

Kate Marshall
State Treasurer



Renee L. Parker, Esq.
Chief of Staff

Robin V. Reedy
Chief Deputy Treasurer

STATE OF NEVADA
OFFICE OF THE STATE TREASURER

June 18, 2008

VIA HAND DELIVERY, FAX AND FIRST CLASS MAIL

Governor Jim Gibbons
State of Nevada
101 N. Carson Street
Suite 1
Carson City, NV 89701

The Honorable William J. Raggio
P.O. Box 281
Reno NV 89504

The Honorable Speaker Barbara Buckley
5442 Holbrook Drive
Las Vegas NV 89103

Dear Governor Gibbons, Senator Raggio and Speaker Buckley:

As we discussed in our meeting last week and in anticipation of your need for financial information to assist you in your decision making process going forward, enclosed herewith is a cash flow analysis estimating the State's Fiscal Year 2009 cash position on a monthly basis. I have enclosed two versions of this analysis as follows: (1) version one is based upon the 4.5% budget reserves already implemented by the Governor; (2) the second version accounts for the additional 2% budget reserves proposed in the Department of Administration's All Agency Memorandum #2008-24, which was issued June 12, 2008. In addition, as of today, my office has determined that the Unclaimed Property Division can make a one time sale of securities after July 1, 2008 to increase projected FY09 revenues by an additional \$9 million bringing total revenue projection for FY09 to \$34 million. I have also enclosed information prepared by our financial advisors pertaining to the proposed tobacco securitization, and information about options other states and/or the federal government have implemented to address their respective budget shortfalls in years past.

CARSON CITY OFFICE

State Treasurer
101 N. Carson Street, Suite 4
Carson City, Nevada 89701-4786
(775) 684-5600 Telephone
(775) 684-5623 Fax

STATE TREASURER PROGRAMS

Governor Guinn Millennium Scholarship Program
Nevada Prepaid Tuition Program
Unclaimed Property
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LAS VEGAS OFFICE

555 E. Washington Avenue, Suite 4600
Las Vegas, Nevada 89101-1074
(702) 486-2025 Telephone
(702) 486-3246 Fax



As you can see from the cash flow analysis, it appears that under either scenario the State will have sufficient cash to pay its expenses until the 2009 Legislature meets and can appropriate additional monies from the Rainy Day Fund, if necessary. Specifically, under the current 4.5% budget reserve scenario, the State would begin the month of February 2009 with approximately \$207 Million; if an additional 2% budget reserve were implemented the amount increases to almost \$245 Million. I must caution you, however, that this information was prepared based on estimated figures provided to us by the Department of Administration and any slight change to these numbers could significantly impact the State's cash position. In addition, due to the volatility of daily cash positions, any balance below \$200 Million puts the State at greater financial exposure to negative cash balances. Based on this information, cash management standards suggest that it would be prudent to appropriate approximately \$200 Million from the Rainy Day Fund to the General Fund to ensure sufficient cash is available to meet the State's obligations until February 2009. Another option would be to amend NRS 353.288 during the proposed Special Session to allow IFC to appropriate monies from the Rainy Day Fund, as necessary, in the interim.

With respect to the Lt. Governor's proposal to securitize the State's tobacco revenues, as you know, we have been unable to obtain a copy of the Lt. Governor's working papers for the plan he proposed to determine the assumptions he used to arrive at his estimated proceeds. Since my office was also requested to research the viability of a tobacco financing, I requested Merrill Lynch prepare an estimate of proceeds based on various scenarios, and include an analysis relating to the tax consequences of any bonds issued and the types of securities that can be issued. I have enclosed a copy of their memorandum for your review. Specifically, the proceeds generated under each scenario are highlighted in the table presented at the bottom of page 4 of the enclosed memorandum. As you can see, without the backing of the State, bondholders are demanding premium interest rates for fully securitized tobacco bonds. These interest rates relate to the complex legal and related financial issues raised by the Attorney General. Any additional disclosures required to assist the Attorney General in protecting the State should we choose to securitize, could also alter these scenarios.

In addition, in researching this issue I came across testimony to the Nevada Legislature by the Lt. Governor when he was Treasurer wherein he raised concern about securitizing tobacco monies to balance the budget. I have enclosed for your reference the portion of the minutes from the April 7, 2003 Senate Committee on Government Affairs containing a discussion of SB 448, a tobacco securitization bill submitted by the Lt. Governor/then Treasurer. As you can see on page 22 of the minutes, the Lt. Governor indicated that he was not recommending securitizing in 2003 because "it is too expensive and the market is not right . . .," but he stated that he may desire to proceed with securitization "should the market recover sufficiently." In addition, on page 24 of the enclosed minutes, the Lt. Governor stated that "it is a tremendous fiduciary failure for states and local jurisdictions

to sell this 20- to 30-year revenue to balance today's budget. . ." In this connection, if the Legislature does consider tobacco securitization as an option to balance today's budget, I request the opportunity to work with the Attorney General before any plan is finalized to determine the extent to which such action would put the State at risk of engaging in a fiduciary failure, and the ability to put any attempts at securitizing on hold if such a determination is made.

Regarding options other states and/or the federal government have implemented to address their respective budget shortfalls, I provide for your assessment the following information:

(1) Implementing a moratorium on out of state travel for all State employees for travel under General Fund accounts for Fiscal Year 2009, except for specific instances approved by the Governor. For Fiscal Year 07, out of state travel for the General Fund was \$587,158.28 and is estimated to be approximately \$720,422 for FY08.

(2) Implementing a moratorium or a partial moratorium on in-state travel for all State employees for travel under General Fund accounts for Fiscal Year 2009, except for specific instances approved by the Governor. For Fiscal Year 07, in-state travel for the General Fund was \$6,750,000 and is approximately \$6,371,000 to date for FY08.

(3) Implementing a moratorium on Overtime for cash paid from General Fund accounts for all State employees for Fiscal Year 2009, except for specific instances approved by the Governor. According to State accounting records for Fiscal Years 2007 and 2008, over \$18 Million was paid by State agencies to State employees out of the General Fund each year for overtime compensation. Requiring overtime only be worked for compensatory time except for critical needs could free up this money to alleviate the budget shortfall.

(4) Options other states have considered to address their respective budget shortfalls include increasing fees or adding a state fee component in the following areas: (a) marriage licenses; (b) divorce filing fees; (c) DUI license reinstatement fees; (d) DMV duplicate license fees; (e) DMV ID card fees; (f) outdoor advertising fees; (g) elevator inspection late fees; and (h) hazardous waste transport fees.

Finally, with respect to the Department of Administration's request to provide information concerning the proposed additional 2%, 3% and 4% budget reserves, I am prepared to revert at the end of Fiscal Year 2008, the entire 4.5% portion previously implemented and attributable to my office for both Fiscal Years 2008 and 2009. If implemented, I also commit to you to revert an additional 2%, 3% or 4% over the biennium.

Governor Jim Gibbons
Senator Raggio
Speaker Buckley
June 18, 2008
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If you have any questions concerning the foregoing, please do not hesitate to contact me or my Chief of Staff, Renee Lequerica, at (775) 684-7109.

Regards,

A handwritten signature in black ink, appearing to read "Kate Marshall". The signature is written in a cursive style with a large, looping initial "K".

Kate Marshall
State Treasurer

Encl:

Cc: Andrew Clinger, Director, Department of Administration
Mark Stevens, Fiscal Analyst
Gary Ghiggeri, Fiscal Analyst

365,000,000 June 15 2008 Cash
 (95,000,000) Expected net increase for the month
 Capital Project reversions - posted after 6/30/08

 270,000,000 Actual Ending Cash

270,000,000 Estimated Beginning FY09
 (570,968,449) total fy09 revenue shortfall/increased expenditures
 144,480,279 Expected savings from budget cuts

 (156,488,170) Expected ending cash

270,000,000 Estimated Beginning FY09
 115,000,000 Capital Project reversions - reclassify to bond funds
 69,000,000 Capital Project reversions - unspent appropriations
 (34,444,144) Percentage of revenue shortfall assigned to July
 12,040,023 Expected Savings from budget cuts
 87,230,423 Buildup of resources to pay DSA
 11,035,849 Buildup of resources to pay Appropriations to non GF accounts
 (41,390,137) Total non GF Appropriations transferred in July
 (48,211,000) Expected transfer to HWY Fund (AB544)
 (4,653,662) Expected additional Expenses

 435,607,352 Estimated July 2008 balance

(34,444,144) Percentage of shortfall assigned to August
 12,040,023 Expected Savings from budget cuts
 (261,691,268) Net budgeted DSA payment (assumed full payment)
 87,230,423 Buildup of resources to pay DSA
 11,035,849 Buildup of resources to pay Appropriations to non GF accounts
 (33,076,365) Expected additional DSA payment (assumed full payment)
 (4,653,662) Expected additional Medicaid Expenses

 212,048,209 Estimated August 2008 balance

(33,573,230) Percentage of shortfall assigned to September
 12,040,023 Expected Savings from budget cuts
 0 Assumed delay of 1/3 DSA from previous month
 87,230,423 Buildup of resources to pay DSA
 11,035,849 Buildup of resources to pay Appropriations to non GF accounts
 (4,653,662) Expected additional Expenses

 284,127,612 Estimated September 2008 balance

(33,573,230) Percentage of shortfall assigned to October
12,040,023 Expected Savings from budget cuts
87,230,423 Buildup of resources to pay DSA
11,035,849 Buildup of resources to pay Appropriations to non GF accounts
(41,733,000) Expected transfer to HWY Fund (AB544)
(4,653,662) Expected additional Expenses
314,474,015 Estimated October 2008 balance

(45,785,158) Percentage of shortfall assigned to November
12,040,023 Expected Savings from budget cuts
(180,845,634) Net budgeted DSA payment (assumed 2/3 payment)
87,230,423 Buildup of resources to pay DSA
11,035,849 Buildup of resources to pay Appropriations to non GF accounts
(22,061,935) Expected additional DSA payment (assumed 2/3 payment)
(4,653,662) Expected additional Expenses
171,433,921 Estimated November 2008 balance

(41,153,047) Percentage of shortfall assigned to December
12,040,023 Expected Savings from budget cuts
(80,845,634) Assumed delay of 1/3 DSA from previous month
87,230,423 Buildup of resources to pay DSA
11,035,849 Buildup of resources to pay Appropriations to non GF accounts
(11,014,429) Assumed delay of 1/3 additional DSA from previous month
(4,653,662) Expected additional Expenses
144,073,443 Estimated December 2008 balance

(41,153,047) Percentage of shortfall assigned to January
12,040,023 Expected Savings from budget cuts
87,230,423 Buildup of resources to pay DSA
0 Assumed delay of 1/3 DSA from previous month
11,035,849 Buildup of resources to pay Appropriations to non GF accounts
(1,096,050) Expected transfer to HWY Fund (AB544)
(4,653,662) Expected additional Expenses
207,476,979 Estimated January 2009 balance

(23,738,609) Percentage of shortfall assigned to February
12,040,023 Expected Savings from budget cuts
(100,000,000) Net budgeted DSA payment (assumed 1/3 payment)
87,230,423 Buildup of resources to pay DSA
11,035,849 Buildup of resources to pay Appropriations to non GF accounts
(11,047,506) Expected additional DSA payment (assumed 1/3 payment)
(4,653,662) Expected additional Expenses
178,343,497 Estimated February 2009 balance

Assumes 4.5% budget cuts

(23,738,609) Percentage of shortfall assigned to March
12,040,023 Expected Savings from budget cuts
(80,845,634) Net budgeted DSA payment (assumed 1/3 payment)
87,230,423 Buildup of resources to pay DSA
11,035,849 Buildup of resources to pay Appropriations to non GF accounts
(11,014,429) Expected additional DSA payment (assumed 1/3 payment)
(4,653,662) Expected additional Expenses
168,397,458 Estimated March 2009 balance

(23,738,609) Percentage of shortfall assigned to April
12,040,023 Expected Savings from budget cuts
(80,845,634) Net budgeted DSA payment (assumed 1/3 payment)
87,230,423 Buildup of resources to pay DSA
11,035,849 Buildup of resources to pay Appropriations to non GF accounts
(11,014,429) Expected additional DSA payment (assumed 1/3 payment)
(4,653,662) Expected additional Expenses
158,451,418 Estimated April 2009 balance

(23,738,609) Percentage of shortfall assigned to May
12,040,023 Expected Savings from budget cuts
(100,000,000) Net budgeted DSA payment (assumed 1/3 payment)
87,230,423 Buildup of resources to pay DSA
11,035,849 Buildup of resources to pay Appropriations to non GF accounts
(11,047,506) Expected additional DSA payment (assumed 1/3 payment)
(4,653,662) Expected additional Expenses
129,317,937 Estimated May 2009 balance

(23,738,609) Percentage of shortfall assigned to June
12,040,023 Expected Savings from budget cuts
(80,845,634) Net budgeted DSA payment (assumed 1/3 payment)
87,230,423 Buildup of resources to pay DSA
11,035,849 Buildup of resources to pay Appropriations to non GF accounts
(11,014,429) Expected additional DSA payment (assumed 1/3 payment)
(4,653,662) Expected additional Expenses
119,371,897 Estimated June 2009 balance

(382,819,045) Expected revenue shortfall (average of LCB and Budget projections)

(157,000,000) Expected annual DSA shortfall per Jim Wells

(102,503,865) Expected annual DSA shortfall per LCB

(137,412,509) Expected annual DSA shortfall per Budget

(132,305,458) Expected annual DSA shortfall - average

(39,525,862) Expected additional Medicaid Expenditures (LCB & Budget agree)

(651,857) Expected additional Check Up Expenditures (LCB only)

(195,000) Expected additional Aged & Blind Expenditures (LCB & Budget don't agree)

(15,471,227) Expected additional DCFS Expenditures (Budget only)

(55,843,946) Expected additional expenses over budget per LCB

(570,968,449) Total net FY09 budget shortfall

41,390,137 FY09 Appropriations to non GF accounts

91,040,050 FY09 Appropriations to HWY Fund (AB544)

132,430,187

144,480,279 4.5% budget cuts per Budget

Assumes 4.5% budget cuts

365,000,000 June 15 2008 Cash
 (95,000,000) Expected net increase for the month
Capital Project reversions - posted after 6/30/08
 270,000,000 Actual Ending Cash

270,000,000 Estimated Beginning FY09
 (570,968,449) total fy09 revenue shortfall/increased expenditures
208,693,737 Expected savings from budget cuts
 (92,274,712) Expected ending cash

270,000,000 Estimated Beginning FY09
 115,000,000 Capital Project reversions - reclassify to bond funds
 69,000,000 Capital Project reversions - unspent appropriations
 (34,444,144) Percentage of revenue shortfall assigned to July
 17,391,145 Expected Savings from budget cuts
 87,230,423 Buildup of resources to pay DSA
 11,035,849 Buildup of resources to pay Appropriations to non GF accounts
 (41,390,137) Total non GF Appropriations transferred in July
 (48,211,000) Expected transfer to HWY Fund (AB544)
(4,653,662) Expected additional Expenses
440,958,474 Estimated July 2008 balance

(34,444,144) Percentage of shortfall assigned to August
 17,391,145 Expected Savings from budget cuts
 (261,691,268) Net budgeted DSA payment (assumed full payment)
 87,230,423 Buildup of resources to pay DSA
 11,035,849 Buildup of resources to pay Appropriations to non GF accounts
 (33,076,365) Expected additional DSA payment (assumed full payment)
(4,653,662) Expected additional Medicaid Expenses
222,750,452 Estimated August 2008 balance

(33,573,230) Percentage of shortfall assigned to September
 17,391,145 Expected Savings from budget cuts
 0 Assumed delay of 1/3 DSA from previous month
 87,230,423 Buildup of resources to pay DSA
 11,035,849 Buildup of resources to pay Appropriations to non GF accounts
(4,653,662) Expected additional Expenses
300,180,977 Estimated September 2008 balance

(33,573,230) Percentage of shortfall assigned to October
17,391,145 Expected Savings from budget cuts
87,230,423 Buildup of resources to pay DSA
11,035,849 Buildup of resources to pay Appropriations to non GF accounts
(41,733,000) Expected transfer to HWY Fund (AB544)
(4,653,662) Expected additional Expenses
335,878,501 Estimated October 2008 balance

(45,785,158) Percentage of shortfall assigned to November
17,391,145 Expected Savings from budget cuts
(180,845,634) Net budgeted DSA payment (assumed 2/3 payment)
87,230,423 Buildup of resources to pay DSA
11,035,849 Buildup of resources to pay Appropriations to non GF accounts
(22,061,935) Expected additional DSA payment (assumed 2/3 payment)
(4,653,662) Expected additional Expenses
198,189,528 Estimated November 2008 balance

(41,153,047) Percentage of shortfall assigned to December
17,391,145 Expected Savings from budget cuts
(80,845,634) Assumed delay of 1/3 DSA from previous month
87,230,423 Buildup of resources to pay DSA
11,035,849 Buildup of resources to pay Appropriations to non GF accounts
(11,014,429) Assumed delay of 1/3 additional DSA from previous month
(4,653,662) Expected additional Expenses
176,180,172 Estimated December 2008 balance

(41,153,047) Percentage of shortfall assigned to January
17,391,145 Expected Savings from budget cuts
87,230,423 Buildup of resources to pay DSA
0 Assumed delay of 1/3 DSA from previous month
11,035,849 Buildup of resources to pay Appropriations to non GF accounts
(1,096,050) Expected transfer to HWY Fund (AB544)
(4,653,662) Expected additional Expenses
244,934,829 Estimated January 2009 balance

(23,738,609) Percentage of shortfall assigned to February
17,391,145 Expected Savings from budget cuts
(100,000,000) Net budgeted DSA payment (assumed 1/3 payment)
87,230,423 Buildup of resources to pay DSA
11,035,849 Buildup of resources to pay Appropriations to non GF accounts
(11,047,506) Expected additional DSA payment (assumed 1/3 payment)
(4,653,662) Expected additional Expenses
221,152,469 Estimated February 2009 balance

181853790

(23,738,609) Percentage of shortfall assigned to March
17,391,145 Expected Savings from budget cuts
(80,845,634) Net budgeted DSA payment (assumed 1/3 payment)
87,230,423 Buildup of resources to pay DSA
11,035,849 Buildup of resources to pay Appropriations to non GF accounts
(11,014,429) Expected additional DSA payment (assumed 1/3 payment)
(4,653,662) Expected additional Expenses
216,557,551 Estimated March 2009 balance

(23,738,609) Percentage of shortfall assigned to April
17,391,145 Expected Savings from budget cuts
(80,845,634) Net budgeted DSA payment (assumed 1/3 payment)
87,230,423 Buildup of resources to pay DSA
11,035,849 Buildup of resources to pay Appropriations to non GF accounts
(11,014,429) Expected additional DSA payment (assumed 1/3 payment)
(4,653,662) Expected additional Expenses
211,962,633 Estimated April 2009 balance

(23,738,609) Percentage of shortfall assigned to May
17,391,145 Expected Savings from budget cuts
(100,000,000) Net budgeted DSA payment (assumed 1/3 payment)
87,230,423 Buildup of resources to pay DSA
11,035,849 Buildup of resources to pay Appropriations to non GF accounts
(11,047,506) Expected additional DSA payment (assumed 1/3 payment)
(4,653,662) Expected additional Expenses
188,180,273 Estimated May 2009 balance

(23,738,609) Percentage of shortfall assigned to June
17,391,145 Expected Savings from budget cuts
(80,845,634) Net budgeted DSA payment (assumed 1/3 payment)
87,230,423 Buildup of resources to pay DSA
11,035,849 Buildup of resources to pay Appropriations to non GF accounts
(11,014,429) Expected additional DSA payment (assumed 1/3 payment)
(4,653,662) Expected additional Expenses
183,585,355 Estimated June 2009 balance

127,511,830

Paid in July

(11,014,429) Expected additional DSA payment (assumed 1/3 payment)
(80,845,634) Net budgeted DSA payment (assumed 1/3 payment)

Assumed 6.5% budget cuts

(382,819,045) Expected revenue shortfall (average of LCB and Budget projections)

(157,000,000) Expected annual DSA shortfall per Jim Wells

(102,503,865) Expected annual DSA shortfall per LCB

(137,412,509) Expected annual DSA shortfall per Budget

(132,305,458) Expected annual DSA shortfall - average

(39,525,862) Expected additional Medicaid Expenditures (LCB & Budget agree)

(651,857) Expected additional Check Up Expenditures (LCB only)

(195,000) Expected additional Aged & Blind Expenditures (LCB & Budget don't agree)

(15,471,227) Expected additional DCFS Expenditures (Budget only)

(55,843,946) Expected additional expenses over budget per LCB

(570,968,449) Total net FY09 budget shortfall

41,390,137 FY09 Appropriations to non GF accounts

91,040,050 FY09 Appropriations to HWY Fund (AB544)

132,430,187

144,480,279 4 .5% budget cuts per Budget

64,213,458 2% budget cuts per Budget

208,693,737

Memorandum

To: Kate Marshall *State of Nevada Treasurer*
Robin Reedy *Chief Deputy Treasurer*
Lori Chatwood *Deputy Treasurer*

From: Jeff Brown 206-830-6025
David Stephens 212-449-5288
Chris Cole 212-449-6033
Merrill Lynch Public Finance

Date: June 10, 2008



Subject: Deficit and Tobacco Financing

The State asked Merrill Lynch to estimate the amount of proceeds that might be available for the State from a bond issue to fund State of Nevada operating expenses during this biennium and the expected repayment source for which would be Nevada's receipts under the Master Settlement Agreement with tobacco companies.

This memorandum will address some key points:

- When issuers are allowed to finance deficits with tax-exempt bonds;
- A technical note on what "maturity" means in tobacco bond structures;
- The types of security the State can offer bond holders;
- The different rates the State would pay, depending on taxability and security;
- The amount of proceeds the State would receive; and
- Future compliance issues with the IRS.

WHEN ISSUERS ARE ALLOWED TO FINANCE DEFICITS WITH TAX EXEMPT BONDS

Generally, the State is permitted to issue long-term bonds to finance physical capital projects for governmental use or refunding bonds related to such bonds. However, there is an exception permitted for payment of government operating expenditures when the government entity is operating with a deficit.

Assuming the State is willing not to invest the bond proceeds at a rate in excess of the bond yield (not a problem with the borrowing in the 5-7% area and reinvestment rates in the 2 ½% area), the State could borrow an amount equal to the biggest cumulative deficit it reasonably forecasts generating during the next three years ("three year temporary period"). The State must forecast that the State will consume these proceeds using a "gross proceeds spent last" allocation method. This allocation methodology is more strict than the more flexible proceeds allocation rules for bonds to finance capital expenditures. It basically requires the State to use up: (i) available starting cash first (after holding back a reasonable required working capital reserve of no more than 5% of the prior year's operating expenses), (ii) then to use periodic revenues second, and (iii) last paying operating expenses from bond proceeds.

For Nevada, based on preliminary numbers assembled by Mark Winebarger of your office, the table immediately below shows a rough calculation of eligible borrowing over the next fiscal year (beginning July 1, 2008, ending June 30 2009). If the State has good forecasts into FYE 2010

and 2011, the amount could be larger. Also, deficit financing can be combined in a multi-purpose issue with other tax-exempt borrowing purposes such as capital expenditures or refunding of current maturities of prior capital bonds.

Estimate of Eligible Deficit Bonds

Cash Flow Item	Amount
Beginning available cash (per Mark)	\$ 500,000,000
Plus Revenues FYE 2009 adjusted for recession	3,135,499,210
Less Expenditures FYE 2009 adjusted for recession (Rainy Day fund doesn't count)	(3,751,869,775)
Less 5% of FYE 2008 Expense as "reasonably required reserve" (IRS) [Approximate—May be less depending on Nevada past practice.]	(166,700,000)
Amount of Deficit for Bonding FYE 2009	\$(283,070,565)

Additionally, there are some other tests that would be relevant if re-investment rates were higher:

- Specifically there is a "thirteen month" temporary period based upon an expectation of spending funds within 13 months—this allows the State to invest at a yield above the bond rate (but the State has to rebate unless it also pass the test in the next bullet).
- Next, there are two variants of a six month actual expenditure test that allows the State to actually keep arbitrage earnings.

IMPORTANT TECHNICAL NOTE ABOUT THE MEANING OF "MATURITY" IN TOBACCO FINANCINGS

One type of financing is a pure securitization of some or all of the tobacco revenues. In such a financing, a state that is party to the MSA sells its tobacco receipts for cash (bond proceeds) to a newly-created, cleverly-named securitization vehicle that is independent of the State (e.g., the Comstock entity in the Lt. Governor's memo, "Northern Tobacco" for Alaska, "Golden State" for California, "Badger Tobacco" for Wisconsin, etc.) As you read this memorandum, it is very important to understand one very salient complexity to such pure securitization tobacco financings, namely the "turbo structure."

- Tobacco bonds are a type of special revenue bond—the pledge is whatever revenues are received under the MSA, but the issuer has zero control over the amount of receipts. Therefore, such a special revenue bond is a lot like a borrowing against sales tax that voters have set at a certain rate (e.g., ½ cent); and such a special revenue bond is very different from an enterprise bond in which the issuer has ratemaking flexibility (such as water, sewer, power or toll revenue bonds).
- As you recall, in a special revenue bond financing, debt service is structured so that, on a forecast basis, the net revenues of the issuer cover debt service with a safety margin. The safety margin is the "coverage" on the bonds. Pretend that an issuer of sales tax bonds forecasts having \$130 million of revenues available for debt service payments. If the issuer wishes to achieve a 1.30x coverage ratio, the issuer must limit debt service to \$100 million per year. So if the \$130 million sales tax revenues is received as forecast, the first \$100 million is spent on the bonds, and the remaining surplus/coverage margin of \$30 million is available for capital expenditures or other lawful purposes.

- In tobacco bonds, using similar numbers, the big distinction is the disposal of the surplus/coverage margin. Assuming forecast base case tobacco MSA receipts of \$130 million and \$100 million of scheduled debt service, there will again be \$30 million left over. However, because there has been a true sale of the receivables for so long as the bonds are outstanding, the state government involved no longer “owns” the \$30 million. Therefore, a structure was evolved that recycles the \$30 million surplus/coverage margin into additional principal redemptions beyond the minimum scheduled amortizations shown on the cover of the Official Statement. That extra-fast redemption is called a “turbo amortization.” In practice, this turbo redemption feature means that pinning down what speakers mean by the “maturity” of a turbo tobacco bond requires some considerable care. As an example, take a structure that has a *scheduled legal maturity or nominal maturity* of 40 years (meaning that a bond default will occur if amortizations are not sufficient to retire the bonds according to this scheduled/nominal 40 year schedule). In today’s environment, under Base Case tobacco industry projections derived from consulting firm Global Insight, the bonds would actually have a “*Base Case turbo redemption maturity*” of 22 years. However, if stress cases actually materialize, it would take far longer to amortize the bonds, and the actual turbo redemption could stretch out much longer.

THE TYPES OF SECURITY THE STATE CAN OFFER BOND HOLDERS

One type of financing is a pure securitization of some or all of the tobacco revenues. This is a common tobacco financing path, though not the only path to derive bond proceeds from tobacco. It has the benefits that are described in the Lieutenant Governor’s memo. Those are basically that the State gets its money today and terminates its exposure to the fortunes of the tobacco companies and, more particularly, the vagaries of the future interpretations of, and compliance with, the MSA by the tobacco companies. The State offloads the risk entirely onto investors for the entire period that the tobacco bonds remain outstanding. The actual form of the financing is a “true sale” of the State’s receivables to the actual bond issuer, thereby obtaining a clean separation between the finances of the State and the credit of the issuer. (After the bonds are repaid, which occurs around the year 2030 in the conventional tobacco borrowing structure, the State will once again get MSA payments free and clear from the claim by bondholders—this amount is referred to as the “residual.”) The drawback of a pure tobacco securitization, as we will explain, is cost. This is the type of financing that has been done for western states such as Alaska, Washington and California.

The other type of financing is a State of Nevada Appropriation Bond, which you anticipate paying back with receipts from the MSA, but where the holder is truly looking for payment to the State of Nevada. Because such a financing would use a State appropriation pledge, rather than a G.O. pledge, the credit enhancement would not impact the State’s bonding capacity under the Nevada constitutional G.O. debt limitation. In such a financing, the State does not offload tobacco risk. Rather, the State gears the total debt service on the borrowing to correspond to the anticipated receipts under the MSA, but may need to supplement tobacco receipts with general state funds (subject to appropriation) if a shortfall occurs that exceeds any built in coverage safety margin. This is what was done for the State of Oregon’s 2003 deficit financing. The State of New York, in a recent tobacco refinancing did the same thing. The twofold reasons that Oregon and New York (among others) credit enhanced the tobacco payments with a state subject-to-appropriation credit safety blanket were: (i) The proceeds received are much bigger with state credit support, because the interest rates are so much lower, and (ii) The relevant states effectively made a risk assessment from which they concluded that the bond market was charging an interest rate premium that economically exceeded the value of offloading the

tobacco risks to investors, primarily because the buyer base for pure tobacco bonds is so limited.

THE DIFFERENT RATES THE STATE WOULD PAY, DEPENDING ON TAXABILITY AND SECURITY

The rates are vastly different depending on whether the State's bonds are taxable or not, and depending on whether the State provides a subject-to-appropriation pledge or not. For sake of simplicity we will give comparative rates for 30 year maturities for each of the cases immediately below:

Indicative 30-year Bond Rates

	30 year Tax-Exempt Bond	Taxable Bond
State of Nevada Appropriation Pledge, Aa3/AA-	4.70% area (MMD + 20bp)	6.10% area (LIB + 100bp)
Tobacco-Secured Only, BBB	7.15% area (MMD + 250bp)	8.70% area (UST + 400bp)

THE AMOUNT OF PROCEEDS THE STATE WOULD GET

Beyond the credit factors and taxability issues, the State can control the amount of money it gets by pledging different percentages of its annual tobacco receipts. Your staff directed us to look at 100%, 60% and 40%.

In the Merrill Lynch analysis we have tried very hard to have comparability between "pure securitization" cases and Appropriation Bond cases. This is because, as was alluded to in the Lt. Governor's presentation, using "100%" of tobacco revenues is a misnomer. Actually, even if the State has pledged 100% of tobacco revenues in order to get desired ratings on a nominal 40 year bond issue, the tobacco bond principal amount is limited in order to withstand rating-agency prescribed stress cases. Thus there will likely be spare funds available for turbo redemption.

- So for the various pure tobacco securitization cases we derived the maximum amount of proceeds that can be obtained today for each pledge (100%, 60% or 40%) in a 40-year scheduled maturity bond issue that has a turbo redemption feature. In general, under base case assumptions, these structures use whatever tobacco receipts have been pledged for about 22 years, after which the residual MSA receipts will revert to the State.
- Therefore, to keep apples-to-apples comparability in the Nevada appropriation cases, we limited the Appropriation Bonds to an amount that could be serviced by the same 22 years worth of base case MSA receipts. Once the 22 years had passed, the State would no longer need MSA receipts to service the appropriation debt, and the residuals are once again uncommitted and available for General Fund expenditure.

The table below sets forth the amount of net proceeds (after deducting fees, costs, and reserves) available to the State in each of twelve cases:

Proceeds Generated by Scenario

	Tax-Exempt Appropriation	Tax-Exempt Pure Tobacco Securitization	Taxable Appropriation	Taxable Pure Tobacco Securitization
100% Pledged	\$749,923,881 @ 4.78%	\$574,863,486 @ 7.14%	\$630,763,650 @ 6.06%	\$473,694,745 @ 8.66%
60% Pledged	\$449,935,991 @ 4.78%	\$342,553,750 @ 7.15%	\$369,497,700 @ 6.04%	\$281,835,290 @ 8.68%
40% Pledged	\$299,947,257 @ 4.78%	\$226,422,662 @ 7.15%	\$246,316,950 @ 6.04%	\$186,377,084 @ 8.68%

The main point of the table above was to put a spotlight on the impacts of different structures by highlighting the differences in net proceeds, holding everything else constant. That is, both the top left number of \$749 million proceeds and the top right number of \$473 million proceeds portray cases where:

- the Base Case Global Insight projections materialize;
- pure tobacco bonds "turbo" in 22 years;
- the Appropriation Bonds are structured to pay off in 22 years with all the payments successfully made via earmarked tobacco receipts (there was no call on general state resources needed); and
- after 22 years, in all the "100% cases", future tobacco MSA payments to the State are unencumbered.

This kind of analysis is primarily useful to help the State decide whether the beneficial risk transfer obtained through "pure tobacco securitization" is sufficiently important to justify the greatly diminished receipts. The analysis should not be taken as a prescription for the best way to structure an Appropriation issue, should that route be pursued. Rather, if the State were to proceed with an Appropriation Bond issue, the State Treasurer might be well-advised to sell a smaller principal amount and stretch the financing out longer, thereby building in an implicit coverage factor. For instance, in the "60% pledge case" the State might choose to do a \$342 million Appropriation issue (same par amount that the State would have received in the tax-exempt securitization case) for 40 years. If MSA revenues are low, the State still has a coverage cushion, and if MSA revenues hit "Base Case" there will be considerable annual residuals in each year available to supplement the budget.

FUTURE COMPLIANCE ISSUES WITH THE IRS

The future compliance issues relate to possible arbitrage rebate if the State's cash position is restored at a later date as the economy recovers. This is a specialized area that requires significant tax expertise, so we are not in a position to offer advice to the State. Rather, we are attempting to summarize advice we have gotten in parallel situations.

If the State has done deficit financing (whether Appropriation Bonds or pure tobacco securitization bonds) and later develops large, replenished ending budget cash surpluses, a compliance issue arises as to the use of excess moneys (defined below). The IRS takes the view that a portion of the excess moneys should be used for remedial actions rather than leaving the bonds outstanding at a low tax-exempt rate and having excess moneys earning high taxable rates. Such remedial actions would be either to redeem a portion of the subject debt or to purchase outstanding tax-exempt obligations of other issuers, thus removing an equivalent amount of tax-exempt bonds from the market.

One key compliance issue is to understand the first post-issuance date on which the State is obligated to calculate whether it has excess moneys. Certain bond counsel firms are of the view that this requirement exists each year after issuance. Others take the view that the measurement requirement commences as of the first year in which the issuer's original forecasts contemplated the general of excess moneys (for example, five years after issuance).

The other key compliance issue is to measure the amount of the excess moneys and to decide the subcomponent of the excess moneys that is targeted for remedial action. The following is an example of the methodology used:

- In a particular future fiscal year the State has \$600 million of fiscal year ending General Fund cash available (in an unrestricted manner) for the payment of General Fund operating expenses in the subsequent fiscal year.
- Further, 5% of the prior year's expenditures is \$170 million and that appears to be the proper amount of working capital reserve.
- Finally, the deficit bonds remaining in that future fiscal year are \$400 million.
- In this case there are \$430 million of "excess moneys" available, and the \$400 million subcomponent of the excess moneys equal to the then-outstanding bond principal must be used either to repay all outstanding deficit bonds or to purchase non-AMT tax-exempt municipal bonds.

As a practical matter, this "problem" can be removed in the Appropriation Bond case in a number of ways including:

- Having the first optional call date on the bonds at the date of the first calculation of excess moneys.
- Systematically increasing the amount of State tax revenues that are dedicated towards reducing the large Unamortized Actuarial Liability in the State's pension funds.
- Taking any excess that develops and using it to pay for future capital expenditures that might have otherwise required borrowing.
- Possibly paying off outstanding State of Nevada bond issues, subject to certain possible complications if such action is analyzed as an advance refunding.

In the case where Comstock is the issuer, the State cannot direct Comstock to redeem Comstock's bonds with Comstock's money. That is because any spare money Comstock has is already directed to turbo redemption. As a practical matter, if after the Comstock borrowing the State needs to take remedial action, steps could also include:

- State buys Comstock bonds back on the open market
- In the original Comstock documents State and Comstock agree that Comstock will accept money from the State to prepay Comstock bonds (as allowed under the ordinary call, defeasance, and tender provisions of the Comstock documents) if required for tax compliance
- State buys non-AMT municipal bonds and leave Comstock's tobacco issue untouched.

SUMMARY

This memorandum addressed some key points, for which we state our point-by-point short-form summaries to wrap up:

- When the State is allowed to finance deficits with tax-exempt bonds? Answer: *When it has a forecast operating deficit sufficient to use up the bond proceeds within a three-year temporary period while following a "proceeds spent last" allocation method.*
- What does "maturity" mean in tobacco bond structures? Answer: *There are two "maturities". The scheduled or nominal maturity is usually in the 40-year area; however,*

there will be an additional turbo redemption feature that forcibly channels excess funds above those required for scheduled debt service into additional early redemptions of principal.

- Why do we care about the prior bullet point? Answer: *If we are trying to isolate the benefit of various State of Nevada credit enhancements, we want to make sure that we maintain comparability by having the same "residuals" left over in each case (either Nevada-enhanced or pure tobacco) after the bonds are paid off; therefore we use the turbo redemption debt service as our benchmark.*
- What are the types of security that the State can offer bond holders? Answer: *The State can offer pure tobacco securitizations that offload all future upside and downside of the tobacco industry to holders at a high interest rate; or it can offer low interest rate bonds that are primarily State of Nevada securities, that internally earmark tobacco receipts as the repayment source, and that leave all future upside and downside of the tobacco industry to the State.*
- What are the different rates the State would pay, depending on taxability and security? Answer: *The lowest rates would be for tax-exempt bonds that feature State of Nevada credit enhancement, with all the other securities being higher in yield by roughly 1% to 4% as in table below:*

Extra TIC from Differing Structures

	Tax-Exempt Bond	Taxable Bond
State of Nevada Appropriation Pledge, rated Aa3/AA-	Base Case: 4.78% TIC	+ 2.36%
Tobacco-Secured Only, Rated BBB	+1.28%	+ 3.88%

- What is the amount of proceeds that the State would get? Answer: *Since the proceeds received are nothing more than the present value of the tobacco receipts at different interest rates, the amount received upfront goes up as the State pledges increasing percentages of the tobacco receipts; and the amount goes down as the borrowing rates rise. For any particular percentage of tobacco receipts pledged, the State could think of the tax-exempt Nevada appropriation structure as the 100% case, and of the other three cases suffering a structure or taxability penalty or "haircut" so that the State gets less than 100%:*

Haircuts from Differing Structures

	Tax-Exempt Bond	Taxable Bond
State of Nevada Appropriation Pledge, rated Aa3/AA-	Base Case: 100%	77%
Tobacco-Secured Only, Rated BBB	84%	63%

- What are future compliance issues with the IRS? Answer: *If in the future, the State develops General Fund surpluses that are available for payment of General Fund operating expenditures, deficit bonds are still outstanding, and the surplus exceeds reasonable working capital reserve amounts, the State must take remedial action such as redeeming bonds or investing excess moneys in non-AMT municipal bonds.*

**MINUTES OF THE
SENATE COMMITTEE ON GOVERNMENT AFFAIRS**

**Seventy-second Session
April 7, 2003**

The Senate Committee on Government Affairs was called to order by Chairman Ann O'Connell, at 2:11 p.m., on Monday, April 7, 2003, in Room 2149 of the Legislative Building, Carson City, Nevada. Exhibit A is the Agenda. Exhibit B is the Attendance Roster. All exhibits are available and on file at the Research Library of the Legislative Counsel Bureau.

COMMITTEE MEMBERS PRESENT:

Senator Ann O'Connell, Chairman
Senator Sandra J. Tiffany, Vice Chairman
Senator William J. Raggio
Senator Randolph J. Townsend
Senator Warren B. Hardy II
Senator Dina Titus
Senator Terry Care

GUEST LEGISLATORS PRESENT:

Senator Raymond (Ray) D. Rawson, Clark County Senatorial District No. 6

STAFF MEMBERS PRESENT:

Michael Stewart, Committee Policy Analyst
Scott Wasserman, Committee Counsel
Tara DeWeese, Committee Secretary

OTHERS PRESENT:

Antonio Gutierrez, Legislative Intern, University of Nevada, Las Vegas
Gary Peck, Lobbyist, American Civil Liberties Union of Nevada
Laura M. Mijanovich, Lobbyist, American Civil Liberties Union of Nevada
Gregory Roehm, Sergeant, Nevada Highway Patrol, Department of Public Safety
Mary Wilson, League of United Latin American Citizens, and National Association for the Advancement of Colored People
Marc Ashley, Staff Attorney, Washoe Legal Services
James J. Jackson, Lobbyist, Nevada Attorneys for Criminal Justice
Mark J. Nichols, Lobbyist, National Association of Social Workers-Nevada
Leslie A. Mix, President, Hispanic Chamber of Commerce of Northern Nevada
Joseph H. Edson, Lobbyist, Progressive Leadership Alliance of Nevada
James Martin, President, League of United Latin American Citizens Council 11090
Dana Mathiesen, Deputy Director, Department of Motor Vehicles
Richard P. Clark, Executive Director, Peace Officers' Standards and Training Commission
Stan Olsen, Lobbyist, Las Vegas Metropolitan Police, and Nevada Sheriff's and Chief's Association/South
Michael Cleveland, Lobbyist, Police Officers Research Association of Nevada, and Reno Police

MR. KROLICKI:

We are changing the weekly report to the locals. The State Treasurer would provide the report; since we have the information, we would be the conduit.

MR. FOLEY:

The significance of the first change under section 8, page 7, line 6, is it initially stated the banks holding the collateral must be located within the State of Nevada. We are changing that to be a trust department of a state, national or Federal Reserve Bank, so the banks can be located anywhere within the United States as long as they meet the qualifications.

CHAIRMAN O'CONNELL:

Are you taking out the other language or adding to it?

MR. FOLEY:

We are replacing "trust department of a state or national bank located in this state" with "trust department of state, national or federal reserve district bank." Currently, the state and many municipal accounts are being collateralized whether with the Federal Reserve Banks located in San Francisco or US Bank in Des Moines or Bank of America with the Bank of New York. For them, making the adjustment and locating within the state would be quite a sacrifice and a difficult situation.

MR. KROLICKI:

Those from the banking community and the Nevada Bankers Association are in concurrence with the proposed changes.

CHAIRMAN O'CONNELL:

Since we do not have the language you are taking out of these amendments, can you tell us, are we dealing with the entire sentence?

MR. FOLEY:

The lines that are above in the section, "trust department of a state or national bank located in this state" would be replaced with "trust department."

MR. KROLICKI:

Senate Bill 448 is the tobacco securitization bill. The bill deals with securitization and addresses changes we propose for Millennium Scholarship eligibility. This legislation securitizes half of the Master Settlement Agreement and those monies dedicated to the Millennium Scholarships, the 40 percent portion, and the 10 percent portion attributed to the Trust Fund for Public Health.

It is important to give a context of where we are today with tobacco securitization, and the Master Settlement Agreement. Many things have happened in the last 2 years since we spoke on the subject.

The Master Settlement Agreement (MSA) payments, as projected by the company hired by the National Attorneys General Association, have been reforecast for the next 25 years. Every time there is a securitization, we get new projections. The most recent projection we have is from a deal priced and sold in Virginia; although, because of the situation with Philip Morris and other tobacco market factors, the deal was pulled back. The offer was pulled from the market because the Illinois case severely affected Philip Morris. The new numbers with the Virginia transaction reduced the next 4 years of MSA payments by an average of 8 percent, which affects the projection made 2 weeks ago we thought we would be getting for the next 4 years.

Tobacco money now constitutes a cottage industry for the states, which we talked about 2 years ago; it is

now a \$20 billion industry. In the booklet (Exhibit K. Original is on record in the Research Library.), we report \$20 billion in bonds have been sold. The most important thing to note is a case in Illinois, where Philip Morris was assessed a judicial penalty of \$10 billion and required to post a \$12 billion bond to appeal the decision. Philip Morris has indicated it is likely they would be unable to post the bond and suggested the possibility of bankruptcy. On April 15 the four companies make their payments and we receive our annual portion of the tobacco settlement. Philip Morris suggested their \$16 million contribution due Nevada on April 15 is in jeopardy; Philip Morris's contribution represents over 50 percent of the MSA payment. Since we did not securitize 2 years ago, we have lost an opportunity cost of over \$100 million. We were looking at a \$450 million securitization proceed pile when we originally talked about all of the money, not just half as this bill is asking. Today, the number would be about \$350 million, so we have left over \$100 million on the table.

The changes proposed in the MSA monies we receive, regardless of securitization, substantially and materially affects the testimony I gave to the Board of Regents 2 weeks ago. Within 2 weeks the ability to fund the Millennium Scholarships, as currently comprised, dramatically slipped from fiscal year 2009 to 2006. We believe we have lost 3 years in the ability to fund the Millennium Scholarships unless the numbers change. If we were to securitize as we had suggested 2 weeks ago, we would be able to sustain the Millennium Scholarships until 2016 without requiring assistance from the General Fund. Now with securitization we are looking at a 2013 sunset.

CHAIRMAN O'CONNELL:

Are you talking about help to the drug situation with this money? Is that money protected?

MR. KROLICKI:

The money is not protected. Again, fully complying with the MSA, these numbers are affected by consumption rates. If Philip Morris does not make its payment on April 15, half of our annual money will not arrive. Senior Rx and everything we fund with the MSA payments are in jeopardy. They could make a late payment with penalties. We have been working with the Attorney General's Office to make sure we collect the penalties, but the Illinois case is troublesome because it is only a small jurisdiction assessing a \$10 billion damage award for the company's light cigarettes. The abilities around this country to pursue similar cases are great.

CHAIRMAN O'CONNELL:

With every state looking for new revenue, including raising cigarette taxes, will that have an effect as far as the tobacco companies' sales?

MR. KROLICKI:

The elasticity of the drug market is probably greater than many commodities, but the higher you raise the price, the less people will smoke. Regardless of the tax plans I have seen, we are looking to raise the tobacco tax by two or three times. Last fiscal year we received \$47 million from tobacco excise taxes. If doubled or tripled, we would receive \$150 million. Add the MSA payments of between \$40 million and \$50 million. Tobacco would generate close to \$200 million for Nevada. It is an untenable position. We now have 45 attorneys general in the United States trying to obtain leniency for Philip Morris so the company can make its April 15 payments. We should do everything we can to diversify ourselves from this revenue source.

SENATOR RAGGIO:

We supported this in the last session, and it died in the Assembly. On page 16 (Exhibit K), apparently you mentioned Virginia, California, and Missouri have abandoned or postponed utilization of the process?

MR. KROLICKI:

I do not believe they will, because of the uncertainty in the marketplace, and the potential bankruptcy of Philip Morris.

SENATOR RAGGIO:

If we pass S.B. 448, where are we? Do we wait and see whether or not we can realize the kind of revenue we anticipate from securitization?

MR. KROLICKI:

We have grappled with that question in the Treasurer's Office and in discussion with the Governor's Office, especially as it relates to the Millennium Scholarships. It is a tragedy not to have these potential resources available to the citizens of Nevada. I would not securitize right now, because it is too expensive and the market is not right. However, I would hope to have the ability in statute to proceed with securitization, should the market recover sufficiently. One of the amendments we would propose is a sunset clause or State Board of Finance or Interim Finance Committee approval, if that gave some comfort. We need the ability to move on behalf of Nevada should a second opportunity arise.

SENATOR TIFFANY:

Do we have enough money in the bank today to cover the Millennium Scholarship youths now in college for 4 years?

MR. KROLICKI:

Assuming the four tobacco companies perform under the MSA, yes.

SENATOR TIFFANY:

No, with what we have now excluding future MSA payments.

MR. KROLICKI:

The trust fund has approximately \$15 million and added to the payments we will receive April 15, we will only have enough money to fulfill next year's obligation.

SENATOR TIFFANY:

What is each year's obligation?

MR. KROLICKI:

It is hard to get an accurate number of students who will be utilizing the scholarship, but it is about \$20 million to \$23 million each year. The amount can grow, but those are the projections we have.

SENATOR TIFFANY:

Without the payments on April 15, we could not meet our obligation. What is the state's obligation to the Millennium Scholarships? Would we need to use General Fund money?

MR. KROLICKI:

There is no obligation from the General Fund. The funding comes completely from the settlement.

Look at it from a cash management side. If we are short, we could still fulfill much of the obligation. If Philip Morris is unable to make its payment, perhaps they can come up with some remedy in 120 to 180 days to comply with the MSA. The problems presented to us prove why we should have the ability to securitize.

SENATOR TIFFANY:

Many scenarios could occur to negatively affect the state's ability to continue the scholarship. I am not advocating we do not continue, but I see potential problems in the future.

SENATOR CARE:

More than a dozen states have appeal bond caps, which we did this last session. As more states enact caps, the market would stabilize to some degree and it may improve conditions. I cannot see the damage awards from the Illinois case being upheld on appeal. Posting the bond is the problem. If the remaining states did what we did a few years ago, would it have an impact on the market?

MR. KROLICKI:

Illinois faced the same question and chose not to reduce the bond; it was denied in committee. The situation continues to linger out there because now they have to go back to the same court that did not grant them the original relief. At some point in time these companies cannot sustain judgments of a substantial size and volume. If you look at the 4 states that settled separately and the 46 states constituting the MSA at almost a quarter of a trillion dollars, how many industries can have a quarter-trillion dollar assessment and still meet ongoing concerns? The tobacco industry could probably do another settlement that size and still be viable, but at some point in time, especially when not paid over 25 years, they cannot perform. We are in the awkward position of protecting these companies many of us try to drive out of business. It is a very precarious situation and rank with hypocrisy.

SENATOR TITUS:

I recently read an article in *The New York Times* stating there are some hidden costs. If you remember, I am one of the people who voted against securitization last time. I seem to have more ammunition to vote against it this time. Maybe you could address some of these things. According to the article:

While it may be sound public policy to sell a risky asset, the relative price associated with such a sale must be taken into consideration and compared to the risks associated with the

tobacco receipts before the value of such a trade can be determined. Based on our analysis, we have found that issuing tobacco bonds can cost a state or local government 250 to 500 basis points of added interest costs versus a traditional state [general obligation] GO or appropriations back financing ... Although transferring the risk associated with receiving tobacco receipts could have merit, the current costs of such a transfer is quite staggering and may not justify such a transaction, particularly given the other revenue other state and local governments receive from taxing cigarette sales.

Third, another rationale for raising funds through the sale of tobacco receipts is that such a transaction might not adversely affect a state or local government's bond rating. Those expressing this view argue that tobacco bonds are nonrecourse obligations and as such should be excluded from any analysis of the trustworthiness of the recipient. Although this concept is great in theory, the actual results have been to the contrary. The issuance of tobacco bonds is often viewed as an indication that a state or local government has run out of options and is now desperately selling its tobacco receipts as a last resort approach to filling a budget gap, as a result several states which have issued tobacco bonds have either been downgraded or are currently on a credit watch.

MR. KROLICKI:

I agree with everything you just read, although several things need to be placed in perspective. One is "running out of options." It is a tremendous fiduciary failure for states and local jurisdictions to sell this 20- to 30-year revenue to balance today's budget. We have seen many states do that as with the just-postponed California deal worth a couple of billion dollars of tobacco bonds. We are not proposing this method here.

Assembly Joint Resolution (A.J.R.) 10 is another piece of legislation from the State Treasurer's Office which is a constitutional amendment to preserve settlement monies for their originally intended purposes, education and health care.

ASSEMBLY JOINT RESOLUTION 10: Proposes to amend Nevada Constitution to provide requirements for use of proceeds from certain settlement agreements and civil litigation between State of Nevada and manufacturers of tobacco products and to provide for sale of right to receive those proceeds. (BDR C-300)

MR. KROLICKI:

If we were to securitize and we have bond proceeds, assuming the market was there, you could only withdraw 15 percent of those proceeds on an annual basis. By putting a speed limit on the proceeds, you could not raid the money to balance your budget because it would take too long. I agree with you on the price of the sale. Some states, Wisconsin in particular, desperately needed funds within weeks to balance their budgets last year, and they paid the price. If the market knows you are desperate, it will take advantage of you.

We are not in a desperate situation, we are trying to preserve a resource. We do not want to pay too much cost in issuance of the coupon on the bond. As I said earlier, if I had to do it tomorrow, I would not because it is too expensive. There is a saturation point, whether it is Wisconsin, New York, California, or Nevada, the credit still belongs to four tobacco companies. At some point in time, the insurance companies and asset managers who buy the risk for their portfolios might reach a point where there is more supply than demand. This has already occurred with many states abusing what these monies were intended to do originally. Nevada has been one of the better states in terms of utilizing these monies, particularly for health care at 60 percent.