PUBLIC OVERSIGHT HEARING

ON
B16-605, "TOBACCO SETTLEMENT TRUST FUND AND TOBACCO SETTLEMENT FINANCING AMENDMENT ACT OF 2006"

Before the
Committee of the Whole
Council of the District of Columbia
The Honorable Linda W. Cropp, Chair

March 13, 2006, 10:00 a.m.
John A. Wilson Building
Council Chambers

Testimony of
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Good morning, Chairman Cropp and members of the Council. My name is Lasana Mack, and I am the District's Treasurer and Deputy Chief Financial Officer for Finance and Treasury. I am here to present testimony regarding the proposed "Tobacco Settlement Trust Fund and Tobacco Settlement Financing Amendment Act of 2006."

After an initial determination by legal counsel that the accompanying proposed resolution was necessary to accomplish the purposes of the proposed act, it has since been determined by internal and external legal counsel that such a resolution is not necessary. Therefore, the Office of the Chief Financial Officer (OCFO) encourages the Council to withdraw the proposed resolution from consideration.

The primary purpose of the proposed legislation is to permit an additional "securitization" of the stream of revenues to be received by the District pursuant to the Master Settlement Agreement among the major tobacco manufacturers and most states in the United States and the District of Columbia, which I will refer to from this point forward as "tobacco settlement securitization."

This financing vehicle and its related components are somewhat complex. I will summarize the proposed transaction in my testimony, and I am prepared to address any questions that you may have at the conclusion of my testimony to provide any clarification or additional details that you may seek.

Tobacco settlement securitization entails selling bonds for which the annual debt service is payable solely from revenues that the District is entitled to receive pursuant to the Master Settlement Agreement ("Tobacco Bonds"). The District executed a tobacco settlement securitization in 2001 in the amount of $521 million, and these bonds are scheduled to be paid off in 2026. Tobacco settlement revenues (TSRs) to be received by the District after 2026 would not be needed to pay off these bonds and would, therefore, come to the District.

Over the past year, bond market investors have gained additional comfort with purchasing bonds backed by TSRs, and a market has emerged for tobacco bonds with longer maturities structured as zero-coupon bonds or capital appreciation bonds (CABs) (meaning that there are no payments in the early years with balloon payments in the out-years). This new market for CABs with long maturities allows the District to securitize its expected TSRs in the years beyond the planned maturity (payoff) of its initial tobacco bonds (the new tobacco bonds would likely have a planned payoff in or around 2040).

It is currently projected that the issuance of additional tobacco bonds would generate approximately $210 million. However, the market for these long-dated CABs consists of a limited number of investors and is subject to significant fluctuations based on developments in the tobacco settlement arena – specifically, pending court cases and potential reduction of the amount that the tobacco companies are required to pay to the states and the District based on tobacco consumption figures.

At this time, market conditions are favorable, and the OCFO has determined that it is prudent to proceed expeditiously to execute this prospective transaction for the benefit of the District. However, it is still quite possible that the market could change between now and the time that the transaction can be executed (approximately 3 months). This could substantially change the amount that the District is able to obtain, or even possibly eliminate the opportunity for the District to obtain funds in this manner; but again, as it currently stands, it is expected that the District would be able to generate approximately $210 million.

As with the first District tobacco settlement securitization, this transaction would entail leveraging a prospective revenue stream – a relatively risky prospective revenue stream – and receiving funds upfront via the proceeds of an issuance of bonds backed by this revenue stream. As such, it represents a transfer of risk from the District to bondholders – the risk of non-receipt of such payments from the tobacco companies. Of course, as with any risk transfer in a financial transaction, bondholders must receive some compensation in order to accept that risk, and such compensation comes in the form of interest they receive on the bonds that they purchase. The OCFO deems this a prudent financing transaction for the District.

The proceeds of the District's 2001 tobacco settlement securitization were utilized to pay off almost $500 million of outstanding District debt. In addition, some of the budgetary savings produced by paying off that debt was utilized to fund the District's cash reserves, and some of it was used to fund District health-related General Fund expenses. However, as a result of numerous inquiries that the OCFO has received regarding the initial tobacco settlement securitization, we are aware that some questions have been raised by various parties regarding the District's apparent lack of direct application of tobacco settlement revenues for health care-related purposes.

The Mayor has determined that the best use for the funds to be acquired through this proposed transaction would be to fund the District's share of the construction costs associated with the proposed National Capital Medical Center. This would provide for use of tobacco settlement revenues in a manner that would be directly health care-related. The legislation that is before you today has been drafted to provide the ability to fund the National Capital Medical Center with the proceeds of this proposed transaction, but would also allow for such proceeds to be used for the alternative options of: 1) funding other capital projects of the District, or 2) repaying outstanding District indebtedness, in the event that the District's policymakers decide upon either of such other potential uses.

In the final analysis, from the perspective of the OCFO, this is a prudent transaction to do, and because of the relative weakness of the market for this type of security, the sooner we do it the better, in order to allow the District to take advantage of this financing opportunity. Because the revenue stream that would support these bonds is not a District tax stream and is not a General Fund revenue stream being used to support on-going District operations, it would not be assessed by the bond rating agencies in a manner that would add to the District's debt burden (i.e., it would not be considered District "tax-supported debt"). As such, it is a unique opportunity to raise funds via a bond issuance and not add to the District's debt burden. For this reason and because of the risk-transfer reason cited above, the OCFO believes that it makes financial sense to do this transaction, independent of the use of the proceeds. Therefore, we urge the Council to act favorably upon this proposed legislation, independent of its decision to approve or disapprove of the National Capital Medical Center project.

Before I conclude my testimony, I will provide answers to two questions that I anticipate members of the Council might have: 1) What does this proposed transaction mean as far as the "residuals" that the District is currently entitled to receive pursuant to the first tobacco settlement securitization?; and 2) How much would the District be giving up in future revenues by executing this proposed transaction?

1) Residuals are annual amounts of TSRs in excess of the annual debt service payments on the 2001 tobacco bonds, which the District currently is entitled to receive. However, the District is currently not receiving such residuals due to the existence of something called a “trapping event”, which is the result of one of the major tobacco companies’ bond rating being downgraded to below investment grade. According to agreements associated with the 2001 tobacco bonds, this means that the residuals that would otherwise come to the District are required to be “trapped” in an account with the bond trustee and cannot be released to the District unless or until the trapping event goes away.

   Under the proposed structure of the new bond issuance, the District would have to pledge all residuals to be received after 2014 to the new bonds. However, any residuals received through 2014, to the extent that they are released from the “trapping account” (upon the termination of the “trapping event”), would be able to be received by the District. This amount is estimated to be up to approximately $90 million in total, and experts in the field have advised us that it is their view that there is at least a 50-50 chance of a termination of the trapping event during this time period, allowing the District to receive these funds.

   As with the existing tobacco bonds, the District would retain the right to receive all TSRs after all of the tobacco bonds (the initial bonds and the proposed new bonds) are paid off (expected to be 2040 under the proposed structure for the new tobacco bonds).

2) In present value terms, the District would be giving up the amount that it would be receiving, currently estimated at $210 million. However, in nominal dollars, given the fact that, due to the time value of money, dollars today are worth much more than dollars to be received in the distant future, the District would be giving up future TSRs of approximately $1 billion. The projected amount of the proceeds of this bond issuance, $210 million, represents that $1 billion in future revenues discounted back to today at the expected interest rate on the new bonds, approximately 7%.

Chairman Cropp, members of the Council, this concludes my testimony. I am prepared to address any questions that you may have.