

OFFICE OF THE INDEPENDENT BUDGET ANALYST REPORT

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Item: Tobacco Settlement Revenue Securitization

OVERVIEW

On September 12, 2005, the City Council directed the City Manager to evaluate pension solutions, including leveraging up to approximately \$17 million per year, an amount equivalent to the employee pick up savings estimated as of September 2005. On February 6, 2006, the City Council authorized the Mayor to proceed with the proposed securitization transaction and the preparation of financing documents to execute a tobacco securitization in Fiscal Year 2006.

FISCAL/POLICY DISCUSSION

If approved, the City will securitize up to \$10.1 million in annual Tobacco Settlement Revenue (TSR) receipts beginning in Fiscal Year 2007. The City will deposit \$8.67 million in Fiscal Year 2006 TSRs and \$91.3 million in upfront bond proceeds into the San Diego City Employees' Retirement System (SDCERS) to generate a combined deposit of up to \$100 million to reduce the City's outstanding pension fund liability.

On April 17, 2006, the City received \$8.67 million in TSRs. This amount was \$1.63 million less than the approximately \$10.3 million the City expected to receive in Fiscal Year 2006 TSRs. This 16% reduction in TSRs is due to a Nonparticipating Manufacturers (NPM) Adjustment that was made to the April 2006 payment.

Why was the NPM adjusted and what are the risks of future NPM Adjustments?

The three largest cigarette manufacturers requested an NPM Adjustment to the April 2006 payment due to market share loss for calendar year 2003. It was determined by an independent economic consultant that the provisions of the Master Settlement Agreement were a significant factor contributing to the market share loss. It is uncertain whether the participating manufacturers will seek or be entitled to additional NPM Adjustments that could affect the City's future TSRs. The financing plan presented by the Mayor allows for this adjustment in Fiscal Year 2006 only. In the event that future adjustments to TSRs are made and/or the TSRs fall below \$10.1 million, the final maturity of the bonds

could be extended. This would increase the financing costs incurred by the City. Due to the increased risk of the TSRs, it would benefit the City to securitize this revenue stream, thereby transferring the risk to investors.

What is the benefit of the \$100 million transfer to the Pension System? On February 6, 2006, the Independent Budget Analyst (IBA) Report No. 06-3 asked what the economic benefit is to SDCERS for securitizing TSRs. Information provided by the Mayor's staff indicates that a \$100 million infusion into the Pension System is estimated to increase the funding ratio from 68.2% to 70.4%. This percentage increase was based on information provided by CCHEIRON, the actuary for SDCERS in their March 17, 2006 report. These are the only numbers we have to rely on at this time. The IBA has contacted SDCERS, and they agree with the assumptions used for the percentage.

On March 29, 2006, the Mayor reported in the Tobacco Settlement Revenue Securitization Report to Council No. 06-033 that an estimated \$11 million potential cashflow benefit would be derived from the tobacco bond financing by reducing the net UAAL payments vs. the "PAYGO" scenario. This was based on the Proposed Tobacco Securitization interest rate of 6.87%. Based on current market conditions, the Proposed Tobacco Securitization interest rate is 7.17%. This now results in an estimated \$3.1 million potential cashflow benefit that can be derived from the tobacco bond financing in terms of reducing net UAAL payments vs. the "PAYGO" scenario. This is a decrease of approximately \$7.9 million. If the goal of the City is to infuse an upfront \$100 million transfer into the Pension System, then there is still a benefit of securitizing tobacco revenues. The actuarial assets as of June 30, 2005, will be enhanced by \$100 million resulting in a funding ratio change. Furthermore, the "PAYGO" scenario does not satisfy the terms of the labor agreements.

Are there any restrictions on the use of the City's TSRs? Mark Blake of the City Attorney's Office opined in a February 6, 2006 Memorandum regarding Tobacco Securitization bonds that there are no restrictions contained in the Master Settlement Agreement regarding the use of the City's tobacco revenues.

Does the proposed securitization legally satisfy the terms of the labor agreements? The Memorandum of Understanding (MOU) between the City of San Diego and the San Diego Municipal Employees' Association reads as follows:

All monies resulting from the 3% negotiated employee pension contribution increase effective July 2, 2005, and the additional 1.0% negotiated employee pension contribution increase effective July 1, 2007 (i.e., City savings that result from substituting those increases for City "pick-up" of employee pension contributions), shall be designated exclusively for payment to support a leveraged mechanism to reduce the SDCERS unfunded actuarially accrued liability ("UAAL"), such as Pension Obligation Bonds, lease capitalization, or a similar

mechanism selected by the City. If the City does not implement a leveraged mechanism to reduce the UAAL within the term of this MOU, then these monies shall be deposited into the SDCERS Employee Contribution Rate Reserve and used to defray the pension contribution obligation of employees in MEA-represented bargaining units.

On February 6, 2006, IBA Report No. 06-3 asked if the proposed securitization legally satisfies the terms of the labor agreements. The Mayor's staff has stated that this securitization satisfies the terms of the labor agreements. The Fiscal Year 2006 estimated employee pick up savings is approximately \$17.5 million while the proposed securitization leverages just \$10.1 million; leaving approximately \$7.4 million of the employee pick up savings unleveraged. The Mayor's staff has mentioned other alternatives to using the remaining employee pick up savings, including leveraging for Pension Obligation Bonds or other securitizations. The Mayor's staff should affirm that the remaining \$7.4 million will be used to satisfy the labor agreements as well, and provide specifics as to those plans as soon as possible.

The deposit of the Fiscal Year 2006 anticipated TSRs of \$8.67 million is a change from the prior conceptual Report to Council No. 06-12 that was approved at the City Council on February 6, 2006. In the financing plan report, it states that a "true sale" would be better established if the Fiscal Year 2006 TSRs were deposited directly to the Pension System, rather than applying the TSRs to fund all or a portion of the debt service reserve fund. The Mayor's staff should affirm that depositing the Fiscal Year 2006 TSRs into the Pension System on a cash basis satisfies the terms of the labor agreements and preserves the employee offset savings into the future.

What is the Cost of the Tobacco Settlement Revenue Securitization? The memorandum updating the proposed TSR Securitization states that the cost of borrowing for this financing plan is estimated to be 7.17%. The gross proceeds from the securitization are estimated at \$107.7 million with net proceeds for the Pension System estimated at \$91.3 million. The difference of approximately \$16.4 million is the cost of issuance, debt service reserve, capitalized interest and issuer operating expenses. In addition to these cost, according to the memorandum, assuming final maturity of 2025, the financing cost at a 7.17% rate could be approximately \$75 million. The total cost of securitization could be up to approximately \$91.4 million assuming final maturity of 2025. In the event that TSRs are below \$10.1 million, it could cause the anticipated final maturity of the bonds to be extended, thereby increasing the financing costs.

QUESTIONS/COMMENTS

Although uncertain at this time, if there are future NPM Adjustments, the anticipated final maturity of the bonds could be extended, thereby potentially increasing the financing costs.

Due to the fact that leveraging of the remaining \$7.4 million is not anticipated to take place prior to June 30, 2006, will this satisfy the terms of the labor agreements?

Does depositing the City's anticipated Fiscal Year 2006 TSRs of \$8.67 million directly into the Pension System, legally satisfy the terms of the labor agreements?

CONCLUSION

The implementation of pension solutions is an important step towards the fiscal health of the San Diego City Employees' Retirement System and the City of San Diego. It has been stated that this proposal increases the funded ratio of the SDCERS to 70.4%, which is a step in the right direction and a high priority of the City Council and the Office of the IBA.

Although the uncertain future NPM Adjustments could extend the final maturity of the bonds thereby potentially increasing the financing costs, the more pressing issue is the tobacco securitization legally satisfying the terms of the labor agreements as currently structured. The IBA recommends that the City Attorney opines whether or not the tobacco securitization, as currently structured, legally satisfies the terms of all labor agreements.

If the tobacco securitization as currently proposed legally satisfies the terms of the labor agreements, then the Office of the IBA will recommend approving the financing plan to securitize tobacco settlement revenues.

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