TSA

TOBACCO SETTLEMENT AUTHORITY

FINAL REPORT

Tobacco Settlement Asset-Backed Bonds Series 2002

JANUARY 2003

TABLE OF CONTENTS

January 2003

Tobacco Settlement Asset-Backed Bonds
Series 2002

Executive Summary

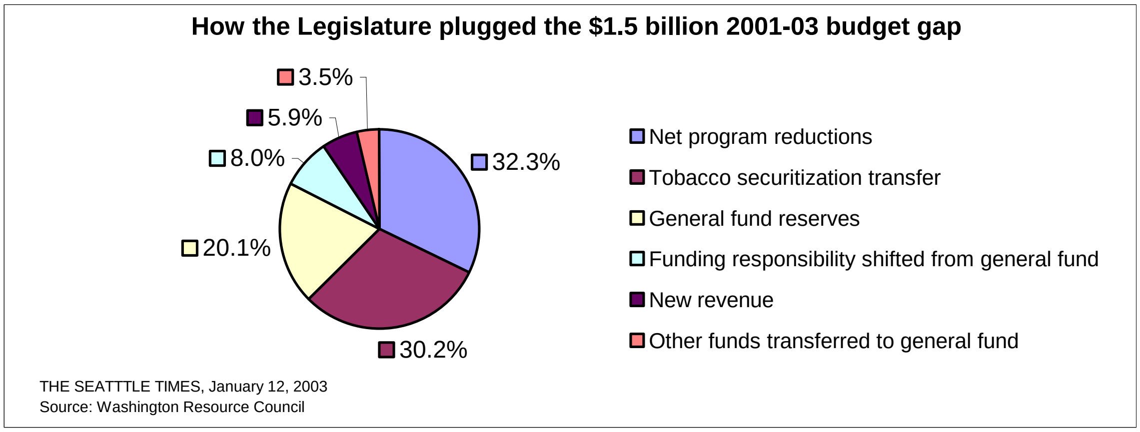
Faced with a $1.5 billion shortfall in the state's general fund, the Legislature authorized, and Governor Gary Locke signed into law on April 4, 2002, legislation establishing the Tobacco Settlement Authority (the Authority). The legislation authorized the Authority to issue revenue bonds backed by part of the state's portion of the revenue stream from the Master Settlement Agreement between the state and the five major tobacco manufacturers. In exchange, the Authority would deposit $450 million in bond proceeds into the state general fund.

On May 2, 2002, the governor appointed Dick Swanson, Chair of the Board of HomeStreet Bank, as chair of the five-member Authority board. The Washington State Housing Finance Commission was designated by the legislation to provide administrative and technical support to the Authority. The Authority's stated objectives were to plan, structure and implement the proposed tobacco-backed bond transaction in the best interests of the citizens of the state and complete the transaction by June 30, 2003. The Authority immediately began an open competitive process to recruit a national team of financial and legal experts familiar with tobacco transactions to assist the Authority.

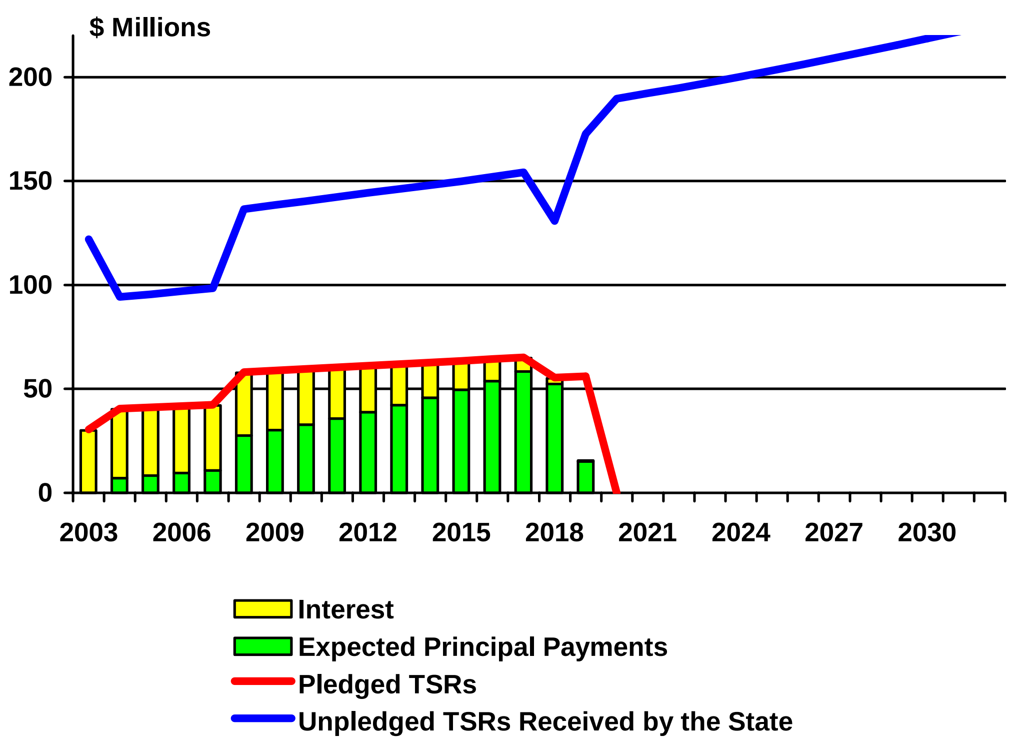
During August and September 2002, the Authority, in consultation with the Office of the Governor, the Office of the Attorney General, the Office of the State Treasurer, key legislative staff, and the Office of Financial Management, considered a variety of bond structure and policy alternatives. At the October Authority board meeting, based on the recommendation of the finance team, the Authority board unanimously authorized the issuance of bonds.

On November 5, 2002, the Authority sold tax-exempt bonds netting $507.2 million of proceeds ($517.9 million of par bonds less $10.7 million of original issue discount). On that day, $450 million was deposited by the Authority into the state general fund in exchange for acquiring 29.2% of the tobacco revenue settlement stream from the state. The remaining proceeds funded required bond transaction reserves and paid costs of issuance of the bonds. The net interest rate on these bonds was 6.75%.

How the Legislature Plugged the $1.5 Billion 2001-03 Budget Gap. As illustrated on the chart below, the Authority deposit of $450 million into the state general fund provided 30.2% of budget relief to the state's $1.5 billion 2001-03 budget deficit.



Washington State Tobacco Settlement Revenues. As illustrated on the chart below, the Authority bonds amortize utilizing a full turbo structure where every dollar of the pledged 29.2% tobacco settlement revenues (TSRs) will be used to 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 turbo repayment structure will allow the Authority to repay the bonds within about 17 years rather than the 30 years indicated by the scheduled debt service payments. At that point, the 29.2% TSR pledge to the Authority will revert to the state.



TSA Washington State Tobacco Settlement Authority

Final Report **January 2003**

Tobacco Settlement Asset-Backed Bonds
Series 2002

Background

In June 1996, the state of Washington brought suit against the major tobacco companies, seeking reimbursement for costs incurred in treating tobacco-related illnesses as well as damages for violations of consumer protection and antitrust laws. On November 23, 1998, Attorney General Christine Gregoire of Washington and representatives of 45 other states (as well as six nonstate plaintiffs ranging from the District of Columbia to the Commonwealth of the Northern Mariana Islands) announced a national settlement with the five largest tobacco manufacturers. The settlement of Washington's case was approved by the King County Superior Court and the decision became final on December 24, 1998.

The national Master Settlement Agreement requires annual payments by the four largest tobacco companies to the participating states; up to $206 billion will be received during the first 25 years of the agreement. The state of Washington is scheduled to receive approximately $4 billion during the first 25 years, with $323 million received during the 1999-01 biennium. The settlement agreement does not restrict the state's use of the monies; thus, the Legislature may direct the monies to be expended for any purpose. During the 1999-01 and 2001-03 biennia, the monies have been used to support a tobacco prevention and control program in the Department of Health and to support the Basic Health Plan and other health programs funded by the health services account. 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 current 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 agency, governed by a five-member board appointed by the governor, with administrative support provided by the staff of the Washington State Housing Finance Commission, an existing state commission.

The enabling legislation authorized the Authority to issue revenue bonds backed by part of the state's portion of the revenue stream from the Master Settlement Agreement. The legislation authorized the governor, on behalf of the state, to enter into a sales agreement with the Authority in which the state would sell, and the Authority would purchase, a portion of the revenue stream. The legislation directed that the proceeds of revenue bonds issued by the Authority would net the state $450 million no later than June 2003. 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. 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.

In addition to generating immediate state revenue, the tobacco securitization would transfer the risk associated with the possible decline in the future revenue stream (as a result of a decline in tobacco sales or bankruptcy of tobacco manufacturers, for example) from the state to investors in the Authority's revenue bonds. However, only the risk associated with that portion of the TSRs sold to the Authority would be so transferred.

Formation of the Tobacco Settlement Authority

On May 2, 2002, the governor appointed as the Authority Board of Directors: Dick Swanson, Chair of the Board of HomeStreet Bank; Sue Painter, Systems Director at Providence Health Systems; Randy Main, Vice President and Chief Financial Officer of the Fred Hutchinson Cancer Research Center; Carla DewBerry, an attorney with Bennet Bigelow & Leedom; and Tom Corley, President, Holy Family Hospital. Dick Swanson was appointed Chair of the Authority to serve in that capacity concurrent with the governor's term in office. Sue Painter, Secretary of the Board, and Randy Main were appointed to four-year terms with the Authority; and Carla DewBerry and Tom Corley were appointed to two-year terms.

The Authority's charge was to issue 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. The Authority's desire was to make its proceedings open and public in compliance with the Open Public Meetings Act.

Further, the Authority's goals were to:

- Work cooperatively with the Office of the Governor, the Office of the Attorney General, the Office of the State Treasurer, key legislative staff, and the Office of Financial Management;
- Determine how to minimize the pledge of TSRs required to support the Authority's financing; and
- Deliver the proceeds of the financing when most needed to meet state cash flow requirements, estimated to be early November 2002.

Selection of the Finance Team

The Authority assembled a team of legal and financial experts familiar with tobacco settlement revenue securitizations. As a number of states and jurisdictions had previously issued tobacco-backed bonds, the Authority decided to build on the best practices used in such financings. Before the formal Request for Proposals (RFPs) for professional services process began, Authority staff held numerous informal meetings with a variety of legal and financial experts and did extensive research in tobacco-backed bond financing. Authority staff shared the results of its research in a formal orientation with the Authority Board prior to its first meeting.

One of the directives from the governor's office was that all consultant positions for the bond transaction, including all legal advisors, underwriters, financial advisors, and trustee, be made available in an open competitive process to allow the opportunity for any firm interested in doing business with the Authority to compete.

In June 2002, RFPs were issued on a national basis for legal, financial advisory, underwriting and trustee services. Firms were allowed to submit a proposal for one or more activities requested in the RFP. Preference was given to firms that had prior tobacco financing experience, had knowledge of Washington State government, could deliver their services in a timely manner, and had competitive pricing. A total of 35 proposals were received as follows: 7 legal; 6 financial advisory; 17 underwriting; and 5 trustee.

After reviewing all timely proposals submitted, holding extensive interviews, making numerous reference checks, and judging each firm's ability to work together as a team player in a cooperative and noncompetitive structuring process, the Board selected the following firms: general counsel and co-bond counsel, Preston Gates & Ellis LLP; co-bond counsel, Hawkins, Delafield & Wood; financial advisor, Public Financial Management-CSG Advisors; senior book-running manager, Bear, Stearns & Co.; co-senior manager, Goldman, Sachs & Co; and trustee, U. S. Bank. The underwriters later selected Orrick, Herrington & Sutcliffe LLP to be underwriters' counsel.

As the time to actually market the bonds got closer, the Board selected the following firms as co-managers: Merrill Lynch & Co., RBC Dain Rauscher Inc., UBS Paine Webber Inc., and U.S. Bancorp Piper Jaffray. In the selection of co-managers, the Board gave preference to firms that had prior experience in marketing tobacco bonds and had a large in-state retail sales force.

During August and September 2002 the finance team began a series of bond structuring meetings, held preliminary negotiations with the governor's office regarding the purchase of tobacco settlement revenues, and began outlining bond issue structuring choices and policy decisions that the Authority Board would need to make. With directions from the Board and staff, the finance team proceeded to complete the structuring of the bond issue and brought back to the Board in October a proposed final structure for the bond issue and a form of the sale agreement with the state of Washington. The Board then authorized the issuance of the bonds through a bond resolution and authorized the distribution of the preliminary offering circular. The Authority anticipated entering the market to issue the bonds in the last half of October, or if necessary, depending on market conditions, early November 2002.

Structuring the Bond Transaction

Goal of the Structuring. The primary goal in structuring the bond transaction was to expeditiously deliver $450 million to the state general fund at the least cost to the state. It became clear to the Authority that the most efficient way to implement this goal was to issue tax-exempt bonds. The cost of taxable bonds would materially increase the amount of TSRs required to service the debt and therefore, would be more expensive to the state. As a result, maximizing the amount of tax-exempt bonds was crucial to minimizing the cost of the transaction.

Factors Considered. During the RFP process, Goldman Sachs recommended that the Authority consider the potential advantages of using variable rate securities as part of the transaction. They strongly endorsed this strategy as it had the potential to lower borrowing costs.

Thus, the two most complex and significant structuring issues identified by the finance team were first, the extent to which the entire bond transaction could be issued as tax exempt securities or some combination of tax-exempt and taxable; and second, whether to include a variable rate component as part of the overall bond issue or do it all as a fixed rate.

The determination as to what extent the bonds were tax-exempt depended on the state's use of the $450 million. The finance team identified three eligible uses of the bond proceeds to qualify the bonds as tax exempt. These eligible uses were as follows:

1) Funding capital expenditures;
2) Refunding of existing state general fund tax exempt debt service; and
3) Funding working capital.

The recommended preference was to maximize bond proceeds use for the capital expenditure option. The finance team began extensive research, with the assistance of the Office of the Treasurer and the Office of Financial Management, to identify all eligible capital expenditure and refunding options. Since most of the capital expenditures of the state were not funded on a pay-as-you-go basis out of the general fund, additional tax-exempt uses had to be identified to reach the $450 million total.

As a subset of the refunding option, the Board considered some form of short-term borrowing to enable more of the capital-related principal and interest payments that would be made out of the state general fund before the actual issuance of the Authority's bonds to be refunded, particularly in the months of August, September and October. The finance team researched the possibility and for a variety of reasons, including cost and incremental benefit, recommended that the Board not pursue this option.

Since a sufficient amount of capital expenditures and refunding options would not be available to use all of the $450 million in bond proceeds, the finance team explored working capital expenses as the third alternative for an eligible tax-exempt use; however, including working capital in the Authority's transaction carried future tax compliance requirements. Specifically, the state would have to comply with an ongoing deficit analysis, which required that any future available state funds above a reasonable working capital reserve (5% of the prior year's general fund budget) be used in one of the following ways:

- Redeem or purchase tax-exempt working capital bonds of the relevant bond issue;
- Redeem or purchase other bonds of the state, the Authority or related parties which have a comparable remaining burden on the market;
- Invest in nonamortizing tax-exempt bonds; or
- Take any other action approved by tax counsel at the time.

This requirement applies only to the amount *in excess* of the 5% reserve that is *greater than* the amount of the working capital bonds that remain outstanding at the time of the calculation.

The ongoing deficit analysis would be completed once per year, on the first day of each fiscal year, beginning in the first year the state reasonably expects to have surplus funds available or five years after the issue date (whichever is sooner). For most states that have completed or considered working capital financings, these restrictions were not likely to present a significant future burden. Unlike Washington, these states have generally not maintained balances over 5% of their annual expenditures. However, as recently as the end of Fiscal Year (FY) 2001, Washington maintained a total ending general fund state balance (including the emergency reserve) of nearly $1.1 billion, or over 6.5% of the state's $15.5 billion budget.

Given this history, the state faced the possibility that an ongoing deficit analysis would result in some restrictions on future general fund balances. To minimize this exposure, the tax-exempt working capital component of the financing could be front-loaded and thus paid first. If it were a relatively small piece of the overall transaction, the state would be able to amortize the working capital bonds quickly and minimize the need to perform the annual deficit analysis thereafter.

The finance team felt comfortable with the issuance of tax-exempt bonds to finance working capital on a long-term basis, subject to the state understanding the necessary ongoing tax compliance requirements to demonstrate that such working capital bonds would not stay outstanding longer than necessary. Based on a series of discussions with the state Office of Financial Management, the finance team recommended that a portion of the bonds be tax-exempt working capital bonds. This approach seemed reasonable as the long-term projections of the state's fund balance did not show such reserves equaling or exceeding 5% of the applicable prior year's budgeted expenditures; therefore, this would impose no burden on the state relative to the working capital component of the financing except the ongoing monitoring of the unamortized working capital bond amount compared to the available fund balance.

The key reasons to consider this alternative were as follows: First, because over time the amount of the working capital bonds declines as initial payments to which the working capital use were allocated mature, it was expected that these bonds would be paid off within twelve years. Since the IRS-required testing would not start until after the fifth year, ongoing compliance would only need to be done for up to seven years.

Second, the 5% permitted reserve over time grows because it is based on the amount of the prior year's budget. Typically, the budget increases every year; therefore, the 5% reserve amount would increase. However, as the amount of outstanding working capital bonds declines, the maximum amount of the surplus that would be subject to tax requirements would decline.

Third, Washington law has a provision that requires three quarters of all surpluses go to the student achievement fund and therefore are not considered surpluses. This fact further minimizes the likelihood that a reserve in excess of the 5% level will materialize or persist while the working capital bonds remain outstanding.

Preliminary Base Case Bond Structure. In September 2002, the finance team presented to the Board its preliminary recommendations regarding a tax-exempt base case structure as follows:

- The amortization structure;
- The estimated tobacco settlement revenue percentage purchased from the state and pledged to the repayment of the bonds, and the corresponding residual cash flow to the state from the unpledged portion;
- Ratings in the prevailing interest rate environment; and
- Transaction timing.

The finance team presented three amortization or principal payment structuring alternatives: turbo, modified turbo and residual release. In a full turbo structure, every dollar of pledged TSRs is used to redeem bonds as quickly as possible with no residual from the pledged portion released to the state until all bonds are repaid. A full turbo structure was characterized as having the following attributes: minimizing the pledge of TSRs; being preferred by investors; potentially reducing the cost of funds by five to ten basis points (0.05% - 0.10%) over nonturbo structures; and reducing overall debt service by approximately $130 million compared to a nonturbo approach.

In a modified or delayed turbo structure, only interest would be paid in FY 2003 – 2005. Turbo amortization would be delayed until FY 2006 to increase the budgetary benefit in the coming biennium. Modified turbo had a relatively low pledge, low cost of funds and low debt service; however, it had never been marketed before and could have had a negative pricing impact compared to a full turbo structure.

In a residual release structure, pledged TSRs would be used to redeem bonds up to a predetermined, fixed schedule and residual cash flow (unused TSRs) would be released annually to the state. Residual structures would increase overall debt service, increase the Authority cost of funds and would have required a higher percentage pledge (0.8% to 1.2%), but would provide approximately $8 million more per year in residual TSRs to the state after principal amortization began on all structures.

The finance team recommended a full turbo structure because it was most consistent with the objectives of the Authority. It paid off the bonds as soon as possible, and it achieved both the lowest tobacco settlement revenue percentage pledge and the most efficient financing within a finite pledge amount.

Under the set of finance team assumptions estimated in September, 29.6% of the amount of revenue that would be coming to the state under the Master Settlement Agreement would be required to be sold to the Authority and pledged to the repayment of the Authority's bonds. This was one of the most visible numbers in the transaction, and it was based on a number of assumptions. The estimated TSR percentage pledge would ultimately be finalized as market conditions developed, but the team thought that a fixed-rate, full-turbo structure would generate the lowest required percentage pledge, relative to other structures, under most market conditions.

The Authority finance team also considered purchasing something other than a fixed percentage of the TSRs from the state (e.g., a fixed dollar amount per year); however, this approach would (1) make it difficult for the state to budget the use of any remaining TSRs, and (2) limit the Authority's ability to structure and sell any subsequent financings at the lowest possible cost. These potentially negative impacts resulted in the recommendation to pursue only a fixed percentage TSR purchase as part of the transaction with the state.

At a 29.6% pledge, estimated remaining cash flows to the state would be between $94.6 million and $139.6 million per year. The estimated remaining cash flow number would be higher in 2003 due to the fact that interest in 2003 was capitalized above the amount the state had already budgeted. The state had budgeted $30 million as an expenditure for funds that would be sold to the Authority and not received. Thus, the Authority would in effect purchase $30 million of TSRs from FY 2003 to pay debt service on the bonds, and then capitalize a small amount above that—the remainder of the interest required through FY 2003.

The finance team recommended an A1 rating from Moody's and an A rating from Standard & Poor's. That would be equivalent to an A rating for the entire transaction consistent with virtually every other previous tax-exempt tobacco securitization. While it was possible to achieve a AA category rating from Moody's, it was not recommended because it would require a higher tobacco settlement revenue percentage pledge on the entire transaction and, in the tax-exempt arena, investors have not been willing to pay substantially more (in terms of price, less in terms of yield) for the higher rating; thus, the higher percentage pledge required for the AA rating would not result in a lower cost of funds for the Authority.

It is important to note that in pricing decisions, investors are sensitive to the distinction between specialty states and nonspecialty states.

- *Specialty states* have significant state income taxes and they exempt interest earned on their own bonds from state taxes, but not necessarily the interest on bonds of issuers from other jurisdictions. Consequently, there is a natural in-state demand by investors.
- *Nonspecialty states*, such as Washington, have little or no state income tax and therefore do not normally have significant in-state investor demand.

In nonspecialty state tobacco securitization transactions that have come to market since August 2001, interest rate spreads to national benchmarks have increased on each successive transaction; thus, it was further recommended that the Authority proceed to market as quickly as possible to avoid a crowded tobacco issuance and general tax-exempt bond calendar and increasingly wider spreads for nonspecialty states in particular. As a result, the Authority Board and staff worked with the senior managers to create an expectation in the market that the Authority would be marketing bonds in October 2002.

In addition to the base case fixed-rate bond structure, Bear Stearns and Goldman Sachs initially recommended that the Authority consider the use of up to $200 million of unenhanced auction rate securities in the structure as auction rate securities offer a lower expected cost of funds and could have structuring and marketing benefits for the Authority's transaction. Auction rate securities would be structured in the longest maturities of the issue, thereby replacing the 30-year term bond, which generally carries the highest interest rate. Auction rate securities would also tap a new investor base to address market saturation in tobacco bonds. Floating rate tobacco securities were estimated to yield 2.71% at the time of the recommendation, providing over 400 basis points (4%) of interest savings compared to fixed rate bonds. Assuming the same pledge of TSRs as a fixed rate issue, the lower interest rates expected for auction rate securities would result in a more rapid turbo amortization. As a result, residual cash flow would be released to the state sooner and overall debt service would be lower.

There were risks associated with auction rate securities however. The primary risk in a floating rate transaction would be that interest rates would rise to levels that exceed the Authority's fixed rate cost of funds. The finance team agreed that this interest rate risk would be mitigated by the fact that an increase in short-term interest rates is generally accompanied by an increase in inflation. The inflation adjustment in the Master Settlement Agreement increases revenues annually by 3% or the Consumer Price Index, whichever is larger. The increase in revenues would likely offset an increase in auction rate debt service as long as rising rates were due to inflationary pressure rather than credit concerns. The interest rate on the auction rate securities would be a function of short-term interest rates and the credit spread/penalty associated with tobacco securitizations. The increasing cost associated with this second component would not be offset by inflationary increases in TSRs under the Master Settlement Agreement.

In addition to the interest rate risk for auction rate securities, the Authority considered the possibility of a failed auction. In a failed auction, investors would continue to hold the bonds; however, the interest rate would go to a maximum rate of 15%. A failed auction would result in negative publicity for the Authority; a failed auction could impact the Authority's market receptivity for a second transaction; and a failed auction would likely impact pricing performance of any Authority auction rate securities in the long run. However, it was further noted that in the 15-year history of the auction rate securities market, there have only been two known instances of failed auctions, both of which were associated with severe credit declines and the actual or potential bankruptcy of an obligor rather than the mechanics of the auction process.

The potential introduction of auction rate securities also raised some implementation issues. First, floating rate tobacco bonds had never before been issued and the rating agencies were considering this structure for the first time. The key issues related to the establishment of appropriate revenue sufficiency stress tests for interest rate risk had not been established by the rating agencies. Detailed negotiations had started but no definitive feedback from the rating agencies on the appropriate stress tests had been received.

Second, tobacco auction rate securities documents would have to be created. Key issues included reserve and capitalized interest fund sizing, retention and flow of funds. As a result, a first-time tobacco auction rate securities transaction would require two to four weeks more to implement than a fixed rate transaction. Third, the investor base was untested for tobacco auction rate securities.

The finance team felt that tobacco auction rate securities were likely marketable; however, the approach to actual investors had to wait until there was a definitive structure. Premarketing to auction rate securities investors would require at least one week. Fixed rate premarketing would also require special attention, as auction rate securities would impact the expected average life of the fixed rate bonds due to interest rate swings, and this dynamic would have to be explained to fixed-rate investors.

The Authority noted that a two-to-four-week extension was an issue for the following reasons:

- The Authority had committed to the governor and the Office of Financial Management that the bond would go to market in October 2002, which could be done using a fixed-rate base case scenario;
- A delay into late November would put Washington's tobacco bonds in the market with Missouri's expected tobacco bond sale; and
- The Authority would lose approximately $12 million in tax-exempt refunding potential after November 1, 2002.

It was concluded that auction rate securities could be considered in any subsequent transaction undertaken by the Authority.

The Authority agreed with the finance team on a deadline for the discussions regarding the possible inclusion of auction rate securities with the rating agencies. Initially this deadline was set for September 20, and later extended to September 27, 2002. If the agencies had indicated by then that they would not require an increase in the tobacco settlement revenue pledge, or a significant increase in the reserves over the levels required for a fixed-rate transaction, and the deal could include auction rate securities and still close by October 29, 2002, the variable rate option would have been given additional consideration. However, if the information needed was not forthcoming in a manner the Board and finance team could deal with fully on September 27, 2002, the recommendation would be to go forward with the fixed-rate transaction.

In September, the Authority also discussed a proposed marketing strategy. Assuming a fixed rate transaction, the following marketing strategy was proposed:

- Electronic presentations (for institutional investors);
- Institutional conference call (walk through electronic road show and answer questions);
- Series of one-on-one calls (for investors as requested);
- One-on-one visits (if requested); and
- Group meetings (only if auction rate securities were incorporated).

In an effort to maximize the orders for these bonds, assuming a fixed rate structure, staff and the financial advisors discussed how to best create an environment in which all members of the underwriter syndicate had access to timely information for their premarketing. The goal was to maximize the distribution channels as much as possible. During the weeks leading up to the scheduled pricing dates for the bonds, formal discussions took place with the underwriting syndicate to outline the priority of orders, develop designation policies (for the sales commission or "takedown" on each maturity of the bonds), and address other issues essential to a fair and orderly pricing process.

It should be noted that during this bond structuring process, Authority staff communicated on a consistent basis with the Washington State Senate Ways & Means and House Appropriations committees, the Office of the State Treasurer, the Office of the Attorney General, Office of Financial Management, and members of the executive branch. They were kept informed about Authority activities, issues the finance team was pursuing, and structuring of the bond issue.

Each of these entities received notices of Authority board meetings, agendas and minutes throughout the entire process. On two occasions, the Authority Chair and staff met with the State Treasurer in his Olympia office to keep him apprised of the progress of the transaction and to note his concerns. The Authority Chair and staff also met with key legislative staff people from the Senate and House in a joint meeting in Olympia to brief them on the transaction and address their concerns and questions.

Purchase and Sale Agreement

Simultaneous to the bond transaction structuring process by the finance team, the legal team worked with the attorney general's office to structure the Purchase and Sale Agreement. This agreement with the state was important because it specified how much of the TSRs would be sold by the state to the Authority; it contained certain covenants regarding the state's enforcement of the Master Settlement Agreement and the model statute that arranged for escrows with nonparticipating manufacturers; and it included covenants relating to the use of the bond proceeds by the state.

In addition, the rating agencies had a direct interest in the ongoing activities of the attorney general's office regarding enforcement of the Master Settlement Agreement. Not only did they require specific legal covenants in the Purchase and Sale Agreement; they also wanted the attorney general's office to perform due diligence and enforcement.

As the attorney general was so active in the litigation itself, no problems were anticipated in the attorney general's vigorous demonstration to the rating agencies that the state would enforce the Master Settlement Agreement. Also important to note was that while the Authority was issuing the bonds and would be essentially depositing the money with the state, the tax exemption on the Authority's bonds actually depended on actions of the state.

The Purchase and Sale Agreement was a critical document in establishing the state's obligation and its responsibility regarding spending and investing the money received from the Authority. It was very clear that the governor's office understood, as the legislation required, that the state agreed to do what was necessary to keep the interest on the bonds tax exempt.

Bond Transaction Approach Selected

At the September 18, 2002, Authority board meeting, representatives of the Office of Financial Management told the Board that the state needed the Authority bond proceeds deposited by October 29, 2002. In consultation with state officials subsequent to the September 18 meeting, it was determined that the October 29, 2002, date was not as critical as long as funds were available to the state no later than the first week of November 2002.

Further, the finance team announced at the meeting that it could not get rating guidelines necessary for auction rate securities from the rating agencies in time to meet the agreed-upon transaction schedule. Therefore, the potential use of auction rate securities as a part of the transaction was dropped in order to keep the previously agreed upon timeline.

At the October 8, 2002, Authority board meeting, the finance team made their final bond transaction recommendations to the Authority.

The finance team recommended a full turbo structure where every dollar of the pledged TSRs would be used to redeem the bonds as quickly as possible, and no residual would be released to the state from the pledged TSRs until the bonds had been repaid. This minimized the percentage of TSRs pledged and had the potential to reduce the Authority's costs of funds by shortening the average life and final maturity of the bonds.

At that time, a turbo transaction would require approximately a 29.55% pledge of state TSRs to achieve the net proceeds objective of $450 million. This pledge was an estimate and subject to changes in market conditions. This was emphasized in the Offering Circular. On the day of pricing, the Authority would lock-in definitive interest rates and the TSR percentage would be calculated.

Assuming a 29.55% pledge, the remaining cash flow available to the state ranged from $94 million to about $140 million per year between 2002 and 2010.

The bond transaction was structured so that the portion of the debt allocable to working capital would be amortized first to minimize the duration of the state's compliance with the working capital deficit analysis.

Market Conditions

At the October 8, 2002, Authority board meeting, the finance team also gave an update of current market conditions. An overview of interest rates since the Authority's legislation was passed in the spring of 2002, revealed that while mortgage and tax-exempt municipal rates had fallen, tax-exempt tobacco rates had more or less held stable, and had actually gone up slightly. In this challenging market, the focus of the finance team was to favorably position the transaction in the market relative to other large tobacco issues.

The impact of the state of Washington (a nonspecialty state) not having a state income tax in comparison to other states that have a state income tax was discussed. Specialty states (states with significant income taxes) had enjoyed about a 50 to 60 basis point (0.50%-0.60%) advantage in terms of lower yields on tobacco securitization bonds than nonspecialty states, but the solid structure of the Authority's issue and good market timing were potentially helpful in bridging the nonspecialty/specialty gap. It was suggested that the primary pricing goal should be that the bond performed competitively with other nonspecialty states.

The market in general for tobacco bonds showed that trades in the secondary market of tax-exempt tobacco transactions for nonspecialty states had generally worsened since those issues were sold, but they had generally stabilized prior to the October Authority board meeting.

It was noted that there were some other factors that would be on investors' minds, such as a recent $28-billion judgment in California. On September 26, 2002, a Los Angeles, California, jury awarded $750,000 in economic damages and $100,000 for pain and suffering to a smoker with lung cancer in Bullock v. Philip Morris. On October 4, 2002, the same jury awarded the plaintiff $28 billion in punitive damages. However, these cases did not generally have an adverse impact on the market, as the secondary market trades indicated, because judgments of that size had a record of being overturned on appeal.

An active secondary market in nonspecialty state tobacco bonds was cited as favorable to the Authority's pricing process in the two following general ways:

1) It established a dynamic target, a general level of rates to be used as a reference in addition to the pricing history of primary issues with no subsequent "real time" trading activity; and
2) Investors could sell holdings from one series of tobacco bonds and trade into bonds from other series.

Based on the recommendations of the finance team, on October 8, 2002, the Authority Board unanimously authorized the issuance of the bonds through a bond resolution and authorized the distribution of the Preliminary Official Statement.

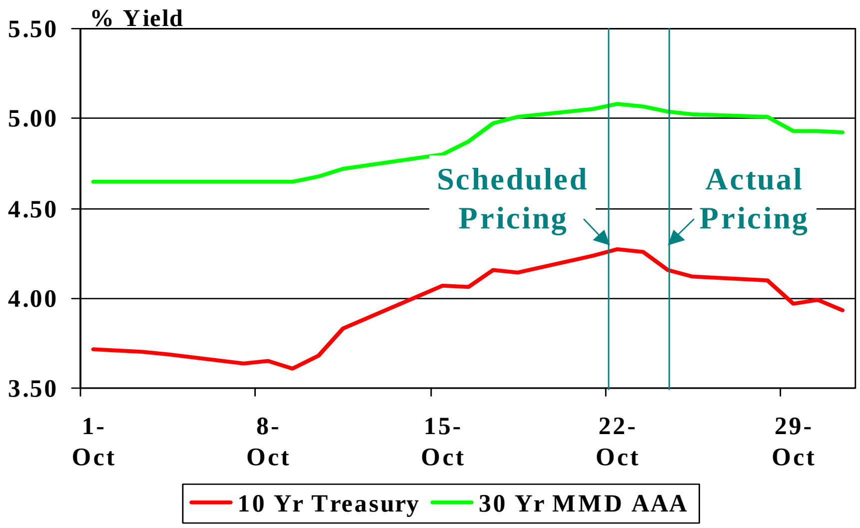
Finance/Marketing Schedule

The finance team recommended the retail-only order period be on October 21 and the institutional order period be on October 22, 2002. Preclosing was scheduled for October 29 and closing on October 30, 2002. In anticipation of a possible second meeting should market conditions change and it became impossible to issue the bonds within the delegated authority to the Chair, a tentative meeting by conference call was scheduled for 3:00 p.m. on October 21, 2002, following the pricing call. Staff sent out a public meeting notice indicating that the meeting would be open to the public at the Tobacco Settlement Authority office.

Market Conditions at the Time of Sale

Scheduled Pricing. The Authority transaction pricing was originally scheduled for a retail order period on October 21 with a formal, institutional pricing on October 22, 2002.

October 9 through October 22, 2002 Market Anomaly. As shown in the graph below, in the days leading up to the scheduled sale, there was a significant sell-off in the fixed income markets.



- The ten-year treasury rose 66 basis points between October 9 and October 22, 2002.
- During the same period, the municipal market data (MMD) AAA index rose 43 basis points, and yields on secondary trading of bonds issued in a recent South Dakota tobacco transaction (as reported by Muller Evaluation Services) rose 34 basis points.
- The significant increases in yields were also accompanied by widening credit spreads for all types of issuers.

These increases represent one of the largest two-week, bond market sell-offs in over twenty years and were precipitated by the following:

- Falling business inventories with increasing sales;
- An unexpected surge in the major stock market indices;
- An increasing negative tone in the fixed income markets given the long succession of gains realized earlier in the year;
- Significant cash outflows from municipal bond funds; and
- Brisk selling in the fixed income markets with growing bids-wanted lists and growing inventories among Wall Street firms.

While a few new issues were priced in these extremely negative conditions, all were affected by a significant lack of investor demand while institutional purchasers sat on the sidelines awaiting the end of the free fall.

Recommendation of the Underwriting Group and the Financial Advisors. Throughout the sell-off, the Authority's underwriting team and financial advisors unanimously recommended a day-to-day status review for the Authority securitization.

Beginning on October 18, 2002, the group gathered daily for market update conference calls. In addition to the unanimous recommendation that the Authority wait for a positive tone to return to the markets, the suggestion was made to hold the retail and institutional order periods simultaneously to maximize the Authority's flexibility to rapidly enter the market. To ensure that retail was given the appropriate incentive to place orders and to properly compensate local firms for their work in cultivating this segment of the market, retail purchasers were given priority on the day of sale, and a pricing in a single morning was planned.

Some stability returned to the markets around October 23, the date that marked the end of the sell-off. However, a positive tone did not return until October 24, 2002, when the Authority's underwriting group and financial advisors recommended entering the market.

Market Conditions on the Day of Sale. On October 24, 2002, the treasury market gained confidence and yields fell, while equities sold off. In economic news, initial jobless claims for the week ending October 19, 2002, were announced. This key indicator had fallen by 25,000 to 389,000, providing some evidence that the pace of layoffs was stabilizing.

Results of Sale

Pricing Result. After opening the pricing period with serial maturities in 2005 through 2012 and term bonds yielding 6.65% in 2026 and 6.90% in 2032, Bear Stearns and the underwriting team built a strong book of orders in the term bonds but found that demand was weak in the serial range from 2008 through 2012**.**

The underwriting syndicate had offered to underwrite the issue if the yields were raised in the area of weakest investor demand (the 2010-2012 maturities); however, the idea of moving approximately $27 million in bonds from these 2011-2012 maturities to a term bond yielding 6.65% was abandoned. Based on this more financially favorable set of pricing adjustments, the Authority agreed to accept the syndicate's underwriting offer, which included a yield improvement on three maturities, representing 35% of the loan.

	INITIAL PRICING STRUCTURE		PROPOSED STRUCTURE		FINAL PRICING STRUCTURE	
Maturity	**Coupon**	**Yield**	**Coupon**	**Yield**	**Coupon**	**Yield**
2005	3.500%	3.500%	3.500%	3.500%	3.400%	3.400%
2006	3.875%	3.875%	3.875%	3.875%	3.800%	3.800%
2007						
2008	4.750%	4.750%	4.750%	4.750%	5.000%	4.750%
2009	5.000%	5.000%	5.000%	5.000%	5.250%	5.000%
2010	5.250%	5.250%	5.250%	5.250%	5.250%	5.500%
2011	5.375%	5.375%			6.250%	5.750%
2012	5.500%	5.500%			5.500%	5.875%
2013						
2023						
2024			6.500%	6.650%		
2025						
2026	6.500%	6.650%			6.500%	6.650%
2027						
2028						
2029						
2030						
2031						
2032	6.625%	6.900%	6.625%	6.875%	6.625%	6.875%

The table above shows the results of the yield adjustments from the preliminary pricing scale to the final structure. The 2005 maturity was improved by 10 basis points; the 2006 maturity was improved by 7.5 basis points; and the $180 million 2032 term bond was improved by 2.5 basis points. In those serial maturities where few orders had been received (2010-2012), the syndicate underwrote the bonds with a yield increase ranging from 0.25% to 0.375%.

Key Transaction Results. The Authority issued $517,905,000 of tobacco settlement asset-backed bonds to provide $450 million to the state, which required the purchase of 29.2% of the state's TSRs for as long as any of the bonds remain outstanding. The pledged TSRs consisted of the following:

- The first $30 million of TSRs received by the state before July 1, 2003; and
- 29% of the TSRs received by the state on or after July 1, 2003.

Despite the extreme disruption in the fixed-income markets just prior to pricing, the 29.2% pledge was below the Authority's 30% target.

On November 5, 2002, the Authority's bond transaction closed, and $450 million was deposited with the state.

Present Value Analysis

The Authority's debt service consists of entirely fixed rate bonds. However, due to the conservative projection of the amount and timing of future TSRs from which it will make its principal and interest (debt service) payments, the Authority will likely receive more TSRs each year than will be required to make the minimum scheduled debt service payments. In any given year, the excess TSRs can be used to prepay principal. Much like prepaying portions of the principal amount of a mortgage, prepayments will reduce the amount of interest the Authority will pay on its bonds.

Therefore, the Authority expects to make significant prepayments each year on its bonds as permitted under the turbo amortization structure. The difference between the Authority's scheduled and expected total debt service (i.e., the amount of interest it will forego due to annual prepayments of principal) is approximately $300 million. This will contribute to the Authority's projected ability to repay the bonds within about 17 years rather than the 30 years indicated by the scheduled debt service payments. Moreover, the Authority's liquidity reserve for the bonds and the availability of capitalized interest for a portion of the interest due in FY 2003 will further reduce the debt service on the bonds by nearly $6 million.

In describing the future (and total) cost of the Authority's financing in terms of today's dollars, a present value analysis is used. Such an analysis allows the Authority to determine the relative efficiency of its financing. A present value analysis essentially answers this question: What is the cost of the debt service payments over time in terms of today's dollars?

To answer that question, the future payments are "converted" into today's dollars by applying a discount rate to each of the future debt service payments. The discount rate used in this analysis is 5%, a representative rate in today's market. The analysis includes the expected debt service payments and the net requirements after accounting for interest earnings and capitalized interest.

As shown in the following table, in present value terms the Authority is scheduled to pay $0.12 of interest for each dollar of principal amount borrowed using the expected principal repayment schedule.

Estimated Debt Service	*Nominal*	*Interest Cost per Dollar Borrowed*	*Present Value Using 5%*	*Interest Cost per Dollar Borrowed*
Gross Debt Service	$883,426,893	$0.71	$579,670,604	$0.12
Net Debt Service	$877,737,334	$0.70	$574,139,578	$0.11

Post-Closing Responsibilities and Ongoing Compliance Requirements

As with any tax-exempt bond issue, the Authority's 2002 bonds are subject to certain reporting requirements under the 1986 Tax Act, as amended. In addition, the Authority's governing bond indenture requires various annual certifications.

The Authority's tax certificate imposes various ongoing federal tax compliance requirements to ensure the tax-exempt status of the interest on the bonds. These tax compliance requirements include tax accounting for the investment and expenditure of the bond proceeds, the requirement to rebate certain excess earnings to the federal government every five years, and certain special ongoing tax compliance requirements that start on July 1, 2007, with respect to the working capital portion of the bonds.

Initially, the Authority will need to coordinate with the state to monitor the state's initial investments and expenditures of the net bond proceeds for governmental purposes. Once all of the net bond proceeds have been spent (which is expected to occur by about June 30, 2003), it will be necessary to do a final accounting of the uses of the bond proceeds between capital project purposes and working capital purposes.

In addition, the Authority will need to arrange for periodic arbitrage rebate analyses, record keeping reports, and payment of rebate, if any, owed to the federal government once every five years. As a practical matter, it is unlikely that the Authority will owe any arbitrage rebate since the arbitrage yield on the bonds is considerably greater than the yield on the main ongoing investments in the liquidity reserve account.

Finally, certain special ongoing federal tax compliance requirements apply to the working capital portion of the bonds. These tax compliance requirements start on July 1, 2007, and require annual testing of certain prescribed surplus "available amounts" in the state general fund and the taking of certain remedial compliance actions with respect to any such surplus amounts found. Permitted remedial compliance actions include redeeming bonds, redeeming other state bonds, investing the prescribed surplus amounts in certain non-AMT tax-exempt investments, and other actions.

An annual audit of the Authority's finances must be completed.

Annual continuing disclosure reports are required under the indenture executed and pursuant to S.E.C. Rule 15c2-12. The reports will include compiling the operating data required under the indenture and disseminating the disclosure reports to the nationally recognized municipal securities information repositories. The funds received by the Authority from the Master Settlement Agreement escrow agent need to be properly invested prior to their periodic transfer for debt service and Authority expenses.

Per the indenture, various officers' certificates are to be prepared annually, including those that detail the following:

- The operating cap for the upcoming fiscal year, based on the initial operating cap in 2003 and inflated by the inflation adjustment percentage as defined in the Master Settlement Agreement, plus other includable adjustments;
- The amount of operating expenses for the upcoming fiscal year;
- The amount to be deposited to the operating contingency account for operating expenses in excess of the operating cap;
- All collections by category, such as annual payments, strategic contribution fund payments, partial lump sum payments or total lump sum payments and instructions relating to the application of such funds; and
- Directions for payment of operating expenses by the trustee from the operating account or the operating contingency account.

Summary

On May 2, 2002, the Authority was formed by appointment of Governor Locke to issue 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 current biennium.

The Authority's goals were to:

- Work cooperatively with the Office of the Governor, the Office of the Attorney General, the Office of the State Treasurer, key legislative staff, and the Office of Financial Management;
- Determine how to minimize the pledge of TSRs required to support the Authority's financing; and
- Complete the financing by early November 2002.

On November 5, 2002, $450 million was deposited by the Authority into the state general fund in exchange for acquiring 29.2% of the state's tobacco revenue settlement stream for the estimated 17-year period that the bonds remain outstanding.

Appendix

Tobacco Settlement Asset-Backed Bonds
Series 2002

Frequently Asked Questions

Why were the tobacco bonds issued?

To provide $450 million for budget relief at the request of the Washington State Legislature.

Why was more than $450 million issued?

The total amount was $517,905,000. This provided the $450 million plus reserves required by the rating agencies. The reserves will be used to pay debt service on the bonds in the final year(s) of their amortization schedule. Approximately 1.2% of the proceeds were used to pay costs of issuing the bonds including underwriters' discount.

Is the state obligated on the bonds?

No. The bonds are issued by the Tobacco Settlement Authority and paid from a portion of the tobacco settlement revenues precisely so they can never directly affect the state's credit, its credit ratings, or its borrowing capacity. The state, like the other 17 states and territories that have issued tobacco bonds so far have no obligation or liability in any way in relation to the repayment of tobacco securitization bonds.

What is the security for these bonds?

The state has sold the Tobacco Settlement Authority a portion of the tobacco settlement revenues that would otherwise come to the state each year. In return, the state has received $450 million.

How much of the tobacco settlement revenues were sold?

The state sold 29.2% of the tobacco settlement revenues it would otherwise receive each year until the bonds are paid off.

How does this percentage compare with other states?

Each state has had its own financial and budgetary objectives in selling tobacco settlement revenues (TSRs). Most states have sold 100% of their anticipated TSRs. Washington needed a fixed amount ($450 million) from the securitization, so the percentage of the TSRs sold to the Authority was much less than 100% (in actuality, it was 29.2%).

What happens when the bonds are paid off?

When the bonds are paid off, all (100%) of the future tobacco settlement revenues will go to the state.

When are the bonds expected to be paid off?

Investors purchase these bonds based on a very elaborate model of expected tobacco settlement revenues. This model projects that the bonds will be paid off in 2019. Numerous factors affect this, including domestic cigarette sales, inflation, and various adjustments to tobacco settlement revenues received under the Master Settlement Agreement.

What is the rating on the bonds?

The bonds are rated A1 by Moody's and A by Standard and Poor's.

Are the bonds all tax exempt?

Yes. The entire bond issue is tax exempt and therefore the Authority will pay lower interest rates.

What was the interest rate on the bonds and how does it compare to other types of bonds?

Because tobacco settlement bonds are not an obligation of the state and are secured solely by revenues received from the major tobacco companies, they have significantly higher interest rates then other tax-exempt bonds. Nationally, tobacco settlement bonds generally have sold at an interest rate up to 1.85%-2.00% above the rate on state general obligation bonds.

The net interest cost on these bonds is 6.75%. If the state had issued general obligation bonds with the same maturity, backed by state taxes, the net interest cost would probably have been about 4.80%.

How does this rate compare to that on other tobacco settlement bonds?

The Authority's bonds priced at levels comparable to the trading performance of other nonspecialty state tobacco settlement bond transactions. States with little or no state income tax are commonly referred to as "nonspecialty" states. In states such as Washington where there is no state income tax, the rate on tobacco settlement bonds during 2002 has generally been about 2% higher than state general obligation bonds.

Why were the bonds sold in October?

The Tobacco Settlement Authority was formed in May 2002 and was able, by working closely with the Office of Financial Management, to find a way to make all the bonds tax exempt. The Authority approved the bond sale on October 8, 2002, priced the bonds on October 24, 2002, and closed the issue on November 5, 2002. This timing was critical because the $450 million was needed to pay state bills starting in mid-November 2002.

What were the results of the bond sale?

The bonds were sold in an unusually difficult month in the bond market, with major fluctuations in rates on U.S. Treasuries and all types of bonds. This uncertainty was affected by swings in the stock market, drops in consumer confidence, federal budgetary deficits and the potential for war. In addition, a widening credit spread caused by the increasing supply of tobacco settlement bonds, fears of bankruptcy in the corporate world, and a number of adverse judgments against certain tobacco companies had become evident in the market.

Despite these uncertainties, the underwriters led by Bear, Stearns & Co. Inc. and Goldman, Sachs & Co., with help from RBC Dain Rauscher Inc., Merrill Lynch & Co., UBS Paine Webber Inc. and U.S. Bancorp Piper Jaffray, were able to effectively market the bonds at a net interest cost of 6.75% and use only 29.2% of the state's expected tobacco settlement revenues.

How were the underwriters chosen?

The Tobacco Settlement Authority sent a request for proposals to 41 firms, received 17 responses and interviewed 4 potential senior managers. Bear, Stearns was selected as the book-running senior manager and Goldman, Sachs as the co-senior manager based on the strength of their written responses, presentation and references. Bear, Stearns had sold more tobacco settlement bonds than any other firm, and offered the Authority one of the lowest fee structures of any potential senior manager.

TSA

TOBACCO SETTLEMENT AUTHORITY

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