## OFFICE OF THE INDEPENDENT BUDGET ANALYST REPORT

**Date Issued:** February 1, 2006 **IBA Report Number:** 06-3

**City Council Agenda Date:** February 6, 2006

**Item Number:** 201

**Item:** Pension Solutions: – Securitization of Tobacco Settlement Revenues

## OVERVIEW

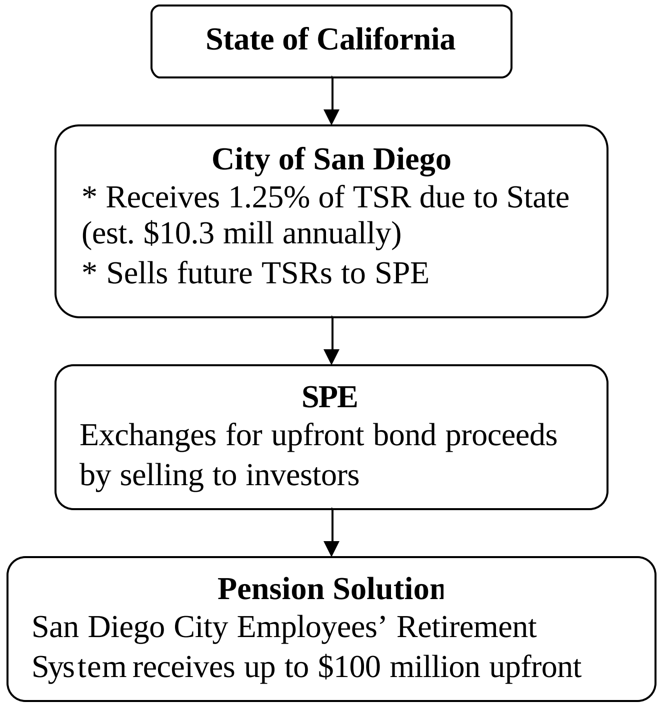
### Definitions

- **Tobacco Settlement Revenue (TSR):** Revenues received from the State of California from the Master Settlement Agreement, which resolved certain cigarette smoking-related litigation between the four largest United States tobacco manufactures and 46 states and 6 other U.S. territories.
- **Securitization:** In general, when a public entity proposes to sell an ongoing revenue stream, such revenue stream is "securitized".
- **Special Purpose Entity (SPE):** An entity that is created for the sole purpose of engaging in the business of acquiring, owning, and selling the City of San Diego's tobacco settlement revenues.
- **Employee "pick up"/offset Savings:** City expenditure savings due to the City paying a reduced amount of pension contributions on behalf of the employee and a negotiated salary reduction for Local 127 per the current labor agreement.
- **Discount Rate:** Interest rate or charge for a loan.

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, through securitizing a City revenue source during Fiscal Year 2006. The Mayor has issued this proposal to securitize TSRs. This solution proposes securitizing up to $10.3 million in annual TSR receipts beginning in Fiscal Year 2006 and using the upfront bond proceeds of up to $100 million to reduce the City's outstanding pension fund liability.

The proposal discusses how securitizing TSRs is a viable option due to the lack of current audited financial statements that precludes the City from offering securities to the public capital markets. The proposal also recommends establishing a tobacco bond issuance vehicle, a new SPE, in order to execute the proposed securitization transaction consisting of the City's Chief Financial Officer, the City's Chief Operating Officer, and an independent outside member appointed by the Mayor and confirmed by the City Council.

The following chart shows how the TSRs are received from the State to the City of San Diego and the monetary flow of the proposed securitization:




The Office of the Independent Budget Analyst has performed a review in order to evaluate the fiscal impact of the tobacco securitization pension solution and the recommendations therein.

**FISCAL/POLICY DISCUSSION**

Efforts to increase the funded ratio of the San Diego City Employees' Retirement System (SDCERS) are strongly supported by the Independent Budget Analyst (IBA). Similarly, one of the City Council's top priorities is to increase the funded ratio of the SDCERS. As such, this pension solution concept is an important step in improving the financial position of SDCERS and the overall fiscal health and stability of the City of San Diego.

**Is there an impact to the General Fund?** The City has allocated annual tobacco settlement revenues for a variety of uses. In Fiscal Year 2006, tobacco settlement revenues of $10.1 million, were appropriated to the Healthy Kids (6 to 6 Program), Parks and the Multiple Species Conservation Program, enforcement of the City's anti-smoking and anti-substance abuse laws, the Library System Improvements Program, Unappropriated Reserve and to the General Fund. Although these programs will lose their TSR allocation due to securitization, the Mayor proposes to continue funding these programs by substituting the employee offset savings. Therefore, City services should not be impacted due to the loss of the tobacco funds in the General Fund.

It should be noted that there are no restrictions on the use of TSRs for the City of San Diego. However, a portion of the TSRs were appropriated to the "Smart and Healthy San Diego Plan" that was adopted by the City in Fiscal Year 1999, the allocation of these revenues is at the discretion of the City Council.

**What are the risks?** There are some concerns that tobacco revenues will decline due to the downward trend in cigarette consumption. In recent years, there have been various efforts in smoking prevention. The tobacco companies are allowed to decrease the amount they pay to the states if the nationwide sales of cigarettes decrease. There is also a concern that the U.S. tobacco companies' inability to make their full payments due to financial problems caused by lawsuits could reduce payments to the states as well. If realized, the risk of lower tobacco settlement revenues could extend the timeline of repaying the debt incurred through this securitization.

In addition to the decline in cigarette consumption and potential financial problems of the U.S. tobacco companies, there is also the risk of higher interest rates that in turn lower the net proceeds deposited into SDCERS that can be generated through a securitization. In the event the City of San Diego is unable to securitize the TSRs, it is recommended that a further detailed analysis be requested and reviewed regarding the effects of the future risk of TSRs.

## QUESTIONS/COMMENTS

What is the cost to securitize the City's future TSRs? If a total bond size of $105 million is required to produce net proceeds of $100 million, is the total cost $5 million?

How does the City's discount rate compare to other California municipalities that have securitized their TSRs? Would it be different based on the City's bond ratings, the increased risk of TSRs nationwide, or other factors?

What is the economic benefit to SDCERS for securitizing TSRs vs. depositing TSRs directly into the retirement system on a cash basis each year? Quantifying the return on investment will assist policymakers in understanding the benefit of pursuing this option.

What is the impact to the City if the TSRs are less than $10.3 million in any given year? Is there a penalty to the City?

The chart on page 7 of the Pension Solutions proposal breaks down the expenditure savings by fund. The combined expenditure savings is approximately $18.3 million.

What is the balance of the $18.3 million employee savings offset from the General and Non-General Funds being used for if the City is leveraging $10.3 million? How is the $6.5 million employee savings offset from Non-General Funds being reflected and used? Does this make up a portion of the $10.3 million? Will this impact the labor agreement requirements?

Does the proposed securitization legally satisfy the terms of the labor agreements?

Given the long term bond repayment schedule, and the labor contracts that vary from 1 to 3 years, is it okay to assume that the City will have the employee savings offset beyond the contract period?

**CONCLUSION**

Pension solutions are an important step towards the fiscal health of the San Diego City Employees' Retirement System and the City of San Diego. This proposal increases the funded ratio of the SDCERS, which is a high priority of the City Council and the Office of the IBA. The following should be considered as part of this proposal:

- It is requested that the Mayor's Office provide more information on the usage of the balance of the funds upon return to the Budget Committee and the City Council in March along with the legal documents concerning the SPE and the financing documents that will be presented for review and approval.

Provided that the Mayor's Office can give assurance that this pension solution meets the terms of the current labor contracts, the Office of the Independent Budget Analyst recommends approving the resolution to authorize the Mayor to pursue this pension solution, with a request to present answers and updates to policy questions included in this report when the item is returned to the Budget Committee and the City Council.

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