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Minnesota House of Representatives

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TO: Representative Ryan Winkler

FROM: Koryn Zewers, Fiscal Analyst

RE: Appropriation Bonds and Tobacco Securitization

Per your request, below is a comparison of appropriation bonds to tobacco securitization as well as a brief discussion of the impact such bonds would have on the State's credit rating.

Appropriation Bonds

Appropriation bonds would be issued by the State and debt service payments would be made from the general fund (or another named fund). The State has not sold appropriation bonds in the past. However, the State has provided appropriations to entities who have in turn sold bonds, and these bonds are considered appropriation bonds. Below are additional details related to this type of bonding.

- **Debt Service:** Initial estimates indicate the interest rate on $700 million in appropriation bonds amortized over 20 years would be just over 5 percent with a debt service payment of approximately $77 million for the FY 2012-13 biennium. Debt service payments for the FY 2014-15 biennium would total approximately $123 million, and the total cost over the life of the bonds would be approximately $1 billion (i.e. approximately $300 million in interest payments and other costs to the state). These preliminary estimates are highly dependent on the market at the time of the sale, the State's bond rating, and the structure of the bonds; they are subject to change.

- **Debt Capacity**: The appropriation and issuance of appropriation bonds would impact the State's Debt Management Guidelines. Currently, the State has $1.6 billion in additional bonding capacity under guideline 1, which is the limiting guideline. This guideline states, "Total tax-supported principal outstanding shall be 3.25 percent or less of total state personal income." Although this measure will not be impacted immediately, it will be affected with the next bond sale, forecast, and when the state retires debt.

- **Difference from GO Bonds:** In a February 3, 2009, letter, the State's Bond Counsel asserted that appropriation bonds are not legal obligations to the State and therefore not public debt. The State would not pledge its full faith, credit, and taxing powers to pay the debt service. However, later that month, the Attorney General issued an opinion on the matter and created uncertainty as to how a court would rule regarding the constitutionality of appropriation bonds. This uncertainty would need to be resolved prior to a bond sale issuing the appropriation bonds.

Securitization of Tobacco Settlements

Securitization of the tobacco settlement revenues would turn future tobacco payments into current funding. This could be done by either selling off the rights to future tobacco payments themselves or by selling state bonds backed by future tobacco payments. In most, if not all cases, other states have sold bonds backed by the payments versus selling the rights to future payments. The information below is based on the assumption that if the State decided to securitize the tobacco payments, it would sell bonds.

- **Debt Service:** Initial estimates indicate the interest rate on the tobacco payment-backed bonds (amortized over 20 years) would be approximately 6.2 percent with a debt service payment of approximately $120 million for the FY 2012-13 biennium. Debt service payments for the FY 2014-15 biennium would total approximately $195 million, and the total cost over the life of the bonds would be approximately $1.2 billion based on the current assumptions. These preliminary estimates are highly dependent on the market at the time of the sale, the State's bond rating, and the structure of the bonds; they are subject to change.

- **Debt Capacity**: The appropriation and issuance of bonds backed by tobacco revenues would not impact the State's Debt Management Guidelines.

- **Other Financial Considerations:** Since the tobacco revenues would be pledged to pay the debt service on the bonds, these funds could not be used for other purposes. Although debt service payments would be just under $200 million for the out biennium, approximately $320 million would need to be set aside to pay the debt service on the bonds. These funds could be used in the future; however, there would be a one-time reduction in available revenue.

Minnesota's Credit Rating

It is difficult to determine at this time how the issuance of appropriation bonds or bonds backed by tobacco revenues would impact the State's rating. However, On July 7, 2011, Fitch Ratings downgraded its rating on approximately $5.7 billion of Minnesota's bonds from a AAA rating to a AA+ rating. The letter from Fitch Ratings indicated a number of rationale for the downgrade including the following: "The downgrade reflects the state's reliance on non-recurring gap-closing measures over the course of the recession, the difficulties in reaching consensus on a plan to address the resulting large budget gap for the biennium that began on July 1, the likelihood that the final budget agreement will again include non-recurring solutions, and an increasingly contentious budgeting environment in the state in recent years. Fitch believes that as a result Minnesota's financial posture is no longer consistent with an 'AAA' rating."

Please let me know if you have any additional questions on this. I can be reached at koryn.zewers@house.mn or at (651) 296-4178.