

December 2002

## SECURITIZATION OF TOBACCO SETTLEMENT COLLECTIONS

### DEFINITION

Securitization is the process by which a state sells the revenue stream of its future tobacco settlement payments, for a set number of years, in return for a single up-front payment. The future tobacco settlement collections are sold by the state to a special purpose entity (SPE), whose sole purpose is to issue bonds backed by these funds. The SPE is responsible for the debt service on the bonds and is designed to be a legally separate entity from the state. This means the credit rating for these bonds is separate from the state's rating and is based on the credit worthiness of the tobacco industry and the structure of the financing. The bond purchasers assume any risk that the tobacco settlement collections may be reduced, stalled, or halted.

### BOND ISSUANCES

The intended use of the money will determine whether the bonds issued are taxable or tax-exempt. If bond proceeds are used for governmental purposes the bonds will be tax-exempt. If the proceeds benefit a private purpose or will be reinvested, such as pension financing or endowment funding, the bonds will be taxable. The actual bond terms and the revenue generated from the issuance will depend on a number of factors, including:

- **The desired bond rating** - By assuming worst-case scenarios for future tobacco settlement collections into the assumptions, states can predict with some certainty that bondholders can be repaid in full and thus achieve a higher rating.
- **The amount of risk the state is willing to assume** - A state may elect to pledge its "moral obligation" to repay bondholders if the tobacco collections are insufficient to pay the debt service.
- **The revenue the state will receive from the issuance** - Factors that determine the net proceeds of the bond issuance include:
  - The interest rate (yield) on the bonds;
  - Whether a state is issuing taxable or tax-exempt bonds; taxable bonds usually have a higher associated interest rate;

The term of the bonds (e.g. 10, 20, or 30 years); and

Whether the state is repaying the bonds at an accelerated (turbo) rate.

- **Bond proceed usage** - The demand for tax-exempt bonds tend to be greater in states with higher income tax rates or are contemplating raising taxes.
- **Rating agencies requirements and their assumptions** - Increases in supply of tobacco asset-backed securities has resulted in bond firms selling the bonds at higher yields, which lowers the amount of dollars a state realizes from such a sale.
- **Bond issuance fees** - The net bond proceeds received by states are reduced by fees paid, usually based on the amount the bonds issued, to security firms for issuing the bonds and bond counsel for the preparation of the legal documents associated with the issuance.
- **Percentage of future collections sold** - States may sell all or a portion of future tobacco settlement collections based on a set number of years or percentage of annual collections.

### REVENUE STREAM RISKS

The tobacco settlement revenue stream could be impacted by volume adjustments or if one of the four companies participating in the Master Settlement Agreement (Philip Morris, R.J. Reynolds, Brown and Williamson, and Lorillard), files for bankruptcy. A volume adjust is an adjustment made to a settlement payment to reflect increases or decreases in tobacco settlement manufacturers' operating income and domestic cigarette sales. Increases in sales of the cigarette companies not participating in the Master Settlement Agreement and "roll-your-own" cigarettes, increases in cigarette taxes, and the impact of smoking prevention campaigns are some of the factors that may affect the sales and operating income of the major cigarette manufacturers.

## STATES THAT HAVE SECURITIZED TOBACCO SETTLEMENT

| State (Year)                        | Bond Issuance Amount and Percent of Future Collections Sold            | Detail and Purpose   |
|-------------------------------------|--|--|
| Alaska - (2000 and 2001)            | \$209 million - 80 percent (40 percent in 2000 and 40 percent in 2001) | Alaska's first bond issuance is for 21 years, and the second issuance is for 24 years. Alaska is using a turbo redemption, and anticipates bonds could be repaid by 2013. The total tobacco collections anticipated through 2025 is \$788 million (approximately \$567 million is dedicated to bond repayment). The proceeds from the securitization will be used for schools and upgrade port facilities. |
| California - (2002 - not completed) | Approximately \$4.5 billion (100 percent)                              | California anticipates it will sell all of its tobacco collections revenue stream through the year 2024, which equates to approximately \$9.13 billion in collections. The proceeds will be used to maintain a health care safety net.   |
| Iowa (2001)                         | \$644 million - (100 percent)  | Iowa sold its tobacco collection revenue stream for the next 30 years. Approximately \$1.6 billion of anticipated future tobacco settlement collections are dedicated to retire the bond debt. The proceeds will be used to retire capital debt and create a health care services trust fund.  |
| Louisiana (2001)                    | \$1.2 billion (60 percent)   | Louisiana issued bonds with a scheduled maturity date in 2039. An estimated \$4.5 billion of collections will be required over that period for the related bond debt retirement. The proceeds were used to establish an endowment fund for health care, education and scholarships.  |
| Missouri (2002 - not completed)     | \$600 million (maximum of 30%)   | Missouri is authorized to sell a maximum of 30 percent of the \$4.5 billion (\$1.35 billion) it expects to receive from the settlement agreement over the next 25 years. The estimated bond issuance is for \$600 million. The proceeds will be used to offset the state's budget deficit.   |
| New Jersey (2002 - not completed)   | \$1.8 billion (42 percent)   | New Jersey proposal would generate \$1.8 billion by issuing 25-year bonds to be repaid at a turbo rate of approximately 15 years. The proceeds will be used to offset New Jersey's budget deficit.   |
| Oregon (2002 - not completed)       | An amount to generate \$150 million (approximately 77 percent)         | The term of the payments cannot exceed eight years but are anticipated to be as short as four years. Based on estimates, approximately 77 percent of the tobacco settlement revenue stream will be sold under the four-year repayment plan. The proceeds will be used to offset Oregon's budget deficit.   |
| Rhode Island (2002)                 | \$685 million (100 percent)  | Rhode Island issued \$685 million of bonds to be repaid over 40 years from tobacco settlement collections. Rhode Island estimated \$2.8 billion of collections will be provided for the repayment of the bonds over that period. The proceeds will be used to offset the state's budget deficit.   |
| South Carolina (2000)               | \$934 million (100 percent)  | South Carolina sold the tobacco revenue stream through the year 2018. South Carolina estimated that collections will be approximately \$1.7 billion over that period. The proceeds will establish a health care endowment (72%), and establish rural infrastructure and support tobacco farmers (28%).   |
| South Dakota (2002)                 | \$270 million (100 percent)  | South Dakota issued \$270 million in bonds to be repaid with tobacco settlement collections received through the year 2025, estimated to be \$565 million. The state will retain collections when the bonds are paid off. The securitization proceeds were used to establish an education endowment.   |
| Washington (2002)                   | \$518 million (29.2 percent)   | The bonds have maturity dates ranging from 2005 to 2032. Washington anticipates that through the use of turbo redemption all the bonds will be repaid by 2019. The state received approximately 38 cents for each dollar of future collections sold. The proceeds will be used to offset the state's budget deficit.   |
| Wisconsin (2001)                    | \$1.6 billion (100 percent)  | Wisconsin issued 30-year bonds to be repaid from tobacco settlement collections; however, the bonds are anticipated to be repaid over a shorter period. The state will retain collections when the bonds are paid off. Wisconsin estimates tobacco settlement payments to be \$2.7 billion over the next 20 years. The securitized funds will be used to offset the state's budget deficit.                |

North Dakota is projecting to receive \$776.6 million in tobacco settlement collections from the 1999-2001 through 2023-25 bienniums. By state law the collections are allocated 45 percent to the water development trust fund, 45 percent to the common schools trust fund, and 5 percent to the community health trust fund. The State Water

Commission is authorized to issue bonds for flood control projects, the Southwest Pipeline Project and an outlet to Devils Lake, and North Dakota Century Code Section 61-02.1-04 provides that the bonds must be repaid from the water development trust fund.