

CALIFORNIA DEBT AND INVESTMENT ADVISORY COMMISSION

ISSUE BRIEF

TOBACCO SECURITIZATION

BOND ISSUANCE IN CALIFORNIA

CDIAC # 08.04

TOBACCO SECURITIZATION BOND ISSUANCE IN CALIFORNIA

Four major U.S. tobacco companies and a select group of states and territories¹ signed a Master Settlement Agreement (MSA) on November 23, 1998. The MSA is the result of the largest civil settlement in U.S. history. The settlement arose out of approximately 40 lawsuits initiated by various states to recover costs associated with medical services for smoking-related diseases (e.g., Medicaid), which led to settlement discussions in early 1997.² Under this agreement, the major tobacco companies provide the settling states with \$246 billion over a 25-year period. A number of governments in California, like those in other settling states, have securitized the tobacco payments by issuing bonds repaid from the proceeds of the settlement.³

This issue brief describes the terms of the MSA and California's relevant legislation, a review of tobacco-securitization issuances to date, and the benefits and risks associated with issuing tobacco securitization bonds.

THE TERMS OF THE MASTER SETTLEMENT AGREEMENT

The MSA has many participants, including 46 states,⁴ the District of Columbia, five U.S. territories (the Commonwealth of Puerto Rico, Guam, the Virgin Islands, American Samoa, and the Northern Marianas) and the participating manufacturers/tobacco companies (Brown & Williamson Tobacco Corporation, Lorillard Tobacco Company, Philip Morris Incorporated, and R.J. Reynolds Tobacco Company). The participating manufacturers agreed to pay the settling states a total of \$246 billion over a 25-year period; however, if the annual losses of tobacco sales of the participating manufacturers are more than two percent compared to the other tobacco companies that are not part of the MSA, the participating manufacturers can reduce their payments.⁵ The annual distribution that each state receives depends on population and a calculation using the consumer price index and the amount that domestic tobacco sales have declined, which is then used to adjust the 1998 base amount.⁶ Therefore, the amount that each state receives will vary from year to year. As determined by the MSA, each year California and New York will receive the largest share of funds (12.764 percent and 12.762 percent, respectively). For fiscal year 2007, California received \$745 million in tobacco settlement funds.⁷ Of this amount, the state received \$400 million and local agencies received about \$345 million.

Allocation for California tobacco funds starts with the escrow agent at the MSA level. For details on the components of the MSA, please see Figure 2. Once calculations for the states have been processed, California's share is given to the state escrow agent who then allocates shares to the state and local agencies.

FIGURE 1

WHAT IS A SECURITIZED BOND?

Unlike other bonds that are backed by revenues or taxes, a securitized bond is backed by a stream of future payments to the public entity. A tobacco securitization bond is backed by payments pursuant to a tobacco settlement, and is based on tobacco sales from the participating manufacturers.

¹ Hereafter, known as the "settling" states.

² www.cato.org/pubs/pas/pa371.pdf

³ A securitization bond is different from a general obligation or revenue bond, as typically issued by a government entity (please see Figure 1).

⁴ Mississippi, Florida, Texas, and Minnesota are not participating in the MSA because they already reached settlement agreements with the tobacco industry.

⁵ Hanson, M. and Posner, M. (March 6, 2007), *Bond Buyer, All Eyes on Tobacco Deal – California Sale Could Be Bellwether*.

⁶ National Conference of State Legislatures, *State Management and Allocation of Tobacco Settlement Revenue 2003*.

⁷ Harrison, C. (November 25, 2007), *The Eureka Reporter, Tobacco Education Gets Shorted*.

FIGURE 2

THE MSA IS COMPRISED OF SEVERAL SECTIONS:

- Public Access to Documents
- Tobacco Control and Underage Use Laws
- Establishment of a National Foundation
- Enforcement
- Certain Ongoing Responsibilities of the Settling States
- Payments, Effect of Federal Tobacco-Related Legislation
- Calculation and Disbursement of Payments*
- Settling States' Release
- Discharge and Covenant
- Consent Decrees and Dismissal of Claims
- Participating Manufacturers' Dismissal of Related Lawsuits
- Voluntary Act of the Parties
- Construction, Recovery of Costs and Attorneys' Fees
- Miscellaneous

In addition, the MSA provides a definition of terms that are used throughout the agreement and a section titled "Permanent Relief." "Permanent Relief" stipulates activities that participating manufacturers are either prohibited from or are permitted access to. Some examples of the "Permanent Relief" sections include prohibition on youth targeting, elimination of outdoor advertising and transit advertisements, ban on youth access to free samples, ban on gifts to underage persons based on proofs of purchase, limitations on lobbying, and prohibition on agreements to suppress research.

* This section includes the role and identity of the independent auditor (the party responsible for calculating and determining payment amounts), tobacco fund payments (calculation, treatment, and disputes), and disbursement and charges.

STATE LEGISLATION AFFECTING TOBACCO SECURITIZATION BONDS IN CALIFORNIA⁸

There are two significant pieces of California legislation related to tobacco securitization bonds: Assembly Bill 430 (Cardenas, et al., Chapter 171, Statutes of 2001) and Senate Bill 1141 (Committee on Budget and Fiscal Review, Chapter 641, Statutes of 2006).

⁸ Excerpts for AB 430 and SB 1141 are from the Legislative Counsel website (www.leginfo.ca.gov).

ASSEMBLY BILL 430

AB 430, enacted as part of the 2001 budget package, created the Tobacco Settlement Fund. The bill specified that each year, starting in fiscal year 2001-02, approximately \$402 million be deposited in that fund. The amount received is the state's share of funds pursuant to the tobacco litigation MSA. The distribution of money from the Tobacco Settlement Fund will be made by annual appropriation of the Legislature and used for health care purposes.

As a result of this bill, Sections 104896 through 104899 were added to the California Health and Safety Code. Essentially, those sections stipulate that the funds be used towards health care expansions in state programs, including Medi-Cal and Healthy Families. The funds are allocated to reduce the use of tobacco products and to help stop smoking.

SENATE BILL 1141

AB 1752 (Chapter 225, Statutes of 2003), California Government Code Section 63049.1(c) limited the issuance of tobacco securitization bonds to \$5 billion. SB 1141 (Chapter 641, Statutes of 2006) eliminated that limitation and allows proceeds of the sale of any residual interests in the assets be deposited in the Tobacco Asset Sales Revenue Fund, a separate account for investing proceeds.⁹

TOBACCO SECURITIZATION BONDS

In 2002, the Legislative Analyst's Office estimated that the State of California would receive approximately \$21 billion¹⁰ over the 25-year period.¹¹ Payments are received annually, with approximately half allocated to the cities of Los Angeles, San Diego, San Francisco, and San Jose (these cities filed their own lawsuits against the tobacco companies), and the 58 counties. Los Angeles, San Diego, San Francisco, and San Jose each receive 1.25 percent of the payments while the counties receive 45.0 percent (the percentage of funds each county receives is based on population).¹² In addition to the annual payments from April 15, 2008 through April 15, 2017, the state will receive strategic contribution fund payments. These funds are distributed to the settling states for their contribution to the tobacco litigation.¹³ The yearly base amount of the strategic contribution fund payments to the settling states, which is subject to certain adjustments such as inflation, is \$861 million. Of the \$861 million, the State of California's share is 5.173 percent (\$44.5 million); half of which is retained by the state and the other half is distributed among the local agencies.

In contrast to more "traditional" general obligation bond instruments, tobacco securitization bonds do not require voter approval.¹⁴ If a local

⁹ Residual interests are settlement revenues that the state will receive in future years after existing bond holders are fully paid.

¹⁰ The original estimate was expected to exceed \$25 billion. California Budget Project Budget Brief, *Borrowing Against the Future: Is Securitizing California's Tobacco Settlement Revenues the Best Way to Close the Budget Gap?*

¹¹ The MSA provides that the participating manufacturers will distribute annual payments indefinitely each April 15.

¹² Legislative Analyst's Office, *Analysis of the 2002-03 Budget Bill*. www.lao.ca.gov/analysis_2002/health_ss/healthss_04_CC_TSF_anl02.htm. (Future revenue streams are determined by an independent auditor.)

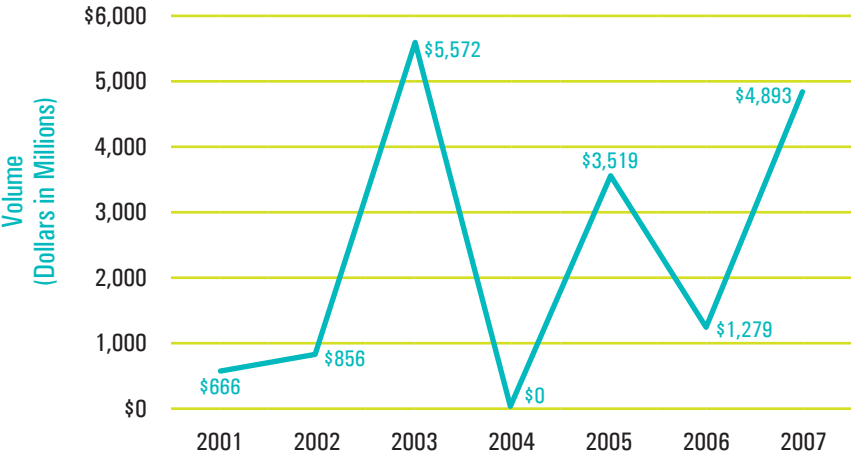
¹³ Prackup, J.T., et al. (January 3, 2007), Fitch Ratings, *Structured Finance, Asset-Backed Criteria Report, Rating US Tobacco Settlement Asset-Back Bonds*.

¹⁴ California Budget Project Budget Brief, *Borrowing Against the Future: Is Securitizing California's Tobacco Settlement Revenues the Best Way to Close the Budget Gap?*

agency decides to issue a tobacco securitization bond, it must first get approval from its governing body. The legislature must authorize the state’s issuance of a tobacco securitization bond.

In the seven-year period since state and local issuers began selling tobacco securitization bonds, 2004 was the only year in which there were no tobacco securitization bond sales (see Figure 3). This was due to another lawsuit against cigarette manufacturers which made public agencies reluctant to issue. The greatest volume was sold in 2003 (\$5.6 billion), comprised of two issues by the Golden State Tobacco Securitization Corporation.

FIGURE 3
CALIFORNIA TOBACCO SECURITIZATION
BOND ISSUANCE
2001-2007



In the seven-year period, state and local governments issued bonds totaling \$16.8 billion and 41 bonds. Please see Figure 4 and Appendix.

LOCAL BOND SALES

Since 2001, local agencies have issued \$3.6 billion (21.6 percent) of the \$16.8 billion tobacco securitization bonds sold. Twenty-eight local agencies have issued bonds through the six joint powers authorities (JPAs) and one non-profit corporation (NPC). In August 2001, the Northern California Tobacco Securitization Authority issued the first tobacco securitization bond in California in the amount of \$121.6 million. In all, four tobacco bond sales occurred in 2001 amounting to \$666.5 million. They use the bonds to finance capital improvements and health care projects, and for an upfront infusion of cash,¹⁵ instead of waiting each year for an annual allotment.¹⁶ In addition, local agencies choose to securitize their future tobacco settlement

¹⁵ California Budget Project Budget Brief, *Borrowing Against the Future: Is Securitizing California’s Tobacco Settlement Revenues the Best Way to Close the Budget Gap?*

¹⁶ Nicholson, K. (September 8, 1999), *Securitization: An Option for State Tobacco Settlement Funds.*

FIGURE 4

TOBACCO SECURITIZATION BOND ISSUERS

2001-2007

(DOLLARS IN MILLIONS)*

Issuer	Volume	Number of Sales	Percent of Total Volume
STATE			
Golden State Tobacco Securitization Corporation	\$13,160	4	78.4%
LOCAL			
California County Tobacco Securitization Agency (JPA)	1,361	23	8.1
Southern California Tobacco Securitization Authority (JPA)	1,050	3	6.3
Northern California Tobacco Securitization Authority (JPA)	455	5	2.7
Inland Empire Tobacco Securitization Authority (JPA)	294	1	1.8
California Statewide Financing Authority (JPA)	258	3	1.5
San Diego Tobacco Settlement Funding Corporation (NPC)	105	1	0.6
Silicon Valley Tobacco Securitization Authority (JPA)	102	1	0.6
TOTAL	\$16,786	41	100.0%

*Totals may not add due to rounding

revenue stream to fill budget deficits.¹⁷ Local agencies that have not identified an immediate use for the funds tend not to securitize their future tobacco settlement funds. Those local agencies deposit their annual tobacco settlement funds in an endowment fund to use later for capital improvement projects. On the other hand, if a local agency has a specific project that needs funding, then the agency could raise that money by securitizing their tobacco settlement revenues.

All but one California local agency has issued tobacco securitization bonds as part of a JPA. The lone exception has issued its bond through a NPC. Please see Figure 4. Although it is not necessary, local agencies choose to become a part of a JPA to minimize risk of default. Local agencies issue tobacco securitization bonds under a JPA

¹⁷ Davis, R.L. (March 2006), *Budget Relief and Deficit Financing by Local Governments in California*.

because each member under the JPA agrees to share and exercise joint powers. Since the local agencies need a buyer for their tobacco settlement revenues, the JPA fills that role. The tobacco settlement revenues are sold by each of the counties to a special purpose JPA (a JPA that was formed specifically for the purpose of buying the tobacco securitization bonds). Depending on a local agency's governing ordinances, the agency can either use their settlement funds for health care purposes or capital improvements.¹⁸

STATE BOND SALES

The state sells its bonds through the Golden State Tobacco Securitization Corporation. Since 2003, the corporation has sold \$13.2 billion in tobacco securitization bonds, 78.4 percent of the total volume of tobacco securitization bonds sold in California. In 2003, it issued approximately \$5.6 billion in two separate tobacco bond sales (\$3.0 billion and \$2.6 billion) to help balance the state's budget. The state's most recent bond sale was for \$4.45 billion on March 7, 2007, and was the largest single state tobacco securitization bond issuance in the country. The proceeds of the sale provided \$900 million for K-12 schools and community colleges, and \$350 million for infrastructure projects. In addition, the sale provided \$2.86 billion refinancing for tobacco securitization bonds issued in 2003.

All of the state and most of the local tobacco securitization bonds issued are exempt from federal and state taxation. Taxability depends on how the bond proceeds will be used. For example, bonds that are used for capital improvements are typically tax-exempt. For the most part, the projects for which the tobacco securitization bonds were issued consisted of capital improvement projects and refunding. The Silicon Valley Tobacco Securitization Authority is the only agency that issued a tobacco securitization bond specifically for health care facilities (that bond was tax-exempt both on the state and federal level). The San Diego Tobacco Settlement Funding Corporation issued the only bond that was both federally and state taxable. The California County Tobacco Securitization Agency issued 23 tobacco bonds. Of those 23 bonds, five were taxable on the federal level, but were tax-exempt on the state level.

RISKS

The actual annual settlement payment, though scheduled as a steady and predictable revenue stream over each year, can vary year to year and could significantly decrease over time. To help them manage this variability, governments may sell the future payment stream at a discount. Securitizing the revenue stream to private investors helps governments plan their finances.

¹⁸ The original intent of the tobacco settlement was for funds to be used for health purposes; however, there are no restrictions to using tobacco settlement funds for health purposes.

Both issuers and private investors must evaluate the risks associated with these payments, including:¹⁹

- Bankruptcy of the participating tobacco companies – a declaration of bankruptcy from any of the participating manufacturers could decrease the amount projected to be distributed to the settling states;
- Reductions in U.S. consumption below current projections – although projections were made assuming a decline in smoking, those projections may prove to be conservative;²⁰
- Loss of market share to nonparticipating companies – the four major participating manufacturers could experience a decrease in tobacco revenues if faced with increased competition from tobacco manufacturers not part of the MSA;
- A decrease in revenues – participating manufacturers' tobacco sales could decrease.

CONCLUSION

The issuance of tobacco securitization bonds is unique in that U.S. states and territories will be receiving tobacco settlement funds in perpetuity due to the lawsuit. The funds allow state and local governments to use the proceeds to fund capital improvement projects and healthcare programs/facilities. This type of bond issuance is also distinctive in that future payments are not only related to population changes, but to tobacco revenue as well (if sales decline, then future payments may be adversely affected). State legislation has affected the management of tobacco funds by creating a special Tobacco Settlement Fund and by removing the \$5 billion limit on the volume of tobacco securitization issuance. Although the state has chosen to securitize a considerable amount of its future tobacco settlement revenues, many local agencies have chosen not to issue tobacco securitization bonds, but to accept their annual payments. There are benefits to issuing tobacco securitization bonds, such as providing funds for capital improvements and health care projects; however, the risks must be considered.

¹⁹ www.leginfo.ca.gov/pub/05-06/bill/sen/sb_1101-1150/sb_1141_cfa_20060831_024846_asm_floor.html

²⁰ Global Insight estimates that the average rate of cigarette consumption will decline 1.81 percent. On a per capita basis, the firm estimates consumption will decrease at an annual of 2.51 percent (Diffley, J. and Cataldi, J. [August 3, 2007], *A Forecast of U.S. Cigarette Consumption (2007-2057) for Inland Empire Tobacco Securitization Authority*).

APPENDIX

STATE AND LOCAL TOBACCO BOND ISSUANCE
2001-2007

Issuer	Principal Amount	Name of Project	Issue Name	Purpose Type	Sale Date
STATE					
Golden State Tobacco Securitization Corporation	\$3,000,000,000	Tobacco Settlement Series A-1 – A-5	Asset-Backed Bonds Series 2003 A	Other	1/15/2003
Golden State Tobacco Securitization Corporation	\$2,572,285,000	Tobacco Settlement	Series 2003 B Enhanced Asset-Backed Bonds	Other	9/25/2003
Golden State Tobacco Securitization Corporation	\$4,446,826,391	Sr Series A-1 & 2, First Sub Ser B & Second Sub Series C	Asset-Backed Bonds Series 2007 (Series B & C CABs)	Other	3/8/2007
Golden State Tobacco Securitization Corporation	\$3,140,563,508	Tobacco Settlement	Enhanced Asset-Backed Bonds Series 2005 A	Other	7/28/2005
LOCAL					
California County Tobacco Securitization Agency	\$26,775,000	Merced County Tobacco Funding Corp Series A	Settlement Asset-Backed Bonds	Other	4/4/2002
California County Tobacco Securitization Agency	\$3,740,000	Merced County Tobacco Funding Corp Series B	Settlement Asset-Backed Bonds	Other	4/4/2002
California County Tobacco Securitization Agency	\$59,215,000	Stanislaus County Tobacco Funding Corp Series A	Settlement Asset-Backed Bonds	Other	4/4/2002
California County Tobacco Securitization Agency	\$8,090,000	Stanislaus County Tobacco Funding Corp Series B	Settlement Asset-Backed Bonds	Other	4/4/2002
California County Tobacco Securitization Agency	\$37,405,000	Sonoma County Securitization Corp Series A	Settlement Asset-Backed Bonds	Other	4/30/2002
California County Tobacco Securitization Agency	\$30,005,000	Sonoma County Securitization Corp Series B	Settlement Asset-Backed Bonds	Other	4/30/2002
California County Tobacco Securitization Agency	\$40,960,000	Kern County Tobacco Funding Corp Series A	Tobacco Settlement Asset-Backed Bonds	Other	5/30/2002
California County Tobacco Securitization Agency	\$56,885,000	Kern County Tobacco Funding Corp Series B	Tobacco Settlement Asset-Backed Bonds	Other	5/30/2002
California County Tobacco Securitization Agency	\$7,400,000	Kern County Tobacco Funding Corp Series C	Tobacco Settlement Asset-Backed Bonds	Other	5/30/2002
California County Tobacco Securitization Agency	\$41,590,000	Gold Country Settlement Funding Corp	Tobacco Settlement Asset-Backed Bonds Series 2002	Other	6/13/2002

Issuer	Principal Amount	Name of Project	Issue Name	Purpose Type	Sale Date
California County Tobacco Securitization Agency	\$92,955,000	Fresno County Tobacco Funding Corp	Asset-Backed Bonds	Other	7/9/2002
California County Tobacco Securitization Agency	\$31,245,000	Golden Gate Tobacco Funding Corp Series A	Tobacco Settlement Asset-Backed Bonds	Other	7/9/2002
California County Tobacco Securitization Agency	\$3,100,000	Golden Gate Tobacco Funding Corp Series B	Tobacco Settlement Asset-Backed Bonds	Other	7/9/2002
California County Tobacco Securitization Agency	\$220,525,000	Alameda County Tobacco Asset Securitization Corp	Tobacco Settlement Asset-Backed Bonds	Multiple Capital Improvements	10/16/2002
California County Tobacco Securitization Agency	\$37,490,000	Merced County Tobacco Funding Corp Series A	Tobacco Settlement Asset-Backed Refunding Bonds 2005	Other	10/21/2005
California County Tobacco Securitization Agency	\$2,200,000	Merced County Tobacco Funding Corp Series B	Tobacco Settlement Asset-Backed Taxable Refunding Bonds 2005	Other	10/21/2005
California County Tobacco Securitization Agency	\$83,060,000	Sonoma County Securitization Corp	Tobacco Settlement Asset-Backed Refunding Bonds 2005 Ser A	Other	10/21/2005
California County Tobacco Securitization Agency	\$67,858,509	Alameda County Tobacco Asset Securitization Corp Sub Series A – C	2006 Asset-Backed Bonds Turbo CABs*	Multiple Capital Improvements	2/2/2006
California County Tobacco Securitization Agency	\$319,827,107	Los Angeles County Securitization Corp	Tobacco Settlement Asset-Backed Bonds Series 2006	Multiple Capital Improvements	2/3/2006
California County Tobacco Securitization Agency	\$42,153,611	Stanislaus County Tobacco Funding Corp Sub Series A – D	2006 Tobacco Settlement Asset-Backed Bonds Turbo CABs	Other	3/23/2006
California County Tobacco Securitization Agency	\$39,015,131	Fresno County Tobacco Funding Corp Sub Series A – D	2006 Tobacco Settlement Asset-Backed Bonds CABs	Multiple Capital Improvements	4/6/2006
California County Tobacco Securitization Agency	\$59,372,118	Gold Country Settlement Funding Corp Series A & B	Tobacco Settlement Asset-Backed Bonds Series 2006	Other	5/19/2006
California County Tobacco Securitization Agency	\$49,870,081	Golden Gate Funding Corp Series A, B & Sub Series C – F	2007 Tobacco Settlement Asset-Backed Bonds	Multiple Capital Improvements	5/31/2007
California Statewide Financing Authority	\$98,770,000	Pooled Tobacco Securitization Program Series A	Tobacco Settlement Asset-Backed Bonds	Multiple Capital Improvements	7/27/2002

Issuer	Principal Amount	Name of Project	Issue Name	Purpose Type	Sale Date
California Statewide Financing Authority	\$97,775,000	Pooled Tobacco Securitization Program Series B	Tobacco Settlement Asset-Backed Bonds	Multiple Capital Improvements	7/27/2002
California Statewide Financing Authority	\$61,750,538	Pooled Tobacco Securitization Ser A – D	2006 Tobacco Settlement Asset-Backed Bonds CABs	Multiple Capital Improvements	4/13/2006
Inland Empire Tobacco Securitization Authority	\$294,084,291		Tobacco Settlement Turbo Asset-Backed Bonds Series 2007	Other	8/1/2007
Northern California Tobacco Securitization Authority	\$121,615,000	Series A	Asset-Backed Bonds	Other	8/1/2001
Northern California Tobacco Securitization Authority	\$78,005,000	Series B	Asset-Backed Bonds	Other	8/16/2001
Northern California Tobacco Securitization Authority	\$11,674,044	Sacramento County Tobacco Securitization Corp First Sub CABs Series B	Asset-Backed Bonds Series 2005	Multiple Capital Improvements	12/2/2005
Northern California Tobacco Securitization Authority	\$11,658,524	Sacramento County Tobacco Securitization Corp Second Sub CABs Series C	Asset-Backed Bonds Series 2005	Multiple Capital Improvements	12/2/2005
Northern California Tobacco Securitization Authority	\$232,153,721	Sacramento County Tobacco Securitization Corp Sr Series A-1 & A-2	Asset-Backed Bonds Series 2005	Multiple Capital Improvements	12/2/2005
San Diego Tobacco Settlement Funding Corporation	\$105,400,000		Tobacco Settlement Asset-Backed Bonds Series 2006	Other	6/21/2006
Silicon Valley Tobacco Securitization Authority	\$102,030,012	Santa Clara County Tobacco Assets	Settlement Asset-Backed Turbo CABs Series A – D 2007	Health Care Facilities	1/12/2007
Southern California Tobacco Securitization Authority	\$398,105,000	Sr Series A	Tobacco Settlement Asset-Backed Bonds	Other	12/13/2001
Southern California Tobacco Securitization Authority	\$68,735,000	Sub Series B	Tobacco Settlement Asset-Backed Bonds	Other	12/13/2001
Southern California Tobacco Securitization Authority	\$583,630,660	San Diego County Tobacco Asset Securitization Corp Sr Series A, 1st Sub Series B, 2nd Sub Series C & 3rd Sub Series D	2006 Tobacco Settlement Asset-Backed Bonds	Other	5/25/2006

*Capital appreciation bonds.



ACKNOWLEDGEMENTS

Nova Edwards, Research Analyst, researched and authored this Issue Brief.

John Decker, Executive Director, and Kristin Szakaly-Moore, Director of Policy Research, reviewed and edited this Issue Brief.

CDIAC wishes to thank Roger L. Davis and Jenna C. Magan, Partners at Orrick, Herrington & Sutcliffe LLP, for their valuable input in completing this Issue Brief.

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