

## BUCKEYE TOBACCO SETTLEMENT FINANCING AUTHORITY

### Minutes of June 9, 2011 Meeting

The Buckeye Tobacco Settlement Financing Authority (the Authority) held a meeting commencing at 3:30 p.m. on Thursday, June 9, 2011, in the 35th Floor Conference Room, Office of Budget and Management, James A. Rhodes State Office Tower, 30 East Broad Street, Columbus, Ohio, pursuant to notice of meeting given by the Secretary of the Authority pursuant to section 4.2 of Bylaws.

[Copies of the items marked \* are attached hereto and made a part of these minutes.]

The Chairman called the meeting to order.

Mr. Kauffman, as Assistant Secretary, reported that new designations of Michael Grodhaus and Diane Brey, in the alternative, for the Governor; Seth Metcalf and Joe Acquilino, in the alternative, for the Treasurer of State; and Kurt Kauffman and Larry Scurlock, in the alternative, for the Director of Budget and Management, pursuant to Section 183.52 of the Revised Code, were filed since the last meeting of the Authority.

Pursuant to Section 3.1 of the Bylaws, Mr. Grodhaus presided as Chair of the meeting. Upon roll call, the Chairman declared a quorum to be present. The following member and designees of the Authority, eligible to vote at the meeting, were present:

Michael Grodhaus, Office of the Governor

Seth Metcalf, Treasurer of State

Timothy S. Keen, Director of Budget and Management

Also present were Kurt Kauffman (Assistant Secretary), Gordon Short, Joe Aquilino, Heather Menze and Dana Wasserman (Treasurer's office), Larry Scurlock and John Sohner (Office of Budget and Management), Greg Stype (Squire Sanders & Dempsey), Bill Kennedy (Kennedy Cottrell Richards), and Scott Miller (U.S. Bank).

The Assistant Secretary filed the certificate\* of compliance with the public meeting notice provisions of Section 121.22 of the Revised Code.

After discussion, Mr. Grodhaus moved, seconded by Mr. Keen, to approve the minutes of the June 24, 2010 Authority meeting based on the attestation as to the accuracy of their contents (since none of the current members or designees were members or designees in 2010) by the Assistant Secretary who was present at that meeting. There being no discussion, the motion was approved upon roll call as follows: Ayes – Grodhaus, Keen, Metcalf; Nays – None. The Chair declared the motion passed.

Mr. Kauffman provided an overview of the role of the Authority's staff in the financial statement preparation and audit process and presented a brief summary of FY 2010 audit results and timeline for preparing the FY2011 financial statements.\* Mr. Keen asked for clarification on the financial activity for which the Authority is responsible. Mr. Kennedy confirmed that the Authority's financial responsibility is to manage the reserve fund, collect Master Settlement Agreement (MSA) payments, to prepare annual financial statements, and to pay all operating costs associated with the Authority's activities. Mr. Kauffman noted that MSA payments are distributed directly to U.S. Bank, as Bond Trustee.

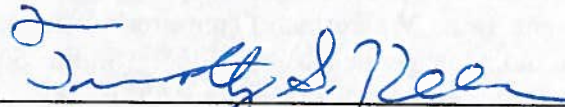
Mr. Kauffman then presented an update on the tobacco settlement receipts (TSRs) received in calendar year 2011\*. He explained that 2011 is the first year in which TSRs in conjunction with

interest earnings on the reserve fund and other pledged accounts are expected to be insufficient to fully pay the annual debt service. The likely consequence of the debt service shortfall is a tapping of the senior liquidity reserve fund in the amount of the shortfall (approximately \$7 million). Mr. Keen asked if there is a requirement to replenish the draw on the reserve fund. Mr. Kauffman explained that the flow of funds includes replenishment of the reserve fund from annual TSRs once operating expenses and debt service for that year have been funded and before any excess TSRs would be used to fund turbo redemption payments. Mr. Keen also asked if the numbers in the table are actuals or estimates for calendar year 2011. Mr. Kauffman explained the TSRs and debt service payments are actual figures, however the interest earnings are estimates, given the calendar year is not complete.

Mr. Short then presented an analysis of various investment options for the senior liquidity reserve fund.\* He noted that the reserve fund is currently invested in low interest commercial paper maturing at each distribution date. Mr. Short said his office is evaluating alternative investment strategies, including investing a portion of the reserve over a longer time horizon, while remaining sensitive to the liquidity requirements. After some discussion regarding timing and necessary authorizations for those investments, Mr. Keen said he appreciated the Treasurer's efforts in this area.

Mr. Scurlock then presented the Authority's operating budget for fiscal year 2011 and its proposed budget for 2012. He began by reviewing the fiscal year 2011 year-to-date expenses, noting a slight negative variance from the budgeted amount. Mr. Scurlock also explained that the budget for fiscal year 2012, for the first time, includes an amount (\$159,100) for enforcement expenses of the Attorney General office.

There being no further business, the meeting was adjourned.



Timothy S. Keen, Secretary  
Buckeye Tobacco Settlement Financing Authority



## THE BUCKEYE TOBACCO SETTLEMENT FINANCING AUTHORITY

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**JOSH MANDEL, TREASURER**  
TREASURER OF STATE

**JOHN R. KASICH, CHAIRMAN**  
GOVERNOR

**TIMOTHY S. KEEN, SECRETARY**  
DIRECTOR OF BUDGET AND MANAGEMENT

### **CERTIFICATION REGARDING NOTIFICATION OF MEETING TO THE PUBLIC AND NEWS MEDIA**

The undersigned, Assistant Secretary of the Buckeye Tobacco Settlement Financing Authority, hereby certifies that the notice of the time, place and purposes of the meeting of the Authority of June 9, 2011 at 3:30 p.m. was posted on Tuesday, June 7, 2011 in the State House press room, the Office of Budget and Management (34<sup>th</sup> Floor, 30 East Broad Street), and the Office of the Treasurer of State (9<sup>th</sup> Floor, 30 East Broad Street), all in accordance Section 121.22 of the Revised Code and the Open Meetings Rule for notification of meetings to the public and news media adopted by the Authority July 2, 2007.

Dated: June 7, 2011

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Kurt Kauffman  
Assistant Secretary of the  
Buckeye Tobacco Settlement Financing Authority



June 9, 2011

TO: Members of the Buckeye Tobacco Settlement Financing Authority and their designees

John R. Kasich, Governor  
Josh Mandel, Treasurer of State

Mike Grodhaus  
Seth Metcalf

FROM: Timothy S. Keen, Secretary, Buckeye Tobacco Settlement Financing Authority

SUBJECT: **Meeting on Thursday, June 9, 2011, at 3:30 p.m. in Conference Room A of the Office of Budget and Management (35<sup>th</sup> Floor, Rhodes State Office Tower)**

Pursuant to the Bylaws of the Buckeye Tobacco Settlement Financing Authority, I am notifying you of the meeting of the Authority to be held on Thursday, June 9, 2011, commencing at 3:30 p.m. in Conference Room A of the Office of Budget and Management (35<sup>th</sup> Floor, Rhodes State Office Tower, 30 East Broad Street, Columbus, Ohio). Staff will present an overview of the Authority's fiscal year 2010 audited financial statements, its fiscal year 2011 and proposed fiscal year 2012 operating budgets, and the status of tobacco settlement receipts and debt service payments for calendar year 2011. The Treasurer of State's office will present information on current and potential investments for the Senior Liquidity Reserve Fund.

Enclosed are a meeting agenda, the June 24, 2010 meeting minutes, copies of the fiscal year 2010 audited financial statements, and the operating budget for fiscal years 2010 and 2011, all as referred to in that agenda.

If you or members of your staff have any questions, please contact me or Kurt Kauffman of my staff at 466-0691.

cc. Mike DeWine, Attorney General  
Joe Aquilino, Director of Debt Management Office, Treasurer of State  
Larry Scurlock, Asst. Debt Manager, Office of Budget and Management



**BUCKEYE TOBACCO SETTLEMENT FINANCING AUTHORITY**  
**STAFF PRESENTATION**  
**June 9, 2011**

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FY2010 Financial Statement Preparation

- Preparation of the FY2010 financial statements began in July and ran through August.
- Staff and U.S. Bank (bond trustee) provided Kennedy Cottrell Richards (KCR) with the information, account statements and reports needed to compile the financial statements.
- Once the financial statements were compiled, OBM and TOS met with KCR to review and verify all cash based numbers in the report and examine all line-items that experience a variance of 5% or more from its prior fiscal year value.
  - Moving forward, AOS recommends that one or more BTSFA members be directly involved in this review of the financial statements and that any changes or comments be documented.

FY2010 Audit Process and Results

- Conducted by the Auditor of State from late August through early October.
- The FY2010 Audit Opinion was ‘unqualified’ and the financial statements were found to present fairly, in all material aspects, the financial position of the Authority in accordance with Generally Accepted Accounting Principles.
- With respect to internal controls, the Audit did not identify any significant deficiencies or material weaknesses in internal controls over financial reporting.
- In regard to compliance, the Audit did not identify any instances of noncompliance with material laws and regulations impacting the Authority.
- The FY2010 Audit did not include a Management Letter.

FY2011 Financial Statement Preparation and Audit Timeline

- Under the reporting requirements of the American Recovery and Reinvestment Act of 2009, the timeline for the State’s CAFR and, thus, the timeline for completion of the Authority’s FY2011 audited financial statements was accelerated.
- Financial Statements are scheduled to be completed and submitted to the Auditor of State on or before August 12, 2011. The audit of those financial statements and the audit opinions must be submitted to OBM by September 30, 2011. No extensions will be granted.



## 2011 Tobacco Settlement Receipts versus Debt Service Requirements

*\$ in Millions*

Calendar Year (CY)	MSA Payments to Ohio	Interest Earnings (Reserve Fund)	Total Pledged Funds	Debt Service Payments	Shortfall
2008	\$333.13	\$22.38	\$355.52	\$352.70	--
2009	\$364.88	\$5.35	\$370.23	\$367.89	--
2010	\$305.56	\$1.74	\$307.30	\$305.98	--
2011 est.	\$289.29	\$1.70	\$290.99	\$297.75	\$6.76

- Pledged Tobacco Settlement Receipts (TSRs) for CY 2011 totaled \$289.29 million, a decline of 5.3% from CY 2010 TSRs of \$305.56 million.
  - The decrease in CY2011 TSRs is attributable primarily to a 6% decline in domestic cigarette consumption in 2010 and the decision by Philip Morris USA to deposit, for the first time, a portion of its MSA payment into the Disputed Payment Account.
  - These negative factors were mitigated by the inflation adjustment component of the MSA payment formula.
  
- The lower TSRs combined with low prevailing interest rates on investable balances are currently expected to result in a shortfall of about \$7.0 million on the December 1, 2011 interest payment.
  - The senior liquidity debt service reserve fund (\$389.2 million balance) will be tapped to cover the amount of the shortfall.
  - Tapping the debt service reserve fund ensures bondholders will receive their full payment on schedule and is not an event of default.
  - There is no recourse to the State budget for this shortfall.
  
- Amounts potentially due and payable to Ohio (and pledged to the BTSFA bond holders) on deposit in disputed accounts or withheld is \$105.8 million.
  - Resolution of disputed and withheld amounts is currently the subject of arbitration related to the Non-Participating Manufacturer (NPM) adjustment included in the MSA payment formula.
  - The NPM adjustment is disallowed if States can demonstrate ‘diligent enforcement’ of their qualifying statutes that require NPMs to make escrow deposits analogous to the MSA required payments.
  - The arbitration process is beginning with NPM adjustments for 2003 (reflected in the April 2006 payment). Resolution is not expected to occur prior to CY 2012.



**JOSH MANDEL**  
STATE TREASURER OF OHIO

# **Buckeye Tobacco Settlement Financing Authority**

Review of Investment Options for the  
Senior Debt Liquidity Reserve Account



# JOSH MANDEL

STATE TREASURER OF OHIO

## Considerations in Choosing BTSFA Investments

- Future rising interest rate environment
- Rating agencies acceptance of investments
- Counterparty risk
- Liquidity needs
- Return to bondholders
- Concentration of Credit Risk





**JOSH MANDEL**  
STATE TREASURER OF OHIO

## Limitations on Investments

(Per the Trust Agreement dated 10/1/2007)

- Eligible investments must generally mature or be redeemable on or before the Business Day preceding each distribution date (e.g., every June 1 and December 1)
- Investments are marked-to-market, therefore, decreases in investment value could require diverting MSA payments to replenish the reserve fund



**JOSH MANDEL**  
STATE TREASURER OF OHIO

# Considered Investment Options

- Reserve Fund CD
- Commercial Paper
- Interest Rate Swap



# JOSH MANDEL

## STATE TREASURER OF OHIO

### Reserve Fund CD

Acts as a normal Certificate of Deposit with terms not to exceed 5 years and paying interest semiannually.

#### Pros

- Shorter term limits interest rate risk
- Prepayment waiver is available to enable payment of debt service
- Maximum maturity of up to 5 years
- Pays interest semiannually
- Higher rate of return than commercial paper

#### Cons

- Locking into a rate could be detrimental in a rising rate environment
- Shorter term would equate to a lower rate
- Prepayment waiver will reduce the rate paid on the CD
- Credit risk in the issuer of the CD
- FDIC insurance only up to \$250K
- Need acceptance by ratings agencies



# Standalone Commercial Paper

## Pros

- Very safe, highly rated companies
  - *S&P A-1/Moody's P-1 /Fitch F1*
  - State approved issuers list
- Typically higher yields than equivalent agency and Treasury debt
- Diversification of credit risk

## Cons

- Lower rate of return than Reserve Fund CD
- Unsecured debt



## Interest Rate Swap

Enhancement in addition to other eligible investments. The BTSFA *receives* a fixed a rate of return and *pays* a counterparty a variable rate (e.g. LIBOR) plus a fixed spread.

### Pros

- Fixed payment to the BTSFA could be higher than that of eligible investments
- Variable index rates could fall, reducing the variable payment
- Permits liquidity of underlying investments

### Cons

- A rise in long-term rates could make the fixed interest rate less attractive
- BTSFA could owe payment upon termination
- Longer-term commitment (generally 20-30 years)
- Adding flexibility to the terms will decrease the fixed rate



**JOSH MANDEL**  
STATE TREASURER OF OHIO

# Proposed Strategy for Future BTSFA Reserve Fund Investments

Safely increase return to bondholders in a rising rate environment

Combination of Investments :

- Investment options are not mutually exclusive. A combination of different investments could provide diversification and higher returns while meeting the liquidity needs of the fund
  - Example:
    - \$189M in Reserve Fund CD
    - \$200M in commercial paper
      - Combined with an interest rate swap