Legislative Fiscal Bureau

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Tobacco Securitization Bond Transaction
(Tobacco Securitization)

[LFB Summary of the Governor's Budget Reform Bill: Page 85 and 86, #1 thru #3]

CURRENT LAW

Under 2001 Act 16 (the 2001-03 biennial budget), the Department of Administration (DOA) Secretary is authorized to securitize the state's rights to its tobacco settlement payments. The Secretary can sell, transfer or assign the rights to the Wisconsin Health and Educational Facilities Authority (WHEFA) or to a nonstock, nonprofit corporation formed by WHEFA or the state. 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 payments, the corporation would provide the state with the proceeds from those bonds. In 2001-02, $450 million of the revenue bond proceeds are to be deposited to the general fund. In addition, an estimated $470 million in proceeds from the bonds are to be deposited to a permanent endowment fund created under Act 16.

Under Act 16, beginning on June 15, 2004, the Joint Finance Committee is required to annually transfer from the permanent endowment fund to the tobacco control fund the lesser of $25 million or 8.5% of the market value of the investments in the permanent endowment fund on June 1 in that year. If 8.5% of the market value of investments in the fund is greater than $25 million the difference between the 8.5% calculation amount and $25 million is to be transferred to the general fund. Therefore, net of these transfers, the growth in the balance of the endowment fund is estimated to 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.

GOVERNOR

Create a sum sufficient segregated appropriation from the permanent endowment fund to make state shared revenue distributions to towns, villages, cities and counties. DOA estimates that the $380,000,000 SEG in 2001-02 and $214,000,000 SEG in 2002-03 would be appropriated from the permanent endowment fund to make 2002 and 2003 shared revenue payments. Specify that these shared revenue payments would be an allowable use of the funds deposited to the permanent endowment fund.

Require the Department of Administration to annually determine the amount to be paid from the permanent endowment fund into one or more sinking funds of the bond security redemption fund and any escrow accounts established under escrow agreements authorized by the Secretary of Administration that relate to contracting public debt. Create a sum sufficient SEG appropriation equal to the amount determined by the Secretary of Administration. Specify that these debt payments are an allowable use the funds deposited to the permanent endowment fund. Require DOA, when preparing the appropriation schedule that will be included in the final printed version of the 2001 statutes, to insert the amount of $200,000,000 as the estimated expenditure amount in 2001-02 from this newly created appropriation. This payment from the permanent endowment fund would offset $200,000,000 GPR of debt service that would otherwise be paid from agency, sum sufficient, GPR debt service appropriations.

DISCUSSION POINTS

1. On February 22, 2002, this office issued a memorandum (copy attached) that analyzed the Governor's proposed tobacco securitization transaction. The memorandum outlined the tobacco securitization transaction that makes up the basis for the Governor's budget reform proposal. It also analyzed the financial implications of the proposal when compared to the tobacco securitization transaction that was considered at the time of legislative deliberations on the 2001-03 biennial budget.

2. Table 1 indicates the estimated bond proceeds under the current law transaction and proposed budget reform bill tobacco securitization transaction. The securitization transaction under the Governor's budget reform bill helps balance state general fund revenues and expenditures in the 2001-03 biennium. Specifically, the $470 million in permanent endowment fund assets as well as an estimated $324 million in additional tobacco securitization bond proceeds generated under the proposed securitization transaction would be used to assist in making payments for shared revenue and debt service on state general obligation bonds, which otherwise would have been paid from the general fund.

TABLE 1

Projected Uses of Tobacco Securitization Bond Proceeds
($ in Millions)

Purpose	Current Law	Budget Reform Bill
Deposit to General Fund	$450	$450
Deposit to Endowment Fund	$560	$794
Less Payments of GPR Debt Service	0	-200
Less Payments of Shared Revenue	0	-594
Net Endowment Fund	$560	$0
Debt Service and Other Reserves	146	159
Capitalized Interest	171	179
Costs of Issuance	12	15
Total	$1,339	$1,597

3. The Governor's budget message indicated that using the bond proceeds to pay debt service would allow for a more efficient use of the tobacco securitization proceeds under federal tax law. The Governor also indicated that in order to incorporate the financial impact of the $200 million reduction in GPR expenditures in 2001-02, the budget reform bill would have to have been passed and effective before February 15, 2002. According to DOA officials, the required passage date was primarily due to the timing of the state's required semi-annual debt service payments. In May and November of each year the state makes debt service payments on its general obligation bonds. Because the state has outstanding operating notes, the state is required to assess each agency for the debt service amounts that result from undertaking agency projects or programs for which bonds have been issued 45 days in advance of the debt service payments being due. Therefore, on March 15, 2002, state agencies will deposit the required amounts to the bond security redemption fund, from which the debt service payments will be made.

4. DOA capital finance officials indicate that the use of tobacco bond proceeds for state debt payment would likely be treated the same as other state capital expenditures under federal tax law. However, if the debt service amounts owed by each agency have been deposited to the bond security redemption fund, federal tax law may no longer allow the state to make the May, 2002, payment using $200 million in tax exempt tobacco securitization bond proceeds. This is believed to be the case because if the March debt service assessment has already been made, the state will have shown that it has operating funds to make the required debt payments and the bond proceeds would not be needed to make these payments. DOA capital finance officials also indicate that a February 15 deadline for passage of the budget reform bill would have been required in order to provide DOA with sufficient direction and time necessary to complete the tobacco securitization transaction prior to the March 15, agency debt service assessment date.

5. Because the March 15 deadline for the securitization transaction is not likely to be met, the $200 million in tobacco bond proceeds could be deposited to the general fund for GPR expenditures other than debt service in 2001-02. However, in order to get the most advantageous federal tax treatment associated with these $200 million in bond proceeds, the proceeds could be used to make the November, 2002, GPR debt payment. However, this alternative would result in the 2001-02 general fund balance being reduced by $200 million from the amount projected under the Governor's budget reform bill.

6. If the Governor's tobacco securitization transaction is not approved and Committee chooses to maintain a $470 million balance in the permanent endowment fund, it is likely that the state would issue a greater percentage of tax exempt bonds than under the current law transaction and use only these tax exempt bond proceeds for immediate expenditure in the biennium. Such a transaction would involve approximately 40% in taxable bonds, with $470 million in proceeds from these bonds being deposited to the permanent endowment fund. Because the endowment would be funded with taxable bond proceeds it would not be restricted by federal tax law on the investment return that could be received on the bond proceeds.

7. By issuing a larger percentage of tax exempt bonds under this alternative transaction, the state would receive an estimated $1.404 billion in bond proceeds, which would result in a total of $596.4 million in bond proceeds being available to the state for expenditure in the 2001-03 biennium. This would be $146.4 million more than the $450 million that is available to the general fund under the current law transaction while the $470 million endowment fund balance that was anticipated under 2001 Act 16 would be maintained.

8. The primary advantages of this securitization alternative are that a permanent endowment fund that is funded with taxable bond proceeds whose earnings are not restricted by federal tax law would be maintained and the state would continue to receive cash flows from the permanent endowment fund over the 30-year transaction period. The total cash flows under this alternative over the 30 year period would be of somewhat lesser value to the state than the value of the current law transaction. However, this alternative transaction would be of greater value to the state than if the state did not securitize its tobacco settlement payments and would be of significantly greater value to the state than the Governor's budget reform proposal.

9. The primary disadvantage of this alternative is that $647.6 million less in bond proceeds would be available for immediate expenditure in the 2001-03 biennium, when compared to the Governor's budget reform proposal. Of this amount $470 million would be associated with maintaining an permanent endowment fund balance at the current law level, with the remaining $177.6 million being associated with issuing partly taxable bonds versus the Governor's proposed 100% tax exempt bond securitization transaction.

10. Alternatively, the Committee could choose to create a smaller endowment fund balance under the tobacco securitization transaction than the $470 balance that was envisioned under Act 16. For example, the Committee could direct DOA to maintain an endowment fund balance of $200 million under the tobacco securitization transaction.

11. The primary advantage of maintaining even a lesser amount in an endowment fund would be that the state would continue to have some funds associated with securitizing its tobacco settlement payments that would be an ongoing asset for the state and would provide revenues to the state in the future. The disadvantage would be that the state would have significantly less in funds available for expenditure in the 2001-03 biennium. The exact amount of taxable bond proceeds, which would primarily make up the endowment fund, and tax exempt bond proceeds, which would make up the funds available for expenditure in the biennium, would depend on the size of the endowment fund to be maintained.

Repayment Schedule for Permanent Endowment Fund

12. As Table 1 indicates, the Governor's proposal would expend all of the bond proceeds generated from tobacco securitization and the permanent endowment fund created under Act 16 would have a zero balance. The Governor, in his budget reform bill message, indicated a commitment to restoring the permanent endowment fund. However, the bill does not specify any schedule or funds for the repayment of the endowment fund.

13. The Legislature could establish a schedule in statute for the repayment of $470 million in bond proceeds to the permanent endowment fund. Beginning in 2003-04, an annual repayment amount of $25 million per year would result in full repayment of the $470 million by 2021-22. An annual repayment of $50 million per year would result in full repayment by 2012-13.

14. While the exact federal tax law treatment is not certain, federal tax law could affect state repayments to the permanent endowment fund. Federal tax law may require that as long as principal on the tobacco securitization bonds remains outstanding, funds deposited to the permanent endowment fund could be treated as if they are derived from tax exempt proceeds and be subject to yield restrictions. However, if these restrictions would result in significant foregone earnings, the Legislature could modify the repayment schedule of future general fund monies to instead deposit the monies in the state's budget stabilization fund until total payments of $470 million have been made. This could provide for a fund balance outside the state's general fund, similar to the permanent endowment fund envisioned under Act 16, while avoiding the more stringent federal tax law restrictions that may be associated with deposits to that endowment fund.

ALTERNATIVES TO BILL

A. Governor's Securitization Transaction

1. Approve the Governor's recommendation to sell only tax exempt bonds related to securitization and deposit the funds in the permanent endowment fund.

2. Modify the Governor's recommendations relating to the state's tobacco securitization by specifying that $200,000,000 in bond proceeds in the permanent endowment fund would be expended for debt service in 2002-03 rather than in 2001-02 to reflect that the funds would be used to assist with the state's November, 2002, GPR debt payments rather than the May, 2002, GPR debt

payments.

3. Delete the Governor's recommendation and direct the Department of Administration to carry out a tobacco securitization that involves a mixture of taxable and tax exempt bonds that would provide for a deposit of $470 million to the permanent endowment fund. In addition to the $450 million in tobacco securitization bond proceeds to be deposited to the state's general fund in 2001-02 under current law, deposit an additional $146.4 million in bond proceeds to the state's general fund in 2001-02 to be available for expenditure in the biennium.

Alternative A3	GPR
2001-03 REVENUE	- $433,600,000

B. Future Payments to Permanent Endowment Fund

1. Specify that beginning in 2003-04, in June of that fiscal year, the state would make an annual transfer of $25 million from the general fund to the permanent endowment fund, until total payments of $470 million have been made.

2. Specify that beginning in 2003-04, in June of that fiscal year, the state would make an annual transfer of $50 million from the general fund to the permanent endowment fund, until total payments of $470 million have been made.

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Attachment