

TOBACCO SETTLEMENT
FINANCING CORPORATION

Financial Statements

June 30, 2018

(With Independent Auditors' Report Thereon)

TOBACCO SETTLEMENT FINANCING CORPORATION

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INDEPENDENT AUDITORS' REPORT

The Board of Directors
Tobacco Settlement Financing Corporation:

Report on Financial Statements

We have audited the accompanying financial statements of the governmental activities and the governmental fund of Tobacco Settlement Financing Corporation (a component unit of the State of Rhode Island) (the Corporation) as of and for the year ended June 30, 2018, and the related notes to financial statements, which collectively comprise the Corporation's basic financial statements as listed in the table of contents

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express opinions on these financial statements based on our audit. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and those standards applicable to financial audits contained in Government Auditing Standards, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinions.

Opinions

In our opinion, the financial statements referred to above present fairly, in all material respects, the respective financial position of the governmental activities and the governmental fund of Tobacco Settlement Financing Corporation as of June 30, 2018, and the respective changes in financial position and, where applicable, cash flows thereof for the year then ended in accordance with accounting principles generally accepted in the United States of America.

Other Matters

Required Supplementary Information

Accounting principles generally accepted in the United States of America require that the management's discussion and analysis on pages 4 through 11 be presented to supplement the basic financial statements. Such information, although not a part of the basic financial statements, is required by the Governmental Accounting Standards Board, who considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context. We have applied certain limited procedures to the required supplementary information in accordance with auditing standards generally accepted in the United States of America, which consisted of inquiries of management about the methods of preparing the information and comparing the information for consistency with management's responses to our inquiries, the basic financial statements, and other knowledge we obtained during our audit of the basic financial statements. We do not express an opinion or provide any assurance on the information because the limited procedures do not provide us with sufficient evidence to express an opinion or provide any assurance.

Other Information

Our audit was conducted for the purpose of forming opinions on the financial statements that collectively comprise Tobacco Settlement Financing Corporation's basic financial statements. The supplemental information as listed in the table of contents is presented for purposes of additional analysis and is not a required part of the basic financial statements.

The supplemental information is the responsibility of management and were derived from and relates directly to the underlying accounting and other records used to prepare the basic financial statements. Such information has been subjected to the auditing procedures applied in the audit of the basic financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the basic financial statements or to the basic financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States of America. In our opinion, the supplemental information is fairly stated, in all material respects, in relation to the basic financial statements as a whole.

Other Reporting Required by Government Auditing Standards

In accordance with Government Auditing Standards, we have also issued our report dated December 19, 2018, on our consideration of the Corporation's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, grant agreements and other matters. The purpose of that report is solely to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with Government Auditing Standards in considering the Corporation's internal control over financial reporting and compliance.

EFPR Group, CPAs, PLLC

Williamsville, New York
December 19, 2018

Tobacco Settlement Financing Corporation

Management's Discussion and Analysis Fiscal Year Ended June 30, 2018

Management's discussion and analysis (MD&A) provides a narrative overview and analysis of the financial activities of the Tobacco Settlement Financing Corporation (hereinafter referred to as "TSFC" or the "Corporation") for the fiscal year ended June 30, 2018. MD&A is intended to serve as an introduction to the Corporation's basic financial statements, which have the following components: (1) government-wide financial statements, (2) fund financial statements, and (3) notes to the financial statements. The MD&A is designed to (a) assist the reader in focusing on significant financial matters, (b) provide an overview of the Corporation's financial activities, and (c) highlight individual fund matters. The following presentation is by necessity highly summarized, and in order to gain a thorough understanding of the Corporation's financial condition, the following financial statements, notes and supplementary information should be reviewed in their entirety.

The Tobacco Settlement Financing Corporation (TSFC) was created in 2002 as a public corporation, having a distinct legal existence from the State of Rhode Island (the "State") and not constituting a department of State government. The TSFC was created to finance the acquisition from the State of the State's right, title and interest and in the State's right to receive the moneys due under and pursuant to (i) the Master Settlement Agreement (MSA), dated November 23, 1998, among the attorneys general of 46 states, the District of Columbia, the Commonwealth of Puerto Rico, Guam, the U.S. Virgin Islands, American Samoa and the Territory of the Northern Marianas and Philip Morris, Incorporated, R.J. Reynolds Tobacco Company, Brown & Williamson Tobacco Corporation and Lorillard Tobacco Company and (ii) the Consent Decree and Final Judgment of the Rhode Island Superior Court for Providence County dated December 17, 1998, as the same has been and may be corrected, amended or modified, in the class action styled State of Rhode Island v. American Tobacco, Inc., et al. (Docket No. 97-3058), including, without limitation, the rights of the State to receive the moneys due to it thereunder.

It should also be noted that while attempts have been made to disclose pertinent risk factors, it is difficult to capture all current litigation and other proceedings relating to the Master Settlement Agreement, and the reader should not rely upon management's discussion contained herein when making investment decisions.

The Corporation issued \$685,390,000 of its Tobacco Settlement Asset-Backed Bonds, Series 2002A in June 2002, which were fully redeemed on March 19, 2015.

In June 2007, the Corporation issued \$197,005,742 of its Tobacco Settlement Asset-Backed Bonds, Series 2007A, B and C, which were structurally subordinate to the payment in full of the 2002 Series Bonds. The Trustee was entitled to receive the "Residual" tobacco settlement revenues pledged to pay the 2007 Series A, B and C Bonds upon full payment of the 2002 Series A Bonds.

On March 19, 2015 the Corporation issued \$620,935,000 of Tobacco Settlement Asset-Backed Bonds that bear interest at annual rates ranging from 0.590% to 5.000% and mature in varying amounts through June 1, 2050. The proceeds of this issuance, along with the release of debt service reserve funds related to the bonds retired and the proceeds received for early termination of investment contracts, were used to fully redeem the 2002 Series bonds and repurchase and retire the principal amount of \$76,220,155 of the 2007 Series bonds, as well as pay accreted interest of \$13,600,495 on the retired 2007 Series bonds. The remaining 2007 Series A and B bonds (all Series C bonds were repurchased and retired with proceeds from the 2015 issuance) are structurally subordinate to the payment in full of the 2015 Series bonds.

As more fully discussed in Note 4 of the Notes to Financial Statements, the States settled an NPM Adjustment dispute for calendar year 2015, incorporated into the final NPM Adjustment Settlement Agreement implementing the Settlement Term Sheet. A total of \$2,890,371 was received with the April 2018 disbursement.

All of the bonds are payable both as to principal and interest solely out of the assets of the Corporation pledged for such purpose, and neither the faith and credit nor the taxing power of the State of Rhode Island or any political subdivision thereof is pledged to the payment of the principal of or the interest on the bonds. The bonds do not constitute an indebtedness of or a general, legal or "moral" obligation of the State or any political subdivision of the State.

Tobacco Settlement Financing Corporation

Management's Discussion and Analysis Fiscal Year Ended June 30, 2018

Financial Highlights

Future revenues continue to be threatened by factors discussed under "Risk Factors and Future Revenue" and the "Economic Outlook" sections of this MD&A.

The following are the key highlights from the government-wide financial statements:

- The liabilities of TSFC exceeded its assets at June 30, 2018 by \$723,264,668. This occurred primarily because no receivables for future revenues were recognized at June 30, 2018, except for one-half of the estimated Tobacco Settlement Revenues (TSR's) to be received in April 2019, for calendar year 2018. Please see Note 1 of the Notes to Financial Statements for a description of the Corporation's revenue recognition policy. This deficiency decreased by \$11,926,008 from June 30, 2017. The decrease in the net deficiency is primarily due to TSR revenue and investment income exceeding interest expense, including accreted interest due in the future.
- Revenues, consisting of TSRs and investment income amounted to \$46,777,377 for fiscal year 2018. This compares to \$30,521,474 for fiscal year 2017, an increase of \$16,255,903. This increase was mainly attributable to settlement credits of \$16,866,135 deducted from the annual MSA payment in the prior year.
- Expenses amounted to \$34,851,369 for fiscal year 2018. This compares to \$37,129,175 for fiscal year 2017. The decrease was related to various professional fees incurred in connection with the DPA settlement in the prior year.
- The Corporation had \$20,535,000 in redemptions of outstanding bonds during the fiscal year consisting of \$10,315,000 of turbo redemptions and \$10,220,000 of scheduled redemptions. See Note 3 of the Notes to Financial Statements.

Disputed Payments Account Settlement & Early Extinguishment of Debt

On March 24, 2017, the Rhode Island Attorney General (the "Attorney General") announced that his office had reached a settlement in principle with various tobacco manufacturers over disputed payments for the years 2004 through 2014 under the Master Settlement Agreement (the "MSA") among such tobacco manufacturers (the "Participating Manufacturers" or "PMs") and certain participating states (each an "MSA State") including the State of Rhode Island ("Rhode Island" or the "State"), eliminating a potential liability to the State of over \$500 million. Disputed payments arose from a provision in the MSA that allows the PMs to withhold a portion of the annual distribution to the MSA States if certain conditions are met. Under the MSA, the MSA States have certain obligations to diligently enforce certain state statutes with respect to tobacco manufacturers that are not signatories to the MSA (the "Non-participating Manufacturers", or "NPMs"). If the PMs decide to dispute an MSA State's diligent enforcement of such statutes, the PMs may deposit a portion of their annual distribution to such MSA State (the "MSA Payment") into a disputed payments account for such MSA State until the dispute is adjudicated. The PMs have annually disputed each MSA State's diligent enforcement actions. The State has always and continues to maintain that it diligently enforces its applicable statutes against the NPMs. Under the terms of the multistate settlement with the PMs (the "Settlement Term Sheet"), settling MSA States received an upfront payment of 54 percent of the disputed payments deposited by the PMs in the settling MSA State's disputed payments account for the years 2004-2014.¹ The PMs receive the remaining 46 percent in the form of credits taken against the MSA payments due to the settling MSA States in payment years 2017 through 2021. Under the Settlement Term Sheet, the PMs also would not place into the disputed payment accounts certain amounts with respect

¹ 24 settling MSA States other than Rhode Island and Oregon settled their claims in respect to the disputed payments for the years 2003 through 2014. Rhode Island's settlement did not include year 2003 because the PMs issued an order of "no contest" for Rhode Island during the 2003 Arbitration. This meant that the PMs decided not to pursue its diligent enforcement claims against Rhode Island for 2003.

Tobacco Settlement Financing Corporation

Management's Discussion and Analysis Fiscal Year Ended June 30, 2018

to payment years 2017 through 2021 (reflecting certain disputed amounts relating to years 2014 through and including 2020) that would otherwise be deposited into the disputed payment accounts and not paid to the MSA States if the MSA States did not join the Settlement Term Sheet. A final comprehensive agreement ("the Settlement Agreement") was fully executed in the fall of 2017 by the signatory PMs and 26 MSA States.²

Because the State had assigned all revenues from the MSA to the Tobacco Settlement Financing Corporation ("TSFC"), which in turn used those committed revenues to secure its bonds, the TSFC was required to seek bondholder approval before the State could enter into the Settlement Term Sheet. A consent solicitation process was conducted in March 2017 and the requisite approvals from bondholders were received as of March 17, 2017. Upon receipt of the bondholder approvals, the Attorney General signed a joinder letter joining the multistate settlement. Rhode Island's joinder letter became effective upon written approval of the Participating Manufacturers on April 3, 2017.

As a result of the State joining the Settlement Term Sheet, in April of 2017, the Trustee for the TSFC received a payment from the PMs of \$82,173,014. This payment was comprised of a \$31,056,599 2017 MSA payment by the PMs and a \$51,116,414 transfer from the State's Disputed Payments Account. As noted above, the Participating Manufacturers will receive credits through 2021. The largest credits were taken against the State's 2017 MSA payment. As a result, the expected 2017 MSA payment of \$47,922,735 was reduced by credits totaling \$16,866,135, resulting in a net 2017 MSA payment of \$31,056,599. The 2018 MSA payment of \$47,719,663 was reduced by credits totaling \$1,803,448, resulting in a new 2018 MSA payment of \$45,916,215.

Over the next three years, the credits are expected to be offset almost entirely by additional payments resulting from the multistate settlement that would otherwise have been deposited in the disputed payments account.

Bonds issued by the TSFC in 2007 (the "2007 TSFC Bonds") and in 2015 (the "2015 TSFC Bonds" and collectively with the 2007 TSFC Bonds, the "TSFC Bonds") remain outstanding. Pursuant to the indentures governing the TSFC Bonds, as amended during the 2015 refunding of the 2002 bonds, the State was entitled to receive 30 percent of the State's disputed payments on deposit in the State's disputed payments account as of the date of issuance of the 2015 TSFC Bonds, with the remaining 70 percent to be used to redeem \$212,160,000 (future value) of the Series A component of the 2007 TSFC Bonds (the "2007 Series A TSFC Bonds"). The disputed payments deposited after the date of issuance of the 2015 TSFC Bonds would be applied to pay debt service due on the 2015 TSFC Bonds in accordance with the terms of the indentures governing the TSFC Bonds. Of the \$51,116,414 received from the disputed payments account in April 2017, \$38,276,966 was on deposit in the State's disputed payments account as of March 19, 2015, the date of issuance of the 2015 TSFC Bonds, and the balance of \$12,839,450 was deposited after that date. The State received \$11,483,090 or 30 percent of the \$38,276,966 on deposit as of March 19, 2015. After payment of costs associated with the consent solicitation process and other transaction related costs, the net transfer to the State in May 2017 was \$10,360,190.

Overview of the Financial Statements

This discussion and analysis is intended to serve as an introduction to the Corporation's basic financial statements. The basic financial statements include three components:

1. Government-wide financial statements
2. Fund financial statements
3. Notes to the financial statements

This report also contains other supplementary information in addition to the basic financial statements.

² There are currently 36 State signatories to the Settlement Agreement, subject to each State's respective joinder letters. The NPM Adjustment Arbitration regarding calendar year 2004 remains ongoing with non-settled States.

Tobacco Settlement Financing Corporation

Management's Discussion and Analysis Fiscal Year Ended June 30, 2018

Government-wide Financial Statements

The government-wide financial statements provide a broad view of the Corporation's finances. The statements provide both short-term and long-term information about the Corporation's financial position, which assists in assessing the Corporation's financial condition at the end of the year. These financial statements are prepared using the accrual basis of accounting, which recognizes all revenues and grants when earned, and expenses at the time the related liabilities are incurred.

- The Statement of Net Position presents all of the Corporation's assets, deferred outflows of resources, liabilities, and deferred inflows of resources, with the difference being reported as "net position (deficiency)." Over time, increases and decreases in the Corporation's net position may serve as a useful indicator of whether the financial position of the Corporation is improving or deteriorating.
- The Statement of Activities presents information showing how the Corporation's net position (deficiency) changed during the fiscal year. All changes in net position (deficiency) are reported as soon as the underlying event giving rise to the change occurs, regardless of the timing of related cash flows. Therefore, revenues and expenses are reported in this statement for some items that will not result in cash flows until future fiscal periods.

Fund Financial Statements

A fund is a grouping of related accounts that is used to maintain control over resources that have been segregated for specific activities or objectives. The Corporation uses fund accounting to ensure and demonstrate compliance with finance-related legal requirements. The fund financial statements focus on the individual parts of the Corporation and report the Corporation's operations in more detail than the government-wide financial statements.

- **Governmental funds:** All of the Corporation's activities are financed through governmental funds. Governmental funds are used to account for essentially the same functions reported as governmental activities in the government-wide financial statements. However, unlike the government-wide financial statements, the governmental fund financial statements focus on near-term inflows and outflows of spendable resources, as well as on spendable resources available at the end of the fiscal year. Such information helps determine whether there are more or fewer financial resources that can be spent in the near future to finance the Corporation's activities.

Because the focus of governmental funds is narrower than that of the government-wide financial statements, it is useful to compare the information presented for governmental funds with similar information presented for governmental activities in the government-wide financial statements. By doing so, readers may better understand the long-term impact of the Corporation's near-term financial decisions. Both the governmental fund balance sheet and the governmental fund statement of revenues, expenditures and changes in fund balances provide a reconciliation to facilitate this comparison between governmental funds and the governmental activities.

Notes to Financial Statements

The notes provide additional information that is essential to a full understanding of the data provided in the government-wide and fund financial statements. The notes to financial statements can be found immediately following the fund financial statements.

Supplementary information, which follows the notes to financial statements, includes the calculation of debt service coverage ratios and information about the actual MSA receipts compared to base case projections at the time the revenue bonds were sold.

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Management's Discussion and Analysis Fiscal Year Ended June 30, 2018

Government-wide Financial Statement Analysis

The Corporation's net deficiency totaled \$723,264,668 at the end of fiscal year 2018, as compared with a net deficiency of \$735,190,676 at June 30, 2017. The decrease in the net deficiency is primarily due to the payment of \$20,535,000 in principal on outstanding bonds, offset by an increase of \$11,702,000 in accreted interest.

As discussed previously, the overall deficiency in net position is primarily attributable to long term receivables for future TSR revenues not being recognized while the full amount of bonds payable is reflected on the Statement of Net Position.

A condensed statement of activities for fiscal years ended 2018 and 2017 follows:

	<u>2018</u>		<u>2017</u>		<u>Change</u>
Revenues	\$ 46,777,377	\$	81,637,888	\$	(34,860,511)
Expenses	(34,851,369)		(37,129,175)		2,277,806
Special Items			(10,360,190)		10,360,190
	<u>\$ 11,926,008</u>	\$	<u>34,148,523</u>	\$	<u>(22,222,515)</u>

During fiscal year 2018, the Corporation recognized \$46,777,377 of revenues from the TSRs and investment income, a decrease of \$34,990,511 from fiscal year 2017. This decrease was attributable to the DPA Settlement of \$51,116,414 received in the prior year less \$16,866,135 in settlement credits which were offset against the 2017 TSR's as discussed in the section above headed "**Disputed Payments Account Settlement & Early Extinguishment of Debt**".

In 2018 Rhode Island received additional, one-time revenue, along with the annual MSA payment. A total of \$4,632,611 was received under the Settlement Agreement, which was 72% of the 2017 disputed payment. In addition, \$2,890,371 was received from the settlement of the 2015 disputed payment.

Total expenses amounted to \$34,851,369 for fiscal year 2018, as compared to \$37,129,175 in the prior fiscal year. The decrease was attributed to fees incurred in the prior year because of the DPA Settlement.

Analysis of Fund Financial Statements

The governmental fund had a combined fund balance of \$75,572,457 at June 30, 2018. This represents an increase of \$89,008 from June 30, 2017.

Long-Term Debt

In June 2007, the TSFC issued \$197,005,742 of asset-backed bonds, which included \$176,974,412 of Series 2007 A Bonds, \$17,336,218 of Series 2007 B Bonds and \$2,695,112 of Series 2007 C Bonds.

As of October 18, 2018, Standard & Poor's Rating Services rates the TSFC 2007 Series A debt "CCC+" and the Series B debt "CCC".

In March 2015, the TSFC issued \$620,935,000 of asset-backed bonds, which included \$332,300,000 of Series 2015 A Bonds and \$288,635,000 of Series B Bonds. In connection with this issuance, all of the outstanding 2002 Series asset-backed bonds were redeemed. In addition, principal of \$68,324,411 of 2007 Series A, principal of \$5,200,633 of 2007 Series B, and all of 2007 Series C bonds were repurchased and retired.

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Management's Discussion and Analysis Fiscal Year Ended June 30, 2018

At the time of the original issuance on March 19, 2015, Standard & Poor's rated the 2015 Series A asset-backed bonds maturing from 2016 to 2025 "A," those bonds maturing from 2026 to 2030 and in 2035 were rated "A-," and the June 1, 2040 maturity was rated "BBB+."

On August 20, 2015, Standard & Poor's announced that the ratings for certain of the 2015 asset-backed bonds were being changed as follows: the rating on the 2015 Series A asset-backed bonds maturing from 2019 to 2025 was changed to "BBB+," the rating on the bonds maturing from 2026 to 2030 and in 2035 was changed to "BBB," and the rating on the June 1, 2040 maturity bonds was also changed to "BBB."

On February 22, 2018, Standard & Poor's announced that the ratings for certain of the 2015 asset-backed bonds were being changed as follows: the rating on the 2015 Series A asset-backed bonds maturing from 2019 to 2021 was changed to "A," the rating on the bonds maturing from 2026 to 2027 was changed to "BBB+." These ratings have not changed since that date.

Fitch Ratings rated both the 2015 Series A and Series B bonds "BBB+sf" at the time of issuance. However, effective June 16, 2016, Fitch has since withdrawn its ratings for all U.S. Tobacco asset-back securities, including those issued by the Corporation.

Ratings on all the bonds are subject to change at any time and readers should refer to information available from the rating services for the most current ratings. Currently, only Standard & Poor's rates the TSFC bonds.

The Corporation has issued capital appreciation bonds which were sold at a deep discount from par and accrete to full value at maturity. No periodic interest payments are made while the bonds are outstanding, however, accreted interest expense is recognized and included in the carrying amount of the capital appreciation bonds on the government-wide (full-accrual) financial statements. While recognized for accounting and financial reporting purposes, the Corporation has no requirement to accumulate current resources for the accreted interest payable at maturity on the capital appreciation bonds.

The current year addition to accreted interest was \$11,702,000 for a cumulative balance of \$97,468,000.

During fiscal year 2018, the Corporation paid \$10,315,000 in principal on long-term debt pursuant to the turbo redemption provisions of the Trust Indenture relating to its outstanding bonds. The amount of principal determined by the Trustee to be subject to the turbo redemption was based upon actual cash available in June 2018.

For additional information relating to long-term debt, see the notes to the financial statements.

Risk Factors and Future Revenue

The Corporation has little or no control over the level of revenues that are collected. Risk factors possibly impacting the level of revenues to be received by the TSFC are beyond the control of the Corporation and include, but are not limited to, decreases in cigarette consumption, financial viability of the Participating Manufacturers, and the liability of the tobacco industry. In the event of non-payment of the amounts due and payable under the Master Settlement Agreement that have been assigned to the Corporation, the State of Rhode Island has pledged to pursue legal remedies to the extent possible to obtain amounts due pursuant to the Master Settlement Agreement and payable to the Corporation.

Many adjustments are included in the calculation of an MSA Payment, such as a volume adjustment, cost of living adjustment and Non-Participating Manufacturer (NPM) adjustment. An NPM adjustment would permit the Participating Manufacturers (PM) to reduce their MSA payments provided that the PMs' market share loss exceeds 2% of the original participating manufacturers' 1997 market share, that the MSA was a significant factor for the PMs' market share loss, and that the states did not enact a Model Escrow Statute included in the MSA and diligently enforce it and the MSA. If the NPM adjustment is applied,

Tobacco Settlement Financing Corporation

Management's Discussion and Analysis Fiscal Year Ended June 30, 2018

the payment reduction is based on the percentage of market share lost to NPMs multiplied by three and allocated to states that did not diligently enforce the MSA and the escrow statute, up to the amount of the allocable share. The offset is not carried forward to other MSA payments.

States have collected less TSRs than originally expected due to a decline in cigarette volume attributable to many factors, including, but not limited to, the Master Settlement Agreement and higher excise taxes, both state and federal. The adjustment for inflation has offset the volume adjustment, but it has not outweighed it to date.

On April 21, 2017, the PMs paid the Settling States \$6,193,097,859. Rhode Island received an actual MSA payment of \$82,173,013, including the DPA Settlement. A further breakdown of the payment is below:

DPA Settlement	\$51,116,414
TSR Revenue	47,922,734
Less: DPA Settlement Credits	16,866,135

On April 19, 2018, the PM's paid the Settling States \$6,692,190,292. Rhode Island received an actual MSA payment of \$45,916,215. Included in this MSA payment of \$45,916,215, Rhode Island received certain one-time revenue totaling \$7,522,982. Specifically, a total of \$4,632,611 was received under the Settlement Agreement, which was 72% of the 2017 disputed payment and \$2,890,371 was received from the settlement of the 2015 disputed payment.

Rhode Island will continue to vigorously enforce the MSA and related statutes. Although a Settling State that diligently enforces its Qualifying Statute is not subject to the NPM Adjustment, many procedural uncertainties, as described above, still remain regarding the NPM Adjustment. Future NPM Adjustment claims for Settling States remain possible for calendar years 2016 and all future years. One of the financial benefits of the NPM Settlement Term Sheet is that the signatory States and the PMs split disputed payments for future years 50%/50%. Without this settlement, 100% of the disputed monies would be held in the Disputed Payments Account ("DPA"). The settlement agreement allows 50% of future disputed payments to be given to Rhode Island immediately in the corresponding Payment Year as a credit, with the PMs keeping 50%. When the dispute over a particular year is finally resolved, the prevailing party will receive the other party's 50% as a credit to that year's payment.

Should the PMs be determined with finality to be entitled to a full NPM Adjustment in a future year, thereby requiring Rhode Island to return the 50% of a disputed payment it previously received, operation of the NPM Adjustment would also have a material adverse effect on the amounts of TSRs available to the Corporation to make turbo redemptions and other payments on the bonds. Prior to the Settlement Agreement, 100% of a State's MSA Payment in a given year was at risk until the disputed payment issue was resolved. If a State was found non-diligent, the State could lose up to 100% of its MSA Payment for a given year. The Settlement Agreement allows for a reduction in the form of a reduced reimbursement percentage for those States found non-diligent, so the State would retain a portion of its MSA Payment even if found non-diligent for non-settled years.³ Any finding of non-diligence on behalf of the State

³ As detailed in the Settlement Term Sheet and the Bond Consent Solicitation Statement (and incorporated under Section V.C.9(a) and (b), and corresponding Exhibit M, of the Settlement Agreement), Rhode Island is entitled to a TSR reimbursement (reduction of liability to PMs if found non-diligent in a given year) equaling the sum of the percentage equal to (a) the total number of NPM Cigarettes on which SET was paid in such year in the Settling States, divided by the total nationwide number of NPM Cigarettes on which federal excise tax was paid in such year, plus (b) the percentage equal to the total number of NPM Cigarettes on which an Equity Fee was paid in such year in Previously Settled States (States that settled with the PMs before the MSA was executed) that had in effect an Equity Fee Law for the entirety of the year, divided by the total nationwide number of NPM Cigarettes on which federal excise tax was paid in such year.

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Management's Discussion and Analysis Fiscal Year Ended June 30, 2018

in future arbitrations could have a material adverse effect on receipt of TSRs.⁴ Any failure on the part of the PMs to perform its obligations under the MSA and/or the Settlement Agreement could also have a material adverse effect on receipt of future TSRs.

Litigation could always threaten the ability of the tobacco companies to pay the amounts owed under the MSA, including, but not limited to, bankruptcy. A number of PMs have filed for bankruptcy in the past, and Rhode Island and the other Settling States pursued those claims in bankruptcy court. The issue of whether or not the PMs would seek bankruptcy protection in the future continues to be a possibility.

In addition, please see Note 5 of the notes to financial statements for additional information about Commitments and Contingencies.

Economic Outlook

Future payments of all types on the Bonds are contingent on actual MSA Receipts. These receipts are dependent on a number of factors, including, but not limited to, the rates of consumption of tobacco products.

In structuring the financial transactions for the issuance of the bonds, the Corporation engaged the services of independent consultants to develop forecasts of these Receipts.

It should be noted that shipments of cigarettes have decreased at a rate greater than was projected when the Corporation issued the Series 2007 and Series 2015 bonds. Over the past few years there have been significant increases in tobacco excise taxes in various jurisdictions, including Rhode Island, and at the Federal level, and varying restrictions on public smoking have been enacted, further contributing to a decline in tobacco consumption.

Please see the "Supplemental Schedule of Actual MSA Receipts Compared to Base Case Projections at Time of Sale" in the Supplementary Information section of this report for more information about this decrease in MSA revenues vs. that projected when the respective bonds were sold.

Requests for Information

This financial report is designed to provide a general overview of the TSFC finances for all those with an interest in this organization. Questions concerning any of the information provided in this report or requests for additional financial information should be addressed to Chairperson, Tobacco Settlement Financing Corporation, c/o State Budget Office, One Capitol Hill, Providence, Rhode Island 02908.

⁴ As detailed in the Settlement Term Sheet and the Bond Consent Solicitation Statement (and incorporated under Section V.B.8 of the Settlement Agreement), a State's MSA payment may also be subject to an adjustment on all SET-paid NPM cigarettes for future unsettled years if a State does not meet a safe harbor provision. A State will not be subject to this revised adjustment if (i) escrow was deposited on 96% of all NPM cigarettes sold in the State during that year on which SET was paid, or (ii) the number of SET-paid NPM cigarettes sold in the State during that year on which escrow was not deposited did not exceed 2 million cigarettes.

Tobacco Settlement Financing Corporation

Statement of Net Position June 30, 2018

Assets:

Current assets	
Cash equivalents	\$ 259,363
Cash equivalents-restricted	51,768,094
Receivables	23,545,000
Total current assets	<u>75,572,457</u>
 Total assets	 <u>75,572,457</u>

Liabilities:

Current liabilities:	
Accrued interest	2,138,000
Bonds payable	10,580,000
Total current liabilities	<u>12,718,000</u>
 Noncurrent liabilities:	
Bonds payable, net of unamortized premium/discount	754,570,125
Total noncurrent liabilities	<u>754,570,125</u>
 Total liabilities	 <u>767,288,125</u>

Deferred inflows of resources:

Deferred gain on refunding of debt	<u>31,549,000</u>
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Net position (deficiency):

Restricted for debt service	75,313,094
Unrestricted/(deficiency)	(798,577,762)
	<u>\$ (723,264,668)</u>

The notes to the financial statements are an integral part of this statement.

Tobacco Settlement Financing Corporation

Statement of Activities
For the Fiscal Year Ended June 30, 2018

Revenues:	
Tobacco settlement revenues	\$ 46,237,215
Investment income	540,162
Total revenues	<u>46,777,377</u>
Expenses:	
General and administrative	51,563
Amortization of premium/(discount) and deferred gain on refunding of debt (net)	(2,970,000)
Interest and other charges	37,769,806
Total expenses	<u>34,851,369</u>
Increase in net position	11,926,008
Net position/(deficiency)	
Beginning of the year	(735,190,676)
End of year	<u>\$ (723,264,668)</u>

The notes to the financial statements are an integral part of this statement.

Tobacco Settlement Financing Corporation

Statement of Cash Flows For the Fiscal Year Ended June 30, 2018

Cash flows from operating activities:	
Cash received from tobacco settlement revenues	\$ 45,916,215
Payments to vendors	(51,563)
Net cash provided by operating activities	45,864,652
Cash flows from non-capital financing activities:	
Principal paid on long-term debt	(20,535,000)
Interest paid on long-term debt	(26,101,806)
Net cash used for non-capital financing activities	(46,636,806)
Cash flows from investing activities:	
Investment earnings	540,162
Net cash provided by investing activities	540,162
Net increase in cash	(231,992)
Cash and cash equivalents, July 1	52,259,449
Cash and cash equivalents, June 30	\$ 52,027,457
Reconciliation of increase in net position to net cash provided by operating activities:	
Increase in net position (deficiency)	\$ 11,926,008
Adjustments to reconcile increase in net position to net cash provided by (used for operating activities):	
(Increase) in tobacco revenue receivable	(321,000)
(Decrease) in bond premiums/discounts and deferred gains on refunding (net)	(2,970,000)
(Decrease) in accrued interest	(34,000)
(Increase) in accretion of interest on capital appreciation bonds	11,702,000
Not classified as operating:	
Interest and other charges	26,101,806
Investment earnings	(540,162)
	\$ 45,864,652

The notes to the financial statements are an integral part of this statement.

Tobacco Settlement Financing Corporation

Balance Sheet, Governmental Fund
June 30, 2018

Assets:

Current assets		
Cash equivalents	\$	259,363
Cash equivalents-restricted		51,768,094
Receivables		23,545,000
Total assets	\$	<u>75,572,457</u>
Fund balance:		
Restricted for debt service	\$	75,313,094
Assigned for future expenditures		259,363
Total fund balance	\$	<u>75,572,457</u>
Fund balance - governmental funds	\$	75,572,457
Amounts reported in the Statement of Net Position differ because:		
Bonds, accrued interest and other liabilities are not due and payable in the current period and therefore are not reported in the funds.		
	Bonds payable	(642,002,711)
	Deferred discounts	434,586
	Deferred premiums	(26,114,000)
	Accreted interest	(97,468,000)
	Accrued interest	(2,138,000)
		<u>(767,288,125)</u>
Deferred inflows of resources/ deferred gain on refunding of bonds		(31,549,000)
Net Position/Deficiency in Statement of Net Position	\$	<u><u>(723,264,668)</u></u>

The notes to the financial statements are an integral part of this statement.

Tobacco Settlement Financing Corporation

Statement of Revenues, Expenditures, and Changes in Fund Balance
Governmental Fund
For the Fiscal Year Ended June 30, 2018

Revenues:

Tobacco settlement revenues	\$ 46,237,215
Investment income	540,162
	46,777,377

Expenditures:

Current:	
General and administrative	51,563
Debt service:	
Principal	20,535,000
Interest and other charges	26,101,806
	46,688,369
Excess of revenues over expenditures	89,008
Fund balance - beginning	75,483,449
Fund balance - ending	\$ 75,572,457
Net change in fund balance - total governmental funds	\$ 89,008

Amounts reported in the Statement of Activities differ because:

Repayment of bond principal is an expenditure in the governmental funds, but the repayment reduces long-term liabilities in the Statement of Net Position. Interest expense, and bond premiums/(discounts) are recognized when the transaction occurs in the governmental funds.

	Principal paid on maturing debt	10,220,000
	Principal paid on turbo debt	10,315,000
	Accrued interest	34,000
	Accreted interest	(11,702,000)
	Amortization of gain on refunding	680,000
	Amortization of discount 2007 bonds	(13,000)
	Amortization of premium 2015 bonds	2,303,000
		2,303,000
Change in net position (deficiency) in the Statement of Activities		\$ 11,926,008

The notes to the financial statements are an integral part of this statement.

Tobacco Settlement Financing Corporation

Notes to Financial Statements For the Year Ending June 30, 2018

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Reporting Entity

The Tobacco Settlement Financing Corporation (the Corporation) was organized on June 13, 2002 as a public corporation by the State of Rhode Island (the State), pursuant to Title 42 of the General Laws, Chapter 133. The purpose of the Corporation is to purchase Tobacco Settlement Revenues from the State. The Corporation is authorized to issue bonds necessary to provide sufficient funds for carrying out its purpose.

In June 2002, and again in June 2007, the Corporation issued asset-backed bonds that are the sole obligation of the Corporation. Accordingly, the State is not liable for any bonds or debts issued by the Corporation. Also, in June 2002 and 2007, pursuant to Purchase and Sale Agreements with the State, the State sold to the Corporation its future rights in the Tobacco Settlement Revenues (TSRs) under the Master Settlement Agreement and the Consent Decree and Final Judgment (the MSA). When the Corporation's obligations with the bonds have been fulfilled, the TSRs will revert back to the State. In March 2015 the Corporation issued asset-backed bonds that were used to fully retire the June 2002 bonds and repurchase and retire a portion of the 2007 bonds.

The future receipts of TSR payments are dependent on a variety of significant factors, which include but are not limited to:

- the financial capability of the participating cigarette manufacturers to pay TSRs;
- future cigarette consumption which impacts the TSR payments; and
- future legal and legislative challenges against the tobacco manufacturers and the MSA that provides for the TSR payments.

Changes in any of the above factors could affect the Corporation's ability to pay scheduled future debt service requirements.

All of the bonds of the Corporation are asset-backed instruments that are secured solely by the Tobacco Settlement Revenues.

The bonds are payable both as to principal and interest solely out of the assets of the Corporation pledged for such purpose, and neither the faith and credit nor the taxing power of the State of Rhode Island or any political subdivision thereof is pledged to the payment of the principal of or the interest on the bonds. The bonds do not constitute an indebtedness of or a general, legal or "moral" obligation of the State or any political subdivision of the State.

The Corporation is a component unit of the State of Rhode Island for financial reporting purposes. Accordingly, the Corporation's financial statements are included in the State of Rhode Island's Comprehensive Annual Financial Report.

These financial statements were prepared in accordance with accounting principles generally accepted in the United States of America, as prescribed by the Governmental Accounting Standards Board.

Basis of Presentation - Government-wide Financial Statements

The Statement of Net Position displays information on the financial position of the Corporation. The Statement of Activities presents the revenues and expenses of the Corporation for the fiscal period.

The Corporation is treated as a special-purpose government. The government-wide financial statements are reported using the economic resources measurement focus and the accrual basis of accounting. Under this method, revenues are recognized when earned and expenses are recognized when incurred, regardless of the related cash flows.

Tobacco Settlement Financing Corporation

Notes to Financial Statements For the Year Ending June 30, 2018

Basis of Presentation - Fund Financial Statements

The fund financial statements provide detailed information for the Corporation's individual funds.

In order to ensure observances of limitations and restrictions placed on the use of resources available to the Corporation, the accounts of the Corporation are maintained in accordance with the principles of "Fund Accounting." This is a procedure by which resources for various purposes are classified for accounting and reporting purposes into funds that are in accordance with specified activities or objectives. Separate accounts are maintained for each fund.

The Corporation uses a single fund for financial reporting purposes, which is an amalgamation of multiple funds established by the trustee under the bond indentures.

The flow of current financial resources measurement focus and the modified accrual basis of accounting are utilized in the preparation of the fund financial statements. Under the modified accrual basis of accounting, revenues are recognized when susceptible to accrual (i.e., when "measurable and available"). "Measurable" means that the amount of the transaction can be determined and "available" means collected within the current period or soon enough thereafter to pay liabilities of the current period. Expenditures are recorded when the related fund liability is incurred, except for unmatured interest on long-term debt which is recognized when due.

Cash Equivalents

Cash equivalents are defined as highly liquid investments with a maturity of three months or less at the time of purchase and at June 30, 2018 consisted of a money market fund that invests only in U.S. Treasury securities. Cash equivalents are valued at amortized cost, which approximates fair value.

Cash Equivalents - Restricted

Cash equivalents-restricted are defined as highly liquid investments with a maturity of three months or less at the time of purchase and at June 30, 2018 consisted of a money market fund that invests only in U.S. Treasury securities. These funds are held by the trustee and restricted for use only for debt service or debt service reserve fund purposes.

Equity Classifications

Government-wide Financial Statements

Equity is classified as net position and displayed in two components:

- Restricted net position - Consists of net position with constraints placed on the use thereof either by 1) external groups such as creditors, grantors, contributors, or laws or regulations of other governments, or 2) law through constitutional provisions or enabling legislation.
- Unrestricted net position - that portion of net position that does not meet the definition of "restricted."

Tobacco Settlement Financing Corporation

Notes to Financial Statements For the Year Ending June 30, 2018

Fund Financial Statements

Governmental fund equity is classified as fund balance in accordance with GASB Statement No. 54, Fund Balance Reporting and Governmental Fund Type Definitions. Fund balance is classified as non-spendable, restricted, committed, assigned or unassigned as described below:

- **Non-Spendable** - the amount of fund balance that cannot be spent because it is either not in spendable form or there is a legal or contractual requirement for the funds to remain intact.
- **Restricted** - the amount of fund balance that can only be spent on specific expenses due to constraints on the spending because of legal restrictions, outside party creditors, and grantor/donor requirements. The Corporation's restricted fund balance amounts can only be spent for future bond payments due to constraints on the spending because of legal obligations. The financial activities of the Corporation are limited by its enabling legislation and by its revenue bond resolution.
- **Committed** - the Corporation's Board of Directors, as the Corporation's highest level of decision-making authority, may commit fund balance for specific purposes pursuant to constraints imposed by formal actions taken, such as an ordinance or resolution. These committed amounts cannot be used for any other purpose unless the Corporation's Board of Directors removes or changes the specific use through the same type of formal action taken to establish the commitment. This constraint must be imposed prior to the fiscal year end, but the specific amount may be determined at a later date.
- **Assigned** - the amount of fund balance that includes the portion of the spendable fund balance that reflects funds intended to be used by the government for specific purposes assigned by management. The assigned fund balance, designated by the Corporation's Board of Directors, represents a "plan" for spending the amount, but it is not restricted or committed.
- **Unassigned** - the amount of fund balance that remains from residual positive net resources of the General Fund and Debt Service Fund in excess of what can properly be classified in one of the other four categories, not subject to any constraints or intended use, no external or self-imposed limitations, no set spending plan and are available for any purposes. Unassigned fund balance is commonly used for emergency expenditures not previously considered. In addition, the resources classified as unassigned can be used to cover expenditures for revenues not yet received.

Fund balance classifications are presented consistent with the bond indentures (restricted amounts) or as assigned by the Corporation's Board of Directors. The Corporation's resources are primarily from one restricted source and accordingly the Corporation has not adopted a formal spending hierarchy policy for when multiple funding sources are available.

Income Taxes

The Corporation is exempt from federal and state income taxes.

Use of Estimates

Management uses estimates and assumptions in preparing financial statements. Those estimates and assumptions affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities, and reported revenues and expenses. Actual results could differ from those estimates.

Tobacco Settlement Financing Corporation

Notes to Financial Statements For the Year Ending June 30, 2018

Amortization of Bond Premiums and Discounts

Bond premiums and discounts are deferred and amortized over the term of the bonds, using the outstanding principal method. Bond premiums and discounts are presented as an adjustment to the face amount of the bonds payable.

Deferred Inflows of Resources

In March 2015 the Corporation issued 2015 Series A and B bonds which were used to fully redeem the remaining balance of the 2002 Series bonds, and to repurchase and retire a portion of the 2007 Series bonds. The resulting deferred gain on the refunding of debt is reflected as deferred inflows of resources on the Statement of Net Position. These deferred inflows are being amortized using the outstanding principal method for the gain related to the redemption of the Series 2002 bonds and the straight line method for the gain related to the repurchase and retirement of certain of the Series 2007 capital appreciation bonds.

Accreted Interest

The Corporation has issued capital appreciation bonds which were sold at a deep discount from par and accrete to full value at maturity. No periodic interest payments are made while the bonds are outstanding, however, accreted interest expense is recognized and included in the carrying amount of the capital appreciation bonds on the government-wide (full-accrual) financial statements. While recognized for accounting and financial reporting purposes, the Corporation has no requirement to accumulate current resources for the accreted interest payable at maturity on the capital appreciation bonds.

The current year addition to accreted interest was \$11,702,000 for a cumulative balance of \$97,468,000.

Revenue Recognition

The Corporation recognizes receivables and revenue with respect to TSRs based on the domestic shipment of cigarettes. The Corporation accrues at June 30th for TSRs that are derived from estimated sales of cigarettes from January 1 to June 30. This accrual is estimated based upon the historical TSR payments for the prior three fiscal years.

The GASB issued Statement No. 48, *Sales and Pledges of Receivables and Future Revenues and Intra-Entity Transfers of Assets and Future Revenues (the Statement)*, effective for financial statement periods beginning on or after December 15, 2006. The Statement required restatement of prior period financial statements, except for the deferral requirements relative to sales of future revenues which were permitted to be applied prospectively.

As allowed under GASB Statement No. 48, the Corporation and State elected to not retroactively apply the deferral requirements to its 2002 and 2007 TSR sales completed prior to the effective date. In accordance with accounting standards in effect at the time of the 2002 and 2007 TSR sales, the State fully recognized the amount received for its sale of future TSRs to the Tobacco Settlement Financing Corporation as revenue in those years.

In addition, GASB Statement No. 48 and other applicable pronouncements provide that the event that results in the recognition of an account receivable and revenue with respect to TSRs is the domestic shipment of cigarettes. The Corporation accrues at June 30th for TSRs that are derived from estimated sales of cigarettes from January 1 to June 30. This accrual is estimated based upon the historical TSR payments for the prior three fiscal years.

Tobacco Settlement Financing Corporation

Notes to Financial Statements For the Year Ending June 30, 2018

2. CASH EQUIVALENTS

At June 30, 2018, the carrying amount of cash equivalents, which approximate fair value, was \$52,027,457.

Information about the money market fund held at June 30, 2018 is presented in the table below.

Description	Fair Value	Average Days to Maturity	Moody's Rating	Standard & Poors Rating
Goldman Sachs Financial Square Treasury Instruments Fund #506	\$ 52,027,457	35	Aaa-mf	AAAm

Of the amount reflected above, \$51,768,094 is held by the trustee and restricted for use only for debt service or debt service reserve fund purposes.

The Corporation categorizes its fair value measurements within the fair value hierarchy established by GAAP. The hierarchy is based on the valuation inputs used to measure the fair value of the asset. Level 1 inputs are quoted prices in active markets for identical assets. Level 2 inputs are inputs, other than quoted prices, that are observable for the asset, either directly or indirectly. Level 3 inputs are unobservable inputs for an asset.

The Goldman Sachs Financial Square Treasury Instruments Fund transacts with its participants at a stable net asset value (NAV) per share. Cash equivalents reported at the NAV are not subject to the leveling categorization as described above. There are no participant withdrawal limitations.

3. LONG-TERM DEBT

On June 27, 2002 the Corporation issued \$685,390,000 of Tobacco Settlement Asset-Backed Bonds (2002 Series). The bond proceeds were used to purchase the State's future rights in the Tobacco Settlement Revenues (TSRs) under the Master Settlement Agreement and the Consent Decree and Final Judgment (the MSA). The bonds accrued interest at rates ranging from 5.920% to 6.250% and matured in varying amounts through June 1, 2042. The bonds were subject to early redemption provisions, in whole or in part, at the redemption price of 100% of the principal amount plus accrued interest, without premium. The 2002 Series bonds were fully redeemed on March 19, 2015.

On June 27, 2007 the Corporation issued \$197,005,742 of additional Tobacco Settlement Asset-Backed Bonds (2007 Series). The bond proceeds were used to purchase the State's future rights to residual Tobacco Settlement Revenues which were not purchased under the 2002 purchase agreement. The bonds are Capital Appreciation Bonds, on which no periodic interest payments are made, but which are issued at a deep discount from par and accreting to full value at maturity in the year 2052. At maturity, the bond redemption values represent accreted yields ranging from 6.000% to 6.750%. The bonds are subject to early redemption provisions, in whole or in part, at the redemption price of 100% of the issue amount plus accreted interest, without premium. A portion of the 2007 Series Bonds were redeemed in March 2015 and June 2017.

On March 19, 2015 the Corporation issued \$620,935,000 of Tobacco Settlement Asset-Backed Bonds (Series A and B) that bear interest at annual rates ranging from 0.590% to 5.000% and mature in varying amounts through June 1, 2050. The bonds are subject to a number of early redemption provisions, in whole or in part, at the redemption price of 100% of the principal amount plus accrued interest, without premium. Term Maturities represent the minimum amount of principal that the Corporation has to pay as of specific dates.

The Series 2015 bond indenture contains "Turbo Maturity" provisions, whereby the Corporation is required to apply the funds collected that are in excess of the then current funding requirements of the indenture to the early redemption of certain of the Series 2015 B bonds (based upon a minimum turbo redemption schedule established for the bonds). The amount available for turbo redemptions on the Series 2015 B bonds are credited against the term maturities in ascending

Tobacco Settlement Financing Corporation

Notes to Financial Statements For the Year Ending June 30, 2018

chronological order based on a schedule contained in the indenture. Excess turbo funds available, if any, will be used to retire Series 2007 bonds.

The proceeds of the issuance of the Series 2015 bonds, along with the release of debt service funds related to the bonds retired, and the proceeds from the early termination of investment contracts, were used to fully redeem the remaining balance of the 2002 Series bonds, and to repurchase and retire the principal amount of \$76,220,155 of the 2007 Series bonds as well as pay accreted interest of \$13,600,495 on the retired 2007 Series bonds.

A deferred gain on refunding of debt in the aggregate amount of \$31,549,000 on the Series 2002 and Series 2007 bonds, net of \$680,000 amortization, is reflected as a deferred inflow of resources in the accompanying Statement of Net Position.

A reserve account in the amount of \$26,700,250 was established for the Series 2015A bonds. The Corporation is required to maintain this reserve account to the extent of available funds. Amounts on deposit with the trustee in the reserve account are available to pay (i) the principal of sinking fund installments of, and interest on, the Series 2015A bonds to the extent revenues are insufficient for such purpose and (ii) upon the occurrence of an event of default, extraordinary prepayments. Unless an event of default has occurred, amounts withdrawn from the reserve account will be replenished from revenues.

In addition, a reserve account in the amount of \$12,175,975 was established for the Series 2015B bonds. The Corporation is required to maintain this reserve account to the extent of available funds. Amounts on deposit with the trustee in the reserve account are available to pay (i) the principal of sinking fund installments of, and interest on, the Series 2015B bonds to the extent revenues are insufficient for such purpose and (ii) upon the occurrence of an event of default, extraordinary prepayments. Unless an event of default has occurred, amounts withdrawn from the reserve account will be replenished from revenues.

With respect to the 2015 Series bonds, the table below reflects scheduled principal payments due as stated in the maturity schedule included in the indenture. As stated above the bonds are subject to a number of early redemption provisions, in whole or in part, at the redemption price of 100% of the principal amount plus accrued interest, without premium.

Principal and interest payments that are due according to the maturity schedule are as follows:

Fiscal Year Ending June 30	Principal	Accreted Interest	Interest	Total
2019	10,580,000		25,425,975	36,005,975
2020	11,020,000		24,896,975	35,916,975
2021	11,505,000		24,345,975	35,850,975
2022	12,040,000		23,770,725	35,810,725
2023	12,635,000		23,168,725	35,803,725
2024 - 2028	72,345,000		105,676,625	178,021,625
2029 - 2033	70,005,000		87,478,625	157,483,625
2034 - 2038	67,095,000		70,389,875	137,484,875
2039 - 2043	61,940,000		53,982,475	115,922,475
2044 - 2048	85,820,000		38,006,300	123,826,300
2049 - 2052	227,017,711	1,411,722,289	12,113,000	1,650,853,000
	<u>\$ 642,002,711</u>	<u>\$ 1,411,722,289</u>	<u>\$ 489,255,275</u>	<u>\$ 2,542,980,275</u>

Tobacco Settlement Financing Corporation

Notes to Financial Statements For the Year Ending June 30, 2018

The balance due on the Corporation's bonds payable reconciles to the reported amount included in the statement of net position as follows:

Original bond principal	\$	882,395,742
Turbo redemptions through June 30, 2018		(184,690,000)
Bonds issued		620,935,000
Bonds refunded/retired		(638,933,031)
Bond principal redeemed		(37,705,000)
Accretion of interest on capital appreciation bonds		97,468,000
		739,470,711
Unamortized bond premium		26,114,000
Unamortized bond discount		(434,586)
		765,150,125
Bonds payable, per statement of net position	\$	765,150,125

The components of bonds payable, as reflected in the financial statements, are as follows:

	Beginning Balance	Additions	Reductions	Ending Balance	Amounts Due Within One Year	Amounts Due Thereafter
Bonds payable	\$ 662,537,711	\$	\$ (20,535,000)	\$ 642,002,711	\$ 10,580,000	\$ 631,422,711
Accreted interest	85,766,000	11,702,000		97,468,000		97,468,000
Net unamortized premium	28,417,000		(2,303,000)	26,114,000		26,114,000
Net unamortized discount	(447,586)		13,000	(434,586)		(434,586)
	\$ 776,273,125	\$ 11,702,000	\$ (22,825,000)	\$ 765,150,125	\$ 10,580,000	\$ 754,570,125

During the years ended June 30, 2018, 2017 and 2016 the Corporation utilized \$10,315,000, \$6,275,000, and \$10,005,000 of excess collections to early redeem an equal amount of outstanding bonds, consistent with the "turbo redemption" requirements.

The 2007 Series A and B bonds are structurally subordinate to the payment in full of the 2015 Series bonds.

The Corporation was in compliance with its Debt Service Reserve requirements as of June 30, 2018.

Tobacco Settlement Financing Corporation

Notes to Financial Statements For the Year Ending June 30, 2018

4. DISPUTED PAYMENTS ACCOUNT SETTLEMENTS

On March 24, 2017, the Rhode Island Attorney General (the "Attorney General") announced that his office had reached a settlement in principle with various tobacco manufacturers over disputed payments for the years 2004 through 2014 under the Master Settlement Agreement (the "MSA") among such tobacco manufacturers (the "Participating Manufacturers" or "PMs") and certain participating states (each an "MSA State") including the State of Rhode Island ("Rhode Island" or the "State"). Disputed payments arose from a provision in the MSA that allows the PMs to withhold a portion of the annual distribution to the MSA States if certain conditions are met. Under the MSA, the MSA States have certain obligations to diligently enforce certain state statutes with respect to tobacco manufacturers that are not signatories to the MSA (the "Non-participating Manufacturers", or "NPMs"). If the PMs decide to dispute an MSA State's diligent enforcement of such statutes, the PMs may deposit a portion of their annual distribution to such MSA State (the "MSA Payment") into a Disputed Payments Account ("DPA") for such MSA State until the dispute is adjudicated. The PMs have annually disputed each MSA State's diligent enforcement actions. The State has always and continues to maintain that it diligently enforces its applicable statutes against the NPMs. Under the terms of the multistate settlement with the PMs (the "Settlement Term Sheet"), settling MSA States received an upfront payment of 54 percent of the disputed payments deposited by the PMs in the settling MSA State's disputed payments account for the years 2004-2014.¹ The PMs receive the remaining 46 percent in the form of offsets taken against the MSA payments due to the settling MSA States in payment years 2017 through 2021. Under the Settlement Term Sheet, the PMs also would not place into the disputed payment accounts certain amounts with respect to payment years 2017 through 2021 (reflecting certain disputed amounts relating to years 2014 through and including 2020) that would otherwise be deposited into the disputed payment accounts and not paid to the MSA States if the MSA States did not join the Settlement Term Sheet.

Because the State had assigned all revenues from the MSA to the Tobacco Settlement Financing Corporation ("TSFC"), which in turn used those committed revenues to secure its bonds, the TSFC was required to seek bondholder approval before the State could enter into the Settlement Term Sheet. A consent solicitation process was conducted in March 2017 and the requisite approvals from bondholders were received as of March 17, 2017. Upon receipt of the bondholder approvals, the Attorney General signed a joinder letter joining the multistate settlement. Rhode Island's joinder letter became effective upon written approval of the Participating Manufacturers on April 3, 2017.

As a result of the State joining the Settlement Term Sheet, in April of 2017, the Trustee for the TSFC received a payment from the PMs of \$82,173,014. This payment was comprised of a \$31,056,599 2017 MSA payment by the PMs and a \$51,116,414 transfer from the State's Disputed Payments Account. As noted above, the Participating Manufacturers will receive credits through 2021. The largest credits were taken against the State's 2017 MSA payment. As a result, the expected 2017 MSA payment of \$47,922,735 was reduced by credits totaling \$16,866,135, resulting in a net 2017 MSA payment of \$31,056,599. The 2018 MSA payment of \$47,719,663 was reduced by credits totaling \$1,803,448, resulting in a net 2018 MSA payment of \$45,916,215.

Over the next three years, the credits are expected to be offset almost entirely by additional payments resulting from the multistate settlement that would otherwise have been deposited in the disputed payments account.

The NPM Adjustment Settlement Agreement ("Settlement Agreement") entered by the Attorney General on March 24, 2017 authorized the States and the PMs to split disputed payments 72% state/28% PMs for 2016 and 2017 and 50%/50% in future years. Without this settlement, 100% of the monies for each respective unresolved year would be held in the DPA. Rhode Island received approximately \$4,915,407 in additional funds in April 2017 and \$4,632,611 in April 2018. This represents 72% of the disputed payment amounts for 2016 and 2017, respectively.

¹ 24 settling MSA States other than Rhode Island and Oregon settled their claims in respect to the disputed payments for the years 2003 through 2014. Rhode Island's settlement did not include year 2003 because the PMs issued an order of "no contest" for Rhode Island during the 2003 Arbitration. This meant that the PMs decided not to pursue its diligent enforcement claims against Rhode Island for 2003.

Tobacco Settlement Financing Corporation

Notes to Financial Statements For the Year Ending June 30, 2018

The Settlement Agreement was fully executed in the fall of 2017 by the signatory PMs and 26 MSA States.² The states, including Rhode Island, settled 2015 on a 75%/25% split to resolve the NPM Adjustment dispute, rather than a 50%/50% split with an NPM Adjustment dispute to still be resolved and monies trued-up in future years. By settling 2015, Rhode Island was disbursed an additional \$2,890,371 in Payment Year 2018 that Rhode Island otherwise would not have received without settling Year 2015. This additional revenue resulted from the PMs crediting RI the extra 25% it did not previously receive.

Rhode Island will continue to vigorously enforce the MSA and related statutes. Although a Settling State that diligently enforces its Qualifying Statute is not subject to the NPM Adjustment, many procedural uncertainties, as described above, remain regarding the NPM Adjustment. Future NPM Adjustment claims for Settling States remain possible for calendar years 2016 and all future years. One of the financial benefits of the NPM Settlement Term Sheet is that the signatory States and the PMs split disputed payments for future years 50%/50%. Without this settlement, 100% of the disputed monies would be held in the DPA. The settlement agreement allows 50% of future disputed payments to be paid to Rhode Island immediately in the corresponding Payment Year as a credit, with the PMs keeping 50%. When the dispute over a particular year is finally resolved, the prevailing party will receive the other party's 50% as a credit to that year's payment.

Should the PMs be determined with finality to be entitled to a full NPM Adjustment in a future year, thereby requiring Rhode Island to return the 50% of a disputed payment it previously received, this could have a material adverse effect on the amounts of TSRs available to the Corporation to make turbo redemptions and other payments on the bonds. Prior to the Settlement Agreement, 100% of a State's MSA Payment in a given year was at risk until the disputed payment issue was resolved. If a State was found non-diligent, the State could lose up to 100% of its MSA Payment for a given year. The Settlement Agreement allows for a reduction in the form of a reduced reimbursement percentage for those States found non-diligent, so the State would retain a portion of its MSA Payment even if found non-diligent for non-settled years.³ The reimbursement percentages are specific to the year being settled and are also impacted by the number of States found to be non-diligent; thus it is unknown how much of Rhode Island's MSA revenues would be at risk in a given year. However, any finding of non-diligence on behalf of the State in future arbitrations could have a material adverse effect on receipt of TSRs.⁴ Any failure on the part of the PMs to perform its obligations under the MSA and/or the Settlement Agreement could also have a material adverse effect on receipt of future TSRs.

² There are currently 36 State signatories to the Settlement Agreement, subject to each State's respective joinder letters. The NPM Adjustment Arbitration regarding calendar year 2004 remains ongoing with non-settled States.

³ As detailed in the Settlement Term Sheet and the Bond Consent Solicitation Statement (and incorporated under Section V.C.9(a) and (b), and corresponding Exhibit M, of the Settlement Agreement), Rhode Island is entitled to a TSR reimbursement (reduction of liability to PMs if found non-diligent in a given year) equaling the sum of the percentage equal to (a) the total number of NPM Cigarettes on which the State Excise Tax ("SET") was paid in such year in the Settling States, divided by the total nationwide number of NPM Cigarettes on which federal excise tax was paid in such year, plus (b) the percentage equal to the total number of NPM Cigarettes on which an Equity Fee was paid in such year in Previously Settled States (States that settled with the PMs before the MSA was executed) that had in effect an Equity Fee Law for the entirety of the year, divided by the total nationwide number of NPM Cigarettes on which federal excise tax was paid in such year.

⁴ As detailed in the Settlement Term Sheet and the Bond Consent Solicitation Statement (and incorporated under Section V.B.8 of the Settlement Agreement), a State's MSA payment may also be subject to an adjustment on all SET-paid NPM cigarettes for future unsettled years if a State does not meet a safe harbor provision. A State will not be subject to this revised adjustment if (i) escrow was deposited on 96% of all NPM cigarettes sold in the State during that year on which SET was paid, or (ii) the number of SET-paid NPM cigarettes sold in the State during that year on which escrow was not deposited did not exceed 2 million cigarettes.

Tobacco Settlement Financing Corporation

Notes to Financial Statements For the Year Ending June 30, 2018

5. COMMITMENTS AND CONTINGENCIES

As stated above under Note 4, the State entered into a NPM Adjustment Settlement Agreement (“Settlement”) to resolve disputed payments for 2004 through 2014 (2003 was previously resolved through arbitration in the State’s favor) and subsequently resolved 2015 receiving 75% of the disputed monies for that year with the April 2018 disbursements.

As discussed in Note 4, the Participating Tobacco Manufacturers (“PMs”) agreed not to dispute payments through the years of settlement. At present, for Rhode Island, that is through 2015. It is possible that the PMs could dispute the MSA amounts beginning with the 2016 NPM Adjustment, which could result in the Corporation receiving less revenue than assumed in out-year projections and impact its ability to service its debt obligations. Under the MSA, if a State is found non-diligent, it could lose up to its entire MSA payment for a given year.

As part of the Settlement, for years 2017-2021, the tobacco companies agreed to give Rhode Island (the bondholders) 50% of the NPM Adjustment that otherwise would have been deposited in the Disputed Payment Account (“DPA”). Thus, the State will receive certain DPA monies for future potential disputes that it otherwise would not have received until or unless there was a diligence determination at a later date.

Unsuccessful litigation has been filed in the past alleging, among other claims, that the MSA violates provisions of the U.S. Constitution, state constitutions, federal antitrust and civil rights laws, and state consumer protection laws. These lawsuits sought to prevent the states from collecting any monies under the MSA, and/or a determination that prevents the tobacco manufacturers from collecting MSA payments through price increases to cigarette consumers. In addition, class action lawsuits have been filed in jurisdictions alleging violations of state Medicaid agreements. While there are currently no known cases pending, such cases could be brought in the future where an adverse ruling could potentially result in the Corporation not having adequate financial resources to service its debt obligations.

Investment income earned by the Corporation is limited by U.S. Treasury regulations. Income earned in excess of allowable amounts will be remitted to the federal government as required by the applicable laws and regulations. The Corporation is required to submit payment of its rebateable arbitrage earnings on the five-year anniversary of the bond issue, and on each succeeding five-year anniversary. No accrual for rebateable arbitrage is necessary as of June 30, 2018.

Tobacco Settlement Financing Corporation

Notes to Financial Statements For the Year Ending June 30, 2018

6. PLEDGED REVENUE

As more fully disclosed in Note 1, the Corporation issued asset backed bonds to acquire from the State its share of the Tobacco Settlement Revenues. When the asset backed bonds are fully retired, future TSRs will revert to the State. Currently the amount of debt outstanding is \$765,150,125 with final maturity scheduled for 2052.

Analysis of the Corporation's pledged revenue as compared to annual debt service is as follows:

Revenue Bonds - Tobacco Settlement Finance Corporation

Revenues:

Tobacco settlement revenues, cash basis (a)	\$ 45,916,215	
Investment income	<u>540,162</u>	
Total revenues	46,456,377	
General and administrative expenses	<u>(51,563)</u>	
Net revenue available for debt service	<u>\$ 46,404,814</u>	
Required debt service payments	\$ 36,286,863	
Covered ratio before turbo principal payments (b)		127.90%
Turbo redemptions - principal (c)	<u>10,315,000</u>	
Total annual debt service	<u>\$ 46,601,863</u>	
Covered ratio after turbo principal payments (d)		99.60%
Term of commitment - through June 2052		

(a) Included for fiscal year 2018 are certain one-time revenue items totaling \$7,522,982. A total of \$4,632,611 was received under the Settlement Agreement, which was 72% of the 2017 disputed payment, and \$2,890,371 was received from the settlement of the 2015 disputed payment.

(b) Coverage ratio equals net revenue available for debt service divided by required debt service payments.

(c) "Turbo" redemptions whereby the Corporation is required to apply collections that are in excess of current funding requirements to the early redemption of the bonds are discussed in Note 3 of the Notes to the Financial Statements.

(d) Coverage ratio equals net revenue available for debt service divided by total annual debt service.

7. ADMINISTRATIVE EXPENSES

The State of Rhode Island performs certain accounting, legal, and administrative services on behalf of the Corporation for which it receives no compensation. The values of such services are not material to the Corporation's financial statements, and have not been reflected herein.

Tobacco Settlement Financing Corporation

Notes to Financial Statements For the Year Ending June 30, 2018

8. RISK MANAGEMENT

The Corporation is exposed to various risks of loss related to torts, asset misappropriation, and errors and omissions that could occur in the normal course of operations. The Corporation retains the risk of loss in the event of any judgments against it. As of June 30, 2018, there are no known asserted or unasserted claims or judgments pending against the Corporation.

Members of the Board and persons acting on the Corporation's behalf, while acting within the scope of their duties or employment, are indemnified against damages pursuant to the Corporation's enabling legislation, state law and a memorandum of understanding between the Corporation and the State.

9. SUBSEQUENT EVENTS

The Corporation has evaluated subsequent events through December 19, 2018, the date the financial statements were available to be issued.

Tobacco Settlement Financing Corporation

Supplemental Calculation of Debt Service Coverage Ratios for the Fiscal Years Ended June 30, 2018 and 2017

	2018	2017
Revenues:		
Tobacco settlement revenues, cash basis (a) and (b)	\$ 45,916,215	\$ 31,056,599
Investment income	540,162	211,896
Total revenues	46,456,377	31,268,495
General and administrative expenses	(51,563)	(84,300)
Net amounts available for debt service	\$ 46,404,814	\$ 31,184,195
Annual debt service (principal and interest)		
Required debt service	\$ 36,286,863	\$ 37,996,450
Covered ratio before "turbo redemption" principal payments	127.90%	82.10%
Annual debt service (principal) "Turbo redemption"	10,315,000	6,275,000
Total annual debt service	\$ 46,601,863	\$ 44,271,450
Coverage ratio after "turbo redemption" principal payments	99.60%	70.40%

(a) - Included for fiscal year 2018 are certain one-time revenue items totaling \$7,522,982. A total of \$4,632,611 was received under the Settlement Agreement, which was 72% of the 2017 disputed payment, and \$2,890,371 was received from the settlement of the 2015 disputed payment.

(b) - For fiscal year 2017 the amount received by the Corporation is net of credits of \$16,866,135 made in connection with the disputed payment account settlement.

See Note 4 of the Notes to Financial Statements for more information about these items.

Tobacco Settlement Financing Corporation

Supplemental Schedule of Actual MSA Receipts Compared to Base Case Projections at Time of Sale

Fiscal Year Ended June 30	A 2002 Series A & B DRI-WEFA Base Case Expected MSA Revenue	B 2007 Series A, B, & C Global Insight Base Case Expected MSA Revenue	C 2015 Series A & B Global Insight Base Case Expected MSA Revenue	D Actual MSA Revenue Received	D-A Variance of DRI-WEFA Compared to Actual	D-B Variance of Global Insight Compared to Actual	D-C Variance of Global Insight Compared to Actual
2004	\$ 47,047,106	\$	\$	\$ 45,190,449	\$ (1,856,657)	\$	\$
2005	47,570,858			45,315,617	(2,255,241)		
2006	48,196,297			42,060,409	(6,135,888)		
2007	48,825,273			44,024,516	(4,800,757)		
2008	50,476,947	57,443,691		53,246,221	2,769,274	(4,197,470)	
2009	51,191,991	58,186,214		58,038,800	6,846,809	(147,414)	
2010	51,870,793	58,863,587		48,620,449	(3,250,344)	(10,243,138)	
2011	52,612,259	59,577,361		45,812,110	(6,800,149)	(13,765,251)	
2012	53,353,020	60,279,274		46,710,285	(6,642,735)	(13,568,989)	
2013	54,057,103	60,971,444		46,692,088	(7,365,015)	(14,279,356)	
2014	54,744,345	61,641,825		51,756,761	(2,987,584)	(9,885,064)	
2015	55,417,655	62,295,687	51,722,705	45,295,062	(10,122,593)	(17,000,625)	(6,427,643)
2016	56,201,194	63,069,895	51,381,334	47,432,299	(8,768,895)	(15,637,596)	(3,949,035)
2017	56,983,598	63,846,379	51,160,653	31,056,599 (b)	(25,926,999)	(32,789,780)	(20,104,054)
2018	64,683,020	61,167,538	48,192,187	45,916,215 (a)	(18,766,805)	(15,251,323)	(2,275,972)
2019	65,539,256	61,877,676	47,948,336				

(a) - Included for fiscal year 2018 are certain one-time revenue items totaling \$7,522,982. A total of \$4,632,611 was received under the Settlement Agreement, which was 72% of the 2017 disputed payment, and \$2,890,371 was received from the settlement of the 2015 disputed payment.

(b) - For fiscal year 2017 the amount received by the Corporation is net of credits of \$16,866,135 made in connection with the disputed payment account settlement.

See Note 4 of the Notes to Financial Statements for more information about these items.

**INDEPENDENT AUDITORS' REPORT ON INTERNAL CONTROL OVER
FINANCIAL REPORTING AND ON COMPLIANCE AND OTHER MATTERS
BASED ON AN AUDIT OF FINANCIAL STATEMENTS PERFORMED
IN ACCORDANCE WITH GOVERNMENT AUDITING STANDARDS**

The Board of Directors
Tobacco Settlement Financing Corporation:

We have audited, in accordance with the auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in Government Auditing Standards issued by the Comptroller General of the United States, the financial statements of the governmental activities and the governmental fund of Tobacco Settlement Financing Corporation (a component unit of the State of Rhode Island) (the Corporation), as of and for the year ended June 30, 2018, and the related notes to the financial statements, which collectively comprise the Corporation's basic financial statements, and have issued our report thereon dated December 19, 2018.

Internal Control over Financial Reporting

In planning and performing our audit of the financial statements, we considered the Corporation's internal control over financial reporting (internal control) to determine the audit procedures that are appropriate in the circumstances for the purpose of expressing our opinions on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Corporation's internal control. Accordingly, we do not express an opinion on the effectiveness of the Corporation's internal control.

A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, misstatements on a timely basis. A material weakness is a deficiency, or a combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis. A significant deficiency is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

Our consideration of internal control was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control that might be material weaknesses or, significant deficiencies. Given these limitations, during our audit we did not identify any deficiencies in internal control that we consider to be material weaknesses. However, material weaknesses may exist that have not been identified.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the Corporation's financial statements are free from material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under Government Auditing Standards.

Purpose of this Report

The purpose of this report is solely to describe the scope of our testing of internal control and compliance and the results of that testing, and not to provide an opinion on the effectiveness of the Corporation's internal control or on compliance. This report is an integral part of an audit performed in accordance with Government Auditing Standards in considering the Corporation's internal control and compliance. Accordingly, this communication is not suitable for any other purpose.

EFPR Group, CPAs, PLLC

Williamsville, New York
December 19, 2018