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Tobacco Settlement Bonds: a Critical Analysis of 9 States and 3 Territories

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Abstract

Tobacco Settlement bonds were issued by states to obtain early use of the funds awarded to them in the Tobacco Master Settlement Agreement (MSA). Entered into in November 1998, the MSA was a settlement of 46 states attorney's general lawsuits against the tobacco industry, which in return was released from future liability on civil lawsuits resulting from damages caused by smoking. This paper explores the settlement agreement, the use of capital appreciation bonds by nine of states, Washington DC, Puerto Rico and Guam and the probable failure of the bonds and securitization efforts by the states.

Key Words: tobacco settlement bonds, capital appreciation bonds, default, securitization
JEL classification: G2

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1. Introduction

Tobacco settlement bonds are a result of the states and US territories seeking to receive a cash inflow immediately instead of payments in perpetuity from the Tobacco Master Settlement Agreement (MSA) that was entered into in November 1998. This settlement was reached between the tobacco industry, Philip Morris Inc., R. J. Reynolds, Brown, Williamson & Lorillard, and the attorneys general of 46 states. The agreement was a settlement of Medicaid lawsuits by multiple states' attorneys general and individual plaintiffs against the tobacco industry for recovery of their tobacco-related health-care costs. The resultant settlement agreement exempted the companies listed as defendants, the Original Participating Manufacturers (OPM), from private tort liability regarding harm caused by tobacco use. In return for this exemption from tort liability, the companies agreed to curtail or cease certain tobacco marketing practices, as well as to pay, in perpetuity, various annual payments to the states to compensate them for some of the medical costs of caring for persons with smoking-related illnesses. The money also funded a new anti-smoking advocacy group, called the American Legacy Foundation, which is responsible for such campaigns as The Truth. The settlement also dissolved the tobacco industry group's Tobacco Institute, the Center for Indoor Air Research, and the Council for Tobacco Research. In the MSA, the OPM's agreed to pay a minimum of $206 billion over the first 25 years of the agreement. It is these funds, in perpetuity that the 9 states, Puerto Rico, Guam and Washington DC (the 12) gave up for pennies on the dollar by issuing capital appreciation bonds as tobacco settlement bonds.

A municipal bond is defined as a debt security issued by a public agency (such as state, city or school district), to finance (new money) or refinance (refunding) capital expenditures. Typically, the federal, state, and local governments allow the interest income on municipal bonds to be exempt from income taxes. Most municipal bonds are called current interest bonds. These bonds pay interest on a semiannual basis at the coupon rate over their entire life and are issued from 10 to 30 years. The face value of the bond is redeemed at the maturity date. The issuing entity records a liability equal to the present value of the face value.

A Capital Appreciation Bond (CAB) is a municipal security on which the investment return on an initial principal amount is reinvested at a stated rate until maturity, at which time the investor receives a single payment representing the face value of the bond and all accrued and compounded interest. CAB's do not pay periodic interest payments so have no debt service to report on budgets. Principle equaling the bonds' face value and all accrued and accumulated interest are paid on the bond's maturity date. The growing compounded value of the bond, although not carried at this increasing figure on either the investor's or states balance sheet is called accretion. CAB's are frequently issued in multiples of $5000, and sold at deep discounts. This purchase price, although much lower than the ultimate payout, is the amount of debt the issuing entity records.

Mathematically, CAB's are similar to zero coupon bonds. The difference is that the initial amount of funds received by the issuing entity is considered to be the principal amount for a CAB, while the value at maturity is considered to be the principal amount for a zero coupon bond. In both cases the value of the bond increases over time until maturity. CABs, which often do not have a sinking fund, are then carried on the books at their principal value which is the discounted amount for which they are first issued, not their payoff costs or accreted value. There is no debt service until the bond is due.

Accretion means a gradual increase in value over time. The Municipal Securities Rulemaking Bureau (MSRB) defines accretion of discount as an accounting process by which the book value of a security purchased at a discount from par is increased during the security's holding period. The accretion reflects the increase in the securities value as it approaches the redemption or maturity date and face amount of the bond. Compound accreted value is defined by the MSRB as the nominal value (at any given time), of a CAB, of which all or a portion of the investment return is received in the form of an accretion from the initial principal amount up to the maturity or redemption value. The compound accreted value is equal to the initial principal amount plus the accretions (calculated on the compound interest method) to present date. In the case of capital appreciation bonds many mutual funds carry the value of the bonds at their original purchase price because of the strong possibility of default.

The minority of the tobacco settlement bonds are capital appreciation bonds created to allow immediate use of funds with a long delayed payback (up to 55 years) of interest and principal. These bonds have securitized their future tobacco settlement payments by selling the right to receive a portion of future settlement proceeds in exchange for a discounted lump-sum payment to the state. They are similar to zero coupon bonds and not the more typical current interest bond. They are issued for periods well in excess of the normal 25 year municipal bond. A normal payback for a municipal bond is 2 to 3 times the amount borrowed by the municipal bond issuer. This paper explores the consequences to the twelve states and territories that issued these capital appreciation bonds with the following qualities: a) they had maturities that ranged from 29.1 to 54.8 years, b) they frequently were held with no insurance or insurance with a troubled company, and c) there was no sinking fund and compounding of deferred interest. The result of these decisions is a payback of 10.41 to 1800.02 times the amount borrowed for an average payback of 117.13 times. These same capital appreciation bonds have been issued by school districts all over the United States. Interestingly, Michigan and California which have issued 55%of the tobacco settlement bonds have banned this type of bond for school districts, the same type of bond that the states feel it is appropriate for them to use for the tobacco settlement bonds.

2. Characteristics of Capital Appreciation Tobacco Settlement Bonds

The table below is a breakdown of the aggregate capital appreciation tobacco settlement bonds for each state. The total amount borrowed is $22,604,520,000 with only $573,180,000 received by the states issuing the bonds after the discount leaving a total maturity amount to be repaid of $67,134,019,000. Considering the difference between the funds received and the amount to be paid back at maturity for the total of the outstanding tobacco settlement bonds issued, these twelve states will repay a staggering 117.13 times the amount borrowed. While these CABs represent only a small portion of the total tobacco bonds outstanding, 8.3%, the rest are normal bonds, they represent a very significant liability for the 12 in the future.

Table 1. Breakdown of the Aggregate Capital Appreciation Tobacco Settlement Bonds

State of issuance	Issue Amount ($Mils)	Maturity Amount (Mils)	Number of Bonds issued	Discounted Amount Received ($Mils)	Payback Ratio
Alaska	411.99	537.21	5	1.07	503.47
California	9355.59	20724.17	103	126.07	164.4
DC	248.26	4424.00	4	13.93	317.59
Guam	50.48	164.02	3	2.76	59.49
Iowa	609.05	1365.00	6	40.46	33.74
Michigan	650.40	6751.87	9	3.75	1800.02

New Jersey	3622.21	4717.00	19	27.01	174.67
New York	820.92	2485.15	25	238.81	10.41
Ohio	5531.59	11836.45	22	51.81	228.47
Puerto Rico	195.88	8634.58	2	51.81	166.67
Rhode Island	197.01	2834.18	3	13.37	206.97
West Virginia	911.14	2660.07	2	2.35	1030.72
Totals	**22604.52**	**67134.02**	**203**	**573.18**	**117.13**

Source: Reuters Data Base, eMAXX

Initially, an investor may believe that the risk for default is mitigated by the insurance on these bonds. While this may normally be true, the selection of the carriers and the problems which these carriers are experiencing undermines this assumption. The status of these insurance carriers, shown in Table 2, clearly illustrates the risk to those bonds that are insured. These statistics are for California only; no other states have insured their tobacco settlement bonds. The total insured represents 10.7% of the bonds issued by California and less than .1% of the total outstanding tobacco settlement bonds. In addition, even this tiny amount is insured by two companies under restructure or bankruptcy and one with a credit rating of only AA-.

Table 2. Insurers for California Capital Appreciation Tobacco Settlement Bonds

Insurer	Amount Covered	Issues
AMBAC	$80,890,000	Filed chapter 11, Nov 8, 2010
AGM	$96,780,000	Credit rating AA-
FGIC	$44,876,000	Under restructure by MD Ins Commissioner
Totals	$222,546,000	Credit rating lowered to A3 in January 2013

Source: Reuters Data Base, eMAXX

Almost all of the bonds (96.8%) have a call provision, but only 57.1% have a provision for a sinking fund. Some bonds include a “turbo redemption” feature. This clause allows for an accelerated redemption of the bonds at the states discretion with no penalty for so doing. However, this same clause clearly states that failure to redeem the bonds or exercise this feature “shall not be considered a default on the bond”. So, if the states don’t have to redeem the bonds and have not set aside any money for the redemption (sinking fund) why include this clause other than to be able to point it out to taxpayers? According to Cezar Podkul of Pro-Publica, bonds have been called only in New York’s Niagara County. The bonds called are 100% owned by Oppenheimer funds who were carrying them on their books at the original payment price of $1,782,960 in 2005 on a $437 million bond issue, (Niagara’s portion of the $4.679 billion par value of all the NYCTT V CABs). The negotiated redemption pays Oppenheimer $6,887,568, on an accreted value of $12,651,150 for a difference of $5,763,582. This represents a gain of 16.2% per year on their speculative bond investment.

This leaves the question of refunding, other than by negotiation. The bonds are backed by the provisions for payment in the MSA. For the bonds to be refunded there would need to be another source of funding. Given the amount required for refund and the percentage with a sinking fund, the sources of money with the states budgetary issues would certainly be questionable.

According to a July 12th article by Joan Gralla in the Chicago Tribune citing Reuters, the majority of tobacco bonds sold by U.S. states, counties and cities will default if cigarette consumption keeps falling at a 3% to 4% annual pace. In the same article, the Wall Street credit agency, Fitch, indicated that 74% of the outstanding balance of all tobacco settlement bonds will be in default". According to James Klotz, President of FMS bonds, Inc., Moody's has placed more than $20 billion of municipal bonds backed by funds from the MSA under review. They are concerned about a reduction in the flow of funds because of decreased smoking by consumers. The tobacco companies, in a dispute over the minimum required payment under the MSA, held back some $7 billion in funds. In a settlement of this dispute again according to Moody's, the states will receive only 54% or $4 billion of the approximately $7 billion withheld in the dispute, significantly less than expected. Thus, it will require a growing percentage of any future settlement funds for any sinking fund payments to retire the "securitized" settlement payments since the number of smokers and correspondingly payments from the tobacco companies are decreasing.

The decision to securitize the MSA with bonds is a result of a concept introduced by investment firms and banks which assigns the right to future income from settlement dollars in return for discounted right to immediate funds. The investment firms pass on the risk to investors, securing fees and commissions. At a time when income to states is decreasing and they are battling constant budget issues, this immediate inflow of funds may appear very attractive. This process ignores the long term consequences of a possible default on the bonds and its long term effect on the states' credit and future bonds. Because of increasing concerns of defaults, some states are considering moving the newer issues to general obligations status, thus placing the states directly behind the good faith and credit of the bonds. This could have an even more devastating impact and impair the states' ability to meet future obligations.

Securitization of tobacco settlement bonds is the issuance of bonds, and in this case CABs that are backed by future revenue streams from the MSA payments to the states and municipalities. In exchange for money at the issuance of the bond, the entities postpone repayment of interest and principal for 40 to 55 years, mortgaging their future payments in return for pennies on the dollar. In many cases these bonds are issued through a Special Purpose Entity (SPE) designed to be separate from the states. However, some states are discussing making the CAB's general obligations bonds from the states to insure that they avoid the stigma of a default and retain good relationships with the underwriters and bond brokers who handle their normal municipal bonds. By rolling these upfront payments into their general fund the 12 states insure that the bonds remain tax free. The municipal entities can choose any portion of the declining tobacco revenue to securitize the loan and in several cases have had to increase this pledge amount in order to sell additional bonds.

Recently, the states have introduced a "turbo redemption" feature which has an accelerated redemption in the bond indenture. They fail to provide any sinking fund and do not specify how the money to redeem any bond is to be raised. As a further indication of how seriously the states consider this feature, the indenture clearly states that failure to fund the feature or use the feature to redeem the bond does not constitute a default on any portion of the bond issue. A major drawback of this feature, should it ever be used, it reduces the risk to the bondholder and increases the risk to the state of long term declines in the tobacco revenue. According to the Federal Reserve Bank of Boston, "coupled with other indicators, the sale of tobacco bonds for deficit financing may adversely affect a state's overall credit rating". This is in spite of the attempt to shield the state by the use of SPEs. The Bank further cites two additional issues with securitization: first" if future payment streams diminish to the point where they are insufficient to cover debt service, a state could face pressure to back the bonds with general revenue. Second, inappropriate use of bond proceeds (e.g., using proceeds to close a budget gap without addressing the underlying structural causes) could adversely affect a state's overall credit rating."

These points are further emphasized by the Campaign for Tobacco-Free Kids when they state "States that use securitization funds to address budget deficits may also have their credit or bond ratings downgraded because securitizing eliminates a substantial future state revenue stream in exchange for a one-time budgetary band-aid that does nothing to address underlying state revenue and expenditure problems". Further the campaign states that "States will receive only pennies for every future dollar of settlement revenues they securitize, and investors, investment firms, and bond lawyers will end up getting a big chunk of the securitization proceeds", which reduces any possible of this securitization and bond issuance even further. This downgrade can easily occur if the states or municipalities fail to address budget deficits and pledge future dollars for immediate gratification of funds today, which are immediately spent, as in the case of New Jersey where additional securitization raised the bond rating to A but reduced the state's rating to C.

The problem remains that should default appear emanate, there will be an increasing amount of pressure put on the states by these same brokers and underwriters with whom the states must continue to work for a state or municipality guarantee. For the 12 states, should the bondholders choose to spend $1,000,000 per legislature in this effort, it would represent less than 2% of the potential profits from the bonds. Again, according to the Campaign for Tobacco Free Kids "Even in those cases where the securitization arrangement expressly eliminates any legal obligation of the state to compensate those who purchase settlement bonds, the expectation is that the state will protect bond holders anyway". This puts the burden directly on the backs of the citizens.

Table 3. Securitization in 12 States

Issuing State	Callable Amount (Mils)	Total Maturity Amount (Mils)	Percent of bonds callable	Total Maturity value of bonds with sinking fund Sinking Fund (Mils)	Percent of bonds with Sinking Fund
Alaska	537.205	537.205	100%	537.205	100
California	18052.409	20724.172	87.1%	12,858.874	62.0%
DC	4424.000	4424.325	100%	0	0%
Guam	164.020	164.02	100%	14.990	9.1%
Iowa	1365.000	1365	100%	0%	0%
Michigan	6751.870	6751.870	100%	6,051.245	89.6%
New Jersey	4717.000	4717.000	100%	4717.000	100%
New York	2485.151	2485.151	100%	2,285.776	92.0%
Ohio	11836.446	11836.446	100%	11836.446	100%
Puerto Rico	8634.580	8634.580	100%	0	0%
Rhode Island	2834.180	2834.18	100%	0	0%
West Virginia	2660.070	2660.07	100%	0	0%
Totals	**64461.931**	**67134.019**	**96.0%**	**38301.536**	**57.1%**

Source: Reuters Data Base, eMAXX

3. The Settlement Agreement

As previously stated, the MSA was reached in November 1998 between the four largest tobacco companies (Philip Morris Inc., R. J. Reynolds, Brown & Williamson and Lorillard) and the attorneys general of 46 states in settlement of Medicaid lawsuits for the recovery of the tobacco related health care costs. The companies agreed to a change in their marketing, lobbying, litigation and sponsorship practices as well as payments in perpetuity payments to the various states a percentage of tobacco revenue. Further, there was an agreement for a minimal payment of $206 billion in the first twenty five years of the agreement. In return, the companies were exempted from civil liability occurring from the harm caused by the use of their tobacco products for class action lawsuits. While individual actions could continue to be filed, the settlement eliminated punitive damages in these lawsuits.

The amount of annual contribution is dependent on many factors but primarily based on the number of cigarettes sold beyond the grandfathered volume calculated as either the highest of the individual company's individual market share in 1998 or 125% of the individual company's market share in 1997. The total from the original four parties to be received by the states over 25 years was over $206 billion to be distributed from an escrow account. The amount that is to be distributes is as follows:

- $12.742 billion up front
- Annual Payments beginning April 15, 2000 of $183.177 billion through 2025
- Strategic Contribution Fund (2008 to 2017) $8.61 billion
- National Foundation $250 million over 10 years
- Public Education Fund at least $1.45 billion from 2000 to 2003
- State Enforcement Fund $50 million in a one-time payment
- National Association of Attorneys General $1.5 billion over the next 10 years

The problem is that the payments are predicated upon U.S. smoking patterns and can decrease from the figures outlined above. This in fact has been the case as U.S. smoking has been decreasing. According to a Gallup poll taken in 2012, the percentage of adults who smoke cigarettes has declined from 25% in 1997 to 20% in 2012, having reached a high in 2002 of 28%. Table 4 shows the flow of payments to escrow from 1999 through 2011 from the Master Settlement Agreement. As can be seen the drops have been dramatic and should the trend continue, there will be problems with cash flow to the states and correspondingly to the bonds. In Table 4, one can see that the cash flow from the companies the escrow account has decrease dramatically in recent years, reversing a rising trend when most of the bonds were issued. This trend does not bode well for the solvency of the bonds. For example in New York the counties that have "securitized the payments by issuing bonds are receiving about 40 cents on the dollar through 2025. On the bright side for the states, they have effectively transferred the risk, for a greatly reduced lump-sum payment, of not being paid from tobacco sales payments should the cash flow from the companies involved continue to drop. On the dark side for investors, "analysts are predicting that some state and local governments could default on their bonds as early as 2014." Ohio, New Jersey, California and New York were cited.

Table 4. Flow of Payments to Escrow from 1999 through 2011

	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Amount Paid in billions	$3.90	$ 5.96	$6.39	$ 7.02	$ 5.86	$6.29	$6.38	$ 5.83	$6.07	$ 6.99	$7.65	$ 6.39	$6.04
% Change	N/A	52.9%	7.2%	9.9%	-16.5%	7.2%	1.4%	-8.5%	4.1%	15.2%	9.4%	-16.4%	-5.6%

Source: National Association of Attorneys General (NAAG)

A compromise to the MSA was reached on December 22, 2012. Tobacco companies had started placing their payments into an escrow account some time before asserting that they could not sustain the current level of minimum required payments with the falling sales of cigarettes. This revised settlement directly affects the funds for 17 states allowing a release of those escrowed funds gives the states $1.68 billion in disputed payments in 2013. In return, the tobacco companies receive a credit against future payments of $1.68 billion over the next five years. While this agreement will certainly provide a current windfall, it allows for future reduction in payments should cigarette sales continue to decline. A three judge panel formed in July 2010 must approve the settlement.

The problem originally resulted from a section of the 1998 agreement that was designed to offset the effect on companies that signed the agreement and those that did not. It reduced the payments for those signing the agreement by the amount equal to the market share lost to the companies that did not. Those reductions created an immediate dispute with the signing companies arguing that their sales could not justify payments. This approval will set up a framework for future disputes about the ability of the tobacco companies to maintain any given level of payments. Thus as sales fall, they now have a framework to reduce future payments accordingly.

4. Use of the Funds

The money received from the MSA was intended for use in the payments for tobacco related health care and anti-smoking campaigns. The table below is an indication of how well the states are using the funds for this intended purpose. Even though the agreement on the use of funds is not binding on the states, the intent was clear. While data is available for all states, this paper is exploring primarily those states that have issued capital appreciation municipal bonds backed by the Master Settlement Fund payments. The only state issuing tobacco settlement bonds that is funding at the levels recommended by the Center for Disease Control and Prevention (CDC) is Alaska. The budget amount for the US in total is only 12.4% of the $3.7 billion recommended by the CDC in 2013. In Table 5 below the recommendations by the CDC are those levels they estimate it requires having an effective and comprehensive tobacco prevention program. The MSA receipts are the actual amount received by the states addressed and the amount spent is the actual amounts spend for prevention by these states.

Table 5. Use of Funds for Intended Purpose

	Alaska	California	DC	Iowa	Michigan	New Jersey	New York	Ohio	Rhode Island	West Virginia
2012 MSA Receipts	$ 30.0	$ 735.8	$ 38.3	$ 65.7	$ 256.2	$ 39.3	$ 737.7	$ 295.2	$ 46.7	$ 63.7
2012 Spending	$ 10.8	$ 70.0	$ -	$ 3.2	$ 1.8	$ 1.2	$ 41.1	$ -	$ 0.4	$ 5.7
% of CDC Reccom	101.3%	15.8%	0.0%	8.9%	1.5%	1.0%	16.3%	0.0%	2.5%	20.3%
2011 MSA Receipts	$ 29.4	$ 721.5	$ 37.6	$ 64.4	$ 251.2	$ 38.6	$ 723.5	$ 289.5	$ 45.8	$ 62.5
2011 Spending	$ 9.8	$ 75.0	$ 0.6	$ 7.3	$ 2.6	$ 0.6	$ 58.4	$ -	$ 0.7	$ 5.7
% of CDC Reccom	92.0%	17.0%	5.4%	20.0%	2.1%	0.5%	23.0%	0.0%	4.8%	20.4%
2010 MSA Receipts	$ 31.5	$ 762.5	$ 39.2	$ 68.7	$ 265.7	$ 40.9	$ 764.4	$ 306.1	$ 48.6	$ 66.5
2010 Spending	$ 9.2	$ 77.1	$ 0.9	$ 10.1	$ 2.6	$ 7.6	$ 55.2	$ 6.0	$ 0.7	$ 5.7
% of CDC Reccom	86.0%	17.4%	8.1%	27.5%	2.1%	6.3%	21.7%	4.1%	4.6%	20.5%
2009 MSA Receipts	$ 37.3	$ 914.4	$ 47.6	$ 81.6	$ 318.4	$ 48.9	$ 916.8	$ 366.9	$ 58.0	$ 79.1
2009 Spending	$ 8.2	$ 77.7	$ -	$ 10.4	$ 3.7	$ 9.1	$ 80.4	$ 6.0	$ -	$ 5.7
% of CDC Reccom	76.6%	17.6%	34.3%	28.3%	3.1%	7.6%	31.6%	4.1%	6.1%	20.5%
2008 MSA Receipts	$ 34.7	$ 832.1	$ 43.6	$ 75.5	$ 290.2	$ 44.9	$ 834.5	$ 334.3	$ 53.2	$ 73.0
2008 Spending	$ 7.5	$ 77.4	$ 3.8	$ 12.3	$ 3.6	$ 11.0	$ 85.5	$ 44.7	$ 0.9	$ 5.7
% of CDC Reccom	92.5%	46.9%	48.1%	63.5%	6.6%	24.4%	89.2%	72.4%	9.5%	40.0%
2007 MSA Receipts	$ 20.7	$ 774.8	$ 36.9	$ 52.8	$ 264.2	$ 36.2	$ 774.7	$ 305.8	$ 43.6	$ 53.8
2007 Spending	$ 6.2	$ 84.0	$ 0.5	$ 6.5	$ -	$ 11.0	$ 85.5	$ 45.0	$ 1.0	$ 5.4
% of CDC Reccom	76.6%	50.9%	6.7%	33.6%	0.0%	24.4%	89.2%	72.9%	9.6%	38.1%

Source: Campaign for Tobacco Free Kids,

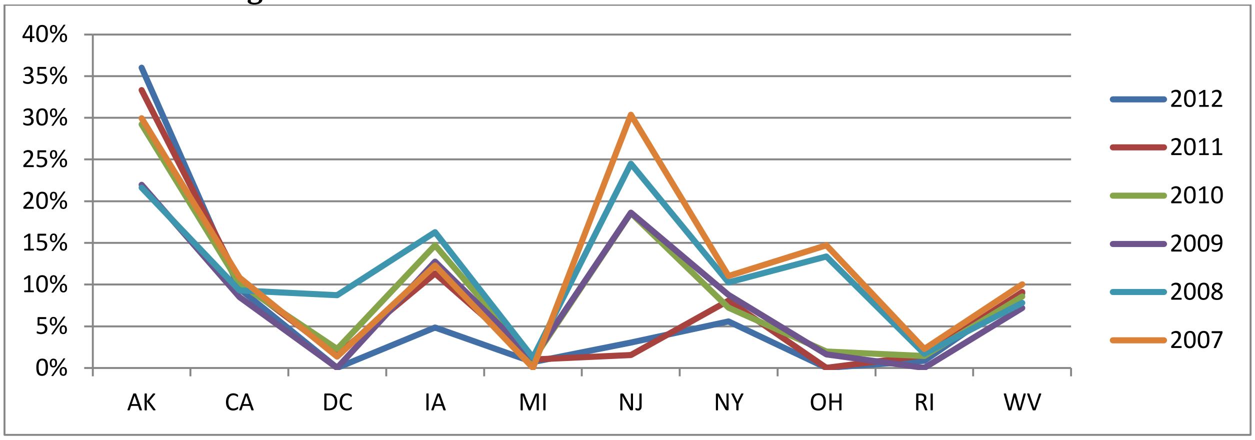
It seems apparent that the states are using funds as needed for various purposes that they feel take priority. In light of the demands on state funds precipitated by the 2008 recession, reduced tax revenues and tightened budgets, some accounting is due. While it is true there is no requirement that the funds be used as intended, it seems only logical that some accountability be exercised when such a minimal amount is so used or manipulation is used to gain access to the funds without clear public disclosure. There are several states that have allocated no funding whatsoever from the billions received to prevention programs in fiscal year 2013. These include New Hampshire, New Jersey, North Carolina and Ohio. Washington has decided to cut its tobacco prevention programs by 90% while Maryland has reduced its prevention programs by 75% for 2013. Several examples of the schemes and alternative uses to which these funds have been put are shown below. While the use of the funds in this manor is not addressed in the MSA, these examples serve to illustrate what happens with fiscal irresponsibility. The first six are from Cory Eucalitto in an article on Tobacco Settlement bond Gimmicks and ABC News in July 2013.

- Wrangell Alaska spent$3.5 million of their tobacco settlement money to renovate shipping docks
- Niagara County, New York spent $700,000 of their settlement money to install a sprinkler system at a public golf course and $24 million for a county jail and office building
- Los Angeles California sought settlement money to be used to defend police officers accused of planting guns and drugs on suspects, the request was declined
- New Mexico, they passed a law, apparently an optional one, requiring that 50 percent of annual funds received from the settlement be placed in a Tobacco Settlement Permanent Fund. "Once the Tobacco Settlement Permanent Fund reached a certain size, it was supposed to retain all of the annual payments and annually distribute 4.7 percent of its 5-year average market value to the program fund. The permanent fund has not been receiving the money as intended. The required 50 percent distribution occurred in only 4 of the last 12 years. In the other 8 years, the money went to replace general fund revenues."

- In New Hampshire, when the largest tobacco companies began to withhold a portion of the required annual payments claiming that they were owed a refund as a result of falling revenue on which the settlement was based New Hampshire and 16 other states entered into a new settlement with the companies which allowed them to receive payments immediately. According to New Hampshire's Josiah Bartlett Center for Public Policy “the states in the agreement agreed to pay back the disputed funds in return for the settlement. While state treasuries would get quick cash infusion from the settlement, they would have to pay back half of the amount almost immediately, and most of the rest of the settlement over the next four years. New Hampshire is scheduled to receive $30 million from the deal this month, well within fiscal year 2013. However, the state budget that passed the House last week with the support of Governor Maggie Hassan counts $21.6 million of the payment as fiscal year 2014 revenue and $2.5 million as fiscal year 2015 revenue, creating a deficit. That created deficit allows the Governor to make the settlement money available to support General Fund spending”.
- In Oregon, according to the Oregonian, the public health advocates requested $4 million to fund a strong anti- smoking campaign, lobbying lawmakers to create a website and run radio ads the budget committee declined to do so.
- Hawaii, according to KITV.com, has received $536.8 million, from the tobacco industry. Of that, only 13% or $71.8 million has been set aside for the Tobacco Prevention and Control Trust Fund intended for anti-smoking programs and public service announcements. However the lion's share of the tobacco settlement, $464.9 million has been diverted by state lawmakers for other purposes.
- Perhaps the most contentious is ABC news reporting that North Carolina gave $42 million of the settlement funds to market tobacco and modernize the tobacco curing process and an additional $200,000 of the tobacco money to the Carolina Horse Park, an equestrian center near Pinehurst, N.C.

The chart below shows the percentage of funds received from the MSA by the states using capital appreciation bonds for the years 2007 through 2012 as well as the percentage of those funds that those states are spending on prevention. Clearly the funds have been diverted to areas deemed by the states to be more appropriate and while understandable in light of budget issues, this behavior violates the spirit of the MSA. Of these states, only Alaska, Ohio, New Jersey and New York have all the borrowing covered by a sinking fund. In the case of California, the state is considering making new issues of the capital appreciation bonds a general obligation of the state, guaranteed by the tax revenues of the state instead of just the receipts from the MSA. While the states treat the funds as new revenue, they continue to pay the Medicade costs of smokers.

Chart 1. Percentage of Funds received from the MSA



Source: Source: Campaign for Tobacco Free Kids,

5. The Outlook for the Bonds

The overall rating for the tobacco settlement bonds has been dropping. In California, for instance, the bonds are rated BBB+ which was a concern for an upcoming new issuance by the Golden State Tobacco Securitization Corporation (GSTSC). The security for enhanced tobacco bonds derives from the covenant that the state director of finance will request that the governor include in the annual state budget an appropriation for the full amount of debt service and operating expenses due in the next fiscal year. Thus, the rating is based on the credit quality of the state of California, whose general obligation bonds are rated 'A-' with a positive outlook by Fitch. This will effectively convert the tobacco settlement bonds to a general obligation bond and insure that their rating will track with that of the State of California, A- with a positive outlook. With revenue from bonds continuing to decline, states are looking for ways to maintain their credit rating on bonds in order to allow refinancing or new issues. This step would place the state of California behind the referenced bonds bypassing the MSA which makes the revenue from the bonds the sole source of backing for the bonds. On January 22, 2013 Moody’s started a review process for 31 tobacco settlement bonds because of the credit implications of the payment disputes caused by the falling revenues from tobacco sales. This settlement agreement, if approved by an arbitration panel, will reduce the cash flow to the secured bonds by approximately 54%. The agreement establishes a new formula that suggests that the future cash flow for the bonds could continue to decline for the life of the bonds. On September 11, 2011 after completing a review Moody's downgraded sixty tranches in 13 tobacco settlement bonds valued at approximately $17 billion. However, they confirmed seven tranches in three bond issues valued at approximately $1.1 billion. Looking at the trends shows a decline in revenue of 5.6% in 2011 following a decline in cigarette shipments of 9.2% in 2009 and 6.45% in 2010. This is the reason that the big tobacco companies placed the majority of the payments in an escrow fund and the modification to the MSA discussed above. While this does release the reduced funds, it also allows for significantly reduced future cash flows. Both Virginia and Ohio have been forced to move funds from their debt reserves in order to meet interest and serial bond repayments in 2011. According to HJ Sims Company, a nationwide Broker-Dealer, Moody’s downgraded $3.5 Million of long term tobacco bonds from Baa3 to a range of B1 through Caa1. The Guliano Law Firm Securities Arbitration Blog, in March 2011, stated that “Investors suffering losses in the Oppenheimer Rochester Funds may have claims against their stockbrokers or financial advisors for failure to perform due diligence.” This statement followed a $5 billion loss or 66% of the value in the fund in 2010. The majority of the municipal bonds held in the Oppenheimer Rochester Funds are capital appreciation bonds, and the fall in their value reflects the downgrades and revised settlement agreement on their value. Even further compounding their sustainability of cash flows is the proposal by President Obama to increase the taxes on cigarettes from $1.01 to $1.95 per pack. The consensus, per Kenneth Shea a senior tobacco at Bloomberg, would cut consumption by 12%. When this is added to the already downward slope of cigarette sales it clearly does not bode well for any continues sustainability of current cash flow

When the bonds were first issued, projections of potential payment declines by the tobacco companies seemed to hover around 1.8% per year which reflected slowing cigarette sales. In reality this decline has fallen by just over 4% per year. Considering that the capital appreciation bonds have maturities ranging from forty to fifty years the reserves will run out of money and defaults will be the result. Looking at Table 6 below, the trend is obvious. Projections are made from 2013 on, with 2013 reflecting the author's estimate of 4% decline plus the 12% prediction of decline as a result of President Obama's cigarette increase of $.95 per pack (shown in red in the table). With this trend the number of cigarettes sold will be just over 20% of sales in the base year of 1997.).

Table 6. Projection of Potential Payment

Year	Total Cigarettes Sold in billions	Percentage Decrease	Year	Projected Total Cigarettes Sold in billions	Projected Percentage decrease
1997	476	Base Year	2013	225	16.00%
1998	465	2.31%	2014	189	4.00%
1999	435	6.45%	2015	182	4.00%
2000	430	1.15%	2016	174	4.00%
2001	425	1.16%	2017	167	4.00%
2002	415	2.35%	2018	161	4.00%
2003	400	3.61%	2019	154	4.00%
2004	388	3.00%	2020	148	4.00%
2005	376	3.09%	2021	142	4.00%
2006	372	1.06%	2022	136	4.00%
2007	360	3.23%	2023	131	4.00%
2008	323	10.28%	2024	126	4.00%
2009	290	9.20%	2025	121	4.00%
2010	282	6.45%	2026	116	4.00%
2011	274	5.60%	2027	111	4.00%
2012	265	3.28%	2028	107	4.00%
			2029	103	4.00%
			2030	98	4.00%

Source: Tobacco Settlement and Outlook, US Department of Agriculture

In an article in the New York Times, they quote Richard Larkin, Director of director of credit analysis at Herbert J. Sims & Company who says that "analysis of tobacco bonds issued by seven states and New York City, he found that if tobacco payments continued to decline by 4 percent per year, full-blown defaults would begin in 2024, when Ohio would be about $350 million short on $1.1 billion of tobacco bonds maturing that year. New Jersey, California, New York City and Virginia would be several billion dollars short on tobacco bonds maturing in the years after that.

6. Conclusion

Not only are the tobacco settlement bonds in danger of default, perhaps as early as 2024, but the states are actually discussing the possibility of making these bonds general obligation bonds, thus placing the taxpayers and state's taxing ability on the line for the total value of the bonds. At present, the states are securitizing the bonds with future tobacco settlement payments. This simply removes those monies from the general funds, reducing the money available to meet existing state obligations. Since the tobacco settlement payments are decreasing, this guarantee will fade in the future and the possibility of default on the redemption of the bonds will again loom large. In discussions with Governors and State's Attorney General's, Cezary Podkul found a consensus that none of them wanted a bond default "during their watch". Reasons cited varied between the effect on future borrowing ability, increased interest cost and damaged relationships with the bond underwriters and bond brokers normally handling their new bond issues. Regardless of the "logic" or "reasons" given, the probability of a default without intervention by the states with some sort of state backed guarantee is a high. Any type of guarantee would necessarily involve taxpayers funds and unless there is some huge windfall that remains unknown at this point in time have a detrimental effect either on the state's credit rating or necessitate a tax increase to raise the required funds to pay the costs of a new bond issue to refund the existing tobacco settlement bonds that are outstanding.

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