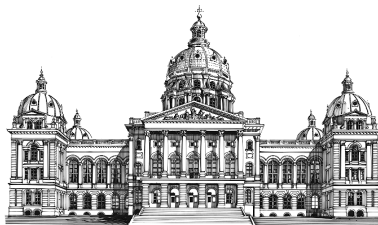

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Restricted Capital Funds Account of the Tobacco Settlement Trust Fund

ISSUE

The Restricted Capital Fund was established to receive \$540.0 million in tax-exempt bond proceeds as a result of the Tobacco Securitization process. This *Issue Review* provides information on the restrictions associated with these funds as well as the most recent cash flow estimates of the Fund.

CODE AUTHORITY

Chapter 12E, Code of Iowa

BACKGROUND

In the fall of 2001, the Tobacco Settlement Authority (TSA) sold \$604.2 million in tax-exempt bonds. After the deduction of issuance fees, underwriter discounts, and the debt service reserve fund allocation, net proceeds of \$540.0 million were deposited into the Restricted Capital Fund. Significant provisions on the use of tax-exempt bond proceeds are discussed below.

Qualified Capital Projects

The bond proceeds and the interest earned on those proceeds may be used for qualified capital projects in accordance with Internal Revenue Code regulations. This includes expenditures for depreciable assets such as construction and renovation of facilities, and equipment purchases. Unqualified expenditures would include operational expenses and routine facility maintenance.

The Master Settlement Agreement also allows the tax-exempt bond proceeds to be used for payment of attorney litigation fees associated with the Master Settlement Agreement and the refunding of certain outstanding tax-exempt bonds (i.e., Iowa Communications Network [ICN] bonds, prison construction bonds, and a portion of the Regents academic revenue bonds).

Required Spending Schedule of Bond Proceeds

The Internal Revenue Code requires tax-exempt bond proceeds to be expended in accordance with the following Hedge Bond spending schedule:

1. Year 1 (FY 2002): 10.0% of proceeds expended
2. Year 2 (FY 2003): 30.0% of proceeds expended
3. Year 3 (FY 2004): 60.0% of proceeds expended
4. Year 5 (FY 2006): 85.0% of proceeds expended
5. Year 6 (FY 2007): The balance of the bond proceeds, including investment earnings, must be expended.

Average Economic Life Test for Capital Projects

Qualified capital projects funded with tax-exempt bond proceeds must have average reasonable expected lives such that the weighted average maturity of the bonds will not exceed 120.0% of the average expected economic lives of the projects funded. The average weighted maturity of the bonds is 18.5 years; therefore, the average economic lives of the projects must be greater than 15.4 years.

In determining the 120.0% economic life, the overall weighted mix of all capital projects funded is used in the calculation for the economic life test. For example, large construction projects with an economic life of 40 years will offset smaller, less costly projects with useful lives of less than 15 years.

Restrictions on Replacement Funds

Tax-exempt bonds cannot be used to finance a capital project if the bonds would replace other funds with such a close connection to the project to suggest that those funds otherwise would have been used to finance the capital project. The determination as to whether or not funding of a proposed project would violate the replacement restrictions is made on a case-by-case basis through the advice of tax counsel.

PROJECTED FUND BALANCES

Attachment A shows the balances of the Restricted Capital Fund beginning with FY 2002 and projected to FY 2007 (the year all proceeds must be expended). The spreadsheet includes revised interest estimates based on the appropriations enacted through the 2002 Legislative Session, as well as the actual earnings in FY 2002.

The General Assembly has made appropriations from the Fund totaling \$401.6 million through FY 2006. In addition to the \$401.6 million are the projected debt service payments for FY 2004 through FY 2007 for the ICN bonds, prison infrastructure bonds, and a portion of the Regents academic revenue bonds (Tuition Replacement). Although not yet appropriated, these debt service payments are considered an obligation of the tax-exempt bond proceeds. The scheduled debt service payments for FY 2004 through FY 2007 total \$91.8 million. The obligations of the Fund (appropriations plus projected debt service) total \$493.4 million.

The following provides an explanation of the various revenues and expenditures listed on the attached table.

- Tax-Exempt Bond Proceeds – The amount of bond proceeds deposited into the Fund on October 25, 2001.
- Interest – The projected interest is based on a rate of 3.9%. The FY 2002 interest earnings ranged from 3.5% to 3.8%. The interest earned in FY 2002 totaled \$13.2 million.

- Projected Debt Service Payments – The amount needed to pay the scheduled debt service payments for the ICN bonds, prison infrastructure bonds, and a portion of the Regents academic revenue bonds. These funds have yet to be appropriated. Beginning in FY 2008, the debt service payments for the prison infrastructure bonds and the Regents bonds will need to be funded from the General Fund or an alternative source. The ICN bonds are scheduled to be retired in FY 2006.
- Available for Capital Projects in FY 2004 – Estimated amount of funding that will be available for appropriation in FY 2004. This is discussed in greater detail below under Future Funding for Capital Projects.
- Tobacco Settlement Authority (TSA) Enforcement – One-time set-aside payment to cover potential legal action associated with enforcing tobacco industry compliance with the tobacco settlement agreement. This set-aside is required under the Master Settlement Agreement.
- Tobacco Settlement Authority (TSA) Operations – Expenses for the operation of the Tobacco Settlement Authority. This includes reimbursement to the Attorney General's Office for legal services for the Authority, costs for tax counsel services, auditing fees, and staff and support costs provided by the Treasurer's Office and the Department of Management.

FUTURE FUNDING FOR CAPITAL PROJECTS

Based on the above assumptions in interest earnings, the General Assembly will have approximately \$90.0 million available to appropriate for capital projects in FY 2004. This would maintain approximately the same level of funding for capital projects that was appropriated in FY 2003. Fiscal Year 2004 will likely be the last year that a significant amount of funding will be available for capital projects until after FY 2008. In FY 2008, the State Wagering Tax allocation that is currently deposited into the Endowment for Iowa's Health Account will be deposited into the Rebuild Iowa Infrastructure Fund (RIIF) and available for capital projects. As part of the tobacco securitization process, the General Assembly appropriated State Wagering Tax proceeds to the Endowment over a six-year period in the following amounts: \$80.0 million in FY 2002, \$75.0 million in FY 2003, and \$70.0 million annually for FY 2004 through FY 2007. Prior to FY 2002, these funds were deposited into the RIIF for funding infrastructure and environmental programs and projects.

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Restricted Capital Funds Account
Of the Tobacco Settlement Trust Fund
<http://staffweb.legis.state.ia.us/lfb/IREVIEW/irview.htm>
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**Restricted Capital Fund
of the Tobacco Settlement Trust Fund**

| | Actual | Legislative Action and Out-Year Estimates | | | | |
|---|-----------------------|---|-----------------------|----------------------|----------------------|----------------------|
| | FY 2002 | FY 2003 | FY 2004 | FY 2005 | FY 2006 | FY 2007 |
| Resources | | | | | | |
| Balance Forward | \$ 0 | \$ 427,502,362 | \$ 257,421,641 | \$ 78,586,843 | \$ 34,361,384 | \$ 15,224,825 |
| Tax-Exempt Bond Proceeds | 540,045,010 | 0 | 0 | 0 | 0 | 0 |
| Preliminary Interest Estimates | 13,208,002 | 16,672,592 | 10,039,444 | 3,064,887 | 1,340,094 | 593,768 |
| Total Available Resources | <u>\$ 553,253,012</u> | <u>\$ 444,174,954</u> | <u>\$ 267,461,085</u> | <u>\$ 81,651,730</u> | <u>\$ 35,701,478</u> | <u>\$ 15,818,593</u> |
| Expenditures | | | | | | |
| Enacted Appropriations | \$ 125,432,642 | \$ 186,553,313 | \$ 69,270,300 | \$ 17,854,100 | \$ 2,500,000 | \$ 0 |
| Projected Debt Service Payments | 0 ¹ | 0 ¹ | 29,403,942 | 29,236,246 | 17,776,653 | 15,408,460 |
| Available for Capital Projects in FY 2004 | 0 | 0 | 90,000,000 | 0 | 0 | 0 |
| TSA Enforcement | 200,000 | 0 | 0 | 0 | 0 | 0 |
| TSA Operations | 118,008 | 200,000 | 200,000 | 200,000 | 200,000 | 200,000 |
| Total Expenditures | <u>\$ 125,750,650</u> | <u>\$ 186,753,313</u> | <u>\$ 188,874,242</u> | <u>\$ 47,290,346</u> | <u>\$ 20,476,653</u> | <u>\$ 15,608,460</u> |
| Ending Balance | <u>\$ 427,502,362</u> | <u>\$ 257,421,641</u> | <u>\$ 78,586,843</u> | <u>\$ 34,361,384</u> | <u>\$ 15,224,825</u> | <u>\$ 210,133</u> |

TSA = Tobacco Settlement Authority

¹ The debt service appropriations for FY 2002 and 2003 are included in the Enacted Appropriations amounts.