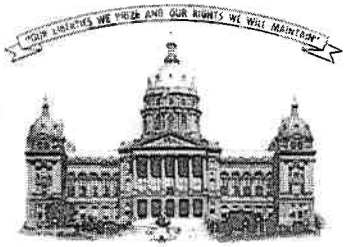
Attachment M

DENNIS C. PROUTY
DIRECTOR
515/281-5279
FAX 281-8451



STATE CAPITOL
DES MOINES, IOWA
50319

STATE OF IOWA
LEGISLATIVE FISCAL BUREAU

MEMORANDUM

To: Legislative Fiscal Committee

From: Dennis Prouty and Beth Lenstra

Date: September 18, 2000

Re: Update on Tobacco Securitization

Enclosed are three documents related to tobacco securitization:

- "State Tobacco MSA Payment Plans" – U.S. Bancorp Piper Jaffray. This document provides an overview of each State's tobacco settlement, plus its securitization and expenditure plans.
- "Securitization: An option for State Tobacco Settlement Funds" – National Governor's Association Center for Best Practices. This document provides an explanation of securitization, potential benefits, and potential risks of the process.
- Update on Tobacco Securitization. This document provides a compilation of each State and local jurisdiction's tobacco securitization activities.

Please call Dennis Prouty (515-281-3509) or Beth Lenstra (515-281-6301) if you have any questions or concerns.

Fisc_Com.tobaccoupdate

TABLE OF CONTENTS

STATE TOBACCO SETTLEMENT OVERVIEW

Forty-six states signed the Master Settlement Agreement (MSA) between the states' attorneys general and the nation's largest tobacco companies. Four states – Texas, Minnesota, Mississippi, and Florida – signed separate agreements. Most states are using proceeds from the MSA to fund programs related to the following:

- Tobacco prevention and cessation programs
- Health care related programs
  - Prescription plan services for the elderly
  - Medicaid supplements
  - Health insurance for low-income families
  - Health insurance for children
- Creating endowment funds where only interest earnings are spent

The chart to the right outlines the total expected future payments to the states under the MSA.

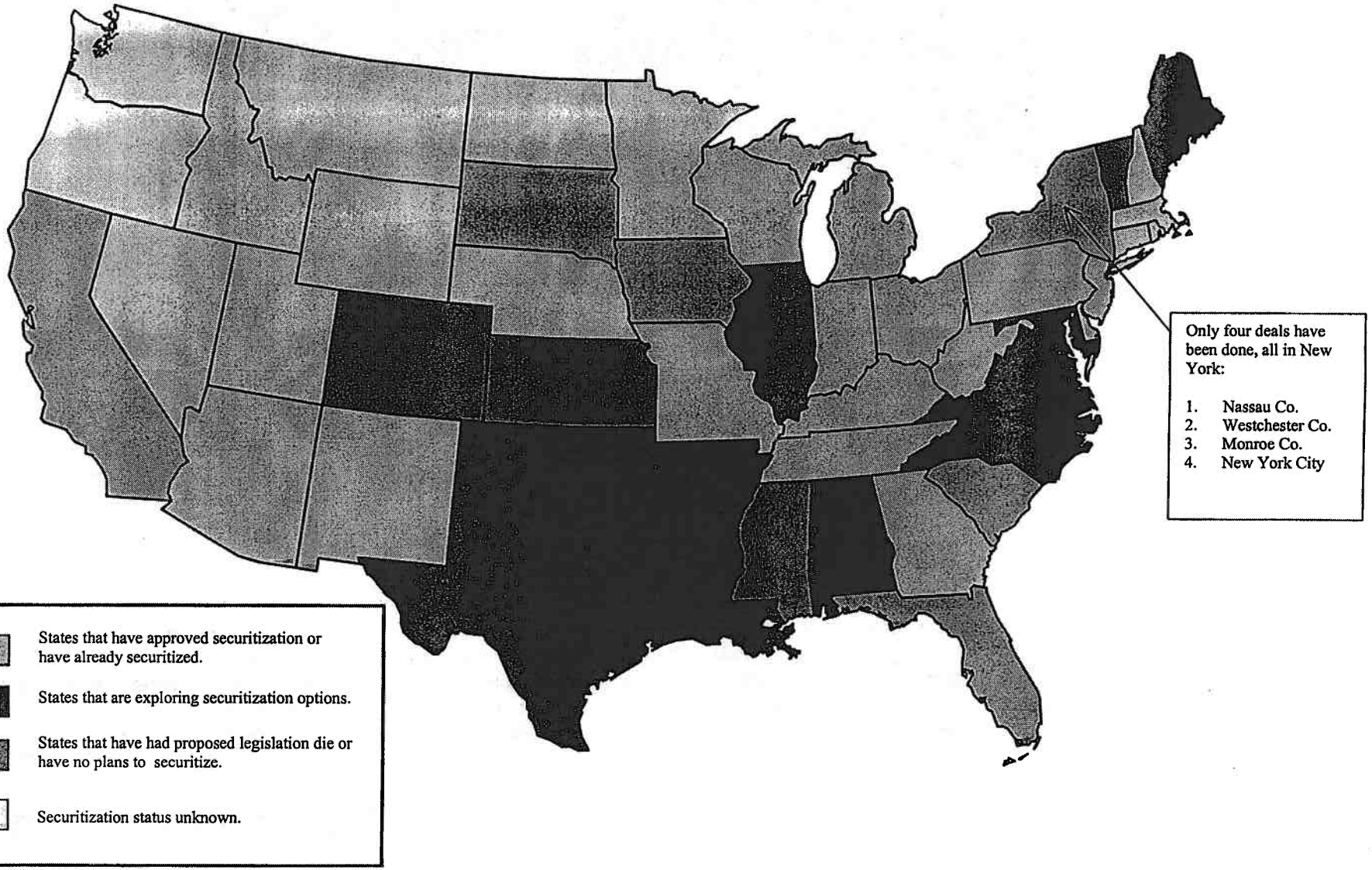
The following sections contain details on the securitization plans of selected states as well as expected expenditure types and levels.

Settlement Amounts (in $billions)

State	Amount	State	Amount
Alabama	$ 3.2	Montana	$ 0.8
Alaska	0.7	Nebraska	1.2
Arizona	2.9	Nevada	1.2
Arkansas	1.6	New Hampshire	1.3
California	25.0	New Jersey	7.6
Colorado	2.7	New Mexico	1.2
Connecticut	3.6	New York	25.0
Delaware	0.8	North Carolina	4.6
D.C.	1.2	North Dakota	0.7
Florida*	13.0	Ohio	9.9
Georgia	4.8	Oklahoma	2.0
Hawaii	1.2	Oregon	2.2
Idaho	0.7	Penn.	11.3
Illinois	9.1	Rhode Island	1.4
Indiana	4.0	South Carolina	2.3
Iowa	1.7	South Dakota	0.7
Kansas	1.6	Tennessee	4.8
Kentucky	3.5	Texas*	15.3
Louisiana	4.4	Utah	0.9
Maine	1.5	Vermont	0.8
Maryland	4.4	Virginia	4.0
Massachusetts	7.9	Washington	4.0
Michigan	8.5	West Virginia	1.7
Minnesota*	6.1	Wisconsin	4.1
Mississippi*	4.1	Wyoming	0.5
Missouri	4.5		

* Not part of the Master Settlement Agreement, signed separate agreements with the tobacco companies

SUMMARY OF STATE SECURITIZATION PLANS



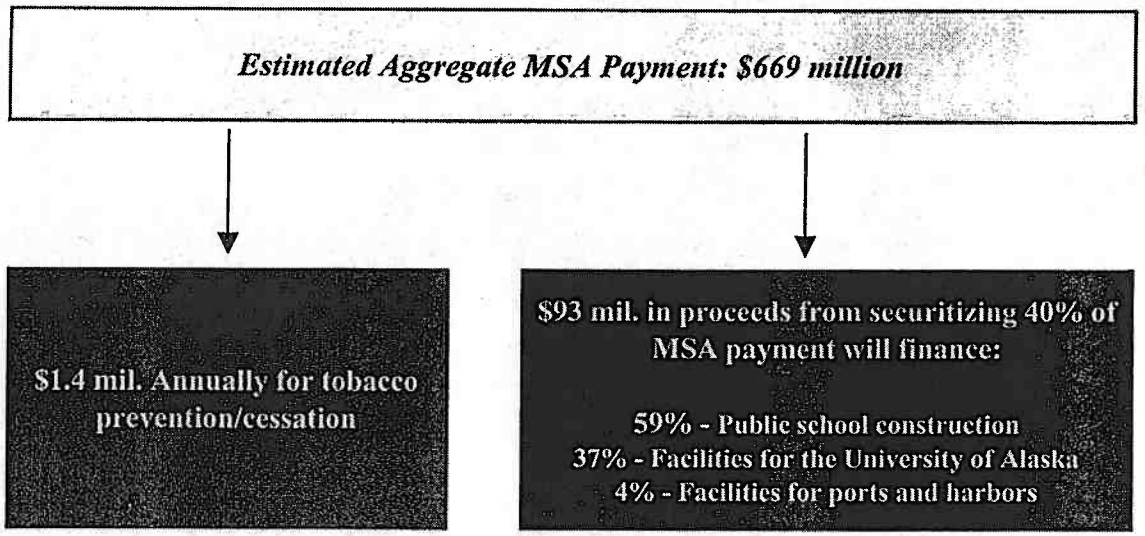
ALASKA ($669 MILLION)

Securitization:

The 1999-2000 legislature approved securitizing the majority of its MSA payments. The drive to pass the legislation and utilize a significant portion of the tobacco securitization proceeds for schools was caused by the settlement of a lawsuit by a rural school district. The school district was seeking equalization of treatment in regards to the dissemination of state monies for the upgrading and building of new schools. A portion of the funding is being achieved via tobacco revenue bonds and the balance is being funded with State G.O.'s. The size of the settlement was $360 million, with $93 million being funded with tobacco revenues and the State funding the balance. The State recently completed a selection of an underwriting team and it is expected to sell bonds in the fall 2000.

Expenditure Plans:

Effective January 01, 2001, the State (per HB 281) will sell to the Alaska Housing Finance Corporation the right to receive 40% of the revenue derived from the tobacco MSA. The state expects to receive a total of approximately $93 million from securitizing its MSA payments. Proceeds will finance various construction projects. The remaining $1.4 million annually will fund tobacco prevention and cessation programs.



CALIFORNIA ($25 BILLION)

Under the settlement, 50% of the total funds will go to the State of California; 40% will go to the 58 counties based on population size; and 10% will be split between the cities of San Francisco, San Jose, San Diego, and Los Angeles. There is currently a proposal (SB 1142) that would prohibit any local jurisdiction in the State from securitizing their tobacco settlement payments. The following section provides examples of what some cities and counties are doing in California.

ORANGE COUNTY, CALIFORNIA

Securitization:
As of July, 2000, some County Supervisors were leaning toward a plan to securitize the settlement funds the county expects to receive. They currently expect to receive $900 million over 25 years from the agreement. If the county issued bonds backed by the expected MSA payments, they could expect to obtain about $350 million now. This plan could render the November ballot initiative, which would allocate most of the settlement payments to health care, useless.

Expenditure Plans:
A ballot initiative, which would direct how the settlement funds must be spent, will be on the November ballot. The initiative would direct that the County spend 80% of the settlement funds on health care and 20% on law enforcement. Three Orange County Supervisors strongly oppose the initiative and, instead, want to spend the money on debt reduction and jails. On July 24, 2000 it was announced that a Superior Court hearing will be held on August 30th regarding the Orange County Supervisors petition to keep the settlement funds voter initiative off the November ballot. A decision is expected soon after the hearing.

LOS ANGELES, CALIFORNIA

Securitization/Expenditure Plans:
On May 15th, the LA City Council voted unanimously to reject the Mayor's plan to use the city's anticipated $300 million in settlement funds over the next 25 years to issue bonds and immediately raise $91 million to pay off expected damage awards resulting from the LA Police Department's abuses.

CITY OF SAN DIEGO, CALIFORNIA

Securitization/Expenditure Plans:
San Diego selected its securitization financing team the week of July 28th. It is possible that San Diego and the County of Sacramento could create a vehicle for joint financing.

CALIFORNIA (CONT.)

SACRAMENTO COUNTY, CALIFORNIA

Securitization:

Sacramento is in the process of selecting underwriters and plans on issuing bonds prior to November 2000. This is being driven by the legislation mentioned previously for the state of California regarding prohibiting tobacco settlement revenue securitization. Furthermore, the County Counsel has deemed that any proceeds not spent by the approval of the ballot could become restricted by the State. Therefore, they intend to move fast.

However, the County also concluded there is a great amount of risk over the longer term as to whether the payments promised by the tobacco companies will ultimately be paid. The County concluded factors such as declining tobacco consumption in the United States and the risk of large punitive damage awards from further litigation combine to create a high risk scenario to rely upon payments to fund programs and/or to fund facilities on a pay-as-you-go basis.

The County decided its best interests are served by a tax-exempt securitization of the longer-term payment stream (beginning with the payments anticipated in Fiscal Year 2005-2006). Sacramento believes the near-term (now through 2004) settlement revenues are more secure than the longer-term (2005 and beyond) revenues. In order for a tax-exempt securitization to be possible, the County must dedicate the use of the bond proceeds to government facilities and/or equipment purchases.

The County's initial concerns regarding securitization included the default risk of non-payment from the tobacco companies that would be transferred to investors from the County. A scenario where a default on the securities occurs because of declining consumption or even non-payment from the tobacco companies due to bankruptcy raises the specter of the County having a moral duty to pay the debt service from its other General Fund revenues. However, the tobacco securities sold to date have included numerous disclosures of the potential risk, issuance in large denominations of securities that could only be purchased by institutional investors and extremely high net worth individuals, and a "sophisticated investor" disclosure agreement that requires the purchaser of the securities to acknowledge they know the risk at the time of purchase of the securities or future transfer of the securities. Therefore, the County of Sacramento believes there will be no moral (or legal) obligation for the County to pay the debt service if the tobacco companies default.

Expenditure Plans:

Sacramento County anticipates receiving approximately $103 million in capital funding from their proposed tobacco securitization. Proposed uses of the proceeds include:

- New Primary Care Health Clinic
- New Animal Care Shelter
- Expanded Juvenile Hall/Court Facility
- Conversion of Public Works Fleet to Clean-Air Vehicles

COLORADO ($2.7 BILLION)

Securitization:

The state treasurer proposed securitization in March 2000. The bill was successful in passing the House; however, it died in the Senate Committee by a matter of a single vote. Opposition was coming from a prominent Senator due to two major reasons:

I. Certain health care groups such as the American Cancer society had been promised funding over the 25 year period. To securitize, especially utilizing taxable bonds, would have required a sufficiently high investment rate for the proceeds to guarantee those payments. Without such a guarantee this Senator withdrew support for the bill;

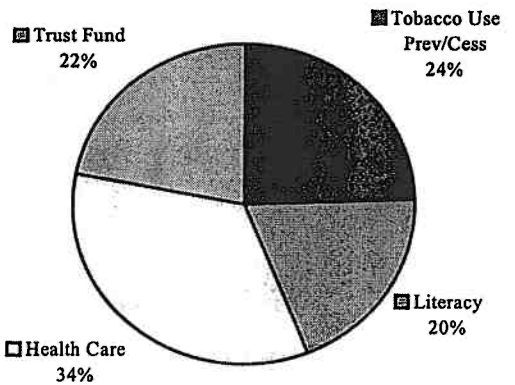
II. Lobbyists for the Cancer Society and other organizations put strong pressure on legislators when it became apparent the State was leaning towards a tax-exempt issue which would have precluded some of their projects from being funded. These projects could have been funded under a taxable bond structure; however, that structure had been shot down due to too high an interest rate expectation.

Expenditure Plans:

Tobacco settlement moneys may only be used for programs that promote tobacco use prevention, education, cessation, and research; expand health coverage and health care services for the uninsured; or improve literacy and reading comprehension. The state has also established a Tobacco Litigation Settlement Trust Fund, which will receive approximately 20% of MSA payments annually. The state has effectively designated program allocations for the duration of receipt of MSA payments. The following chart depicts FY 2000-01 appropriations. Percentages in parentheses reflect current and future percentage program allocations.

FY 2000-01 Appropriations

Program	(in $millions)
Tobacco Litigation Settlement Cash Fund	
Tobacco Program Fund (25%)	$ 19.0
Read to Achieve Fund (20%)	15.2
Primary and Preventive Care Grants (15%)	11.4
Pharmaceutical Assistance Fund (10%)	7.6
Children's Basic Health Plan Trust Fund (10%)	7.6
Total	$ 60.8
Tobacco Litigation Settlement Trust Fund (20%)	$ 17.1
Total	$ 77.9



FLORIDA ($13.0 BILLION)

Securitization:

The State has already received $1.1 billion. The head of the State's Bond Finance Division firmly is behind securitization for the following reasons:

I. Believes it is important to diversify the State's singular, undiversified risk away from the tobacco industry;
II. Earnings on the trust fund will be available for appropriations on an ongoing basis;
III. To the extent over time the legislature grows to "expect" to be able to spend a certain amount of money each year from the earnings, he believes it is very important to have money in hand rather than rely upon payments from the tobacco companies many years into the future. Another way of saying this is the more the expenditures become "built into" the annual budgetary process, the more important it is to securitize to ensure that cashflow.

On May 09, 2000, the Governor signed into law a bill (HB 1721) creating the Tobacco Settlement Financing Corporation. The Corporation is authorized to issue bonds secured by the state's tobacco settlement payments. Issuance of bonds by the corporation is subject to approval by the state legislature. The total principal amount of bonds issued by the corporation shall not exceed $3.0 billion, and the principal amount of bonds issued in any single fiscal year shall not exceed $1.5 billion, beginning with the 2000-2001 fiscal year. Furthermore, no series of bonds issued shall have a true interest cost rate of more than 4 percent over the yield on U.S. Treasury obligations which have a maturity approximately equal to the average life of such series of bonds. Proceeds will be invested in accordance with the State's investment guideline currently utilized by the State of Florida Pension Retirement System.

The corporation will be governed by a board of directors consisting of the Governor, the Treasurer, the Comptroller, the Attorney General, two directors appointed from the membership of the Senate by the President of the Senate, and two directors appointed from the membership of the House of Representatives by the Speaker of the House.

Expenditure Plans:

Created the Lawton Chiles Endowment Fund, which has the stated goal of providing a perpetual source of funding for the future of the state children's health programs, child welfare programs, children's community-based health and human services initiatives, elder programs, and biomedical research. Only interest is appropriated, while the principal amount of the settlement payments will remain intact.

Annual Expenditures

50.0%	Children's services
33.5%	Biomedical research
16.5 %	Senior services

ILLINOIS ($9.1 BILLION)

Securitization:

The State Treasurer is exploring four options regarding the MSA payments:

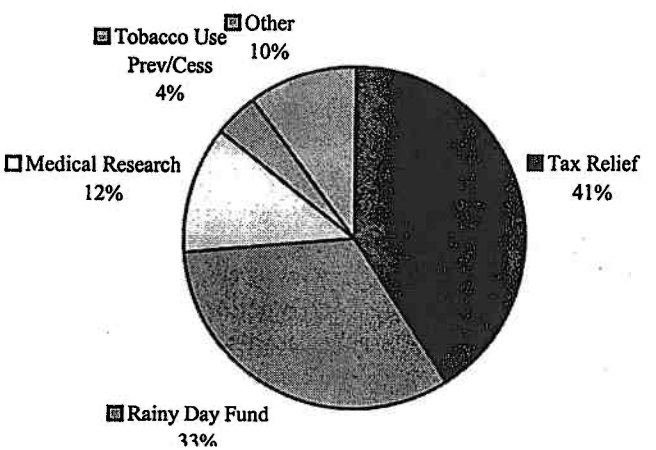
I. Pay-as-you-go – the state fully spends every payment as it is received annually for various projects, initiatives, benefits, or tax cuts;
II. Bond and spend – Securitize the MSA payments and spend all the proceeds generated from the securitization;
III. Stabilized trust –The state deposits all or a portion of the annual payments into a trust, and the trust earns interest on the growing balance. The state would spend the earnings only from the trust;
IV. Bonding trust – The State securitizes, but the proceeds are saved rather than spent.

On Feb. 16th, an Illinois Circuit Judge refused to dismiss a Cook County lawsuit seeking $4 billion of the settlement money to be paid to the state by the tobacco industry. The judge ruled that, under the Illinois Constitution, the Attorney General could not ignore Cook County when he settled the tobacco lawsuit because Cook County has special powers as the state's only home rule county. Cook County has argued that the state could not settle the lawsuit Cook County had filed against the tobacco industry without Cook County's consent. Furthermore, the County has argued that they incurred costs related to tobacco-caused diseases which the state did not take into consideration and for which the state now owes the County.

Expenditure Plans:

FY 2000 Appropriations

Program	(in $millions)
Property Tax Relief	$ 280.0
Budget Reserve Account	225.0
Medical Research	81.6
Prescription Drug Assistance for Senior Citizens	35.0
Tax-Credit for Low-Income Workers	35.0
Tobacco Prevention and Cessation	29.5
Total	$ 686.1



IOWA ($1.7 BILLION)

Securitization:

Effective May 19, 2000 (House Bill 2579), Iowa created the Tobacco Settlement Authority. Powers of the authority include investing available funds and issuing bonds and use the proceeds from the bonds to provide a stable revenue source to the state. Incoming funds to the Authority are those derived under the Master Settlement Agreement. The Authority may acquire and retain any type of property or investment which persons of prudence, discretion, and intelligence would acquire or retain for their own financial interests. In other words, the investment of MSA payments is not restricted by the State's investment laws.

The bill provides time until March 1, 2001 to propose a plan before both houses and the Governor. Approval must be received by the Governor and a constitutional majority of both houses. The plan must evaluate securitization and sale of the revenues to independent third parties and it must address whether or not the advisors recommend selling all the future receipts or just a portion of them.

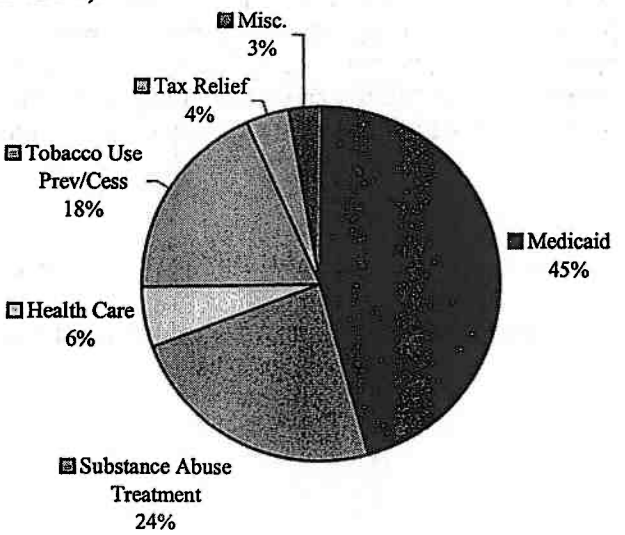
The governing board of the authority consists of the Treasurer of State, the Auditor of State, and the Director of the Department of Management.

Expenditure Plans:

Effective May 5, 2000, the following budgetary items were appropriated for fiscal year 2000 (HB 2555):

FY 2000 Appropriations

Program	(in $millions)
Medicaid reimbursement	$ 23.0
Substance Abuse Treatment	11.9
Tobacco Use Prevention and Control Initiative Program	9.3
Healthy Iowans 2010 Plan:	2.8
(Includes home health care, public health nursing services, and the establishment of a poison control center)	
Property tax relief fund	2.0
Miscellaneous	1.5
Total	$ 50.5



KANSAS ($1.6 BILLION)

Securitization:

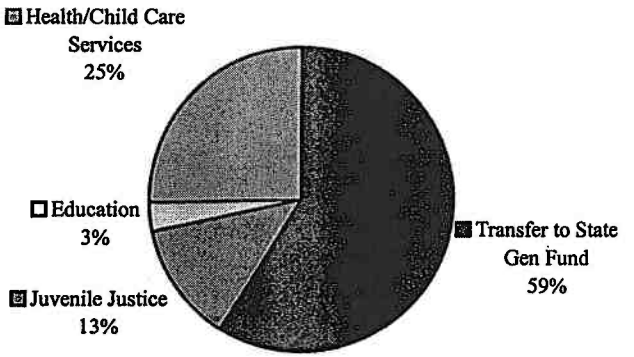
The Kansas Development Finance Authority was initially skeptical of the securitization issue. Upon completion of its analysis of securitization, the Authority, as well as the Governor, became supportive of securitization. A proposal to establish the Kansas Tobacco Settlement Financing Corporation for the issuance of bonds for securitization of tobacco litigation settlement receipts was approved by the Senate; however, time ran out in this most recent session before the measure could be voted on in the House. The securitization issue is not dead, but will be brought back in the 2001 legislative session.

Expenditure Plans:

In 1999, the legislature established a trust fund, Kansas Endowment for Youth (KEY), where all tobacco payments will be deposited. The State received approximately $21 million in settlement payments in 1999, which was used to reimburse the State General Fund. Of the approximately $48 million the State expects to receive in 2000, additional transfers will be made to the State General Fund, as well as $20 million for approved initiatives out of the KEY fund. Initiatives include juvenile justice prevention programs ($4 mil.) and home and community based social rehabilitation services ($8 mil.). It should be noted that no money was allocated in 2000 for smoking prevention and cessation programs, and $500,000 allocated in 2001. The following chart depicts the allocation of tobacco payments in 2000:

FY 2000 Appropriations

Program	(in $millions)
Transfer to State General Fund	$ 28.0
Child Care Services	10.8
Juvenile Justice Programs	6.1
Department of Education	1.5
Department of Health	1.2
Total	$ 47.6



MISSISSIPPI ($4.1 BILLION)

Securitization:
Mississippi was the first state to settle with the tobacco companies and does not, at this point, envision securitizing.

Expenditure Plans:
The state settled quickly because Mississippi was ranked 50th of all states in numerous categories such as education spending and health care. The state wanted to immediately make an impact for the citizens by quickly getting programs in place. The state legislature in 1999 (HB 519) established a health care trust fund. The trust will receive all funds from the tobacco settlement, including income from the investment of those funds. Health care is the only authorized expenditure out of the trust. In addition, a thirteen person investment policy committee was created to determine investment guidelines.

The state has already established programs funding health insurance for all children up to the age of 16 in the state and a program to provide eye examinations and provide glasses for all "needy" students in public schools.

NEW YORK ($25.0 BILLION)

The State of New York's portion of the settlement with tobacco companies is $25 billion, with additional payments continuing after 2025. The state will receive 51.1 percent of the tobacco money, while New York City will get 26.6 percent, and counties outside New York City will share the remaining 22.3 percent.

NEW YORK CITY:

Securitization:

On June 28, 1999, New York City signed a law that would allow it to sell its rights to receive the tobacco settlement funds to a recently formed Tobacco Settlement Asset Securitization Corporation (TSASC). This helped alleviate a problem the City was facing: the amount of debt that the City is able to incur is limited by the New York State Constitution. The most recent forecast of the City's indebtedness had indicated the City would reach its debt limit Fiscal Year 2000. Furthermore, a constitutional amendment, which would be required in order for the City to increase its debt limit, would not become effective until January 2002. Therefore, securitizing the tobacco settlement would provide $2.5 billion in funding for the City's capital program and help the City avoid reaching the constitutionally imposed debt limit.

On November 03, 1999, TSASC, Inc., announced the first issuance of approximately $709 million of Tobacco Flexible Amortization Bonds, or TFABS. Demand was particularly strong from a wide variety of institutional investors who put in over $1 billion of priority orders. In a two-day retail presale order period on the Tuesday and Wednesday before pricing, $55 million of orders were received from individual investors. The yields on the TSASC bonds ranged from 4.02% to 6.44%. Approximately $2.8 billion of anticipated bond issuance over the next four years will be conducted through TSASC.

The Bonds issued are not a debt of the State of New York or of the City of New York. TSASC does not have the power to pledge the credit, the revenues or the taxing power of the State or the City, and neither the credit, revenues, nor the taxing power of the State or the City will be deemed to be pledged to the payment of any of the Bonds. Furthermore, TSASC has no taxing power.

Expenditure Plans:

Planned expenditures include school construction, health care initiatives, and capital financing needs. Tobacco settlement bonds will enable the City to fund its capital needs, particularly for schools, through January 2002, when the State constitutional amendment increasing the City's capacity to issue General Obligation debt could become effective.

NEW YORK (CONT.)

Up to 30 counties in New York are considering whether to opt into a pool being organized by the New York State Association of Counties which would securitize their respective settlement payments by issuing bonds. To date, Monroe, Erie, Nassau and Westchester counties have sold or approved the sale of such bonds. The following is a brief summary of some New York counties and their plans to securitize:

Cattaraugus County: The County Legislature will hold a public hearing on August 23rd to get opinions on whether the county should securitize its expected $42 million in settlement funds. The county legislature has already indicated it is interested in issuing bonds, which would generate approximately $14.6 million in proceeds. (As of July 26, 2000)

Erie County: Erie County was authorized by the State (HB 11161) to establish a trust fund for investment and expenditure of proceeds of tobacco asset securitization financing. Proceeds will only be used for the county's share of Medicaid expenditures and its contribution to the Erie County Medical Center operating budget, debt service, economic development, and regional asset purposes. Previous estimates indicated the sale might raise $235 million in proceeds; however, this has now been changed to roughly $200 million. The concern is that a number of New York counties are planning to issue bonds backed by settlement payments, and this may flood the market with such bond issues. Erie County would split the proceeds raised between the Erie County Medical Center and the county share of the Medicaid program. (As of July 19, 2000)

Monroe County: Monroe County securitized its share of the MSA payments on July 31, 2000. The transaction marked the first time that the rating agencies have assigned the same rating to all maturities of a tobacco issue. The terms of the deal included a clause requiring that, in the event of default, any available cash will be divided among holders of all outstanding maturities, rather than exclusively being applied to repay holders of the earliest maturity. This provided all maturities with equal access to any available assets, allowing for a uniform credit rating across the scale of due dates. The entire issue was rated A by S&P and A1 by Moody's. A municipal bond fund manager noted two concerns in buying tobacco backed bonds – a relative lack of secondary market liquidity for the bonds, and that supply will soar as other governments bring similar issues to market. Since tobacco securitizations are backed by the same settlement, the credits are generally considered the same, and portfolio managers will be limited to how much they can buy from the sector. This could cause new deals to be structured on a taxable basis, to attract new investors.

Niagara County: The County Legislature will hold a public hearing on August 1st to get opinions on its plan to securitize its share of tobacco settlement funds. The county expects to receive about $39 million. Proceeds will fund capital construction projects and to pay interest only on existing county bonds. (As of July 19, 2000)

Wyoming County: The County Supervisors were expected to tentatively approve a plan to join the state Association of Counties plan to issue bonds backed by the settlement funds. The county expects to get about $7 million by issuing the bonds. Proceeds would fund debt reduction, roads, and emergency communications systems. (As of July 11, 2000)

VIRGINIA ($4.0 BILLION)

Securitization:

The Governor and State Treasurer are both in agreement that securitization would help diversify away risk. Support for securitization is coming from special interest groups in the health care arena as the realize they will receive their money over a longer period of time, and some would rather have it today than wait. However, legislation (SB 263) died in the Senate in February 2000 that would have created the Tobacco Settlement Financing Corporation. The Corporation would have had the authority to issue bonds secured by MSA payments.

Expenditure Plans:

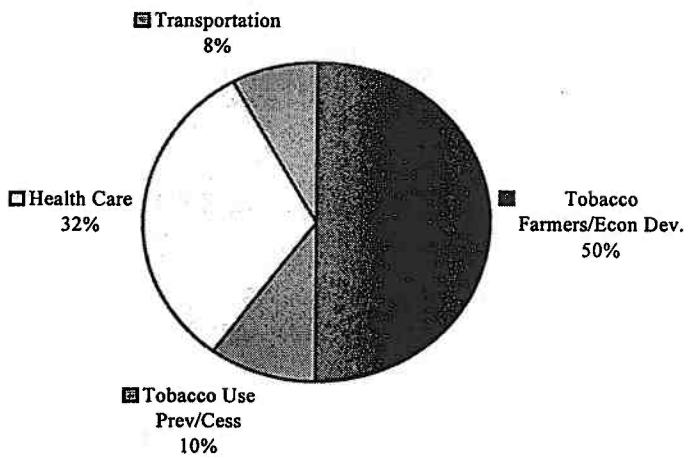
Legislation (SB 1165) in 1999 established two non-reverting funds in Virginia, which will receive a total of 60% of MSA payments annually. The balance of the money will be appropriated annually by the state legislature. The two non-reverting funds created are:

I. Tobacco Indemnification and Community Revitalization Fund: will receive 50% of MSA payments every year. Expenditures out of this fund will compensate tobacco farmers for the decline or elimination of the tobacco quota and to promote economic growth and development in tobacco dependent communities.

II. Virginia Tobacco Settlement Foundation: will receive 10% of MSA payments every year. Expenditures out of this will assist in financing efforts to restrict the use of tobacco products by minors.

FY 2000 Appropriations

Program	%
Recurring Appropriations	
Tobacco Indemnification and Community Revitalization Fund	50.0%
Virginia Tobacco Settlement Foundation	10.0%
FY-only Appropriations	
Commonwealth Transportation Fund for mass transit	8.0%
Commonwealth Health Care Research Fund	8.0%
Comprehensive Health Investment Project	6.0%
School Health Incentive Fund	8.0%
Virginia Health Care Foundation	6.0%
Healthy Families of Virginia	4.0%
Total	100.0%



STATE TOBACCO SECURITIZATION STATUS

APPROVED

- *Alaska:* Plans to securitize late 2000, early 2001.
- *California:* Under the settlement, 50% of the funds will go to the state, 40% will go to 58 counties based on population size, and 10% will be split between the cities of San Francisco, San Jose, San Diego, and LA.
  - Orange County – leaning toward securitizing
  - Sacramento Co. – plans to issue bonds prior to November 2000.
  - City of San Diego – has selected financing team.
- *Florida*: Tobacco Settlement Financing Corporation may issue bonds subject to approval by the Legislature. (approved 5/9/00)
- *Iowa:* Securitization allowed by legislation (HF2579 & SF2461 4/23/00)
- *New York:* Under the settlement, NY state receives 51.1%, NY City 26.6%, and counties outside NYC 22.3%. Four entities have already issued bonds:
  1. Nassau Co.
  2. Westchester Co.
  3. Monroe Co.
  4. New York City

  As many as 30 counties could join to issue bonds.
- *South Carolina:* Plans to securitize all of the expected MSA payments ($2.3 billion). Created the Tobacco Settlement Revenue Management Authority as the issuing authority.
- *South Dakota:* SB 85 allows for the issuance of bonds.

EXPLORING

- ***Alabama***: Governor will ask the legislature to securitize portion of TSF in 2001 (July 13, 2000)
- ***Arkansas:*** Mixed report
- ***Illinois:*** Exploring four financing options, including securitizing.
- ***Louisiana:*** Exploring securitization (no legislation as of June 30, 2000)
- ***Maine:*** weighing options
- ***Maryland:*** may explore possibility of issuing bonds to finance payments to tobacco farmers. (June 28, 2000)
- ***North Carolina:*** legislation pending (May 30, 2000; HB 1823) authorizing the issuance of Master Tobacco Settlement Receipts Bonds.
- ***Oklahoma:*** Exploring its options April 03, 2000
- ***Virginia:*** Governor proposed securitization n August 1999.
- ***Washington DC:*** Mayor proposed securitizing April 06, 2000.

NO PLANS

- ***Colorado***: State Treasurer proposed securitization (March 15, 2000). Died in legislature (May 02, 2000)
- ***Kansas:*** Proposed bill creating Kansas Tobacco Settlement Corporation which could issue bonds. Died in committee on 5/24/00. Issue is expected to be brought back in the 2001 legislative session.
- ***Mississippi:*** a non-MSA participant that decided not to securitize, but rather immediately create children's health care programs.
- ***Vermont***: "wait and see" approach to what other states are doing.

STATE EXPENDITURE PLANS: APPROVED SECURITIZATION

State/MSA Amount	Planned Uses of Funds
ALASKA $669 million	Will securitize proceeds • Build schools in rural areas • Facilities for the University of Alaska • Public housing facilities
CALIFORNIA $25 billion	The state, cities, and counties have all been allocated portions of the MSA amount. The following is a highlight of some of the spending proposals. • Health care programs • Anti-tobacco • Law enforcement • Jails • Retiring outstanding debt
FLORIDA $13 billion	Proceeds deposited into the Lawton-Chiles Trust Fund. Interest spent on the following: 50% Children's services 34% Bio-medical research 17% Senior services
IOWA $1.7 billion	All expenditures on health care • Access to health care • Public health and smoking prevention • Substance abuse treatment and prevention Note: by spending all of the $55 mil. expected in FY 2001 on health care, Iowa was able to obtain an additional $37 mil. in matching federal funds and grants.
NEW YORK $25.0 billion	New York City securitized, and will use the proceeds for school construction, health care initiatives, and capital financing needs. Counties around the state are allocating money for the following: • Medicaid expenditures • Debt reduction • Capital construction projects
SOUTH CAROLINA $2.3 billion	Will securitize proceeds Spending plan includes: 73% Health services, including prescription drug program for the elderly, substantial amount to the Medicaid program 15% Tobacco farmers 10% Rural economic development 2% Local gov't sewer and water projects
SOUTH DAKOTA $684 million	MSA funds to trust fund, only interest will be spent No details available for spending plans

STATE EXPENDITURE PLANS: EXPLORING SECURITIZATION

State/MSA Amount	Planned Uses of Funds
ILLINOIS **$9.1 billion**	$280 million for property tax relief $225 million for a rainy day fund
LOUISIANA **$4.4 billion**	Created two funds: Millennium Trust (45% of Tobacco funds, only interest is spent, evenly among the following programs): • Children's Health • Grants for innovative health care sciences • Tuition aid for LA college students • Elementary and secondary education funding Louisiana Fund (balance of MSA proceeds, interest only) • Health care and education initiatives
MAINE **$1.5 billion**	$22 mil. Smoking cessation and prevention 25 mil. Medicaid shortfall 25 mil. Reserve fund 10 mil. Prescription drug program for the elderly
MARYLAND **$4.4 billion**	Majority will fund 20 health related or education programs, focusing on: • Teacher pay raises • Anti-tobacco programs • Fight against cancer
NORTH CAROLINA **$4.6 billion**	Interest only to be spent on the following: • 1/2 of funds to be spent on economic development for communities adversely affected by reductions in tobacco sales. • 1/4 Health programs • 1/4 tobacco farmers, quota holders, and tobacco-related businesses
VIRGINIA **$4 billion**	$30 mil. Issued to tobacco farmers 16 mil. Economic development to localities based on a formula 11 mil. Virginia Tech to develop an institute for research of plant and animal genetics 11 mil. Anti-smoking programs
WASHINGTON, DC **$1.2 billion**	1/2 Health and education programs 1/2 Invested in new endowment fund

STATE EXPENDITURE PLANS: NO SECURITIZATION PLANS

State/MSA Amount	Planned Uses of Funds
COLORADO **$2.7 billion**	$17.1 mil. Trust fund, interest spent for future use 19.0 mil. Anti-tobacco program 15.2 mil. Literacy program 11.4 mil. Grants for community health centers 7.6 mil. Children's Health Insurance Program
KANSAS **$1.6 billion**	$28.0 mil. Transfer to State General Fund 10.8 mil. Child care services 6.1 mil. Juvenile justice programs 1.5 mil. Education 1.2 mil. Department of Health 0.0 mil. Tobacco prevention and cessation programs
MISSISSIPPI **$4.1 billion**	Established a health care trust. Programs established include the following: • Health insurance for all children up to age 16 • Eye examinations and glasses for "needy" students in public schools
VERMONT **$805.6 million**	$17 mil. Health insurance for low-income citizens 8 mil. Tobacco prevention and cessation programs

STATE EXPENDITURE PLANS: UNKNOWN SECURITIZATION PLANS

State/MSA Amount	Planned Uses of Funds
ARIZONA **$2.9 billion**	$80 million to build a state hospital for the mentally ill
MICHIGAN **$8.5 billion**	75% allocated to a Merit Scholarship program Balance will fund a Life Sciences Corridor for research in biotechnology No money allocated for smoking prevention/cessation
MISSOURI **$4.5 billion**	On May 05, 2000 the legislature adjourned without passing legislation on how to spend the settlement funds Question over whether the funds might need to be reimbursed to income tax payers due to a State amendment requiring any excess state revenue that grows significantly faster than the income of Missouri residents. In addition, if the MSA funds are not classified as state revenues (instead as reimbursement), they may be subject to legal challenges by hospitals/cities/towns
NEW JERSEY **$7.6 billion**	Senate passed $100 million bailout plan to rescue to failed HMOs. Paid out of MSA funds.
NORTH DAKOTA **$717.1 million**	45% will pay off water development bonds 45% for schools 10% health programs
OHIO **$9.9 billion**	50% school construction 10% biomedical research

From the NGA Center for Best Practices

Securitization: An Option for State Tobacco Settlement Funds *

September 8, 1999—by Kelly Nicholson
Health Policy Studies Division, NGA Center for Best Practices

Some states and localities are considering securitizing their tobacco settlement funds to receive a lump, up-front payment through a process of selling bonds that are backed by settlement payments.

In this *Issue Brief*:

Summary

Governors have been taking inventory of their state's needs and priorities in preparation for receiving funds from the national tobacco settlement agreement reached in November 1998. Some states and localities are considering securitizing their tobacco settlement funds to receive a lump, up-front payment. "Securitization," in the case of the tobacco settlement, is the process of selling bonds that are backed by settlement payments.

Securitization could benefit states with an immediate need or special project, such as a capital expenditure or the establishment of an endowment. However, reduced, stalled, or halted tobacco settlement payments could hinder states' ability to pay debt service on the bonds. States exploring this option should also be aware of their specific debt issue restrictions.

The securitization option needs thorough examination. Rating agencies have yet to issue bond ratings because of the complexities of the tobacco settlement and the unique circumstances of each state and locality that may be considering securitization.

Given the unprecedented nature of the tobacco settlement, the outstanding legal questions, and the various economic uncertainties, states should proceed along this path carefully.

The Tobacco Settlement

On November 23, 1998, the attorneys general of forty-six states, five commonwealths and territories, and the District of Columbia reached an agreement with five major tobacco companies, which represent 97.5 percent of the tobacco industry. Worth $206 billion over the next twenty-six years, the Master Settlement Agreement (MSA) will provide payments to states based on a formula developed by the attorneys general. Four additional states—Florida, Minnesota, Mississippi, and Texas—individually settled with the tobacco industry for more than $40 billion.

States will begin receiving settlement funds when 80 percent of the settling states that comprise at least 80 percent of the states' total financial allocation reach "state-specific finality," or June 30, 2000, whichever is earlier. In preparation for this date, states are examining and determining optimal ways to use their settlement funds. States have different economic circumstances and programmatic needs, and Governors seek to tailor their plans for using the funds accordingly. Some states and localities are considering securitizing their tobacco settlement funds to receive a large, up-front payment.

How Securitization Would Work

Securitization, in the case of the tobacco settlement, is the process of issuing bonds that are backed by tobacco settlement funds. The bond issuance would be considered an asset- or revenue-backed transaction, depending on the bond structure. Governments would transfer or "sell" their expected tobacco payment funding stream to a special-purpose entity (SPE), whose sole purpose is to issue bonds backed by these funds. The SPE would be responsible for the debt service on the bonds.

The legislatively created SPE would be designed to be essentially bankruptcy-proof. The state would also be legally separate from the entity and, therefore, would not put its own credit rating at risk through the tobacco bond issuance. This mechanism would afford states some protection from possible complications resulting from reduced, stalled, or halted payment streams from the MSA.

Potential Benefits to States of Securitization

Securitization would provide a sizeable, up-front payment, rather than smaller payments spread over a number of years. For states with immediate, pressing needs or a special project, securitization may be an option worth considering. For example, states may have health- or education-related infrastructure needs that require large capital outlays. They may also want to endow a fund with a large initial payment, rather than letting it build over time. Tobacco settlement payments will vary from year to year, depending on inflation and domestic cigarette consumption among other factors, so the up-front payment would provide a state with some budgetary certainty. Historically, states have used incoming revenues as security for bonds for special projects. For example, Garvee bonds—or grant anticipation revenue vehicles—allow

states to use future federal highway aid as bond security.

Factors Affecting Tobacco Settlement Bond Issuance

Once a state creates an SPE and transfers the settlement payments to it, the SPE can issue the bonds. The SPE pledges a portion of each annual settlement payment to pay the debt service and assumes all of the risk. The remaining settlement amount after payment of the debt service, often called the "residual," could be used as the state chooses. It could flow into the general fund to be appropriated annually or placed in another special fund for future purposes.

The actual bond structure will depend on several factors, including:

- the rating the state wants for the bonds and the amount of risk the state is willing to incur;
- the amount of money the state wants in an up-front payment;
- bond proceed usage; and
- rating agencies' requirements and their assumptions.

Rating Objectives and the "Stress Test"

Depending on state goals, the desired rating will vary among states. Some states will want to achieve the highest rating possible, while others may be satisfied with a lower rating. Regardless of the desired rating, it will be critical for states to "stress test" their financing structures by building worst-case scenarios into their assumptions. States can then predict, with some certainty, that bondholders can be repaid, even if the revenue stream is in jeopardy. Depending on the desired rating and amount of immediate funds that a state needs, states can control, to a certain extent, the amount of risk to the bondholder and possibly to the state.

Type of Bonds

The type of bond issued, either tax-exempt or taxable, will depend on the intended uses for the money. If bond proceeds are used for governmental purposes, such as capital expenditures, the bonds will be tax-exempt. If proceeds are used for projects that will benefit a private purpose, such as some stadium constructions, or that will be reinvested, as in the case of pension financing or endowment funding, the bonds will be taxable. Taxable bonds have higher interest, but the difference between the two options otherwise is not significant.

Additional Security Requirements

For the state to achieve a desired rating, rating agencies may require additional security, other than just the settlement funds, to guarantee bond repayment Some states may elect to pledge their "moral obligation" to fulfill the financial commitment. This means that in addition to pledging the tobacco settlement payments, the state commits to do whatever is necessary to repay bondholders if the payments are insufficient to pay the debt service. For example, states could pledge part of their state tobacco tax revenues or any other source of revenue in the event of a shortfall.

How Rating Agencies May Rate These Bonds

The rating of these bonds will vary from state to state, depending on state goals, the structure of the bond issue, back-up commitments, and the amount of revenue pledged to the issuance. However, rating agencies' final decisions are uncertain at this time. To date, no bond structure has been finalized for rating agency consideration so a bond issuance has yet to be rated. The rating agencies are considering different variables.

On June 17, 1999, Standard and Poor's (S & P) released an article on the benefits and challenges of securitization.[1] S & P analysts said they will rate this type of bond according to four main issues:

- MSA payment mechanics;
- proceed usage by states and municipalities;
- potential securitizations (or the structure); and
- related legal issues, including bankruptcy of the tobacco companies, outstanding litigation, and MSA design.

It is likely that S & P will use the "weak-link" approach to bond rating, which means the ratings will be linked to the credit ratings of the original participating manufacturers. Without further credit enhancement, this approach limits the possible rating on a transaction to the lowest unsecured rating of the four cigarette companies. Under this scenario, the bond could have a BBB- rating, which is equivalent to that of R.J. Reynolds Tobacco Company.

However, Moody's Investors Service believes that these bonds may, with appropriate legal and structural enhancement, achieve ratings higher than those of the underlying four major cigarette companies.[2]

Revenue Stream Risks

The rating of these bonds will depend on the assumptions made by rating agencies. A major consideration is the potential risk associated with the stream of tobacco settlement payments. If tobacco settlement payments fall short of expected levels or stop altogether, the SPE could have difficulty paying the debt service on the bonds. There are two main unknown risks: bankruptcy and consumption patterns.

Bankruptcy

A participating manufacturer could file for bankruptcy under Chapter 7 (liquidation) or Chapter 11 (reorganization). If this occurs, the funding stream could be reduced in a given year, interrupted, or even halted. Bondholders could lose their investment, and it is likely that they would call on the state to financially back its implied obligation.

Consumption Patterns

Future tobacco consumption patterns are uncertain. State allotments will rise or fall depending on several factors outlined in the MSA. One of the most crucial factors is the volume adjustment that will increase or decrease state payments based on the number of domestic cigarettes shipped, compared with a 1997 baseline. The volume

adjustment becomes more complicated if tobacco company revenues stay level or rise, because another calculation is then applied to that adjustment. Estimates of future settlement payments are only educated guesses.

Moody's projects consumption declines of 12 percent in 1999, 2 percent in 2000, and 1.5 percent per year thereafter.[3] Standard and Poor's projects declines of 10 percent in 1999, 3 percent in 2000, 2.5 percent in 2001, and 2 percent per year thereafter.[4]

Other Outstanding Variables

Other outstanding variables that could affect consumption rates or state payments include:

- a potential federal lawsuit against tobacco companies to recover Medicare and other smoking-related federal health costs;
- a possible increase in the federal cigarette tax;
- individual lawsuits against the industry and states;
- possible Food and Drug Administration regulation of tobacco products and the pending Supreme Court case on this issue; and
- the impact of the national smoking prevention and public education campaign and MSA marketing, advertising, and lobbying restrictions.

Constitutional or Other Limitations on Debt Issue

Every state has different limits, restrictions, and requirements with regard to debt issue. Most states have constitutional or statutory limits on debt amount or the type of debt that may be incurred by the state.[5] To incur debt, states will often need a constitutional amendment, voter referendum, or legislative approval. Governors need to be aware of the restrictions on debt issue within their state.

Potential Risks to States of Securitization

States considering securitization face several potential risks. If annual payments are reduced, stalled, or halted, this will affect the state's ability to repay the bonds. In addition, the state's reputation could be tainted if the bonds cannot be repaid, even though its credit rating may not harmed. It is conceivable that citizens could compel the state to repay bondholders, regardless of whether the state committed to do so. Moreover, it is important to note that there are costs associated with bond issuance, including legal and interest costs.

Outlook for Securitization

Securitization of tobacco settlement payments needs thorough examination. Rating agencies have yet to issue bond ratings because of the complexities of the tobacco settlement and the unique circumstances of each state and locality that may be considering securitization. Given the unprecedented nature of the MSA, the outstanding legal questions, and the various economic uncertainties, states should

proceed along this path carefully.

Securitization will appeal to states that want to address a specific need within an immediate or set expenditure timeframe. States can use these proceeds for special projects, one-time expenditures, or a temporary supplemental funding source. They should not look to those bonds to cover ongoing operating expenses.

Some parties interested in securitization believe it is an attractive option because the state is guaranteed a fixed amount of money, rather than having to wait each year for an unpredictable amount because of the offsets built into the MSA. They also assume that the risk is transferred to someone else—the bondholder. However, the state's name will be on whatever bond that is issued with its settlement funds, even though a totally separate SPE issues the bonds. State experience has shown that regardless of whether a state obligates itself to make good on a particular bond or loan, it may ultimately be held responsible for assuming that debt.

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[1] Christopher Howley, Richard Gugliada, and Nicole Delz Lynch, "Commentary: Tobacco Settlement Securitization Offers Benefits and Challenges," Public Finance (New York: Standard & Poor's, June 17, 1999).

[2] Tracy Sacco, "Raters Focus on Bankruptcy Risk for Tobacco Bonds," Reuters, 1 July 1999.

[3] Dale McCormick, "What Should Maine Do with 1.5 Billion Dollars: An Overview of Maine's Tobacco Settlement, " MaineINTEREST, Special Issue (winter 1999).

[4] Howley et al.

[5] National Association of State Treasurers,State Treasury Activities and Functions (Lexington, Ky.: National Association of State Treasurers, 1997).

Update on Tobacco Securitization

State	Description
Alaska	Proceeding with $100.0 million issue.
North Dakota	State issued $32.0 million in revenue bonds, partially secured by tobacco funds.
Iowa	Securitization legislation enacted. Implementation plan being developed.
Indiana	Governor and Attorney General have proposed securitization to capitalize a permanent fund to support
	long-term state priorities.
Ohio	Treasurer has proposed securitization to capitalize a Trust Fund and transfer industry risks to bondholders.
Maine	Treasurer has proposed securitization to capitalize a Trust Fund and transfer industry risks to bondholders.
Illinois	Treasurer has proposed securitization to capitalize a Trust Fund and transfer industry risks to bondholders.
State of New York	No activity.
NYC	Completed $709.0 million tax exempt issue. Financed capital projects related to school construction
	and renovation.
Nassau County	Completed $295.0 million issue to finance annual payments to the Nassau Health Care Corp. and to
	partially fund the county's operating deficit.
Westchester County	Completed $104.0 million issue to provide a lump sum payment to the Westchester County Health Care Corp.
Monroe County	Completed $163.0 million issue. Provided $83.0 million for escrow to defease existing G.O. debt and
	$54.0 million for new capital projects, plus funds for reserves and expenses.
Erie County	Planning to issue $200.0 million tax-exempt securitization to capitalize a trust fund that can be used for county
	debt service, for contributions for county medical center and for economic development projects.
Oneida County	Planning to issue $55.0 million transaction to fund new capital projects or to defease outstanding G.O. debt.
Chautauqua County	Planning to issue revenue bonds after 2003 for various capital projects and to defease existing
	G.O. debt.
Niagra County	Planning to issue revenue bonds. $47.0 million securitization planned for a variety of projects.
Albany County	Comptroller has proposed securitizing to fund various county projects.
Oregon	Treasurer proposed $400.0 million securitization; 50% tax exempt (match local school construction) and 50%
	taxable (capitalize health care trust fund); residual to a Rainy Day Fund. Legislature rejected proposal.
Colorado	Treasurer proposed $1.0 billion securitization to transfer tobacco industry risks to bondholders and
	eliminate conflict of interest between receipt of funds and the State's smoking cessation efforts. Legislature
	rejected proposal.
New Mexico	Legislation proposed bonding via NMFA using "Severance Tax Model".
Louisiana	State considering establishing Trust Fund that can be invested in equities.
Texas	Legislation authorizing securitization to fund local school construction grants introduced in last session.

Update on Tobacco Securitization

Oklahoma	Governor proposed securitization, and there are other plans to use funds to back debt for public higher
	education capital funding. Situation pending.
Arkansas	Governor taking initiative, which includes leveraging, to ballot this Fall.
Alabama	Legislation created Alabama 21st Century Authority, with $250.0 million securitization authorization.
Puerto Rico	Commonwealth proceeding with $400.0 million securitization this Fall.
Florida	Legislation passed which conditionally authorizes up to $2.4 billion of tobacco bonds with proceeds to be
	deposited in Lawton Chiles Endowment.
South Carolina	State anticipates securitizing 100% of its Master Settlement Agreement (MSA) payments this Fall
	($600.0 to $800.0 million).
Georgia	Legislation signed which authorizes $1.5 billion for securitization, targeting rural economic
	development.
Virginia	Governor proposed $800.0 million tax exempt securitization for transportation. Legislature rejected proposal.
District of Columbia	District Council approved securitization with $300.0 million transaction expected this Fall.
State of California	No activity.
Sonoma County	Have expressed interest in endowment concept.
Butte County	Likely to securitize; emphasis is on risk-transfer.
Solano County	Exploring healthcare endowment.
Sacramento County	Proceeding with securitization of cashflows after FY 2005.
Alameda County	Considering securitization to provide long-term, stable funding source, primarily for health care.
Contra Costa County	County in process of selecting firm for $140.0 million issue for Trust Fund.
Stanislaus County	Proceeding with securitization.
San Francisco	Ballot measure requires funds to be used to offset cost of Laguna Honda Hospital replacement, for
	which there is $299.0 million of G.O. bond authorization. Likely to issue variable rate G.O.s, using
	tobacco funds to pay down debt periodically.
Monterey County	May use securitization to partially fund new county/city government center.
Santa Clara	Exploring healthcare endowment.
Orange County	Securitization stymied by local initiative.
Los Angeles County	May use securitization to partially fund County-USC medical center replacement.
Ventura County	Securitization stymied by local initiative.
City of Los Angeles	Mayor proposed securitization to create liability reserve for LAPD Rampart Division litigation.
	Council vetoed proposal.
El Dorado County	Considering securitization to finance courthouse complex. As a sale of a receivable, this approach would
	comply with County ordinance that otherwise requires a public vote for lease-debt.
Merced County	Have expressed interest in endowment concept.

San Bernardino County	Interested in using proceeds to defease existing County hospital debt.
Tulare County	Issued $45.0 million of taxable double-barreled, tobacco-backed lease revenue bonds in 1999 to
	capitalize a Millennium Fund.
Riverside County	Interested in using proceeds to fund endowment.
Imperial County	Interested in using proceeds to defease existing health care facility debt.
City of San Diego	Considering pledge of tobacco funds to backstop General Fund Certificates of Participation for new
	downtown library.
County of San Diego	Proceeding with transaction.
	States and localities not listed have expressed no interest in securitizing the Master Settlement Agreement
	payments.
	Sources: Morgan Stanley Dean Witter; Treasurer of State