TSA

TOBACCO SETTLEMENT AUTHORITY

Final Report

Tobacco Settlement Revenue Refunding Bonds Series 2013

JULY 2014

Tobacco Settlement Revenue Refunding Bonds, Series 2013
Final Report – July 2014

Table of Contents

	Page
Executive Summary	i
PURPOSE	1
HISTORY	1
Enabling Legislation	2
Board and Decision Making Structure	2
2002 BOND ISSUE SUMMARY	3
Refunding Benchmarks	3
2013 REFUNDING BOND ISSUE SUMMARY	4
Finance Team	4
Legal Review	5
Structure of Bonds	5
OBSTACLES ENCOUNTERED	6
Market Disruption	6
2003 NPM Adjustment Arbitration	6
PERCEIVED RISKS	8
RESULTS OF SALE	8
CONCLUSION	9
APPENDIX	
Timeline	A-1
Press Release and FAQs	A-2

Tobacco Settlement Revenue Refunding Bonds, Series 2013
Final Report – July 2014

Executive Summary

Faced with a $1.5 billion shortfall in the state's general fund, the Legislature authorized, and Governor Gary Locke signed into law on April 4, 2002, legislation establishing the Tobacco Settlement Authority (the "Authority" or "TSA"). The legislation authorized the Authority to issue revenue bonds backed by not more than 30% of the state's allocable share of the revenue stream from the Master Settlement Agreement (MSA) between the state and the participating tobacco manufacturers. The resulting bond issue in the amount of $517.9 million was completed in 2002. In exchange for the tobacco revenue, the Authority deposited $450 million of bond proceeds into the state's general fund. This was done with no financial risk or cost to the state of Washington or to Washington state residents.

A detailed history of the 2002 bond issuance can be found in the Final Report – Tobacco Settlement Asset-Backed Bonds, Series 2002, which is available on the Authority's website at http://www.tsa-wa.org/finaltsa.pdf.

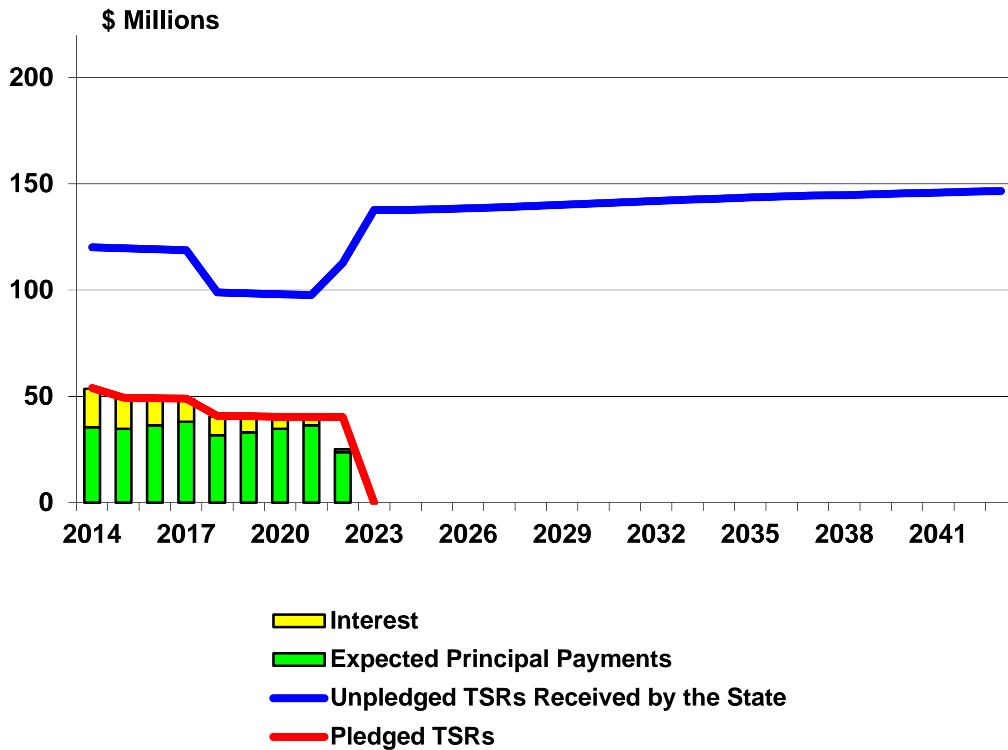
In 2013, due to favorable market conditions, the Tobacco Settlement Authority refinanced the Series 2002 Bonds. Throughout the process, the Authority consulted with key state officials. Meetings were held with the Office of the Governor, the Office of the Attorney General, the Office of the State Treasurer, and the Office of Financial Management.

At the July 1, 2013 Authority board meeting, based on the recommendations of the Authority's executive staff and its contracted team of financial and legal consultants, the Authority board unanimously authorized the issuance of the refunding bonds.

The tax-exempt refunding revenue bonds of $334,700,000 closed October 17, 2013 after some unexpected delays caused by disruption in the bond market and the immanency of a long-awaited decision by the arbitration panel regarding the state's diligent enforcement of its tobacco escrow statute for sales year 2003. The bonds were sold at a premium, netting $358,748,170 of proceeds. The proceeds plus funds remaining in the 2002 reserve and debt service accounts refunded the $369,900,000 of Series 2002 Bonds outstanding, funded required bond reserves, and paid the costs of issuance of the bonds. The net interest rate on these bonds was 4.45%. Standard and Poor's Ratings Services (S&P) rated the transaction, assigning an A rating to the bonds maturing through 2023 and an A- rating on the bonds maturing thereafter.

The refunding generated an estimated $89.9 million in savings to the state by lowering the interest rate and shortening the expected final maturity by two years. This represents $58.2 million of present value savings measured at the date of issuance. By shortening the expected final maturity, the previously pledged tobacco settlement revenues (TSRs) will be returned to the state sooner, giving the state access to the full TSR income stream.

Washington State Tobacco Settlement Revenues. As illustrated on the chart below, the Authority bonds amortize utilizing an early call structure where every dollar of the pledged 29.2% of TSRs will be used to optionally redeem the bonds as quickly as possible. No residual will be released to the state from the pledged TSRs until the bonds are repaid. Thus, the early call structure will allow the Authority to repay the refunding bonds within about 8 years rather than the 19 years indicated by the scheduled debt service payments. At that point, the 29.2% TSR pledge to the Authority will revert to the state.



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PURPOSE

The purpose of this paper is to provide general historical background and a summary of the key decision points relative to timing, structure and outcomes of the Authority's 2013 bond refunding.

HISTORY

In June 1996, the state of Washington brought suit against the major tobacco companies, seeking reimbursement for costs incurred for treating tobacco-related illnesses as well as damages for violations of consumer protection and antitrust laws. In 1998, 46 states, including Washington, and 6 other U.S. jurisdictions reached a settlement with the major tobacco companies. At the time, the award to Washington State was calculated to be approximately $4 billion over the first 25 years.

The Master Settlement Agreement (MSA) was entered into in November 1998, originally between the four largest tobacco companies (Original Participating Manufacturers – OPMs) and the Attorneys General of the settling jurisdictions. In addition to these OPMs, the MSA permits other tobacco companies to join the settlement. These companies, referred to as the Subsequent Participating Manufacturers (SPMs), are also bound by the MSA and must make payments to the settling jurisdictions. As of June 2013, there were 3 OPMs and 52 SPMs, collectively referred to as the Participating Manufacturers (PMs). Any tobacco company choosing not to participate in the MSA is referred to as a Nonparticipating Manufacturer (NPM).

Under the MSA, the PMs agreed to curtail or cease certain tobacco marketing practices, as well as to pay, in perpetuity, various annual payments to the settling jurisdictions to compensate them for some of the medical costs of caring for persons with smoking-related illnesses. The monies transferred from the tobacco companies under the Master Settlement Agreement are referred to as tobacco settlement revenues (TSRs).

Enabling Legislation

Faced with a $1.5 billion shortfall in the state general fund for the 2001-03 biennium, the Legislature authorized, and Governor Gary Locke signed into law on April 4, 2002, Senate Bill 6828. Passed as part of the state budget, the new law established the Tobacco Settlement Authority (the Authority) as a state entity.

The enabling legislation authorized the Authority to issue revenue bonds backed by not more than 30% of the state's portion of the revenue stream from the MSA. These revenue bonds would not be obligations of the state of Washington and would be backed solely by that portion of the TSRs that was purchased by the Authority from the state. Neither the faith and credit nor the taxing power of the state of Washington or any municipal corporation, subdivision or agency of the state would be pledged to the payment of the bonds.

The Authority's charge was to issue revenue bonds to securitize a portion of the future revenue stream available under the Master Settlement Agreement in order to generate $450 million for the state of Washington in the 2001-03 biennium. The Authority's stated objectives were to plan, structure and implement the bond transaction in the best interests of the citizens of the state, with a focus on economic efficiency, optimal timing, management of risks, and the conduct of business in a manner that was consistent with state ethical requirements.

Board and Decision Making Structure

The role of the state in Authority operations and decision-making is limited by statute to providing advice and coordinating required legal opinions and certifications.

Decisions of the Authority are made by its board which is composed of five members appointed by the Governor. The Authority is staffed by the Washington State Housing Finance Commission, an existing state commission with extensive experience in the issuance of bonds.

2002 BOND ISSUE SUMMARY

The Authority's 2002 bond issue was structured more conservatively than most tobacco bond issues at the time due to uncertainty with regard to the projected payments under the MSA. Authority bonds were amortized utilizing a structure where every dollar of the pledged 29.2% of TSRs after payment of scheduled debt service received would be used to redeem the bonds. This "turbo" bond structure allowed the Authority to pay down $148 million of the 2002 bonds prior to the refunding. As of the refunding date, $369.9 million of the Series 2002 Bonds remained outstanding, $190 million of the 2026 term bond and $179.5 million of the 2032 term bond. The Series 2002 Bonds were rated BBB/A3 for the 2026 maturity and BBB/Baa1 for the 2032 maturity by S&P and Moody's respectively. The bonds became callable at par June 1, 2013 and had an expected maturity of 2025.

At the time the 2002 bonds were issued, it was expected that the turbo repayment structure would allow the Authority to repay the bonds in 2019 rather than at the scheduled 30-year final maturity of 2032. The receipt of TSRs was less than expected and repayment on the 2002 bonds was slower than originally projected due to a number of factors, most significantly tobacco consumption declines.

For a more detailed analysis of the 2002 bond issue, refer to the Final Report – Tobacco Settlement Asset-Backed Bonds, Series 2002. The report is available on the Authority's website at http://www.tsa-wa.org/finaltsa.pdf.

Refunding Benchmarks

The Authority's primary activities after issuance of the 2002 bonds were to monitor investments and payments, perform its continuing disclosure obligations, periodically report on the tobacco securitization market, and assess the feasibility of refunding the outstanding 2002 bond issue and/or completing a new issue.

The generally accepted target for refunding the outstanding bonds was set at a minimum net present value (NPV) savings of 5%. NPV compares the value of a dollar today to the value of that same dollar in the future, taking inflation and returns into account. In order to be financially supportable, the refunding had to save the equivalent of 5% of the total bond payments expected to be paid by the scheduled final maturity of the 2002 bonds (2032). After extensive analysis, staff and the finance team determined that this 5% savings benchmark could be achieved under market conditions in 2013.

2013 REFUNDING BOND ISSUE SUMMARY

Authority Coordination with the State

The Authority informed key state leaders of its interest in refunding the 2002 bonds and the potential savings that could be generated by a refunding. Authority executive staff met with the Office of the Governor, the Office of the Attorney General, the Office of the State Treasurer, and the Office of Financial Management.

Staff and legal counsel coordinated and worked most closely with the Attorney General's office. For the refunding, the Attorney General provided legal opinions regarding, among other subjects, the enforceability of the purchase and sale agreement and the validity of the MSA.

Finance Team

Throughout the life of the 2002 bonds, the Authority maintained current contracts with a team of national financial and legal experts familiar with tobacco transactions. Members of the Authority's finance team were selected pursuant to a competitive process, as required by state law. The contracted scope of work for each finance team member included any work required to refund the 2002 bonds if refunding became feasible.

The Authority's contracted finance team was comprised of the following:

- Barclays Capital, Book-Running Senior Manager;
- Citigroup Global Markets Inc., Co-Senior Manager;
- Public Financial Management Inc., Financial Advisor;
- Pacifica Law Group LLP, Co-Bond Counsel and General Counsel;
- Hawkins, Delafield & Wood LLP, Co-Bond Counsel;
- Nixon Peabody LLP, Disclosure Counsel

Orrick, Herrington & Sutcliffe LLP acted as Underwriter's Counsel.

The selling syndicate headed by Barclays Capital and Citigroup Global Markets was comprised of co-managers consisting of Bank of America Merrill Lynch, KeyBanc Capital Markets, Raymond James, and RBC Capital Markets.

Legal Review

Before exploring possible refunding of the 2002 bonds, the Authority's General Counsel reviewed the Authority's statute, existing bond law, and the 2002 bond issue documents. They determined that the statute, the bond indenture and Purchase and Sale Agreement (PSA) did not impose any constraints on refunding options.

The Attorney General's Office agreed that the PSA did not constrain refunding and did not need to be amended, which allowed for the continuation of refunding discussions.

Structure of the Bonds

The refunding was structured to a more conservative and stringent stress test that allowed for an "A" category rating based on S&P rating criteria for tobacco bonds.

Since the issuance of the 2002 bonds, most of the legal uncertainty regarding the receipt of TSRs had been removed. However, tobacco consumption had declined since 1981 and the decline had averaged roughly 3 – 7% per year since that time. For 2013, domestic cigarette shipment volumes fell 4.86%. The 2013 bonds were structured to withstand a year over year tobacco consumption decline of 10.38%, whereas the 2002 bonds could only withstand consumption declines of around 4%.

The refunding takes advantage of fixed amortization serial bonds and a series of early call bonds maturing between 2024 through 2033. The early call bonds are callable as early as 2014. They function similar to the turbo structure of the 2002 bonds, with excess TSRs applied to their redemption In the event that TSRs are received more quickly than projected, these bonds can be optionally called and further shorten the expected maturity of the bonds. The refunding bonds have a scheduled final maturity of 2033 with an expected maturity of 2023, which is two years shorter than the 2025 expected maturity of the 2002 bonds estimated at the time of the refunding. In addition to returning the revenue stream to the state earlier than expected under the 2002 bonds, the Authority was able to lower the interest rates on the bonds, saving the state about $89.9 million over the anticipated life of the bonds based upon market conditions at the time of sale. This represents a net present value (NPV) savings of $58.2 million to the state (15.73% of the refunded bonds), well in excess of the minimum target benchmark savings of 5%.

The refunded bonds required a fully funded liquidity reserve account in the amount of $31,997,719, considerably less than the $45,534,106.25 required reserve account for the 2002 bonds.

The refunding bonds received a rating upgrade relative to the 2002 bonds, with fixed serial bonds maturing through 2023 rated "A" by S&P; and, early call bonds with an optional redemption feature maturing after 2023 receiving an "A-" rating.

OBSTACLES ENCOUNTERED

The Authority Board approved the issuance of the refunding bonds on July 1, 2013, with a scheduled sale on July 23, 2013. In early July 2013, in consultation with Authority Board Chair Carla DewBerry, the refunding transaction was put on hold for two reasons:

1. **Market Disruption**

   On June 19, 2013 the Federal Reserve Board released updated economic projections which indicated improving fundamentals. In a press conference on that day, Ben Bernanke, then Chairman of the Federal Reserve Board, stated that the Central Bank would begin easing up on its controversial stimulus program in 2014.

   Markets reacted negatively to the news. The event has been referred to as the worst three day sell off in a quarter of a century. There was significant disruption in the bond markets with interest rates rising as a result of investors' concerns.

   In September 2013 the Fed did not begin reducing its quantitative easing program as anticipated and the bond market rallied.

2. **2003 NPM Adjustment Arbitration**

   At the same time as the market reaction to Mr. Bernanke's comments, the finance team expressed concern about investors' perception of the impact of the 2003 NPM Adjustment.

Tobacco product manufacturers that have not signed the MSA are known as NPMs. The MSA includes a mechanism—the NPM Adjustment— whereby PMs' payment obligations are reduced if PMs lose at least a prescribed level of market share to NPMs as a result of the PMs' observance of the MSA. As contemplated by the MSA, Washington enacted an NPM escrow statute, commonly referred to as a "Qualifying Statute". The statute requires NPMs to establish an escrow account and make annual payments to the account based upon their sales of cigarettes in Washington, including roll-your-own tobacco.

The MSA provides that the NPM Adjustment will not apply to any state that has diligently enforced its Qualifying Statute during the sales year under review. Participating Manufacturers (PMs) have argued that some states have failed to enforce their respective Qualifying Statutes, which has resulted in market share loss for them. In response, the PMs made claims for the application of the NPM Adjustment and placed a portion of the TSRs they would normally release to the states into a disputed payment account. As a result, states have not been receiving their full share of TSRs each year. Approximately $7.1 billion in disputed payments had been withheld from 2003 - 2012 MSA payments pending resolution of the NPM Adjustment claims.

In December 2012 nineteen jurisdictions reached a settlement with the original participating tobacco manufacturers (OPMs) to resolve NPM adjustment disputes for years 2003 – 2012 and create a better method to resolve such disputes in the future. The agreement provided for a release of the signatory state's portion of more than $4 billion from the MSA's Disputed Payment Accounts as well as credit to the OPMs against a portion of the signatory state's future MSA payments. Washington State perceived the settlement as a onetime windfall to the PMs that would result in a net loss to the state and declined to sign the settlement agreement.

During 2013 a panel of judges heard the arguments of the states that did not settle regarding their enforcement of their respective Qualifying Statutes during 2003. Washington's hearing was in May 2013, but the panel did not announce their decisions until after they completed hearings for all of the states. A positive diligent enforcement decision by the arbitration panel would release money held in the 2003 disputed payments account to Washington State. The Authority's portion of the payment, if received, would be used to pay down bonds.

On September 11, 2013 the arbitration panel released its decision regarding the 2003 NPM adjustment arbitration. Washington State was found to have diligently enforced its Qualifying Statute for sales year 2003 and would receive its allocable share of the funds that were held back for that year. The decision was unanimous.

Finance team members had continued to work on various aspects of the transaction to ensure that the refunding would not lose momentum and that the team would be ready to proceed immediately when the arbitration panel made its decision, assuming that market conditions supported moving forward. Concurrently with the 2003 NPM Adjustment Arbitration decision, market conditions for the sale of tobacco refunding bonds had become more favorable. Preparations for the issuance of refunding bonds resumed in September 2013.

PERCEIVED RISKS

The MSA provides that the amounts payable by the PMs are subject to numerous adjustments, offsets and recalculations, some of which are material. The amount of TSRs actually collected depends on many factors, including domestic cigarette consumption, which is negatively impacted by growing sales of E-Cigarettes and tax increases; the financial constraints of the PMs and the tobacco industry; litigation generally, including litigation challenging the MSA and related state statutes; and ever-increasing federal, state and local regulations burdening the tobacco industry.

In addition, PMs have disputed MSA payments each year and will continue to do so – one year at a time. Proceedings to determine states' diligent enforcement claims for sales years 2004 – 2013 have not been scheduled. No assurance can be given that the arbitration panel's decision regarding Washington State's diligent enforcement of its Qualifying Statute during 2003 will serve as precedent for similar disputes concerning subsequent sales years.

RESULTS OF SALE

The 2013 refunding issue was very successful. At a 15.73% net present value savings calculated at closing, it significantly exceeded the agreed upon benchmark of 5% net present value savings and had very good reception in the market.

The transaction was priced at very aggressive levels. Calculations at the time indicated that the refunding would generate $58.2 million in present value savings. The expected maturity of the refunding bonds is forecasted to be two years shorter than the Series 2002 Bonds. The transaction received an "A" rating from S&P on the bonds maturing through 2023 and an "A-" on the bonds maturing thereafter. The net interest cost on the bonds was 4.45%. This rate represents interest payable not taking into account the time value of money. The transaction achieved a total interest cost (TIC) of 4.28% with very tight spreads to the benchmark index in the municipal market. Total interest cost is a method of calculating an issuer's borrowing interest cost, which considers the present value of the debt service payments.

The transaction was oversubscribed by 3.4 times, ranging from 1.0 time for the 2028 and 2030 maturities to 7.1 times for the 2018 maturity. There was broad institutional investor support for the transaction. Investor participation comprised both new investors as well as existing holders of the refunded bonds. Twenty-eight (28) distinct institutional investors participated, including a wide array of bond funds and investment advisors. Because of the significant investor interest, yields were lowered by up to 10 basis points per series.

CONCLUSION

On October 17, 2013 the Authority refunded its outstanding 2002 bonds, issuing $334,700,000 in refunding bonds in order to refund all of its outstanding Series 2002 Bonds. The refunding generated an estimated present value savings of $58.2 million to the Authority and shortened the expected final maturity of the 2002 bonds by two years. This is estimated to return $89.9 million more in TSRs to the state over the life of the refunding bonds than would have been returned under the 2002 bonds.

The refunding presented the Authority with an opportunity to reduce the payments of the Authority, to use fewer tobacco settlement revenues than the 2002 bond issue would require, and to retire the refunded bonds earlier than the 2002 bonds. This will return more tobacco revenue to the state earlier than had been anticipated and allow those funds to be put to other uses.

TIMELINE
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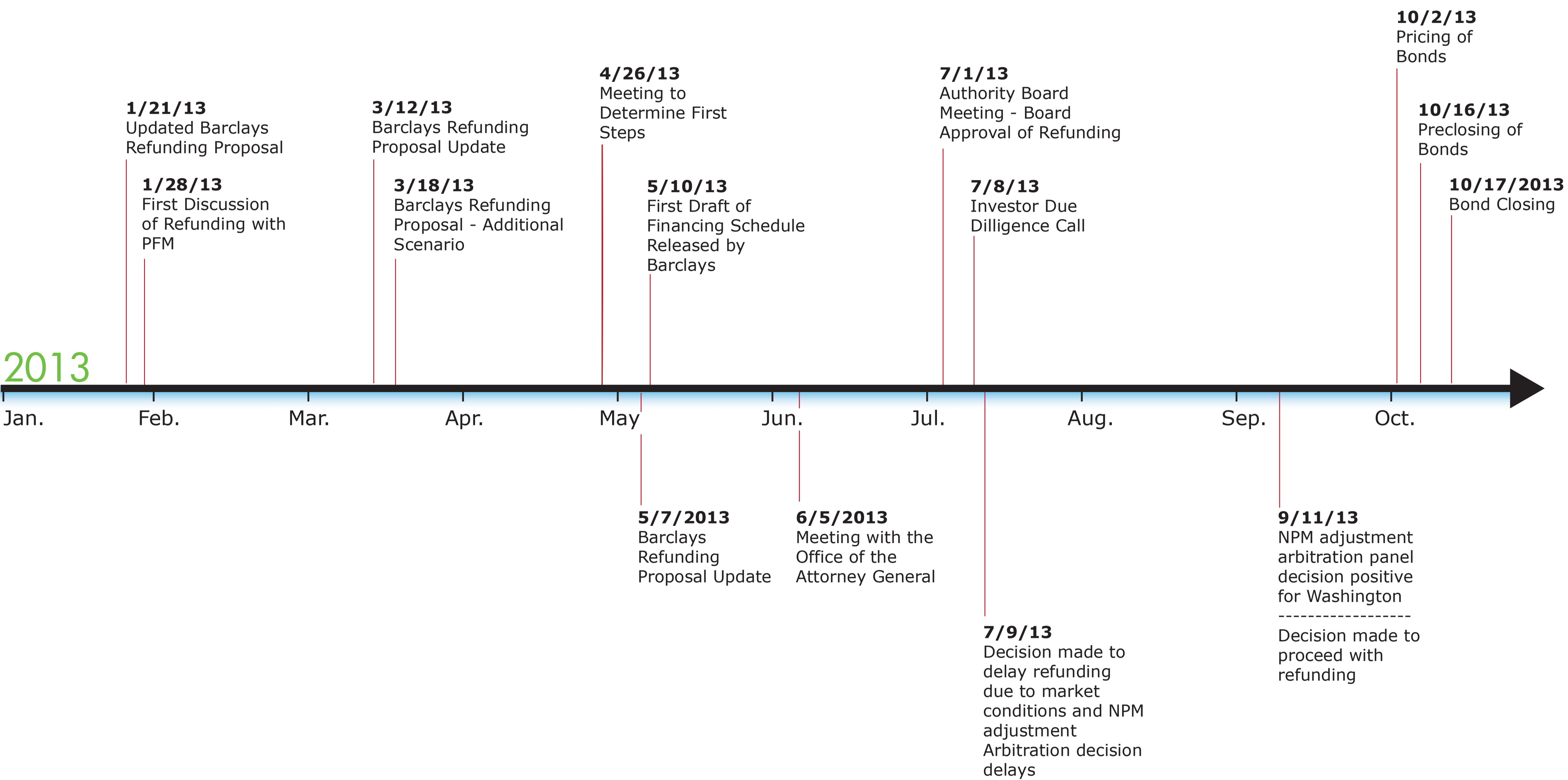
Final Report - July 2014



TSA
TOBACCO SETTLEMENT AUTHORITY

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October 17, 2013

Tobacco-bond refinancing to save millions for state

SEATTLE – Today the Washington State Tobacco Settlement Authority closed the refinancing of a bond issue that will save an estimated $90 million in interest over the next decade.

The savings come from taking advantage of favorable interest rates, similar to refinancing a home mortgage, to refinance bonds the TSA issued in 2002 to generate revenue for the state.

"I'm pleased that through the diligence and stewardship of the Tobacco Settlement Authority, this refinancing will be a win for the people of Washington," said Governor Jay Inslee.

Thanks to the refinancing, the Tobacco Settlement Authority will be able to pay off approximately $517 million in bonds sooner than anticipated—saving interest and returning revenue to the state.

The tobacco-settlement bonds originated in the late 1990s, when 46 states, including Washington, reached a settlement with the major tobacco companies over violations of antitrust and consumer-protection laws. Washington state was awarded about $4 billion, to be received in payments over time.

During the "dot-com" recession, the state did not have enough revenue to balance the 2001-03 budget. Legislators decided to borrow against the future tobacco settlement money in order to add funds to the state coffers right away. The amount the state needed was $450 million.

In 2002, the legislature and governor passed a law creating the Tobacco Settlement Authority, a five-member board appointed by the Governor, to issue the bonds and incur the debt. In November 2002, the TSA issued the bonds, which were purchased by investors, generating $450 million that the TSA deposited into the state general fund and additional funds required for closing costs, a reserve account and oversight. The TSA continues to pay off the debt using 29.2 percent of the state's annual tobacco revenues.

Today's refinancing means that the 29.2 percent currently used by the TSA to repay the debt will begin flowing directly to the state years earlier than anticipated. The interest savings are just under $90 million, or $58 million in today's dollars when adjusted for inflation.

"The current schedule will allow TSA to repay the debt in 2024, after which an estimated $40 to $41 million will go to the state of Washington each year," said TSA Chair Carla M. Dewberry. "We will all benefit from this savings in the long run."

For further information, see the FAQ below, visit www.tsa-wa.org or contact the TSA.

TSA

TOBACCO SETTLEMENT AUTHORITY

FAQ:

What is the Tobacco Settlement Authority?

The Tobacco Settlement Authority was created by state law in 2002 to issue bonds against future tobacco-settlement revenues. It is a five-member board appointed by the Governor, with administrative support provided by the staff of the Washington State Housing Finance Commission.

Why were the tobacco bonds issued?

To provide $450 million for state budget relief in 2002 at the direction of the state legislature.

How much revenue was generated?

The bonds were sold for $517 million. Most ($450 million) was deposited into the state's general fund in 2002. The remainder covers required closing costs, a reserve account, and oversight.

What are tobacco-settlement revenues?

In the late 1990s, 46 states, including Washington, reached a Master Settlement Agreement with the major tobacco companies over violations of antitrust and consumer-protection laws. Washington state was awarded approximately $4 billion, to be received over a period of 25 years. Payments to the state in accordance with the Master Settlement Agreement are tobacco-settlement revenues.

How do the bonds work?

Per legislation, the Tobacco Settlement Authority issued bonds that were purchased by private investors and it must repay the bonds over time, a process known as securitization. The TSA receives 29.2% of the tobacco-settlement revenues that come to the state each April and uses this portion to pay off the bonds. (The state Office of Financial Management receives the other 70.8%.)

How does this percentage compare with other states?

Most states have sold 100% of their anticipated tobacco revenues. Washington decided to issue bonds against no more than 30% of its expected tobacco revenues.

Is this debt carried by the state?

No. The state has no obligation or liability in any way related to the repayment of these bonds. The bonds can never directly affect the state's credit, its credit ratings, or its borrowing capacity.

Are the bonds all tax exempt?

Yes. The entire bond issue is tax exempt, meaning that investors do not have to pay federal income tax on interest on the bonds. Therefore, the Authority pays lower interest rates.