
Example		
Proceeds Deposited to General Fund	$350.0	$350.0
Annual Transfers From Endowment Fund	112.7	84.2
Annual Residuals	3,167.0	745.6
Endowment Fund Balance	667.0	477.7
Total	$4,296.7	$1,657.6
Current Law		
Tobacco Payments	$5,574.3	$1,743.7
Difference	-$1,277.6	-$86.1

Impact of Proposal on the General Fund. Under the proposed securitization, the rights to the tobacco settlement payments would be sold or assigned and the settlement payments would no longer be available in the amounts currently projected for deposit into the general fund. While the securitization proposal would provide the state an asset in the form of an endowment fund, which would provide revenue to the general fund each year, the transaction would reduce estimated general fund revenues for several biennia. The general fund would only receive revenues equal to 8.5% of the proposed endowment fund assets plus any residual tobacco payment amounts in excess of annual debt service payments on the revenue bonds. Table 5 indicates the estimated impact to the general fund over the life of the transaction. These reduced revenues would be offset by the $1.12 billion endowment fund created under the proposal.

TABLE 5

Impact of Tobacco Securitization
Proposal on General Fund Revenues
($ in Millions)

Biennium	Proposed Securitization	Current Law	Difference	Cumulative Difference
2001-03	$663.1	$313.1	$350.0	$350.0
2003-05	149.2	264.6	-115.5	234.6
2005-07	155.1	271.4	-116.3	118.3
2007-09	166.4	327.6	-161.2	-42.9
2009-11	173.5	336.6	-163.1	-206.0
2011-13	181.2	346.1	-164.9	-370.9
2013-15	187.7	355.0	-167.3	-538.2
2015-17	197.2	364.7	-167.5	-705.7
2017-19	202.8	364.3	-161.5	-867.2
2019-21	353.8	373.9	-20.1	-887.3
2021-23	541.3	384.2	157.1	-730.2
2023-25	558.5	395.1	163.4	-566.8
2025-27	576.8	406.8	170.0	-396.8
2027-29	595.8	418.9	176.9	-219.9
2029-31	615.5	431.5	184.0	-35.9
2031-32*	315.3	220.5	94.8	58.9

*Includes only first year of 2031-33 biennium, or the 30th year of transaction.

As indicated in Table 5, after the 2001-03 biennium, estimated revenues to the general fund would be reduced during each biennium through the 2019-21 biennium, which is when the tobacco bonds are expected to be repaid. Specifically, general fund revenues would be reduced by $115.5 million in the 2003-05 biennium. Once the bonds are repaid, estimated revenues to the general fund would exceed projected tobacco payments because the state would regain its rights to the annual tobacco payment amounts and 8.5% of the endowment fund assets would continue to be transferred each year. However, as indicated in Table 5, the general fund would not have fully recouped the loss in revenues until the 2031-33 biennium, or the 30th year of the transaction.

Continued Risk to the State. Under current law, the state faces the full risk associated with potential declines in tobacco settlement payments. As proposed, the state would continue to face some risk associated with declining tobacco settlement payments. Under securitization, each dollar decline in annual tobacco payments would reduce the revenues to the state by a dollar up to the point that payments fall below the required debt service amounts. Before the state's risk associated with its tobacco payments would be reduced, those payments would have to decline by: (a) the amount of annual residuals in excess of the flexible debt service schedule shown in

Table 2; and (b) an amount in excess of the annual debt service amounts under the required 30-year debt service schedule. For example, in 2005, revenues would have to decline by more than $30.2 million (22.7%) before the risk to the state associated with the tobacco payments would be reduced. This equals the $18.1 million in residuals in excess of the flexible debt service payments, plus an additional $12.1 million in tobacco payments in excess of the debt service amounts under the required 30-year debt service schedule. The holders of the tobacco bonds would first incur losses if annual tobacco payments would fall below the debt service amounts required under the 30-year debt service schedule outlined in the obligation resolution. After all debt service on the bonds is paid, the state would again assume all the risk associated with the annual tobacco settlement payment revenues.

The state would also continue to face some unpredictability associated with the flow of revenues to the general fund from the endowment fund under the proposed transaction. Under the proposed transaction, the endowment fund assets would be invested in stock market equities and other investments similar to SWIB's fixed or variable trusts. The scenarios prepared for DOA use the assumption that the fund would earn 10.5% each year for most years of the transaction. SWIB has earned 12.8% on its fixed trust fund and 13.9% on its variable trust fund over the past 20 years. However, over the last ten years, annual rates of return on the fixed trust fund have ranged from 3.8% to 18.9% while annual rates of return have ranged between 2.9% and 25.0% on the variable trust fund. In addition, past performance does not guarantee future returns. While the potential return on stock market investments can be significantly higher than cash investments or governmental holdings, such investments are susceptible to annual fluctuations. The timing of these fluctuations could have an effect on the amount of the funds transferred to the general fund under the proposal. For example, if the fund, on average, earns DOA's assumed rate of return, extended down periods for investments, in particular in the early years, could impact the balance in the endowment fund and the annual transfer of funds to the general fund. Budgeting for these anticipated revenues could be difficult for subsequent Legislatures.

Lastly, while legally the state may have no obligation to bondholders if tobacco settlement payments do not cover the required debt service amounts, politically and financially the state may choose to make good on the bonds. As a result, the state could have the same amount of risk that is associated with the current tobacco settlement payments.

Securitization with Prepayment of Principal

Due to potential federal tax concerns and to enhance the marketability of obligations backed by the state's tobacco payments, it is possible that accelerated prepayment of principal may be required under securitization. This prepayment mechanism could require that all annual tobacco payment residuals in excess of scheduled debt service payments be used to pay down the outstanding principal on the bonds secured by the tobacco payments. As a result, no residual tobacco payment amounts would flow to the general fund until all outstanding principal on the bonds is repaid. Table 6 indicates the cash flows under a securitization transaction involving a full prepayment of principal.

TABLE 6

Accelerated Prepayment Securitization Scenario
(In Millions)

		Securitization Costs		General Fund Revenues				Endowment Fund	
Year	Tobacco Payments	Debt Service*	Operating Costs	One-Time Transfer	Residuals	Transfer From Endowment	Total Transfer	Earnings Less Transfers	Fund Balance
2002	$155.5	$7.3	$0.5	$350.0	$155.5	$0.0	$505.5	$26.7	$596.7
2003	157.6	7.3	0.5	0.0	157.6	0.0	157.6	56.3	653.0
2004	131.6	131.0	0.5	0.0	0.0	56.0	56.0	6.4	659.4
2005	133.0	132.5	0.6	0.0	0.0	56.7	56.7	7.6	667.0
2006	134.8	134.2	0.6	0.0	0.0	57.4	57.4	8.5	675.4
2007	136.6	136.0	0.6	0.0	0.0	58.2	58.2	9.4	684.8
2008	162.6	162.0	0.6	0.0	0.0	59.1	59.1	10.5	695.4
2009	164.9	164.3	0.6	0.0	0.0	60.1	60.1	12.1	707.4
2010	167.1	166.5	0.7	0.0	0.0	61.3	61.3	13.9	721.3
2011	169.5	168.8	0.7	0.0	0.0	62.5	62.5	14.4	735.7
2012	171.9	171.2	0.7	0.0	0.0	63.8	63.8	14.7	750.4
2013	174.2	173.4	0.7	0.0	0.0	65.1	65.1	15.0	765.4
2014	176.4	175.6	0.8	0.0	0.0	66.4	66.4	15.3	780.7
2015	178.6	177.8	0.8	0.0	0.0	67.7	67.7	15.6	796.4
2016	181.1	55.0	0.8	0.0	125.3	69.0	194.4	15.9	812.3
2017	183.6	0.0	0.0	0.0	183.6	70.4	254.0	16.2	828.5
2018	180.9	0.0	0.0	0.0	180.9	71.8	252.8	16.6	845.1
2019	183.4	0.0	0.0	0.0	183.4	73.3	256.6	16.9	862.0
2020	185.7	0.0	0.0	0.0	185.7	74.7	260.4	17.2	879.3
2021	188.2	0.0	0.0	0.0	188.2	76.2	264.5	17.6	896.8
2022	190.8	0.0	0.0	0.0	190.8	77.8	268.5	17.9	914.8
2023	193.4	0.0	0.0	0.0	193.4	79.3	272.7	18.3	933.1
2024	196.1	0.0	0.0	0.0	196.1	80.9	277.0	18.7	951.7
2025	199.0	0.0	0.0	0.0	199.0	82.5	281.5	19.0	970.8
2026	201.9	0.0	0.0	0.0	201.9	84.2	286.1	19.4	990.2
2027	204.9	0.0	0.0	0.0	204.9	85.8	290.7	19.8	1,010.0
2028	207.9	0.0	0.0	0.0	207.9	87.6	295.5	20.2	1,030.2
2029	211.0	0.0	0.0	0.0	211.0	89.3	300.3	20.6	1,050.8
2030	214.2	0.0	0.0	0.0	214.2	91.1	305.3	21.0	1,071.8
2031	217.3	0.0	0.0	0.0	217.3	92.9	310.3	21.4	1,093.2
2032	220.5	0.0	0.0	0.0	220.5	94.8	315.3	21.9	1,115.1
Total	$5,574.3	$1,963.1	$9.7	$350.0	$3,617.2	$2,116.1	$6,083.3	$545.1	$1,115.1

*Limited debt service payments would be made from the debt service reserve fund in the first two years.

As indicated in Table 6, prepaying principal would reduce the overall debt service and operating costs compared to the transaction outlined by DOA shown in Table 2. In addition, the overall transfers to the general fund under this scenario would be greater over the 30-year period. This occurs because the outstanding principal on the tobacco bonds would be repaid in 2016, which results in the state regaining its right to the full annual tobacco settlement payments four years earlier than under the proposed transaction. In addition, similar to the transaction outlined by DOA, the 8.5% transfer from the endowment fund would be deposited to the general fund throughout the transaction.

While the overall debt service and transaction costs would be reduced because outstanding principal on the bonds would be repaid earlier, this scenario assumes the same financing rate on the tax exempt and taxable obligations as the transaction outlined by DOA. In addition, it is assumed that the same amount of funds would be deposited to the endowment fund and no funds would be appropriated from the endowment fund by this or subsequent Legislatures. Therefore, the size of the endowment fund in the 30th year and the annual amounts transferred from the endowment fund would not be affected by the prepayment requirement.

While using all available annual tobacco payment revenues to prepay principal would result in more cash flows to the state over the 30-year period, no annual tobacco payment residuals would be available for deposit to the general fund through 2015. Table 7 indicates the impact that securitizing the state tobacco settlement payments would have on the general fund in each biennium of the transaction if an accelerated prepayment of principal would be required.

TABLE 7

Impact of Accelerated Prepayment Securitization on General Fund Revenues
($ in Millions)

Biennium	Proposed Securitization	Current Law	Difference	Cumulative Difference
2001-03	$663.1	$313.1	$350.0	$350.0
2003-05	112.7	264.6	-151.9	198.1
2005-07	115.6	271.4	-155.7	42.4
2007-09	119.2	327.6	-208.3	-166.0
2009-11	123.8	336.6	-212.8	-378.8
2011-13	128.8	346.1	-217.2	-596.0
2013-15	134.1	355.0	-220.9	-816.9
2015-17	448.4	364.7	83.7	-733.2
2017-19	509.4	364.3	145.1	-588.1
2019-21	524.9	373.9	151.0	-437.2
2021-23	541.3	384.2	157.1	-280.1
2023-25	558.5	395.1	163.4	-116.7
2025-27	576.8	406.8	170.0	53.3
2027-29	595.8	418.9	176.9	230.2
2029-31	615.5	431.5	184.0	414.2
2031-33*	315.3	220.5	94.8	509.0

*Includes only first year of 2031-33 biennium, or the 30th year of the transaction.

As indicated in Table 7, revenues to the general fund would be reduced by $816.9 million through 2013-15. This compares to a $538.2 million reduction through the same period under the transaction outlined by DOA shown in Table 5. In the 2003-05 biennium alone, revenues to the general fund would be reduced by $151.9 million, or an additional $36.4 million reduction compared to the transaction outlined by DOA.

However, because the total debt service and transaction costs would be less under a transaction that requires prepayment of principal, the larger losses in general fund revenues in the early years of the transaction would be more than recouped in the later years of the transaction. Also, despite the greater reduction in revenues to the general fund until all outstanding principal is repaid, the larger annual transfers to the general fund after that point results in a cash flow stream that is more beneficial to the state on a present value basis than the transaction outlined by DOA.

Other Scenarios

A wide array of possible securitization transactions exists. As mentioned earlier, market conditions and federal tax law concerns will impact the exact structure of the securitization carried out under the enabling provisions contained in the bill. However, the decision of whether or not to create an endowment fund and to allow the value of the fund to grow will also be an important factor in determining the type of securitization transaction that occurs. In general, any proposal that would create an endowment fund that is intended to grow over time would require a determination to be made on the optimal balance between federal tax exempt bonds, which generate more initial proceeds, and the taxable bonds, which allow potentially higher returns to the fund. The impact to the general fund in future biennia would also vary depending on the amount of initial proceeds deposited to the endowment fund. Under the bill, the final determination on the structure of the transaction, and consequently the size of the endowment fund, would be made by the Governor and the DOA Secretary. However, any budgetary decisions made by the Legislature that impact the amount available for deposit to the endowment fund would have an impact on the type of options available to the Secretary.

Endowment Fund. If an endowment fund would be created as provided in the bill, the securitization transaction would likely be some variation of the transaction discussed earlier. Any decision to deposit more than $570 million in bond proceeds in the endowment fund would mean that less funds would be available for deposit to the general fund in this biennium. However, the amount of the annual loss in revenue to the general fund in subsequent years would be reduced, because the larger fund balance would result in larger transfers to the general fund each year.

Conversely, if more than $350 million of the securitization proceeds would be spent in the 2001-03 biennium, less funds would be available for deposit in the endowment fund. Under this scenario, because the endowment balance would be smaller, fewer funds would be available for the annual transfers from the endowment fund to the general fund. This scenario would result in

a larger reduction in revenues to the general fund beginning in 2003-04 than under the Governor's proposal.

Another option would be to increase the amount of the endowment fund earnings that would be transferred to the general fund each year. This would reduce the impact of the securitization on the general fund in subsequent years. For example, the bill could be amended to require the transfer of 10% of the balance in the endowment fund to the general fund rather than just 8.5%. This option would mean that the balance in the endowment fund would not grow much beyond the amount of bond proceeds initially deposited to the fund.

No Endowment Fund. If the decision would be made to not create an endowment fund, it is likely that the transaction would be entirely funded with federal tax exempt bonds. Funding such a transaction with taxable bonds would not be in the state's financial interest. While taxable bonds could be used, significantly less proceeds would be generated and higher financing costs would result compared to tax exempt bonds. Also, because no funds would be available for investment, there would be no need for the higher investment earning potential of taxable bond proceeds.

If no endowment fund would be created, more bond proceeds could be used in the 2001-03 biennium or the size of the securitization transaction could be down-sized. However, the amount of tax exempt bond proceeds that would be allowed to be used in the 2001-03 biennium may be limited more by the state's ability to use those proceeds than by the projected amount of tobacco settlement payments. Under federal regulations, if the tax exempt proceeds are not used to fund an endowment fund, the proceeds would have to be expended immediately for "working capital" or cash funded capital projects. While the amount of such projects is limited, the administration, in depositing $350 million in tax exempt bond proceeds from tobacco securitization in the general fund in 2001-02 has assumed that $350 million of such projects exist.

If the state were to securitize its tobacco payments in an amount necessary to fund only $350 million in working capital projects in 2001-02, it is estimated that the state would have to forego approximately $467.5 million in projected tobacco settlement revenues from 2003-04 to 2007-08 to finance the transaction. While such a transaction would provide the general fund with revenues that would be sufficient to meet the Governor's budgeted expenditure level in the current biennium, the transaction could reduce revenues to the general fund by an estimated $264.6 million in the next biennium. Using securitization bond proceeds to fund a larger amount of working capital projects in the 2001-03 biennium would increase the number of years that tobacco payments would be needed to repay the bonds.

Creation of Health Trust Fund Without Securitization. This option is intended to outline a proposal that is consistent with public testimony offered by the State Attorney General and others relating to earmarking tobacco settlement monies for some years for deposit to a separate health-related trust fund. Under this alternative, the tobacco securitization proposal would be deleted from the bill. Instead, tobacco settlement payments for the next eight years (fiscal years 2001-02 through 2008-09) would be deposited in a health trust fund. These monies

would be invested by SWIB. Beginning in year ten (2010-11), payments for health related programs would be made from this trust fund. After an initial payment of $180 million in 2010-11, these payments could be set at $200 million annually without impairing the balance of the proposed health trust fund. Table 8 identifies the cash flows under a proposal to create a health trust fund. For purposes of the estimates presented in Table 8, an average annual 10.5% rate of return is used to calculate the annual earnings on the balances of the trust fund.

As indicated in Table 8, allocating eight years of tobacco settlement revenues to a trust fund would allow the accumulation of an approximate $1.9 billion balance in that fund that would support $200 million of annual spending in perpetuity, beginning in 2010-11 at a somewhat lower rate of expenditure. Table 9 compares the total cash flows and net present value of those cash flows under this option and under current law. For purposes of calculating net present value, an annual discount rate of 8.7% is applied.

TABLE 8

Scenario to Create Health-Related Trust Fund
($ in Millions)

Year	Tobacco Payments	General Fund Revenues	Trust Fund Revenues, Expenditures and Balance: Transfers In	Earnings	Payments Out	Fund Balance
2002	$155.5	$0.0	$155.5	$0.0	$0.0	$155.5
2003	157.6	0.0	157.6	16.3	0.0	329.4
2004	131.6	0.0	131.6	34.6	0.0	495.6
2005	133.0	0.0	133.0	52.0	0.0	680.7
2006	134.8	0.0	134.8	71.5	0.0	886.9
2007	136.6	0.0	136.6	93.1	0.0	1,116.7
2008	162.6	0.0	162.6	117.2	0.0	1,396.5
2009	164.9	0.0	164.9	146.6	0.0	1,708.0
2010	167.1	167.1	0.0	179.3	0.0	1,887.4
2011	169.5	169.5	0.0	198.2	180.0	1,905.6
2012	171.9	171.9	0.0	200.1	200.0	1,905.6
2013	174.2	174.2	0.0	200.1	200.0	1,905.7
2014	176.4	176.4	0.0	200.1	200.0	1,905.8
2015	178.6	178.6	0.0	200.1	200.0	1,905.9
2016	181.1	181.1	0.0	200.1	200.0	1,906.1
2017	183.6	183.6	0.0	200.1	200.0	1,906.2
2018	180.9	180.9	0.0	200.2	200.0	1,906.4
2019	183.4	183.4	0.0	200.2	200.0	1,906.5
2020	185.7	185.7	0.0	200.2	200.0	1,906.7
2021	188.2	188.2	0.0	200.2	200.0	1,906.9
2022	190.8	190.8	0.0	200.2	200.0	1,907.1
2023	193.4	193.4	0.0	200.2	200.0	1,907.4
2024	196.1	196.1	0.0	200.3	200.0	1,907.7
2025	199.0	199.0	0.0	200.3	200.0	1,908.0
2026	201.9	201.9	0.0	200.3	200.0	1,908.3
2027	204.9	204.9	0.0	200.4	200.0	1,908.7
2028	207.9	207.9	0.0	200.4	200.0	1,909.1
2029	211.0	211.0	0.0	200.5	200.0	1,909.5
2030	214.2	214.2	0.0	200.5	200.0	1,910.0
2031	217.3	217.3	0.0	200.6	200.0	1,910.6
2032	220.5	220.5	0.0	200.6	200.0	1,911.2
TOTAL	$5,574.2	$4,397.6	$1,176.6	$5,114.6	$4,380.0	$1,911.2

TABLE 9

Proposal for Health-Related Trust Fund
Comparison of Cash Flows
($ in Millions)

Proposal	Total Cash Flow	Net Present Value
Tobacco Payments	$4,397.6	$922.6
Health Expenditures from Trust Fund	4,380.0	903.2
Health Trust Fund Balance	1,911.2	143.9
Total	$10,688.8	$1,969.7
Current Law		
Tobacco Payments	$5,574.3	$1,743.7
Difference	$5,114.5	$226.0

As presented in Table 9, the total funds made available to the state by 2032 would be $5,114.5 million higher than under current projections of the tobacco payments for that period. In addition, the net present value would be $226.0 million greater than the net present value of the current projections of annual tobacco settlement payments. These figures are derived using the assumptions that: (a) SWIB will annually earn 10.5%; and (b) that the funds deposited to the health trust fund would not be appropriated at a greater level than shown in Table 8, so that the trust fund balance could reach and maintain a $1.9 billion balance.

Under the proposed creation of a health trust fund, tobacco settlement payments would be deposited in a separate segregated fund and would no longer be available for deposit in the general fund over the next eight years. While the proposal would provide the state an asset in the form of the balance of the trust fund, the proposal would reduce general fund revenues for several biennia. Table 10 shows the estimated impact on the general fund through 2031-32. Expenditures from the proposed trust fund are shown as if they are transferred to the general fund.

TABLE 10

Impact of Proposed Health Trust Fund on General Fund Revenues
($ in Millions)

Biennium	Under Proposed Trust Fund	Under Current Law	Difference	Cumulative Difference
2001-03	$0.0	$313.1	-$313.1	-$313.1
2003-05	0.0	264.6	-264.6	-577.7
2005-07	0.0	271.4	-271.4	-849.1
2007-09	0.0	327.6	-327.6	-1,176.7
2009-11	516.6	336.6	180.0	-996.7
2011-13	746.1	346.1	400.0	-596.7
2013-15	755.0	355.0	400.0	-196.7
2015-17	764.7	364.7	400.0	203.3
2017-19	764.3	364.3	400.0	603.3
2019-21	773.9	373.9	400.0	1,003.3
2021-23	784.2	384.2	400.0	1,403.3
2023-25	795.1	395.1	400.0	1,803.3
2025-27	806.8	406.8	400.0	2,203.3
2027-29	818.9	418.9	400.0	2,603.3
2029-31	831.5	431.5	400.0	3,003.3
2031-33*	420.5	220.5	200.0	3,203.3

*Includes only first year of 2031-33 biennium.

As indicated in Table 10, estimated revenues to the general fund would be reduced during each biennium through the 2007-09 biennium, which is when the proposed trust fund would be funded. In the 2001-03 biennium, revenues would be reduced by $313.1 million from current law (-$663.1 million compared to the revenues under the securitization proposal in the 2001-03 budget bill). Once the trust fund has accumulated a balance of $1.9 billion, estimated revenues to the general fund and for health program expenditures would exceed projected tobacco payments. The general fund would have fully recouped the loss in revenues by the 2015-17 biennium, and would have received an additional $3.2 billion by 2031-32.

SECTION 4

Tobacco Securitization Issues

This section of the paper outlines some the major policy issues surrounding the Governor's proposal to securitize the state's tobacco settlement payments. It also identifies some technical modifications to the proposal.

Should Revenues of State be Securitized?

Under the proposed securitization, the lump sum payment amount received by the state would be not equal to the discounted present value of the tobacco settlement payment stream being sold, but rather it would be the amount of bond proceeds that could be generated by issuing bonds secured by that revenue stream. So, in effect, through a third party corporation, the state would be using its tobacco settlement payment revenue stream to back the issuance of bonds. The proposed securitization of the tobacco payments is somewhat similar to the state's other revenue obligation programs in which it is using future payment streams to fund current program activities. For example, the state uses the payment stream from annual motor vehicle registration fees to fund the transportation revenue bond program.

However, one of the potential advantages that has been identified associated with the proposed securitization of tobacco payments is that unlike the state's other revenue bond programs, the state may have no liability in the event tobacco payments do not adequately back the obligations issued. It is believed that investors in tobacco obligations issued by the proposed bankruptcy-remote corporation would have no recourse back to the state. As a result, the state would be limiting its risk against future reductions in tobacco settlement payments.

While the state would not be providing any moral obligation associated with the tobacco bonds issued under securitization, the contention that the settling states or local government would be free from liability has yet to be legally tested. In addition, even if the state would have no legal responsibility, having bonds in default that are effectively tied to the state's rights to tobacco settlement payments could be perceived as harmful to the state's financial reputation. As indicated in a National Governor's Association issue paper on tobacco securitization, it is conceivable that states would be politically compelled to repay bondholders regardless of whether the state is legally committed to do so. If the state would choose to pay investors in the tobacco securitization bonds if revenues proved inadequate, securitization may not reduce any of the state's risk associated with future tobacco settlement payments.

Another difference between the state's other revenue bond programs and the proposed tobacco securitization exists. The state's other revenue bond programs are generally used to fund projects that result in long-term assets to the state like roads in the case of transportation revenue bonds, petroleum site cleanups in the case of PECFA bonds and local water facilities and treatment plants in the case of the clean water fund program. While a portion of the tobacco

securitization proceeds would be used to create a long-term asset in the form of an endowment fund, $350 million of the proceeds would be used to fund current operating expenditures in the Governor's proposed 2001-03 biennial budget. Therefore, unlike the other programs, the proposed securitization, in part, involves borrowing against a future revenue stream to pay current expenses. Further, any reduction in the size of the endowment fund to provide an increase in the amount of tobacco securitization proceeds available for additional 2001-03 spending or tax reductions would make the proposal even more distinct from the state's other revenue bond programs.

The decision to securitize the state's tobacco payments is also similar to the state's general fund supported general obligation borrowing program. The Legislature, by authorizing general fund supported borrowing, is pledging future general fund revenues to pay the debt service on those obligations. However, unlike general obligation bonds, which pledge all state revenues, tobacco securitization is pledging a specific revenue source that is deposited to the general fund. Therefore, the tobacco securitization proposal may be seen as a setting a precedent for securitizing other portions of the state's general fund revenues.

Lastly, because the financing rate on the state's general obligation bonds would be significantly lower than the 8.7% blended rate on the tobacco bonds under securitization, the question arises as to whether the state could use general obligation bonds to fund the $350 million needed in the 2001-03 biennium. The State Constitution limits the use of general obligation borrowing to specific public purposes, largely relating to capital projects. Therefore, general obligation bonds could not be used to directly fund the $350 million in operating deficits in 2001-02 proposed to be funded with securitization proceeds.

Impact of Securitization on Future Legislatures. Under the tobacco securitization proposal, the state would receive $350 million in additional general fund revenues in 2001-02 to help fund the proposed general fund expenditure levels in the 2001-03 biennium. However, annual general fund revenues to the state beyond the 2001-03 biennium would be reduced each year until tobacco bonds issued under securitization would be repaid. Unlike ongoing GPR spending commitments, which reduce available general fund revenues, or ongoing general fund tax reductions, which reduce the receipt of general fund revenues, these future reductions in general fund revenues associated with tobacco securitization could not be undone by subsequent Legislatures. That is, if this Legislature enacts a general fund spending increase or a general fund tax reduction, subsequent Legislatures could revisit those taxing and spending decisions. Under tobacco securitization, subsequent Legislatures could not revisit the decision to forego the ongoing revenues from tobacco settlement payments for one-time funding in the 2001-03 biennium and to establish an endowment fund. Those revenues would be pledged to the pay back the tobacco bonds.

Use of Securitization Proceeds To Establish an Endowment Fund

Aside from the one-time deposit to the general fund to address the current budget, DOA officials indicate that the primary policy reason for proposing securitization of tobacco payments would be to establish an endowment fund that could be viewed an asset to the state and could

provide a better margin of safety to the general fund in the event of an economic downturn. Because the proposed securitization would involve a corporation remote from the state issuing the obligations secured by the state's tobacco settlement payments, DOA officials believe the state could list the bond proceeds deposited to the endowment fund as an asset on the state's balance sheet without showing the liability associated with the debt service on the bonds.

DOA indicates that such an accounting of these funds would allow the state to offset a portion of the state's annual accounting deficit under generally accepted accounting principles (GAAP), which is projected to be $1.4 billion at the end of 2000-01. This would occur because the asset created under the transaction (the endowment fund) could be viewed as an offset to the GAAP deficit, while the liability created under the transaction (the other entity's bonds) would not be shown on the state's balance sheet. Currently, only Wisconsin and Illinois carry an annual GAAP deficit. This annual GAAP deficit primarily reflects the state's year end general fund balance less any known funding commitments at fiscal year end, that are to be paid in the subsequent fiscal year. In recent years, the year end general fund balances have been unable to offset these commitments which has resulted in a GAAP deficit. This GAAP accounting measure is different than the state's statutory basis of accounting which is used for budget purposes, and from the structural balance measure (projected at a $558 million deficit for 2000-01), which equals annual revenues over expenditures. These measures are interrelated in that a budgetary structural deficit increases the likelihood of lower fiscal year ending balances, which is the starting point for GAAP accounting.

Compared with other state's, Wisconsin has a low required statutory balance, which is equal to 1.2% of GPR expenditures in 2000-01. The state also has no rainy day fund available in the event of an economic downturn. All these factors are significant in determining Wisconsin's creditworthiness in the investment markets. While the state has not been downgraded in its bond rating because of these factors, all three major rating agencies have expressed credit concerns associated with the state's financial position. One rating agency (Moody's), recently listed the state's GAAP and structural deficits, low general fund ending balances and lack of rainy day funds as factors in revising the outlook on its current rating for Wisconsin general obligation bonds from stable to negative. Another (Standard and Poors) has indicated that the gradual accumulation of financial reserves will be a primary determinant in future rating actions of the state by that agency. If a rating downgrade occurs, the state could lose its short-term commercial paper borrowing program, which takes advantage of low, short-term borrowing rates, which could increase the state's debt financing costs. In addition, higher annual general fund debt service payments on future general obligation bond issues could result.

The existence of an endowment fund would likely improve the state's annual financial statements and could be viewed as a positive factor for the state's position in the investment markets. In addition, under the DOA scenario, the endowment fund would be a long-term source of general fund revenues that would be transferred from the endowment fund to the general fund each year. These annual revenues would mitigate some of the loss in general fund revenues prior to the tobacco bonds being repaid, at which point the general fund would be better off on an annual basis by these revenues from the endowment fund. However, this scenario relies on the

assumptions that the fund would earn around 10.5% annually and that the assets in the endowment fund would not be appropriated for other purposes.

Conversely, rating agencies also note that Wisconsin's has a diversified economy and a low debt burden, both of which enhance the state's creditworthiness. In addition, despite no "rainy day" fund or other substantial general fund reserves, over the past few years state bond issues have been viewed as strong investments. This has been illustrated in the market for the past few years, where the state's bond issues, although rated AA, have consistently received financing rates similar to those received by issuers in the AA+ or AAA rating categories.

The timing of the proposed endowment fund coincides with a projected decline in state general fund revenues in 2000-01, perhaps accentuating the need for the fund. However, as indicated in the following table, while the state has had strong annual growth in general fund revenues over the past six years, the Legislature is being asked to establish a long term endowment fund through securitization during a fiscal year when general fund revenues are projected to decline.

	Total General Fund Revenues	Annual Percent Change
1994-95	$7,945,630,000	
1995-96	8,346,413,000	5.0%
1996-97	8,954,625,400	7.3
1997-98	9,962,419,100	11.3
1998-99	10,113,690,000	1.5
1999-00	11,387,296,000	12.6
2000-01*	10,487,846,100	-7.9

*Projected; reflects effects of tax reductions in tax year 2000.

Lastly, while the need for an endowment fund may exist, creating that fund through securitizing the state's tobacco payments could be viewed as borrowing against those future tobacco payment revenues for the purpose of saving now. In addition, under the proposal, the state would be foregoing most of its tobacco settlement payment stream for the next 20 years to assist in this savings plan. Whether the state should borrow today and forego future revenues to create an endowment fund is a policy issue facing the Legislature. Furthermore, under the proposal, the state would be speculating that SWIB could outperform the cost of this borrowing. Whether or not it is a role of the state government to be involved in borrowing against future revenues with the intention of investing those funds and receiving higher returns is also a policy issue facing the Legislature under this proposal.

Financing with Securitization Revenues. Under the proposed securitization, $350 million in revenues would be deposited to the general fund in 2001-02 to assist in funding the proposed GPR expenditure levels under the Governor's 2001-03 budget bill. However, annual tobacco payment revenues would no longer be deposited to the general fund to assist in supporting ongoing expenditure levels. This loss in the annual revenues would be somewhat

mitigated under the proposal by the 8.5% transfer of the endowment fund to the general fund. For example, in first year of the 2003-05 biennium, a projected $131.6 million from tobacco payments would no longer be deposited to the general fund, but those lost revenues would be partially offset by a $56.0 million transfer from the endowment fund. In addition, any residuals in excess of debt service on the tobacco bonds may also be available for deposit to the general fund.

However, if the Legislature determines that more than $350 million in tobacco bond proceeds are to be used to fund expenditures or to reduce revenues through tax reductions or other measures in the 2001-03 biennium, the endowment fund balance would be reduced. This would reduce the amount of revenues that would be transferred from endowment fund to the general fund in the future. Such a scenario could result in a "double hit" to the general fund in future biennia in that GPR expenditures could be higher while revenues to the general fund would be lower. For example, if an additional $200 million ($550 million in total) in total securitization proceeds would be used in the 2001-03 biennium to fund GPR expenditures or tax reductions rather than being placed in the proposed endowment fund, GPR expenditures could be $200 million higher, or revenues $200 million lower, going into the 2003-05 biennium. In addition, the revenues (8.5% of endowment fund) available for transfer from the $200 million smaller endowment fund balance would also be reduced, resulting in less general fund revenues being available to meet the higher GPR expenditure levels in 2003-05. Conversely, if less monies would be deposited to the general fund, the endowment fund could be enhanced.

Bond rating agencies have also indicated that continued use of one-time revenues to increase ongoing expenditure levels or to fund general fund tax reductions is also a credit concern.

Legislative Oversight Issues

Under the bill, most of the authority relating to the sale, transfer or assignment of the state's tobacco settlement payment is provided to the DOA Secretary. Specifically, the DOA Secretary would have the authority to do the following: (a) sell for cash or other considerations the state's right to receive any of the payments under the tobacco settlement agreement; (b) organize one or more nonstock corporations or limited liability companies in accordance with state statutes for any purpose related to the sale of the state's right to receive any of the payments under the tobacco settlement agreement; and (c) take any action necessary to facilitate and complete the sale. The DOA Secretary would also be provided authority to make various pledges and agreements on behalf of the state relating to the proposed securitization, including claims against the state.

As proposed, the sale, assignment or transfer of state's tobacco settlement payment stream would have a significant impact on general fund revenues of the state and the finances of the state several biennia. Since revenue creation and the appropriation of those revenues is primarily a function of the Legislature, it may be desirable to provide more legislative oversight over this undertaking than what is provided in the bill.

Conversely, because the tobacco securitization involves a complex transaction, and its exact structure would depend on the investment market as well as federal tax law, the flexibility provided the Secretary under the bill may be needed. In addition, DOA staff is involved in structuring the state's general obligation and revenue obligation programs, which also have an impact on future available revenues and expenditures.

The bill also provides the DOA Secretary the following authority relating to the transfer of funds from the permanent endowment fund to the general fund: (a) to direct SWIB to transfer to the general fund all proceeds of, and investment earnings on, investments of the permanent endowment fund that are received in the fiscal year; and (b) to identify all other amounts as payments of residual interests to the state from the sale of the state's right to receive payments under the tobacco settlement agreement that are received in the fiscal year. Aside from the passage of this enabling legislation, no legislative oversight relating to these transfers would be provided. Because these transfers would affect general fund revenues and expenditures beyond the 2001-03 biennium, to ensure the future Legislature's role in determining revenue and expenditure levels, additional legislative oversight could be provided.

Other Issues

Tobacco Control Issues. Some have contended that securitizing the state's future tobacco settlement payments would remove the state from being reliant on the continued success of the tobacco manufacturers' sales to fund those payments. However, under the proposal, future state revenues could continue to be affected by a decline in the state's tobacco payments. As long as bonds backed by the tobacco payments remain outstanding, the state could continue to receive settlement payments amounts in excess of the annual debt service on those bonds. In addition, after those bonds are repaid, the state would regain its rights to those payments.

It has been argued that the tobacco securitization proposal could remove any connection between the tobacco settlement payments and the reasons for lawsuits against tobacco manufacturers, such as the overall health problems associated with smoking. Further, concern exists that funding for the Tobacco Control Board and its smoking prevention programs would no longer be connected to the payments received under the settlement.

In 1999-00, the Tobacco Control Board received the first revenues from the tobacco settlement payment to fund the Board's activities. Under the Governor's budget bill, the Board would receive funding directly from the general fund, if the securitization of the state's tobacco payments would take place prior to any settlement payments being received in the 2001-03 biennium. Arguably, because under current law all remaining tobacco settlement payments above those needed to fund the Tobacco Control Board activities are deposited to the general fund, these activities are currently being funded with general fund revenues. From this perspective, funding those activities directly from the general fund is effectively no different than the treatment of those funds under current law.

SWIB's Fiduciary Responsibilities. Under the bill, the DOA Secretary would be provided the authority to direct SWIB to invest in: (a) evidences of indebtedness, including subordinated obligations, that are secured by tobacco settlement revenues, and that are issued by any nonstock

corporations or limited liability companies or by the Wisconsin Health and Educational Facilities Authority (WHEFA); and (b) certificates or other evidences of ownership interest in all or any portion of tobacco settlement revenues. The Board would be required to invest these assets subject to any terms and conditions specified by the DOA Secretary. In investing these assets, SWIB would not be subject the general standards of fiduciary responsibility that apply to the Board when it otherwise invests money or property.

DOA has indicated that under these provisions, the DOA Secretary would direct SWIB to receive and hold certificates for any amounts of residual tobacco settlement payments in excess of annual debt service payments in the endowment fund. DOA contends that under its fiduciary responsibilities, SWIB could not currently hold these certificates as an asset of the fund. DOA has indicated that these provisions would need to be modified to more effectively capture this intent.

Timing of Transaction. Under the bill, $350 million of proceeds from the proposed tobacco securitization transaction are included as general fund revenues in 2001-02. Staff from DOA indicate that there should be adequate time in 2001-02 to prepare the transaction for market. However, given the potential for litigation, it is possible that proceeds would not be available for deposit by June 30, 2002. If litigation would ensue, the receipt of general fund revenues would depend on the outcome and timing of the resolution of the matter by the Courts.