Legislative Fiscal Bureau
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Revenue Obligations for Purchase of Tobacco Securitization Bonds (Building Commission)

[LFB 2003-05 Budget Summary: Page 78, #5]

CURRENT LAW

Under 2001 Act 16 (the 2001-03 biennial budget), the Secretary of the Department of Administration (DOA) was authorized to securitize the state's rights to its tobacco settlement payments. Under the transaction, the state assigned the rights for up to 30 years of its tobacco settlement payments to the Badger Tobacco Asset Securitization Corporation, in exchange for $1.567 billion in net bond proceeds to the state, $1.275 billion of which was available to the state in the 2001-03 biennium.

GOVERNOR

Establish a revenue obligation bond program, where DOA could purchase some or all of the state's outstanding tobacco securitization bonds. To finance these purchases, authorize the Building Commission to issue up to $1.6 billion in revenue obligations. The newly-issued revenue obligation bonds would be backed by the tobacco settlement payments that would have otherwise been used to pay off the tobacco securitization bonds and by the state's moral obligation pledge to appropriate any funds that may be necessary to repay the obligations and maintain the required reserves. Any funds associated with the savings under a transaction involving the repurchase of the state's tobacco bonds, as determined by the Building Commission, would be transferred in equal amounts to the tobacco control fund and general fund.

DISCUSSION POINTS

Tobacco Securitization

1. On April 18, 2002, DOA formed a nonstock, nonprofit corporation called the Badger Tobacco Asset Securitization Corporation (BTASC) for the purposes of securitizing the state tobacco settlement payments. On May 1, 2002, the Corporation priced the tobacco securitization bonds backed by the newly-assigned rights to the state's tobacco settlement payments. Based on that pricing, the state netted $1.567 billion in total bond proceeds with $1.275 billion of these proceeds available to the state after establishing the required reserves and capitalized interest and issuance costs. The transaction was finalized on May 23, 2002.

2. Under the securitization transaction, the state assigned the rights to the next 30 years of its tobacco settlement payments to the BTASC. While 30 years of tobacco settlement payments are pledged to support the bonds issued by the Corporation, fewer years of payments will actually be needed. Under the securitization undertaken by the state and BTASC, it is estimated that the bonds could be repaid by as early as 2018, at which time the state would regain the rights to its annual tobacco settlement payments.

3. The BTASC bonds include five different sets of bonds, including two series of shorter maturity, fixed term bonds with a par value of $412.9 million and three series of longer-maturity, senior lien bonds with a par value of $1.178 billion. The entire series was issued with two repayment schedules: (a) a 30-year maturity debt service schedule that assumed only those tobacco payments necessary to make the lower debt service associated with the longer maturity would be used each year; and (b) an expected, shorter-term (approximately 15-year) maturity schedule, under which every dollar of tobacco settlement payments are applied to debt service and early payment of principal on the bonds each year.

4. While the bonds do carry financing rates that reflect concerns about the potential risk associated with the tobacco settlement payments, even under the 30-year repayment schedule, annual tobacco payments are currently projected to exceed the annual debt service on the tobacco bonds by between 30% and 60%, which means tobacco settlement payments would have to drop significantly before the 30-year repayment schedule is not met. BTASC plans to use these excess settlement payments to repay the bonds under shorter-term repayment schedule, which could result in the BTASC bonds being repaid by 2018 rather than the 2032 payoff date under the longer-term maturity schedule. However, despite applying the shorter repayment schedule to the bonds, BTASC would not be considered in default if it could not make payments under the 2018 repayment schedule. Rather, BTASC would only be considered in default on its tobacco bonds if the annual tobacco settlement payments are not sufficient to cover the annual debt service payments under the 30-year repayment schedule.

5. Because of legal and financial issues associated with tobacco manufacturers, some concern about the ability of tobacco companies to make their required tobacco settlement payments existed at the time the Legislature deliberated over the state's tobacco securitization transaction.

Under tobacco securitization, DOA, at that time, contended that the state could limit the risk associated with the tobacco settlement payment stream by transferring that risk to the holders of the tobacco revenue bonds. It was argued that because the tobacco securitization bonds would be issued by a separate entity like BTASC, the state would not be liable to bondholders if the tobacco revenues would be insufficient to make the necessary debt service payments on the tobacco bonds. Instead, the bondholders would be subject to the risk associated with the payment stream.

6. However, as noted during deliberations on the state's securitization transaction, some uncertainty exists as to whether or not states that have signed onto the tobacco settlement agreement are actually free from any legal liability to BTASC bondholders. Despite assigning the rights to its payments to a third party under securitization, the state continues to have enforcement authority of the agreement and state statutes relating to the agreement, which could have some bearing on the future tobacco payments necessary to repay the tobacco securitization bonds. Therefore, it could be argued that bondholders may have some a legal recourse with the state associated with the securitization transaction if the state's enforcement levels could be proven to have impacted the state's tobacco settlement payment amounts. In addition, even if the state would have no legal responsibility associated with the BTASC's bonds, having bonds in default that are effectively tied to the state's rights to its tobacco settlement payments could be perceived as harmful to the state's financial reputation. Therefore, it is possible that the state would choose to repay bondholders, regardless of whether the state is legally committed to do so.

Current Tobacco Bond Market

7. Since BTASC issued its tobacco bonds, several other states have also issued bonds securitized by the tobacco settlement payments. More recent tobacco bond issues have not faired as well in the market as the BTASC bonds. California, for example, which recently issued $3.0 billion in tobacco bonds, found that investors demanded higher yields, and consequently lower prices, on its bonds, than anticipated.

8. Financial analysts indicate that the yields and pricing on recent tobacco bond issues reflect the fact that the market is having to cope with a large volume of tobacco bond obligations. This may pose pricing problems, because investors do not differentiate the tobacco bonds issued by each state or local government, but rather view the bonds as backed by similar revenue streams from the major tobacco companies responsible for the settlement payments. As a result the bonds are perceived as carrying the same credit risk. Consequently, institutional investors or mutual funds that hold New York and Wisconsin tobacco bonds may risk overexposure to the same credit risk if they were to purchase other states' tobacco bonds.

9. The high yields and diminished pricing of the California tobacco bonds has also had an impact on the value of tobacco bonds currently held by bondholders. Because the tobacco bonds involve similar credit risks, the yield increases associated with the California bonds make the current tobacco bondholders' bonds less valuable. Due to this reduced value of the tobacco bond market, DOA Capital Finance officials believe that bondholders may be willing to sell their BTASC bonds to the state. In addition, the state may be able to take advantage of the market, and buy the

BTASC bonds at a price that would be beneficial to the state. However, the bond market's knowledge that the state would be buying BTASC bonds could differentiate those bonds from other tobacco bonds, which could increase the price that the state would have to pay for the bonds. Therefore, whether the state would purchase the BTASC bonds at a premium or a discount would depend on the balance of the overall conditions of the tobacco bond market and the impact that the knowledge of the state's willingness to buy BTASC bonds would have on the individual market for those bonds.

Tobacco Bond Repurchase Proposal

10. Under the Governor's proposal, the state could issue up to $1.6 billion in revenue obligations, the proceeds of which would be used to repurchase BTASC bonds. The revenue obligations would be supported by the same tobacco settlement payments currently used to support the BTASC bonds and by the Legislature's moral obligation to appropriate any funds that may be necessary to repay the bonds and maintain the required reserves on the bonds.

11. While the bill would provide the Building Commission the authority to carry out the tobacco bond repurchase transaction, the specific details of any repurchase transaction are not known at this time. The pubic finance bond market environment in general and tobacco bond market in particular, as well as the corresponding willingness of current BTASC bondholders to sell their bonds, will all affect the size of any potential savings associated with a BTASC bond purchase transaction.

12. However, for illustration purposes, DOA Capital Finance officials have outlined a possible transaction that could involve the state issuing revenue bonds to purchase approximately $1.178 billion of the nearly $1.6 billion in BTASC bonds that were issued. The proceeds of the state-issued revenue bonds would then be used to immediately payoff the tobacco bonds, and the tobacco settlement payment that were to be used to repay the tobacco bonds would instead be used to repay the state-issued revenue bonds. The transaction would involve the state purchasing only the longer-term, senior lien BTASC bonds. The state would issue these revenue bonds with a repayment schedule that mirrors the principal repayment schedule of both the 30-year repayment schedules on the BTASC bonds and the expected, approximately 15-year repayment schedule on the BTASC bonds.

13. By attaching the state's moral obligation pledge to the new state-issued revenue bonds, under the transaction outlined by DOA Capital Finance officials, it is believed that the state could significantly reduce the interest costs from the current rates. Under this scenario, the state would be assuming some of the risk associated with tobacco settlement payments, which would differentiate these revenue bonds from other tobacco bonds that solely backed tobacco settlement payments. The bonds would no longer expose investors to the same risk as other tobacco bonds by depending on an assessment of the strength of small number of tobacco companies. Rather, the state's pledge to meet any shortfall in annual tobacco company settlement payments would also be assessed. Because the principal on the newly issued tobacco revenue bonds would be repaid under the same 15-year repayment schedule that the BTASC bonds would have been repaid, but with

lower interest costs, annual tobacco settlement payment revenues in excess of the principal and interest costs on new bonds could be available to the state.

14. Under the bill, any funds associated with the savings under a transaction involving the purchase of BTASC bonds, as determined by the Building Commission, would be transferred in equal amounts to the tobacco control fund and general fund. However, the bill does not include any estimate of the possible savings under this proposal in the balances of these funds.

15. In the hypothetical example outlined by DOA, interest costs associated with $1.178 billion in bonds could be $707.5 million compared with $516.0 million in interest costs on the state-issued moral obligation revenue bonds. As a result, the potential financial benefits associated with this transaction could total $191.5 million over the life of the transaction, with the present value of those benefits totaling $148.9 million before the bond issuance and administrative costs associated with the transaction are factored in. However, this example is provided for illustration purposes only. Whether any financial benefits would exist under the transaction would depend on the market conditions at the time BTASC bonds were purchased and the state-issued bonds are sold. DOA Capital Finance officials warn that the ability of the transaction to generate benefits to the state relies entirely on the spread between the interest rates on the existing sets of tobacco bonds and the replacement state moral obligation revenue bonds; the transaction is extremely sensitive to market conditions. Any increase in the cost of the BTASC bonds when repurchased or increase in the financing costs associated with the state-issued moral obligation revenue bonds would also decrease the savings available to the state.

16. Further, if a significant interest rate spread exists, the size of the potential financial benefits to the state will also be dependent on the amount of BTASC bonds that can be repurchased as well as the types of bonds repurchased. DOA officials indicate that no estimate of these benefits is included in the bill for the 2003-05 biennium, because the amount of BTASC bonds that would be available to be purchased by the state cannot be known until such a purchase offer is extended.

17. The question facing the Committee and the Legislature is whether to provide DOA and the Building Commission with the authority to carry out a transaction that could provide the state with potential benefits, but would also require the state to reassume some risk associated with the tobacco settlement payments. As mentioned earlier, off-loading that risk to bondholders was one of the arguments for securitizing the state's tobacco payments. That risk, unlike the state simply receiving the tobacco settlement payments and expending those amounts each year, could result in the state being obligated to make debt service payments on state moral obligation revenue bonds. Therefore, if a tobacco bond repurchase transaction were undertaken by DOA, and tobacco settlement payments declined significantly, the Legislature could be called on to appropriate the funds necessary to cover the debt service on the bonds in the future. As an example of potential risks relating to major tobacco companies, recent legal difficulties involving Philip Morris have resulted in cancellations of bond offerings by states planning tobacco securitization transactions. The Price class action case in Illinois and the related bond requirement for Philip Morris have raised concerns over the security of tobacco settlement revenues, and have caused a rating downgrade of tobacco bonds. In view of this continuing litigation and the associated risk involved, it may be

undesirable to increase the state's exposure.

18. Although the state is assuming the risk associated with future tobacco settlement payments, the state would not be morally obligated to appropriate funds under the transaction outlined by DOA, unless the annual debt service requirements under the 30-year maturity schedule are not met. Similar to the BTASC bonds, if the tobacco payment levels decline significantly, the repayment structure on the state's moral obligation tobacco bonds would allow the state to revert to the lower annual debt service payments required under the 30-year repayment schedule rather than meet the higher payment levels on the 15-year repayment schedule. And, as mentioned earlier, even under the lower payments required under 30-year repayment schedule, tobacco settlement payments would exceed the required debt service payment on these bonds by as much as 30% to 60% each year, and thus would have to decline significantly before the state would have to appropriate any funds under its moral obligation.

19. Another question facing the Committee related to this transaction is whether or not the state should add risk through the use of its moral obligation pledge on tobacco bonds in order to generate potential revenues to the state. The question is whether the state should act as a financial investor by attempting to make money off the potential differences in interest rates on tobacco bonds in the market. Typically, the state incurs debt to pay for construction of state roads and buildings, the purchases of land and buildings and to carry out specific programs aimed at improving the state internally.

20. Conversely, some would argue that replacing the BTASC tobacco bonds with state moral obligations revenue bonds is similar to state debt refinancing transactions, which are undertaken frequently to take advantage of lower interest rates. However, under the state debt refinancing transactions, although the original bonds are refunded, the debt payments on the refunding bonds can still be tied to a state project, purchase, or program. In addition, refinancing state debt usually involves the state generating interest rate savings by refunding debt that involves the same level of risk to the state. Under the proposed refinancing transaction, the state would be generating financial benefits to the state by adding potential risk.

Deposit of Transaction Savings

21. The bill would require that the savings associated any tobacco bond repurchase transaction be transferred in equal amounts to the tobacco control fund and general fund. However, because the bill does not include any revenue to these funds associated with the transaction, the funds are not available for expenditure. Therefore, if any savings are generated in the 2003-05 biennium, additional action by the Legislature would be necessary to appropriate these funds.

22. The tobacco control fund would be eliminated under a previous action of the Committee. As a result, the Committee could put all of the savings in the general fund and consider the appropriation of monies for tobacco control in conjunction with all other general fund spending needs.

ALTERNATIVES

1. Approve the Governor's recommendation to authorize the Building Commission to issue up to $1.6 billion in revenue obligations to purchase some or all of the state's outstanding tobacco securitization bonds. Provide the Legislature's moral obligation pledge to appropriate the funds necessary to replenish the reserve funds associated with the transaction, if funds are not sufficient to meet the payment obligations associated with the revenue bonds issued under the program. Require that any savings, as determined by the Building Commission, would be transferred in equal amounts to the tobacco control fund and general fund.

2. Modify the Governor's recommendation by requiring that all funds associated with the savings under a transaction involving the repurchase of BTASC bonds, as determined by the Building Commission, would be transferred to the general fund.

3. Delete provision.

Alternative 3	BR
2003-05 FUNDING (Change to Bill)	**-** $1,600,000,000

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