HB 1597

Department of Legislative Services

Maryland General Assembly
2008 Session

FISCAL AND POLICY NOTE

House Bill 1597 (Delegate Schuh)
Appropriations and Health and Government Operations

Maryland Tobacco Settlement Securitization Authority Act

This bill establishes a Maryland Tobacco Settlement Securitization Authority. The State may sell to the authority the State's right, title, and interest in a securitized portion of the stream of payments made into the Cigarette Restitution Fund (CRF) from the Master Settlement Agreement in exchange for a cash payment to the Public School Construction Fund and delivery of the residual interest to the general fund. The authority is authorized to issue bonds to finance the cash payment to the Public School Construction Fund and cover reasonable and necessary expenses of the authority.

The bill takes effect June 1, 2008.

Fiscal Summary

State Effect: General fund expenditures could increase by a maximum of $175.0 million annually beginning in FY 2009 to maintain current services funded by CRF, if the entire revenue stream were securitized. Debt service expenditures would increase by at least $18.6 million annually beginning in FY 2009 compared to the current practice of issuing general obligation bonds. Assuming a 25-year term to maturity, the increase in debt service costs would total $465.0 million.

Local Effect: If only planned school construction projects are funded – through securitization rather than general obligation bonds – there would be no local government impact. However, to the extent additional projects are approved due to securitization, local government expenditures would increase to cover their share of eligible costs as well as other costs.

Small Business Effect: None.

Analysis

Bill Summary: The bill establishes a Maryland Tobacco Settlement Securitization Authority. The authority will have five members on its Board of Directors: the State Treasurer, the Comptroller, and three other members who are knowledgeable in settlement securitization as appointed by the Governor. The authority is authorized to securitize revenues due to CRF and provide an advanced payment of monies due to CRF to the Public School Construction Fund. By August 30 of each year, the board must certify to the Secretary of Budget and Management the annual securitized portion to be appropriated to the authority from CRF the following year. The Governor must include this amount in the annual budget bill as long as funds are available in CRF. If funds in CRF are insufficient to satisfy the required appropriation, the Governor is not obligated to appropriate funds from any other source. The bill specifies that the authority may exercise any power possessed by a private corporation in performing authorized functions.

The State is authorized to sell a portion of the State's interest in the stream of payments due to CRF from the Master Settlement Agreement to the newly created authority. In exchange, the authority would issue bonds and provide a cash payment to the Public School Construction Fund. The amount that would be sold to the authority would be equal to the principal and interest on the bonds payable in that fiscal year. The amount would also include the cost to issue the bonds, any required reserve funds, and the reasonable expenses of the authority. In subsequent years the amount sold would include any annual payment due and payable on the bonds, not to exceed 1.5% of the principal amount of the bonds. Any residual interest or excess amount – not required to repay bondholders, establish or replenish reserve funds, or pay any other costs of the authority – must be delivered to the general fund.

The authority may issue bonds, notes, and other obligations, including refunding bonds, with a maximum term to maturity of 40 years. Bonds issued may be tax-exempt and may not constitute a debt, liability, or pledge of full faith and credit of the State or any political subdivision of the State and must be secured solely from, and secured by, payments of the securitized portion to the authority from the CRF.

Current Law: In 1998, Maryland and 45 other states signed the Master Settlement Agreement with the four largest tobacco product manufacturers in the United States. The Master Settlement Agreement requires these manufacturers to pay the states in exchange for the states releasing them of past, present, and certain future claims. The manufacturers also must fund a national public health foundation and change their advertising and marketing practices and corporate culture to reduce underage smoking. Chapter 169 of 1999, amended by Chapter 141 of 2001, enacted the Master Settlement Agreement model statute, which requires tobacco product manufacturers to either join the agreement or deposit funds into an escrow fund to pay a judgment or claim brought by the State or any releasing party located or residing in the State.

CRF, is a special, nonlapsing fund supported by revenue from the Master Settlement Agreement. CRF monies must be used to fund • the Tobacco Use Prevention and Cessation Program; • the Cancer Prevention, Education, Screening, and Treatment Program; and • other programs that serve health-related purposes as specified in statute. For each fiscal year for which CRF appropriations are made, at least 50% of the appropriations must be for these purposes. At least another 30% has to be appropriated to the Medicaid program. In addition, 0.15% has to be appropriated for enforcement of escrow accounts for nonparticipating tobacco product manufacturers.

Background: The following is a brief overview of the Master Settlement Agreement, Cigarette Restitution Fund, revenue securitization, and the State's Public School Construction Program.

Master Settlement Agreement and CRS

Under the Master Settlement Agreement, payments are to be made to the states through escrow accounts. Participating manufacturers are required to pay into those accounts according to a specified schedule in proportion to their market share. From those accounts, states receive an allocated share. Actual payments are subject to adjustment for various economic and technical factors. One of these adjustments is the "nonparticipating manufacturers adjustment," which reduces payments if the market share of participating manufacturers shrinks as a result of the settlement, as determined by a consultant. If participating manufacturers are determined to have lost market share, the participating manufacturer's obligation to the Master Settlement Agreement would be decreased.

In April 2005, the participating manufacturers gave notice that they were pursuing an adjustment on the basis of lost market share to nonparticipating manufacturers. This claim was based on the supposition that participating in the Master Settlement Agreement was a significant factor contributing to that loss. An arbitrator has since ruled that participation in the Master Settlement Agreement was a significant contributing factor to that loss in sales years 2003 and 2004 and a similar ruling is anticipated for sales year 2005. A March 2006 ruling entitled tobacco manufacturers to reduce their 2006 Master Settlement Payment (for sales year 2003) by approximately $1.1 billion, or 18%, of which Maryland's share is approximately $26.0 million. Of this amount, $15.7 million (representing the payments from RJ Reynolds and Lorillard) was placed into escrow pending the resolution of this litigation. Future revenues from the Master Settlement Agreement are dependent on the results of this litigation.

The distribution of Master Settlement Agreement funds among states is determined by formula, with Maryland receiving 2.26% of settlement monies which are adjusted for inflation, volume, and prior settlements. In addition, the State collects 3.3% of monies from the Strategic Contribution Fund, distributed according to each state's contribution toward resolution of the state lawsuits against the major tobacco manufactures; this amounts to approximately $28.0 million a year. **Exhibit 1** provides CRF revenue and expenditure detail for fiscal 2007 to 2009.

Securitization of Master Settlement Agreement Revenues

In the context of the bill, *securitization* refers to "selling" a revenue stream to a private entity in exchange for an immediate payment of cash. The revenue stream in this instance is the annual payments due to the State from the Master Settlement Agreement. Securitization is commonly utilized in the real estate industry, where it is applied to pools of leased property, and in the lending industry, where it is applied to lenders' claims on mortgages, home equity loans, student loans, and other debts.

Many states have made efforts to securitize revenues from the Master Settlement Agreement, some successfully. According to a 2007 report by the Center for Community Solutions, at least 18 states, plus Puerto Rico and some California counties and the City of San Diego, have chosen to securitize at least some their tobacco settlement funds. Most states chose to only securitize a portion. Generally speaking, the states have fallen into three categories: those that use the proceeds to fund special programs through endowments, those that use it for one-time expenditures, and those that have used it as a temporary supplemental funding source to cover ongoing expenses.

Maryland has a policy that debt should only be used to fund capital projects. Capital projects involve land or structures and have useful life of at least 15 years. The policy ensures that the State is not paying debt service on bonds longer than the useful life of the expense. Although proceeds from the issuance of bonds would be paid to the Public School Construction Fund, general funds would be required to maintain current health and educational services that are currently funded through CRF.

Exhibit 1
Cigarette Restitution Fund Budget Estimates
Fiscal 2007-2009
($ in Millions)

	FY 2007 Actual	FY 2008 Working	FY 2009 Allowance
Beginning Fund Balance	**$4.5**	**$12.9**	**$4.2**
Settlement Payments	154.5	150.7	151.5
NPM and Other Shortfalls in Payments[1]	-16.1	-16.5	-16.5
Other Adjustments	7.7	36.1	35.7
Subtotal	**$150.7**	**$183.2**	**$175.0**
Prior Year Recoveries	1.1	1.0	
Total Available Revenue	**$151.8**	**$184.2**	**$175.0**
Health			
Tobacco Use Prevention/Cessation	17.8	17.3	17.3
Cancer Prevention, Evaluation, and Treatment	28.1	25.4	25.5
Substance Abuse	17.1	17.1	17.1
Medicaid	63.7	106.7	97.5
Administration	0.5	1.0	1.0
Subtotal	**$127.1**	**$167.5**	**$158.5**
Other			
Aid to Nonpublic Schools	4.0	3.7	3.7
Crop Conversion	7.6	8.3	8.5
Attorney General	0.2	0.4	0.5
Subtotal	**$11.8**	**$12.4**	**$12.7**
Total Expenses	**$138.9**	**$179.9**	**$171.1**
Ending Fund Balance	**$12.9**	**$4.2**	**$3.9**

NPM: Nonparticipating Manufacturer
[1]The NPM adjustment represents $15.7 million of this $16.1 million in fiscal 2007; an estimate of $16.5 million is used in fiscal 2008 and 2009.
Note: Numbers may not sum to total due to rounding.

Public School Construction Program

The State pays at least 50% of eligible costs of school construction and renovation projects, based on a funding formula that takes into account numerous factors including each local school system's wealth and ability to pay. The State match varies by county as shown in **Exhibit 2**. Local school systems have sole responsibility for procuring school construction contracts once the State has approved a school construction project. Since local school systems are not considered units of the State, State procurement law and regulations do not directly apply to them, although State regulations require competitive bidding and other procurement and construction guidelines.

Subject to the final approval of the Board of Public Works (BPW), the Interagency Committee on School Construction (IAC) manages State review and approval of local school construction projects. Each year, local school systems develop and submit to IAC a facilities master plan that includes an analysis of future school facility needs based on the current condition of school buildings and projected enrollment. Subsequently, each local school system submits a capital improvement plan to IAC that includes projects for which it seeks planning approval, projects for which it seeks funding approval, and projects that the local school system has forward funded. Based on its assessment of the relative merit of all the project proposals it receives, and subject to the projected level of school construction funds available, IAC determines which projects to recommend to BPW for State funding. By December 31 of each year, IAC recommends to BPW projects comprising 75% of the preliminary school construction allocation projected to be available. Local school systems may then appeal the IAC recommendations directly to BPW. By March 1 of each year, beginning in 2008, IAC recommends to BPW and the General Assembly projects comprising 90% of the allocation for school construction submitted in the Governor's capital budget. Following the legislative session, IAC recommends projects comprising the remaining school construction funds included in the enacted capital budget.

The Public Schools Facilities Act of 2004 established a State goal to provide $2 billion in State funding over the following eight years to address deficiencies in school facilities, or $250 million per year through fiscal 2013. Fiscal 2009 will be the fourth consecutive year that the goal has been met or exceeded. **Exhibit 3** shows the up and down cycles of school construction funding since fiscal 1998. **Exhibit 4** estimates the planned State general obligation bonds that will be issued for school construction beginning with the fiscal 2009 budget. The exhibit also identifies the amount of State funding requested by all local school systems.

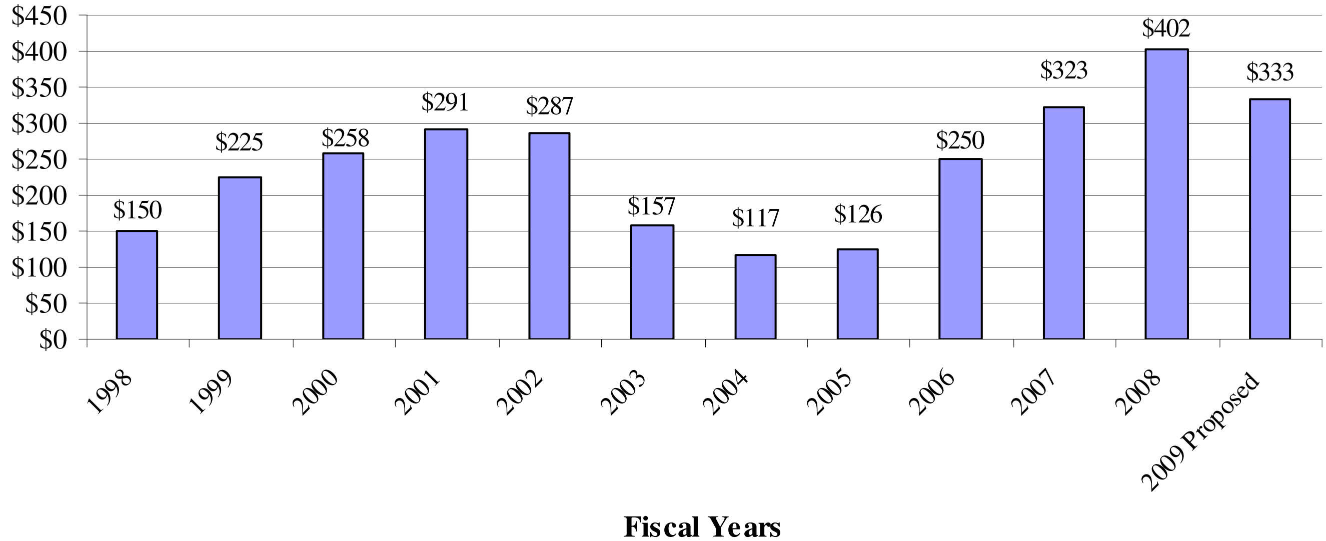
Exhibit 2
State Share of Eligible School Construction Costs
Fiscal 2006-2012

County	FY 2006-2009	FY 2010	FY 2011	FY 2012
Allegany	90%	91%	91%	91%
Anne Arundel	50%	50%	50%	50%
Baltimore City	97%	94%	94%	94%
Baltimore	50%	50%	50%	50%
Calvert	69%	64%	61%	61%
Caroline	89%	86%	86%	86%
Carroll	65%	61%	61%	61%
Cecil	70%	75%	75%	75%
Charles	70%	77%	77%	77%
Dorchester	77%	72%	71%	71%
Frederick	72%	72%	72%	72%
Garrett	70%	65%	60%	59%
Harford	65%	60%	59%	59%
Howard	58%	61%	61%	61%
Kent	50%	50%	50%	50%
Montgomery	50%	50%	50%	50%
Prince George's	69-75%*	73%	73%	73%
Queen Anne's	70%	65%	60%	55%
St. Mary's	72%	75%	75%	75%
Somerset	97%	92%	88%	88%
Talbot	50%	50%	50%	50%
Washington	65%	73%	73%	73%
Wicomico	81%	87%	87%	87%
Worcester	50%	50%	50%	50%

*For fiscal 2006-2008, the State share for Prince George's County is 75% for funding allocated up to $35 million, and 69% for funding allocated in excess of $35 million as required in law. The split share expired in June 2008 and for fiscal 2009 the State share for Prince George's County is 69%.

Source: Public School Construction Program

Exhibit 3
State Funding for Public School Construction
($ in Millions)



Source: Public School Construction Program

Exhibit 4
Public School Construction Program
Planned State Funds Fiscal 2009-2013
($ in Thousands)

	FY 2009	FY 2010	FY 2011	FY 2012	FY 2013	Total
GO Bonds	$300,000	$250,000	$250,000	$250,000	$250,000	$1,300,000
Special Funds	27,400	2,400				
Total	$327,400	$252,400	$250,000	$250,000	$250,000	$1,329,800
School Requests	$888,814	$928,422	$745,032	$785,510	$781,858	$4,129,636

Source: Department of Legislative Services

State Fiscal Effect: CRF revenues received from the Master Settlement Agreement are based on the amount of tobacco shipped for domestic consumption. Thus, revenues owed by the State can fluctuate due to tobacco use. In addition, if a tobacco manufacturer were to file bankruptcy, for example due to individual lawsuits, or close, revenues could significantly decline. Securitizing these revenues would benefit the State by guaranteeing receipt of a portion of these revenues. It is also the uncertainty of these revenues that make securitization an additional cost.

Maryland maintains a AAA bond rating by the three major rating agencies. In February 2008, the most recent public bond sale, $400 million in general obligation bonds were issued at 4.14% interest. Because any bonds issued by the Maryland Tobacco Settlement Securitization Authority would not be considered State debt, the authority would receive its own credit rating and would issue bonds at a greater expense than State general obligation bonds. Fitch Ratings advises that the industry bonds backed by Master Settlement Agreement revenues are rated at BBB+ or lower. Thus, bonds issued by the authority would receive an effective interest rate notably higher than State-issued general obligation bonds. A significant benefit to issuing debt through the authority is that additional debt issued would not affect State debt affordability limits.

An actuarial valuation of the Master Settlement Agreement funds due to the State is not currently available. A valuation of the fund would take into account the potential for revenue loss from litigation, bankruptcy, and a potential decrease in cigarettes purchased in the State as well as provide an estimate of the funds available for securitization. Under the scenario that the authority would securitize a portion of the revenues due to CRF and allocate them toward the $1.3 billion in planned school construction over the next five years, the expenditures on interest (excluding principal) would increase by $18.6 million annually beginning in fiscal 2009 compared to the current practice of issuing general obligation bonds. The total interest expense would increase by $465 million over the life of the bond. This estimate assumes that the authority would receive an interest rate 2% higher than State general obligation bonds and a 25-year term to maturity. If securitized to cover all school construction requests, bond issuance could increase by up to $4 billion and debt service costs would increase correspondingly.

To the extent revenues that are due to CRF are securitized, they would no longer be available to fund educational and health programs. Thus, general fund expenditures could increase by as much as $175 million annually beginning in fiscal 2009 to maintain all services funded by CRF. This estimate assumes all CRF revenues are securitized. If only the amount necessary to cover the $1.3 billion in planned school construction were securitized, about $103 million in general funds would have to be redirected to maintain current services funded by CRF. State law mandates that over 80% of CRF monies are allocated to specified programs.

Additional Information

Prior Introductions: None.

Cross File: None.

Information Source(s): Department of Budget and Management, Department of Legislative Services

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