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Tobacco Securitization Proposal (Tobacco Settlement Securitization)

[LFB 2001-03 Budget Summary: Page 53, #6, Page 637, #1 and Page 638, #2]

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

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 DOA Secretary would be allowed to enter into a contract with any firm or individual engaged in providing financial services for the performance of any of his or her functions relating to the sale, assignment or transfer of the state's tobacco settlement rights using selection and procurement procedures established by the Secretary. The awarding of any such contract would not be subject to the state's competitive, public notice and minority-owned business bidding requirements for state contracts. Further, such contracts would not be subject to the requirements for state contracts for contractual services, including the requirement that DOA prepare a written justification that the contract for services are necessary and the Department of Employee Relations review the contracts to ensure that the services of state employees are being utilized and to review the possible use of the limited-term employees of the state in lieu of the contract.

The bill would provide $500,000 GPR in 2001-02 from a sum sufficient appropriation created under the bill to pay the costs incurred by the DOA Secretary in any sale of the state's rights to receive any payments under the tobacco settlement agreement and in organizing and initially capitalizing any corporation or company relating to sale of the state's rights to tobacco settlement payments

DISCUSSION POINTS

Background

1. On April 24, 2001, this office issued a paper that provided an extensive analysis of the Governor's proposed tobacco securitization (See Legislative Fiscal Bureau budget paper #885) for an April 26, 2001, Joint Committee on Finance briefing. The paper outlined the tobacco master settlement agreement and the potential impacts to the states payments under that agreement and provided information on the characteristics of other tobacco securitization that have occurred across the country. The paper also outlined the Governor's proposed securitization transaction and addressed policy issues surrounding the proposed sale of the state's rights to its tobacco settlement payments.

2. DOA indicates that 30 years of the state's tobacco payments could secure a total of $1.257 billion in tobacco revenue bond proceeds. The proceeds would be available for the following purposes:

TABLE 1

Use of Revenue Obligation Proceeds
(In Millions)

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

3. As indicated in the table, the proposal would deposit $350 million of the bonds proceed associated with the state's sale, assignment or transfer of the state's rights to its tobacco settlement payments to the general fund in 2001-02. With the remaining funds at the state's disposal from the transaction, the Governor propose establishing a $570 million endowment fund.

4. SWIB would invest the assets of the permanent endowment fund created 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. SWIB 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.

5. 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 annual under the securitization transaction outlined by DOA. Annually, after June 1, but not later than June 15, beginning in SWIB would be required to calculate monies that are available for transfer from the permanent endowment fund to the general fund. Those monies would be as follows.

a. 8.5% of the market value of the endowment fund on June 1 of each year:

b. all proceeds of, and investment earnings on, investments of the permanent endowment fund made at the direction the DOA Secretary that are received in the fiscal year; and

c. all other amounts identified by the DOA Secretary 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.

Legislative Oversight of the Proposed Securitization Transaction

6. 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.

7. 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 for 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.

8. If the Committee is concerned about the amount of authority provided the DOA Secretary under a transaction that involves such a large amount of state funds and that will impact the finances of the state for years to come, the Committee could require that before the DOA Secretary could enter into any contract to sell, assign or transfer the state's tobacco settlement payment rights the Secretary would have to submit the proposed transaction, including the structure of the transaction, estimates of the bond proceeds that would be generated from the transaction and any state pledges relating to the transaction, to the Joint Committee on Finance for approval. Because of the issues and concerns related to the timing and entry into the bond market that are associated with any borrowing transaction, the Committee could require that the transaction be submitted for approval under a 14-day passive review.

9. 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 impact on future available revenues and expenditures.

10. When the securitization transaction is complete, the DOA Secretary would deposit the bond proceeds associated with the sale in the general fund and the permanent endowment fund. However, because any Committee approval of a proposed securitization transaction would occur

before the actual transaction took place and the bonds secured by the state's tobacco payments are issued, the size of the transaction would not be known. Because the depositing and transferring of revenues among funds is typically a legislative function, in order to develop a better oversight of the deposit of the bond proceeds from the transaction, the Committee could require that after any bonds secured by the state's tobacco payments are sold, the DOA Secretary must submit a report to the Committee on the transaction and on the distribution of the bond proceeds.

Legislative Oversight of the Annual Transfers of Funds

11. As mentioned earlier, the bill also provides the DOA Secretary the authority to direct SWIB to annually, after June 1, but before June 15, transfer funds from the permanent endowment fund to the general fund. 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 a legislative role in determining revenue and expenditure levels, additional legislative oversight could be provided.

12. To increase legislative oversight of these annual transfers, the Committee could delete the authority provided to the DOA Secretary and instead provide the Committee the authority to transfer these amounts at its fourth quarterly meeting in each fiscal year under s. 13.10 of the statutes.

SWIB Fiduciary Responsibilities

13. The bill would provide the DOA Secretary authority to direct SWIB on the types of assets in which the Board could invest the permanent endowment fund. 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.

14. 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.

15. SWIB's investment of assets is generally subject to standards of fiduciary responsibility that apply to the Board when it otherwise invests money or property. However, SWIB's fiduciary responsibilities exist within the statutory limitations placed on the allowable investments of each fund under SWIB's control. That is, SWIB may invest assets of a fund in lower earning investments and still be within its fiduciary responsibilities, if SWIB is statutorily required to invest the assets of that fund in that type of investment.

DOA Contracting for Financial Services

16. No funding detail has been developed that would support the current $500,000 GPR expenditure estimate under a new GPR sum sufficient appropriation in DOA to fund costs incurred by the Secretary of DOA in implementing the tobacco securitization proposal. However, it could be argued that the development of a tobacco securitization agreement may be sufficiently complex that additional funding should be provided so that DOA has sufficient resources to structure this transaction advantageously. Alternatively, funding could be reserved on a contingent basis for this purpose. Under this alternative, the new GPR-funded appropriation under DOA to fund costs incurred by the Secretary of DOA in implementing the tobacco securitization proposal could be created as a biennial appropriation. The $500,000 GPR provided under the bill in 2001-02 could be placed in reserve in the Committee's s. 20.865(4)(a) appropriation for possible release to DOA, once the Department has identified its funding needs and demonstrated that these additional costs cannot be funded from any other source.

17. The bill would allow DOA to enter into a contract with any firm or individual engaged in providing financial services for the performance of any of his or her functions relating to the sale, assignment or transfer of the state's tobacco settlement rights using selection and procurement procedures established by the Secretary. The awarding of any such contract would not be subject to the state's competitive, public notice and minority-owned business bidding requirements for state contracts.

18. The state's competitive, public notice and minority-owned business bidding requirements for state contracts are designed to foster competition for state contracts, which can reduce the costs the state pays for the services contracted for. Given the size of the securitization transaction and the value of the contract that would be entered into, the Committee could consider deleting the provisions that would exempt the contracting of financial service related to the proposed tobacco transaction from the state's competitive, public notice and minority-owned business bidding requirements for state contracts.

19. However, it could be argued that because the timing of the securitization may be crucial to state's ability to maximize its financial position in the financial markets, these state contracting requirements could hinder the state's position.

ALTERNATIVES TO BILL

A. Securitization

1. Approve the Governor's recommendations to securitize the state's annual tobacco settlement payments and deposit the proceeds from the transaction into a newly created segregated permanent endowment fund. Further transfer $350 million SEG from the endowment fund to the general fund.

2. Delete the Governor's recommendation. No funding would be available from securitization and no authority would be provided to carry out a securitization of the state's tobacco payments.

Alternative A2	GPR	SEG	TOTAL
2001-03 REVENUE (Change to Bill)	- $350,000,000	- $350,000,000	- $700,000,000
2001-03 FUNDING (Change to Bill)	- $500,000	- $350,000,000	- $350,500,000

B. Legislative Oversight

1. Approve the Governor's recommendation.

2. Require that before the DOA Secretary could enter into any contract to sell, assign or transfer the state's tobacco settlement payment rights the Secretary would have to submit the proposed transaction, including the structure of the transaction, the estimated bond proceed that would be generated from the sale and any state pledges relating to the sale, to the Joint Committee on Finance for approval under a 14-day passive review.

3. Require that after any bonds secured by the state's tobacco payments are issued, the DOA Secretary must submit a report to the Committee on the transaction and on the distribution of the bond proceeds.

4. Delete the authority provided to DOA Secretary to annually direct SWIB to transfer amounts from the permanent endowment fund and, instead, provide the Committee the authority to transfer these amounts at its fourth quarter meeting under s. 13.10 of the statutes.

C. SWIB's Fiduciary Responsibilities

1. Approve the Governor's recommendation.

2. Delete the authority of the DOA Secretary to direct SWIB on the types of assets in which the Board could invest the permanent endowment fund and the exemption of SWIB's fiduciary responsibilities in the investments of those assets. Specify that SWIB could hold: (a) evidences of indebtedness, including subordinated obligations, that are secured by tobacco settlement revenues, and that are issued by 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.

D. DOA Contracting for Financial Services

1. Approve the Governor's recommendation to provide $500,000 GPR in 2001-02 from a sum sufficient appropriation created under the bill to pay the costs incurred by the DOA Secretary

in any sale of the state's rights to receive any payments under the tobacco settlement agreement and in organizing and initially capitalizing any corporation or company relating to sale of the state's rights to tobacco settlement payments.

2. Modify the Governor's recommendation to, instead, provide $500,000 GPR in 2001-02 in the Joint Committee on Finance s. 20.865(4)(a) appropriation for possible release to DOA, once the Department has identified its funding needs to pay the costs incurred by the DOA Secretary in any sale of the state's rights to receive any payments under the tobacco settlement agreement and in organizing and initially capitalizing any corporation or company relating to sale of the state's rights to tobacco settlement payments. The funding could be provided when DOA demonstrates that these additional costs cannot be funded from any other source.

3. Delete the Governor's recommendation to provide $500,000 GPR in 2001-02 for contracting for financial services related to tobacco securitization.

Alternative D3	GPR
2001-03 FUNDING (Change to Bill)	**-** $500,000

E. Purchasing Requirements

1. Approve the Governor's recommendations.

2. Delete the provisions that would exempt the contracting of financial service related to the proposed tobacco transaction from the state's competitive, public notice and minority-owned business bidding requirements for state contracts

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