This Preliminary Official Statement and the information contained herein are subject to completion or amendment without notice. Under no circumstances shall this Preliminary Official Statement constitute an offer to sell or the solicitation of an offer to buy, nor shall there be any sale of the securities, in any jurisdiction in which such offer, solicitation or sale would be unlawful prior to registration or qualification under the securities laws of such jurisdiction.

PRELIMINARY OFFICIAL STATEMENT DATED MARCH 13, 2015

NEW ISSUE; BOOK-ENTRY ONLY **RATINGS: See "RATINGS" herein**

*In the opinion of Orrick, Herrington & Sutcliffe LLP, as Transaction Counsel to the Issuer, based upon an analysis of existing laws, regulations, rulings and court decisions, and assuming, among other matters, the accuracy of certain representations and compliance with certain covenants, interest on the Series 2015A Bonds is excluded from gross income for federal income tax purposes under Section 103 of the Internal Revenue Code of 1986 (the "**Code**") and is exempt from State of California personal income taxes. Transaction Counsel is of the further opinion that interest on the Series 2015A Bonds is not a specific preference item for purposes of the federal individual or corporate alternative minimum taxes, although Transaction Counsel observes that such interest is included in adjusted current earnings when calculating corporate alternative minimum taxable income. Transaction Counsel expresses no opinion regarding any other tax consequence related to the ownership or disposition of, or the amount, accrual or receipt of interest on, the Series 2015A Bonds. See "TAX MATTERS" herein.*

$1,704,990,000*
Golden State Tobacco Securitization Corporation
Enhanced Tobacco Settlement Asset-Backed Bonds,
Series 2015A

Dated: Date of Delivery Maturity Dates: June 1, as set forth on the inside cover page

Golden State Tobacco Securitization Corporation (the "**Issuer**"), a special purpose trust established as a not-for-profit corporation by the Act (as defined below), is issuing its $1,704,990,000* aggregate principal amount of Enhanced Tobacco Settlement Asset-Backed Bonds, Series 2015A (the "**Series 2015A Bonds**"). The Series 2015A Bonds are being issued pursuant to an indenture by and between the Issuer and The Bank of New York Mellon Trust Company, N.A. (formerly known as The Bank of New York Trust Company, N.A., successor to BNY Western Trust Company), as Trustee (the "**Trustee**"), dated as of September 1, 2003 (the "**Master Indenture**"), as supplemented by the Series 2003B Supplement, dated as of September 1, 2003, as supplemented and amended by the First Supplemental Indenture, dated as of July 1, 2005 (the "**First Supplemental Indenture**"), the Second Supplemental Indenture, dated as of April 1, 2013 (the "**Second Supplemental Indenture**"), and the Third Supplemental Indenture, dated as of April 1, 2015 (the "**Third Supplemental Indenture**"). The Master Indenture, as supplemented and amended, is hereinafter referred to as the "**Indenture**". The Indenture only permits the issuance of additional refunding bonds. The Issuer will use the proceeds from the issuance of the Series 2015A Bonds, together with amounts released from the Liquidity Reserve Account, the Supplemental Reserve Account and the Surplus Account, (i) to refund on a current basis a portion equal to $1,959,775,000* aggregate principal amount of the Issuer's Enhanced Tobacco Settlement Asset-Backed Bonds, Series 2005A (the "**Series 2005A Bonds**") that are outstanding under the Indenture and (ii) to pay the costs of issuance of the Series 2015A Bonds. Following the refunding of such portion of the Series 2005A Bonds, $593,300,000* aggregate principal amount at maturity of the Series 2005A Bonds (including Capital Appreciation Bonds, as defined herein) will remain outstanding under the Indenture, and $375,105,000 aggregate principal amount of the Issuer's Enhanced Tobacco Settlement Asset-Backed Bonds, Series 2013A (the "**Series 2013A Bonds**"), which were issued in April 2013 to refund a portion of the Series 2005A Bonds, is currently outstanding under the Indenture. The Series 2015A Bonds are payable on a parity with the outstanding Series 2013A Bonds and Series 2005A Bonds. The Series 2015A Bonds, together with the Series 2013A Bonds and the Series 2005A Bonds remaining outstanding under the Indenture and any additional refunding bonds issued under the Indenture, are referred to herein as the "**Bonds**".

Pursuant to the Issuer's enabling legislation (the "**Act**"), and the Purchase and Sale Agreement, dated as of September 1, 2003, as amended and supplemented by the First Supplemental Purchase and Sale Agreement, dated as of July 1, 2005, and the Second Supplemental Purchase and Sale Agreement, dated as of April 1, 2015 (collectively, the "**Purchase and Sale Agreement**"), each between the California Infrastructure and Economic Development Bank, as agent for the State of California (the "**State**"), and the Issuer, the State sold to the Issuer on September 30, 2003 (the "**TSR Sale Date**"), without recourse, all of its right, title and interest in, to and under the Pledged TSRs. "**Pledged TSRs**" are the State's right to 43.43% of the State's "**Tobacco Assets**" (as defined in the Act), consisting of all of the State's then remaining unsold share of payments under the Master Settlement Agreement entered into by participating tobacco product manufacturers (the "**PMs**"), 46 states and six other U.S. jurisdictions in November 1998 in settlement of certain smoking-related litigation (the "**MSA**") and as further provided in the Memorandum of Understanding (the "**MOU**"), the Agreement Regarding Interpretation of Memorandum of Understanding, as amended (the "**ARIMOU**"), and the Escrow Agreement dated April 12, 2000, as amended (the "**California Escrow Agreement**") between the State and Citibank, N.A., as escrow agent, including (i) all amounts (other than Litigation Expense Reimbursements and California Escrow Agent Fees, as defined herein) received by the State under the MSA on or after the TSR Sale Date, including all adjustments to payments made to the State under the MSA prior to the TSR Sale Date, and (ii) all Lump Sum Payments, Partial Lump Sum Payments and Total Lump Sum Payments received by the State under the MSA on or after the TSR Sale Date. Pledged TSRs do not include the State's right to enforce any provisions of the MSA. The Issuer has assigned and pledged the Pledged TSRs to the Trustee pursuant to the Indenture in order to secure payment of the Bonds. Prior to the TSR Sale Date, the State sold its right to 56.57% of the Tobacco Assets to the Issuer and the Issuer assigned such Tobacco Assets to a trustee under a separate indenture as security for the Issuer's Tobacco Settlement Asset-Backed Bonds, Series 2003A, which were refunded in whole with proceeds of the Issuer's Tobacco Settlement Asset-Backed Bonds, Series 2007. The Trustee under such separate indenture is referred to herein as the "**Series 2007 Trustee**" and the Tobacco Assets assigned to the Series 2007 Trustee are referred to herein as the "**Series 2007 Pledged TSRs**." The right of the Trustee to receive Pledged TSRs is equal to and on a parity with, and is not inferior or superior to, the right of the Series 2007 Trustee to receive the Series 2007 Pledged TSRs. Neither the Issuer nor the Trustee shall have the right to make a claim to mitigate all or any part of an asserted deficiency in the Pledged TSRs from the Series 2007 Pledged TSRs and, likewise, neither the Issuer nor the State nor any participating jurisdiction (as such term is used in the Indenture) nor the Series 2007 Trustee shall have any right to make a claim to mitigate all or any part of an asserted deficiency in the Series 2007 Pledged TSRs from the Pledged TSRs.

The Bonds are limited obligations of the Issuer payable solely from and secured solely by the Pledged TSRs and the other collateral pledged under the Indenture including appropriations from the State for Debt Service (as defined in the Indenture), if any (collectively, the "Collateral"). The Legislature is not obligated by the Act, any covenant made in the Purchase and Sale Agreement, or any other provision of law, to appropriate or otherwise make funds available to pay Operating Expenses or Debt Service on the Series 2015A Bonds. The amount of Pledged TSRs actually collected depends on many factors, including future domestic cigarette consumption, the financial capability of the PMs and the tobacco industry, litigation generally, including litigation challenging the MSA and related state statutes, and federal, state and local regulations affecting the tobacco industry. Payments by the PMs under the MSA are subject to certain adjustments, including the NPM Adjustment (defined herein), some of which have occurred and may continue to occur and may be material. As discussed further herein, the State was one of several jurisdictions to enter into a settlement with the OPMs and certain SPMs (defined herein) regarding claims related to the 2003 through 2012 NPM Adjustments and the determination of subsequent NPM Adjustments. See "RISK FACTORS" and "LEGAL CONSIDERATIONS" herein for a discussion of certain factors that should be considered in connection with an investment in the Series 2015A Bonds.

The Series 2015A Bonds will be dated their date of delivery and mature on June 1 in the years as set forth on the inside cover page (each such date, a "**Maturity Date**"). Interest on the Series 2015A Bonds will be payable on each June 1 and December 1, commencing June 1, 2015. The Series 2015A Bonds are also subject to optional and mandatory redemption as described herein.

See the inside cover page for the Maturity Schedule, the Interest Rates, and Prices or Yields with respect to the Series 2015A Bonds.

This cover contains information for reference only. Potential investors must read the entire Official Statement to obtain information essential to making an informed investment decision.

THE ISSUER HAS NO AUTHORITY TO AND DOES NOT INTEND OR PURPORT TO PLEDGE THE FAITH, CREDIT, OR TAXING POWER OF THE STATE OR ANY OF ITS POLITICAL SUBDIVISIONS IN CONNECTION WITH THE ISSUANCE OF THE SERIES 2015A BONDS. THE SERIES 2015A BONDS ARE LIMITED OBLIGATIONS OF THE ISSUER; ARE SECURED SOLELY BY AND PAYABLE SOLELY FROM THE COLLATERAL; AND ARE NEITHER GENERAL NOR LEGAL OBLIGATIONS OF THE STATE OR ANY OF ITS POLITICAL SUBDIVISIONS. NEITHER THE FAITH AND CREDIT NOR THE TAXING POWER NOR ANY OTHER ASSETS OR REVENUES OF THE STATE OR OF ANY POLITICAL SUBDIVISION, OTHER THAN THE ISSUER TO THE EXTENT OF THE COLLATERAL, IS OR SHALL BE PLEDGED TO THE PAYMENT OF THE PRINCIPAL OF OR THE INTEREST ON THE SERIES 2015A BONDS. THE ISSUER HAS NO TAXING POWER.

The Series 2015A Bonds are offered when, as and if issued by the Issuer and accepted by the Underwriters, subject to the approval of validity by Orrick, Herrington & Sutcliffe LLP, as Transaction Counsel to the Issuer. Certain legal matters will be passed upon by Hawkins Delafield & Wood LLP, Sacramento, California, as Disclosure Counsel to the Issuer, and by Orrick, Herrington & Sutcliffe LLP and Stradling Yocca Carlson & Rauth, P.C., each as Co-Disclosure Counsel to the State with respect to Appendix A attached hereto. Certain legal matters will be passed upon for the State by its Attorney General, and for the Underwriters by Hiscock & Barclay LLP, Albany, New York, as counsel to the Underwriters. It is expected that the Series 2015A Bonds will be available for delivery on or about April 7, 2015, in book-entry form through The Depository Trust Company, New York, New York.

Barclays
(Joint Senior Manager)

Jefferies
(Co-Senior Manager)

Citigroup[1]
(Joint Senior Manager)

Academy Securities, Inc.
FirstSouthwest
KeyBanc Capital Markets Inc.
Oppenheimer & Co. Inc.
Raymond James
Southwest Securities, Inc.
Wedbush Securities Inc.
The Williams Capital Group, L.P.

Blaylock Beal Van, LLC
FTN Financial
BofA Merrill Lynch
Piper Jaffray & Co.
RH Investment Corporation
Stern Brothers & Co.
Wells Fargo Securities

Drexel Hamilton, LLC
Hutchinson, Shockey, Erley & Co.
Mesirow Financial Inc.
Prager & Co., LLC
Robert W. Baird & Co. Incorporated
U.S. Bancorp Investments, Inc.
William Blair & Company
Wulff, Hansen & Co.

March __, 2015

* Preliminary, subject to change.

[1] Billing and delivery agent for the Series 2015A Bonds.

MATURITY SCHEDULE, INTEREST RATES, AND PRICES OR YIELDS*

$1,704,990,000
Golden State Tobacco Securitization Corporation
Enhanced Tobacco Settlement Asset-Backed Bonds, Series 2015A

$526,310,000 Series 2015A Serial Bonds

Due (June 1)	Principal Amount	Interest Rate	Price or Yield	CUSIP No.†
2016	$38,765,000	%	%	
2017	9,430,000			
2018	22,775,000			
2019	23,180,000			
2020	23,500,000			
2021	23,625,000			
2022	4,650,000			
2023	2,480,000			
2024	220,000			
2025	1,060,000			
2026	5,020,000			
2027	2,625,000			
2028	735,000			
2031	11,630,000			
2032	84,455,000			
2033	87,465,000			
2034	90,655,000			
2035	94,040,000			

$1,178,680,000 Series 2015A Term Bonds

$528,435,000 ___% Series 2015A Term Bonds due June 1, 2040; Price: ___%; CUSIP No.† _________

$650,245,000 ___% Series 2015A Term Bonds due June 1, 2045; Price: ___%; CUSIP No.† _________

* Preliminary, subject to change.

† Copyright, American Bankers Association ("ABA"). CUSIP data herein are provided by CUSIP Global Services, operated on behalf of the ABA by S&P Capital IQ, a division of McGraw Hill Financial Inc. The CUSIP numbers listed above are being provided solely for the convenience of Bondholders only at the time of issuance of the Series 2015A Bonds, and the Issuer does not make any representation with respect to such numbers or undertake any responsibility for their accuracy now or at any time in the future. The CUSIP number for a specific maturity is subject to being changed after the issuance of the Series 2015A Bonds as a result of various subsequent actions.

Certain persons participating in this offering may engage in transactions that stabilize or maintain the price of the securities at a level above that which might otherwise prevail in the open market, or otherwise affect the price of the securities offered hereby, including over-allotment and stabilizing transactions. Such stabilizing, if commenced, may be discontinued at any time.

No dealer, broker, salesperson or other person is authorized in connection with any offering made hereby to give any information or make any representation other than as contained herein, and, if given or made, such information or representations must not be relied upon as having been authorized by the Issuer, the State or the Underwriters. This Official Statement does not constitute an offer to sell, or a solicitation of an offer to buy, any of the securities offered hereby by any person in any jurisdiction in which it is unlawful for such person to make such an offer or solicitation.

There can be no assurance that a secondary market for the Series 2015A Bonds will develop or, if one develops, that such secondary market will provide Owners with liquidity or be maintained for the life of the Series 2015A Bonds.

This Official Statement has been prepared by the Issuer and contains information furnished by the State, IHS Global (as defined herein) and other sources, all of which are believed to be reliable. Information concerning the State contained in "APPENDIX A—THE STATE OF CALIFORNIA," and the State's audited Comprehensive Annual Financial Report for the fiscal year ended June 30, 2013 attached hereto as "APPENDIX B—STATE OF CALIFORNIA COMPREHENSIVE ANNUAL FINANCIAL REPORT FOR THE FISCAL YEAR ENDED JUNE 30, 2013," have been obtained from the State. Information concerning the domestic tobacco industry and participants therein has been obtained from certain publicly available information provided by certain participants and certain other sources (see "APPENDIX G—CERTAIN INFORMATION RELATING TO THE DOMESTIC TOBACCO INDUSTRY" attached hereto). The participants in such industry have not provided any information to the Issuer for use in connection with this offering. In certain cases, domestic tobacco industry information provided herein (such as market share data) may be derived from sources which are inconsistent or in conflict with each other. The Issuer has no independent knowledge of any facts indicating that the information contained within "APPENDIX G—CERTAIN INFORMATION RELATING TO THE DOMESTIC TOBACCO INDUSTRY" attached hereto is inaccurate in any material respect, but has not independently verified this information and cannot and does not warrant the accuracy or completeness of this information. The information contained under the heading "SUMMARY OF THE TOBACCO CONSUMPTION REPORT" herein and in Appendix C attached hereto has been included in reliance upon IHS Global as an expert in econometric forecasting.

The information and expressions of opinion contained herein are subject to change without notice, and neither the delivery of this Official Statement nor any sale made hereunder shall, under any circumstances, create an implication that there has been no change in the affairs of the Issuer or the State or the matters covered by the report of IHS Global included as Appendix C, or under "APPENDIX G—CERTAIN INFORMATION RELATING TO THE DOMESTIC TOBACCO INDUSTRY" attached to this Official Statement since the date hereof or that the information contained herein is correct as of any date subsequent to the date hereof. Such information and expressions of opinion are made for the purpose of providing information to prospective investors and are not to be used for any other purpose or relied on by any other party.

This Official Statement contains forecasts, projections and estimates that are based on current expectations or assumptions. In light of the important factors that may materially affect the amount of Pledged TSRs (see "RISK FACTORS" and "SUMMARY OF THE MSA" herein), the inclusion in this Official Statement of such forecasts, projections and estimates should not be regarded as a representation by the Issuer, IHS Global or the Underwriters that such forecasts, projections and estimates will occur. Such forecasts, projections and estimates are not intended as representations of fact or guarantees of results.

References in this Official Statement to the Act, the Indenture, the Purchase and Sale Agreement and the Continuing Disclosure Certificate do not purport to be complete. Refer to the Act, the Indenture, the Purchase and Sale Agreement and the Continuing Disclosure Certificate for full and complete details of their provisions. Copies of the Act, the Indenture, the Purchase and Sale Agreement and the Continuing Disclosure Certificate are on file with the Issuer and the Trustee.

The order and placement of material in this Official Statement, including its appendices, are not to be deemed a determination of relevance, materiality or importance, and all materials in this Official Statement, including its appendices, must be considered in its entirety.

If and when included in this Official Statement, the words "expects," "forecasts," "projects," "intends," "anticipates," "estimates," "assumes" and analogous expressions are intended to identify forward-looking statements and any such statements inherently are subject to a variety of risks and uncertainties that could cause actual results to differ materially from those that have been projected. Such risks and uncertainties include, among others, general economic and business conditions, changes in political, social and economic conditions, regulatory initiatives and compliance with governmental regulations, litigation and various other events, conditions and circumstances, many of which are beyond the control of the Issuer. These forward-looking statements speak only as of the date of this Official Statement. The Issuer disclaims any obligation or undertaking to release publicly any updates or revisions to any forward-looking statement contained herein to reflect any changes in the Issuer's expectations with regard thereto or any change in events, conditions or circumstances on which any such statement is based.

The proposed securities transactions described herein will be made upon the exemption from registration provided in Section 3(a)2 of the Securities Act of 1933, as amended.

The Series 2015A Bonds have not been approved or disapproved by the United States Securities and Exchange Commission, any State securities commission or any other regulatory authority, nor has any of the foregoing passed upon the accuracy or adequacy of this Official Statement. Any representation to the contrary is a criminal offense.

The Underwriters have provided the following sentence for inclusion in this Official Statement: The Underwriters have reviewed the information in this Official Statement in accordance with, and as part of, their responsibilities to investors under the federal securities laws as applied to the facts and circumstances of this transaction, but the Underwriters do not guarantee the accuracy or completeness of such information.

TABLE OF CONTENTS

SUMMARY STATEMENT S-1
INTRODUCTORY STATEMENT 1
SECURITY FOR THE BONDS 3
Consent to Amendments to Indenture and Purchase and Sale Agreement 3
Pledge of Collateral 4
State Appropriations 5
Application of Collections 6
Liquidity Reserve Account 10
Elimination of Supplemental Reserve Requirement 11
THE SERIES 2015A BONDS 11
Payments of Interest 11
Payments of Principal at Maturity 12
Redemption by Mandatory Sinking Fund Payments 12
Application of Funds Upon the Occurrence of an Event of Default 12
Optional Redemption 13
Redemption from Amounts in the Partial Lump Sum Payment Account 13
Redemption by Application of a Total Lump Sum Payment 13
Mandatory Clean-up Redemption 14
Purchase of Series 2015A Bonds 14
Effect of Defeasance, Redemption or Purchase 14
Partial Redemptions 14
Notice of Redemption 15
Additional Bonds 15
Book-Entry-Only System 15
THE ISSUER 18
ESTIMATED SOURCES AND USES OF FUNDS 19
Sources of Funds 19
Uses of Funds 19
OUTSTANDING BONDS 20
Series 2005A Bonds and Series 2013A Bonds 20
TABLE OF PROJECTED AVAILABLE FUNDS AND DEBT SERVICE COVERAGE 21
Projected Available Funds and Debt Service Coverage 21
Allocation of Principal or Accreted Value Payments 23
RISK FACTORS 23
Potential Payment Decreases Under the Terms of the MSA 24
If Litigation Challenging the MSA, the Qualifying Statutes and Related Legislation Were Successful, Payments under the MSA Might be Suspended or Terminated 28
Litigation Seeking Monetary Relief from Tobacco Industry Participants May Adversely Impact the Ability of the PMs to Continue to Make Payments Under the MSA 29
Declines in Cigarette Consumption May Materially Adversely Affect Pledged TSRs Available for the Series 2015A Bonds 33
Risks Relating to the Tobacco Consumption Report 42
Other Risks Relating to the MSA and Related Statutes .. 42
General Economic Conditions and Lack of Access to Favorable Financing May Materially Adversely Impact the Ability of the PMs to Continue to Operate, Leading to Reduced Sales of Cigarettes and Payments under the MSA 43
Bankruptcy of a PM May Delay, Reduce or Eliminate Payments of Pledged TSRs 44
Bonds Secured Solely by the Collateral 45
Risk Related to the Liquidity Reserve Account 45
Rating Agency Actions With Respect to Unenhanced Tobacco Settlement Revenue Bonds Highlight the Importance to Investors of Analyzing the Likelihood of a Need for State Appropriations 45
Enforceability of Obligation of Governor to Include Appropriation in the Budget; No Obligation of State to Appropriate 46
Limited Remedies 47
Limited Liquidity of the Bonds; Price Volatility 47
Limited Nature of Ratings; Reduction, Suspension or Withdrawal of a Rating 47
LEGAL CONSIDERATIONS 48
Bankruptcy Considerations 48
MSA and Qualifying Statute Enforceability 50
Limitations on Certain Opinions of Counsel: No Assurance as to Outcome of Litigation 52
Enforcement of Rights to Pledged TSRs 52
No Assurance As to the Outcome of Litigation 53
SUMMARY OF THE MSA 53
General 53
Parties to the MSA 54
Scope of Release 55
Overview of Payments by the Participating Manufacturers; MSA Escrow Agent 56
Initial Payments 57
Annual Payments 57
Strategic Contribution Fund Payments 58
Adjustments to Payments 59
Subsequent Participating Manufacturers 62
Payments Made to Date 63
"Most Favored Nation" Provisions 65
State-Specific Finality and Final Approval 65
Disbursement of Funds from Escrow 65
Advertising and Marketing Restrictions; Educational Programs 66
Remedies upon the Failure of a PM to Make a Payment 66
Termination of Agreement 67
Severability 67
Amendments and Waivers 67
MSA Provisions Relating to Model/Qualifying Statutes 67
California Qualifying Statute 70
California Complementary Legislation 71

State Statutory Enforcement Framework........................73
Litigation Challenging the MSA, the Qualifying Statutes and Related Legislation 76
Potential Payment Decreases Under the Terms of the MSA...80
Other Disputes Related to MSA Payments.....................95
THE CALIFORNIA CONSENT DECREE, THE MOU, THE ARIMOU AND THE CALIFORNIA ESCROW AGREEMENT 96
General Description...96
Flow of Funds and California Escrow Agreement 96
Enforcement Provisions of the Decree, the MOU and the ARIMOU 97
SUMMARY OF THE TOBACCO CONSUMPTION REPORT 97
General 98
Cigarette Consumption in the United States...................98
Factors Affecting Cigarette Consumption 99
Empirical Model of Cigarette Consumption and IHS Global Forecast..100
Comparison with Prior Forecast 101
TABLES OF PROJECTED PLEDGED TSRs, PROJECTION METHODOLOGY AND BOND STRUCTURING ASSUMPTIONS..........................101
Introduction 101
Collection Methodology and Assumptions..................102
Adjustments to Payments Under the NPM Adjustment Stipulated Partial Settlement and Award 104
Projection of Payments to be Received by the Trustee.105
Interest Earnings..108
Bond Structuring Methodology 108
THE PURCHASE AND SALE AGREEMENT...........109
Conveyance of Pledged TSRs 109
Representations of State 109
Limitation on Liability...111
Non-Impairment Covenant of State.............................111
Tax Covenant...111
California Escrow Agent 112
Continuing Disclosure 112
Amendment 112
Assignment by the Issuer...112
Definitions 113
THE INDENTURE..113
No Liability on Bonds 113
Security Interest and Pledge 114
Defeasance...114
Effect of Defeasance, Redemption or Purchase............115
Establishment of Accounts 115
Investments..115
Unclaimed Money 117
Contract; Obligations to Owners; Representations of the Issuer 118
Non-Impairment Covenant of State.............................118
Operating Expenses 119
Tax Covenants 119
Accounts and Reports..120
Ratings...120
Affirmative Covenants...120
Negative Covenants...121
Prior Notice...123
Trustee's Responsibility 123
Rights and Duties of the Fiduciaries............................124
Resignation or Removal of the Trustee 125
Successor Fiduciaries...125
Reports to Owners 126
Compensation and Expenses of the Fiduciaries............126
Nonpetition Covenant..126
Action by Owners..127
Registered Owners...127
Events of Default...127
Remedies 128
Remedies Cumulative..129
Delay or Omission Not a Waiver.................................129
Supplements and Amendments to the Indenture...........130
Definitions and Interpretation......................................130
CONTINUING DISCLOSURE UNDERTAKING......137
TAX MATTERS 138
FINANCIAL STATEMENTS......................................140
RATINGS..140
VERIFICATION OF MATHEMATICAL COMPUTATIONS 141
UNDERWRITING 141
LEGAL MATTERS...141
OTHER PARTIES...142
IHS Global...142
Financial Advisors...142

APPENDIX A – THE STATE OF CALIFORNIA A-1
APPENDIX B – STATE OF CALIFORNIA COMPREHENSIVE ANNUAL FINANCIAL REPORT FOR THE FISCAL YEAR ENDED JUNE 30, 2013 .... B-1
APPENDIX C – TOBACCO CONSUMPTION REPORT C-1
APPENDIX D – MASTER SETTLEMENT AGREEMENT D-1
APPENDIX E – NPM ADJUSTMENT STIPULATED PARTIAL SETTLEMENT AND AWARD AND SETTLEMENT TERM SHEET E-1
APPENDIX F-1 – PROPOSED FORM OF OPINION OF TRANSACTION COUNSEL F-1-1
APPENDIX F-2 – PROPOSED FORM OF OPINION OF THE ATTORNEY GENERAL OF THE STATE F-2-1
APPENDIX G – CERTAIN INFORMATION RELATING TO THE DOMESTIC TOBACCO INDUSTRY G-1
APPENDIX H – FORM OF CONTINUING DISCLOSURE CERTIFICATE H-1
APPENDIX I – SERIES 2005A BONDS TO BE REFUNDED I-1
APPENDIX J – LETTERS FROM CERTAIN UNDERWRITERS J-1
APPENDIX K – INDEX OF DEFINED TERMS K-1

(THIS PAGE INTENTIONALLY LEFT BLANK)

SUMMARY STATEMENT

This Summary Statement is subject in all respects to more complete information contained in this Official Statement and should not be considered a complete statement of the facts material to making an investment decision. The offering of the Series 2015A Bonds to potential investors is made only by means of the entire Official Statement. For an index of certain terms used herein, see Appendix K. Definitions of certain capitalized terms not defined elsewhere in this Official Statement are set forth in "THE INDENTURE—Definitions and Interpretation."

Overview.................................... Golden State Tobacco Securitization Corporation (the "**Issuer**") is issuing its $1,704,990,000[*] aggregate principal amount of Enhanced Tobacco Settlement Asset-Backed Bonds, Series 2015A (the "**Series 2015A Bonds**").

The Series 2015A Bonds are being issued pursuant to an indenture by and between the Issuer and The Bank of New York Mellon Trust Company, N.A. (formerly known as The Bank of New York Trust Company, N.A. and successor to BNY Western Trust Company), as Trustee (the "**Trustee**"), dated as of September 1, 2003 (the "**Master Indenture**"), as supplemented by the Series 2003B Supplement, dated as of September 1, 2003, as supplemented and amended by the First Supplemental Indenture, dated as of July 1, 2005 (the "**First Supplemental Indenture**"), the Second Supplemental Indenture, dated as of April 1, 2013 (the "**Second Supplemental Indenture**"), and the Third Supplemental Indenture, dated as of April 1, 2015 (the "**Third Supplemental Indenture**"). The Master Indenture, as supplemented and amended, is hereinafter referred to as the "**Indenture**". The Indenture only permits the issuance of additional refunding bonds, subject to the satisfaction of certain conditions described herein.

The Issuer will use the proceeds from the issuance of the Series 2015A Bonds, together with amounts released from the Liquidity Reserve Account, the Supplemental Reserve Account and the Surplus Account, (i) to refund on a current basis a portion equal to $1,959,775,000[*] aggregate principal amount of the Issuer's Enhanced Tobacco Settlement Asset-Backed Bonds, Series 2005A (the "**Series 2005A Bonds**") that are outstanding under the Indenture and (ii) to pay the costs of issuance of the Series 2015A Bonds. See "APPENDIX I—SERIES 2005A BONDS TO BE REFUNDED" for a listing of the Series 2005A Bonds that are expected to be refunded and defeased on the Series 2015A Closing Date (as defined herein). See also "ESTIMATED SOURCES AND USES OF FUNDS" herein.

Following the refunding of such portion of the Series 2005A Bonds, $593,300,000[*] aggregate principal amount at maturity of the Series

[*] Preliminary, subject to change.

2005A Bonds will remain outstanding under the Indenture, constituting Current Interest Bonds and Capital Appreciation Bonds, as such terms are defined herein, and $375,105,000 aggregate principal amount of the Issuer's Enhanced Tobacco Settlement Asset-Backed Bonds, Series 2013A (the "**Series 2013A Bonds**"), constituting Current Interest Bonds, which were issued in April 2013 to refund a portion of the Series 2005A Bonds, is currently outstanding under the Indenture. See "OUTSTANDING BONDS." The Series 2015A Bonds are payable on a parity with the outstanding Series 2013A Bonds and Series 2005A Bonds. The Series 2015A Bonds, together with the Series 2013A Bonds and the Series 2005A Bonds remaining outstanding under the Indenture and any additional refunding bonds issued under the Indenture, are referred to herein as the "**Bonds**". See "THE SERIES 2015A BONDS—Additional Bonds" herein.

Pursuant to authorization granted in Article 7 of Chapter 2 of Division 1 of Title 6.7 of the California Government Code, as amended (the "**Act**"), and the Purchase and Sale Agreement, dated as of September 1, 2003, as amended and supplemented by the First Supplemental Purchase and Sale Agreement, dated as of July 1, 2005, and the Second Supplemental Purchase and Sale Agreement (the "**Second Supplemental Purchase and Sale Agreement**"), dated as of April 1, 2015 (collectively, the "**Purchase and Sale Agreement**"), each between the California Infrastructure and Economic Development Bank (the "**CIEDB**"), for and on behalf of and as agent for the State of California (the "**State**"), and the Issuer, the State sold to the Issuer on September 30, 2003 (the "**TSR Sale Date**"), without recourse, all of its right, title and interest in, to and under the Pledged TSRs. "**Pledged TSRs**" are the State's right to 43.43% of the State's "**Tobacco Assets**" (as defined in the Act), consisting of all of the State's then remaining unsold share of payments under the Master Settlement Agreement (as defined herein, the "**MSA**") and as further provided in the Memorandum of Understanding (the "**MOU**"), as agreed to by the State and the Participating Jurisdictions (as defined below), the Agreement Regarding Interpretation of Memorandum of Understanding, as amended (the "**ARIMOU**"), and an Escrow Agreement, dated April 12, 2000, as amended (the "**California Escrow Agreement**") between the State and Citibank, N.A., as escrow agent (the "**California Escrow Agent**"), including (i) all amounts (other than Litigation Expense Reimbursements and California Escrow Agent Fees, each as herein defined) received by the State under the MSA on or after the TSR Sale Date, including all adjustments to payments made to the State under the MSA prior to the TSR Sale Date, and (ii) all Lump Sum Payments, Partial Lump Sum Payments and Total Lump Sum Payments (defined under "*Distributions and Priorities*" below) received by the State under the MSA on or after the TSR Sale Date. Pledged TSRs do not include the State's right to enforce any provisions of the MSA or the Consent Decree and Final

Judgment pursuant to which the MSA was approved in the State (the "**Decree**"). Pledged TSRs also do not include any TSRs previously received by the State or any amounts previously paid to the State pursuant to the Purchase and Sale Agreement.

Prior to the TSR Sale Date, the State sold its right to 56.57% of the Tobacco Assets to the Issuer and the Issuer assigned such Tobacco Assets to a trustee under a separate indenture as security for the Issuer's Tobacco Settlement Asset-Backed Bonds, Series 2003A, which were refunded in whole with proceeds of the Issuer's Tobacco Settlement Asset-Backed Bonds, Series 2007 (the "**Series 2007 Bonds**"). The Trustee under such separate indenture is referred to herein as the "**Series 2007 Trustee**" and the Tobacco Assets assigned to the Series 2007 Trustee are referred to herein as the "**Series 2007 Pledged TSRs**."

The right of the Trustee to receive Pledged TSRs is equal to and on a parity with, and is not inferior or superior to, the right of the Series 2007 Trustee to receive the Series 2007 Pledged TSRs. Neither the Issuer nor the Trustee shall have the right to make a claim to mitigate all or any part of an asserted deficiency in the Pledged TSRs from the Series 2007 Pledged TSRs and, likewise, neither the Issuer nor the State nor any participating jurisdiction (as such term is used in the Indenture) nor the 2007 Trustee shall have any right to make a claim to mitigate all or any part of an asserted deficiency in the Series 2007 Pledged TSRs from the Pledged TSRs. The right of the Series 2007 Trustee to receive the Series 2007 Pledged TSRs is equal to and on a parity with, and shall not be inferior or superior to, the right of the Trustee to receive the Pledged TSRs.

The Issuer has no authority to and does not intend or purport to pledge the faith, credit, or taxing power of the State or any of its political subdivisions in connection with the issuance of the Series 2015A Bonds. The Series 2015A Bonds are limited obligations of the Issuer; are secured solely by and payable solely from the Collateral (as defined herein); and are neither general nor legal obligations of the State or any of its political subdivisions. Neither the faith and credit nor the taxing power nor any other assets or revenues of the State or of any political subdivision thereof, other than the Issuer to the extent of the Collateral, is or shall be pledged to the payment of the principal of or the interest on the Series 2015A Bonds. The Issuer has no taxing power.

Consent to Amendments to Indenture and Purchase and Sale Agreement......................... As a result of their purchase of the Series 2015A Bonds, owners thereof (but not the Underwriters) will be deemed to have consented to certain amendments to the Indenture and the Purchase and Sale Agreement. Such amendments relate to changing (1) the Liquidity Reserve Requirement from $214,307,881.25 to $150,000,000, (2) the Supplemental Reserve Requirement from $31,949,870.09 to $0, (3) the provisions of the Indenture relating to the valuation of investments in the Liquidity Reserve Account and (4) the non-impairment covenants of the State contained in the Indenture and the Purchase and Sale Agreement to add a standard of material adversity, to reflect an amendment to the Act (Stats. 2009, ch. 28, effective August 6, 2009, which amended Section 63049.4 of the California Government Code). The Series 2015A Bonds will represent a Majority in Interest of the Bonds to be Outstanding upon the issuance of the Series 2015A Bonds and accordingly these amendments will be effective on the date of issuance of the Series 2015A Bonds. The Underwriters have not consented to, and shall not be deemed to have consented to, such amendments to the Indenture and the Purchase and Sale Agreement. See "SECURITY FOR THE BONDS—Consent to Amendments to Indenture and Purchase and Sale Agreement," "SECURITY FOR THE BONDS—Liquidity Reserve Account," "SECURITY FOR THE BONDS—Elimination of Supplemental Reserve Requirement," "THE INDENTURE—Investments—*Valuation*," "THE PURCHASE AND SALE AGREEMENT—Non-Impairment Covenant of the State" and "THE INDENTURE—Non-Impairment Covenant of the State."

The Issuer .... The Issuer is a special purpose trust established as a not-for-profit corporation by the Act. The Issuer is authorized to have purchased the Pledged TSRs and to issue bonds of the Issuer payable solely from and secured solely by the Collateral.

Sale of Pledged TSRs .... Pursuant to the Purchase and Sale Agreement, the CIEDB, as agent of the State, sold to the Issuer, on the TSR Sale Date, the State's right, title and interest in, to and under the Pledged TSRs. The Issuer has assigned and pledged the purchased Pledged TSRs to the Trustee pursuant to the Indenture in order to secure payment of the Bonds. The California Escrow Agent has been irrevocably instructed by the Attorney General of the State to disburse the Pledged TSRs directly to the Trustee. See "THE PURCHASE AND SALE AGREEMENT" and "SECURITY FOR THE BONDS" herein.

Collateral .... The Bonds are limited obligations of the Issuer payable solely from and secured solely by (a) the Purchase and Sale Agreement and the Pledged TSRs; (b) the Pledged Accounts (as defined below), all money, instruments, payment intangibles, investment property, or other property credited to or on deposit in the Pledged Accounts (which excludes the Pledged TSRs allocable to the Operating Account, the Operating Contingency Account or the Rebate Account) and all investment earnings on amounts on deposit in or credited to the Pledged Accounts; (c) any payment received by the Issuer pursuant to a Swap Contract (defined herein); (d) State Appropriations for Debt Service, if any; and (e) all present and future claims, demands, causes, and things in action in respect of any or all of the foregoing and all proceeds of the foregoing (collectively, the "**Collateral**").

"**Pledged Accounts**" means the Collections Account (except to the extent that money therein is allocable to the Operating Account, the Operating Contingency Account or the Rebate Account), the Debt Service Account, the Partial Lump Sum Payment Account, the Liquidity Reserve Account, the Surplus Account and all subaccounts contained in the named accounts.

State Appropriations................

In order to enhance the security of the Bonds (including the Series 2015A Bonds), the Trustee, the Issuer and the State have agreed in the Indenture and the Purchase and Sale Agreement to follow certain procedures in a two-step process for (1) requesting appropriations of funds from the State, and (2) certifying deficiencies in amounts available to pay debt service on the Bonds and/or Operating Expenses, and disbursing funds appropriated by the State to the Trustee for the payment of debt service on the Bonds and/or Operating Expenses ("**State Appropriations**").

Request for State Appropriations. As provided in the Indenture, on each October 20, the Trustee is required to calculate the amount of Debt Service and Operating Expenses to become due during the next succeeding Fiscal Year on the Bonds. On or before each November 1 (based on the preceding October 20 calculation), the Trustee is required to notify the Issuer of such amounts and the Issuer has covenanted to notify the Director of Finance of such amounts in order to enable the Director of Finance and the Governor to request such amounts from the Legislature in an appropriation line item in the annual budget act. In order to assist the Issuer in financing or refinancing the purchase of the Pledged TSRs by enhancing the security of the Bonds, in furtherance of the Act, the State has covenanted in the Purchase and Sale Agreement that on or before January 10 of each year, the Director of Finance of the State shall request the Governor to include in the annual budget act (for the Fiscal Year commencing July 1 of such year) an appropriation line item from the General Fund of the State for allocation by the Department of Finance to the Issuer in an amount equal to the Debt Service and Operating Expenses to become due during such Fiscal Year on the Bonds. The Director of Finance shall provide a copy of such request to the Joint Legislative Budget Committee. The Director of Finance shall also certify to the Trustee that the Director of Finance has complied with his or her obligations under the two preceding sentences. Pursuant to the Act, the State has covenanted in the Purchase and Sale Agreement that the Governor shall each year request from the Legislature the appropriation line item referred to above in the annual budget act.

The Legislature is not obligated by the Act, any covenant made in the Purchase and Sale Agreement, or any other provision of law, to appropriate or otherwise make funds available to pay Operating Expenses or Debt Service on the Bonds. See "SECURITY FOR THE BONDS—State Appropriations" and "RISK FACTORS—Enforceability of Obligation of Governor to Include Appropriation in the Budget; No Obligation of State to Appropriate" herein.

Certification of Actual Deficiencies; Disbursement and Encumbrance of Appropriated Amounts. On each April 25 (and at any other time upon request of the Issuer), the Trustee is required to calculate the amount of cash and investments on deposit in the Pledged Accounts, the Operating Account and the Operating Contingency Account. On or before each May 1 (based on the preceding April 25 calculation), the Trustee will notify the Issuer as to the amount of any deficiency in (i) such amounts in the Pledged Accounts to pay Debt Service on the Bonds to be paid during the next succeeding 12 months, and (ii) such amounts in the Operating Account and the Operating Contingency Account to pay all Operating Expenses scheduled to become due during the next succeeding 12 months. The Issuer has covenanted to notify the State's Department of Finance by May 5 of each year (and at any other time as may be necessary) of any deficiencies in such amounts. Upon receipt of an Officer's Certificate of the Issuer delivered in May which certifies the existence of a deficiency with regard to the next succeeding June 1 Distribution Date, any amounts appropriated relating to such June 1 Distribution Date shall be disbursed by the Department of Finance to the Trustee no later than five (5) days prior to such Distribution Date for the purpose of paying the Operating Expenses and Debt Service on the Bonds specified in such Officer's Certificate. In the event such Officer's Certificate delivered in May also certifies the existence of a deficiency with regard to the next succeeding December 1 Distribution Date and to the extent that amounts have been appropriated and remain available for Debt Service and/or Operating Expenses, the amounts so appropriated shall be encumbered as soon as reasonably practical following receipt of such Officer's Certificate and in any event before the end of the fiscal year, and the amounts so appropriated shall be disbursed by the Department of Finance to the Trustee (subject to adjustment as to the amount upon receipt of a supplemental Officer's Certificate pursuant to the Indenture) no later than five (5) days prior to such December 1 Distribution Date for the purpose of paying the Operating Expenses and Debt Service on the Bonds specified in such Officer's Certificate. See "SECURITY FOR THE BONDS—State Appropriations."

See "APPENDIX A—THE STATE OF CALIFORNIA" for a discussion of the State's economy and finances, and see "APPENDIX B—STATE OF CALIFORNIA COMPREHENSIVE ANNUAL FINANCIAL REPORT FOR THE FISCAL YEAR

ENDED JUNE 30, 2013" for a copy of the State's audited Comprehensive Annual Financial Report for the fiscal year ended June 30, 2013. See also "FINANCIAL STATEMENTS" herein.

Securities Offered The Series 2015A Bonds will be issued pursuant to the Indenture. It is expected that the Series 2015A Bonds will be delivered in book-entry form through the facilities of The Depository Trust Company ("**DTC**"), New York, New York, on or about April 7, 2015 (the "**Series 2015A Closing Date**"). Individual purchases of beneficial ownership interests in the Series 2015A Bonds may be made in the principal amount of $5,000 or any integral multiple thereof. Beneficial owners of the Series 2015A Bonds will not receive physical delivery of bond certificates. See "THE SERIES 2015A BONDS—Book-Entry-Only System" herein.

The net proceeds of the Series 2015A Bonds are not pledged to, and are not available for, the payment of Debt Service on the Series 2015A Bonds.

Principal The Series 2015A Bonds will mature on June 1 in the years as set forth on the inside cover page (each such date, a "**Maturity Date**"). The Series 2015A Bonds maturing on June 1 in the years 2040* and 2045* are Term Bonds subject to redemption in part from Mandatory Sinking Fund Payments as described under "THE SERIES 2015A BONDS—Redemption by Mandatory Sinking Fund Payments." Failure to pay when due any Serial Maturity, Mandatory Sinking Fund Payment or Term Bond Maturity (each as defined herein) is an Event of Default. See "THE INDENTURE—Events of Default" herein.

Interest The Series 2015A Bonds constitute Current Interest Bonds, as defined herein. Interest on the outstanding principal amount of the Series 2015A Bonds will be payable on each June 1 and December 1 (each, a "**Distribution Date**") commencing June 1, 2015. Interest on the Series 2015A Bonds will be computed on the basis of a 360-day year consisting of twelve 30-day months. Failure to pay the full amount of interest on any Series 2015A Bonds when due is an Event of Default. See "THE INDENTURE—Events of Default" herein.

Optional Redemption The Series 2015A Bonds maturing on or prior to June 1, 2025* are not subject to optional redemption. The Series 2015A Bonds maturing on or after June 1, 2026* are subject to optional redemption prior to maturity, in whole or in part, from any source (other than State Appropriations), on any date on or after June 1, 2025* at a redemption price equal to 100% of the principal amount being redeemed, plus interest accrued to the redemption date, without premium. See "THE SERIES 2015A BONDS—Optional Redemption" herein.

* Preliminary, subject to change.

Liquidity Reserve Account ....

A reserve account (the "**Liquidity Reserve Account**") was established by the Trustee under the Indenture in an amount equal to $214,307,881.25 (as amended as described below, the "**Liquidity Reserve Requirement**"). Pursuant to the Third Supplemental Indenture, the Liquidity Reserve Requirement is amended to $150,000,000, and the funds held in the Liquidity Reserve Account in excess of such amended Liquidity Reserve Requirement will be released on the Series 2015A Closing Date and applied to the refunding of a portion of the Series 2005A Bonds. See "SUMMARY STATEMENT—Consent to Amendments to Indenture and Purchase and Sale Agreement" and "SECURITY FOR THE BONDS—Consent to Amendments to Indenture and Purchase and Sale Agreement" herein.

Amounts on deposit in the Liquidity Reserve Account will be available to pay Serial Maturities, Mandatory Sinking Fund Payments, Term Bond Maturities (as such terms are defined herein) and interest on the Bonds (prior to application of State Appropriations, if any), and Swap Payments, to the extent amounts in the Debt Service Account, the Partial Lump Sum Payment Account and the Surplus Account, in that order, are insufficient for such purpose. Any amount remaining after such payments in excess of the Liquidity Reserve Requirement will be deposited in the Collections Account. See "SECURITY FOR THE BONDS—Application of Collections—*Distribution Date Transfers*" herein.

Unless an Event of Default has occurred, available funds on deposit in the Collections Account will be transferred to the Liquidity Reserve Account in accordance with the priority of transfers set forth in the Indenture in an amount sufficient to cause the amount on deposit in the Liquidity Reserve Account to equal the Liquidity Reserve Requirement; provided, however, that no State Appropriations shall be deposited into the Liquidity Reserve Account. See "SECURITY FOR THE BONDS—Application of Collections—*Transfers to Accounts*" herein. See also "RISK FACTORS—Risk Related to the Liquidity Reserve Account."

Elimination of Supplemental Reserve Requirement...............

A reserve account (the "**Supplemental Reserve Account**") was established by the Trustee under the Indenture in an amount equal to $31,949,870.09 (as amended as described below, the "**Supplemental Reserve Requirement**"). Pursuant to the Third Supplemental Indenture, the Supplemental Reserve Requirement is amended to $0, and amounts in the Supplemental Reserve Account will be released on the Series 2015A Closing Date and applied to the refunding of a portion of the Series 2005A Bonds. Therefore, following the issuance of the Series 2015A Bonds and the application of the proceeds thereof, the Supplemental Reserve Requirement, and the balance in the Supplemental Reserve Account, will be $0. See "SUMMARY STATEMENT—Consent to

Amendments to Indenture and Purchase and Sale Agreement" and "SECURITY FOR THE BONDS—Consent to Amendments to Indenture and Purchase and Sale Agreement" herein.

Distributions and Priorities......

"**Collections**" consist of all funds collected as Pledged TSRs, amounts paid to the Issuer under any Swap Contract, investment earnings on the Pledged Accounts, and State Appropriations, if any. Promptly upon receipt, the Trustee will deposit all Collections (excluding investment earnings on amounts on deposit with the Trustee under the Indenture), in an account established and maintained by the Trustee under the Indenture (the "**Collections Account**"). All Collections that have been identified by an Officer's Certificate as consisting of Partial Lump Sum Payments received by the Trustee will be promptly (and, in any event, no later than the Business Day immediately preceding the next following Distribution Date) transferred to the Partial Lump Sum Payment Account. All Collections that have been identified by an Officer's Certificate as consisting of Total Lump Sum Payments received by the Trustee will be promptly (and, in any event, no later than the Business Day immediately preceding the next Distribution Date) applied in the manner described under "*Distribution Date Transfers*" below. All Collections that have been identified by an Officer's Certificate as consisting of State Appropriations received by the Trustee shall be promptly applied (and in any event, no later than the Business Day immediately preceding the next Distribution Date) as described under "*State Appropriations Transfers*" below in accordance with the instructions received by the Trustee pursuant to such Officer's Certificate. In addition, on each Distribution Date, the Trustee will deposit in the Collections Account and apply as set forth below (i) all Collections consisting of investment earnings available on such Distribution Date on amounts on deposit with the Trustee under the Indenture (excluding amounts in the Costs of Issuance Account, the Rebate Account, the Operating Account, the Operating Contingency Account and the Partial Lump Sum Payment Account), and (ii) all amounts in the Liquidity Reserve Account in excess of the Liquidity Reserve Requirement determined to exist pursuant to the valuation procedure provided in the Indenture, taking into account investment earnings and other amounts to be available in the Liquidity Reserve Account on such Distribution Date.

"**Lump Sum Payment**" means a final payment under the MSA from a PM (as defined below) that results in, or is due to, a release of that PM from all of its future payment obligations under the MSA. Any Lump Sum Payment shall be applied as Collections. The term "Lump Sum Payment" does not include any payments that are Partial Lump Sum Payments.

"**Partial Lump Sum Payment**" means a payment under the MSA from a PM that results in, or is due to, a release of that PM from a portion, but not all, of its future payment obligations under the MSA.

"**Total Lump Sum Payment**" means a final payment under the MSA from all of the PMs that results in, or is due to, a release of all of the PMs from all of their future payment obligations under the MSA.

"**Swap Contract**" means an interest rate exchange, cap, collar, hedge or similar agreement entered into by the Issuer (with respect to the Bonds).

"**Swap Payment**" means any payment with respect to a Swap Contract, except that such payments shall not include any payment to be made by the Issuer to a counterparty with respect to the termination of the Swap Contract or any loss payments thereunder.

The Issuer is not currently a party to any Swap Contract.

Transfers to Accounts. As soon as practicable, but no later than the earlier of (a) the fifth Business Day following each date of actual receipt by the Trustee of any Pledged TSRs (a "**Deposit Date**"), or (b) the Distribution Date following each Deposit Date, the Trustee will withdraw the funds on deposit in the Collections Account and transfer such amounts as follows:

(i) to the Operating Account an amount sufficient to cause the amount therein (taking into account any amounts deposited from State Appropriations as specified under "*State Appropriations Transfers*" below) to equal the amount specified by an Officer's Certificate delivered with respect to the 12-month period applicable to such Officer's Certificate, in order to pay (a) the Operating Expenses, (excluding any payment in respect of loss under or termination of any Swap Contract, investment agreement or forward purchase agreement), to the extent that the amount thereof does not exceed the Operating Cap, and (b) the Tax Obligations;

(ii) to the Debt Service Account an amount sufficient to cause the amount therein (taking into account any amounts deposited from State Appropriations as specified under "*State Appropriations Transfers*" below) to equal the interest on the Outstanding Current Interest Bonds and all Swap Payments that will come due (1) in the next succeeding Bond Year, if the Deposit Date is on or after December 1 and on or before May 31 of any Bond Year, or (2) in the then-current Bond Year, if the Deposit Date is on or after June 1 and on or before November 30 of any Bond Year; provided that the amount to be deposited pursuant to this clause (ii) shall be calculated assuming that the amount of each Serial Maturity, Mandatory

Sinking Fund Payment and Term Bond Maturity shall be first adjusted as described in "THE INDENTURE—Effect of Defeasance, Redemption or Purchase";

(iii) to the Debt Service Account an amount sufficient to cause the amount therein (taking into account any amounts deposited from State Appropriations as specified under "*State Appropriations Transfers*" below) to equal the amount specified in clause (ii) above plus, if the Deposit Date is on or after December 1 and on or before May 31 of any Bond Year, the Serial Maturity, Mandatory Sinking Fund Payment or Term Bond Maturity, if any, due in or scheduled for the next succeeding Bond Year, provided that the amount of each Serial Maturity, Mandatory Sinking Fund Payment and Term Bond Maturity shall first be adjusted to account for prior principal or Accreted Value payments, redemptions or purchases of Bonds as described in "THE INDENTURE—Effect of Defeasance, Redemption or Purchase";

(iv) unless an Event of Default has occurred, to the Liquidity Reserve Account an amount sufficient to cause the amount on deposit therein to equal the Liquidity Reserve Requirement, provided that no State Appropriations shall be deposited into the Liquidity Reserve Account;

(v) to the Operating Contingency Account, the amount, if any, necessary to make the amount therein (taking into account any amounts deposited from State Appropriations as specified under "*State Appropriations Transfers*" below) equal to $500,000, plus an amount specified by the Officer's Certificate most recently delivered or deemed delivered in order to pay, for the 12-month period applicable to such Officer's Certificate, the Operating Expenses in excess of the Operating Cap;

(vi) (reserved);

(vii) to the Surplus Account, all amounts remaining in the Collections Account until no Bonds remain Outstanding; and

(viii) thereafter, to the Residual Account, all amounts remaining in the Collections Account.

"**Operating Expenses**" means the reasonable operating expenses of the Issuer (including, without limitation, the cost of preparation of accounting and other reports, costs of maintenance of the ratings on the Bonds, insurance premiums, deductibles and retention payments, and costs of meetings or other required activities of the Issuer), premiums for Reserve Facilities, legal fees and expenses of the Issuer, its officers, directors and employees, fees and expenses incurred for professional consultants and fiduciaries (including, but not limited to, computation of the amount of Tax Obligations and related computations), the fees, expenses, and disbursements of the

Trustee, including the fees and expenses of counsel to the Trustee, payments in respect of loss under or termination of any Swap Contract, investment agreement or forward purchase agreement relating to any Account, costs incurred in order to preserve the tax-exempt status of any tax-exempt Bonds and the costs related to the Issuer's or the Trustee's enforcement rights with respect to the Indenture, the Purchase and Sale Agreement or the Bonds. The term "Operating Expenses" does not include the costs of issuance of the Bonds.

"**Operating Cap**" means (i) $455,173.68 in the Fiscal Year ending June 30, 2015, inflated in each following Fiscal Year by the percentage representing the fraction "1+x" over "1+y", where "x" equals the Inflation Adjustment Percentage (as defined in the MSA) applicable to MSA payments due in the calendar year ending in such Fiscal Year, and "y" equals the Inflation Adjustment Percentage applicable to MSA payments due in the preceding Fiscal Year, as calculated by or on behalf of the Issuer and set forth in an Officer's Certificate, plus (ii) in each Fiscal Year, Tax Obligations specified in an Officer's Certificate.

"**Tax Obligations**" means the Rebate Requirement and any penalties, fines, or other payments required to be made to the United States of America under the arbitrage or rebate provisions of the Internal Revenue Code of 1986, as amended (the "**Code**"). "**Rebate Requirement**" will have the meaning ascribed thereto in the Issuer Tax Certificate executed by the Issuer at the time of issuance of the Series 2015A Bonds, as originally executed and as it may be amended or supplemented from time to time in accordance with the terms thereof (the "**Issuer Tax Certificate**").

"**Bond Year**" means, for so long as Bonds are Outstanding, the 12-month period ending each May 31.

Distribution Date Transfers. Unless an Event of Default has occurred, on each Distribution Date, the Trustee will apply amounts in the various funds and accounts in the following order of priority:

(i) from the Debt Service Account, the Partial Lump Sum Payment Account and, to the extent that amounts in the foregoing accounts are insufficient, the Surplus Account and the Liquidity Reserve Account, in that order, to pay interest on the Current Interest Bonds and Swap Payments due on such Distribution Date;

(ii) from the Debt Service Account, the Partial Lump Sum Payment Account and, to the extent that amounts in the foregoing accounts are insufficient, the Surplus Account and the Liquidity Reserve Account, in that order, to pay, in the following order, the Serial Maturity, Mandatory Sinking Fund Payments and Term Bond Maturity, if any, due on or scheduled for such Distribution Date, provided that the amounts thereof shall have first been adjusted as described in "THE INDENTURE—Effect of Defeasance, Redemption or Purchase"; and

(iii) from the Residual Account, to pay all amounts on deposit therein to the registered owner of the Residual Certificate.

Application of Funds Upon the Occurrence of an Event of Default. Upon the occurrence of any Event of Default and on each succeeding Distribution Date, the Trustee will apply all funds in the Debt Service Account, the Liquidity Reserve Account, the Partial Lump Sum Payment Account and the Surplus Account to pay Pro Rata, first, the accrued interest on the Current Interest Bonds then Outstanding and Swap Payments (including, in each case, interest at the stated rate on any unpaid interest, to the extent legally permissible) and, second, principal of or Accreted Value on all Bonds then Outstanding.

Application of a Total Lump Sum Payment. Upon the receipt of a Total Lump Sum Payment, the Trustee will, after making provision for the amounts required to be deposited pursuant to clause (i) under "*Transfers to Accounts*" above, use all remaining proceeds of such Total Lump Sum Payment to pay Pro Rata, first, the accrued interest on the Current Interest Bonds then Outstanding and Swap Payments (including interest at the stated rate on any unpaid interest, to the extent legally permissible) and, second, principal of or Accreted Value on all Bonds then Outstanding. See "THE SERIES 2015A BONDS—Redemption by Application of a Total Lump Sum Payment."

Application of Amounts in the Partial Lump Sum Payment Account. Funds in the Partial Lump Sum Payment Account shall be applied by the Trustee at any time, in accordance with directions in an Officer's Certificate, in the following order: (1) to redeem Current Interest Bond maturities in minimum authorized denominations on any date in accordance with the Indenture and (2) thereafter, either (a) to defease Capital Appreciation Bonds and Convertible Bonds, or (b) to redeem on any date in accordance with the Indenture, Capital Appreciation Bonds and Convertible Bonds at a redemption price equal to the lesser of (i) one hundred five percent (105%) of the Accreted Value thereof on the redemption date or (ii) the Accreted Value at maturity thereof.

The Series 2015A Bonds are subject to redemption, at a redemption price equal to 100% of the principal amount of the Series 2015A Bonds to be redeemed plus accrued interest thereon to the date fixed for redemption, without premium, from amounts on deposit in the Partial Lump Sum Payment Account. See "THE SERIES 2015A BONDS—Redemption from Amounts in the Partial Lump Sum Payment Account." In the Second Supplemental Indenture, the

Issuer agreed that any Officer's Certificate provided in connection with a redemption of Bonds from funds in the Partial Lump Sum Payment Account shall direct the Trustee not to redeem any Series 2013A Bonds until June 1, 2023 unless no Series 2005A Bonds constituting Current Interest Bonds (and no Current Interest Bonds issued to refund the Series 2005A Bonds, such as the Series 2015A Bonds) remain outstanding. Accordingly, in the event of a redemption from amounts on deposit in the Partial Lump Sum Payment Account prior to such date, the Series 2005A Bonds that are Current Interest Bonds and the Series 2015A Bonds would be selected for redemption prior to the Series 2013A Bonds. Following the refunding of a portion of the Series 2005A Bonds with proceeds of the Series 2015A Bonds, $210,030,000* aggregate principal amount of the Series 2005A Bonds constituting Current Interest Bonds will remain outstanding under the Indenture.

State Appropriations Transfers. Upon the receipt of a sum that has been identified as a State Appropriation, the Trustee will promptly (and in any event, no later than the Business Day immediately preceding the next Distribution Date) make deposits into the following accounts in the amounts specified by the Issuer in the following order of priority:

(1) to the extent the State Appropriation is to pay Operating Expenses, (a) to the Operating Account, an amount sufficient to cause the amount therein as specified in clause (i) under "*Transfers to Accounts*" above; (b) to the Operating Contingency Account, an amount sufficient to cause the amount therein to equal the amount required to be on deposit therein as specified in clause (v) under "*Transfers to Accounts*" above, and

(2) to the extent the State Appropriation is to pay Debt Service, (a) to the Debt Service Account, an amount sufficient to cause the amount therein to equal the amount required to be on deposit therein as specified in clause (ii) under "*Transfers to Accounts*" above; and (b) to the Debt Service Account, an amount sufficient to cause the amount therein to equal the amount required to be on deposit therein as specified in clause (iii) under "*Transfers to Accounts*" above; and

(3) to the extent the State Appropriation does not distinguish between Operating Expenses and Debt Service, (a) to the Operating Account, an amount sufficient to cause the amount therein to equal the amount required to be on deposit therein as specified in clause (i) under "*Transfers to Accounts*" above; (b) to the Debt Service Account, an amount sufficient to cause the amount therein to equal the amount required to be on deposit therein as specified in clause (ii) under "*Transfers to Accounts*" above; (c) to the Debt Service Account, an amount sufficient to cause the amount therein to equal

* Preliminary, subject to change.

the amount required to be on deposit therein as specified in clause (iii) under "*Transfers to Accounts*" above; and (d) to the Operating Contingency Account, an amount sufficient to cause the amount therein to equal the amount required to be on deposit therein as specified in clause (v) under "*Transfers to Accounts*" above. See "RISK FACTORS—Enforceability of Obligation of Governor to Include Appropriation in the Budget; No Obligation of State to Appropriate" herein.

Other Transfers. Funds in the Surplus Account shall be applied by the Trustee at any time, in accordance with directions in an Officer's Certificate, (1) to defease Bonds, (2) to pay the optional redemption price of Bonds to be redeemed in accordance with the Indenture, (3) to purchase Bonds on any date, or (4) to provide for the payment of Debt Service on the Bonds.

On the Series 2015A Closing Date, all amounts then on deposit in the Surplus Account will be released and applied to the refunding of a portion of the Series 2005A Bonds. See "ESTIMATED SOURCES AND USES OF FUNDS" herein.

Mandatory Clean-Up Redemption .... On the tenth (10th) day of the calendar month preceding each Distribution Date, the Trustee shall compare (i) the liquidation value of the aggregate amount on deposit in the Debt Service Account, the Liquidity Reserve Account, the Partial Lump Sum Payment Account and the Surplus Account (other than (a) amounts representing proceeds of refunding obligations, (b) amounts that do not constitute Pledged TSRs, State Appropriations or payments made to the Issuer or Trustee under Swap Contracts, and (c) amounts set aside for the payment of particular Bonds) to (ii) the sum of (a) the principal amount of and accrued interest (if any) to such Distribution Date on all Current Interest Bonds that will remain Outstanding after the application of amounts described above on such Distribution Date and (b) the amount necessary to defease or redeem (as set forth in an Officer's Certificate) pursuant to the Indenture all Capital Appreciation Bonds and Convertible Bonds that will remain Outstanding after the application of amounts described above on such Distribution Date, and if the amount in clause (i) is equal to or greater than the amount described in clause (ii) as of such Distribution Date, then the Trustee shall liquidate the investments in the Pledged Accounts and shall withdraw from the Pledged Accounts an amount sufficient to, and shall, retire the Bonds in full on such Distribution Date as provided in the Indenture. See "THE SERIES 2015A BONDS—Mandatory Clean-up Redemption."

Events of Default .... The occurrence of any of the following events will constitute an "**Event of Default**" on the Bonds under the Indenture: (i) the Issuer fails to pay when due any Swap Payment or interest on any Current Interest Bonds or fails to pay when due any Serial Maturity, Mandatory Sinking Fund Payment or Term Bond Maturity; (ii) failure of the Issuer to observe or perform any other covenant, condition, agreement, or provision contained in the Bonds or the Indenture which is not remedied within 60 days after Written Notice, specifying such default and requiring the same to be remedied, has been given to the Issuer by the Trustee or by the Owners of at least 25% of the Bond Obligation of the Bonds then Outstanding; (iii) the material breach of certain covenants made by the State in the Indenture which breach is not remedied within 60 days after Written Notice; and (iv) failure of the Director of Finance to provide the certification (as described under "*State Appropriations*" above) to the effect that the Director of Finance has complied with his or her obligation to request the inclusion of an appropriation line item for Debt Service and Operating Expenses, which breach is not remedied within 60 days after Written Notice. If the default with respect to clause (ii), (iii) or (iv) above is such that it cannot be corrected within 60 days, it will not constitute an Event of Default if corrective action is instituted by the Issuer within 60 days and diligently pursued until the default is corrected.

Neither the failure of the Governor to request from the Legislature an appropriation line item for Debt Service and Operating Expenses in the annual budget act nor any failure by the Legislature to appropriate any such amount will constitute an Event of Default under the Indenture. See "RISK FACTORS—Enforceability of Obligation of Governor to Include Appropriation in the Budget; No Obligation of State to Appropriate."

Upon the occurrence of an Event of Default under the Indenture, all future payments will be made on a Pro Rata basis. "**Pro Rata**" means, for an allocation of available amounts to any payment of interest, Accreted Value, principal or Swap Payments to be made under the Indenture, the application of a fraction to such available amounts (a) the numerator of which is equal to the amount due to the respective Owners and any party who has entered into a Swap Contract with the Issuer to whom such payment is owing, and (b) the denominator of which is equal to the total amount due to all Owners and Swap Contract counterparties to whom such payment is owing. See "SECURITY FOR THE BONDS—Application of Collections—*Application of Funds Upon the Occurrence of an Event of Default*."

Additional Bonds .... Additional Bonds may be issued under the Indenture only for the purpose of refunding Bonds (including the funding of defeasance escrows).

Master Settlement Agreement .. The Master Settlement Agreement (the "**MSA**") was entered into on November 23, 1998, among the attorneys general of 46 states (including the State), the District of Columbia, Puerto Rico, Guam, the U.S. Virgin Islands, American Samoa and the Commonwealth of the Northern Mariana Islands (collectively, the "**Settling States**") and the then four largest United States tobacco manufacturers: Philip Morris Incorporated (now Philip Morris USA Inc., "**Philip Morris**"), R.J. Reynolds Tobacco Company ("**Reynolds Tobacco**"), Brown & Williamson Tobacco Corporation ("**B&W**") and Lorillard Tobacco Company ("**Lorillard**") (collectively, the "**Original Participating Manufacturers**" or "**OPMs**"). On January 5, 2004, Reynolds American Inc. ("**Reynolds American**") was incorporated as a holding company to facilitate the combination of the U.S. assets, liabilities and operations of B&W with those of Reynolds Tobacco, which occurred on June 30, 2004. References herein to the "Original Participating Manufacturers" or "OPMs" mean, for the period prior to June 30, 2004, collectively, Philip Morris, Reynolds Tobacco, B&W and Lorillard and for the period on and after June 30, 2004, collectively Philip Morris, Reynolds American and Lorillard.

On July 15, 2014 Reynolds American and Lorillard, Inc. (the parent company of Lorillard) entered into an agreement for a merger, which the shareholders of both companies approved in January 2015. The companies have stated their expectations of the merger occurring in mid-2015, subject to regulatory approval. In connection with the merger, Imperial Tobacco Group PLC ("**Imperial Tobacco**") is expected to purchase Reynolds American's Kool, Salem and Winston cigarette brands, Lorillard Inc.'s Maverick cigarette brand and blu eCig electronic cigarette brand, and other assets. The payment obligations under the MSA follow tobacco product brands if they are transferred by any of the PMs. See "APPENDIX G—CERTAIN INFORMATION RELATING TO THE DOMESTIC TOBACCO INDUSTRY—Industry Overview" attached hereto.

The MSA resolved cigarette smoking-related litigation among the Settling States and the OPMs, released the OPMs from past and present smoking-related claims by the Settling States and provides for a continuing release of future smoking-related claims in exchange for certain payments to be made to the Settling States (including Annual Payments and Strategic Contribution Fund Payments, as defined herein). The MSA also provides for the imposition of certain tobacco advertising and marketing restrictions, among other things. The Issuer is not a party to the MSA.

The MSA is an industry-wide settlement of litigation between the Settling States and the Participating Manufacturers (as defined below). The MSA provides for tobacco companies other than the OPMs to become parties to the MSA. Tobacco companies that become parties to the MSA after the OPMs are referred to herein as "**Subsequent Participating Manufacturers**" or "**SPMs**," and the SPMs, together with the OPMs, are referred to herein as the "**Participating Manufacturers**" or "**PMs**." Tobacco companies that do not become parties to the MSA are referred to herein as

"**Non-Participating Manufacturers**" or "**NPMs**." See "SUMMARY OF THE MSA" herein.

"**Final Approval**" of the MSA occurred on November 12, 1999, when 80% of the Settling States by number and dollar volume achieved State-Specific Finality.

MSA Payments .... Under the MSA, the OPMs are required to pay to the Settling States:

(i) five initial payments, all of which have been paid (the "**Initial Payments**");

(ii) annual payments on each April 15, commencing April 15, 2000 and continuing in perpetuity (of which the April 15, 2000 through April 15, 2014 annual payments have already been paid) (the "**Annual Payments**") in the following base amounts (subject to adjustment as described herein):

Year	Base Amount	Year	Base Amount
2000	$4,500,000,000	2010	$8,139,000,000
2001	5,000,000,000	2011	8,139,000,000
2002	6,500,000,000	2012	8,139,000,000
2003	6,500,000,000	2013	8,139,000,000
2004	8,000,000,000	2014	8,139,000,000
2005	8,000,000,000	2015	8,139,000,000
2006	8,000,000,000	2016	8,139,000,000
2007	8,000,000,000	2017	8,139,000,000
2008	8,139,000,000	Thereafter	9,000,000,000
2009	8,139,000,000		

and (iii) ten annual payments of $861 million each (subject to adjustment as described herein) on each April 15, commencing April 15, 2008 and continuing through April 15, 2017, of which the April 15, 2008 through April 15, 2014 payments have already been paid (the "**Strategic Contribution Fund Payments**").

All payments received and to be received by the State under the MSA and the Decree are collectively referred to herein as the "**Tobacco Settlement Revenues**" or "**TSRs**."

Under the MSA, each OPM is required to pay an allocable portion of each Annual Payment and Strategic Contribution Fund Payment based on its relative market share (as determined in accordance with the MSA, "**Relative Market Share**") of cigarettes shipped in the United States by the OPMs during the preceding calendar year, subject to adjustments as described herein. Each SPM has Annual Payment and Strategic Contribution Fund Payment obligations under the MSA (separate from the payment obligations of the OPMs) according to its market share (as determined in accordance with the MSA, "**Market Share**"). However, any SPM that became a party to the MSA within 90 days after it became effective pays only if its

Market Share exceeds the higher of its 1998 Market Share or 125% of its 1997 Market Share (such higher share, the "**Base Share**").

Under the MSA, the State is entitled to 12.7639554% of the Annual Payments and 5.1730408% of the Strategic Contribution Fund Payments made by PMs under the MSA and distributed through the National Escrow Agreement, entered into on December 23, 1998 (the "**National Escrow Agreement**"), among the Settling States, the OPMs and the MSA Escrow Agent. By operation of the MOU and the ARIMOU, however, the State has allocated 50% of such payments to the Participating Jurisdictions (as defined below) and retained only the remaining 50%. Therefore, the State is entitled to 6.3819777% of the Annual Payments and 2.5865204% of the Strategic Contribution Fund Payments made by PMs under the MSA. As noted above, the State sold 43.43% of these payments to the Issuer pursuant to the Purchase and Sale Agreement, and the Issuer pledged such payments to the Trustee as security for the Bonds.

Payments by the PMs are required to be made to Citibank, N.A., as the escrow agent appointed pursuant to the MSA (the "**MSA Escrow Agent**"), which is required, in turn, to remit an allocable share of such payments to the parties entitled thereto. Upon the sale of the Pledged TSRs, the State directed the MSA Escrow Agent to remit the Pledged TSRs directly to the Trustee. Such direction is irrevocable until after the Bonds have been repaid.

Under the MSA, and as described further herein, the base amounts of Annual Payments and Strategic Contribution Fund Payments are subject to various adjustments, offsets and recalculations, including the NPM Adjustment, which operates in the event of losses in Market Share by PMs to NPMs as a result of such PMs' participation in the MSA. The application of adjustments pursuant to the terms of the MSA has resulted in reduced Annual Payments and Strategic Contribution Fund Payments in all prior years. As discussed further herein, the State was one of several jurisdictions to enter into a settlement with the OPMs and certain SPMs regarding claims related to the 2003 through 2012 NPM Adjustments and the determination of subsequent NPM Adjustments. See "RISK FACTORS—Potential Payment Decreases Under the Terms of the MSA," "SUMMARY OF THE MSA—Adjustments to Payments" and "—Potential Payment Decreases Under the Terms of the MSA," and "APPENDIX E—NPM ADJUSTMENT STIPULATED PARTIAL SETTLEMENT AND AWARD AND SETTLEMENT TERM SHEET." See also the penultimate paragraph of "SUMMARY OF THE MSA—Potential Payment Decreases Under the Terms of the MSA—*NPM Adjustment—NPM Adjustment Settlement and Award*."

See generally "SUMMARY OF THE MSA" herein.

The California Consent Decree, the MOU, the ARIMOU and the California Escrow Agreement..

On December 9, 1998, a Consent Decree and Final Judgment (the "**Decree**") was entered in the Superior Court of the State of California for San Diego County. The Decree, which is final and non-appealable, resulted in the achievement of California State-Specific Finality under the MSA. See "SUMMARY OF THE MSA—State-Specific Finality and Final Approval" herein.

Prior to the entering of the Decree, the plaintiffs of certain pending cases agreed, among other things, to coordinate their pending cases and to allocate certain portions of the recovery among the State, its counties, the Cities of San Jose, Los Angeles and San Diego and the City and County of San Francisco (the "**Participating Jurisdictions**"). This agreement was memorialized in the MOU, by and among counsel representing the State and various counsel representing a number of the Participating Jurisdictions. To set forth the understanding of the interpretation to be given to the terms of the MOU and to establish procedures for the resolution of any future disputes that may arise regarding the interpretation of the MOU among the State and the Participating Jurisdictions, the parties entered into the ARIMOU.

Under the MOU, 45% of the State's entire allocation of TSRs under the MSA is allocated to the Participating Jurisdictions which are counties, 5% is allocated to the four cities which are Participating Jurisdictions (1.25% each), and the remaining 50% is allocated to the State. Although the percentage allocations of TSRs among the county Participating Jurisdictions are subject to adjustment to reflect shifts in population, the 50% share of TSRs allocated to the State is permanently fixed and not subject to adjustment based on changes in population.

Under the MSA, the State's portion of the TSRs is deposited into the California State-Specific Account held by the MSA Escrow Agent. Pursuant to the terms of the MOU, the ARIMOU and the California Escrow Agreement, the State has instructed the MSA Escrow Agent to transfer (upon receipt thereof) all amounts in the California State-Specific Account to the California Escrow Agent. The California Escrow Agent is required to deposit the State's 50% share of the TSRs into an account for the benefit of the State (the "**California State Government Escrow Account**"), and the remaining 50% of the TSRs into separate sub-accounts of an account for the benefit of the Participating Jurisdictions or as otherwise directed by the local jurisdiction (this account is referred to herein as the "**California Local Government Escrow Account**"). The MOU provides that the distribution of tobacco-related recoveries is not subject to alteration by legislative, judicial or executive action at any level, and, if such alteration were to occur and survive legal challenge, any modification would be borne proportionally by the State and the

Participating Jurisdictions. In connection with the sale of the Pledged TSRs to the Issuer, the State irrevocably instructed the California Escrow Agent to disburse the Pledged TSRs to the Trustee. See “THE CALIFORNIA CONSENT DECREE, THE MOU, THE ARIMOU AND THE CALIFORNIA ESCROW AGREEMENT” herein.

Industry Overview.................... The market for cigarettes is highly competitive and is characterized by brand recognition and loyalty. See “APPENDIX G—CERTAIN INFORMATION RELATING TO THE DOMESTIC TOBACCO INDUSTRY” attached hereto. The three OPMs—Philip Morris, Reynolds American and Lorillard—are the largest manufacturers of cigarettes in the United States (based on 2014 domestic market share). The merger of Reynolds American and Lorillard, Inc., which the companies have stated their expectations of occurring in mid-2015, is expected to result in the combined company being the second-largest domestic tobacco product manufacturer. The related asset acquisition by Imperial Tobacco, which is to occur at substantially the same time as the merger, is expected to result in Imperial Tobacco becoming the third-largest tobacco product manufacturer in the U.S. tobacco market. See “APPENDIX G—CERTAIN INFORMATION RELATING TO THE DOMESTIC TOBACCO INDUSTRY—Industry Overview” attached hereto.

As reported by the National Association of Attorneys General (“**NAAG**”), based upon OPM shipments reported to Management Science Associates, Inc., an independent third-party database management organization that collects wholesale shipment data (“**MSAI**”), the OPMs accounted for approximately 85.20%[*] of the U.S. domestic cigarette market in payment year 2014 (sales year 2013), based upon shipments and measuring roll-your-own cigarettes at 0.09 ounces per cigarette conversion rate, or approximately 84.95%[*] measuring roll-your-own cigarettes at 0.0325 ounces per cigarette conversion rate. Also as reported by NAAG, based upon shipments reported to MSAI, the SPMs accounted for approximately 8.43%[*] of the U.S. domestic cigarette market in payment year 2014 (sales year 2013), based upon shipments and measuring roll-your-own cigarettes at 0.09 ounces per cigarette conversion rate, or approximately 8.70%[*] measuring roll-your-own cigarettes at 0.0325 ounces per cigarette conversion rate.

[*] The aggregate market share information is based on information as reported by the NAAG and may differ materially from the market share information as reported by the OPMs for purposes of their filings with the Securities and Exchange Commission. See “TABLES OF PROJECTED PLEDGED TSRs, PROJECTION METHODOLOGY AND BOND STRUCTURING ASSUMPTIONS” herein and “APPENDIX G—CERTAIN INFORMATION RELATING TO THE DOMESTIC TOBACCO INDUSTRY” attached hereto. The aggregate market share information for 2013 from NAAG used in the bond structuring assumptions may differ materially in the future from the market share information used by the MSA Auditor (defined herein) in calculating the adjustments to Annual Payments and Strategic Contribution Fund Payments in future years. See “SUMMARY OF THE MSA—Adjustments to Payments.”

Cigarette Consumption............ As described in the Tobacco Consumption Report (as defined herein), domestic cigarette consumption grew dramatically in the 20th century, reaching a peak of 640 billion cigarettes in 1981. Consumption declined in the 1980s, 1990s and 2000s, falling to less than 400 billion cigarettes in 2003 and to approximately 266 billion cigarettes in 2014, according to the Tobacco Consumption Report. See "SUMMARY OF THE TOBACCO CONSUMPTION REPORT" herein and "APPENDIX C—TOBACCO CONSUMPTION REPORT" and "APPENDIX G—CERTAIN INFORMATION RELATING TO THE DOMESTIC TOBACCO INDUSTRY" attached hereto.

Tobacco Consumption Report.. IHS Global Inc. ("**IHS Global**"), formerly known as DRI•WEFA, Inc., has prepared a report dated March 13, 2015 on the consumption of cigarettes in the United States from 2015 through 2045 entitled, "A Forecast of U.S. Cigarette Consumption (2015-2045) for the Golden State Tobacco Securitization Corporation" (the "**Tobacco Consumption Report**"). IHS Global is an internationally recognized econometric and consulting firm of over 300 economists and is a part of IHS Inc., a global information company with over 1,000 researchers, analysts, and economists in more than 30 countries.

IHS Global has developed a cigarette consumption model based on historical United States data between 1965 and 2013. IHS Global constructed this cigarette consumption model after considering the impact of demographics, cigarette prices, disposable income, employment and unemployment, industry advertising expenditures, the future effect of the incidence of smoking among underage youth and qualitative variables that captured the impact of anti-smoking regulations, legislation, health warnings and the availability of alternative tobacco and nicotine products. After determining which variables were effective in building this empirical model of adult per capita cigarette consumption in the U.S. (real cigarette prices, real per capita disposable personal income, the impact of workplace smoking restrictions first instituted widely in the 1980s, the stricter restrictions on smoking in public places instituted over the last decade, and the trend over time in individual behavior and preferences), IHS Global employed a standard multivariate regression analysis to determine the nature of the economic relationship between these variables and adult per capita cigarette consumption in the United States. The multivariate regression analysis resulted in IHS Global's projection of the average annual rate of decline in U.S. cigarette consumption from 2015 through 2045 to be approximately 3.0% and of total consumption in 2045 to be 104 billion cigarettes (a 61% decline from the 2014 level). The projections and forecasts regarding future cigarette consumption included in the Tobacco Consumption Report are estimates which have been prepared on the basis of certain assumptions and hypotheses. No representation or warranty of any kind is or can be made with respect to the accuracy or completeness of, and no representation or warranty should be inferred from, these projections and forecasts. See "SUMMARY OF THE TOBACCO CONSUMPTION REPORT" herein and "APPENDIX C—TOBACCO CONSUMPTION REPORT" attached hereto. See also "RISK FACTORS—Risks Relating to the Tobacco Consumption Report" and "TABLES OF PROJECTED PLEDGED TSRs, PROJECTION METHODOLOGY AND BOND STRUCTURING ASSUMPTIONS" herein.

Covenants.................................. The Issuer has made certain covenants for the benefit of the Owners, including a covenant not to impair the exclusion of interest on the Series 2015A Bonds from gross income for federal income tax purposes. Pursuant to the Act and the Purchase and Sale Agreement (including as amended by the Second Supplemental Purchase and Sale Agreement), the State has pledged to and agreed with the holders of any Bonds of the Issuer that the State will not amend the MSA, the MOU, the ARIMOU or the California Escrow Agreement, or take any other action, in any way that would materially adversely alter, limit, or impair the rights to receive the Pledged TSRs, nor in any way materially impair the rights and remedies of such bondholders or the security for their bonds until those bonds, together with the interest thereon and costs and expenses in connection with any action or proceeding on behalf of such bondholders, are fully paid and discharged. See "SECURITY FOR THE BONDS—Consent to Amendments to Indenture and Purchase and Sale Agreement." In addition, in furtherance of the Act, the State has covenanted in the Purchase and Sale Agreement that the Director of Finance shall request the Governor, and the Governor, in turn, will request the Legislature to include in the annual budget act an appropriation line item from the General Fund of the State for allocation by the Department of Finance to the Issuer in an amount equal to the Debt Service and Operating Expenses to become due during the next succeeding Fiscal Year on the Bonds, as described above under "*State Appropriations*" and as further described herein. *The Legislature is not obligated by the Act, any covenant made in the Purchase and Sale Agreement, or any other provision of law, to appropriate or otherwise make funds available to pay Operating Expenses or Debt Service on the Series 2015A Bonds.* See "RISK FACTORS—Enforceability of Obligation of Governor to Include Appropriation in the Budget; No Obligation of State to Appropriate."

The State has further pledged and agreed that it shall enforce its rights to collect all moneys due from the PMs under the MSA and, in addition, shall diligently enforce the California Model Statute against all NPMs in the State, in each case in the manner and to the extent necessary in the judgment of the Attorney General of the State to collect all moneys to which the State is entitled under the MSA. Notwithstanding the pledges of the State described above, the

Attorney General of the State may, in his or her discretion, enforce any and all of the provisions of the MSA, without limitation. See "THE PURCHASE AND SALE AGREEMENT" and "THE INDENTURE" herein for a summary of the covenants made by the Issuer and the State.

Risk Factors.............................. Reference is made to "RISK FACTORS" herein for a description of certain considerations relevant to an investment in the Series 2015A Bonds.

Legal Considerations............... Reference is made to "LEGAL CONSIDERATIONS" herein for a description of certain legal issues relevant to an investment in the Series 2015A Bonds.

Tax Matters.............................. In the opinion of Orrick, Herrington & Sutcliffe LLP, as Transaction Counsel to the Issuer, based upon an analysis of existing laws, regulations, rulings and court decisions, and assuming, among other matters, the accuracy of certain representations and compliance with certain covenants, interest on the Series 2015A Bonds is excluded from gross income for federal income tax purposes under Section 103 of the Internal Revenue Code of 1986 (the "**Code**") and is exempt from State of California personal income taxes. Transaction Counsel is of the further opinion that interest on the Series 2015A Bonds is not a specific preference item for purposes of the federal individual or corporate alternative minimum taxes, although Transaction Counsel observes that such interest is included in adjusted current earnings when calculating corporate alternative minimum taxable income. Transaction Counsel expresses no opinion regarding any other tax consequence related to the ownership or disposition of, or the amount, accrual or receipt of interest on, the Series 2015A Bonds. See "TAX MATTERS" herein.

Continuing Disclosure .... The Issuer has agreed to provide to the Municipal Securities Rulemaking Board (the "**MSRB**"), through its Electronic Municipal Market Access ("**EMMA**") system, pursuant to Rule 15c2 12(b)(5) adopted by the Securities and Exchange Commission (the "**SEC**"), certain annual financial information and operating data of the Issuer and annual continuing disclosure prepared by the State in relation to the general obligation bonds of the State, as well as, in a timely manner, notices of certain specified events (but in no event in excess of ten business days after the occurrence of the event). See "CONTINUING DISCLOSURE UNDERTAKING" herein and "APPENDIX H—FORM OF CONTINUING DISCLOSURE CERTIFICATE" attached hereto.

Ratings .... It is a condition to the obligation of the Underwriters to purchase the Series 2015A Bonds that, at the date of delivery thereof to the Underwriters, the Series 2015A Bonds be assigned a rating of "A1" by Moody's Investors Service, Inc. ("**Moody's**"), a rating of "A" by

Standard & Poor's Ratings Services, a division of McGraw Hill Financial Inc. ("**S&P**") and a rating of "A" by Fitch Ratings ("**Fitch**" and, collectively with Moody's and S&P, the "**Rating Agencies**").

It is expected that the Rating Agencies' ratings of the Series 2015A Bonds will not reflect the security provided by the Pledged TSRs, but rather, the State Appropriations and the risks inherent thereto. See "APPENDIX A—THE STATE OF CALIFORNIA" and "APPENDIX B—STATE OF CALIFORNIA COMPREHENSIVE ANNUAL FINANCIAL REPORT FOR THE FISCAL YEAR ENDED JUNE 30, 2013" attached hereto. See also "RISK FACTORS—Enforceability of Obligation of Governor to Include Appropriation in the Budget; No Obligation of State to Appropriate."

There is no assurance that the initial ratings assigned to the Series 2015A Bonds will continue for any given period of time or that any of such ratings will not be revised downward, suspended or withdrawn entirely by any of the Rating Agencies. Any such downward revision, suspension or withdrawal of such ratings may have an adverse effect on the availability of a market for or the market price of the Series 2015A Bonds. See "RATINGS" herein.

(THIS PAGE INTENTIONALLY LEFT BLANK)

INTRODUCTORY STATEMENT

This Official Statement sets forth information concerning the issuance by Golden State Tobacco Securitization Corporation (the "**Issuer**") of its $1,704,990,000* aggregate principal amount of Enhanced Tobacco Settlement Asset-Backed Bonds, Series 2015A (the "**Series 2015A Bonds**"). The Series 2015A Bonds are being issued pursuant to an indenture by and between the Issuer and The Bank of New York Mellon Trust Company, N.A. (formerly known as The Bank of New York Trust Company, N.A., successor to BNY Western Trust Company), as Trustee (the "**Trustee**"), dated as of September 1, 2003 (the "**Master Indenture**"), as supplemented by the Series 2003B Supplement, dated as of September 1, 2003, as supplemented and amended by the First Supplemental Indenture, dated as of July 1, 2005 (the "**First Supplemental Indenture**"), the Second Supplemental Indenture, dated as of April 1, 2013 (the "**Second Supplemental Indenture**"), and the Third Supplemental Indenture, dated as of April 1, 2015 (the "**Third Supplemental Indenture**"). The Master Indenture, as supplemented and amended, is hereinafter referred to as the "**Indenture**". The Indenture only permits the issuance of additional refunding bonds subject to the satisfaction of certain conditions described herein.

The Issuer will use the proceeds from the issuance of the Series 2015A Bonds, together with amounts released from the Liquidity Reserve Account, the Supplemental Reserve Account and the Surplus Account, (i) to refund on a current basis a portion equal to $1,959,775,000* aggregate principal amount of the Issuer's Enhanced Tobacco Settlement Asset-Backed Bonds, Series 2005A (the "**Series 2005A Bonds**") that are outstanding under the Indenture and (ii) to pay the costs of issuance of the Series 2015A Bonds. See "APPENDIX I—SERIES 2005A BONDS TO BE REFUNDED" for a listing of the Series 2005A Bonds that are expected to be refunded and defeased on the Series 2015A Closing Date. See also "ESTIMATED SOURCES AND USES OF FUNDS" herein.

Following the refunding of such portion of the Series 2005A Bonds, $593,300,000* aggregate principal amount at maturity of the Series 2005A Bonds will remain outstanding under the Indenture, constituting Current Interest Bonds and Capital Appreciation Bonds, as such terms are defined herein, and $375,105,000 aggregate principal amount of the Issuer's Enhanced Tobacco Settlement Asset-Backed Bonds, Series 2013A (the "**Series 2013A Bonds**"), constituting Current Interest Bonds, which were issued in April 2013 to refund a portion of the Series 2005A Bonds, is currently outstanding under the Indenture. See "OUTSTANDING BONDS." The Series 2015A Bonds are payable on a parity with the outstanding Series 2013A Bonds and Series 2005A Bonds. The Series 2015A Bonds, together with the Series 2013A Bonds and the Series 2005A Bonds remaining outstanding under the Indenture and any additional refunding bonds issued under the Indenture, are referred to herein as the "**Bonds**." See "THE SERIES 2015A BONDS—Additional Bonds" herein.

As a result of their purchase of the Series 2015A Bonds, owners thereof (but not the Underwriters) will be deemed to have consented to certain amendments to the Indenture and the Purchase and Sale Agreement. See "SECURITY FOR THE BONDS—Consent to Amendments to Indenture and Purchase and Sale Agreement" herein.

The Issuer is a special purpose trust established as a not-for-profit corporation by Article 7 of Chapter 2 of Division 1 of Title 6.7 of the Government Code (the "**Act**") of the State of California (the "**State**"). Pursuant to the Issuer's Articles of Incorporation, the Issuer shall have all powers conferred under the Act.

The Issuer has no authority to and does not intend or purport to pledge the faith, credit, or taxing power of the State or any of its political subdivisions in connection with the issuance of the

* Preliminary, subject to change.

Series 2015A Bonds. The Series 2015A Bonds are limited obligations of the Issuer; are secured solely by and payable solely from the Collateral (as described herein); and are neither general nor legal obligations of the State or any of its political subdivisions. Neither the faith and credit nor the taxing power nor any other assets or revenues of the State or of any political subdivision thereof, other than the Issuer to the extent of the Collateral, is or shall be pledged to the payment of the principal of or the interest on the Series 2015A Bonds. The Issuer has no taxing power.

See "SECURITY FOR THE BONDS—State Appropriations" herein for a description of the State Appropriations (as defined herein) that are available to pay debt service on the Bonds (including the Series 2015A Bonds) and Operating Expenses in the event of a deficiency in the cash and investments on deposit in the Pledged Accounts, the Operating Account and the Operating Contingency Account to pay Debt Service on the Bonds and Operating Expenses, respectively. See "APPENDIX A—THE STATE OF CALIFORNIA" for a discussion of the State's economy and finances, and see "APPENDIX B—STATE OF CALIFORNIA COMPREHENSIVE ANNUAL FINANCIAL REPORT FOR THE FISCAL YEAR ENDED JUNE 30, 2013" for a copy of the State's audited Comprehensive Annual Financial Report for the fiscal year ended June 30, 2013. See also "FINANCIAL STATEMENTS" herein.

The Master Settlement Agreement (the "**MSA**"), which was entered into on November 23, 1998, among the attorneys general of 46 states (including the State), the District of Columbia, Puerto Rico, Guam, the U.S. Virgin Islands, American Samoa and the Commonwealth of the Northern Mariana Islands (collectively, the "**Settling States**") and the then four largest United States tobacco manufacturers (namely, Philip Morris Incorporated (now Philip Morris USA Inc., "**Philip Morris**"), R.J. Reynolds Tobacco Company ("**Reynolds Tobacco**"), Brown & Williamson Tobacco Corporation ("**B&W**") and Lorillard Tobacco Company ("**Lorillard**") (collectively, the "**Original Participating Manufacturers**" or "**OPMs**")), resolved all cigarette smoking-related litigation between the Settling States and the OPMs, released the OPMs and the tobacco companies that become parties to the MSA after the OPMs (the "**Subsequent Participating Manufacturers**" or "**SPMs**," and together with the OPMs, the "**Participating Manufacturers**" or "**PMs**") from past and present smoking-related claims, and provides for a continuing release of future smoking-related claims in exchange for payments to be made to the Settling States, as well as, among other things, certain tobacco advertising and marketing restrictions.

Under the MSA, the base amounts of Annual Payments and Strategic Contribution Fund Payments (as each such term is defined herein) are subject to various adjustments, offsets and recalculations, including the "**NPM Adjustment**," which operates in the event of losses in Market Share (as defined herein) by PMs to tobacco companies that are not parties to the MSA ("**Non-Participating Manufacturers**" or "**NPMs**"), as a result of such PMs' participation in the MSA. As discussed further herein, the State was one of several jurisdictions to enter into a settlement with the OPMs and certain SPMs regarding claims related to the 2003 through 2012 NPM Adjustments and the determination of subsequent NPM Adjustments. See "RISK FACTORS—Potential Payment Decreases Under the Terms of the MSA," "SUMMARY OF THE MSA—Adjustments to Payments" and "—Potential Payment Decreases Under the Terms of the MSA," and "APPENDIX E—NPM ADJUSTMENT STIPULATED PARTIAL SETTLEMENT AND AWARD AND SETTLEMENT TERM SHEET." See also the penultimate paragraph of "SUMMARY OF THE MSA—Potential Payment Decreases Under the Terms of the MSA—*NPM Adjustment—NPM Adjustment Settlement and Award*."

Under the MSA, as modified by the Memorandum of Understanding (the "**MOU**") as agreed to by the State and its counties, the Cities of San Jose, Los Angeles and San Diego and the City and County of San Francisco (the "**Participating Jurisdictions**"), and the Agreement Regarding Interpretation of Memorandum of Understanding, as amended (the "**ARIMOU**"), the State is entitled to 6.3819777% of the Annual Payments and 2.5865204% of the Strategic Contribution Fund Payments made by the PMs under the MSA. Pursuant to the Purchase and Sale Agreement, dated as of September 1, 2003, as amended and supplemented by the First Supplemental Purchase and Sale Agreement, dated as of July 1, 2005, and the Second Supplemental Purchase and Sale Agreement (the "**Second Supplemental Purchase and Sale Agreement**"), dated as of April 1, 2015 (collectively, the "**Purchase and Sale Agreement**"), each between the California Infrastructure and Economic Development Bank (the "**CIEDB**"), for and on behalf of and as agent for the State, and the Issuer, the State sold to the Issuer on September 30, 2003 (the "**TSR Sale Date**"), without recourse, all of its right, title and interest in, to and under the "**Pledged TSRs**," which are the State's right to 43.43% of the State's "**Tobacco Assets**" (as defined in the Act), consisting of all of the State's then remaining unsold share of payments under the MSA and as further provided in the MOU, as agreed to by the State and the Participating Jurisdictions, the ARIMOU and the Escrow Agreement, dated April 12, 2000, as amended (the "**California Escrow Agreement**") between the State and Citibank, N.A., as escrow agent (the "**California Escrow Agent**"). See "SUMMARY OF THE MSA," "THE CALIFORNIA CONSENT DECREE, THE MOU, THE ARIMOU AND THE CALIFORNIA ESCROW AGREEMENT" and "THE PURCHASE AND SALE AGREEMENT" herein.

Prior to the TSR Sale Date, the State sold its right to 56.57% of the Tobacco Assets to the Issuer and the Issuer assigned such Tobacco Assets to a trustee under a separate indenture as security for the Issuer's Tobacco Settlement Asset-Backed Bonds, Series 2003A, which were refunded in whole with proceeds of the Issuer's Tobacco Settlement Asset-Backed Bonds, Series 2007. The Trustee under such separate indenture is referred to herein as the "**Series 2007 Trustee**" and the Tobacco Assets assigned to the Series 2007 Trustee are referred to herein as the "**Series 2007 Pledged TSRs**." The right of the Trustee to receive Pledged TSRs is equal to and on a parity with, and is not inferior or superior to, the right of the Series 2007 Trustee to receive the Series 2007 Pledged TSRs. Neither the Issuer nor the Trustee shall have the right to make a claim to mitigate all or any part of an asserted deficiency in the Pledged TSRs from the Series 2007 Pledged TSRs and, likewise, neither the Issuer nor the State nor any participating jurisdiction (as such term is used in the Indenture) nor the Series 2007 Trustee shall have any right to make a claim to mitigate all or any part of an asserted deficiency in the Series 2007 Pledged TSRs from the Pledged TSRs. The right of the Series 2007 Trustee to receive the Series 2007 Pledged TSRs is equal to and on a parity with, and shall not be inferior or superior to, the right of the Trustee to receive the Pledged TSRs.

See "APPENDIX G—CERTAIN INFORMATION RELATING TO THE DOMESTIC TOBACCO INDUSTRY" attached hereto for a discussion of certain information relating to the domestic tobacco industry.

The Series 2015A Bonds constitute Current Interest Bonds, as defined herein. The Series 2015A Bonds will be dated their date of delivery and mature on June 1 of the years shown on the inside cover page. Interest on the Series 2015A Bonds will be payable on each June 1 and December 1 (each, a "**Distribution Date**"), commencing June 1, 2015. Certain methodologies and assumptions were utilized to establish the maturities and Mandatory Sinking Fund Payments for the Series 2015A Bonds, as described under "TABLES OF PROJECTED PLEDGED TSRs, PROJECTION METHODOLOGY AND BOND STRUCTURING ASSUMPTIONS" herein. The amount and timing of payments on the Series 2015A Bonds may be affected by various factors. See "RISK FACTORS" and "LEGAL CONSIDERATIONS" herein.

SECURITY FOR THE BONDS

Consent to Amendments to Indenture and Purchase and Sale Agreement

As a result of their purchase of the Series 2015A Bonds, owners thereof (but not the Underwriters) will be deemed to have consented to certain amendments to the Indenture and the Purchase and Sale Agreement. Such amendments relate to changing (1) the Liquidity Reserve Requirement from

$214,307,881.25 to $150,000,000, (2) the Supplemental Reserve Requirement from $31,949,870.09 to $0, (3) the provisions of the Indenture relating to the valuation of investments in the Liquidity Reserve Account and (4) the non-impairment covenants of the State contained in the Indenture and the Purchase and Sale Agreement to add a standard of material adversity, to reflect an amendment to the Act (Stats. 2009, ch. 28, effective August 6, 2009, which amended Section 63049.4 of the California Government Code). The Series 2015A Bonds will represent a Majority in Interest of the Bonds to be Outstanding upon the issuance of the Series 2015A Bonds and accordingly these amendments will be effective on the date of issuance of the Series 2015A Bonds. The Underwriters have not consented to, and shall not be deemed to have consented to, such amendments to the Indenture and the Purchase and Sale Agreement. See "SECURITY FOR THE BONDS—Liquidity Reserve Account," "SECURITY FOR THE BONDS—Elimination of Supplemental Reserve Requirement," "THE INDENTURE—Investments—*Valuation*," "THE PURCHASE AND SALE AGREEMENT—Non-Impairment Covenant of the State" and "THE INDENTURE—Non-Impairment Covenant of the State."

Pledge of Collateral

Pursuant to the Indenture, the Bonds, the Swap Payments and the Residual Certificate will be secured by the "**Collateral**," consisting of all of the Issuer's right, title and interest, whether now owned or hereafter acquired, in, to and under: (a) the Purchase and Sale Agreement and the Pledged TSRs; (b) the Pledged Accounts, all money, instruments, payment intangibles, investment property, or other property credited to or on deposit in the Pledged Accounts, and all investment earnings on amounts on deposit in or credited to the Pledged Accounts; (c) any payment received by the Issuer pursuant to a Swap Contract; (d) State Appropriations for Debt Service, if any; and (e) all present and future claims, demands, causes, and things in action in respect of any or all of the foregoing and all payments on or under and all proceeds of every kind and nature whatsoever in respect of any or all of the foregoing, including all proceeds of the conversion, voluntary or involuntary, into cash or other liquid property, all cash proceeds, accounts, general intangibles, notes, drafts, acceptances, chattel paper, checks, deposit accounts, insurance proceeds, condemnation awards, rights to payment of any and every kind, and other forms of obligations and receivables, instruments, payment intangibles, and other property that at any time constitute all or part of or are included in the proceeds of any of the foregoing. The pledge and security interest described in clause (a) above is subject to and does not include the rights of the Issuer under the Purchase and Sale Agreement pursuant to provisions for the Issuer's consent, notices to the Issuer, indemnities for the Issuer's benefit, and any right or power reserved to the Issuer by law or by the terms of the Purchase and Sale Agreement, nor does the same preclude the Issuer's enforcement of its reserved rights under the Purchase and Sale Agreement. The Issuer covenants that it will implement, protect and defend the security interest and pledge by all appropriate action for the benefit of the Owners of the Bonds, and the owner of the Residual Certificate (currently the State) and any party that has entered into a Swap Contract. The Issuer is not currently a party to any Swap Contract.

Pursuant to the Act, the pledge of Collateral shall be valid and binding in accordance with its terms from the date of original execution of the Indenture, and amounts so pledged and thereafter received shall immediately be subject to the lien of the pledge without the need for physical delivery, recordation, filing or other future act.

The Issuer has no authority to and does not intend or purport to pledge the faith, credit, or taxing power of the State or any of its political subdivisions in connection with the issuance of the Series 2015A Bonds. The Bonds are limited obligations of the Issuer; are secured solely by and payable solely from the Collateral; and are neither general nor legal obligations of the State or any of its political subdivisions. Neither the faith and credit nor the taxing power nor any other assets or revenues of the State or of any political subdivision thereof, other than the Issuer to the extent of

the Collateral, is or shall be pledged to the payment of the principal of or Accreted Value on or the interest on the Bonds. The Issuer has no taxing power.

Unless deposited in one of the Pledged Accounts, none of the proceeds of the Bonds or any earnings therefrom will in any way be pledged to the payment of the Bonds or be part of the Collateral. The "**Pledged Accounts**" are the Collections Account (except to the extent that money therein is allocable to the Operating Account, the Operating Contingency Account or the Rebate Account), the Debt Service Account, the Partial Lump Sum Payment Account, the Liquidity Reserve Account, the Surplus Account and all subaccounts contained in the named accounts. Amounts in the Operating Account, the Operating Contingency Account, the Costs of Issuance Account and the Rebate Account will not be held as security for the Bonds under the Indenture.

State Appropriations

In order to enhance the security of the Bonds, the Trustee, the Issuer and the State have agreed in the Indenture and the Purchase and Sale Agreement to follow certain procedures in a two-step process for (1) requesting appropriations of funds from the State, and (2) certifying deficiencies in amounts available to pay debt service on the Bonds and/or Operating Expenses, and disbursing funds appropriated by the State to the Trustee for the payment of debt service on the Bonds and/or Operating Expenses ("**State Appropriations**").

Request for State Appropriations. As provided in the Indenture, on each October 20, the Trustee is required to calculate the amount of Debt Service and Operating Expenses to become due during the next succeeding Fiscal Year on the Bonds. On or before each November 1 (based on the preceding October 20 calculation), the Trustee is required to notify the Issuer of such amounts and the Issuer has covenanted to notify the Director of Finance of such amounts in order to enable the Director of Finance and the Governor to request such amounts from the Legislature in an appropriation line item in the annual budget act. See "THE INDENTURE—Affirmative Covenants—*Annual State Appropriation Request*" herein.

In order to assist the Issuer in financing or refinancing the purchase of the Pledged TSRs by enhancing the security of the Bonds, in furtherance of the Act, the State has covenanted in the Purchase and Sale Agreement that on or before January 10 of each year, the Director of Finance of the State shall request the Governor to include in the annual budget act an appropriation line item from the General Fund of the State for allocation by the Department of Finance to the Issuer in an amount equal to the Debt Service and Operating Expenses to become due during the next succeeding Fiscal Year on the Bonds. The Director of Finance shall provide a copy of such request to the Joint Legislative Budget Committee. The Director of Finance shall also certify to the Trustee that the Director of Finance has complied with his or her obligations under the two preceding sentences. Pursuant to the Act, the State has covenanted in the Purchase and Sale Agreement that the Governor shall each year request from the Legislature the appropriation line item referred to above in the annual budget act.

Because of the timing of the State's budgeting process, every year since 2004 the Governor has requested an appropriation in the amount of $1,000 with provisional language that authorizes the Director of Finance to augment the $1,000 for debt service and operating expenses if the tobacco settlement revenues and other available funds are insufficient for such purposes. The Director of Finance may augment the $1,000 up to $200 million without further legislative approval. The specific provisional language contained in each annual budget act since 2004 that authorizes the augmentation is: "…upon certification by the Golden State Tobacco Securitization Corporation, the Department of Finance may authorize expenditures of up to $200,000,000 in excess of the amount appropriated in this item for the payment of debt service on the Enhanced Tobacco Settlement Asset-Backed Bonds and the payment of operating expenses of the Golden State Tobacco Securitization Corporation in the event tobacco settlement revenues and certain other available amounts are insufficient to pay the costs of debt service and operating costs for the 12 months following such certification".

The Legislature is not obligated by the Act, any covenant made in the Purchase and Sale Agreement, or any other provision of law, to appropriate or otherwise make funds available to pay Operating Expenses or Debt Service on the Bonds. See "RISK FACTORS—Enforceability of Obligation of Governor to Include Appropriation in the Budget; No Obligation of State to Appropriate."

Certification of Actual Deficiencies; Disbursement and Encumbrance of Appropriated Amounts. On each April 25 (and at any other time upon request of the Issuer), the Trustee is required to calculate the amount of cash and investments on deposit in the Pledged Accounts, the Operating Account and the Operating Contingency Account. On or before each May 1 (based on the preceding April 25 calculation), the Trustee will notify the Issuer as to the amount of any deficiency in (i) such amounts in the Pledged Accounts to pay Debt Service on the Bonds to be paid during the next succeeding 12 months, and (ii) such amounts in the Operating Account and the Operating Contingency Account to pay all Operating Expenses scheduled to become due during the next succeeding 12 months. The Issuer has covenanted to notify the State's Department of Finance by May 5 of each year (and at any other time as may be necessary) of any deficiencies in such amounts. See "THE INDENTURE—Affirmative Covenants—*Deficiency Certifications*."

Upon receipt of an Officer's Certificate of the Issuer delivered in May which certifies the existence of a deficiency with regard to the next succeeding June 1 Distribution Date, any amounts appropriated relating to such June 1 Distribution Date shall be disbursed by the Department of Finance to the Trustee no later than five (5) days prior to such Distribution Date for the purpose of paying the Operating Expenses and Debt Service on the Bonds specified in such Officer's Certificate. In the event such Officer's Certificate delivered in May also certifies the existence of a deficiency with regard to the next succeeding December 1 Distribution Date and to the extent that amounts have been appropriated and remain available for Debt Service and/or Operating Expenses, the amounts so appropriated shall be encumbered as soon as reasonably practical following receipt of such Officer's Certificate and in any event before the end of the fiscal year, and the amounts so appropriated shall be disbursed by the Department of Finance to the Trustee (subject to adjustment as to the amount upon receipt of a supplemental Officer's Certificate pursuant to the Indenture) no later than five (5) days prior to such December 1 Distribution Date for the purpose of paying the Operating Expenses and Debt Service on the Bonds specified in such Officer's Certificate.

See "APPENDIX A—THE STATE OF CALIFORNIA" for a discussion of the State's economy and finances, and see "APPENDIX B—STATE OF CALIFORNIA COMPREHENSIVE ANNUAL FINANCIAL REPORT FOR THE FISCAL YEAR ENDED JUNE 30, 2013" for a copy of the State's audited Comprehensive Annual Financial Report for the fiscal year ended June 30, 2013. See also "FINANCIAL STATEMENTS" herein.

Application of Collections

The Trustee will deposit all Collections, excluding investment earnings on amounts on deposit with the Trustee under the Indenture, in the Collections Account promptly upon receipt. All Collections that have been identified by an Officer's Certificate as consisting of Partial Lump Sum Payments received by the Trustee will be promptly transferred (and in any event, no later than the Business Day immediately preceding the next Distribution Date) to the Partial Lump Sum Payment Account and applied in the manner described under "—*Application of Amounts in the Partial Lump Sum Payment Account*" below. All Collections that have been identified by an Officer's Certificate as consisting of Total Lump Sum

Payments received by the Trustee will be promptly applied (and in any event, no later than the Business Day immediately preceding the next Distribution Date) in the manner described under "—*Application of a Total Lump Sum Payment*" below. All Collections that have been identified by an Officer's Certificate as consisting of State Appropriations received by the Trustee shall be promptly applied (and in any event, no later than the Business Day immediately preceding the next Distribution Date) as described under "*State Appropriations Transfers*" below. In addition, on each Distribution Date, the Trustee will transfer to the Collections Account and apply as set forth below (i) all Collections consisting of investment earnings available on such Distribution Date on amounts on deposit with the Trustee under the Indenture (excluding amounts in the Costs of Issuance Account, the Rebate Account, the Operating Account, the Operating Contingency Account and the Partial Lump Sum Payment Account), and (ii) all amounts in the Liquidity Reserve Account in excess of the Liquidity Reserve Requirement determined to exist pursuant to the valuation procedure set forth under the Indenture, taking into account investment earnings and other amounts to be available in the Liquidity Reserve Account on such Distribution Date.

Transfers to Accounts. As soon as practicable, but no later than the earlier of (a) the fifth Business Day following each Deposit Date, or (b) the Distribution Date following each Deposit Date, the Trustee will withdraw the funds on deposit in the Collections Account (other than from State Appropriations, if any) and transfer such amounts as follows:

(i) to the Operating Account an amount sufficient to cause the amount therein (taking into account any amounts deposited from State Appropriations as specified under "*State Appropriations Transfers*" below) to equal the amount specified by an Officer's Certificate delivered with respect to the 12-month period applicable to such Officer's Certificate, in order to pay (a) the Operating Expenses, (excluding any payment in respect of loss under or termination of any Swap Contract, investment agreement or forward purchase agreement), to the extent that the amount thereof does not exceed the Operating Cap, and (b) the Tax Obligations;

(ii) to the Debt Service Account an amount sufficient to cause the amount therein (taking into account any amounts deposited from State Appropriations as specified under "*State Appropriations Transfers*" below) to equal the interest on the Outstanding Current Interest Bonds and all Swap Payments that will come due (1) in the next succeeding Bond Year, if the Deposit Date is on or after December 1 and on or before May 31 of any Bond Year, or (2) in the then-current Bond Year, if the Deposit Date is on or after June 1 and on or before November 30 of any Bond Year; provided that the amount to be deposited pursuant to this clause (ii) shall be calculated assuming that the amount of each Serial Maturity, Mandatory Sinking Fund Payment and Term Bond Maturity shall be first adjusted as described in "THE INDENTURE—Effect of Defeasance, Redemption or Purchase";

(iii) to the Debt Service Account an amount sufficient to cause the amount therein (taking into account any amounts deposited from State Appropriations as specified under "*State Appropriations Transfers*" below) to equal the amount specified in clause (ii) above plus, if the Deposit Date is on or after December 1 and on or before May 31 of any Bond Year, the Serial Maturity, Mandatory Sinking Fund Payment or Term Bond Maturity, if any, due in or scheduled for the next succeeding Bond Year, provided that the amount of each Serial Maturity, Mandatory Sinking Fund Payment and Term Bond Maturity shall first be adjusted to account for prior principal or Accreted Value payments, defeasances, redemptions or purchases of Bonds as described in "THE INDENTURE—Effect of Defeasance, Redemption or Purchase";

(iv) unless an Event of Default has occurred, to the Liquidity Reserve Account an amount sufficient to cause the amount on deposit therein to equal the Liquidity Reserve Requirement, provided that no State Appropriations shall be deposited into the Liquidity Reserve Account;

(v) to the Operating Contingency Account, the amount, if any, necessary to make the amount therein (taking into account any amounts deposited from State Appropriations as specified under "*State Appropriations Transfers*" below) equal to $500,000, plus an amount specified by the Officer's Certificate most recently delivered or deemed delivered in order to pay, for the 12-month period applicable to such Officer's Certificate, the Operating Expenses in excess of the Operating Cap;

(vi) (reserved);

(vii) to the Surplus Account, all amounts remaining in the Collections Account until no Bonds remain Outstanding; and

(viii) thereafter, to the Residual Account, all amounts remaining in the Collections Account.

On the tenth (10th) day of the calendar month preceding each Distribution Date, the Trustee shall compare (i) the liquidation value of the aggregate amount on deposit in the Debt Service Account, the Liquidity Reserve Account, the Partial Lump Sum Payment Account and the Surplus Account (other than (a) amounts representing proceeds of refunding obligations, (b) amounts that do not constitute Pledged TSRs, State Appropriations or payments made to the Issuer or Trustee under Swap Contracts, and (c) amounts set aside for the payment of particular Bonds) to (ii) the sum of (a) the principal amount of and accrued interest (if any) to such Distribution Date on all Current Interest Bonds that will remain Outstanding after the application of amounts described below on such Distribution Date and (b) the amount necessary to defease or redeem (as set forth in an Officer's Certificate) pursuant to the Indenture all Capital Appreciation Bonds and Convertible Bonds that will remain Outstanding after the application of amounts described above on such Distribution Date, and if the amount in clause (i) is equal to or greater than the amount described in clause (ii) as of such Distribution Date, then the Trustee shall liquidate the investments in the Pledged Accounts and shall withdraw from the Pledged Accounts an amount sufficient to, and shall, retire the Bonds in full on such Distribution Date as provided in the Indenture. See "THE SERIES 2015A BONDS—Mandatory Clean-up Redemption."

Distribution Date Transfers. Unless an Event of Default has occurred, on each Distribution Date, the Trustee will apply amounts in the various funds and accounts in the following order of priority:

(i) from the Debt Service Account, the Partial Lump Sum Payment Account and, to the extent that amounts in the foregoing accounts are insufficient, the Surplus Account and the Liquidity Reserve Account, in that order, to pay interest on the Current Interest Bonds and Swap Payments due on such Distribution Date;

(ii) from the Debt Service Account, the Partial Lump Sum Payment Account and, to the extent that amounts in the foregoing accounts are insufficient, the Surplus Account and the Liquidity Reserve Account, in that order, to pay, in the following order, the Serial Maturity, Mandatory Sinking Fund Payments and Term Bond Maturity, if any, due on or scheduled for such Distribution Date, provided that the amounts thereof shall have first been adjusted as described in "THE INDENTURE—Effect of Defeasance, Redemption or Purchase"; and

(iii) from the Residual Account, to pay all amounts on deposit therein to the registered owner of the Residual Certificate.

Application of Funds Upon the Occurrence of an Event of Default. Upon the occurrence of any Event of Default and on each succeeding Distribution Date, the Trustee will apply all funds in the Debt Service Account, the Liquidity Reserve Account, the Partial Lump Sum Payment Account and the Surplus Account to pay Pro Rata, first, the accrued interest on the Current Interest Bonds then

Outstanding and Swap Payments (including, in each case, interest at the stated rate on any unpaid interest, to the extent legally permissible) and, second, principal of or Accreted Value on all Bonds then Outstanding.

Application of a Total Lump Sum Payment. Upon the receipt of a Total Lump Sum Payment, the Trustee will, after making provision for the amounts required to be deposited pursuant to clause (i) under "*Transfers to Accounts*" above, use all remaining proceeds of such Total Lump Sum Payment to pay Pro Rata, first, the accrued interest on the Current Interest Bonds then Outstanding and Swap Payments (including interest at the stated rate on any unpaid interest, to the extent legally permissible) and, second, principal of or Accreted Value on all Bonds then Outstanding. See "THE SERIES 2015A BONDS—Redemption by Application of a Total Lump Sum Payment."

Application of Amounts in the Partial Lump Sum Payment Account. Funds in the Partial Lump Sum Payment Account shall be applied by the Trustee at any time, in accordance with directions in an Officer's Certificate, in the following order: (1) to redeem Current Interest Bond maturities in minimum authorized denominations on any date in accordance with the Indenture and (2) thereafter, either (a) to defease Capital Appreciation Bonds and Convertible Bonds, or (b) to redeem on any date in accordance with the Indenture, Capital Appreciation Bonds and Convertible Bonds at a redemption price equal to the lesser of (i) one hundred five percent (105%) of the Accreted Value thereof on the redemption date or (ii) the Accreted Value at maturity thereof. In the Second Supplemental Indenture, the Issuer agreed that any Officer's Certificate provided in connection with a redemption of Bonds from funds in the Partial Lump Sum Payment Account shall direct the Trustee not to redeem any Series 2013A Bonds until June 1, 2023 unless no Series 2005A Bonds constituting Current Interest Bonds (and no Current Interest Bonds issued to refund the Series 2005A Bonds, such as the Series 2015A Bonds) remain outstanding. Accordingly, in the event of a redemption from amounts on deposit in the Partial Lump Sum Payment Account prior to such date, the Series 2005A Bonds that are Current Interest Bonds and the Series 2015A Bonds would be selected for redemption prior to the Series 2013A Bonds. Following the refunding of a portion of the Series 2005A Bonds with proceeds of the Series 2015A Bonds, $210,030,000[*] aggregate principal amount of the Series 2005A Bonds constituting Current Interest Bonds will remain outstanding under the Indenture. See "THE SERIES 2015A BONDS—Redemption from Amounts in the Partial Lump Sum Payment Account."

State Appropriations Transfers. Upon the receipt of a sum that has been identified as a State Appropriation, the Trustee will promptly (and in any event, no later than the Business Day immediately preceding the next Distribution Date) make deposits into the following accounts in the amounts specified by the Issuer in the following order of priority:

(1) to the extent the State Appropriation is to pay Operating Expenses,

   (a) to the Operating Account, an amount sufficient to cause the amount therein as specified in clause (i) under "*Transfers to Accounts*" above;

   (b) to the Operating Contingency Account, an amount sufficient to cause the amount therein to equal the amount required to be on deposit therein as specified in clause (v) under "*Transfers to Accounts*" above, and

(2) to the extent the State Appropriation is to pay Debt Service,

[*] Preliminary, subject to change.

(a) to the Debt Service Account, an amount sufficient to cause the amount therein to equal the amount required to be on deposit therein as specified in clause (ii) under "*Transfers to Accounts*" above; and

(b) to the Debt Service Account, an amount sufficient to cause the amount therein to equal the amount required to be on deposit therein as specified in clause (iii) under "*Transfers to Accounts*" above.

(3) to the extent the State Appropriation does not distinguish between Operating Expenses and Debt Service,

(a) to the Operating Account, an amount sufficient to cause the amount therein to equal the amount required to be on deposit therein as specified in clause (i) under "*Transfers to Accounts*" above;

(b) to the Debt Service Account, an amount sufficient to cause the amount therein to equal the amount required to be on deposit therein as specified in clause (ii) under "*Transfers to Accounts*" above;

(c) to the Debt Service Account, an amount sufficient to cause the amount therein to equal the amount required to be on deposit therein as specified in clause (iii) under "*Transfers to Accounts*" above; and

(d) to the Operating Contingency Account, an amount sufficient to cause the amount therein to equal the amount required to be on deposit therein as specified in clause (v) under "*Transfers to Accounts*" above.

Other Transfers. Funds in the Surplus Account shall be applied by the Trustee at any time, in accordance with directions in an Officer's Certificate, (1) to defease Bonds, (2) to pay the optional redemption price of Bonds to be redeemed in accordance with the Indenture (see "THE SERIES 2015A BONDS—Optional Redemption" herein), (3) to purchase Bonds on any date (see "THE SERIES 2015A BONDS—Purchase of Series 2015A Bonds"), or (4) to provide for the payment of Debt Service on the Bonds.

On the Series 2015A Closing Date, all amounts then on deposit in the Surplus Account will be released and applied to the refunding of a portion of the Series 2005A Bonds. See "ESTIMATED SOURCES AND USES OF FUNDS" herein.

Liquidity Reserve Account

A Liquidity Reserve Account was established under the Indenture in an amount equal to $214,307,881.25 (as amended as described below, the "**Liquidity Reserve Requirement**"). Pursuant to the Third Supplemental Indenture, the Liquidity Reserve Requirement is amended to $150,000,000, and the funds held in the Liquidity Reserve Account in excess of such amended Liquidity Reserve Requirement will be released on the Series 2015A Closing Date and applied to the refunding of a portion of the Series 2005A Bonds. See "—Consent to Amendments to Indenture and Purchase and Sale Agreement" above.

Amounts in the Liquidity Reserve Account shall be used, to the extent that amounts in the Debt Service Account, the Partial Lump Sum Payment Account and the Surplus Account, in that order, are insufficient, to pay interest and principal on the Bonds and Swap Payments. See "—Application of

Collections—*Distribution Date Transfers*" above. Unless an Event of Default has occurred, available funds on deposit in the Collections Account will be transferred to the Liquidity Reserve Account in accordance with the priority of transfers set forth in the Indenture in an amount sufficient to cause the amount on deposit in the Liquidity Reserve Account to equal the Liquidity Reserve Requirement; provided, however, that no State Appropriations shall be deposited into the Liquidity Reserve Account. See "—Application of Collections—*Transfers to Accounts*" above. See "RISK FACTORS—Risk Related to the Liquidity Reserve Account."

In lieu of maintaining and depositing moneys in the Liquidity Reserve Account, the Issuer may at any time substitute one or more Reserve Facilities, subject to the requirements of the Indenture. The Issuer shall not substitute a Reserve Facility for all or any part of the amounts on deposit in the Liquidity Reserve Account if such substitution will cause the then current ratings on the Bonds to be downgraded or withdrawn. See "THE INDENTURE—Investments—*Reserve Facilities*."

Elimination of Supplemental Reserve Requirement

A reserve account (the "**Supplemental Reserve Account**") was established by the Trustee under the Indenture in an amount equal to $31,949,870.09 (as amended as described below, the "**Supplemental Reserve Requirement**"). Pursuant to the Third Supplemental Indenture, the Supplemental Reserve Requirement is amended to $0, and amounts in the Supplemental Reserve Account will be released on the Series 2015A Closing Date and applied to the refunding of a portion of the Series 2005A Bonds. Therefore, following the issuance of the Series 2015A Bonds and the application of the proceeds thereof, the Supplemental Reserve Requirement, and the balance in the Supplemental Reserve Account, will be $0. See "—Consent to Amendments to Indenture and Purchase and Sale Agreement" above.

THE SERIES 2015A BONDS

The following summary describes certain terms of the Series 2015A Bonds. This summary does not purport to be complete and is subject to, and qualified in its entirety by reference to, the provisions of the Indenture and the Series 2015A Bonds. Copies of the Indenture may be obtained upon written request to the Trustee.

The Series 2015A Bonds will initially be represented by bond certificates registered in the name of The Depository Trust Company ("**DTC**"), New York, New York, or its nominee. DTC will act as securities depository for the Series 2015A Bonds. The Series 2015A Bonds will be available for purchase in principal denominations of $5,000 or any integral multiple thereof, in book-entry form only. Except under the limited circumstances described herein, no Beneficial Owner (as defined herein) of the Series 2015A Bonds will be entitled to receive a physical certificate representing its ownership interest in such Series 2015A Bonds. See "—Book-Entry-Only System" below.

Payments of Interest

Interest on the outstanding principal balance of the Series 2015A Bonds will be payable on each June 1 and December 1, commencing June 1, 2015. Interest will accrue from and including the Series 2015A Closing Date. Interest on the Series 2015A Bonds will be computed on the basis of a 360-day year consisting of twelve 30-day months. Failure to pay the full amount of interest payable on any Distribution Date is an Event of Default.

For each Distribution Date, payments will be made to Owners of record (the "**Owners**") as of the Record Date. "**Record Date**" means, with respect to Series 2015A Bonds, the 15th day of the calendar month immediately preceding the calendar month in which a Distribution Date occurs. The Trustee and the Issuer may establish special record dates for the determination of the Owners for various purposes of the Indenture, including giving consent or direction to the Trustee.

Payments of Principal at Maturity

Serial Maturities and Term Bond Maturities, each as defined herein, of the Series 2015A Bonds are payable upon the respective Maturity Date of each Series 2015A Bond, as set forth on the inside cover page of this Official Statement. Failure to pay the full amount of a Serial Maturity or a Term Bond Maturity payable on the applicable Maturity Date is an Event of Default.

Redemption by Mandatory Sinking Fund Payments

The Series 2015A Bonds having Maturity Dates in the years 2040* and 2045* are Term Bonds and shall have the Mandatory Sinking Fund Payments shown below.

Series 2015A Term Bond Maturing June 1, 2040*

Sinking Fund Redemption Date (June 1)*	Principal Amount to be Redeemed*
2036	$ 97,625,000
2037	101,425,000
2038	105,450,000
2039	109,715,000
2040[1]	114,220,000

Series 2015A Term Bond Maturing June 1, 2045*

Sinking Fund Redemption Date (June 1)*	Principal Amount to be Redeemed*
2041	$118,995,000
2042	124,045,000
2043	129,680,000
2044	136,500,000
2045[1]	141,025,000

[1] Maturity Date

Failure to pay the full amount of a Mandatory Sinking Fund Payment as set forth above is an Event of Default.

Application of Funds Upon the Occurrence of an Event of Default

Upon the occurrence of any Event of Default and on each succeeding Distribution Date, the Trustee will apply all funds in the Debt Service Account, the Liquidity Reserve Account, the Partial Lump Sum Payment Account and the Surplus Account to pay Pro Rata, first, the accrued interest on the Current Interest Bonds then Outstanding and Swap Payments (including, in each case, interest at the stated rate on any unpaid interest, to the extent legally permissible) and, second, principal of or Accreted Value on all Bonds then Outstanding.

* Preliminary, subject to change.

Optional Redemption

The Series 2015A Bonds maturing on or prior to June 1, 2025* are not subject to optional redemption. The Series 2015A Bonds maturing on or after June 1, 2026* are subject to optional redemption prior to maturity, in whole or in part, from any source (other than State Appropriations), on any date on or after June 1, 2025*, at a redemption price equal to 100% of the principal amount being redeemed, plus interest accrued to the redemption date, without premium.

Any such redemption will be credited as described under "—Effect of Defeasance, Redemption or Purchase" below. If less than all of the Series 2015A Bonds of any maturity are to be redeemed, the Owners of the Series 2015A Bonds of such maturity will be paid as described below under the heading "—Partial Redemptions."

Redemption from Amounts in the Partial Lump Sum Payment Account

The Series 2015A Bonds are subject to redemption, at a redemption price equal to 100% of the principal amount of the Series 2015A Bonds to be redeemed plus accrued interest thereon to the date fixed for redemption, without premium, from amounts on deposit in the Partial Lump Sum Payment Account. Funds in the Partial Lump Sum Payment Account shall be applied by the Trustee at any time, in accordance with directions in an Officer's Certificate.

In the Second Supplemental Indenture, the Issuer agreed that any Officer's Certificate provided in connection with a redemption of Bonds from funds in the Partial Lump Sum Payment Account shall direct the Trustee not to redeem any Series 2013A Bonds until June 1, 2023 unless no Series 2005A Bonds constituting Current Interest Bonds (and no Current Interest Bonds issued to refund the Series 2005A Bonds, such as the Series 2015A Bonds) remain outstanding. Accordingly, in the event of a redemption from amounts on deposit in the Partial Lump Sum Payment Account prior to such date, the Series 2005A Bonds that are Current Interest Bonds and the Series 2015A Bonds would be selected for redemption prior to the Series 2013A Bonds. Following the refunding of a portion of the Series 2005A Bonds with proceeds of the Series 2015A Bonds, $210,030,000* aggregate principal amount of the Series 2005A Bonds constituting Current Interest Bonds will remain outstanding under the Indenture. See "SECURITY FOR THE BONDS—Application of Collections—*Application of Amounts in the Partial Lump Sum Payment Account*."

Any such redemption will be credited as described under "—Effect of Defeasance, Redemption or Purchase" below. If less than all of the Series 2015A Bonds of any maturity are to be redeemed, the Owners of the Series 2015A Bonds of such maturity will be paid as described below under the heading "—Partial Redemptions."

Redemption by Application of a Total Lump Sum Payment

The Series 2015A Bonds are subject to mandatory redemption in whole on any Distribution Date at a redemption price equal to one hundred percent (100%) of the principal amount being redeemed plus interest accrued to the redemption date from moneys withdrawn as specified in the following paragraph.

Upon the receipt of a Total Lump Sum Payment, the Trustee will, after making provision for the amounts required to be deposited pursuant to clause (i) under "SECURITY FOR THE BONDS—Application of Collections—*Transfers to Accounts*", use all remaining proceeds of such Total Lump Sum Payment to pay Pro Rata, first, the accrued interest on the Current Interest Bonds then Outstanding and

* Preliminary, subject to change.

Swap Payments (including interest at the stated rate on any unpaid interest, to the extent legally permissible) and, second, principal of or Accreted Value on all Bonds then Outstanding. See "SECURITY FOR THE BONDS—Application of Collections—*Application of a Total Lump Sum Payment*."

Mandatory Clean-up Redemption

The Series 2015A Bonds are subject to mandatory redemption in whole on any Distribution Date at a redemption price equal to one hundred percent (100%) of the principal amount being redeemed plus interest accrued to the redemption date from moneys withdrawn as specified in the following paragraph.

On the tenth (10th) day of the calendar month preceding each Distribution Date, the Trustee shall compare (i) the liquidation value of the aggregate amount on deposit in the Debt Service Account, the Liquidity Reserve Account, the Partial Lump Sum Payment Account and the Surplus Account (other than (a) amounts representing proceeds of refunding obligations, (b) amounts that do not constitute Pledged TSRs, State Appropriations or payments made to the Issuer or Trustee under Swap Contracts, and (c) amounts set aside for the payment of particular Bonds) to (ii) the sum of (a) the principal amount of and accrued interest (if any) to such Distribution Date on all Current Interest Bonds that will remain Outstanding after the application of amounts described above on such Distribution Date and (b) the amount necessary to defease or redeem (as set forth in an Officer's Certificate) pursuant to the Indenture all Capital Appreciation Bonds and Convertible Bonds that will remain Outstanding after the application of amounts available under the Indenture to pay Debt Service on the Bonds on such Distribution Date, and if the amount in clause (i) is equal to or greater than the amount described in clause (ii) as of such Distribution Date, then the Trustee shall liquidate the investments in the Pledged Accounts and shall withdraw from the Pledged Accounts an amount sufficient to, and shall, retire the Bonds in full on such Distribution Date as provided in the Indenture.

Purchase of Series 2015A Bonds

The Issuer may cause the Trustee to purchase Series 2015A Bonds in the open market on any date from amounts held in the Surplus Account at such price or prices as the Issuer in its sole discretion may determine. Any such purchase will be credited as described under "—Effect of Defeasance, Redemption or Purchase" below.

Effect of Defeasance, Redemption or Purchase

There shall, at the option of the Issuer, be applied to or credited against any Serial Maturity, Mandatory Sinking Fund Payment or Term Bond Maturity, the principal amount of any Series 2015A Bonds therefrom that have been defeased, purchased or redeemed and not previously so applied or credited.

Partial Redemptions

If less than all the Outstanding Series 2015A Bonds of like interest rate and Maturity Date are to be redeemed, the particular Series 2015A Bonds to be redeemed shall be selected by the Trustee by such method as it shall deem fair and appropriate, including by lot, and which may provide for the selection for redemption of portions (equal to any authorized denominations) of the principal of Series 2015A Bonds of a denomination larger than the minimum authorized denomination.

So long as Cede & Co. is the registered owner of the Series 2015A Bonds, as nominee of DTC, all notices of redemption, including partial redemptions, will go only to DTC. In the case of a partial redemption of the Series 2015A Bonds, DTC's practice is to determine by lot the amount of the interest of each Direct Participant to be redeemed.

Notice of Redemption

When a Bond is to be redeemed prior to its stated maturity date, the Trustee will give notice to the Owner thereof in the name of the Issuer, which notice will identify the Bond to be redeemed, state the date fixed for redemption, and state that such Bond will be redeemed at the Corporate Trust Office of the Trustee or a Paying Agent or at such other place as may be designated by the Trustee. The notice will further state that on such date there will become due and payable upon each Bond to be redeemed the redemption price thereof, together with interest accrued to the redemption date, and that money therefor having been deposited with the Trustee or Paying Agent, from and after such date, interest thereon will cease to accrue. The Trustee will give not less than 15 nor more than 20 days notice by mail, or otherwise transmit the redemption notice in accordance with any appropriate provisions under the Indenture, to the registered owners of any Bonds which are to be redeemed, at their addresses shown on the registration books of the Issuer. Such notice may be waived by any Owners holding Bonds to be redeemed. Failure by a particular Owner to receive notice, or any defect in the notice to such Owner, will not affect the redemption of any other Bond. Any notice of redemption given pursuant to the Indenture may be rescinded by Written Notice to the Trustee by the Issuer no later than five days prior to the date specified for redemption. The Trustee will give notice of such rescission as soon thereafter as practicable in the same manner and to the same persons, as notice of such redemption was given as described above. In making the determination as to how much money will be available in the Surplus Account on any redemption date for the purpose of giving notice of redemption, the Trustee shall take into account investment earnings which it reasonably expects to be available for application. The Trustee shall transfer such amounts from the Debt Service Account to the Surplus Account on or before the date such notice is given.

Additional Bonds

Additional Bonds may be issued under the Indenture only for the purpose of refunding Bonds (including the funding of defeasance escrows).

Book-Entry-Only System

The Depository Trust Company ("**DTC**"), New York, New York, will act as securities depository for the Series 2015A Bonds. The Series 2015A Bonds will be issued as fully-registered securities registered in the name of Cede & Co. (DTC's partnership nominee) or such other name as may be requested by an authorized representative of DTC. One fully-registered bond certificate will be issued for each CUSIP of each maturity of the Series 2015A Bonds, each in the aggregate principal amount of such maturity, and will be deposited with DTC.

DTC, the world's largest securities depository, is a limited-purpose trust company organized under the New York Banking Law, a "banking organization" within the meaning of the New York Banking Law, a member of the Federal Reserve System, a "clearing corporation" within the meaning of the New York Uniform Commercial Code, and a "clearing agency" registered pursuant to the provisions of Section 17A of the Securities Exchange Act of 1934. DTC holds and provides asset servicing for over 3.5 million issues of U.S. and non-U.S. equity issues, corporate and municipal debt issues, and money market instruments (from over 100 countries) that DTC's participants ("**Direct Participants**") deposit with DTC. DTC also facilitates the post-trade settlement among Direct Participants of sales and other securities transactions in deposited securities, through electronic computerized book-entry transfers and pledges between Direct Participants' accounts. This eliminates the need for physical movement of securities certificates. Direct Participants include both U.S. and non-U.S. securities brokers and dealers, banks, trust companies, clearing corporations, and certain other organizations. DTC is a wholly-owned subsidiary of The Depository Trust & Clearing Corporation ("**DTCC**"). DTCC is the holding company for DTC, National Securities Clearing Corporation and Fixed Income Clearing Corporation, all of which are registered clearing agencies. DTCC is owned by the users of its regulated subsidiaries. Access to the DTC system is also available to others such as both U.S. and non-U.S. securities brokers and dealers, banks, trust companies, and clearing corporations that clear through or maintain a custodial relationship with a Direct Participant, either directly or indirectly ("**Indirect Participants**"). DTC has a Standard & Poor's rating of AA+. The DTC Rules applicable to its Participants are on file with the Securities and Exchange Commission. More information about DTC can be found at www.dtcc.com.

Purchases of Series 2015A Bonds under the DTC system must be made by or through Direct Participants, which will receive a credit for the Series 2015A Bonds on DTC's records. The ownership interest of each actual purchaser of each Series 2015A Bond ("**Beneficial Owner**") is in turn to be recorded on the Direct and Indirect Participants' records. Beneficial Owners will not receive written confirmation from DTC of their purchase. Beneficial Owners are, however, expected to receive written confirmations providing details of the transaction, as well as periodic statements of their holdings, from the Direct or Indirect Participant through which the Beneficial Owner entered into the transaction. Transfers of ownership interests in the Series 2015A Bonds are to be accomplished by entries made on the books of Direct and Indirect Participants acting on behalf of Beneficial Owners. Beneficial Owners will not receive certificates representing their ownership interests in the Series 2015A Bonds, except in the event that use of the book-entry system for the Series 2015A Bonds is discontinued.

To facilitate subsequent transfers, all the Series 2015A Bonds deposited by Direct Participants with DTC are registered in the name of DTC's partnership nominee, Cede & Co., or such other name as may be requested by an authorized representative of DTC. The deposit of the Series 2015A Bonds with DTC and their registration in the name of Cede & Co. or such other DTC nominee do not effect any change in beneficial ownership. DTC has no knowledge of the actual Beneficial Owners of the Series 2015A Bonds; DTC's records reflect only the identity of the Direct Participants to whose accounts such Series 2015A Bonds are credited, which may or may not be the Beneficial Owners. The Direct and Indirect Participants will remain responsible for keeping account of their holdings on behalf of their customers.

Conveyance of notices and other communications by DTC to Direct Participants, by Direct Participants to Indirect Participants, and by Direct Participants and Indirect Participants to Beneficial Owners will be governed by arrangements among them, subject to any statutory or regulatory requirements as may be in effect from time to time. Beneficial Owners of the Series 2015A Bonds may wish to take certain steps to augment the transmission to them of notices of significant events with respect to the Series 2015A Bonds, such as redemptions, tenders, defaults, and proposed amendments to the Series 2015A Bond documents. For example, Beneficial Owners of the Series 2015A Bonds may wish to ascertain that the nominee holding the Series 2015A Bonds for their benefit has agreed to obtain and transmit notices to Beneficial Owners. In the alternative, Beneficial Owners may wish to provide their names and addresses to the registrar and request that copies of notices be provided directly to them.

Redemption notices shall be sent to DTC. If less than all of the Series 2015A Bonds within a maturity are being redeemed, DTC's practice is to determine by lot the amount of the interest of each Direct Participant in such maturity to be redeemed.

Neither DTC nor Cede & Co. (nor any other DTC nominee) will consent or vote with respect to the Series 2015A Bonds unless authorized by a Direct Participant in accordance with DTC's MMI Procedures. Under its usual procedures, DTC mails an Omnibus Proxy to the Issuer as soon as possible after the record date. The Omnibus Proxy assigns Cede & Co.'s consenting or voting rights to those Direct Participants to whose accounts Series 2015A Bonds are credited on the record date (identified in a listing attached to the Omnibus Proxy).

Interest payments, Serial Maturities, Mandatory Sinking Fund Payments, Term Bond Maturities and other redemptions on the Series 2015A Bonds will be made to Cede & Co., or such other nominee as may be requested by an authorized representative of DTC. DTC's practice is to credit Direct Participants' accounts upon DTC's receipt of funds and corresponding detail information from the Issuer or the Trustee, on a payable date in accordance with their respective holdings shown on DTC's records. Payments by Participants to Beneficial Owners will be governed by standing instructions and customary practices, as is the case with securities held for the accounts of customers in bearer form or registered in "street name," and will be the responsibility of such Participant and not of DTC, the Trustee or the Issuer, subject to any statutory or regulatory requirements as may be in effect from time to time. Payment of interest, Serial Maturities, Mandatory Sinking Fund Payments, Term Bond Maturities and other redemptions on the Series 2015A Bonds to Cede & Co. (or such other nominee as may be requested by an authorized representative of DTC) is the responsibility of the Issuer or the Trustee, disbursement of such payments to Direct Participants will be the responsibility of DTC, and disbursement of such payments to the Beneficial Owners will be the responsibility of Direct and Indirect Participants.

DTC may discontinue providing its services as depository with respect to the Series 2015A Bonds at any time by giving reasonable notice to the Issuer or Trustee. Under such circumstances, in the event that a successor depository is not obtained, such Series 2015A Bond certificates are required to be printed and delivered.

To the extent permitted by law, the Issuer may decide to discontinue use of the system of book-entry-only transfers through DTC (or a successor securities depository). In that event, bond certificates will be printed and delivered to DTC.

Except as described below, neither DTC nor Cede & Co. will take any action to enforce covenants with respect to any security registered in the name of Cede & Co. Under its current procedures, on the written instructions of a Direct Participant, DTC will cause Cede & Co. to sign a demand to exercise Owner rights as record holder of the quantity of securities specified in the Direct Participant's instructions, and not as record holder of all the securities of that issue registered in the name of Cede & Co. Also, in accordance with DTC's current procedures, all factual representations to be made by Cede & Co. to the Issuer, the Trustee or any other party must be made to DTC and Cede & Co. by the Direct Participant in its instructions to DTC.

For so long as the Series 2015A Bonds are issued in book entry form through the facilities of DTC, any Beneficial Owner desiring to cause the Issuer or the Trustee to comply with any of its obligations with respect to the Series 2015A Bonds must make arrangements with the Direct Participant or Indirect Participant through whom such Beneficial Owner's ownership interest in the Series 2015A Bonds is recorded in order for the Direct Participant in whose DTC account such ownership interest is recorded to make the instructions to DTC described above.

NONE OF THE ISSUER, THE TRUSTEE OR ANY UNDERWRITER (OTHER THAN IN ITS CAPACITY, IF ANY, AS A DIRECT PARTICIPANT OR INDIRECT PARTICIPANT) WILL HAVE ANY OBLIGATION TO DIRECT PARTICIPANTS OR INDIRECT PARTICIPANTS OR THE PERSONS FOR WHOM THEY ACT AS NOMINEES WITH RESPECT TO DTC'S PROCEDURES OR ANY PROCEDURES OR ARRANGEMENTS BETWEEN DIRECT PARTICIPANTS, INDIRECT PARTICIPANTS AND THE PERSONS FOR WHOM THEY ACT RELATING TO THE MAKING OF ANY DEMAND BY CEDE & CO. AS THE REGISTERED OWNER OF THE SERIES 2015A BONDS, THE ADHERENCE TO SUCH PROCEDURES OR ARRANGEMENTS OR THE EFFECTIVENESS OF ANY ACTION TAKEN PURSUANT TO SUCH PROCEDURES OR ARRANGEMENTS.

THE ABOVE INFORMATION CONCERNING DTC AND DTC'S BOOK ENTRY SYSTEM HAS BEEN OBTAINED FROM SOURCES THAT THE ISSUER BELIEVES TO BE RELIABLE, BUT THE ISSUER TAKES NO RESPONSIBILITY FOR THE ACCURACY THEREOF. NEITHER THE ISSUER, THE STATE NOR THE TRUSTEE WILL HAVE ANY RESPONSIBILITY OR OBLIGATION TO DIRECT PARTICIPANTS OR INDIRECT PARTICIPANTS, BENEFICIAL OWNERS OR OTHER NOMINEES OF SUCH BENEFICIAL OWNERS FOR (1) SENDING TRANSACTION STATEMENTS; (2) MAINTAINING, SUPERVISING OR REVIEWING, OR THE ACCURACY OF, ANY RECORDS MAINTAINED BY DTC OR ANY DIRECT PARTICIPANT OR INDIRECT PARTICIPANT OR OTHER NOMINEES OF SUCH BENEFICIAL OWNERS; (3) PAYMENT OR THE TIMELINESS OF PAYMENT BY DTC TO ANY DIRECT PARTICIPANT OR INDIRECT PARTICIPANT, OR BY ANY DIRECT PARTICIPANT OR INDIRECT PARTICIPANT OR OTHER NOMINEES OF BENEFICIAL OWNERS TO ANY BENEFICIAL OWNER, OF ANY AMOUNT DUE IN RESPECT OF THE PRINCIPAL OF OR REDEMPTION PREMIUM, IF ANY, OR INTEREST ON THE SERIES 2015A BONDS; (4) DELIVERY OR TIMELY DELIVERY BY DTC TO ANY DIRECT PARTICIPANT OR INDIRECT PARTICIPANT, OR BY ANY DIRECT PARTICIPANT OR INDIRECT PARTICIPANT OR OTHER NOMINEES OF BENEFICIAL OWNERS TO ANY BENEFICIAL OWNERS, OF ANY NOTICE OR OTHER COMMUNICATION WHICH IS REQUIRED OR PERMITTED UNDER THE TERMS OF THE INDENTURE TO BE GIVEN TO OWNERS; (5) THE SELECTION OF THE BENEFICIAL OWNERS TO RECEIVE PAYMENT IN THE EVENT OF ANY PARTIAL REDEMPTION OF THE SERIES 2015A BONDS; OR (6) ANY ACTION TAKEN BY DTC OR ITS NOMINEE AS THE REGISTERED OWNER OF THE SERIES 2015A BONDS.

None of the Issuer, the State, the Trustee or the Underwriters can give any assurance that DTC or Direct Participants and Indirect Participants will distribute payments of premium, if any, interest, Serial Maturities, Mandatory Sinking Fund Payments, Term Bond Maturities and other redemptions on the Series 2015A Bonds paid to DTC or its nominee, or send any notice, to the Beneficial Owners, or that they will do so in a timely manner or that DTC will act in the manner described in this Official Statement.

So long as Cede & Co. is the registered owner of the Series 2015A Bonds, as nominee for DTC, references in this Official Statement to Owners or registered owners of the Series 2015A Bonds (other than under the caption "TAX MATTERS" herein) shall mean Cede & Co., as aforesaid, and shall not mean the Beneficial Owners of the Series 2015A Bonds.

THE ISSUER

The Issuer is a special purpose trust established as a not-for-profit corporation by the Act. Pursuant to the Act and the Issuer's Articles of Incorporation, the Issuer is authorized to have purchased TSRs from the State and issue bonds, including refunding bonds, secured by and payable from such purchased TSRs and certain State Appropriations, if any, pursuant to the Act.

The Issuer's address is Golden State Tobacco Securitization Corporation, c/o California Department of Finance, 915 L Street, Ninth Floor, Sacramento, California 95814.

ESTIMATED SOURCES AND USES OF FUNDS

The estimated sources and uses of funds of the Series 2015A Bonds are expected to be as follows:

Sources of Funds

Series 2015A Bonds Aggregate Principal Amount	$
Original Issue Premium on the Series 2015A Bonds	
Release from Liquidity Reserve Account	
Release from Supplemental Reserve Account	
Release from Surplus Account	
Total Sources	$

Uses of Funds

Transfer to refunding escrow	$
Costs of Issuance[1]	
Total Uses	$

[1] Includes underwriting, financial advisory, legal, trustee and other fees and expenses.

OUTSTANDING BONDS

Series 2005A Bonds and Series 2013A Bonds

Following the issuance of the Series 2015A Bonds, the application of the proceeds thereof and the defeasance of the portion of Series 2005A Bonds to be refunded with proceeds of the Series 2015A Bonds, the following Series 2005A Bonds and Series 2013A Bonds will be Outstanding under the Indenture:

Maturity Date (June 1)*	Series 2005A Current Interest Serial and Serial Convertible Bonds Principal Amount*[1]	Series 2005A Capital Appreciation Bonds Maturity Value*	Series 2005A Current Interest Term Bonds Principal Amount*	Series 2013A Current Interest Serial Bonds Principal Amount*	Total*
2015					
2016					
2017				$30,685,000	$30,685,000
2018				42,655,000	42,655,000
2019				43,935,000	43,935,000
2020				45,420,000	45,420,000
2021				47,175,000	47,175,000
2022	$67,995,000				67,995,000
2023	72,035,000				72,035,000
2024		$74,535,000			74,535,000
2025		75,575,000			75,575,000
2026		76,620,000			76,620,000
2027		77,710,000			77,710,000
2028		78,830,000			78,830,000
2029				80,180,000	80,180,000
2030				85,055,000	85,055,000
2031			$70,000,000		70,000,000
2032					
2033					
2034					
2035					
2036					
2037					
2038					
2039					
2040					
2041					
2042					
2043					
2044					
2045					
Total	**$140,030,000**	**$383,270,000**	**$70,000,000**	**$375,105,000**	**$968,405,000**

* Preliminary, subject to change.

[1] The Series 2005A Bonds listed in this column were converted to Current Interest Bonds in June 2010.

Since the issuance of the Series 2005A Bonds and the Series 2013A Bonds, $177,570,000 principal amount of the Series 2005A Bonds (and none of the Series 2013A Bonds) have been redeemed (or purchased and cancelled) by application of the amounts on deposit in the Surplus Account. See "SECURITY FOR THE BONDS—Application of Collections—*Other Transfers*."

TABLE OF PROJECTED AVAILABLE FUNDS AND DEBT SERVICE COVERAGE

Projected Available Funds and Debt Service Coverage

Set forth below is a table showing debt service for the Series 2015A Bonds, the Series 2013A Bonds and the Series 2005A Bonds that will remain outstanding following the refunding of a portion of the Series 2005A Bonds with proceeds of the Series 2015A Bonds, and the resulting projected debt service coverage ratios, assuming (i) cigarette consumption is consistent with the forecast contained within the Tobacco Consumption Report, (ii) Collections (other than State Appropriations, if any) are received in accordance with the Collection Methodology and Assumptions, (iii) no redemptions, defeasances, purchases or payments for Debt Service are made from funds on deposit in the Surplus Account and (iv) no State Appropriations are received. See "TABLES OF PROJECTED PLEDGED TSRs, PROJECTION METHODOLOGY AND BOND STRUCTURING ASSUMPTIONS." See also "RISK FACTORS—Risks Relating to the Tobacco Consumption Report."

As used herein, "**debt service coverage ratio**" means, for any period, a fraction, the numerator of which is the amount of projected Collections (other than State Appropriations, if any) received in such period which includes earnings on the Liquidity Reserve Account to the extent deposited in the Debt Service Account, and the denominator of which is the sum of current interest, Serial Maturities, Term Bond Maturities, Mandatory Sinking Fund Payments and Operating Expenses required to be paid in such period for the Series 2015A Bonds, the Series 2013A Bonds and the Series 2005A Bonds that will remain outstanding following the refunding of a portion of the Series 2005A Bonds with proceeds of the Series 2015A Bonds. Using the forecast contained within the Tobacco Consumption Report, the average projected debt service coverage ratio is 1.20x[*], with a minimum projected debt service coverage ratio in 2016[*] of 1.07x[*] and a maximum projected debt service coverage ratio in 2015[*] of 1.89x[*].

[*] Preliminary, subject to change.

Projected Available Funds and Debt Service Coverage Table*

Year[1]	Projected Total Available Funds[2]	Principal	Current Interest	Operating Expenses	Total Debt Service & Operating Expenses	Projected Debt Service Coverage
2015	$159,070,071	-	$ 83,796,808	$ 455,174	$ 84,251,981	1.89x
2016	162,793,563	$ 38,765,000	112,665,008	468,829	151,898,836	1.07x
2017	163,039,842	40,115,000	110,743,008	482,894	151,340,901	1.08x
2018	187,288,808	65,430,000	108,157,883	497,381	174,085,263	1.08x
2019	186,348,653	67,115,000	104,847,758	512,302	172,475,059	1.08x
2020	185,553,590	68,920,000	101,448,633	527,671	170,896,304	1.09x
2021	185,015,026	70,800,000	98,007,383	543,501	169,350,884	1.09x
2022	184,629,752	72,645,000	94,624,246	559,806	167,829,052	1.10x
2023	184,506,228	74,515,000	91,242,305	576,600	166,333,905	1.11x
2024	184,615,675	74,755,000	89,518,000	593,898	164,866,898	1.12x
2025	184,974,678	76,635,000	89,486,000	611,715	166,732,715	1.11x
2026	185,530,193	81,640,000	89,334,000	630,067	171,604,067	1.08x
2027	186,220,485	80,335,000	89,142,875	648,969	170,126,844	1.09x
2028	186,993,376	79,565,000	89,058,875	668,438	169,292,313	1.10x
2029	187,782,012	80,180,000	87,036,000	688,491	167,904,491	1.12x
2030	188,556,443	85,055,000	82,938,875	709,146	168,703,021	1.12x
2031	189,331,109	81,630,000	78,805,500	730,420	161,165,920	1.17x
2032	190,121,711	84,455,000	74,653,375	752,333	159,860,708	1.19x
2033	190,927,361	87,465,000	70,355,375	774,903	158,595,278	1.20x
2034	191,619,501	90,655,000	65,902,375	798,150	157,355,525	1.22x
2035	192,287,861	94,040,000	61,285,000	822,094	156,147,094	1.23x
2036	192,955,567	97,625,000	56,493,375	846,757	154,965,132	1.25x
2037	193,589,539	101,425,000	51,517,125	872,160	153,814,285	1.26x
2038	194,205,536	105,450,000	46,345,250	898,325	152,693,575	1.27x
2039	194,804,924	109,715,000	40,966,125	925,274	151,606,399	1.28x
2040	195,314,427	114,220,000	35,367,750	953,033	150,540,783	1.30x
2041	195,794,738	118,995,000	29,537,375	981,624	149,513,999	1.31x
2042	196,330,190	124,045,000	23,461,375	1,011,072	148,517,447	1.32x
2043	196,809,350	129,680,000	17,118,250	1,041,404	147,839,654	1.33x
2044	197,250,793	136,500,000	10,463,750	1,072,647	148,036,397	1.33x
2045	197,669,150	141,025,000	3,525,625	1,104,826	145,655,451	1.36x
Total	$5,811,930,153	$2,673,395,000	$2,187,845,279	$22,759,903	$4,884,000,182	

* Preliminary, subject to change. Columns may not add up to totals due to rounding.

[1] This table sets forth aggregate projected available funds and debt service coverage for the Series 2005A Bonds, the Series 2013A Bonds and the Series 2015A Bonds for each of the years until the final maturity date of such Bonds. Assumes that the Bonds are paid at maturity or mandatory sinking fund date and that the Issuer does not exercise its right to redeem, purchase or defease the Bonds prior thereto.

[2] Includes Pledged TSRs plus earnings on the Liquidity Reserve Account (which are assumed at the rate described in "TABLES OF PROJECTED PLEDGED TSRs, PROJECTION METHODOLOGY AND BOND STRUCTURING ASSUMPTIONS—Interest Earnings") deposited in the Debt Service Account. Projections are based on the forecast contained within the Tobacco Consumption Report. See "RISK FACTORS—Risks Relating to the Tobacco Consumption Report."

The estimated debt service coverage ratios shown in the preceding table assume that Collections are received in accordance with the Collection Methodology and Assumptions and applied, subject to the payment priorities set forth in the Indenture, only to pay operating expenses and Debt Service as due. If actual Collections (other than State Appropriations, if any) are received in the amounts assumed under the forecast contained within the Tobacco Consumption Report and the Collection Methodology and Assumptions, Surplus Collections would be applied to the Surplus Account, as required pursuant to the Indenture. No assurance can be given that Collections will be received in accordance with the Collection Methodology and Assumptions and the Tobacco Consumption Report. See "RISK FACTORS—Risks Relating to the Tobacco Consumption Report."

Allocation of Principal or Accreted Value Payments

Due to a number of factors, including the actual consumption of cigarettes in the United States, the amount of Pledged TSRs will fluctuate from year to year. Unless an Event of Default has occurred, Collections available to make principal or Accreted Value payments on the Bonds on any Distribution Date will be allocated to Serial Maturities, Mandatory Sinking Fund Payments and Term Bond Maturities due. If an Event of Default has occurred, available moneys will be applied among all Outstanding Bonds and Swap Payments on a Pro Rata basis.

RISK FACTORS

The Series 2015A Bonds differ from many other state and local governmental securities in a number of respects, and more specifically differ from tobacco settlement revenue bonds that are payable solely from payments under the MSA. The Series 2015A Bonds have two sources of security: the first is the Pledged TSRs; and the second is the State Appropriations in the event of a deficiency in the cash and investments on deposit in the Pledged Accounts, the Operating Account and the Operating Contingency Account to pay Debt Service on the Bonds and Operating Expenses, respectively. Each source of security has different risk factors. The list of risks set forth herein is not a complete list of the risks associated with the Pledged TSRs or the State Appropriations, nor does the order of presentation necessarily reflect the relative importance of the various and separate risks.

The discussion herein of the risks facing the domestic tobacco industry and potentially impacting the Pledged TSRs has been compiled from certain publicly available documents of the tobacco companies and their current or former parent companies, certain publicly available analyses of the domestic tobacco industry and other public sources. Certain of those companies file annual, quarterly and certain other reports with the Securities and Exchange Commission (the "**SEC**"). Such reports are available on the SEC's website (www.sec.gov) and upon request from the SEC's Investor Information Service, 100 F Street, NE, Washington, D.C. 20549 (phone: (800) SEC-0330 or (202) 551-5450; fax: (202) 343-1028; e-mail: publicinfo@sec.gov).

Potential purchasers of the Series 2015A Bonds are advised to consider carefully the following factors, among others, and to review the other information in this Official Statement in evaluating an investment in the Series 2015A Bonds. Any one or more of the risks discussed, and other risks, could lead to a decrease in the market value and/or the liquidity of the Series 2015A Bonds. There can be no assurance that other risk factors will not become material in the future. Further information regarding these risk factors can be found under "SUMMARY OF THE MSA" herein and "APPENDIX G—CERTAIN INFORMATION RELATING TO THE DOMESTIC TOBACCO INDUSTRY" attached hereto. See also "APPENDIX C—TOBACCO CONSUMPTION REPORT" attached hereto.

Potential Payment Decreases Under the Terms of the MSA

Adjustments to MSA Payments

The MSA provides that the amounts payable by the PMs are subject to numerous adjustments, offsets and recalculations, some of which are material, including without limitation, the NPM Adjustment discussed below. See "*—Disputed MSA Payments and the Potential for Future Year Offsets to MSA Payments*" and "*—NPM Adjustment*" below for a description of disputes concerning MSA payments and the calculation thereof, including a settlement that the State and certain other Settling States entered into regarding the NPM Adjustment. Adjustments, offsets and recalculations could significantly reduce the Pledged TSRs available to the Issuer to pay debt service on the Series 2015A Bonds.

An amendment to the MSA (as described further herein, the "**PSS Credit Amendment**") has been proposed that would allow SPMs to elect to receive a reduction in their MSA payments in an amount equal to a percentage of the fees paid to Previously Settled States pursuant to state legislation in the Previously Settled States requiring tobacco product manufacturers that did not sign onto the Previously Settled State Settlements to pay a fee to such Previously Settled States. By its terms, the PSS Credit Amendment will only take effect if and when all Settling States having aggregate Allocable Shares equal to at least 99.937049% (the equivalent of the aggregate Allocable Share of the 46 states that are Settling States), and all OPMs and Commonwealth Brands, Inc., have executed the PSS Credit Amendment. No assurance can be given as to if or when such an amendment will take effect. The State has not yet executed documentation approving the PSS Credit Amendment, but staff of the State Attorney General's office have recommended to the Attorney General of the State that she approve the PSS Credit Amendment. Further, no assurance can be given as to whether such amendment will reduce the amount of Pledged TSRs available to the Issuer to pay debt service on the Series 2015A Bonds. See "RISK FACTORS—Other Risks Relating to the MSA and Related Statutes—*Amendments, Waivers and Termination*" and "*—Reliance on State Enforcement of the MSA and State Impairment*" and "SUMMARY OF THE MSA—Adjustments to Payments—*Previously Settled States Reduction—PSS Credit Amendment*." See also "SECURITY FOR THE BONDS—Consent to Amendments to Indenture and Purchase and Sale Agreement," "THE PURCHASE AND SALE AGREEMENT—Non-Impairment Covenant of the State" and "THE INDENTURE—Non-Impairment Covenant of the State" herein.

For additional information regarding the MSA and the payment adjustments, see "SUMMARY OF THE MSA—Adjustments to Payments."

Disputed MSA Payments and the Potential for Future Year Offsets to MSA Payments

The Settling States and one or more of the PMs are disputing or have disputed the calculations of some Annual Payments and Strategic Contribution Fund Payments, totaling over $9.4 billion, for the sales years 2003 through 2013 (payment years 2004 through 2014) according to NAAG; including moneys withheld outright, moneys deposited to the Disputed Payments Account under the MSA (the "**Disputed Payments Account**") or, as in the case of the largest OPM (Philip Morris) for payment years prior to 2011, moneys actually paid by the PM to the states, but with the PM asserting a reservation of right to dispute such amount paid pursuant to the MSA. This total includes amounts with respect to which the OPMs have stated that they have filed dispute notices and significant additional amounts that the OPMs have indicated may lead to claimed reductions in their MSA payments due in future years.

Disputes concerning payments of Annual Payments and Strategic Contribution Fund Payments and their calculations may be raised up to four years after the respective Payment Due Date (as defined in the MSA). The resolution of disputed payments that arise in prior years may result in the application of offsets against subsequent Annual Payments and Strategic Contribution Fund Payments, and such offsets may materially adversely affect the amount and timing of the payment of Pledged TSRs. The future diversion of disputed payments to the Disputed Payments Account, the withholding of all or a portion of any disputed amounts, or the application of offsets against future MSA payments in the form of a PM credit could lead to material reductions in the amount of the Pledged TSRs available to pay principal and interest on the Series 2015A Bonds and material changes to the timing of payment of such Pledged TSRs. See "*—NPM Adjustment*" below.

Under the MSA, amounts held in the Disputed Payments Account with respect to a sales year could be released to the PMs if any Settling State is found to have not diligently enforced its Qualifying Statute during such sales year, or could be released to those Settling States which are found to have diligently enforced their respective Qualifying Statutes during such sales year. Amounts held in the Disputed Payments Account could also be released pursuant to a settlement of the disputes among the Settling States and the PMs, as was the case in April 2013 and April 2014 in connection with the settlement (which the State joined) regarding the NPM Adjustment, as discussed below. See "*—NPM Adjustment*" below.

The cash flow assumptions used to prepare the coverage tables herein do not factor in an offset for miscalculated or disputed payments or any release of funds currently held in the Disputed Payments Account other than pursuant to the NPM Adjustment Stipulated Partial Settlement and Award (as defined below). See "TABLES OF PROJECTED PLEDGED TSRs, PROJECTION METHODOLOGY AND BOND STRUCTURING ASSUMPTIONS."

For additional information regarding the MSA and the payment adjustments, see "SUMMARY OF THE MSA—Adjustments to Payments" and "—Potential Payment Decreases Under the Terms of the MSA." See also "APPENDIX E—NPM ADJUSTMENT STIPULATED PARTIAL SETTLEMENT AND AWARD AND SETTLEMENT TERM SHEET."

NPM Adjustment

One of the adjustments under the MSA is the "**NPM Adjustment**", which operates in certain circumstances to reduce the payments of the PMs under the MSA in the event of losses in Market Share by PMs (who are subject to the payment obligations and marketing restrictions of the MSA) to non-participating manufacturers ("**NPMs**") (who are not subject to such obligations and restrictions), during a calendar year as a result of such PMs' participation in the MSA. Under the MSA, three conditions must be met in order to trigger an NPM Adjustment for one or more Settling States: (1) a Market Share loss for the applicable year must exist (as described herein); (2) a nationally recognized firm of economic consultants must determine that the disadvantages experienced as a result of the provisions of the MSA were a "significant factor" contributing to the Market Share loss for the year in question; and (3) the Settling States in question must be found to not have diligently enforced their Qualifying Statutes. If the PMs make a claim for an NPM Adjustment for any particular year and a Settling State is determined to be one of a few states (or the only state) not to have diligently enforced its Qualifying Statute in such year, the amount of the NPM Adjustment applied to such Settling State in the year following such determination could be as great as the amount of Annual Payments and Strategic Contribution Fund Payments that could otherwise have been received by such Settling State in such year.

The PMs have disputed MSA payments in sales years 2003 through 2013 (payment years 2004 through 2014) on the basis that certain Settling States, including the State, did not diligently enforce their respective Qualifying Statutes in each of those years. In July 2010, a three-judge panel was selected to arbitrate the 2003 NPM Adjustment claims (the "**Arbitration Panel**"). Following the completion of discovery, the PMs determined to continue to contest the 2003 diligent enforcement claims of 33 states (including the State), the District of Columbia and Puerto Rico and to no longer contest such claims by 12 other states and four U.S. territories (the "**non-contested states**"). Subsequently, as discussed below, the State and several other jurisdictions entered into a settlement with the OPMs and certain SPMs regarding such claims related to the 2003 through 2012 NPM Adjustments and the determination of subsequent NPM Adjustments. Other contested jurisdictions, as discussed below, continued in arbitration proceedings with the PMs regarding the 2003 NPM Adjustment.

NPM Adjustment Stipulated Partial Settlement and Award. On December 17, 2012, terms of a settlement agreement (the "**NPM Adjustment Settlement Term Sheet**") were agreed to by 19 jurisdictions (including the State), the OPMs and certain SPMs regarding claims related to the 2003 through 2012 NPM Adjustments and the determination of subsequent NPM Adjustments. Five additional jurisdictions (Oklahoma, Connecticut, South Carolina, Indiana and Kentucky) have joined the NPM Adjustment Settlement Term Sheet as of the date hereof. On March 12, 2013, the Arbitration Panel issued a Stipulated Partial Settlement and Award (the "**NPM Adjustment Stipulated Partial Settlement and Award**"), in which it ruled that the NPM Adjustment Settlement Term Sheet was binding on the signatory jurisdictions (the "**Term Sheet Signatories**") and directed PricewaterhouseCoopers LLP, the independent auditor under the MSA (the "**MSA Auditor**"), to implement the terms of the NPM Adjustment Settlement Term Sheet. The Arbitration Panel concluded in the NPM Adjustment Stipulated Partial Settlement and Award that neither the NPM Adjustment Stipulated Partial Settlement and Award nor the NPM Adjustment Settlement Term Sheet constitutes an amendment to the MSA that would require the consent of any non-signatory jurisdiction. No assurance can be given, however, that a court would not hold that the NPM Adjustment Stipulated Partial Settlement and Award and the NPM Adjustment Settlement Term Sheet constitute amendments to the MSA. See "—Other Risks Relating to the MSA and Related Statutes—*Amendments, Waivers and Termination*" and "*—Reliance on State Enforcement of the MSA and State Impairment*."

Under the NPM Adjustment Settlement Term Sheet, OPMs have received certain reductions in April 2013 and April 2014 and will receive reductions to subsequent MSA payments in the form of credits and transition year reductions, as described herein, to reflect a percentage of the Term Sheet Signatories' aggregate share of the OPMs' 2003 through 2012 NPM Adjustment claims, and each of the Term Sheet Signatories has received its allocable share of over $4.7 billion from the Disputed Payments Account under the MSA in connection with the April 2013 MSA Payment. The NPM Adjustment Settlement Term Sheet also details the determination of NPM Adjustments for 2013 onward for the Term Sheet Signatories, and provides that, except in certain cases (primarily, if the dispute was noticed for arbitration by the PM over one year prior to the payment date and the arbitration has not begun despite good faith efforts by the PM), the PMs will not withhold payments or pay into the Disputed Payments Account based on a dispute arising out of the revised NPM Adjustment as set forth in the NPM Adjustment Settlement Term Sheet. The NPM Adjustment Settlement Term Sheet provides further that the Term Sheet Signatories and the signatory PMs will split the amounts at issue under the provisions relating to NPM sales for which state cigarette excise tax was not paid, for 2015 and each subsequent year, on a 50-50 basis, subject to repayment without interest by the PMs or credit without interest by the Term Sheet Signatories after the arbitration for that year concludes, as described herein. For a discussion of the terms of the NPM Adjustment Settlement Term Sheet, the NPM Adjustment Stipulated Partial Settlement and Award and subsequent developments, see "SUMMARY OF THE MSA—Potential Payment Decreases Under the Terms of the MSA—*NPM Adjustment—NPM Adjustment Settlement and Award*," including the penultimate paragraph thereof. See "APPENDIX E—NPM ADJUSTMENT STIPULATED PARTIAL SETTLEMENT AND AWARD AND SETTLEMENT TERM SHEET" for copies of the NPM Adjustment Stipulated Partial Settlement and Award and the NPM Adjustment Settlement Term Sheet (including the August 2010 memorandum of understanding referenced therein).

Non-signatory jurisdictions (the "**Term Sheet Non-Signatories**") have objected to the NPM Adjustment Settlement Term Sheet. In total, fourteen Term Sheet Non-Signatories filed motions to vacate and/or modify the NPM Adjustment Stipulated Partial Settlement and Award. According to Lorillard, Inc.'s Form 10-K filed with the SEC for the calendar year 2014, as of February 6, 2015 eight of these motions were still pending, as discussed herein, after three states withdrew their opposition, one state did not appeal a denial of its challenge, and two states joined the NPM Adjustment Settlement Term Sheet. No assurance can be given that other challenges to the NPM Adjustment Stipulated Partial Settlement and Award will not be commenced in other MSA courts. If any such challenge is successful, there could be an adverse effect on the amount and/or timing of Pledged TSRs available to the Issuer to pay debt service on the Series 2015A Bonds.

No assurance can be given as to the implementation in future years of the NPM Adjustment Stipulated Partial Settlement and Award by the MSA Auditor with regard to the State, as to whether or not the NPM Adjustment Stipulated Partial Settlement and Award will be revised and any consequences thereto, or as to any final settlement or resolution of disputes concerning the NPM Adjustment Stipulated Partial Settlement and Award (including the magnitude of the effect of any resolution of disputes). Any such development could have an adverse effect on the amount and/or timing of Pledged TSRs available to the Issuer to pay debt service on the Series 2015A Bonds.

Results of 2003 NPM Adjustment Arbitration; Subsequent NPM Adjustment Arbitrations. Fifteen contested states continued in arbitration proceedings with the PMs regarding the 2003 NPM Adjustment, and the Arbitration Panel released its decision with respect to those states on September 11, 2013. The Arbitration Panel unanimously determined that 9 states diligently enforced their respective Qualifying Statute during sales year 2003 and therefore were not subject to the NPM Adjustment for 2003 pursuant to the MSA, and that 6 states did not diligently enforce their respective Qualifying Statutes and were therefore subject to the NPM Adjustment for 2003 pursuant to the MSA. According to Lorillard, Inc. in its Form 10-K filed with the SEC for the calendar year 2014, the OPMs are entitled to receive $458 million plus interest and earnings as a result of the Arbitration Panel's ruling.

All six of the states that were determined by the Arbitration Panel's final awards not to have diligently enforced their Qualifying Statutes in 2003 (Indiana, Kentucky, Maryland, Missouri, New Mexico and Pennsylvania) filed motions to vacate such final awards with respect to those states. In April 2014, the MSA court in Pennsylvania upheld the Arbitration Panel's non-diligence finding for Pennsylvania, but also ruled that the states that signed the NPM Adjustment Settlement Term Sheet and had been contested in the 2003 NPM Adjustment arbitration (such as the State) would be deemed non-diligent for purposes of calculating Pennsylvania's share of the 2003 NPM Adjustment, resulting in a partial reduction of Pennsylvania's share of the 2003 NPM Adjustment allocation. In May 2014, the Missouri MSA court issued a decision similar to the Pennsylvania court. Decisions such as those of the MSA courts in Pennsylvania and Missouri could have an adverse effect on Term Sheet Signatories such as the State and on the amount and/or timing of Pledged TSRs available to the Issuer to pay debt service on the Series 2015A Bonds. In July 2014, a Maryland state trial court denied both Maryland's motion to vacate the Arbitration Panel's ruling that Maryland had not diligently enforced and Maryland's motion to vacate or modify the final award. According to Altria's Form 10-K filed with the SEC for the calendar year 2014, Philip Morris is appealing the Pennsylvania and Missouri decisions modifying the final award; Maryland is appealing its court's decision declining to modify the final award; each of Maryland and Missouri is appealing its court's ruling denying its motion to vacate the Arbitration Panel's diligence ruling as to that state; and the motions filed by New Mexico remain pending in its state trial court. The other two of the six states found to be non-diligent, Indiana and Kentucky, became Term Sheet Signatories in June 2014 on modified terms and have indefinitely stayed their motions. See "SUMMARY OF THE MSA—Potential Payment Decreases Under the Terms of the MSA—*NPM Adjustment—2003 NPM Adjustment Arbitration Results*."

Proceedings to determine state diligent enforcement claims for sales years 2004 through 2013 have not yet been scheduled. Reynolds American has reported in its Form 10-K filed with the SEC for the calendar year 2014 that preliminary discussions are underway with the Term Sheet Non-Signatories to initiate arbitration proceedings with respect to the 2004 NPM Adjustment. The Term Sheet Non-Signatories' arbitration proceedings could have an adverse effect on Term Sheet Signatories such as the State and on the amount and/or timing of Pledged TSRs available to the Issuer to pay debt service on the Series 2015A Bonds.

If Litigation Challenging the MSA, the Qualifying Statutes and Related Legislation Were Successful, Payments under the MSA Might be Suspended or Terminated

Certain parties, including smokers, smokers' rights organizations, consumer groups, cigarette importers, cigarette distributors, cigarette manufacturers, Native American tribes, taxpayers, taxpayers' groups and other parties have filed actions against some, and in certain cases all, of the signatories to the MSA, alleging, among other things, that the MSA and related legislation including the Settling States' Qualifying Statutes, Allocable Share Release Amendments and Complementary Legislation (as each such term is defined herein), as well as other legislation such as "contraband statutes", are void or unenforceable under certain provisions of law, such as the U.S. Constitution, state constitutions, federal antitrust laws, state consumer protection laws, bankruptcy laws, federal cigarette advertising and labeling law, unfair competition laws and the North American Free Trade Agreement ("**NAFTA**"). Certain of the lawsuits further sought, among other relief, an injunction against one or more of the Settling States from collecting any moneys under the MSA and barring the PMs from collecting cigarette price increases related to the MSA. In addition, class action lawsuits have been filed in several federal and state courts alleging that under the federal Medicaid law, any amount of tobacco settlement funds that the Settling States receive in excess of what they paid through the Medicaid program to treat tobacco related diseases should be paid directly to Medicaid recipients.

All of the judgments rendered to date on the merits have rejected challenges to the MSA, Qualifying Statutes and Complementary Legislation presented in the cases. For example, in *VIBO Corporation, Inc. d/b/a/ General Tobacco v. Conway*, *et al.*, 669 F.3d 675 (6th Cir. 2012) ("***VIBO***"), a three-judge panel of the U.S. Court of Appeals for the Sixth Circuit (the "**Sixth Circuit**") ruled on February 22, 2012 that the MSA does not amount to an unlawful conspiracy or anti-competitive behavior by the government and, accordingly, affirmed the district court's order dismissing plaintiffs' federal antitrust, federal constitutional and common law challenges to the enforceability of the MSA. The time period for the plaintiffs to file a petition for certiorari to the U.S. Supreme Court expired. In *Grand River Enters. Six Nations, Ltd. v. King*, 2012 WL 263100 (S.D.N.Y. 2012) ("***Grand River***"), the U.S. District Court for the Southern District of New York (the "**Southern District**") on January 30, 2012 denied the plaintiffs' motion to amend the Southern District's March 22, 2011 dismissal by summary judgment of plaintiffs' claims that the MSA and related legislation violated Section 1 of the Sherman Antitrust Act of 1890 (the "**Sherman Act**") and the Commerce Clause of the Constitution of the United States. Plaintiffs had appealed to the U.S. Court of Appeals for the Second Circuit (the "**Second Circuit**") both the Southern District's March 22, 2011 dismissal and January 30, 2012 denial, but on June 1, 2012 withdrew both appeals, which withdrawals were approved by order of the Second Circuit on August 10, 2012, rendering the case final before the Second Circuit. In *Freedom Holdings v. Cuomo,* 624 F.3d 38 (2d Cir. 2010) ("***Freedom Holdings***"), the Second Circuit affirmed the judgment of the Southern District that New York State's Qualifying Statute did not violate federal antitrust laws or the Commerce Clause of the U.S. Constitution. The U.S. Supreme Court denied plaintiff's petition for certiorari. These cases are discussed more fully herein. See "SUMMARY OF THE MSA—Litigation Challenging the MSA, the Qualifying Statutes and Related Legislation."

Ninth Circuit Cases. In the Ninth Circuit, in which the State is located, the U.S. Court of Appeals for the Ninth Circuit (the "**Ninth Circuit**"), in *Sanders v. Brown*, 504 F. 3d 903 (9th Cir. 2007), affirmed the United States District Court for the Northern District of California's dismissal of an antitrust challenge to the MSA and California's Qualifying Statute and Complementary Legislation brought by a class of California consumers against the State of California and the OPMs, and held that the class failed to show that the State's Qualifying Statute and Complementary Legislation are *per se* illegal under the Sherman Act. The United States Supreme Court denied plaintiff's petition for certiorari in 2008. In *PTI, Inc. v. Philip Morris Inc.*, 100 F.Supp.2d 1179 (C.D. Cal. 2000) certain cigarette importers and cigarette distributors sought to enjoin the passage or enforcement of the State's Qualifying Statute, alleging that the passage, implementation and/or enforcement of the Qualifying Statute would violate federal antitrust laws and certain provisions of the federal constitution, and the court dismissed with prejudice all federal antitrust and constitutional claims on the merits. See "SUMMARY OF THE MSA—Litigation Challenging the MSA, the Qualifying Statutes and Related Legislation."

The MSA, the Qualifying Statute and related state legislation may continue to be challenged in the future. A determination by a court having jurisdiction over the State that the MSA, the NPM Adjustment Settlement Term Sheet, the Qualifying Statute or related State legislation (including the 2013 amendment to the State's Qualifying Statute made in furtherance of the NPM Adjustment Settlement Term Sheet, as discussed herein) is void or unenforceable could have a materially adverse effect on the payments by the PMs under the MSA and the amount and/or the timing of Pledged TSRs available to the Issuer to pay debt service on the Series 2015A Bonds. See "SUMMARY OF THE MSA." For a description of the opinions to be delivered by Transaction Counsel and of the Attorney General of the State with respect to the MSA and the State's Qualifying Statute, see "LEGAL CONSIDERATIONS" herein. See also "SUMMARY OF THE MSA—Potential Payment Decreases Under the Terms of the MSA—*NPM Adjustment—NPM Adjustment Settlement and Award*," including the penultimate paragraph thereof.

Litigation Seeking Monetary Relief from Tobacco Industry Participants May Adversely Impact the Ability of the PMs to Continue to Make Payments Under the MSA

The tobacco industry has been the target of litigation for many years. Both individual and class action lawsuits have been brought by or on behalf of smokers alleging various theories of recovery including that smoking has been injurious to their health, by non-smokers alleging harm from environmental tobacco smoke ("**ETS**"), also known as "secondhand smoke", and by federal, state and local governments seeking recovery of expenditures relating to the adverse effects on the public health caused by smoking. The MSA was the result of such litigation. If additional litigation against the PMs is successful on a significant level, the ability of the PMs to continue to operate their businesses and make payments under the MSA may be adversely affected. See "APPENDIX G—CERTAIN INFORMATION RELATING TO THE DOMESTIC TOBACCO INDUSTRY—Civil Litigation" and "SUMMARY OF THE MSA" for more information regarding the litigation described below.

The tobacco companies are defendants in over 7,200 tobacco-related lawsuits (according to Lorillard), which are extremely costly to defend, could result in substantial judgments, liabilities and bonding difficulties, and may negatively impact their ability to continue to operate.

Numerous legal actions, proceedings and claims arising out of the sale, distribution, manufacture, development, advertising, marketing and claimed health effects of cigarettes are pending against the PMs, and it is likely that similar claims will continue to be filed for the foreseeable future. The claimants have sought recovery on a variety of legal theories, including, among others, negligence, fraud, misrepresentation, strict liability in tort, design defect, breach of warranty, enterprise liability (including claims asserted under the Racketeer Influenced and Corrupt Organizations Act ("**RICO**")), civil conspiracy, intentional infliction of harm, injunctive relief, indemnity, restitution, unjust enrichment, public nuisance, unfair trade practices, claims based on antitrust laws and state consumer protection acts, and claims based on failure to warn of the harmful or addictive nature of tobacco products. Various forms of relief are sought, including compensatory and, where available, punitive damages in amounts ranging in some cases into the hundreds of millions or even billions of dollars. Claimants in some of the cases have sought treble damages, statutory damages, disgorgement of rights, equitable and injunctive relief and medical monitoring, among other damages.

It is possible that the outcome of these and similar cases, individually or in the aggregate, could result in bankruptcy or cessation of operations by one or more of the PMs. It is also possible that the PMs may be unable to post a surety bond in an amount sufficient to stay execution of a judgment in jurisdictions that require such bond pending an appeal on the merits of the case. Even if the PMs are successful in defending some or all of these actions, these types of cases are very expensive to defend. A material increase in the number of pending claims could significantly increase defense costs and have an adverse effect on the results of operations and financial condition of the PMs. Adverse decisions in litigation against the tobacco companies could have an adverse impact on the industry overall.

Any of the foregoing results could potentially lower the volume of cigarette sales and, thus, the amounts of payments under the MSA. See "APPENDIX G—CERTAIN INFORMATION RELATING TO THE DOMESTIC TOBACCO INDUSTRY—Civil Litigation".

The Florida Supreme Court's ruling in Engle has resulted in additional litigation against cigarette manufacturers.

The case of *Engle v. R.J. Reynolds Tobacco Co., et al.* (Circuit Court, Dade County, Florida, filed May 5, 1994) was certified in 1996 as a class action on behalf of Florida residents, and survivors of Florida residents, who were injured or died from medical conditions allegedly caused by addiction to smoking, and a multi-phase trial resulted in verdicts in favor of the class. During a three-phase trial, a Florida jury awarded compensatory damages to three individuals and approximately $145 billion in punitive damages to the certified class. In 2006, the Florida Supreme Court issued a ruling that, among other things, vacated the punitive damages award and determined that the case could not proceed further as a class action.

However, the Florida Supreme Court ruling in *Engle* permitted members of the *Engle* class to file individual claims, including claims for punitive damages. The PMs currently are defendants in approximately 3,900 cases (involving approximately 5,000 plaintiffs) pending in various state and federal courts in Florida that were filed by members of the *Engle* class (the "***Engle*** **Progeny Cases**"). The Florida Supreme Court held that these individual plaintiffs are entitled to rely on a number of the jury's findings in favor of the plaintiffs in the first phase of the *Engle* trial. According to Lorillard, various intermediate state and federal Florida appellate courts have issued rulings that address the scope of the preclusive effect of the findings from the first phase of the *Engle* trial, including whether those findings relieve plaintiffs from the burden of proving certain legal elements of their claims. Following review of one of those cases, the Florida Supreme Court ruled on March 14, 2013 that a tobacco manufacturer's due process rights are not violated by relying upon the findings of the first phase of the *Engle* trial. In August 2013 Philip Morris, Reynolds Tobacco and Liggett Group filed a petition for writ of certiorari with the U.S. Supreme Court with respect to that ruling, which the U.S. Supreme Court denied on October 7, 2013. In two other cases, the United States Court of Appeals for the Eleventh Circuit ruled that a tobacco manufacturer's due process rights are not violated by relying upon the findings of the first phase of the *Engle* trial. On March 28, 2014 the defendant filed a petition with the U.S. Supreme Court seeking to answer the question of whether the phase I *Engle* findings can be applied to establish certain elements of plaintiffs' claims. On June 9, 2014, the U.S. Supreme Court denied this petition for writ of certiorari for those two cases, and on the same date also declined to accept review of nine other cases. It is not possible to predict the final outcomes of any of the *Engle* Progeny Cases, but such outcomes may adversely affect the operations of the defendants and thus payments under the MSA. On February 25, 2015 the three OPMs reached a tentative agreement for the settlement of certain federal *Engle* Progeny Cases pending against them, as discussed further herein. In October 2013 Vector Group Ltd. and Liggett Group, LLC reached an agreement (which is now final) resolving substantially all of the individual *Engle* Progeny Cases pending against them, as discussed further herein. See "APPENDIX G—CERTAIN INFORMATION RELATING TO THE DOMESTIC TOBACCO INDUSTRY—Civil Litigation—*Engle Progeny Cases*" for a discussion of the *Engle* Progeny Cases.

A December 2008 decision by the United States Supreme Court could limit the ability of cigarette manufacturers to contend that certain claims asserted against them in product liability litigation are barred. The Supreme Court's decision also could encourage litigation involving cigarettes labeled as "lights" or "low tar."

In December 2008, the United States Supreme Court in a purported "lights" class action case, *Good v. Altria Group, Inc.*, issued a decision that neither the Federal Cigarette Labeling and Advertising Act nor the Federal Trade Commission's ("**FTC**") regulation of cigarettes' tar and nicotine disclosures preempts (or bars) some of plaintiffs' claims. The decision also more broadly addresses the scope of preemption based on the Federal Cigarette Labeling and Advertising Act, and could significantly limit cigarette manufacturers' arguments that certain of plaintiffs' other claims in smoking and health litigation, including claims based on the alleged concealment of information with respect to the hazards of smoking, are preempted. In addition, the Supreme Court's ruling could encourage litigation against cigarette manufacturers regarding the sale of cigarettes labeled as "lights" or "low tar", and it may limit cigarette manufacturers' ability to defend such claims with regard to the use of these descriptors prior to the Food and Drug Administration's ("**FDA**") ban thereof in June 2010. According to Lorillard, Inc.'s Form 10-K filed with the SEC for the calendar year 2014, there are approximately 16 such "lights" class actions pending in various courts. Notably, on April 29, 2014, the Illinois Appellate Court, Fifth Judicial District, in an appeal of the "lights" class action case *Price, et al. v. Philip Morris Inc.*, based on the *Good* decision, reinstated a $10.1 billion 2003 verdict against Philip Morris, who appealed this decision to the Illinois Supreme Court on May 13, 2014. On September 24, 2014 the Illinois Supreme Court agreed to hear the appeal, and the verdict has been stayed pending appeal. See "APPENDIX G—CERTAIN INFORMATION RELATING TO THE DOMESTIC TOBACCO INDUSTRY—Regulatory Issues" and "—Civil Litigation—*Class Action Cases*" herein.

The amount or range of losses that could result from unfavorable outcomes of pending litigation are unable to be meaningfully estimated.

The ultimate outcome of these and any other pending or future lawsuits is uncertain. The PMs have stated that the possibility of material losses related to tobacco litigation is more than remote, that litigation is subject to many uncertainties, and that generally it is not possible to predict the outcome of the litigation pending against PMs or to reasonably estimate the amount or range of any possible loss. Moreover, it is possible that a PM's consolidated results of operations, cash flows or financial position could be materially adversely affected by the ultimate outcome of certain pending or future litigation matters or difficulties in obtaining the bonds required to stay execution of judgments on appeal, potentially leading to cessation of operations or insolvency or bankruptcy of one or more PMs.

Verdicts of substantial magnitude that are enforceable as to one or more PMs, if they occur, could encourage commencement of additional litigation, or could negatively affect perceptions of potential triers of fact with respect to the tobacco industry, possibly to the detriment of pending litigation. An unfavorable outcome or settlement or one or more adverse judgments could result in bankruptcy, insolvency or a decision by the affected PMs to substantially increase cigarette prices, which could reduce cigarette consumption. In addition, the financial condition of any or all of the PM defendants could be adversely affected by the ultimate outcome of pending litigation, including bonding and litigation costs or a verdict or verdicts awarding substantial compensatory or punitive damages. Depending upon the magnitude of any such negative financial impact (and irrespective of whether the PM is thereby rendered insolvent), an adverse outcome in one or more of the lawsuits could substantially impair the affected PM's ability to make payments under the MSA and could have an adverse effect on the amount and/or timing of Pledged TSRs available to the Issuer to pay debt service on the Series 2015A Bonds. See "APPENDIX G—CERTAIN INFORMATION RELATING TO THE DOMESTIC TOBACCO INDUSTRY—Civil Litigation" and "LEGAL CONSIDERATIONS."

The PMs have substantial payment obligations under litigation settlement agreements which, together with their other litigation liabilities, may adversely affect the ability of the PMs to continue operations in the future.

In 1998, the OPMs entered into the MSA with 46 states and various other governments and jurisdictions to settle asserted and unasserted health care cost recovery and other claims. Certain U.S. tobacco product manufacturers had previously settled similar claims brought by Florida, Minnesota, Mississippi and Texas (the "**Previously Settled State Settlements**" and, together with the MSA, are referred to as the "**State Settlement Agreements**").

Under the State Settlement Agreements, the PMs are obligated to pay billions of dollars each year. Annual payments under the State Settlement Agreements are required to be paid in perpetuity and are based, among other things, on domestic market share and unit volume of domestic shipments; with respect to the MSA, payments are based on data from the year preceding the year in which payment is due, and, with respect to the Previously Settled State Settlements, payments are based on data from the year in which payment is due. A material reduction in the volume of cigarette sales by the PMs could adversely affect the financial condition of the PMs and the ability of PMs to make payments under the MSA. See "SUMMARY OF THE MSA".

Failures by PMs to make payments coupled with an inability on the part of the Settling States to enforce and collect defaulted payments under the MSA could adversely affect the Pledged TSRs actually received by the Issuer.

If a PM were to discontinue making payments under the MSA for any reason, the Pledged TSRs would be adversely affected. Any attempts to enforce payments under the MSA from a PM in breach could be costly and time consuming as well as be likely to include litigation. For example, VIBO Corporation, Inc., d/b/a General Tobacco ("**General Tobacco**") ceased production of cigarettes in 2010 and has defaulted upon certain of its MSA payments. General Tobacco has stated that it will be unable to make any back payments it owes under the MSA. Two Settling States brought suit on behalf of all of the Settling States seeking full payment by General Tobacco of its MSA obligations. The ability of the Settling States to enforce and collect such payments in instances such as this is limited by the ability of the defaulting PM to meet its obligations and may be costly. Failure by other PMs to make payments coupled with an inability on the part of the Settling States to enforce and collect defaulted payments under the MSA could adversely affect the Pledged TSRs actually received by the Issuer.

The verdict returned in the federal government's reimbursement case could adversely affect PMs' cigarette sales and their profits therefrom and thus payments under the MSA.

In August 2006, a final judgment and remedial order was entered in *United States of America v. Philip Morris USA, Inc., et al.* (U.S. District Court, District of Columbia, filed September 22, 1999) (the

"**DOJ Case**") and in June 2010 the U.S. Supreme Court denied all petitions for review of the case. The district court based its final judgment and remedial order on the government's only remaining claims, which were based on the tobacco industry defendants' alleged violations of RICO. Although the verdict did not award monetary damages to the plaintiff U.S. government, the final judgment and remedial order imposed a number of requirements on the defendants. Such requirements include, but are not limited to, corrective statements by defendants related to the health effects of smoking. The remedial order placed certain prohibitions on the manner in which defendants market their cigarette products and enjoined any use of "lights" or similar product descriptors. The final judgment and remedial order has not yet been fully implemented. On July 27, 2012, the U.S. Court of Appeals for the District of Columbia Circuit affirmed the district court's denial in June 2011 of the defendants' motion to vacate. On November 27, 2012, the district court released its order on the required text of the corrective statements that the defendants must put on their websites. In January 2013, defendants appealed to the U.S. Court of Appeals for the District of Columbia Circuit the district court's November 2012 order on the text of the corrective statements, claiming a violation of free speech rights. On June 2, 2014, the U.S. District Court for the District of Columbia approved a joint motion by the U.S. government and the defendant tobacco companies, pursuant to which, for specified time periods following the date when all appeals are exhausted, corrective statements would be disseminated in newspapers (print and online), on television, on the tobacco companies' websites, and on "onserts" affixed to cigarette packs. The court's consent order stays implementation of the corrective statements remedy until the exhaustion of the defendants' appeal challenging the constitutionality of the corrective statements. Oral argument for the appeal regarding the language of the corrective statements was scheduled for February 23, 2015, according to Reynolds American in its Form 10-K filed with the SEC for the calendar year 2014. The District Court has not yet entered an amended final judgment addressing all of the directions from the Court of Appeals. It is possible that the remedial order, including the prohibitions on the use of the descriptors relating to low tar cigarettes and the stark text required in the corrective statements, will negatively affect the PMs' sales of and profits from cigarettes, as well as result in significant compliance costs. See "APPENDIX G—CERTAIN INFORMATION RELATING TO THE DOMESTIC TOBACCO INDUSTRY—Civil Litigation".

Declines in Cigarette Consumption May Materially Adversely Affect Pledged TSRs Available for the Series 2015A Bonds

Cigarette consumption in the U.S. has declined significantly over the last several decades. According to a report issued by the Centers for Disease Control ("**CDC**") in November 2014, the smoking rate for adults in the United States, after hovering at approximately 20% to 21% for more than seven years, fell to approximately 18% in 2013. Results of the National Risk Behavior Survey released by the CDC in June 2014 found that the number of high school students who had smoked a cigarette in the previous month had dropped to 15.7% in 2013 from 18.1% in 2011, 21.9% in 2003 and 36.4% in 1997. According to Reynolds American in its Form 10-K filed with the SEC for the calendar year 2014, total industry domestic cigarette shipment volume declined to 264.6 billion cigarettes as of December 31, 2014 (as compared to shipments of approximately 400 billion in 2003, according to the Tobacco Consumption Report). According to Lorillard Inc.'s Form 10-K filed with the SEC for the calendar year 2014, domestic cigarette shipments have decreased at a compound annual rate of approximately 3.9% from 2004 through 2014. See "APPENDIX G—CERTAIN INFORMATION RELATING TO THE DOMESTIC TOBACCO INDUSTRY—Cigarette Shipment Trends."

Payments under the MSA are determined in part by the volume of cigarettes sold by the PMs in the U.S. cigarette market. Price increases; restrictions on advertising and promotions; increases in excise taxes; smoking bans in public places; the raising of the minimum age to possess or purchase tobacco products; other increased regulation such as state and local bans on characterizing flavors; a decline in the social acceptability of smoking; health concerns; funding of smoking prevention campaigns; increased pressure from anti-tobacco groups; increased usage of alternative products such as e-cigarettes; curtailments in the chain of distribution (on September 3, 2014, the national pharmacy chain CVS reportedly stopped selling all cigarettes and other tobacco products in all its stores); and other factors have reduced U.S. cigarette consumption in recent years. U.S. cigarette consumption is expected to continue to decline for the reasons stated above and others. Continuing declines in cigarette consumption could adversely impact the amount and timing of the Pledged TSRs available to the Issuer to pay debt service on the Series 2015A Bonds. The following factors, among others, may negatively impact cigarette consumption in the U.S.

A deterioration in general economic conditions in the U.S. could lead to a decrease in cigarette consumption and adversely affect payments under the MSA.

The volume of cigarette sales in the U.S. is adversely affected by general economic downturns as smokers tend to reduce expenditures on cigarettes, especially premium brands, in times of economic hardship. To the extent that such conditions are experienced over the life of the Series 2015A Bonds, payments under the MSA could be adversely affected. In addition, consumers may become more price-sensitive, which may result in some consumers switching to lower priced, deep discount NPM brands or counterfeit brands. Reductions in consumption could lead to reductions of payments under the MSA and could have an adverse effect on the amount and/or timing of Pledged TSRs available to the Issuer to pay debt service on the Series 2015A Bonds.

The regulation of tobacco products by the FDA may adversely affect overall consumption of cigarettes in the U.S.

The Family Smoking Prevention and Tobacco Control Act (the "**FSPTCA**"), signed by President Obama on June 22, 2009, granted the FDA broad authority over the manufacture, sale, marketing and packaging of tobacco products. The legislation, among other things:

- establishes a Tobacco Products Scientific Advisory Committee ("**TPSAC**") to, among other things, evaluate the issues surrounding the use of menthol as a flavoring or ingredient in cigarettes within one year of the committee's establishment;

- grants the FDA the regulatory authority to consider and impose broad additional restrictions through a rule-making process, including a ban on the use of menthol in cigarettes upon a finding that such a prohibition would be appropriate for the public health;

- requires larger and more severe health warnings on cigarette packs and cartons;

- bans the use of descriptors on tobacco products, such as "low tar" and "light";

- requires the disclosure of ingredients and additives to consumers;

- requires pre-market approval by the FDA for claims made with respect to reduced risk or reduced exposure products;

- allows the FDA to require the reduction of nicotine or any other compound in cigarettes;

- allows the FDA to mandate the use of reduced risk technologies in conventional cigarettes;

- allows the FDA to place more severe restrictions on the advertising, marketing and sales of cigarettes; and

- permits inconsistent state regulation of the advertising or promotion of cigarettes and eliminates the existing federal preemption of such regulation.

Since the passage of the FSPTCA, the FDA has taken additional actions, including, among others, prohibiting fruit, candy or clove flavored cigarettes (menthol is currently exempted from this ban), prohibiting misleading marketing terms ("Light," "Low," and "Mild") for tobacco products, rejecting applications for the introduction of new tobacco products into the market, and requiring warning labels for smokeless tobacco products.

Tobacco manufacturers have filed suit regarding certain provisions of the FSPTCA and actions taken thereunder. In August 2009, a group of tobacco manufacturers (including Reynolds Tobacco and Lorillard) and a tobacco retailer filed a complaint against the United States of America in the United States District Court for the Western District of Kentucky, *Commonwealth Brands, Inc. v. U.S.*, in which they asserted that various provisions of the FSPTCA violate their free speech rights under the First Amendment, constitute an unlawful taking under the Fifth Amendment, and are an infringement on their Fifth Amendment due process rights. In March 2012, the United States Court of Appeals for the Sixth Circuit affirmed the district court's earlier decision upholding the FSPTCA's restrictions on the marketing of modified-risk tobacco products, the FSPTCA's bans on event sponsorship, branding non-tobacco merchandise, and free sampling, and the requirement that tobacco manufacturers reserve significant packaging space for textual health warnings. The Sixth Circuit further affirmed the district court's grant of summary judgment to plaintiffs on the FSPTCA's restriction of tobacco advertising to black and white text, as well as the district court's decision to uphold the constitutionality of the color graphic and non-graphic warning label requirement. On May 31, 2012, the Sixth Circuit denied the plaintiffs' motion for rehearing en banc, and on October 30, 2012, the plaintiffs filed a petition for writ of certiorari with the U.S. Supreme Court. The U.S. Supreme Court denied such petition on April 22, 2013. See "APPENDIX G—CERTAIN INFORMATION RELATING TO THE DOMESTIC TOBACCO INDUSTRY—Regulatory Issues" for a discussion of this case.

On June 22, 2011, the FDA issued a final regulation for the imposition of larger, graphic health warnings on cigarette packaging and advertising, which was scheduled to take effect September 22, 2012 (but which the FDA is currently enjoined from enforcing, as described below). On August 16, 2011, five tobacco companies (including Reynolds Tobacco and Lorillard) filed a lawsuit against the FDA in the U.S. District Court for the District of Columbia, *R. J. Reynolds Tobacco Co. v. U.S. Food and Drug Administration*, challenging the FDA's final regulation specifying nine new graphic "warnings" pursuant to the FSPTCA and seeking a declaratory judgment that the final regulation violates the plaintiffs' rights under the First Amendment to the U.S. Constitution and the Administrative Procedure Act ("**APA**"). On February 29, 2012, the district court granted the plaintiffs' motion for summary judgment and entered an order permanently enjoining the FDA, until 15 months following the issuance of new regulations that are substantively and procedurally valid and permissible under the United States Constitution and federal law, from enforcing against plaintiffs the new textual and graphic warnings required by the FSPTCA. On August 24, 2012, the Court of Appeals for the District of Columbia Circuit affirmed the district court's decision invalidating the graphic warning rule. On October 9, 2012, the FDA filed a motion for rehearing en banc with the Court of Appeals, and on December 5, 2012, the Court of Appeals denied the FDA's petition for a rehearing en banc. On March 19, 2013, the FDA announced that it would not file a petition for a writ of certiorari with the U.S. Supreme Court, but instead would undertake research to support a new rulemaking on different warning labels consistent with the FSPTCA. The FDA has not provided a timeline for the revised labels. See "APPENDIX G—CERTAIN INFORMATION RELATING TO THE DOMESTIC TOBACCO INDUSTRY—Regulatory Issues" for a discussion of this case.

The FDA has yet to issue guidance with respect to many provisions of the FSPTCA. It is likely that future regulations promulgated by the FSPTCA, including regulation of menthol short of an outright ban thereof, as discussed below, could result in a decrease in cigarette sales in the U.S., and an increase in costs to PMs, potentially resulting in a material adverse effect on the PMs' financial condition, results of operations and cash flows. Additionally, the ability of the PMs to gain efficient market clearance for new cigarette products or establish a new brand name could be affected by FDA rules and regulations. The negative impact of the foregoing factors could be to reduce consumption of cigarettes in the U.S., thereby reducing payments under the MSA which could have an adverse effect on the amount and/or timing of Pledged TSRs available to the Issuer to pay debt service on the Series 2015A Bonds.

Concerns that mentholated cigarettes may pose greater health risks could result in further FDA regulation which could materially adversely affect the volume of cigarettes sold in the U.S. and thus payments under the MSA.

Some plaintiffs and constituencies, including public health agencies and non-governmental organizations, have claimed or expressed concerns that mentholated cigarettes may pose greater health risks than non-mentholated cigarettes, including concerns that mentholated cigarettes may make it easier to start smoking and harder to quit, and increase smoking initiation among youth and the incidence of smoking among youth. Such plaintiffs and constituencies may seek restrictions or a ban on the production and sale of mentholated cigarettes. On November 8, 2013, twenty-seven states (including the State) sent a letter to the FDA in support of a ban on menthol flavored cigarettes. Any ban or material limitation on the use of menthol in cigarettes could materially adversely affect the results of operations, cash flow and financial condition of the PMs, especially Lorillard, which is heavily dependent on sales of its Newport brand of mentholated cigarettes. It is expected that Reynolds American will acquire the Newport brand as part of its acquisition of Lorillard, Inc., as further described herein. According to Lorillard, Inc. in its Form 10-K filed with the SEC for the calendar year 2014, mentholated cigarettes are reported to have comprised 31.7% and 31.4% of the U.S. domestic cigarette market in the calendar years 2014 and 2013, respectively.

The FSPTCA directs the TPSAC to evaluate issues surrounding the use of menthol as a flavoring or ingredient in cigarettes. In addition, the legislation permits the FDA to ban menthol upon a finding that such a prohibition would be appropriate for the public health. The TPSAC or the Menthol Report Subcommittee held meetings throughout 2010 and 2011 to consider the issues surrounding the use of menthol in cigarettes. At a March 2011 meeting, TPSAC presented its findings that menthol likely increases experimentation and regular smoking, menthol likely increases the likelihood and degree of addiction for youth smokers, non-white menthol smokers (particularly African-Americans) are less likely to quit smoking and are less responsive to certain cessation medications, and consumers continue to believe that smoking menthol cigarettes is less harmful than smoking nonmenthol cigarettes as a result of the cigarette industry's historical marketing. TPSAC's overall recommendation to the FDA was that "removal of menthol cigarettes from the marketplace would benefit public health in the United States." On July 23, 2013, the FDA released a preliminary evaluation on menthol cigarettes, finding among other things that menthol cigarettes likely pose a public health risk above that seen with non-menthol cigarettes. The FDA is not required to follow the TPSAC's recommendations, and the FDA has not yet taken any action with respect to menthol use. There is no timeline or statutory requirement for the FDA to act on the TPSAC's recommendations. As discussed in "APPENDIX G—CERTAIN INFORMATION RELATING TO THE DOMESTIC TOBACCO INDUSTRY—Regulatory Issues—*FSPTCA Litigation*," on July 21, 2014, the U.S. District Court for the District of Columbia ruled in favor of Lorillard and Reynolds Tobacco in a case that challenged the TPSAC's membership, finding that three of the panel's members had conflicts of interest that biased them against the tobacco industry, ordering the FDA to reconstitute the committee, and barring the FDA from using the committee's findings in the 2011 menthol report. The FDA appealed the district court's decision to the U.S. Court of Appeals for the District of

Columbia in September 2014, and briefing on the appeal will be completed on May 2, 2015, according to Reynolds American's Form 10-K filed with the SEC for the calendar year 2014. On March 5, 2015, the FDA announced the resignation or termination of four members from the TPSAC and the addition of three members to the TPSAC, in response to the district court's order to reconstitute the committee. The FDA also announced that it would work expeditiously to fill the remaining vacancy.

If the FDA determines that the regulation of menthol is warranted, the FDA could promulgate regulations that, among other things, could result in a ban on or a restriction on the use of menthol in cigarettes. A ban or any material restriction on the use of menthol in cigarettes could adversely affect the overall sales volume of cigarettes by the PMs, thereby reducing payments under the MSA, which could have an adverse effect on the amount and/or timing of Pledged TSRs available to the Issuer to pay debt service on the Series 2015A Bonds.

The volume of cigarettes sold by PMs in the U.S. cigarette market is expected to continue to decline as a result of increases in cigarette excise taxes.

In the U.S., tobacco products are subject to substantial and increasing federal and state excise taxation, which has a negative effect on consumption. On April 2, 2009, Congress increased the federal excise tax per pack of cigarettes to $1.01 per pack (an increase of $0.62), and significantly increased taxes on other tobacco products. The federal excise tax rate for snuff increased $0.925 per pound to $1.51 per pound. The federal excise tax on small cigars, defined as those weighing three pounds or less per thousand, increased by $48.502 per thousand to $50.33 per thousand. President Obama's 2016 federal budget proposal, released in early February 2015, includes a proposed increase in the federal excise tax on a pack of cigarettes to $1.95 per pack (and proposed proportionate increases in all other tobacco product tax rates). All of the states, the District of Columbia, Puerto Rico, Guam and the Northern Mariana Islands currently impose cigarette taxes, which in 2014 ranged from $0.17 per pack in Missouri to $4.35 per pack in New York. Since January 1, 2002, 47 states, the District of Columbia and several U.S. territories have raised their cigarette taxes, many of them more than once. According to Reynolds American in its Form 10-K filed with the SEC for the calendar year 2014, as of December 31, 2014 the weighted average state cigarette excise tax per pack, calculated on a 12-month rolling average basis, was approximately $1.29. In addition to federal and state excise taxes, certain city and county governments also impose substantial excise taxes on tobacco products sold; for example, in October 2014, Philadelphia enacted a $2.00 per pack local cigarette excise tax. According to Lorillard, Inc. in its Form 10-K filed with the SEC for the calendar year 2014, combined state and local excise taxes ranged from $0.17 to $6.16 per pack of cigarettes in the calendar year 2014. According to Altria in its Form 10-K filed with the SEC for the calendar year 2014, between the end of 1998 (the year that the MSA was executed) and February 20, 2015, the weighted-average state and certain local cigarette excise taxes increased from $0.36 to $1.49 per pack. Altria has reported that during 2013, Massachusetts, Minnesota, Oregon and Puerto Rico had enacted legislation to increase their cigarette taxes, and Altria further reported in its Form 10-K filed with the SEC for the calendar year 2014 that during 2014, Vermont was the only state to have enacted a cigarette excise tax increase in 2014. In 2015, the Governors of Kansas, Louisiana, Nevada and Washington have proposed excise tax increases, and proposals to increase excise taxes have been introduced in 16 other states, according to the Tobacco Consumption Report. In California, Senator Richard Pan introduced a proposal in February 2015 that would impose an additional tax on the distribution of cigarettes at the rate of $0.10 for each cigarette distributed, which would be the equivalent of $2.00 per pack (in addition to the State's current $0.87 per pack excise tax). See "APPENDIX G—CERTAIN INFORMATION RELATING TO THE DOMESTIC TOBACCO INDUSTRY—Regulatory Issues—*Excise Taxes*" herein for a further description of excise taxes on cigarettes.

It is expected that states and local governments will continue to raise excise taxes on cigarettes in 2015 and future years. Increased excise taxes are likely to result in declines in overall sales volume and shifts by consumers to less expensive brands, deep discount brands, counterfeit brands or pipe tobacco for roll-your-own consumers. Reductions in consumption will lead to reductions of payments under the MSA and could have a negative effect on the amount and/or timing of Pledged TSRs available to the Issuer to pay debt service on the Series 2015A Bonds.

The volume of cigarettes sold by PMs in the U.S. cigarette market is expected to continue to decline because of efforts to raise the minimum age for purchase and possession of cigarettes.

U.S. cigarette consumption is expected to continue to decline due to legislative efforts to raise the minimum age to possess or purchase tobacco products. The minimum age to purchase tobacco products recently rose to 21 in Hawaii County, Hawaii, and in Suffolk County and New York City, New York, and several other municipalities. Similar proposals to raise the smoking age have also been introduced in the California, Colorado, Hawaii, Missouri, New York State, New Jersey, Utah, Vermont, Rhode Island and Washington legislatures, and in the Council of the District of Columbia, according to the Tobacco Consumption Report. Four states, Alabama, Alaska, New Jersey, and Utah, and several New York counties currently set the minimum age at 19, according to the Tobacco Consumption Report. On March 12, 2015, the Institute of Medicine of the National Academy of Sciences released a report recommending that the minimum age of legal access to tobacco products be raised to 21. The report concluded that raising the minimum legal age to 21 would likely decrease smoking prevalence by 12% among today's teenagers when they become adults. Declines in consumption could lead to reductions of payments under the MSA and could have an adverse effect on the amount and/or timing of Pledged TSRs available to the Issuer to pay debt service on the Series 2015A Bonds.

Increased restrictions on smoking in public places could adversely affect U.S. tobacco consumption and therefore amounts to be paid under the MSA.

In recent years, federal, state and many local and municipal governments and agencies, as well as private businesses, have adopted legislation, regulations, insurance provisions or policies which prohibit, restrict, or discourage smoking generally, smoking in public buildings and facilities, stores, restaurants and bars, and smoking on airline flights and in the workplace. Other similar laws and regulations are currently under consideration and may be enacted by state and local governments in the future. Restrictions on smoking in public and other places may lead to a decrease in the number of people who smoke or a decrease in the number of cigarettes smoked or both. Smoking bans have recently been extended by many state and local governments to outdoor public areas, such as beaches, parks and space outside restaurants, and others may do so in the future. Increased restrictions on smoking in public and other places have caused a decrease, and may continue to cause a decrease, in the volume of cigarettes that would otherwise be sold in the U.S. absent such restrictions, which may have a material adverse effect on payments under the MSA. See "APPENDIX G—CERTAIN INFORMATION RELATING TO THE DOMESTIC TOBACCO INDUSTRY—Regulatory Issues—*State and Local Regulation*".

Several of the PMs and their competitors have developed alternative tobacco and cigarette products, including electronic cigarettes, sales of which do not currently result in payments under the MSA.

Certain of the major cigarette makers have developed (or acquired) and marketed alternative cigarette products. For example, numerous manufacturers have developed and are marketing "electronic cigarettes" or "e-cigarettes," which are not tobacco products but are battery powered devices that vaporize liquid nicotine which is then inhaled. The manufacturers (and certain states, as noted below) do not deem e-cigarettes to constitute "cigarettes" within the meaning of the MSA because they do not contain or burn or heat tobacco, and e-cigarettes are currently not subject to the advertising restrictions to which tobacco products are subject. In addition, most jurisdictions do not subject electronic cigarettes to excise taxes.

There are currently over 450 e-cigarette brands on the market, and more than 7,000 available flavors of e-cigarettes, according to some estimates. The parent companies of all three OPMs own e-cigarette brands: Lorillard, Inc. markets the blu eCig brand, which is expected to be sold to Imperial Tobacco as part of the proposed merger of Reynolds American and Lorillard, Inc.; Altria markets the "MarkTen" brand, and in April 2014 Altria acquired the e-vapor business of Green Smoke, Inc., an e-cigarette maker that sells both disposable and reusable products; and Reynolds American markets the VUSE brand. The fastest growth in e-cigarettes comes from devices called "vaporizers", which are larger, customizable devices that hold more liquid, produce larger vapor clouds and last longer. They allow users to mix and match hardware and refill cartridges with liquid bought in bulk, so that they are cheaper than e-cigarettes.

Altria reported in its Form 10-K filed with the SEC for the calendar year 2014 that its Nu Mark subsidiary estimates 2014 total consumer expenditures on e-vapor products to be approximately $2 billion based on annualized sales information. The CDC in September 2014 reported results of a survey that indicated that in 2013 approximately 8.5% of the adult population (representing approximately two-and-a-half times the 2010 estimates), and 36.5% of smokers (representing approximately four times the 2010 estimates), had tried e-cigarettes at some time. Altria reported in its Form 10-K filed with the SEC for the calendar year 2014 that it believes that nearly all adult smokers are aware of e-vapor products and approximately 60% have tried them. A report released by the CDC in August 2014 showed that more than a quarter of a million youth who had never smoked a cigarette used electronic cigarettes in 2013, and the CDC further reported in November 2014 that in 2013, 4.5% of high school students, or more than 750,000 youth, reported using e-cigarettes in the previous 30 days—triple the percentage who reported doing so in 2011. Furthermore, in December 2014 the University of Michigan's Survey for Research Center reported its findings that e-cigarette use exceeded traditional cigarette smoking among teens in 2014. Certain reports have predicted that sales of e-cigarettes could outpace traditional cigarettes before 2050. It has also been reported that e-cigarettes will capture more than half the smoking market within a decade.

On April 25, 2014, the FDA released proposed rules that would extend its regulatory authority to electronic cigarettes and certain other tobacco products under the FSPTCA. Among other things, the proposed rules would require that electronic cigarette manufacturers implement minimum age and identification restrictions to prevent sales to individuals under age 18, and include a health warning. Notably, the proposed rules do not restrict flavored products, online sales or advertising. It is not known how long the regulatory process to finalize and implement the rules may take. No assurance can be given that any regulation of e-cigarettes by the FDA will stop the trend of increased sales of e-cigarettes. In December 2014, Representatives Henry Waxman and Frank Pallone and Senator Dick Durbin sent letters to 29 Attorneys General urging them to classify electronic cigarettes as cigarettes under the MSA in order to prevent e-cigarette companies from targeting youth and getting them addicted to their products. In February 2015, eight Attorneys General sent a response letter stating their position that the MSA does not cover e-cigarettes. The State has not taken any position regarding the MSA's applicability to electronic cigarettes. A classification of e-cigarettes as cigarettes under the MSA could mitigate potential decreases in payments under the MSA due to declining consumption of traditional cigarettes if electronic cigarettes gain market share over traditional cigarettes. There can be no assurance that such classification will occur, and the nature and timing of any future amendments to the MSA, or interpretations under the MSA, cannot be predicted.

Cigarette manufacturers also market other types of alternative products. Philip Morris developed an alternative cigarette, called Accord, in which the tobacco is electronically heated rather than burned. Reynolds Tobacco announced in November 2014 that it would introduce in Wisconsin in January 2015 a product called REVO, a cigarette that uses a carbon tip to heat tobacco instead of burning it, releasing a tobacco-flavored vapor and not traditional cigarette smoke. Reynolds Tobacco has stated that it hopes that REVO will appeal to smokers who don't like e-cigarettes but would like an alternative to traditional smoking. Reynolds Tobacco also has developed and is marketing dissolvable tobacco tablets, orbs, strips and sticks. Sales of moist snuff products have increased by 65.6% between 2005 and 2011, according to the National Center for Biotechnology Information. Reynolds Tobacco and Philip Morris are both marketing their versions of "snus", a smokeless, spitless tobacco product that originated in Sweden. In May 2006, Reynolds Tobacco introduced Camel Snus. Philip Morris manufactures Marlboro Snus and Marlboro Smokeless Tobacco Stick, and a subsidiary of Altria manufactures Copenhagen and Skoal smokeless products. In May 2012, Altria announced that its subsidiary Nu Mark LLC introduced Verve nicotine discs, a mint-flavored, chewable, disposable tobacco product that contains tobacco-derived nicotine. A June 2014 report by the CDC found that smokeless tobacco use among U.S. workers has remained relatively steady since 2005, with 2.7% of U.S. workers using smokeless tobacco products in 2005 and 3.0% of U.S. workers using smokeless tobacco products in 2010, while cigarette use has declined since 2005.

It has been reported that increases in cigarette taxes have caused an increase in the sale of e-cigarettes and other alternatives to cigarettes. While such alternative cigarette products continue to be deemed not to constitute "cigarettes" under the MSA and gain market share of the domestic cigarette market to the detriment of traditional cigarettes, payments under the MSA and thus amounts of Pledged TSRs available to the Issuer may decrease. See "APPENDIX G—CERTAIN INFORMATION RELATING TO THE DOMESTIC TOBACCO INDUSTRY—E-Cigarettes" and "—Smokeless Tobacco Products."

U.S. tobacco companies are subject to significant limitations on advertising and marketing cigarettes that could negatively impact sales volume.

Television and radio advertisements of tobacco products have been prohibited since 1971. U.S. tobacco companies generally cannot use billboard advertising, cartoon characters, sponsorship of concerts, non-tobacco merchandise bearing brand names and various other advertising and marketing techniques. In addition, the MSA prohibits the targeting of youth in advertising, promotion or marketing of tobacco products. Accordingly, the tobacco companies have determined not to advertise cigarettes in magazines with large readership among people under the age of 18. The FSPTCA grants authority over the regulation of tobacco products to the FDA. Under the FSPTCA, the FDA has issued rules restricting access and marketing of cigarettes and smokeless tobacco products to youth, and announced its plans to propose a new rule in the future for the imposition of larger, graphic health warnings on cigarette packaging and advertising, as discussed herein. In addition, many states, cities and counties have enacted legislation or regulations further restricting tobacco advertising, marketing and sales promotions, and others may do so in the future. Additional restrictions may be imposed or agreed to in the future. These limitations significantly impair the ability of tobacco product manufacturers to launch new premium brands. Moreover, these limitations may make it difficult to maintain sales volume of cigarettes in the U.S.

Electronic cigarettes are not currently subject to the advertising restrictions to which tobacco products are subject, and the FDA did not include advertising restrictions in its proposed regulations. Therefore, electronic cigarettes, which can currently be marketed more extensively than traditional cigarettes and other tobacco products, could gain market share to the detriment of the domestic cigarette market. See "APPENDIX G—CERTAIN INFORMATION RELATING TO THE DOMESTIC TOBACCO INDUSTRY—E-Cigarettes."

Smoking cessation products may reduce cigarette sales volumes and adversely affect payments under the MSA.

Large pharmaceutical companies have developed and increasingly expanded their marketing of smoking cessation products. Companies such as GlaxoSmithKline, Johnson & Johnson, Novartis and Pfizer are very well capitalized public companies that have entered this market and have the capability to fund significant investments in research and development and marketing of these products. Smoking cessation products now can be obtained both in prescription and over-the-counter forms. From Nicorette gum in 1984, to nicotine patches, nicotine inhalers and tablets, as well as other non-pharmaceutical smoking cessation products, this market has evolved into a $1 billion business in the U.S., according to some estimates. Studies have shown that these programs are effective, and that excise taxes and smoking restrictions drive additional expenditures to the smoking cessation market. In 2004, it was estimated that over 50% of all smokers had quit smoking, and it is likely that many of those former smokers were aided by smoking cessation products. Results of a study by the CDC released in November 2011 found that, in 2010, 52.4% of smokers had attempted to quit and 6.2% had recently quit. In January 2014 the CDC released further results indicating that quit rates had increased to 52.9% for attempts made in the past year. To the extent that existing smoking cessation products, new products or products used in combination become more effective and more widely available, or that more smokers use these products, sales volumes of cigarettes in the U.S. may decline, adversely affecting payments under the MSA. See "APPENDIX G—CERTAIN INFORMATION RELATING TO THE DOMESTIC TOBACCO INDUSTRY—Smoking Cessation Products".

The U.S. cigarette industry is subject to significant law, regulation and other requirements that could materially adversely affect the businesses, results of operations or financial condition of tobacco product manufacturers.

The consumption of cigarettes in the U.S., and therefore the amounts payable under the MSA, could be materially adversely affected by new or future legal requirements imposed by legislative or regulatory initiatives, including but not limited to those relating to health care reform, climate change and environmental matters.

The availability of counterfeit cigarettes could adversely affect payments by the PMs under the MSA.

Sales of counterfeit cigarettes in the U.S. could adversely impact sales by the PMs of the brands that are counterfeited and potentially damage the value and reputation of those brands. Smokers who mistake counterfeit cigarettes for cigarettes of the PMs may attribute quality and taste deficiencies in the counterfeit product to the actual branded products brands and discontinue purchasing such brands. Most significantly, the availability of counterfeit cigarettes together with substantial increases in excise taxes and other potential price increases of branded products could result in increased demand for counterfeit products that could have an adverse effect on the sales volume of the PMs, resulting in lower payments under the MSA.

A decline in the overall consumption of cigarettes could have an adverse effect on the payments by PMs under the MSA and the amount and/or timing of Pledged TSRs available to the Issuer to pay debt service on the Series 2015A Bonds. See "APPENDIX G—CERTAIN INFORMATION RELATING TO THE DOMESTIC TOBACCO INDUSTRY" for a further discussion of the foregoing factors and events.

Risks Relating to the Tobacco Consumption Report

The Collection Methodology and Assumptions and Bond Structuring Methodology (each as defined herein) are based upon the tobacco consumption forecast contained in the Tobacco Consumption Report. See "TABLES OF PROJECTED PLEDGED TSRs, PROJECTION METHODOLOGY AND BOND STRUCTURING ASSUMPTIONS." No assurance can be given that future consumption will be consistent with that which is projected in the Tobacco Consumption Report. Prior reports delivered to the Issuer by IHS Global have projected consumption to be more than that which actually occurred. See "APPENDIX C—TOBACCO CONSUMPTION REPORT" attached hereto.

Other Risks Relating to the MSA and Related Statutes

Severability

Most of the major provisions of the MSA are not severable. If a court materially modifies, renders unenforceable or finds unlawful any non-severable provision, the attorneys general of the Settling States and the OPMs are required by the MSA to attempt to negotiate substitute terms. If, however, any OPM does not agree to the substitute terms, the MSA terminates in all Settling States affected by the court's ruling. See "SUMMARY OF THE MSA—Severability".

Amendments, Waivers and Termination

As a settlement agreement between the PMs and the Settling States, the MSA is subject to amendment in accordance with its terms, and may be terminated upon consent of the parties thereto. Parties to the MSA, including the State, may waive the performance provisions of the MSA. The Issuer is not a party to the MSA; accordingly, the Issuer has no right to challenge any such amendment, waiver or termination. While the economic interests of the State and the holders of the Series 2015A Bonds are expected to be the same in many circumstances, no assurance can be given that such an amendment, waiver or termination of the MSA would not have a material adverse effect on the Issuer's ability to make payments to the holders of the Series 2015A Bonds. See "SUMMARY OF THE MSA—Amendments and Waivers" herein.

Reliance on State Enforcement of the MSA and State Impairment

The State may not convey and has not conveyed to the Issuer or the holders of the Series 2015A Bonds any right to enforce the terms of the MSA. Pursuant to its terms, the MSA, as it relates to the State, can only be enforced by the State. However, no assurance can be given that the State will enforce any particular provision of the MSA. Pursuant to the Act and the Purchase and Sale Agreement (including as amended by the Second Supplemental Purchase and Sale Agreement), the State has pledged with the Owners of any Bonds that the State will not amend the MSA, the MOU, or the California Escrow Agreement, or take any other action, in any way that would materially adversely alter, limit, or impair the rights to receive Tobacco Assets sold to the Issuer pursuant to the Purchase and Sale Agreement and the Act, nor in any way materially impair the rights and remedies of Bondholders or the security for their Bonds until those Bonds, together with the interest thereon and costs and expenses in connection with any action or proceeding on behalf of the Bondholders, are fully paid and discharged.[*] The State further pledged pursuant to the Act and the Purchase and Sale Agreement, that (i) it shall enforce its rights to

[*] As of the Series 2015A Closing Date, the non-impairment covenants of the State contained in the purchase and sale agreement and indenture related to the Series 2007 Bonds do not contain a material adversity standard similar to that being added to the Purchase and Sale Agreement and the Indenture on the Series 2015A Closing Date. See "SECURITY FOR THE BONDS—Consent to Amendments to Indenture and Purchase and Sale Agreement." The Issuer cannot predict the content or timing of any future amendment to the MSA, the MOU, or the California Escrow Agreement.

collect all moneys due from the participating tobacco products manufacturers under the MSA, and (ii) it shall diligently enforce the State's Model Statute as contemplated in the MSA against all tobacco product manufacturers selling tobacco products in the State and that are not signatories to the MSA, in each case in the manner and to the extent necessary in the judgment of the Attorney General to collect all moneys to which the State is entitled under the MSA. The failure of the State to comply with these covenants may have a material adverse effect on the receipt of Pledged TSRs by the Issuer and on the Issuer's ability to make payments to the holders of the Series 2015A Bonds.

It is also possible that the State could attempt to claim some or all of the Pledged TSRs for itself or otherwise interfere with the security for the Series 2015A Bonds, in which case the holders of the Series 2015A Bonds, the Trustee or the Issuer could assert claims based on contractual, fiduciary or constitutional rights, but no prediction can be made as to the disposition of such claims.

See "LEGAL CONSIDERATIONS," "THE PURCHASE AND SALE AGREEMENT—Non-Impairment Covenant of the State," "THE INDENTURE—Non-Impairment Covenant of the State" and "SECURITY FOR THE BONDS—Consent to Amendments to Indenture and Purchase and Sale Agreement" herein.

Amendment to the State's Qualifying Statute

The MSA provides that if a state adopts the Model Statute or a Qualifying Statute but then repeals it or amends it in such fashion that it is no longer a Qualifying Statute, then such state will no longer be entitled to any protection from the NPM Adjustment. The State amended its Qualifying Statute in 2013 in furtherance of the NPM Adjustment Settlement Term Sheet and NPM Adjustment Stipulated Partial Settlement and Award, and the State received letters from counsels to the OPMs and certain SPMs to the effect that such amendment does not affect the status of the State's Qualifying Statute as a Qualifying Statute under the MSA. See "SUMMARY OF THE MSA—California Qualifying Statute." No assurance can be provided, however, that a PM would not assert that, or a court or arbitrator would not determine that, the State's Qualifying Statute as so amended would not continue to constitute a Qualifying Statute. Should it be determined that any amendments to the State's Qualifying Statute cause it to no longer be a Qualifying Statute, then the State would no longer be entitled to any protection from the NPM Adjustment, and there could be substantial reductions in the amount of Pledged TSRs available to the Issuer to make payments on the Series 2015A Bonds. See "LEGAL CONSIDERATIONS—MSA and Qualifying Statute Enforceability."

General Economic Conditions and Lack of Access to Favorable Financing May Materially Adversely Impact the Ability of the PMs to Continue to Operate, Leading to Reduced Sales of Cigarettes and Payments under the MSA

The ability of the PMs to continue their operations selling cigarettes in the U.S. generally is dependent on the health of the overall economy and the ability to access the capital markets on favorable terms. To the extent that market conditions materially adversely impact their operations, the PMs may sell fewer cigarettes, potentially resulting in reduced payments under the MSA.

Adverse changes in financial market conditions or the credit ratings of the PMs could result in lack of access to financing, losses, higher costs and decreased profitability for the PMs, potentially affecting the volume of cigarette sales.

Adverse changes in the liquidity in the financial markets could result in additional realized or unrealized losses associated with the value of the investments of the PMs, which would negatively impact the PMs' consolidated results of operations, cash flows and financial position. Changes in financial market conditions could negatively impact the PMs' interest rate risk, foreign currency exchange rate risk and the return on corporate cash, thus increasing costs, lowering income and reducing profitability. If these losses negatively affect the overall volume of cigarette sales, payments under the MSA may decrease.

The outstanding notes issued by certain of the PMs are rated investment grade. If their credit ratings fall below investment grade, certain debt securities may adjust interest payments upwards or require posting of additional collateral. Additionally, if credit ratings fall below investment grade, the PMs affected may not be able to sell additional debt securities or borrow money in such amounts, at the times, at the lower interest rates or upon the more favorable terms and conditions that might be available if its debt was rated investment grade. Furthermore, future debt security issuances or other borrowings may be subject to further negative terms, including limitations on indebtedness or similar restrictive covenants. If these conditions negatively affect the overall volume of cigarette sales, payments under the MSA may decrease.

Bankruptcy of a PM May Delay, Reduce or Eliminate Payments of Pledged TSRs

The only source of payment for the Series 2015A Bonds (other than amounts in the Liquidity Reserve Account and State Appropriations, if any) is the Pledged TSRs that are paid by the PMs. Therefore, if one or more PMs were to become a debtor in a case under Title 11 of the United States Code (the "**Bankruptcy Code**"), there could be delays in or reductions or elimination of Pledged TSRs, and the holders of the Series 2015A Bonds could incur losses on their investments.

In the event of the bankruptcy of a PM, unless approval of the bankruptcy court is obtained, the automatic stay provisions of the Bankruptcy Code could prevent any action by the State, the Issuer, the Trustee or the holders of the Series 2015A Bonds to collect any Pledged TSRs or any other amounts owing by the bankrupt PM. In addition, even if the bankrupt PM wanted to continue paying the Pledged TSRs, it could be prohibited as a matter of law from making such payments. In particular, if it were to be determined that the MSA was not an "executory contract" under the Bankruptcy Code, then the PM may be unable to make further payments of Pledged TSRs. If the MSA is determined in a bankruptcy case to be an "executory contract" under the Bankruptcy Code, the bankrupt PM may be able to reject the MSA and stop making payments under it.

Furthermore, payments previously made to the holders of the Series 2015A Bonds could be avoided as preferential payments, so that the holders of the Series 2015A Bonds would be required to return such payments to the bankrupt PM. Also, the bankrupt PM may have the power to alter the terms of its payment obligations under the MSA without the consent, and even over the objection of the State, the Issuer, the Trustee or the holders of the Series 2015A Bonds. Finally, while there are provisions of the MSA that purport to deal with the situation when a PM goes into bankruptcy (including provisions regarding the termination of that PM's obligations) (see "SUMMARY OF THE MSA—Termination of Agreement"), such provisions may be unenforceable. NAAG has stated that it actively monitors any bankruptcy related activity of the PMs with the goals of preventing the debtors from using bankruptcy law to avoid their MSA or state law payment obligations to the state and ensuring that states can continue to perform their regulatory duties despite the bankruptcy filing, but there can be no assurance that the actions of NAAG will be successful. There may be other possible effects of a bankruptcy of a PM that could result in delays or reductions in, or elimination of, Pledged TSRs. Regardless of any specific adverse determination in a PM bankruptcy proceeding, the fact of a PM bankruptcy proceeding could have an adverse effect on the timing of receipt, amount and value of the Pledged TSRs, and thus could have an adverse effect on the liquidity and market value of the Series 2015A Bonds.

For a further discussion of certain bankruptcy issues and a description of certain legal opinions to be delivered by Transaction Counsel with respect to PM bankruptcy matters, see "LEGAL CONSIDERATIONS" herein.

Bonds Secured Solely by the Collateral

The Issuer has no authority to and does not intend or purport to pledge the faith, credit, or taxing power of the State or any of its political subdivisions in connection with the issuance of the Bonds. The Bonds are limited obligations of the Issuer; are secured solely by and payable solely from the Collateral; and are neither general nor legal obligations of the State or any of its political subdivisions. Neither the faith and credit nor the taxing power nor any other assets or revenues of the State or of any political subdivision thereof, other than the Issuer to the extent of the Collateral, is or shall be pledged to the payment of the principal of or Accreted Value on or the interest on the Bonds. Investors in the Bonds must look solely to the Collateral for repayment of their investment. The Issuer's only source of funds for payments on the Bonds is the Collateral. The Issuer has no taxing power.

Risk Related to the Liquidity Reserve Account

Approximately $7.94 million of funds in the Supplemental Reserve Account were used to pay a portion of the debt service due on the Series 2005A Bonds in 2011 and 2012. Pursuant to the Third Supplemental Indenture, the Supplemental Reserve Requirement is amended to $0, and amounts in the Supplemental Reserve Account will be released on the Series 2015A Closing Date and applied to the refunding of a portion of the Series 2005A Bonds. Therefore, following the issuance of the Series 2015A Bonds and the application of the proceeds thereof, the Supplemental Reserve Requirement, and the balance in the Supplemental Reserve Account, will be $0. Funds in the Liquidity Reserve Account will be used in the future to pay interest and principal on the Bonds to the extent that amounts in the Debt Service Account, the Partial Lump Sum Payment Account and the Surplus Account, in that order, are insufficient therefor. Pursuant to the Third Supplemental Indenture, the Liquidity Reserve Requirement is amended from $214,307,881.25 to $150,000,000, and the funds held in the Liquidity Reserve Account in excess of such amended Liquidity Reserve Requirement will be released on the Series 2015A Closing Date and applied to the refunding of a portion of the Series 2005A Bonds. There can be no assurance that funds in the Liquidity Reserve Account will not be needed in order to pay interest and principal on the Bonds. See "SECURITY FOR THE BONDS—Liquidity Reserve Account" and "SECURITY FOR THE BONDS—Elimination of Supplemental Reserve Requirement."

Rating Agency Actions With Respect to Unenhanced Tobacco Settlement Revenue Bonds Highlight the Importance to Investors of Analyzing the Likelihood of a Need for State Appropriations

In recent years Rating Agencies have revised their assumptions regarding their ratings of unenhanced tobacco settlement revenue bonds on account of the continuing decline in MSA payments resulting from cigarette volume decline, withholdings by PMs of MSA payments and disputes relating to MSA payments. S&P revised its assumptions for all tobacco settlement securitizations in October 2011 and then placed 86 classes from 23 tobacco settlement securitizations on CreditWatch Negative. On January 27, 2012, S&P lowered its ratings on 87 classes from 22 tobacco settlement securitizations, among other actions. In September 2011 Moody's downgraded 60 tranches from 13 tobacco settlement securitizations as a result of updated cash flow modeling assumptions. In July 2012, Fitch placed 150 tranches of tobacco settlement revenue bonds on negative watch. None of such rating actions affected the ratings of then-outstanding Bonds of the Issuer, as such ratings are based on State Appropriations. See "RISK FACTORS—Enforceability of Obligation of Governor to Include Appropriation in the Budget; No Obligation of State to Appropriate."

In January 2013, Moody's placed 31 series of tobacco settlement revenue bonds under review as a result of the potential impact of the NPM Adjustment Settlement Term Sheet, stating that the provisions of the NPM Adjustment Settlement Term Sheet could reduce the cash flow of the joining states (such as the State) and indirectly affect the non-joining states. On February 20, 2014 Moody's reported that it had updated its methodology for rating tobacco settlement revenue securitizations based upon the NPM Adjustment Settlement Term Sheet, and consequently upgraded the ratings of 55 tranches, downgraded the ratings of 7 tranches, confirmed the ratings of 73 tranches that were placed on review with direction uncertain in January 2013, and affirmed the ratings of 3 tranches, stating that it made two assumption changes for all states, including the states that did not join the NPM Adjustment Settlement Term Sheet: (i) that the tobacco companies will continue making NPM Adjustments for the entire duration of the transactions, and (ii) that the states will recover the NPM Adjustments 8 to 12 years later. See "SUMMARY OF THE MSA—Potential Payment Decreases Under the Terms of the MSA—*NPM Adjustment—NPM Adjustment Settlement and Award*." Moody's rating actions did not affect then-outstanding Bonds of the Issuer, as such ratings are based on State Appropriations. See also "RISK FACTORS—Enforceability of Obligation of Governor to Include Appropriation in the Budget; No Obligation of State to Appropriate."

The Series 2015A Bonds are enhanced by the State Appropriations (and, as noted below under "RISK FACTORS—Limited Nature of Ratings; Reduction, Suspension or Withdrawal of a Rating," the ratings on the Series 2015A Bonds are expected to reflect such State Appropriations). The Rating Agency actions with respect to unenhanced tobacco settlement revenue bonds described in the preceding paragraphs highlight the importance to investors of analyzing the likelihood of a need for State Appropriations. See "SECURITY FOR THE BONDS—State Appropriations," "RISK FACTORS—Enforceability of Obligation of Governor to Include Appropriation in the Budget; No Obligation of State to Appropriate," "APPENDIX A—THE STATE OF CALIFORNIA" and "APPENDIX B—STATE OF CALIFORNIA COMPREHENSIVE ANNUAL FINANCIAL REPORT FOR THE FISCAL YEAR ENDED JUNE 30, 2013."

Enforceability of Obligation of Governor to Include Appropriation in the Budget; No Obligation of State to Appropriate

In furtherance of the Act, the State has covenanted in the Purchase and Sale Agreement that on or before January 10 of each year, the Director of Finance of the State shall request the Governor to include in the annual budget act an appropriation line item from the General Fund of the State for allocation by the Department of Finance to the Issuer in an amount equal to the Debt Service and Operating Expenses to become due during the next succeeding Fiscal Year on the Bonds. The Director of Finance is required to provide a copy of such request to the Joint Legislative Budget Committee. The Director of Finance is also required to certify to the Trustee that the Director of Finance has complied with his or her obligations under the two preceding sentences. Pursuant to the Act, the State has covenanted in the Purchase and Sale Agreement that the Governor shall each year request from the Legislature the appropriation line item referred to above in the annual budget act. On the Series 2015A Closing Date, the Attorney General of the State will render an opinion that, among other things, the Purchase and Sale Agreement, including the covenant of the Director of Finance to request inclusion of an appropriation line item as described above, is the legal, valid, binding and enforceable agreement of the State. However, the Attorney General will express no opinion as to the legality, validity or the binding and enforceable nature of the obligation of the Governor to request such appropriation line item from the Legislature as described above. See "SECURITY FOR THE BONDS—State Appropriations" and "APPENDIX F-2—Proposed Form of Opinion of the Attorney General of the State."

No assurance can be given that the Governor could be compelled by a bondholder or another interested party to include the line item in the Governor's Budget submitted to the Legislature.

Moreover, even if the Governor includes the line item in the proposed budget act, the Legislature is not obligated to appropriate or otherwise make funds available to pay Operating Expenses and/or Debt Service on the Bonds in the amount requested by the Governor or in any other amount, and no assurance can be given that the Legislature will make any such appropriation or that such appropriation will be for the time period requested by the Governor. Bondholders have no right to compel any such appropriation.

An appropriation, under certain circumstances, may be challenged as a gift of public funds. In the opinion of the Attorney General, any appropriation made by the Legislature that is otherwise valid and that is made in conjunction with adequate findings by the Legislature of public purpose would be upheld against a challenge that it was a gift of public funds. California courts give great deference to the Legislature's findings of public purpose, and will uphold legislative findings unless they are found to be unreasonable and arbitrary.

See "APPENDIX A—THE STATE OF CALIFORNIA" for a discussion of the State's economy and finances, and see "APPENDIX B—STATE OF CALIFORNIA COMPREHENSIVE ANNUAL FINANCIAL REPORT FOR THE FISCAL YEAR ENDED JUNE 30, 2013" for a copy of the State's audited Comprehensive Annual Financial Report for the fiscal year ended June 30, 2013. See also "FINANCIAL STATEMENTS" herein.

Limited Remedies

The Trustee may be limited under the Purchase and Sale Agreement to enforcing the terms of such agreement and to receiving the Pledged TSRs and applying them in accordance with the Indenture. If an Event of Default occurs, the Trustee may not be able to sell its rights under the Purchase and Sale Agreement. The Issuer is not a party to the MSA and has not made any representation or warranty that the MSA is enforceable. Remedies under the Purchase and Sale Agreement do not include the repurchase by the State of the Tobacco Assets under any circumstances, including unenforceability of the MSA, the Qualifying Statute or breach of any representation or warranty. The remedies of the holders of the Bonds are no greater than those afforded to the Trustee.

Limited Liquidity of the Bonds; Price Volatility

There is currently a limited secondary market for securities such as the Series 2015A Bonds. The Underwriters are under no obligation to make a secondary market for the Series 2015A Bonds. There can be no assurance that a secondary market for the Series 2015A Bonds will develop, or if a secondary market does develop, that it will provide holders of the Series 2015A Bonds with liquidity or that it will continue for the life of the Series 2015A Bonds. Tobacco settlement revenue bonds generally have also exhibited greater price volatility than traditional municipal bonds. Any purchaser of the Series 2015A Bonds must be prepared to hold such securities for an indefinite period of time or until redemption or final payment of such securities.

Limited Nature of Ratings; Reduction, Suspension or Withdrawal of a Rating

The Series 2015A Bonds will be assigned ratings by S&P, Fitch and Moody's (collectively, the "**Rating Agencies**"). It is expected that the Rating Agencies' ratings of the Series 2015A Bonds will not reflect the security provided by the Pledged TSRs, but rather, the State Appropriations and the risks inherent thereto. See "APPENDIX A—THE STATE OF CALIFORNIA" and "APPENDIX B—STATE OF CALIFORNIA COMPREHENSIVE ANNUAL FINANCIAL REPORT FOR THE FISCAL YEAR ENDED JUNE 30, 2013" attached hereto. See also "RISK FACTORS—Enforceability of Obligation of Governor to Include Appropriation in the Budget; No Obligation of State to Appropriate."

Any rating assigned to the Series 2015A Bonds by a Rating Agency will reflect such Rating Agency's assessment of the likelihood of the payment of principal or and interest on the Series 2015A Bonds. The rating of the Series 2015A Bonds will not be a recommendation to purchase, hold or sell such Bonds and such rating will not address the marketability of such Bonds, any market price or suitability for a particular investor. There is no assurance that any rating will remain for any given period of time or that any rating will not be lowered, suspended or withdrawn entirely by a Rating Agency if, in such Rating Agency's judgment, circumstances so warrant based on factors prevailing at the time. Any such reduction, suspension or withdrawal of a rating, if it were to occur, could adversely affect the availability of a market for, or the market price of, the Series 2015A Bonds.

LEGAL CONSIDERATIONS

The following discussion summarizes some, but not all, of the possible legal issues that could affect the Series 2015A Bonds. The discussion does not address every possible legal challenge that could result in a decision that would cause the Pledged TSRs to be reduced or eliminated. References in the discussion to various opinions of Transaction Counsel and the Attorney General are incomplete summaries of such opinions and are qualified in their entirety by reference to the actual opinions.

Bankruptcy Considerations

General. The enforceability of the rights and remedies of the State under the MSA (and thus the Issuer, the Trustee and the holders of the Series 2015A Bonds as collateral assignees) and of the obligations of a PM under the MSA are subject to the Bankruptcy Code and to other applicable insolvency, moratorium or similar laws relating to or affecting the enforcement of creditors' rights generally. Some of the risks associated with a bankruptcy of a PM are described below and include the risks of delay in or reduction of amount of the payment or of nonpayment under the MSA and the risk that the State (and, thus, the Issuer) may be stayed for an extended time from enforcing any rights under the MSA or with respect to the payments owed by the bankrupt PM or from commencing legal proceedings against the bankrupt PM. As a result, if a PM becomes a debtor in a bankruptcy case and defaults in making payments required under the MSA, Pledged TSRs available to the Issuer to pay holders of the Series 2015A Bonds may be reduced or eliminated. Furthermore, certain payments previously made to holders of the Series 2015A Bonds could be avoided as preferential payments, so that holders of the Series 2015A Bonds would be required to return such payments to the bankrupt PM. See "SUMMARY OF THE MSA—Payments Made to Date" and "—Potential Payment Decreases Under the Terms of the MSA—*Disputed or Recalculated Payments and Other Disputes under the Terms of the MSA*" for a discussion of certain bankruptcy filings by PMs.

Chapter 7 Liquidation. If a PM becomes bankrupt and does not reorganize under Chapter 11, it may be liquidated under Chapter 7 of the Bankruptcy Code, in which event its operations will cease and its assets will be sold. In such an event, there would likely be an elimination of payments received from the PM that is in the Chapter 7 case. To the extent that the volume of cigarettes sold by other PMs increased as a result of cessation of operations by the PM being liquidated under Chapter 7 of the Bankruptcy Code, the market share of such other PMs should increase.

Chapter 11 Reorganization. Should a PM become a debtor in a Chapter 11 reorganization bankruptcy case, the PM may not be authorized to make any payments owing under the MSA, or may be required to obtain bankruptcy court approval before making such payments. Legal proceedings necessary to determine whether such PM's obligations under the MSA can be paid during the pendency of the bankruptcy proceedings could be time-consuming and could result in delays in, or elimination of, payments by the bankrupt PM.

Examples of other bankruptcy-related risks include:

MSA as Executory Contract. The treatment of the MSA under the Bankruptcy Code may be dependent upon whether the MSA is held to be an executory contract (which is not defined by the Bankruptcy Code but generally is considered to be a contract in which material performance remains due to some extent from both parties). Under the Bankruptcy Code, if the MSA is treated as an executory contract, a trustee in bankruptcy or a PM acting as a debtor-in-possession would have the right to assume or reject the MSA. However, there is no time period within which a trustee or PM in bankruptcy would be required to assume or reject the MSA. Legal proceedings necessary to resolve the issue of whether the MSA is an executory contract under the Bankruptcy Code could be time consuming and could result in delays in, or elimination of, payments by the bankrupt PM.

Transaction Counsel will render an opinion to the Rating Agencies that, subject to all the assumptions, qualifications and limitations set forth therein, if a PM became the debtor in a case under the Bankruptcy Code commenced after the date of issuance of the Series 2015A Bonds, and the matter were properly briefed and presented to a federal court with jurisdiction over such bankruptcy case, the court, exercising reasonable judgment after full consideration of all relevant factors, would hold that the MSA is an "executory contract" under Section 365 of the Bankruptcy Code. Certain of the assumptions contained in this opinion will be assumptions that certain facts or circumstances will exist or occur, and Transaction Counsel can provide no assurance that such facts or circumstances will exist or occur as assumed in the opinion. This opinion will be based on an analysis of existing laws and court decisions, and will cover certain matters not directly addressed by such authorities. There are no court decisions directly on point, there are court decisions that could be viewed as contrary to the conclusions expressed in the opinion, and the matter is not free from doubt. Accordingly, no assurance can be given that a particular court would not hold that the MSA is not an executory contract, thus resulting in delays or reductions in, or elimination of, payments on the Series 2015A Bonds.

Assumption or Rejection of MSA. Should a bankrupt PM determine to assume the MSA, it would have to cure all outstanding MSA payment defaults and provide "adequate assurance" that all future payments under the MSA will be paid in full. "Adequate assurance" is not defined in the Bankruptcy Code and is determined by the bankruptcy court. If the bankruptcy court rules that the PM cannot provide such adequate assurance, payments under the MSA may be delayed or eliminated.

However, if a bankrupt PM decides to reject the MSA and a court approves such a decision, the State (and thus the Issuer, the Trustee and the holders of the Series 2015A Bonds, as collateral assignees) may then have a prepetition unsecured, nonpriority claim for damages. Rejection of an executory contract should be treated as a breach of the contract by the PM. However, under the Bankruptcy Code, the State (and thus the Issuer, the Trustee and the holders of the Series 2015A Bonds) nevertheless may not, without the permission of the bankruptcy court, commence or continue any action against the PM to enforce remedies under the MSA (including an action to collect payments due under the MSA). In addition, because amounts owed by the PM under the MSA are not fixed, legal proceedings may be necessary to quantify the claims of the State (and thus the Issuer, the Trustee and the holders of the Series 2015A Bonds) for damages as a result of the PM's rejection of the MSA. Such legal proceedings could be time consuming and could result in delays, reductions, or elimination of, payments by the bankrupt PM.

Modification of MSA Obligations. If the MSA is determined not to be an "executory contract", the PM determines to reject the MSA or the PM is otherwise not authorized to make payments under the MSA, then a bankruptcy of the PM could result in long delays and possibly in large reductions in the amount of Pledged TSRs available to pay the holders of the Series 2015A Bonds because, under the Bankruptcy Code, the obligations of the PM under the MSA could be modified or discharged in their entirety. For example, the bankruptcy court may approve a plan of reorganization or liquidation of the PM that alters the timing or the amount of payments to be made by the PM under the MSA to the State (and, thus, to the Issuer, the Trustee and holders of the Series 2015A Bonds).

MSA and Qualifying Statute Enforceability

Most of the major provisions of the MSA are not severable. If a court materially modifies, renders unenforceable or finds unlawful any nonseverable provision, the attorneys general of the Settling States and the OPMs are required by the MSA to attempt to negotiate substitute terms. However, if any OPM does not agree to the substitute terms, the MSA would terminate in all Settling States affected by the court's ruling. Even if substitute terms are agreed upon, payments under such terms may be less than payments under the MSA or otherwise could be made according to or subject to different terms and conditions that could reduce the amount available to pay the principal of and interest on the Series 2015A Bonds.

Certain smokers, smokers' rights organizations, consumer groups, cigarette importers, cigarette wholesalers, cigarette distributors, cigarette manufacturers, Native American tribes, taxpayers, taxpayers' groups and other parties have filed lawsuits against some, and in certain cases all, of the signatories to the MSA, alleging, among other things, that the MSA, Qualifying Statutes and Complementary Legislation violate and are void or unenforceable under certain provisions of law, such as of the United States Constitution, the federal antitrust laws, federal civil rights laws, state constitutions, state consumer protection laws, bankruptcy laws, federal cigarette advertising and labeling law, unfair competition laws and NAFTA. Certain of the lawsuits have sought, among other relief, an injunction against one or more of the Settling States from collecting any moneys under the MSA and barring the PMs from collecting cigarette price increases related to the MSA or a determination that the MSA is void or unenforceable.

To date, all of the judgments on the merits have rejected the challenges presented in the cases. For example, in *VIBO*, the Sixth Circuit ruled that the MSA does not amount to an unlawful conspiracy or anti-competitive behavior by the government and, accordingly, affirmed the district court's order dismissing plaintiffs' federal antitrust, federal constitutional and common law challenges to the enforceability of the MSA. The time period for the plaintiffs to file a petition for certiorari to the U.S. Supreme Court expired. In *Grand River*, the U.S. District Court for the Southern District of New York denied the plaintiffs' motion to amend the Southern District's dismissal by summary judgment of plaintiffs' claims that the MSA and related legislation violated Section 1 of the Sherman Antitrust Act and the Commerce Clause of the Constitution of the United States. Plaintiffs had appealed to the Second Circuit both the Southern District's dismissal and denial, but subsequently withdrew both appeals, which withdrawals were approved by order of the Second Circuit on August 10, 2012, rendering the case final before the Second Circuit. In another decision, *Freedom Holdings*, the Second Circuit affirmed the district court's judgment, after a bench trial, in favor of defendants on similar challenges to New York's Qualifying Statute and Complementary Legislation, and the U.S. Supreme Court has denied the plaintiffs' petition for certiorari. In *Sanders v. Brown*, the U.S. Court of Appeals for the Ninth Circuit, in which the State is located, affirmed the district court's dismissal of an antitrust challenge to the MSA and California's Qualifying Statute and Complementary Legislation. The U.S. Supreme Court denied plaintiff's petition for certiorari. These cases are discussed more fully herein.

A determination by a court in a future case that a nonseverable provision of the MSA is void or voidable would, in the absence of an agreement to a substitute term, result in the termination of the MSA in any Settling States affected by the court's ruling. Accordingly, in the event of an adverse court ruling, holders of the Series 2015A Bonds could incur a complete loss of the Pledged TSRs. See "RISK FACTORS—If Litigation Challenging the MSA, the Qualifying Statutes and Related Legislation Were

Successful, Payments Under the MSA Might be Suspended or Terminated" and "SUMMARY OF THE MSA—Litigation Challenging the MSA, the Qualifying Statutes and Related Legislation".

The Qualifying Statutes and related legislation, like the MSA, have been the subject of litigation in cases alleging that the Qualifying Statute and related legislation violate certain provisions of the United States Constitution or state constitutions or are preempted by federal antitrust laws. The lawsuits have sought, among other relief, injunctions against the enforcement of the Qualifying Statute and related legislation. To date, such challenges have not been ultimately successful. The Qualifying Statutes and related legislation may continue to be challenged in the future. Although a determination that a Qualifying Statute is unconstitutional would have no effect on the enforceability of the MSA, such a determination could have an adverse effect on payments to be made under the MSA if an NPM were to gain market share in the future and there occurred the requisite impact on the Market Share of the PMs under the MSA. See "SUMMARY OF THE MSA—Litigation Challenging the MSA, the Qualifying Statutes and Related Legislation".

Transaction Counsel will render an opinion on the Series 2015A Closing Date to the Rating Agencies that, subject to all the assumptions, qualifications, and limitations set forth therein, if the matter were properly briefed and presented to a court, the court, applying existing legal principles to the facts and exercising reasonable judgment after full consideration of all relevant factors, would hold that (a) the MSA is a valid and enforceable agreement and (b) the California Model Statute is valid, enforceable, and constitutional in all material respects. Certain of the assumptions contained in this opinion will be assumptions that certain facts or circumstances will exist or occur, and Transaction Counsel can provide no assurance that such facts or circumstances will exist or occur as assumed in the opinion. Transaction Counsel will assume, among other things, that each of the NPM Adjustment Settlement Term Sheet, each arbitration award with respect thereto (including the NPM Adjustment Stipulated Partial Settlement and Award), and the 2013 amendment to the California Model Statute (Chapter 168 of the California Statutes of 2013) is valid, binding, and enforceable in accordance with its terms, constitutional, and does not conflict with, and is permitted by, the MSA. Transaction Counsel will also assume that the California Model Statute, both before and after the 2013 amendment, is a "Qualifying Statute" within the meaning of the MSA. This opinion will be based on an analysis of existing laws and court decisions, and will cover certain matters not directly addressed by such authorities. There are no court decisions directly on point, there are court decisions that could be viewed as contrary to the conclusions expressed in the opinion, the matter is not free from doubt, and there can be no assurance that a court applying existing legal principles would not hold otherwise. Accordingly, no assurance can be given that a particular court would not hold that the MSA is not valid or enforceable, or that the California Model Statute is not valid, enforceable, or constitutional, thus resulting in delays or reductions in, or elimination of, payments on the Series 2015A Bonds.

The Attorney General of the State will render an opinion to the Issuer on the Series 2015A Closing Date, subject to all the facts, assumptions and qualifications set forth therein, that the MSA is a valid and binding agreement of the State, enforceable against the State in accordance with its terms and that the State's Qualifying Statute has been duly enacted by the State and is in full force and effect.

The opinions as to the enforceability of the MSA and the obligations of the aforementioned signatories are also subject to the effect of bankruptcy, insolvency, and other laws affecting creditors' rights or remedies and general principles of equity, regardless of whether such enforceability is considered in a proceeding in equity or at law.

See "RISK FACTORS—If Litigation Challenging the MSA, the Qualifying Statutes and Related Legislation Were Successful, Payments under the MSA Might be Suspended or Terminated," "RISK FACTORS—Potential Payment Decreases Under the Terms of the MSA—*NPM Adjustment*" and "RISK

FACTORS—Other Risks Relating to the MSA and Related Statutes—*Amendment to the State's Qualifying Statute*." See also "SUMMARY OF THE MSA—Potential Payment Decreases Under the Terms of the MSA—*NPM Adjustment—NPM Adjustment Settlement and Award*," including the penultimate paragraph thereof.

Limitations on Certain Opinions of Counsel: No Assurance as to Outcome of Litigation

A court's decision regarding the matters upon which a lawyer is opining would be based on such court's own analysis and interpretation of the factual evidence before it and of applicable legal principles. Thus, if a court reached a result different from that expressed in an opinion, such as that the MSA is void or voidable or that the State's Qualifying Statute is unenforceable, it would not necessarily constitute reversible error or be inconsistent with that opinion. An opinion of counsel is not a prediction of what a particular court (including any appellate court) that reached the issue on the merits would hold, but, instead, is the opinion of such counsel as to the proper result to be reached by a court applying existing legal rules to the facts as properly found after appropriate briefing and argument and, in addition, is not a guarantee, warranty or representation, but rather reflects the informed professional judgment of such counsel as to specific questions of law. Opinions of counsel are not binding on any court or party to a court proceeding. The descriptions of the opinions set forth herein are summaries, do not purport to be complete and are qualified in their entirety by the opinions themselves.

Enforcement of Rights to Pledged TSRs

It is possible that the State could in the future attempt to claim some or all of the Pledged TSRs for itself, or otherwise interfere with the security for the Series 2015A Bonds. In that event, the holders of the Series 2015A Bonds, the Trustee or the Issuer could assert claims based on contractual or constitutional rights.

Contractual Remedies. Under State law, settlements are treated as contracts and may be enforced according to their terms. The Decree coupled with the MSA is a court-approved settlement of lawsuits that establishes the State's right to receive the Tobacco Assets (including the Pledged TSRs). Pursuant to the Act and the Purchase and Sale Agreement, the State has pledged to and agreed with the holders of the Series 2015A Bonds, among other things, not to take any action to materially adversely alter, limit, or impair the rights to receive Pledged TSRs nor in any way to materially impair the rights and remedies of such holders. Thus, if the State violates such pledge and agreement so as to impair the Issuer's right to the Pledged TSRs, the Trustee, as assignee of the Issuer's rights under the Purchase and Sale Agreement, could seek to compel the State to honor such pledge and agreement. In general, as interested parties, the Issuer on its own behalf and the Trustee on behalf of the holders of the Series 2015A Bonds could also seek to enforce the State's rights under the MSA, although, as third parties to the MSA, their rights to do so are uncertain.

Based on the U.S. Supreme Court's standard of review for Contract Clause challenges in *Energy Reserves Group, Inc. v. Kansas Power Light Co.*, 459 U.S. 400 (1983), the State must justify the exercise of its inherent police power to safeguard the vital interests of its people before the State may alter contracts similar to the MSA or the financing arrangements in a manner that would substantially impair the rights of the holders of the Series 2015A Bonds to be paid from the Pledged TSRs. In those instances, however, where a state's own contractual obligations involving financing will be substantially impaired, the U.S. Supreme Court applies a stricter standard of judgment to a state's actions due to the risk that a state's self-interest rather than any public necessity will be the motivation for its actions. Indeed, in *United States Trust Company of New York v. New Jersey*, 431 U.S. 1 (1977), the U.S. Supreme Court noted that only once in an entire century had the U.S. Supreme Court upheld the alteration of a municipal bond contract. Thus, in order to justify the enactment by the State of legislation that substantially impairs the contractual rights of the holders of the Series 2015A Bonds to be paid from the Pledged TSRs, the State not only must demonstrate a significant and legitimate public purpose, such as the remedying of a broad and general social or economic problem, but must also demonstrate that its actions under such circumstances satisfy the U.S. Supreme Court's strict standard of judgment employed in *United States Trust Company* and also that the impairment of the rights of the holders of the Series 2015A Bonds are based upon reasonable conditions and are of a character appropriate to the public purpose justifying the legislation's adoption.

Constitutional Rights. Holders of the Series 2015A Bonds may also have constitutional claims under the Due Process Clauses of the United States Constitution and State Constitution in the event the State attempts to claim some or all of the Pledged TSRs for itself, or otherwise interferes with the security for the Series 2015A Bonds.

No Assurance As to the Outcome of Litigation

With respect to all matters of litigation mentioned above that have been brought and may in the future be brought against the PMs, or involving the enforceability or constitutionality of the MSA and/or the State's related legislation, Qualifying Statute or the enforcement of the right to the Pledged TSRs or otherwise filed in connection with the tobacco industry, the outcome of such litigation, in general, cannot be predicted with certainty and depends, among other things, on (i) the issues being appropriately presented and argued before the courts (including the applicable appellate courts) and (ii) the courts, having been presented with such issues, correctly applying applicable legal principles in reaching appropriate decisions regarding the merits. In addition, the courts may, in their exercise of equitable jurisdiction, reach judgments based not upon the legal merits but upon a balancing of the equities among the parties. Accordingly, no assurance can be given as to the outcome of any such litigation and any such adverse outcome could have a material and adverse impact on the amount of Pledged TSRs available to the Issuer to pay the principal of and interest on the Series 2015A Bonds.

SUMMARY OF THE MSA

The following is a brief summary of certain provisions of the MSA and related information. This summary is not complete and is subject to, and qualified in its entirety by reference to, the MSA as amended. A copy of the MSA in its original form is attached hereto as Appendix D, but several amendments have been made to the MSA which are not included in Appendix D. Except for those amendments pursuant to which certain tobacco companies became SPMs (as defined below), such amendments involve technical and administrative provisions not material to the summary below. In addition, the following includes certain information related to litigation challenges to the MSA, and disputes and a settlement regarding the NPM Adjustment, which are also referenced under "RISK FACTORS" herein.

General

The MSA is an industry-wide settlement of litigation between the Settling States (including the State) and the OPMs and was entered into between the attorneys general of the Settling States and the OPMs on November 23, 1998. The MSA provides for other tobacco companies (the "**SPMs**") to become parties to the MSA. The three OPMs together with the SPMs (there currently are 52 SPMs) are referred to as the "**PMs**". The settlement represents the resolution of a large potential financial liability of the PMs for smoking-related injuries, the costs of which have been borne and will likely continue to be borne by states. Pursuant to the MSA, the Settling States agreed to settle all their past, present and future smoking-related claims against the PMs in exchange for agreements and undertakings by the PMs concerning a number of issues. These issues include, among others, making payments to the Settling

States, abiding by more stringent advertising restrictions and funding educational programs, all in accordance with the terms and conditions set forth in the MSA. Distributors of PMs' products are also covered by the settlement of such claims to the same extent as the PMs.

Parties to the MSA

The Settling States are all of the states, territories and the District of Columbia, except for the four states (Florida, Minnesota, Mississippi and Texas) that separately settled with the OPMs prior to the adoption of the MSA (the "**Previously Settled States**"). According to NAAG, as of January 27, 2015 (the most current reference date cited by NAAG), 55 PMs are parties to the MSA. The chart below identifies each of such PMs that are parties to the MSA as of such date:

OPMs

Lorillard Tobacco Company
Philip Morris USA Inc. (formerly Philip Morris Incorporated)
R.J. Reynolds Tobacco Company (formerly R.J. Reynolds Tobacco Company and Brown & Williamson Tobacco Corporation)

SPMs

Bekenton, S.A.[*]
Canary Islands Cigar Co.
Caribbean-American Tobacco Corp. (CATCORP)
The Chancellor Tobacco Company, UK Ltd.
Commonwealth Brands, Inc.
Daughters & Ryan, Inc.
M/s. Dhanraj International[*]
Eastern Company S.A.E.
Ets L Lacroix Fils NV S.A. (Belgium)
Farmer's Tobacco Co. of Cynthiana, Inc.
General Jack's Incorporated
General Tobacco (VIBO Corporation d/b/a General Tobacco)[†]
House of Prince A/S
Imperial Tobacco Limited/ITL (USA) Limited
Imperial Tobacco Limited/ITL (UK)
Imperial Tobacco Mullingar (Ireland)
Imperial Tobacco Polska S.A. (Poland)
Imperial Tobacco Production Ukraine
Imperial Tobacco Sigara ve Tutunculuk Sanayi Ve Ticaret S.A. (Turkey)
International Tobacco Group (Las Vegas), Inc.
ITG Brands, LLC (formerly Lignum-2, Inc. and Lignum-2, LLC)
Japan Tobacco International USA, Inc.
King Maker Marketing
Konci G&D Management Group (USA) Inc.
Kretek International
Liberty Brands, LLC[*]
Liggett Group, LLC

Mac Baren Tobacco Company A/S
Monte Paz (Compania Industrial de Tabacos Monte Paz S.A.)
NASCO Products, LLC[††]
OOO Tabaksfacrik Reemtsma Wolga (Russia)
P.T. Djarum
Pacific Stanford Manufacturing Corporation
Peter Stokkebye Tobaksfabrik A/S
Planta Tabak-manufaktur Gmbh & Co.
Poschl Tabak GmbH & Co. KG
Premier Manufacturing Incorporated
Reemtsma Cigarettenfacbriken GmbH (Reemtsma)
Santa Fe Natural Tobacco Company, Inc.
Scandinavian Tobacco Group Lane Ltd. (formerly Lane Limited and Tobacco Exporters International (USA) Ltd.)
Sherman's 1400 Broadway N.Y.C. Inc.
Societe National d'Exploitation Industrielle des Tabacs et Allumettes (SEITA)
Tabacalera del Este, S.A. (TABESA)
Top Tobacco, LP
U.S. Flue-Cured Tobacco Growers, Inc.
Van Nelle Tabak Nederland B.V. (Netherlands)
Vector Tobacco Inc. (formerly Vector Tobacco Inc. and Medallion Company, Inc.)
Virginia Carolina Corporation, Inc.
Von Eicken Group
Wind River Tobacco Company, LLC
VIP Tobacco USA, LTD. (formerly Winner Sales Company)
ZNF International, LLC

[*] Has filed for bankruptcy relief.

[†] Ceased production of cigarettes and other tobacco products.

[††] Acquired by 22nd Century Group, Inc. in August 2014, with 22nd Century Group, Inc. and its subsidiaries reportedly becoming signatories to an adherence agreement to the MSA.

See "APPENDIX G—CERTAIN INFORMATION RELATING TO THE DOMESTIC TOBACCO INDUSTRY—Industry Overview" for a discussion of the proposed merger of Reynolds American and Lorillard, Inc., and the related asset acquisition by Imperial Tobacco, which the companies have stated their expectations of occurring in mid-2015.

The MSA restricts PMs from transferring their tobacco product brands, cigarette product formulas and cigarette businesses (unless they are being transferred exclusively for use outside the United States) to any entity that is not a PM under the MSA, unless the transferee agrees to assume the obligations of the transferring PM under the MSA related to such brands, formulas or businesses. The MSA expressly provides that the payment obligations of each PM are not the obligation or responsibility of any affiliate of such PM and, further, that the remedies, penalties or sanctions that may be imposed or assessed in connection with a breach or violation of the MSA will apply only to the PMs and not against any other person or entity. Obligations of the SPMs, to the extent that they differ from the obligations of the OPMs, are described below under "—Subsequent Participating Manufacturers".

Scope of Release

Under the MSA, the PMs and the other Released Parties (defined below) are released from:

- claims based on past conduct, acts or omissions (including any future damages arising therefrom) in any way relating to the use, sale, distribution, manufacture, development, advertising, marketing or health effects of, or exposure to, or research statements or warnings regarding, tobacco products; and

- monetary claims based on future conduct, acts or omissions in any way relating to the use of or exposure to tobacco products manufactured in the ordinary course of business, including future claims for reimbursement of healthcare costs.

This release is binding upon each Settling State and any of its past, present and future agents, officers acting in their official capacities, legal representatives, agencies, departments, commissions and divisions. The MSA is further stated to be binding on the following persons, to the full extent of the power of the signatories to the MSA to release past, present and future claims on their behalf: (i) any Settling State's subdivisions (political or otherwise, including, but not limited to, municipalities, counties, parishes, villages, unincorporated districts and hospital districts), public entities, public instrumentalities and public educational institutions; and (ii) persons or entities acting in a *parens patriae*, sovereign, quasi-sovereign, private attorney general, qui tam, taxpayer, or any other capacity, whether or not any of them participate in the MSA (a) to the extent that any such person or entity is seeking relief on behalf of or generally applicable to the general public in such Settling State or the people of such Settling State, as opposed solely to private or individual relief for separate and distinct injuries, or (b) to the extent that any such entity (as opposed to an individual) is seeking recovery of healthcare expenses (other than premium or capitation payments for the benefit of present or retired state employees) paid or reimbursed, directly or indirectly, by a Settling State. All such persons or entities are referred to collectively in the MSA as "**Releasing Parties**".

To the extent that the Attorney General of the State does not have the power or authority to bind any of the Releasing Parties in the State, the release of claims contemplated by the MSA may be ineffective as to the Releasing Parties and any amounts that become payable by the PMs on account of their claims, whether by way of settlement, stipulated judgment or litigated judgment, will trigger the Litigating Releasing Parties Offset. See "—Adjustments to Payments" below.

The release inures to the benefit of all PMs and their past, present and future affiliates, and the respective divisions, officers, directors, employees, representatives, insurers, lenders, underwriters, tobacco-related organizations, trade associations, suppliers, agents, auditors, advertising agencies, public relations entities, attorneys, retailers and distributors of any PM or any such affiliate (and the predecessors, heirs, executors, administrators, successors and assigns of each of the foregoing). They are referred to in the MSA individually as a "**Released Party**" and collectively as the "**Released Parties**". However, the term "Released Parties" does not include any person or entity (including, but not limited to, an affiliate) that is an NPM at any time after the MSA execution date, unless such person or entity becomes a PM.

Overview of Payments by the Participating Manufacturers; MSA Escrow Agent

The MSA requires that the PMs make several types of payments, including Initial Payments, Annual Payments and Strategic Contribution Fund Payments, as discussed below.* Annual Payments and Strategic Contribution Fund Payments are subject to various adjustments and offsets, some of which could be material. See "—Adjustments to Payments" and "—Subsequent Participating Manufacturers" below. Thus far, most of the PMs† have made Annual Payments for 2000 through and including 2014, and Strategic Contribution Fund Payments for 2008 through and including 2014, subject to certain withholdings and payments into the Disputed Payments Account under the MSA described in "RISK FACTORS—Potential Payment Decreases Under the Terms of the MSA" and "SUMMARY OF THE MSA—Potential Payment Decreases Under the Terms of the MSA". See "—Payments Made to Date" below.

Payments required to be made by the OPMs are calculated annually based on actual domestic shipments of cigarettes in the prior calendar year by reference to the OPMs' domestic shipment of cigarettes in 1997, with consideration under certain circumstances for the profitability of each OPM. Payments to be made by the SPMs are recalculated each year, based on the Market Share of each individual SPM in relation to the Market Share of the OPMs. For SPMs that became signatories to the MSA within 90 days of its execution, payments are recalculated each year based on the Market Share less the Base Share of such SPM in relation to the Market Share of the OPMs. See "—Subsequent Participating Manufacturers" below. Pursuant to an escrow agreement (the "**MSA Escrow Agreement**") established in conjunction with the MSA, the Annual Payments and Strategic Contribution Fund Payments are to be made to Citibank, N.A., as escrow agent (the "**MSA Escrow Agent**"), which in turn will disburse the funds to the parties entitled thereto. 43.43% of the State's portion of payments due under the MSA, the MOU and the ARIMOU which are made after the TSR Sale Date (and 43.43% of any Lump Sum Payments, Partial Lump Sum Payments and Total Lump Sum Payments made on and after the TSR Sale Date) has been sold to the Issuer pursuant to the Purchase and Sale Agreement, and the State has instructed the California Escrow Agent to make such payments directly to the Trustee.

Beginning with the payments due in the year 2000, PricewaterhouseCoopers LLP, the independent auditor under the MSA (the "**MSA Auditor**") has, among other things, calculated and determined the amount of all payments owed pursuant to the MSA, the adjustments, reductions and offsets thereto (and all resulting carry-forwards, if any), and the allocation of such payments, adjustments, reductions, offsets and carry-forwards among the PMs and among the Settling States. *This information is not publicly available and the MSA Auditor has agreed to maintain the confidentiality of all such*

[*] Other payments that are required to be made by the PMs, such as payments of attorneys' fees and payments to a national foundation established pursuant to the MSA are not allocated to the Settling States under the MSA and are not available to the bondholders, and consequently are not discussed herein.

[†] VIBO Corporation, Inc., d/b/a General Tobacco, ceased production of cigarettes in 2010 and has defaulted upon certain of its MSA payments. General Tobacco has stated that it will be unable to make any back payments it owes under the MSA.

information, except that the MSA Auditor may provide such information to PMs and the Settling States as set forth in the MSA.

Initial Payments

Initial Payments were made only by the OPMs; SPMs were not required to make Initial Payments. In December 1998, the OPMs collectively made an up-front Initial Payment of $2.40 billion. The 2000 Initial Payment, which had a scheduled base amount of $2.47 billion, was paid in December 1999 in the approximate amount of $2.13 billion due to various adjustments. The 2001 Initial Payment, which had a scheduled base amount of $2.55 billion, was paid in December 2000 in the approximate amount of $2.04 billion after taking into account various adjustments and an earlier overpayment. The 2002 Initial Payment, which had a scheduled base amount of $2.62 billion, was paid in December 2001, in the approximate amount of $1.89 billion after taking into account various adjustments and a deposit made to the Disputed Payments Account. Approximately $204 million, which was substantially all of the money previously deposited in the Disputed Payments Account for payment to the Settling States, was distributed to the Settling States with the Annual Payment due April 15, 2002. The 2003 Initial Payment, which had a scheduled base amount of $2.7 billion, was paid in December 2002 and January 2003, in the approximate amount of $2.14 billion after taking into account various adjustments. No Initial Payments were due after the 2003 Initial Payment.

Annual Payments

The OPMs and the SPMs are required to make Annual Payments on each April 15 in perpetuity. Most of the PMs made the first fifteen Annual Payments due April 15 in each of the years 2000 through 2014. The scheduled base amounts of the Annual Payments and the approximate amounts actually paid after application of adjustments discussed herein are set forth in the following table.

Annual Payments*

Year	Base Amount	Adjusted Payment†
2000	$4,500,000,000	$3,500,000,000
2001	5,000,000,000	4,100,000,000
2002	6,500,000,000	5,200,000,000
2003	6,500,000,000	5,100,000,000
2004	8,000,000,000	6,200,000,000
2005	8,000,000,000	6,300,000,000
2006	8,000,000,000	5,800,000,000
2007	8,000,000,000	6,000,000,000
2008	8,139,000,000	6,200,000,000
2009	8,139,000,000	6,300,000,000
2010	$8,139,000,000	$5,700,000,000
2011	8,139,000,000	5,400,000,000
2012	8,139,000,000	5,500,000,000
2013	8,139,000,000	6,700,000,000††
2014	8,139,000,000	Not Reported††
2015	8,139,000,000	
2016	8,139,000,000	
2017	8,139,000,000	
Thereafter	9,000,000,000	

* The Annual Payments from 2000 through 2014 have been made. Subsequent adjustments to Annual Payments for a given year may impact Annual Payments due in subsequent years.

† Amounts are approximated.

†† Includes adjustments resulting from the NPM Adjustment Settlement Term Sheet.

The respective portion of each base amount applicable to each OPM is calculated by multiplying the base amount by the OPM's Relative Market Share (as defined below) during the preceding calendar year. The base annual payments in the above table will be increased by at least the minimum 3% Inflation Adjustment, adjusted by the Volume Adjustment, reduced by the Previously Settled States Reduction, and further adjusted by the other adjustments described below. Each SPM has Annual Payment obligations under the MSA (separate from the payment obligations of the OPMs) according to its Market Share. However, any SPM that became a party to the MSA within 90 days after it became effective pays only if its Market Share exceeds the higher of its 1998 Market Share or 125% of its 1997 Market Share (such higher share, the "**Base Share**").

"**Relative Market Share**" is defined as an OPM's percentage share of the number of cigarettes shipped by all OPMs in or to the 50 states, the District of Columbia and Puerto Rico (defined hereafter as the "**United States**"), as measured by the OPM's reports of shipments to Management Science Associates, Inc. ("**MSAI**") (or any successor acceptable to all the OPMs and a majority of the attorneys general of the Settling States who are also members of the NAAG executive committee). The term "**cigarette**" is defined in the MSA to mean any product that contains nicotine, is intended to be burned, contains tobacco and is likely to be offered to, or purchased by, consumers as a cigarette and includes "roll-your-own" tobacco.

The base amounts shown in the table above are subject to the following adjustments applied in the following order:

- the Inflation Adjustment,
- the Volume Adjustment,
- the Previously Settled States Reduction,
- the Non-Settling States Reduction,
- the NPM Adjustment,
- the Offset for Miscalculated or Disputed Payments,
- the Litigating Releasing Parties Offset, and
- the Offset for Claims-Over.

Application of these adjustments resulted in a material reduction from the scheduled base amounts of the Annual Payments due from the PMs to the State for the years 2000 through 2014, as discussed below under the caption "—Payments Made to Date".

Strategic Contribution Fund Payments

The OPMs are also required to make Strategic Contribution Fund Payments on April 15 of each year from 2008 through 2017. The base amount of each Strategic Contribution Fund Payment is $861 million. The respective portion of each base amount applicable to each OPM is calculated by multiplying the base amount by the OPM's Relative Market Share during the preceding calendar year. The SPMs will be required to make Strategic Contribution Fund Payments if their Market Share increases above their respective Base Shares. See "—Subsequent Participating Manufacturers" below.

The base amounts of the Strategic Contribution Fund Payments are subject to the following adjustments applied in the following order:

- the Inflation Adjustment,
- the Volume Adjustment,
- the Non-Settling States Reduction,
- the NPM Adjustment,
- the Offset for Miscalculated or Disputed Payments,
- the Litigating Releasing Parties Offset, and
- the Offset for Claims-Over.

Application of these adjustments resulted in a material reduction from the scheduled base amounts of the Strategic Contribution Fund Payments due from the PMs to the State for the years 2008 through 2014, as discussed below under "—Payments Made to Date."

Adjustments to Payments

The base amounts of the Initial Payments were, and the Annual Payments and Strategic Contribution Fund Payments described above are, subject to certain adjustments to be applied sequentially and in accordance with formulas contained in the MSA.

Inflation Adjustment. The base amounts of the Annual Payments and Strategic Contribution Fund Payments are increased each year to account for inflation. The increase in each year will be 3% or a percentage equal to the percentage increase in the Consumer Price Index (the "**CPI**") (or such other similar measures as may be agreed to by the Settling States and the PMs) for the preceding year, whichever is greater (the "**Inflation Adjustment**"). The inflation adjustment percentages are compounded annually on a cumulative basis beginning in 1999 and were first applied in 2000.

Volume Adjustment. Each of the Initial Payments was, and each of the Annual Payments and Strategic Contribution Fund Payments is, increased or decreased by an adjustment which accounts for fluctuations in the number of cigarettes shipped by the OPMs in or to the United States (the "**Volume Adjustment**").

If the aggregate number of cigarettes shipped in or to the United States by the OPMs in any given year (the "**Actual Volume**") is greater than 475,656,000,000 cigarettes (the "**Base Volume**"), the base amount allocable to the OPMs is adjusted to equal the base amount (in the case of Annual Payments and Strategic Contribution Fund Payments, after application of the Inflation Adjustment) multiplied by a ratio, the numerator of which is the Actual Volume and the denominator of which is the Base Volume.

If the Actual Volume in a given year is less than the Base Volume, the base amount due from the OPMs (in the case of Annual Payments and Strategic Contribution Fund Payments, after application of the Inflation Adjustment) is decreased by 98% of the percentage by which the Actual Volume is less than the Base Volume, multiplied by such base amount. If, however, the aggregate operating income of the OPMs from sales of cigarettes in the United States during the year (the "**Actual Operating Income**") is greater than $7,195,340,000, as adjusted for inflation in accordance with the Inflation Adjustment (the "**Base Operating Income**"), all or a portion of the volume reduction is added back (the "**Income Adjustment**"). The amount by which the Actual Operating Income of the OPMs exceeds the Base Operating Income is multiplied by the percentage of the allocable shares under the MSA represented by Settling States in which State-Specific Finality has been reached and divided by four, then added to the payment due. However, in no case will the amount added back due to the increase in operating income exceed the amount deducted due to the decrease in domestic volume. Any add-back due to an increase in Actual Operating Income will be allocated among the OPMs on a pro rata basis in accordance with their respective increases in Actual Operating Income over 1997 Base Operating Income.

Previously Settled States Reduction. The base amounts of the Annual Payments (as adjusted by the Inflation Adjustment and the Volume Adjustment, if any) are subject to a reduction reflecting the four states that had settled with the OPMs prior to the adoption of the MSA (Florida, Minnesota, Mississippi and Texas) (the "**Previously Settled States Reduction**"). The Previously Settled States Reduction reduces by 12.4500000% each applicable payment on or before December 31, 2007, by 12.2373756% each applicable payment between January 1, 2008 and December 31, 2017, and by 11.0666667% each applicable payment on or after January 1, 2018. The SPMs are not entitled to any reduction pursuant to the Previously Settled States Reduction. Initial Payments were not, and Strategic Contribution Fund Payments are not, subject to the Previously Settled States Reduction.

PSS Credit Amendment. Most of the Settling States (not including the State; *but see* "—Potential Payment Decreases Under the Terms of the MSA—*NPM Adjustment—NPM Adjustment Settlement and Award*" below) have executed documentation approving an amendment to the MSA that would allow SPMs to elect to receive a reduction in their MSA payments in an amount equal to a percentage (100% or a lesser percentage, depending on the SPM's election and the number of years the amendment has been in effect) of the fees paid to Previously Settled States pursuant to state legislation in the Previously Settled States requiring tobacco product manufacturers that did not sign onto the Previously Settled State Settlements to pay a fee to such Previously Settled States (the "**PSS Credit Amendment**"). The PSS Credit Amendment would also provide for certain increases in the electing SPMs' MSA payments. Two Previously Settled States currently impose a fee on tobacco product manufacturers that did not sign onto the applicable state's Previously Settled State Settlement ($0.50 per pack of 20 cigarettes in Minnesota, and $0.27, adjusted for inflation, per pack of 20 cigarettes in Mississippi), and a third Previously Settled State, Texas, is currently enjoined from enforcing such a fee pending appeal of litigation, as discussed in "APPENDIX G—CERTAIN INFORMATION RELATING TO THE DOMESTIC TOBACCO INDUSTRY—Regulatory Issues—*Excise Taxes*." The PSS Credit Amendment is not currently in effect, because by its terms it will only take effect if and when all Settling States having aggregate Allocable Shares equal to at least 99.937049% (the equivalent of the aggregate Allocable Share of the 46 states that are Settling States), and all OPMs and Commonwealth Brands, Inc., have executed the PSS Credit Amendment. No assurance can be given as to if or when the PSS Credit Amendment will take effect. Further, no assurance can be given as to whether the PSS Credit Amendment will reduce the amount of Pledged TSRs available to the Issuer to pay debt service on the Series 2015A Bonds. See "SECURITY FOR THE BONDS—Consent to Amendments to Indenture and Purchase and Sale Agreement," "THE PURCHASE AND SALE AGREEMENT—Non-Impairment Covenant of the State" and "THE INDENTURE—Non-Impairment Covenant of the State" herein. See also "RISK FACTORS—Other Risks Relating to the MSA and Related Statutes—*Amendments, Waivers and Termination*" and "—*Reliance on State Enforcement of the MSA and State Impairment*."

Non-Settling States Reduction. In the event that the MSA terminates as to any Settling State, the remaining Annual Payments and Strategic Contribution Fund Payments, if any, due from the PMs shall be reduced to account for the absence of such state. This adjustment has no effect on the amounts to be collected by states that remain a party to the MSA, and the reduction is therefore not detailed.

Non-Participating Manufacturers Adjustment. The "**NPM Adjustment**" is based upon market share increases, measured by domestic sales of cigarettes by NPMs, and operates to reduce the payments of the PMs under the MSA in the event that the PMs incur losses in Market Share to NPMs during a calendar year as a result of the MSA. Under the MSA, three conditions must be met in order to trigger an NPM Adjustment: (1) the aggregate Market Share of the PMs in any year must fall more than 2% below the aggregate Market Share held by those same PMs in 1997, (2) a nationally recognized firm of economic consultants must determine that the disadvantages experienced as a result of the provisions of the MSA were a significant factor contributing to the Market Share loss for the year in question, and (3) the Settling States in question must fail to prove that they have diligently enforced their Model Statutes. The NPM Adjustment is applied to the subsequent year's Annual Payment and Strategic Contribution Fund Payment and the decrease in total funds available as a result of the NPM Adjustment is then allocated on a pro rata basis among those Settling States that have been found (i) to not diligently enforce their Qualifying Statutes, or (ii) to have enacted the Model Statute or a Qualifying Statute that is declared invalid or unenforceable by a court of competent jurisdiction. The 1997 Market Share percentage for the PMs, less 2%, is defined in the MSA as the "**Base Aggregate Participating Manufacturer Market Share**". If the PMs' actual aggregate Market Share is between 0% and 16⅔%

less than the Base Aggregate Participating Manufacturer Market Share, the amounts paid by the PMs would be decreased by three times the percentage decrease in the PMs' actual aggregate Market Share. If, however, the aggregate Market Share loss from the Base Aggregate Participating Manufacturer Market Share is greater than 16 ⅔%, the NPM Adjustment will be calculated as follows:

$$\text{NPM Adjustment} = 50\% + \\ [50\% / (\text{Base Aggregate Participating Manufacturer Market Share} - 16\tfrac{2}{3}\%)] \\ \text{x } [\text{market share loss} - 16\tfrac{2}{3}\%]$$

Regardless of how the NPM Adjustment is calculated, it is always subtracted from, and may not exceed, the total Annual Payments and Strategic Contribution Fund Payments due from the PMs in any given year. The NPM Adjustment for any given year for a specific state cannot exceed the amount of Annual Payments and Strategic Contribution Fund Payments due to such state. The NPM Adjustment does not apply at all if the number of cigarettes shipped in or to the United States in the year prior to the year in which the payment is due by all manufacturers that were PMs prior to December 7, 1998 exceeds the number of cigarettes shipped in or to the United States by all such PMs in 1997.

The NPM Adjustment is also state-specific, in that a Settling State may avoid or mitigate the effects of an NPM Adjustment by enacting and diligently enforcing the Model Statute or a Qualifying Statute. Any Settling State that adopts and diligently enforces the Model Statute or a Qualifying Statute is exempt from the NPM Adjustment. The State has adopted the Model Statute, which is a Qualifying Statute. See "—California Qualifying Statute" below. The decrease in total funds available due to the NPM Adjustment is allocated on a pro rata basis among those Settling States that either (i) did not enact and diligently enforce a Model Statute or Qualifying Statute, or (ii) enacted a Model Statute or a Qualifying Statute that is declared invalid or unenforceable by a court of competent jurisdiction. If a Settling State enacts and diligently enforces a Qualifying Statute that is a Model Statute but it is declared invalid or unenforceable by a court of competent jurisdiction, the NPM Adjustment for any given year will not exceed 65% of the amount of such state's allocated payment for the subsequent year. If a Qualifying Statute that is not the Model Statute is held invalid or unenforceable, however, such state is not entitled to any protection from the NPM Adjustment. Moreover, if a state adopts the Model Statute or a Qualifying Statute but then repeals it or amends it in such fashion that it is no longer a Qualifying Statute, then such state will no longer be entitled to any protection from the NPM Adjustment. A state's protection from the NPM Adjustment is conditioned upon the diligent enforcement of its Model Statute or Qualifying Statute, as the case may be. See "RISK FACTORS—Potential Payment Decreases Under the Terms of the MSA" above and "SUMMARY OF THE MSA—Potential Payment Decreases Under the Terms of the MSA—*NPM Adjustment*" and "—MSA Provisions Relating to Model/Qualifying Statutes" below. See also "—'Most Favored Nation' Provisions" below.

For a discussion of the terms of the partial settlement regarding the NPM Adjustment, which the State joined, as well as arbitration decisions regarding the 2003 NPM Adjustment for those jurisdictions that did not join the settlement, see "—Potential Payment Decreases Under the Terms of the MSA—*NPM Adjustment—NPM Adjustment Settlement and Award*" and "*—2003 NPM Adjustment Arbitration Results*" below.

Offset for Miscalculated or Disputed Payments. If the MSA Auditor receives notice of a miscalculation of an Annual Payment made by a PM within four years, or a Strategic Contribution Fund Payment made by a PM within four years, the MSA Auditor will recalculate the payment and make provisions for rectifying the error (the "**Offset for Miscalculated or Disputed Payments**"). There are no time limits specified for recalculations although the MSA Auditor is required to determine amounts promptly. Disputes as to determinations by the MSA Auditor may be submitted to binding arbitration governed by the Federal Arbitration Act. In the event that mispayments have been made, they will be corrected through payments with interest (in the event of underpayments) or withholdings with interest (in the event of overpayments). Interest will be at the prime rate, except where a party fails to pay undisputed amounts or fails to provide necessary information readily available to it, in which case a penalty rate of prime plus 3% applies. If a PM disputes any required payment, it must determine whether any portion of the payment is undisputed and pay that amount for disbursement to the Settling States. The disputed portion may be paid into the Disputed Payments Account pending resolution of the dispute, or may be withheld. Failure to pay such disputed amounts into the Disputed Payments Account can result in liability for interest at the penalty rate if the disputed amount was in fact properly due and owing. See "RISK FACTORS—Potential Payment Decreases Under the Terms of the MSA".

Litigating Releasing Parties Offset. If any Releasing Party initiates litigation against a PM for any of the claims released in the MSA, the PM may be entitled to an offset against such PM's payment obligation under the MSA (the "**Litigating Releasing Parties Offset**"). A defendant PM may offset dollar-for-dollar any amount paid in settlement, stipulated judgment or litigated judgment against the amount to be collected by the applicable Settling State under the MSA only if the PM has taken all ordinary and reasonable measures to defend that action fully and only if any settlement or stipulated judgment was consented to by the state attorney general. The Litigating Releasing Parties Offset is state-specific. Any reduction in MSA payments as a result of the Litigating Releasing Parties Offset would apply only to the Settling State of the Releasing Party.

Offset for Claims-Over. If a Releasing Party pursues and collects on a released claim against an NPM or a retailer, supplier or distributor arising from the sale or distribution of tobacco products of any NPM or the supply of component parts of tobacco products to any NPM (collectively, the "**Non-Released Parties**"), and the Non-Released Party in turn successfully pursues a claim for contribution or indemnification against a Released Party (as defined herein), the Releasing Party must (i) reduce or credit against any judgment or settlement such Releasing Party obtains against the Non-Released Party the full amount of any judgment or settlement such Non-Released Party may obtain against the Released Party, and (ii) obtain from such Non-Released Party for the benefit of such Released Party a satisfaction in full of such Non-Released Party's judgment or settlement against the Released Party. In the event that such reduction or satisfaction in full does not fully relieve the Released Party of its duty to pay to the Non-Released Party, the PM is entitled to a dollar-for-dollar offset from its payment to the applicable Settling State (the "**Offset for Claims-Over**"). For purposes of the Offset for Claims-Over, any person or entity that is enumerated in the definition of Releasing Party set forth above is treated as a Releasing Party without regard to whether the applicable attorney general had the power to release claims of such person or entity. The Offset for Claims-Over is state-specific and would apply only to MSA payments owed to the Settling State of the Releasing Party.

Subsequent Participating Manufacturers

SPMs are obligated to make Annual Payments and Strategic Contribution Fund Payments, which are made at the same times as the Annual Payments and Strategic Contribution Fund Payments to be made by OPMs. Annual Payments and Strategic Contribution Fund Payments for SPMs are calculated differently, however, from Annual Payments and Strategic Contribution Fund Payments for OPMs. Each SPM's payment obligation is determined according to its Market Share if, and only if, its "**Market Share**" (defined in the MSA to mean a manufacturer's share, expressed as a percentage, of the total number of cigarettes sold in the United States in a given year, as measured by excise taxes (or similar taxes, in the case of Puerto Rico)), for the year preceding the payment exceeds its Base Share. If an SPM executes the MSA after February 22, 1999 (i.e., 90 days after the effective date of the MSA), its Base Share is deemed to be zero. Fourteen of the current 52 SPMs signed the MSA on or before the February 22, 1999 deadline.

For each Annual Payment and Strategic Contribution Fund Payment, each SPM is required to pay an amount equal to the base amount of the Annual Payment and the Strategic Contribution Fund Payment owed by the OPMs, collectively, adjusted for the Volume Adjustment described above but prior to any other adjustments, reductions or offsets, multiplied by (i) the difference between that SPM's Market Share for the preceding year and its Base Share, divided by (ii) the aggregate Market Share of the OPMs for the preceding year. Other than the application of the Volume Adjustment, payments by the SPMs are also subject to the same adjustments (including the Inflation Adjustment), reductions and offsets as are the payments made by the OPMs, with the exception of the Previously Settled States Reduction.

Because the Annual Payments and Strategic Contribution Fund Payments to be made by the SPMs are calculated in a manner different from the calculations for Annual Payments and Strategic Contribution Fund Payments to be made by the OPMs, a change in Market Share between the OPMs and the SPMs could cause the amount of Annual Payments and Strategic Contribution Fund Payments required to be made by the PMs in the aggregate to be greater or less than the amount that would be payable if their Market Share remained the same.

Payments Made to Date

As required, the OPMs have made all of the Initial Payments, and most PMs have made Annual Payments since 2000 and Strategic Contribution Fund Payments since 2008, and the MSA Escrow Agent has disbursed the State's allocable portions thereof and certain other amounts under the MSA totaling approximately $12.655 billion to the State, according to NAAG as of June 24, 2014, which amount is inclusive of payments to the Participating Jurisdictions. Under the MSA, the computation of Annual Payments and Strategic Contribution Fund Payments by the MSA Auditor under the MSA is confidential and may not be used for purposes other than those stated in the MSA. The following table sets forth the State's share of unadjusted payments due to the State pursuant to the MSA, as modified by the MOU and the ARIMOU, and the amounts actually received by the State (or the Trustee, as applicable), which may reflect adjustments attributable to prior years' payments.

(Remainder of Page Intentionally Left Blank)

Payments Made to Date*

	State of California Unadjusted Allocable Share of MSA Base Payment Amount, as Modified by the MOU and ARIMOU†	Actual Receipts†(1)
Up-Front Initial Payment	**$153.2 million**	**$157.1 million (2)**
2000 Initial Payment	**157.6 million**	**137.3 million (2)**
2001 Initial Payment	**162.7 million**	**123.6 million (2)**
2002 Initial Payment	**167.2 million**	**127.9 million (2)**
2003 Initial Payment	**172.3 million**	**136.6 million (2)**
2000 Annual Payment	**$287.2 million**	**$220.7 million (2)**
2001 Annual Payment	**319.1 million**	**262.7 million (2)**
2002 Annual Payment	**414.8 million**	**350.3 million (2)**
2003 Annual Payment	**414.8 million**	**341.5 million (2)**
2004 Annual Payment	**510.6 million**	**401.2 million (3)**
2005 Annual Payment	**510.6 million**	**402.4 million (3)**
2006 Annual Payment	**510.6 million**	**372.2 million (3)**
2007 Annual Payment	**510.6 million**	**387.4 million (3)**
2008 Annual Payment	**519.4 million**	**416.1 million (3)**
2009 Annual Payment	**519.4 million**	**457.2 million (3)**
2010 Annual Payment	**519.4 million**	**381.2 million (3)**
2011 Annual Payment	**519.4 million**	**360.8 million (3)**
2012 Annual Payment	**519.4 million**	**367.9 million (3)**
2013 Annual Payment	**519.4 million**	**533.4 million (3)(4)**
2014 Annual Payment	**519.4 million**	**345.9 million (3)(4)**
2008 Strategic Contribution Fund Payment	**$22.3 million**	**$20.5 million (3)**
2009 Strategic Contribution Fund Payment	**22.3 million**	**21.0 million (3)**
2010 Strategic Contribution Fund Payment	**22.3 million**	**18.2 million (3)**
2011 Strategic Contribution Fund Payment	**22.3 million**	**16.6 million (3)**
2012 Strategic Contribution Fund Payment	**22.3 million**	**16.9 million (3)**
2013 Strategic Contribution Fund Payment	**22.3 million**	**22.2 million (3)(4)**
2014 Strategic Contribution Fund Payment	**22.3 million**	**17.4 million (3)(4)**

* The amounts in this table "Payments Made to Date" reflect the State's base payment amounts and actual receipts, which, in accordance with the MOU and the ARIMOU, represent 50% of the total amounts allocated to California under the MSA and are exclusive of the 50% allocated to the Participating Jurisdictions. However, the amounts in this table are inclusive of amounts pledged to the Series 2007 Trustee; accordingly, the Series 2015A Bonds, the Series 2013A Bonds and the Series 2005A Bonds are secured by 43.43% of the amounts in this table.

† Rounded.

(1) As reported by the State and the Issuer, to the best of the State's and the Issuer's knowledge, as applicable, amounts reflect the State's and the Issuer's (as applicable) actual receipts after applicable adjustments or disputes. Any subsequent recalculation is reflected in the period that it impacted the State's or the Issuer's receipts, as applicable. Accordingly, actual receipts in any year may include payments attributable to prior years as a result of adjustments or disputes regarding such prior years.

(2) Received by the State.

(3) Received by the Issuer.

(4) Reflects amounts released to the State from the Disputed Payments Account and credits to the PMs in accordance with the NPM Adjustment Settlement Term Sheet, as discussed herein.

The terms of the MSA relating to such payments and various adjustments thereto are described above under the captions "—Initial Payments", "—Annual Payments", "—Strategic Contribution Fund Payments" and "—Adjustment to Payments". One or more of the PMs are disputing or have disputed the calculations of some of the Initial Payments for the years 2000 through 2003, some of the Annual Payments for the years 2000 through 2014 and some of the Strategic Contribution Fund Payments for the years 2008 through 2014. See "—Potential Payment Decreases Under the Terms of the MSA." In addition, subsequent revisions in the information delivered to the MSA Auditor (on which the MSA Auditor's calculations of the Initial Payments, Annual Payments and Strategic Contribution Fund

Payments are based) have in the past and may in the future result in a recalculation of the payments shown above. Such revisions may also result in routine recalculation of future payments. No assurance can be given as to the magnitude of any such recalculation and such recalculation could trigger the Offset for Miscalculated or Disputed Payments.

"Most Favored Nation" Provisions

In the event that any non-foreign governmental entity other than the federal government should reach a settlement of released claims with PMs that provides more favorable terms to the governmental entity than does the MSA to the Settling States, the terms of the MSA will be modified to match those of the more favorable settlement. Only the non-economic terms may be considered for comparison.

In the event that any Settling State should reach a settlement of released claims with NPMs that provides more favorable terms to the NPMs than the MSA does to the PMs, or relieves in any respect the obligation of any PM to make payments under the MSA, the terms of the MSA will be deemed modified to match the NPM settlement or such payment terms, but only with respect to the particular Settling State. In no event will the adjustments discussed in this paragraph modify the MSA with regard to other Settling States. See "RISK FACTORS—Potential Payment Decreases Under the Terms of the MSA."

State-Specific Finality and Final Approval

The MSA provides that payments could not be disbursed to the individual Settling States until the occurrence of each of two events: State-Specific Finality and Final Approval.

"**State-Specific Finality**" means, with respect to an individual Settling State, that (i) such state has settled its pending or potential litigation against the tobacco companies with a consent decree, which decree has been approved and entered by a court within the Settling State and (ii) the time for all appeals against the consent decree has expired. All Settling States have achieved State-Specific Finality. State-Specific Finality for the State was achieved on October 28, 1999.

"**Final Approval**" marks the approval of the MSA by the Settling States and means the earlier of (i) the date on which at least 80% of the Settling States, both in terms of number and dollar volume entitlement to the proceeds of the MSA, have reached State-Specific Finality, or (ii) June 30, 2000. Final Approval was achieved on November 12, 1999.

Disbursement of Funds from Escrow

The MSA Auditor makes all calculations necessary to determine the amounts to be paid by each PM, as well as the amounts to be disbursed to each of the Settling States. Not less than 40 days prior to the date on which any payment is due, the MSA Auditor must provide copies of the disbursement calculations to all parties to the MSA, who must within 30 days prior to the date on which such payment is due advise the other parties if it questions or challenges the calculations. The final calculation is due from the MSA Auditor not less than 15 days prior to the payment due date. The calculation is subject to further adjustments if previously missing information is received. In the event of a challenge to the calculations, the non-challenged part of a payment shall be processed in the normal course. Challenges will be submitted to binding arbitration. The information provided by the MSA Auditor to the State with respect to calculations of amounts to be paid by PMs is confidential under the terms of the MSA and may not be disclosed to the Issuer or the Owners.

Disbursement of the funds by the MSA Escrow Agent from the escrow accounts shall occur within ten business days of receipt of the particular funds. The MSA Escrow Agent will disburse the funds due to, or as directed by, each Settling State in accordance with instructions received from that state.

Advertising and Marketing Restrictions; Educational Programs

The MSA prohibits the PMs from certain advertising, marketing and other activities that may promote the sale of cigarettes and smokeless tobacco products ("**Tobacco Products**"). Under the MSA, the PMs are generally prohibited from targeting persons under 18 years of age within the Settling States in the advertising, promotion or marketing of Tobacco Products and from taking any action to initiate, maintain or increase smoking by underage persons within the Settling States. Specifically, the PMs may not: (i) use any cartoon characters in advertising, promoting, packaging or labeling Tobacco Products; (ii) distribute any free samples of Tobacco Products except in a restricted facility where the operator thereof is able to ensure that no underage persons are present; or (iii) provide to any underage person any item in exchange for the purchase of Tobacco Products or for the furnishing of proofs-of-purchase coupons. The PMs are also prohibited from placing any new outdoor and transit advertising, and are committed to remove any existing outdoor and transit advertising for Tobacco Products in the Settling States. Other examples of prohibited activities include, subject to limited exceptions: (i) the sponsorship of any athletic, musical, artistic or other social or cultural event in exchange for the use of tobacco brand names as part of the event; (ii) the making of payments to anyone to use, display, make reference to or use as a prop any Tobacco Product or item bearing a tobacco brand name in any motion picture, television show, theatrical production, music performance, commercial film or video game; and (iii) the sale or distribution in the Settling States of any non-tobacco items containing tobacco brand names or selling messages.

In addition, the OPMs have agreed under the MSA to provide funding for the organization and operation of a charitable foundation (the "**Foundation**") and educational programs to be operated within the Foundation. The main purpose of the Foundation will be to support programs to reduce the use of Tobacco Products by underage persons and to prevent diseases associated with the use of Tobacco Products. Each OPM may be required to pay its Relative Market Share of $300,000,000 on April 15, 2004, and on April 15 of each year thereafter (as adjusted by the Inflation Adjustment, the Volume Adjustment and the offset for miscalculated or disputed payments) in perpetuity if, during the year preceding the year when payment is due, the sum of the Market Shares of the OPMs equals or exceeds 99.05%. The Foundation may also be funded by contributions made by other entities.

Remedies upon the Failure of a PM to Make a Payment

Each PM is obligated to pay when due the undisputed portions of the total amount calculated as due from it by the MSA Auditor's final calculation. Failure to pay such portion shall render the PM liable for interest thereon from the date such payment is due to (but not including) the date paid at the prime rate published from time to time by The Wall Street Journal or, in the event The Wall Street Journal is no longer published or no longer publishes such rate, an equivalent successor reference rate determined by the MSA Auditor, plus three percentage points. In addition, any Settling State may bring an action in court to enforce the terms of the MSA. Before initiating such proceeding, the Settling State is required to provide thirty (30) days' written notice to the attorney general of each Settling State, to NAAG and to each PM of its intent to initiate proceedings.

Termination of Agreement

The MSA is terminated as to a Settling State if (i) the MSA or consent decree in that jurisdiction is disapproved by a court and the time for an appeal has expired, the appeal is dismissed or the disapproval is affirmed, or (ii) the representations and warranties of the attorney general of that jurisdiction relating to the ability to release claims are breached or not effectively given. In addition, in the event that a PM enters bankruptcy and fails to perform its financial obligations under the MSA, the Settling States, by vote of at least 75% of the Settling States, both in terms of number and of entitlement to the proceeds of the MSA, may terminate certain financial obligations of that particular manufacturer under the MSA.

The MSA provides that if it is terminated, then the statute of limitations with respect to released claims will be tolled from the date the Settling State signed the MSA until the later of the time permitted by applicable law or one year from the date of termination and the parties will jointly move for the reinstatement of the claims and actions dismissed pursuant to the MSA. The parties will return to the positions they were in prior to the execution of the MSA.

Severability

By its terms, most of the major provisions of the MSA are not severable from its other terms. If a court materially modifies, renders unenforceable or finds unlawful any non-severable provision, the attorneys general of the Settling States and the OPMs are to attempt to negotiate substitute terms. If any OPM does not agree to the substitute terms, the MSA terminates in all Settling States affected by the court's ruling.

Amendments and Waivers

The MSA may be amended by all PMs and Settling States affected by the amendment. The terms of any amendment will not be enforceable against any Settling State which is not a party to the amendment. Any waiver will be effective only against the parties to such waiver and only with respect to the breach specifically waived.

MSA Provisions Relating to Model/Qualifying Statutes

General

The MSA sets forth the schedule and calculation of payments to be made by OPMs to the Settling States. As described above, the Annual Payments and Strategic Contribution Fund Payments are subject to, among other adjustments and reductions, the NPM Adjustment, which may reduce the amount of money that a Settling State receives pursuant to the MSA. The NPM Adjustment will reduce payments of a PM if such PM experiences certain losses of Market Share in the United States in a particular year as a result of participation in the MSA and any of the Settling States fail to prove that they have diligently enforced their Qualifying Statutes in such year.

Settling States may eliminate or mitigate the effect of the NPM Adjustment by taking certain actions, including the adoption and diligent enforcement of a statute, law, regulation or rule (a "**Qualifying Statute**" or "**Escrow Statute**") which eliminates the cost disadvantages that PMs' experience in relation to NPMs as a result of the provisions of the MSA. "Qualifying Statute", as defined in Section IX(d)(2)(E) of the MSA, means a statute, regulation, law, and/or rule adopted by a Settling State that "effectively and fully neutralizes the cost disadvantages that PMs experience vis-à-vis NPMs within such Settling State as a result of the provisions of the MSA". Exhibit T to the MSA sets forth a model form of Qualifying Statute (a "**Model Statute**") that will qualify as a Qualifying Statute so long as the statute is enacted without modification or addition (except for particularized state procedural or technical requirements) and is not enacted in conjunction with any other legislative or regulatory proposal. The State has enacted the Model Statute, which is a Qualifying Statute. The MSA also provides a procedure by which a Settling State may enact a statute that is not the Model Statute and receive a determination from a nationally recognized firm of economic consultants that such statute is a Qualifying Statute. See "RISK FACTORS—Potential Payment Decreases under the Terms of the MSA" and "—If Litigation Challenging the MSA, the Qualifying Statutes and Related Legislation Were Successful, Payments under the MSA Might be Suspended or Terminated".

If a Settling State continuously has a Qualifying Statute in full force and effect and diligently enforces the provisions of such statute, the MSA states that the payments allocated to such Settling State will not be subject to a reduction due to the NPM Adjustment. Furthermore, the MSA dictates that the aggregate amount of the NPM Adjustment is to be allocated, in a pro rata manner, among all Settling States that do not adopt and diligently enforce a Qualifying Statute. In addition, if the NPM Adjustment allocated to a particular Settling State exceeds its allocated payment, the excess is to be reallocated equally among the remaining Settling States that have not adopted and diligently enforced a Qualifying Statute. Thus, Settling States that do not adopt and diligently enforce a Qualifying Statute will receive reduced allocated payments if an NPM Adjustment is in effect. The MSA provides an economic incentive for most states to adopt and diligently enforce a Qualifying Statute.

The MSA provides that if a Settling State enacts a Qualifying Statute that is the Model Statute and uses its best efforts to keep the Model Statute in effect, but a court invalidates the statute, then, although that state remains subject to the NPM Adjustment, the NPM Adjustment is limited to no more, on a yearly basis, than 65% of the amount of such state's allocated payment (including reallocations described above). The determination from a nationally recognized firm of economic consultants that a statute constitutes a Qualifying Statute is subject to reconsideration in certain circumstances and such statute may later be deemed not to constitute a Qualifying Statute. In the event that a Qualifying Statute that is not the Model Statute is invalidated or declared unenforceable by a court, or, upon reconsideration by a nationally recognized firm of economic consultants, is determined not to be a Qualifying Statute, the Settling State that adopted such statute will become fully subject to the NPM Adjustment. Moreover, if a state adopts the Model Statute or a Qualifying Statute but then repeals it or amends it in such fashion that it is no longer a Qualifying Statute, then such state will no longer be entitled to any protection from the NPM Adjustment. A state's protection from the NPM Adjustment is conditioned upon the diligent enforcement of its Model Statute or Qualifying Statute, as the case may be.

For a discussion of the terms of the partial settlement regarding the NPM Adjustment, which the State joined, as well as State's amendment to its Qualifying Statute in furtherance of the settlement, see "—Potential Payment Decreases Under the Terms of the MSA—*NPM Adjustment—NPM Adjustment Settlement and Award*" and "—California Qualifying Statute", respectively, below.

Summary of the Model Statute

One of the objectives of the MSA (as set forth in the Findings and Purpose section of the Model Statute) is to shift the financial burdens of cigarette smoking from the Settling States to the tobacco product manufacturers. The Model Statute provides that any tobacco manufacturer who does not join the MSA will be subject to the provisions of the Model Statute because, as provided under the MSA,

> [i]t would be contrary to the policy of the state if tobacco product manufacturers who determine not to enter into such a settlement could use a resulting cost advantage to derive large, short-term profits in the years

> before liability may arise without ensuring that the state will have an eventual source of recovery from them if they are proven to have acted culpably. It is thus in the interest of the state to require that such manufacturers establish a reserve fund to guarantee a source of compensation and to prevent such manufacturers from deriving large, short-term profits and then becoming judgment-proof before liability may arise.

Accordingly, pursuant to the Model Statute, a tobacco manufacturer that is an NPM under the MSA must deposit an amount for each cigarette that constitutes a "unit sold" into an escrow account (which amount increases on a yearly basis, as set forth in the Model Statute).

The amounts deposited into the escrow accounts by the NPMs may only be used in limited circumstances. Although the NPM receives the interest or other appreciation on such funds, the principal may only be released (i) to pay a judgment or settlement on any claim of the type that would have been released by the MSA brought against such NPM by the applicable Settling State or any Releasing Party located within such state; (ii) with respect to Settling States that have enacted and have in effect Allocable Share Release Amendments (described in the next paragraph), to the extent that the NPM establishes that the amount it was required to deposit into the escrow account was greater than the total payments that such NPM would have been required to make if it had been a PM under the MSA (as determined before certain adjustments or offsets) or, with respect to Settling States that do not have in effect such Allocable Share Release Amendments, to the extent that the NPM establishes that the amount it was required to deposit into the escrow account was greater than such state's allocable share of the total payments that such NPM would have been required to make if it had been a PM under the MSA (as determined before certain adjustments or offsets); or (iii) 25 years after the date that the funds were placed into escrow (less any amounts paid out pursuant to (i) or (ii)).

The Model Statute, in its original form, required an NPM to make escrow deposits approximately in the amount that the NPM would have had to pay to all of the states had it been a PM and further authorized the NPM to obtain from the applicable Settling State the release of the amount by which the escrow deposit in that state exceeded that state's allocable share of the total payments that the NPM would have made as a PM. In recent years legislation has been enacted in the State and all of the other Settling States except Missouri to amend the Qualifying or Model Statutes in those states by eliminating the reference to the allocable share and limiting the possible release an NPM may obtain under the Model Statute to the excess above the total payment that the NPM would have paid for its cigarettes had it been a PM (each an "**Allocable Share Release Amendment**"). NAAG has endorsed these legislative efforts. A majority of the PMs, including all OPMs, have indicated their agreement in writing that in the event a Settling State enacts legislation substantially in the form of the model Allocable Share Release Amendment, such Settling State's previously enacted Model Statute or Qualifying Statute will continue to constitute the Model Statute or a Qualifying Statute within the meaning of the MSA.

If the NPM fails to place funds into escrow as required, the attorney general of the applicable Settling State may bring a civil action on behalf of the state against the NPM. If a court finds that an NPM violated the statute, it may impose civil penalties in the following amounts: (i) an amount not to exceed 5% of the amount improperly withheld from escrow per day of the violation and in an amount not to exceed 100% of the original amount improperly withheld from escrow; (ii) in the event of a knowing violation, an amount not to exceed 15% of the amount improperly withheld from escrow per day of the violation and in an amount not to exceed 300% of the original amount improperly withheld from escrow; and (iii) in the event of a second knowing violation, the court may prohibit the NPM from selling cigarettes to consumers within such state (whether directly or through a distributor, retailer or similar intermediary) for a period not to exceed two years. NPMs include foreign tobacco manufacturers that intend to sell cigarettes in the United States that do not themselves engage in an activity in the United States but may not include the wholesalers of such cigarettes. However, enforcement of the Model Statute against such foreign manufacturers that do not do business in the United States may be difficult. See "RISK FACTORS—If Litigation Challenging the MSA, the Qualifying Statutes and Related Legislation Were Successful, Payments under the MSA Might be Suspended or Terminated".

Complementary Legislation

At least 45 Settling States (including the State) have passed legislation (often termed "**Complementary Legislation**") to further ensure that NPMs are making escrow payments required by the states' respective Qualifying Statutes, as well as other legislation to assist in the regulation of tobacco sales. See "—California Complementary Legislation" below.

All of the OPMs and other PMs have provided written assurances that the Settling States have no duty to enact Complementary Legislation, that the failure to enact such legislation will not be used in determining whether a Settling State has diligently enforced its Qualifying Statute pursuant to the terms of the MSA, and that diligent enforcement obligations under the MSA shall not apply to the Complementary Legislation. In addition, the written assurances contain an agreement that the Complementary Legislation will not constitute an amendment to a Settling State's Qualifying Statute. However, a determination that a Settling State's Complementary Legislation is invalid may make enforcement of its Qualifying Statute more difficult, which could lead to an increase in the market share of NPMs, resulting in a reduction of Annual Payments and Strategic Contribution Fund Payments under the MSA. The Qualifying Statutes and related Complementary Legislation in many Settling States have been challenged on various constitutional grounds, including claims based on preemption by the federal antitrust laws. See "—Litigation Challenging the MSA, the Qualifying Statutes and Related Legislation" and "—MSA Provisions Relating to Model/Qualifying Statutes".

California Qualifying Statute

By letter dated June 18, 1999, counsel for the OPMs notified the State that SB 822, the bill which contained the State's escrow statute, was, if enacted without change, a Qualifying Statute and a Model Statute within the meaning of the MSA. Such bill was enacted without change on October 10, 1999 as the State's Qualifying Statute, in Division 103, Part 3, Chapter 1, Sections 104555 et seq. of the California Health and Safety Code. The State's Qualifying Statute is the Model Statute in the form attached to the MSA as Exhibit T, with certain modifications approved by the OPMs. By letter dated January 19, 2000, counsel to the OPMs confirmed that the OPMs will not dispute that the State's Qualifying Statute constitutes a Model Statute under the MSA.

In 2003, the State enacted an Allocable Share Release Amendment to amend Section 104557 of the Health and Safety Code. The amendment changed the release calculation from being based on the State's allocable share of the payments the NPM would have made if it were a signatory to the MSA to being based on the payments that the NPM would have made as a signatory to the MSA on account of units sold in the State by the NPM. A majority of the PMs, including all three OPMs, had indicated in writing that in the event a Settling State enacted legislation substantially in the form of the Model Allocable Share Release Amendment, the Settling State's previously enacted Qualifying Statute would continue to constitute a Model Statute and a Qualifying Statute within the meaning of the MSA. The State's Allocable Share Release Amendment was in the form of the Model Allocable Share Release Amendment. In 2013, in furtherance of the NPM Adjustment Settlement Term Sheet and NPM Adjustment Stipulated Partial Settlement and Award, the State amended the definition of "**units sold**" in the State's Qualifying Statute to be "the number of individual cigarettes sold to a consumer in the state by the applicable tobacco product manufacturer, whether directly or through a distributor, retailer, or similar intermediary or intermediaries, during the year in question, regardless of whether the state excise tax was due or collected" (with the definition further providing that "units sold" does not include "cigarettes sold on federal military installations, sold by a Native American tribe to a member of that tribe on that tribe's land, or that are otherwise exempt from state excise tax pursuant to federal law"). The State received letters from counsels to the OPMs and certain SPMs to the effect that such amendment does not affect the status of the State's Qualifying Statute as a Qualifying Statute under the MSA. See "RISK FACTORS—Other Risks Relating to the MSA and Related Statutes—*Amendment to the State's Qualifying Statute*" and "LEGAL CONSIDERATIONS—MSA and Qualifying Statute Enforceability."

Pursuant to Section 104557 of the State Qualifying Statute, each tobacco product manufacturer that elects to place funds into escrow pursuant to the Qualifying Statute (as opposed to becoming a PM) shall annually certify to the Attorney General of the State that it is in compliance with the escrow deposit requirements of the Qualifying Statute. The Attorney General may bring a civil action on behalf of the State against any tobacco product manufacturer that fails to place into escrow the funds required under the Qualifying Statute. Any tobacco product manufacturer that fails in any year to place into escrow the funds required shall (1) be required within 15 days to place the funds into escrow as shall bring it into compliance with the Qualifying Statute (and the court, upon a finding of a violation of the escrow deposit requirements, may impose a civil penalty to be paid to the General Fund of the State in an amount not to exceed 5% of the amount improperly withheld from escrow per day of the violation and in a total amount not to exceed 100% of the original amount improperly withheld from escrow), (2) in the case of a knowing violation, be required within 15 days to place the funds into escrow as shall bring it into compliance with the Qualifying Statute (and the court, upon a finding of a knowing violation of the escrow deposit requirements, may impose a civil penalty to be paid to the General Fund of the State in an amount not to exceed 15% of the amount improperly withheld from escrow per day of the violation and in a total amount not to exceed 300% of the original amount improperly withheld from escrow), and (3) in the case of a second knowing violation, be prohibited from selling cigarettes to consumers within the State, whether directly or through a distributor, retailer, or similar intermediary, for a period not to exceed two years. Each failure to make an annual deposit required under the Qualifying Statute constitutes a separate violation.

The State has pledged in the Purchase and Sale Agreement to diligently enforce its Qualifying Statute. In the view of the Office of the Attorney General of the State, the State has been and is diligently enforcing its Qualifying Statute. See "—State Statutory Enforcement Framework" below. The PMs, however, have disputed this view and asserted in connection with the 2003 NPM Adjustment dispute that the State did not diligently enforce its Qualifying Statute in 2003. See "—Potential Payment Decreases Under the Terms of the MSA—*NPM Adjustment—2003 NPM Adjustment Claims*." See also "RISK FACTORS—Other Risks Relating to the MSA and Related Statutes—*Amendments, Waivers and Termination*" and "—*Reliance on State Enforcement of the MSA and State Impairment*."

California Complementary Legislation

Pursuant to the provisions of Section 30165.1 of the California Revenue and Taxation Code (the State's Complementary Legislation), every tobacco product manufacturer whose cigarettes are sold in the State, whether directly or through a distributor, retailer, or similar intermediary or intermediaries, shall execute and deliver on a form and in the manner prescribed by the State Attorney General, a certification to the Attorney General no later than the 30th day of April each year that, as of the date of the certification, the tobacco product manufacturer is either a PM that has made all payments calculated by the MSA Auditor to be due under the MSA, except to the extent the PM is disputing any of the payments, or is in full compliance with the State's Qualifying Statute, including all installment payments required by the State's Qualifying Statute and Complementary Legislation, and any regulations promulgated pursuant thereto. A tobacco product manufacturer located outside the U.S. shall provide to the Attorney General, and keep current, a list of all importers that sell or will be selling their cigarettes in the State. A PM (whether located inside or outside the U.S.) shall include in its annual certification a complete list of its brand families. The PM shall update the list 30 days prior to any addition to or modification of its brand families. An NPM shall include in its annual certification a complete list of all of its brand families in accordance with the following requirements: (A) separately listing brand families of cigarettes and the number of units sold for each brand family that were sold in the State during the preceding calendar year, (B) separately listing all of its brand families that have been sold in the State at any time during the current calendar year, (C) indicating by an asterisk any brand family sold in the State during the preceding calendar year that is no longer being sold in the State as of the date of the certification and (D) identifying by name and address any other manufacturer, including all fabricators or makers of the brand families in the preceding or current calendar year in a form, manner, and detail as required by the Attorney General. The NPM shall update the list 30 days prior to any change in a fabricator for any brand family or any addition to or modification of its brand families. In the case of an NPM, the certification shall further certify all of the following: (A) that the NPM is registered to do business in the State, or has appointed a resident agent for service of process and provided notice thereof as required by the Complementary Legislation, (B) that the NPM has done all of the following: (i) established and continues to maintain a qualified escrow fund in accordance with the Qualifying Statute and implementing regulations, (ii) executed a qualified escrow agreement that has been reviewed and approved by the Attorney General and that governs the qualified escrow fund, and (iii) if the NPM is not the fabricator or maker of the cigarettes, that the escrow agreement, certification, reports, and any other forms required by the Qualifying Statute and implementing regulations are signed by the company that fabricates or makes the cigarettes and in the manner required by the Attorney General, (C) that the NPM is in full compliance with both of the following: (i) the Qualifying Statute, the Complementary Legislation, and any regulations promulgated pursuant thereto and (ii) the State's Cigarette and Tobacco Products Licensing Act, and any regulations promulgated pursuant thereto (and the NPM shall provide a copy of a valid, corresponding federal permit issued by the United States Treasury, Alcohol and Tobacco Tax and Trade Bureau), (D) that the NPM has provided specified information regarding its qualified escrow fund, including the amount the NPM placed in the fund for cigarettes sold in the State during the preceding calendar year, the date and amount of each deposit, and any confirming evidence or verification as may be deemed necessary by the Attorney General, and the amounts and dates of any withdrawal or transfer of funds the NPM made at any time from the fund or from any other qualified escrow fund into which it ever made escrow payments pursuant to the Qualifying Statute.

Each NPM located outside the U.S. and its importers are required to report, in the manner required by the Attorney General, all cigarette and tobacco products sold in the State each month, including, but not limited to, the quantity, including tobacco weight and number of cigarette sticks, the wholesale cost and sale price of each brand family. Furthermore, the State's Complementary Legislation provides that, not later than 25 days after the end of each calendar quarter, and more frequently if so directed by the Board of Equalization or the Attorney General of the State, each distributor shall submit any information as the Board of Equalization or Attorney General requires to facilitate compliance with the Complementary Legislation, including, but not limited to, a list by brand family of the total number of cigarettes or, in the case of roll-your-own tobacco, the total ounces for which the distributor affixed stamps during the previous calendar month or otherwise paid the tax due.

In addition, the State's Complementary Legislation requires that the Attorney General publish on its internet web site a directory listing all tobacco product manufacturers that have provided current, timely, and accurate certifications conforming to the annual certification requirements of the Complementary Legislation and all brand families that are listed in the certifications (except as specified in the Complementary Legislation). The Complementary Legislation sets forth procedures for removal of tobacco product manufacturers that no longer qualify for being named on the directory. The Complementary Legislation provides that no person shall affix, or cause to be affixed, any tax stamp or meter impression to a package of cigarettes, or pay the tax levied on a cigarette, unless the brand family of the cigarettes or tobacco product, and the tobacco product manufacturer that makes or sells the cigarettes or tobacco product, are included on the directory. The Complementary Legislation also provides that no person may sell, offer or possess for sale in the State, ship or otherwise distribute into or within the State or import for personal consumption in the State, cigarettes of a tobacco product manufacturer or brand family not included in the then current directory. Furthermore, the Complementary Legislation provides that no person shall either (A) sell or distribute cigarettes that the person knows or should know are intended to be distributed in violation of the foregoing two sentences or (B) acquire, hold, own, possess, transport, import, or cause to be imported cigarettes that the person knows or should know are intended to be distributed in violation of the foregoing two sentences. Notwithstanding the foregoing, a licensed retailer may possess, transport and sell the tax-stamped cigarettes of a manufacturer or brand family affected by a notice of removal from the directory for no more than 60 days following the effective date of the manufacturer or brand family's removal from the directory. After 60 days following removal from the directory, the cigarettes of a manufacturer or brand family identified in the related notice of removal are contraband and are subject to seizure and destruction and may not be purchased or sold in the State.

In addition to any other civil or criminal penalty provided by law, upon a finding that a person has affixed or caused to be affixed a tax stamp or meter impression in violation of the Complementary Legislation, or failed to submit quarterly information required by the Board of Equalization to facilitate compliance with the Complementary Legislation, as described above, the Board of Equalization may revoke or suspend the license or licenses issued to the person by the Board of Equalization.

State Statutory Enforcement Framework

California Statutory Enforcement Provisions. The State's statutory framework for enforcing laws relating to the manufacture, distribution, sale, possession and taxation of cigarettes within the State of California includes the State Qualifying Statute and Complementary Legislation, as well as, among other things:

- laws prohibiting smoking in most enclosed spaces of places of employment (including restaurants and bars), except for designated break rooms that are separately ventilated directly to the outside and located in a non-work area where no one is required to enter as part of their work responsibilities (Labor Code § 6404.5 (2007); Government Code §§ 7596 to 7598 (2007); Education Code §§ 48900 & 48901 (1986); and Health and Safety Code § 1596.795 (1993)) (although exceptions include, among others, 65% of rooms in a hotel, motel, or similar transient lodging establishment and a percentage of all lobby areas in hotel, motel, or similar establishments (Labor Code § 6404.5 (2007));

- laws prohibiting smoking by employees and members of the public inside buildings owned or leased by the State, a county, a city, a city and county, or a California Community College district or within 20 feet of a main exit, entrance, or operable window of these buildings (Government Code §§ 7596 to 7598 (2007));

- laws prohibiting smoking in a motor vehicle, whether in motion or at rest, in which there is a person under 18 years of age in the vehicle (Health and Safety Code §§ 118947 to 118949 (2008));

- tax laws imposing taxes on cigarettes and other tobacco products (the current State tax on a pack of 20 cigarettes is $0.87; Revenue and Taxation Code §§ 30101 (1994), 30123 (1989) & 30131.2 (1999)) and requiring stamps or meter impressions to be affixed to packages of cigarettes prior to distribution to evidence payment of cigarette taxes (Revenue and Taxation Code § 30163 (2000));

- laws setting forth licensing requirements for tobacco products (Business and Professions Code §§ 22970 to 22991 (2011) and Revenue and Taxation Code §§ 30140 et seq. & 30155 et seq. (1979));

- penal laws providing that every person, firm, or corporation that knowingly sells, gives, or in any way furnishes tobacco products or paraphernalia, including blunt wraps, to a minor is guilty of an infraction and shall be subject either to criminal action for a misdemeanor or to civil action punishable by a fine (Penal Code § 308 (2006)) and providing that every minor who purchases, receives, or possesses any tobacco product or paraphernalia shall be punished by a fine and hours of community service (Penal Code § 308 (2006) and Business and Professions Code § 22952 (1994)), and laws authorizing the Department of Health Services to assess civil penalties against any person, firm, or corporation that sells, gives, or in any way furnishes to another person who is under the age of 18 years tobacco products or tobacco paraphernalia (Business and Professions Code § 22958 (2008));

- laws prohibiting any person engaged in the retail sale of tobacco products or tobacco paraphernalia to sell, offer for sale, or display for sale, tobacco products or tobacco paraphernalia by self-service display, with certain exceptions for cigars, pipe tobacco, snuff, chewing tobacco, or dipping tobacco (Business and Professions Code § 22962 (2007)) and laws governing the location of tobacco product vending machines (Business and Professions Code § 22960 (1995));

- laws governing internet sales of tobacco products, by virtue of the tax laws providing that no person may engage in a retail sale of cigarettes in the State unless the sale is a vendor-assisted, face-to-face sale, except that a person may engage in delivery sale of cigarettes or tobacco products to a person in the State if the delivery seller has fully complied with the Jenkins Act, obtains and maintains an applicable State license, complies with any applicable State law that imposes escrow or other payment obligations on tobacco product manufacturers and complies with any Attorney General reporting requirements (Revenue and Taxation Code § 30101.7 (2011));

- laws restricting advertising of tobacco products (Government Code § 19994.35 (1993) and Business and Professions Code § 22961 (1997));

- health laws setting fire safety standards for cigarettes and deeming cigarettes that have been sold or offered for sale that do not comply with the fire safety standards to be contraband and subject to seizure (Health and Safety Code §§ 14950 to 14960 (2007)); and

- various implementing regulations promulgated by the California Board of Equalization.

Enforcement. This statutory enforcement framework is administered and enforced by the Office of the Attorney General of the State of California, the California Board of Equalization, the California Fire Marshal, or the local public prosecutors in the city or county in which the violation occurred. See "—California Complementary Legislation" above.

In addition, pursuant to the California Cigarette and Tobacco Products Licensing Act, upon discovery by the Board of Equalization or a law enforcement agency that a retailer or any other person possesses, stores, owns, or has made a retail sale of an unstamped package of cigarettes, the Board of Equalization or the law enforcement agency shall be authorized to seize unstamped packages of cigarettes at the retail, or any other person's location, and any cigarettes seized will be deemed forfeited. In addition, upon discovery by the Board of Equalization or a law enforcement agency that a retailer or any other person possesses, stores, owns, or has made a retail sale of tobacco products on which tax is due but has not been paid to the Board of Equalization, the Board of Equalization or law enforcement agency is authorized to seize such tobacco products at the retail, or any other person's location, and any tobacco products seized will be deemed forfeited. In addition to any other civil or criminal penalty provided by law, upon a finding that a retailer has violated such provisions, the Board of Equalization may revoke or suspend the license of the retailer. (Business and Professions Code § 22974.3 and 22974.7)

The California Cigarette and Tobacco Products Licensing Act also provides that, upon discovery by the Board of Equalization or a law enforcement agency that a distributor possesses, stores, owns, or has made a sale of an unstamped package of cigarettes bearing a counterfeit California state tax stamp or that a wholesaler possesses, stores, owns, or has made a sale of an unstamped package of cigarettes, the Board of Equalization or the law enforcement agency shall be authorized to seize the unstamped packages of cigarettes at the distributor's or the wholesaler's location, and any cigarettes seized will be deemed forfeited. In addition, upon discovery by the Board of Equalization or a law enforcement agency that a distributor or a wholesaler possesses, stores, owns, or has made a sale of tobacco products on which tax is due but has not been paid to the Board of Equalization, or its designee, the Board of Equalization or law enforcement agency is authorized to seize such tobacco products at the distributor or wholesaler location, and any tobacco products seized will be deemed forfeited. In addition to any other civil or criminal penalty provided by law, upon a finding that any distributor or any wholesaler has violated such provisions, the Board of Equalization may revoke or suspend the license of the distributor or wholesaler. (Business and Professions Code § 22978.2 and 22978.7)

Further, the California Cigarette and Tobacco Products Licensing Act provides that a person or entity that engages in the business of selling cigarettes or tobacco products in the State either without a valid license or after a license has been suspended or revoked, and each officer of any corporation that so engages in such business, is guilty of a misdemeanor. Continued sales or gifting of cigarettes and tobacco products either without a valid license or after a notification of suspension or revocation shall result in the seizure of all cigarettes and tobacco products in the possession of the person by the Board of Equalization or a law enforcement agency. Any cigarettes and tobacco products seized by the Board of Equalization or by a law enforcement agency shall be deemed forfeited. (Business and Professions Code § 22980.2)

Indian Country Cigarette Sales. The State's ability to enforce State laws, including State cigarette tax laws and regulatory provisions, is limited in various geographical areas in the State that constitute "**Indian Country**" as defined by 18 U.S.C. § 1151. The State does not have authority to regulate an Indian Tribe's ("**Tribe**") manufacture and wholesale distribution of tobacco products in its Indian Country when those products are not distributed outside of that Indian Country. The State is not aware of any cigarette manufacturers that are located in Indian Country within the State. However, two large cigarette distributors are located in Indian Country within the State. These distributors sell untaxed contraband cigarettes manufactured by NPMs to retailers located in Indian Country in the State and directly to members of the general public. The State also does not have authority to regulate sales of tobacco products to Indians in Indian Country or to collect the State cigarette tax on a sale to an Indian where the sale occurs in Indian Country. The State has authority to require a Tribe to collect the State cigarette tax on cigarettes sold in Indian Country to a non-Indian. (See *Chemehuevi Indian Tribe v. California State Board of Equalization*, 800 F.2d 1446 (9th Cir. 1986).) However, principles of Indian sovereign immunity limit the judicial remedies available to the State with respect to such sales.

Numerous retailers located in Indian Country in the State sell untaxed contraband cigarettes to members of the general public, and the State has filed lawsuits against some of those retailers.

The State has not entered into any cigarette tax collection agreements with any Tribes located within the State.

Litigation Challenging the MSA, the Qualifying Statutes and Related Legislation

General Overview

Certain smokers, smokers' rights organizations, consumer groups, cigarette importers, cigarette distributors, cigarette manufacturers, Native American tribes, taxpayers, taxpayers' groups and other parties have filed actions against some, and in certain cases all, of the signatories to the MSA alleging, among other things, that the MSA, Settling States' Qualifying Statutes, Complementary Legislation and related legislation are void or unenforceable under certain provisions of law, such as the U.S. Constitution, state constitutions, federal antitrust laws, state consumer protection laws, bankruptcy laws, federal cigarette advertising and labeling law, and unfair competition laws as described below in this subsection. Certain of the lawsuits have further sought, among other relief, an injunction against one or more of the Settling States from collecting any moneys under the MSA and barring the PMs from collecting cigarette price increases related to the MSA, as well as injunctions against the enforcement of the Qualifying Statutes and the related legislation. In addition, class action lawsuits have been filed in several federal and state courts alleging that under the federal Medicaid law, any amount of tobacco settlement funds that the Settling States receive in excess of what they paid through the Medicaid program to treat tobacco related diseases should be paid directly to Medicaid recipients. To date, such challenges to the MSA, Qualifying Statutes, Complementary Legislation and related legislation have not been ultimately successful. The MSA, Qualifying Statutes, Complementary Legislation and related legislation may also continue to be challenged in the future.

A determination that a Qualifying Statute is unconstitutional would have no effect on the enforceability of the MSA itself; such a determination could, however, have an adverse effect on payments to be made under the MSA if one or more NPMs were to gain market share. See "SUMMARY OF THE MSA—Adjustments to Payments—*Non-Participating Manufacturers Adjustment*", "—MSA Provisions Relating to Model/Qualifying Statutes" and "LEGAL CONSIDERATIONS".

A determination that an Allocable Share Release Amendment is unenforceable would not constitute a breach of the MSA but could permit NPMs to exploit differences among states, and thereby potentially increase their market share at the expense of the PMs. See "SUMMARY OF THE MSA—MSA Provisions Relating to Model/Qualifying Statutes".

A determination that the State's Complementary Legislation is unenforceable would not constitute a breach of the MSA or affect the enforceability of the State's Qualifying Statute; such a determination could, however, make enforcement of the State's Qualifying Statute against NPMs more difficult for the State. See "SUMMARY OF THE MSA—MSA Provisions Relating to Model/Qualifying Statutes".

Litigation Status

All of the judgments rendered to date on the merits have rejected the challenges to the MSA and Settling States' Qualifying Statutes and Complementary Legislation presented in the cases. For example, in *VIBO*, a tobacco manufacturer who became a party to the MSA in 2004 (General Tobacco)[*] sued the attorneys general of the Settling States, the OPMs, and other SPMs in the U.S. District Court for Western Kentucky in 2008. It alleged that the MSA and the refusal of the PMs to waive the PMs' most-favored nation rights and the Settling States' refusal to settle with the plaintiff on terms that the plaintiff preferred violated the federal antitrust laws and the Equal Protection, Commerce, Due Process, and Compact Clauses of the U.S. Constitution, and that the settling governmental entities fraudulently induced it to enter into the MSA. The plaintiff alleged that MSA participants, such as itself, that were not in existence when the MSA was executed in 1998 but subsequently became participants, were unlawfully required to pay significantly more sums to the states than companies that joined the MSA within 90 days after its execution. In 2009, the district court granted motions to dismiss on all claims. First, the district court held that the PMs' involvement in the creation of the MSA, and their assertion of influence on the Settling States by refusing to give up any most favored nation protections that they held under the MSA (and thus deterring the Settling States from providing the plaintiff the settlement terms that the plaintiff desired) was protected from antitrust liability by the *Noerr-Pennington* ("***NP***") doctrine. The judicially created *NP* doctrine protects from antitrust liability persons or entities who petition or lobby the federal or state government to take actions that may impose restraints on trade. Second, the district court held that the attorneys general's involvement in and enforcement of the MSA, and their refusal to grant the plaintiff certain settlement terms, were sovereign acts of the states and immune from antitrust attack under the state action exemption. Third, the district court ruled that plaintiff had waived all of its federal constitutional challenges based on the Equal Protection, Due Process, and Commerce Clauses when it became a party to the MSA because the MSA provides in Section XV that all parties agree to waive "for the purposes of performance of the [MSA] any and all claims that the provisions of [the MSA] violate the state or federal constitutions". The district court further held that plaintiffs' Compact Clause claim should be dismissed because the MSA does not enhance state power to the detriment of the federal government power. Plaintiff appealed the dismissal of its claims to the U.S. Court of Appeals for the Sixth Circuit. On February 22, 2012, a three judge panel of the U.S. Court of Appeals for the Sixth Circuit ruled that the MSA does not amount to an unlawful conspiracy or anti-competitive behavior by the government and, accordingly, affirmed the district court's order and dismissed plaintiffs' appeal in this case. The time period for the plaintiffs to file a petition for certiorari to the U.S. Supreme Court expired.

In *Grand River*, certain cigarette manufacturers and distributors who were NPMs brought suit in 2002 against 31 states, including the State, and their attorneys general, alleging, among other things, that the Escrow Statutes contravened the Commerce Clause of the U.S. Constitution, the Sherman Act, and in the case of plaintiff Grand River, the Constitution's Indian Commerce Clause. The district court had dismissed all claims against the states other than New York for lack of personal jurisdiction, and dismissed all claims except the antitrust claim against New York. On interlocutory appeal, the Second Circuit reversed the district court's dismissal against the non-New York defendants, reversed the dismissal of the dormant Commerce Clause claim, and affirmed the dismissal of the plaintiffs' other constitutional claims. As to the Commerce Clause claim, the Second Circuit held that the plaintiffs "stated a possible claim that the practical effect of the challenged statutes and the MSA is to control prices outside of the enacting states by tying both the SPM settlement and NPM escrow payments to national market share, which in turn affects interstate pricing decisions." On remand, the Southern District on March 22, 2011 granted summary judgment to the defendants on all of plaintiffs' Sherman Act and Commerce Clause claims. Plaintiffs appealed to the Second Circuit and petitioned the Southern District to amend its dismissal of plaintiffs' Sherman Act and Commerce Clause claims. On January 30, 2012 the Southern District denied the plaintiffs' motion to amend the Southern District's March 22, 2011 dismissal by summary judgment of plaintiffs' claims that the MSA and related legislation violated the Sherman Act and the Commerce Clause. Plaintiffs then appealed this denial to the Second Circuit. On June 1, 2012

[*] General Tobacco ceased production of cigarettes and other tobacco products in 2010.

plaintiffs withdrew both appeals before the Second Circuit, which withdrawals were approved by order of the Second Circuit on August 10, 2012, rendering the case final before the Second Circuit.

In *Freedom Holdings*, two cigarette importers who were NPMs sought in 2002 to enjoin the enforcement of New York State's Qualifying Statute and Contraband Statute, claiming that the MSA and the legislation violated Section 1 of the Sherman Act, and the Commerce Clause of the U.S. Constitution. The Southern District dismissed the plaintiffs' complaint for failure to state a claim. On appeal, a three judge panel of the Second Circuit reversed the district court's dismissal. The Court held that, accepting the allegations of the complaint as true, the complaint alleged an "express market-sharing agreement among private tobacco manufacturers", and that the MSA, Escrow Statutes, and complementary legislation allowed the originally settling defendants to "set supracompetitive prices that effectively cause other manufacturers either to charge similar prices or to cease selling". The Court additionally held that, at the pleading stage, the defendants had not established that the legislation was protected by the state action exemption articulated under *Parker v. Brown* ("**Parker**") and its progeny, or as protected petitioning of government under the *NP* doctrine. The Court upheld the dismissal of the plaintiffs' Commerce Clause claim—although reserving the dormant Commerce Clause issue that plaintiffs had not asserted—and permitted the plaintiffs to amend to add allegations in their Fourteenth Amendment Equal Protection claim. The Second Circuit issued a subsequent opinion denying a motion for rehearing. The plaintiffs thereafter amended their complaint and brought a motion for a preliminary injunction against New York's Qualifying Statute and Contraband Statute. The district court granted an injunction against the Allocable Share Release Amendment, but otherwise denied the motion. The plaintiffs appealed and the Second Circuit affirmed the district court's denial of the broader preliminary injunction on the ground that plaintiffs had not established irreparable injury. After remand from the Second Circuit, the district court in *Freedom Holdings* conducted an evidentiary hearing and bench trial, and issued judgment for defendants on all of the plaintiffs' claims. The court held that the MSA and its implementing legislation were not illegal per se and not pre-empted by the Sherman Act, that even if it were necessary to reach the issue of state action exemption, that it shielded the defendants' conduct, and that the MSA and the legislation did not contravene the dormant Commerce Clause. On October 18, 2010, the Second Circuit affirmed the dismissal of the plaintiffs' claims. The U.S. Supreme Court denied plaintiffs' petition for writ of certiorari.

In *S&M Brands v. Caldwell*, certain NPMs and cigarette distributors brought an action in a federal district court in Louisiana in 2005 seeking, among other relief: (1) a declaration that the MSA and Louisiana's Qualifying Statute and Complementary Legislation are invalid as violations of the U.S. Constitution and the Federal Cigarette Labeling and Advertising Act; and (2) an injunction barring the enforcement of the MSA and Louisiana's Qualifying Statute and Complementary Legislation. Following the state defendant's motion to dismiss the complaint for lack of jurisdiction, the U.S. District Court for the Western District of Louisiana (the "**Western District**") allowed the case to proceed on claims that the MSA and Louisiana's Complementary Legislation are violations of the federal antitrust laws and of the Compact Clause, Commerce Clause, Due Process Clause and First Amendment of the U.S. Constitution, and the Federal Cigarette Labeling and Advertising Act, and dismissed the claims that alleged violation of the Tenth Amendment of the U.S. Constitution. In September 2009, the Western District granted defendant's motion for summary judgment and dismissed with prejudice all claims by the plaintiffs. In August 2010, the Fifth Circuit affirmed the Western District's order granting summary judgment for the defendants. The Fifth Circuit held that the district court correctly concluded that the MSA did not violate the Compact Clause because the MSA only increases states' power vis-à-vis the PMs and does not result in an accompanying decrease of the power of the federal government. The Fifth Circuit also ruled that the Escrow Statute did not violate the federal antitrust laws for the reasons set forth in its prior decision in *Xcaliber Int'l Ltd. v. Caldwell*, and held that the MSA did not violate federal antitrust laws after adopting the rationales of the Sixth Circuit and other circuits that previously considered the issue. In addition, the Fifth Circuit affirmed the dismissal of plaintiffs' Commerce Clause and Due Process Clause claims because plaintiffs had failed to show that Louisiana's Escrow Statute and the MSA had the effect of increasing cigarette prices outside of Louisiana. With respect to plaintiffs' First Amendment challenge to the MSA and the Escrow Statute, the Fifth Circuit found that the only statute applicable to plaintiffs as NPMs was the Escrow Statute, which the court determined did not compel or abridge plaintiffs' speech. Similarly, the Fifth Circuit found that the MSA and Escrow Statute did not violate the Federal Cigarette Labeling and Advertising Act because plaintiffs are not compelled to join the MSA and the Escrow Statute does not have any connection with cigarette packaging, advertising, or promotion. The U.S. Supreme Court denied plaintiffs' petition for writ of certiorari.

In the Ninth Circuit, in which the State is located, the U.S. Court of Appeals for the Ninth Circuit (the "**Ninth Circuit**"), in *Sanders v. Brown*, affirmed the United States District Court for the Northern District of California's dismissal of an antitrust challenge to the MSA and the State's Qualifying Statute and Complementary Legislation brought by a class of California consumers against the State and the OPMs, and held that the class failed to show that the State's Qualifying Statute and Complementary Legislation are per se illegal under the Sherman Act. The United States Supreme Court denied plaintiff's petition for certiorari in 2008. In *PTI, Inc. v. Philip Morris Inc.*, certain cigarette importers and cigarette distributors sought to enjoin the passage or enforcement of the State's Qualifying Statute, alleging that the passage, implementation and/or enforcement of the Qualifying Statute would violate federal antitrust laws and certain provisions of the federal constitution, and the court dismissed with prejudice all federal antitrust and constitutional claims on the merits.

In the other decisions upholding the MSA or accompanying legislation, the decisions were rendered either on motions to dismiss or motions for summary judgment. Courts rendering those decisions include the U.S. Courts of Appeals for the Tenth Circuit in *KT & G Corp. v. Edmondson*, and *Hise v. Philip Morris Inc.*; the Eighth Circuit in *Grand River Enterprises v. Beebe*; the Third Circuit in *Mariana v. Fisher*, and *A.D. Bedell Wholesale Co. v. Philip Morris Inc.*; the Fourth Circuit in *Star Sci., Inc. v. Beales*; the Sixth Circuit in *S&M Brands v. Cooper, S&M Brands, Inc. v. Summers and Tritent Inter'l Corp. v. Commonwealth of Kentucky*; and multiple lower courts.

In January 2011, an international arbitration tribunal rejected claims brought against the United States challenging MSA-related legislation in various states under NAFTA.

Among several U.S. Courts of Appeals and other lower courts that have rejected challenges to the MSA and related statutes, there have been conflicting interpretations of federal antitrust law immunity doctrines. The existence of a conflict as to the rulings of different federal courts on these and other related issues, especially between Circuit Courts of Appeals, is one factor that the U.S. Supreme Court may take into account when deciding whether to exercise its discretion in agreeing to hear an appeal. Any final decision by the U.S. Supreme Court on the substantive merits of a case challenging the validity or enforceability of the MSA or related legislation would be binding everywhere in the United States, including in the State.

The MSA, the Qualifying Statute and related state legislation may be challenged in the future. A determination by a court having jurisdiction over the State that the MSA, the NPM Adjustment Settlement Term Sheet, the Qualifying Statute or related State legislation (including the 2013 amendment to the State's Qualifying Statute made in furtherance of the NPM Adjustment Settlement Term Sheet, as discussed herein) is void or unenforceable could have a materially adverse effect on the payments by the PMs under the MSA and the amount and/or the timing of Pledged TSRs available to the Issuer and could ultimately result in the complete cessation of the Pledged TSRs available to the Issuer. A determination by any court that the MSA, the NPM Adjustment Settlement Term Sheet, the Qualifying Statute or related State legislation (including the 2013 amendment to the State's Qualifying Statute made in furtherance of the NPM Adjustment Settlement Term Sheet, as discussed herein) is void or unenforceable could also lead to a decrease in the market value and/or liquidity of the Series 2015A Bonds. See "LEGAL CONSIDERATIONS" for a further discussion of these matters as well as a description of the opinions of Orrick, Herrington & Sutcliffe LLP, Transaction Counsel to the Issuer, and the Attorney General of the State, addressing certain of such matters. See "RISK FACTORS—If Litigation Challenging the MSA, the Qualifying Statutes and Related Legislation Were Successful, Payments under the MSA Might be Suspended or Terminated" and "RISK FACTORS—Potential Payment Decreases Under the Terms of the MSA—*NPM Adjustment*." See also "SUMMARY OF THE MSA—Potential Payment Decreases Under the Terms of the MSA—*NPM Adjustment—NPM Adjustment Settlement and Award*," including the penultimate paragraph thereof.

Potential Payment Decreases Under the Terms of the MSA

Adjustments to MSA Payments

The MSA provides that the amounts payable by the PMs are subject to numerous adjustments, offsets and recalculations, some of which are material. For additional information regarding the MSA and the payment adjustments, see "SUMMARY OF THE MSA—Adjustments to Payments". Such adjustments, offsets and recalculations could reduce the Pledged TSRs available to the Issuer below the respective amounts required to pay the Series 2015A Bonds and could lead to a decrease in the market value and/or the liquidity of the Series 2015A Bonds. See also "—*NPM Adjustment*" below.

The assumptions used to project debt service coverage ratios are based on the premise that certain adjustments will occur, including adjustments pursuant to the NPM Adjustment Stipulated Partial Settlement and Award, as set forth under "TABLES OF PROJECTED PLEDGED TSRs, PROJECTION METHODOLOGY AND BOND STRUCTURING ASSUMPTIONS." Actual adjustments could be materially different from what has been assumed and described herein.

Growth of NPM Market Share and Other Factors

Should a decline in consumption occur, but be accompanied by a material increase in the relative aggregate market share of the NPMs, shipments by PMs would decline at a rate greater than the decline in consumption. This would result in greater reductions of Annual Payments and Strategic Contribution Fund Payments by the PMs due to application of the Volume Adjustment, even for Settling States that have adopted enforceable Qualifying Statutes and are diligently enforcing such statutes and are thus exempt from the NPM Adjustment. In addition, tobacco product manufacturers have introduced a number of alternative products, including electronic cigarettes, which the manufacturers (and certain states, as discussed herein) do not deem to constitute "cigarettes" within the meaning of the MSA. If consumers use these alternative products in lieu of smoking traditional cigarettes, it could reduce the size of the traditional cigarette market. See "RISK FACTORS—Declines in Cigarette Consumption May Materially Adversely Affect Pledged TSRs Available for the Series 2015A Bonds." Furthermore, the capital costs required to establish a profitable cigarette manufacturing facility are relatively low, and new cigarette manufacturers, whether SPMs or NPMs, are less likely than OPMs to be subject to frequent litigation.

The Model Statute in its original form had required each NPM to make escrow deposits approximately in the amount that the NPM would have had to pay had it been a PM, but entitled the NPM to a release, from each Settling State in which the NPM had made an escrow deposit, of the amount by which the escrow deposit exceeds that Settling State's allocable share of the total payments that the NPM would have been required to make had it been a PM. The State and all the other Settling States except Missouri have enacted Allocable Share Release Amendments that amended this provision in their Model/Qualifying Statutes, by eliminating the reference to the allocable share and limiting the possible release an NPM may obtain to the excess above the total payment that the NPM would have paid had it been a PM. NPMs have unsuccessfully challenged Allocable Share Release Amendments in several states, but it is possible that NPMs will challenge similar legislation in other states. See "—Litigation Challenging the MSA, the Qualifying Statutes and Related Legislation". To the extent that either: (1) other jurisdictions do not enforce Allocable Share Release Amendments (or, in the case of Missouri, which did not enact an Allocable Share Release Amendment, to the extent that such state continues not to enact an Allocable Share Release Amendment); or (2) a jurisdiction's Allocable Share Release Amendment is invalidated, NPMs could concentrate sales in such jurisdiction to take advantage by limiting the amount of its escrow payment obligations to only a fraction of the payment it would have been required to make had it been a PM. As noted above, the State further amended its definition of "units sold" subject to the required escrow deposits under the Qualifying Statute, in furtherance of the NPM Adjustment Settlement Term Sheet and NPM Adjustment Stipulated Partial Settlement and Award. Because the price of cigarettes affects consumption, NPM cost advantage is one of the factors that has resulted and could continue to result in increases in market share for the NPMs.

A significant loss of Market Share by PMs to NPMs could have a material adverse effect on the payments by PMs under the MSA and on the amount and/or timing of Pledged TSRs available to the Issuer to pay debt service on the Series 2015A Bonds.

NPM Adjustment

The following discussion describes the NPM Adjustment as applied under the MSA. See "—*NPM Adjustment Settlement and Award*" below for a discussion of the settlement entered into by 24 jurisdictions (including the State), the OPMs and certain of the SPMs, and the calculation and application of the NPM Adjustment under such settlement. See "—*2003 NPM Adjustment Claims*" and "—*2003 NPM Adjustment Arbitration Results*" below for a discussion of arbitration proceedings and the decisions of the Arbitration Panel regarding certain states with respect to the 2003 NPM Adjustment.

Description of the NPM Adjustment. The NPM Adjustment, measured by domestic sales of cigarettes by NPMs, operates in certain circumstances to reduce the payments of the PMs under the MSA in the event of losses in Market Share to NPMs during a calendar year as a result of the MSA. As noted above under "—Adjustments to Payments," three conditions must be met in order to trigger an NPM Adjustment for one or more Settling States: (1) a Market Share Loss (as defined in the MSA) for the applicable year must exist, which means that the aggregate Market Share of the PMs in any year must fall more than 2% below the aggregate Market Share held by those same PMs in 1997 (a condition that has existed for every year since 2000); (2) a nationally recognized firm of economic consultants must determine that the disadvantages experienced as a result of the provisions of the MSA were a significant factor contributing to the Market Share loss for the year in question; and (3) the Settling States in question must be found to not have diligently enforced their Qualifying Statutes.[*]

Application of the NPM Adjustment. The entire NPM Adjustment is ultimately applied to a subsequent year's Annual Payment and Strategic Contribution Fund Payment due to those Settling States: (1) that have been found to have not diligently enforced their Qualifying Statutes throughout the year; or (2) that have enacted the Model Statute or a Qualifying Statute that is declared invalid or unenforceable by a court of competent jurisdiction. The 1997 Market Share percentage for the PMs, less 2%, is defined in the MSA as the "**Base Aggregate Participating Manufacturer Market Share**". If the PMs' actual aggregate Market Share is between 0% and 16 2/3% less than the Base Aggregate Participating

[*] The NPM Adjustment does not apply at all if the number of cigarettes shipped in or to the United States in the year prior to the year in which the payment is due by all manufacturers that were PMs prior to December 7, 1998 exceeds the number of cigarettes shipped in or to the United States by all such PMs in 1997.

Manufacturer Market Share, the amounts paid by the PMs would be decreased by three times the percentage decrease in the PMs' actual aggregate Market Share. If, however, the PMs' Market Share loss is greater than 16 2/3%, then the NPM Adjustment will equal 50% plus an amount determined by formula as set forth in the footnote below.*

The MSA further provides that in no event will the amount of an NPM Adjustment applied to any Settling State in any given year exceed the amount of Annual Payments and Strategic Contribution Fund Payments to be received by such Settling State in such year.

Regardless of how the NPM Adjustment is calculated, it is always subtracted from the total Annual Payments and Strategic Contribution Fund Payments due from the PMs and then ultimately allocated on a Pro Rata (as defined in the MSA) basis only among those Settling States: (1) that have been proven to have not diligently enforced their Qualifying Statute; or (2) that have enacted the Model Statute or a Qualifying Statute that is declared invalid or unenforceable by a court of competent jurisdiction.** However, the practical effect of a decision by a PM to claim an NPM Adjustment for a given year and pay its portion of the amount of such claimed NPM Adjustment into the Disputed Payments Account, or withhold payment of such amount, would be to reduce the payments to all Settling States on a pro rata basis until a resolution is reached regarding the diligent enforcement dispute for all Settling States for such year, or until a settlement is reached for some or all such disputes for such year. If the PMs make a claim for an NPM Adjustment for any particular year and a state is determined to be one of a few states (or the only state) not to have diligently enforced its Model Statute or Qualifying Statute in such year, the amount of the NPM Adjustment applied to such state in the year following such determination could be as great as the amount of Annual Payments and Strategic Contribution Fund Payments that could otherwise have been received by such state in such year.

As previously noted, any Settling State that adopts, maintains and diligently enforces its Qualifying Statute is exempt from the NPM Adjustment. The "diligent enforcement" exemption afforded a Settling State is based on actual enforcement efforts for the calendar year preceding each Annual Payment. A final resolution of "diligent enforcement" for a sales year does not preclude a PM from disputing "diligent enforcement" in a subsequent year. If the other preconditions to an NPM Adjustment exist for a given year, an NPM Adjustment would apply, absent the protection of the Settling State "diligently enforcing" its Qualifying Statute. No provision of the MSA, however, attempts to define what activities, if undertaken by a Settling State, would constitute diligent enforcement. Furthermore, the MSA does not explicitly state which party bears the burden of proving or disproving whether a Settling State has diligently enforced its Qualifying Statute, or whether any diligent enforcement dispute would be resolved in state courts or through arbitration. However, regarding the 2003 NPM Adjustment dispute, the State's MSA court determined that the 2003 NPM Adjustment dispute was to be determined by a panel of arbitrators, and such panel of arbitrators determined that, when contested, a state bears the burden of proving its diligence. As discussed further below, the State had been a contested state in the 2003 NPM Adjustment dispute but then joined the NPM Adjustment Settlement Term Sheet, thereby resolving its 2003 NPM Adjustment dispute, together with its 2004 to 2012 NPM Adjustment disputes.

* If the aggregate market share loss from the Base Aggregate Participating Manufacturer Share is greater than 16 2/3%, the NPM Adjustment will be calculated as follows:

NPM Adjustment = 50% +
[50% / (Base Aggregate Participating Manufacturer Market Share – 16 2/3%)]
x [market share loss – 16 2/3%]

** If a court of competent jurisdiction declares a Settling State's Qualifying Statute to be invalid or unenforceable, then the NPM Adjustment for such state is limited to no more, on a yearly basis, than 65% of the amount of such state's allocated payment.

The MSA provides that arbitration, if required by the MSA, will be governed by the United States Federal Arbitration Act. The decision of an arbitration panel under the Federal Arbitration Act may only be overturned under limited circumstances, including a showing of a manifest disregard of the law by the panel. Regardless of the forum in which a diligent enforcement dispute is heard, no assurance can be given as to how long it will take to resolve such a dispute with finality.

The Collection Methodology and Assumptions and the debt service coverage table for the Bonds do not factor in an offset for miscalculated or disputed payments or any release of funds currently held in the Disputed Payments Account other than pursuant to the NPM Adjustment Stipulated Partial Settlement and Award. If the assumptions are not realized and future NPM Adjustments, withholdings or Disputed Payments are otherwise taken against MSA payments to the State beyond that which is projected pursuant to the NPM Adjustment Stipulated Partial Settlement and Award, it could have a material adverse effect on the payments by PMs under the MSA, and could have a material adverse effect on the amount and/or timing of Pledged TSRs available to the Issuer. See "TABLES OF PROJECTED PLEDGED TSRs, PROJECTION METHODOLOGY AND BOND STRUCTURING ASSUMPTIONS".

Settlement of 1999 through 2002 NPM Adjustment Claims. In June 2003, the OPMs, certain SPMs and the Settling States settled all NPM Adjustment claims for the payment years 1999 through 2002, subject, however, under limited circumstances, to the reinstatement of a PM's right to an NPM Adjustment for the payment years 2001 and 2002. In connection therewith, such PMs and the Settling States agreed prospectively that PMs claiming an NPM Adjustment for any year will not make such a deposit into the Disputed Payments Account or withhold payment with respect thereto unless and until the selected economic consultants determine that the disadvantages of the MSA were a significant factor contributing to the Market Share loss giving rise to the alleged NPM Adjustment. If the selected economic consultants make such a "significant factor" determination regarding a year for which one or more PMs have claimed an NPM Adjustment, such PMs may, in fact, either make a deposit into the Disputed Payments Account or withhold payment reflecting the claimed NPM Adjustment. As discussed below under "*—Ongoing 2004 through 2013 NPM Adjustment Claims*," the Settling States have since agreed that no "significant factor" determination will be necessary for certain years. See "SUMMARY OF THE MSA—Adjustments to Payments".

2003 through 2013 NPM Adjustment Claims Generally. According to NAAG, one or more of the PMs are disputing or have disputed the calculations of some Annual Payments and Strategic Contribution Fund Payments, totaling over $9.4 billion, for the sales years 2003 through 2013 as part of the NPM Adjustment, which could lead to offsets against the MSA payments in future years. A discussion of the State's settlement of claims regarding the 2003 through 2012 NPM Adjustments appears below under "—*NPM Adjustment Settlement and Award*." Pursuant to the provisions of the MSA, domestic tobacco product manufacturers participated in proceedings regarding the 2003 NPM Adjustment, results of which were released on September 11, 2013, as discussed below under "*—2003 NPM Adjustment Arbitration Results*".

As part of the NPM Adjustment proceedings, an independent economic consulting firm jointly selected by the MSA parties or otherwise selected pursuant to the MSA's provisions is required to determine whether the disadvantages of the MSA were a "significant factor" contributing to the participating manufacturers' collective loss of market share for the year in question. If the firm determines that the disadvantages of the MSA were such a "significant factor," each Settling State may avoid a downward adjustment to its share of the PMs' annual payments for that year by establishing that it diligently enforced its Qualifying Statute during the entirety of that year. Any potential downward adjustment would then be reallocated to any states that do not establish such diligent enforcement.

Once a significant factor determination in favor of the PMs for a particular year has been made by an economic consulting firm, or the states' agreement not to contest that the disadvantages of the MSA were a significant factor contributing to the PMs' collective loss of market share in a particular year has become effective (as occurred with respect to certain years discussed below under "*—Ongoing 2004 through 2013 NPM Adjustment Claims*"), a PM has the right under the MSA to pay the disputed amount of the NPM Adjustment for that year into the MSA's Disputed Payments Account or withhold it altogether.

2003 NPM Adjustment Claims. An independent economic consulting firm, jointly selected by the MSA parties, determined that the disadvantages of the MSA were a significant factor contributing to the PMs' collective loss of market share for 2003. Following the "significant factor" determination with respect to 2003, each of 38 Settling States filed a declaratory judgment action in state court seeking a declaration that such Settling State diligently enforced its Qualifying Statute during 2003. The OPMs and SPMs responded to these actions by filing motions to compel arbitration in accordance with the terms of the MSA, including motions to compel arbitration in 11 states and territories that did not file declaratory judgment actions. According to Reynolds American's Form 10-K filed with the SEC for the calendar year 2014, 47 of the 48 courts that had addressed the question whether the dispute concerning the 2003 NPM Adjustment is arbitrable had ruled that arbitration is required under the MSA. The Montana Supreme Court ruled that Montana did not agree to arbitrate the question of whether it diligently enforced a Qualifying Statute and that diligent enforcement claims of that state must be litigated in state court, rather than in arbitration. Subsequently, in June 2012, Montana and the PMs reached an agreement whereby the PMs agreed not to contest Montana's claim that it diligently enforced the Qualifying Statute during 2003 and therefore Montana would not be subject to the 2003 NPM Adjustment.

The OPMs and approximately 25 other PMs entered into an agreement regarding arbitration with 45 states and territories concerning the 2003 NPM Adjustment. The agreement effectively provides for a partial liability reduction for the 2003 NPM Adjustment for states that entered into the agreement by January 30, 2009 and are determined in the arbitration not to have diligently enforced a Qualifying Statute during 2003. Based on the number of states that entered into the agreement by January 30, 2009 (45), the partial liability reduction for those states is 20%. This partial liability reduction would be effectuated by the PMs jointly reimbursing such states 20% of their respective amounts of the NPM Adjustment. The selection of a three-judge panel arbitrating the 2003 NPM Adjustment claims (the "**Arbitration Panel**") was completed in July 2010.

Following the completion of discovery, the PMs determined to continue to contest the 2003 diligent enforcement claims of 33 states (including the State), the District of Columbia and Puerto Rico and to no longer contest such claims by 12 other states and four U.S. territories (the "**non-contested states**"). Eighteen of these contested states (including the State), the District of Columbia and Puerto Rico, as well as two non-contested states, subsequently entered into the NPM Adjustment Settlement Term Sheet with the OPMs and certain of the SPMs as discussed below under "*—NPM Adjustment Settlement and Award*", leaving 15 states contested in the 2003 NPM Adjustment arbitration proceedings. A common issues hearing was held in April 2012 and state-specific evidentiary hearings began in May 2012 and were completed in May 2013. The decisions of the Arbitration Panel with regard to those 15 states and their enforcement in 2003 of their Qualifying Statutes are discussed below under "*—2003 NPM Adjustment Arbitration Results*". Two of those 15 states subsequently joined the NPM Adjustment Settlement Term Sheet, as discussed below.

NPM Adjustment Settlement and Award. On December 17, 2012, terms of a settlement agreement (the "**NPM Adjustment Settlement Term Sheet**") were agreed to by 19 jurisdictions (including the State), the OPMs and certain SPMs regarding claims related to the 2003 through 2012 NPM Adjustments and the determination of subsequent NPM Adjustments. The 19 jurisdictions that signed the NPM Adjustment Settlement Term Sheet on December 17, 2012 were Alabama, Arizona, Arkansas, California, the District of Columbia, Georgia, Kansas, Louisiana, Michigan, Nebraska, Nevada, New Hampshire, New Jersey, North Carolina, Puerto Rico, Tennessee, Virginia, West Virginia and Wyoming. On April 12, 2013, Oklahoma joined the NPM Adjustment Settlement Term Sheet; on May 24, 2013, Connecticut and South Carolina joined the NPM Adjustment Settlement Term Sheet; on June 10, 2014, Kentucky joined the NPM Adjustment Settlement Term Sheet (on modified terms); and on June 26, 2014, Indiana joined the NPM Adjustment Settlement Term Sheet (on modified terms), bringing the total number of jurisdictions that have joined the settlement to 24, representing approximately 50% Allocable Share. Such jurisdictions that joined the NPM Adjustment Settlement Term Sheet are collectively referred to herein as the "**Term Sheet Signatories**," which term, where appropriate, includes any additional jurisdictions that subsequently sign the NPM Adjustment Settlement Term Sheet. Additional jurisdictions were permitted to join the settlement up to the end date of the last individual state-specific diligent enforcement hearings (the last diligent enforcement hearing for the jurisdictions that did not sign on to the NPM Adjustment Settlement Term Sheet occurred in May 2013), although they will have different and potentially less favorable payment obligations as detailed in the NPM Adjustment Settlement Term Sheet. After such time, additional jurisdictions may join the settlement only if the signatory PMs, in their sole discretion, agree.

The NPM Adjustment Settlement Term Sheet was subject to approval by the Arbitration Panel. On March 12, 2013, the Arbitration Panel issued its Stipulated Partial Settlement and Award (the "**NPM Adjustment Stipulated Partial Settlement and Award**"). In the NPM Adjustment Stipulated Partial Settlement and Award, the Arbitration Panel, as a threshold matter, ruled that it had jurisdiction (i) to enter the NPM Adjustment Stipulated Partial Settlement and Award, (ii) to rule on the objections of those jurisdictions that did not join the settlement (the "**Term Sheet Non-Signatories**"), (iii) to determine how the 2003 NPM Adjustment Settlement would be allocated among the Term Sheet Non-Signatories in light of the settlement and (iv) to incorporate and direct the MSA Auditor to implement the provisions of the NPM Adjustment Settlement Term Sheet, including as they pertain to years beyond 2003. The Arbitration Panel noted that it was neither "approving" the NPM Adjustment Settlement Term Sheet nor assessing the merits of any NPM Adjustment dispute, but giving effect to the Term Sheet Signatories' and signatory PMs' agreed settlement payments as among themselves, by directing the MSA Auditor to implement the settlement provisions at issue.

In the NPM Adjustment Stipulated Partial Settlement and Award, the Arbitration Panel specifically directed the MSA Auditor (i) to release approximately $1.76 billion (plus accumulated earnings thereon) from the Disputed Payments Account to the Term Sheet Signatories, allocating such released amount among the Term Sheet Signatories as they directed in connection with the April 15, 2013 MSA payment and (ii) to apply a credit in the aggregate amount of approximately $1.65 billion to the OPMs' MSA payments, allocating such credit among the OPMs as they directed with 50% of the credit applied against the April 15, 2013 MSA payment and 12.5% to be applied against each of the April 15, 2014 through 2017 MSA payments. Under the NPM Adjustment Settlement Term Sheet, parallel provisions exist for SPMs, which stipulated a credit of approximately $31 million to the SPMs' April 2013 MSA payments. The NPM Adjustment Settlement Term Sheet provided for the Term Sheet Signatories to allocate the settlement amount for the 2003 NPM Adjustment among themselves (through the application of the credits to PMs or the receipt by the Term Sheet Signatories of amounts released from the Disputed Payments Account, or both) so as to fully compensate those Term Sheet Signatories whose diligent enforcement for 2003 was non-contested.

While not ruling on years subsequent to the 2003 NPM Adjustment, the Arbitration Panel ruled that the reduction of the 2003 NPM Adjustment, in light of the NPM Adjustment Stipulated Partial Settlement and Award (for purposes of allocating the 2003 NPM Adjustment to the Term Sheet Non-Signatories), would be on a *pro rata* basis: the dollar amount of the 2003 NPM Adjustment would be reduced by a percentage equal to the aggregate allocable share of the Term Sheet Signatories. In addition, the Arbitration Panel directed the MSA Auditor to treat the Term Sheet Signatories as not being subject to the 2003 NPM Adjustment, resulting in a reallocation of the Term Sheet Signatories' share of the 2003 NPM Adjustment among those Term Sheet Non-Signatories that are found not to have diligently enforced their Qualifying Statutes during 2003. This framework creates an incentive for Term Sheet Non-Signatories to contest the diligent enforcement of Term Sheet Signatories for years 2004 onward. The Arbitration Panel concluded that the NPM Adjustment Settlement Term Sheet and the NPM Adjustment Stipulated Partial Settlement and Award do not legally prejudice or adversely affect the Term Sheet Non-Signatories, but that, should a Term Sheet Non-Signatory found by the Arbitration Panel to be non-diligent have a good faith belief that the *pro rata* reduction method did not adequately compensate it for a Term Sheet Signatory's removal from the reallocation pool, its relief, if any, is by appeal to its individual MSA state court. The Arbitration Panel further concluded that neither the NPM Adjustment Stipulated Partial Settlement and Award nor the NPM Adjustment Settlement Term Sheet constitutes an amendment to the MSA that would require the consent of any Term Sheet Non-Signatory. No assurance can be given, however, that a court would not hold that the NPM Adjustment Stipulated Partial Settlement and Award and the NPM Adjustment Settlement Term Sheet constitute amendments to the MSA. See "RISK FACTORS—Other Risks Relating to the MSA and Related Statutes—*Amendments, Waivers and Termination*" and "*—Reliance on State Enforcement of the MSA and State Impairment*."

Pursuant to the NPM Adjustment Settlement Term Sheet, including as implemented in April 2013 and April 2014 following the NPM Adjustment Stipulated Partial Settlement and Award, the OPMs and certain SPMs have received certain reductions in 2013 and 2014 and will receive reductions to future MSA payments in the form of credits and transition year reductions to reflect a percentage of the Term Sheet Signatories' aggregate share of the OPMs' and certain SPMs' aggregate 2003 through 2012 NPM Adjustment claims. The amount of such percentages is dependent on the number of jurisdictions that eventually join the final settlement. In particular, Altria reported in its Form 10-K filed with the SEC for the calendar year 2014 that it expects to receive a total of at least $599 million for the 2003 through 2012 NPM Adjustment claims and that of this total, Philip Morris has already received $579 million in the form of reductions to its MSA payments in 2013 or 2014 and it expects to receive the remaining $20 million as a reduction to its MSA payment due in April 2015. Altria further reported in its Form 10-K filed with the SEC for the calendar year 2014 that Philip Morris has already received $35 million for the 2013 transition year under the NPM Adjustment Settlement Term Sheet, discussed below, in the form of a reduction to its MSA payments in 2014, and expects to receive an additional $3 million for the 2013 transition year, as a result of Indiana and Kentucky having joined the NPM Adjustment Settlement Term Sheet, in the form of a reduction to its MSA payment due in April 2015. Altria further reported that Philip Morris will also receive a payment for the 2014 transition year, in an amount subsequently to be calculated, in the form of a reduction to its MSA payment due in April 2015. Reynolds American, in its Form 10-K filed with the SEC for the calendar year 2014, reported that, based on the jurisdictions bound by the NPM Adjustment Settlement Term Sheet through December 31, 2013, Reynolds Tobacco and Reynolds American's subsidiary Santa Fe Natural Tobacco Company, Inc., an SPM, will receive credits that they currently estimate to total approximately $1.1 billion with respect to their NPM Adjustment claims for the period from 2003 through 2012, to be applied against annual payments under the MSA over a five-year period, which commenced with the April 2013 MSA payment, and a result of the two states, Indiana and Kentucky, that joined the NPM Adjustment Settlement Term Sheet in June 2014, Reynolds Tobacco and Santa Fe Natural Tobacco Company, Inc. collectively will receive credits that they currently estimate to total approximately $170 million with respect to their NPM Adjustment claims from 2003 through 2012, to be applied against annual payments under the MSA over a five-year period effectively beginning with the April 2014 MSA payment related to the addition of these two states. In addition, Reynolds American reported in its Form 10-K filed with the SEC for the calendar year 2014 that as a result of meeting the performance requirements associated with the NPM Adjustment Settlement Term Sheet, Reynolds American (for both Reynolds Tobacco and Santa Fe Natural Tobacco Company, Inc.) recognized additional credits of $311 million and $264 million for the years ended December 31, 2014 and 2013, respectively. Reynolds Tobacco expects to recognize additional credits through 2017, according to Reynolds American's Form 10-K filed with the SEC for the calendar year 2014. Lorillard, Inc. reported in its Form 10-K filed with the SEC for the calendar year 2014 that it currently expects to receive credits over six years of approximately $254 million on its outstanding claims, with $165 million having occurred in April 2013, $36 million having occurred in April 2014 (including $14 million received in April 2014 related to the 2003 NPM Adjustment award from the two states, Kentucky and Indiana, that joined the NPM Adjustment Settlement Term Sheet in June 2014) and approximately $53 million over the following five years.

In addition, as part of the NPM Adjustment Settlement Term Sheet, in April 2013, the 20 Term Sheet Signatories that had signed the Term Sheet by that time received their aggregate Allocable Share of over $4.7 billion from the Disputed Payments Account under the MSA. Further amounts were released from the Disputed Payments Account to the additional 4 jurisdictions that joined the NPM Adjustment Settlement Term Sheet (Connecticut and South Carolina in 2013, and Kentucky and Indiana in 2014, each according to their Allocable Share).

The NPM Adjustment Settlement Term Sheet also sets forth the terms by which NPM Adjustments for 2013 onward are to be determined. For the two-year transition period of sales years 2013¬2014, the revised adjustment for SET-Paid NPM Sales, as described in the next succeeding paragraph, will apply (with certain exceptions). The revised adjustment for Non-SET-Paid NPM Sales, described in the second next succeeding paragraph, will not apply during this transition period. In addition, for each of those years, signatory PM payments will be adjusted based on a comparison of the Market Share Losses (as defined in the MSA) in 2013 or 2014 to the 2011 Market Share Loss. If the Market Share Loss is below the 2011 level, the adjustment is 25%, using the original NPM Adjustment formula. For Market Share Loss above the 2011 level, the adjustment is indexed upwards based on the number of cigarettes above the 2011 Market Share Loss starting at 30% and increasing to 50%.

Beginning in 2013, there is a state-specific adjustment that applies to sales of SET-paid NPM cigarettes ("**SET-Paid NPM Sales**"). "**SET**" consists of state cigarette excise tax or other state tax on the distribution or sale of cigarettes (other than a state or local sales tax that is applicable to consumer products generally and is not in lieu of an excise tax) and, after 2014, any excise or other tax imposed by a state or federally recognized tribe on the distribution or sale of cigarettes. For SET-Paid NPM Sales of "**non-compliant NPM cigarettes**" (defined in the NPM Adjustment Settlement Term Sheet, with certain exceptions, as any cigarette sale for which escrow is not deposited, either by payment by the NPM or by collection upon a bond), the adjustment of PM payments due from signatory PMs will be three times the per-cigarette escrow deposit rate contained in the Model Statute for the year of the sale, including the inflation adjustment in the statute. There will be a proportional adjustment for each signatory SPM in proportion to the size of its MSA payment for that year. A Term Sheet Signatory will not be subject to this revised adjustment if (i) escrow was deposited on 96% of all NPM cigarettes sold in the Term Sheet Signatory jurisdiction during that year on which SET was paid, or (ii) the number of SET-paid NPM cigarettes sold in the Term Sheet Signatory jurisdiction during that year on which escrow was not deposited did not exceed 2 million cigarettes.

Non-SET-Paid NPM Sales ("**Non-SET-Paid NPM Sales**") will be handled as to the Term Sheet Signatories per the terms of the MSA, with the following adjustments. A data clearinghouse (the "**Data Clearinghouse**") will calculate the total FET-paid NPM volume in the Settling States and nationwide. "**FET**" means the federal excise tax. Beginning in 2015, for Non-SET-Paid NPM Sales, the total NPM Adjustment liability, if any, of each Term Sheet Signatory under the original formula for a year would be reduced by a percentage equal to the sum of (i) the percentage represented by the fraction of the total SET-paid NPM volume in the Settling States divided by nationwide FET-paid NPM volume for that year plus (ii) in the case of a Term Sheet Signatory that has, as of January 1 of the year at issue, executed documentation approving the PSS Credit Amendment (even if the PSS Credit Amendment has not yet taken effect), the percentage represented by the fraction of (x) the total equity-fee-paid NPM sales in those Previously Settled States that had in effect for the entire year at issue an NPM equity fee law that, by its terms, imposed a per-pack fee equal to or greater than 90% of the escrow rate for sales made that year under the Qualifying Statute on all cigarette sales in such state that it has the authority under federal law to tax, divided by (y) nationwide FET-paid NPM volume. Such liability reduction will be effectuated by each Term Sheet Signatory that is found non-diligent and allocated a share of the NPM Adjustment amount receiving a reimbursement by the signatory PMs. The NPM Adjustment Settlement Term Sheet provides that the Term Sheet Signatories and the signatory PMs will split the amounts at issue under the above-described Non-SET-Paid NPM Sales provisions for 2015 and each subsequent year on a 50-50 basis, subject to repayment without interest by the PMs or credit without interest by the Term Sheet Signatories after the arbitration for that year concludes.

The State has not yet executed documentation approving the PSS Credit Amendment, but staff of the State Attorney General's office have recommended to the Attorney General of the State that she approve the PSS Credit Amendment. No assurance can be given that the State will execute such an approval, or when any such approval will be executed. See "SECURITY FOR THE BONDS—Consent to Amendments to Indenture and Purchase and Sale Agreement," "THE PURCHASE AND SALE AGREEMENT—Non-Impairment Covenant of the State" and "THE INDENTURE—Non-Impairment Covenant of the State" herein.* See also "RISK FACTORS—Other Risks Relating to the MSA and Related Statutes—*Amendments, Waivers and Termination*" and "*—Reliance on State Enforcement of the MSA and State Impairment*."

In furtherance of the NPM Adjustment Settlement Term Sheet framework and NPM Adjustment Stipulated Partial Settlement and Award, the State in 2013 amended the definition of "units sold" subject to the required escrow deposits under the Qualifying Statute to be "the number of individual cigarettes sold to a consumer in the state by the applicable tobacco product manufacturer, whether directly or through a distributor, retailer, or similar intermediary or intermediaries, during the year in question, regardless of whether the state excise tax was due or collected". See "SUMMARY OF THE MSA—California Qualifying Statute." See also "RISK FACTORS—Other Risks Relating to the MSA and Related Statutes—*Amendment to the State's Qualifying Statute*" and "LEGAL CONSIDERATIONS—MSA and Qualifying Statute Enforceability."

The NPM Adjustment Settlement Term Sheet also provides that, except in certain cases (primarily, if the dispute was noticed for arbitration by the PM over one year prior to the payment date and the arbitration has not begun despite good faith efforts by the PM), the PMs will not withhold payments or pay into the Disputed Payments Account based on a dispute arising out of the revised NPM Adjustment as set forth in the NPM Adjustment Settlement Term Sheet.

Pursuant to the agreements by which Kentucky and Indiana joined the NPM Adjustment Settlement Term Sheet in June 2014, the settlement with respect to those states includes the modified terms that the OPMs are to receive reductions to their MSA payments in an amount equal to the sum of (i) 65% of the amount of the 2003 NPM Adjustment applicable to those states under the Arbitration Panel's award, plus 65% of interest and earnings on that amount as was calculated by the MSA Auditor, and (ii)

* As of the Series 2015A Closing Date, the non-impairment covenants of the State contained in the purchase and sale agreement and indenture related to the Series 2007 Bonds do not contain a material adversity standard similar to that being added to the Purchase and Sale Agreement and the Indenture on the Series 2015A Closing Date. See "SECURITY FOR THE BONDS—Consent to Amendments to Indenture and Purchase and Sale Agreement." The Issuer cannot predict the content or timing of any future amendment to the MSA, the MOU, or the California Escrow Agreement.

55% of those states' aggregate allocable share of the OPMs' aggregate 2004 - 2012 NPM Adjustments plus interest. All other terms of settlement as discussed above apply to Kentucky and Indiana.

The NPM Adjustment Settlement Term Sheet provides that the parties will cooperate in the drafting and execution of a comprehensive final settlement agreement incorporating the terms of the NPM Adjustment Settlement Term Sheet, as well as all other customary terms and conditions acceptable to the parties, and that the documentation process will be subject to the oversight of the Arbitration Panel.

In January 2013, Moody's placed 31 series of tobacco settlement revenue bonds under review as a result of the potential impact of the NPM Adjustment Settlement Term Sheet, stating that the provisions of the NPM Adjustment Settlement Term Sheet could reduce the cash flow of the joining states (such as the State) and indirectly affect the non-joining states. On February 20, 2014 Moody's reported that it had updated its methodology for rating tobacco settlement revenue securitizations based upon the NPM Adjustment Settlement Term Sheet, and consequently upgraded the ratings of 55 tranches, downgraded the ratings of 7 tranches, confirmed the ratings of 73 tranches that were placed on review with direction uncertain in January 2013, and affirmed the ratings of 3 tranches, stating that it made two assumption changes for all states, including the states that did not join the NPM Adjustment Settlement Term Sheet: (i) that the tobacco companies will continue making NPM Adjustments for the entire duration of the transactions, and (ii) that the states will recover the NPM Adjustments 8 to 12 years later. Moody's rating actions did not affect the ratings of then-outstanding Bonds of the Issuer, as such ratings are based on State Appropriations.

No assurance can be given as to the implementation in future years of the NPM Adjustment Stipulated Partial Settlement and Award by the MSA Auditor with regard to the State, as to whether or not the NPM Adjustment Stipulated Partial Settlement and Award will be revised and any consequences thereto, or as to any final settlement or resolution of disputes concerning the NPM Adjustment Stipulated Partial Settlement and Award (including the magnitude of the effect of any resolution of disputes) and the effect of such factors on the amount and/or timing of Pledged TSRs available to the Issuer to pay debt service on the Series 2015A Bonds. See "*—Disputes Concerning the NPM Adjustment Settlement Term Sheet and Stipulated Partial Settlement and Award*" below.

The NPM Adjustment Settlement Term Sheet provides that "[p]ending the execution of the final settlement agreement, [the NPM Adjustment Settlement Term Sheet] is binding on all signatories provided the conditions [therein] are met." Similarly, the NPM Adjustment Stipulated Partial Settlement and Award provides that the NPM Adjustment Settlement Term Sheet "is now binding on all signatories." Reynolds American, the parent company of OPM Reynolds Tobacco, a signatory to the NPM Adjustment Settlement Term Sheet, has stated in its SEC filings, most recently in its Form 10-K filed with the SEC for the calendar year 2014, that the NPM Adjustment Settlement Term Sheet "is binding on all signatories." Despite the foregoing, no assurance can be given that the Term Sheet Signatories and the signatory PMs will be bound to the terms of the NPM Adjustment Settlement Term Sheet, as expressed at present, until the time that a final settlement agreement, if any, is executed. No opinion of legal counsel is being rendered in connection with the issuance of the Series 2015A Bonds to the effect that the NPM Adjustment Settlement Term Sheet is valid, binding or enforceable.

See "APPENDIX E—NPM ADJUSTMENT STIPULATED PARTIAL SETTLEMENT AND AWARD AND SETTLEMENT TERM SHEET" for copies of the NPM Adjustment Stipulated Partial Settlement and Award and the NPM Adjustment Settlement Term Sheet (including the August 2010 memorandum of understanding referenced therein).

Disputes Concerning the NPM Adjustment Settlement Term Sheet and Stipulated Partial Settlement and Award. Several states have disputed the NPM Adjustment Settlement Term Sheet and Stipulated Partial Settlement and Award. As an initial step, on March 13, 2013, the Office of the Attorney General of the State of Illinois sent a letter, on behalf of itself and 23 other Term Sheet Non-Signatories (to which letter several additional Term Sheet Non-Signatories later joined), to the MSA Auditor, affirming their position that the Arbitration Panel lacked jurisdiction and that the NPM Adjustment Stipulated Partial Settlement and Award was inconsistent with the terms of the MSA, and informing the MSA Auditor that they objected to and would contest any action by the MSA Auditor to release funds from the Disputed Payments Account or to reallocate the 2003 NPM Adjustment under the terms of the NPM Adjustment Stipulated Partial Settlement and Award.

Subsequently, motions were filed by 14 Term Sheet Non-Signatories in their respective MSA courts to vacate and/or modify the NPM Adjustment Stipulated Partial Settlement and Award. Two of the states (Colorado and Ohio) had also unsuccessfully sought to preliminarily enjoin the implementation of the NPM Adjustment Stipulated Partial Settlement and Award (the MSA Auditor carried out the implementation of the NPM Adjustment Stipulated Partial Settlement and Award over the objections of the Term Sheet Non-Signatories, as discussed above). According to Lorillard, Inc.'s Form 10-K filed with the SEC for the calendar year 2014, as of February 6, 2015 eight of these motions were still pending, after three states withdrew their opposition, one state did not appeal a denial of its challenge, and two states joined the NPM Adjustment Settlement Term Sheet. The outcomes of the pending claims filed by the Term Sheet Non-Signatories cannot be predicted. No assurance can be given that other challenges to the NPM Adjustment Stipulated Partial Settlement and Award will not be commenced in other MSA courts.

2003 NPM Adjustment Arbitration Results. On September 11, 2013, the Arbitration Panel released its decisions with respect to each of the fifteen contested states that were Term Sheet Non-Signatories. The Arbitration Panel determined that nine states diligently enforced their respective Qualifying Statutes during 2003, and six states (Indiana, Kentucky, Maryland, Missouri, New Mexico and Pennsylvania, which have an aggregate allocable share of 14.6792685%) did not diligently enforce their respective Qualifying Statutes during 2003. As a result, the nine states that were determined to have diligently enforced their respective Qualifying Statutes, as well as the jurisdictions that were either not contested or were not subject to the arbitration proceedings, were not to be subject to the 2003 NPM Adjustment, and their share of the 2003 NPM Adjustment was to be reallocated in accordance with the MSA to the six states found by the Arbitration Panel to have not diligently enforced their respective Qualifying Statutes during 2003. Indiana and Kentucky, two of the six states that were held to be non-diligent for 2003, subsequently joined the NPM Adjustment Settlement Term Sheet in June 2014, as discussed above. According to Lorillard, Inc. in its Form 10-K filed with the SEC for the calendar year 2014, the OPMs are entitled to receive $458 million plus interest and earnings as a result of the Arbitration Panel's ruling.

All six of the states that were determined by the Arbitration Panel's final awards not to have diligently enforced their Qualifying Statutes in 2003 filed motions to vacate such final awards with respect to those states. In April 2014, the MSA court in Pennsylvania upheld the Arbitration Panel's non-diligence finding for Pennsylvania, but also ruled that the states that signed the NPM Adjustment Settlement Term Sheet and had been contested in the 2003 NPM Adjustment arbitration (such as the State) would be deemed non-diligent for purposes of calculating Pennsylvania's share of the 2003 NPM Adjustment, resulting in a partial reduction of Pennsylvania's share of the 2003 NPM Adjustment allocation. In May 2014, the Missouri MSA court issued a decision similar to the Pennsylvania court. No assurance can be given as to the effect of decisions such as those of the MSA courts in Pennsylvania and Missouri on Term Sheet Signatories such as the State. In July 2014, a Maryland state trial court denied both Maryland's motion to vacate the Arbitration Panel's ruling that Maryland had not diligently enforced and Maryland's motion to vacate or modify the final award. According to Altria's Form 10-K filed with the SEC for the calendar year 2014, Philip Morris is appealing the Pennsylvania and Missouri decisions modifying the final award; Maryland is appealing its court's decision declining to modify the final award; each of Maryland and Missouri is appealing its court's ruling denying its motion to vacate the Arbitration Panel's diligence ruling as to that state; and the motions filed by New Mexico remain pending in its state trial court. The other two of the six states found to be non-diligent became Term Sheet Signatories, as noted above: on June 10, 2014, Kentucky joined the NPM Adjustment Settlement Term Sheet, and on June 26, 2014, Indiana joined the NPM Adjustment Settlement Term Sheet, each on modified and less advantageous financial terms than those obtained by previous Term Sheet Signatories such as the State.

According to Lorillard, Inc. in its Form 10-K filed with the SEC for the calendar year 2014, the MSA Auditor issued final calculations on March 31, 2014 for the April 2014 MSA payment that implemented the 2003 NPM Adjustment through the non-diligent states receiving reductions in future MSA payments they receive and the OPMs and diligent states receiving amounts due to them through payments from the Disputed Payments Account and/or adjustments associated with future payments, and on April 14, 2014 the MSA Auditor issued revised final calculations for the April 2014 MSA payments that implemented the Pennsylvania court's ruling. On June 23, 2014 the MSA Auditor issued revised final calculations for the April 2014 MSA payments that implemented the Missouri ruling, according to Lorillard, Inc. in its Form 10-K filed with the SEC for the calendar year 2014, and the MSA Auditor issued further revised final calculations for the April 2014 MSA payments on July 22, 2014 requiring payment of a portion of the Disputed Payments Account earnings to the Term Sheet Non-Signatories; Lorillard has disputed these revised calculations and has paid $2 million into the Disputed Payments Account pending the dispute's resolution. According to Reynolds American's Form 10-K filed with the SEC for the calendar year 2014, until such time as the various remaining state motions challenging the rulings of the Arbitration Panel have been resolved, uncertainty exists as to the timing, process and amount of ultimate recovery with respect to the remaining share of the 2003 NPM Adjustment claim.

The Arbitration Panel's decisions regarding 2003 diligent enforcement defined diligent enforcement as "an ongoing and intentional consideration of the requirements of a Settling State's Qualifying Statute, and a significant attempt by the Settling State to meet those requirements, taking into account a Settling State's competing laws and policies that may conflict with its MSA contractual obligations." The Arbitration Panel considered various factors in deciding whether or not a state met the diligent enforcement standard, including, in no particular order, (i) such state's collection rate of amounts to be deposited by NPMs into escrow accounts, (ii) the number of lawsuits against manufacturers brought by such state, (iii) how the state gathered reliable data, (iv) resources allocated to enforcement, (v) prevention of non-compliant NPMs from future sales, (vi) legislation enacted by the state, (vii) actions short of legislation taken by the state, and (viii) efforts made to be aware of NAAG and other states' enforcement efforts. The Arbitration Panel stated that such factors were not necessarily given equal weight, but were considered as a whole. Where certain terms defined in the Model Statute were disputed, the Arbitration Panel relied on the plain meaning of the defined terms and did not penalize states for a rational interpretation of the terms in enforcing their Qualifying Statutes. The Arbitration Panel did not penalize states that provided rational reasons for implementing policies and legislation with respect to enforcement of their Qualifying Statutes, finding that a good faith effort to address an issue where there is no evidence of intentional escrow evasion was an indication of diligent enforcement. The Arbitration Panel also stated that although the Settling States are required under the MSA to diligently enforce their Qualifying Statutes, the Settling States are not required "to elevate those obligations above other statutory or rational policy considerations."

Ongoing 2004 Through 2013 NPM Adjustment Claims. An independent economic consulting firm, jointly selected by the MSA parties, determined that the disadvantages of the MSA were a significant factor contributing to the PMs' collective loss of market share for sales years 2004 and 2005 (as well as 2003, as discussed above). A different independent economic consulting firm, jointly selected by the MSA parties, determined that the disadvantages of the MSA were a significant factor contributing to the PMs' collective loss of market share for the sales year 2006. Following the firm's determination for 2006, the OPMs and the Settling States agreed that the Settling States would not contest that the disadvantages of the MSA were a significant factor contributing to the PMs' collective loss of market share for the sales years 2007 – 2012 (the "**significant factor agreement**"). This agreement became effective for sales years 2007, 2008, 2009, 2010, 2011 and 2012 on February 1, 2010, 2011, 2012, 2013, 2014 and 2015, respectively. According to Altria's Form 10-K filed with the SEC for the calendar year 2014, a significant factor proceeding for 2013 cannot be commenced until April 2015.

According to Altria's Form 10-K filed with the SEC for the calendar year 2014, Philip Morris believes that the MSA requires state claims of diligent enforcement for 2004 - 2013 to be determined in a multi-state arbitration, although a number of Term Sheet Non-Signatories have filed motions in their state MSA courts contending that the claims are to be determined either in separate arbitrations for individual states or that there is no arbitrable dispute for 2004. Proceedings with respect to diligent enforcement claims for the sales years 2004 through 2013 have not yet been scheduled, but Reynolds American reported in its Form 10-K filed with the SEC for the calendar year 2014 that preliminary discussions are underway with the Term Sheet Non-Signatories to initiate arbitration proceedings with respect to the 2004 NPM Adjustment. Altria has reported in its Form 10-K filed with the SEC for the calendar year 2014 that no assurance can be given as to when proceedings for 2004-2013 will be scheduled or the precise form those proceedings will take. Altria has further stated in its Form 10-K filed with the SEC for the calendar year 2014 that it continues to pursue the NPM Adjustments for sales years 2004 - 2013 against the Term Sheet Non-Signatories. It is possible that Term Sheet Non-Signatories could enter into settlements with regard to the NPM Adjustments for sales years 2004 and beyond.

The approximate maximum principal amounts of the PMs' aggregate share of the disputed NPM Adjustment for the sales years 2003 through 2013 (payment years 2004 through 2014), as reported by NAAG as of May 5, 2014, and without regard to the effects of the NPM Adjustment Settlement Term Sheet and the Stipulated Partial Settlement and Award, are as follows:

(Remainder of Page Intentionally Left Blank)

OPM and SPM Maximum Potential NPM Adjustment Amounts

Sales Years 2003-2013 (Payment Years 2004-2014) [1]

	Sales Year 2003 (Payment Year 2004)	Sales Year 2004 (Payment Year 2005)	Sales Year 2005 (Payment Year 2006)	Sales Year 2006 (Payment Year 2007)	Sales Year 2007 (Payment Year 2008)	Sales Year 2008 (Payment Year 2009)	Sales Year 2009 (Payment Year 2010)	Sales Year 2010 (Payment Year 2011)	Sales Year 2011 (Payment Year 2012)	Sales Year 2012 (Payment Year 2013)	Sales Year 2013 (Payment Year 2014)
OPMs											
Annual Payment	$1,061,158,548.39	$1,061,288,733.95	$702,715,076.82	$646,394,781.27	$626,577,960.85	$733,259,041.08	$704,682,906.24	$720,900,101.29	$601,918,327.47	$650,595,746.07	$677,336,376.22
Strategic Contribution Fund Payments					$75,526,196.88	$88,385,277.10	$84,940,778.70	$86,895,560.30	$72,553,784.12	$78,421,242.81	$81,644,493.90
SPMs											
Annual Payment	$86,407,516.48	$76,107,191.03	$50,630,561.09	$53,949,636.76	$42,733,823.61	$60,378,182.91	$62,807,562.71	$59,097,501.45	$46,626,494.22	$48,875,804.10	$44,639,809.41
Strategic Contribution Fund Payments					$4,520,680.94	$6,387,223.92	$6,644,220.61	$6,251,744.54	$4,932,474.69	$5,170,422.33	$4,722,309.37
Total	$1,147,566,064.87	$1,137,395,924.98	$753,345,637.91	$700,344,418.03	$749,358,662.28	$888,409,725.01	$859,075,468.26	$873,144,907.58	$726,031,080.50	$783,063,215.31	$808,342,988.90

[1] Payments are subject to adjustments from disputes for up to four years following the payment due date under the MSA under the Offset for Miscalculated or Disputed Payment provisions.

The foregoing amounts may be recalculated by the MSA Auditor if it receives information that is different from or in addition to the information on which it based these calculations, including, among other things, if it receives revised sales volumes from any PM. Disputes among the manufacturers could also reduce the foregoing amounts.

Altria has stated in its Form 10-K filed with the SEC for the calendar year 2014 that the MSA Auditor calculated the following approximate amounts as Philip Morris's maximum potential share of the NPM Adjustments for the years 2004 - 2013 (exclusive of interest or earnings): $388 million for 2004, $181 million for 2005, $154 million for 2006, $185 million for 2007, $250 million for 2008, $211 million for 2009, $219 million for 2010, $165 million for 2011, $207 million for 2012 and $215 million for 2013, which maximum amounts will be reduced by a judgment reduction to reflect the settlement with the Term Sheet Signatories and may be further reduced by other developments including agreements that may be entered in the future, disputes that may arise or recalculation of the NPM Adjustment amounts by the MSA Auditor. Altria noted in its Form 10-K filed with the SEC for the calendar year 2014 that the receipt by Philip Morris of amounts in respect of the 2003 NPM Adjustment and interest from Term Sheet Non-Signatories does not provide any assurance that Philip Morris will receive any NPM Adjustment amounts (or associated interest or earnings) for 2004 or any subsequent year. Reynolds American, Reynolds Tobacco's parent company, has reported in its Form 10-K filed with the SEC for the calendar year 2014 that Reynolds Tobacco has disputed a total of approximately $5.2 billion for the years 2003 through 2013 in connection with the NPM Adjustment. In its Form 10-K filed with the SEC for the calendar year 2014, Lorillard, Inc. reported that in April of 2013, 2012, 2011, 2010, 2009, 2008, 2007 and 2006, Lorillard, Inc. had deposited $119 million, $106 million, $104 million, $83 million, $73 million, $72 million, $111 million and $109 million, respectively, in the Disputed Payments Account, based on a loss of market share in 2010, 2009, 2008, 2007, 2006, 2005, 2004 and 2003 to NPMs, and that in 2014 it deposited $93 million in the Disputed Payments Account, $88 million of which was based on a loss of market share in 2011 to NPMs, and the remaining amount was for adjustments related to escrow payments for other years. Certain amounts in the Disputed Payments Account have been released to the Term Sheet Signatories as a result of the NPM Adjustment Settlement Term Sheet and certain amounts in the Disputed Payments Account have been released to the OPMs as a result of the 2003 arbitration decisions, as discussed above.

Disputed or Recalculated Payments and Other Disputes under the Terms of the MSA

Disputes concerning Annual Payments and Strategic Contribution Fund Payments and their calculations may be raised up to four years after the respective Payment Due Date (as defined in the MSA). The resolution of disputed payments may result in the application of an offset against subsequent Annual Payments or Strategic Contribution Fund Payments. The diversion of disputed payments to the Disputed Payments Account, the withholding of all or a portion of any disputed amounts or the application of offsets against future payments could also have a material adverse effect on the amount and/or timing of MSA payments. Furthermore, miscalculations or recalculations by the MSA Auditor or disputed calculations by any of the parties to the MSA, such as those described above under "—*NPM Adjustment*", have resulted and could in the future result in offsets to, or delays in disbursements of, payments to the Settling States pending resolution of the disputed item in accordance with the provisions of the MSA. Amounts held in the Disputed Payments Account could be released under the MSA to those Settling States which are found to have diligently enforced their Qualifying Statutes, or could be released pursuant to a settlement of the disputes among Settling States and the PMs (such as the NPM Adjustment Settlement Term Sheet, which the State joined), all as discussed above under "—*NPM Adjustment*." The Collection Methodology and Assumptions and the debt service coverage table for the Bonds do not factor in an offset for miscalculated or disputed payments other than pursuant to the NPM Adjustment Stipulated Partial Settlement and Award. See "SUMMARY OF THE MSA—Adjustments to Payments—*Offset for Miscalculated or Disputed Payments*," "—Potential Payment Decreases Under the Terms of the

MSA—*NPM Adjustment—Application of the NPM Adjustment*," "*—NPM Adjustment Settlement and Award*," and "TABLES OF PROJECTED PLEDGED TSRs, PROJECTION METHODOLOGY AND BOND STRUCTURING ASSUMPTIONS."

California, Kentucky and Iowa have had disputes and have filed suit against Bekenton USA, Inc. ("**Bekenton**"), to among other things, compel Bekenton to comply with its full payment obligations under the MSA. In June 2005, the State of California filed an application in San Diego County Superior Court seeking an enforcement order against Bekenton. Bekenton was allowed by the court to file a suit that argued, among other things, that the State of California breached the "most favored nation" ("**MFN**") provisions of the MSA by allowing three other SPMs to join the MSA under more favorable terms, and that it was entitled to similar relief under another clause of the MSA (the "**Relief Clause**"), which requires that if any PM is relieved of a payment obligation, such relief becomes applicable to all of the PMs. In a November 2005 tentative ruling (which subsequently became a final order on March 15, 2006), the court denied Bekenton's MFN claim and its motion to file suit under the Relief Clause. In 2005, Bekenton also filed for bankruptcy relief. In the Kentucky case, Bekenton failed to make its full MSA payment of approximately $7.7 million in April 2005, and, instead, paid only $198,000, less than 3% of the total payment due. The Commonwealth of Kentucky commenced an action against Bekenton in which Bekenton claimed that under the Relief Clause it was entitled to reduce its payment. In April 2006, the court dismissed Bekenton's claim for a reduction, holding that the Relief Clause was not applicable since the agreement with another PM did not relieve the PM of any payment obligations. In the Iowa case, the State of Iowa sought to de-list Bekenton as a PM for failing to comply with the MSA payment provisions and to prohibit Bekenton from doing business in Iowa for failing to comply with the escrow payment provisions of the Iowa Qualifying Statute. In August 2005, an Iowa state court enjoined Iowa from "de-listing" Bekenton, permitting Bekenton to continue selling cigarettes in Iowa. The court found that the MSA itself provides procedures for the resolution of disputes regarding MSA payments and that such procedures should be followed in this case.

For a discussion of litigation presenting challenges to the MSA and Settling States' Qualifying Statutes and Complementary Legislation, see "—Litigation Challenging the MSA, the Qualifying Statutes and Related Legislation" above.

Other Disputes Related to MSA Payments

Certain PMs were in dispute regarding (i) whether the "roll-your-own" tobacco conversion of 0.0325 ounces for one individual cigarette should continue to be used for purposes of calculating the downward Volume Adjustments to the MSA payments, or, rather, a 0.09 ounce conversion; and (ii) whether the total domestic cigarette market and certain other calculations related to the PMs' MSA payments should continue to be determined based on the "net" number of cigarettes on which federal excise tax is paid, or, rather, an "adjusted gross" number of cigarettes. In the "roll-your-own" dispute, the PMs contended that the 0.09 ounce conversion should be used, whereas the Settling States contended that the 0.0325 ounce conversion is required under the MSA. In the "net vs. gross" dispute, PMs contended that the MSA requires calculations based on a gross approach, while the Settling States contended that a net approach is required by the MSA.

Forty-three jurisdictions entered into arbitration involving these two disputes. The State was not a party to this arbitration proceeding. In an award dated January 21, 2013, the arbitration panel held that (i) the MSA Auditor is to use the Market Share for Liggett Group LLC (an SPM) on a net basis, but increase that calculation by a specified factor to avoid unfairness given the gross basis used for Liggett Group LLC in the MSA Auditor's March 30, 2000 calculation, and (ii) the MSA Auditor is to use the 0.0325 ounce conversion method for purposes of roll-your-own tobacco. Altria reported in its Form 10-K filed with the SEC for the calendar year 2014 it does not currently have access to the data necessary to determine the magnitude and the direction of the effects of this ruling on past and future MSA payments. No prediction can be made as to the effect on states (like the State) that did not participate in the arbitration proceeding.

THE CALIFORNIA CONSENT DECREE, THE MOU, THE ARIMOU AND THE CALIFORNIA ESCROW AGREEMENT

There follows a brief description of the Decree, the MOU, the ARIMOU and the California Escrow Agreement. This description is not complete and is subject to, and qualified in its entirety by reference to, the terms of the Decree, the MOU, the ARIMOU and the California Escrow Agreement.

General Description

On December 9, 1998, a Consent Decree and Final Judgment (the "**Decree**"), which governs the class action portion of the State's action against the tobacco companies, was entered in the Superior Court of the State of California for the County of San Diego. The Decree, which is final and non-appealable, settled the litigation brought by the State against the OPMs and resulted in the achievement of California State-Specific Finality under the MSA. The Decree incorporated by reference the MOU. The Superior Court of the State of California for the County of San Diego entered an order approving the ARIMOU on January 18, 2000. On July 30, 2001, an order was issued by the Superior Court of the State of California for San Diego County amending the ARIMOU with respect to certain rights of each Eligible City or County to transfer its MOU Proportional Allocable Shares in tobacco securitizations.

Prior to the entering of the Decree, the plaintiffs of certain pending lawsuits agreed, among other things, to coordinate their pending cases and to allocate certain portions of the recovery among the State and the Participating Jurisdictions. This agreement was memorialized in the MOU, by and among various counsel representing the State and a number of the Participating Jurisdictions. To set forth the understanding of the interpretation to be given to the terms of the MOU and to establish procedures for the resolution of any future disputes that may arise regarding the interpretation of the MOU among the State and the Participating Jurisdictions, the parties entered into the ARIMOU.

Under the MOU, 45% of the State's entire allocation of TSRs under the MSA is allocated to the Participating Jurisdictions which are counties, 5% is allocated to the four cities which are Participating Jurisdictions (1.25% each), and the remaining 50% is retained by the State. Although the percentage allocations of TSRs among the county Participating Jurisdictions are subject to adjustment to reflect shifts in population, the 50% share of TSRs allocated to the State is permanently fixed and not subject to adjustment based on changes in population.

Flow of Funds and California Escrow Agreement

Under the MSA, the State's portion of the TSRs are deposited into the California State-Specific Account held by Citibank, N.A., as the MSA Escrow Agent. Pursuant to the terms of the MOU, the ARIMOU and an Escrow Agreement between the State and the California Escrow Agent, the State has instructed the MSA Escrow Agent to transfer (upon receipt thereof) all amounts in the California State-Specific Account to Citibank, N.A., as the California Escrow Agent. The California Escrow Agent will deposit the State's 50% share of the TSRs in an account for the benefit of the State (the "**California State Government Escrow Account**"), and the remaining 50% of the TSRs into separate accounts (within the "**California Local Government Escrow Account**") for the benefit of the Participating Jurisdictions.

Pursuant to the California Escrow Agreement, the California Escrow Agent, within one business day of a deposit into the California State Government Escrow Account, will distribute to the State its allocable proportional share of the TSRs as determined by the MOU and the ARIMOU, unless the California Escrow Agent receives different instructions in writing from the State three business days prior to a deposit. The California Escrow Agent has been irrevocably instructed by the Attorney General of the State to disburse the Pledged TSRs directly to the Trustee. See "THE PURCHASE AND SALE AGREEMENT" and "SECURITY FOR THE BONDS" herein.

All fees and expenses due and owing the California Escrow Agent will be deducted equally from the California State Government Escrow Account and the California Local Government Escrow Account prior to the disbursement of any funds pursuant to the California Escrow Agreement. Such fees are set forth in the California Escrow Agreement and may be adjusted to conform to its then current guidelines. If at any time the California Escrow Agent is served with any judicial or administrative order or decree that affects the amounts deposited with the California Escrow Agent, the California Escrow Agent is authorized to comply with such order or decree in any manner it or its legal counsel deems appropriate. If any fees, expenses or costs incurred by the California Escrow Agent or its legal counsel are not promptly paid, the California Escrow Agent may reimburse itself from TSRs in escrow, but is not permitted to place a lien on any such TSRs. The California Escrow Agreement provides that only the State and the California Escrow Agent, and their respective permitted successors, are entitled to its benefits.

The California Escrow Agreement also provides a mechanism for the State to escrow TSRs to satisfy "claims over" entitling a PM to an offset for amounts paid under the MSA. See "SUMMARY OF THE MSA—Adjustment to Payments—*Offset for Claims-Over*" herein.

Enforcement Provisions of the Decree, the MOU and the ARIMOU

The MOU provides that the distribution of tobacco-related recoveries is not subject to alteration by legislative, judicial or executive action at any level, and, if such alteration were to occur and survive legal challenge, any modification would be borne proportionally by the State and the Participating Jurisdictions. The Decree specifically incorporates the entire MOU as if it were set forth in full in the Decree. Thus, the allocation of the State's TSRs under the MSA among the State and the Participating Jurisdictions set forth in the MOU is final and non-appealable. However, the MSA provides (and the Decree confirms) that only the State is entitled to enforce the PMs' payment obligations under the MSA, and the State is prohibited expressly from assigning or transferring its enforcement rights. In addition, under the ARIMOU the State and the Participating Jurisdictions are the only intended beneficiaries of the ARIMOU and the only parties entitled to enforce its terms and those provisions of the MOU incorporated into the ARIMOU.

SUMMARY OF THE TOBACCO CONSUMPTION REPORT

The following is a brief summary of the Tobacco Consumption Report, a copy of which is attached hereto as Appendix C. This summary does not purport to be complete and the Tobacco Consumption Report should be read in its entirety for an understanding of the assumptions on which it is based and the conclusions it reaches. The Tobacco Consumption Report forecasts future United States cigarette consumption. The MSA payments are based in part on cigarettes shipped in and to the United States. Cigarette shipments and cigarette consumption may not match as a result of various factors such as inventory adjustments, but are substantially the same when compared over a period of time.

IHS Global's forecasts, including, but not limited to, the forecast regarding future cigarette consumption, are estimates, which have been prepared by IHS Global on the basis of certain assumptions and hypotheses. No representation or warranty of any kind is or can be made with respect to the accuracy or completeness of, and no representation or warranty should be inferred from, these forecasts. The cigarette consumption forecast contained in the Tobacco Consumption Report is based upon assumptions *as to future events and, accordingly, is subject to varying degrees of uncertainty. Some assumptions inevitably will not materialize and, additionally, unanticipated events and circumstances may occur. Therefore, for example, actual cigarette consumption inevitably will vary from the forecast included in the Tobacco Consumption Report and the variations may be material and adverse. See "RISK FACTORS—Risks Relating to the Tobacco Consumption Report."*

General

IHS Global Inc. ("**IHS Global**"), formerly known as DRI•WEFA, Inc., has prepared a report dated March 13, 2015 on the consumption of cigarettes in the United States from 2015 through 2045 entitled, "A Forecast of U.S. Cigarette Consumption (2015-2045) for the Golden State Tobacco Securitization Corporation" (the "**Tobacco Consumption Report**"). IHS Global is an internationally recognized econometric and consulting firm of over 300 economists and is a part of IHS Inc., a global information company with over 1,000 researchers, analysts, and economists in more than 30 countries.

IHS Global developed a cigarette consumption model based on historical U.S. data between 1965 and 2013. IHS Global considered the impact of demographics, cigarette prices, disposable income, employment and unemployment, industry advertising expenditures, the future effect of the incidence of smoking amongst underage youth, and qualitative variables that captured the impact of anti-smoking regulations, legislation, health warnings and the availability of alternative tobacco and nicotine products. IHS Global found the following variables to be effective in building an empirical model of adult per capita cigarette consumption: real cigarette prices, real per capita disposable personal income, the impact of workplace smoking restrictions first instituted widely in the 1980s, the stricter restrictions on smoking in public places instituted over the last decade, and the trend over time in individual behavior and preferences. The forecast is based on reasonable assumptions regarding the future paths of these factors. IHS Global's econometric model, coupled with their long term forecast of the U.S. economy, has been used to project total U.S. cigarette consumption from 2015 through 2045. The forecast indicates that total consumption in 2045 will be approximately 104.0 billion cigarettes (or 104.6 billion including roll-your-own tobacco equivalents), a 61% decline from the 2014 level. From 2015 through 2045 the average annual rate of decline is projected to be approximately 3.0%.

Cigarette Consumption in the United States

The U.S. Department of Agriculture, which has compiled data on cigarette consumption between 1900 and 2007, reports that consumption grew from 2.5 billion cigarettes in 1900 to a peak of 640 billion in 1981. Following the release of the Surgeon General's report in 1964, cigarette consumption continued to increase at an average annual rate of 1.2% between 1965 and 1981. Between 1981 and 1990, U.S. cigarette consumption declined at an average annual rate of 2.2%. From 1990 to 1998, the average annual rate of decline in cigarette consumption was 1.5%; the decline increased to 3.1% in 1998 (with a consumption level of 465 billion cigarettes in that year) and increased further to 6.5% in 1999, which correlates with large price increases in 1998 and 1999 following the execution of the MSA and the Previously Settled State Settlements. In 2000 and 2001, the rate of decline moderated to 1.2%, and then accelerated in 2002 and 2003 to an annual rate of 3.0% (with consumption of less than 400 billion cigarettes in 2003), coincident with a large number of state excise tax increases. The decline moderated for the next four years, through 2007, averaging 2.3%. The rate of decline accelerated dramatically beginning in 2008, with a 3.8% decline in the number of cigarettes (including roll-your-own equivalents to cigarettes as defined by the MSA at 0.0325 ounces of loose tobacco per cigarette) for that year and 9.1% in 2009, which correlated with the rapid spread of indoor smoking bans, the economic recession, the increase in federal excise tax effective April 1, 2009, and additional state excise tax increases. The decline in cigarette consumption was 6.4% in 2010, and decelerated to 2.8% in 2011 and 2.0% in 2012. In 2013, the decline sharpened to nearly 5%. This decline has been attributed by the industry in part to a weak economy and the rapid increase in usage of electronic cigarettes. Full year 2014 shipments reported by MSAI were 3.2% lower than 2013, with actual consumption net of a change in inventory estimated to be down 3.4%.

Factors Affecting Cigarette Consumption

The Tobacco Consumption Report notes that the following factors affect smoking in some manner and are variables that are relevant in building a model of cigarette demand: (i) general population growth, (ii) price increases, (iii) changes in disposable income, (iv) youth consumption, (v) trend over time, (vi) workplace smoking bans, (vii) smoking bans in public places, (viii) nicotine dependence and (ix) health warnings.

Price Elasticity of Demand. The Tobacco Consumption Report notes that according to economic research, the demand for cigarettes is price inelastic, with an elasticity generally found to be between -0.3 and -0.5. Pursuant to IHS Global's multivariate regression analysis, the long-run price elasticity of consumption for the entire population is -0.33 (signifying that a 1.0% increase in the price of cigarettes decreases consumption by 0.33%).

Changes in Disposable Income. Pursuant to IHS Global's multivariate regression analysis, the income elasticity of consumption is 0.27 (signifying that a 1.0% increase in real disposable income per capita increases per capita cigarette consumption by 0.27%).

Youth Consumption. IHS Global compiled U.S. data from the CDC that measures the incidence of smoking in the 12-17 year age group as the percentage of the population in this category that first become daily smokers. This percentage, after falling since the early 1970s, began to increase in 1990 and increased through that decade. IHS Global assumes in its report that this recent trend peaked in the late 1990s and that youth smoking has resumed its longer term decline.

Trend Over Time and Health Warnings. The Tobacco Consumption Report notes that since 1964 there has been a significant decline in adult per capita cigarette consumption. The Surgeon General's health warning in 1964 and numerous subsequent mandatory health warnings, together with the increased health awareness and knowledge of the population over the past thirty years, may have contributed to decreases in cigarette consumption levels. If, as IHS Global assumes, the awareness of the adult population continues to change in this way, IHS Global reports that overall consumption of cigarettes will decline gradually over time.

Smoking Bans in Public Places. The Tobacco Consumption Report notes that beginning in the 1970s numerous states have passed laws banning smoking in public places as well as private workplaces. In September 2003 Alabama joined the other 49 states and the District of Columbia in requiring smoke-free indoor air to some degree or in some public places. The most comprehensive bans, extending to restaurants and bars, have been enacted since 1998 in 39 states and a number of large cities. Restrictions to all workplaces, restaurants and bars cover 65.2% of the U.S. Based on its regression analysis, IHS Global estimates that the restrictions on workplace smoking instituted beginning in the late 1970s have reduced smoking by about 2%.

Smokeless Tobacco Products. The Tobacco Consumption Report notes that chewing tobacco and snuff are the most significant components of the smokeless tobacco product market. Moist snuff consumption has increased at an annual rate of more than 5% since 2002. Snuff is now being marketed to adult cigarette smokers as an alternative to cigarettes.

The Tobacco Consumption Report also discusses the increased usage of e-cigarettes (which are different from smokeless tobacco products) in recent years and notes that e-cigarettes themselves do not reduce traditional cigarette consumption except to the extent that they are substitutes for traditional cigarette usage.

Nicotine Dependence. The Tobacco Consumption Report notes that the Surgeon General and the American Medical Association both conclude that nicotine is an addictive drug that produces dependence; the American Psychiatric Association has determined that cigarette smoking causes nicotine dependence in smokers and nicotine withdrawal in those who stop smoking; and the American Medical Association Council on Scientific Affairs found that one-third to one-half of all people who experiment with smoking become smokers.

Regulation. The Tobacco Consumption Report notes that since June 22, 2009, when President Obama signed the FSPTCA, the FDA has had broad authority over the sale, distribution, and advertising of tobacco products, and that a significant issue before the FDA is the role of menthol cigarettes. IHS Global reports that menthol cigarette sales represent approximately 30% of total cigarette sales, and menthol smoking rates have increased among young adults during the past decade. The Tobacco Consumption Report cites a September 2012 publication from the American Journal of Public Health that showed that nearly 40% of menthol smokers say they would quit smoking if menthol cigarettes were no longer available, and states that while an outright ban by the FDA would no doubt prompt a significant number of these smokers to switch to other brands, any significant amount of quitting as a result would have a large negative effect on total consumption and sales. The cited survey suggests that the effect might be as large as a 12% reduction in cigarette consumption, according to the Tobacco Consumption Report. IHS Global's empirical model incorporates a negative impact on cigarette consumption due to tobacco tax increases, and a negative trend decline in levels of smoking since the Surgeon General's 1964 warning, subsequent anti-smoking initiatives, and regulations which restrict smoking. Their model and forecast acknowledges the efficacy of these activities in reducing smoking and assumes that the effectiveness of such anti-smoking efforts will continue.

Empirical Model of Cigarette Consumption and IHS Global Forecast

An econometric model is a set of mathematical equations which statistically best describes the available historical data. It can be applied, with assumptions on the projected path of independent explanatory variables, to predict the future path of the dependent variable being studied, in the case of the Tobacco Consumption Report, adult per capita cigarette consumption. IHS Global has found the following variables to be effective in building an empirical model of adult per capita cigarette consumption for the United States: (1) the real price of cigarettes; (2) the level of real disposable income per capita; (3) the impact of restrictions on smoking in public places; and (4) the trend over time in individual behavior and preferences.

IHS Global used the tools of standard multivariate regression analysis to determine the nature of the economic relationship between these variables and adult per capita cigarette consumption in the U.S. Using that relationship, along with a standard population growth forecast, IHS Global projected actual cigarette consumption (in billions of cigarettes) out to 2045. The forecast also takes into account the effect of the Surgeon General's health warning in 1964 and the effect of nicotine dependence.

According to IHS Global's regression equation, cigarette consumption per capita displays a trend decline of 2.4% per year. The trend reflects the impact of a systematic change in public attitudes toward smoking and may also reflect the cumulative impact of health warnings, advertising restrictions, and other variables that are statistically insignificant when viewed in isolation. The Tobacco Consumption Report notes that some of the impact of the availability of e-cigarettes may be captured in this trend.

IHS Global's forecast is based on assumptions regarding the future path of the explanatory variables in the regression equation. Projections of U.S. population and real per capita personal disposable income are standard IHS Global forecasts. The forecast assumptions have incorporated price increases in excess of general inflation to offset excise and other taxes. In addition, IHS Global assumes in its report that the prevalence of indoor and outdoor restrictions on smoking will continue to increase, that by 2020 100% of states and municipalities will completely restrict smoking in workplaces, restaurants and bars, and that outdoor and residential restrictions will also proliferate over the following decades.

IHS Global projects the average annual rate of decline from 2015 through 2045 to be approximately 3.0%, with total consumption in 2045 projected to be approximately 104 billion cigarettes, a 61% decline from the 2014 level.

Comparison with Prior Forecast

In April 2013 IHS Global presented a report to the Issuer that projected cigarette consumption in each projected year to be more than that projected in the Tobacco Consumption Report. IHS Global attributes the difference primarily to weaker than expected consumption in 2013.

No assurance can be given that actual cigarette consumption in the United States during the term of the Series 2015A Bonds will be as assumed, or that the other assumptions underlying the Collection Methodology and Assumptions, including that certain adjustments and offsets will not apply to payments due under the MSA, will be consistent with future events. See "RISK FACTORS" herein.

TABLES OF PROJECTED PLEDGED TSRs, PROJECTION METHODOLOGY AND BOND STRUCTURING ASSUMPTIONS

Introduction

The following discussion describes the methodology and assumptions used to project the amount of Pledged TSRs to be received by the Issuer (the "**Collection Methodology and Assumptions**"), as well as the methodology and assumptions used to structure Serial Maturities, Mandatory Sinking Fund Payments and Term Bond Maturities for the Series 2015A Bonds (the "**Bond Structuring Methodology**").

The assumptions set forth herein are only assumptions and no guarantee can be made as to the ultimate outcome of certain events assumed herein. If actual results are different from those assumed, it could have a material effect on the receipt of Pledged TSRs. See "RISK FACTORS" herein. The discussions are followed by tables of projected Pledged TSRs to be received by the Trustee.

In projecting the amount of Pledged TSRs to be received by the Issuer, the forecast of cigarette consumption in the United States developed by IHS Global and contained within the Tobacco Consumption Report (which forecasts that domestic cigarette consumption through 2045 will decline at an average annual rate of approximately 3.0%) was applied to calculate Annual Payments and Strategic Contribution Fund Payments to be made by the PMs pursuant to the MSA. See "RISK FACTORS—Risks Relating to the Tobacco Consumption Report." The calculation of payments required to be made was performed in accordance with the terms of the MSA; however, as described below, certain assumptions were made with respect to consumption of cigarettes in the United States and the applicability of certain adjustments and offsets to such payments set forth in the MSA and the NPM Adjustment Settlement Term Sheet. In addition, it was assumed that the PMs make all payments required to be made by them pursuant to the MSA, and that the market share for each class of the PMs remains constant throughout the forecast period at approximately 85.02% for the OPMs (based on sales year 2013 OPM cigarette shipments of 234,841,000,000 divided by total net market cigarette shipments of 276,208,637,449 as reported by NAAG, each measuring roll-your-own shipments at 0.0325 ounces per cigarette conversion rate) and approximately 8.43% for the SPMs (based on the NAAG reported market share for SPMs in sales year 2013 measuring roll-your-own at 0.09 ounces per cigarette conversion rate).[†] It was further assumed that each company that is currently a PM remains such throughout the term of the Series 2015A Bonds. For purposes of calculating expected Annual Payments and Strategic Contribution Fund Payments for April 2015, it was assumed that sales year 2014 domestic cigarette consumption declines were in accordance with the Tobacco Consumption Report.

Collection Methodology and Assumptions

Cigarette Consumption

In applying the consumption forecast from the Tobacco Consumption Report, it was assumed that United States cigarette consumption, which was forecasted by IHS Global, was equal to the number of cigarettes shipped in and to the United States, the District of Columbia and Puerto Rico, which is the number that is applied to determine the Volume Adjustment. The Tobacco Consumption Report states that the quantities of cigarettes shipped and cigarettes consumed may not match at any given point in time as a result of various factors such as inventory adjustments, but are substantially the same when compared over a period of time. IHS Global's forecast for United States cigarette consumption is set forth in the Tobacco Consumption Report in "APPENDIX C—THE TOBACCO CONSUMPTION REPORT." The Tobacco Consumption Report contains a discussion of the assumptions underlying the projections of cigarette consumption contained therein. No assurance can be given that future consumption will be consistent with that projected in the Tobacco Consumption Report. See "RISK FACTORS—Risks Relating to the Tobacco Consumption Report."

Annual Payments and Strategic Contribution Fund Payments

In accordance with the Collection Methodology and Assumptions, the amount of Annual Payments and Strategic Contribution Fund Payments to be made by the PMs was calculated by applying the adjustments applicable to the base amounts of such Annual Payments and Strategic Contribution Fund Payments in the order, and in the amounts, set out in the MSA, as follows:

Inflation Adjustment. First, the Inflation Adjustment was applied to the schedule of base amounts for the Annual Payments and Strategic Contribution Fund Payments set forth in the MSA. The inflation rate is compounded annually from 1999 at the greater of 3.0% or the percentage increase in the CPI in the prior year as published by the Bureau of Labor Statistics (released each January). The calculations of Annual Payments and Strategic Contribution Fund Payments assume the minimum Inflation Adjustment provided in the MSA of 3.0% in every year except for calendar years 2000, 2004, 2005 and 2007, where actual CPI results of 3.387%, 3.256%, 3.416% and 4.081% respectively, were used. Thereafter, the Inflation Adjustment was assumed to be the minimum provided in the MSA, at a rate of 3.0% per year, compounded annually, for the rest of the projection period.

Volume Adjustment. Next, the Annual Payments and Strategic Contribution Fund Payments calculated for each year after application of the Inflation Adjustment were adjusted for the Volume Adjustment by applying the forecast contained within the Tobacco Consumption Report for United States cigarette consumption to the OPM shipments as reported to MSAI. No add back or benefit was assumed

[†] The aggregate market share information utilized in the bond structuring assumptions may differ materially from the market share information utilized by the MSA Auditor in calculating adjustments to Annual Payments and Strategic Contribution Fund Payments. See "SUMMARY OF THE MSA—Adjustments to Payments."

from any Income Adjustment. See "SUMMARY OF THE MSA—Adjustments to Payments—*Volume Adjustment*" for a description of the formula used to calculate the Volume Adjustment.

Previously-Settled States Reduction. Next, with respect to the Annual Payments only, amounts calculated for each year after application of the Inflation Adjustment and the Volume Adjustment were reduced by the Previously-Settled States Reduction, which applies only to the Annual Payments owed by the OPMs. The Previously-Settled States Reduction does not apply to Strategic Contribution Fund Payments. The Previously-Settled States Reduction is as follows for each year of the following periods:

2013 through 2017	12.2373756%
2018 and after	11.0666667%

Non-Settling States Reduction. The Non-Settling States Reduction was not applied to the Annual Payments and Strategic Contribution Fund Payments because such reduction has no effect on the amount of payments to be received by states that remain parties to the MSA. Thus, the Collection Methodology and Assumptions include an assumption that the State will remain a party to the MSA.

NPM Adjustment. The Collection Methodology and Assumptions account for adjustments pursuant to the NPM Adjustment Settlement Term Sheet and include an assumption that the State has diligently enforced and will diligently enforce a Qualifying Statute that is not held to be unenforceable. The Collection Methodology and Assumptions further include an assumption that the State will not be subject to the SET-Paid NPM Sales adjustment liability nor the Non-SET-Paid NPM Sales adjustment liability under the NPM Adjustment Settlement Term Sheet. See "—Adjustments to Payments Under the NPM Adjustment Stipulated Partial Settlement and Award" below. For a discussion of the NPM Adjustment Settlement Term Sheet and NPM Adjustment Stipulated Partial Settlement and Award, see "SUMMARY OF THE MSA—Potential Payment Decreases Under the Terms of the MSA—*NPM Adjustment—NPM Adjustment Settlement and Award*" and "APPENDIX E—NPM ADJUSTMENT STIPULATED PARTIAL SETTLEMENT AND AWARD AND SETTLEMENT TERM SHEET," and for a discussion of the State's Qualifying Statute (which is the Model Statute), see "SUMMARY OF THE MSA—MSA Provisions Relating to Model/Qualifying Statutes" and "—California Qualifying Statute".

Offset for Miscalculated or Disputed Payments. The Collection Methodology and Assumptions include an assumption that there will be no adjustments to the Annual Payments and Strategic Contribution Fund Payments due to miscalculated or disputed payments.

Litigating Releasing Parties Offset. The Collection Methodology and Assumptions include an assumption that the Litigating Releasing Parties Offset will not apply.

Offset for Claims-Over. The Collection Methodology and Assumptions include an assumption that the Offset for Claims-Over will not apply.

Subsequent Participating Manufacturers. The Collection Methodology and Assumptions treat the SPMs as a single manufacturer having executed the MSA on or prior to February 22, 1997 for purposes of calculating Annual Payments and Strategic Contribution Fund Payments under Section IX(i) of the MSA. Further, the Market Share of the SPMs is determined assuming 0.09 ounces of roll-your-own tobacco constitute an individual Cigarette and is assumed to remain constant at 8.43% throughout the period forecasted in the Tobacco Consumption Report. Because the SPM Market Share exceeds the Base Share, the SPMs are assumed to make Annual Payments and Strategic Contribution Fund Payments in each year in the same manner as the OPMs but assuming a Market Share equal to (y) the SPM Market Share (8.43%) less the Base Share (3.539%) divided by (z) the aggregate Market Share of the OPMs based on measuring roll-your-own cigarettes at 0.09 ounces per cigarette conversion rate (85.20%).

Allocation Percentage for the State of California Under the MSA, the MOU and the ARIMOU. The amounts of Annual Payments and Strategic Contribution Fund Payments, after application of the Inflation Adjustment, the Volume Adjustment and the Previously-Settled States Reduction (applicable only to Annual Payments) for each year, and after application of the NPM Adjustment Settlement Term Sheet, for applicable years, were multiplied by the allocation percentage for the State under the MSA as modified by the MOU and the ARIMOU (6.3819777% for Annual Payments and 2.5865204% for Strategic Contribution Fund Payments, which percentages represent 50% of the State's 12.7639554% and 5.1730408% allocations under the MSA for Annual Payments and Strategic Contribution Fund Payments, respectively, with the remaining 50% being allocated to the Participating Jurisdictions) in order to determine the amount of Annual Payments and Strategic Contribution Fund Payments to be made by the PMs in each year to be allocated to the State.

Pledged TSRs. The amount of Annual Payments and Strategic Contribution Fund Payments in each year to be allocated to the State under the MSA, as modified by the MOU and the ARIMOU, calculated as described in the preceding paragraph, was multiplied by 43.43% since only that portion constitutes Pledged TSRs.

California Escrow Agent Fees. 43.43% of the California Escrow Agent Fees (assumed to be $30,000 per annum) have been deducted from the Pledged TSRs received by the Issuer.

Adjustments to Payments Under the NPM Adjustment Stipulated Partial Settlement and Award

In April 2013 and April 2014, the MSA Auditor implemented the provisions of the NPM Adjustment Settlement Term Sheet relating to the distributions from the Disputed Payments Account to the Term Sheet Signatories, including the State, and the credits to be allocated to the PMs. As a result, the State received its allocable share of the settlement in connection with its MSA payments received in April 2013 and PM Credits applicable to both the April 2013 and April 2014 MSA payments. For a discussion of the terms of the NPM Adjustment Settlement Term Sheet, the NPM Adjustment Stipulated Partial Settlement and Award and subsequent developments, see "SUMMARY OF THE MSA—Potential Payment Decreases Under the Terms of the MSA—*NPM Adjustment—NPM Adjustment Settlement and Award*." No assurance can be given as to the impact of a final settlement or resolution of disputes regarding the NPM Adjustment on the amount and/or timing of Pledged TSRs available to the Issuer to pay debt service on the Series 2015A Bonds.

Credits to PM MSA Payments. The NPM Adjustment Stipulated Partial Settlement and Award ordered the MSA Auditor to apply credits to the PMs' MSA payments due in April 2013 through and including April 2017 (the "**PM Credits**"). PM Credits applied against the State's MSA payments are projected based on publicly available MSA Auditor information, which indicates that the aggregate Term Sheet Signatories' PM Credits for April 2013 were $882,551,879, consisting of $841,376,242 attributable to Annual Payments and $41,175,637 attributable to Strategic Contribution Fund Payments. It was assumed that the April 2013 PM Credits represent 50% of the credits due to the OPMs and approximately 40% of the credits due to the SPMs, which results in remaining PM Credits for Annual Payments of $856,173,389 (consisting of OPM credits of $810,672,421 and SPM credits of $45,500,968) and Strategic Contribution Fund Payments of $41,925,900 (consisting of OPM credits of $39,673,040 and SPM credits of $2,252,860), allocating the credits based on the relationship provided in the NPM Adjustment Stipulated Partial Settlement and Award. The balance of the PM Credits allocable to the State are assumed to be credited in equal installments against the OPMs' MSA payments due in April 2014 through and including April 2017 and the SPM payments due in April 2014 through April 2016 (collectively, the "**2014-2017 PM Credits**"). No interest will be paid on the 2014-2017 PM Credits. Based on these assumptions, the portions of the State's MSA payments to be received in 2015 and 2016 constituting Pledged TSRs are projected to be reduced in 2015 and 2016 by $14,030,579 and in 2017 by

$13,053,686 attributable to Annual Payments, and are projected to be reduced in 2015 and 2016 by $339,774 and in 2017 by $315,859 attributable to Strategic Contribution Fund Payments.

Transition Year NPM Adjustments. The NPM Adjustment Stipulated Partial Settlement and Award provides for the MSA Auditor to implement certain provisions of the NPM Adjustment Settlement Term Sheet as they relate to transition years' NPM Adjustments for sales years 2013 and 2014. The transition year NPM Adjustment credit with respect to sales year 2013 occurred in April 2014. With respect to the transition year NPM Adjustment for sales year 2014 set forth in Section II of the NPM Adjustment Settlement Term Sheet, the State's Annual Payments and Strategic Contribution Fund Payments due in April 2015 were assumed to be reduced by an amount equal to 25% of the NPM Adjustment for sales year 2011. The portion of the State's April 2015 MSA payments constituting Pledged TSRs is therefore projected to be reduced by $4,164,035 attributable to Annual Payments and by $201,629 attributable to Strategic Contribution Fund Payments. See "APPENDIX E—NPM ADJUSTMENT STIPULATED PARTIAL SETTLEMENT AND AWARD AND SETTLEMENT TERM SHEET."

Projection of Payments to be Received by the Trustee

The following tables show the projection of Annual Payments, Strategic Contribution Fund Payments and total payments to be received by the Issuer in each year through 2045, calculated in accordance with the Collection Methodology and Assumptions and using the forecast contained within the Tobacco Consumption Report. The forecast contained within the Tobacco Consumption Report for United States cigarette consumption is set forth in "APPENDIX C—TOBACCO CONSUMPTION REPORT" attached hereto. See Appendix C hereto for a discussion of the assumptions underlying the projections of cigarette consumption contained in the Tobacco Consumption Report. See also "RISK FACTORS—Risks Relating to the Tobacco Consumption Report."

(Remainder of Page Intentionally Left Blank)

Projection of Annual Payments to be Received by the Trustee

Year[1]	IHS Global Forecast of Cigarette Consumption	Estimated OPM Consumption	Base Annual Payment	Inflation Adjustment	Volume Adjustment	Previously Settled States Reduction	Total Adjusted Annual Payments By OPMs	Pledged TSR Allocation[2]	OPM Annual Payments[3]	SPM Annual Payments	PM Credits And Transition NPM Adjustment[4]	Total Annual Payments to Trustee
2014	267,205,760,938	227,186,487,726										
2015	257,305,168,462	218,768,702,034	$8,139,000,000	$5,194,839,649	$(6,825,923,738)	$(796,398,114)	$5,711,517,797	2.77169292%	$158,292,705	$10,360,618	$(18,194,614)	$150,458,709
2016	248,357,760,497	211,161,342,886	8,139,000,000	5,594,855,221	(7,268,891,592)	(791,141,882)	5,673,821,747	2.77169292	157,247,886	10,292,238	(14,030,579)	153,509,545
2017	239,454,484,057	203,591,505,707	8,139,000,000	6,006,870,935	(7,708,674,203)	(787,743,942)	5,649,452,789	2.77169292	156,572,454	10,248,033	(13,053,686)	153,766,801
2018	230,915,106,457	196,331,066,421	9,000,000,000	7,111,589,400	(9,031,156,117)	(783,567,952)	6,296,865,331	2.77169292	174,516,741	11,272,067	-	185,788,808
2019	222,844,998,493	189,469,614,491	9,000,000,000	7,594,937,100	(9,550,330,720)	(779,603,108)	6,265,003,271	2.77169292	173,633,623	11,215,031	-	184,848,653
2020	215,356,353,156	183,102,539,822	9,000,000,000	8,092,785,600	(10,078,477,048)	(776,250,149)	6,238,058,404	2.77169292	172,886,794	11,166,796	-	184,053,590
2021	208,289,109,637	177,093,753,831	9,000,000,000	8,605,569,600	(10,611,784,354)	(773,978,903)	6,219,806,343	2.77169292	172,380,903	11,134,123	-	183,515,026
2022	201,746,025,700	171,530,624,304	9,000,000,000	9,133,736,400	(11,154,632,948)	(772,354,118)	6,206,749,334	2.77169292	172,019,003	11,110,750	-	183,129,752
2023	195,661,144,017	166,357,072,308	9,000,000,000	9,677,748,600	(11,703,352,347)	(771,833,188)	6,202,563,065	2.77169292	171,902,972	11,103,256	-	183,006,228
2024	190,023,868,654	161,564,088,858	9,000,000,000	10,238,081,400	(12,259,514,416)	(772,294,749)	6,206,272,236	2.77169292	172,005,779	11,109,896	-	183,115,675
2025	184,748,762,896	157,079,033,051	9,000,000,000	10,815,223,500	(12,822,975,828)	(773,808,745)	6,218,438,927	2.77169292	172,343,002	11,131,676	-	183,474,678
2026	179,749,519,546	152,828,523,879	9,000,000,000	11,409,679,800	(13,396,262,865)	(776,151,476)	6,237,265,458	2.77169292	172,864,816	11,165,377	-	184,030,193
2027	174,958,070,077	148,754,687,400	9,000,000,000	12,021,970,500	(13,982,248,276)	(779,062,595)	6,260,659,629	2.77169292	173,513,230	11,207,255	-	184,720,485
2028	170,298,917,463	144,793,333,744	9,000,000,000	12,652,629,300	(14,583,454,178)	(782,322,049)	6,286,853,073	2.77169292	174,239,232	11,254,144	-	185,493,376
2029	165,739,609,203	140,916,870,802	9,000,000,000	13,302,207,900	(15,202,979,905)	(785,647,900)	6,313,580,094	2.77169292	174,980,023	11,301,988	-	186,282,012
2030	161,291,951,634	137,135,336,683	9,000,000,000	13,971,274,200	(15,842,534,596)	(788,913,852)	6,339,825,752	2.77169292	175,707,472	11,348,971	-	187,056,443
2031	156,967,320,014	133,458,402,979	9,000,000,000	14,660,412,300	(16,502,152,179)	(792,180,789)	6,366,079,332	2.77169292	176,435,141	11,395,968	-	187,831,109
2032	152,761,130,955	129,882,172,753	9,000,000,000	15,370,224,300	(17,181,836,349)	(795,514,936)	6,392,873,015	2.77169292	177,177,779	11,443,931	-	188,621,711
2033	148,561,609,396	126,311,611,438	9,000,000,000	16,101,331,200	(17,882,241,979)	(798,912,543)	6,420,176,678	2.77169292	177,934,553	11,492,808	-	189,427,361
2034	144,448,016,789	122,814,109,538	9,000,000,000	16,854,371,100	(18,608,906,172)	(801,831,454)	6,443,633,473	2.77169292	178,584,703	11,534,798	-	190,119,501
2035	140,437,813,694	119,404,512,556	9,000,000,000	17,630,001,900	(19,359,067,497)	(804,650,076)	6,466,284,327	2.77169292	179,212,516	11,575,345	-	190,787,861
2036	136,503,012,438	116,059,024,517	9,000,000,000	18,428,902,200	(20,132,523,218)	(807,465,943)	6,488,913,039	2.77169292	179,839,714	11,615,853	-	191,455,567
2037	132,655,161,522	112,787,464,309	9,000,000,000	19,251,769,500	(20,931,231,493)	(810,139,542)	6,510,398,465	2.77169292	180,435,224	11,654,315	-	192,089,539
2038	128,893,919,301	109,589,541,455	9,000,000,000	20,099,322,900	(21,755,310,806)	(812,737,341)	6,531,274,754	2.77169292	181,013,851	11,691,685	-	192,705,536
2039	125,166,214,923	106,420,133,497	9,000,000,000	20,972,302,200	(22,605,448,960)	(815,265,094)	6,551,588,146	2.77169292	181,576,875	11,728,048	-	193,304,924
2040	121,516,657,285	103,317,168,281	9,000,000,000	21,871,471,500	(23,485,202,413)	(817,413,781)	6,568,855,306	2.77169292	182,055,468	11,758,959	-	193,814,427
2041	118,000,450,415	100,327,581,957	9,000,000,000	22,797,615,600	(24,393,043,088)	(819,439,360)	6,585,133,152	2.77169292	182,506,640	11,788,098	-	194,294,738
2042	114,539,999,628	97,385,401,154	9,000,000,000	23,751,544,500	(25,326,567,263)	(821,697,483)	6,603,279,754	2.77169292	183,009,608	11,820,582	-	194,830,190
2043	111,147,722,729	94,501,183,870	9,000,000,000	24,734,090,700	(26,290,853,888)	(823,718,210)	6,619,518,603	2.77169292	183,459,699	11,849,651	-	195,309,350
2044	107,832,168,133	91,682,198,228	9,000,000,000	25,746,113,700	(27,286,054,642)	(825,579,872)	6,634,479,186	2.77169292	183,874,361	11,876,432	-	195,750,793
2045	104,593,701,529	88,928,755,147	9,000,000,000	26,788,497,300	(28,312,495,713)	(827,344,178)	6,648,657,409	2.77169292	184,267,337	11,901,813	-	196,169,150

[1] MSA payment amounts are calculated based on IHS Global's cigarette consumption forecast for the prior year.

[2] The State is entitled to 12.7639554% of the Annual Payments under the MSA. The Pledged TSRs constitute 43.43% of the 50% of the State's Tobacco Settlement Revenues allocated to the State under the MOU and ARIMOU.

[3] Adjusted to reflect California Escrow Agent Fees.

[4] For a discussion of the PM credits and the 2015 transition NPM Adjustment pursuant to the NPM Adjustment Stipulated Partial Settlement and Award, see "—Collection Methodology and Assumptions" above.

Projection of Strategic Contribution Fund Payments and Total Payments to be Received by the Trustee

			Strategic Contribution Fund Payments										
Year[1]	IHS Global Forecast of Cigarette Consumption	Estimated OPM Consumption	Base Strategic Contribution Fund Payments	Inflation Adjustment	Volume Adjustment	Total Adjusted Strategic Contribution Fund Payments by OPMs	Pledged TSR Allocation[2]	OPM Strategic Contribution Fund Payments	SPM Strategic Contribution Fund Payments	PM Credits And Transition NPM Adjustment[3]	Total Annual Payments to Trustee	Total Strategic Contribution Fund Payments to Trustee	Total Payments to Trustee
2014	267,205,760,938	227,186,487,726											
2015	257,305,168,462	218,768,702,034	$861,000,000	$549,546,251	$(722,093,665)	$688,452,586	1.12332581%	$7,733,566	$444,200	$(541,404)	$150,458,709	$7,636,362	$158,095,071
2016	248,357,760,497	211,161,342,886	861,000,000	591,862,679	(768,953,884)	683,908,795	1.12332581	7,682,524	441,268	(339,774)	153,509,545	7,784,018	161,293,563
2017	239,454,484,057	203,591,505,707	861,000,000	635,448,566	(815,477,146)	680,971,420	1.12332581	7,649,528	439,373	(315,859)	153,766,801	7,773,041	161,539,842
2018	230,915,106,457	196,331,066,421	-	-	-	-	-	-	-	-	185,788,808	-	185,788,808
2019	222,844,998,493	189,469,614,491	-	-	-	-	-	-	-	-	184,848,653	-	184,848,653
2020	215,356,353,156	183,102,539,822	-	-	-	-	-	-	-	-	184,053,590	-	184,053,590
2021	208,289,109,637	177,093,753,831	-	-	-	-	-	-	-	-	183,515,026	-	183,515,026
2022	201,746,025,700	171,530,624,304	-	-	-	-	-	-	-	-	183,129,752	-	183,129,752
2023	195,661,144,017	166,357,072,308	-	-	-	-	-	-	-	-	183,006,228	-	183,006,228
2024	190,023,868,654	161,564,088,858	-	-	-	-	-	-	-	-	183,115,675	-	183,115,675
2025	184,748,762,896	157,079,033,051	-	-	-	-	-	-	-	-	183,474,678	-	183,474,678
2026	179,749,519,546	152,828,523,879	-	-	-	-	-	-	-	-	184,030,193	-	184,030,193
2027	174,958,070,077	148,754,687,400	-	-	-	-	-	-	-	-	184,720,485	-	184,720,485
2028	170,298,917,463	144,793,333,744	-	-	-	-	-	-	-	-	185,493,376	-	185,493,376
2029	165,739,609,203	140,916,870,802	-	-	-	-	-	-	-	-	186,282,012	-	186,282,012
2030	161,291,951,634	137,135,336,683	-	-	-	-	-	-	-	-	187,056,443	-	187,056,443
2031	156,967,320,014	133,458,402,979	-	-	-	-	-	-	-	-	187,831,109	-	187,831,109
2032	152,761,130,955	129,882,172,753	-	-	-	-	-	-	-	-	188,621,711	-	188,621,711
2033	148,561,609,396	126,311,611,438	-	-	-	-	-	-	-	-	189,427,361	-	189,427,361
2034	144,448,016,789	122,814,109,538	-	-	-	-	-	-	-	-	190,119,501	-	190,119,501
2035	140,437,813,694	119,404,512,556	-	-	-	-	-	-	-	-	190,787,861	-	190,787,861
2036	136,503,012,438	116,059,024,517	-	-	-	-	-	-	-	-	191,455,567	-	191,455,567
2037	132,655,161,522	112,787,464,309	-	-	-	-	-	-	-	-	192,089,539	-	192,089,539
2038	128,893,919,301	109,589,541,455	-	-	-	-	-	-	-	-	192,705,536	-	192,705,536
2039	125,166,214,923	106,420,133,497	-	-	-	-	-	-	-	-	193,304,924	-	193,304,924
2040	121,516,657,285	103,317,168,281	-	-	-	-	-	-	-	-	193,814,427	-	193,814,427
2041	118,000,450,415	100,327,581,957	-	-	-	-	-	-	-	-	194,294,738	-	194,294,738
2042	114,539,999,628	97,385,401,154	-	-	-	-	-	-	-	-	194,830,190	-	194,830,190
2043	111,147,722,729	94,501,183,870	-	-	-	-	-	-	-	-	195,309,350	-	195,309,350
2044	107,832,168,133	91,682,198,228	-	-	-	-	-	-	-	-	195,750,793	-	195,750,793
2045	104,593,701,529	88,928,755,147	-	-	-	-	-	-	-	-	196,169,150	-	196,169,150

[1] MSA payment amounts are calculated based on IHS Global's cigarette consumption forecast for the prior year.

[2] The State is entitled to 5.1730408% of the Strategic Contribution Fund Payments under the MSA. The Pledged TSRs constitute 43.43% of the 50% of the State's Tobacco Settlement Revenues allocated to the State under the MOU and ARIMOU.

[3] For a discussion of the PM credits and the 2015 transition NPM Adjustment pursuant to the NPM Adjustment Stipulated Partial Settlement and Award, see "—Collection Methodology and Assumptions" above.

Interest Earnings

The Collection Methodology and Assumptions assume that the Trustee will receive ten days after April 15 the Issuer's share of the Annual Payments owed by the PMs in 2015 and each year thereafter. It is further assumed that the Trustee will receive ten days after April 15 the Issuer's share of Strategic Contribution Fund Payments in each year from 2015 through 2017. No interest is assumed to be earned on the Annual Payments and Strategic Contribution Fund Payments from the date received by the Trustee until the applicable Distribution Date.

Amounts on deposit in the Liquidity Reserve Account are assumed to be invested at a rate of 1% per annum.

Bond Structuring Methodology

The Bond Structuring Methodology of the Series 2015A Bonds and the forecast contained within the Tobacco Consumption Report were applied to the projections of Pledged TSRs described above. See "SUMMARY OF THE TOBACCO CONSUMPTION REPORT" and "APPENDIX C—TOBACCO CONSUMPTION REPORT." See also "RISK FACTORS—Risks Relating to the Tobacco Consumption Report."

The Bond Structuring Methodology is as follows:

Issue Size. The objective in issuing the Series 2015A Bonds is to receive proceeds in an amount, together with amounts released from the Liquidity Reserve Account, the Supplemental Reserve Account and the Surplus Account, sufficient to: (i) refund on a current basis a portion equal to $1,959,775,000[*] aggregate principal amount of the Series 2005A Bonds outstanding under the Indenture and (ii) pay the costs of issuance of the Series 2015A Bonds.

Issuance Date. The Series 2015A Bonds are assumed to be issued on April 7, 2015.

Maturities. The schedules of Series 2015A Bond Maturity Dates are set forth on the inside cover page hereof.

Mandatory Sinking Fund Payments. The schedules of Mandatory Sinking Fund Payments for the Series 2015A Bonds constituting Term Bonds are set forth in "THE SERIES 2015A BONDS—Redemption by Mandatory Sinking Fund Payments."

Liquidity Reserve Account. The Liquidity Reserve Requirement is $150,000,000.

Supplemental Reserve Account. The Supplemental Reserve Requirement is $0 and the balance in the Supplemental Reserve Account is $0.

Operating Expense Assumptions. Annual operating expenses of the Issuer have been assumed at the Operating Cap of $455,173.68 through June 30, 2015, which is assumed to be inflated in each year thereafter by 3%. No operating expenses are assumed in excess of the annual Operating Cap and no arbitrage rebate expense was assumed since it has been assumed that the yield on the Issuer's investments will not exceed the yield on the Bonds.

[*] Preliminary, subject to change.

Operating Contingency Account. The Issuer currently maintains $558,610 in the Operating Contingency Account.

Interest Rates. The Series 2015A Bonds were assumed to bear interest at the rates shown on the inside cover page hereof.

Miscellaneous. The Bond Structuring Methodology assumes that there is no optional redemption or purchase of the Bonds, that no Event of Default occurs, that no State Appropriation, Lump Sum Payment, Partial Lump Sum Payment or Total Lump Sum Payment is received, and that interest is calculated on a 30/360 basis. It is further assumed that all Distribution Dates occur on the first day of each June and December, whether or not such date is a Business Day.

No assurance can be given that actual cigarette consumption in the United States during the term of the Series 2015A Bonds will be as assumed, or that the other assumptions underlying the Collection Methodology and Assumptions and Bond Structuring Methodology, including that certain adjustments and offsets will not apply to payments due under the MSA, will be consistent with future events. If actual events deviate from one or more of the assumptions underlying the Collection Methodology and Assumptions and Bond Structuring Methodology, the amount of Pledged TSRs available to the Issuer to pay the principal of and interest on the Series 2015A Bonds could be adversely affected. See "RISK FACTORS" and "LEGAL CONSIDERATIONS" herein.

THE PURCHASE AND SALE AGREEMENT

The following summary describes certain terms of the Purchase and Sale Agreement. This summary does not purport to be complete and is subject to, and qualified in its entirety, by reference to the provisions of the Purchase and Sale Agreement. Copies of the Purchase and Sale Agreement may be obtained upon written request to the Trustee.

Conveyance of Pledged TSRs

Pursuant to the Purchase and Sale Agreement, on the TSR Sale Date, the State sold, transferred, assigned, set over and otherwise conveyed to the Issuer without recourse (subject to the obligations set forth in the Purchase and Sale Agreement) all of its right, title and interest in, to and under the Pledged TSRs.

Representations of State

The State made the following representations on which the Issuer is deemed to have relied in acquiring the Pledged TSRs. **The representations speak as of the TSR Sale Date**, survive the sale of the Pledged TSRs and the pledge thereof to the Trustee pursuant to the Indenture, and, pursuant to the Purchase and Sale Agreement, have been made applicable to Series 2015A Bonds.

Power and Authority. The CIEDB is duly authorized by the Act to sell the Pledged TSRs for, and on behalf of, the State, solely as its agent, and has full power and authority to execute and deliver the Purchase and Sale Agreement.

Binding Obligation. The Purchase and Sale Agreement has been duly executed and delivered by the CIEDB, for, and on behalf of, the State, solely as its agent, and, assuming the due authorization, execution and delivery of the Purchase and Sale Agreement by the Issuer, constitutes a legal, valid and binding obligation of the State enforceable in accordance with its terms and the Act; provided, however, that no representation is made with respect to the legality, validity or the binding and enforceable nature of the Governor's or the State's obligations under Section 4.07(b) of the Purchase and Sale Agreement and Section 63049.1(b)(1) of the Act.

No Consents. No consent, approval, authorization, order, registration or qualification of or with any court or governmental agency or body is required for the consummation of the transactions contemplated by the Purchase and Sale Agreement, except for those which have been obtained and are in full force and effect.

No Violation. The consummation by the State of the transactions contemplated by the Transaction Documents and the fulfillment of the terms thereof do not, to the State's knowledge, in any material way conflict with, result in any material breach by the State of any of the material terms and provisions of, or constitute (with or without notice or lapse of time) a material default by the State under any indenture, agreement or other instrument to which the State is a party (including the MSA, the MOU and the ARIMOU) or by which it shall be bound; nor violate any law or any order, rule or regulation applicable to the State of any court or of any federal or state regulatory body, administrative agency or other governmental instrumentality having jurisdiction over the State or its property.

No Proceedings. To the State's knowledge, except as disclosed in this Official Statement, there are no proceedings or investigations pending against the State, before any court, regulatory body, administrative agency or other governmental instrumentality having jurisdiction over the State: (i) asserting the invalidity of any of the Act, the Decree, the MSA, the MOU, the ARIMOU, the California Model Statute, the Transaction Documents or the Bonds; (ii) seeking to prevent the sale of the Pledged TSRs, the issuance of the Bonds or the consummation of any of the transactions contemplated by any of the Transaction Documents; or (iii) seeking any determination or ruling that would materially and adversely affect the validity or enforceability of any of the Transaction Documents, the Bonds, the MSA, the MOU, the ARIMOU or the Decree.

Title to Pledged TSRs. The State was the sole owner of the Pledged TSRs prior to their sale to the Issuer. On and after the TSR Sale Date, (i) the State had no right, title or interest in or to the Pledged TSRs, and (ii) the Pledged TSRs became property of the Issuer, and not of the State, the CIEDB or the State Public Works Board, and have been owned, received, held and disbursed by the Issuer or the Trustee and not by the State or the State Treasury, (iii) none of the Pledged TSRs shall be subject to garnishment, levy, execution, attachment, or other process or writ, including, but not limited to, a writ of mandate or remedy in connection with the assertion or enforcement of any debt, claim, settlement or judgment against the State, the CIEDB or the State Public Works Board, and (iv) after the pledge, assignment and grant of a security interest by the Issuer to the Trustee pursuant to the Indenture for the benefit of the Bondholders of any or all right, title and interest of the Issuer in, to and under the Pledged TSRs, such Pledged TSRs have been and shall continue to be paid directly to the Trustee.

True Sale; Absence of Liens on Pledged TSRs. The State has irrevocably sold the Pledged TSRs free and clear of any and all State liens, pledges, charges, security interests or any other statutory impediments to transfer of any nature encumbering the Pledged TSRs. Pursuant to the Act, the sale of the Pledged TSRs under the Purchase and Sale Agreement is, and shall be treated as, a true sale and absolute transfer of the property so transferred, and not as a pledge or any other security interest for any borrowing.

Assignment to Owners. The State acknowledged that the Issuer would assign to the Trustee for the benefit of the Owners all of its rights and remedies with respect to the breach of any obligations, representations and warranties of the State under the Purchase and Sale Agreement.

Limitation on Liability

The State and any officer or employee or agent of the State may rely in good faith on the advice of counsel or on any document of any kind, prima facie properly executed and submitted by any person respecting any matters arising under the provisions of the Purchase and Sale Agreement. Neither the State nor any of the officers or employees or agents of the State shall be under any liability to the Issuer, except as provided under the Purchase and Sale Agreement, for any action taken or for refraining from the taking of any action pursuant to the Purchase and Sale Agreement or for errors in judgment.

Non-Impairment Covenant of State

Pursuant to the Act, the State has pledged to and agreed with the holders of any Bonds of the Issuer that it will not amend the MSA, the MOU, the ARIMOU or the California Escrow Agreement, or take any other action, in any way that would materially adversely alter, limit, or impair the rights to receive the Pledged TSRs, nor in any way materially impair the rights and remedies of such bondholders or the security for their bonds until those bonds, together with the interest thereon and costs and expenses in connection with any action or proceeding on behalf of such bondholders, are fully paid and discharged.[*] See "SECURITY FOR THE BONDS—Consent to Amendments to Indenture and Purchase and Sale Agreement." The State has further pledged and agreed that it shall enforce its rights to collect all moneys due from the PMs under the MSA and, in addition, shall diligently enforce the California Model Statute against all NPMs in the State, in each case in the manner and to the extent necessary in the judgment of the Attorney General of the State to collect all moneys to which the State is entitled under the MSA. Notwithstanding the pledges of the State described above, the Attorney General of the State may, in his or her discretion, enforce any and all of the provisions of the MSA, without limitation.

Further, notwithstanding these pledges and undertakings by the State, nothing in the Indenture or in the Act shall, or shall be construed to, preclude or limit the State's power or authority to tax or regulate the purchase or sale of cigarettes, to regulate smoking, or to promote the reduction or cessation of smoking, or to take other similar actions within its sovereign powers in relation to smoking.

Tax Covenant

The State will at all times do and perform all acts and things permitted by law and necessary or desirable to assure that interest paid by the Issuer on the Series 2015A Bonds shall be excludable from gross income for federal income tax purposes pursuant to Section 103(a) of the Code; and no gross proceeds of the Series 2015A Bonds will at any time be used directly or indirectly to acquire securities or obligations the acquisition or holding of which would cause any Series 2015A Bond to be an arbitrage bond or a hedge bond as defined in the Code and the applicable Treasury Regulations promulgated thereunder.

[*] Pursuant to the Second Supplemental Purchase and Sale Agreement, the words appearing in italics are being added to the Purchase and Sale Agreement (emphasis added): "Pursuant to Section 63049.4(a) of the Act, the State pledges and agrees with the Owners of any Bonds that the State will not amend the MSA, the Memorandum of Understanding, or the California Escrow Agreement, or take any other action, in any way that would *materially adversely* alter, limit, or impair the rights to receive Tobacco Assets sold to the Corporation pursuant to this Agreement and the Act, nor in any way *materially* impair the rights and remedies of Bondholders or the security for their Bonds until those Bonds, together with the interest thereon and costs and expenses in connection with any action or proceeding on behalf of the Bondholders, are fully paid and discharged." As of the Series 2015A Closing Date, the non-impairment covenants of the State contained in the purchase and sale agreement and indenture related to the Series 2007 Bonds do not contain a material adversity standard similar to that being added to the Purchase and Sale Agreement and the Indenture on the Series 2015A Closing Date. See "SECURITY FOR THE BONDS—Consent to Amendments to Indenture and Purchase and Sale Agreement." The Issuer cannot predict the content or timing of any future amendment to the MSA, the MOU, or the California Escrow Agreement.

California Escrow Agent

The State, acting through the Attorney General, has directed the California Escrow Agent to remit directly to the Trustee all Pledged TSRs. Such direction is irrevocable until the Bonds have been repaid. Should the State receive any such payments from the California Escrow Agent, it will immediately remit such payments to the Trustee.

Notwithstanding any prior termination of the Purchase and Sale Agreement, the State has covenanted that it will not, prior to the date which is one year and one day after the termination of the Indenture, acquiesce, petition, or otherwise invoke or cause the Issuer to invoke the process of any court or government authority for the purpose of commencing or sustaining a case against the Issuer under any federal or state bankruptcy, insolvency, or similar law or appointing a receiver, liquidator, assignee, trustee, custodian, sequestrator, or other similar official of the Issuer or any substantial part of its property, or ordering the winding up or liquidation of the affairs of the Issuer.

Continuing Disclosure

The State has agreed to provide to the Issuer and the Trustee, a copy of the annual continuing disclosure prepared by the State in relation to the general obligation bonds of the State, and to incur all costs associated with such continuing disclosure. The failure of the State to provide ongoing disclosure shall not be considered a default or Event of Default under the Purchase and Sale Agreement or the Indenture.

Amendment

The Purchase and Sale Agreement may be amended by agreement of the State and the Issuer with the consent of the Trustee but without the consent of any of the Owners: (a) to cure any ambiguity, (b) to correct or supplement any provisions in the Purchase and Sale Agreement, (c) to correct or amplify the description of the Pledged TSRs, (d) to add additional covenants for the benefit of the Issuer, or (e) for the purpose of adding any provisions to or changing in any manner or eliminating any of the provisions in the Purchase and Sale Agreement that shall not, as evidenced by a Rating Confirmation delivered to the Trustee, adversely affect in any material respect the Bonds. Further, with the consent of a majority of the Owners, the Purchase and Sale Agreement may be amended from time to time by the State and the Issuer for the purpose of adding any provisions to or changing in any manner or eliminating any of the provisions of the Purchase and Sale Agreement or of modifying in any manner the rights of the Owners if accompanied by a Rating Confirmation delivered to the Trustee; but no such amendment shall reduce the aforesaid portion of the outstanding amount of the Bonds, the Owners of which are required to consent to any such amendment, without the consent of all Owners.

It shall not be necessary for the consent of Owners to approve the particular form of any proposed amendment or consent, but it shall be sufficient if such consent shall approve the substance thereof.

Prior to the execution of any amendment to the Purchase and Sale Agreement, the Trustee shall be entitled to receive and rely upon an Opinion of Counsel stating that the execution of such amendment is authorized or permitted by the Purchase and Sale Agreement and will not adversely affect the exclusion of interest on any tax-exempt Bonds from gross income for federal income tax purposes.

Assignment by the Issuer

The State acknowledged and consented to any pledge, assignment and grant of a security interest by the Issuer to the Trustee pursuant to the Indenture for the benefit of the Owners of any or all of the

Issuer’s right, title and interest in, to and under the Pledged TSRs and the assignment of any or all of the Issuer’s rights and obligations in, to and under the Purchase and Sale Agreement to the Trustee.

Definitions

In addition to terms defined elsewhere herein, the following terms have the following meanings in this summary, unless the context otherwise requires:

“**Bond Purchase Agreement**” means the Bond Purchase Agreement by and among the State, the Issuer, and Barclays Capital Inc. and Citigroup Global Markets Inc., as co-representatives of the underwriters, relating to the sale of the Series 2015A Bonds, in such form as the parties thereto shall agree.

“**Opinion of Counsel**” means one or more written opinions of counsel who may be an employee of or counsel to the State, which counsel shall be acceptable to the Trustee.

“**Rating Confirmation**” means written confirmation from each national rating agency which, at the request of the Issuer, assigned a rating and continues to have a rating assigned to the Bonds, to the effect that the then-current rating assigned by such rating agency to the Bonds, without regard to any bond insurance or any other form of credit enhancement, will not be adversely affected by the proposed action for which a Rating Confirmation is sought.

“**State Lien**” means a security interest, lien, charge, pledge, equity or encumbrance of any kind, attaching to the interests of the State in and to the Pledged TSRs, whether or not as a result of any act or omission of the State.

“**Transaction Documents**” means the Purchase and Sale Agreement, the Indenture, and the Bond Purchase Agreement.

THE INDENTURE

The following summary describes certain terms of the Indenture pursuant to which the Series 2015A Bonds will be issued. This summary does not purport to be complete and is subject and qualified in its entirety by reference to the provisions of the Indenture. Copies of the Indenture may be obtained upon written request to the Trustee. See “SECURITY FOR THE BONDS” and “THE SERIES 2015A BONDS” herein for further descriptions of certain terms and provisions of the Indenture and the Bonds.

No Liability on Bonds

Neither the Issuer, the Board, the members of the Board, the State, nor any person executing the Bonds or other obligations of the Issuer will be liable personally thereon or be subject to any personal liability or accountability by reason of the issuance thereof.

The Issuer has no authority to and does not intend or purport to pledge the faith, credit, or taxing power of the State or any of its political subdivisions in connection with the issuance of the Bonds. The Bonds are limited obligations of the Issuer; are secured solely by and payable solely from the Collateral; and are neither general nor legal obligations of the State or any of its political subdivisions. Neither the faith and credit nor the taxing power nor any other assets or revenues of the State or of any political subdivision thereof, other than the Issuer to the extent of the Collateral, is or shall be pledged to the payment of the principal of or Accreted Value on or the interest on the Bonds. The Issuer has no taxing power.

Security Interest and Pledge

In order to secure payment of the Bonds, the Swap Payments and the Residual Certificate, the Issuer has pledged to the Trustee, and has granted to the Trustee a first priority security interest in, all of the Issuer's right, title, and interest, whether now owned or thereafter acquired, in, to, and under the Collateral. The Issuer has covenanted that it will implement, protect, and defend the security interest and pledge by all appropriate action for the benefit of the Owners of the Bonds, the owner of the Residual Certificate, and any party that has entered into a Swap Contract.

None of the proceeds of the Bonds or any earnings therefrom, unless deposited in one of the Pledged Accounts, will in any way be pledged to the payment of the Bonds. Such amounts will not be part of the Collateral.

The State has sold all of the Series 2007 Pledged TSRs to the Issuer for assignment to the Series 2007 Trustee. The right of the Trustee to receive Pledged TSRs is equal to and on a parity with, and is not inferior or superior to, the right of the Series 2007 Trustee to receive the Series 2007 Pledged TSRs. Neither the Issuer nor the Trustee shall have the right to make a claim to mitigate all or any part of an asserted deficiency in the Pledged TSRs from the Series 2007 Pledged TSRs and, likewise, neither the Issuer nor the State nor any participating jurisdiction (as such term is used in the Indenture) nor the Series 2007 Trustee shall have any right to make a claim to mitigate all or any part of an asserted deficiency in the Series 2007 Pledged TSRs from the Pledged TSRs. The right of the Series 2007 Trustee to receive the Series 2007 Pledged TSRs is equal to and on a parity with, and shall not be inferior or superior to, the right of the Trustee to receive the Pledged TSRs.

Defeasance

Total Defeasance. When (i) there is held by or for the account of the Trustee Defeasance Collateral in such principal amounts, bearing interest at such fixed rates and with such maturities, including any applicable redemption premiums, as will provide sufficient funds to pay, or to redeem in accordance with the terms of the Indenture, all obligations to Owners in whole (to be verified by a nationally recognized firm of independent verification agents), (ii) any required notice of redemption will have been duly given in accordance with the Indenture or irrevocable instructions to give notice will have been given to the Trustee, and (iii) all the rights thereunder of the Fiduciaries have been provided for, and (iv) the Trustee shall have received an opinion of Counsel to the effect that such defeasance will not adversely affect the exclusion of interest on any Bond from gross income for federal income tax purposes, then upon Written Notice from the Issuer to the Trustee, such Owners and counterparties to such related Swap Contracts will cease to be entitled to any benefit or security under the Indenture except the right to receive payment of the funds so held and other rights which by their nature cannot be satisfied prior to or simultaneously with termination of the lien under the Indenture, the security interests created by the Indenture (except in such funds and investments) will terminate, and the Issuer, after the satisfaction of all Operating Expenses, and the Trustee will execute and deliver such instruments as may be necessary to discharge the Trustee's lien and security interests created under the Indenture and to make the Pledged TSRs and other Collateral payable to the order of the owner of the Residual Certificate. Upon such defeasance, the funds and investments required to pay or redeem the Bonds will be irrevocably set aside for that purpose, subject, however, to the terms of the Indenture, and money held for defeasance will be invested only as provided in the Indenture and applied by the Trustee and other Paying Agents, if any, to the retirement of the Bonds. Any funds or property held by the Trustee and not required for payment or redemption of the Bonds will be distributed to the registered owner of the Residual Certificate.

Partial Defeasance. Subject to the Issuer's tax covenants in the Indenture, the Issuer may create a defeasance escrow for the retirement and defeasance of any Bonds in accordance with subsections (i), (ii) and (iv) of the preceding paragraph. Thereafter, the Owners of such Defeased Bonds and counterparties to such related Swap Contracts shall cease to be entitled to any benefit or security under the Indenture except the right to receive payment of the funds held in such defeasance escrow and other rights which by their nature cannot be satisfied prior to or simultaneously with termination of the lien hereof of the Indenture.

Effect of Defeasance, Redemption or Purchase

There shall, at the option of the Issuer, be applied to or credited against any Serial Maturity, Mandatory Sinking Fund Payment or Term Bond Maturity, the principal amount of or Accreted Value on any Bonds that have been defeased, purchased or redeemed and not previously so applied or credited.

Establishment of Accounts

Accounts Held by the Trustee. The Trustee will establish and maintain the following segregated trust accounts in the Issuer's name:

(1) the Collections Account;

(2) the Debt Service Account;

(3) the Partial Lump Sum Payment Account;

(4) the Operating Account;

(5) the Liquidity Reserve Account;

(6) the Supplemental Reserve Account[*];

(7) the Operating Contingency Account;

(8) the Surplus Account;

(9) the Rebate Account;

(10) the Costs of Issuance Account; and

(11) the Residual Account.

Investments

Generally. Pending its use under the Indenture, money in the Accounts held by the Trustee may be invested by the Trustee as directed in an Officer's Certificate in Eligible Investments maturing or redeemable at the option of the holder at or before the time when such money is expected to be needed and will be so invested as directed in an Officer's Certificate if there is not then an Event of Default actually known to an Authorized Officer of the Trustee. In the event an Officer's Certificate with such

[*] Following the issuance of the Series 2015A Bonds and the application of the proceeds thereof, the Supplemental Reserve Requirement, and the balance in the Supplemental Reserve Account, will be $0. See "SECURITY FOR THE BONDS—Consent to Amendments to Indenture and Purchase and Sale Agreement."

investment directions is not timely received, the Trustee shall notify the Issuer of the absence of such directions and shall invest such moneys in investments described in clause (viii) of the definition of Eligible Investments until an Officer's Certificate containing investment directions is received by the Trustee. Eligible Investments will mature or be redeemable at the option of the Issuer on or before the Business Day immediately preceding each next succeeding Distribution Date, except to the extent that other Eligible Investments timely mature or are so redeemable in an amount sufficient to make payments in respect of interest, Serial Maturities, Mandatory Sinking Fund Payments and Term Bond Maturities pursuant to the terms of the Indenture on such next succeeding Distribution Dates. Investments will be held by the Trustee in the respective Accounts and will be sold or redeemed to the extent necessary to make payments or transfers from each Account. In the absence of negligence or bad faith on its part, the Trustee will not be liable for any losses on investments made at the direction of the Issuer.

Reserve Account. Notwithstanding the provisions described in the preceding paragraph, moneys in the Liquidity Reserve Account may be invested by the Trustee as directed in an Officer's Certificate in any Eligible Investment with a maturity of not more than five (5) years; provided that a forward purchase agreement or investment agreement may have a term in excess of five (5) years. On the Business Day immediately preceding June 1, 2015 and each June 1 Distribution Date thereafter, the Trustee will value the money and investments in the Liquidity Reserve Account, taking into account amounts to be available on such June 1 Distribution Date. Any amounts in the Liquidity Reserve Account in excess of the Liquidity Reserve Requirement will be deposited in the Collections Account. If after receipt of any Pledged TSRs, the Trustee determines that a withdrawal from the Liquidity Reserve Account will be required on December 1 of any year, the Trustee shall notify the provider under any applicable forward purchase agreement or investment agreement at least ten (10) Business Days prior to the Business Day next preceding June 1 of such year, of the amount of money in the Liquidity Reserve Account that must be invested in securities maturing prior to such December 1.

Reserve Facilities. In lieu of maintaining and depositing moneys in the Liquidity Reserve Account, the Issuer may at any time substitute one or more Reserve Facilities, subject to the requirements described below. The Issuer shall not substitute a Reserve Facility for all or any part of the amounts on deposit in the Liquidity Reserve Account if such substitution will cause the then current ratings on the Bonds to be downgraded or withdrawn.

Any such Reserve Facility shall be issued by an institution then rated in a rating category (without regard to subcategories) not lower than the then current ratings on the Bonds, and in any event not rated lower than "A3" and "A–" by Moody's and Standard & Poor's, respectively. Any such Reserve Facility shall permit the Trustee to obtain amounts thereunder for deposit in the Liquidity Reserve Account, which, together with any moneys or other Reserve Facility on deposit therein, are not less than the Liquidity Reserve Requirement, and which may be applied to any purpose for which moneys in the Liquidity Reserve Account may be applied. The Trustee shall make a drawing on such Reserve Facility (i) whenever moneys are required for the purposes for which moneys in the applicable Reserve Account may be applied, and (ii) prior to any expiration or termination thereof; provided, however, that no such drawing need be made if other moneys are available in the applicable Reserve Account in the amount of the applicable Reserve Requirement. Amounts deposited in the applicable Reserve Account may be used to reimburse the provider of a Reserve Facility for draws on such Reserve Facility. In the event that after the substitution of a Reserve Facility for all or any part of the amounts on deposit in either Reserve Account, the amount therein is greater than the applicable Reserve Requirement, upon receipt of an Officer's Certificate, the Trustee shall transfer such excess to the Collections Account.

Valuation. In computing the amount in any Account, the value of Eligible Investments will be calculated as follows:

(1) as to investments the bid and asked prices of which are published on a regular basis in a recognized pricing service subscribed to by the Trustee, or in The Wall Street Journal (or, if not there, then in The New York Times), the average of the bid and asked prices for such investments so published on or most recently prior to such time of determination;

(2) as to investments the bid and asked prices of which are not published on a regular basis in a recognized pricing service subscribed to by the Trustee, or in The Wall Street Journal or The New York Times, the average bid price at such time of determination for such investments by any two nationally recognized government securities dealers (selected by the Trustee in its absolute discretion) at the time making a market in such investments or the bid price published by a nationally recognized pricing service;

(3) as to certificates of deposit and bankers acceptances, the face amount thereof, plus accrued interest;

(4) as to any investment specified in clauses (i) and (ii) of the definition of Eligible Investments and held in a Reserve Account, the Adjusted Cost Basis for such investment plus accrued interest. For this purpose, "Adjusted Cost Basis" means (y) the purchase price of such investment, excluding accrued interest, and adjusted for the amortization of any premium or discount to face value if the Issuer provides an Officer's Certificate to the Trustee with such adjustment or (z) the value as determined in paragraphs (1) through (3) above if the Issuer does not provide an Officer's Certificate to the Trustee with such adjustment[*]; and

(5) as to any investment not specified above, the value thereof established by prior agreement between the Issuer and the Trustee (with Written Notice to each Rating Agency).

The Trustee may hold undivided interests in Eligible Investments for more than one Account (for which they are eligible, but not including the Rebate Account) and may make interfund transfers in kind.

In respect of Defeasance Collateral held for Defeased Bonds, the provisions above will be effective only to the extent it is consistent with other applicable provisions of the Indenture or any separate escrow agreement.

Unclaimed Money

Except as may otherwise be required by applicable law, in case any money deposited with the Trustee or a Paying Agent for the payment of the principal of or Accreted Value on, or interest or premium, if any, on any Bond remains unclaimed for two years after such principal or Accreted Value, interest or premium has become due and payable, the Trustee or Paying Agent may, and upon receipt of a written request of the Issuer will, pay over to the Issuer the amount so deposited and thereupon the Trustee or Paying Agent will be released from any further liability under the Indenture with respect to the payment of principal or Accreted Value, interest or premium, and the Owner of such Bond shall be entitled (subject to any applicable statute of limitations) to look only to the Issuer as an unsecured creditor for the payment thereof.

[*] Clause (4) is being added pursuant to the Third Supplemental Indenture. See "SECURITY FOR THE BONDS—Consent to Amendments to Indenture and Purchase and Sale Agreement."

Contract; Obligations to Owners; Representations of the Issuer

In consideration of the purchase and acceptance of any or all of the Bonds by those who will hold the same from time to time, the provisions of the Indenture will be a part of the contract of the Issuer with the Owners. The pledge and grant of a security interest made in the Indenture and the covenants set forth under the Indenture to be performed by the Issuer will be for the equal benefit, protection and security of the Owners. All of the Bonds will be of equal rank without preference, priority, or distinction of any thereof over any other except as expressly provided pursuant to the Indenture.

The Issuer covenants to pay when due all sums payable on the Bonds, but only from the Collateral and subject to the limitations set forth in the Indenture. The obligation of the Issuer to pay principal, Accreted Value, interest, and redemption premium, if any, to the Owners will be absolute and unconditional, will be binding and enforceable in all circumstances whatsoever, and will not be subject to setoff, recoupment, or counterclaim.

The Issuer represents and warrants that (i) it is duly authorized under the laws of the State to issue the Bonds and the Residual Certificate, and to execute, deliver, and perform the terms of the Indenture; (ii) all action on its part required for or relating to the issuance of the Bonds and the Residual Certificate and the execution and delivery of the Indenture has been duly taken; (iii) the Bonds and the Residual Certificate, upon the issuance and authentication thereof, and the Indenture, upon the execution and delivery thereof, will be valid and enforceable obligations of the Issuer in accordance with their terms; (iv) it has not theretofore conveyed, assigned, pledged, granted a security interest in, or otherwise disposed of the Collateral; and (v) the execution, delivery, and performance of the Indenture and the issuance of the Bonds and the Residual Certificate are not in contravention of law or any agreement, instrument, indenture, or other undertaking to which it is a party or by which it is bound and no other approval, consent, or notice from any governmental agency is required on the part of the Issuer in connection with the issuance of the Bonds or the Residual Certificate.

The Indenture creates a valid and binding pledge of the Collateral, in favor of the Trustee as security for the payment of the Bonds and the Residual Certificate, enforceable by the Trustee in accordance with the terms thereof.

The Issuer has not heretofore made a pledge of, granted a lien on or security interest in, or made an assignment or sale of such Collateral that ranks on a parity with or prior to the security interest granted by the Indenture. The Issuer has not described such Collateral in a Uniform Commercial Code financing statement that will remain effective when the Bonds are issued. The Issuer will not make or suffer to exist any pledge or assignment of, lien on, or security interest in such Collateral that ranks prior to or on a parity with the pledge and security interest granted by the Indenture, or file any financing statement describing any such pledge, assignment, lien, or security interest, except as expressly permitted by the Indenture.

Non-Impairment Covenant of State

Pursuant to the Act and the Purchase and Sale Agreement, the State has pledged to and agreed with the holders of any Bonds of the Issuer that it will not amend the MSA, the MOU, the ARIMOU or the California Escrow Agreement, or take any other action, in any way that would materially adversely alter, limit, or impair the rights to receive the Pledged TSRs, nor in any way materially impair the rights and remedies of such bondholders or the security for their bonds until those bonds, together with the interest thereon and costs and expenses in connection with any action or proceeding on behalf of such bondholders, are fully paid and discharged.[*] See "SECURITY FOR THE BONDS—Consent to Amendments to Indenture and Purchase and Sale Agreement." The State has further pledged and agreed that it shall enforce its rights to collect all moneys due from the PMs under the MSA and, in addition, shall diligently enforce the California Model Statute against all NPMs in the State, in each case in the manner and to the extent necessary in the judgment of the Attorney General of the State to collect all moneys to which the State is entitled under the MSA. Notwithstanding the pledges of the State described above, the Attorney General of the State may, in his or her discretion, enforce any and all of the provisions of the MSA, without limitation.

Operating Expenses

The Issuer shall pay its Operating Expenses to the parties entitled thereto, to the extent that funds are available therefor, but solely to the extent provided in the Indenture. Payments made in respect of termination of or loss payments under any Swap Contract, investment agreement or forward purchase agreement shall be made only from the Operating Contingency Account and only to the extent that the amount in such account exceeds $500,000.

On April 1 of each year during which the Bonds are Outstanding (beginning April 1, 2015 for the Fiscal Year ending June 30, 2016), the Issuer will deliver an Officer's Certificate to the Trustee estimating the Operating Expenses and the Tax Obligations that will be incurred or paid by the Issuer during the next Fiscal Year. The Officer's Certificate or a supplemental Officer's Certificate delivered at any time may also set forth Operating Expenses that have already been incurred by the Issuer but that have not yet been repaid, provided that the Operating Cap will continue to apply to all such amounts. The Issuer may at any time submit a supplemental Officer's Certificate setting forth Operating Expenses in excess of the Operating Cap. Collections to pay such Operating Expenses will be deposited in the Operating Contingency Account if, but only if, all of the deposits required to pay current interest on the Bonds and Swap Payments, Serial Maturities, Term Bond Maturities and Mandatory Sinking Fund Payments have been made and the Liquidity Reserve Account is fully funded. In the event that the Issuer fails to deliver an Officer's Certificate on or prior to any April 1, the Issuer will be deemed to have delivered an Officer's Certificate certifying that the amount of the Operating Expenses and the Tax Obligations for the next succeeding 12-month period will be the same as in the then-current 12-month period. To the extent there are amounts on deposit in the Operating Account or the Operating Contingency Account in excess of the amounts required to be on deposit therein, respectively, the Officer's Certificate or a supplemental Officer's Certificate delivered at any time may also direct the Trustee to transfer such excess amounts to the Collections Account.

Tax Covenants

The Issuer will at all times do and perform all acts and things permitted by law and the Indenture which are necessary or desirable in order to assure that interest paid on any tax-exempt Bonds will be

[*] Pursuant to the Third Supplemental Indenture, the words appearing in italics are being added to the Indenture (emphasis added): "Pursuant to the Act and the Agreement, the State has pledged to and agreed with the Owners of Bonds, that the State will not amend the MSA, the Memorandum of Understanding, or the California Escrow Agreement, or take any other action, in any way that would *materially adversely* alter, limit, or impair the rights to receive Pledged TSRs sold to the Issuer pursuant to the Agreement and the Act, nor in any way *materially* impair the rights and remedies of Owners or the security for their Bonds until those Bonds, together with the interest thereon and costs and expenses in connection with any action or proceeding on behalf of the Owners, are fully paid and discharged." As of the Series 2015A Closing Date, the non-impairment covenants of the State contained in the purchase and sale agreement and indenture related to the Series 2007 Bonds do not contain a material adversity standard similar to that being added to the Purchase and Sale Agreement and the Indenture on the Series 2015A Closing Date. See "SECURITY FOR THE BONDS—Consent to Amendments to Indenture and Purchase and Sale Agreement." The Issuer cannot predict the content or timing of any future amendment to the MSA, the MOU, or the California Escrow Agreement.

excluded from gross income for federal income tax purposes and will take no action that would result in such interest not being excluded from gross income for federal income tax purposes. Without limiting the generality of the foregoing, the Issuer agrees that it will comply with the provisions of the Issuer Tax Certificate, which provisions are incorporated by reference under the Indenture. This covenant will survive defeasance or redemption of the Bonds.

Accounts and Reports

The Issuer will (1) as specified in the Indenture, instruct the Trustee to keep books of account in which complete and accurate entries will be made of its transactions relating to all funds and accounts under the Indenture, which books will at all reasonable times be subject to the inspection of the Owners of an aggregate of not less than 25% of the Bond Obligation of the Bonds then Outstanding or their representatives duly authorized in writing; and (2) annually, within 210 days after the close of each Fiscal Year, deliver to the Trustee and each Rating Agency, a copy of its financial statements for such Fiscal Year, as audited by an independent certified public accountant or accountants.

Ratings

The Issuer will pay such reasonable fees and provide such available information as may be necessary to obtain and keep in effect ratings on all the Bonds from at least two nationally recognized statistical rating organizations.

Affirmative Covenants

Maintenance of Existence. The Issuer will keep in full effect its corporate existence and all of its rights and powers.

Protection of Collateral. The Issuer will from time to time authorize, execute, deliver and file all financing statements, continuation statements, amendments to financing statements, documents and instruments, and will take such other action, as is necessary or advisable to maintain or preserve the lien and security interest (and the perfection and priority thereof) of the Indenture; to perfect or protect the validity of any grant made or to be made by the Indenture; to preserve and defend title to the Collateral and the rights of the Trustee in the Collateral against the claims of all Persons and parties, including the challenge by any party to the validity or enforceability of the Indenture; to pay any and all taxes levied or assessed upon all or any part of the Collateral; or to carry out more effectively the purposes of the Indenture.

Performance of Obligations. The Issuer will diligently pursue any and all actions to enforce its rights in the Collateral and under each instrument or agreement included therein, and will not take any action and will use its best efforts not to permit any action to be taken by others that would release any Person from any of such Person's covenants or obligations under any such instrument or agreement or that would result in the amendment, hypothecation, subordination, termination, or discharge of, or impair the validity or effectiveness of, any such instrument or agreement.

Notice of Events of Default. The Issuer will give the Trustee and Rating Agencies prompt Written Notice of each Event of Default that is known to the Issuer.

Other. The Issuer will:

(1) conduct its own business in its own name and not in the name of any other Person;

(2) observe all formalities as a distinct entity, and take all actions to maintain its existence as a nonstock, not-for-profit corporation under the laws of the State;

(3) operate its business and activities such that it does not engage in any business or activity of any kind, or enter into any transaction or indenture, mortgage, instrument, agreement, contract, lease, or other undertaking, other than the transactions contemplated and authorized by the Indenture or the Series 2007 Indenture, and does not create, incur, guarantee, assume, or suffer to exist any indebtedness or other liabilities, whether direct or contingent, other than (a) as a result of the endorsement of negotiable instruments for deposit or collection or similar transactions in the ordinary course of business, (b) the incurrence of obligations under the Indenture or the Series 2007 Indenture, and (c) the incurrence of operating expenses in the ordinary course of business of the type otherwise contemplated by the Indenture or the Series 2007 Indenture; and

(4) maintain its books and records separate from those of any other Person and maintain its assets readily identifiable as its own assets rather than assets of any other Person.

Annual State Appropriation Request. The Issuer will certify to the State by November 1 of each year, taking into account the information received from the Trustee pursuant to the Indenture, the amount of Debt Service and Operating Expenses to become due during the next succeeding Fiscal Year on the Bonds, in order to enable the Director of Finance and the Governor to request such amounts from the Legislature in an appropriation line item in the annual budget act, as provided in the Purchase and Sale Agreement.

Deficiency Certifications.

May Certification. The Issuer will certify to the State by May 5 of each year, taking into account the information received from the Trustee pursuant to the Indenture, (i) the difference, if negative, between the amount of Pledged TSRs received by the Issuer pursuant to the Purchase and Sale Agreement by the end of April of such calendar year, plus any other amounts available for Operating Expenses in the Operating Account or the Operating Contingency Account or for Debt Service in the Pledged Accounts, less the amount of Operating Expenses and Debt Service on any Bonds or Refunding Bonds to become due during the next succeeding 12 months, and (ii) if the amount in clause (i) is negative, the amount necessary to pay Debt Service on the Bonds, and/or the amount necessary to pay Operating Expenses to become due during the next succeeding twelve months, which amounts shall be deposited by the Trustee upon receipt as provided in the Indenture.

Supplemental Certification. The Issuer may at any time deliver a supplemental deficiency certification to correct or supplement a prior deficiency certification. In the event that the Issuer has delivered an Officer's Certificate as described under "May Certification" above pursuant to which funds appropriated by the Legislature have been encumbered as provided in the Purchase and Sale Agreement with regard to a December 1 Distribution Date, the Issuer shall deliver a supplemental Officer's Certificate prior to receiving the disbursement of such encumbered funds if the amount necessary to pay Debt Service on the Bonds or Refunding Bonds and/or the amount necessary to pay Operating Expenses to become due on such December 1 Distribution Date is more or less than the amount previously certified as described above.

Negative Covenants

Sale of Assets. Except as expressly permitted by the Indenture, the Issuer will not sell, transfer, exchange, or otherwise dispose of any of its properties or assets that are subject to the lien of the Indenture.

Termination. The Issuer will not terminate its existence or engage in any action that would result in the termination of the Issuer.

Limitation of Liens. The Issuer will not (1) permit the validity or effectiveness of the Indenture to be impaired, or permit the security interest created by the Indenture to be amended, hypothecated, subordinated, terminated, or discharged, or permit any Person to be released from any covenants or obligations with respect to the Bonds or the Residual Certificate under the Indenture except as may be expressly permitted thereby, (2) permit any lien, charge, excise, claim, security interest, mortgage, or other encumbrance (other than the security interest created by the Indenture) to be created on or extend to or otherwise arise upon or burden the Collateral or any part thereof or any interest therein or the proceeds thereof, or (3) permit the security interest created by the Indenture not to constitute a valid first priority security interest in the Collateral.

Payments Restricted. The Issuer will not, directly or indirectly, make distributions from the Collections Account except in accordance with the Indenture.

No Setoff. The Issuer will not claim any credit on, or make any deductions from the principal of or Accreted Value on or premium, if any, or interest due in respect of, the Bonds or assert any claim against any present or former Owner by reason of the payment of taxes levied or assessed upon any part of the Collateral.

Limitations on Consolidation, Merger, Sales of Assets, Etc. Except as otherwise provided in the Indenture, the Issuer will not consolidate or merge with or into any other person, or convey or transfer all or substantially all of its properties or assets, or be succeeded by any other public corporate entity, unless:

(1) the person surviving such consolidation or merger (if other than the Issuer), or such transferee, or such successor, as applicable, is organized and existing by virtue of or under the laws of the United States or any state and expressly assumes the due and punctual payment of the principal of or Accreted Value on and premium, if any, and interest on all Bonds and the performance or observance of every agreement and covenant of the Issuer in the Indenture;

(2) immediately after giving effect to such transaction, no Event of Default has occurred and is continuing under the Indenture;

(3) the Issuer has received a Rating Confirmation;

(4) the Issuer has received an opinion of counsel to the effect that such transaction will not have material adverse tax consequences to the Issuer and will not adversely affect the exclusion of interest on any Bond from gross income for federal income tax purposes;

(5) any action as is necessary to maintain the security interest created by the Indenture has been taken; and

(6) the Issuer has delivered to the Trustee an officer's certificate and an opinion of counsel to the effect that such transaction complies with the Indenture and that all conditions precedent to such transaction have been complied with.

No Other Debt. The Issuer will not issue bonds or other debt securities other than to finance or refinance "tobacco assets" as defined in and pursuant to the Act and will provide written notice to each Rating Agency of any bonds or other debt securities so issued.

Swap Contracts. The Issuer shall not enter into any Swap Contract until it has first obtained a Rating Confirmation with respect to such Swap Contract, nor shall it enter into any Swap Contract unless such Swap Contract provides that any payments to be made to or for the benefit of the Issuer shall be made to the Trustee for deposit into the Collections Account.

Amendments to Articles of Incorporation or Bylaws. The Issuer shall not amend its Articles of Incorporation or its Bylaws without the unanimous consent of its Board of Directors.

Prior Notice

The Trustee will give each Rating Agency 15 days prior Written Notice of any amendment to the Indenture or the defeasance or redemption of Bonds.

Trustee's Responsibility

The duties and responsibilities of the Trustee will be as provided by law and as set forth in the Indenture. Notwithstanding the foregoing, no provision of the Indenture will require the Trustee to expend or risk its own funds or otherwise incur any financial liability in the performance of any of its duties under the Indenture, or in the exercise of any of its rights or powers, unless it receives indemnity satisfactory to it against any loss, liability, or expense, provided that the Trustee will perform its duties under Article V of the Indenture and make the payments and distributions required by the Indenture without requiring that any indemnity be provided to it. Whether or not therein expressly so provided, every provision of the Indenture relating to the conduct or affecting the liability of or affording protection to the Trustee will be subject to the provisions of the Indenture.

As Trustee under the Indenture:

(1) the Trustee may conclusively rely and will be fully protected in acting or refraining from acting upon any Officer's Certificate, opinion of counsel (or both), resolution, certificate, statement, instrument, opinion, report, notice, request, direction, consent, order, facsimile transmission, electronic mail, bond, debenture, note, other evidence of indebtedness, or other paper or document believed by it to be genuine and to have been signed or presented by the proper person or persons. The Trustee need not investigate any fact or matter stated in the document, but the Trustee, in its discretion, may make such further inquiry or investigation into such facts or matters as it may see fit;

(2) before the Trustee acts or refrains from acting, it may require an Officer's Certificate and/or an opinion of counsel. The Trustee will not be liable for any action it takes or omits to take in good faith in reliance on such certificate or opinion. Whenever in the administration of the trusts of the Indenture the Trustee will deem it necessary or desirable that a matter be proved or established prior to taking or suffering or omitting to take any action under the Indenture, such matter (unless other evidence in respect thereof be specifically prescribed in the Indenture) may, in the absence of negligence or bad faith on the part of the Trustee, be deemed to be conclusively proved and established by an Officer's Certificate delivered to the Trustee, and such certificate, in the absence of negligence or bad faith on the part of the Trustee, will be full warrant to the Trustee for any action taken, suffered or omitted to be taken by it under the provisions of the Indenture upon the faith thereof;

(3) any request, direction, order, or demand of the Issuer mentioned under the Indenture will be sufficiently evidenced by an Officer's Certificate (unless other evidence in respect thereof be specifically prescribed in the Indenture); and any resolution of the Issuer may be evidenced to the Trustee by a copy thereof certified by the secretary or an assistant secretary of the Issuer;

(4) prior to the occurrence of an Event of Default under the Indenture of which the Trustee has actual knowledge or notice and after the curing or waiving of all Events of Default, the Trustee will not be bound to make any investigation into the facts or matters stated in any resolution, certificate, Officer's Certificate, opinion of counsel, resolution, statement, instrument, opinion, report, notice, request, consent, order, facsimile transmission, electronic mail, approval, appraisal, bond, debenture, note, coupon, security, or other paper or document unless requested in writing so to do by a Majority in Interest of the Bonds affected and then Outstanding, and if the payment within a reasonable time to the Trustee of the costs, expenses, or liabilities likely to be incurred by it in the making of such investigation is, in the opinion of the Trustee, not reasonably assured to the Trustee by the security afforded to it by the terms of the Indenture, the Trustee may require indemnity satisfactory to it against such expenses or liabilities as a condition to proceeding; and

(5) the Trustee will, prior to an Event of Default, and after the curing of all Events of Default that may have occurred, perform such duties and only such duties as are specifically set forth in the Indenture and no implied duties or obligations shall be read into the Indenture. The Trustee shall, during the existence of any Event of Default (that has not been cured), exercise such of the rights and powers vested in it by the Indenture, and use the same degree of care and skill in the exercise, as a prudent man would exercise or use under the circumstances in the conduct of his own affairs.

Rights and Duties of the Fiduciaries

All money and investments received by the Fiduciaries under the Indenture will be held in trust, in a segregated trust account in the trust department of such Fiduciary, not commingled with any other funds, and applied solely pursuant to the provisions of the Indenture.

The Fiduciaries will keep proper accounts of their transactions under the Indenture (separate from its other accounts), which will be open to inspection on reasonable notice by the Issuer and its representatives duly authorized in writing.

The Fiduciaries will not be required to monitor the financial condition of the Issuer and, unless otherwise expressly provided, will not have any responsibility with respect to reports, notices, certificates, or other documents filed with them under the Indenture, except to make them available for inspection by the Owners.

Each Fiduciary will be entitled to the advice of counsel (who may be counsel for any party) and will not be liable for any action taken in good faith in reliance on such advice. Each Fiduciary may rely conclusively on any notice, certificate, or other document furnished to it under the Indenture and reasonably believed by it to be genuine. A Fiduciary will not be liable for any action taken or omitted to be taken by it in good faith and reasonably believed by it to be within the discretion or power conferred upon it, or taken by it pursuant to any direction or instruction by which it is governed under the Indenture or omitted to be taken by it by reason of the lack of direction or instruction required for such action. When any payment or consent or other action by a Fiduciary is called for by the Indenture, the Fiduciary may defer such action pending receipt of such evidence, if any, as it may reasonably require in support thereof; except that the Trustee will make the payments and distributions required by the Indenture without requiring that any further evidence be provided to it. A permissive right or power to act will not be construed as a requirement to act.

No recourse will be had for any claim based on the Indenture or the Bonds against any director, officer, agent, or employee of any Fiduciary unless such claim is based upon the bad faith, negligence, willful misconduct, fraud or deceit of such person.

Nothing in the Indenture will obligate any Fiduciary to pay any debt or meet any financial obligations to any Person in relation to the Bonds except from money received for such purposes under the provisions of the Indenture or from the exercise of the Trustee's rights thereunder.

The Fiduciaries may be or become the owner of or trade in the Bonds with the same rights as if they were not the Fiduciaries.

The Fiduciaries will not be required to furnish any bond or surety.

Nothing under the Indenture will relieve any Fiduciary of responsibility for its negligence, bad faith or willful misconduct.

The Trustee shall not be deemed to have knowledge of any default or Event of Default unless and until the Trustee's corporate trust office responsible for the administration of its duties under the Indenture has actual knowledge thereof or the Trustee has received written notice thereof at its corporate trust office.

The Trustee shall have no responsibility or liability with respect to any information, statements or recital in any official statement or other disclosure material prepared or distributed with respect to the issuance of the Bonds.

Resignation or Removal of the Trustee

The Trustee may resign on not less than 60 days Written Notice to the Issuer, the Owners and the Rating Agencies. The Trustee will promptly certify to the Issuer that it has given Written Notice to all Owners, and such certificate will be conclusive evidence that such notice was given as required under the Indenture. The Trustee shall provide notice to the Issuer within two (2) Business Days of any changes in its ratings by the Rating Agencies and shall be removed if rated below investment grade by the Rating Agencies and each successor Trustee will have an investment grade rating from the Rating Agencies. The Trustee may be removed by Written Notice from the Issuer (if not in default) or a Majority in Interest of the Outstanding Bonds to the Trustee and the Issuer. Such resignation or removal will not take effect until a successor has been appointed and has accepted the duties of Trustee.

Successor Fiduciaries

Any corporation or association which succeeds to the related corporate trust business of a Fiduciary as a whole or substantially as a whole, whether by sale, merger, consolidation, or otherwise, will thereby become vested with all the property, rights, powers, and duties thereof under the Indenture, without any further act or conveyance.

In case a Fiduciary resigns or is removed or becomes incapable of acting, or becomes bankrupt or insolvent, or if a receiver, liquidator, or conservator of a Fiduciary or of its property is appointed, or if a public officer takes charge or control of a Fiduciary, or of its property or affairs, then such Fiduciary will with due care terminate its activities under the Indenture and a successor may, or in the case of the Trustee will, be appointed by the Issuer. The Issuer will notify the Owners and the Rating Agencies of the appointment of a successor Trustee in writing within 20 days from the appointment. The Issuer will promptly certify to the successor Trustee that it has given such notice to all Owners, and such certificate will be conclusive evidence that such notice was given as required under the Indenture. If no appointment of a successor Trustee is made within 45 days after the giving of Written Notice in accordance with the provisions relating to the resignation or removal of the Trustee under the Indenture or after the occurrence of any other event requiring or authorizing such appointment, the outgoing Trustee or any Owner may apply to any court of competent jurisdiction for the appointment of such a successor, and such court may thereupon, after such notice, if any, as such court may deem proper, appoint such successor. Any successor Trustee appointed under this section will be a bank or trust company eligible under the laws of the State and will have a capital and surplus of not less than $100,000,000. Any such successor Trustee will notify the Issuer of its acceptance of the appointment and, upon giving such notice, will become Trustee, vested with all the property, rights, powers, and duties of the Trustee under the Indenture, without any further act or conveyance. Such successor Trustee will execute, deliver, record, and file such instruments as are required to confirm or perfect its succession under the Indenture and any predecessor Trustee will from time to time execute, deliver, record, and file such instruments as the incumbent Trustee may reasonably require to confirm or perfect any succession under the Indenture.

Reports to Owners

The Trustee will deliver to each Rating Agency, the Issuer, the owner of the Residual Certificate, and any Owner, upon request, with respect to the Bonds, at least one Business Day prior to each Distribution Date therefor, a statement prepared by the Trustee with the assistance of the Issuer setting forth:

- the Outstanding Bonds on such Distribution Date;

- the amount of interest to be paid to Owners on such Distribution Date;

- any Serial Maturity, Term Bond Maturity or Mandatory Sinking Fund Payment due on or scheduled for such Distribution Date, and the payments, if any, to be made from the Residual Account to the registered owner of the Residual Certificate as of that Distribution Date;

- the amount on deposit in each Account as of that Distribution Date, including the amount on deposit in the Partial Lump Sum Payment Account; and

- whether the amount on deposit in either Reserve Account is sufficient to satisfy its respective Reserve Requirement as of such Distribution Date and, if not, the amount of the shortfall.

Compensation and Expenses of the Fiduciaries

The Fiduciaries are entitled to payment and/or reimbursement for reasonable fees and costs for their services and all advances, legal fees, and other expenses reasonably and necessarily made or incurred by them in connection with such services. Upon an Event of Default, but only upon such an Event of Default, the Fiduciaries will have a right of payment prior to payment on account of principal of or Accreted Value on, or premium, if any, or interest on any Bond or Swap Payment for the foregoing fees, costs, expenses and advances; provided, however, that in no event will the Fiduciaries have any such prior right of payment or claim against any moneys or obligations deposited with or paid to the Fiduciaries for the redemption or payment of Bonds which are deemed to have been paid.

Nonpetition Covenant

Notwithstanding any prior termination of the Indenture, no Fiduciary or Owner will, prior to the date which is one year and one day after the termination of the Indenture, acquiesce, petition, or otherwise invoke or cause the Issuer to invoke the process of any court or government authority for the purpose of commencing or sustaining a case against the Issuer under any federal or state bankruptcy, insolvency or similar law or appointing a receiver, liquidator, assignee, trustee, custodian, sequestrator or other similar official of the Issuer or any substantial part of its property, or ordering the winding up or liquidation of the affairs of the Issuer.

Action by Owners

Any request, authorization, direction, notice, consent, waiver, or other action provided by the Indenture to be given or taken by Owners may be contained in and evidenced by one or more writings of substantially the same tenor signed by the requisite number of Owners or their attorneys duly appointed in writing. Proof of the execution of any such instrument, or of an instrument appointing any such attorney, will be sufficient for any purpose of the Indenture (except as otherwise expressly provided in the Indenture) if made in the following manner, but the Issuer or the Trustee may nevertheless in its discretion require further or other proof in cases where it deems the same desirable. The fact and date of the execution by any Owner or its attorney of such instrument may be proved by the certificate or signature guarantee by a guarantor institution participating in a guarantee program acceptable to the Trustee, or of any notary public or other officer authorized to take acknowledgements of deeds to be recorded in the jurisdiction in which such notary public or other officer purports to act, that the person signing such request or other instrument acknowledged to such notary public or other officer the execution thereof, or by an affidavit of a witness of such execution, duly sworn to before such notary public or other officer. The authority of the person or persons executing any such instrument on behalf of a corporate Owner may be established without further proof if such instrument is signed by a person purporting to be the president or a vice president of such corporation with a corporate seal affixed and attested by a person purporting to be its clerk or secretary or an assistant clerk or secretary. Any action of the Owner will be irrevocable and bind all future record and beneficial owners thereof.

Registered Owners

The enumeration of certain provisions of the Indenture applicable to DTC as Owner of immobilized Bonds will not be construed in limitation of the rights of the Issuer and each Fiduciary to rely upon the registration books in all circumstances and to treat the registered owners of Bonds as the owners thereof for all purposes not otherwise specifically provided for by law or in the Indenture. Notwithstanding any other provisions of the Indenture, any payment to the registered owner of a Bond will satisfy the Issuer's obligations thereon to the extent of such payment.

Events of Default

"**Event of Default**" in the Indenture means any one of the events set forth below:

(1) failure to pay when due any Swap Payment or interest on any Current Interest Bonds;

(2) failure to pay when due any Serial Maturity, Mandatory Sinking Fund Payment or Term Bond Maturity;

(3) failure of the Issuer to observe or perform any other covenant, condition, agreement, or provision contained in the Bonds or in the Indenture which breach is not remedied within 60 days after Written Notice, specifying such default and requiring the same to be remedied, shall have been given to the Issuer by the Trustee or by the Owners of at least 25% of the Bond Obligation of the Bonds then Outstanding. In the case of a default specified in this paragraph (3), if the default be such that it cannot be corrected within the said 60-day period, it will not constitute an Event of Default if corrective action is instituted by the Issuer within said 60-day period and diligently pursued until the default is corrected;

(4) a material breach by the State of its covenants contained in the Indenture (as set forth above under "Contract; Obligations to Owners; Representations of the Issuer"), which breach is not remedied within 60 days after Written Notice, specifying such default and requiring the same to be remedied, will have been given to the Issuer and the State by the Trustee or by the Owners of at least 25% of the Bond Obligation of the Bonds then Outstanding. In the case of a default specified in this paragraph (4), if the default be such that it cannot be corrected within the said 60-day period, it will not constitute an Event of Default if corrective action is instituted by the State within said 60-day period and diligently pursued until the default is corrected; and

(5) failure of the Director of Finance to provide the certification required under Section 4.07(a) of the Purchase and Sale Agreement to the effect that the Director of Finance has complied with his or her obligations under that section, which breach is not remedied within 60 days after Written Notice, specifying such default and requiring the same to be remedied, shall have been given to the Director of Finance by the Trustee or by the Owners of at least 25% of the Bond Obligation of the Bonds then Outstanding. In the case of a default specified in this paragraph (5), if the default be such that it cannot be corrected within the said 60-day period, it shall not constitute an Event of Default if corrective action is instituted by the Director of Finance within said 60-day period and diligently pursued until the default is corrected.

Remedies

Remedies of the Trustee. If an Event of Default occurs:

(1) The Trustee may, and upon written request of the Owners of at least 25% of the Bond Obligation of the Bonds Outstanding will, in its own name by action or proceeding in accordance with law:

(a) enforce all rights of the Owners and require the Issuer or the State to carry out their respective agreements under the Bonds, the Indenture or the Agreement;

(b) sue upon such Bonds;

(c) require the Issuer to account as if it were the trustee of an express trust for such Owners; and

(d) enjoin any acts or things which may be unlawful or in violation of the rights of such Owners.

(2) The Trustee will, in addition to the other provisions of this section, have and possess all of the powers necessary or appropriate for the exercise of any functions incident to the general representation of Owners in the enforcement and protection of their rights.

(3) Upon an Event of Default under (1) or (2) under the definition of "Events of Default" above, or a failure to make any other payment required under the Indenture within seven days after the same becomes due and payable, the Trustee will give Written Notice thereof to the Issuer. The Trustee will give notice under subsection (3), (4) or (5) under the definition of "Events of Default" above when instructed to do so by the written direction of another Fiduciary or the Owners of at least 25% of the Bond Obligation of the Outstanding Bonds. Upon the occurrence of an Event of Default, the Trustee will proceed under the provisions of the Indenture for the benefit of the Owners in accordance with the written direction of a Majority in Interest of the Outstanding Bonds. The Trustee will not be required to take any remedial action (other than the giving of notice) unless reasonable indemnity is furnished for any expense

or liability to be incurred therein. Upon receipt of Written Notice, direction, and indemnity, and after making such investigation, if any, as it deems appropriate to verify the occurrence of any Event of Default of which it is notified as aforesaid, the Trustee will promptly pursue the remedies provided by the Indenture or any such remedies (not contrary to any such direction) as it deems appropriate for the protection of the Owners, and will act for the protection of the Owners with the same promptness and prudence as would be expected of a prudent person in the conduct of such person's own affairs.

(4) Upon the occurrence of any Event of Default and on each succeeding Distribution Date, the Trustee shall apply all funds in the Debt Service Account, the Liquidity Reserve Account, the Partial Lump Sum Payment Account and the Surplus Account to pay Pro Rata, first, the accrued interest on the Current Interest Bonds then Outstanding and Swap Payments (including, in each case, interest at the stated rate on any unpaid interest, to the extent legally permissible) and, second, principal of or Accreted Value on all Bonds then Outstanding. The Residual Certificate shall be paid only after all Bonds and Swap Payments have been fully paid and after all Operating Expenses due or to become due have been fully paid.

Individual Remedies. No one or more Owners will by its or their action affect, disturb, or prejudice the pledge created by the Indenture, or enforce any right under the Indenture, except in the manner therein provided, and all proceedings at law or in equity to enforce any provision of the Indenture will be instituted, had, and maintained in the manner provided therein and for the equal benefit of all Owners of the same class, but nothing in the Indenture will affect or impair the right of any Owner to enforce payment of the principal of or Accreted Value on, premium, if any, or interest thereon at and after the same comes due pursuant to the Indenture, or the obligation of the Issuer to pay such principal or Accreted Value, premium, if any, and interest on each of the Bonds to the respective Owners thereof at the time, place, from the source, and in the manner expressed in the Indenture and in the Bonds.

Venue. The venue of every action, suit, or special proceeding against the Issuer will be laid in federal or state courts located in Sacramento County, California, unless waived by the Issuer.

Waiver. If the Trustee determines that any default has been cured before becoming an Event of Default and before the entry of any final judgment or decree with respect to it, the Trustee may waive the default and its consequences, by Written Notice to the Issuer, and will do so upon written instruction of the Owners of at least 25% of the Bond Obligation of the Outstanding Bonds.

Remedies Cumulative

The rights and remedies under the Indenture are cumulative and do not exclude any other rights and remedies allowed by law, provided that there is no duplication of recovery. The failure to insist upon a strict performance of any of the obligations of the Issuer or to exercise any remedy for any violation thereof will not be taken as a waiver for the future of the right to insist upon strict performance by the Issuer or of the right to exercise any remedy for the violation.

Delay or Omission Not a Waiver

No delay or omission of the Trustee or of any Owner to exercise any right or remedy accruing upon any Event of Default will impair any such right or remedy or constitute a waiver of any such Event of Default or an acquiescence therein. Every right and remedy given under the Indenture or by law to the Trustee or to the Owners may be exercised from time to time, and as often as may be deemed expedient, by the Trustee or by the Owners, as the case may be.

Supplements and Amendments to the Indenture

The Indenture may be:

(1) supplemented or amended in writing by the Issuer and the Trustee (a) to provide for earlier or greater deposits into the Debt Service Account, (b) to subject any property to the security interest created by the Indenture, (c) to add to the covenants and agreements of the Issuer or surrender or limit any right or power of the Issuer, (d) to identify particular Bonds for purposes not inconsistent with the Indenture, including credit or liquidity support, remarketing, and defeasance, (e) to cure any ambiguity or defect, (f) to protect the exclusion of interest on the Bonds from gross income for federal income tax purposes, or the exemption from registration of the Bonds under the Securities Act of 1933, as amended, or of the Indenture under the Trust Indenture Act of 1939, as amended, (g) to make any other changes to the Indenture that, as evidenced by a Rating Confirmation, are not materially adverse to the Owners of Outstanding Bonds, (h) to provide for the issuance of refunding Bonds or (i) with a Rating Confirmation, to provide for the issuance of variable rate refunding Bonds or refunding Bonds that are inflation protected bonds; or

(2) amended in writing by the Issuer and the Trustee, (a) to adopt amendments that do not take effect unless and until such amendment is consented to by such Owners in accordance with the further provisions of the Indenture, or (b) pursuant to the following paragraph.

The Indenture may also be amended:

(1) only with Written Notice to the Rating Agencies and the written consent of a Majority in Interest of the Bonds to be Outstanding at the effective date thereof and affected thereby; but

(2) only with the unanimous written consent of the affected Owners for any of the following purposes: (a) to extend the maturity of any Bond, (b) to reduce the principal amount or Accreted Value, applicable premium, or interest rate of any Bond, (c) to make any Bond redeemable other than in accordance with its terms, (d) to create a preference or priority of any Bond over any other Bond of the same class, or (e) to reduce the percentage of the Bond Obligation of the Bonds required to be represented by the Owners giving their consent to any amendment.

Any amendment of the Indenture will be accompanied by an opinion of counsel to the effect that the amendment is permitted by the Indenture and does not adversely affect the exclusion of interest on the Bonds from gross income for federal income tax purposes.

When the Issuer determines that the requisite number of consents have been obtained for an amendment under the Indenture, it will file a certificate to that effect in its records and give notice to the Trustee and the Owners. The Trustee will promptly certify to the Issuer that it has given such notice to all Owners, and such certificate will be conclusive evidence that such notice was given in the manner required under the Indenture. It will not be necessary for the consent of Owners pursuant to this section to approve the particular form of any proposed amendment, but it will be sufficient if such consent will approve the substance thereof.

Definitions and Interpretation

In addition to terms defined elsewhere in the Indenture, the following words and terms as used in the Indenture will have the following meanings unless the context or use clearly indicates another or different meaning or intent:

"**Accounts**" means the accounts established under the provisions of the Indenture.

"**Accreted Value**" means, with respect to any Capital Appreciation Bond, an amount equal to the initial principal amount of such bond, plus interest accrued thereon from its date compounded on each Distribution Date, commencing on the first Distribution Date after its issuance (through and including the maturity date of such bond, or in the case of a Convertible Bond, through and including the applicable Conversion Date) at the "original issue yield" for such Bond specified in the Indenture; provided, however, that the Trustee shall calculate or cause to be calculated the Accreted Value on any date other than a Distribution Date specified in the Indenture by straight line interpolation of the Accreted Values as of the immediately preceding and succeeding Distribution Dates. In performing such calculation, the Trustee shall be entitled to engage and rely upon a firm of accountants, consultants or financial advisors with appropriate knowledge and experience. The term "original issue yield" means, with respect to any particular Bond, the yield to the applicable Maturity Date of such Bond from the initial date of delivery thereof calculated on the basis of semiannual compounding on each Distribution Date.

"**Authorized Officer**" means, (i) in the case of the Issuer, the Treasurer of the State, the Controller of the State and the Director of Finance of the State, or their duly designated deputies, in their respective capacities of Directors of the Issuer, and any other person authorized to act under the Indenture by appropriate Written Notice from an Authorized Officer of the Issuer to the Trustee, and (ii) in the case of the Trustee, any officer assigned to the Corporate Trust Office, including any managing director, vice president, assistant vice president, assistant treasurer, assistant secretary or any other officer of the Trustee customarily performing functions similar to those performed by any of the above designated officers and having direct responsibility for the administration of the Indenture, and also, with respect to a particular matter, any other officer, to whom such matter is referred because of such officer's knowledge of and familiarity with the particular subject.

"**Bond Obligation**" means, as of any given date of calculation, (a) with respect to any Outstanding Current Interest Bond, the principal amount of such Current Interest Bond, and (b) with respect to any Outstanding Capital Appreciation Bond, the Accreted Value thereof as of such date.

"**Business Day**" means any day other than (i) a Saturday or a Sunday, or (ii) a day on which the offices of the State or banking institutions in New York, New York; San Francisco, California; or the city in which the Corporate Trust Office of the Trustee is otherwise located, are required or authorized by law to be closed.

"**Capital Appreciation Bond**" means a Bond (including, as the context requires, a Convertible Bond prior to the applicable Conversion Date), the interest on which is payable at maturity (or, in the case of a Convertible Bond, the interest on which accretes until the Conversion Date) and compounded semiannually on each Distribution Date to the Maturity Date, Conversion Date or redemption date thereof, as the case may be.

"**California Escrow Agent Fees**" means the fees and expenses of the California escrow agent paid pursuant to the California Escrow Agreement

"**Conversion Date**" means the date on and after which a Convertible Bond is deemed to be a Current Interest Bond.

"**Convertible Bond**" means a Capital Appreciation Bond which is deemed to be a Current Interest Bond on or after the applicable Conversion Date.

"**Corporate Trust Office**" means the office of the Trustee at which the corporate trust business of the Trustee related to the Indenture will, at any particular time, be principally administered.

"**Counsel**" means nationally recognized bond counsel or such other counsel as may be selected by the Issuer for a specific purpose under the Indenture.

"**Current Interest Bond**" means a Bond (including, as the context requires, a Convertible Bond on and after the applicable Conversion Date), the interest on which is payable on each Distribution Date.

"**Debt Service**" means interest, redemption premium, principal, Accreted Value and Mandatory Sinking Fund Payments due on Outstanding Bonds; provided that the method of estimating Debt Service on variable rate Bonds shall be set forth in the Series Supplement providing for the issuance of such variable rate Bonds.

"**Debt Service Account**" means the Account held by the Trustee pursuant to the Indenture.

"**Defeasance Collateral**" means money and, to the extent permitted by applicable law:

(i) direct obligations of the United States government, which are not redeemable at the option of the issuer thereof;

(ii) (a) obligations of the State; (b) obligations, the timely payment of the principal and interest on which are unconditionally guaranteed by the State or the United States government; (c) certificates of deposit of banks or trust companies in the State, secured, if the Issuer shall so require, by obligations of the United States of America or of the State of a market value equal at all times to the amount of the deposit; (d) notes, bonds, debentures, mortgages and other evidences of indebtedness, issued or guaranteed at the time of the investment by the United States Postal Service, Fannie Mae, the Federal Home Loan Mortgage Corporation, the Student Loan Marketing Association, the Federal Farm Credit System, or any other United States government sponsored agency; (e) notes, bonds, debentures, mortgages and other evidences of indebtedness, issued or guaranteed at the time of investment by the Asian Development Bank, Bank Nederlandse Gemeenten, European Bank for Reconstruction and Development, European Investment Bank, Inter-American Development Bank and International Bank for Reconstruction and Development; or (f) general obligation bonds and notes of any state other than the State, and bonds and notes of any county, town, city, village, fire district or school district of the State; provided that the above-listed investments are not redeemable at the option of the issuer thereof and shall be rated at the time of the investment in the highest long-term rating category by each Rating Agency;

(iii) any depositary receipt issued by an Eligible Bank as custodian with respect to any Defeasance Collateral which is specified in clause (i) above and held by such Eligible Bank for the account of the holder of such depositary receipt, or with respect to any specific payment of principal of or interest on any such Defeasance Collateral which is so specified and held, provided that (except as required by law) such custodian is not authorized to make any deduction from the amount payable to the holder of such depositary receipt from any amount received by the custodian in respect of the Defeasance Collateral or the specific payment of principal or interest evidenced by such depositary receipt; or

(iv) any certificate of deposit specified in the definition of Eligible Investments below, including certificates of deposit issued by the Trustee or by a Paying Agent or by an affiliate of the Trustee or a Paying Agent, secured by obligations specified in clause (i) above of a market value equal at all times to the amount of the deposit, which shall be rated at the time of the investment in the highest long-term rating category by each Rating Agency.

"**Defeased Bonds**" means Bonds that remain in the hands of their Owners but are no longer deemed Outstanding because they have been defeased in accordance with the provisions of the Indenture.

"**Eligible Bank**" means any (i) bank or trust company organized under the laws of any state of the United States of America (including the Trustee and any of its affiliates), (ii) national banking association, (iii) savings bank or savings and loan association chartered or organized under the laws of any state of the United States of America, or (iv) federal branch or agency pursuant to the International Banking Act of 1978 or any successor provisions of law, or domestic branch or agency of a foreign bank which branch or agency is duly licensed or authorized to do business under the laws of any state or territory of the United States of America.

"**Eligible Investments**" means with respect to any Account:

(i) Defeasance Collateral;

(ii) direct obligations of, or obligations guaranteed as to timely payment of principal and interest by, the Federal Home Loan Mortgage Corporation, Fannie Mae, the Federal Home Loan Board or the Federal Farm Credit System;

(iii) demand and time deposits in or certificates of deposit of, or bankers' acceptances issued by, any bank (including the Trustee and any of its affiliates) or trust company, savings and loan association, or savings bank, payable on demand or on a specified date no more than three months after the date of issuance thereof, if such deposits or instruments are rated "A-1+" by S&P, "P-1" by Moody's and "F1" by Fitch;

(iv) certificates, notes, warrants, bonds, obligations, or other evidences of indebtedness of a state or a political subdivision thereof rated by each Rating Agency rating such bonds in one of its three highest rating categories;

(v) commercial or finance company paper (including both non-interest-bearing discount obligations and interest bearing obligations payable on demand or on a specified date not more than 190 days after the date of issuance thereof) that is rated "A-1" by S&P, "P-1" by Moody's, if rated by Moody's, and "F1" by Fitch, if rated by Fitch, and is rated by no less than two of such rating agencies;

(vi) repurchase obligations with respect to any security described in clause (i), (ii) or (iii) above entered into with a primary dealer, depository institution, or trust company (acting as principal) rated "A-1+" by S&P, "P-1" by Moody's, and "F1" by Fitch (if payable on demand or on a specified date no more than three months after the date of issuance thereof), or rated by each Rating Agency rating such bonds in one of its three highest long term rating categories, or collateralized by securities described in clause (i), (ii) or (iii) above with any registered broker/dealer or with any domestic commercial bank whose long-term debt obligations are rated "investment grade" by each Rating Agency, provided that (1) a specific written agreement governs the transaction, (2) the securities are held, free and clear of any lien, by the Trustee or an independent third party acting solely as agent for the Trustee, and such third party is (a) a Federal Reserve Bank, or (b) a member of the Federal Deposit Insurance Corporation that has combined surplus and undivided profits of not less than $25 million, and the Trustee will have received written confirmation from such third party that it holds such securities, free and clear of any lien, as agent for the Trustee, (3) the agreement has a term of 30 days or less, or the Trustee will value the collateral securities no less frequently than monthly and will liquidate the collateral securities if any deficiency in the required collateral percentage is not restored within five Business Days of such valuation, and (4) the fair market value of the collateral securities in relation to the amount of the obligation, including principal and interest, is equal to at least 102% or, if greater, the amount then required by S&P in order that the ratings then assigned by S&P to the Bonds will not be lowered or suspended;

(vii) securities bearing interest or sold at a discount (payable on demand or on a specified date no more than three months after the date of issuance thereof) that are issued by any corporation incorporated under the laws of the United States of America or any state thereof and rated "A-1+" by S&P, "P-1" by Moody's and "F1" by Fitch, if rated by Fitch, at the time of such investment or contractual commitment providing for such investment; provided that securities issued by any such corporation will not be Eligible Investments to the extent that investment therein would cause the then-outstanding principal amount of securities issued by such corporation that are then held to exceed 20% of the aggregate principal amount of all Eligible Investments then held;

(viii) units of taxable or tax-exempt money market funds which funds are regulated investment companies and seek to maintain a constant net asset value per share and have been rated by each Rating Agency rating such bonds in one of its three highest rating categories, including if so rated any such fund which the Trustee or an affiliate of the Trustee serves as an investment advisor, administrator, shareholder, servicing agent and/or custodian or sub-custodian, notwithstanding that (x) the Trustee or an affiliate of the Trustee charges and collects fees and expenses (not exceeding current income) from such funds for services rendered, (y) the Trustee charges and collects fees and expenses for services rendered pursuant to the Indenture, and (z) services performed for such funds and pursuant to the Indenture may converge at any time (the Issuer specifically authorizes the Trustee or an affiliate of the Trustee to charge and collect all fees and expenses from such funds for services rendered to such funds, in addition to any fees and expenses the Trustee may charge and collect for services rendered pursuant to the Indenture);

(ix) investment agreements or guaranteed investment contracts rated, or with any financial institution or corporation whose senior long-term debt obligations are rated, or guaranteed by a financial institution whose senior long-term debt obligations are rated, at the time such agreement or contract is entered into, by each Rating Agency rating such agreements, contracts or obligations, as the case may be, not lower than the then current ratings on the Bonds, and in any event not lower than "A3" and "A–" by Moody's and Standard & Poor's, respectively, if the Issuer has an option to terminate such agreement in the event that such rating is downgraded below the rating on the Bonds, or if not so rated, then collateralized by securities described in clause (i), (ii) or (iii) above with any registered broker/dealer or with any domestic commercial bank whose long-term debt obligations are rated "investment grade" by each Rating Agency; provided that (1) a specific written agreement governs the transaction, (2) the securities are held, free and clear of any lien, by the Trustee or an independent third party acting solely as agent for the Trustee, and such third party is (a) a Federal Reserve Bank, or (b) a member of the Federal Deposit Insurance Corporation that has combined surplus and undivided profits of not less than $25 million, and the Trustee will have received written confirmation from such third party that it holds such securities, free and clear of any lien, as agent for the Trustee, (3) the agreement has a term of 30 days or less, or the Trustee will value the collateral securities no less frequently than monthly and will liquidate the collateral securities if any deficiency in the required collateral percentage is not restored within five Business Days of such valuation, and (4) the fair market value of the collateral securities in relation to the amount of the obligation, including principal and interest, is equal to at least 102% or, if greater, the amount then required by S&P in order that the ratings then assigned by S&P to the Bonds will not be lowered or suspended; and

(x) other obligations or securities that are non-callable and that are acceptable to each Rating Agency;

provided, that no Eligible Investment may (a) except for Defeasance Collateral, evidence the right to receive only interest with respect to the obligations underlying such instrument, or (b) be purchased at a price greater than par if such instrument may be prepaid or called at a price less than its purchase price prior to its stated maturity. Any references to a rating by a Rating Agency in this definition must include a rating by S&P so long as S&P has a rating in effect for the Bonds and shall otherwise apply only if and to the extent that the obligations described are then rated by such Rating Agency.

"**Fiduciary**" means the Trustee, each Paying Agent and the Registrar.

"**Fiscal Year**" means the 12-month period ending each June 30, or such other 12-month period as the Board may determine from time to time to be the Issuer's fiscal year. In the event that the Board changes the Issuer's Fiscal Year, the Issuer shall deliver an Officer's Certificate to the Trustee stating such change.

"**Issuer Tax Certificate**" means the Issuer Tax Certificate executed by the Issuer at the time of issuance of the Bonds, as originally executed and as it may be amended and supplemented from time to time in accordance with the terms of the Indenture.

"**Litigation Expense Reimbursements**" means the reimbursements and payments made or to be made to the State or any department or agency of the State pursuant to Section XVII(a) and (b) of the MSA.

"**Majority in Interest**" means the Owners of a majority of the Bond Obligation of the Outstanding Bonds eligible to act on a matter, measured by face value at maturity.

"**Mandatory Sinking Fund Payment**" for a Term Bond represents the amount scheduled to be paid as of the specified Distribution Date.

"**Maturity Date**" means, with respect to any Bond, the final date on which all remaining principal of or Accreted Value on such Bond is due and payable.

"**Officer's Certificate**" means a certificate signed by an Authorized Officer of the Issuer or, if so specified, of the Trustee.

"**Operating Contingency Account**" means the Account held by the Trustee pursuant to the Indenture.

"**Outstanding**," when used as of any particular time with respect to any Bonds, means all Bonds issued under the Indenture, excluding: (i) Bonds that have been exchanged or replaced, or delivered to the Trustee for credit against a principal or Accreted Value payment; (ii) Bonds that have been paid; (iii) Bonds that have become due and for the payment of which money has been duly provided; (iv) Bonds the payment of which will have been provided for pursuant to the Indenture; and (v) for purposes of any consent or other action to be taken by the Owners of a Majority in Interest or specified percentage of Bonds under the Indenture, Bonds held by or for the account of the Issuer, or any Person controlling, controlled by, or under common control with the Issuer. For the purposes of this definition, "**control**," when used with respect to any specified Person, means the power to direct the management and policies of such Person, directly or indirectly, whether through the ownership of voting securities, by contract or otherwise, and the terms "controlling" and "controlled" have meanings correlative to the foregoing.

"**Paying Agent**" means each Paying Agent designated from time to time pursuant to the Indenture.

"**Person**" means any individual, corporation, estate, partnership, joint venture, association, joint stock company, limited liability company, trust, unincorporated organization, government or any agency or political subdivision thereof, or any other entity of any type.

"**Rebate Account**" means the Account, if any, established and maintained by the Trustee pursuant to the Indenture.

"**Reserve Account**" means the Liquidity Reserve Account.

"**Reserve Facility**" means a letter of credit, line of credit, municipal bond insurance policy, surety bond or other financial instrument meeting the requirements of the Indenture and deposited in the Liquidity Reserve Account, which obligates a third party to pay or provide funds for the payment of the principal of or Accreted Value on and/or interest on any Bonds and which is designated as a Reserve Facility in an Officer's Certificate.

"**Reserve Requirement**" means the Liquidity Reserve Requirement.

"**Residual Certificate**" means the certificate issued to the State as part of the purchase price of the Pledged TSRs and represents the State's residual interest in the Collateral after all Bonds have been paid in full.

"**Serial Maturity**" means the principal amount of or Accreted Value on Serial Bonds due in any year as set forth in a Series Supplement.

"**Series 2007 Indenture**" means the Indenture, dated as of February 1, 2007, between the Issuer and the Series 2007 Trustee, as amended or supplemented from time to time in accordance with the terms thereof.

"**Series 2007 Pledged TSRs**" means the "Pledged TSRs" as defined in the Series 2007 Indenture.

"**Series 2007 Trustee**" means The Bank of New York Mellon Trust Company, N.A. (formerly known as The Bank of New York Trust Company, N.A., successor to BNY Western Trust Company), acting in its capacity as trustee under the Series 2007 Indenture, or its successor, as provided therein.

"**State Appropriations**" means amounts appropriated by the State Legislature, allocated by the State Director of Finance and disbursed to the Trustee to pay Operating Expenses and/or Debt Service on the Bonds or refunding Bonds pursuant to Section 63049.1(b) of the Act and the Purchase and Sale Agreement.

"**Surplus Account**" means the Account held by the Trustee pursuant to the Indenture.

"**Supplemental Indenture**" means a supplement or amendment of the Indenture executed and delivered in accordance with the terms of the Indenture.

"**Swap Contract**" means an interest rate exchange, cap, collar, hedge or similar agreement entered into by the Issuer (with respect to the Bonds).

"**Swap Payment**" means any payment with respect to a Swap Contract, except that such payments shall not include any payment to be made by the Issuer to a counterparty with respect to the termination of the Swap Contract or any loss payments thereunder.

“**Term Bond Maturity**” means the payment of principal or Accreted Value required to be made upon the final maturity of any Term Bond, as such schedule is set forth in a Series Supplement.

“**Written Notice**,” “written notice” or “notice in writing” means notice in writing which may be delivered by hand, first class mail, overnight delivery, facsimile transmission or electronically.

CONTINUING DISCLOSURE UNDERTAKING

In order to assist the Underwriters in complying with Rule 15c2-12 (the “**Rule**”) of the Securities and Exchange Commission (“**SEC**”) promulgated under the Securities Exchange Act of 1934, as amended (the “**1934 Act**”), the Issuer will execute a Continuing Disclosure Certificate (the “**Continuing Disclosure Certificate**”) for the benefit of the holders and beneficial owners of the Series 2015A Bonds.

The Issuer will covenant in the Continuing Disclosure Certificate to provide to the Municipal Securities Rulemaking Board (the “**MSRB**”), through its Electronic Municipal Market Access (“**EMMA**”) system, (x) not later than April 1 of each Fiscal Year in which the Series 2015A Bonds are outstanding, commencing April 1, 2016, an annual report consisting of (1) audited financial statements of the Issuer for the preceding Fiscal Year, (2) an update of operating data for the preceding Fiscal Year set forth under the column titled “Total Payments to Trustee” in the second table appearing under the heading “Projection of Payments to be Received by the Trustee” in “TABLES OF PROJECTED PLEDGED TSRs, PROJECTION METHODOLOGY AND BOND STRUCTURING ASSUMPTIONS” herein, (3) the actual “debt service coverage” ratio for the preceding Fiscal Year, calculated as described in “TABLE OF PROJECTED AVAILABLE FUNDS AND DEBT SERVICE COVERAGE” herein and (4) information provided by the State to the Issuer as described herein under “THE PURCHASE AND SALE AGREEMENT—Continuing Disclosure”; and (y) in a timely manner, notices of certain specified events (each, a “**Listed Event**”) (but in no event in excess of ten business days after the occurrence of the event). See “APPENDIX H—FORM OF CONTINUING DISCLOSURE CERTIFICATE” attached hereto for the form of the Continuing Disclosure Certificate.

The State has agreed pursuant to the Purchase and Sale Agreement to provide to the Issuer and the Trustee a copy of the annual continuing disclosure prepared by the State in relation to the general obligation bonds of the State, and to incur all costs associated with such continuing disclosure. The failure of the State to provide ongoing disclosure shall not be considered a default or Event of Default under the Purchase and Sale Agreement or the Indenture.

The Issuer’s obligations under the Continuing Disclosure Certificate will terminate upon the maturity, legal defeasance, prior redemption or acceleration of all of the outstanding Series 2015A Bonds. If such termination occurs prior to the final maturity of the Series 2015A Bonds, the Issuer must give notice of such termination in the same manner as for a Listed Event.

The Continuing Disclosure Certificate inures solely to the benefit of the holders and beneficial owners from time to time of the Series 2015A Bonds, and creates no rights in any other person or entity (except the right of the Issuer or any bondholder or beneficial owner to enforce the provisions of the Continuing Disclosure Certificate on behalf of the bondholders). The Continuing Disclosure Certificate is not intended to create any monetary rights on behalf of any person based upon the Rule. The sole remedy in the event of any failure of the Issuer to comply with the Continuing Disclosure Certificate is an action to compel performance.

The Issuer has entered into a number of continuing disclosure undertakings under the Rule in connection with its bonds. For annual reports for its Series 2005A Bonds and Series 2013A Bonds, the undertakings have two parts — submission of the Issuer’s annual financial information, and submission of the annual continuing disclosure report prepared by the State for its general obligation bonds (the "**State GO Annual Report**"). It is the Issuer's practice to release its annual financial report when that information becomes available, and the Issuer has had to submit the State GO Annual Report at a later time. The State GO Annual Report typically is not ready until its due date on April 1, because of the complexity of completing the audits of all of the State's funds, including the General Fund, which is well after the Issuer's annual financial information is completed. In connection with its continuing disclosure undertakings for the Series 2005A Bonds and Series 2013A Bonds for the fiscal year ended June 30, 2013, the Issuer was 66 days late in filing the State GO Annual Report, and in connection with its continuing disclosure undertaking for the Series 2005A Bonds, the Issuer failed to file the State GO Annual Reports for the fiscal years ended June 30, 2009 and 2010 and was 78 days late in filing the State GO Annual Report for the fiscal year ended June 30, 2011. The Issuer notes that the State GO Annual Reports were filed by the State in a timely manner on EMMA and were widely available to the public and investors in connection with the many billions of dollars of outstanding State general obligation bonds and lease-revenue bonds. The Issuer has established processes designed to enhance future compliance with its continuing disclosure undertakings, including timely filing of the State GO Annual Report.

TAX MATTERS

In the opinion of Transaction Counsel to the Issuer, based upon an analysis of existing laws, regulations, rulings and court decisions, and assuming, among other matters, the accuracy of certain representations and compliance with certain covenants, interest on the Series 2015A Bonds is excluded from gross income for federal income tax purposes under Section 103 of the Code and is exempt from State of California personal income taxes. Transaction Counsel is of the further opinion that interest on the Series 2015A Bonds is not a specific preference item for purposes of the federal individual or corporate alternative minimum taxes, although Transaction Counsel observes that such interest is included in adjusted current earnings when calculating corporate alternative minimum taxable income. A complete copy of the proposed form of opinion of Transaction Counsel is set forth in Appendix F-1 hereto.

To the extent the issue price of any maturity of the Series 2015A Bonds is less than the amount to be paid at maturity of such Series 2015A Bonds (excluding amounts stated to be interest and payable at least annually over the term of such Series 2015A Bonds), the difference constitutes "original issue discount," the accrual of which, to the extent properly allocable to each Beneficial Owner thereof, is treated as interest on the Series 2015A Bonds which is excluded from gross income for federal income tax purposes. For this purpose, the issue price of a particular maturity of the Series 2015A Bonds is the first price at which a substantial amount of such maturity of the Series 2015A Bonds is sold to the public (excluding bond houses, brokers, or similar persons or organizations acting in the capacity of underwriters, placement agents or wholesalers). The original issue discount with respect to any maturity of the Series 2015A Bonds accrues daily over the term to maturity of such Series 2015A Bonds on the basis of a constant interest rate compounded semiannually (with straight-line interpolations between compounding dates). The accruing original issue discount is added to the adjusted basis of such Series 2015A Bonds to determine taxable gain or loss upon disposition (including sale, redemption or payment on maturity) of such Series 2015A Bonds. Beneficial Owners of the Series 2015A Bonds should consult their own tax advisors with respect to the tax consequences of ownership of Series 2015A Bonds with original issue discount, including the treatment of Beneficial Owners who do not purchase such Bonds in the original offering to the public at the first price at which a substantial amount of such Series 2015A Bonds is sold to the public.

Series 2015A Bonds purchased, whether at original issuance or otherwise, for an amount higher than their principal amount payable at maturity (or, in some cases, at their earlier call date) ("**Premium Bonds**") will be treated as having amortizable bond premium. No deduction is allowable for the amortizable bond premium in the case of bonds, like the Premium Bonds, the interest on which is excluded from gross income for federal income tax purposes. However, the amount of tax-exempt interest received, and a Beneficial Owner's basis in a Premium Bond, will be reduced by the amount of amortizable bond premium properly allocable to such Beneficial Owner. Beneficial Owners of Premium Bonds should consult their own tax advisors with respect to the proper treatment of amortizable bond premium in their particular circumstances.

The Code imposes various restrictions, conditions and requirements relating to the exclusion from gross income for federal income tax purposes of interest on obligations such as the Series 2015A Bonds. The State and the Issuer have made certain representations and covenanted to comply with certain restrictions, conditions and requirements designed to ensure that interest on the Series 2015A Bonds will not be included in the federal gross income. Inaccuracy of these representations or failure to comply with these covenants may result in interest on the Series 2015A Bonds being included in gross income for federal income tax purposes, possibly from the date of original issuance of the Series 2015A Bonds. The opinion of Transaction Counsel assumes the accuracy of these representations and compliance with these covenants. Transaction Counsel has not undertaken to determine (or to inform any person) whether any actions taken (or not taken), or events occurring (or not occurring), or any other matters coming to Transaction Counsel's attention after the date of issuance of the Series 2015A Bonds may adversely affect the value of, or the tax status of interest on, the Series 2015A Bonds. Accordingly, the opinion of Transaction Counsel is not intended to, and may not, be relied upon in connection with any such actions, events or matters.

Although Transaction Counsel is of the opinion that interest on the Series 2015A Bonds is excluded from gross income for federal income tax purposes and is exempt from State of California personal income taxes, the ownership or disposition of, or the amount, accrual or receipt of interest on, the Series 2015A Bonds may otherwise affect a Beneficial Owner's federal, state or local tax liability. The nature and extent of these other tax consequences depend upon the particular tax status of the Beneficial Owner or the Beneficial Owner's other items of income or deduction. Transaction Counsel expresses no opinion regarding any such other tax consequences.

Current and future legislative proposals, if enacted into law, clarification of the Code or court decisions may cause interest on the Series 2015A Bonds to be subject, directly or indirectly, in whole or in part, to federal income taxation or to be subject to or exempted from state income taxation, or otherwise prevent Beneficial Owners from realizing the full current benefit of the tax status of such interest. The introduction or enactment of any such legislative proposals or clarification of the Code or court decisions may also affect, perhaps significantly, the market price for, or marketability of, the Series 2015A Bonds. Prospective purchasers of the Series 2015A Bonds should consult their own tax advisors regarding the potential impact of any pending or proposed federal or state tax legislation, regulations or litigation, as to which Transaction Counsel is expected to express no opinion.

The opinion of Transaction Counsel is based on current legal authority, covers certain matters not directly addressed by such authorities, and represents Transaction Counsel's judgment as to the proper treatment of the Series 2015A Bonds for federal income tax purposes. It is not binding on the Internal Revenue Service ("**IRS**") or the courts. Furthermore, Transaction Counsel cannot give and has not given any opinion or assurance about the future activities of the State or the Issuer, or about the effect of future changes in the Code, the applicable regulations, the interpretation thereof or the enforcement thereof by the IRS. The State and the Issuer have covenanted, however, to comply with the requirements of the Code.

Transaction Counsel's engagement with respect to the Series 2015A Bonds ends with the issuance of the Series 2015A Bonds, and, unless separately engaged, Transaction Counsel is not obligated to defend the State, the Issuer or the Beneficial Owners regarding the tax-exempt status of the Series 2015A Bonds in the event of an audit examination by the IRS. Under current procedures, parties other than the State, the Issuer and their appointed counsel, including the Beneficial Owners, would have little, if any, right to participate in the audit examination process. Moreover, because achieving judicial review in connection with an audit examination of tax-exempt bonds is difficult, obtaining an independent review of IRS positions with which the State or the Issuer legitimately disagrees may not be practicable. Any action of the IRS, including but not limited to selection of the Series 2015A Bonds for audit, or the course or result of such audit, or an audit of bonds presenting similar tax issues may affect the market price for, or the marketability of, the Series 2015A Bonds, and may cause the State, the Issuer or the Beneficial Owners to incur significant expense.

FINANCIAL STATEMENTS

The State's audited Comprehensive Annual Financial Report for the fiscal year ended June 30, 2013 is included as Appendix B to this Official Statement. Certain unaudited financial information for the periods July 1, 2013 to June 30, 2014 and July 1, 2014 through February 28, 2015, respectively, are included as EXHIBIT 1 and EXHIBIT 2 to Appendix A to this Official Statement.

The State's audited Comprehensive Annual Financial Report for the fiscal year ended June 30, 2014 is expected to be released in the latter part of March 2015, and when released, will be available on the State Treasurer's website and other State websites and, if available, will be included in the final Official Statement to replace the Appendix B in this Preliminary Official Statement.

See "APPENDIX A—THE STATE OF CALIFORNIA" and "APPENDIX B—STATE OF CALIFORNIA COMPREHENSIVE ANNUAL FINANCIAL REPORT FOR THE FISCAL YEAR ENDED JUNE 30, 2013" attached hereto.

RATINGS

It is a condition to the obligation of the Underwriters to purchase the Series 2015A Bonds that, at the date of delivery thereof to the Underwriters, the Series 2015A Bonds be assigned a rating of "A1" by Moody's Investors Service, Inc. ("**Moody's**"), a rating of "A" by Standard & Poor's Ratings Services, a division of McGraw Hill Financial Inc. ("**S&P**") and a rating of "A" by Fitch Ratings ("**Fitch**" and, collectively with Moody's and S&P, the "**Rating Agencies**").

It is expected that the Rating Agencies' ratings of the Series 2015A Bonds will not reflect the security provided by the Pledged TSRs, but rather, the State Appropriations and the risks inherent thereto. See "APPENDIX A—THE STATE OF CALIFORNIA" and "APPENDIX B—STATE OF CALIFORNIA COMPREHENSIVE ANNUAL FINANCIAL REPORT FOR THE FISCAL YEAR ENDED JUNE 30, 2013" attached hereto. See also "RISK FACTORS—Enforceability of Obligation of Governor to Include Appropriation in the Budget; No Obligation of State to Appropriate."

The ratings by Fitch, S&P and Moody's of the Series 2015A Bonds reflect only the views of such organizations and any desired explanation of the significance of such ratings and any outlooks or other statements given by such Rating Agencies with respect thereto should be obtained from the Rating Agency furnishing the same, at the following addresses: Fitch Ratings, 33 Whitehall Street, New York, New York 10004; Standard & Poor's Ratings Services, a division of McGraw Hill Financial Inc., 55 Water Street, New York, New York 10041; Moody's Investors Service, Inc., 7 World Trade Center, New York, New York 10007.

There is no assurance that the initial ratings assigned to the Series 2015A Bonds will continue for any given period of time or that any of such ratings will not be revised downward, suspended or withdrawn entirely by any of the Rating Agencies. Any such downward revision, suspension or withdrawal of such ratings may have an adverse effect on the availability of a market for or the market price of the Series 2015A Bonds.

VERIFICATION OF MATHEMATICAL COMPUTATIONS

Upon delivery of the Series 2015A Bonds, the arithmetical accuracy of certain computations included in the schedules provided by the Underwriters on behalf of the Issuer relating to: (i) the adequacy of the amounts to be applied to the refunding of the portion of the Series 2005A Bonds described herein; and (ii) the yields with respect to the Series 2015A Bonds and on the amounts to be applied to the refunding of the portion of the Series 2005A Bonds described herein upon delivery of the Series 2015A Bonds, will be verified by Causey Demgen & Moore P.C., independent certified public accountants (the "**Verification Agent**").

UNDERWRITING

The underwriters listed on the cover page hereof (the "**Underwriters**") have jointly and severally agreed, subject to certain conditions, to purchase all, but not less than all, of the Series 2015A Bonds from the Issuer at a purchase price of $__________, which represents the aggregate principal amount of the Series 2015A Bonds, plus original issue premium in the amount of $________, less an underwriters' discount in the amount of $__________. The Underwriters will be obligated to purchase all of the Series 2015A Bonds if any are purchased.

The Series 2015A Bonds may be offered and sold to certain dealers (including dealers depositing the Series 2015A Bonds into investment trusts) and institutional purchasers at prices lower than the initial public offering prices, and such public offering prices may be changed, from time to time, by the Underwriters.

Barclays Capital Inc. and Citigroup Global Markets Inc. are acting as co-representatives on behalf of the Underwriters.

Citigroup Global Markets Inc. is an affiliate of Citibank, N.A. which is acting as MSA Escrow Agent under the MSA and as California Escrow Agent under the California Escrow Agreement.

Several of the Underwriters have provided letters to the State Treasurer relating to their distribution practices or other affiliations for inclusion in this Official Statement, which are set forth in Appendix J attached hereto. Neither the Issuer nor the State guarantees the accuracy or completeness of the information contained in such letters, and the information therein is not to be construed as a representation of the Issuer or the State or of any Underwriter other than the Underwriter providing such representation.

LEGAL MATTERS

The Issuer has not been served with and is not aware of any litigation pending in any court (either State or federal) to restrain or enjoin the issuance and delivery of the Series 2015A Bonds, or questioning the creation, organization or existence of the Issuer, the validity or enforceability of the Indenture, the transfer of the Pledged TSRs by the State to the Issuer, the proceedings for the authorization, execution, authentication and delivery of the Series 2015A Bonds or the validity of the Series 2015A Bonds. For a discussion of other legal matters, including certain pending litigation involving the MSA and the PMs, see

"RISK FACTORS" and "LEGAL CONSIDERATIONS" herein and "APPENDIX G—CERTAIN INFORMATION RELATING TO THE DOMESTIC TOBACCO INDUSTRY" attached hereto.

Orrick, Herrington & Sutcliffe LLP, Transaction Counsel to the Issuer, will render its opinion with respect to the validity of the Series 2015A Bonds in substantially the form set forth in Appendix F-1 hereto. Transaction Counsel undertakes no responsibility for the accuracy, completeness or fairness of this Official Statement.

Certain legal matters will be passed upon by the Attorney General of the State, as counsel to the State, whose opinion will be rendered in substantially the form set forth in Appendix F-2 hereto.

Certain legal matters will be passed upon by Hawkins Delafield & Wood LLP, as Disclosure Counsel to the Issuer, and by Orrick, Herrington & Sutcliffe LLP and Stradling Yocca Carlson & Rauth, P.C., each as Co-Disclosure Counsel to the State with respect to Appendix A.

Certain legal matters will be passed upon by Hiscock & Barclay LLP, as counsel to the Underwriters.

OTHER PARTIES

IHS Global

IHS Global has been retained by the Issuer as an independent econometric expert. The Tobacco Consumption Report attached as Appendix C hereto is included herein in reliance on IHS Global as experts in such matters. IHS Global's fees for acting as the Issuer's independent econometric consultant are not contingent upon the issuance of the Series 2015A Bonds. The Tobacco Consumption Report should be read in its entirety.

Financial Advisors

Public Resources Advisory Group ("**PRAG**") and Lamont Financial Services Corporation ("**Lamont Financial**") have been retained to act as financial advisors, in each case in connection with certain aspects of the issuance of the Series 2015A Bonds.

Although PRAG and Lamont Financial assisted in the preparation of this Official Statement, neither PRAG nor Lamont Financial is obligated to undertake, and neither has undertaken to make, an independent verification or to assume responsibility for the accuracy, completeness, or fairness of the information contained in this Official Statement.

GOLDEN STATE TOBACCO SECURITIZATION CORPORATION

By: ______________________________
Title:

March __, 2015

APPENDIX A

THE STATE OF CALIFORNIA

(THIS PAGE INTENTIONALLY LEFT BLANK)

APPENDIX A

THE STATE OF CALIFORNIA

THE GREAT SEAL OF THE STATE OF CALIFORNIA

EUREKA

March 13, 2015

(THIS PAGE INTENTIONALLY LEFT BLANK)

TABLE OF CONTENTS

INTRODUCTION TO THE STATE OF CALIFORNIA AND APPENDIX A A-1

State Financial Condition A-1

State Revenues, Expenditures and Cash Management A-2

General Fund A-2

State Indebtedness and Other Obligations A-3

State Pension Funds and Retiree Health Care Costs A-4

Financial Statements A-5

Population and Economy of the State A-5

Certain Defined Terms A-5

RECENT DEVELOPMENTS A-7

PROPOSED FISCAL YEAR 2015-16 BUDGET A-8

General A-8

Development of Revenue Estimates A-9

Economic Assumptions Underlying the 2015-16 Governor's Budget A-12

Multi-Year Budget Projections A-12

CURRENT STATE BUDGET A-14

General A-14

Fiscal Year 2014-15 Revised General Fund Estimates in the 2015-16 Governor's BudgetA-18

Budget Risks A-19

Summary of State Revenues and Expenditures A-20

Revenue and Expenditure Assumptions A-24

DEBTS AND LIABILITIES UNDER PROPOSITION 2 .... A-25

CASH MANAGEMENT A-26

Traditional Cash Management Tools A-26

Cash Management in Fiscal Year 2014-15 .... A-27

Other Cash Management Tools A-28

STATE INDEBTEDNESS AND OTHER OBLIGATIONS A-29

General A-29

Capital Facilities Financing A-29

1. General Obligation Bonds A-29
2. Variable Rate General Obligation Bonds A-30

3. General Obligation Commercial Paper Program A-30
4. Bank Arrangements A-31
5. Lease-Revenue Obligations A-31
6. Non-Recourse Debt A-32
7. Build America Bonds A-32
Future Issuance Plans; General Fund Debt Ratio A-33
Economic Recovery Bonds A-34
Tobacco Settlement Revenue Bonds A-34
Cash Management Borrowings A-36
Indirect, Nonpublic or Contingent Obligations A-36
STATE FINANCES A-38
The General Fund A-38
Budget Reserves A-38
1. Special Fund for Economic Uncertainties A-38
2. Budget Stabilization Account A-39
Inter-Fund Borrowings A-40
State Warrants A-42
1. Registered Warrants A-43
2. Reimbursement Warrants A-43
3. Refunding Reimbursement Warrants A-44
Sources of Tax Revenue A-44
1. Personal Income Tax A-44
2. Sales and Use Tax A-47
3. Corporation Tax A-49
4. Insurance Tax A-52
5. Other Taxes A-52
6. Special Fund Revenues A-52
7. Taxes on Tobacco Products A-53
Recent Tax Receipts A-53
State Expenditures A-57
State Appropriations Limit A-58
Proposition 98 and K-14 Funding A-59
Local Governments A-63

1. Constitutional and Statutory Limitations on Local Government A-63
2. Redevelopment Agency Funds A-65
3. Property Tax Revenues A-66
4. Realigning Services to Local Governments A-66
5. Trial Courts A-67
6. Welfare System A-67

Health and Human Services A-68

1. CalWORKs A-68
2. SSI/SSP A-69
3. Health Programs A-70

California Department of Corrections and Rehabilitation A-73

Unemployment Insurance A-75

Cap and Trade Program A-76

Retiree Health Care Costs A-77

PENSION TRUSTS A-81

General A-81

Pension Reform A-83

CalPERS A-85

1. General A-85
2. PERF A-86
3. Members A-86
4. Retirement Benefits A-88
5. Member Contributions A-89
6. Actuarial Methods A-89
7. Actuarial Valuation; Determination of Required Contributions A-91
8. Actuarial Assumptions A-92
9. Funding Status A-93
10. State Contributions A-96
11. Prospective Funding Status; Future Contributions A-96
12. Investment Policy; Investment Returns A-99
13. Other Retirement Plans A-101

CalSTRS A-101

1. General A-101

2. Members and Employers A-103
3. Retirement Benefits A-103
4. Change in Accounting Standards A-104
5. Funding for the DB Program A-105
6. Actuarial Methods and Assumptions A-108
7. Actuarial Valuation A-110
8. Funding Status A-111
9. Prospective Funding Status; Future Contributions A-113
10. Investment Policy; Investment Returns A-113
11. Funding for the SBMA A-115
THE BUDGET PROCESS A-116
General A-116
Constraints on the Budget Process A-117
1. Balanced Budget Amendment (Proposition 58) A-118
2. Local Government Finance (Proposition 1A of 2004) A-118
3. After School Education Funding (Proposition 49) A-119
4. Mental Health Services (Proposition 63) A-120
5. Transportation Financing (Proposition 1A of 2006) A-120
6. Proposition 22 – Local Government Funds A-120
7. Proposition 26 – Increases in Taxes or Fees A-121
8. Proposition 25 – On-Time Budget Act of 2010 .... A-121
9. Proposition 30 – The Schools and Local Public Safety Protection Act of 2012 . A-122
10. Proposition 39 – The California Clean Energy Jobs Act A-122
FINANCIAL STATEMENTS A-123
INVESTMENT OF STATE FUNDS A-124
OVERVIEW OF STATE GOVERNMENT A-125
Organization of State Government A-125
Higher Education A-126
Employee Relations A-127
ECONOMY AND POPULATION A-129
Introduction A-129
Population, Labor Force and Demographic Trends A-129
Employment, Income, Construction and Export Growth A-131

LITIGATION A-134

Budget-Related Litigation A-134

1. Actions Challenging Cap and Trade Program Auctions A-134
2. Actions Challenging School Financing A-135
3. Actions Challenging Statutes Which Reformed California Redevelopment LawA-135
4. Action Challenging Use of Mortgage Settlement Proceeds A-136
5. Action Challenging Fire Prevention Fee A-137

Tax Cases A-137

Environmental Matters A-139

Escheated Property Claims A-140

Actions Seeking Damages for Alleged Violations of Privacy Rights A-140

Action Regarding Special Education A-141

Actions Regarding Medi-Cal Reimbursements and Fees A-141

Prison Healthcare Reform and Reduction of Prison Population A-142

Actions Regarding Proposed Sale of State-Owned Properties A-143

High-Speed Rail Litigation A-143

Action Regarding State Mandates A-144

BANK ARRANGEMENTS A-144

STATE DEBT TABLES A-144

BANK ARRANGEMENTS TABLE A-146

EXHIBIT 1 – STATE CONTROLLER'S STATEMENT OF GENERAL FUND CASH RECEIPTS AND DISBURSEMENTS, JULY 1, 2013 – JUNE 30, 2014 (UNAUDITED) EX-1

EXHIBIT 2 – STATE CONTROLLER'S STATEMENT OF GENERAL FUND CASH RECEIPTS AND DISBURSEMENTS, JULY 1, 2014 – FEBRUARY 28, 2015 (UNAUDITED) EX-2

TABLES

TABLE 1 GENERAL FUND BUDGET SUMMARY A-9

TABLE 2 SELECTED NATIONAL AND CALIFORNIA ECONOMIC DATA.................. A-12

TABLE 3 GENERAL FUND MULTI-YEAR BUDGET PROJECTION A-13

TABLE 4 STATEMENT OF ESTIMATED REVENUES, EXPENDITURES, AND CHANGES IN FUND BALANCE – GENERAL FUND (BUDGETARY BASIS) FISCAL YEARS 2011-12 THROUGH 2015-16.................................... A-21

TABLE 5 GENERAL FUND REVENUES AND TRANSFERS.. A-23

TABLE 6 GENERAL FUND REVENUE BY SOURCES AND EXPENDITURES FISCAL YEARS 2013-14 THROUGH 2015-16 .... A-24

TABLE 7 DEBTS AND LIABILITIES UNDER PROPOSITION 2 2015-16 GOVERNOR'S BUDGET A-26

TABLE 8 STATE OF CALIFORNIA REVENUE ANTICIPATION NOTES ISSUED FISCAL YEARS 2009-10 TO 2014-15 .... A-36

TABLE 9 INTERNAL BORROWABLE RESOURCES (CASH BASIS)............................ A-42

TABLE 10 PERSONAL INCOME TAX GENERAL FUND REVENUES (PIT) FISCAL YEARS 2009-10 THROUGH 2015-16.. A-46

TABLE 11 REVENUES FROM CAPITAL GAINS FISCAL YEARS 2006-07 THROUGH 2015-16 .... A-47

TABLE 12 SALES AND USE TAX GENERAL FUND REVENUES FISCAL YEARS 2009-10 THROUGH 2015-16.. A-49

TABLE 13 CORPORATE INCOME TAX REVENUES FISCAL YEARS 2009-10 THROUGH 2015-16 .... A-51

TABLE 14 IMPACT OF LEGISLATION AND PROPOSITION 39 ON CORPORATE INCOME TAX REVENUES FISCAL YEARS 2008-09 THROUGH 2015-16 ... A-52

TABLE 15 RECENT TAX RECEIPTS A-54

TABLE 16 COMPARATIVE YIELD OF STATE TAXES – ALL FUNDS FISCAL YEARS 2010-11 THROUGH 2015-16 (MODIFIED ACCRUAL BASIS).......... A-55

TABLE 17 GOVERNMENTAL COST FUNDS (BUDGETARY BASIS) SCHEDULE OF EXPENDITURES BY FUNCTION AND CHARACTER FISCAL YEARS 2008-09 TO 2012-13.. A-57

TABLE 18 STATE APPROPRIATIONS LIMIT A-59

TABLE 19 PROPOSITION 98 FUNDING.. A-62

TABLE 20 PROPOSITION 98 FUTURE OBLIGATIONS BALANCES A-63

TABLE 21 CALWORKS EXPENDITURES A-69

TABLE 22 MEDI-CAL EXPENDITURES A-70

TABLE 23 OPEB PAY-AS-YOU-GO FUNDING FISCAL YEARS 2009-10 TO 2013-14 .... A-79

TABLE 24 ACTUAL COSTS/BUDGET FOR OTHER POSTEMPLOYMENT BENEFITS FISCAL YEARS 2007-08 THROUGH 2015-16 .... A-80

TABLE 25 PERF MEMBERSHIP (STATE EMPLOYEES) AS OF JUNE 30, 2013 AND 2014 .... A-88

TABLE 26 PERF (STATE ONLY) SCHEDULE OF BENEFITS PAID A-89

TABLE 27 CERTAIN ACTUARIAL ASSUMPTIONS UTILIZED FOR PERF A-92

TABLE 28 PERF SCHEDULE OF FUNDING PROGRESS STATE EMPLOYEES ONLY (FISCAL YEARS ENDED JUNE 30) A-95

TABLE 29 STATE CONTRIBUTION TO PERF, INCLUDING CSU FISCAL YEARS 2007-08 TO 2015-16 FISCAL YEAR ENDING JUNE 30 .... A-96

TABLE 30 CALPERS INVESTMENT RESULTS BASED ON MARKET VALUE A-100

TABLE 31 PERF TIME-WEIGHTED AVERAGE RETURNS AS OF JUNE 30, 2014 .... A-101

TABLE 32 DB PROGRAM MEMBERSHIP A-103

TABLE 33 DB PROGRAM SCHEDULE OF BENEFITS PAID AND ADMINISTRATIVE EXPENSES A-104

TABLE 34 DB PROGRAM SCHEDULE OF CONTRIBUTIONS FROM EMPLOYERS AND THE STATE A-108

TABLE 35 CERTAIN ACTUARIAL METHODS AND ASSUMPTIONS UTILIZED FOR DB PROGRAM FISCAL YEAR ENDING JUNE 30 .... A-110

TABLE 36 DB PROGRAM SCHEDULE OF FUNDING PROGRESS (FISCAL YEARS ENDED JUNE 30) A-112

TABLE 37 CALSTRS ASSET ALLOCATION A-114

TABLE 38 CALSTRS INVESTMENT RESULTS BASED ON MARKET VALUE A-114

TABLE 39 CALSTRS TIME-WEIGHTED AVERAGE RETURNS AS OF JUNE 30, 2014 .... A-115

TABLE 40 SBMA FUNDING A-116

TABLE 41 ANALYSIS OF POOLED MONEY INVESTMENT ACCOUNT PORTFOLIO A-124

TABLE 42 COLLECTIVE BARGAINING UNITS A-128

TABLE 43 POPULATION 2003-2013 .... A-130

TABLE 44 LABOR FORCE 2002-2014 .... A-131

TABLE 45 NONFARM PAYROLL EMPLOYMENT BY MAJOR SECTOR 2004 AND 2014 .... A-131

TABLE 46 TOTAL PERSONAL INCOME IN CALIFORNIA 2002-2013 .... A-132

TABLE 47 PERSONAL INCOME PER CAPITA 2002-2013 .... A-132
TABLE 48 RESIDENTIAL CONSTRUCTION PERMITS AUTHORIZED 2002-2014..... A-133
TABLE 49 NON-RESIDENTIAL CONSTRUCTION 2002-2014 .... A-133
TABLE 50 CALIFORNIA'S EXPORTS OF GOODS 2002-2014.. A-134

INTRODUCTION TO
THE STATE OF CALIFORNIA AND APPENDIX A

APPENDIX A is the part of the Official Statement that provides investors with information concerning the State of California. This Introduction is intended to give readers a very brief overview of the main topics covered in APPENDIX A. Investors are advised to read the entire Official Statement, including APPENDIX A, to obtain information essential to making an informed investment decision. See "Certain Defined Terms" at the end of this section for certain defined terms used in this APPENDIX A.

State Financial Condition

During the recent recession, which officially ended in 2009, the state experienced the most significant economic downturn since the Great Depression of the 1930s. As a result, state tax revenues declined precipitously, resulting in large budget gaps and occasional cash shortfalls in the period from 2008 through 2011, which were addressed largely through various spending cuts and payment deferrals.

Voters approved Proposition 30 in 2012, providing increased revenues through the next several fiscal years. Prior to the termination of the temporary additional personal income tax rates under Proposition 30 on December 31, 2018, the Administration's plan is to pay off most of the unprecedented level of budgetary borrowings, debts and deferrals which were accumulated in order to balance budgets largely over the past decade. As of the 2015-16 Governor's Budget, the state's budget is projected to remain balanced through fiscal year 2018-19 with a positive budget reserve balance at the end of every year. See "DEBTS AND LIABILITIES UNDER PROPOSITION 2" and "CURRENT STATE BUDGET – Multi-Year Budget Projections."

Voters also approved Proposition 2 in November 2014, which directs specified revenues towards increasing reserves in the state's rainy day fund and paying down specified debts. See "BUDGET RESERVES." This mechanism will save money for the next recession and pay down the state's debts and liabilities. By the end of fiscal year 2015-16, the state's rainy day fund is projected to have a balance of $2.8 billion. Under the Proposition 2 requirements, the 2015-16 Governor's Budget also proposes an additional $1.2 billion to pay off loans from special funds and past liabilities from Proposition 98.

In addition, the 2015-16 Governor's Budget repays the remaining $1 billion in budgetary deferrals to schools and community colleges, discharges the last of the $15 billion in Economic Recovery Bonds that were issued to cover budget deficits from as far back as 2002, and repays local governments $533 million in mandated reimbursements.

Despite the recent significant budgetary improvements as well as the progress in paying down certain liabilities, there remain a number of major risks and pressures that threaten the state's financial condition, including the need to continue to pay remaining obligations which were deferred to balance budgets during the economic downturn, as well as significant unfunded liabilities of the two main retirement systems managed by state entities, CalPERS and CalSTRS. In recent years, the state has committed significant increases in annual payments to these systems to reduce the unfunded liabilities. See "DEBTS AND LIABILITIES UNDER PROPOSITION

2", "CURRENT STATE BUDGET-Budget Risks" and "STATE FINANCES-Retiree Health Care Costs." In addition, the state's revenues (particularly the personal income tax) can be volatile and correlate to overall economic conditions. There can be no assurances that the state will not face fiscal stress and cash pressures again, or that other changes in the state or national economies will not materially adversely affect the financial condition of the state.

State Revenues, Expenditures and Cash Management

The state receives revenues from taxes, fees and other sources, the most significant of which are the personal income tax, sales and use tax, and corporation tax (which collectively constitute over 90 percent of total General Fund revenues and transfers). The state expends money on a variety of programs and services. Significant elements of state expenditures include education (both kindergarten through twelfth grade ("K-12") and higher education), health and human services, and correctional programs. For a discussion of the sources and uses of state funds, see "STATE FINANCES."

The 2014 Budget Act and related legislation (the "2014-15 Budget") provided for a multi-year General Fund plan that was balanced and projected a $449 million reserve at the end of fiscal year 2014-15, in addition to $1.606 billion in the Budget Stabilization Account ("BSA" or "rainy day fund"). The 2015-16 Governor's Budget projects that the state will end fiscal year 2014-15 with a reserve of $452 million, plus the $1.606 billion in the BSA. See "CURRENT STATE BUDGET".

The 2015-16 Governor's Budget proposes a multi-year General Fund strategy that is balanced and pays down the debts and liabilities as required pursuant to Proposition 2. See "DEBTS AND LIABILITIES UNDER PROPOSITION 2." Additionally, a $1.220 billion transfer into the BSA is projected in fiscal year 2015-16, bringing the cumulative balance to $2.826 billion.

The state manages its cash flow requirements during the fiscal year primarily with a combination of external borrowing and internal borrowing by the General Fund from over 700 special funds. Since June 2008, the General Fund has typically ended each fiscal year with a net borrowing from these special funds. However, as of June 30, 2014, the General Fund had a cash surplus of $1.9 billion and did not owe any monies to these special funds and other state funds from internal borrowing for cash management purposes (compared to almost $2.435 billion owed at June 30, 2013 and $9.593 billion at June 30, 2012). The 2015-16 Governor's Budget projects that the State will not have any need to use external cash flow borrowing in fiscal year 2015-16. See "STATE FINANCES – Inter-Fund Borrowings."

General Fund

The moneys of the state are segregated into the General Fund and over 1,000 other funds, including special, bond and other funds. The General Fund consists of revenues received by the State Treasury and not required by law to be credited to any other fund, as well as earnings from the investment of state moneys not allocable to another fund. The General Fund is the principal operating fund for the majority of governmental activities and is the depository of most of the major tax revenue sources of the state. For additional financial data relating to the General Fund, see the State Controller's unaudited reports of General Fund cash receipts and disbursements attached to this APPENDIX A as EXHIBIT 1 and EXHIBIT 2 and the audited financial statements in APPENDIX B to this Official Statement. See "STATE FINANCES" and "FINANCIAL STATEMENTS."

The state Constitution specifies that an annual budget shall be proposed by the Governor by January 10 of each year for the next fiscal year (the "Governor's Budget"). Under state law, the annual proposed Governor's Budget cannot provide for projected expenditures in excess of projected resources for the ensuing fiscal year. State law also requires the Governor to update the Governor's Budget projections and budgetary proposals by May 14 of each year (the "May Revision"). The May Revision is normally the basis for final negotiations between the Governor and Legislature to reach agreement on appropriations and other legislation to fund state government for the ensuing fiscal year (the "Budget Act"). The state Constitution calls for adoption of a balanced budget by a majority vote of each House of the Legislature by June 15 of each year. The Governor has 12 calendar days to either sign or veto the enrolled budget.

Over the years, a number of laws and constitutional amendments have been enacted, often through voter initiatives, which have made it more difficult for the state to raise taxes, restricted the use of the General Fund or special fund revenues, or otherwise limited the Legislature and the Governor's discretion in enacting budgets. See "THE BUDGET PROCESS – Constraints on the Budget Process."

State Indebtedness and Other Obligations

As of January 1, 2015, the state had outstanding obligations payable principally from the state's General Fund or from lease payments paid from the operating budget of the respective lessees, which operating budgets are primarily, but not exclusively, derived from the General Fund, consisting of $76.7 billion principal amount of general obligation bonds and $11.1 billion of lease-revenue bonds. As of January 1, 2015, there was approximately $31.1 billion of authorized and unissued long-term voter-approved general obligation bonds which, when issued, would be payable principally from the General Fund and approximately $3.89 billion of authorized and unissued lease-revenue bonds. See "STATE INDEBTEDNESS AND OTHER OBLIGATIONS – Future Issuance Plans; General Fund Debt Ratio."

Certain state agencies and authorities issue revenue obligations for which the General Fund has no liability. Revenue bonds represent obligations payable from state revenue-producing enterprises and projects, which are not payable from the General Fund, and conduit obligations payable only from revenues paid by local governments or private users of facilities financed by the revenue bonds.

The state has always paid when due the principal of and interest on its general obligation bonds, general obligation commercial paper notes, lease-revenue obligations and short-term obligations, including revenue anticipation notes and revenue anticipation warrants. Detailed information regarding the state's long-term debt appears in the sections "STATE INDEBTEDNESS AND OTHER OBLIGATIONS" and "STATE DEBT TABLES."

State Pension Funds and Retiree Health Care Costs

The two main state pension funds face large unfunded future liabilities. CalPERS reported an unfunded accrued liability allocable to state employees (excluding judges and elected officials) as of June 30, 2013, of $36.4 billion on an actuarial value of assets ("AVA") basis (an increase of $8.2 billion from the June 30, 2012 Valuation) and $49.9 billion on a market value of assets ("MVA") basis (an increase of $4.4 billion from the June 30, 2012 Valuation). The California State Teachers' Retirement System ("CalSTRS") reported the unfunded accrued liability of its Defined Benefit Plan as of June 30, 2013 at $73.7 billion on an AVA basis (an increase of $2.7 billion from the June 30, 2012 valuation), and $74.4 billion on an MVA basis (a decrease of $6 billion from the June 30, 2012 valuation).

General Fund contributions to CalPERS and CalSTRS are estimated to be approximately $2.7 billion and $1.5 billion, respectively, for the 2014-15 fiscal year. The combined contributions, which include contributions for California State University ("CSU"), represent about 3.7 percent of all General Fund expenditures in fiscal year 2014-15. These contributions are expected to rise in fiscal year 2015-16, to a total of approximately 4.3 percent of General Fund expenditures. See 'PROPOSED FISCAL YEAR 2015-16 BUDGET" and "CURRENT STATE BUDGET."

There can be no assurances that the state's annual required contributions to CalPERS and CalSTRS will not significantly increase in the future. The actual amount of any increases will depend on a variety of factors, including but not limited to investment returns, actuarial assumptions, experience and retirement benefit adjustments. The Governor signed Chapter 47, Statutes of 2014 (AB 1469) on June 24, 2014, that increases statutorily required contributions to CalSTRS from the state, school districts, and teachers beginning July 1, 2014. The AB 1469 funding plan includes additional increases in contribution rates for the state, school districts, and teachers over the next several years in order to eliminate the current CalSTRS unfunded liability by fiscal year 2045-46. Recent action by the CalPERS Board to revise amortization and smoothing policies is expected to result in more rapid increases in state retirement contributions commencing in fiscal year 2015-16. The CalPERS Board in February 2014 also adopted staff recommendations to change mortality and other assumptions, which resulted in increased contribution rates starting in fiscal year 2014-15. See "PENSION TRUSTS – Prospective Funding Status; Future Contributions."

The state also provides postemployment health care and dental benefits to state employees and their spouses and dependents (when applicable) and utilizes a "pay-as-you-go" funding policy. These are sometimes referred to as Other Post Employment Benefits or "OPEB." As reported in the state's OPEB Actuarial Valuation Report, the state has an Unfunded Actuarial Accrued Liability relating to state retirees' other postemployment benefits which was estimated at $71.81 billion as of June 30, 2014 (as compared to $64.57 billion estimated as of June 30, 2013).

The 2015-16 Governor's Budget proposes a comprehensive strategy to eliminate the OPEB Unfunded Actuarial Accrued Liability over a period of 32 years with increased funding shared equally between state employers and employees. The 2015-16 Governor's Budget also proposes reducing the cost structure of employee and retiree health care benefits. See "STATE FINANCES – Retiree Health Care Costs."

Financial Statements

APPENDIX B to this Official Statement, which is incorporated into this APPENDIX A, contains the Audited Basic Financial Statements of the state for the year ended June 30, 2013, together with certain information required by governmental accounting and financial reporting standards to be included in the Financial Statements, including a "Management's Discussion and Analysis" that describes and analyzes the financial position of the state and provides an overview of the state's activities for the fiscal year ended June 30, 2013. See "FINANCIAL STATEMENTS." The State's audited Comprehensive Annual Financial Report for the fiscal year ended June 30, 2014 is expected to be released in the latter part of March 2015, and when released, will be available on the State Treasurer's website and other State websites and, if available, will be included in the final Official Statement to replace the Appendix B in the Preliminary Official Statement.

In addition, EXHIBIT 1 and EXHIBIT 2 to APPENDIX A contains the State Controller's unaudited reports of General Fund cash receipts and disbursements for the period July 1, 2013 through June 30, 2014 and for the period July 1, 2014 through February 28, 2015, respectively.

Population and Economy of the State

California is by far the most populous state in the nation, nearly 50 percent larger than the second-ranked state according to the 2010 United States Census. The 2014 estimate of California's population is 38.5 million residents, which is 12 percent of the total United States population.

California's economy, the largest among the 50 states and one of the largest and most diverse in the world, has major components in high technology, trade, entertainment, agriculture, manufacturing, government, tourism, construction and services. The relative proportion of the various components of the California economy closely resembles the make-up of the national economy. The California economy continues to benefit from broad-based growth.

Demographic and economic statistical information and a discussion of economic assumptions are included in this APPENDIX A under "CURRENT STATE BUDGET – Economic Assumptions Underlying the 2015-16 Governor's Budget" and "ECONOMY AND POPULATION."

Certain Defined Terms

The following terms and abbreviations are used in this APPENDIX A:

"Administration" means the Governor's Office and those individuals, departments, and offices reporting to it (including the Department of Finance).

"BSA" or "Budget Stabilization Account" means the Budget Stabilization Account created under Proposition 58 and amended by Proposition 2. See "STATE FINANCES – Budget Reserves."

"ERBs" or "Economic Recovery Bonds" means Economic Recovery Bonds of the state issued pursuant to Proposition 57. See "STATE INDEBTEDNESS AND OTHER OBLIGATIONS – Economic Recovery Bonds."

"EXHIBIT 1" means the State Controller's Unaudited Statement of General Fund Cash Receipts and Disbursements for the period from July 1, 2013 through June 30, 2014 as attached to this APPENDIX A as EXHIBIT 1.

"EXHIBIT 2" means the State Controller's Unaudited Statement of General Fund Cash Receipts and Disbursements for the period from July 1, 2014 through February 28, 2015 as attached to this APPENDIX A as EXHIBIT 2.

"LAO" means the Legislative Analyst's Office, an entity of the State Legislature.

"Proposition 2" means a legislative constitutional amendment that amends the provisions governing the Budget Stabilization Account, which was approved by the voters in the November 2014 statewide general election. See "STATE FINANCES – Budget Reserves."

"Proposition 30" means The Schools and Local Public Safety Protection Act of 2012, an initiative measure which was approved by the voters in the November 2012 statewide general election. See "STATE FINANCES – Sources of Tax Revenue."

"Proposition 39" means the California Clean Energy Jobs Act, an initiative measure which was approved by the voters in the November 2012 statewide general election. See "STATE FINANCES – Sources of Tax Revenue."

"Proposition 47" means The Safe Neighborhoods and Schools Act, an initiative measure which was approved by voters in the November 2014 statewide general election. See "THE BUDGET PROCESS – Constraints on the Budget Process."

"SB 105" means Senate Bill 105 (Chapter 310, Statutes of 2013), providing additional appropriations in fiscal year 2013-14 to address a court-ordered reduction of the prisoner population in state prisons.

"SFEU" means the Special Fund for Economic Uncertainties, created pursuant to Government Code Section 16418.

"2014 Budget Act" means the Budget Act for fiscal year 2014-15, adopted on June 20, 2014.

"2014-15 Governor's Budget" means the Governor's Budget for fiscal year 2014-15 released on January 9, 2014.

"2014-15 May Revision" means the May Revision of the 2014-15 Governor's Budget released May 13, 2014.

"2014-15 Budget" means the 2014 Budget Act plus related legislation to implement the budget.

"2015-16 Governor's Budget" means the Governor's Budget for fiscal year 2015-16 released on January 9, 2015.

"2015-16 May Revision" means the May Revision of the 2015-16 Governor's Budget scheduled to be released on or before May 14, 2015.

Reference to the "state" as a noun or adjective means the State of California, following the practice of the Department of Finance.

RECENT DEVELOPMENTS

The following are certain significant recent developments concerning the state:

The 2015-16 Governor's Budget. On January 9, 2015, the Governor released his proposed budget for the 2015-16 fiscal year. The proposal sets forth a structurally balanced budget which continues to pay down debt while it invests in education, strengthens the state's infrastructure, addresses poverty and income inequality, and builds a strong reserve fund. See "PROPOSED FISCAL YEAR 2015-16 BUDGET."

Strong Revenues. The 2015-16 Governor's Budget reported that General Fund revenues primarily from the major tax sources of personal income tax, sales and use tax, and corporation tax, are estimated to be about $3.0 billion higher, for the combined 2013-14 and 2014-15 fiscal years, than was projected at the time the 2014 Budget Act was enacted in June 2014. Additional adjustments of $0.7 billion to the 2014-15 beginning balance result in a $3.7 billion increase in available resources in fiscal year 2014-15. Virtually all of these additional resources will, pursuant to state law, be used to further reduce budgetary debts and be appropriated for increased support of K-14 schools and increased Medi-Cal costs. See "CURRENT STATE BUDGET." See "CURRENT STATE BUDGET."

Recent Tax Receipts. The Department of Finance reported that, based on agency cash receipts, tax receipts for January 2015 were $527 million above the 2015-16 Governor's Budget estimate of $12.15 billion. Fiscal year-to-date tax receipts for 2014-15 are $472 million above the 2015-16 Governor's Budget estimate of $60.655 billion. The Department of Finance believes the higher-than-expected receipts are mainly due to the receipt in January of sales taxes that were expected to be received in February.

Drought Conditions. California is in the third year of a drought. After three years of lower precipitation than usual, the drought effects in 2014 were only able to be offset by temporary measures such as additional groundwater pumping, shifting crop patterns, and fallowing fields. California receives the majority of its rainfall during October through March. As of the end of January 2015, more than three-quarters of California is still classified as experiencing extreme or exceptional drought conditions. However, a relatively small proportion of California's economy will be directly impacted by water shortages. In particular, agricultural production totaled $46.7 billion out of $2.2 trillion in 2013 California GDP.

PROPOSED FISCAL YEAR 2015-16 BUDGET

General

The 2015-16 Governor's Budget, released on January 9, 2015, proposes a multi-year plan that is balanced, and continues to pay down budgetary debt from past years.

General Fund revenues and transfers for fiscal year 2015-16 are projected at $113.4 billion, an increase of $5.3 billion, or 4.9 percent, compared with a revised estimate of $108.0 billion in General Fund revenues and transfers for fiscal year 2014-15. These estimates include transfers to the BSA, also referred to as the state's "rainy day fund," of $1.2 billion in fiscal year 2015-16 and $1.6 billion in fiscal year 2014-15. The transfers have the effect of lowering the total reported levels of General Fund revenues and transfers for the related fiscal years by the amounts of the transfers.

General Fund expenditures for fiscal year 2015-16 are projected at $113.3 billion, an increase of $1.6 billion, or 1.4 percent, compared with a revised estimate of $111.7 billion in General Fund expenditures for fiscal year 2014-15. The fiscal year 2014-15 expenditure level includes a one-time increase of $1.6 billion in General Fund expenditures due to the early repayment of the Economic Recovery Bonds, pursuant to Proposition 58 (which was in effect prior to the enactment of Proposition 2).

The 2015-16 Governor's Budget has the following major components:

- Proposition 98 (K-14 Education) – proposes $65.7 billion total funding for fiscal year 2015-16, of which $47.0 billion is from the General Fund. When combined with more than $250 million in settle-up payments for prior years, the 2015-16 Governor's Budget proposes an increased investment of $7.8 billion in K-14 education. The 2015-16 Governor's Budget also proposes to eliminate all remaining school budgetary deferrals. See "STATE FINANCES – Proposition 98 and K-14 Funding".

- Higher Education – proposes total state funding of $14.5 billion for all major segments of Higher Education, including $14.1 billion from the General Fund (both Non-Proposition 98 and Proposition 98). The remaining funds include special and bond funds.

- Health and Human Services – proposes $52.5 billion, including $31.9 billion from the General Fund and $20.5 billion from special funds, for these programs. State implementation of federal health care reform has provided coverage to millions of Californians, beginning in January 2014. See "STATE FINANCES – Health and Human Services".

- Public Safety – proposes total state funding of $12.7 billion, including $10.2 billion from the General Fund and $2.5 billion from special funds, for Corrections and Rehabilitation. See "STATE FINANCES – California Department of Corrections and Rehabilitation".

- Cash Management. – projects that the state will not have any need to use external cash flow borrowing in fiscal year 2015-16. See "STATE FINANCES – Inter-Fund Borrowings."

For a description of certain risks identified in connection with the preparation of the 2015-16 Governor's Budget, see "CURRENT STATE BUDGET – Budget Risks."

The following table summarizes the General Fund budget in the 2015-16 Governor's Budget and compares to the General Fund budget for the current fiscal year as of the 2014 Budget Act:

TABLE 1
General Fund Budget Summary
(Dollars in Millions)

	As of 2014 Budget Act	As of 2015-16 Governor's Budget	
	Fiscal Year 2014-15	Fiscal Year 2014-15	Fiscal Year 2015-16
Prior Year Balance	$ 3,903	$ 5,100	$ 1,423
Revenues and Transfers	105,488	108,042	113,380
Total Resources Available	109,391	113,142	114,803
Non-Proposition 98 Expenditures	63,525	65,071	66,279
Proposition 98 Expenditures	44,462	46,648	47,019
Total Expenditures	107,987	111,719	113,298
Fund Balance	1,404	1,423	1,505
Reserve for Liquidation of Encumbrances	955	971	971
Special Fund for Economic Uncertainties	449	452	534
Budget Stabilization Account/ Rainy Day Fund	$ 1,606	$ 1,606	$ 2,826

Source: State of California, Department of Finance.

Development of Revenue Estimates

Development of the forecast for the major General Fund revenues begins with a forecast of national economic activity prepared by an independent economic forecasting firm. The Department of Finance's Economic Research Unit, under the direction of the Chief Economist, adjusts the national forecast based on the Department of Finance's economic outlook. The national economic forecast is used to develop a forecast of similar indicators for California activity.

After finalizing the forecasts of major national and California economic indicators, revenue estimates are generated using revenue forecasting models developed and maintained by the Department of Finance. With each forecast, adjustments are made for any legislative, judicial, or administrative changes, as well as for recent cash flow results. The forecast is updated twice a year and released with the Governor's Budget by January 10 and the May Revision by May 14.

National Economy. The national economy continues to grow. After output of the national economy (Real Gross Domestic Product or "real GDP") grew by 2.2 percent in 2013, growth increased to 2.4 percent in 2014.

The national unemployment rate declined gradually from the middle of 2011 through the end of 2014, to 5.6 percent in December 2014. The unemployment rate fell by 1.1 percentage points in 2014. Nonfarm payroll employment continued to expand at a modest pace from 2011 through 2014.

Home building has been gradually improving but is still relatively weak compared to pre-crisis levels and historical averages. While still at a subdued level with respect to pre-crisis levels, housing starts were up over 8.7 percent in 2014. Home prices in most metropolitan areas have continued to improve.

After shrinking in 2013, the U.S. trade deficit increased by 7.6 percent in 2014 to $452.6 billion.

California Economy. California's recovery spread to more sectors of the economy in 2013, with continued progress in 2014. Growth in the high-technology sector, international trade, and tourism are being supplemented by better residential construction and real estate conditions. Overall, California's real GDP increased by 2 percent in 2013, and totaled $2.2 trillion at current prices, making it the eighth largest economy in the world. While the current drought is one of the most severe in California's history, some farmers were able to offset the effects of surface water shortfalls in 2014 through groundwater pumping, shifting crop patterns, and planting fewer acres. A continuation of drought conditions in 2015, however, would be expected to have more severe impacts, as options for adjustment would be more limited.

Personal income increased in sixteen of the eighteen quarters through the third quarter of 2014, with decreases only in the fourth quarter of 2011 and the first quarter of 2013. The decrease in early 2013 was partially due to the expiration of the federal payroll tax holiday.

In February 2014, the private sector had surpassed the pre-recession peak in payroll employment, but the declines in the government sector meant that total nonfarm payroll jobs did not surpass the pre-recession peak until June 2014. Despite the drought, farm employment has been relatively steady, with farm jobs averaging 406,700 through December in 2014 compared with 407,400 over the same period in 2013. The state unemployment rate reached a high of 12.4 percent in late 2010. The rate has improved since then, falling to 7.0 percent in December 2014. In comparison, the national unemployment rate was 5.6 percent in December 2014.

After hitting a low of close to 200,000 units (seasonally-adjusted and annualized) in the middle of 2007, sales of existing single-family homes have rebounded to over 360,000 units annually. Home prices continued to climb in 2013 and 2014 reaching levels not seen in more than five years. The median price of existing, single-family homes sold in December 2014 was $452,570. However, this remains 24 percent below the pre-recession peak.

California issued 83,000 residential building permits in 2013, 42.6 percent more than were issued in 2012 but still only 39 percent of the 213,000 permits issued in 2004. There were 86,000 permits issued in 2014, an increase of 4 percent over 2013. These remain mostly permits for multi-family structures.

After growing 3.9 percent in 2013, California export growth slowed to 3.6 percent in 2014.

The California economy is expected to continue making steady progress. Industry employment is forecast to expand 2.4 percent in 2015, and 2.3 percent growth is projected for 2016. Personal income is projected to grow 4.4 percent in 2014, 4.5 percent in 2015, and 5.3 percent in 2016.

Despite moderate growth in the past year, which appears to be continuing into 2015, there are still risks to the economy. Economic expansions do not last forever. In the post-war period, the average expansion length is almost five years and the longest expansion was ten years. As of January 2015, the current expansion has lasted close to six years. There are few immediate signs of a contraction, but it would be an historical anomaly for the U.S. not to see another recession before 2020.

[BALANCE OF PAGE INTENTIONALLY LEFT BLANK]

Economic Assumptions Underlying the 2015-16 Governor's Budget

The revenue and expenditure assumptions utilized in connection with the 2015-16 Governor's Budget are based upon certain projections of the performance of the California, national, and global economies in calendar years 2015 and 2016. These economic assumptions are set forth below.

TABLE 2
Selected National and California Economic Data

	2014	2015 (Projected)	2016 (Projected)
United States			
Real gross domestic product (2009 CW $, percent change)	2.2	2.6	2.8
Personal income (percent change)	4.2	4.3	5.0
Nonfarm wage and salary employment (millions)	138.8	141.4	143.5
(percent change)	1.8	1.9	1.5
California			
Personal income ($ billions)	1,938.0	2,025.6	2,132.2
(percent change)	4.4	4.5	5.3
Nonfarm wage and salary employment (thousands)	15,532.2	15,907.5	16,277.6
(percent change)	2.5	2.4	2.3
Unemployment rate (percent)	7.5	6.6	6.2
Housing units authorized (thousands)	82.7	100.9	112.2
(percent change)	(0.3)	21.9	11.2
New auto registrations (thousands)	1,719.3	1,778.4	1,859.3
(percent change)	6.9	3.4	4.5
Total taxable sales ($ billions)	620.3	649.0	678.8
(percent change)	6.0	4.6	4.6

CW: Chain Weighted

Note: Percentage changes calculated from unrounded data.

Source: State of California, Department of Finance, 2015-16 Governor's Budget.

Multi-Year Budget Projections

In connection with the preparation of the 2015-16 Governor's Budget, the Department of Finance prepared high level multi-year budget projections, as set forth below. The projections are based on a variety of assumptions, including assumptions concerning economic conditions, and state revenues and expenditures.

The year-to-year changes in Revenues and Transfers are driven, in general, by expected continued moderate economic growth. However, due largely to the strength of the stock market through the end of 2014, capital gains are expected to be above normal levels for 2014 and 2015. (Normal level is considered to be 4.4 percent of personal income in the state.) As such, growth in tax receipts is expected to be higher than normal through fiscal year 2015-16. Tax revenue is expected to grow by 7.2 percent from fiscal year 2013-14 to fiscal year 2014-15, and by 5.4 percent from fiscal year 2014-15 to fiscal year 2015-16. The growth rate for fiscal year 2014-15 reflects the reduction of fiscal year 2013-14 personal income tax revenue due to the acceleration of income into 2012 as a result of changes in the federal tax laws in late 2012 and early 2013.

For fiscal years 2016-17 and 2017-18, the underlying tax revenue is projected to grow at approximately 4 percent a year. The annual growth rate drops to less than 1 percent in fiscal year 2018-19, due to the phase-out of Proposition 30 Revenues. The other main factor explaining the year-to-year changes in Revenues and Transfers is the change in the amounts of loan repayments to special funds made each year consistent with the projections shown in Table 7 below. The multi-year projections show that, under the assumptions made, the state would be able to achieve balanced budgets for the next several years, while continuing to reduce various debts and liabilities. The reduction of debts and liabilities are generally included in the multi-year projection as increases in expenditures. In the case of loan repayments to special funds, they are reductions in Revenues and Transfers. Actual conditions may differ materially from the assumptions, and there can be no assurances the projections will be achieved.

TABLE 3
General Fund Multi-Year Budget Projection
(Dollars in Millions)

			Fiscal Year		
	2014-15	**2015-16**	**2016-17**	**2017-18**	**2018-19**
Prior Year Balance	$ 5,100	$ 1,423	$ 1,505	$ 1,569	$ 2,112
Revenues and Transfers[a]	109,648	114,600	118,773	124,281	125,891
Transfer to BSA/Rainy Day Fund[b]	(1,606)	(1,220)	(1,080)	(1,134)	(1,045)
Total Resources Available	**$113,142**	**$114,803**	**$119,198**	**$124,716**	**$126,958**
Non-Proposition 98 Expenditures	65,071	66,279	69,419	72,324	75,598
Proposition 98 Expenditures	46,648	47,019	48,210	50,280	50,384
Total Expenditures	**$111,719**	**$113,298**	**$117,629**	**$122,604**	**$125,982**
Fund Balance	**$1,423**	**$1,505**	**$1,569**	**$2,112**	**$976**
Reserve for Encumbrances	971	971	971	971	971
Special Fund for Economic Uncertainties	**$452**	**$534**	**$598**	**$1,141**	**$5**
Budget Stabilization Account (BSA)/Rainy Day Fund	$1,606	$2,826	$3,906	$5,040	$6,085
Operating Surplus/(Deficit) with BSA/Rainy Day Fund Transfer	**$(3,677)**[c]	**$82**	**$64**	**$543**	**$(1,136)**[d]

Source: State of California, Department of Finance

[a] The personal income tax portion of Proposition 30 expires after tax year 2018. Roughly one-half of the impact of Proposition 30 is expected to be lost in 2018-19, and beginning with 2019-20, there will be no remaining impact from Proposition 30. The sales tax portion of Proposition 30 will expire after December 31, 2016. Information showing the projected Proposition 30 amounts is shown below:

	2014-15	**2015-16**	**2016-17**	**2017-18**	**2018-19**
Prop 30 – Income Tax	$6,458	$6,489	$6,765	$7,132	$2,912
Prop 30 – Sales Tax	1,409	1,529	804	0	0

[b] The 2014-15 transfer to the BSA is pursuant to Proposition 58. The 2015-16 through 2018-19 transfers are pursuant to Proposition 2 approved by voters in November 2014. See “STATE FINANCES – Budget Reserves”.

[c] The 2014-15 operating deficit is largely the result of using the ending fund balance carried over from 2013-14 of $5.1 billion to pay down debt and liabilities.

[d] While 2018-19 is forecasted to result in an operating deficit, it maintains a balanced budget because of the use of accumulated reserve funds.

CURRENT STATE BUDGET

General

The 2014-15 Budget, including the 2014 Budget Act, was enacted on June 20, 2014. It included a multi-year plan that is balanced, established a rainy day fund, addressed the CalSTRS unfunded liabilities, and paid down a substantial portion of budgetary debt from past years.

When the 2014 Budget was enacted, General Fund revenues and transfers for fiscal year 2014-15 were projected at $105.5 billion. As of the 2015-16 Governor's Budget, they are projected to increase to $108.0 billion (net of $1.6 billion transfer to the BSA). General Fund expenditures for fiscal year 2014-15 are projected to increase from $108.0 billion to $111.7 billion. See Table 1 for the estimates as of the 2014 Budget Act and 2015-16 Governor's Budget, and see "Fiscal Year 2014-15 Revised Estimates in the 2015-16 Governor's Budget" for more information.

Pursuant to Proposition 58 of 2004, the state set aside $3.212 billion (3 percent of estimated General Fund revenues) in the BSA, of which half will remain in the BSA, and half was transferred to retire Economic Recovery Bonds. Under the state's budgeting procedures (and included in the figures in the previous paragraph), the $1.6 billion transferred to the BSA for "rainy day" purposes will be reflected as a reduction of revenues and transfers, while the $1.6 billion used to retire the Economic Recovery Bonds will be reflected as an expenditure of General Fund resources. See "STATE FINANCES – Budget Reserves – Budget Stabilization Account."

The 2014-15 Budget had the following other major components:

- Proposition 98 – contained funding of $60.9 billion for fiscal year 2014-15, of which $44.5 billion is from the General Fund. When combined with General Fund increases of $4.9 billion in fiscal years 2012-13 and 2013-14, the 2014-15 Budget included a $10.3 billion increase in the General Fund investment in K-14 education compared to the 2013-14 Budget. The Budget also repaid $5.1 billion in school budgetary deferrals in fiscal year 2014-15, and included a "trigger" mechanism (described below) that is expected to result in the retirement of an additional $1 billion of the remaining deferral balances from 2013-14 and 2014-15, as state revenues are expected to rise higher than anticipated in the 2014-15 Budget. See "STATE FINANCES – Proposition 98 and K-14 Funding".

- Higher Education – contained total state funding of $13.0 billion for all major segments of Higher Education, including $12.6 billion from the General Fund (both Non-Proposition 98 and Proposition 98), an increase of $1.2 billion General Fund from revised estimates for fiscal year 2013-14. The remaining funds include special and bond funds.

- Health and Human Services – contained $49.0 billion, including $29.7 billion from the General Fund and $19.4 billion from special funds, for these programs. See "STATE FINANCES – Health and Human Services."

- Implementation of the Affordable Care Act – contained $14.5 billion, including $477.7 million from the General Fund at the 2014 Budget Act, to implement federal health care reform, which started in January 2014, and provided coverage to millions of Californians. The revised projection for 2014-15, at the 2015-16 Governor's Budget, contains $14.6 billion, including $537.9 million from the General Fund, an increase of $60.2 million from the General Fund. See "STATE FINANCES – Health and Human Services – Health Programs – Health Care Reform."

- Prison Funding – contained total state funding of $12.0 billion, including $9.6 billion from the General Fund and $2.4 billion from special funds, for the Department of Corrections and Rehabilitation and other related programs. See "STATE FINANCES – California Department of Corrections and Rehabilitation" and "LITIGATION – Prison Healthcare Reform and Reduction of Prison Population."

- Redevelopment Agency Dissolution Savings – reflected Proposition 98 General Fund savings of $1.1 billion in fiscal year 2013-14 and $811 million in fiscal year 2014-15. This reflected the receipt of a like amount of property tax revenues in each fiscal year by K-12 schools and community colleges.

- Payment of Interest on Unemployment Insurance Fund Debt – contained $218.5 million from the General Fund to make the 2014 interest payment on the outstanding loan from the federal unemployment account. Interest will continue to accrue and be payable annually until the principal on the loan is repaid. The principal amount of the federal loan is projected to be $8.8 billion at the end of calendar year 2014 compared to $9.7 billion at the end of 2013. See "STATE FINANCES – Unemployment Insurance."

- Cash Management – Cash flow needs are being managed through internal and external borrowing. The state issued $2.8 billion in revenue anticipation notes for cash management purposes, compared with $5.5 billion in fiscal year 2013-14.

- "Trigger" Mechanism for Additional General Fund Expenditures – contained provisions to use extra funds if state revenues rose higher than anticipated in the 2014-15 Budget. As the revenues are now projected to pass the trigger level, these funds will be used to eliminate the remaining $1 billion in school deferrals (see Proposition 98 above) and further reduce $500 million in local government mandate claims.

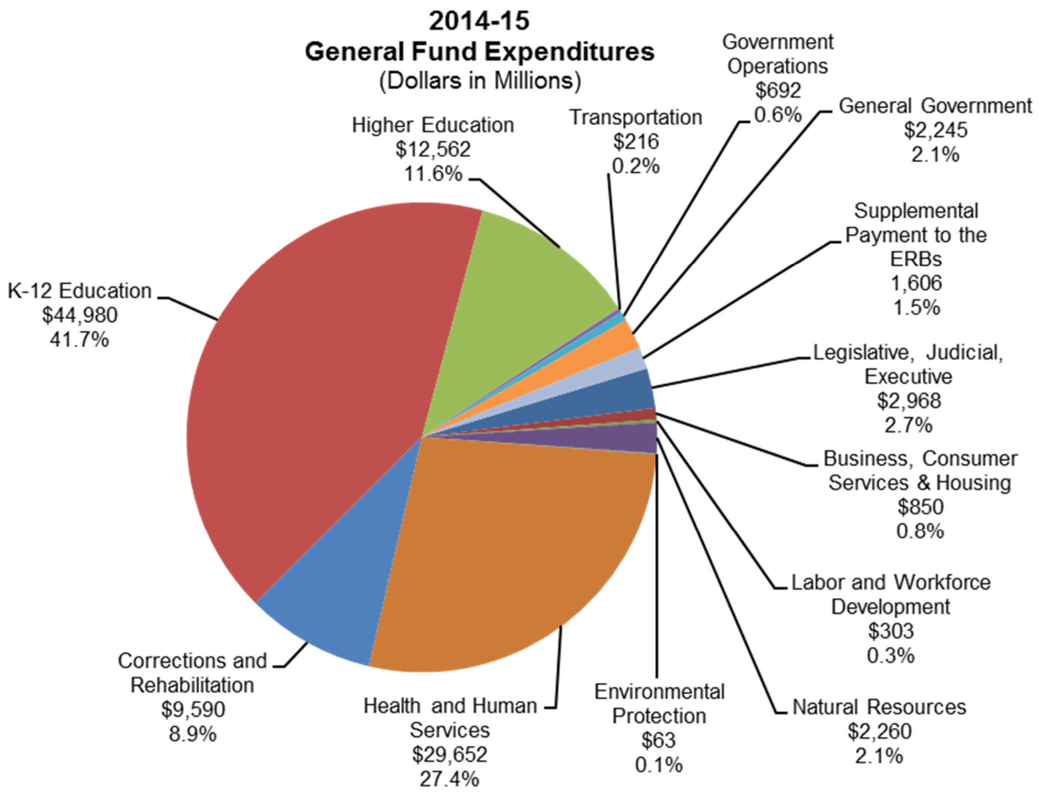
- Paying Down Debts and Liabilities – the 2014-15 Budget reduced more than $10 billion of debts, deferrals, and budgetary obligations accumulated over the prior decade. Prior to application of extra revenues described above under "Trigger Mechanism," the 2014-15 Budget paid down the deferral of payments to schools by $5 billion, paid off the Economic Recovery Bonds, repaid various special fund loans and funded $100 million in mandate claims that have been owed to local governments since 2004 or longer. See "DEBTS AND LIABILITIES UNDER PROPOSITION 2."

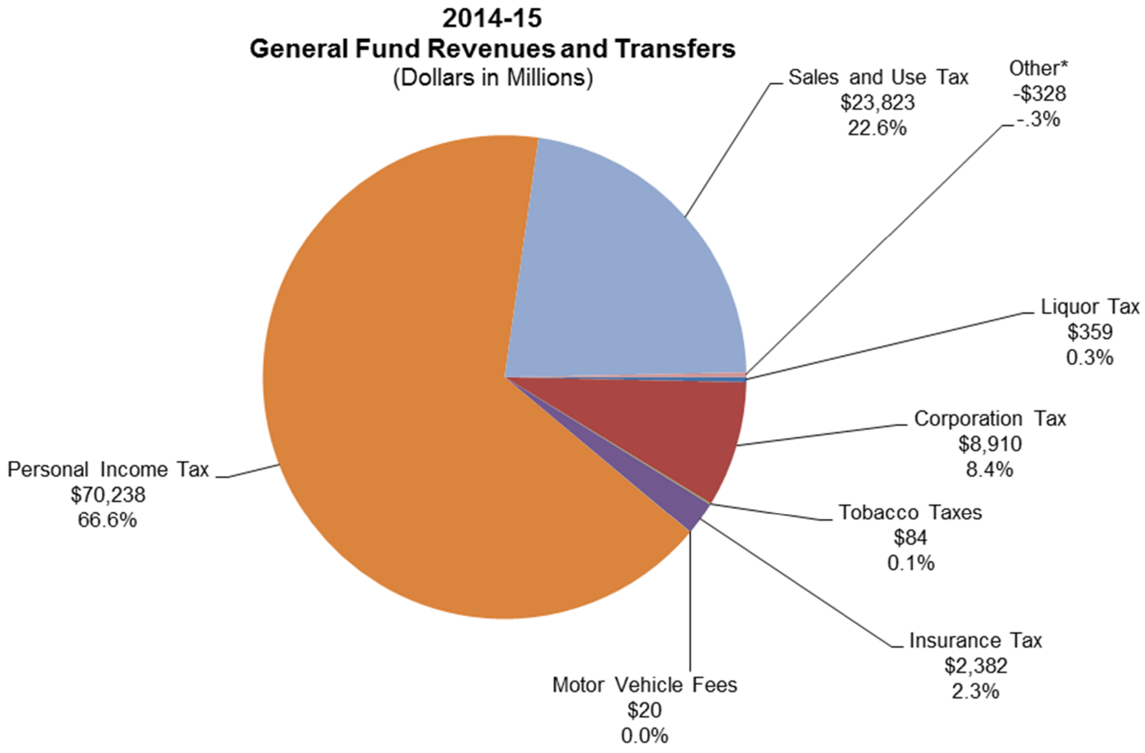
- Shoring Up Teacher Pensions – the 2014-15 Budget set forth a plan of shared responsibility among the state, school districts and teachers to eliminate the current unfunded liability in CalSTRS (the pension system for public school teachers in the state) in about 30 years. Barring state action, CalSTRS was expected to run out of money in 33 years. The first year's contributions from each of the state, school districts and teachers are modest, totaling about $275 million ($59.1 million General Fund). The contributions will increase in subsequent years, reaching more than $5 billion annually in total funds (approximately $900 million General Fund) when the rates are fully phased in for all parties by 2020-21. See "PENSION TRUSTS."

The following charts summarize the principal components of the 2014 Budget Act, as of its adoption.

In the chart below showing General Fund Expenditures, the state's expenditures for contributions to the pension funds and for debt service on bonds are not shown separately, but are included within the applicable expenditure category in the chart. The state's contributions to CalPERS and CalSTRS in fiscal year 2014-15 are a combined $4.2 billion, or 3.7 percent of total expenditures from the General Fund. The net debt service costs on general obligation bonds and lease-revenue bonds paid by rental payments from the General Fund total $5.9 billion, or 5.46 percent of total expenditures. These debt service costs were net of reimbursement from various special funds (e.g., vehicle weight fees offsetting costs of transportation bonds) and subsidy payments from the federal government for taxable Build America Bonds. See "STATE INDEBTEDNESS AND OTHER OBLIGATIONS – Build America Bonds."

[BALANCE OF PAGE INTENTIONALLY LEFT BLANK]





*The "Other" category is negative because it includes a transfer to the BSA of $1,606 million.

Fiscal Year 2014-15 Revised General Fund Estimates in the 2015-16 Governor's Budget

The 2015-16 Governor's Budget makes various mid-fiscal-year revisions to General Fund estimates involving the beginning fund balance, revenues, and expenditures for 2014-15. These revisions project an increase in the beginning fund balance of $1.2 billion, an increase in fiscal year 2014-15 revenues and transfers of about $2.5 billion, and an increase in fiscal year 2014-15 expenditures of about $3.7 billion. Thus, based on its various assumptions and proposals, the 2015-16 Governor's Budget projects a positive ending General Fund reserve balance of $452 million at the end of fiscal year 2014-15, compared to the positive ending balance of $449 million estimated when the 2014 Budget Act and related legislation was enacted. These ending General Fund reserve balance figures for fiscal year 2014-15 do not include the ending balance in the BSA on June 30, 2015 of $1.606 million.

The mid-year revisions for fiscal year 2014-15 are primarily due to the factors set forth below. (Please note that totals may not add because of rounding and that these figures are preliminary estimates subject to further adjustment after receipt of additional information concerning final revenues and expenditures for the entire fiscal year 2014-15.)

1. Net gain of $1.2 billion in beginning General Fund balance for fiscal year 2014-15 related to activities in prior fiscal years. This net gain in the starting balance for fiscal year 2014-15 is primarily due to the following components:

- $1.0 billion increase due to lower Non-Proposition 98 spending in fiscal year 2013-14;

- $0.5 billion increase due to higher revenues in fiscal year 2013-14; and,

- $0.3 billion decrease due to increased spending for a Proposition-98 Settle-up payment to be appropriated in fiscal year 2015-16.

Further information about the 2013-14 fiscal year budget can be found in prior state official statements, available at the Electronic Municipal Market Access ("EMMA") website, of the Municipal Securities Rulemaking Board at http://www.emma.msrb.org. (Such official statements are not part of or incorporated into this APPENDIX A.)

2. General Fund revenues and transfers for fiscal year 2014-15 are projected at a revised $108.0 billion (net of a $1.606 billion transfer to the BSA), which is $2.5 billion higher than the estimate of $105.5 billion when the 2014-15 Budget was enacted. The increase is based on the following major factors:

- $1.5 billion increase in personal income tax revenue;

- $0.4 billion decrease in sales and use tax revenue;

- $0.7 billion increase in corporation tax revenue; and;

- $0.6 billion increase in other revenues and transfers.

3. General Fund expenditures for fiscal year 2014-15 are projected at $111.7 billion, an increase of $3.7 billion compared with the estimate of $108.0 billion when the 2014-15 Budget was enacted. The net increase in expenditures is mainly attributable to the following:

- $2.2 billion increase in Proposition 98 expenditures; and,

- $1.5 billion increase in Non-Proposition 98 expenditures including $0.6 billion for Medi-Cal and $0.5 billion for repayment of deferred local government mandate payments.

4. The reserve for encumbrance was increased by $16 million since the enactment of the 2014 Budget Act and related legislation.

Budget Risks

The 2014-15 Budget and the 2015-16 Governor's Budget are both based on a variety of estimates and assumptions. If actual results differ from those assumptions, the state's financial condition could be adversely or positively affected. There can be no assurance that the financial condition of the state will not be materially and adversely affected by actual conditions or circumstances in the remainder of fiscal year 2014-15 and beyond.

Budget risks with potentially significant General Fund impact include, but may not be limited to, the following:

- Threat of Economic Recession — The economic forecasts used in connection with the 2014-15 Budget and the 2015-16 Governor's Budget assume a continued moderate expansion of the economy. Yet, economic expansions do not last forever, and in the post-World War II period, the average expansion has been about five years. The current expansion has already exceeded the average by nine months. While there are few signs of an immediate contraction, the Administration understands that another recession is inevitable.

- Federal Fiscal Challenges — As it has done in the past, the federal government could continue to shift its costs to the state in order to address its own fiscal challenges. The federal government's policies have added hundreds of millions of dollars in costs to the state's budget in the past year alone. In addition, depending upon its implementation, changes in federal immigration policy could drive state program costs up by hundreds of millions of dollars more.

- Capital Gains Volatility — Capital gains are the state's most volatile revenue source. The amount of revenue the General Fund derives from capital gains can vary greatly from year to year. For example, in 2007, income taxes on capital gains contributed nearly $11 billion to the General Fund, but just two years later, in 2009, the contribution had dropped to $2.3 billion. For calendar year 2014, income taxes on capital gains are expected to contribute nearly $12 billion to General Fund revenue. Under Proposition 2, some of this volatility will be mitigated by using spikes in capital gains to save money for the next recession and to pay down the state's liabilities. See "STATE FINANCES - Budget Reserves".

- Redevelopment Dissolution — Between fiscal year 2011-12 and fiscal year 2015-16, cities, counties, special districts, and schools are estimated to receive approximately $9.6 billion in property tax revenues that previously would have been spent by redevelopment agencies. These dollars are invested in core local public services such as police and fire protection, and are critical to the state balancing its budget because property tax revenues distributed to K-14 schools result in corresponding savings for the state's General Fund. There are several pending lawsuits involving the dissolution of redevelopment agencies. See "LITIGATION - Budget-Related Litigation - Actions Challenging Statutes Which Reformed California Redevelopment Law."

- Health Care Costs — Medi-Cal is the budget's second largest program. Additionally, the state provides health benefits to its own employees and retirees. As the state implements federal health care reform, budgetary spending will become even more dependent upon the rate of health care inflation. If this inflation rises faster than expected, annual General Fund spending could quickly rise by hundreds of millions of dollars.

- Debts and Liabilities — The state's budget challenges have been exacerbated by an unprecedented level of debts, deferrals, and budgetary obligations accumulated over the prior decade. Recent state budgets have reduced this debt from $34.7 billion to a projected $11.1 billion by the end of 2015-16. In addition, the state faces hundreds of billions of dollars in other long-term cost pressures, debts, and liabilities, including state retiree pension and health care costs.

Summary of State Revenues and Expenditures

The table below presents the actual revenues, expenditures and changes in fund balance for the General Fund for fiscal years 2011-12, 2012-13 and 2013-14, and the estimated results for fiscal years 2014-15 and 2015-16. In addition to the Special Fund for Economic Uncertainties, part of the fund balance of the General Fund, the 2015-16 Governor's Budget projects there will be a cumulative balance of $2.826 billion in the rainy day fund at June 30, 2016.

[BALANCE OF PAGE INTENTIONALLY LEFT BLANK]

Consistent with historical practice, the projected beginning of period fund balance of any given fiscal year can be updated from time to time subsequent to initial projections to reflect changes attributable to revisions in preceding fiscal years' activity and estimates. Changes affecting the beginning of period fund balance can include changes in both revenue and expenditure final estimates for previous years' fiscal activity.

TABLE 4
Statement of Estimated Revenues, Expenditures, and Changes in Fund Balance – General Fund (Budgetary Basis)[a]
Fiscal Years 2011-12 through 2015-16

(Dollars in Millions)

	2011-12	2012-13	Estimated[b] 2013-14	Estimated[b] 2014-15	Proposed[b] 2015-16
Fund Balance–Beginning of Period	$(2,326.5)	$(1,608.6)	$4,285.1	$5,100.4	$1,422.6
Restatements					
Prior Year Adjustment	1,071.7	1,288.4	(2,021.3)	–	–
Fund Balance–Beginning of Period, as Restated	**$(1,254.8)**	**$ (320.2)**	**$2,263.8**	**$5,100.4**	**$1,422.6**
Revenues	$85,568.5	$98,417.8	$102,298.2	$109,650.3	$115,132.0
Other Financing Sources					
Transfers from Other Funds	1,998.6	2,047.3	376.5	(1,608.4)[c]	(1,752.0)[c]
Other Additions	261.5	392.8	–	–	–
Total Revenues and Other Sources	**$87,828.6**	**$100,857.9**	**$102,674.7**	**$108,041.9**	**$113,380.0**
Expenditures					
State Operations[d]	$23,682.8	$25,960.1	$25,902.0	$28,468.8	$29,791.5
Local Assistance	63,845.2	69,828.4	73,803.2	81,411.9	83,260.5
Capital Outlay	103.1	119.5	65.4	149.2	161.7
Unclassified	–	–	67.5	1,689.8[e]	84.1
Other Uses	–	–	–	–	–
Transfer to Other Funds	551.3	344.6	–[f]	–[f]	–[f]
Total Expenditures and Other Uses	**$88,182.4**	**$96,252.6**	**$99,838.1**	**$111,719.7**	**$113,297.8**
Revenues and Other Sources Over or (Under)					
Expenditures and Other Uses	$(353.8)	4,605.3	$2,836.6	$(3,677.8)	$82.2
Fund Balance					
Deferred Payroll[g]	752.9	731.9	–	–	–
Reserved for Encumbrances	617.9	732.2	970.6	970.6	970.6
Reserved for Unencumbered Balances of Continuing Appropriations[h]	1,685.4	1,057.7		–	–
Unreserved–Undesignated [i]	(4,664.8)	1,763.3	4,129.8	452.0	534.2
Fund Balance–End of Period	**$(1,608.6)**	**$4,285.1**	**$5,100.4**	**$1,422.6**	**$1,504.8**

(Footnotes on Following Page)

[a] These statements have been prepared on a budgetary basis in accordance with state law and some modifications would be necessary in order to comply with generally accepted accounting principles ("GAAP"). The Supplementary Information contained in the state's Audited Basic Financial Statements for the year ended June 30, 2014, attached as APPENDIX B to this Official Statement, contains a description of the differences between the budgetary basis and the GAAP basis of accounting and a reconciliation of the June 30, 2014 fund balance between the two methods. See "FINANCIAL STATEMENTS."

[b] Source: Department of Finance, as of the 2015-16 Governor's Budget.

[c] Includes a $1,606 million transfer in 2014-15 and a $1,220 million transfer in 2015-16, to the Budget Stabilization Account (BSA) for rainy day purposes.

[d] Includes debt service on general obligation bonds. The estimated amount of debt service is $5.1 billion and $5.4 billion for fiscal years 2014-15 and 2015-16, respectively. These amounts are net of the federal Build America Bonds subsidy and various reimbursements to the General Fund from other funds, totaling approximately $1.4 billion in fiscal year 2014-15 and $1.5 billion in fiscal year 2015-16, to offset debt service costs of certain bonds. (See "STATE INDEBTEDNESS AND OTHER OBLIGATIONS – Capital Facilities Financing – Build America Bonds.") The 2014-15 estimated debt service includes $193 million funded out of the UC's budget and $189 million funded out of the CSU's budget to pay debt service costs. The 2015-16 estimated debt service includes $206 million funded out of the UC's budget and $203 million funded out of the CSU's budget to pay debt service. Debt service amounts for earlier years are set forth in the table titled "Outstanding State Debt Fiscal Years 2007-08 through 2012-13" under "STATE DEBT TABLES."

[e] Includes expenditure of $1,606 million for early repayment of the Economic Recovery Bonds.

[f] "Transfer to Other Funds" is included in "Transfers from Other Funds."

[g] Deferred Payroll, which began with the June 2010 payroll, is on-going and represents the amount of June payroll expenses deferred to July of the following fiscal year, for all state departments paid through the uniform payroll system. The Department of Finance, pursuant to Government Code Sections 12472.5 and 13302, implements the deferrals of June payroll expenditures for various governmental and nongovernmental cost funds. Deferral amounts for fiscal years 2013-14 and 2014-15 are not yet available.

[h] For purposes of determining whether the General Fund budget, in any given fiscal year, is in a surplus or deficit condition, see Chapter 1238, Statutes of 1990, amending Government Code Section 13307. As part of the amendment, the unencumbered balances of continuing appropriations, which exist when no commitment for expenditure is made, should be an item of disclosure, but the amount shall not be deducted from the fund balance. In accordance with Government Code Section 12460, the BLBAR reflects a specific reserve for the encumbered balance for continuing appropriations.

[i] Both actual and estimated amounts include SFEU. The Department of Finance generally includes in its estimates of the SFEU and set aside reserves, if any, the items reported in the table under "Reserved for Unencumbered Balances of Continuing Appropriations," and "Unreserved – Undesignated."

Source: Actual amounts for fiscal years 2011-12 to 2012-13: State of California, Office of the State Controller. Amounts for fiscal years 2013-14, 2014-15, and 2015-16: State of California, Department of Finance.

[BALANCE OF PAGE INTENTIONALLY LEFT BLANK]

The following table contains certain summary information concerning major General Fund revenue sources for an eight-year period:

TABLE 5
General Fund Revenues and Transfers
(Dollars in Thousands)

Fiscal Year	Sales & Use Tax	Personal Income Tax	Corporate Income Tax	Other Revenues and Transfers	Total
2008-09	$23,753,364	$43,375,959	$9,535,679	$6,107,110	$82,772,112
2009-10	26,740,781	44,852,331	9,114,589	6,337,891	87,045,592
2010-11	26,983,000	49,445,469	9,613,594	7,401,213	93,443,276
2011-12	18,658,000[(a)]	54,261,266[(b)(d)]	7,233,000	6,633,378[(c)]	86,785,644
2012-13	20,482,000[(d)]	64,484,000[(d)]	7,783,000[(e)]	6,652,578	99,401,578
2013-14	22,759,000[(d)]	66,522,000[(d)]	8,107,000[(e)]	4,797,128	102,185,128
2014-15[(f)]	23,823,000[(d)]	70,238,000[(d)]	8,910,000[(e)]	2,517,339[(g)]	105,488,339
2015-16[(f)]	25,166,000[(d)]	75,212,000[(d)]	10,173,000[(e)]	2,828,089[(g)]	118,380,041

[(a)] Reflects a decrease in the Sales & Use Tax rate from 6 percent to 5 percent (rate was temporarily increased from 5 percent to 6 percent from April 1, 2009 through June 30, 2011) and realignment of revenues related to shifting 1.0625 percent of the Sales & Use Tax rate to the Local Revenue Fund 2011. These two changes decrease General Fund revenues by roughly $10 billion annually.

[(b)] Reflects the expiration of a temporary 0.25 percent surcharge and the reduced dependent exemption credit for the 2009 and 2010 tax years. These two changes decrease General Fund revenues by an estimated $3.537 billion in fiscal year 2011-12.

[(c)] Reflects the expiration of a temporary 0.5 percent increase in the vehicle license fee rate (rate was increased from 0.65 percent to 1.15 percent, effective May 19, 2009 through June 30, 2011), decreasing General Fund revenues by an estimated $1.330 billion in fiscal year 2011-12.

[(d)] Reflects the passage of Proposition 30, The Schools and Local Public Safety Protection Act of 2012, which temporarily increases tax rates on the highest income Californians, and temporarily increases the sales and use tax rate by 0.25 percent. Since higher personal income tax rate applies to income received in 2012, a majority of the expected new revenue for that year is allocated to fiscal year 2011-12, although the cash receipts did not begin occurring until December 2012.

[(e)] Reflects the passage of Proposition 39, which requires single sales factor apportionment for most multi-state businesses. See “STATE FINANCES – Sources of Tax Revenue – Corporation Tax” for a discussion of recent difficulties in projecting corporation tax receipts.

[(f)] Estimated.

[(g)] Includes transfer of $1.606 billion in fiscal year 2014-15 and $1.220 billion in fiscal year 2015-16 from the General Fund to the Budget Stabilization Account for rainy day purposes.

Source: State of California, Department of Finance.

Revenue and Expenditure Assumptions

The table below presents the Department of Finance's budget basis statements of General Fund revenue sources and expenditures by function for fiscal years 2013-14 through 2015-16, as set forth in the 2015-16 Governor's Budget.

TABLE 6
General Fund Revenue by Sources and Expenditures
Fiscal Years 2013-14 through 2015-16

(Dollars in Millions)

Revenues **Source**	**2013-14 Actual[a] (as of January 2015)**	**2014-15 Revised (as of January 2015)**	**2015-16 Proposed (as of January 2015)**
Personal Income Tax	$ 66,560	$ 71,699	$ 75,213
Sales and Use Tax	22,263	23,438	25,166
Corporation Tax	8,858	9,618	10,173
Insurance Tax	2,363	2,490	2,531
Alcoholic Beverage Taxes and Fees	354	367	374
Cigarette Tax	86	84	82
Motor Vehicle Fees	22	20	21
Other[b]	2,169	1,932	1,040
Subtotal	$ 102,675	$ 109,648	$ 114,600
Transfer to the Budget Stabilization Account/Rainy Day Fund	0	-1,606	-1,220
Total	$ 102,675	$ 108,042	$ 113,380

Expenditures **Function**	**2013-14 Actual**	**2014-15 Revised**	**2015-16 Proposed**
Legislative, Judicial and Executive	$ 2,687	$ 3,007	$ 3,131
Business, Consumer Services & Housing	641	839	639
Transportation	77	158	237
Natural Resources	2,177	2,497	2,561
Environmental Protection	43	78	68
Health and Human Services	28,347	30,490	31,929
Corrections and Rehabilitation	9,213	9,995	10,160
K-12 Education	42,575	47,121	47,173
Higher Education	11,381	12,947	14,063
Labor and Workforce Development	297	282	265
Government Operations	716	730	701
General Government			
Non-Agency Departments	478	1,267	676
Tax Relief/Local Government	418	446	444
Statewide Expenditures	788	256	1,251
Supplemental Payment to the Economic Recovery Bonds	0	1,606	0
Total Expenditures	$ 99,838	$ 111,719	$ 113,298

[a] Fiscal year 2013-14 amounts subject to further adjustment.

[b] Generally consists of transfers and loans, and various smaller amounts for miscellaneous fees, taxes, royalties, tribal gaming revenues, unclaimed property and other sources.

Source: State of California, Department of Finance. Figures in this table may differ from the figures in Table 16; see "Note" to Table 16. 2013-14 amounts subject to further adjustment.

DEBTS AND LIABILITIES UNDER PROPOSITION 2

Voters approved Proposition 2 in November 2014, which revised the state's method of funding budget reserves. Under Proposition 2, starting in fiscal year 2015-16, 1.5 percent of annual General Fund revenues, plus the excess of capital gains tax receipts above a certain level, not necessary to fund Proposition 98, will be applied equally to funding the state's "rainy day fund" and paying down state debts and liabilities. See 'STATE FINANCES – Budget Reserves." Accordingly, the state will focus on paying down the remaining debt and liabilities eligible under Proposition 2. They include certain budgetary borrowing accumulated over a number of years and specified payments over and above the base payments for state pensions and retiree health costs. The two main retirement systems managed by state entities, CalPERS and CalSTRS, each have substantial unfunded liabilities. See "PENSION TRUSTS." The state also has a substantial unfunded liability relating to postemployment healthcare benefits for state employee retirees. See "STATE FINANCES – Retiree Health Care Costs." The table below displays the categories of debts and liabilities the Administration considers eligible for accelerated payments under Proposition 2. (Although included as an eligible use of Proposition 2 funds, the state is not legally responsible for the pension and retiree health care costs of the University of California, an independent corporate entity under state law.)

Despite eliminating the structural deficit and maintaining a balanced budget over the last four budgets, the state continues to face major long-term challenges and must continue to address the consequences of budget-balancing actions taken in the past. The 2014-15 Budget included triggers that authorized additional payments towards reducing these debts if revenues exceed projected revenues adopted as part of the 2014-15 Budget. Based on the updated revenue estimates in the 2015-16 Governor's Budget, it is estimated that the condition to trigger such payments will be met. At this time, it is estimated that $1.5 billion of additional funds will be used to eliminate the remaining school deferrals and to pay down local government mandate claims.

In fiscal year 2015-16, the Governor's Budget proposes to reduce loans from special funds ($965 million) and underfunding of Proposition 98 ($256 million). The proposed strategy within the multi-year forecast period is to continue to pay down budgetary borrowing. The Administration projects that all outstanding budgetary deferrals to the schools and community colleges, Economic Recovery Bonds, loans from special funds, underfunding of Proposition 98 (settle up payments), and borrowing from transportation funds under Proposition 42 will be entirely repaid by the end of fiscal year 2018-19. Remaining outstanding budgetary borrowing after fiscal year 2018-19 is projected to include reimbursements of state mandated costs to local governments, schools and community colleges and accounting deferrals. For more information regarding accounting deferrals, see the Section "Timing Differences" in the Required Supplemental Information in Appendix B, "Audited Basic Financial Statements of the State of California for the Year Ended June 30, 2013".

TABLE 7
Debts and Liabilities Under Proposition 2
2015-16 Governor's Budget

(Dollars in Millions)

	Outstanding Amount at Start of 2015-16	Proposed Use of 2015-16 Accelerated Payment	Proposed Use of 2016-17 Accelerated Payment	Proposed Use of 2017-18 Accelerated Payment	Proposed Use of 2018-19 Accelerated Payment	Remaining Amount Not Currently Scheduled
Budgetary Borrowing						
Loans from Special Funds	$3,028	$965	$1,123	$694	$246	$0
Underfunding of Proposition 98—Settle-Up	1,512	256	0	445	811	$0
Unpaid Mandate Claims for Local Governments (prior to 2004-05) [1/]	257	0	0	0	0	$257
State Retirement Liabilities (Unfunded Actuarial Estimate)						
State Retiree Health	71,773	0	0	0	0	N/A
State Employee Pensions	49,978	0	0	0	0	N/A
Teacher Pensions [2/]	74,374	0	0	0	0	N/A
Judges' Pensions	3,371	0	0	0	0	N/A
Deferred payments to CalPERS	530	0	0	0	0	N/A
University of California Retirement Liabilities (Unfunded Actuarial Estimate)						
University of California Employee Pensions	7,633	0	0	0	0	N/A
University of California Retiree Health	14,519	0	0	0	0	N/A
Total	**$226,975**	**$1,221**	**$1,123**	**$1,139**	**$1,057**	**$257**

[1/] Amount outstanding reflects $533 million paid under the 2014 Budget Act trigger.

[2/] The state portion of the unfunded liability for teacher pensions is $19.932 billion. See "PENSION TRUSTS – CalSTRS."

CASH MANAGEMENT

Traditional Cash Management Tools

General. The majority of the state's General Fund receipts are received in the latter part of the fiscal year. Disbursements from the General Fund occur more evenly throughout the fiscal year. The state's cash management program customarily addresses this timing difference by making use of internal borrowing (see "– Internal Borrowing") and by issuing short-term notes in the capital markets (see "– External Borrowing").

External Borrowing. External borrowing is typically done with revenue anticipation notes ("RANs") that are payable not later than the last day of the fiscal year in which they are issued. RANs have been issued in all but one fiscal year since the mid-1980s and have always been paid at maturity. See "STATE INDEBTEDNESS AND OTHER OBLIGATIONS – Cash Management Borrowings." The state also is authorized under certain circumstances to issue revenue anticipation warrants ("RAWs") that are payable in the succeeding fiscal year. The state issued RAWs to bridge short-term cash management shortages in the early 1990's and early 2000's. See "STATE FINANCES – State Warrants – Reimbursement Warrants" for more information on RAWs.

RANs and RAWs are both payable from any "Unapplied Money" in the General Fund on their maturity date, subject to the prior application of such money in the General Fund to pay

Priority Payments. "Priority Payments" consist of: (i) the setting apart of state revenues in support of the public school system and public institutions of higher education (as provided in Section 8 of Article XVI of the state Constitution); (ii) payment of the principal of and interest on general obligation bonds and general obligation commercial paper notes of the state as and when due; (iii) a contingent obligation for General Fund payments to local governments for certain costs for realigned public safety programs if not provided from a share of state sales and use taxes, as provided in Article XIII, Section 36 of the Constitution, enacted by Proposition 30 of 2012 (see "THE BUDGET PROCESS – Constraints on the Budget Process – Proposition 30");" (iv) reimbursement from the General Fund to any special fund or account to the extent such reimbursement is legally required to be made to repay borrowings therefrom pursuant to California Government Code Sections 16310 or 16418; and (v) payment of state employees' wages and benefits, state payments to pension and other state employee benefit trust funds, state Medi-Cal claims, lease payments to support lease-revenue bonds, and any amounts determined by a court of competent jurisdiction to be required by federal law or the state Constitution to be paid with state warrants that can be cashed immediately. See "STATE FINANCES – State Warrants."

Internal Borrowing. The General Fund is currently authorized by law to borrow for cash management purposes from more than 700 of the state's approximately 1,300 other funds in the State Treasury (the "Special Funds"). Total borrowing from Special Funds must be approved quarterly by the Pooled Money Investment Board ("PMIB"). The State Controller submits an authorization request to the PMIB quarterly, based on forecasted available funds and borrowing needs. The Legislature may from time to time adopt legislation establishing additional authority to borrow from Special Funds. The PMIB has authorized the internal borrowing of up to $24.975 billion for the period ending March 30, 2015.

One fund from which moneys may be borrowed to provide additional cash resources to the General Fund is the BSA, a reserve fund established in 2004 by Proposition 58. However, during fiscal years 2008-09 to 2013-14, there were no funds available in the BSA. The BSA has been funded at $1.606 billion in fiscal year 2014-15. See "STATE FINANCES – Budget Reserves – Budget Stabilization Account." The state also may transfer funds into the General Fund from the state's SFEU, which is not a Special Fund. See "STATE FINANCES – Inter-Fund Borrowings" for a further description of this process.

Cash Management in Fiscal Year 2014-15

The state entered the 2014-15 fiscal year in the strongest cash position since the start of the recession in 2008. For the first time since fiscal year 2007-08, the state began the current fiscal year without any internal borrowings, and a positive cash balance in the General Fund of $1.922 billion. The state currently expects to manage its cash flow needs for fiscal year 2014-15 entirely through the use of internal borrowing and an external RANs borrowing of $2.8 billion. This is the smallest RAN since fiscal year 2006-07, and compares with RANs of $10 billion in fiscal year 2012-13 and $5.5 billion in fiscal year 2013-14.

State fiscal officers constantly monitor the state's cash position and if it appears that cash resources may become inadequate (including the maintenance of a projected cash reserve of at least $2.5 billion at any time), they will consider the use of other cash management techniques as described in this section, including seeking additional legislation.

Other Cash Management Tools

The state has employed additional cash management measures during some fiscal years; all of the following techniques were used at one time or another during the last several fiscal years, but none of them is planned to be used in fiscal year 2014-15.

- The State Controller has delayed certain types of disbursements from the General Fund.
- Legislation was enacted increasing the state's internal borrowing capability, and the state has increased the General Fund's internal borrowings. See "STATE FINANCES – Inter-Fund Borrowings."
- Legislation has been enacted deferring some of the state's disbursements until later in the then-current fiscal year, when more cash receipts are expected.
- The issuance of registered warrants (commonly referred to as "IOUs") because of insufficient cash resources (last occurred in 2009). (See "STATE FINANCES – State Warrants" for an explanation of registered warrants.)
- Legislation was enacted in fiscal year 2011-12 to increase borrowable resources through creation of the State Agency Investment Fund ("SAIF") to allow state entities whose monies are not required by law to be deposited in the Pooled Money Investment Account ("PMIA"), to make deposits of at least $500 million into this new borrowable fund within the PMIA.

From time to time, the Legislature changes by statute the due date for various payments, including those owed to public schools, universities and local governments, until a later date in the fiscal year in order to more closely align the state's revenues with its expenditures. This technique has been used several times in the last few fiscal years. Some of these statutory deferrals were made permanent, and others were implemented only for one fiscal year.

In addition, state law gives the State Controller some flexibility as to how quickly the state must pay its bills. For instance, income tax refunds for personal income taxes are not legally due until 45 days after the return filing deadline, which is normally April 15. Accordingly, while the state has typically paid tax refunds as returns are filed, it can conserve cash by withholding refund payments until after the April 15 due date. Payments to vendors generally must be made within 45 days of receipt of an invoice. The state may delay payment until the end of this period, or it may even choose to make these payments later and pay interest. These delays are only used if the State Controller foresees a relatively short-term cash flow shortage.

STATE INDEBTEDNESS AND OTHER OBLIGATIONS

General

The State Treasurer is responsible for the sale of most debt obligations of the state and its various authorities and agencies. The state has always paid when due the principal of and interest on its general obligation bonds, general obligation commercial paper notes, lease-revenue obligations and short-term obligations, including RANs and RAWs. Additional information regarding the state's long-term debt appears in the section "STATE DEBT TABLES."

Capital Facilities Financing

1. General Obligation Bonds

The state Constitution prohibits the creation of general obligation indebtedness of the state unless a bond measure is approved by a majority of the electorate voting at a general election or a direct primary. Each general obligation bond act provides a continuing appropriation from the General Fund of amounts for the payment of debt service on the related general obligation bonds, subject under state law only to the prior application of moneys in the General Fund to the support of the public school system and public institutions of higher education. Under the state Constitution, appropriations to pay debt service on any general obligation bonds cannot be repealed until the principal and interest on such bonds have been paid. See "STATE FINANCES – State Expenditures." Certain general obligation bond programs, called "self-liquidating bonds," receive revenues from specified sources so that moneys from the General Fund are not expected to be needed to pay debt service, but the General Fund will pay the debt service, pursuant to the continuing appropriation contained in the bond act, if the specified revenue source is not sufficient. The principal self-liquidating bond programs are the ERBs, supported by a special sales tax, and veterans general obligation bonds, supported by mortgage repayments from housing loans made to military veterans. See "– Economic Recovery Bonds."

General obligation bonds are typically authorized for infrastructure and other capital improvements at the state and local level. Pursuant to the state Constitution, general obligation bonds cannot be used to finance state budget deficits (except as already authorized by ERBs, as described below).

As of January 1, 2015, the state had outstanding $79.0 billion aggregate principal amount of long-term general obligation bonds, of which $76.7 billion were payable primarily from the state's General Fund, and $2.3 billion were "self-liquidating" bonds payable first from other special revenue funds. As of January 1, 2015, there were unused voter authorizations for the future issuance of $31.7 billion of long-term general obligation bonds, some of which may first be issued as commercial paper notes (see "General Obligation Commercial Paper Program" below). Of this unissued amount, $596.2 million is for general obligation bonds payable first from other revenue sources. See the table "Authorized and Outstanding General Obligation Bonds" following the caption "STATE DEBT TABLES."

2. *Variable Rate General Obligation Bonds*

The general obligation bond law permits the state to issue as variable rate indebtedness up to 20 percent of the aggregate amount of long-term general obligation bonds outstanding. These bonds are described generally in the following table and represent about 4.59 percent of the state's total outstanding general obligation bonds. With respect to the $1,050,000,000 of variable rate general obligation bonds having mandatory tender dates, if these bonds cannot be remarketed on their respective scheduled mandatory tender dates, there is no default but the interest rate on the series of such bonds not remarketed on such date would be increased in installments thereafter until such bonds can be remarketed or refunded, ultimately reaching either 11 percent on the 181st day or 10 percent on the 180th day, as applicable. Furthermore, with respect to the $100,000,000 of these bonds with a mandatory tender date of May 1, 2015, until such bonds are remarketed or refunded, they will be subject to quarterly mandatory redemptions of $5,000,000 each over a period of five years commencing six months after the initial unsuccessful remarketing. The bonds with a mandatory tender date of May 1, 2015 will either be remarketed or refunded prior to their tender date.

Type of Bonds	Outstanding Principal Amount ($000) as of January 1, 2015	Current Variable Rate Interest Mode	Liquidity Support[(a)]	Other Information
General Obligation	$2,473,690	Daily/Weekly VRDO	Letters of Credit	
General Obligation	400,000	Indexed Floating Rate to Respective Mandatory Tender Dates	None	Mandatory Tenders on May 1, 2015, December 1, 2016, December 1, 2017, December 3, 2018
General Obligation	98,100	Indexed Floating Rate to Respective Maturity Dates	None	Fixed Maturities on each May 1 in the years 2017 through 2020
General Obligation	650,000	Fixed Term Rate to Respective Mandatory Tender Dates	None	Mandatory Tenders on December 1, 2016, December 1, 2017 and December 2, 2019
TOTAL	$3,621,790			

[(a)] See "Bank Arrangements."

Source: State of California, Office of the State Treasurer

The state is obligated to redeem, on the applicable purchase date, any weekly and daily variable rate demand obligations ("VRDOs") tendered for purchase if there is a failure to pay the related purchase price of such VRDOs on such purchase date from proceeds of the remarketing thereof, or from liquidity support related to such VRDOs. The state has not entered into any interest rate hedging contracts in relation to any of its variable rate general obligation bonds. The state has no auction rate bonds outstanding.

3. *General Obligation Commercial Paper Program*

Pursuant to legislation enacted in 1995, voter-approved general obligation indebtedness may be issued either as long-term bonds or, for some but not all bond acts, as commercial paper notes. Commercial paper notes may be renewed or may be refunded by the issuance of bonds. It is currently the state's policy to use commercial paper notes to provide flexibility for bond programs, such as to provide interim funding for voter-approved projects and to facilitate refunding of variable rate bonds into fixed rate bonds. Commercial paper notes are not included in the calculation of permitted variable rate indebtedness described under "Variable Rate General Obligation Bonds" and are not included in the figures provided above in the section "General Obligation Bonds." A total of $2.225 billion in principal amount of commercial paper notes is now authorized under agreements with various banks, including an agreement for the direct purchase of up to $500 million of commercial paper notes by a bank. See the "BANK ARRANGEMENTS" table for a list of the credit agreements supporting the commercial paper program. As of January 1, 2015, there was $594,035,000 principal amount of commercial paper notes outstanding.

4. *Bank Arrangements*

In connection with VRDOs and the commercial paper program ("CP"), the state has entered into a number of reimbursement agreements or other credit agreements with a variety of financial institutions as set forth in the table titled "BANK ARRANGEMENTS." These agreements include various representations and covenants of the state, and the terms (including interest rates and repayment schedules) by which the state would be required to pay or repay any obligations thereunder (including drawings resulting from any failed remarketings). To the extent that VRDOs or CP offered to the public cannot be remarketed over an extended period (whether due to downgrades of the credit ratings of the institution providing credit enhancement or other factors) and the applicable financial institution is obligated to purchase VRDOs or CP, interest payable by the state pursuant to the reimbursement agreement or credit agreement would generally increase over current market levels relating to the VRDOs or CP, and, with respect to VRDOs the principal repayment period would generally be shorter (typically less than five years) than the repayment period otherwise applicable to the VRDOs. In addition, after the occurrence of certain events of default as specified in a credit agreement, payment of the related VRDOs may be further accelerated and payment of related CP, as applicable, may also be accelerated and interest payable by the State on such VRDOs or CP could increase significantly.

5. *Lease-Revenue Obligations*

In addition to general obligation bonds, the state acquires and constructs capital facilities through the issuance of lease-revenue obligations (also referred to as lease-purchase obligations). Such borrowing must be authorized by the Legislature in a separate act or appropriation. Under these arrangements, the SPWB, another state or local agency or a joint powers authority issued bonds to pay for the acquisition or construction of facilities such as office buildings, university buildings, courthouses or correctional institutions. These facilities are leased to a state agency, the California State University or the Judicial Council under a long-term lease which provides the source of revenues which are pledged to the payment of the debt service on the lease-revenue bonds. Under applicable court decisions, such lease arrangements do not constitute the creation of "indebtedness" within the meaning of the state constitutional provisions that require voter approval. For purposes of this APPENDIX A and the tables under "STATE DEBT TABLES," the terms "lease-revenue obligation," "lease-revenue financing," "lease-purchase obligation" or "lease-purchase" mean principally bonds or certificates of participation for capital facilities where the lease payments providing the security are payable from the operating budget of the respective lessees, which are primarily, but not exclusively, derived from the General Fund. The state had $11,103,220,000 in general fund supported lease-revenue obligations outstanding as of January 1, 2015. The tables under "STATE DEBT TABLES" do not include equipment leases or leases which were not sold, directly or indirectly, to the public capital markets. The SPWB, which is authorized to sell lease-revenue bonds, had approximately $3.89 billion of authorized and unissued bonds as of January 1, 2015.

6. Non-Recourse Debt

Certain state agencies and authorities issue revenue obligations for which the General Fund has no liability. These revenue bonds represent obligations payable from state revenue-producing enterprises and projects, and conduit obligations payable from revenues paid by private users or local governments of facilities financed by the revenue bonds. In each case, such revenue bonds are not payable from the General Fund. The enterprises and projects include transportation projects, various public works projects, public and private educational facilities (including the California State University and University of California systems), housing, health facilities and pollution control facilities. State agencies and authorities had approximately $58.05 billion aggregate principal amount of revenue bonds and notes which are non-recourse to the General Fund outstanding as of December 31, 2014, as further described in the table "State Agency Revenue Bonds and Conduit Financing" under "STATE DEBT TABLES."

7. Build America Bonds

In February 2009, Congress enacted certain new municipal bond provisions as part of the federal economic stimulus act ("ARRA"), which allowed municipal issuers such as the state to issue "Build America Bonds" ("BABs") for new infrastructure investments. BABs are bonds whose interest is subject to federal income tax, but pursuant to ARRA the U.S. Treasury was to repay the issuer an amount equal to 35 percent of the interest cost on any BABs issued during 2009 and 2010. The BAB subsidy payments related to general obligation bonds are General Fund revenues to the state, while subsidy payments related to SPWB lease-revenue bonds are deposited into a fund which is made available to the SPWB for any lawful purpose. In neither instance are the subsidy payments specifically pledged to repayment of the BABs to which they relate. The cash subsidy payment with respect to the BABs, to which the state is entitled, is treated by the Internal Revenue Service ("IRS") as a refund of a tax credit and such refund may be offset by the Department of the Treasury by any liability of the state payable to the federal government. None of the state's BAB subsidy payments to date have been reduced because of such an offset.

Between April 2009 and December 2010, the state issued $13.54 billion of BAB general obligation ("GO") bonds and the SPWB issued $550.64 million of BAB lease-revenue bonds. In November 2013, the SPWB redeemed $149.62 million of BABs. The aggregate amount of the subsidy payments expected to be received from fiscal year 2014-15 through the maturity of these bonds (mostly 20 to 30 years) based on the 35 percent subsidy rate is approximately $7.9 billion for the general obligation BABs and $209 million for the SPWB lease-revenue BABs.

Pursuant to certain federal budget legislation adopted in August 2011, starting as of March 1, 2013, the government's BAB subsidy payments were reduced as part of a government-wide "sequestration" of many program expenditures. The reduction of the BAB subsidy payment is presently scheduled to continue until 2024, although Congress can terminate or modify it sooner, or extend it. Each BAB subsidy payment was reduced by 8.7 percent for the federal 2013 fiscal year (ended September 30, 2013) and 7.2 percent for the federal 2014 fiscal year (ended September 30, 2014). This resulted in a reduction of approximately $26.58 million in subsidies from a total of $363.86 million expected to be received during the federal 2014 fiscal year. The sequestration percentage is recalculated for each fiscal year, and has been set at 7.3 percent for the federal 2015 fiscal year. None of the BAB subsidy payments are pledged to pay debt service for the GO and SPWB BABs, so this reduction will not affect the state's ability to pay its debt service on time, nor have any material impact on the state's General Fund.

Future Issuance Plans; General Fund Debt Ratio

Based on estimates from the 2015-16 Governor's Budget as well as updates from the Department of Finance, approximately $3.55 billion of new money general obligation bonds (some of which may initially be in the form of commercial paper notes) and approximately $282 million of lease-revenue bonds are expected to be issued in calendar year 2015. These estimates will be updated by the State Treasurer's Office based on information provided by the Department of Finance with respect to the updated funding needs of, and actual spending by, departments. In addition, the actual amount of bonds sold will depend on other factors such as overall budget constraints, market conditions and other considerations. The state also expects to issue refunding bonds as market conditions warrant.

The ratio of debt service on general obligation and lease-revenue bonds supported by the General Fund, to annual General Fund revenues and transfers (the "General Fund Debt Ratio"), can fluctuate as assumptions for future debt issuance and revenue projections are updated from time to time. Any changes to these assumptions will impact the projected General Fund Debt Ratio. Based on the revenue estimates contained in the 2015-16 Governor's Budget and bond issuance estimates referred to in the preceding paragraph, the General Fund Debt Ratio is estimated to equal approximately 7.07 percent in fiscal year 2014-15 and 6.97 percent in fiscal year 2015-16.

The General Fund Debt Ratio is calculated based on actual gross debt service, without adjusting for receipts from the U.S. Treasury for the state's current outstanding general obligation and lease-revenue BABs or the availability of any special funds that may be used to pay a portion of the debt service to help reduce General Fund costs. The total of these offsets for general obligation and lease-revenue bond debt service is estimated to equal approximately $1.40 billion for fiscal year 2014-15 and $1.52 billion for fiscal year 2015-16. Including the estimated offsets reduces the General Fund Debt Ratio to 5.78 percent in fiscal year 2014-15 and 5.63 percent in fiscal year 2015-16. The actual General Fund Debt Ratio in future fiscal years will depend on a variety of factors, including actual debt issuance (which may include additional issuance approved in the future by the Legislature and, for general obligation bonds, the voters), actual interest rates, debt service structure, and actual General Fund revenues and transfers.

See the table "OUTSTANDING STATE DEBT, FISCAL YEARS 2009-10 THROUGH 2013-14" under "STATE DEBT TABLES" for certain historical ratios of debt service to General Fund receipts.

Economic Recovery Bonds

The California Economic Recovery Bond Act ("Proposition 57") was approved by the voters on March 2, 2004. Proposition 57 authorized the issuance of up to $15 billion in Economic Recovery Bonds (ERBs) to finance the negative General Fund reserve balance as of June 30, 2004, and other General Fund obligations undertaken prior to June 30, 2004. Repayment of the ERBs is secured by a pledge of revenues from a one-quarter cent increase in the state's sales and use tax (the "special sales tax") that became effective July 1, 2004. In addition, as voter-approved general obligation bonds, the ERBs are secured by the state's full faith and credit and payable from the General Fund in the event the dedicated sales and use tax revenue is insufficient to repay the bonds.

The entire authorized amount of ERBs was issued in three sales, in May and June 2004, and in February 2008. No further ERBs can be issued under Proposition 57. However, the State is authorized to refund ERBs. The state issued refunding ERBs in 2009 to restructure the program in response to a drop in taxable sales caused by the recession, and in 2011 for debt service savings.

Three different sources of funds are required to be applied to the early retirement (principally by redemption or creation of defeasance escrow funds) of ERBs: (i) all proceeds from the dedicated special sales tax in excess of the amounts needed, on a semi-annual basis, to pay debt service and other required costs of the bonds, (ii) all proceeds from the sale of specified surplus state property, and (iii) fifty percent of each annual deposit, up to $5 billion in the aggregate, of deposits in the BSA (see "THE BUDGET PROCESS – Constraints on the Budget Process – Balanced Budget Amendment (Proposition 58)"). As of January 1, 2015, funds from these sources have been used for early retirement of approximately $7.83 billion of bonds during fiscal years 2005-06 through the first half of fiscal year 2014-15, including the application of $3.115 billion transferred from the BSA.

The state accumulated approximately $727 million in excess special sales tax and investment earnings from July 2, 2014 through January 1, 2015. The state used these moneys to defease $634,440,000 of ERBs on February 3, 2015. The Administration estimates that all outstanding ERBs will be effectively retired in the first quarter of fiscal year 2015-16.

Tobacco Settlement Revenue Bonds

In 1998, the state signed a settlement agreement (the "Master Settlement Agreement" or "MSA") with the four major cigarette manufacturers (the "participating manufacturers" or "PMs"). Under the MSA, the PMs agreed to make payments to the state in perpetuity, which at the time were predicted to total approximately $25 billion (subject to adjustments) over the first 25 years. Under a separate Memorandum of Understanding, half of the payments made by the cigarette manufacturers are paid to the state and half to certain local governments. The specific amount to be received by the state and such local governments is subject to adjustment under the

MSA, including reduction of the PMs' payments for decreases in cigarette shipment volumes by the PMs, payments owed to certain "Previously Settled States" and certain other types of offsets.

State law enacted in 2002 (the "Tobacco Securitization Law") authorized the establishment of a special purpose trust to purchase the tobacco assets and to issue revenue bonds secured by the tobacco settlement revenues received beginning in the 2003-04 fiscal year. Legislation in 2003 amended the Tobacco Securitization Law to authorize a credit enhancement mechanism that requires the Governor to request an appropriation from the General Fund in the annual Budget Act for payment of debt service and other related costs in the event tobacco settlement revenues and certain other amounts are insufficient. The Legislature is not obligated to make any General Fund appropriation.

In 2003, two separate sales of these assets financed with revenue bonds (the "2003 Bonds") produced about $4.75 billion in proceeds which were transferred to the General Fund. In 2005 and 2007, the state refunded all of the original 2003 Bonds, generating additional proceeds of approximately $1.783 billion, which were also transferred to the General Fund. The credit enhancement mechanism was applied to only the second 2003 sale of bonds and was continued when those bonds were refunded in 2005 and in 2013 (the "2005 Bonds" and the "2013 Bonds"). This credit enhancement mechanism only applies to the outstanding principal amount of approximately $2.66 billion of 2005 and 2013 Bonds.

Tobacco settlement revenue bonds are neither general nor legal obligations of the state or any of its political subdivisions, and neither the faith and credit, nor the taxing power, nor any other assets or revenues of the state or of any political subdivision, shall be pledged to the payment of any such bonds. However, as described above, the state committed to request the Legislature for a General Fund appropriation in the event there are insufficient tobacco settlement revenues to pay debt service with respect to the 2005 and 2013 Bonds, and certain other available amounts, including reserve funds, are depleted. Since the issuance of the 2005 Bonds, this appropriation has been requested and approved by the Legislature, to be utilized in the event tobacco settlement revenues and other available moneys are not sufficient to pay debt service. However, use of the appropriated moneys has never been required.

One of the reserve funds relating to the 2005 Bonds was used to make required debt service interest payments on the 2005 Bonds in 2011 and 2012 in part due to the withholding related to the declining tobacco consumption and disputes over declining PM market share. The total amount of the draws was approximately $7.94 million. In April 2013 the reserve fund was replenished in full following the disbursements of the non-participating manufacturer settlement funds and receipt of the scheduled tobacco settlement revenues. As of December 1, 2014, the amount of the balance of the liquidity and supplemental reserve accounts allocable to the 2005 and 2013 bonds was $246.54 million. If, in any future year tobacco settlement revenues are less than required debt service payments on the 2005 and 2013 Bonds in such year, additional draws on the reserve funds will be required. Future revenues in excess of debt service requirements, if any, will be used to replenish the reserve funds of the bonds. The state General Fund is not obligated to replenish the reserve funds, nor to request an appropriation to replenish the reserve funds.

The state is currently contemplating the current refunding of a portion of the 2005 Bonds with a par amount of approximately $2.1 billion assuming the refunding provides sufficient savings to the state.

Although the state cannot predict the amount of future tobacco settlement revenues, if declines in tobacco consumption continue, or if tobacco settlement revenues are unavailable in currently expected amounts due to future disputes with PMs or for other reasons, the amount of tobacco settlement revenues and other available moneys, including the reserve funds, may at some point in the future be insufficient to pay debt service on the 2005 and 2013 Bonds, and the Governor would be required to request an appropriation from the General Fund. However, the Legislature is not obligated to make an appropriation.

Cash Management Borrowings

As part of its cash management program, the state has regularly issued short-term obligations to meet cash management needs. See "CASH MANAGEMENT."

The following table shows the amount of RANs issued in the past five fiscal years and the current fiscal year.

TABLE 8
State of California Revenue Anticipation Notes Issued
Fiscal Years 2009-10 to 2014-15

(Dollars in Billions)

Fiscal Year	Type	Principal Amount	Date of Issue	Maturity or Redemption Date
2009-10	Interim Notes	$1.5	August 27, 2009	September 29, 2009*
	Notes Series A-1	2.825	September 29, 2009	May 25, 2010
	Notes Series A-2	5.975	September 29, 2009	June 23, 2010
2010-11	Interim Notes	6.7	October 28, 2010	November 23, 2010*
	Notes Series A-1	2.25	November 23, 2010	May 25, 2011
	Notes Series A-2	7.75	November 23, 2010	June 28, 2011
2011-12	Interim Notes	5.4	July 28, 2011	September 22, 2011*
	Notes Series A-1	0.5	September 22, 2011	May 24, 2012
	Notes Series A-2	4.9	September 22, 2011	June 26, 2012
	Notes Series B	1.0	February 22, 2012	June 28, 2012
2012-13	Notes Series A-1	2.5	August 23, 2012	May 30, 2013
	Notes Series A-2	7.5	August 23, 2012	June 20, 2013
2013-14	Notes Series A-1	1.5	August 22, 2013	May 28, 2014
	Notes Series A-2	4.0	August 22, 2013	June 23, 2014
2014-15	Notes	2.8	September 23, 2014	June 22, 2015

* Redemption date.
Source: State of California, Office of the State Treasurer

Indirect, Nonpublic or Contingent Obligations

Unemployment Insurance Fund Borrowing. As described in "STATE FINANCES – Unemployment Insurance," commencing in fiscal year 2011-12, the state has been required to pay interest on loans made by the federal government to the state Unemployment Insurance ("UI") Fund. The principal amount of these loans was approximately $8.7 billion at the end of calendar 2014, and is projected to be approximately $7.4 billion at the end of calendar 2015. The

September 2014 interest payment of $217.4 million was paid by the General Fund. The Governor's Budget provides $184.4 million from the General Fund to make the 2015 interest payment.

Office of Statewide Health Planning and Development Guarantees. Pursuant to a law created in 1969, the Office of Statewide Health Planning and Development of the State of California ("OSHPD") insures loans and bond issues for financing and refinancing of construction and renovation projects for nonprofit and publicly-owned healthcare facilities. This program (commonly called "Cal-Mortgage Loan Insurance") is currently authorized by statute to insure up to $3 billion for health facility projects.

State law established the Health Facility Construction Loan Insurance Fund (the "Fund") as a trust fund which is continuously appropriated and may only be used for purposes of this program. The Fund is used as a depository of fees and insurance premiums and any recoveries and is the initial source of funds used to pay administrative costs of the program and shortfalls resulting from defaults by insured borrowers. If the Fund were unable to make payment on an insured loan or bond, state law provides for the State Treasurer to issue debentures to the holders of the defaulted loan or bond which are payable on parity with state general obligation bonds. All claims on insured loans to date have been paid from the Fund.

As of October 31, 2014, OSHPD insured 110 loans to nonprofit or publicly owned health facilities throughout California with an aggregate par amount of approximately $1.771 billion. The cash balance of the Fund was approximately $169.7 million as of October 31, 2014. OSHPD engaged Oliver Wyman Actuarial Consulting, Inc. to perform the biennial actuarial study of the Fund as of June 30, 2012, and the study was completed in July 2014 (the "2012 actuarial study"). Based upon a number of assumptions, the 2012 actuarial study concluded, among other things, that the Fund appeared to be sufficient, under the "expected scenario" to maintain a positive balance until at least fiscal year 2041-42. Even under the "most pessimistic scenario," the 2012 actuarial study found that there was a 70 percent likelihood that the Fund's reserves as of June 30, 2012 would protect against any General Fund losses until at least 2020-21, and a 90 percent likelihood that the Fund's reserves as of June 30, 2012 would protect against any General Fund losses until at least fiscal year 2017-18. There can be no assurances that the financial condition of the Fund has not materially declined since the 2012 actuarial study. More information on the program can be obtained from OSHPD's website.

Equipment Lease/Purchase Program. The state Department of General Services operates a centralized program which allows state departments to acquire equipment, software or services under financing programs with approved vendors. The Department of General Services collects the required payments from the participating departments' support budgets and makes the payments for the equipment on behalf of the applicable state department. The payments are subject to annual appropriation by the Legislature. If for any reason the annual payments are not appropriated, the state department is obligated to return the equipment to the vendor. These contracts are represented as capital leases in the state's financial statements. As of January 1, 2015, the aggregate total under this program was approximately $112.6 million.

STATE FINANCES

The General Fund

The moneys of the state are segregated into the General Fund and over 1,000 other funds, including special, bond and trust funds. The General Fund consists of revenues received by the State Treasury and not required by law to be credited to any other fund, as well as earnings from the investment of state moneys not allocable to another fund. The General Fund is the principal operating fund for the majority of governmental activities and is the depository of most of the major revenue sources of the state. For additional financial data relating to the General Fund, see the financial statements incorporated in or attached to this APPENDIX A. See also "FINANCIAL STATEMENTS." The General Fund may be expended as a consequence of appropriation measures enacted by the Legislature and approved by the Governor (including the annual Budget Act), as well as appropriations pursuant to various constitutional authorizations and initiative statutes.

Budget Reserves

1. Special Fund for Economic Uncertainties

The SFEU is funded with General Fund revenues and was established to protect the state from unforeseen revenue reductions and/or unanticipated expenditure increases. The State Controller may transfer funds from the SFEU to the General Fund as necessary to meet cash needs of the General Fund and such transfers are characterized as "loans." The State Controller is required to return moneys so transferred, without payment of interest, as soon as there are sufficient moneys in the General Fund. At the end of each fiscal year, the State Controller is required to transfer from the SFEU to the General Fund any amount necessary to eliminate any deficit in the General Fund.

The legislation creating the SFEU (Government Code Section 16418) also contains a continuous appropriation authorizing the State Controller to transfer the unencumbered balance of the General Fund to the SFEU as of the end of each fiscal year. However, if, at the end of any fiscal year in which it has been determined revenues exceed the amount that may be appropriated, as defined in subdivision (a) of Section 2 of Article XIII B of the state Constitution, then the transfer shall be reduced by the amount of the excess revenues. The estimates of the transfer shall be made jointly by the LAO and the Department of Finance. For a further description of Article XIII B, see "– State Appropriations Limit." In certain circumstances, moneys in the SFEU may be used in connection with disaster relief.

For budgeting and accounting purposes, any appropriation made from the SFEU, other than appropriations contained in Government Code Section 16418, is deemed an appropriation from the General Fund. For year-end reporting purposes, the State Controller is required to add the balance in the SFEU to the balance in the General Fund so as to show the total moneys then available for General Fund purposes.

See Table 1 and footnote (j) in Table 4 for information concerning the recent balances in the SFEU and projections of the balances for the previous and current fiscal years. As in any year, the Budget Act and related trailer bills are not the only pieces of legislation which appropriate funds. Other factors, including re-estimates of revenues and expenditures, existing statutory requirements and additional legislation introduced and passed by the Legislature may impact the fiscal year-end balance in the SFEU.

2. Budget Stabilization Account

Proposition 58, approved in March 2004, created the BSA as a second budgetary reserve. The provisions of Proposition 58 have been superseded by Proposition 2, described below, which was approved at the November 4, 2014 election. Proposition 58 provided that beginning with fiscal year 2006-07, a specified portion of estimated annual General Fund revenues (reaching a ceiling of 3 percent by fiscal year 2008-09) would be transferred by the State Controller into the BSA no later than September 30 of each fiscal year unless the transfer is suspended or reduced as described below. These transfers would have continued until the balance in the BSA reached $8 billion or 5 percent of the estimated General Fund revenues for that fiscal year, whichever was greater. Proposition 58 provided that the annual transfers could be suspended or reduced for a fiscal year by an executive order issued by the Governor no later than June 1 of the preceding fiscal year. Proposition 58 also provided that one-half of the annual transfers shall be used to retire ERBs, until a total of $5 billion has been used for that purpose. As of November, 2014, a total of $3.101 billion of the $5 billion amount has been applied to the retirement of ERBs. (See "STATE INDEBTEDNESS AND OTHER OBLIGATIONS – Economic Recovery Bonds").

The 2014 Budget Act provides for a transfer of $3.213 billion to the BSA, half of which ($1.606 billion) was used to retire Economic Recovery Bonds, with the other half remaining in the BSA as a "rainy day" budgetary reserve.

Proposition 2, approved by the voters in November 2014, provides for a stronger rainy day fund that requires both paying down liabilities and saving for a rainy day by making specified deposits into the BSA. In response to the volatility of capital gains revenues and the resulting boom-and-bust budget cycles, Proposition 2 takes into account the state's heavy dependence on the performance of the stock market and the resulting capital gains. Proposition 2 will, beginning with the 2015-16 fiscal year:

- Require a calculation of capital gains revenues in excess of 8 percent of General Fund tax revenues that are not required to fund a Proposition 98 increase. In addition, require a calculation of 1.5 percent of annual General Fund revenues. The combination of these two amounts will be used for the purposes set forth below.

- Half of each year's calculated amount for the next 15 years is to be used to pay specified types of debt or other long-term liabilities. The other half is to be deposited into the BSA. After the first 15 years, at least half of each year's deposit would be saved in the BSA, with the remainder used for supplemental debt payments or savings.

- Set the maximum size to be reserved in the BSA at 10 percent of General Fund revenues.

- Allow the withdrawal of funds only for a disaster or if spending remains at or below the highest level of spending from the past three years. The maximum amount that could be withdrawn in the first year of a recession would be limited to half of the fund's balance.

- Require that the state provide a multiyear budget forecast to help better manage the state's longer term finances.

- Create the Public School System Stabilization Account ("PSSSA"), a special fund that serves as a Proposition 98 reserve, whereby spikes in funding would be saved for future years. This would smooth school spending and thereby minimize future cuts. This reserve would make no changes to the Proposition 98 calculations, and it would not begin to operate until the existing maintenance factor is fully paid off.

Under current projections, Proposition 2 will result in over $6 billion in savings and $4.5 billion in additional debt payments in its first four years of operation. If capital gains increase above current projections during that period, even more money could go into the BSA.

Inter-Fund Borrowings

Inter-fund borrowing is used to meet temporary imbalances of receipts and disbursements in the General Fund. In the event the General Fund is or will be exhausted, the State Controller is required to notify the Governor and the PMIB (comprised of the Director of Finance, the State Treasurer and the State Controller). The Governor may then order the State Controller to direct the transfer of all or any part of the moneys not needed in Special Funds to the General Fund, as determined by the PMIB. All money so transferred must be returned to the special fund from which it was transferred as soon as there is sufficient money in the General Fund to do so. Transfers cannot be made which will interfere with the objective for which such special fund was created, or from certain specific funds. In general, when moneys transferred to the General Fund in any fiscal year from any special fund pursuant to the inter-fund borrowing mechanism exceed 10 percent of the total additions to such special fund as shown in the statement of operations of the preceding fiscal year as set forth in the Budgetary/Legal Basis Annual Report of the State Controller, interest must be paid on such excess at a rate determined by the PMIB to be the current earning rate of the PMIA. This provision does not apply to temporary borrowings from the BSA or other accounts within the General Fund.

The amount of loans from the SFEU, the BSA and other internal sources to the General Fund, as of the end of any month is displayed in the State Controller's Statement of General Fund Cash Receipts and Disbursements, on the first page under "Borrowable Resources – Outstanding Loans." See EXHIBIT 1 and EXHIBIT 2 to APPENDIX A.

Any determination of whether a proposed borrowing from one of the special funds is permissible must be made with regard to the facts and circumstances existing at the time of the proposed borrowing. The Attorney General has identified certain criteria relevant to such a determination. For instance, amounts in the special funds eligible for inter-fund borrowings are legally available to be transferred to the General Fund if a reasonable estimate of expected General Fund revenues, based upon legislation already enacted, indicates that such transfers can be paid from the General Fund promptly if needed by the special funds or within a short period of time if not needed. In determining whether this requirement has been met, the Attorney General has stated that consideration may be given to the fact that General Fund revenues are projected to exceed expenditures entitled to a higher priority than payment of internal transfers, i.e., expenditures for the support of the public school system and public institutions of higher education.

Enactment of Proposition 22 on November 2, 2010 prohibited future inter-fund borrowing from certain transportation funds. However, legislation (Chapter 1, Statutes of 2012 – “SB 95”) was enacted on February 3, 2012 to clarify the intent of Proposition 22, making those transportation funds available for short-term cash management borrowing purposes.

In addition to temporary inter-fund cash management borrowings described in this section, budgets enacted in the current and past fiscal years have included other budgetary transfers and long-term loans from Special Funds to the General Fund. In some cases, such budgetary loans and transfers have the effect of reducing internal borrowable resources.

The following table shows internal borrowable resources available for temporary cash management loans to the General Fund on June 30 of each of the fiscal years 2010-11 through 2013-14 and estimates the amount currently available based on the 2014-15 Budget. See EXHIBIT 1 and EXHIBIT 2 to APPENDIX A. The amount of internal borrowable resources fluctuates throughout the year.

[BALANCE OF PAGE INTENTIONALLY LEFT BLANK]

TABLE 9
Internal Borrowable Resources
(Cash Basis)

(Dollars in Millions)

	June 30					
	2011	**2012[(a)]**	**2013**	**2014**	**2015[(b)]**	**2016[(b)]**
Available Internal Borrowable Resources	$18,193.3	$20,824.3	$21,215.3	$23,761.5	$25,179.5	$28,532.4
Outstanding Loans						
From Special Fund for Economic Uncertainties	1,190.8	474.9	948.2	0	449.7	534.2
Budget Stabilization Account					1,606.4	2,826.4
From Special Funds and Accounts	6,973.7	9,118.4	1,486.7	0	1,667.6	997.2
Total Outstanding Internal Loans	(8,164.5)	(9,593.3)	(2,434.9)	0	(3,723.7)	(4,357.8)
Unused Internal Borrowable Resources	$10,028.8	$11,231.0	$18,780.4	$23,761.5	$21,455.8	$24,174.6

[(a)] Increase in internal borrowable resources at June 30, 2012 is largely a result of the SAIF program, which was in effect from September 2011 to April 2013. See "CASH MANAGEMENT – Cash Management Tools."

[(b)] Projected as 2015-16 Governor's Budget.

Source: Years ended June 30, 2011 through June 30, 2014: State of California, Office of the State Controller.
Year ending June 30, 2015 and June 30, 2016: State of California, Department of Finance.

State Warrants

No money may be drawn from the State Treasury except upon a warrant duly issued by the State Controller. The State Controller is obligated to draw every warrant on the fund out of which it is payable for the payment of money directed by state law to be paid out of the State Treasury; however, a warrant may not be drawn unless authorized by law and unless unexhausted specific appropriations provided by law are available to meet it. As described below, state law provides two methods for the State Controller to respond if the General Fund has insufficient "Unapplied Money" available to pay a warrant when it is drawn, referred to generally as "registered warrants" and "reimbursement warrants." "Unapplied Money" consists of money in the General Fund for which outstanding warrants have not already been drawn and which would remain in the General Fund if all outstanding warrants previously drawn and then due were paid subject to the prior application of such money to obligations of the state with a higher priority. See "CASH MANAGEMENT – Traditional Cash Management Tools." Unapplied Money may include moneys transferred to the General Fund from the SFEU and the BSA and internal borrowings from state Special Funds (to the extent permitted by law); however the state is not obligated to utilize interfund borrowings for the payment of state obligations if insufficient Unapplied Money is available for such payment. See "STATE FINANCES – Budget Reserves – Special Fund for Economic Uncertainties" and "Inter-Fund Borrowings."

1. Registered Warrants

If a warrant is drawn on the General Fund for an amount in excess of the amount of Unapplied Money in the General Fund, after deducting from such Unapplied Money the amount, as estimated by the State Controller, required by law to be earmarked, reserved or set apart from the Unapplied Money for the payment of obligations having priority over obligations to which such warrant is applicable, the warrant must be registered on the reverse side as not paid because of the shortage of funds in the General Fund. The State Controller may issue registered warrants before exhausting all cash management tools that could provide Unapplied Money to the General Fund. See "CASH MANAGEMENT."

Registered warrants are interest bearing obligations that may be issued either with or without a maturity date. Most registered warrants bear interest at a rate designated by the PMIB up to a maximum of five percent per annum except, if the PMIB determines that it is in the best interests of the state to do so, the PMIB may fix the rate of interest paid on registered warrants at no more than 12 percent per annum. If issued with a maturity date, the principal and interest on such warrant will not be due until that date (although it may be optionally redeemed early if the state has sufficient Unapplied Money to do so) and the state may make other payments prior to that maturity date. If a registered warrant is issued without a maturity date, or its maturity date has occurred, it becomes redeemable by the holders on the date determined by the State Controller, with the approval of the PMIB.

State law generally requires that registered warrants be redeemable in the order they are issued but not prior to their maturity date, if any. The state issued approximately $2.6 billion of registered warrants to pay certain obligations of the state not having payment priority under law commencing on July 2, 2009, all of which were called for early redemption on September 4, 2009. (The State Controller was able to manage cash resources to ensure that higher priority payments, such as for schools and debt service, were made on time in July and August 2009.) The issuance of the registered warrants permitted the state to pay Priority Payments with regular warrants which could be cashed.

2. Reimbursement Warrants

In lieu of issuing individual registered warrants to numerous creditors, state law provides an alternative procedure whereby the Governor, upon request of the State Controller, may authorize utilizing the General Cash Revolving Fund in the State Treasury to borrow from other state Special Funds to meet payments authorized by law. The State Controller may then issue "reimbursement warrants" (sometimes called "revenue anticipation warrants" or "RAWs") for sale to investors to reimburse the General Cash Revolving Fund, thereby increasing cash resources for the General Fund to cover required payments. The General Cash Revolving Fund exists solely to facilitate the issuance of reimbursement warrants. Reimbursement warrants have a fixed maturity date which may not be later than the end of the fiscal year following the year in which they were issued.

The principal of and interest on reimbursement warrants must be paid by the State Treasurer on their respective maturity dates from any Unapplied Money in the General Fund and available for such payment. In the event that Unapplied Money is not available for payment on the respective maturity dates of reimbursement warrants, and refunding reimbursement warrants (see "− Refunding Reimbursement Warrants") have not been sold at such times as necessary to pay such reimbursement warrants, such reimbursement warrants will be paid, together with all interest due thereon (including interest accrued at the original interest rate after the maturity date), at such times as the State Controller, with the approval of the PMIB, may determine.

The state has issued reimbursement warrants on several occasions in order to meet its cash needs when state revenues were reduced because of an economic recession, and the state incurred budget deficits. The state last issued reimbursement warrants in June 2002 and in June 2003.

3. *Refunding Reimbursement Warrants*

If it appears to the State Controller that, on the maturity date of any reimbursement warrant there will not be sufficient Unapplied Money in the General Fund to pay maturing reimbursement warrants, the State Controller is authorized under state law, with the written approval of the State Treasurer, to issue and sell refunding reimbursement warrants to refund the prior, maturing reimbursement warrants. Proceeds of such refunding reimbursement warrants must be used exclusively to repay the maturing warrants. In all other respects, refunding reimbursement warrants are treated like reimbursement warrants, as described above.

Sources of Tax Revenue

The following is a summary of the state's major tax revenues and tax laws. Further information on state revenues is contained under "CURRENT STATE BUDGET," and "STATE FINANCES – Recent Tax Receipts." In fiscal year 2013-14, approximately 97.5 percent of the state's General Fund revenues and transfers were derived from personal income taxes, corporation taxes, and sales and use taxes. See Table 16 titled "Comparative Yield of State Taxes – All Funds, Fiscal Years 2009-10 through 2015-16" for a summary of the actual and projected sources of the state's tax revenue for those fiscal years.

1. *Personal Income Tax*

The California personal income tax is closely modeled after the federal income tax law. It is imposed on net taxable income (gross income less exclusions and deductions), with rates ranging from 1 percent to 12.3 percent. In addition, a 1 percent surcharge is imposed on taxable income above $1 million and proceeds from such tax are dedicated to the Mental Health Services Fund. The personal income tax brackets, along with other tax law parameters, are adjusted annually by the change in the consumer price index to prevent taxpayers from being pushed into higher tax brackets without a real increase in income. Personal, dependent, and other credits are allowed against the gross tax liability. In addition, taxpayers may be subject to an alternative minimum tax ("AMT"), which is much like the federal AMT. The personal income tax structure is considered to be highly progressive. For example, the Franchise Tax Board indicates that the top 1 percent of taxpayers paid 50.6 percent of the total personal income tax in tax year 2012.

The 2015-16 Governor's Budget revenue projections include the revenue expected from Proposition 30 (The Schools and Local Public Safety Protection Act of 2012) passed by the voters on November 6, 2012. This measure provides for an increase in the personal income tax rate of 1 percent for joint filing taxpayers with income above $500,000 and equal to or below $600,000; 2 percent increase for incomes above $600,000 and equal to or below $1,000,000; and three percent increase for incomes above $1,000,000. Tax rates for single filers will start at incomes one-half those for joint filers. These additional rates will remain in effect for seven years, commencing with calendar year 2012. The Administration estimates that the additional revenue from the addition of the three new tax brackets was $5.5 billion in fiscal year 2012-13 and $6.0 billion in fiscal year 2013-14, and is projected to be $6.5 billion in fiscal year 2014-15, and $6.5 billion in fiscal year 2015-16.

[BALANCE OF PAGE INTENTIONALLY LEFT BLANK]

TABLE 10
Personal Income Tax General Fund Revenues (PIT)
Fiscal Years 2009-10 through 2015-16

Fiscal Year	Dollars In Millions	Percent Total General Fund Revenues And Transfers
2009-10[a]	44,852	51.5
2010-11[a]	49,445	52.9
2011-12[b]	54,261	62.5
2012-13[b]	64,484	64.9
2013-14[b][e]	66,560	64.8
2014-15[b][e]	71,699	66.4
2015-16[b][e]	75,213	66.3

[a] Includes revenue from the temporary 0.25 percent surcharge on all personal income tax brackets and a reduction in the dependent exemption credit in 2009 and 2010.

[b] Includes revenue from the higher rates imposed by Proposition 30 that are dedicated to the Education Protection Account. See "Proposition 98 and K-14 Funding."

[e] Estimated.

Source: State of California, Department of Finance.

Personal income tax receipts over the past few years have been impacted by changes in federal tax legislation, including increases in the rate of taxation on capital gains and a surtax on certain unearned income which went into effect on January 1, 2013. This led to the acceleration of realization of some income into calendar year 2012, for fiscal year 2012-13, which might otherwise have been received in a later fiscal year.

Taxes on capital gains realizations, which are linked to stock market and real estate performance, can add significant volatility to personal income tax receipts. For example, capital gains tax receipts accounted for nearly 12 percent of General Fund revenues and transfers in 1999-00 and 2000-01, but dropped below 4 percent in 2002-03 and 2009-10. The 2015-16 Budget projects that capital gains will account for 10.7 percent of General Fund revenues and transfers in fiscal year 2014-15, and 9.3 percent in fiscal year 2015-16. See "CURRENT STATE BUDGET – Budget Risks."

The following table shows actual and projected tax revenues related to capital gains (which are included in the table showing total personal income tax receipts above):

[BALANCE OF PAGE INTENTIONALLY LEFT BLANK]

TABLE 11
Revenues from Capital Gains
Fiscal Years 2006-07 through 2015-16

Fiscal Year	Dollars In Millions	Percent Total General Fund Revenues And Transfers
2006-07	$9,999	10.5%
2007-08	8,980	8.8
2008-09	3,863	4.7
2009-10	2,983	3.4
2010-11	4,526	4.8
2011-12	6,020	6.9
2012-13	9,709	9.8
2013-14	9,269	9.0
2014-15[(a)]	11,567	10.7
2015-16[(a)]	10,577	9.3

[(a)] Revenues and Transfers include transfers of $1.6 billion in 2014-15 and $1.2 billion in 2015-16 to the Budget Stabilization Account.

Source: State of California, Franchise Tax Board provided calendar year estimates based on actual capital gains realizations through 2011. From 2012 onward, State of California, Department of Finance estimated calendar year capital gains based on actual capital gains realizations for 2012 and the forecasted realizations for 2013 and forward. Fiscal year totals shown in this table are estimated by adding 70 percent of calendar year total in first half of fiscal year to 30 percent of calendar year total in second half of fiscal year.

2. *Sales and Use Tax*

The sales tax is imposed upon retailers for the privilege of selling tangible personal property in California. Most retail sales and leases are subject to the tax. However, exemptions have been provided for certain essentials such as food for home consumption, prescription drugs, gas delivered through mains, and electricity. Other exemptions provide relief for a variety of sales ranging from custom computer software to aircraft.

The California use tax is imposed at the same rates as the regular sales tax on consumers of tangible personal property that is used, consumed, or stored in this state. Use tax applies to purchases from out-of-state vendors that are not required to collect tax on their sales. Use tax also applies to most leases of tangible personal property.

As of January 1, 2015, the breakdown for the uniform statewide state and local sales and use tax (referred to herein as the "sales tax") rate of 7.50 percent was as follows (many local jurisdictions have voted additional sales taxes for local purposes):

- 3.9375 percent imposed as a state General Fund tax;
- 0.25 percent dedicated to the Education Protection Account, per Proposition 30.

- 1.0625 percent dedicated to local governments for realignment purposes (Local Revenue Fund 2011);
- 0.5 percent dedicated to local governments for health and welfare program realignment (Local Revenue Fund);
- 0.5 percent dedicated to local governments for public safety services (Local Public Safety Fund);
- 1.0 percent local tax imposed under the Uniform Local Sales and Use Tax Law, with 0.25 percent dedicated to county transportation purposes and 0.75 percent for city and county general-purpose use; and
- 0.25 percent deposited into the Fiscal Recovery Fund to repay the state's ERBs (the "special sales tax").

Passage of Proposition 30 added a 0.25 percent additional sales tax rate from January 1, 2013 through December 31, 2016. Proposition 30 also constitutionally guarantees that the 1.0625 percent of the sales tax rate is dedicated to the cost of the realignment of certain defined public safety services programs from the state to the counties and explicitly states that this sales tax revenue does not constitute General Fund revenue for purposes of the Proposition 98 guarantee. The 1.0625 percent of the sales tax rate was expected to generate $6.2 billion in fiscal year 2014-15 and $6.6 billion in fiscal year 2015-16.

Legislation passed as part of the 2011 Budget Act imposes a use tax collection responsibility for certain out-of-state, and particularly internet, retailers who meet certain criteria. The new responsibility took effect in September 2012. In fiscal year 2012-13, $132 million in General Fund revenue was received as a result of this legislation. Additional General Fund revenue from this source is estimated at $202 million in fiscal year 2013-14, $233 million in fiscal year 2014-15, and $267 million in fiscal year 2015-16.

Existing law provides that 0.25 percent of the base state and local sales tax rate may be suspended in any calendar year upon certification by the Director of Finance, by November 1 in the prior year, that both of the following have occurred: (1) the General Fund reserve (excluding the revenues derived from the 0.25 percent special sales tax) is expected to exceed 3 percent of revenues in that fiscal year (excluding the revenues derived from the 0.25 percent special sales tax) and (2) actual revenues for the period May 1 through September 30 equal or exceed the previous May Revision forecast. The 0.25 percent rate will be reinstated the following year if the Director of Finance subsequently determines conditions (1) or (2) above are not met for that fiscal year. The Department of Finance estimates that the reserve level will be insufficient to trigger a reduction for calendar year 2015. See "Proposed Fiscal Year 2015-16 Budget – Summary of State Revenues and Expenditures" for a projection of the fiscal years 2014-15 and 2015-16 General Fund Reserve.

Existing law provides that the special sales tax will be collected until the first day of the calendar quarter at least 90 days after the Director of Finance certifies that all ERBs and related obligations have been paid or retired or provision for their repayment has been made or enough sales taxes have been collected to pay all ERBs and related obligations to final maturity. At such time the special sales tax will terminate and the city and county portion of taxes under the uniform local sales and use tax will be automatically increased by 0.25 percent. The 2015-16 Governor's Budget anticipates that the ERBs will be repaid or funds to pay the outstanding ERBs will have been set aside in an irrevocable escrow fund by the first quarter of fiscal year 2015-16. See "STATE INDEBTEDNESS AND OTHER OBLIGATIONS – Economic Recovery Bonds." A large portion, and perhaps all, of the special sales taxes collected between the date all the ERBs are paid or defeased, and January 1, 2016, will be used to pay back cities and counties for the revenue they had foregone from the loss of 0.25 percent tax rate under the uniform local sales and use tax.

The following table shows actual and projected sales and use tax revenue:

TABLE 12
Sales and Use Tax General Fund Revenues
Fiscal Years 2009-10 through 2015-16

Fiscal Year	Dollars In Millions	Percent Total General Fund Revenues And Transfers
2009-10[a]	$26,741	30.7%
2010-11[a]	26,983	28.9
2011-12	18,658	21.5
2012-13[b]	20,482	20.6
2013-14[b][e]	22,263	21.7
2014-15[b][e]	23,438	21.7
2015-16[b][e]	25,166	22.2

[a] Includes revenue from an additional 1 percent tax rate effective from April 1, 2009 to June 30, 2011.

[b] Includes revenue from the higher rates imposed by Proposition 30 that are dedicated to the Education Protection Account.

[e] Estimated.

Source: State of California, Department of Finance.

3. *Corporation Tax*

Corporation tax revenues are derived from the following taxes:

1. The Franchise Tax and the Corporate Income Tax are levied at an 8.84 percent rate on profits. The former is imposed on corporations for the privilege of doing business in California, while the latter is imposed on corporations that derive income from California sources but are not sufficiently present to be classified as doing business in the state.

2. Banks and other financial corporations are subject to the franchise tax plus an additional tax at the rate of 2 percent on their net income. This additional tax is in lieu of personal property taxes and business license taxes.

3. The AMT is similar to that in federal law. In general, the AMT is based on a higher level of net income computed by adding back certain tax preferences. This tax is imposed at a rate of 6.65 percent.

4. A minimum Franchise Tax of up to $800 is imposed on corporations subject to the franchise tax but not on those subject to the corporate income tax. New corporations are exempted from the minimum franchise tax for the first year of incorporation.

5. Sub-Chapter S corporations are taxed at 1.5 percent of profits.

6. Fees paid by limited liability companies ("LLCs"), which account for 3.6 percent of corporation tax revenue, are considered "corporation taxes."

Six actions have been filed contending that the Legislature's modification of Revenue and Taxation Code Section 25128, which implemented the double-weighting of the sales factor in California's apportionment of income formula for the taxation of multistate business entities, is invalid and/or unconstitutional. Now consolidated in one matter and collectively referred to as *Gillette Company v. Franchise Tax Board ("Gillette")*, the plaintiffs contend that the single-weighted sales factor specified in Section 25128 prior to amendment was contained within the Multistate Tax Compact ("MTC") and therefore cannot be modified without repealing the legislation that enacted MTC. An adverse ruling in these cases could affect multiple taxpayers and create potential exposure to refund claims for past years of approximately $750 million. The trial court ruled for the state in each of these matters, but the California Court of Appeal ruled on October 2, 2012 in favor of the taxpayers. The Franchise Tax Board has requested and the California Supreme Court has accepted review of this case and a decision is not expected until mid-2015. Even if the taxpayers prevail in the Supreme Court in these cases, they will likely be remanded to the trial court to determine other issues not considered before these appeals arose. Therefore, if the *Gillette* taxpayers are ultimately successful in their suit for refund, the vast majority of the revenue loss may not occur for several years. See "LITIGATION – Tax Cases."

One significant revenue measure enacted as part of the 2012-13 Budget was repeal of the state's participation in MTC, as a response to the *Gillette* litigation. By repealing its participation in MTC, the state will ensure that most taxpayers will not be allowed to use the equal weighted sales formula for apportioning income for calendar year 2012 and later tax years. Nonetheless, the current ruling in the *Gillette* case could result in a revenue loss of up to $150 million in fiscal year 2014-15 at the earliest (although these amounts could be recaptured if the state ultimately prevails in the case at the California Supreme Court).

Another portion of the legislation repealing the state's participation in MTC finds and declares that there is a common law doctrine stating that elections affecting the computation of tax must be made on original tax returns. This provision seeks to render ineffective most attempts by taxpayers to file amended returns and obtain retroactive refunds, in the event that the state ultimately loses the *Gillette* cases. However, the implementation of this provision is likely to engender further litigation and the outcome cannot be assured.

The following table shows actual and projected corporate income tax revenues:

TABLE 13
Corporate Income Tax Revenues
Fiscal Years 2009-10 through 2015-16

Fiscal Year	Dollars In Millions	Percent Total General Fund Revenues And Transfers
2009-10	$9,115	10.5%
2010-11	9,614	10.3
2011-12	7,233	8.3
2012-13	7,783	7.8
2013-14[(e)]	8,858	8.6
2014-15[(e)]	9,618	8.9
2015-16[(e)]	10,173	9.0

[(e)] Estimated, see paragraph following Table 14.

Source: State of California, Department of Finance.

Legislation enacted in the budget acts of 2008, 2009, and 2010 is expected to significantly reduce corporation tax revenues. The third column of Table 14 shows that, while that legislation added over $1 billion of revenue in fiscal year 2008-09 and 2009-10, by fiscal year 2011-12, that legislation is expected to generate, on a net basis, a revenue loss of almost $1 billion in each fiscal year. Starting in fiscal year 2012-13, that legislation is expected to generate revenue losses of about $1.3 billion per year. However, the passage of Proposition 39 on November 6, 2012 reverses portions of these recent tax changes. Proposition 39 is expected to generate revenue gains of $677 million in fiscal year 2014-15 and over $736 million in fiscal year 2015-16 and subsequent years. The legislatively enacted law changes, together with Proposition 39, are expected to generate a net revenue loss of $600 million in fiscal year 2014-15 and $351 million in fiscal year 2015-16. Not all of the revenue generated by Proposition 39, however, benefits the General Fund, as the measure dedicates about half of the new revenues in fiscal years 2013-14 to 2017-18 to energy programs. See the table below for the impact of legislation since 2008 and Proposition 39 on prior fiscal years.

[BALANCE OF PAGE INTENTIONALLY LEFT BLANK]

TABLE 14
Impact of Legislation and Proposition 39 on Corporate Income Tax Revenues
Fiscal Years 2008-09 through 2015-16

(Dollars in Millions)

Fiscal Year	Total	Impact of Enacted Legislation	Impact of Proposition 39	Net Impact of Law Changes Since 2008
2008-09	9,536	$1,095	$0	$1,095
2009-10	9,115	1,266	0	1,226
2010-11	9,614	139	0	139
2011-12	7,233	(870)	0	(870)
2012-13	7,783	(1,599)	292	(1,307)
2013-14	8,858(e)	(1,469)	595	(874)
2014-15	9,618(e)	(1,277)	677	(600)
2015-16	10,173(e)	(1,087)	736	(351)

(e) Estimated.

Source: State of California, Department of Finance.

As shown in Table 14, state tax law changes made in 2008 and 2009 to deal with the budget crisis traded short-term revenue gains for reduced corporate taxes in later years. For example, in fiscal year 2011-12 and fiscal year 2012-13, corporate profits were rebounding strongly, yet revenue declined significantly. In more recent years, continued strong corporate profit growth combined with the lessening impact of legislation is leading to stronger corporate income tax revenues. However, the projected level of corporate income tax revenues in fiscal year 2015-16 is still below the peak level of $11.8 billion in fiscal year 2007-08.

4. *Insurance Tax*

The majority of insurance written in California is subject to a 2.35 percent gross premium tax. For insurers, this premium tax takes the place of all other state and local taxes except those on real property and motor vehicles. Exceptions to the 2.35 percent rate are certain pension and profit-sharing plans which are taxed at the lesser rate of 0.5 percent, surplus lines and non-admitted insurance at 3 percent and ocean marine insurers at 5 percent of underwriting profits.

5. *Other Taxes*

Other General Fund taxes and licenses include: Cigarette Taxes; Alcoholic Beverage Taxes; Horse Racing License Fees; and Trailer Coach License Fees.

6. *Special Fund Revenues*

The state Constitution and statutes specify the uses of certain revenues. Such receipts are accounted for in various special funds. In general, special fund revenues comprise three categories of income:

- Receipts from tax levies which are allocated to specified functions, such as motor vehicle taxes and fees and certain taxes on tobacco products.

- Charges for certain services provided by the state government to individuals, businesses, or organizations, such as fees for the provision of business and professional licenses.

- Rental royalties and other receipts designated for particular purposes (e.g., oil and gas royalties).

Motor vehicle-related taxes and fees are projected to account for approximately 25 percent of all special fund revenues in fiscal year 2015-16. Principal sources of this income are motor vehicle fuel taxes, registration and weight fees and vehicle license fees. In fiscal year 2015-16, $11.4 billion is projected to come from the ownership or operation of motor vehicles. About $4.3 billion of this revenue is projected to be returned to local governments. The remainder will be available for various state programs related to transportation and services to vehicle owners. For a discussion of Proposition 1A of 2004, which replaced a portion of vehicle license fees with increased property tax revenues, see "STATE FINANCES – Local Governments."

7. Taxes on Tobacco Products

The state imposes an excise tax on cigarettes of 87 cents per pack and the equivalent rates on other tobacco products. Tobacco product excise tax revenues are earmarked as follows:

1. Fifty cents of the per-pack tax on cigarettes and the equivalent rate levied on non-cigarette tobacco products are deposited in the California Children and Families First Trust Fund and are allocated primarily for early childhood development programs.

2. Twenty-five cents of the per-pack tax on cigarettes and the equivalent rates levied on non-cigarette tobacco products are allocated to the Cigarette and Tobacco Products Surtax Fund. These funds are appropriated for anti-tobacco education and research, indigent health services, and environmental and recreation programs.

3. Ten cents of the per-pack tax is allocated to the state's General Fund.

4. The remaining two cents of the per-pack tax is deposited into the Breast Cancer Fund.

Recent Tax Receipts

The following table shows the trend of major General Fund and total taxes per capita and per $100 of personal income for the past four fiscal years, the current fiscal year, and the budget year.

TABLE 15
Recent Tax Receipts

	State Taxes Per Capita[a]		Taxes per $100 of Personal Income	
Fiscal Year	General Fund	Total	General Fund	Total
2010-11	$2,409.86	$2,866.35	$5.70	$6.77
2011-12[b]	2,205.21	2,830.72	4.92	6.31
2012-13[b][c]	2,520.48	3,163.61	5.29	6.64
2013-14[b][c]	2,633.04	3,323.58	5.41	6.83
2014-15[b][c]	2,797.37	3,513.98	5.56	6.98
2015-16[b][c]	2,922.39	3,634.29	5.61	6.97

[a] Data reflects July 1 population estimates benchmarked to the 2010 Census.

[b] Includes revenues from Proposition 30.

[c] Includes revenues from Proposition 39.

Source: State of California, Department of Finance.

The following table displays the actual and estimated revenues by major source for the past four fiscal years, the current fiscal year, and the budget year. This table shows taxes that provide revenue both to the General Fund and state special funds.

[BALANCE OF PAGE INTENTIONALLY LEFT BLANK]

TABLE 16
Comparative Yield of State Taxes – All Funds
Fiscal Years 2010-11 through 2015-16
(Modified Accrual Basis)

(Dollars in Thousands)

Fiscal Year	Sales and Use[a]	Personal Income[b]	Corporation[c]	Tobacco	Inheritance, Estate and Gift[d]	Insurance[e]	Alcoholic Beverage	Horse Racing	Motor Vehicle Fuel[f]	Motor Vehicle Fees[g]
2010-11	$33,443,592	$50,508,431	$9,613,595	$906,807	$0	$2,307,021	$334,178	$13,078	$5,705,527	$6,568,834
2011-12	31,245,211	54,635,590	7,962,603	897,355	0	2,415,781	346,241	15,838	5,544,530	5,908,046
2012-13	33,847,381	66,647,862	7,459,443	867,906	0	2,242,697	356,527	14,089	5,492,850	5,903,604
2013-14	43,925,965	67,976,000	8,107,000	812,464	0	2,287,000	351,000	14,589	6,014,023	6,051,483
2014-15[h]	46,079,168	73,500,570	9,617,712	791,830	0	2,490,301	366,901	14,984	5,679,036	6,368,834
2015-16[h]	49,074,944	76,967,557	10,173,304	770,499	0	2,530,729	373,698	15,384	4,909,791	6,555,937

[a] These figures:

- Fiscal years 2010-11 through 2013-14 include allocations to the General Fund, Public Transportation Account, State Fiscal Recovery Fund, Local Public Safety Fund, Local Revenue Fund (1991 Realignment), and the 2011 Local Revenue Fund (2011 Realignment). The figures do not include the Bradley Burns tax, dedicated to city and county operations. The 2011 Realignment, which redirects 1.0625 percent to the Local Revenue Fund 2011, began in fiscal year 2011-12 and is ongoing.
- Fiscal years 2014-15 through 2015-16 include allocations to the General Fund, Public Transportation Account, State Fiscal Recovery Fund, Local Public Safety Fund, and both Local Revenue Funds (1991 and 2011 Realignment), and the Bradley Burns tax, which is dedicated to city and county operations.
- For fiscal year 2010-11, includes the impact of a temporary increase in the General Fund sales and use tax rate from 5 percent to 6 percent, effective April 1, 2009 through June 30, 2011.
- Includes the impact of the fuel tax swap that eliminated the General Fund portion of sales and use tax on motor vehicle gasoline fuel sales.
- Beginning in fiscal year 2012-13, includes the impact of Proposition 30 (The Schools and Local Public Safety Protection Act of 2012). Proposition 30 temporarily increases the state sales tax by 0.25 percent effective January 1, 2013 through December 31, 2016. See "STATE FINANCES–Sources of Tax Revenue – Sales and Use Tax."
- Beginning in fiscal year 2013-14, includes revenue for a tax on Medi-Cal managed care premiums, with the rate being equal to the state General Fund sales tax rate.

(Footnotes Continued on Following Page)

(Continued from Previous Page)

[b] These figures include the revenue estimate for a 1.0 percent surcharge on taxpayers with taxable income over $1 million, with the proceeds funding mental health programs pursuant to Proposition 63.

Starting in fiscal year 2011-12, the figures also include the impact of Proposition 30. Proposition 30 temporarily adds three tax brackets for taxable incomes beginning at $250,000 ($500,000 joint) with rates of 10.3 percent, 11.3 percent, and 12.3 percent effective retroactive to January 1, 2012 through December 31, 2018.

Starting in fiscal year 2013-14, these figures include the impact of the economic development initiative, Chapters 69 and 70, Statutes of 2013 (AB 93 and SB 90).

[c] These figures include impact of legislation on corporate tax revenues in the budget acts of 2008, 2009 and 2010, which accelerated corporate tax (CT) collections in fiscal years 2008-09 through 2010-11, and reduced CT collections starting in fiscal year 2011-12. See "STATE FINANCES – Sources of Tax Revenue – Corporation Tax" for a discussion of the impact of legislation on corporate income tax revenues.

Starting in fiscal year 2012-13, these figures include the impact of Proposition 39, effective for tax years beginning January 1, 2013.

Starting in fiscal year 2013-14, these figures include the impact of the economic development initiative, Chapters 69 and 70, Statutes of 2013 (AB 93 and SB 90).

[d] From fiscal years 2008-09 through 2011-12, the state estate tax is based on the state death tax credit allowed against the federal estate tax. As a result, the federal Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) progressively reduced the state estate tax in calendar years 2002 through 2004 and eliminated it beginning in calendar year 2005. The EGTRRA was scheduled to sunset after 2010, at which time the federal estate tax would have been reinstated along with the state estate tax. The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, however, made changes to the estate tax for 2011 and 2012. One of those changes was an extension for 2011 and 2012 of the elimination of the state estate tax credit, which had been in effect since 2005.

The American Taxpayer Relief Act of 2012 permanently eliminated state death tax credit (and thus the state portion of estate tax) beginning January 1, 2013.

[e] Figures include insurance tax on Medi-Cal managed care plans from fiscal year 2009-10 through 2012-13. A Board of Equalization decision regarding the taxation of premiums on cash versus accrued basis has resulted in refunds of $15 million in fiscal year 2008-09, $0 million in fiscal year 2009-10, $2 million in fiscal year 2010-11, about $10 million in fiscal year 2012-13, and estimated refunds of $35 million in fiscal year 2013-14, $10 million in fiscal year 2014-15 and $26 million in fiscal year 2015-16.

[f] These figures include motor vehicle fuel tax (gasoline), use fuel tax (diesel and other fuels), and jet fuel tax.

Starting in fiscal year 2010-11, the figures include the revenue impact of the fuel tax swap that eliminated the General Fund portion of sales and use tax on motor vehicle gasoline fuel sales beginning in 2010-11.

Excise Tax on Gasoline fuel: As part of the fuel tax swap implemented beginning July 1, 2010, the excise tax rate on gasoline fuel was increased from 18 cents to 35.3 cents in fiscal year 2010-11. It was set at 35.7 cents in fiscal year 2011-12, 36 cents in fiscal year 2012-13, 39.5 cents in fiscal year 2013-14, 36 cents in fiscal year 2014-15, and is forecast to decrease to 30.5 cents in fiscal year 2015-16. This rate will be adjusted each year to maintain revenue neutrality with the elimination of the General Fund portion of sales tax on gasoline fuel.

Excise Tax on Diesel fuel: Also as part of the fuel tax swap, the excise tax rate on diesel fuel was reduced from 18 cents to 13 cents in fiscal year 2011-12, 10 cents in fiscal year 2012-13 and 2013-14, increased to 11 cents in fiscal year 2014-15, and is forecast to increase to 12.5 cents in 2015-16. This rate will also be adjusted each year to maintain revenue neutrality with a sales tax increase on diesel fuel.

[g] Registration and weight fees, motor vehicle license fees and other fees. See "STATE FINANCES – Local Governments."

For fiscal year 2010-11, the figure includes the impact of a temporary increase in the vehicle license fee from 0.65 percent to 1.15 percent, effective May 19, 2009 through June 30, 2011. Starting in fiscal year 2011-12, the vehicle license fee decreased from 1.15 percent to 0.65 percent.

[h] Estimated for fiscal years 2014-15 and 2015-16.

Note: This table includes revenues accruing both to the General Fund and special funds. Some revenue sources are dedicated to local governments.

Source: Actual amounts for fiscal years 2010-11 through 2013-14: State of California, Office of the State Controller.

Estimated amounts for fiscal years 2014-15 and 2015-16: State of California, Department of Finance.

State Expenditures

The following table summarizes the major categories of state expenditures, including both General Fund and special fund programs for fiscal years 2008-09 through 2012-13. (Information for fiscal year 2013-14 is expected to be available from the State Controller's Office by March 2015.)

TABLE 17
Governmental Cost Funds (Budgetary Basis)
Schedule of Expenditures by Function and Character
Fiscal Years 2008-09 to 2012-13

(Dollars in Thousands)

	Fiscal Year				
	2008-09	**2009-10[d][e]**	**2010-11[d][e][f]**	**2011-12[d]**	**2012-13[d]**
Function					
Legislative, Judicial, Executive					
Legislative	$ 330,594	$ 323,371	$ 325,244	$ 331,052	$ 329,903
Judicial	3,962,289	2,606,012	3,742,539	3,360,882	2,961,759
Executive	1,669,476	1,615,119	1,810,506	1,543,381	1,548,666
State and Consumer Services	1,248,522	1,079,608	1,173,185	1,249,034	1,275,754
Business, Transportation and Housing					
Business and Housing	228,408	215,295	227,899	239,838	211,466
Transportation[a]	7,331,284	7,178,962	7,109,753	5,452,535	5,950,645
Natural Resources	3,225,625	3,307,987	3,414,859	3,358,016	3,505,612
Environmental Protection	1,032,212	831,753	962,109	1,027,911	907,427
Health and Human Services	35,041,981	31,129,184	41,642,841	41,359,564	44,613,839
Corrections and Rehabilitation	9,566,474	7,860,690	9,514,121	7,892,864	8,530,717
Education					
Education – K through 12	34,354,841	33,850,883	33,193,396	32,755,642	39,789,023
Higher Education	9,486,317	9,735,095	10,623,763	9,256,322	9,055,279
Labor and Workforce Development	414,307	374,059	370,993	700,449	710,343
General Government					
General Administration	1,728,781	1,711,273	1,757,991	1,712,184	1,948,034
Debt Service	5,693,895	6,049,251	6,222,307	6,561,871	5,721,714
Tax Relief	480,312	438,725	438,082	434,385	427,285
Shared Revenues	1,976,050	2,151,407	2,231,710	1,997,607	3,660,110
Other Statewide Expenditures	1,168,937	54,058	1,330,757	1,453,787	1,365,657
Expenditure Adjustment for Encumbrances [b]	551,826	1,785,703	18,316	2,195,656	(136,097)
Credits for Overhead Services by General Fund	(507,543)	(362,614)	(417,786)	(485,301)	(592,314)
Statewide Indirect Cost Recoveries	(94,458)	(80,454)	(100,543)	(109,807)	(132,847)
Total	$ 118,890,130	$ 111,855,367	$ 125,592,042	$ 122,287,872	$ 131,651,975
Character					
State Operations	$ 38,101,282	$ 36,673,078	$ 40,451,395	$ 39,579,635	$ 39,122,859
Local Assistance [c]	78,795,864	72,795,422	84,254,039	81,820,212	91,890,033
Capital Outlay	1,992,984	2,386,867	886,608	888,025	639,083
Total	$ 118,890,130	$ 111,855,367	$ 125,592,042	$ 122,287,872	$ 131,651,975

[a] Beginning with fiscal year 2011-12, the Department of Transportation ("DOT") changed the basis of financial reporting from a modified accrual basis to a cash basis for the State Highway Account ("Fund 0042"), the Public Transportation Account ("Fund 0046"), the Traffic Congestion Relief Fund ("Fund 3007"), the Transportation Investment Fund ("Fund 3008"), and the Transportation Deferred Investment Fund ("Fund 3093"). This change resulted in a reduction of the reported expenditures by DOT in these funds for fiscal year 2011-12 due to expenditures incurred, but not paid in fiscal year 2011-12 not being accrued, and the fiscal year 2010-11 reported accruals being reversed. Therefore, in fiscal year 2012-13, reported expenditures increased. The change to cash basis financial reporting for these funds was done at the direction of the Department of Finance, in accordance with the following statutes: Streets and Highways Code Section 183(c), for Fund 0042; Public Utilities Code Section 99310.6, for Fund 0046; Government Code Section 14556.5(b), for Fund 3007; Revenue and Taxation Code Section 7104.3, for Fund 3008; and Revenue and Taxation Code Section 7105(g), for Fund 3093.

(Footnotes Continued on Following Page)

(Continued from Previous Page)

[b] For fiscal year 2008-09 Expenditure Adjustments for Encumbrances has an abnormal balance due to prior year reversal of over encumbered expenditures. Subsequent Budget adjustments per Executive Order S-09-08 issued July 31st did not allow for full expenditure of anticipated encumbered expenses. Health and Human Services, Corrections and Rehabilitation, and Higher Education had the most significant reductions.

Fiscal years 2009-10, 2010-11 and 2011-12 have an abnormal balance due to the prior year reversal of over encumbered expenditures.

In fiscal years 2011-12 and 2012-13 the change to cash basis financial reporting by the DOT in Funds 0042, 0046, 3007, 3008, and 3093 accounts for most of the abnormal balance and the large variance between the two fiscal years.

[c] In fiscal year 2009-10, Proposition 1A of 2004 was suspended when Governor Schwarzenegger declared a fiscal emergency allowing the state to offset local assistance expenditures with $1.9 billion of property tax revenue borrowed from the local governments. The state repaid the obligation, plus interest, in June 2013. Additionally, $1.7 billion of local property tax revenues were shifted to offset General Fund costs in fiscal year 2009-10, $350 million were shifted in fiscal year 2010-11 and in fiscal year 2011-12 another $43 million were shifted.

[d] Executive Orders 10/11-A, 11/12-A, 12/13-A and 13/14-A were issued by the Department of Finance, as authorized under Control Section 12.45 of the Budget Acts of 2009, 2010, 2011 and 2012, respectively, and pursuant to Government Code Sections 12472.5 and 13302, to defer the June 2010, June 2011, June 2012 and June 2013 payroll expenditures for various governmental and nongovernmental cost funds to July 2010, July 2011, July 2012 and July 2013. This affected all state departments paid through the uniform payroll system.

[e] The Department of Conservation ("DOC") did not submit the required year-end financial statements to the State Controller's Office for fiscal years 2009-10 and 2010-11 in time to be included in the Budgetary/Legal Basis Annual Report ("BLBAR"). The DOC amounts reported in the BLBAR include the June 30, 2010 and June 30, 2011 cash balances, plus accruals, derived from actual activity reported through November 30, 2010 and December 5, 2011, respectively.

[f] The State Air Resources Board ("ARB") did not submit the required year-end statements for the Motor Vehicle Account, in the State Transportation Fund, to the State Controller's office for fiscal year 2010-11 in time to be included in the BLBAR. The Motor Vehicle Account amounts reported in the BLBAR include the ARB's June 30, 2011 cash balances plus estimated (not reconciled) accrual amounts provided by ARB.

Source: State of California, Office of the State Controller.

State Appropriations Limit

The state is subject to an annual appropriations limit imposed by Article XIII B of the state Constitution (the "Appropriations Limit"). The Appropriations Limit does not restrict appropriations to pay debt service on voter-authorized bonds.

Article XIII B prohibits the state from spending "appropriations subject to limitation" in excess of the Appropriations Limit. "Appropriations subject to limitation," with respect to the state, are authorizations to spend "proceeds of taxes," which consist of tax revenues, and certain other funds, including proceeds from regulatory licenses, user charges or other fees to the extent that such proceeds exceed "the cost reasonably borne by that entity in providing the regulation, product or service," but "proceeds of taxes" exclude most state subventions to local governments, tax refunds and some benefit payments such as unemployment insurance. No limit is imposed on appropriations of funds which are not "proceeds of taxes," such as reasonable user charges or fees and certain other non-tax funds.

There are various types of appropriations excluded from the Appropriations Limit. For example, debt service costs of bonds existing or authorized by January 1, 1979, or subsequently authorized by the voters, appropriations required to comply with mandates of courts or the federal government, appropriations for qualified capital outlay projects, appropriations for tax refunds, appropriations of revenues derived from any increase in gasoline taxes and motor vehicle weight fees above January 1, 1990 levels, and appropriation of certain special taxes imposed by initiative (e.g., cigarette and tobacco taxes) are all excluded. The Appropriations Limit may also be exceeded in cases of emergency.

The Appropriations Limit in each year is based on the Appropriations Limit for the prior year, adjusted annually for changes in state per capita personal income and changes in population, and adjusted, when applicable, for any transfer of financial responsibility of providing services to or from another unit of government or any transfer of the financial source for the provisions of services from tax proceeds to non-tax proceeds. The measurement of change in population is a blended average of statewide overall population growth, and change in attendance at local school and community college ("K-14") districts. The Appropriations Limit is tested over consecutive two-year periods. Any excess of the aggregate "proceeds of taxes" received over such two-year period above the combined Appropriations Limits for those two years, is divided equally between transfers to K-14 districts and refunds to taxpayers.

The Legislature has enacted legislation to implement Article XIII B which defines certain terms used in Article XIII B and sets forth the methods for determining the Appropriations Limit. California Government Code Section 7912 requires an estimate of the Appropriations Limit to be included in the Governor's Budget, and thereafter to be subject to the budget process and established in the Budget Act.

The following table shows the Appropriations Limit for fiscal years 2011-12 through 2015-16.

TABLE 18
State Appropriations Limit
(Dollars in Millions)

	Fiscal Year				
	2011-12	**2012-13**	**2013-14**	**2014-15**	**2015-16**
State Appropriations Limit	$81,726	$84,221	$89,716	$89,902	$93,143[a]
Appropriations Subject to Limit	-61,952	-71,702	-73,346[a]	-77,712[a]	-85,919[a]
Amount (Over)/Under Limit	$19,774	$12,519	$16,370[a]	$12,190[a]	$7,224[a]

[a] Estimated/projected.

Source: State of California, Department of Finance.

Proposition 98 and K-14 Funding

General. On November 8, 1988, the voters of the state approved Proposition 98, a combined initiative constitutional amendment and statute called the "Classroom Instructional Improvement and Accountability Act." Proposition 98 changed state funding of public education below the university level and the operation of the Appropriations Limit, primarily by guaranteeing K-14 education a minimum level of funding (the "Proposition 98 minimum guarantee"). Proposition 98 (as modified by Proposition 111, enacted on June 5, 1990) guarantees K-14 education the greater of: (a) in general, a fixed percentage of General Fund revenues ("Test 1"), or (b) the amount appropriated to K-14 education in the prior year, adjusted for changes in state per capita personal income and enrollment ("Test 2"). A third test replaces Test 2 in any year that the percentage growth in per capita General Fund revenues from the prior year plus one-half of one percent is less than the percentage growth in state per capita personal income ("Test 3").

Legislation adopted prior to the end of the 1988-89 fiscal year implementing Proposition 98 determined the K-14 education's funding guarantee under Test 1 to be 40.7 percent of General Fund tax revenues based on fiscal year 1986-87 appropriations. This percentage has since been adjusted to approximately 38.4 percent of fiscal year 1986-87 appropriations to account for subsequent changes in the allocation of local property taxes since these changes altered the share of General Fund revenues received by schools and other General Fund changes. The Proposition 98 minimum guarantee has historically been calculated under Test 2, although Tests 1 and 3 have become more common in recent years. If Test 3 is used in any year, the difference between Test 3 and Test 2 becomes a "credit" (called the "maintenance factor") to schools and is paid to them in future years when per capita General Fund revenue growth exceeds per capita personal income growth.

Proposition 98 permits the Legislature, by a two-thirds vote of both Houses (in a bill separate from the Budget Act) and with the Governor's concurrence, to suspend the K-14 education's minimum funding guarantee for a one-year period. The amount of the suspension is added to the maintenance factor, the repayment of which occurs according to a specified state constitutional formula, and eventually restores Proposition 98 funding to the level that would have been required in the absence of such a suspension. Suspending the minimum funding guarantee provides ongoing General Fund savings over multiple fiscal years until the Proposition 98 maintenance factor is fully repaid.

The Proposition 98 minimum guarantee has been funded historically from two sources: local property taxes and the General Fund. Any amount not funded by local property taxes is funded by the General Fund. Thus, local property tax collections represent an offset to General Fund costs in a Test 2 or Test 3 year. The passage of Proposition 30 has temporarily created a third source of funds. The newly created fund, the Education Protection Account ("EPA"), is available to offset Proposition 98 General Fund expenditures for fiscal years 2012-13 through 2018-19, freeing up General Fund resources for other purposes. See "Funding for Fiscal Years 2014-15 and 2015-16" below.

The process for calculating the Proposition 98 minimum guarantee involves recalculations for previous years based on revised estimates of General Fund taxes and local property taxes, average daily attendance ("ADA"), and civilian population. While some of these estimates are adjusted frequently, some may not be final for several years after the close of the fiscal year. Such changes in the estimates can result in significant adjustments to the guarantee, even if that year has ended. Therefore, additional appropriations may be required to fully satisfy the minimum guarantee for a prior year. These funds are referred to as "settle-up" funds, and often include statutory language designating the fiscal year for which the funds count. The factors used to calculate the Proposition 98 minimum guarantee and how much settle-up is owed are considered final when certified as required by the state Education Code. Settle-up payments are made in future years at the discretion of the Legislature and the Governor.

Proposition 98 also contains provisions for the transfer of certain state tax revenues in excess of the Appropriations Limit to K-14 education in Test 1 years when additional moneys are available. No such transfer occurred for the 2013-14 and 2014-15 fiscal years, and no such transfer is anticipated for fiscal year 2015-16. See "STATE FINANCES – State Appropriations Limit."

Proposition 2, approved by the voters in November 2014, creates the PSSSA, a special fund that serves as a Proposition 98 reserve, and requires a deposit in the PSSSA under specified conditions. These conditions are not anticipated to be met in fiscal year 2014-15 or fiscal year 2015-16. Therefore, no deposit into the PSSSA is anticipated.

Funding for Fiscal Years 2014-15 and 2015-16. The 2015-16 Governor's Budget continues to include the additional tax revenues generated by the passage of Proposition 30 in November, 2012. Proposition 30 requires that the resulting temporary increases in personal income tax and sales and use tax rates be deposited into the EPA. Appropriations from the EPA must be used to fund education expenditures and count towards meeting the Proposition 98 minimum guarantee. The funds deposited into the EPA offset $8.6 billion in base Proposition 98 guarantee costs that would have otherwise been funded by the General Fund in fiscal year 2015-16. In addition, Proposition 39, the California Clean Energy Jobs Act, will provide $736 million in revenue that is included in the calculation of the Proposition 98 minimum guarantee. Of this amount, $368.0 million will be transferred to the Clean Energy Jobs Creation Fund in support of energy efficiency related activities in public schools and community colleges.

The 2015-16 Governor's Budget Proposition 98 minimum guarantee level includes changes in revenues and reflects prior "rebenching" of the guarantee (i.e., a change in the minimum guarantee percentage of General Fund revenues). Over the past few fiscal years, the major changes in revenues have been the inclusion of the revenues generated from the passage of Proposition 30 and Proposition 39, the ongoing increase in local tax revenues resulting from the elimination of redevelopment agencies, and the distribution of cash assets previously held by redevelopment agencies. In addition to these major changes, an overall increase in personal income tax, sales and use tax, and base local property tax revenues, result in an increase in the Proposition 98 minimum guarantee over the 2014 Budget Act levels. In fiscal year 2014-15, the Proposition 98 minimum guarantee is estimated to be $63.2 billion, which is a $2.3 billion increase over the 2014 Budget Act level. Proposition 98 funding in fiscal year 2015-16 is proposed to be $65.7 billion, which is a $2.5 billion increase over the revised 2014-15 level. Of this amount, the General Fund share in fiscal year 2015-16 is $47.0 billion, including $8.6 billion in EPA revenues. In fiscal year 2015-16, it is estimated that the state will be in a Test 2 year.

The Proposition 98 minimum guarantee is also rebenched when the law requires an adjustment of the Test 1 percentage to reflect a shift in revenue or movement of programs into or out of the Proposition 98 minimum guarantee. In fiscal years 2014-15 and 2015-16, the Proposition 98 minimum guarantee was rebenched to reflect a $67 million and $72 million, respective increase in offsetting local revenues as a result of the elimination of redevelopment agencies and the one-time distribution of cash assets held by redevelopment agencies. In addition, the fiscal year 2015-16 Proposition 98 minimum guarantee was rebenched by $1.2 billion to account for an increase in offsetting local property tax revenues due to the anticipated retirement of ERBs which resulted in the restoration of a like amount of local property tax revenue for K-12 schools. All rebenchings of the guarantee utilize a current value cost methodology, which results in a dollar for dollar change for each rebenching and provides a single and consistent methodology. The total impact of these rebenchings and the changes in revenues, in addition to other natural changes in Proposition 98 factors, result in the fiscal year 2015-16 Proposition 98 guarantee level of $65.7 billion.

The 2015-16 Governor's Budget reflects Proposition 98 General Fund expenditures in fiscal years 2013-14 through 2015-16, as outlined in the table below.

TABLE 19
Proposition 98 Funding
(Dollars in Millions)

	2013-14		Fiscal Year 2014-15		2015-16	Change From Revised 2014-15 to Proposed 2015-16	
	Enacted[a]	**Revised**[c]	**Enacted**[b]	**Revised**[c]	**Proposed**[c]	**Amount**	**Percent**
K-12 Proposition 98							
State General Fund	$29,741	$32,097	$33,534	$35,029	$34,320	$ (709)	-2.0%
Education Protection Account	5,572	6,492	6,635	7,038	7,697	659	9.4%
Local property tax revenue[d]	13,936	13,671	14,089	14,184	16,069	1,885	13.3%
Subtotals [e]	$49,249	$52,260	$54,258	$56,251	$58,086	$1,835	3.3%
CCC Proposition 98							
State General Fund	$ 3,053	$ 3,433	$ 3,473	$ 3,711	$ 4,050[e]	$ 339	9.1%
Education Protection Account	689	802	820	870	952	82	9.4%
Local property tax revenue[d]	2,291	2,178	2,308	2,321	2,628	307	13.2%
Subtotals [e]	$ 6,033	$ 6,413	$ 6,601	$ 6,902	$ 7,630	$ 728	10.5%
Total Proposition 98							
State General Fund	$32,794	$35,530	$37,007	$38,740	$38,370	$ (370)	-1.0%
Education Protection Account	6,261	7,294	7,455	7,908	8,649	741	9.4%
Local property tax revenue[d]	16,227	15,849	16,397	16,505	18,697	2,192	13.3%
Totals[f]	$55,282	$58,673	$60,859	$63,153	$65,716	$ 2,563	4.1%

[a] As of the 2013 Budget Act, June 27, 2013.

[b] As of the 2014 Budget Act, June 20, 2014.

[c] As of the 2015-16 Governor's Budget, January 9, 2015.

[d] Beginning in fiscal year 2011-12, local property tax revenues include amounts shifted to schools as a result of the elimination of redevelopment agencies. Fiscal years 2013-14, 2014-15, and 2015-16 include the one-time distribution of cash assets held by redevelopment agencies.

[e] Beginning in fiscal year 2015-16, the Community College amount includes $500 million for the K-14 Adult Education Block Grant.

[f] Totals may not add due to rounding.

Source: State of California, Department of Finance.

Future Obligations. As explained above under "General," there are two forms of future obligations for the state General Fund which may be created under Proposition 98: maintenance factor and settle-up payments. Both of these obligations have been implemented in years leading up to fiscal year 2015-16. The following table shows the estimated Proposition 98 future obligations as of the 2015-16 Governor's Budget:

TABLE 20
Proposition 98 Future Obligations Balances
(Dollars in Millions)

	Fiscal Year				
Year-End Balances:	2011-12 Estimated[(a)]	2012-13 Estimated[(a)]	2013-14 Estimated[(a)]	2014-15 Estimated[(a)]	2015-16 Estimated[(a)]
Maintenance Factor	$10,606	$5,828	$6,398	$2,587	$1,938
QEIA Settle-up[(b)]	410	410	410	0	0
Other Settle-Up	1,512	1,512	1,512	1,512[(c)]	1,256

[(a)] Proposition 98 factors and appropriations have been certified through fiscal year 2008-09.

[(b)] The Quality Education Improvement Act ("QEIA") enacted the settlement of a lawsuit concerning the proper amount of the guarantee in fiscal years 2004-05 and 2005-06 that obligated the state to pay a total of $2.7 billion in settle-up based on a statutory repayment plan. The final payment will be made in fiscal year 2014-15.

[(c)] Included in "Underfunding of Proposition 98" in Table 7.

Note: Proposition 98 budgetary deferrals are not included in this Table. The 2014-15 Budget package included deferral payments of $5.2 billion: $662 million made toward the deferral balance in the 2014-15 fiscal year and additional payments of $4.5 billion made in 2014-15 toward deferral balances in 2012-13 and 2013-14. In addition, as a result of a trigger mechanism included in the Budget Act, the remaining deferral balance of $992 million is scheduled to be paid in 2014-15. The trigger mechanism appropriates any additional Proposition 98 resources attributable to the 2013-14 and 2014-15 fiscal years subsequent to the 2014 Budget Act for the purpose of retiring the remaining deferral balance. In total, these payments reduced the amounts deferred from $6.2 billion as of the 2013 Budget Act to $1.7 billion in 2013-14 (the amount deferred from fiscal year 2013-14 to 2014-15) and will eliminate the remaining deferral balance at the end of 2014-15. See "DEBTS AND LIABILITIES UNDER PROPOSITION 2" and "Current State Budget."

Maintenance factor payments are included in the multi-year projection (as shown in Table 3) developed by the Department of Finance based on factors known as of the 2015-16 Governor's Budget. The maintenance factor is adjusted by average daily attendance and per capita personal income growth each year. Therefore, even if a payment is made in a year, the outstanding balance can increase. Payments, as required by statute, are built into the multi-year projection as of the 2015-16 Governor's Budget totaling $3.8 billion in fiscal year 2014-15, and $725 million in fiscal year 2015-16.

No maintenance factor payment was required in fiscal year 2013-14 and none is projected in fiscal years 2016-17 or 2017-18.

Local Governments

The primary units of local government in California are the 58 counties, which range in population from approximately 1,200 in Alpine County to approximately 9.8 million in Los Angeles County.

1. Constitutional and Statutory Limitations on Local Government

Counties are responsible for the provision of many basic services, including indigent health care, welfare, jails, and public safety in unincorporated areas. There are also

482 incorporated cities in California and thousands of special districts formed for education, utilities, and other services. The fiscal condition of local governments was changed when Proposition 13, which added Article XIII A to the state Constitution, was approved by California voters in 1978. Proposition 13 reduced and limited the future growth of property taxes and limited the ability of local governments to impose "special taxes" (those devoted to a specific purpose) without two-thirds voter approval. Although Proposition 13 limited property tax growth rates, it also has had a smoothing effect on property tax revenues, ensuring greater stability in annual revenues than existed before Proposition 13 passed.

Proposition 218, another constitutional amendment enacted by initiative in 1996, further limited the ability of local governments to raise taxes, fees, and other exactions. The limitations include requiring a majority vote approval for general local tax increases, prohibiting fees for services in excess of the cost of providing such service, and providing that no fee may be charged for fire, police, or any other service widely available to the public.

In the aftermath of Proposition 13, the state provided aid to local governments from the General Fund to make up some of the loss of property tax moneys, including assuming principal responsibility for funding K-12 schools and community colleges. During the recession of the early 1990s, the Legislature reduced the post-Proposition 13 aid to local government entities other than K-12 schools and community colleges by requiring cities and counties to transfer some of their property tax revenues to school districts. However, the Legislature also provided additional funding sources, such as sales taxes, and reduced certain mandates for local services funded by cities and counties. See "STATE FINANCES – Sources of Tax Revenue – Sales and Use Tax" for a discussion of the impact of the Economic Recovery Bond issuances on local sales taxes.

The 2004 Budget Act, related legislation and the enactment of Proposition 1A in 2004 and Proposition 22 in 2010 (described below) dramatically changed the state-local fiscal relationship. These constitutional and statutory changes implemented an agreement negotiated between the Governor and local government officials (the "state-local agreement") in connection with the 2004 Budget Act. One change relates to the reduction of the vehicle license fee ("VLF") rate from 2 percent to 0.65 percent of the market value of the vehicle. In order to protect local governments, which had previously received all VLF revenues, the 1.35 percent reduction in VLF revenue to cities and counties from this rate change was backfilled (or offset) by an increase in the amount of property tax revenues they receive. This worked to the benefit of local governments because the backfill amount annually increases in proportion to the growth in property tax revenues, which has historically grown at a higher rate than VLF revenues, although property tax revenues declined between fiscal years 2009-10 and 2011-12. This arrangement is proposed to continue without change in the 2015-16 Governor's Budget.

As part of the state-local agreement, voters at the November 2004 election approved Proposition 1A ("Proposition 1A of 2004"). Proposition 1A of 2004 amended the state Constitution to, among other things, reduce the Legislature's authority over local government revenue sources by placing restrictions on the state's access to local governments' property, sales, and VLF revenues as of November 3, 2004. A detailed description of the provisions of this constitutional amendment is set forth below under the caption "THE BUDGET PROCESS – Constraints on the Budget Process – Local Government Finance (Proposition 1A of 2004)."

The 2009 Budget Act (as amended by the revisions enacted on July 28, 2009) authorized the state to exercise its authority under Proposition 1A of 2004 to borrow an amount equal to about 8 percent of local property tax revenues, or $1.9 billion, which was required to be repaid within three years. State law was also enacted to create a securitization mechanism for local governments to sell their right to receive the state's payment obligations to a local government operated joint powers agency ("JPA"). This JPA sold bonds in a principal amount of $1.895 billion in November 2009 to pay the participating local governments their full property tax allocations when they normally would receive such allocations. Pursuant to Proposition 1A of 2004, the state repaid the local government borrowing (which in turn repaid the bonds of the JPA) in June 2013, from the General Fund.

Proposition 22, adopted on November 2, 2010, supersedes Proposition 1A of 2004 and prohibits any future borrowing by the state from local government funds, and generally prohibits the Legislature from making changes in local government funding sources. Allocation of local transportation funds cannot be changed without an extensive process. The Proposition 1A of 2004 borrowing done as part of the 2009 Budget Act (as amended by the revisions enacted on July 28, 2009) was not affected by Proposition 22.

Actions in recent budgets have sought to use moneys from redevelopment agencies ("RDAs") to offset General Fund costs for Proposition 98. In a lawsuit relating to certain of these actions in fiscal years 2009-10 and 2010-11, which could have resulted in a General Fund liability of up to $2.1 billion, the trial court denied the plaintiff's petition and the appellate court affirmed the trial court ruling. This lawsuit is not impacted by the California Supreme Court ruling in the *Matosantos* case described below.

2. *Redevelopment Agency Funds*

The 2011 Budget Act included legislation (ABx1 27, Chapter 6, Statutes of 2011) seeking additional funds from RDAs as an alternative to the elimination of such agencies pursuant to the terms of related legislation (ABx1 26, Chapter 5, Statutes of 2011).

On December 29, 2011, in the case *California Redevelopment Association et al. v. Matosantos et al.*, the California Supreme Court upheld ABx1 26, which reaffirmed the state's ability to eliminate RDAs, but also ruled that ABx1 27, which required RDAs to remit payments to schools in order to avoid elimination, was unconstitutional. In accordance with the Court's order, RDAs were dissolved on February 1, 2012 pursuant to ABx1 26, and their functions have been taken over by successor agencies. (See "LITIGATION – Budget-Related Litigation – Actions Challenging Statutes Which Reformed California Redevelopment Law" for further information regarding the *Matosantos* case and other litigation on this subject.) Revenues that would have been directed to the RDAs are distributed to make "pass through" payments to local agencies that they would have received under prior law, and to successor agencies for retirement of the RDAs' debts (also known as enforceable obligations) and for limited administrative costs. The remaining revenues are distributed as property taxes to cities, counties, school and community college districts, and special districts under existing law.

Revenues distributed to school and community college districts result in corresponding savings for the state's General Fund. For the 2015-16 Governor's Budget, Proposition 98

General Fund savings are anticipated to be $891 million in fiscal year 2014-15, Projected Proposition 98 General Fund savings in fiscal year 2015-16 are $1.1 billion, and $1.3 billion in fiscal year 2016-17. On an ongoing basis, Proposition 98 General Fund savings are anticipated to be at least $1 billion per year beginning in fiscal year 2017-18, with annual growth proportionate to the changes in property tax growth, and the rate at which the enforceable obligations of the former RDAs are retired.

Local governments have disputed the implementation of ABx1 26 and litigation is pending and expected to be filed in the future on this subject.

3. *Property Tax Revenues*

Although the property tax is a local revenue source, the amount of property tax generated each year has a substantial impact on the state budget because local property tax revenues allocated to K-14 schools typically offset General Fund expenditures.

Assessed value growth is estimated based on statistical modeling and evaluations of real estate trends. The median sales price of new and existing homes rose by almost 27 percent in 2013 and over 9 percent in 2014 (with activity in the 2014 calendar year driving fiscal year 2015-16 assessed valuations for property tax purposes). While the sales volume of existing homes declined by approximately 8 percent in 2014, the impact of this decline on fiscal year 2015-16 property tax revenues will be moderated by the increase in 2014 median prices, coupled with the reassessment to current market value of homes whose assessed values were significantly reduced during the market downturn of 2007 to 2009. Another factor that may drive increased property tax revenues is an increase in sales volume driven by moderating home price increases and rising personal incomes.

Statewide property tax revenues are estimated to increase 6.10 percent in fiscal year 2014-15 and 5.25 percent in fiscal year 2015-16. See Table 19 (Proposition 98 Funding) for information on the impact of these growth rates on the funding of the Proposition 98 guarantee. Property tax estimates used in the calculation of the guarantee are based on growth in statewide property taxes, but also include other factors such as excess tax, redevelopment agency payments, and Educational Revenue Augmentation Fund transfers.

4. *Realigning Services to Local Governments*

The 2011 Budget Act included a major realignment of public safety programs from the state to local governments ("AB 109"). The realignment was designed to move program and fiscal responsibility to the level of government that can best provide the service, eliminate duplication of effort, generate savings, and increase flexibility. The implementation of the Community Corrections Grant Program authorized by AB 109 moved lower-level offenders from state prisons to county supervision and reduced the number of parole violators in the state's prisons. Other realigned programs include local public safety programs, mental health, substance abuse, foster care, child welfare services, and adult protective services. The 2011 Realignment is funded through two sources: (1) a state special fund sales tax of 1.0625 percent (projected to total $6.6 billion in fiscal year 2015-16) and (2) $546.1 million in vehicle license fees (for fiscal year 2015-16). As a result of the realignment, the state expects General Fund savings from the realigned programs to be about $2.6 billion annually beginning in fiscal year 2011-12. In fiscal year 2011-12, about $2.2 billion of these savings was achieved from a reduction in the Proposition 98 Guarantee, and that figure is currently estimated to grow to $2.7 billion in fiscal year 2014-15 and $2.9 billion in fiscal year 2015-16. A lawsuit was filed challenging this calculation of the Proposition 98 Guarantee and on June 1, 2012, the trial court ruled in favor of the state and denied the petition for writ of mandate for recalculation of the Proposition 98 Guarantee; however, plaintiffs have appealed this decision. See "LITIGATION – Budget Related Litigation – Actions Challenging School Financing."

5. Trial Courts

Prior to legislation enacted in 1997, local governments provided the majority of funding for the state's trial court system. The legislation consolidated the trial court funding at the state level in order to streamline the operation of the courts, provide a dedicated revenue source, and relieve fiscal pressure on the counties. In addition, legislation enacted in 2008 provides California's court system with increased fees and fines to expand and repair its infrastructure to address significant caseload increases and reduce delays. The fees raised by this legislation (SB 1407, Statutes of 2008) were intended to support debt service on lease-revenue bonds and other appropriate evidences of indebtedness used to pay qualified infrastructure costs in an amount of up to $5 billion. The SPWB has issued approximately $1.2 billion in lease-revenue bonds to date to finance such costs from the fee increases authorized by SB 1407. Additional legislative authorization is required prior to the issuance of any additional lease-revenue bonds for court construction. The 2015-16 Governor's Budget includes an appropriation of $54.2 million to pay an annual service fee to the private developer of the new Long Beach Courthouse. Service fees for the Long Beach Courthouse, which are subject to annual appropriation by the Legislature, are expected to be approximately $2 billion over a period of 35 years.

The state's trial court system received approximately $2.0 billion in state resources in fiscal year 2014-15 and is projected to receive $2.2 billion in fiscal year 2015-16, as well as $499 million in resources from counties in each fiscal year. The 2015-16 Governor's Budget includes an ongoing General Fund augmentation of $160.2 million to support the state's trial court system and provides up to $50.7 million General Fund to backfill, upon order of the Director of Finance, the anticipated loss of revenue in the Trial Court Trust Fund during fiscal year 2015-16. The 2015-16 Governor's Budget also includes $174.7 million for 12 court construction projects, including $97.9 million from lease-revenue bonds, with debt service expected to be paid from future court construction revenues.

6. Welfare System

Under the CalWORKs (as such term is defined herein) program, counties are given flexibility to develop their own plans, consistent with state law, to implement the program and to administer many of its elements. Counties are required to provide "general assistance" aid to certain persons who cannot obtain welfare from other programs.

Health and Human Services

1. CalWORKs

The state provides welfare benefits to certain adults and children living in the state. Although some of these benefits are available to legal noncitizens, the majority of these benefits are available only to citizens.

These benefits generally take the form of cash payments to beneficiaries, or programs pursuant to which beneficiaries receive food or assistance in procuring employment. Many of these programs are administered by counties within the state, and paid with a combination of federal, state and local funds. Counties are given flexibility to develop their own plans, consistent with state law, to implement the program and to administer many of its elements.

The federal government pays a substantial portion of welfare benefit costs, subject to a requirement that states provide significant matching funds. Federal law imposes detailed eligibility and programmatic requirements in order for states to be entitled to receive federal funds. Federal law also imposes time limits on program availability for individuals, and establishes certain work requirements. The primary federal law establishing funding and eligibility, and programmatic requirements is The Personal Responsibility and Work Opportunity Reconciliation Act of 1996 (P.L. 104-193, the "Law"). Significant elements of the Law include: (i) Temporary Assistance for Needy Families ("TANF"), a block grant program; and (ii) the Supplemental Nutrition Assistance Program at the federal level (referred to as "CalFresh" in California, and formerly known as "food stamps").

Chapter 270, Statutes of 1997, embodies California's response to the federal welfare systems, called California Work Opportunity and Responsibility to Kids ("CalWORKs"). Consistent with the federal law, CalWORKs contains time limits on the receipt of welfare aid. The centerpiece of CalWORKs is the linkage of eligibility to work participation requirements.

CalWORKs became effective on January 1, 1998, replacing the former Aid to Families with Dependent Children (AFDC) program. Caseload under CalWORKs is projected to decrease in fiscal year 2015-16 as compared to revised fiscal year 2014-15 levels. CalWORKs caseload projections are 543,557 cases in fiscal year 2014-15 and 533,335 cases in fiscal year 2015-16. The fiscal year 2015-16 projected caseload represents a major decline from the early 1990s, when caseload peaked at 921,000 cases in fiscal year 1994-95 under the AFDC program. CalWORKs caseload from 1998 through fiscal year 2015-16 is estimated to have declined by approximately 16.8 percent.

The state's required expenditures in connection with the Law are referred to as "Maintenance of Effort" or "MOE." California's required MOE is generally equal to 75 percent of federal fiscal year ("FFY") 1994 historic expenditures. However, in order to qualify for that level of MOE, the state is required to demonstrate a 50 percent work participation rate (WPR) among all families. The federal government determined that the state failed to meet this requirement for FFYs 2007 through 2011, and the state is therefore subject to a penalty. The federal government waived the penalty for FFY 2007, but required the state to increase the required MOE to 80 percent of FFY 1994 historic expenditures. As a result, the state was required to increase its MOE expenditure by approximately $180 million. The 2015-16 Governor's Budget continues to reflect this increase in MOE spending. Currently, the state is seeking relief from the FFYs 2008, 2009, 2010, and 2011 penalties, estimated to be approximately $47.7 million, $113.6 million, $179.7 million, and $246.1 million, respectively. (Any penalties from failing to meet federal WPR requirements would be in addition to the approximately $180 million increased MOE requirement.) In April 2014, the state submitted a corrective compliance plan to the federal government for FFY 2009. On June 24, 2014, the federal government approved the state's plan which requires California to meet or exceed federal WPR requirements by September 30, 2015, to avoid incurring fiscal penalties.

The following table shows CalWORKs caseload and General Fund expenditures for state fiscal years 2010-11 through 2015-16.

TABLE 21
CalWORKs Expenditures

(Dollars in Billions)

Fiscal Year	Caseload	General Fund Expenditures
2010-11	586,659	$2.240
2011-12[a]	575,988	1.158
2012-13	559,920	1.545
2013-14[b]	550,928	1.163
2014-15[c] [d]	543,557	0.654
2015-16[c] [d]	533,335	0.667

[a] Beginning in FY 2011-12, CalWORKs General Fund expenditures reflect a $1.1 billion ongoing annual savings as a result of redirecting 1991-92 realignment revenues from mental health to fund CalWORKs grants, pursuant to Chapter 13, Statutes of 2011.

[b] Reflects approximately $300 million General Fund savings through redirecting a portion of 1991-92 realignment revenues from indigent health to CalWORKs, pursuant to Chapter 24, Statutes of 2013.

[c] Reflects anticipated General Fund savings of $725 million in fiscal year 2014-15 and $698 million in fiscal year 2015-16 from redirecting a portion of fiscal year 1991-92 realignment revenue from indigent health to CalWORKs.

[d] Estimated.

2. SSI/SSP

The federal Supplemental Security Income ("SSI") program provides a monthly cash benefit to eligible seniors and persons with disabilities who meet the program's income and resource requirements. In California, the SSI payment is augmented with a State Supplementary Payment ("SSP") grant. The 2015-16 Governor's Budget includes approximately $2.8 billion for the SSI/SSP program from the General Fund for fiscal year 2015-16, 1 percent more than the revised fiscal year 2014-15 funding level. The average monthly caseload in this program is estimated to be 1.3 million recipients in fiscal year 2015-16, a 0.6 percent increase over the revised fiscal year 2014-15 projected level.

3. *Health Programs*

Medi-Cal – Medi-Cal, California's Medicaid program, is a health care entitlement program for low-income individuals and families who receive public assistance or otherwise lack health care coverage. Medi-Cal serves approximately 32 percent of all Californians. Federal law requires Medi-Cal to provide basic services such as doctor visits, laboratory tests, x-rays, hospital inpatient and outpatient care, hospice, skilled nursing care, and early periodic screening, diagnosis and treatment. Also, federal matching funds are available if states choose to provide any of numerous optional benefits. California's Federal Medical Assistance Percentage is 50 percent, which is the share of federal funding for standard program benefits. There are also federal funds in the Medi-Cal budget for a number of Medi-Cal programs or supplemental payments that are matched with local funds that do not appear in state funding totals or that receive a higher matching rate. A wide range of public and private providers and facilities delivers these services. Providers are reimbursed by the traditional fee-for-service method or by managed care plans that receive capitated payments from the state. Approximately 8.9 million Medi-Cal beneficiaries (more than 70 percent of the people receiving Medi-Cal benefits and services) are expected to enroll in managed care plans.

Average monthly caseload in Medi-Cal is projected to be 11.97 million in fiscal year 2014-15. Caseload is expected to increase in fiscal year 2015-16 by approximately 249,000, or 2.1 percent, to 12.2 million people. This increase is largely due to the implementation of federal health care reform.

The following table shows Medi-Cal expenditures for the fiscal years 2011-12 through 2014-15 and the proposed amounts for fiscal year 2015-16.

TABLE 22
Medi-Cal Expenditures

(Dollars in Billions)

Fiscal Year	General Fund	Other State Funds	Federal Funds	Total[(a)]
2011-12	$15.2	$2.1	$26.4	$43.7
2012-13	15.0	6.4	28.5	49.9
2013-14	16.6	5.7	34.1	56.4
2014-15[(b)]	18.0	11.0	57.3	86.3
2015-16[(c)]	18.8	15.2	61.9	95.9

[(a)] Totals may not add due to rounding.
[(b)] Estimated.
[(c)] Proposed.

The 2015-16 Governor's Budget includes the following major General Fund elements:

- Net savings of $803 million in fiscal year 2014-15 and $1.1 billion in fiscal year 2015-16 from the sales tax on managed care plans. Chapter 33, Statutes of 2013 (SB 78), authorized a tax on the operating revenue of Medi-Cal managed care plans based on the state sales tax rate. Nearly half of this revenue is used for the non federal share of supplemental payments to Medi-Cal managed care plans. The remainder is used to fund increased rates for Medi-Cal managed care plans, which offsets General Fund spending in the Medi-Cal program. The federal government released guidance indicating the tax is likely impermissible under federal Medicaid regulations. The Administration is proposing a new managed care tax that complies with federal law. The new revenue will offset the same amount of General Fund expenditures as the current tax, as well as fund a restoration of the 7 percent across the board reduction to authorized IHSS hours of service. See "In-Home Supportive Services (IHSS)" below.

- Net savings of $236 million in fiscal year 2014-15 and $427.4 million in fiscal year 2015-16 due to the implementation of the Coordinated Care Initiative. Chapter 33, Statutes of 2012 (SB 1008) and Chapter 45, Statutes of 2012 (SB 1036) authorized the Coordinated Care Initiative in which persons eligible for both Medicare and Medi-Cal (dual eligibles) will receive medical, behavioral health, long-term supports and services, and home and community-based services coordinated through a single health plan.

- Net costs of $573.3 million in fiscal year 2015-16 to pay for the federally required and optional expansion of coverage under federal health care reform. See "Health Care Reform."

- Costs of $281.2 million in fiscal year 2015-16 for estimated rate increases to Medi-Cal managed care health plans.

Litigation is pending with respect to certain cost reductions implemented by the state. See "LITIGATION – Actions Regarding Medi-Cal Reimbursements and Fees."

Health Care Reform – The federal Affordable Care Act ("ACA") increases access to public and private health care coverage through various programmatic, regulatory, and tax incentive mechanisms. To expand coverage, the ACA provides for: (1) the health insurance exchange, a new marketplace in which individuals who do not have access to public coverage or affordable employer coverage can purchase insurance and access federal tax credits, and (2) two expansions of Medicaid – a mandatory expansion by simplifying rules affecting eligibility, enrollment, and retention; and an optional expansion to adults with incomes up to 138 percent of the federal poverty level. Additionally, the ACA requires specified rate increases for primary care for two years beginning January 1, 2013 and prohibited California from restricting eligibility primarily for the Medi-Cal and Optional Targeted Low Income Children's (formerly Healthy Families) programs before the new coverage requirements went into effect in 2014.

Health care reform has resulted in a significant net increase of General Fund program costs in fiscal year 2013-14 and beyond. The net impact of health care reform on the General Fund will depend on a variety of factors, including levels of individual and employer participation, changes in insurance premiums, and savings resulting from the reform as beneficiaries in current state-only programs receive coverage through Medi-Cal or the California

Health Benefit Exchange (Exchange), also known as Covered California. The 2015-16 Governor's Budget includes $573.3 million from the General Fund in fiscal year 2015-16 for the costs of expanded eligibility under health care reform.

The 2013 Budget Act implemented the optional expansion to include adults up to 138 percent of the federal poverty level using a state-based approach. Under the ACA, the federal government promises to initially pay for 100 percent of the cost of benefits for newly eligible individuals served under the optional expansion; federal funding will gradually decrease to 90 percent by 2020. To mitigate against future risks to the General Fund, the legislation that implemented the optional expansion (Chapters 3 and 4, Statutes of 2013-14 First Extraordinary Session) (AB/SB X1 1) requires that reductions in federal funding below 90 percent be addressed in a timely manner through the annual state budget or legislative process. If, prior to January 1, 2018, federal funding under the ACA is reduced to 70 percent or less, the implementation of the optional expansion will cease within 12 months.

Under health care reform, county costs and responsibilities for indigent health care are expected to decrease as uninsured individuals obtain health care coverage. The state, in turn, is bearing increased responsibility for providing care to these newly eligible individuals through the Medi-Cal expansion. Chapter 24, Statutes of 2013, specifies two mechanisms for determining county savings, depending on how counties currently deliver indigent care. Once determined, these savings are redirected to fund local human services programs.

County health care savings are estimated to be $724.9 million in fiscal year 2014-15 and $698 million in fiscal year 2015-16. Out year savings for all counties will be estimated in January and May, prior to the start of each fiscal year and based on the most recent data available. A true-up process will be used to adjust funding to the extent actual county savings differ from initial estimates

Chapter 655, Statutes of 2010 ("AB 1602"), and Chapter 659, Statutes of 2010 ("SB 900"), established the Exchange as an independent entity in state government and outlined the authorities and responsibilities of the Exchange and its governing board. The Exchange launched its marketplace for individuals and small businesses to purchase health insurance, called Covered California, on October 1, 2013. This entity established requirements for health plans to participate in the Exchange, standards and criteria for selecting health plans to be offered by the Exchange, and required the Exchange to provide an adequate selection of qualified health plans in each region of the state. Covered California has received over $1 billion in start up funding from the federal government, with the vast majority of the funds paying for staff, information technology systems, and marketing. On October 1, 2013, Covered California began offering affordable health insurance, including plans subsidized with federally funded tax subsidies and products for individuals and small businesses. The Exchange's first open enrollment period closed on April 15, 2014 with 1.4 million individuals enrolled in private health insurance plans and approximately 1.9 million individuals enrolled in Medi-Cal. The Exchange's second open enrollment period was from November 15, 2014 to February 15, 2015. (The February 15, 2015 deadline was extended to April 15, 2015 for certain individuals who were not aware they would face a tax penalty for not buying coverage.) By the end of fiscal year 2014-15, the Exchange must transition from being exclusively funded by federal grants to being self-sustaining from assessment fees paid by health plans and insurers participating in the Exchange.

AB 1602 authorizes the Exchange to assess charges, as a part of premiums, on participating health plans and at rates reasonable to support the ongoing operations of the Exchange and maintain a prudent reserve.

In-Home Supportive Services (IHSS) – On September 17, 2013, the United States Department of Labor released final regulations (effective January 1, 2015) requiring overtime pay for domestic workers, compensation for domestic workers traveling between multiple consumers and medical accompaniment wait time, and compensation for time spent in mandatory training. The 2015-16 Governor's Budget includes $707.6 million ($314.3 million General Fund) annually to comply with the new federal regulations.

To control costs and promote the continued health and safety of Medicaid recipients in the program, Chapter 29, Statutes of 2014 (SB 855) prohibits a provider from exceeding 66 hours in a work week, as reduced by the 7-percent across-the-board reduction to authorized hours required by current law. Additionally, while the current monthly assessment and authorization of services hours remains intact, SB 855 requires monthly hours to be converted to weekly hours. Recipients whose weekly hours do not exceed 40 can adjust their hours over the course of the month without prior authorization from the county social worker. This flexibility is contingent upon maintaining a work week not to exceed 40 hours or the monthly authorized hours. Otherwise, approval is needed from the county social worker. Providers would also be compensated for hours related to mandatory training, medical accompaniment, and travel between their recipients; however, travel hours are subject to a maximum of 7 hours per week.

Current state law requires implementation of the federal rule changes to begin no sooner than January 1, 2015, or the rule's effective date, whichever is later. In two orders issued December 22, 2014 and January 14, 2015, the U.S. District Court in Washington D.C. vacated the U.S. Department of Labor's changes to its regulations regarding home care workers. Because of the court's actions, the federal requirements for overtime and other compensation changes are not effective. Accordingly, the requirements of SB 855 were not implemented. To the extent overtime and other compensation changes are not implemented, SB 855 requires the associated funding included in the 2014 Budget Act be made available for other purposes within the IHSS program. The Administration intends to reevaluate the situation as part of the 2015 May Revision.

The 2015-16 Governor's Budget proposes to restore the current 7-percent across-the-board reduction in service hours with proceeds from the new tax on managed care organizations, effective July 1, 2015. The cost to restore the 7-percent reduction is estimated to be $483.1 million in fiscal year 2015-16. For additional information on the tax, refer to the Medi-Cal section.

California Department of Corrections and Rehabilitation

General – As one of the largest departments in state government, the California Department of Corrections and Rehabilitation ("CDCR") operates 37 youth and adult correctional facilities and 44 youth and adult camps as well as numerous other facilities. The CDCR also contracts for multiple adult parolee service centers and community correctional facilities. The CDCR's infrastructure includes more than 42 million square feet of building space on more than 24,000 acres of land (37 square miles) statewide. The 2015-16 Governor's Budget estimates that population reduction measures will result in an average daily adult inmate population of 134,986 in fiscal year 2014-15 and 133,109 in fiscal year 2015-16. The average daily adult parole population is projected to decrease from 43,226 in fiscal year 2014-15 to 40,467 in fiscal year 2015-16.

The 2015-16 Governor's Budget proposes total expenditures (excluding capital outlay) of $10.3 billion ($10 billion from the General Fund) for CDCR from all funding sources. The CDCR budget includes funding for 61,579 positions at a total cost for salaries and benefits of approximately $7.5 billion. Lease payments total $401.5 million, and the remaining funds are budgeted for operating expenses and equipment, insurance, and local assistance. There is an additional $462.3 million ($91.5 million from the General Fund) budgeted for capital outlay expenditures. The 2015-16 Governor's Budget continues to include savings from the implementation of AB 109. AB 109 shifted responsibility for short-term, lower-level offenders from the state to county jurisdictions. In addition, counties are responsible for community supervision of lower-level offenders upon completion of their prison sentences.

Ruling Concerning Prison Population – Pursuant to various rulings issued by a panel of three federal judges (some affirmed by the United States Supreme Court), the state was ordered to reduce its prison population to 137.5 percent of the system's design capacity, by February 28, 2016. A Compliance Officer was appointed to ensure the state meets this benchmark as well as interim benchmarks and has the authority to order the release of inmates should the state fail to meet any of the benchmarks. The CDCR met the first benchmark on August 31, 2014, and will meet the second benchmark on February 28, 2015. The court also ordered the state to implement a variety of population reduction measures; all of these measures have been implemented as of January 1, 2015. The state has agreed not to pursue further court appeals.

Litigation Concerning Prison Medical Care Services – The federal receiver, the court appointed individual who oversees the CDCR's medical operations (the "Receiver"), has plans for the design and construction of additional facilities and improvements to existing facilities for inmates with medical or mental health care needs. All of these projects will be constructed at existing state correctional institutions. See "Prison Construction Program" below.

The 2015-16 Governor's Budget includes $1.778 billion from the General Fund for the Receiver's Medical Services and Pharmacy Programs, compared to the 2014 Budget Act, which totaled $1.646 billion from the General Fund.

Citing "significant progress" in improving California's prison medical care, a federal District Court judge in January 2012 ordered California officials to begin planning for the end of the federal Receivership of the state's prison medical programs. The court ordered the Receiver to work with the CDCR to determine when the state will assume responsibility for particular tasks. To date, the Receiver has transitioned health care access units, which provide guarding and transportation for inmates accessing health care services, as well as the responsibility for planning for the activation of new construction that is primarily related to serving the health care needs of inmates. Additional transition planning efforts are underway.

Prison Construction Program – On May 3, 2007, the Governor signed AB 900 (Chapter 7, Statutes of 2007), which provides funding for an expansion of capacity in the state prison system to address housing and health care needs. As last amended on June 27, 2012 (see Chapter 42, Statutes of 2012), AB 900 authorized approximately $2.1 billion of lease-revenue bond financing authority for design and construction of state prison facilities that included the California Health Care Facility and several other medical and mental health projects throughout the state, including the projects in the Health Care Facility Improvement Program. A number of the projects authorized with AB 900 authority have already been completed and occupied and many other projects are in construction and will be completed in 2015. Of particular note, the California Health Care Facility began occupancy July 2013 and its adjacent Facility E (formerly referred to as the DeWitt Nelson Correctional Annex) began occupancy in April 2014. The Central California Women's Facility Enhanced Outpatient Program Treatment and Office Space project is scheduled to begin occupancy in June 2015. In addition, as of December 2014, 32 projects in the Health Care Facility Improvement Program have initiated design and construction.

The 2012 Budget Act included $810 million of lease-revenue bond financing authority for the design and construction of three new Level II dormitory housing facilities at existing prisons. Two of these new dormitory housing facilities are located adjacent to Mule Creek State Prison in Ione and the third is located adjacent to Richard J. Donovan Correctional Facility in San Diego. Approximately $795 million of lease-revenue bonds were issued in April 2014 to fund these projects. Construction is currently underway at all three facilities and is anticipated to be completed by the spring of 2016.

Unemployment Insurance

The Unemployment Insurance ("UI") program is a federal-state program that provides weekly UI payments to eligible workers who lose their jobs through no fault of their own. To be eligible for benefits, a claimant must be able and available to work, seeking work, and be willing to accept a suitable job. The regular unemployment program is funded by unemployment tax contributions paid by employers for each covered worker.

Due to the high rate of unemployment, the employer contributions were not sufficient to cover the cost of the benefits to claimants during the recession. Commencing in January 2009, in accordance with federal law, the state began to fund deficits in the state UI Fund through a federal loan to support benefit payments. The UI Fund deficit was $9.7 billion at the end of calendar year 2013 and $8.7 billion at the end of calendar year 2014. Using current economic outlook and unemployment projections, absent changes to the UI Fund financing structure, the deficit is projected to be $7.4 billion at the end of calendar year 2015. Repayment of principal on this federal UI loan is strictly an employer responsibility, and not a liability of the state's General Fund. To ensure that the federal loan is repaid, when a state has an outstanding loan balance for two consecutive years, the federal government reduces the Federal Unemployment Tax Act ("FUTA") credit it gives to employers. This is equivalent to an increase in the FUTA tax on employers, and has the effect of paying off the federal UI loan. These changes have already started and will increase annually until the fund is returned to solvency.

Pursuant to federal law, if the state is unable to repay the loan within the same year it is taken, state funds must be used to pay the annual interest payments on the borrowed funds. While annual interest payments were waived under the American Recovery and Reinvestment Act of 2010, interest payments of $303.5 million and $308.2 million were paid in 2011 and 2012, respectively. Given the condition of the General Fund in those years, loans were authorized from the Unemployment Compensation Disability Fund to the General Fund to pay the UI interest expense. The 2015-16 Governor's Budget proposes a $303.5 million repayment to the Unemployment Compensation Disability Fund of the 2011 loan. To date, interest payments totaling $1.1 billion have been paid by the state. The 2015-16 Governor's Budget provides $184.4 million from the General Fund to make the 2015 interest payment. Interest will continue to accrue and be payable annually until the principal on the UI loan is repaid. Pursuant to federal law, the General Fund is not liable for repayment of the principal of this loan, which will be done over time by reducing federal tax credits to employers in the state, as described above.

The interest due after fiscal year 2015-16 will depend on a variety of factors, including the actual amount of the federal loan outstanding (which in turn will depend on the rate of unemployment, employer contributions to the UI Fund, and any state or federal law changes relating to the funding of the program) and the interest rate imposed by the federal government. The 2014-15 Governor's Budget identified a framework for solvency which identified goals and principles to guide future discussions.

Cap and Trade Program

The Cap and Trade program is a key element in the state's climate plan. It sets a statewide limit on the sources of greenhouse gases ("GHG") responsible for 85 percent of California GHG emissions. In fiscal year 2012-13, the California Air Resources Board ("CARB") began auctioning GHG emission allowances as a market-based compliance mechanism authorized by the California Global Warming Solutions Act, Chapter 488, Statutes of 2006 ("AB 32").

CARB has held nine auctions, through November 2014, which have generated $969 million in allowance proceeds to the Greenhouse Gas Reduction Fund. Currently, GHG emissions from electricity and large industrial sources are subject to the cap. Beginning January 2015, transportation fuels will also be subject to the cap.

The 2013 Budget Act included a one-time General Fund loan of $500 million from Cap and Trade auction proceeds. Emergency drought legislation (Chapter 2, Statutes of 2014) and the 2014 Budget Act provide a total of $881 million of expenditures from the Greenhouse Gas Reduction Fund for programs that reduce GHG emissions. This amount of resources includes repayment of $100 million of the 2013 Budget Act loan, with the remaining balance being repaid with interest when needed to meet the future needs of the high-speed rail project. The 2015-16 Governor's Budget proposes over $1 billion of expenditures to continue the same programs that reduce GHG emissions.

Legal challenges to the authority of CARB to conduct auctions under the state's cap and trade program allege the auction revenues are an unconstitutional tax under the state

Constitution. Auctions are proceeding during the pendency of the legal challenges. See "LITIGATION – Actions Challenging Cap and Trade Program Auctions."

Retiree Health Care Costs

In addition to a pension, described in the following section "PENSION TRUSTS," the state also provides postemployment health care and dental benefits to its employees and their spouses and dependents, when applicable, and, except as otherwise described below, utilizes a "pay-as-you-go" funding policy. These are sometimes referred to as "Other Postemployment Benefits" or "OPEB."

As of June 30, 2013, approximately 163,100 retirees were enrolled to receive health benefits and 135,100 to receive dental benefits. Generally, employees vest for those benefits after serving 10 years with the state. With 10 years of service credit, employees are entitled to 50 percent of the state's full contribution. This rate increases by 5 percent per year and with 20 years of service, the employee is entitled to the full 100/90 formula (as described below). Additional information on the State's OPEB plan can be found in the Comprehensive Annual Financial Report for the fiscal year ended June 30, 2013 included as APPENDIX B to this Official Statement.

Pursuant to the Governmental Accounting Standards Board Statement No. 45, Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions, the state now reports on its liability for postemployment healthcare as well as other forms of postemployment benefits, such as life insurance, in its annual financial reports. The long-term costs for other postemployment benefits may negatively affect the state's financial reports and impact its credit rating if the state does not adequately manage such costs.

On December 16, 2014, the State Controller's Office released the state's latest OPEB actuarial valuation report by the private actuarial firm, Gabriel, Roeder, Smith & Company, which was tasked with calculating the state's liability for these benefits. The report was based on a variety of data and economic, demographic and healthcare trend assumptions described in the report. The primary assumption influencing Annual OPEB Costs and the Actuarial Accrued Liability ("AAL") is the assumed rate of return or discount rate on assets supporting the retiree healthcare liability. Based on PMIA's historical returns, investment policy and expected future returns, a discount rate of 4.25 percent was selected for the pay as you-go funding policy. The economic assumptions such as the price and wage inflation are assumed to be 2.75 percent and 3 percent, respectively. The actuarial valuation contained in the report covers the cost estimates for existing employees, retirees and dependents. The main objective of the report was to estimate the AAL, which is the present value of future retiree healthcare costs attributable to employee service earned in prior fiscal years.

The report looked at three different scenarios: (i) continuation of the "pay-as-you-go" policy; (ii) a "full funding" policy under which assets would be set aside to prepay the future obligations, similar to the way in which pension obligations are funded, and (iii) a "partial funding" policy, a hybrid of the two scenarios. According to the actuarial valuation as of June 30, 2014, the pay-as-you go funding policy results in an unfunded AAL of $71.81 billion as of June 30, 2014. Additionally, the pay-as-you go funding policy results in an annual OPEB cost of $5.14 billion, estimated employer contributions of $1.87 billion and an expected net OPEB obligation of $22.63 billion for fiscal year 2014-15. The annual required contribution for fiscal year 2015-16 is estimated at $5.62 billion.

If the previous assumptions had been exactly realized during the year, the actuarial liability would have increased to $67.99 billion as of June 30, 2014. The key factors contributing to a $3.82 billion increase in expected actuarial liabilities had the previous assumptions been realized are:

- Favorable healthcare claims experience and plan design changes, resulting in a decrease in actuarial liabilities of approximately $3.32 billion.

- Demographic experience did not change the actuarial liabilities significantly. There were most likely offsetting gains and losses that led to this minimal change. Examples of demographic experience gains include: fewer members retiring than assumed, members retiring later than assumed and members not living as long as assumed. Examples of demographic experience losses include: more members retiring than assumed, members retiring earlier than assumed and members living longer than assumed.

- Subsequent to the June 30, 2013, GASB No. 45 actuarial valuation, CalPERS performed a fourteen-year experience study where all pension related assumptions were reviewed. Many of the assumptions were updated to reflect actual experience over the fourteen-year period. These changes have been adopted for this valuation. The assumption changes increased liabilities by approximately $7.14 billion. The largest change was due to the updating of the mortality table used to model post-retirement deaths. Under the new assumptions members are expected to live longer. The change in demographic assumptions is the largest contributor to the loss in actuarial liability.

The valuation depended primarily on the interest discount rate assumption used to develop the present value of future benefits and on the assets available to pay benefits. The discount rate of 4.25 percent represents the long-term expectation of the earnings on the state's General Fund, which is invested in short-term securities in the PMIA. The State Controller's Office plans to issue an actuarial valuation report annually.

The following table is the historic annual OPEB cost summary and the projected schedule of funding progress as of the valuation date for the five fiscal years indicated below:

TABLE 23
OPEB Pay-As-You-Go Funding
Fiscal Years 2009-10 to 2013-14

(Dollars in Billions)

Fiscal Year	Annual OPEB Cost	Net Employer Contribution	Percentage of Annual OPEB Cost Contribution	Net OPEB Obligation	Unfunded Actuarial Accrued Liability[b]	Unfunded Actuarial Accrued Liability as Percent of Payroll[b]
2010-11	$4.21	$1.58	38%	$9.88	$62.14	345%
2011-12	4.74	1.72	36	12.91	63.84	341
2012-13	4.99	1.78	36	16.12	64.57	358
2013-14	5.12	1.87	37	19.36	71.77	373
2014-15[a]	5.13	1.87	36	22.63	N/A	N/A

[a] Net employer contribution and Net OPEB Obligation estimated for fiscal year ending June 30, 2015.

[b] Amounts are projected as of the valuation date.

Source: State of California OPEB Valuation as of June 30, 2014.

The following table illustrates the state's budget for postemployment benefits from fiscal years 2007-08 to 2015-16 and does not reflect any future liability for current employees or annuitants. It is anticipated that these costs will continue to grow in the future. The employer contribution for health premiums maintains the average 100/90 percent contribution formula established in the Government Code. Under this formula, the state averages the premiums of the four largest health benefit plans in order to calculate the maximum amount the state will contribute toward the retiree's health benefits. The state also contributes 90 percent of this average for the health benefits of each of the retiree's dependents. CSU employees fully vest for the 100/90 formula at 5 years of service. Employees in bargaining unit 12, hired after January 1, 2011, are subject to a longer vesting period.

[BALANCE OF PAGE INTENTIONALLY LEFT BLANK]

TABLE 24
Actual Costs/Budget for Other Postemployment Benefits
Fiscal Years 2007-08 through 2015-16

(Dollars in Thousands)

Fiscal Year	State Employees All Funds[c]	State Employees General Fund	CSU Employees All General Fund	Total Contributions All Funds	Total General Fund Contributions
2007-08	1,114,317	1,051,486	N/A	1,114,317	1,051,486
2008-09	1,183,495	1,146,932	N/A	1,183,495	1,146,932
2009-10	1,182,497	1,145,934	N/A	1,182,497	1,145,934
2010-11	1,386,839	1,351,008	N/A	1,386,839	1,351,008
2011-12	1,504,928	1,466,528	N/A	1,504,928	1,466,528
2012-13	1,365,234	1,337,089	222,135	1,587,369	1,359,224[b]
2013-14	1,382,717	1,378,709	225,332	1,608,049	1,604,041
2014-15[a]	1,521,070	1,515,070	263,062	1,784,132	1,778,132
2015-16[a]	1,600,098	1,595,498	263,503	1,863,601	1,859,001

[a] Estimated Contributions.

[b] Contributions for post-employment benefits are included for all years displayed in this table. However, beginning in 2012-13, CSU contributions are split out and identified separately.

[c] "Pay-as-you-go" contributions from General Fund and Public Employee's Contingency Reserve Fund.

Source: State of California, Department of Finance.

Three state employee bargaining units have agreements which provide for some prefunding of OPEB liabilities. These units represent a little less than 10 percent of total state unionized employees.

In accordance with state law, the Bureau of State Audits periodically identifies what it believes to be "high risk" issues facing the state. The funding of OPEB liabilities has been identified as a high-risk issue in the California State Auditor Report 2013-601 dated September 2013.

2015-16 Budget Proposal

As part of the 2015-16 Budget process, the Governor proposed a comprehensive strategy to eliminate the OPEB unfunded actuarial accrued liability, and reduce the cost structure of employee and retiree health care benefits.

Reducing Retiree Health Care Unfunded Liabilities – the 2015-16 Governor's Budget proposes to eliminate the OPEB unfunded actuarial accrued liability in approximately 30 years. The 2015-16 Governor's Budget proposal calls for using the upcoming collective bargaining process to negotiate additional contributions for OPEB prefunding equivalent to the normal costs of those benefits. The goal is to have the additional contributions equally shared between employers and employees and phased in over a three-year period. The funding plan assumes that the state continues to pay for retiree health benefits on a pay-as-you-go basis while assets are accumulated in a trust fund, and that no investment income will be used to pay for benefits until the plan is fully funded. The 2015-16 Governor's Budget does not set aside funding for additional OPEB prefunding. The Department of Finance estimates that the state's share of prefunding for Executive Branch employees will be approximately $600 million annually once fully implemented. (The "Executive Branch" generally excludes employees in the legislative and judicial branches of the state government, as well as employees of CSU and UC. See "OVERVIEW OF STATE GOVERNMENT - Organization of State Government.")

Curbing Health Care Benefit Costs – the 2015-16 Governor's Budget includes proposals designed to address the cost structure of state health care benefits for both retirees and active employees. This includes the addition of lower cost benefit options such as a high deductible health plan coupled with a health savings account. Proposals also include extending the vesting period for new employees to qualify for retiree health care contributions, and reducing the employer subsidies for the retiree health care contributions for new employees.

PENSION TRUSTS

General

The principal retirement systems in which the state participates or contributes funds to are the California Public Employees' Retirement System ("CalPERS") and the California State Teachers' Retirement System ("CalSTRS"). The assets and liabilities of the funds administered by CalPERS and CalSTRS are included in the financial statements of the state as fiduciary funds. A summary description of CalPERS and CalSTRS is set forth in Note 24 (and the Schedule of Funding Progress included in the Required Supplementary Information) to the Audited Basic Financial Statements of the State of California for the Year Ended June 30, 2013. See "FINANCIAL STATEMENTS."

The University of California ("UC") maintains a separate retirement system. From fiscal years 1990-91 through 2011-12, no amounts from the state's General Fund directly contributed to UC's retirement system. The 2012 Budget Act and Chapter 31 of the Statutes of 2012 provided $89.1 million in state General Fund appropriations for UC's employer retirement contributions for fiscal year 2012-13; this funding does not constitute a state obligation to provide funding after fiscal year 2012-13 for additional UC employer retirement costs.

The 2013 Budget Act did not allocate any of UC's appropriation specifically to fund its employer retirement costs, however, the 2013 Budget Act and Chapter 50 of the Statutes of 2013 shifted funding for UC's general obligation and lease-revenue bond debt service into UC's main support appropriation, authorized UC to restructure its debt, and required UC to use any savings from restructuring of debt to reduce the existing unfunded liability of the UC's retirement plan. Information about this system may be obtained directly from UC. The 2015-16 Governor's Budget does not allocate any of UC's appropriation specifically to fund their employer retirement costs.

As described below, the obligation of the state to make payments to CalPERS and CalSTRS to fund retirement benefits constitutes a significant financial obligation. CalPERS and CalSTRS each currently have unfunded liabilities in the tens of billions of dollars. Retirement-related costs payable from the General Fund are expected to increase in the foreseeable future. The actual amount of such increases will depend on a variety of factors, including but not limited to investment returns, actuarial assumptions, experience, retirement benefit adjustments and, in the case of CalSTRS, statutory changes to contribution levels.

This section contains certain information relating to CalPERS and CalSTRS. The information is primarily derived from information produced by CalPERS and CalSTRS, their independent accountants and their actuaries. The state has not independently verified the information provided by CalPERS and CalSTRS and makes no representations nor expresses any opinion as to the accuracy of the information provided by CalPERS and CalSTRS.

The comprehensive annual financial reports of CalPERS and CalSTRS are available on their websites at www.calpers.ca.gov and www.calstrs.ca.gov, respectively. The CalPERS and CalSTRS websites also contain the most recent actuarial valuation reports, as well as other information concerning benefits and other matters. Such information is not incorporated by reference herein. The state cannot guarantee the accuracy of such information. Actuarial assessments are "forward-looking" information that reflect the judgment of the fiduciaries of the pension plans, and are based upon a variety of assumptions, one or more of which may not materialize or be changed in the future. Actuarial assessments will change with the future experience of the pension plans.

On June 25, 2012, the Governmental Accounting Standards Board ("GASB") approved two new standards with respect to pension accounting and financial reporting standards for state and local governments and pension plans. The new standards are set forth in GASB Statements 67 and 68 and will replace GASB Statement 27 and most of GASB Statements 25 and 50. The changes will impact the accounting treatment of pension plans in which state and local governments participate. Major changes include: 1) the inclusion of unfunded pension liabilities on the government's balance sheet (currently, such unfunded liabilities are typically included as notes to the government's financial statements); 2) more components of full pension costs will be shown as expenses regardless of actual contribution levels; 3) lower actuarial discount rates will be required to be used for underfunded plans in certain cases for purposes of the financial statements; 4) closed amortization periods for unfunded liabilities will be required to be used for certain purposes of the financial statements; and 5) the difference between expected and actual investment returns will be recognized over a closed five-year smoothing period.

In addition, GASB Statement 68 states that, for pensions within the scope of the statement, a cost-sharing employer that does not have a special funding situation is required to recognize a net pension liability, deferred outflows of resources, deferred inflows of resources related to pensions, and pension expense based on its proportionate share of the net pension liability for benefits provided through the pension plan. While the new accounting standards change financial statement reporting requirements, they do not impact funding policies of the pension systems. The reporting requirements for pension plans began in fiscal year 2013-14 and the reporting requirements for government employers began in fiscal year 2014-15. The impact of new GASB reporting requirements are reflected in the CalPERS and CalSTRS Comprehensive Annual Financial Reports for year ended June 30, 2014.

Pension Reform

PEPRA

Chapter 296, Statutes of 2012 (AB 340), a comprehensive pension reform package affecting state and local government, increased the retirement age and lowered retirement benefits for most new state and local government employees hired on or after January 1, 2013. AB 340, known as the Public Employees' Pension Reform Act of 2013 ("PEPRA") also includes provisions to increase current employee contributions. Though PEPRA covers most public employees in state government, cities, counties, special districts, school districts, and community colleges, the following discussion relates only to PEPRA's impact on state employee retirement. PEPRA excludes judges, the University of California, and charter cities with independent pension systems from the new retirement plans; however, newly elected or appointed judges would be subject to the new cost-sharing provisions described below.

In a preliminary actuarial analysis, CalPERS noted savings to the state of $10.3 billion to $12.6 billion over the next 30 years due primarily to increased employee contributions and, as the workforce turns over, lower benefit formulas that will gradually reduce normal costs. PEPRA also directs state savings from additional employee contributions to be used toward additional payments on the state's unfunded liability, subject to Budget Act approval. The 2015-16 Governor's Budget includes an additional $106.6 million ($72.6 million General Fund) directed toward the state's unfunded pension liability to reflect the savings resulting from increased employee contributions under PEPRA.

Other provisions reduce the risk of the state incurring additional unfunded liabilities, including prohibiting retroactive benefits increases, generally prohibiting contribution holidays, and prohibiting purchases of additional non-qualified service credit ("air time").

Key changes to retirement plans affecting the state include:

- New, lower defined-benefit formulas that increase retirement ages for new public employees hired on or after January 1, 2013.

- For new employees, a cap on pensionable income in the 2015 calendar year of $117,020, or $140,424 (for employees not in Social Security). Annual increases on the cap would be limited to the Consumer Price Index for All Urban Consumers.

- A standard that employees pay at least 50 percent of normal costs.

- Establishes increases for current state civil service and related excluded employees who are not contributing at least half of normal costs.

- CSU and judicial branch employees hired on or after January 1, 2013 will pay at least 50 percent of the normal cost or the current contribution rate of similarly situated employees, whichever is greater.

- Chapter 528, Statutes of 2013, (SB 13) made clarifying and technical amendments to PEPRA which authorizes CSU, on or after January 1, 2019, to impose higher employee contribution rates on CSU members hired before January 1, 2013. SB 13 also directs savings from increased CSU employee contributions to be retained by the university.

Costs for OPEB are not addressed in PEPRA, however, later retirement ages will help reduce OPEB liabilities in the long term. See "STATE FINANCES – Retiree Health Care Costs."

Provisions in PEPRA affecting CalSTRS did not change the state's statutory contribution rate. However, potential additional employee contributions, limits on pensionable compensation, and higher retirement ages for new members will reduce pressure on the system's unfunded liabilities and potentially state contribution levels in the long term. See "CalSTRS Funding Solution."

On August 20, 2014, the CalPERS Board voted to submit to the Office of Administrative Law for further review proposed regulations on the type of pay items that can be counted in an employee's pension calculation upon retirement. The regulations affect only state and local government employees hired after January 1, 2013.

CalPERS included approximately 100 types of pay items as permitted by the state's recent pension-reform legislation. All of the major cost-savings components of the pension reform law (including lower benefit formulas, cap on pensionable income, and a three-year final compensation period) remain intact.

The Administration does have a disagreement with CalPERS over one pay item included in the proposed regulations – for temporary pay upgrades ("out-of-class" pay). In 2013, no state employees subject to the pension-reform law received an out-of-class pay differential. As the workforce turns over, the Department of Finance estimates that, after 30 years, approximately 1,000 employees (less than one-half of one-percent of today's Executive Branch workforce) could receive an out-of-class pay premium in a given year.

CalSTRS Funding Solution

As described in "PENSION TRUSTS – CalSTRS," the funding of the CalSTRS Defined Benefit Plan (referred to in the state's 2013 Financial Statements and in this APPENDIX A as the "DB Program") is based on contribution rates set by statute instead of actuarially determined amounts as is done for the CalPERS system. Over time, this has contributed to an underfunding of the DB Program which has been a concern in recent years. As one example, the funding status of the DB Program was identified as a high risk issue in the California State Auditor report 2013 601 dated September 2013 because, as stated in the report, the DB Program assets were projected to be depleted in 31 years (33 years based on the June 30, 2013 CalSTRS Valuation) assuming existing contribution rates continue, and other significant actuarial assumptions are realized. In 2013 and 2014, the Governor, the Legislature and CalSTRS worked to develop an approach to addressing the long-term funding needs of the DB Program.

The 2014 Budget Act contained this legislative solution and on June 24, 2014, the Governor signed AB 1469, a comprehensive funding solution intended to eliminate the current CalSTRS unfunded liability on the DB Program by 2046. The plan started modestly in fiscal year 2014-15, providing state, schools, and teachers sufficient time to prepare for future increases in contributions. The 2015-16 Governor's Budget directs an estimated $1.414 billion ($371 million from the state's General Fund) in additional contributions to the DB Program from all three entities.

Under the plan, teacher (member) contributions will increase from 8 percent to a total of 10.25 percent of creditable compensation for members not subject to PEPRA and 9.205 percent for members subject to PEPRA, phased in over time on July 1, 2014, July 1, 2015 and July 1, 2016.

School (employer) contributions will increase from 8.25 percent to a total of 19.1 percent of creditable compensation, phased in on each July 1 from 2014 through 2020. These school contributions will be paid from existing revenue sources.

The state's total contribution to the DB Program will increase from approximately 3.5 percent on July 1, 2014 to 6.3 percent of payroll on July 1, 2016 and thereafter. In addition, the state will continue to pay 2.5 percent of payroll annually for a supplemental inflation protection program—for a total of 8.8 percent.

The plan also provides the CalSTRS Board with limited authority to increase or decrease the school and state contributions based on changing conditions. The plan is intended to eliminate the unfunded liability of the DB Program by 2046. However, while AB 1469 provides for significant increases in the statutorily required contributions to CalSTRS from the state, employers and members, it does not provide that such statutory rates be adjusted to equal actuarially required amounts from time to time. Actuarially required amounts will vary from time to time based on a variety of factors, including actuarial assumptions, investment performance and member benefits. To the extent rates established pursuant to AB 1469 are less than actuarially required amounts from time to time, such circumstances could materially adversely effect the funded status of CalSTRS.

CalPERS

1. General

At June 30, 2014, CalPERS administered a total of 13 funds, including four defined benefit retirement plans: the Public Employees' Retirement Fund ("PERF"), the Legislators' Retirement Fund ("LRF"), the Judges' Retirement Fund ("JRF"), and the Judges' Retirement Fund II ("JRF II"). (These plans, as well as the other plans administered by CalPERS, are described in the comprehensive financial reports of CalPERS, which can be found on CalPERS' website at www.calpers.ca.gov. Such information is not incorporated by reference herein.) The PERF, LRF, JRF, and JRF II are defined benefit pension plans which provide benefits based on members' years of service, age, final compensation, and benefit formula. In addition, benefits are provided for disability, death, and survivors of eligible members or beneficiaries. Certain summary information concerning PERF is set forth below. Certain summary information concerning LRF, JRF, JRF II, and the 1959 Survivor Benefit program is set forth at the end of this section.

CalPERS is administered by a 13-member Board of Administration (the "CalPERS Board"), that includes the State Controller, State Director of the Department of Human Resources, and the State Treasurer, who serve ex officio. The other CalPERS Board members include a member elected by school employees, a member elected by retirees, a member elected by state employees, a member elected by public agency employees, a member designated by the State Personnel Board, a public representative appointed jointly by the Speaker of the Assembly and the Senate Rules Committee, an official of a life insurer appointed by the Governor, an elected local official appointed by the Governor, and two members elected by all employees.

2. PERF

PERF is a multiple-employer defined benefit retirement plan. In addition to the state, employer participants at June 30, 2014 included 1,580 public agencies and 1,513 school districts (representing 3,093 entities). CalPERS acts as the common investment and administrative agent for the member agencies. The state and schools (for "classified employees," which generally consist of school employees other than teachers) are required by law to participate in PERF. Other public agencies can elect whether or not to participate in PERF or administer their own plans. Members of PERF generally become fully vested in their retirement benefits earned to date after five years of credited service. Separate accounts are maintained for each employer participating in PERF, and separate actuarial valuations are performed for each individual employer's plan to determine the employer's periodic contribution rate and other information for the individual plan, based on the benefit formula selected by the employer and the individual plan's proportionate share of PERF assets.

Unless otherwise specified, the information relating to PERF provided in this section relates only to state employees participating in PERF. State employees include Executive Branch, California State University, Judicial, and Legislature employees.

3. Members

Benefits to state employees are paid according to the category of employment and the type of benefit coverage provided by the state. All employees in a covered class of employment who work on a half-time basis or more are eligible to participate in PERF. The five categories of membership applicable to state employees are set forth below. Certain of the categories also have "tiers" of membership. It is up to the employee to select his or her preferred membership tier. Different tiers may have different benefits, as well as different employee contribution requirements. The member categories are as follows:

- Miscellaneous Members – staff, operational, supervisory, and all other eligible employees who are not in special membership categories.

- Safety Members – employees whose principal duties are in active law enforcement or fire prevention and suppression work but are not defined as a State Peace Officer/Firefighter Member, or who occupy positions designated by law as Safety Member positions.

- State Industrial Members – employees of the California Department of Corrections and Rehabilitation who have the same service retirement and other benefits as Miscellaneous Members, but who also have industrial death and disability benefits under certain limited circumstances.

- State Peace Officer/Firefighter Members – employees who are involved in law enforcement, firefighting and fire suppression, public safety, protective services, or the management and supervision thereof, whose positions are defined as State Peace Officer/Firefighter Members in the Government Code or by the Department of Human Resources.

- Patrol Members – California Highway Patrol officers and their related supervisors and managers.

[BALANCE OF PAGE INTENTIONALLY LEFT BLANK]

The following table reflects the number of state employee members of PERF as of June 30, 2013 and June 30, 2014. (PERF's fiscal year commences July 1 and ends June 30 of the following year).

TABLE 25
PERF Membership (State Employees) as of June 30, 2013 and 2014

Category	2013	2014
Retirees	175,851	180,666
Survivors and Beneficiaries	28,785	30,575
Active Members	243,620	246,834
Inactive Members	90,463	94,813
Total	538,719	552,888

Source: CalPERS Comprehensive Annual Financial Report for Fiscal Years ended June 30, 2013 and June 30, 2014.

4. *Retirement Benefits*

For state employees, annual benefits depend on the particular employee's employment category and are generally determined by taking into account years of service credit, final compensation, and age of retirement. Depending on the employment category, annual benefits generally range from 2 percent of final compensation (generally meaning the average pay rate and special compensation over the last one year or three consecutive years of employment, unless the member elects a different period with a higher average) at age 55 for each year of service credit (applicable to Miscellaneous and State Industrial category members) to 3 percent of final compensation for each year of service for retirement at age 50 (for State Peace Officer/Firefighter category members). Annual benefits are also subject to annual cost of living adjustments (generally ranging from 2-3 percent) and an additional adjustment intended to preserve the "purchasing power" of the benefit. Benefits also generally include disability and death benefits. A detailed description of the benefits payable by PERF to state employees is set forth in CalPERS actuarial valuations.

Legislation enacted in October 2010 as part of the state's budget for fiscal year 2010-11 (SB 22, Chapter 3, Sixth Extraordinary Session of 2010) ("SBX6 22") made changes to the retirement formula for state employees hired after January 15, 2011, unless an earlier date was agreed upon in a collective bargaining agreement. Generally, the formula for receiving full retirement benefits was restored to the provisions in effect prior to 1999, when a law increased the percentage formula and reduced the age at which employees could obtain maximum benefits; these formulas vary depending on the category of employment.

SBX6 22 also addressed the problem of pension "spiking" by generally requiring the retirement formula for future employees not currently in the three-year formula to be based on an average of pay in three consecutive years, rather than being based on the single highest year's pay. These reforms will not significantly impact state retirement costs until many years in the future. However, there are also current savings from most existing and future employees contributing a greater percentage, ranging from two to five percent, of their salaries toward future pension benefits. These increases were collectively bargained and extended to most non-represented employees.

AB 340 is a comprehensive pension reform package impacting state and local governments that increased retirement age and reduced benefits for most new employees. See "PENSION TRUSTS – Pension Reform."

The following table shows the amount of benefits paid from PERF for fiscal years 2007-08 through 2012-13.

TABLE 26
PERF (State Only)
Schedule of Benefits Paid

(Dollars in Millions)

Fiscal Year	Amount of Benefits Paid
2007-08	$4,741
2008-09	5,037
2009-10	5,485
2010-11	6,017
2011-12	6,711
2012-13	6,935

Source: CalPERS State and Schools Actuarial Valuation for fiscal years ended June 30, 2007 through June 30, 2012; State Actuarial Valuation for Fiscal Year Ended June 30, 2013.

5. Member Contributions

The benefits for state employees in PERF are funded by contributions from members, the state, and earnings from investments. Member and state contributions are a percentage of applicable member compensation. Member contribution rates are defined by law and vary by bargaining units within the same employee classification. The required contribution rates of active plan members are based on a percentage of salary in excess of a base compensation amount ranging from $0 to $863 monthly, and range from 3 to 13 percent.

6. Actuarial Methods

Generally, the ultimate cost that PERF incurs is equal to benefits paid plus the expenses resulting from administration. These costs are paid through contributions to the plan and investment earnings on PERF's assets. Using the state plan's schedule of benefits, member data, and a set of actuarial assumptions, CalPERS' actuary estimates the cost of the benefits to be paid. Then, using the actuarial funding method determined by CalPERS (as described below), the actuary allocates these costs to the fiscal years within the employee's career. CalPERS' financial objective is to fund in a manner which keeps contribution rates approximately as a level percentage of payroll from generation to generation, while accumulating sufficient assets over each member's working career.

The primary funding method used to accomplish this objective is the "Entry Age Normal Cost Method." New GASB standards will require all states and local governments with pension liabilities to use the Entry Age Normal Cost Method beginning in fiscal year 2014-15 if they are not already doing so. Annual actuarial valuations are performed as of each June 30. Information through the most recent valuation date of June 30, 2013 is set forth below. According to CalPERS, the actuarial assumptions and methods used by CalPERS for funding purposes meet the current parameters set for disclosures presented in the Financial Section by GASB Statements 25 and 27.

Under the Entry Age Normal Cost Method, projected benefits are determined for all members. For active members, liabilities are spread in a manner that produces level annual costs as a level percent of pay in each year from the age of hire (entry age) to the assumed retirement age. The cost allocated to the current fiscal year is called the "normal cost." The Actuarial Accrued Liability ("AAL") for active members is then calculated as the portion of the total cost of the plan allocated to prior years.

The AAL for members currently receiving benefits, for active members beyond the assumed retirement age, and for inactive members entitled to deferred benefits is equal to the present value of the benefits expected to be paid. No normal costs are applicable for these participants. The excess of the total AAL over the value of plan assets is called the unfunded actuarial accrued liability. The required contribution is then determined by adding the normal cost and an amortization of the unfunded liability as a level percentage of assumed future payroll.

With respect to CalPERS, the unfunded liability is broken down into components, or bases, according to their date of origin and the cause that gave rise to that component. A component of the unfunded liability that arose due to a change in plan provisions or in actuarial methods or assumptions is separately tracked and amortized over a declining 20-year period. The actuarial assumptions discussed below are used to determine projected benefits. The effect of differences between those assumptions and the actual experience of the plan is calculated each year when the annual actuarial valuation is performed. These differences are actuarial gains or losses.

Gains and losses are tracked separately and amortized over a rolling 30-year period (except as described below with respect to gains and losses in fiscal years 2008-09 through 2010-11). A maximum 30-year amortization payment on the entire unfunded liability is enforced on the amortization methods described above. In addition, when the amortization methods described above result in either mathematical inconsistencies or unreasonable actuarial results, all unfunded liability components are combined into a single base and amortized over a period of time, as determined by the CalPERS Chief Actuary. There is a minimum employer contribution equal to normal cost, less 30-year amortization of surplus (negative unfunded liability), if any.

In 2009, the CalPERS Board adopted a change to the amortization policy, described in the following section. This change resulted in all actuarial gains and losses for fiscal years 2008-09, 2009-10, and 2010-11 to be amortized over a fixed 30-year period instead of a rolling 30-year period. The rolling 30-year period for amortization resumed with actuarial gains and losses for fiscal year 2011-12.

In April of 2013, the CalPERS Board adopted new amortization and smoothing methodologies. The new methodologies replace the current 15-year asset-smoothing policy with a 5-year direct-rate smoothing process and replace the current 30-year rolling amortization of actuarial gains and losses with a 30-year fixed amortization period. See the following section for further detail.

7. *Actuarial Valuation; Determination of Required Contributions*

The required state contributions to PERF are determined on an annual basis by the CalPERS Chief Actuary. The actuary uses demographic and other data (such as employee age, salary, and service credits) and various assumptions (such as estimated salary increases, interest rates, employee turnover, and mortality and disability rates) to determine the amount that the state must contribute in a given year to provide sufficient funds to PERF to pay benefits when due. The actuary then produces a report, called the "actuarial valuation," in which the actuary reports on the assets, liabilities, and required contribution for the following fiscal year. State law requires the state to make the actuarially-required contribution to PERF each year.

A portion of the actuarial valuations performed by CalPERS actuaries are audited each year by an independent actuarial firm. The actuarial valuations specific to state employees are audited every three years. The most recent audit was for the June 30, 2012 actuarial valuation and was completed February 24, 2014.

The market value of assets measures the value of the assets available in the pension plan to pay benefits. The actuarial value of assets is used to determine the required employer contributions. Various methods exist for calculating the actuarial value of assets. Since 2005, CalPERS has recognized investment gains and losses on the market value of assets equally over a 15-year period when determining the actuarial value of assets. (This is referred to as "smoothing.") The recognized portion is added to the gains and losses and (except as described herein) is amortized over a rolling 30-year period (as described herein under "Actuarial Methods"). This is currently an approved method for determining actuarial value of assets under GASB Statements 25 and 27.

Asset smoothing delays recognition of gains and losses, however, thereby providing an actuarial value of assets that does not reflect the market value of pension plan assets at the time of measurement. As a result, presenting the actuarial value of assets as determined using "smoothing" might provide a more or less favorable presentation of the current financial position of a pension plan than would a method that recognizes investment gains and losses annually. As discussed under the caption "PENSION TRUSTS – General," beginning in fiscal year 2014-15, GASB Statement 68 will require state and local governments with pension liabilities to recognize the difference between expected and actual investment returns over a closed 5-year period. CalPERS will continue to set contributions based on an actuarial value basis until fiscal year 2015-16, at which time CalPERS will implement a new direct-rate smoothing policy as described below.

In addition to the use of "smoothing," as described above, when CalPERS sets contribution rates, the actuarial value of assets generally cannot be more than 120 percent of the market value or less than 80 percent of the market value (referred to as the "corridor"). Any asset value changes outside these ranges will be recognized immediately, and will result in a greater impact on future state contribution rates.

The use of "smoothing" and the "corridor" described above will mitigate short term increases in the state's required annual contribution. While this will limit extreme increases in the state's required annual contribution to CalPERS in the near term, absent investment returns significantly over and above the 7.5 percent assumed by CalPERS, it is expected to result in significantly higher required contributions in future fiscal years.

Depending on actual investment returns and other factors, the state's required annual contribution to PERF could increase significantly. The contribution, not including CSU, is estimated to be $4.4 billion for fiscal year2015-16, approximately $2.3 billion of which is payable from the General Fund. In addition, CSU's contribution is estimated to be approximately $603.6 million for fiscal year 2015-16, approximately $603.3 million of which is payable from the General Fund.

At the April 16 and 17, 2013, meetings, the CalPERS Board approved a plan to replace the current 15-year asset-smoothing policy with a 5-year direct-rate smoothing process and replace the current 30-year rolling amortization of unfunded liabilities with a 30-year fixed amortization period. The Chief Actuary stated that the approach provides a single measure of funded status and unfunded liabilities, less volatility in extreme years, a faster path to full funding, and more transparency to employers about future contribution rates. These changes will accelerate the repayment of unfunded liabilities (including fiscal year 2008-09 investment losses) of the state plans in the near term. Under the CalPERS Board action, actual rates for the state will not be set using the new methods until fiscal year 2015-16, reflected in the June 30, 2014 valuation.

8. *Actuarial Assumptions*

The CalPERS Chief Actuary considers various factors in determining the assumptions to be used in preparing the actuarial report. Demographic assumptions are based on a study of the actual history of retirement, rates of termination/separation of employment, years of life expectancy after retirement, disability, and other factors. This experience study is generally done once every four years. The most recent experience study was completed in 2014 in connection with the preparation of actuarial recommendations by the CalPERS Chief Actuary as described below. The following table sets forth certain economic actuarial assumptions for the fiscal years ended June 30, 2010 through June 30, 2013.

TABLE 27
Certain Actuarial Assumptions Utilized for PERF

Actuarial Assumption	2010	2011	2012	2013
Investment Returns	7.75%	7.50%	7.50%	7.50%
Inflation	3.00	2.75	2.75	2.75
Salary Increase (Total Payroll)	3.25	3.00	3.00	3.00

Source: CalPERS State and Schools Actuarial Valuation for fiscal years ended June 30, 2009 through June 30, 2012; State Actuarial Valuation for Fiscal Year Ended June 30, 2013.

On February 20, 2014, the CalPERS Board of Administration adopted new mortality and retirement assumptions as part of a regular review of demographic experience. Key assumption changes included longer post-retirement life expectancy, earlier retirement ages, and higher-than-expected wage growth for State Peace Officers/Firefighters and California Highway Patrol. The impact of the assumption changes will be phased in over three years, with a twenty year amortization, beginning in 2014-15.

The Department of Finance estimates these changes will incrementally increase state retirement contributions by an additional $430.1 million ($254.2 General Fund) in fiscal year 2014-15, an additional $267.2 million ($138.0 million General Fund) in fiscal year 2015-16, and an additional $281.1 million ($152.7 million General Fund) in fiscal year 2016-17. Since the assumption changes will be fully phased-in by 2016-17, the cumulative additional retirement contributions will be $978.5 million ($545.0 million General Fund). According to CalPERS, the assumption changes are estimated to increase the system's unfunded liability by approximately $9.0 billion in fiscal year 2014-15. These estimates only reflect the new assumptions and do not include other natural changes such as actual payroll and investment performance. In April 2014, the CalPERS Board adopted the fiscal year 2014-15 employer and member retirement contribution rates. The State actuarial valuation for the fiscal year ended June 30, 2013 was released in September 2014.

9. *Funding Status*

The following table sets forth the schedule of funding progress relating to the state's participation in PERF as of the ten most recent actuarial valuation dates. Funding progress is measured by a comparison of the state's share of PERF assets to pay state employee benefits with plan liabilities.

As reflected in the actuarial valuation report for the fiscal year ended June 30, 2013, the investment return for the PERF in fiscal year 2012-13 was 13.2 percent. As a result of this investment return, the funded ratio on an MVA basis was approximately 66.1 percent, and the unfunded liability was approximately $49.9 billion on an MVA basis as of June 30, 2013, as compared to approximately $45.5 billion on an MVA basis as of June 30, 2012.

In September 2014, CalPERS released the June 30, 2013 Actuarial Valuation. As set forth in the valuation, the state employer contribution rate increased for all retirement categories, which was primarily a result of the new mortality assumptions adopted by the CalPERS Board at the February 2014 meeting. Additionally, the unfunded liability increased to $49.9 billion as of June 30, 2013 as compared to $45.5 billion as of June 30, 2012 based on market value of assets. The funded status remained at 66.1 percent due to the higher than assumed 13.8 percent investment return for 2012-13, which offset the increased liabilities created by the new mortality assumptions. For prior fiscal years, the valuation report for the State plans has been combined with the report on the valuation of the Schools Pool. Due to differences in the timing of actuarial assumption changes and a desire to simplify the report and to provide greater flexibility in the future, separate reports are now being provided by CalPERS.

The actuarial report for the fiscal year ended June 30, 2013 can be found on the CalPERS website at *http://www.calpers.ca.gov/eip-docs/about/pubs/employer/2013-state-valuation.pdf.*

[BALANCE OF PAGE INTENTIONALLY LEFT BLANK]

TABLE 28
PERF Schedule of Funding Progress
State Employees Only
(Fiscal Years Ended June 30)

(Dollars in Millions)

	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13
Market Value of Assets (MVA)	$65,488	$74,050	$81,968	$96,988	$91,349	$68,179	$76,266	$91,159	$88,810	$97,453
Actuarial Value of Assets (AVA)	67,081	71,830	77,143	83,439	89,304	93,377	97,346	102,452	106,145	110,989
Actuarial Accrued Liabilities (AAL)-entry age	79,800	86,595	92,557	100,352	107,642	116,827	121,446	129,648	134,314	147,393
Excess of Market Value of Assets over AAL or Surplus (Unfunded) Actuarial Accrued Liabilities (UAAL) MVA Basis	(14,312)	(12,545)	(10,589)	(3,364)	(16,293)	(48,648)	(45,180)	(38,489)	(45,504)	(49,940)
Excess of Actuarial Value of Assets over AAL or Surplus (Unfunded) Actuarial Accrued Liabilities (UAAL) AVA Basis	(12,719)	(14,765)	(15,414)	(16,913)	(18,338)	(23,450)	(24,100)	(27,195)	(28,169)	(36,404)
Covered Payroll	12,624	12,935	13,299	14,571	15,890	16,333	16,281	16,212	15,680	15,347
Funded Ratio (MVA)	82.1 %	85.5 %	88.6%	96.6%	84.9%	58.4%	62.8%	70.3%	66.1%	66.1%
Funded Ratio (AVA)	84.1%	82.9%	83.3%	83.1%	83.0%	79.9%	80.2%	79.0%	79.0%	75.3%

Source: CalPERS State and Schools Actuarial Valuation, Fiscal Year Ended June 30, 2012 and prior years; State Actuarial Valuation, Fiscal Year Ended June 30, 2013.

10. State Contributions

As described above, required contributions to PERF are determined annually on an actuarial basis. Payments into PERF are made from the state and from employee contributions. State contributions are made from the General Fund, special funds, and non-governmental cost funds. From fiscal years 2007-08 to 2014-15, a range of approximately 55 to 63 percent of the state contributions to PERF are made from the General Fund. Table 29 shows the state's actual contributions to PERF for fiscal years 2008-09 through 2013-14 and estimated contributions for fiscal years 2014-15 and 2015-16. The state has made the full amount of actuarially required contribution each year.

TABLE 29
State Contribution to PERF, including CSU
Fiscal Years 2007-08 to 2015-16
Fiscal Year Ending June 30

(Dollars in Thousands)

Fiscal Year	State Employees All Funds[b]	State Employees General Fund[b]	CSU Employees All Funds	CSU General Fund	Total Contributions	Total General Fund Contributions[b]
2008-09	$3,063,009	$1,684,655	N/A	N/A	$3,063,009	$1,684,655
2009-10	2,860,787	1,573,433	N/A	N/A	2,860,787	1,573,433
2010-11	3,230,489	1,776,769	N/A	N/A	3,230,489	1,776,769
2011-12	3,174,494	1,745,972	N/A	N/A	3,174,494	1,745,972
2012-13	2,948,137	1,506,043	449,243	449,000	3,397,380	1,955,043
2013-14	3,219,262	1,644,546	473,798	473,542	3,693,060	2,118,088
2014-15[a]	4,041,591	2,119,742	542,814	542,520	4,584,405	2,662,262
2015-16[a]	4,428,645	2,318,026	603,647	603,344	5,032,292	2,921,371

[a] Estimated contributions.

[b] Pension contributions for CSU employees are included for all years displayed in this table. However, beginning in 2012-13, CSU contributions are split out and identified separately.

Source: State of California, Department of Finance.

11. Prospective Funding Status; Future Contributions

The level of future required contributions from the state depends on a variety of factors, including future investment portfolio performance, actuarial assumptions, and additional potential changes in retirement benefits. There can be no assurances that the required annual contribution to CalPERS will not continue to significantly increase and that such increases will not materially adversely affect the financial condition of the state. See the caption "PENSION TRUSTS – General" for a discussion of new standards adopted by GASB. It is not known at this time how these changes in accounting and financial reporting will impact CalPERS' contribution policies.

The following employer contribution rates are included in the 2015-16 Governor's Budget:

	Fiscal Year 2015-16 Employer Contribution Rates
State Miscellaneous Tier 1	25.982%
California State University, Miscellaneous Tier 1	25.982
State Miscellaneous Tier 2	26.127
State Industrial	18.948
State Safety	19.782
State Peace Officers & Firefighters	39.147
California State University, Peace Officers and Firefighters	39.147
California Highway Patrol	46.919

In accordance with state law, the actuarial valuation for the fiscal year ended June 30, 2013 includes a sensitivity analysis of discount rates 2 percent lower and 2 percent higher than the current discount rate of 7.5 percent. The analysis displays potential required employer contribution rates assuming that the discount rate was adjusted to rates of 5.5 percent or 9.5 percent over the long term. The analysis shows that employer contribution rates are highly sensitive to changes in the discount rate and that employer contribution rates would be significantly reduced if a higher discount rate is used, and employer contribution rates would significantly increase if a lower discount rate is used. The actuarial report for the year ended June 30, 2013 contains information concerning the specific impact on employer contribution rates and unfunded liability resulting from these different discount rate assumptions.

As described herein, on April 17, 2013, the CalPERS Board of Administration approved a recommendation to change the CalPERS amortization and smoothing policies. Beginning with the June 30, 2014 valuation that will set the 2015-16 rates, CalPERS will employ an amortization and rate smoothing policy that will pay for all gains and losses over a fixed 30-year period with the increases or decreases in the rate spread over a 5-year period. The table below, excerpted from the actuarial report for the year ended June 30, 2013, shows projected employer contribution rates for the next six fiscal years, assuming CalPERS earns 18 percent for fiscal year 2013-14 and 7.50 percent every fiscal year thereafter, and assuming that all other actuarial assumptions will be realized and no changes to assumptions, contributions, benefits, or funding methods. These projections take into account the positive impact PEPRA is expected to gradually have on the normal cost.

Plan	New Rate	Projected Future Employer Contribution Rates					
	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20	2020-21
State Miscellaneous Tier 1	24.198%	25.9%	27.6%	27.8%	28.1%	28.3%	28.2%
State Miscellaneous Tier 2	23.510	25.2	27.1	27.5	27.9	28.4	28.4
State Industrial	17.286	18.1	19.0	19.0	19.1	19.1	18.9
State Safety	18.156	18.6	19.0	18.7	18.4	18.1	17.8
POFF	35.180	37.5	39.8	39.9	40.1	40.2	39.9
CHP	42.175	45.6	49.0	49.3	49.7	50.0	49.8

The tables below, excerpted from the actuarial report for the year ended June 30, 2013, show the projected state contribution rates for fiscal year 2016-17 through fiscal year 2018-19 for the employee categories under five different investment return scenarios. The projected rates assume that all other actuarial assumptions will be realized and that no further changes to assumptions, contributions, benefits, or funding will occur. These projected rates also reflect new hires entering into lower benefit formulas with a lower normal cost and implementation of the April 17, 2013 CalPERS Board-approved amortization and rate smoothing method change. The five different investment return scenarios are as follows (figures in parentheses are negative numbers):

- The first scenario assumes a negative (3.80) percent return for each of the 2014-15, 2015-16 and 2016-17 fiscal years.
- The second scenario assumes a 2.80 percent return for each of the 2014-15, 2015-16 and 2016-17 fiscal years.
- The third scenario assumes the return for each of the 2014-15, 2015-16 and 2016-17 fiscal years would be CalPERS' assumed 7.50 percent investment return.
- The fourth scenario assumes a 12.00 percent return for each of the 2014-15, 2015-16 and 2016-17 fiscal years.
- The fifth scenario assumes an 18.90 percent return for each of the 2014-15, 2015-16 and 2016-17 fiscal years.

In all the scenarios, rates are expressed as a percentage of payroll.

Estimated: 2016-17

Assumed return	(3.80)%	2.80%	7.50%	12.00%	18.90%
	Projected Contribution Rates				
State Miscellaneous Tier 1	28.6%	28.0%	27.6%	27.1%	26.5%
State Miscellaneous Tier 2	28.2	27.5	27.1	26.6	26.0
State Industrial	19.8	19.4	19.0	18.7	18.1
State Safety	19.6	19.3	19.0	18.7	18.3
State Peace Officers & Firefighters	41.1	40.3	39.8	39.2	38.4
California Highway Patrol	50.4	49.6	49.0	48.4	47.6

Source: CalPERS State Actuarial Valuation, Fiscal Year Ended June 30, 2013.

Estimated: 2017-18

Assumed return	(3.80)%	2.80%	7.50%	12.00%	18.90%
	Projected Contribution Rates				
State Miscellaneous Tier 1	30.9%	29.1%	27.8%	26.5%	24.4%
State Miscellaneous Tier 2	30.6	28.8	27.5	26.2	24.1
State Industrial	21.5	20.1	19.0	18.0	16.3
State Safety	20.6	19.5	18.7	17.9	16.6
State Peace Officers & Firefighters	44.0	41.6	39.9	38.2	35.5
California Highway Patrol	53.4	51.1	49.3	47.6	44.9

Source: CalPERS State Actuarial Valuation, Fiscal Year Ended June 30, 2013.

Estimated: 2018-19

Assumed return	(3.80)%	2.80%	7.50%	12.00%	18.90%
	Projected Contribution Rates				
State Miscellaneous Tier 1	34.1%	30.7%	28.1%	25.4%	21.0%
State Miscellaneous Tier 2	34.0	30.6	27.9	25.3	20.9
State Industrial	23.9	21.2	19.1	16.9	13.4
State Safety	22.1	20.0	18.4	16.7	14.0
State Peace Officers & Firefighters	47.9	43.5	40.1	36.6	30.9
California Highway Patrol	57.6	53.1	49.7	46.2	40.5

Source: CalPERS State Actuarial Valuation, Fiscal Year Ended June 30, 2013.

12. Investment Policy; Investment Returns

Pursuant to the state Constitution, the CalPERS Board has sole and exclusive fiduciary responsibility over the assets of the PERF. CalPERS' assets are managed both externally by professional investment management firms and internally by CalPERS investment staff. The CalPERS Board monitors the performance of the managers with the assistance of an external investment consultant.

CalPERS has established a series of procedures and guidelines with respect to investments. The procedures, grouped together as the "Investment Policy," serve to guide CalPERS' asset allocation strategy for PERF. The CalPERS Board reviews the Investment Policy annually, taking into consideration the latest actuarial valuation.

CalPERS follows a strategic asset allocation policy that identifies the percentage of funds to be invested in each asset class. Policy targets are typically implemented over a period of several years on market declines and through dollar cost averaging. Listed below is CalPERS' current asset allocation mix by market value and policy target percentages as of September 30, 2014. The strategic allocation policy may be changed by CalPERS from time to time. Additional information concerning CalPERS investments can be found on the CalPERS website.

Asset Class	Actual Investment (Billions)	Actual Investment	Interim Strategic Target[1]
Growth – Public Equity	$155.0	52.5%	51.0%
Growth – Private Equity	31.2	10.6	10.0
Income	52.3	17.7	19.0
Liquidity	5.5	1.9	2.0
Real Estate	25.6	8.7	10.0
Forestland/ Infrastructure	4.4	1.5	2.0
Inflation	15.9	5.4	6.0
Trust Level[2]	5.0	1.7	N/A
Total Fund*	$295.0	100.0%	100.0%

[1] Interim strategic targets adopted by the Investment Committee at the May 2014 Investment Committee Meeting.

[2] Trust Level includes: Absolute Return Strategy, Multi-Asset Class, and Overlay Transition, and Plan Level.

* Figures are rounded for viewing purposes.

Source: http://www.calpers.ca.gov/index.jsp?bc=/investments/assets/assetallocation.xml

The following tables set forth the total return on all assets for PERF for the fiscal years ending June 30, 2004 through June 30, 2014, as well as time-weighted average returns.

TABLE 30
CalPERS Investment Results Based On Market Value

Fiscal Year	Annualized Rate of Return
2003-04	16.6%
2004-05	12.3
2005-06	11.8
2006-07	19.1
2007-08	(5.1)
2008-09	(24.0)
2009-10	13.3
2010-11	21.7
2011-12	0.1
2012-13	13.2
2013-14	18.4

Source: CalPERS Comprehensive Annual Financial Report for Fiscal Years ended June 30, 2004 through June 30, 2014.

TABLE 31
PERF Time-Weighted Average Returns as of June 30, 2014

Period	Time Weighted Average Rate of Return
3 years	10.4%
5 years	12.5
10 years	7.2

Source: CalPERS Comprehensive Annual Financial Report for Fiscal Year ended June 30, 2014.

13. *Other Retirement Plans*

In addition to PERF, CalPERS also administers JRF, JRF II, LRF, and the 1959 Survivor Benefit program, which are defined benefit plans.

In the JRF actuarial reports for the year ended June 30, 2013, CalPERS reported that JRF had an unfunded actuarial liability of approximately $3.3 billion and JRF II had an unfunded actuarial liability of approximately $58.2 million. In the LRF actuarial report for the year ended June 30, 2013, CalPERS reported that LRF had actuarial value of assets that exceeded the actuarial liability by approximately $7.4 million. In the 1959 Survivor Benefit program actuarial report for the year ended June 30, 2013, CalPERS reported that the program had an unfunded actuarial liability of approximately $37.9 million. The state’s fiscal year 2015-16 retirement contributions from the General Fund are estimated to be $189.1 million for JRF, $68.1 million for JRF II, $4.7 million for the 1959 Survivor Benefit Program, and $1.0 million for LRF.

Further information concerning JRF, JRF II, and LRF can be found in CalPERS’ financial reports and actuarial reports and is set forth in Note 24 (and the Schedule of Funding Progress included in the Required Supplementary Information) to the Audited Basic Financial Statements of the State of California for the Year Ended June 30, 2013 attached as APPENDIX B to this Official Statement.

CalSTRS

1. *General*

CalSTRS was established under the California Education Code in 1913 to provide benefits to California public school and community college teachers and to certain other employees of the state’s public school system (kindergarten through community college). CalSTRS is the administrator of multiple-employer, cost-sharing defined benefit plans, a tax-deferred defined contribution plan, a Medicare Premium Payment Program, and a Teachers’ Deferred Compensation Fund.

The largest CalSTRS fund, the State Teachers’ Retirement Plan (the “STRP”), is a multiple employer, cost-sharing, defined benefit plan comprised of four programs: the Defined Benefit Program (referred to in the state’s 2013 Financial Statements and in this Official Statement as the “DB Program”), the Defined Benefit Supplement Program, the Cash Balance

Benefit Program, and the Replacement Benefit Program. Within the DB Program there is also a Supplemental Benefits Maintenance Account (the "SBMA") which provides purchasing power protection for retired members.

The state is not an employer (with certain very limited exceptions) in any of CalSTRS programs but does contribute to the DB Program and the SBMA from its General Fund pursuant to statutes in the Education Code. The DB Program is funded through a combination of investment earnings and statutorily set contributions from three sources: the members of CalSTRS, the employers, and the state. Contribution rates for the members and employers to fund the DB Program are not adjusted to reflect or offset actual investment returns or other factors which affect the funded status of the DB Program. The same is true for the contribution rates for the state. For contributions from employers and the state, the CalSTRS Board was provided new limited rate setting authority under the provisions of AB1469.

As of June 30, 2013 (the fiscal year of the DB Program commences July 1 and ends June 30 of the following year), the DB Program's unfunded actuarial obligation was $73.7 billion (66.9 percent funded ratio) based on an actuarial value of assets basis and $74.4 billion (66.5 percent funded ratio) based on a market value of assets basis. The funding status triggered the requirement for the state to make specified supplemental contributions starting in the fiscal year ended June 30, 2013. See "Funding for the DB Program – State Contributions," "Funding Status" and "Prospective Funding Status; Future Contributions."

The SBMA is a separate account within the DB Program that is funded with a combination of investment earnings and statutorily set contributions from the state. The Purchasing Power Protection Program payments for retired members are made only to the extent funds are available in the SBMA and are not a vested benefit. See "Funding for the SBMA."

CalSTRS is administered by a 12-member Teachers' Retirement Board (the "CalSTRS Board") that includes the California Director of Finance, State Controller, State Superintendent of Public Instruction, and the State Treasurer, who serve ex officio. The other CalSTRS Board members serve four-year terms and include three CalSTRS member-elected representatives representing current educators, one retired CalSTRS member, three public representatives, and one school board representative, each appointed by the Governor and confirmed by the Senate.

The CalSTRS Board appoints a Chief Executive Officer to administer CalSTRS and a Chief Investment Officer to direct investment of CalSTRS' assets in accordance with CalSTRS Board policy. The CalSTRS Board also retains independent actuaries, auditors, and investment advisors. The CalSTRS Board has appointed Crowe Horwath LLP beginning with the fiscal year ended June 30, 2011 to serve as the independent auditor for CalSTRS, Pension Consulting Alliance to provide asset allocation and other investment analyses and Milliman, Inc. (the "CalSTRS Consulting Actuary") to provide actuarial services to CalSTRS and for conducting specialized studies at the request of CalSTRS staff. The CalSTRS System Actuary, a CalSTRS employee, is responsible for reviewing the CalSTRS Consulting Actuary's work for quality control purposes and also conducts day-to-day analyses as requested by CalSTRS staff.

Certain summary information concerning the DB Program is set forth below.

2. *Members and Employers*

As of June 30, 2014, the DB Program included 1,687 employers. The following table reflects the total number of members in the DB Program as of June 30, 2013 and 2014.

TABLE 32
DB Program Membership

Membership	June 30, 2014	June 30, 2013	Percent Change
Active Members	420,887	416,643	1.0%
Inactive Members	182,815	182,576	0.1
Retirees and Beneficiaries	275,627	269,274	2.4
Total Membership	879,329	868,493	1.2

Source: CalSTRS Comprehensive Annual Financial Report for Fiscal Year ended June 30, 2014.

3. *Retirement Benefits*

Member benefits are determined by statute in the Education Code and are generally based on a member's age, final compensation, and years of credited service. Members are 100 percent vested in retirement benefits after five years of credited service and are eligible for normal retirement at age 60 and for early retirement at age 55 or at age 50 with 30 years of credited service. The normal retirement benefit is 2 percent of final compensation (as defined in the Education Code) for each year of credited service (up to 2.4 percent of final compensation for members retiring after age 60), and members who retired on or after January 1, 2001 with 30 or more years of service by December 31, 2010 receive monthly bonus payments of up to $400 per month. Pension reform legislation signed in 2012 increased the retirement age for new CalSTRS members hired on or after January 1, 2013. New members who retire at age 62 will be eligible for a benefit equal to 2 percent of final compensation for each year of credited service (up to 2.4 percent of final compensation for members retiring after age 62).

Benefits are increased by 2 percent (a simple, not a compounded, cost-of-living increase) of the initial allowance, on each September 1 following the first anniversary of the effective date of the benefit.

The following table shows the amount of benefits and administrative expenses paid under the DB Program for the last seven fiscal years:

TABLE 33
DB Program
Schedule of Benefits Paid and Administrative Expenses
(Dollars in Millions)

Fiscal Year	Amount of Benefits Paid	Administrative Expenses
2007-08	$ 7,823	$ 109
2008-09	8,604	113
2009-10	9,358	140
2010-11	10,092	110
2011-12	10,677	138
2012-13	11,355	137
2013-14[1]	11,616	146

[1] Pursuant to GASB 67, the CalSTRS Comprehensive Annual Financial Report for Fiscal Year 2014 no longer displays the DB Program independent of the State Teachers' Retirement Plan. The DB Program amounts were provided by CalSTRS.
Source: CalSTRS Comprehensive Annual Financial Reports for Fiscal Years ended June 30, 2008 through 2014.

4. *Change in Accounting Standards*

The 2014 CalSTRS Financial Statements were prepared in accordance with GASB Statement 67. GASB Statement 67 impacts the financial reporting requirements for CalSTRS but does not change the funding requirements for members, employers, or the state. The 2014 CalSTRS Financial Statements are available on the CalSTRS website at www.calstrs.ca.gov. The primary impacts of GASB Statement 67 on the 2014 CalSTRS Financial Statements are described below.

Under GASB Statement 67, CalSTRS is required to report the net pension liability (NPL) instead of the previously required unfunded actuarial accrued liability (UAAL). Additionally, CalSTRS is now required to provide a schedule in the notes to the financial statements that display the proportionate share of contributions per employer. Employers will consider this schedule when determining their proportionate share of the NPL to be recognized in their financial statements pursuant to GASB Statement 68. The following is a description of these changes from the 2014 CalSTRS Financial Statements:

> "The UAAL mirrored the actuarial accrued obligation calculated by CalSTRS external actuary for funding purposes and represented the excess of the actuarial accrued liability (AAL) over the actuarial value of assets (AVA). Under GASB 67, the UAAL has been replaced by the NPL, which represents the excess of the total pension liability (TPL) over fiduciary net position. A side-by-side comparison of the two calculations is as follows:

Current Year	**Prior Year**
Total Pension Liability	Actuarial Accrued Liability
Less: Fiduciary Net Position	Less: Actuarial Value of Assets
Net Pension Liability	Unfunded Actuarial Accrued Liability

> There are considerable differences between the two numbers. Conceptually, the UAAL is the actuary's measure of the additional amount of assets needed to pay all benefits earned to date by current plan members, while the new NPL is an accrual calculation that reflects future benefits earned by plan members through the employment-exchange process in excess of the plan's fiduciary net position. The difference between the UAAL and NPL is reflected in the different methodologies used to calculate the TPL and AAL.
>
> GASB's new measures implement a 'blended' discount rate that considers a long-term rate of return on plan assets and a high-quality, non-taxable municipal bond index rate, which reflects a pension fund's long-term investment strategy, as well as the potential need to borrow funds to pay pension benefits after net position has been fully depleted. In April 2014, the [CalSTRS Board] approved the use of the Bond Buyer's 20 year index rate to calculate the blended discount rate. At this same meeting, the [CalSTRS Board] also approved the use of the same actuarial methods and assumptions for the STRP financial reporting valuation as those used in the DB actuarial funding valuation.
>
> With the provision of additional member, employer, and general fund contributions effective July 1, 2014, CalSTRS has reported that it does not project a depletion of assets and therefore did not have to calculate a blended rate using the Bond Buyer's 20 year index rate at June 30, 2014. Instead, CalSTRS discounted all future obligations for the STRP using the long-term rate of return on plan assets gross of administrative costs (currently 7.6 percent). Based on that assumption, the STRP has an NPL of $58.4 billion as of June 30, 2014."

Investors should note that the CalSTRS 2014 Financial Statements display the NPL of the entire STRP and do not provide a calculation of the DB Program separately. CalSTRS reports that an actuarial valuation of the DB Program will continue to be prepared and is expected to be available in April 2015.

In addition, CalSTRS has allocated the proportionate share of its NPL to employers and the state (as a nonemployer contributing entity) in the 2014 CalSTRS Financial Statements to assist employers and the state in implementing GASB 68 in their respective financial statements for the year ending June 30, 2015. GASB Statement 68 requires employers and nonemployer contributing entities to report any NPL as a liability in their Statement of Net Position. In the 2014 CalSTRS Financial Statements, 37.65% of the NPL is allocated to the state. The State Controller will continue to evaluate this allocation until release of the state's financial statements for the year ending June 30, 2015 and the percentage may be less than or greater than the 37.65% contained in the 2014 CalSTRS Financial Statements.

5. Funding for the DB Program

The DB Program is funded with a combination of investment income and contributions from members, employers, and the state. Although specific amounts vary from year to year, approximately 55 percent of DB Program assets were derived from investment returns, according to CalSTRS. As described below, the contribution rates of the members, employers, and the state are determined by statute in the Education Code instead of actuarially determined amounts as is done for the CalPERS system. Over time, this has contributed to an underfunding of the DB Program which has been a concern in recent years.

In 2013 and 2014, the Governor, the Legislature and CalSTRS worked to develop an approach to addressing the long-term funding needs of the DB Program. On June 24, 2014, the Governor signed AB 1469, a comprehensive funding solution intended to eliminate the current CalSTRS unfunded liability on the DB Program by 2046. The changes in contribution rates for members, employers and the state required by AB 1469 are described below. While the plan is intended to eliminate the unfunded liability of the DB Program by 2046, there is no assurance that it will be eliminated by that date. See "-Prospective Funding Status; Future Contributions" below. Accordingly, there can be no assurances that the required amounts annually payable among the members, employers, and state will not significantly increase in the future.

Member Contributions. Members are required to make contributions to the DB Program in an amount equal to 8 percent of creditable compensation of the member. However, for services performed between January 1, 2000 and December 31, 2010, the member contribution to the DB Program was 6 percent because 2 percent was directed to the Defined Benefit Supplement Program (to which the state does not contribute).

Under AB 1469, member contributions will increase over time on July 1, 2014, 2015 and 2016 to 10.25 percent for members not subject to PEPRA and to 9.205 percent for members subject to PEPRA.

Employer Contributions. Employers are required to make contributions to the DB Program in an amount equal to 8 percent of creditable compensation plus 0.25 percent to pay costs of the unused sick leave credit; provided that a portion of the employers' contributions has in the past and may in the future be transferred to the Medicare Premium Program which has the effect of further reducing aggregate annual contributions to the DB Program.

Under AB 1469, employer contributions will increase over time on each July 1 of 2014 through 2020 to 19.1 percent of creditable compensation in fiscal year 2020-21 through fiscal year 2045-46. Beginning in fiscal year 2021-22 through fiscal year 2045-46, AB 1469 authorizes the CalSTRS Board to adjust the employer contribution up or down 1 percentage point each year, but no higher than 20.25 percent total and no lower than 8.25 percent, to eliminate the remaining unfunded obligation that existed on July 1, 2014.

State Contributions. The state's General Fund contribution to the DB Program is 2.017 percent of creditable compensation from two fiscal years prior. For example, for fiscal year 2011-12, the state's contribution was based on creditable compensation from fiscal year 2009-10. Before fiscal year 2014-15, the state also contributed an additional 0.524 percent of creditable compensation from two fiscal years prior when there is an unfunded obligation or a normal cost deficit exists for benefits in place as of July 1, 1990. Under the prior structure, the percentage was adjusted up to 0.25 percent per year to reflect the contributions required to fund the unfunded obligation or the normal cost deficit. However, the supplemental contribution could not exceed 1.505 percent of creditable compensation from two fiscal years prior.

Based on the most recent actuarial valuation, as of June 30, 2013, an unfunded obligation exists for the benefits in place as of July 1, 1990, which triggered the supplemental payments for the fiscal year ending June 30, 2012 at a contribution rate of 0.524 percent starting October 1, 2011. An appropriation for this supplemental contribution was included in the 2011 Budget Act. An increased supplemental contribution rate to 0.774 percent was included in the 2012 Budget Act and 1.024 percent was included in the 2013 Budget Act.

Under AB 1469, the state will continue to make a supplemental contribution tied to the unfunded obligation that existed for the benefits in place as of July 1, 1990. The 2015-16 Governor's Budget includes an increased supplemental contribution rate of 2.874 percent. The state's supplemental contribution increases to 4.311 percent on July 1, 2016 for fiscal year 2016-17 through fiscal year 2045-46. Beginning fiscal year 2017-18 through fiscal year 2045-46, the CalSTRS Board is authorized to adjust the supplemental state contribution up 0.50 percent each year to eliminate the unfunded obligation for benefits in place as of July 1, 1990. If there is no unfunded obligation, the supplemental contribution shall be reduced to zero.

[BALANCE OF PAGE INTENTIONALLY LEFT BLANK]

The following table displays the annual actuarially required contributions, the actual contributions for employers, and the percentage of the actuarially required contribution that has been funded by the employers and the state for the last six fiscal years. Contributions from the state are displayed for the budget year and the previous seven fiscal years.

TABLE 34
DB Program
Schedule of Contributions from Employers and the State

(Dollars in Millions)

Fiscal Year	Annual Actuarially Required Contribution[(a)]	Contributed by Employers[(b)]	Contributed by State[(c)]	Total Contributed	Percent of Actuarially Required Contribution Contributed
2008-09	$4,547	$2,331	$536	$2,867	63%
2009-10	4,924	2,130	563	2,693	55
2010-11	5,985	2,228	568	2,796	47
2011-12	6,230	2,166	653	2,819	45
2012-13	6,629	2,192	718	2,910	44
2013-14[(d)]	Not yet released	Not yet released	779	Not yet released	Not yet released
2014-15	Not yet released	Not yet released	904	Not yet released	Not yet released
2015-16	Not yet released	Not yet released	1,324	Not yet released	Not yet released

[(a)] For the DB Program Annual Required Contribution ("ARC") for employers and state, an open amortization period of 30 years is used by the CalSTRS Consulting Actuary to determine the unfunded actuarial liability for Fiscal Years 2009-2013.

[(b)] For employer contributions, amounts are reduced by the amount of transfers to the Medicare Premium Program.

[(c)] State of California, Department of Finance; fiscal years ending June 30, 2015 and 2016 are estimated; amount contributed by state in fiscal year 2007-08 differs from amount reflected in CalSTRS Comprehensive Annual Financial Report for Fiscal Year ended June 30, 2012 due to timing issues. The fiscal years ending June 30, 2012, 2013, 2014, 2015, and 2016 include the pre-1990 benefit described on the previous page. For 2012, the 0.524 percent contribution equates to $106.5 million, for 2013, the 0.774 percent contribution equates to $188.0 million, for 2014, the 1.024 percent contribution equates to $251.5 million and for 2015, the 1.437 percent contribution equates to $376.0 million, for 2016, the 2.874 percent contribution equates to $777.9 million.

[(d)] Pursuant to GASB 67, an Actuarially Determined Contribution ("ADC") replaced the ARC in the CalSTRS Comprehensive Annual Financial Report for Fiscal Year 2014. The ADC calculation includes the entire State Teachers' Retirement Plan. A DB Program specific ADC for Fiscal Year 2014 is currently unavailable.

Source: CalSTRS Comprehensive Annual Financial Report for Fiscal Year ended June 30, 2013 (except as noted in footnote (c) to this Table 34).

6. *Actuarial Methods and Assumptions*

Although contributions are set by statute, the CalSTRS Consulting Actuary prepares annual actuarial valuation reports of the DB Program. The CalSTRS Consulting Actuary also prepares reports reviewing the DB Program's actual experience every four years. The CalSTRS Board uses experience reports to evaluate how realistic the long-term assumptions have been and may be in the future. The most recent valuation report for the DB Program, dated March 20, 2014 (the "2013 CalSTRS Valuation"), was prepared as of June 30, 2013, and is available on the CalSTRS website. The actuarial assumptions and methods used in the 2013 CalSTRS Valuation were based on the most recent experience report (the "2010 Experience Analysis") prepared by the CalSTRS Consulting Actuary in February 2012.

In preparing the 2013 CalSTRS Valuation, the CalSTRS Consulting Actuary used the Entry Age Actuarial Cost Method to measure the accruing costs of benefits under the DB Program. GASB Statements 67 and 68 will require all state and local governments with pension liabilities to use the Entry Age Actuarial Cost Method beginning in fiscal year 2014-15 if they are not already doing so. Under the Entry Age Actuarial Cost Method, the actuarial present value of projected benefits of each individual is allocated on a level basis over the earnings of the individual between entry age and assumed exit age. The portion of the actuarial present value allocated to the valuation year is called the normal cost and represents the cost assigned to a member for a given year, such that it would meet the continuing costs of a particular benefit if contributed each year starting with the date of membership. The CalSTRS Consulting Actuary notes that the Entry Age Actuarial Cost Method is designed to produce a normal cost rate that remains a level percentage of earned salaries and that the normal cost rate is expected to remain fairly stable so long as the benefit provisions are not amended, the assumptions are not changed, membership experience emerges as assumed, and the demographic characteristics of the membership remain reasonably consistent. Some of the key demographic information taken into account includes assumptions about membership, service retirements, disability retirements, deaths, and merit salary increases, and some of the economic items include assumptions about inflation and wage growth.

The portion of the actuarial value of benefits not provided for at a valuation date by the actuarial present value of future normal costs is called the actuarial obligation, and the excess, if any, of the actuarial obligation over the actuarial value of assets is the unfunded actuarial obligation. Assumptions about how long benefits will be paid for active and inactive members and when such members will retire and how long they will live are required in calculating the actuarial obligation, and economic assumptions and valuation methods are required in valuing assets. The following table sets forth certain actuarial methods and assumptions for the four fiscal years ended June 30, 2014.

[BALANCE OF PAGE INTENTIONALLY LEFT BLANK]

TABLE 35
Certain Actuarial Methods and Assumptions Utilized For DB Program
Fiscal Year Ending June 30

	2011	2012	2013	2014
Methods				
Actuarial Cost Method	Entry age normal	Entry age normal	Entry age normal	Entry age normal
Amortization Method	Level Percent of payroll	Level Percent of payroll	Level Percent of payroll	Level Percent of payroll
Amortization Period	Open	Open	Open	Open
Remaining Amortization Period	30 years	30 years	30 years	30 years
Asset Valuation Method	Expected value with 33% adjustment to market value	Expected value with 33% adjustment to market value	Expected value with 33% adjustment to market value	Expected value with 33% adjustment to market value
Actuarial Assumptions				
Investment Rate of Return	7.50%	7.50%	7.50%	7.50%
Interest on Accounts	4.50	4.50	4.50	4.50
Wage Growth	3.75	3.75	3.75	3.75
Consumer Price Inflation	3.00	3.00	3.00	3.00
Post-retirement Benefit Increases	2.00 (simple)	2.00 (simple)	2.00 (simple)	2.00 (simple)

Source: CalSTRS Comprehensive Annual Financial Reports for Fiscal Years ended June 30, 2011, 2012, 2013, and 2014.

7. *Actuarial Valuation*

According to CalSTRS and as reflected in the 2013 CalSTRS Valuation, the biggest source of funding of the DB Program is investment returns, and in calculating the actuarial value of assets, contributions for the past year are added to the actuarial value of assets at the end of the prior year; benefits and expenses are subtracted; an assumed rate of return is added, and as described below, a portion of market value gains and losses are added or subtracted. The assumed investment rate of return on DB Program assets (net of investment and administrative expenses) and the assumed interest to be paid on refunds of member accounts are based in part on an inflation assumption of 3.0 percent.

See the caption "Actuarial Methods and Assumptions" above for a discussion of expected changes in GASB standards that could change the Discount Rate used to calculate the DB Program's unfunded actuarial obligation from a long-term assumed investment rate of return to a blend of the long term assumed investment rate of return and a yield or index rate.

Actual market returns are taken into account but to reduce rate volatility, actual market gains and losses are spread or "smoothed" over a three-year period. That is, one third of the difference between the expected actuarial value of assets and the fair market value of assets is taken into account to determine the actuarial value of assets. According to the 2013 CalSTRS Valuation, due to the asset smoothing method, approximately one-third of the approximately $1.06 billion investment loss was recognized in June 30, 2013 (the difference between the AVA and MVA in Table 36 below). As discussed under the caption "PENSION TRUSTS – General," GASB Statements 67 and 68, beginning in fiscal year 2013-14 for pension plans and fiscal year 2014-15 for employers, will require state and local governments with pension liabilities to recognize the differences between expected and actual investment returns over a closed 5-year period instead of the 3-year period currently used by CalSTRS. CalSTRS will continue to use 3-year period for valuation purposes and the 5-year period for financial reporting purposes.

8. Funding Status

The following table sets forth the schedule of funding progress as of the ten most recent actuarial valuation dates based on information provided by CalSTRS from the actuarial valuation reports for such years. Funding progress is measured by a comparison of DB Program assets with DB Program liabilities.

[BALANCE OF PAGE INTENTIONALLY LEFT BLANK]

TABLE 36
DB Program Schedule of Funding Progress
(Fiscal Years Ended June 30)

(Dollars in Millions)

	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13
Market Value of Assets (MVA)[a]	NA	NA	NA	NA	NA	NA	$117,129	$140,040	$134,835	$147,907
Actuarial Value of Assets (AVA)	$114,094	$121,882	$131,237	$146,419	$155,215	$145,142	140,291	143,930	144,232	148,614
Actuarial Accrued Liabilities (AAL)-entry age	138,254	142,193	150,872	167,129	177,734	185,683	196,315	208,405	215,189	222,281
Excess of Market Value of Assets over AAL or Surplus (Unfunded) Actuarial Accrued Liabilities (UAAL) MVA Basis[a]	NA	NA	NA	NA	NA	NA	(79,186)	(68,365)	(80,354)	(74,374)
Excess of Actuarial Value of Assets over AAL or Surplus (Unfunded) Actuarial Accrued Liabilities (UAAL) AVA Basis	(24,160)	(20,311)	(19,635)	(20,710)	(22,519)	(40,541)	(56,024)	(64,475)	(70,957)	(73,667)
Covered Payroll	22,589	23,257	24,240	25,906	27,118	27,327	26,275	25,576	25,388	25,479
Funded Ratio (MVA)[a]	NA	NA	NA	NA	NA	NA	60%	67%	63%	67%
Funded Ratio (AVA)	83%	86%	87%	88%	87%	78%	71%	69%	67%	67%

[a] The CalSTRS Comprehensive Annual Financial Report reports the SBMA assets with DB Program assets and does not provide a separate accounting of only the DB Program assets. Therefore, market values for DB Program assets were not available for the fiscal years ended June 30, 2004 to 2009. The market value of the DB Program assets (without SBMA assets) for the fiscal year ended June 30, 2010, June 30, 2011, June 30, 2012, and June 30, 2013 was provided by the CalSTRS Consulting Actuary.

Source: CalSTRS Actuarial Valuations for Fiscal Years ended June 30, 2004 through 2013.

According to CalSTRS, the market value of the entire DB Program investment portfolio (including the SBMA assets) was $178.3 billion as of June 30, 2014, an increase from $156.7 billion (or 13.7 percent) on June 30, 2013.

9. Prospective Funding Status; Future Contributions

The CalSTRS Consulting Actuary concluded in the 2013 CalSTRS Valuation (prior to the enactment of AB 1469) that the unfunded actuarial obligation of the DB Program will not be amortized over any future period and that the DB Program is projected to have its assets depleted in about 33 years. As mentioned above, on June 24, 2014, the Governor signed AB 1469, a comprehensive funding solution intended to eliminate the CalSTRS unfunded liability on the DB Program by 2046. The changes in contribution rates for members, employers and the state required by AB 1469 are described above.

The plan also provides the CalSTRS board with limited authority to increase or decrease the school and state contributions based on changing conditions. The plan is intended to eliminate the unfunded liability of the DB Program by 2046. However, while AB 1469 provides for significant increases in the statutorily required contributions to CalSTRS from the State, employers and members, it does not provide that such statutory rates be adjusted to equal actuarially required amounts from time to time. Actuarially required amounts will vary from time to time based on a variety of factors, including actuarial assumptions, investment performance and member benefits. To the extent rates established pursuant to AB 1469 are less than actuarially required amounts from time to time, such circumstances could materially adversely effect the funded status of CalSTRS. Once the actuarial valuation for the DB Program as of June 30, 2014 is released, the impact of the changes in contribution rates made pursuant to AB 1469 on the funded status of the DB Program will be available.

10. Investment Policy; Investment Returns

Pursuant to the state Constitution, the CalSTRS Board has sole and exclusive fiduciary responsibility over all CalSTRS' assets (including the DB Program assets). CalSTRS' assets (including the DB Program assets) are managed both externally by professional investment management firms and internally by CalSTRS investment staff. The CalSTRS Board monitors the performance of the managers with the assistance of an external investment consultant. See "General" above.

CalSTRS has established a series of procedures and guidelines with respect to investments. The procedures, grouped together as the "Investment Policy and Management Plan," serve to guide CalSTRS asset allocation strategy for all CalSTRS' programs, including the DB Program. The CalSTRS Board reviews the Investment Policy and Management Plan annually, taking into consideration the latest actuarial study. CalSTRS follows strategic allocation guidelines that identify targets for the percentage of funds to be invested in each asset class. These targets are typically implemented over a period of several years. Listed below is CalSTRS current asset allocation mix by market value and guideline target percentages. The strategic allocation guidelines may be changed by the CalSTRS Board from time to time. Additional information concerning CalSTRS investments can be found on the CalSTRS website.

TABLE 37
CalSTRS Asset Allocation

Asset	Market Value (Millions)[1]	Actual %[1]	Current Target %[2]
Global Equity	$ 108,630	57.3%	55.0%
Fixed Income	29,936	15.8	17.0
Real Estate	22,336	11.8	13.0
Private Equity	20,647	10.9	13.0
Cash	4,971	2.6	1.0
Inflation Sensitive	1,424	0.8	1.0
Absolute Return	1,782	0.9	0.0
Total Investment Assets	$189,726	100.0%	100.0%

[1] As of November 30, 2014.
[2] Target Allocation adopted September 10, 2013.
Source: http://www.calstrs.com/current-investment-portfolio

The following table sets forth the total return on all CalSTRS' assets (including the DB Program assets) for the fiscal years ended June 30, 2004 through June 30, 2014, as well as time-weighted average returns.

TABLE 38
CalSTRS Investment Results Based On Market Value

Fiscal Year	Annualized Rate of Return
2003-04	17.38%
2004-05	11.09
2005-06	13.21
2006-07	21.03
2007-08	(3.69)
2008-09	(25.03)
2009-10	12.20
2010-11	23.10
2011-12	1.84
2012-13	13.80
2013-14	18.66

Source: CalSTRS Comprehensive Annual Financial Report for Fiscal Year ended June 30, 2014.

TABLE 39
CalSTRS Time-Weighted Average Returns as of June 30, 2014

Period	Time-Weighted Rate of Return
3 years	11.21%
5 years	13.69
10 years	7.65

Source: CalSTRS Comprehensive Annual Financial Report for Fiscal Year ended June 30, 2014.

11. Funding for the SBMA

The SBMA is a separate account within the DB Program that is funded with a combination of investment income and contributions from the state. The contribution rate for the state's funding of the SBMA is also determined by statute in the Education Code. The Purchasing Power Protection Program funded from the SBMA provides quarterly payments to retired and disabled members and beneficiaries to restore purchasing power to beneficiaries if the purchasing power of their initial retirement or disability allowances have fallen below a specified percentage. The Purchasing Power Protection Program payments are made only to the extent funds are available in the SBMA and are not a vested benefit.

State Contributions. The state's General Fund contribution to the SBMA is 2.5 percent of creditable compensation of the fiscal year ending in the prior calendar year, less $70 million for the fiscal year ended June 30, 2010, $71 million for the fiscal year ended June 30, 2011 and $72 million thereafter. The following table summarizes funding of the SBMA during the nine fiscal years ending June 30, 2016. The Education Code requires the state to continue contributions to the SBMA and that the unused balances remain in the SBMA even if they exceed the amounts required to be paid to beneficiaries.

[BALANCE OF PAGE INTENTIONALLY LEFT BLANK]

TABLE 40
SBMA Funding

Fiscal Year	General Fund Contributions[1]	Benefit Payments	Interest[4]	Reserve
2007-08	$1,121,500,844[2]	$223,337,493	$272,827,314	$4,569,622,638
2008-09	597,474,363[3]	341,069,179	382,634,850	5,302,830,510
2009-10	684,935,046	266,244,852	434,401,607	6,112,989,062
2010-11	689,633,129	245,823,604	500,655,955	6,988,857,762
2011-12	662,743,780	234,612,293	568,596,604	8,283,302,000
2012-13	641,762,636	221,451,000	621,247,667	9,269,803,000
2013-14	581,260,411	202,231,779	695,235,203	10,342,893
2014-15	582,183,634	Not yet released	Not yet released	Not yet released
2015-16	604,658,085	Not yet released	Not yet released	Not yet released

[1] State of California, Department of Finance; fiscal years ending June 30, 2015 and 2016 are estimated.

[2] In the fiscal year ended June 30, 2004, the Legislature reduced the planned $558,867,986 contribution by $500 million. After litigation, the state was ordered to repay the $500 million with interest. The principal amount was repaid in the fiscal year ended June 30, 2008, and the interest is to be paid in four annual installments beginning with the fiscal year ended June 30, 2010. The interest payments are included in the contribution amounts for the respective years.

[3] The Education Code was amended to reduce the amount transferred from the General Fund and to provide that the transfer be made in two equal payments, one on November 1 and the second on April 1.

[4] Interest provided by CalSTRS.

Source: CalSTRS Comprehensive Annual Financial Report for Fiscal Year ended June 30, 2014 and a 2011 Report to the Governor and the Legislature (except as noted in footnotes 1 and 4 to this Table 40).

THE BUDGET PROCESS

General

The state's fiscal year begins on July 1 and ends on June 30 of the following year. The state's General Fund budget operates on a legal basis, generally using a modified accrual system of accounting for its General Fund, with revenues credited in the period in which they are measurable and available and expenditures debited in the period in which the corresponding liabilities are incurred.

The annual budget is proposed by the Governor by January 10 of each year for the next fiscal year (the "Governor's Budget"). Under state law and the state constitution, the annual proposed Governor's Budget cannot provide for projected expenditures in excess of projected resources for the ensuing fiscal year. Following the submission of the Governor's Budget, the Legislature takes up the proposal. As required by the Balanced Budget Amendment ("Proposition 58") and as described below, beginning with fiscal year 2004-05, the Legislature may not pass a budget bill in which General Fund expenditures exceed estimated General Fund revenues and beginning fund balances at the time of the passage and as set forth in the budget bill.

Under the state Constitution, money may be drawn from the State Treasury only through an appropriation made by law. The primary source of annual expenditure appropriations is the annual Budget Act as approved by the Legislature and signed by the Governor. Pursuant to Proposition 25, enacted on November 2, 2010, the Budget Act (or other appropriation bills and "trailer bills" which are part of a budget package) must be approved by a majority vote of each House of the Legislature. (This was a reduction from a requirement for a two-thirds vote.) The Governor may reduce or eliminate specific line items in the Budget Act or any other appropriations bill without vetoing the entire bill. Such individual line-item vetoes are subject to override by a two-thirds majority vote of each House of the Legislature.

Appropriations also may be included in legislation other than the Budget Act. Continuing appropriations, available without regard to fiscal year, may also be provided by statute or the state Constitution.

Funds necessary to meet an appropriation are not required to be in the State Treasury at the time an appropriation is enacted; revenues may be appropriated in anticipation of their receipt.

Constraints on the Budget Process

Over the years, a number of laws and constitutional amendments have been enacted, often through voter initiatives, which have made it more difficult for the state to raise taxes, restricted the use of the state's General Fund or special fund revenues, or otherwise limited the Legislature and the Governor's discretion in enacting budgets. Historic examples of provisions that make it more difficult to raise taxes include Proposition 13, passed in 1978, which, among other things, required that any change in state taxes enacted for the purpose of increasing revenues collected pursuant thereto, whether by increased rates or changes in computation, be approved by a two-thirds vote in each house of the Legislature, and Proposition 4, approved in 1979, which limits government spending by establishing an annual limit on the appropriation of tax proceeds. Examples of provisions restricting the use of General Fund revenues are Proposition 98, passed in 1988, which mandates that a minimum amount of General Fund revenues be spent on local education, and Proposition 10, passed in 1998, which raised taxes on tobacco products and mandated how the additional revenues would be expended. See "STATE FINANCES – Proposition 98 and K-14 Funding" and "– Sources of Tax Revenue – Taxes on Tobacco Products."

Constitutional amendments approved by the voters have also affected the budget process. These include Proposition 49, approved in 2002, which requires the expansion of funding for before and after school programs. Proposition 58, approved in 2004, which requires the adoption of a balanced budget and restricts future borrowing to cover budget deficits; Proposition 63, approved in 2004, which imposes a surcharge on taxable income of more than $1 million and earmarks this funding for expanded mental health services; Proposition 1A, approved in 2004, which limits the Legislature's power over local revenue sources, and Proposition 1A, approved in 2006, which limits the Legislature's ability to use sales taxes on motor vehicle fuels for any purpose other than transportation. Propositions 22 and 26, approved on November 2, 2010, further limit the state's fiscal flexibility. Proposition 25, also passed by the voters in November 2010, changed the legislative vote requirement to pass a budget and budget related legislation from two-thirds to a simple majority. It retained the two-thirds vote requirement for taxes. Proposition 30, approved on November 6, 2012, among other things, placed into the state Constitution the current statutory provisions transferring 1.0625 percent of the state sales tax to local governments to fund realignment; and Proposition 39, also approved on November 6, 2012, among other things, dedicates for five years up to $550 million annually to clean energy projects out of an expected $1 billion annual increase in corporate tax revenue due to reversal of a provision adopted in 2009 that gave corporations an option on how to calculate their state income tax liability. Proposition 2 passed by voters on November 4, 2014 amends the Proposition 58 version of the Budget Stabilization Account, and requires one-half of a calculated amount of money to be put aside in a "rainy day fund," with the other half to be used to pay down debts and liabilities for the first fifteen years.

These approved constitutional amendments are described below.

1. *Balanced Budget Amendment (Proposition 58)*

Proposition 58, approved by the voters in 2004, requires the state to enact a balanced budget, and establish a special reserve, and restricts certain future borrowing to cover fiscal year end deficits. As a result of the provisions requiring the enactment of a balanced budget and restricting borrowing, the state would in some cases have to take more immediate actions to correct budgetary shortfalls. Beginning with the budget for fiscal year 2004-05, Proposition 58 requires the Legislature to pass a balanced budget and provides for mid-year adjustments in the event that the budget falls out of balance and the Governor calls a special legislative session to address the shortfall. The balanced budget determination is made by subtracting estimated expenditures from all resources expected to be available, including prior-year balances.

If the Governor determines that the state is facing substantial revenue shortfalls or spending increases, the Governor is authorized to declare a fiscal emergency. He or she would then be required to propose legislation to address the emergency, and call the Legislature into special session for that purpose. If the Legislature fails to pass and send to the Governor legislation to address the fiscal emergency within 45 days, the Legislature would be prohibited from: (i) acting on any other bills or (ii) adjourning in joint recess until such legislation is passed.

Proposition 58 also required the establishment of the BSA, which is funded by annual transfers of specified amounts from the General Fund, unless suspended or reduced by the Governor or until a specified maximum amount has been deposited. The BSA provisions of Proposition 58 were amended and new provisions have been enacted by Proposition 2 of 2014. See below, "Proposition 2 – The State's Rainy Day Fund".

Proposition 58 also prohibits the use of general obligation bonds, revenue bonds, and certain other forms of borrowing to cover fiscal year end budget deficits. The restriction does not apply to certain other types of borrowing, such as: (i) short-term borrowing to cover cash shortfalls in the General Fund (including revenue anticipation notes or revenue anticipation warrants currently used by the state), or (ii) inter-fund borrowings.

2. *Local Government Finance (Proposition 1A of 2004)*

As described under "STATE FINANCES – Local Governments," Senate Constitutional Amendment No. 4 (also known as "Proposition 1A of 2004"), approved by the voters in the November 2004 election, amended the state Constitution to, among other things, reduce the Legislature's authority over local government revenue sources by placing restrictions on the state's access to local governments' property, sales, and vehicle license fee revenues as of November 3, 2004. Beginning with fiscal year 2008-09, the state was able to borrow up to 8 percent of local property tax revenues, but only if the Governor proclaimed such action was necessary due to a severe state fiscal hardship and two-thirds of both houses of the Legislature approve the borrowing. The amount borrowed is required to be paid back within three years. In addition, the state cannot reduce the local sales tax rate or restrict the authority of local governments to impose or change the distribution of the statewide local sales tax.

The provisions of Proposition 1A of 2004 allowing the state to borrow money from local governments from time to time have been repealed by Proposition 22 of 2010, which permanently prohibits any future such borrowing. However, prior to such repeal, the Amended 2009 Budget Act authorized the state to exercise its Proposition 1A of 2004 borrowing authority. This borrowing generated $1.998 billion that was used to offset state General Fund costs for a variety of court, health, corrections, and K-12 programs. Pursuant to Proposition 1A of 2004, the state was required to repay the local government borrowing no later than June 15, 2013. The 2012 Budget Act included $2.1 billion to fully retire the outstanding obligations, with interest, to be paid from the General Fund, and repayment was made in June of 2013.

Proposition 1A of 2004 also prohibits the state from mandating activities on cities, counties or special districts without providing for the funding needed to comply with the mandates. Beginning in fiscal year 2005-06, if the state does not provide funding for the mandated activity, the requirement on cities, counties or special districts to abide by the mandate is suspended. In addition, Proposition 1A of 2004 expands the definition of what constitutes a mandate on local governments to encompass state action that transfers to cities, counties and special districts financial responsibility for a required program for which the state previously had partial or complete financial responsibility. The state mandate provisions of Proposition 1A of 2004 do not apply to schools or community colleges or to mandates relating to employee rights. The 2015-16 Governor's Proposed Budget suspends 56 mandates for the 2015-16 fiscal year. The total estimated back cost owed on these post 2004-05 suspended mandates is approximately $1.056 billion.

Proposition 1A of 2004 further requires the state to reimburse cities, counties, and special districts for mandated costs incurred prior to fiscal year 2004-05 over a term of years. Chapter 72, Statutes of 2005 (AB 138) requires the payment of mandated costs incurred prior to fiscal year 2004-05 to begin in fiscal year 2006-07 and to be paid over a term of 15 years. The 2014 Budget Act includes a $100 million payment against these claims. The 2014-15 Budget also includes a trigger that could pay up to the remaining $800 million in 2014-15 should revenues rise higher than anticipated. The trigger payment is currently estimated at $533 million.

3. After School Education Funding (Proposition 49)

An initiative statute, Proposition 49, called the "After School Education and Safety Program Act of 2002," was approved by the voters on November 5, 2002, and required the state to expand funding for before and after school programs in the state's public elementary, middle and junior high schools. The increase was first triggered in fiscal year 2004-05, which increased funding for these programs to $122 million; since fiscal year 2006-07, these programs have been funded at $550 million annually. These funds are part of the Proposition 98 minimum funding guarantee for K-14 education and, in accordance with the initiative, expenditures can only be reduced in certain low revenue years. See "STATE FINANCES – Proposition 98 and K 14 Funding."

4. *Mental Health Services (Proposition 63)*

On November 2, 2004, the voters approved Proposition 63, the Mental Health Services Act, which imposes a 1 percent tax surcharge on taxpayers with annual taxable income of more than $1 million for purposes of funding and expanding mental health services. Proposition 63 prohibits the Legislature or the Governor from redirecting these funds or from reducing General Fund support for mental health services below the levels provided in fiscal year 2003-04. Chapter 5, Statutes of 2011 (AB 100) allowed the one-time redirection of $861 million of Proposition 63 funds from the reserve in fiscal year 2011-12 for the Early and Periodic Screening, Diagnosis and Treatment ("EPSDT") program, mental health managed care, and mental health services for special education students. Commencing in fiscal year 2012-13, the EPSDT program and mental health managed care are funded with "2011 Realignment" funds as the programs are realigned to counties, mental health services for special education students are funded with Proposition 98 General Fund, and all available Proposition 63 funds are distributed for programs eligible under the Mental Health Services Act.

5. *Transportation Financing (Proposition 1A of 2006)*

On November 7, 2006, voters approved Proposition 1A of 2006, which had been placed on the ballot by the Legislature as Senate Constitutional Amendment No. 7, to protect Proposition 42 transportation funds from any further suspensions. Provisions of the state Constitution enacted as Proposition 42 in 2002, permitted the suspension of the annual transfer of motor vehicle fuel sales tax revenues from the General Fund to the Transportation Investment Fund if the Governor declared that the transfer would result in a "significant negative fiscal impact" on the General Fund and the Legislature agreed with a two-thirds vote of each house. The new measure modified the constitutional provisions of Proposition 42 in a manner similar to Proposition 1A of 2004, so that if such a suspension were to have occurred, the amount owed by the General Fund would have had to be repaid to the Transportation Investment Fund within three years, and only two such suspensions could have been made within any 10-year period. In fiscal year 2003-04, $868 million of the scheduled Proposition 42 transfer was suspended, and in fiscal year 2004-05 the full transfer of $1.258 billion was suspended. Budget Acts for fiscal years 2006-07 through 2010-11 all fully funded the Proposition 42 transfer and partially repaid the earlier suspensions. Chapter 11, Statutes of 2010, in the Eighth Extraordinary Session included an elimination of the state sales tax rate on gasoline and an increase in gasoline excise taxes, effectively removing the revenue subject to these restrictions from the state tax system. However, consistent with the requirements of Proposition 1A of 2006, the 2014Budget Act includes an $83 million repayment of past suspensions. The final payment of $85 million is included in the 2015-16 Governor's Budget.

6. *Proposition 22 – Local Government Funds*

On November 2, 2010, voters approved this measure, called the "Local Taxpayer, Public Safety and Transportation Protection Act of 2010," which supersedes some parts of Proposition

1A of 2004, prohibits any future action by the Legislature to take, reallocate or borrow money raised by local governments and redevelopment agencies for local purposes, and prohibits changes in the allocation of property taxes among local governments designed to aid state finances or pay for state mandates. The Proposition 1A borrowing done in 2009 was grandfathered. In addition, by superseding Proposition 1A of 2006, the state is prohibited from borrowing sales taxes or excise taxes on motor vehicle fuels for budgetary purposes (but legislation enacted in 2012 clarifies these funds may be used for short-term cash management borrowing), or changing the allocations of those taxes among local governments except pursuant to specified procedures involving public notices and hearings. Any law enacted after October 29, 2009 inconsistent with Proposition 22 is repealed. Proposition 22 jeopardized the use of funds from the gasoline excise tax that had been used in the 2010 Budget Act to offset General Fund debt service cost on highway bonds and for lending to the General Fund. Passage of this measure jeopardized an estimated $850 million in General Fund relief in fiscal year 2010-11, an amount which had been expected to grow to almost $1 billion by fiscal year 2013-14. The 2011 Budget Act replaced the use of gasoline excise tax for these purposes with truck weight fees and other transportation revenues that may be used for these purposes under Article XIX of the state Constitution. This preserved the 2011 Budget Act allocations for state and local programs while achieving similar levels of General Fund relief to that obtained in the 2010 Budget Act. These debt service offsets were continued in 2012-13 Budget and are now permanent and ongoing.

The inability of the state to borrow or redirect property tax funds reduces the state's flexibility in reaching budget solutions. The state had used these actions for several billion dollars of solutions prior to the enactment of Proposition 22.

7. Proposition 26 – Increases in Taxes or Fees

On November 2, 2010, voters approved this ballot measure which revises provisions in Articles XIII A and XIII C of the state Constitution dealing with tax increases. The measure specifies that a two-thirds vote of both houses of the Legislature is required for any increase in any tax on any taxpayer, eliminating the prior practice where a tax increase coupled with a tax reduction is treated as being able to be adopted by majority vote. Furthermore, any increase in a fee beyond the amount needed to provide the specific service or benefit is deemed a tax requiring two-thirds vote. Finally, any tax or fee adopted after January 1, 2010 with a majority vote which would have required a two-thirds vote if Proposition 26 were in place would be repealed after one year from the election date unless readopted by the necessary two thirds vote.

8. Proposition 25 – On-Time Budget Act of 2010

On November 2, 2010, voters approved this measure that is intended to end budget delays by changing the legislative vote necessary to pass the budget bill from two-thirds to a majority vote and by requiring legislators to forfeit their pay if the Legislature fails to pass the budget bill on time. This measure does not change Proposition 13's property tax limitations in any way. This measure does not change the two-thirds vote requirement for the Legislature to raise taxes. The lower vote requirement also applies to trailer bills that appropriate funds and are identified by the Legislature "as related to the budget in the budget bill." This measure also provides that the budget bill and other bills providing for appropriations related to the budget bill are to take effect immediately upon being signed by the Governor or upon a date specified in the legislation.

9. Proposition 30 – The Schools and Local Public Safety Protection Act of 2012

On November 6, 2012, voters approved Proposition 30 which provided temporary increases in personal income tax rates for high-income taxpayers and a temporary increase in the state sales tax rate, and specified that the additional revenues will support K-14 public schools and community colleges as part of the Proposition 98 guarantee. Proposition 30 also placed into the state Constitution the current statutory provisions transferring 1.0625 percent of the state sales tax to local governments to fund the "realignment" program for many services including housing criminal offenders. See "STATE FINANCES – Sources of Tax Revenue."

If this portion of the state sales and use tax is reduced or inoperative, the State will pay the amount dedicated to local governments. The constitution specifies that any payment from the General Fund for this "back-up" obligation will have a lower priority than payments to support public schools and universities, and debt service on state general obligation bonds.

10. Proposition 39 – The California Clean Energy Jobs Act

On November 6, 2012, voters approved Proposition 39 thereby amending state statutes governing corporation taxes by reversing a provision adopted in 2009 giving corporations an option on how to calculate the portion of worldwide income attributable to California. By requiring corporations to base their state tax liability on sales in California, it is estimated that state revenues increased by $292 million in 2012-13, $595 million in 2013-14, and almost $900 million by 2018-19. The measure also, for fiscal years 2013-14 to 2018-19, dedicates 50 percent, up to $550 million, per year from the annual estimate of this increased income to funding of projects that create energy efficiency and clean energy jobs in California.

11. Proposition 2 – The State's Rainy Day Fund

Proposition 2 approved by voters in November 2014 amends the Proposition 58 (2004) version of the Budget Stabilization Account (BSA) to build a stronger "rainy day" reserve while requiring accelerated debt payment. Proposition 2 provides that beginning with fiscal year 2015-16, fifty percent of the sum of 1.5 percent of estimated annual General Fund revenues and capital gains revenues over 8 percent of General Fund tax proceeds (not required to fund Proposition 98) will be transferred into the BSA no later than October 1 of each fiscal year unless the transfer is suspended or reduced. For the first fifteen years, the remaining fifty percent will be used for supplemental debt payments and other specified long term liabilities.

Proposition 2 also provides that the Legislature may suspend or reduce the annual BSA transfer for a fiscal year if the Governor declares a budget emergency. Proposition 2 limits the withdrawal of funds from the BSA to half of the fund's balance in the first year of the budget emergency.

See "CURRENT STATE BUDGET" and "STATE FINANCES - Budget Reserves."

12. Proposition 47–The Safe Neighborhoods and Schools Act

Proposition 47 was approved by voters in November 2014. The initiative reduces the classification of certain "nonserious and nonviolent property and drug crimes" from a felony to a misdemeanor unless the defendant has prior convictions for specified violent or serious crimes.

The measure also allows certain offenders who have been previously convicted of such crimes to petition the court for resentencing. In addition, the measure requires any state savings that result from the measure be spent to support programs in K-12 schools, mental health and substance use disorder treatment, and victim services.

Proposition 47 also creates the "Safe Neighborhoods and Schools Fund". Beginning July 31, 2016, and each fiscal year thereafter, the Director of Finance is required to calculate the state savings for the previous fiscal year compared to the fiscal year prior to implementation of the Safe Neighborhoods and Schools Act. Results must be certified to the State Controller's Office no later than August 1 of each fiscal year and the State Controller's Office must transfer the estimated savings to the Safe Neighborhoods and Schools Fund by August 15 of each fiscal year. The distribution from the Safe Neighborhoods and Schools Fund will be as follows:

- 65% to the Board of State and Community Corrections for a grant program to public agencies for mental health, substance use disorder treatment, and diversion programs;

- 25% to the State Department of Education for a grant program to public agencies aimed at improving outcomes in K-12 schools for reducing truancy and/or students at risk of dropping out, or victims of crimes; and

- 10% to the Victims Compensation and Government Claims Board for grants to trauma recovery centers.

FINANCIAL STATEMENTS

The Audited Basic Financial Statements of the State of California for the Year Ended June 30, 2013 (the "Financial Statements") are included as APPENDIX B to this Official Statement and incorporated into this APPENDIX A. The Financial Statements consist of an Independent Auditor's Report, a Management Discussion and Analysis, Basic Financial Statements of the state for the Year Ended June 30, 2013 ("Basic Financial Statements"), and Required Supplementary Information. Only the Basic Financial Statements have been audited, as described in the Independent Auditor's Report. A description of the accounting and financial reporting standards set by the Governmental Accounting Standards Board and used in the Basic Financial Statements is contained in Note 1 of the Basic Financial Statements. The State's audited Comprehensive Annual Financial Report for the fiscal year ended June 30, 2014 is expected to be released in the latter part of March 2015, and when released, will be available on the State Treasurer's website and other State websites and, if available, will be included in the final Official Statement to replace the Appendix B in the Preliminary Official Statement.

The State Controller issues a monthly report on General Fund cash receipts and disbursements. These reports are available on the State Controller's website, and are normally released by the 10th day of every calendar month for the period ended on the last day of the prior month. The State Controller's unaudited reports of General Fund cash receipts and disbursements for the period July 1, 2013 through June 30, 2014 and July 1, 2014 through February 28, 2015 are included as EXHIBIT 1 and EXHIBIT 2, respectively, to this APPENDIX A.

Periodic reports on revenues and/or expenditures during the fiscal year are issued by the Administration, the State Controller's Office and the LAO. The Department of Finance issues a monthly bulletin, available by accessing the internet website of the Department of Finance (www.dof.ca.gov), which reports the most recent revenue receipts as reported by state departments, comparing those receipts to budget projections. The Administration also formally updates its budget projections three times during each fiscal year, in January, May, and at the time of budget enactment. These bulletins and reports are available on the internet at websites maintained by the agencies and by contacting the agencies at their offices in Sacramento, California. Such bulletins and reports are not part of or incorporated into this APPENDIX A. Investors are cautioned that interim financial information is not necessarily indicative of results for a fiscal year. Information which may appear in this APPENDIX A from the Department of Finance concerning monthly receipts of "agency cash" may differ from the State Controller's reports of cash receipts for the same periods because of timing differences in the recording of in-transit items.

INVESTMENT OF STATE FUNDS

Moneys on deposit in the State Centralized Treasury System are invested by the State Treasurer in the PMIA. As of January 31, 2015, the PMIA held approximately $40.4 billion of state moneys, and $20.9 billion invested for about 2,507 local governmental entities through the Local Agency Investment Fund ("LAIF"). The assets of the PMIA as of January 31, 2015 are shown in the following table.

TABLE 41
Analysis of Pooled Money Investment Account Portfolio[(a)]
(Dollars in Thousands)

Type of Security	Amount	Percent of Total
U.S. Treasuries	$ 29,751,226	48.57%
Federal Agency Debentures	2,607,891	4.26
Certificates of Deposit	11,450,045	18.69
Bank Notes	600,000	0.98
Federal Agency Discount Notes	1,499,367	2.45
Time Deposits	5,118,740	8.36
GNMAs	0	0
Commercial Paper	6,793,417	11.09
FHLMC/REMICs	100,382	0.16
AB 55 Loans	319,819	0.52
General Fund Loans	2,618,400	4.27
Other	399,939	0.65
Total	$ 61,259,226	100.00%

[(a)] Totals may not add due to rounding.

Source: State of California, Office of the State Treasurer.

The State's Treasury operations are managed in compliance with the California Government Code and according to a statement of investment policy which sets forth permitted investment vehicles, liquidity parameters and maximum maturity of investments. The PMIA operates with the oversight of the PMIB. The LAIF portion of the PMIA operates with the oversight of the Local Agency Investment Advisory Board (consisting of the State Treasurer and four other appointed members).

The PMIA is not invested, nor has it ever been invested, in structured investment vehicles or collateralized debt obligations. The PMIA portfolio performance, and the PMIA's holdings are displayed quarterly on the State Treasurer's website and may be accessed under PMIB Quarterly Reports. The PMIA is not currently invested in auction rate securities.

The State Treasurer does not invest in leveraged products or inverse floating rate securities. The investment policy permits the use of reverse repurchase agreements subject to limits of no more than 10 percent of the PMIA. All reverse repurchase agreements are cash matched either to the maturity of the reinvestment or an adequately positive cash management date which is approximate to the maturity of the reinvestment.

The average life of the investment portfolio of the PMIA as of January 31, 2015 was 198 days.

OVERVIEW OF STATE GOVERNMENT

Organization of State Government

The state Constitution provides for three separate branches of government: the legislative, the judicial and the executive. The state Constitution guarantees the electorate the right to make basic decisions, including amending the state Constitution and local government charters. In addition, the state voters may directly influence state government through the initiative, referendum and recall processes. The state Constitution provides for mechanisms through which it may be amended or revised.

California's Legislature consists of a 40-member Senate and an eighty-member Assembly. Assembly members are elected for two-year terms, and Senators are elected for four-year terms. Before passage of Proposition 28 on June 5, 2012, Assembly members were limited to three terms in office and Senators to two terms. Proposition 28 reduced the total amount of time a person may serve in the Legislature from 14 to 12 years, but allows a person to serve a total of 12 years in either the Assembly, the Senate, or a combination of both. The new term limits law applies only to members of the Legislature elected after the measure was passed.

The Legislature meets almost year round for a two-year session. The Legislature employs the Legislative Analyst, who provides reports on state finances, among other subjects. The Office of the California State Auditor, an independent office since 1993, annually issues an auditor's report based on an examination of the General Purpose Financial Statements of the State Controller, in accordance with generally accepted accounting principles. See "FINANCIAL STATEMENTS."

The Governor is the chief executive officer of the state. The Governor presents the annual budget and traditionally presents an annual package of bills constituting a legislative program. In addition to the Governor, state law provides for seven other statewide elected officials in the executive branch. The Governor and the other statewide officials may be elected for up to two four-year terms. The current elected statewide officials, their party affiliation and the dates on which they were first elected are as follows:

Office	**Name**	**Party Affiliation**	**First Elected**
Governor	Edmund G. Brown Jr.	Democrat	2010*
Lieutenant Governor	Gavin Newsom	Democrat	2010
Controller	Betty Yee	Democrat	2014
Treasurer	John Chiang	Democrat	2014
Attorney General	Kamala D. Harris	Democrat	2010
Secretary of State	Alex Padilla	Democrat	2014
Superintendent of Public Instruction	Tom Torlakson	Democrat	2010
Insurance Commissioner	Dave Jones	Democrat	2010

* Previously served as Governor 1975-83, prior to term limit law.

Effective July 1, 2013, by way of the Governor's Reorganization Plan, in addition to other entities such as the Department of Finance, the executive branch is principally administered through the following agencies and Secretaries:

1. Business, Consumer Services and Housing,
2. Government Operations,
3. Corrections and Rehabilitation,
4. Labor and Workforce Development,
5. Health and Human Services,
6. Environmental Protection,
7. Natural Resources,
8. Food and Agriculture,
9. Transportation, and
10. Veterans Affairs.

In addition, some state programs are administered by boards and commissions, such as The Regents of the University of California, Public Utilities Commission, Franchise Tax Board and California Transportation Commission, which have authority over certain functions of state government with the power to establish policy and promulgate regulations. The appointment of members of boards and commissions is usually shared by the Legislature and the Governor, and often includes ex officio members.

Higher Education

California has a comprehensive system of public higher education comprised of three segments: the University of California, the California State University System and California Community Colleges. The University of California provides undergraduate, graduate and professional degrees to students, awarding 62,919 degrees in the 2013-14 school year. The ten

University of California campuses and the Hastings College of Law enrolled 243,315 full time students in the 2013-14 school year. The California State University provides undergraduate and graduate degrees, awarding 103,637 degrees in the 2013-14 school year. The California State University enrolled 370,585 full-time students at the 23 campuses in the 2013-14 school year.

The third segment consists of 112 campuses operated by 72 community college districts, which provide associate degrees and certificates to students. Additionally, students may attend California community colleges ("CCCs") to meet basic skills and other general education requirements prior to transferring to a four-year undergraduate institution. The CCCs awarded 190,314 associate degrees and certificates in the 2013-14 school year. For the 2013-14 school year, approximately 1.1 million full-time equivalent students were enrolled at CCCs.

Employee Relations

The 2015-16 Governor's Budget estimates the state work force for fiscal year 2014-15 at approximately 363,000 positions. Approximately 140,000 of those positions represent state employees of the legislative and judicial branches of government and institutions of higher education. Of the remaining 223,000 positions, over 80 percent are subject to collective bargaining under the purview of the Governor and less than 20 percent are excluded from collective bargaining. State law provides that state employees, defined as any civil service employee of the state and teachers under the jurisdiction of the Department of Education or the Superintendent of Public Instruction, and excluding certain other categories, have a right to form, join, and participate in the activities of employee organizations for the purpose of representation on all matters of employer-employee relations. Once a bargaining unit ("BU") selects an employee organization, only that organization can represent those employees.

The scope of representation is limited to wages, hours, and other terms and conditions of employment. Representatives of the Governor are required to meet and confer in good faith and endeavor to reach agreement with the employee organization and, if an agreement is reached, to prepare a memorandum of understanding ("MOU") and present it to the Legislature for ratification. The Governor and the recognized employee organization are authorized to agree mutually on the appointment of a mediator for the purpose of settling any disputes between the parties, or either party could request the Public Employment Relations Board to appoint a mediator.

There are 21 collective BUs that represent state employees. The Service Employees International Union is the exclusive representative for 9 of the 21 BUs, or approximately 50 percent of those represented employees subject to collective bargaining. The International Union of Operating Engineers is the exclusive representative for 2 of the 21 collective BUs. The remaining BUs have their own exclusive representative. All of the state's 21 BUs have an existing MOU. The following table lists the state's 21 BUs, their exclusive representatives, membership levels, and MOU expiration dates.

TABLE 42
Collective Bargaining Units

Unit	Description	Full-Time Equivalents[a]	MOU Expiration
1, 3, 4, 11, 14, 15, 17, 20, and 21	Service Employees International Union, Local 1000: Various	93,810	7/1/2016
2	California Attorneys, Administrative Law Judges & Hearing Officers in State Employment: Attorneys and Administrative Law Judges	3,869	7/1/2016
5	California Association of Highway Patrolmen: Highway Patrol	6,794	7/3/2018
6	California Correctional Peace Officers Association: Corrections	27,200	7/2/2015
7	California Statewide Law Enforcement Association: Protective Services and Public Safety	6,957	7/1/2016
8	California Department of Forestry Firefighters: Firefighters	5,116	7/1/2017
9	Professional Engineers in California Government: Professional Engineers	11,051	7/1/2015
10	California Association of Professional Scientists: Professional Scientists	2,870	7/1/2015
12	International Union of Operating Engineers: Craft and Maintenance	10,793	7/1/2015
13	International Union of Operating Engineers: Stationary Engineers	952	7/1/2016
16	Union of American Physicians and Dentists: Physicians, Dentists, and Podiatrists	1,517	7/1/2016
18	California Association of Psychiatric Technicians: Psychiatric Technicians	5,914	7/1/2016
19	American Federation of State, County and Municipal Employees: Health and Social Services/Professional	4,885	7/1/2016
Total		181,728	

[a] Full-Time equivalents are from the Table 183, State Controller's Office, March 2014. Figures rounded for display purposes.

Source: Department of Human Resources

The following are changes in employee compensation and terms of employment as a result of recent developments in collective bargaining:

- The state and BU 2 reached a tentative agreement on August 14, 2014 that was subsequently ratified by both the Legislature and membership. Provisions of the agreement include a 2 percent GSI, effective July 1, 2014, and a 2.5 percent GSI, effective July 1, 2015.

- The state and BU 8 signed a side letter agreement on August 26, 2014 that was subsequently ratified by both the Legislature and membership. Pursuant to the provisions of the side agreement, BU 8 received a 4 percent GSI, effective January 1, 2015.

- The state and BU 10 reached a tentative agreement on August 12, 2014 that was subsequently ratified by both the Legislature and membership. Provisions of the agreement include a one-time bonus and a pay differential, both effective October 1, 2014, and a 3 percent GSI, effective July 1, 2015.

- The state and BU 13 reached a tentative agreement on August 21, 2014 that was subsequently ratified by both the Legislature and membership. Provisions of the agreement include a one-time bonus, effective July 1, 2014, a pay differential, effective July 1, 2014, a 2 percent GSI, effective July 1, 2014, a 2.5 percent GSI, effective July 1, 2015, and a separate pay differential, effective July 1, 2015.

The 2015-16 Governor's Budget includes an additional $560.4 million ($203.1 million General Fund) for employee compensation and health care costs for active state employees. Included in these costs are the collectively bargained salary increases for many of the state's rank-and-file employees, state managers, and supervisors. The 2015-16 Governor's Budget also includes funding for anticipated increases in 2016 calendar year health care premium costs.

ECONOMY AND POPULATION

Introduction

California's economy, the largest among the 50 states and one of the largest in the world, has major components in high technology, trade, entertainment, agriculture, manufacturing, tourism, construction, and services. California followed the nation's path through the recession and into the recovery. California labor markets deteriorated dramatically during the latter half of 2008 and the first nine months of 2009, suffering their worst losses on record. From July 2007 through February 2010, the state lost 1.3 million nonfarm jobs. These losses switched to very modest gains during 2010 and 2011, which accelerated in 2012 and have continued in 2013 and 2014. California has gained 1.8 million jobs from February 2010 through December 2014, recovering all of the nonfarm jobs lost during the recession. See "PROPOSED FISCAL YEAR 2015-16 BUDGET – Development of Revenue Estimates."

Population, Labor Force and Demographic Trends

In 2014, California's population reached 38.5 million residents. This marks the highest annual growth rate (0.9 percent) of this decade. Since the national census on April 1, 2010, the state has grown by 1,245,000 persons.

California's population is projected to be 38.9 million in July 2015 and 39.2 million by July 2016, which allow for growth rates of 0.91 and 0.93 percent respectively. The forecast further assumes that through the next five years, the state will grow at a slightly higher rate than over the last few years, averaging increases of over 351,000 residents annually through 2019. Natural increase will account for most of the growth during this time; however, net migration into the state is also projected to gradually increase as economic conditions continue to improve. Late in 2018, California's population will hit 40 million and by July 2019, the state will have added 1.8 million people and grow to 40.3 million, a five-year growth rate of 4.6 percent.

The dependency ratio is an economic measure which approximates dependency by dividing the dependent-age population (under 18 plus 65 and over) by the working-age (18 to 64) population. The ratio represents the dependent age population per 100 working-age population. The dependency ratio for California's 2014 population stood at 57.6, compared to 60.4 for the remainder of the United States. The dependency ratio ignores labor force participation rates, as well as employment and unemployment levels.

As the state's growth patterns change, the age and race distribution of California's population continue to transform. In 2014, California became the third state without a white, non-Hispanic plurality. The Asian proportion of the population also shows strong growth, driven by an increased birthrate and international migration. California as well as the U.S. will see an increasingly large senior population. Currently, nearly 9.2 million Californians are less than 18 years old. California has a younger population than the remainder of the U.S (a characteristic that is not expected to change in the near term), with a slightly higher percentage of residents younger than 18 years old, a lower percentage of residents 65 and older, and a younger median age.

Population growth rates vary significantly by age group. The state's projected total five-year growth rate of 4.6 percent is higher than the anticipated 3 percent growth in the preschool-age group. The school-age group will increase by 0.3 percent, and the college-age group will decrease by 4.5 percent. The working-age population will grow by 809,000 or 4.0 percent. The population of the retirement-age group, those 65 and older, will expand rapidly (20.7 percent). The retirement-age growth will be concentrated in the 65 through 74 age cohort, with a growth rate of 25.0 percent.

The following table shows California's population data for 2003 through 2014.

TABLE 43
Population 2003-2013

Year	California Population[(a)]	Increase Over Preceding Year	United States Population[(a)]	Increase Over Preceding Year	California as % of United States
2003	35,388,928	1.3%	290,326,418	0.9%	12.2
2004	35,752,765	1.0	293,045,739	0.9	12.2
2005	35,985,582	0.7	295,753,151	0.9	12.2
2006	36,246,822	0.7	298,593,212	1.0	12.1
2007	36,552,529	0.8	301,579,895	1.0	12.1
2008	36,856,222	0.8	304,374,846	0.9	12.1
2009	37,077,204	0.6	307,006,550	0.9	12.1
2010	37,309,382	0.6	309,326,295	0.8	12.1
2011	37,570,112	0.7	311,582,564	0.7	12.1
2012	37,867,483	0.8	313,873,685	0.7	12.1
2013	38,164,011	0.8	316,128,839	0.7	12.1
2014	38,499,378	0.9	318,351,393	0.7	12.1

[(a)] Population as of July 1.

Source: U. S. figures from U.S. Department of Commerce, Bureau of the Census; California figures from State of California, Department of Finance.

The following table presents civilian labor force data for the resident population, age 16 and over, for the years 2002 to 2014.

TABLE 44
Labor Force 2002-2014
(Thousands)

			Unemployment Rate	
Year	Labor Force	Employment	California	United States
2002	17,344	16,181	6.7%	5.8%
2003	17,391	16,200	6.8	6.0
2004	17,444	16,355	6.2	5.5
2005	17,545	16,592	5.4	5.1
2006	17,687	16,821	4.9	4.6
2007	17,921	16,961	5.4	4.6
2008	18,207	16,894	7.2	5.8
2009	18,220	16,155	11.3	9.3
2010	18,336	16,068	12.4	9.6
2011	18,418	16,250	11.8	8.9
2012	18,519	16,590	10.4	8.1
2013	18,597	16,933	8.9	7.4
2014[p/]	18,863	17,278	7.5	6.2

[p/] Preliminary. Final 2014 and benchmark revision to historical data will be available March 6, 2015.
Source: State of California, Employment Development Department.

Employment, Income, Construction and Export Growth

The following table shows California's nonfarm payroll employment distribution and growth for 2004 and 2014.

TABLE 45
Nonfarm Payroll Employment by Major Sector
2004 and 2014
(Thousands)

	Employment		Distribution of Employment	
Industry Sector	**2004**	**2014[p/]**	**2004**	**2014[p/]**
Mining and Logging	22.8	31.4	0.2%	0.2%
Construction	848.9	671.9	5.8%	4.3%
Manufacturing				
Nondurable Goods	558.7	462.4	3.8%	3.0%
High Technology	387.3	333.8	2.6%	2.2%
Other durable Goods	578.9	453.7	3.9%	2.9%
Trade, Transportation & Utilities	2,741.9	2,852.5	18.7%	18.4%
Information	482.2	468.2	3.3%	3.0%
Financial Activities	894.0	777.9	6.1%	5.0%
Professional & Business Services	2,093.5	2,432.4	14.2%	15.7%
Educational & Health Services	1,753.8	2,384.9	11.9%	15.4%
Leisure & Hospitality	1,438.4	1,717.3	9.8%	11.1%
Other Services	503.9	521.0	3.4%	3.4%
Government				
Federal Government	251.1	242.2	1.7%	1.6%
State & Local Government	2,144.6	2,134.1	14.6%	13.8%
TOTAL	**14,700.0**	**15,483.5**	**100.0%**	**100.0%**

[p/] Preliminary. Final 2014 and benchmark revision to historical data will be available March 6, 2015.
Source: State of California, Employment Development Department. (Note: Figures may not add due to rounding.)

The following tables show California's total and per capita income patterns for selected years.

TABLE 46
Total Personal Income in California 2002-2013
(Dollars in Millions)

Year	Total Personal Income	Annual % Change	California % of U.S.
2002	$1,193,641	1.6%	13.1%
2003	1,244,535	4.3	13.1
2004	1,321,815	6.2	13.2
2005	1,395,992	5.6	13.2
2006	1,499,309	7.4	13.2
2007	1,564,289	4.3	13.0
2008	1,596,230	2.0	12.8
2009	1,537,095	-3.7	12.7
2010	1,578,553	2.7	12.7
2011	1,685,635	6.8	12.8
2012	1,805,194	7.1	13.0
2013	1,856,614	2.8	13.1

Note: omits income for government employees overseas.

Source: U.S. Department of Commerce, Bureau of Economic Analysis

TABLE 47
Personal Income Per Capita 2002-2013

Year	California	Annual % Change	United States	Annual % Change	California % of U.S.
2002	$34,229	0.5%	$31,800	0.9%	107.6%
2003	35,303	3.1	32,677	2.8	108.0
2004	37,156	5.2	34,300	5.0	108.3
2005	38,964	4.9	35,888	4.6	108.6
2006	41,623	6.8	38,127	6.2	109.2
2007	43,152	3.7	39,804	4.4	108.4
2008	43,608	1.1	40,873	2.7	106.7
2009	41,587	-4.6	39,379	-3.7	105.6
2010	42,282	1.7	40,144	1.9	105.3
2011	44,749	5.8	42,332	5.5	105.7
2012	47,505	6.2	44,200	4.4	107.5
2013	48,434	2.0	44,765	1.3	108.2

Note: omits income for government employees overseas.

Source: U.S. Department of Commerce, Bureau of Economic Analysis.

The following tables show California’s residential and non-residential construction.

TABLE 48
Residential Construction Permits Authorized
2002-2014

	Units			
Year	Total	Single	Multiple	Valuation[a] (Dollars in Millions)
2002	167,761	123,865	43,896	$33,305
2003	195,682	138,762	56,920	38,968
2004	212,960	151,417	61,543	44,777
2005	208,972	155,322	53,650	47,138
2006	164,280	108,021	56,259	38,108
2007	113,034	68,409	44,625	28,621
2008	64,962	33,050	31,912	18,072
2009	36,421	25,454	10,967	12,037
2010	44,762	25,526	19,236	13,731
2011	47,092	21,538	25,554	14,356
2012	57,961	27,406	30,555	16,451
2013	82,674	36,281	46,393	22,328
2014[P]	84,485	36,137	48,348	23,746

[a] Valuation includes additions and alterations.

[P/] Preliminary. Final figures will be available mid-2015.

Source: Construction Industry Research Board; California Homebuilding Foundation.

TABLE 49
Non-residential Construction 2002-2014
(Dollars in Thousands)

Year	Commercial	Industrial	Other	Additions and Alterations	Total
2002	$5,195,348	$1,227,754	$2,712,681	$5,393,329	$14,529,112
2003	4,039,561	1,320,222	2,954,039	5,601,117	13,914,939
2004	5,105,541	1,456,283	3,100,982	6,026,567	15,689,373
2005	5,853,351	1,693,373	3,818,100	6,900,709	18,265,533
2006	7,733,068	1,760,888	3,873,055	7,741,610	21,108,621
2007	8,812,083	1,450,875	3,496,471	8,782,424	22,541,853
2008	6,513,610	938,081	2,983,640	8,776,285	19,211,616
2009	1,919,763	359,868	1,984,534	6,602,103	10,866,268
2010	1,990,358	358,338	1,937,166	6,913,901	11,199,763
2011	2,213,037	478,896	2,224,685	8,144,510	13,061,128
2012	3,215,903	1,409,808	2,382,790	7,626,971	14,635,471
2013	5,200,328	1,075,472	6,250,539	8,836,957	21,363,296
2014[P]	6,874,612	1,038,362	5,428,964	10,570,171	23,912,109

[P/] Preliminary. Final figures will be available mid-2015.

Source: Construction Industry Research Board; California Homebuilding Foundation.

The following table shows changes in California's exports of goods for the period from 2002 through 2014.

TABLE 50
California's Exports of Goods 2002-2014
(Dollars in Millions)

Year	Exports[a]	Annual % Change
2002	$92,177.5	--
2003	93,906.3	1.9%
2004	110,143.6	17.3
2005	116,689.9	5.9
2006	127,770.8	9.5
2007	134,318.9	5.1
2008	144,805.7	7.8
2009	120,080.0	-17.1
2010	143,208.2	19.3
2011	159,421.4	11.3
2012	161,746.0	1.5
2013	168,044.8	3.9
2014	174,128.6	3.6

[a] Origin of Movement (OM) series

Source: U.S. Department of Commerce, Bureau of the Census

LITIGATION

The state is a party to numerous legal proceedings. The following describes litigation matters that are pending with service of process on the state accomplished and have been identified by the state as having a potentially significant fiscal impact upon the state's revenues or expenditures. The state makes no representation regarding the likely outcome of these litigation matters.

The following description was developed by the state with the participation of the Office of the Attorney General and other state entities. The Office of the Attorney General does not represent the state, its subdivisions, departments, agencies and other units in all litigation matters, and accordingly there may be litigation matters of which the Office of the Attorney General is not aware. The state does not conduct a docket search of federal or state court litigation filings to identify pending litigation and no inquiry has been made into pending administrative proceedings. There may be litigation and administrative proceedings with potentially significant fiscal impacts that have not been described below.

Budget-Related Litigation

1. Actions Challenging Cap and Trade Program Auctions

In *California Chamber of Commerce, et al. v. California Air Resources Board*, (Sacramento County Superior Court, Case No. 34-2012-80001313), business interests and a taxpayer challenge the authority of the California Air Resources Board to conduct auctions under the state's cap and trade program and allege that the auction revenues are an unconstitutional tax under the state Constitution. A second lawsuit raising substantially similar claims*, Morning Star*

Packing Co., et al. v. California Air Resources Board (Sacramento County Superior Court, Case No. 34-2013-80001464), was consolidated with the *Chamber of Commerce* matter. The trial court ruled for the Board, finding that it had authority to conduct the auctions, and that the auction does not constitute an unconstitutional tax. Petitioners have appealed (Court of Appeal, Third Appellate District, Case Nos. C075930, C075954). See "STATE FINANCES—Cap and Trade Program."

2. *Actions Challenging School Financing*

In *Robles-Wong, et al. v. State of California* (Alameda County Superior Court, Case No. RG-10-515768) and *California Teachers Association ("CTA") Complaint in Intervention*, plaintiffs challenge the state's "education finance system" as unconstitutional. Plaintiffs, consisting of 62 minor school children, various school districts, the California Association of School Administrators, the California School Boards Association and CTA, allege the state has not adequately fulfilled its constitutional obligation to support its public schools, and seek an order enjoining the state from continuing to operate and rely on the current financing system and to develop a new education system that meets constitutional standards as declared by the court. In a related matter, *Campaign for Quality Education, et al. v. State of California* (Alameda County Superior Court, Case No. RG-10-524770), plaintiffs also challenge the constitutionality of the state's education finance system. The court issued a ruling that there was no constitutional right to a particular level of school funding. The court allowed plaintiffs to amend their complaint with respect to alleged violation of plaintiffs' right to equal protection. Plaintiffs in each of these matters elected not to amend, and both matters were dismissed by the trial court. Plaintiffs in each matter appealed (Court of Appeal, First Appellate District, Case Nos. A134423, A134424). Plaintiffs in these matters allege they have suffered $17 billion in education funding cuts over two years. It is currently unknown what the fiscal impact of these matters might be upon the General Fund.

Plaintiff in *California School Boards Association v. State of California* (Alameda County Superior Court, Case No. RG-11-554698), challenges the use of block grant funding to pay for education mandates in the 2012 Budget Act and associated trailer bills. The amended complaint also contends that recent changes to the statutes that control how education mandates are directed and funded violate the requirements of the state Constitution that the state pay local school districts for the costs of state mandated programs. If the court declares that the state has failed to properly pay for mandated educational programs, the state will be limited in the manner in which it funds education going forward.

3. *Actions Challenging Statutes Which Reformed California Redevelopment Law*

In *California Redevelopment Association, et al. v. Matosantos, et al.* (California Supreme Court, Case No. S194861), the California Supreme Court upheld the validity of legislation ("ABx1 26") dissolving all local Redevelopment Agencies ("RDAs") and invalidated a second law ("ABx1 27") that would have permitted existing RDAs to convert themselves into a new form of RDA and continue to exist, although they would have to pay higher fees to school, fire and transit districts to do so.

A second case challenging the constitutionality of these statutes, *City of Cerritos, et al. v. State of California* (Sacramento County Superior Court, Case No. 34-2011-80000952) raises the same theories advanced in *Matosantos*, and also contains challenges based on claimed violations of the single subject rule and the contracts clause, the statutes being outside scope of the proclamation calling the Legislature into special session, and the failure to obtain a 2/3 vote to pass the statutes. The trial court denied the petitioners' motion for a preliminary injunction seeking to block implementation of ABx1 26. Plaintiffs appealed (Court of Appeal, Third Appellate District, Case No. C070484). Plaintiffs' request to stay portions of ABx1 26 was denied by the appellate court.

There are over 100 pending actions that challenge implementation of the statutory process for winding down the affairs of the RDAs, asserting a variety of claims including constitutional claims. Some of the pending cases challenge AB 1484, which requires successor agencies to the former RDAs to remit by July 2012 certain property tax revenues for fiscal year 2011-12 that the successor agency had received, or face a penalty. Some cases challenge other provisions in ABx1 26 or AB 1484 that require successor agencies to remit various funds of former RDAs. One such case, *City of Brentwood, et al. v. California Department of Finance, et al.* (Sacramento County Superior Court, Case No. 34-2013-80001568), challenges provisions that retroactively invalidate transfers of funds from a former RDA to the city or county that created the RDA, and require redistribution of those funds. The trial court denied the petition in this matter, and petitioners appealed (Court of Appeal, Third Appellate District, Case No. C076343). Another case, *League of California Cities, et al. v. Matosantos, et al.* (Sacramento County Superior Court, Case No. 34-2012-80001275), challenges the statutory mechanisms for the Department of Finance or the county auditor-controller to recover these disputed amounts. The trial court denied the petition for a writ in this matter but on reconsideration, granted the writ in part, striking down provisions that allowed the state to withhold a city's sales and use tax. The state appealed (Court of Appeal, Third Appellate District, Case No. C076075). Another matter asserting similar arguments was heard by the trial court on September 20, 2013, and the court issued a ruling in favor of the state, finding all of the challenged statutes facially constitutional. *City of Bellflower, et al. v. Matosantos, et al.* (Sacramento County Superior Court, Case No. 34-2012-80001269). Petitioners appealed (Court of Appeal, Third Appellate District, Case No. C075832). Other cases challenge the implementation of ABx1 26, contending that various obligations incurred by the RDAs are enforceable obligations entitled to payment from tax revenues under ABx 1 26. In *Affordable Housing Coalition v. Sandoval* (Sacramento County Superior Court, Case No. 34 2012-80001158), plaintiffs argue that all former RDAs had obligations to pay for affordable housing that should be funded going forward on an implied contracts theory. The court denied a motion for class action status in this matter.

4. Action Challenging Use of Mortgage Settlement Proceeds

In *National Asian American Coalition, et al. v. Brown, et al.* (Sacramento County Superior Court, Case No. 34-2014-80001784), three non-profit organizations allege that approximately $369 million received by the state in 2012 in connection with the nationwide settlement between states and certain mortgage servicers was deposited in a special fund intended to provide assistance to California homeowners, but that such settlement monies were instead used for other purposes in the fiscal year 2012-13 budget. The plaintiffs allege the use of the settlement monies was inconsistent with the terms of the settlement agreement and California law, and seek to compel state officials to return the monies to the special fund.

5. Action Challenging Fire Prevention Fee

In *Howard Jarvis Taxpayers Association, et al. v. California Department of Forestry and Fire Protection, et al.* (Sacramento County Superior Court, Case No. 34-2012-00133197), plaintiffs challenge a fire prevention fee imposed on owners of structures situated on property for which the state is primarily responsible for fire prevention. The plaintiffs assert that the fee is a "tax" that was invalidly enacted without the required 2/3 vote of the Legislature. The complaint is styled as a class action on behalf of property owners who are subject to and have paid the fee, and seeks a declaration that the fee is invalid and a refund of fees paid.

Tax Cases

Six actions have been filed contending that the Legislature's modification of Revenue and Taxation Code Section 25128, which implemented the double-weighting of the sales factor in California's apportionment of income formula for the taxation of multistate business entities, is invalid and/or unconstitutional. *Kimberly-Clark Worldwide, Inc., et al. v. Franchise Tax Board* (San Francisco County Superior Court, Case No. CGC-10-495916); *Gillette Company and Subsidiaries v. Franchise Tax Board* (San Francisco County Superior Court, Case No. CGC-10-495911); *Procter & Gamble Manufacturing Company & Affiliates v. Franchise Tax Board* (San Francisco County Superior Court, Case No. CGC 10 495912); *Sigma-Aldrich, Inc. and Affiliates v. Franchise Tax Board* (San Francisco County Superior Court, Case No. CGC-10-496437); *RB Holdings (USA), Inc. v. Franchise Tax Board* (San Francisco County Superior Court, Case No. CGC-10-496438); and *Jones Apparel Group v. Franchise Tax Board* (San Francisco County Superior Court, Case No. CGC-10-499083), now consolidated in one matter, collectively referred to as *Gillette Company v. Franchise Tax Board*. Plaintiffs contend that the single-weighted sales factor specified in Section 25128 prior to amendment was contained within the Multistate Tax Compact ("Compact") and therefore cannot be modified without repealing the legislation that enacted the Compact. An adverse ruling in these cases would affect multiple taxpayers and create potential exposure to refund claims in excess of $750 million. The trial court ruled for the state in each of these matters, but, on appeal, the trial court judgment was reversed (Court of Appeal, First Appellate District, Case No. A130803). The appellate court held that the Compact was valid and the state was bound by its provisions for the tax years at issue because the state had not withdrawn from the Compact. The court also held that in attempting to override the contractual terms of the Compact, section 25128 violated the constitutional protections against impairment of contract. The California Supreme Court granted the state's petition for review (California Supreme Court Case No. S206587). See "STATE FINANCES – Sources of Tax Revenue – Corporation Tax."

A pending case challenges the fee imposed by the state tax code upon limited liability companies ("LLCs") registered in California, alleging that it discriminates against interstate commerce and violates the U.S. and the state Constitutions, is an improper exercise of the state's police powers, and has been misapplied by the Franchise Tax Board. *Bakersfield Mall LLC v. Franchise Tax Board* (San Francisco County Superior Court, Case No. CGC-07-462728). *Bakersfield Mall* was filed as a purported class action on behalf of all LLCs operating solely in

California. Plaintiff filed an amended complaint to allege that not all of its income is derived solely from sources in California, which would call into question the class plaintiff purports to represent. A second lawsuit that is virtually identical to *Bakersfield Mall* also seeks to proceed as a class action. *CA-Centerside II, LLC v. Franchise Tax Board* (Fresno County Superior Court, Case No. 10 CECG00434). The cases are coordinated for hearing in San Francisco as the *Franchise Tax Board LLC Tax Refund Cases,* Judicial Council Proceeding No. 4742. The coordination trial judge denied the plaintiffs' joint motion for class certification and the plaintiffs appealed (Court of Appeal, First Appellate District, Case No. A140518). If this immediately appealable order is reversed and the cases proceed as class actions, the claimed refunds could be significant (in excess of $500 million).

Lucent Technologies, Inc. v. State Board of Equalization ("Lucent I") (Los Angeles County Superior Court, Case No. BC 402036), a tax refund case, involves the interpretation of certain statutory sales and use tax-exemptions relating to computer software and licenses to use computer software that are transferred pursuant to technology transfer agreements. A second case, *Lucent Technologies, Inc. v. State Board of Equalization ("Lucent II")* (Los Angeles County Superior Court, Case No. BC 448715), involving the same issue but for different tax years than in the *Lucent I* matter, was consolidated with the *Lucent I* case. In a similar case, *Nortel Networks Inc. v. State Board of Equalization* (Los Angeles County Superior Court, Case No. BC 341568), the trial court ruled in favor of plaintiff and the ruling was affirmed on appeal (Court of Appeal, Second Appellate District, Case No. B213415, California Supreme Court, Case No. S190946). The adverse ruling in the *Nortel* matter, unless limited in scope by a decision in the *Lucent* matters, if applied to other similarly situated taxpayers, could have a significant negative impact, in the range of approximately $300 million annually, on tax revenues. In the *Lucent* matters, the trial court granted plaintiffs' motion for summary judgment and denied the Board of Equalization's motion for summary judgment. Judgment was entered for plaintiffs and the Board of Equalization appealed (Court of Appeal, Second Appellate District, Case No. B257808).

Two pending cases challenge the state's right to require interstate unitary businesses to report their income on a combined basis while allowing intrastate unitary businesses to report the income of each business entity on a separate basis. *Harley Davidson, Inc. and Subsidiaries v. California Franchise Tax Board* (San Diego County Superior Court, Case No. 37-2001-00100846-CU-MC-CTL and Court of Appeal, Fourth Appellate District, Case No. D064241) and *Abercrombie & Fitch Co. & Subsidiaries v. California Franchise Tax Board* (Fresno County Superior Court, Case No. 12 CE CG 03408) challenge the constitutionality of Revenue and Taxation Code Section 25101.15, allowing intrastate unitary businesses the option to report their income on a separate rather than combined basis. The trial court in *Harley Davidson* sustained a demurrer on this issue without leave to amend; the issue is now pending on appeal. The Abercrombie matter is stayed pending resolution of the issue in the Harley-Davidson matter. Should Section 25101.15 be invalidated, a significant amount of otherwise apportionable income from multi-state unitary businesses would be removed from the state taxing power. At this time, it is unknown what future fiscal impact a potential adverse ruling would actually have on corporation taxes (including potentially rebates of previously collected taxes and reduced future tax revenue) because of the uncertainty regarding the number of businesses which currently pay the tax and how taxation on those companies would change as a result of an adverse ruling. However, the fiscal impact could be significant. See "STATE FINANCES – Sources of Tax

Revenues – Corporation Tax" for a discussion of corporation taxes. The *Harley Davidson* case also raises the issue raised in the *Gillette* case regarding modification of the apportionment formula for multi-state businesses; resolution of this issue in *Harley Davidson* has been deferred to await the outcome of the issue in *Gillette* (discussed above).

Environmental Matters

In a federal Environmental Protection Agency ("U.S. EPA") administrative abatement action titled *In the Matter of: Leviathan Mine, Alpine County, California, Regional Water Quality Control Board, Lahontan Region, State of California* (U.S. EPA Region IX CERCLA Docket No. 00-16(a)), the state, as owner of the inactive Leviathan Mine, is a responsible party through the Lahontan Regional Water Quality Control Board ("Regional Board"). The Atlantic Richfield Company ("ARCO") is also a responsible party as the successor in interest to the mining company that caused certain pollution of the mine site. The Leviathan Mine site ("Site") is listed on the U.S. EPA "Superfund" List, and both remediation costs and costs for natural resources damages may be imposed on the state. The alleged bases for the state's liability are the state's ownership of the Site and the terms of a 1983 settlement agreement between the Regional Board and ARCO. The Regional Board purchased the Site to abate the pollution and has undertaken certain remedial actions ("Project"), but the U.S. EPA's decision on the interim and final remedies is pending. ARCO has sued the state, the State Water Resources Control Board, and the Regional Board, seeking to recover past and future clean-up costs, based on the settlement agreement, the state's ownership of the property, and the Regional Board's allegedly defective Project. The October 2012 trial date for this matter was postponed until March 2015, to permit the parties to continue settlement negotiations. *Atlantic Richfield Co. v. State of California* (Los Angeles County Superior Court, Case No. BC 380474). It is possible these matters if determined adversely to the state could result in potential liability in the hundreds of millions of dollars.

In *Consolidated Suction Dredge Mining Cases (Karuk Tribe v. DFG)* (Alameda, Siskiyou, and San Bernardino County Superior Courts), environmental and mining interests challenge the state's regulation of suction dredge gold mining. After initially prohibiting such mining in the state except pursuant to a permit issued by the Department of Fish and Wildlife (formerly Fish and Game) under specified circumstances, the Legislature subsequently placed a moratorium on all suction dredging until certain conditions are met by the Department. The cases are coordinated for hearing in San Bernardino County Superior Court (Case No. JCPDS4720). One of these matters, *The New 49'ERS, Inc. et al. v. California Department of Fish and Game*, claims that federal law preempts and prohibits state regulation of suction dredge mining on federal land. Plaintiffs, who have pled a class action but have yet to seek certification, claim that as many as 11,000 claims, at a value of $500,000 per claim, have been taken. The parties are engaged in ongoing judicially supervised settlement negotiations.

In *City of Colton v. American Promotional Events, Inc., et al.* (Los Angeles County Superior Court, Case No. BC 376008), two defendants in an action involving liability for contaminated groundwater have filed cross complaints seeking indemnification from the state and the Regional Water Quality Control Board in an amount of up to $300 million. In a related action, *Emhart Industries v. Regional Water Quality Control Board* (Los Angeles County Superior Court, Case No. BC 472949), another defendant in an action involving liability for contaminated groundwater seeks indemnification from the state and the Regional Water Quality Control Board in an amount up to $300 million.

Escheated Property Claims

In *Taylor v. Chiang* (U.S. District Court, Eastern District, Case No. S-01-2407 WBS GGH), plaintiffs claim that the state's unclaimed property program violates the United States Constitution and various federal and state laws. They assert that the state has an obligation to pay interest on private property that has escheated to the state, and that failure to do so constitutes an unconstitutional taking of private property. Although the case is styled as a class action, no class has been certified. Plaintiffs also assert that for the escheated property that has been disposed of by the state, plaintiffs are entitled to recover, in addition to the proceeds of such sale, any difference between the sale price and the property's highest market value during the time the state held it; the state asserts that such claims for damages are barred by the Eleventh Amendment. The district court ruled against plaintiffs in a related action, *Suever v. Connell* (U.S. District Court, Northern District, Case No. C03-00156 RS). The Ninth Circuit affirmed and the United States Supreme Court denied review. Meanwhile, the *Taylor* plaintiffs amended their complaint to allege that the Controller applies the Unclaimed Property Law's notice requirements in ways that violate state and federal law, and the district court granted the state's motion to dismiss plaintiffs' claims. Plaintiffs appealed this ruling to the Ninth Circuit. Oral argument was heard in February 2015, and the court took the matter under submission.

Actions Seeking Damages for Alleged Violations of Privacy Rights

In *Gail Marie Harrington-Wisely, et al. v. State of California, et al.* (Los Angeles County Superior Court, Case No. BC 227373), plaintiffs seek damages, asserting that the use by the California Department of Corrections and Rehabilitation ("CDCR") of a body-imaging machine to search visitors entering state prisons for contraband violated the rights of the visitors. This matter was certified as a class action. The trial court granted judgment in favor of the state. Plaintiffs' appeal was dismissed (Court of Appeal, Second Appellate District, Case No. B190431) and the trial court denied plaintiffs' motion for attorneys' fees. The parties agreed to a stipulated judgment and dismissed the case subject to further review if CDCR decides to use similar technology in the future. Plaintiffs filed another appeal of the dismissal of the damage claims and denial of attorneys' fees (Court of Appeal, Second Appellate District, Case No. B248565). If plaintiffs were successful in obtaining an award of damages for every use of the body-imaging machine, damages could be as high as $3 billion.

Plaintiff in *Gilbert P. Hyatt v. Franchise Tax Board* (State of Nevada, Clark County District Court, Case No. A382999) was subject to an audit by the Franchise Tax Board involving a claimed change of residence from California to Nevada. Plaintiff alleges a number of separate torts involving privacy rights and interference with his business relationships arising from the audit. The trial court ruled that plaintiff had not established a causal relation between the audit and the loss of his licensing business with Japanese companies; the Nevada Supreme Court denied review of this ruling. The economic damages claim exceeded $500 million. On the remaining claims, the jury awarded damages of approximately $387 million, including punitive damages, plus interest and attorneys' fees, for a total of approximately $490 million. The total judgment with interest is currently approximately $600 million. On September 18, 2014, the

Nevada Supreme Court reversed the judgment on most of the plaintiff's claims and the award of punitive damages. The Court upheld the award of approximately $1.08 million in damages on the fraud claim, reversed the award of damages for the infliction of emotional distress claim, remanding that claim to the trial court for a new trial on the issue of damages, and reversed and remanded the award of prejudgment interest and costs. The Nevada Supreme Court denied the parties' petitions for rehearing of certain of the issues. Plaintiff's petition relates to the invasion of privacy claims and the Franchise Tax Board's petition relates to the intentional infliction of emotional distress and fraud claims. The Franchise Tax Board has until March 23, 2015 to file a petition for certiorari in the U. S. Supreme Court.

Action Regarding Special Education

Plaintiffs in *Morgan Hill Concerned Parents Assoc. v. California Department of Education* (United States District Court, Eastern District of California, Case No. 2:11-cv-3471-KJM), challenge the oversight and operation by the California Department of Education ("CDE") of the federal Individuals with Disabilities Education Act ("IDEA"). The complaint alleges that CDE, as the designated State Education Agency, has failed to monitor, investigate, and enforce the IDEA statewide. Under the IDEA, local school districts are the Local Educational Agencies responsible for delivering special education directly to eligible students. The complaint seeks injunctive and declaratory relief, and asks the court to retain jurisdiction to monitor the operation of the IDEA by the state.

Actions Regarding Medi-Cal Reimbursements and Fees

In *The Rehabilitation Center of Beverly Hills, et al. v. Department of Health Services, et al.* (Sacramento County Superior Court, Case No. 06CS01592), plaintiffs challenge a quality assurance fee ("QAF") charged to skilled nursing facilities that was enacted in 2004, alleging violations of the federal and state constitutions and state law. Funds assessed under the QAF are made available, in part, to enhance federal financial participation in the Medi-Cal program. Plaintiffs seek a refund of fees paid. The trial court ruled the QAF is properly characterized as a "tax" rather than a "fee." Trial then proceeded on plaintiffs' claims for refund of QAF amounts paid as an allegedly illegal and improperly collected tax. The QAF amounts collected from all providers is approximately $2.6 billion, and California has received additional federal financial participation based on its imposition and collection of the QAF. An adverse ruling could negatively affect the state's receipt of federal funds. The trial court ruled for the state, finding that the QAF is constitutionally valid. Plaintiffs appealed (Court of Appeal, Third Appellate District, Case No. C070361).

In *California Pharmacists Association, et al. v. Maxwell-Jolly, et al.* (U.S. District Court, Central District, Case No. CV09-08200), Medi-Cal pharmacy providers filed a suit challenging reimbursement rates, including the use by DHCS of reduced published average wholesale price data to establish reimbursement rates, and challenging the Legislature's amendment of Welfare and Institutions Code section 14105.45 and enactment of Welfare and Institutions Code section 14105.455. Plaintiffs seek injunctive relief based on alleged violations of federal law. The district court granted a request for preliminary injunction in part, with respect to sections 14104.45 and 14105.455, and denied it in part, with respect to the use of reduced published average wholesale price data to establish reimbursement rates. Plaintiffs filed a motion seeking to modify the district court ruling, and both parties filed notices of appeal to the Ninth Circuit Court of Appeals. The parties have requested mediation. At this time it is unknown what fiscal impact this case would have on the state's General Fund.

In *Centinela Freeman Emergency Medical Associates, et al. v. Maxwell-Jolly, et al.* (Los Angeles County Superior Court, Case No. BC 406372), filed as a class action on behalf of emergency room physicians and emergency department groups, plaintiffs claim that Medi-Cal rates for emergency room physicians are below the cost of providing care. The trial court granted the petition of the plaintiffs and ordered DHCS to conduct an annual review of reimbursement rates for physicians and dentists pursuant to Welfare and Institutions Code section 14079. On November 10, 2014, the trial court discharged the writ. A final decision in this matter adverse to the state could result in costs to the General Fund of $250 million.

Medicaid providers and beneficiaries filed four law suits against both the State and the federal government, seeking to enjoin a set of rate reductions (the AB 97 reductions) that were approved by the federal government in October 2011 with an effective date of June 1, 2011. *Managed Pharmacy Care, et al., v. Sebelius* (U.S. District Court, Central District, Case No. 2:11-cv-09211-CAS(MANx)); *California Medical Assoc., et al., v. Douglas* (U.S. District Court, Central District, Case No. 2:11-cv-09688-CAS (MANx)); *California Medical Transportation Assoc. Inc., v. Douglas* (U.S. District Court, Central District, Case No. 2:11-cv-09830-CAS (MANx)); *California Hospital Association, et al., v. Douglas* (U.S. District Court, Central District, Case No. CV-11-09078 CAS (MRWx)). The Medicaid rates at issue in the four cases include pharmacy service and prescription drugs; services provided by skilled nursing facilities that are distinct part units within a hospital; non-emergency medical transportation services; physician services; dental services; durable medical equipment; and emergency ambulance services. The district court entered a series of preliminary injunctions to prevent the rate reductions from taking effect. Both the federal and state government (DHCS) appealed to the Ninth Circuit Court of Appeals. The Ninth Circuit reversed the district court, vacated the preliminary injunctions, and remanded the case. The Ninth Circuit denied plaintiffs' petitions for rehearing and request for a stay. The United States Supreme Court denied plaintiffs' petitions for certiorari.

Prison Healthcare Reform and Reduction of Prison Population

The adult prison health care delivery system includes medical health care and mental health care. There are two significant cases pending in federal district courts challenging the constitutionality of prison health care. *Plata v. Brown* (U.S. District Court, Northern District, Case No. C 01-1351 TEH) is a class action regarding the adequacy of medical health care; and *Coleman v. Brown* (U.S. District Court, Eastern District, Case No. CIV S-90-0520 KJM JFM P) is a class action regarding mental health care. A third case, *Armstrong v. Brown* (U.S. District Court, Northern District, Case No. C 94-02307 CW) is a class action on behalf of inmates with disabilities alleging violations of the Americans with Disabilities Act and Section 504 of the Rehabilitation Act. In *Plata* the district court appointed a Receiver, who took office in April 2006, to run and operate the medical health care portion of the health care delivery system. The *Plata* Receiver and the Special Master appointed by the *Coleman* court, joined by the court representative appointed by the *Armstrong* court, meet routinely to coordinate efforts in these cases. To date, ongoing costs of remedial activities have been incorporated into the state's budget process. However, at this time, it is unknown what future financial impact this litigation may have on the state's General Fund.

In *Plata* and *Coleman*, discussed above, a three-judge panel was convened to consider plaintiffs' motion for a prisoner-release order. The motions alleged that prison overcrowding was the primary cause of unconstitutional medical and mental health care. After a trial, the panel issued a prisoner release order and ordered the state to prepare a plan for the reduction of approximately 40,000 prisoners over two years.

The three-judge panel has issued orders requiring the state to meet a final population-reduction benchmark by February 28, 2016, and to implement a number of measures designed to reduce the prison population. As of January 1, 2015, the state has implemented all such measures. The three-judge panel also appointed a "compliance officer" to bring the state into compliance if any benchmark is missed by ordering the release of inmates. On August 31, 2014, the state's prison population met the first of the interim benchmarks set by the court, and the state met the second interim benchmark on February 28, 2015. The state has agreed not to pursue further court appeals.

Actions Regarding Proposed Sale of State-Owned Properties

Two taxpayers filed a lawsuit seeking to enjoin the sale of state-owned office properties, which was originally scheduled to close in December 2010, on the grounds that the sale of certain of the buildings that house appellate court facilities required the approval of the Judicial Council, which had not been obtained, and that the entire sale constituted a gift of public funds in violation of the state Constitution and a waste of public funds in violation of state law. *Epstein, et al. v. Schwarzenegger, et al.* (San Francisco County Superior Court, Case. No. CGC-10-505436). Plaintiffs' request for a preliminary injunction was denied. In a second action filed after the state decided not to proceed with the sale, and now coordinated with the *Epstein* matter, the prospective purchaser seeks to compel the state to proceed with the sale of the state-owned properties, or alternatively, for damages for breach of contract. *California First, LP v. California Department of General Services, et al.* (Los Angeles County Superior Court, Case No. BC457070). The trial court denied the state's motion for judgment on the pleadings, in which the state asserted that the plaintiff should not be permitted to pursue claims for damages. The parties have stipulated to bifurcate the matters for trial and to stay the *Epstein* matter pending trial of the *California First* matter. The parties settled the *California First* matter in February 2015, with a payment of $24 million to be made by the state.

High-Speed Rail Litigation

In *Tos, et al. v. California High-Speed Rail Authority, et al.* (Sacramento County Superior Court, Case No. 34-2011-00113919), petitioners claim that the Authority has not complied with the state high-speed rail bond act in approving plans for the high-speed rail system. The trial court ruled that the Authority's plan for funding the high-speed rail project did not comply with certain requirements in the bond act, and ordered the Authority to rescind the plan. Respondents' motion for judgment on the pleadings on petitioners' remaining claims was denied by the trial court on March 4, 2014, and respondents' subsequent petition for writ of mandate from that ruling was denied. Respondents filed a writ petition in the California Supreme Court from the order in *Tos* requiring the Authority to rescind the funding plan, and the Supreme Court transferred the proceeding to the court of appeal (Court of Appeal, Third Appellate District, Case No. C075668). On February 14, 2014, the court of appeal granted an alternative writ and stayed the trial court's order directing the Authority to rescind the funding plan. On July 31, 2014, the Court of Appeal reversed the trial court ruling. On October 15, 2014, the California Supreme Court (California Supreme Court Case No. S220926) denied petitions for review. A hearing on petitioners' remaining claims in *Tos* is expected in 2015.

In *Transportation Solutions Defense and Education Fund v. California Air Resources Board* (Sacramento County Superior Court, Case No. 34-2014-80001974), a transit-advocacy group seeks to reverse a decision of the California Air Resources Board ("ARB") to include the California high-speed rail project as a greenhouse gas reduction measure in the state's AB 32 Scoping Plan Update. The petitioner seeks a declaration that appropriations by the Legislature to fund the high-speed rail project from the Greenhouse Gas Reduction Fund ("GGRF") are invalid and an injunction or writ restraining ARB and the real parties (High Speed Rail Authority and State Controller) from expending funds from the GGRF for the construction of the high-speed rail project.

In the event of a final decision adverse to the state in *Tos* or *Transportation Solutions* that prevents use of bond proceeds or cap and trade funds, it is possible that the federal government may require the state to reimburse federal funds provided for the high-speed rail project if the state fails to provide other matching funds consistent with the federal grant agreement. The potential amount of any such reimbursement cannot be determined at this time.

Action Regarding State Mandates

Petitioners in *Coast Community College District, et al. v. Commission on State Mandates* (Sacramento County Superior Court, Case No. 34-2014-80001842) challenge a determination that costs for complying with certain laws and regulations prescribing standards for the formation and basic operation of California community colleges are not state-mandated costs that must be reimbursed by the state. The potential amount of reimbursement for such costs cannot be determined at this time.

BANK ARRANGEMENTS

The table immediately following the text of APPENDIX A, prior to the State Debt Tables, includes certain information relating to bank arrangements the state has entered into. See also "STATE INDEBTEDNESS AND OTHER OBLIGATIONS – Capital Facilities Financing – Bank Arrangements."

STATE DEBT TABLES

The tables which follow provide information on outstanding state debt, authorized but unissued general obligation bonds and commercial paper notes, debt service requirements for state general obligation and lease-revenue bonds, and authorized and outstanding state revenue bonds. The table titled "Bank Arrangements" contains certain information relating to letters of credit, liquidity facilities and other bank arrangements in connection with variable rate obligations and commercial paper notes. Also, see "STATE INDEBTEDNESS AND OTHER

OBLIGATIONS." For purposes of these tables, "General Fund bonds," also known as "non-self liquidating bonds," are general obligation bonds expected to be paid from the General Fund without reimbursement from any other fund. Although the principal of general obligation commercial paper notes in the "non-self liquidating" category is legally payable from the General Fund, the state expects that principal of such commercial paper notes will be paid only from the issuance of new commercial paper notes or the issuance of long-term general obligation bonds to retire the commercial paper notes. Interest on "non-self liquidating" general obligation commercial paper notes is payable from the General Fund.

"Enterprise Fund bonds," also known as "self liquidating bonds," are general obligation bonds for which program revenues are expected to be sufficient to reimburse in full the General Fund for debt service payments, but any failure to make such a reimbursement does not affect the obligation of the state to pay principal and interest on the bonds from the General Fund.

"Special Revenue Fund bonds" also known as Economic Recovery Bonds or ERBs, are "self liquidating" general obligation bonds which are primarily secured by a pledge of a one-quarter cent statewide sales and use tax deposited in the Fiscal Recovery Fund. Debt service payments are made directly from the Fiscal Recovery Fund and not the General Fund. The Special Revenue Fund bonds are also general obligations of the state to which the full faith and credit of the state are pledged to the punctual payment of the principal of and interest thereon, if the sales tax revenues are insufficient.

As of January 1, 2015, there was $594,035,000 principal amount of commercial paper notes outstanding.

The following tables do not reflect the defeasance of $634,440,000 of fixed rate Economic Recovery Bonds as described in "STATE INDEBTEDNESS AND OTHER OBLIGATIONS – Economic Recovery Bonds."

BANK ARRANGEMENTS TABLE

(See “STATE INDEBTEDNESS AND OTHER OBLIGATIONS – Capital Facilities Financing – Bank Arrangements.”)

As of January 1, 2015

BANK ARRANGEMENTS (See “STATE INDEBTEDNESS AND OTHER OBLIGATIONS – Capital Facilities Financing – Bank Arrangements.”)

Program	Series	Outstanding Par Amount	Credit Provider	Expiration	Type of Credit	Reset Mode
GO VRDOs	2003A 1	$50,000,000	JP Morgan Chase	12/16/2016	LOC	Daily
	2003A 2-3	$200,000,000	Bank of Montreal	10/16/2015	LOC	Daily
GO VRDOs	2003B 1-4	$250,000,000	JP Morgan Chase (80.0%) CA Public Employees’ Retirement System (20.0%)	11/10/2016	LOC	Weekly
GO VRDOs	2003C 1	$100,000,000	Bank of America, N.A.	12/16/2016	LOC	Weekly
	2003C 3-4	$100,000,000	US Bank National Association	4/12/2017	LOC	Weekly
GO VRDOs	2004A 1, 4 & 5	$200,000,000	Citibank, N.A.	10/15/2015	LOC	Daily
GO VRDOs	2004A 2 &3	$150,000,000	State Street Bank & Trust Company	11/10/2016	LOC	Daily
GO VRDOs	2004A 6, 7, 8 & 10	$200,000,000	Citibank, N.A.	10/15/2015	LOC	Weekly
GO VRDOs	2004 A 9	$50,000,000	State Street Bank & Trust Company	11/10/2016	LOC	Weekly
GO VRDOs	2004B 1-3	$165,000,000	Citibank, N.A.	10/15/2015	LOC	Daily
GO VRDOs	2004B 4	$35,000,000	Citibank, N.A.	10/15/2015	LOC	Weekly
GO VRDOs	2004B 5-6	$100,000,000	US Bank National Association	4/5/2018	LOC	Weekly
GO VRDOs	2005A-1-1	$85,850,000	Royal Bank of Canada	11/4/2016	LOC	Weekly
GO VRDOs	2005A-1-2	$85,750,000	Royal Bank of Canada	11/4/2016	LOC	Weekly
GO VRDOs	2005A-2-1	$143,200,000	Barclays Bank PLC	4/11/2017	LOC	Weekly
GO VRDOs	2005A-2-2	$28,400,000	Royal Bank of Canada	11/4/2016	LOC	Weekly
GO VRDOs	2005A-3	$49,100,000	Bank of America, N.A.	12/16/2016	LOC	Weekly
GO VRDOs	2005B-1	$147,100,000	Bank of America, N.A.	2/17/2017	LOC	Weekly
GO VRDOs	2005B-2	$98,100,000	Bank of Tokyo-Mitsubishi UFJ, Ltd.	11/10/2016	LOC	Weekly
GO VRDOs	2005B-3	$49,100,000	Barclays Bank PLC	4/11/2017	LOC	Weekly
GO VRDOs	2005B-4	$49,100,000	JP Morgan Chase	12/16/2016	LOC	Weekly
GO VRDOs	2005B-5	$88,890,000	Barclays Bank PLC	4/11/2017	LOC	Weekly
GO VRDOs	2005B-7	$49,100,000	JP Morgan Chase	12/16/2016	LOC	Daily
Total GO VRDOs		**$2,473,690,000**				

GO CP [a]	A1/B1	$500,000,000	Wells Fargo Bank, N.A.	2/17/2017	LOC	Up to 90 days
	A2/B2	$500,000,000	Royal Bank of Canada	12/16/2016	LOC	Up to 90 days
	A3/B3	$200,000,000	JP Morgan Chase(75%) CA Public Employees' Retirement System (25%)	12/16/2016	LOC	Up to 90 days
	A4/B4	$150,000,000	Morgan Stanley Bank, N.A.	12/16/2016	LOC	Up to 90 days
	A5/B5	$125,000,000	US Bank National Association	12/16/2016	LOC	Up to 90 days
	A6/B6	$50,000,000	Bank of America, N.A.	12/16/2016	LOC	Up to 90 days
	A7/B7	$125,000,000	Mizuho Bank, Ltd.	2/19/2016	LOC	Up to 90 days
	A8/B8	$75,000,000	Bank of the West	2/17/2017	LOC	Up to 90 days
	C1/D1	$500,000,000	Bank of America, N.A.	11/25/2017	Bank Note	Up to 90 days
	Total CP	**$2,225,000,000**				
Grand Total		**$4,698,690,000**				

(a) For commercial paper (CP), the total outstanding par represents the maximum principal commitment under related bank agreements.

(THIS PAGE INTENTIONALLY LEFT BLANK)

OUTSTANDING STATE DEBT
FISCAL YEARS 2009-10 THROUGH 2013-14
(Dollars in Thousands Except for Per Capita Information)

	2009-10	2010-11	2011-12	2012-13	2013-14
Outstanding Debt (a)					
General Obligation Bonds					
General Fund (Non-Self Liquidating)	$ 68,766,304	$ 71,283,705	$ 73,060,865	$ 74,456,230	$ 75,714,125
Enterprise Fund (Self Liquidating)	$ 1,475,440	$ 1,216,115	$ 1,115,935	$ 884,180	$ 671,180
Special Revenue Fund (Self Liquidating)	$ 7,720,220	$ 6,787,220	$ 5,910,480	$ 4,731,745	$ 3,417,115
Total General Obligation Bonds	$ 77,961,964	$ 79,287,040	$ 80,087,280	$ 80,072,155	$ 79,802,420
Revenue Bonds					
Lease-Purchase Debt	$ 9,887,600	$ 9,426,325	$ 11,330,355	$ 11,822,140	$ 11,266,240
Propsosition 1A Receivables Program	$ 1,895,000	$ 1,895,000	$ 1,895,000	$ 0	$ 0
Total Revenue Bonds	$ 11,782,600	$ 11,321,325	$ 13,225,355	$ 11,822,140	$ 11,266,240
Total Outstanding General Obligation and Revenue Bonds	$ 89,744,564	$ 90,608,365	$ 93,312,635	$ 91,894,295	$ 91,068,660
Bond Sales During Fiscal Year					
Non-Self Liquidating General Obligation Bonds	$ 12,446,005	$ 4,525,000	$ 7,817,390	$ 7,417,170	$ 5,905,370
Self Liquidating General Obligation Bonds	$ 118,710	$ 0	$ 0	$ 0	$ 0
Proposition 1A Receivables Revenue Bonds	$ 1,895,000	$ 0	$ 0	$ 0	$ 0
Self Liquidating Special Fund Revenue Bonds	$ 3,435,615	$ 0	$ 438,635	$ 0	$ 0
Lease-Purchase Debt	$ 2,269,235	$ 0	$ 2,627,115	$ 1,678,130	$ 2,391,130
Debt Service (b)					
Non-Self Liquidating General Obligation Bonds	$ 5,035,363	$ 5,704,729	$ 5,782,240	$ 5,424,867	$ 6,307,696
Lease-Purchase Debt	$ 881,994	$ 973,824	$ 980,862	$ 1,194,881	$ 978,202
General Fund Receipts (c)	$ 88,654,941	$ 95,536,379	$ 87,769,787	$ 103,424,674	$ 103,966,197
Non-Self Liquidating General Obligation Bonds Debt Service as a Percentage of General Fund Receipts	5.68%	5.97%	6.59%	5.25%	6.07%
Lease-Purchase Debt Service as a Percentage of General Fund Receipts	0.99%	1.02%	1.12%	1.16%	0.94%
Population (d)	37,077,204	37,309,404	37,570,112	37,872,431	38,204,597
Non-Self Liquidating General Obligation Bonds Outstanding per Capita	$ 1,854.68	$ 1,910.61	$ 1,944.65	$ 1,965.97	$ 1,981.81
Lease-Purchase Debt Outstanding per Capita	$ 266.68	$ 252.65	$ 301.58	$ 312.16	$ 294.89
Personal Income (e)	$ 1,516,677,000	$ 1,587,403,750	$ 1,664,635,750	$ 1,720,052,000	$ 1,819,290,000
Non-Self Liquidating General Obligation Bonds Outstanding as Percentage of Personal Income	4.53%	4.49%	4.39%	4.33%	4.16%
Lease-Purchase Debt Outstanding as Percentage of Personal Income	0.65%	0.59%	0.68%	0.69%	0.62%

(a) Principal outstanding as of July 1 of the next fiscal year. Includes the initial value of capital appreciation bonds rather than the accreted value.

(b) Calculated on a cash basis. The amounts do not reflect any interest subsidy under the Build America Bonds program. Subsidy not pledged to the repayment of debt service. Debt service costs of bonds issued in any fiscal year largely appear in subsequent fiscal years.

(c) Calculated on a cash basis. General Fund Receipts includes both revenues and nonrevenues, such as borrowings, the proceeds of which are deposited in the General Fund (e.g. tobacco securitization bonds and economic recovery bonds).

(d) As of July 1, the beginning of the fiscal year.

(e) Revised estimates as of June 24, 2014.

SOURCES: Population: State of California, Department of Finance.
Personal Income: United States, Department of Commerce, Bureau of Economic Analysis
Outstanding Debt, Bonds Sales During Fiscal Year and Debt Service: State of California, Office of the Treasurer.
General Fund Receipts: State of California, Office of the State Controller.

AUTHORIZED AND OUTSTANDING GENERAL OBLIGATION BONDS
As of January 1, 2015
(Thousands)

		Voter		Long Term	Commercial	
	Proposition	Authorization	Authorization	Bonds	Paper	
	Number	Date	Amount	Outstanding	Outstanding (a)	Unissued
			$	$	$	$
GENERAL FUND BONDS (Non-Self Liquidating)						
+ 1988 School Facilities Bond Act	79	11/08/88	797,745	42,125	0	0
+ 1990 School Facilities Bond Act	123	06/05/90	797,875	90,705	0	0
+ 1992 School Facilities Bond Act	155	11/03/92	898,211	261,385	0	0
California Clean Water, Clean Air, Safe Neighborhood Parks, and Coastal Protection Act of 2002	40	03/05/02	2,600,000	2,153,960	0	259,240
+ California Library Construction and Renovation Bond Act of 1988	85	11/08/88	72,405	12,965	0	0
*+ California Park and Recreational Facilities Act of 1984	18	06/05/84	368,900	12,725	0	0
* California Parklands Act of 1980	1	11/04/80	285,000	2,650	0	0
California Reading and Literacy Improvement and Public Library Construction and Renovation Bond Act of 2000	50	03/07/00	255,000	264,200	0	5,040
*+ California Safe Drinking Water Bond Law of 1976	3	06/08/76	172,500	3,070	0	0
* California Safe Drinking Water Bond Law of 1984	28	11/06/84	75,000	1,905	0	0
* California Safe Drinking Water Bond Law of 1986	55	11/04/86	100,000	23,415	0	0
California Safe Drinking Water Bond Law of 1988	81	11/08/88	75,000	28,270	0	0
*+ California Wildlife, Coastal, and Park Land Conservation Act	70	06/07/88	768,670	119,530	0	0
Children's Hospital Bond Act of 2004	61	11/02/04	750,000	658,330	0	47,445
Children's Hospital Bond Act of 2008	3	11/04/08	980,000	569,995	28,190	371,580
Class Size Reduction Kindergarten-University Public Education Facilities Bond Act of 1998 (Hi-Ed)	1A	11/03/98	2,500,000	1,748,050	0	0
Class Size Reduction Kindergarten-University Public Education Facilities Bond Act of 1998 (K-12)	1A	11/03/98	6,700,000	4,139,005	0	11,400
Clean Air and Transportation Improvement Bond Act of 1990	116	06/05/90	1,990,000	813,845	0	4,985
* Clean Water Bond Law of 1984	25	11/06/84	325,000	11,080	0	0
* Clean Water and Water Conservation Bond Law of 1978	2	06/06/78	375,000	4,570	0	0
Clean Water and Water Reclamation Bond Law of 1988	83	11/08/88	65,000	20,440	0	0
* Community Parklands Act of 1986	43	06/03/86	100,000	2,795	0	0
* County Correctional Facility Capital Expenditure Bond Act of 1986	52	06/03/86	495,000	15,565	0	0
County Correctional Facility Capital Expenditure and Youth Facility Bond Act of 1988	86	11/08/88	500,000	74,295	0	0
++++ Disaster Preparedness and Flood Prevention Bond Act of 2006	1E	11/07/06	3,990,000	2,231,645	0	1,718,652

AUTHORIZED AND OUTSTANDING GENERAL OBLIGATION BONDS
As of January 1, 2015
(Thousands)

GENERAL FUND BONDS (Non-Self Liquidating)

		Voter		Long Term	Commercial	
	Proposition	Authorization	Authorization	Bonds	Paper	
	Number	Date	Amount	Outstanding	Outstanding (a)	Unissued
			$	$	$	$
Earthquake Safety and Public Buildings Rehabilitation Bond Act of 1990	122	06/05/90	300,000	79,800	1,815	7,490
* Fish and Wildlife Habitat Enhancement Act of 1984	19	06/05/84	85,000	5,110	0	0
Higher Education Facilities Bond Act of 1988	78	11/08/88	600,000	24,745	0	0
Higher Education Facilities Bond Act of June 1990	121	06/05/90	450,000	48,865	0	540
Higher Education Facilities Bond Act of June 1992	153	06/02/92	900,000	321,025	0	0
Highway Safety, Traffic Reduction, Air Quality, and Port Security Bond Act of 2006	1B	11/07/06	19,925,000	14,743,250	442,720	4,142,650
Housing and Emergency Shelter Trust Fund Act of 2002	46	11/05/02	2,100,000	821,890	25,000	82,080
Housing and Emergency Shelter Trust Fund Act of 2006	1C	11/07/06	2,850,000	1,663,435	0	1,094,135
Housing and Homeless Bond Act of 1990	107	06/05/90	150,000	1,470	0	0
Kindergarten-University Public Education Facilities Bond Act of 2002 (Hi-Ed)	47	11/05/02	1,650,000	1,400,795	0	0
Kindergarten-University Public Education Facilities Bond Act of 2002 (K-12)	47	11/05/02	11,400,000	9,303,215	0	57,810
Kindergarten-University Public Education Facilities Bond Act of 2004 (Hi-Ed)	55	03/02/04	2,300,000	2,051,470	4,045	58,824
Kindergarten-University Public Education Facilities Bond Act of 2004 (K-12)	55	03/02/04	10,000,000	8,861,990	7,900	143,700
Kindergarten-University Public Education Facilities Bond Act of 2006 (Hi-Ed)	1D	11/07/06	3,087,000	2,997,465	5,085	38,775
Kindergarten-University Public Education Facilities Bond Act of 2006 (K-12)	1D	11/07/06	7,329,000	6,546,520	5	651,710
* Lake Tahoe Acquisitions Bond Act	4	08/02/82	85,000	150	0	0
* New Prison Construction Bond Act of 1986	54	11/04/86	500,000	2,510	0	0
New Prison Construction Bond Act of 1988	80	11/08/88	817,000	13,300	0	2,165
New Prison Construction Bond Act of 1990	120	06/05/90	450,000	17,835	0	605
Passenger Rail and Clean Air Bond Act of 1990	108	06/05/90	1,000,000	49,800	0	0
Public Education Facilities Bond Act of 1996 (Higher Education)	203	03/26/96	975,000	525,785	4,485	4,650
++ Public Education Facilities Bond Act of 1996 (K-12)	203	03/26/96	2,012,035	949,110	0	0
++++ Safe Drinking Water, Clean Water, Watershed Protection, and Flood Protection Act	13	03/07/00	1,884,000	1,419,720	0	43,346
++++ Safe Drinking Water, Water Quality and Supply, Flood Control, River and Coastal Protection Bond Act of 2006	84	11/07/06	5,283,000	2,420,845	20,335	2,805,625
Safe Neighborhood Parks, Clean Water, Clean Air, and Coastal Protection Bond Act of 2000	12	03/07/00	2,100,000	1,529,890	0	73,820
++++ Safe, Clean, Reliable Water Supply Act	204	11/05/96	969,500	557,345	0	62,915
Safe, Reliable High-Speed Passenger Train Bond Act for the 21st Century	1A	11/04/08	9,950,000	815,760	0	9,003,520
* School Building and Earthquake Bond Act of 1974	1	11/05/74	40,000	15,970	0	0

AUTHORIZED AND OUTSTANDING GENERAL OBLIGATION BONDS
As of January 1, 2015
(Thousands)

	Proposition Number	Voter Authorization Date	Authorization Amount	Long Term Bonds Outstanding	Commercial Paper Outstanding (a)	Unissued
			$	$	$	$
GENERAL FUND BONDS (Non-Self Liquidating)						
School Facilities Bond Act of 1990	146	11/06/90	800,000	142,200	0	0
School Facilities Bond Act of 1992	152	06/02/92	1,900,000	536,985	0	10,280
Seismic Retrofit Bond Act of 1996	192	03/26/96	2,000,000	1,186,230	0	0
* State, Urban, and Coastal Park Bond Act of 1976	2	11/02/76	280,000	4,055	0	0
Stem Cell Research and Cures Bond Act of 2004	71	11/02/04	3,000,000	1,464,395	52,045	1,287,650
Veterans Homes Bond Act of 2000	16	03/07/00	50,000	35,205	0	975
Veterans Housing and Homeless Prevention Bond Act of 2014	41	06/03/14	600,000	0	600	599,400
Voting Modernization Bond Act of 2002	41	03/05/02	200,000	36,305	0	64,495
Water Conservation Bond Law of 1988	82	11/08/88	60,000	22,990	0	5,235
++++* Water Conservation and Water Quality Bond Law of 1986	44	06/03/86	136,500	32,270	0	230
++++ Water Security, Clean Drinking Water, Coastal and Beach Protection Act of 2002	50	11/05/02	3,345,000	2,734,920	1,810	309,574
Water Quality, Supply, and Infrastructure Improvement Act of 2014	1	11/04/14	7,545,000	0	0	7,545,000
Total General Fund Bonds			**135,239,341**	**76,691,140**	**594,035**	**30,515,541**
ENTERPRISE FUND BONDS (Self Liquidating)						
* California Water Resources Development Bond Act	1	11/08/60	1,750,000	208,550	0	167,600
Veterans Bond Act of 1986	42	06/03/86	850,000	31,730	0	0
Veterans Bond Act of 1988	76	06/07/88	510,000	34,690	0	0
Veterans Bond Act of 1990	142	11/06/90	400,000	50,475	0	0
Veterans Bond Act of 1996	206	11/05/96	400,000	142,485	0	0
Veterans Bond Act of 2000	16	11/07/00	500,000	243,150	0	128,610
+++ Veterans Bond Act of 2008	12	11/04/08	300,000	0	0	300,000
Total Enterprise Fund Bonds			**4,710,000**	**711,080**	**0**	**596,210**

AUTHORIZED AND OUTSTANDING GENERAL OBLIGATION BONDS
As of January 1, 2015
(Thousands)

	Proposition Number	Voter Authorization Date	Authorization Amount $	Long Term Bonds Outstanding $	Commercial Paper Outstanding (a) $	Unissued $
SPECIAL REVENUE FUND BONDS (Self Liquidating)						
* Economic Recovery Bond Act	57	04/10/04	15,000,000	1,578,725	0	0
Total Special Revenue Fund Bonds			**15,000,000**	**1,578,725**	**0**	**0**
TOTAL GENERAL OBLIGATION BONDS			**154,949,341**	**78,980,945**	**594,035**	**31,111,751**

(a) A total of not more than $2.225 billion of commercial paper principal plus accrued interest may be owing at one time. Bond acts marked with an asterisk (*) are not legally permitted to utilize commercial paper.

+ SB 1018 (06/27/2012) reduced the voter authorized amount

++ SB 71 (06/27/2013) reduced the voter authorized amount

+++ AB 639 (10/10/2013) reduced the voter authorized amount

++++ AB 1471 (11/04/2014) reallocated the voter authorized amount

SOURCE: State of California, Office of the Treasurer.

GENERAL OBLIGATION AND REVENUE BONDS
SUMMARY OF DEBT SERVICE REQUIREMENTS
As of January 1, 2015

	Total Debt		
	Interest	Principal	Total (a)
GENERAL OBLIGATION BONDS			
GENERAL FUND NON-SELF LIQUIDATING (b)			
Fixed Rate	$ 60,818,357,998.15	$ 73,069,350,000.00	133,887,707,998.15
Variable Rate (c)	380,547,089.39	3,621,790,000.00	4,002,337,089.39
ENTERPRISE FUND SELF LIQUIDATING			
Fixed Rate	335,451,106.25	711,080,000.00	1,046,531,106.25
SPECIAL REVENUE FUND SELF LIQUIDATING (d)			
Fixed Rate	376,694,238.75	1,578,725,000.00	1,955,419,238.75
REVENUE BONDS			
GENERAL FUND LEASE-REVENUE			
Lease-Revenue	6,508,711,565.54	11,103,220,000.00	17,611,931,565.54
General Fund and Lease-Revenue Total (e)	**$ 68,419,761,998.08**	**$ 90,084,165,000.00**	**$ 158,503,926,998.08**

(a) Includes scheduled mandatory sinking fund payments.

(b) Does not include outstanding commercial paper.

(c) The estimate of future interest payments is based on rates in effect as of January 1, 2015. The interest rates for the daily, weekly and monthly rate bonds range from 0.01 - 1.18%.

The Highway Safety, Traffic Reduction, Air Quality, and Port Security Bond Act of 2006, Series 2013A & 2013B currently bear interest at a fixed rate of 4.00%, and Series 2014A bears interest at a fixed rate of 3.00%, until reset dates, and are assumed to bear that rate from reset until maturity.

(d) Economic Recovery Bonds.

(e) Estimated interest included.

SOURCE: State of California, Office of the Treasurer.

SCHEDULE OF DEBT SERVICE REQUIREMENTS
FOR GENERAL FUND NON-SELF LIQUIDATING BONDS
Fixed Rate
As of January 1, 2015

Fiscal Year	Current Debt		
Ending June 30	Interest (a)	Principal	Total (b)
2015	$ 1,970,090,007.01	$ 1,524,690,000.00	$ 3,494,780,007.01
2016	3,862,802,731.35	2,756,940,000.00	6,619,742,731.35
2017	3,743,314,314.37	2,541,115,000.00	6,284,429,314.37
2018	3,629,012,833.70	2,489,930,000.00	6,118,942,833.70
2019	3,510,599,391.87	2,672,900,000.00	6,183,499,391.87
2020	3,361,129,738.89	2,735,440,000.00	6,096,569,738.89
2021	3,234,411,098.98	2,392,995,000.00	5,627,406,098.98
2022	3,106,945,354.06	2,659,885,000.00	5,766,830,354.06
2023	2,979,364,484.28	2,263,510,000.00	5,242,874,484.28
2024	2,870,466,439.18	1,988,240,000.00	4,858,706,439.18
2025	2,768,149,239.40	2,224,700,000.00	4,992,849,239.40
2026	2,654,015,752.85	2,272,480,000.00	4,926,495,752.85
2027	2,538,111,568.31	2,308,115,000.00	4,846,226,568.31
2028	2,424,887,305.86	2,338,595,000.00	4,763,482,305.86
2029	2,310,517,225.10	2,482,890,000.00	4,793,407,225.10
2030	2,186,140,259.31	2,689,130,000.00	4,875,270,259.31
2031	2,041,439,833.11	2,751,695,000.00	4,793,134,833.11
2032	1,910,903,596.90	2,513,395,000.00	4,424,298,596.90
2033	1,776,212,445.01	2,535,085,000.00	4,311,297,445.01
2034	1,648,356,866.00	3,404,150,000.00	5,052,506,866.00
2035	1,414,732,256.59	3,164,315,000.00	4,579,047,256.59
2036	1,226,182,600.76	2,774,390,000.00	4,000,572,600.76
2037	1,052,371,374.37	3,122,660,000.00	4,175,031,374.37
2038	863,944,409.44	3,268,625,000.00	4,132,569,409.44
2039	711,595,278.95	3,415,270,000.00	4,126,865,278.95
2040	430,871,512.50	1,767,885,000.00	2,198,756,512.50
2041	269,059,643.75	2,190,000,000.00	2,459,059,643.75
2042	166,779,643.75	1,319,000,000.00	1,485,779,643.75
2043	111,322,268.75	1,326,325,000.00	1,437,647,268.75
2044	37,753,248.75	875,000,000.00	912,753,248.75
2045	6,875,275.00	300,000,000.00	306,875,275.00
Total	**$ 60,818,357,998.15**	**$ 73,069,350,000.00**	**$ 133,887,707,998.15**

(a) The amounts do not reflect any interest subsidy under the Build America Bonds program. Subsidy not pledged to the repayment of debt service.

(b) Includes scheduled mandatory sinking fund payments.
Does not include outstanding commercial paper.

Total represents the remaining debt service requirements from February 1, 2015 through June 30, 2015.

SOURCE: State of California, Office of the Treasurer.

SCHEDULE OF DEBT SERVICE REQUIREMENTS
FOR GENERAL FUND NON-SELF LIQUIDATING BONDS
Variable Rate
As of January 1, 2015

Fiscal Year Ending June 30	Current Debt		
	Interest (a)	**Principal**	**Total (b)**
2015	$ 13,830,036.16	$ -	$ 13,830,036.16
2016	28,457,799.92	24,400,000.00	52,857,799.92
2017	28,393,715.88	188,275,000.00	216,668,715.88
2018	28,108,779.66	247,005,000.00	275,113,779.66
2019	27,713,995.84	117,320,000.00	145,033,995.84
2020	27,467,420.64	109,500,000.00	136,967,420.64
2021	27,276,359.04	58,600,000.00	85,876,359.04
2022	27,242,034.82	43,600,000.00	70,842,034.82
2023	27,202,671.51	65,600,000.00	92,802,671.51
2024	27,180,095.94	178,300,000.00	205,480,095.94
2025	27,084,863.84	121,300,000.00	148,384,863.84
2026	27,035,115.62	208,400,000.00	235,435,115.62
2027	22,475,349.70	395,900,000.00	418,375,349.70
2028	13,404,294.31	404,500,000.00	417,904,294.31
2029	8,135,540.23	415,600,000.00	423,735,540.23
2030	6,889,750.12	262,590,000.00	269,479,750.12
2031	6,324,637.15	172,100,000.00	178,424,637.15
2032	4,720,128.42	325,500,000.00	330,220,128.42
2033	1,602,750.10	280,700,000.00	282,302,750.10
2034	448.77	1,600,000.00	1,600,448.77
2035	220.00	-	220.00
2036	220.95	-	220.95
2037	219.05	-	219.05
2038	220.00	-	220.00
2039	220.00	-	220.00
2040	201.72	1,000,000.00	1,000,201.72
Total	**$ 380,547,089.39**	**$ 3,621,790,000.00**	**$ 4,002,337,089.39**

(a) The estimate of future interest payments is based on rates in effect as of January 1, 2015. The interest rates for the daily, weekly and monthly rate bonds range from 0.01 - 1.18%.

The Highway Safety, Traffic Reduction, Air Quality, and Port Security Bond Act of 2006, Series 2013A & 2013B currently bear interest at a fixed rate of 4.00%, and Series 2014A bears interest at a fixed rate of 3.00%, until reset dates, and are assumed to bear that rate from reset until maturity.

(b) Includes scheduled mandatory sinking fund payments. Does not include outstanding commercial paper.

Total represents the remaining estimated debt service requirements from February 1, 2015 through June 30, 2015.

SOURCE: State of California, Office of the Treasurer.

SCHEDULE OF DEBT SERVICE REQUIREMENTS FOR SPECIAL REVENUE FUND SELF LIQUIDATING BONDS
Fixed Rate
As of January 1, 2015

Fiscal Year Ending June 30	Current Debt		
	Interest	**Principal**	**Total (a)**
2015	$ -	$ -	$ -
2016	77,662,607.50	14,550,000.00	92,212,607.50
2017	74,386,857.50	132,390,000.00	206,776,857.50
2018	67,215,388.75	174,290,000.00	241,505,388.75
2019	48,333,510.00	592,955,000.00	641,288,510.00
2020	33,638,350.00	-	33,638,350.00
2021	33,638,350.00	-	33,638,350.00
2022	29,319,175.00	164,540,000.00	193,859,175.00
2023	12,500,000.00	500,000,000.00	512,500,000.00
Total	**$ 376,694,238.75**	**$ 1,578,725,000.00**	**$ 1,955,419,238.75**

(a) Includes scheduled mandatory sinking fund payments.
Total represents the remaining debt service requirements from February 1, 2015 through June 30, 2015.

SOURCE: State of California, Office of the Treasurer.

SCHEDULE OF DEBT SERVICE REQUIREMENTS
FOR ENTERPRISE FUND SELF LIQUIDATING BONDS
Fixed Rate
As of January 1, 2015

Fiscal Year		Current Debt	
Ending June 30	Interest	Principal	Total(a)
2015	$ 14,332,781.48	$ 23,590,000.00	$ 37,922,781.48
2016	26,908,751.63	75,620,000.00	$ 102,528,751.63
2017	24,192,487.50	69,685,000.00	$ 93,877,487.50
2018	21,916,837.15	56,490,000.00	$ 78,406,837.15
2019	20,284,256.06	43,840,000.00	$ 64,124,256.06
2020	18,862,401.35	37,645,000.00	$ 56,507,401.35
2021	17,401,158.75	29,375,000.00	$ 46,776,158.75
2022	16,415,011.28	13,630,000.00	$ 30,045,011.28
2023	15,847,563.75	9,695,000.00	$ 25,542,563.75
2024	15,536,228.75	4,365,000.00	$ 19,901,228.75
2025	15,334,594.80	4,660,000.00	$ 19,994,594.80
2026	15,230,521.25	-	$ 15,230,521.25
2027	14,854,946.15	16,695,000.00	$ 31,549,946.15
2028	14,279,205.30	8,835,000.00	$ 23,114,205.30
2029	13,663,205.30	18,315,000.00	$ 31,978,205.30
2030	12,716,236.19	23,565,000.00	$ 36,281,236.19
2031	11,619,799.78	24,895,000.00	$ 36,514,799.78
2032	10,282,432.10	36,605,000.00	$ 46,887,432.10
2033	8,668,458.75	39,735,000.00	$ 48,403,458.75
2034	7,081,055.18	34,135,000.00	$ 41,216,055.18
2035	5,692,506.25	28,165,000.00	$ 33,857,506.25
2036	4,569,518.75	22,810,000.00	$ 27,379,518.75
2037	3,548,333.75	23,025,000.00	$ 26,573,333.75
2038	2,662,880.00	15,300,000.00	$ 17,962,880.00
2039	1,950,055.00	16,025,000.00	$ 17,975,055.00
2040	1,195,310.00	16,790,000.00	$ 17,985,310.00
2041	404,570.00	17,590,000.00	$ 17,994,570.00
Total	**$ 335,451,106.25**	**$ 711,080,000.00**	**$ 1,046,531,106.25**

(a) Includes scheduled mandatory sinking fund payments.
Total represents the remaining debt service requirements from February 1, 2015 through June 30, 2015.

SOURCE: State of California, Office of the Treasurer.

STATE PUBLIC WORKS BOARD AND OTHER LEASE-REVENUE FINANCING OUTSTANDING ISSUES As of January 1, 2015

Name of Issue		Outstanding
GENERAL FUND SUPPORTED ISSUES:		
State Public Works Board		
California Community Colleges	$	284,520,000
California Department of Corrections and Rehabilitation		4,213,240,000
Trustees of the California State University		1,052,340,000
Various State Facilities (a)		5,205,485,000
Total State Public Works Board Issues	**$**	**10,755,585,000**
Total Other State Facilities Lease-Revenue Issues (b)	$	347,635,000
Total General Fund Supported Issues	**$**	**11,103,220,000**
SPECIAL FUND SUPPORTED ISSUES:		
East Bay State Building Authority	$	20,480,000
San Bernardino Joint Powers Financing Authority		24,550,000
Total Special Fund Supported Issues	**$**	**45,030,000**
TOTAL	**$**	**11,148,250,000**

(a) This includes projects that are supported by multiple funding sources in addition to the General Fund.

(b) Includes $88,005,000 Sacramento City Financing Authority Lease-Revenue Refunding Bonds State of California - Cal/EPA Building, 2013 Series A, which are supported by lease rentals from the California Environmental Protection Agency; these rental payments are subject to annual appropriation by the State Legislature.

SOURCE: State of California, Office of the Treasurer.

SCHEDULE OF DEBT SERVICE REQUIREMENTS
FOR LEASE-REVENUE DEBT
Fixed Rate
As of January 1, 2015

Fiscal Year Ending June 30	Current Debt		
	Interest (a)	**Principal**	**Total (b)**
2015	$ 280,376,251.28	$ 170,015,000.00	$ 450,391,251.28
2016	557,185,187.97	515,900,000.00	1,073,085,187.97
2017	532,347,241.46	545,870,000.00	1,078,217,241.46
2018	504,752,615.59	605,420,000.00	1,110,172,615.59
2019	475,443,261.34	584,035,000.00	1,059,478,261.34
2020	446,584,092.60	567,500,000.00	1,014,084,092.60
2021	419,305,251.67	535,040,000.00	954,345,251.67
2022	392,579,193.73	522,850,000.00	915,429,193.73
2023	368,082,125.69	473,580,000.00	841,662,125.69
2024	344,448,144.25	458,980,000.00	803,428,144.25
2025	320,921,078.42	482,715,000.00	803,636,078.42
2026	296,094,523.40	490,915,000.00	787,009,523.40
2027	270,152,527.45	516,825,000.00	786,977,527.45
2028	243,232,655.63	530,125,000.00	773,357,655.63
2029	216,079,855.97	492,070,000.00	708,149,855.97
2030	189,554,270.37	485,475,000.00	675,029,270.37
2031	163,118,162.79	483,120,000.00	646,238,162.79
2032	135,732,269.08	489,685,000.00	625,417,269.08
2033	109,679,336.07	413,595,000.00	523,274,336.07
2034	85,300,549.41	425,180,000.00	510,480,549.41
2035	60,517,633.87	391,965,000.00	452,482,633.87
2036	41,903,625.00	247,080,000.00	288,983,625.00
2037	29,529,925.00	259,450,000.00	288,979,925.00
2038	16,432,650.00	200,965,000.00	217,397,650.00
2039	7,358,587.50	134,565,000.00	141,923,587.50
2040	2,000,550.00	80,300,000.00	82,300,550.00
Total	**$ 6,508,711,565.54**	**$ 11,103,220,000.00**	**$ 17,611,931,565.54**

(a) The amounts do not reflect any interest subsidy under the Build America Bonds program. Subsidy not pledged to the repayment of debt service.

(b) Includes scheduled mandatory sinking fund payments.

Total represents the remaining debt service requirements from February 1, 2015 through June 30, 2015.

SOURCE: State of California, Office of the Treasurer.

STATE AGENCY REVENUE BONDS
AND CONDUIT FINANCING
As of December 31, 2014

Issuing Agency	Outstanding[a][b][c]
State Revenue Bond Financing Programs:	
California Alternative Energy and Advanced Transportation Financing Authority	3,835,200
California Department of Transportation - GARVEE	127,405,000
California Earthquake Authority	350,000,000
California Health Facilities Financing Authority	66,165,000
California Housing Finance Agency	3,248,587,525
California Infrastructure and Economic Development Bank	517,930,000
California State University	3,687,508,000
Department of Water Resources - Central Valley Project	2,445,325,000
Department of Water Resources - Power Supply Program	5,943,250,000
The Regents of the University of California	15,267,255,000
Veterans Revenue Debenture	372,705,000
TOTAL	**32,029,965,725**
Conduit Financing:	
California Alternative Energy and Advanced Transportation Financing Authority	56,829,105
California Educational Facilities Authority	4,619,174,096
California Health Facilities Financing Authority	12,984,120,101
California Housing Finance Agency	366,051,603
California Infrastructure and Economic Development Bank	3,867,318,281
California Pollution Control Financing Authority	3,804,706,694
California School Financing Authority	319,123,429
TOTAL	**26,017,323,309**

(a) Totals for California Department of Transportation, California State University, Department of Water Resources and Veterans Revenue Debenture were provided by the State of California, Office of the Treasurer. All other totals were provided by the listed issuing agency.

(b) Does not include the Tobacco Settlement Revenue Bonds issued by Golden State Tobacco Securitization Corporation.

(c) Certain state agencies and authorities issue revenue obligations for which the General Fund has no liability. See "STATE INDEBTEDNESS AND OTHER OBLIGATIONS – Capital Facilities Financing -Non-Recourse Debt." The tables above are intended to provide general information concerning the scope of the various State Revenue Bond Financing and Conduit Financing Programs referenced therein, and are not intended to be an exhaustive listing of all of the outstanding obligations of the respective programs.

(THIS PAGE INTENTIONALLY LEFT BLANK)

EXHIBIT 1 TO APPENDIX A

STATEMENT of GENERAL FUND CASH RECEIPTS and DISBURSEMENTS

June 2014

JOHN CHIANG
California State Controller

JOHN CHIANG
California State Controller

July 10, 2014

Users of the Statement of General Fund Cash Receipts and Disbursements:

Enclosed is the Statement of General Fund Cash Receipts and Disbursements for the period July 1, 2013, through June 30, 2014. This statement reflects the State of California's General Fund cash position and compares actual receipts and disbursements for the 2013-14 fiscal year to cash flow estimates prepared by the Department of Finance (DOF) for the 2013-14 Budget Act. The statement is prepared in compliance with Provision 7 of Budget Act item 0840-001-0001, using records compiled by the State Controller. Prior year actual amounts are also displayed for comparative purposes.

Attachment A compares actual receipts and disbursements for the 2013-14 fiscal year to cash flow estimates published in the 2014-15 Governor's Budget. These cash flow estimates are predicated on projections and assumptions made by the DOF in preparation of the 2014-15 Governor's Budget.

Attachment B compares actual receipts and disbursements for the 2013-14 fiscal year to cash flow estimates prepared by the Department of Finance based upon the 2013-14 Budget Act.

These statements are also available on the Internet at the State Controller's website at www.sco.ca.gov under the category Monthly Financial Reports.

Any questions concerning this report may be directed to Casandra Moore-Hudnall, Division Chief of Accounting and Reporting, by telephone at (916) 445-5834.

Sincerely,
Original signed by:

JOHN CHIANG
California State Controller

STATEMENT OF GENERAL FUND CASH RECEIPTS AND DISBURSEMENTS
A Comparison of Actual to 2014-15 Governor's Budget Estimates
(Amounts in thousands)

	July 1 through June 30				
	2014				**2013**
	Actual	Estimate (a)	Actual Over or (Under) Estimate		Actual
			Amount	%	
GENERAL FUND BEGINNING CASH BALANCE	$ -	$ -	$ -	-	$ -
Add Receipts:					
Revenues	101,572,529	99,487,091	2,085,438	2.1	100,078,372
Nonrevenues	2,393,668	2,003,066	390,602	19.5	3,346,302
Total Receipts	103,966,197	101,490,157	2,476,040	2.4	103,424,674
Less Disbursements:					
State Operations	26,448,309	27,131,944	(683,635)	(2.5)	26,130,710
Local Assistance	72,773,611	72,535,395	238,216	0.3	68,095,108
Capital Outlay	154,544	192,580	(38,036)	(19.8)	117,388
Nongovernmental	233,239	163,016	70,223	43.1	1,923,042
Total Disbursements	99,609,703	100,022,935	(413,232)	(0.4)	96,266,248
Receipts Over / (Under) Disbursements	4,356,494	1,467,222	2,889,272	196.9	7,158,426
Net Increase / (Decrease) in Temporary Loans	(2,434,865)	(1,467,222)	(967,643)	66.0	(7,158,426)
GENERAL FUND ENDING CASH BALANCE	**1,921,629**	**-**	**1,921,629**		-
Special Fund for Economic Uncertainties	1,071,100	103,458	967,642	935.3	-
TOTAL CASH	**$ 2,992,729**	**$ 103,458**	**$ 2,889,271**		$ -

BORROWABLE RESOURCES

Available Borrowable Resources	$ 23,761,526	$ 21,736,100	$ 2,025,426	9.3	$ 21,215,251
Outstanding Loans (b)	-	967,642	(967,642)	(100.0)	2,434,865
Unused Borrowable Resources	$ 23,761,526	$ 20,768,458	$ 2,993,068	14.4	$ 18,780,386

General Note:

This report is based upon funded cash. Funded cash is cash reported to and recorded in the records of the State Controller's Office. Amounts reported as funded cash may differ from amounts in other reports to the extent there are timing differences in the recording of in-transit items.

Footnotes:

(a) A Statement of Estimated Cash Flow for the 2013-14 fiscal year was prepared by the Department of Finance for the 2014-15 Governor's Budget. Any projections or estimates are set forth as such and not as representation of facts.

(b) $4 billion of RANs were repaid on June 23, 2014 as scheduled. The $4.3 billion in excess receipts over disbursements repaid the $2.4 billion of outstanding loans carried forward from June 30, 2013, leaving a net ending cash balance of $1.9 billion and $0.00 in outstanding loans at June 30, 2014.

(c) Negative amounts are the result of repayments received that are greater than disbursements made.

(d) Debt Service amounts are net of offsets such as federal subsidies and reimbursements from other sources. To the extent that these offsets do not occur when anticipated, there can be variances between actuals and estimates on a month-to-month basis.

(e) A $1.0 billion advance was repaid to the General Fund from the Medi-Cal Provider Interim Payment Fund.

SCHEDULE OF CASH RECEIPTS
(Amounts in thousands)

	Month of June		July 1 through June 30				
			2014				2013
	2014	2013	Actual	Estimate (a)	Actual Over or (Under) Estimate		Actual
					Amount	%	
REVENUES							
Alcoholic Beverage Excise Tax	$ 31,370	$ 29,418	$ 329,457	$ 324,939	$ 4,518	1.4	$ 360,803
Corporation Tax	2,480,217	2,112,500	8,511,645	7,786,245	725,400	9.3	7,620,406
Cigarette Tax	982	13,163	80,152	88,994	(8,842)	(9.9)	91,172
Estate, Inheritance, and Gift Tax	2,327	371	8,828	4,605	4,223	91.7	4,303
Insurance Companies Tax	307,021	326,110	2,365,974	2,171,895	194,079	8.9	2,244,313
Personal Income Tax	9,258,300	8,029,598	66,194,590	64,505,331	1,689,259	2.6	67,314,600
Retail Sales and Use Taxes	2,026,168	2,050,138	22,158,717	22,573,625	(414,908)	(1.8)	20,073,343
Vehicle License Fees	41	261	1,951	1,302	649	49.8	7,493
Pooled Money Investment Interest	3,554	4,178	21,351	24,877	(3,526)	(14.2)	23,426
Not Otherwise Classified	675,235	558,666	1,899,864	2,005,278	(105,414)	(5.3)	2,338,513
Total Revenues	**14,785,215**	**13,124,403**	**101,572,529**	**99,487,091**	**2,085,438**	**2.1**	**100,078,372**
NONREVENUES							
Transfers from Special Fund for Economic Uncertainties	-	-	-	-	-	-	-
Transfers from Other Funds	247,020	340,873	1,197,097	1,069,137	127,960	12.0	2,051,308
Miscellaneous	24,182	38,652	1,196,571	933,929	262,642	28.1	1,294,994
Total Nonrevenues	**271,202**	**379,525**	**2,393,668**	**2,003,066**	**390,602**	**19.5**	**3,346,302**
Total Receipts	**$ 15,056,417**	**$ 13,503,928**	**$ 103,966,197**	**$ 101,490,157**	**$ 2,476,040**	**2.4**	**$ 103,424,674**

See notes on page A1.

SCHEDULE OF CASH DISBURSEMENTS
(Amounts in thousands)

	Month of June		July 1 through June 30				
			2014				2013
	2014	2013	Actual	Estimate (a)	Actual Over or (Under) Estimate		Actual
					Amount	%	
STATE OPERATIONS (c)							
Legislative/Judicial/Executive	$ 32,232	$ 73,106	$ 1,478,905	$ 1,370,701	$ 108,204	7.9	$ 1,000,838
Business, Consumer Services and Housing	(4,415)	48,269	10,667	14,907	(4,240)	(28.4)	663,371
Transportation	20	269	593	-	593	-	3,978
Resources	64,873	59,696	1,084,230	1,090,214	(5,984)	(0.5)	1,143,350
Environmental Protection Agency	3,928	3,169	40,943	41,392	(449)	(1.1)	34,023
Health and Human Services:							
Health Care Services and Public Health	(2,978)	16,949	235,749	247,087	(11,338)	(4.6)	217,429
Department of State Hospitals	112,636	65,279	1,375,451	1,411,240	(35,789)	(2.5)	1,161,511
Other Health and Human Services	16,487	(14,830)	517,745	552,043	(34,298)	(6.2)	469,474
Education:							
University of California	2,889	502,167	2,852,368	2,851,927	441	-	2,386,114
State Universities and Colleges	29	62,144	2,551,907	2,632,289	(80,382)	(3.1)	2,244,988
Other Education	7,562	10,901	186,421	194,238	(7,817)	(4.0)	169,881
Dept. of Corrections and Rehabilitation	707,814	646,220	8,785,327	8,760,362	24,965	0.3	7,788,842
Governmental Operations	50,805	-	679,501	752,081	(72,580)	(9.7)	-
General Government	124,765	2,105,094	2,136,658	2,134,014	2,644	0.1	4,270,890
Public Employees Retirement System	(165,093)	(145,308)	(57,274)	(14,451)	(42,823)	296.3	(6,616)
Debt Service (d)	130,941	473,119	4,505,852	5,015,337	(509,485)	(10.2)	4,482,775
Interest on Loans	80,051	161,738	63,266	78,563	(15,297)	(19.5)	99,862
Total State Operations	**1,162,546**	**4,067,982**	**26,448,309**	**27,131,944**	**(683,635)**	**(2.5)**	**26,130,710**
LOCAL ASSISTANCE (c)							
Public Schools - K-12	2,220,509	6,880,525	36,842,575	37,006,560	(163,985)	(0.4)	36,476,720
Community Colleges	354,750	842,868	4,001,929	3,894,433	107,496	2.8	3,584,580
Debt Service-School Building Bonds	-	-	-	(234)	234	(100.0)	-
Contributions to State Teachers' Retirement System	-	-	1,359,827	1,359,826	1	-	1,359,675
Other Education	13,863	(27,177)	1,744,406	1,816,796	(72,390)	(4.0)	1,813,620
School Facilities Aid	-	-	-	234	(234)	(100.0)	-
Dept. of Corrections and Rehabilitation	35	3,009	168,313	174,019	(5,706)	(3.3)	223,654
Dept. of Alcohol and Drug Program	605	1,583	(254)	(1,655)	1,401	(84.7)	42,770
Health Care Services and Public Health:							
Medical Assistance Program	823,586	99,102	16,995,452	16,675,506	319,946	1.9	14,391,478
Other Health Care Services/Public Health	(5,461)	10,178	104,234	186,790	(82,556)	(44.2)	108,352
Developmental Services - Regional Centers	122,783	(21,128)	2,653,769	2,475,757	178,012	7.2	2,037,886
Department of State Hospitals	-	-	-	-	-	-	10,664
Dept. of Social Services:							
SSI/SSP/IHSS	57,972	300,849	4,615,418	4,598,995	16,423	0.4	4,453,798
CalWORKs	(38,517)	55,369	1,481,494	1,452,827	28,667	2.0	1,348,177
Other Social Services	109,633	37,388	766,416	716,381	50,035	7.0	682,154
Tax Relief	-	-	421,734	417,356	4,378	1.0	427,285
Other Local Assistance	44,557	52,554	1,618,298	1,761,804	(143,506)	(8.1)	1,134,295
Total Local Assistance	**3,704,315**	**8,235,120**	**72,773,611**	**72,535,395**	**238,216**	**0.3**	**68,095,108**

See notes on page A1.

(Continued)

SCHEDULE OF CASH DISBURSEMENTS (Continued)
(Amounts in thousands)

	Month of June		July 1 through June 30				
			2014				2013
					Actual Over or (Under) Estimate		
	2014	2013	Actual	Estimate (a)	Amount	%	Actual
CAPITAL OUTLAY	**294**	**8,870**	**154,544**	**192,580**	**(38,036)**	**(19.8)**	**117,388**
NONGOVERNMENTAL (c)							
Transfer to Special Fund for Economic Uncertainties	-	-	122,900	122,900	-	-	473,243
Transfer to Budget Stabilization Account	-	-	-	-	-	-	-
Transfer to Other Funds	419,500	43,740	1,093,514	1,001,548	91,966	9.2	404,748
Transfer to Revolving Fund	(7,279)	(10,989)	(12,787)	7,045	(19,832)	-	(9,808)
Advance:						-	
MediCal Provider Interim Payment	(1,000,000)	-	(1,000,000)	(1,000,000)	- (e)	-	1,000,000
State-County Property Tax						-	
Administration Program	(12,096)	(4,380)	(15,404)	13,745	(29,149)	-	18,682
Social Welfare Federal Fund	141,200	28,000	108,989	(18,250)	127,239	-	(63,763)
Local Governmental Entities	(60,000)	-	(30,913)	-	(30,913)	-	60,000
Tax Relief and Refund Account	-	-	-	-	-	-	-
Counties for Social Welfare	282,612	315,672	(33,060)	36,028	(69,088)	-	39,940
Total Nongovernmental	**(236,063)**	**372,043**	**233,239**	**163,016**	**70,223**	43.1	**1,923,042**
Total Disbursements	**$ 4,631,092**	**$ 12,684,015**	**$ 99,609,703**	**$ 100,022,935**	**$ (413,232)**	**(0.4)**	**$ 96,266,248**
TEMPORARY LOANS							
Special Fund for Economic Uncertainties	$ (1,071,100)	$ 948,200	$ (948,200)	$ 19,442	$ (967,642)	-	$ 473,243
Budget Stabilization Account	-	-	-	-	-	-	-
Outstanding Registered Warrants Account	-	-	-	-	-	-	-
Other Internal Sources	(3,432,596)	1,486,665	(1,486,665)	(1,486,664)	(1)	-	(7,631,669)
Revenue Anticipation Notes	(4,000,000)	(7,500,000)	-	-	-	-	-
Net Increase / (Decrease) Loans	**(8,503,696)**	**$ (5,065,135)**	**$ (2,434,865)**	**$ (1,467,222)**	**$ (967,643)**	**66.0**	**$ (7,158,426)**

See notes on page A1.

(Concluded)

COMPARATIVE STATEMENT OF REVENUES RECEIVED
All Governmental Cost Funds
(Amounts in thousands)

	July 1 through June 30			
	General Fund		**Special Funds**	
	2014	2013	2014	2013
MAJOR TAXES, LICENSES, AND INVESTMENT INCOME:				
Alcoholic Beverage Excise Taxes	$ 329,457	$ 360,803	$ -	$ -
Corporation Tax	8,511,645	7,620,406	-	-
Cigarette Tax	80,152	91,172	700,910	776,194
Estate, Inheritance, and Gift Tax	8,828	4,303	4	-
Insurance Companies Tax	2,365,974	2,244,313	779,224	34,389
Motor Vehicle Fuel Tax:				
Gasoline Tax	-	-	5,699,170	5,196,201
Diesel & Liquid Petroleum Gas	-	-	317,647	333,028
Jet Fuel Tax	-	-	2,811	2,406
Vehicle License Fees	1,951	7,493	2,163,979	1,971,800
Motor Vehicle Registration and Other Fees	-	-	4,165,105	3,920,199
Personal Income Tax	66,194,590	67,314,600	1,189,222	1,200,346
Retail Sales and Use Taxes	22,158,717	20,073,343	14,006,872	13,355,024
Pooled Money Investment Interest	21,351	23,426	148	181
Total Major Taxes, Licenses, and Investment Income	**99,672,665**	**97,739,859**	**29,025,092**	**26,789,768**
NOT OTHERWISE CLASSIFIED:				
Alcoholic Beverage License Fee	3,239	2,479	52,727	52,136
Electrical Energy Tax	-	-	619,337	712,069
Private Rail Car Tax	8,530	7,893	-	-
Penalties on Traffic Violations	-	-	70,883	74,526
Health Care Receipts	12,569	18,442	-	-
Revenues from State Lands	417,751	422,475	-	-
Abandoned Property	485,893	474,738	-	-
Trial Court Revenues	49,003	51,251	1,656,797	1,701,124
Horse Racing Fees	1,058	1,117	12,789	13,461
Cap and Trade	-	-	477,140	257,264
Miscellaneous	921,821	1,360,118	10,403,490	11,754,098
Not Otherwise Classified	**1,899,864**	**2,338,513**	**13,293,163**	**14,564,678**
Total Revenues, All Governmental Cost Funds	**$ 101,572,529**	**$ 100,078,372**	**$ 42,318,255**	**$ 41,354,446**

See notes on page A1.

STATEMENT OF GENERAL FUND CASH RECEIPTS AND DISBURSEMENTS
A Comparison of Actual to 2013-14 Budget Act
(Amounts in thousands)

	July 1 through June 30				
	2014				2013
	Actual	Estimate (a)	Actual Over or (Under) Estimate		Actual
			Amount	%	
GENERAL FUND BEGINNING CASH BALANCE	$ -	$ -	$ -	-	$ -
Add Receipts:					
Revenues	101,572,529	96,346,000	5,226,529	5.4	100,078,372
Nonrevenues	2,393,668	2,051,441	342,227	16.7	3,346,302
Total Receipts	103,966,197	98,397,441	5,568,756	5.7	103,424,674
Less Disbursements:					
State Operations	26,448,309	26,582,163	(133,854)	(0.5)	26,130,710
Local Assistance	72,773,611	72,592,016	181,595	0.3	68,095,108
Capital Outlay	154,544	171,609	(17,065)	(9.9)	117,388
Nongovernmental	233,239	41,387	191,852	463.6	1,923,042
Total Disbursements	99,609,703	99,387,175	222,528	0.2	96,266,248
Receipts Over / (Under) Disbursements	4,356,494	(989,734)	5,346,228	(540.2)	7,158,426
Net Increase / (Decrease) in Temporary Loans	(2,434,865)	989,734	(3,424,599)	(346.0)	(7,158,426)
GENERAL FUND ENDING CASH BALANCE	**1,921,629**	-	**1,921,629**		-
Special Fund for Economic Uncertainties	1,071,100	-	1,071,100	-	-
TOTAL CASH	**$ 2,992,729**	$ -	**$ 2,992,729**		$ -
BORROWABLE RESOURCES					
Available Borrowable Resources	$ 23,761,526	$ 20,981,100	$ 2,780,426	13.3	$ 21,215,251
Outstanding Loans (b)	-	3,424,598	(3,424,598)	(100.0)	2,434,865
Unused Borrowable Resources	$ 23,761,526	$ 17,556,502	$ 6,205,024	35.3	$ 18,780,386

General Note:
This report is based upon funded cash. Funded cash is cash reported to and recorded in the records of the State Controller's Office. Amounts reported as funded cash may differ from amounts in other reports to the extent there are timing differences in the recording of in-transit items.

Footnotes:
(a) A Statement of Estimated Cash Flow for the 2013-14 fiscal year was prepared by the Department of Finance for the 2013 Budget Act. Any projections or estimates are set forth as such and not as representation of facts.
(b) $4 billion of RANs were repaid on June 23, 2014 as scheduled. The $4.3 billion in excess receipts over disbursements repaid the $2.4 billion of outstanding loans carried forward from June 30, 2013, leaving a net ending cash balance of $1.9 billion and $0.00 in outstanding loans at June 30, 2014.
(c) Negative amounts are the result of repayments received that are greater than disbursements made.
(d) Debt Service amounts are net of offsets such as federal subsidies and reimbursements from other sources. To the extent that these offsets do not occur when anticipated, there can be variances between actuals and estimates on a month-to-month basis.
(e) A $1.0 billion advance was repaid to the General Fund from the Medi-Cal Provider Interim Payment Fund.

SCHEDULE OF CASH RECEIPTS
(Amounts in thousands)

			July 1 through June 30				
	Month of June		**2014**				**2013**
	2014	2013	Actual	Estimate (a)	Actual Over or (Under) Estimate		Actual
					Amount	%	
REVENUES							
Alcoholic Beverage Excise Tax	$ 31,370	$ 29,418	$ 329,457	$ 331,000	$ (1,543)	(0.5)	$ 360,803
Corporation Tax	2,480,217	2,112,500	8,511,645	8,109,000	402,645	5.0	7,620,406
Cigarette Tax	982	13,163	80,152	89,000	(8,848)	(9.9)	91,172
Estate, Inheritance, and Gift Tax	2,327	371	8,828	-	8,828	-	4,303
Insurance Companies Tax	307,021	326,110	2,365,974	2,200,000	165,974	7.5	2,244,313
Personal Income Tax	9,258,300	8,029,598	66,194,590	60,805,000	5,389,590	8.9	67,314,600
Retail Sales and Use Taxes	2,026,168	2,050,138	22,158,717	22,735,000	(576,283)	(2.5)	20,073,343
Vehicle License Fees	41	261	1,951	-	1,951	-	7,493
Pooled Money Investment Interest	3,554	4,178	21,351	33,000	(11,649)	(35.3)	23,426
Not Otherwise Classified	675,235	558,666	1,899,864	2,044,000	(144,136)	(7.1)	2,338,513
Total Revenues	**14,785,215**	**13,124,403**	**101,572,529**	**96,346,000**	**5,226,529**	**5.4**	**100,078,372**
NONREVENUES							
Transfers from Special Fund for Economic Uncertainties	-	-	-	-	-	-	-
Transfers from Other Funds	247,020	340,873	1,197,097	1,060,288	136,809	12.9	2,051,308
Miscellaneous	24,182	38,652	1,196,571	991,153	205,418	20.7	1,294,994
Total Nonrevenues	**271,202**	**379,525**	**2,393,668**	**2,051,441**	**342,227**	**16.7**	**3,346,302**
Total Receipts	**$ 15,056,417**	**$ 13,503,928**	**$ 103,966,197**	**$ 98,397,441**	**$ 5,568,756**	**5.7**	**$ 103,424,674**

See notes on page B1.

SCHEDULE OF CASH DISBURSEMENTS
(Amounts in thousands)

	Month of June		July 1 through June 30				
			2014				2013
	2014	2013	Actual	Estimate (a)	Actual Over or (Under) Estimate		Actual
					Amount	%	
STATE OPERATIONS (c)							
Legislative/Judicial/Executive	$ 32,232	$ 73,106	$ 1,478,905	$ 1,442,615	$ 36,290	2.5	$ 1,000,838
Business, Consumer Services and Housing	(4,415)	48,269	10,667	14,684	(4,017)	(27.4)	663,371
Transportation	20	269	593	-	593	-	3,978
Resources	64,873	59,696	1,084,230	1,097,450	(13,220)	(1.2)	1,143,350
Environmental Protection Agency	3,928	3,169	40,943	40,382	561	1.4	34,023
Health and Human Services:							
Health Care Services and Public Health	(2,978)	16,949	235,749	244,002	(8,253)	(3.4)	217,429
Department of State Hospitals	112,636	65,279	1,375,451	1,233,620	141,831	11.5	1,161,511
Other Health and Human Services	16,487	(14,830)	517,745	616,960	(99,215)	(16.1)	469,474
Education:							
University of California	2,889	502,167	2,852,368	2,644,168	208,200	7.9	2,386,114
State Universities and Colleges	29	62,144	2,551,907	2,611,148	(59,241)	(2.3)	2,244,988
Other Education	7,562	10,901	186,421	184,323	2,098	1.1	169,881
Dept. of Corrections and Rehabilitation	707,814	646,220	8,785,327	8,442,870	342,457	4.1	7,788,842
Governmental Operations	50,805	-	679,501	741,265	(61,764)	(8.3)	-
General Government	124,765	2,105,094	2,136,658	2,114,175	22,483	1.1	4,270,890
Public Employees Retirement System	(165,093)	(145,308)	(57,274)	(13,796)	(43,478)	315.1	(6,616)
Debt Service (d)	130,941	473,119	4,505,852	5,026,861	(521,009)	(10.4)	4,482,775
Interest on Loans	80,051	161,738	63,266	141,436	(78,170)	(55.3)	99,862
Total State Operations	**1,162,546**	**4,067,982**	**26,448,309**	**26,582,163**	**(133,854)**	**(0.5)**	**26,130,710**
LOCAL ASSISTANCE (c)							
Public Schools - K-12	2,220,509	6,880,525	36,842,575	36,923,480	(80,905)	(0.2)	36,476,720
Community Colleges	354,750	842,868	4,001,929	3,888,246	113,683	2.9	3,584,580
Debt Service-School Building Bonds	-	-	-	(139)	139	(100.0)	-
Contributions to State Teachers' Retirement System	-	-	1,359,827	1,359,827	-	-	1,359,675
Other Education	13,863	(27,177)	1,744,406	1,938,626	(194,220)	(10.0)	1,813,620
School Facilities Aid	-	-	-	139	(139)	(100.0)	-
Dept. of Corrections and Rehabilitation	35	3,009	168,313	177,247	(8,934)	(5.0)	223,654
Dept. of Alcohol and Drug Program	605	1,583	(254)	-	(254)	-	42,770
Health Care Services and Public Health:							
Medical Assistance Program	823,586	99,102	16,995,452	16,655,483	339,969	2.0	14,391,478
Other Health Care Services/Public Health	(5,461)	10,178	104,234	133,869	(29,635)	(22.1)	108,352
Developmental Services - Regional Centers	122,783	(21,128)	2,653,769	2,421,457	232,312	9.6	2,037,886
Department of State Hospitals	-	-	-	-	-	-	10,664
Dept. of Social Services:							
SSI/SSP/IHSS	57,972	300,849	4,615,418	4,659,942	(44,524)	(1.0)	4,453,798
CalWORKs	(38,517)	55,369	1,481,494	1,303,955	177,539	13.6	1,348,177
Other Social Services	109,633	37,388	766,416	811,971	(45,555)	(5.6)	682,154
Tax Relief	-	-	421,734	418,356	3,378	0.8	427,285
Other Local Assistance	44,557	52,554	1,618,298	1,899,557	(281,259)	(14.8)	1,134,295
Total Local Assistance	**3,704,315**	**8,235,120**	**72,773,611**	**72,592,016**	**181,595**	**0.3**	**68,095,108**

See notes on page B1.

(Continued)

SCHEDULE OF CASH DISBURSEMENTS (Continued)
(Amounts in thousands)

	Month of June		July 1 through June 30				
			2014				2013
					Actual Over or (Under) Estimate		
	2014	2013	Actual	Estimate (a)	Amount	%	Actual
CAPITAL OUTLAY	**294**	**8,870**	**154,544**	**171,609**	**(17,065)**	**(9.9)**	**117,388**
NONGOVERNMENTAL (c)							
Transfer to Special Fund for Economic Uncertainties	-	-	122,900	122,900	-	-	473,243
Transfer to Budget Stabilization Account	-	-	-	-	-	-	-
Transfer to Other Funds	419,500	43,740	1,093,514	850,350	243,164	28.6	404,748
Transfer to Revolving Fund	(7,279)	(10,989)	(12,787)	-	(12,787)	-	(9,808)
Advance:						-	
MediCal Provider Interim Payment	(1,000,000)	-	(1,000,000)	(1,000,000)	- (e)	-	1,000,000
State-County Property Tax						-	
Administration Program	(12,096)	(4,380)	(15,404)	-	(15,404)	-	18,682
Social Welfare Federal Fund	141,200	28,000	108,989	-	108,989	-	(63,763)
Local Governmental Entities	(60,000)	-	(30,913)	55,000	(85,913)	(156.2)	60,000
Tax Relief and Refund Account	-	-	-	-	-	-	-
Counties for Social Welfare	282,612	315,672	(33,060)	13,137	(46,197)	-	39,940
Total Nongovernmental	**(236,063)**	**372,043**	**233,239**	**41,387**	**191,852**	463.6	**1,923,042**
Total Disbursements	**$ 4,631,092**	**$ 12,684,015**	**$ 99,609,703**	**$ 99,387,175**	**$ 222,528**	**0.2**	**$ 96,266,248**
TEMPORARY LOANS							
Special Fund for Economic Uncertainties	$ (1,071,100)	$ 948,200	$ (948,200)	$ 122,900	$ (1,071,100)	-	$ 473,243
Budget Stabilization Account	-	-	-	-	-	-	-
Outstanding Registered Warrants Account	-	-	-	-	-	-	-
Other Internal Sources	(3,432,596)	1,486,665	(1,486,665)	866,834	(2,353,499)	(271.5)	(7,631,669)
Revenue Anticipation Notes	(4,000,000)	(7,500,000)	-	-	-	-	-
Net Increase / (Decrease) Loans	**(8,503,696)**	**$ (5,065,135)**	**$ (2,434,865)**	**$ 989,734**	**$ (3,424,599)**	**(346.0)**	**$ (7,158,426)**

See notes on page B1.

(Concluded)

(THIS PAGE INTENTIONALLY LEFT BLANK)

EXHIBIT 2 TO APPENDIX A

February 2015

STATEMENT of GENERAL FUND CASH RECEIPTS and DISBURSEMENTS

BETTY T. YEE
California State Controller

BETTY T. YEE
California State Controller

March 10, 2015

Users of the Statement of General Fund Cash Receipts and Disbursements:

Enclosed is the Statement of General Fund Cash Receipts and Disbursements for the period July 1, 2014, through February 28, 2015. This statement reflects the State of California's General Fund cash position and compares actual receipts and disbursements for the 2014-15 fiscal year to cash flow estimates prepared by the Department of Finance (DOF) for the 2014-15 Budget Act. The statement is prepared in compliance with Provision 7 of Budget Act item 0840-001-0001, using records compiled by the State Controller. Prior year actual amounts are also displayed for comparative purposes.

Attachment A compares actual receipts and disbursements for the 2014-15 fiscal year to cash flow estimates published in the 2015-16 Governor's Budget. These cash flow estimates are predicated on projections and assumptions made by the DOF in preparation of the 2015-16 Governor's Budget.

Attachment B compares actual receipts and disbursements for the 2014-15 fiscal year to cash flow estimates prepared by the Department of Finance based upon the 2014-15 Budget Act.

These statements are also available on the Internet at the State Controller's website at www.sco.ca.gov under the category Monthly Financial Reports.

Any questions concerning this report may be directed to Casandra Moore-Hudnall, Division Chief of Accounting and Reporting, by telephone at (916) 445-5834.

Sincerely,
Original signed by:

BETTY T. YEE
California State Controller

STATEMENT OF GENERAL FUND CASH RECEIPTS AND DISBURSEMENTS
A Comparison of Actual to 2015-16 Governor's Budget Estimates
(Amounts in thousands)

	July 1 through February 28					
	2015					2014
	Actual	Estimate (a)	Actual Over or (Under) Estimate			Actual
			Amount		%	
GENERAL FUND BEGINNING CASH BALANCE	**$ 1,921,629**	**$ 1,921,629**	**$ -**		-	$ -
Add Receipts:						
Revenues	66,347,527	65,333,660	1,013,867	(e)	1.6	59,798,484
Nonrevenues	1,710,064	1,764,685	(54,621)		(3.1)	1,710,529
Total Receipts	68,057,591	67,098,345	959,246		1.4	61,509,013
Less Disbursements:						
State Operations	20,782,420	21,010,244	(227,824)		(1.1)	17,335,469
Local Assistance	58,835,078	58,220,343	614,735		1.1	56,448,949
Capital Outlay	149,845	182,992	(33,147)		(18.1)	133,645
Nongovernmental	2,069,781	2,123,301	(53,520)		(2.5)	(704,117)
Total Disbursements	81,837,124	81,536,880	300,244		0.4	73,213,946
Receipts Over / (Under) Disbursements	(13,779,533)	(14,438,535)	659,002		-	(11,704,933)
Net Increase / (Decrease) in Temporary Loans	11,857,904	12,516,906	(659,002)		(5.3)	11,704,933
GENERAL FUND ENDING CASH BALANCE	**-**	**-**	**-**			-
Special Fund for Economic Uncertainties	-	-	-		-	-
TOTAL CASH	**$ -**	**$ -**	**$ -**			$ -
BORROWABLE RESOURCES						
Available Borrowable Resources	$ 29,864,232	$ 27,585,039	$ 2,279,193	(f)(g)	8.3	$ 28,392,111
Outstanding Loans (b)	11,857,904	12,516,906	(659,002)		(5.3)	14,139,798
Unused Borrowable Resources	$ 18,006,328	$ 15,068,133	$ 2,938,195		19.5	$ 14,252,313

General Note:

This report is based upon funded cash. Funded cash is cash reported to and recorded in the records of the State Controller's Office. Amounts reported as funded cash may differ from amounts in other reports to the extent there are timing differences in the recording of in-transit items.

Footnotes:

(a) A Statement of Estimated Cash Flow for the 2014-15 fiscal year was prepared by the Department of Finance for the 2015-16 Governor's Budget. Any projections or estimates are set forth as such and not as representation of facts.

(b) Outstanding loan balance of $11.9 billion is comprised of $9.1 billion of internal borrowing and $2.8 billion of external borrowing. Current balance is comprised of $0.0 billion carried forward from June 30, 2014, plus current year Net Increase/(Decrease) in Temporary Loans of $11.9 billion.

(c) Negative amounts are the result of repayments received that are greater than disbursements made.

(d) Debt Service amounts are net of offsets such as federal subsidies and reimbursements from other sources. To the extent that these offsets do not occur when anticipated, there can be variances between actuals and estimates on a month-to-month basis.

(e) Includes ($343.3) million one-time adjustment for an under-allocation of sales and use tax due to local government in prior fiscal years for Public Safety and Local Revenue Realignment.

(f) On September 23, 2014, $2.8 billion of Revenue Anticipation Notes (RANs) proceeds were received.

(g) In September, $1.6 billion was transferred from the General Fund to the Budget Stabilization Account (BSA). This balance in the BSA is included in the Available Borrowable Resources. In addition, $1.6 billion was transferred to the Deficit Recovery Fund to retire economic recovery bonds. This expenditure is reflected in State Operations, General Government.

SCHEDULE OF CASH RECEIPTS
(Amounts in thousands)

			July 1 through February 28				
	Month of February		2015				2014
	2015	2014	Actual	Estimate (a)	Actual Over or (Under) Estimate		Actual
					Amount	%	
REVENUES							
Alcoholic Beverage Excise Tax	$ 55,339	$ 27,295	$ 265,861	$ 250,547	$ 15,314	6.1	$ 236,449
Corporation Tax	3,614	124,382	4,006,051	3,933,139	72,912	1.9	2,838,801
Cigarette Tax	5,990	6,611	63,992	58,464	5,528	9.5	58,608
Estate, Inheritance, and Gift Tax	443	421	2,142	1,569	573	36.5	6,106
Insurance Companies Tax	22,193	16,877	1,221,340	1,245,734	(24,394)	(2.0)	1,147,101
Personal Income Tax	2,630,777	2,300,732	44,735,939	44,177,718	558,221	1.3	39,873,023
Retail Sales and Use Taxes	3,455,719	3,012,661	15,345,269	15,002,835	342,434 (e)	2.3	14,682,171
Vehicle License Fees	10	108	121	91	30	33.0	1,666
Pooled Money Investment Interest	253	537	9,806	11,326	(1,520)	(13.4)	14,940
Not Otherwise Classified	133,202	120,302	697,006	652,237	44,769	6.9	939,619
Total Revenues	**6,307,540**	**5,609,926**	**66,347,527**	**65,333,660**	**1,013,867**	**1.6**	**59,798,484**
NONREVENUES							
Transfers from Special Fund for Economic Uncertainties	-	-	621,400	621,400	-	-	-
Transfers from Other Funds	81,265	44,501	321,838	400,079	(78,241)	(19.6)	902,132
Miscellaneous	200,239	218,795	766,826	743,206	23,620	3.2	808,397
Total Nonrevenues	**281,504**	**263,296**	**1,710,064**	**1,764,685**	**(54,621)**	**(3.1)**	**1,710,529**
Total Receipts	**$ 6,589,044**	**$ 5,873,222**	**$ 68,057,591**	**$ 67,098,345**	**$ 959,246**	**1.4**	**$ 61,509,013**

See notes on page A1.

SCHEDULE OF CASH DISBURSEMENTS
(Amounts in thousands)

			July 1 through February 28				
	Month of February		**2015**				**2014**
	2015	2014	Actual	Estimate (a)	Actual Over or (Under) Estimate		Actual
					Amount	%	
STATE OPERATIONS (c)							
Legislative/Judicial/Executive	$ 127,799	$ 113,948	$ 1,072,312	$ 1,061,764	$ 10,548	1.0	$ 1,167,948
Business, Consumer Services and Housing	2,108	943	15,479	13,895	1,584	11.4	11,572
Transportation	-	-	35	25	10	40.0	464
Resources	85,479	43,043	975,482	977,354	(1,872)	(0.2)	774,893
Environmental Protection Agency	1,587	2,211	26,856	34,960	(8,104)	(23.2)	27,610
Health and Human Services:							
Health Care Services and Public Health	15,571	19,285	216,295	207,680	8,615	4.1	213,369
Department of State Hospitals	126,365	123,241	1,028,515	1,024,322	4,193	0.4	918,076
Other Health and Human Services	47,298	22,993	369,142	458,514	(89,372)	(19.5)	427,141
Education:							
University of California	228,496	917,392	2,077,205	2,077,205	-	-	1,980,031
State Universities and Colleges	211,593	195,794	2,048,623	2,071,468	(22,845)	(1.1)	1,703,187
Other Education	20,405	17,359	134,458	140,041	(5,583)	(4.0)	123,076
Dept. of Corrections and Rehabilitation	762,706	727,918	6,465,023	6,451,365	13,658	0.2	5,817,055
Governmental Operations	99,606	53,183	515,740	485,736	30,004	6.2	439,865
General Government	182,882	157,636	3,285,469	3,278,448	7,021 (g)	0.2	1,542,621
Public Employees Retirement System	(193,952)	(160,800)	102,234	106,363	(4,129)	(3.9)	111,051
Debt Service (d)	422,509	146,099	2,464,172	2,635,950	(171,778)	(6.5)	2,119,613
Interest on Loans	17	6,354	(14,620)	(14,846)	226	(1.5)	(42,103)
Total State Operations	**2,140,469**	**2,386,599**	**20,782,420**	**21,010,244**	**(227,824)**	**(1.1)**	**17,335,469**
LOCAL ASSISTANCE (c)							
Public Schools - K-12	2,912,062	2,526,273	30,344,931	30,078,471	266,460	0.9	29,301,775
Community Colleges	349,924	277,897	3,374,509	3,639,135	(264,626)	(7.3)	3,159,487
Debt Service-School Building Bonds	-	-	-	-	-	-	-
Contributions to State Teachers' Retirement System	-	-	968,957	968,957	-	-	870,541
Other Education	202,606	182,151	1,871,030	1,936,236	(65,206)	(3.4)	1,267,049
School Facilities Aid	-	-	-	-	-	-	-
Dept. of Corrections and Rehabilitation	8,643	2,945	204,061	209,258	(5,197)	(2.5)	167,271
Dept. of Alcohol and Drug Program	-	304	210	210	-	-	(800)
Health Care Services and Public Health:							
Medical Assistance Program	1,242,613	1,148,416	13,395,762	12,802,136	593,626	4.6	12,640,265
Other Health Care Services/Public Health	8,629	39,700	123,533	142,000	(18,467)	(13.0)	60,568
Developmental Services - Regional Centers	425,654	125,387	2,419,748	2,402,148	17,600	0.7	2,341,200
Department of State Hospitals	-	-	-	-	-	-	-
Dept. of Social Services:							
SSI/SSP/IHSS	228,144	344,271	3,487,288	3,488,110	(822)	-	3,399,834
CalWORKs	(4,740)	128,652	316,314	192,438	123,876	64.4	1,137,502
Other Social Services	125,584	142,089	487,576	400,865	86,711	21.6	506,839
Tax Relief	-	-	207,878	213,681	(5,803)	(2.7)	210,867
Other Local Assistance	70,597	61,844	1,633,281	1,746,698	(113,417)	(6.5)	1,386,551
Total Local Assistance	**5,569,716**	**4,979,929**	**58,835,078**	**58,220,343**	**614,735**	**1.1**	**56,448,949**

See notes on page A1.

(Continued)

SCHEDULE OF CASH DISBURSEMENTS (Continued)
(Amounts in thousands)

	Month of February		July 1 through February 28				
			2015				2014
	2015	2014	Actual	Estimate (a)	Actual Over or (Under) Estimate		Actual
					Amount	%	
CAPITAL OUTLAY	**1,556**	**925**	**149,845**	**182,992**	**(33,147)**	**(18.1)**	**133,645**
NONGOVERNMENTAL (c)							
Transfer to Special Fund for Economic Uncertainties	-	-	-	-	-	-	122,900
Transfer to Budget Stabilization Account	-	-	1,606,422	1,606,422	- (g)	-	-
Transfer to Other Funds	-	47,245	802,687	883,198	(80,511)	(9.1)	462,199
Transfer to Revolving Fund	5,899	34	7,473	1,573	5,900	375.1	7,078
Advance:							
MediCal Provider Interim Payment	-	-	-	-	-	-	(1,000,000)
State-County Property Tax Administration Program	(11,325)	(24,505)	38,793	21,730	17,063	78.5	8,541
Social Welfare Federal Fund	(1)	(28,001)	(101,821)	(105,849)	4,028	(3.8)	(18,250)
Local Governmental Entities	-	-	(1,161)	(1,161)	-	-	29,087
Tax Relief and Refund Account	-	-	-	-	-	-	-
Counties for Social Welfare	-	-	(282,612)	(282,612)	-	-	(315,672)
Total Nongovernmental	**(5,427)**	**(5,227)**	**2,069,781**	**2,123,301**	**(53,520)**	**(2.5)**	**(704,117)**
Total Disbursements	**$ 7,706,314**	**$ 7,362,226**	**$ 81,837,124**	**$ 81,536,880**	**$ 300,244**	**0.4**	**$ 73,213,946**
TEMPORARY LOANS							
Special Fund for Economic Uncertainties	$ -	$ -	$ 449,700	$ 449,700	$ -	-	$ 122,900
Budget Stabilization Account	-	-	1,606,422	1,606,422	- (g)	-	-
Outstanding Registered Warrants Account	-	-	-	-	-	-	-
Other Internal Sources	1,117,270	1,489,004	7,001,782	7,660,784	(659,002)	(8.6)	6,082,033
Revenue Anticipation Notes	-	-	2,800,000	2,800,000	- (f)	-	5,500,000
Net Increase / (Decrease) Loans	**1,117,270**	**$ 1,489,004**	**$ 11,857,904**	**$ 12,516,906**	**$ (659,002)**	**(5.3)**	**$ 11,704,933**

See notes on page A1.

(Concluded)

COMPARATIVE STATEMENT OF REVENUES RECEIVED
All Governmental Cost Funds
(Amounts in thousands)

	July 1 through February 28			
	General Fund		**Special Funds**	
	2015	2014	2015	2014
MAJOR TAXES, LICENSES, AND INVESTMENT INCOME:				
Alcoholic Beverage Excise Taxes	$ 265,861	$ 236,449	$ -	$ -
Corporation Tax	4,006,051	2,838,801	-	-
Cigarette Tax	63,992	58,608	551,361	508,827
Estate, Inheritance, and Gift Tax	2,142	6,106	-	4
Insurance Companies Tax	1,221,340	1,147,101	920,082	248,776
Motor Vehicle Fuel Tax:				
Gasoline Tax	-	-	3,634,307	3,813,433
Diesel & Liquid Petroleum Gas	-	-	228,488	210,670
Jet Fuel Tax	-	-	1,778	2,268
Vehicle License Fees	121	1,666	1,505,565	1,437,485
Motor Vehicle Registration and Other Fees	-	-	2,825,936	2,779,929
Personal Income Tax	44,735,939	39,873,023	801,649	717,161
Retail Sales and Use Taxes	15,345,269	14,682,171	9,768,178	9,074,372
Pooled Money Investment Interest	9,806	14,940	104	83
Total Major Taxes, Licenses, and Investment Income	**65,650,521**	**58,858,865**	**20,237,448**	**18,793,008**
NOT OTHERWISE CLASSIFIED:				
Alcoholic Beverage License Fee	1,904	2,122	36,294	34,702
Electrical Energy Tax	-	-	398,422	404,837
Private Rail Car Tax	8,780	7,812	-	-
Penalties on Traffic Violations	-	-	39,101	40,974
Health Care Receipts	5,774	6,126	-	-
Revenues from State Lands	246,390	289,175	-	-
Abandoned Property	(123,290)	(14,207)	-	-
Trial Court Revenues	30,365	32,267	972,223	1,008,241
Horse Racing Fees	814	774	8,150	8,216
Cap and Trade	-	-	234,725	275,294
Miscellaneous	526,269	615,550	5,678,761	7,363,837
Not Otherwise Classified	**697,006**	**939,619**	**7,367,676**	**9,136,101**
Total Revenues, All Governmental Cost Funds	**$ 66,347,527**	**$ 59,798,484**	**$ 27,605,124**	**$ 27,929,109**

See notes on page A1.

STATEMENT OF GENERAL FUND CASH RECEIPTS AND DISBURSEMENTS
A Comparison of Actual to 2014-15 Budget Act
(Amounts in thousands)

	July 1 through February 28				
	2015				2014
	Actual	Estimate (a)	Actual Over or (Under) Estimate		Actual
			Amount	%	
GENERAL FUND BEGINNING CASH BALANCE	**$ 1,921,629**	**$ 1,921,629**	**$ -**	-	$ -
Add Receipts:					
Revenues	66,347,527	62,342,535	4,004,992 (e)	6.4	59,798,484
Nonrevenues	1,710,064	1,414,732	295,332	20.9	1,710,529
Total Receipts	68,057,591	63,757,267	4,300,324	6.7	61,509,013
Less Disbursements:					
State Operations	20,782,420	21,080,417	(297,997)	(1.4)	17,335,469
Local Assistance	58,835,078	59,077,833	(242,755)	(0.4)	56,448,949
Capital Outlay	149,845	156,941	(7,096)	(4.5)	133,645
Nongovernmental	2,069,781	2,079,701	(9,920)	(0.5)	(704,117)
Total Disbursements	81,837,124	82,394,892	(557,768)	(0.7)	73,213,946
Receipts Over / (Under) Disbursements	(13,779,533)	(18,637,625)	4,858,092	(26.1)	(11,704,933)
Net Increase / (Decrease) in Temporary Loans	11,857,904	16,715,996	(4,858,092)	(29.1)	11,704,933
GENERAL FUND ENDING CASH BALANCE	**-**	-	**-**		-
Special Fund for Economic Uncertainties	-	-	-	-	-
TOTAL CASH	**$ -**	**$ -**	**$ -**		$ -
BORROWABLE RESOURCES					
Available Borrowable Resources	$ 29,864,232	$ 26,378,111	$ 3,486,121 (f)(g)	13.2	$ 28,392,111
Outstanding Loans (b)	11,857,904	16,715,996	(4,858,092)	(29.1)	14,139,798
Unused Borrowable Resources	$ 18,006,328	$ 9,662,115	$ 8,344,213	86.4	$ 14,252,313

General Note:

This report is based upon funded cash. Funded cash is cash reported to and recorded in the records of the State Controller's Office. Amounts reported as funded cash may differ from amounts in other reports to the extent there are timing differences in the recording of in-transit items.

Footnotes:

(a) A Statement of Estimated Cash Flow for the 2014-15 fiscal year was prepared by the Department of Finance for the 2014-15 Budget Act. Any projections or estimates are set forth as such and not as representation of facts.

(b) Outstanding loan balance of $11.9 billion is comprised of $9.1 billion of internal borrowing and $2.8 billion of external borrowing. Current balance is comprised of $0.0 billion carried forward from June 30, 2014, plus current year Net Increase/(Decrease) in Temporary Loans of $11.9 billion.

(c) Negative amounts are the result of repayments received that are greater than disbursements made.

(d) Debt Service amounts are net of offsets such as federal subsidies and reimbursements from other sources. To the extent that these offsets do not occur when anticipated, there can be variances between actuals and estimates on a month-to-month basis.

(e) Includes ($343.3) million one-time adjustment for an under-allocation of sales and use tax due to local government in prior fiscal years for Public Safety and Local Revenue Realignment.

(f) On September 23, 2014, $2.8 billion of Revenue Anticipation Notes (RANs) proceeds were received.

(g) In September, $1.6 billion was transferred from the General Fund to the Budget Stabilization Account (BSA). This balance in the BSA is included in the Available Borrowable Resources. In addition, $1.6 billion was transferred to the Deficit Recovery Fund to retire economic recovery bonds. This expenditure is reflected in State Operations, General Government.

SCHEDULE OF CASH RECEIPTS
(Amounts in thousands)

			July 1 through February 28				
	Month of February		**2015**				**2014**
	2015	2014	Actual	Estimate (a)	Actual Over or (Under) Estimate		Actual
					Amount	%	
REVENUES							
Alcoholic Beverage Excise Tax	$ 55,339	$ 27,295	$ 265,861	$ 243,822	$ 22,039	9.0	$ 236,449
Corporation Tax	3,614	124,382	4,006,051	2,766,178	1,239,873	44.8	2,838,801
Cigarette Tax	5,990	6,611	63,992	56,601	7,391	13.1	58,608
Estate, Inheritance, and Gift Tax	443	421	2,142	-	2,142	-	6,106
Insurance Companies Tax	22,193	16,877	1,221,340	1,213,012	8,328	0.7	1,147,101
Personal Income Tax	2,630,777	2,300,732	44,735,939	41,849,724	2,886,215	6.9	39,873,023
Retail Sales and Use Taxes	3,455,719	3,012,661	15,345,269	15,449,944	(104,675) (e)	(0.7)	14,682,171
Vehicle License Fees	10	108	121	-	121	-	1,666
Pooled Money Investment Interest	253	537	9,806	12,254	(2,448)	(20.0)	14,940
Not Otherwise Classified	133,202	120,302	697,006	751,000	(53,994)	(7.2)	939,619
Total Revenues	**6,307,540**	**5,609,926**	**66,347,527**	**62,342,535**	**4,004,992**	**6.4**	**59,798,484**
NONREVENUES							
Transfers from Special Fund for Economic Uncertainties	-	-	621,400	621,400	-	-	-
Transfers from Other Funds	81,265	44,501	321,838	199,433	122,405	61.4	902,132
Miscellaneous	200,239	218,795	766,826	593,899	172,927	29.1	808,397
Total Nonrevenues	**281,504**	**263,296**	**1,710,064**	**1,414,732**	**295,332**	**20.9**	**1,710,529**
Total Receipts	**$ 6,589,044**	**$ 5,873,222**	**$ 68,057,591**	**$ 63,757,267**	**$ 4,300,324**	**6.7**	**$ 61,509,013**

See notes on page B1.

SCHEDULE OF CASH DISBURSEMENTS
(Amounts in thousands)

			July 1 through February 28				
	Month of February		2015				2014
	2015	2014	Actual	Estimate (a)	Actual Over or (Under) Estimate		Actual
					Amount	%	
STATE OPERATIONS (c)							
Legislative/Judicial/Executive	$ 127,799	$ 113,948	$ 1,072,312	$ 1,005,399	$ 66,913	6.7	$ 1,167,948
Business, Consumer Services and Housing	2,108	943	15,479	13,115	2,364	18.0	11,572
Transportation	-	-	35	-	35	-	464
Resources	85,479	43,043	975,482	903,234	72,248	8.0	774,893
Environmental Protection Agency	1,587	2,211	26,856	38,239	(11,383)	(29.8)	27,610
Health and Human Services:							
Health Care Services and Public Health	15,571	19,285	216,295	221,459	(5,164)	(2.3)	213,369
Department of State Hospitals	126,365	123,241	1,028,515	934,444	94,071	10.1	918,076
Other Health and Human Services	47,298	22,993	369,142	442,647	(73,505)	(16.6)	427,141
Education:							
University of California	228,496	917,392	2,077,205	2,074,018	3,187	0.2	1,980,031
State Universities and Colleges	211,593	195,794	2,048,623	2,012,275	36,348	1.8	1,703,187
Other Education	20,405	17,359	134,458	150,456	(15,998)	(10.6)	123,076
Dept. of Corrections and Rehabilitation	762,706	727,918	6,465,023	6,121,703	343,320	5.6	5,817,055
Governmental Operations	99,606	53,183	515,740	458,936	56,804	12.4	439,865
General Government	182,882	157,636	3,285,469	3,637,187	(351,718) (g)	(9.7)	1,542,621
Public Employees Retirement System	(193,952)	(160,800)	102,234	169,617	(67,383)	(39.7)	111,051
Debt Service (d)	422,509	146,099	2,464,172	2,871,600	(407,428)	(14.2)	2,119,613
Interest on Loans	17	6,354	(14,620)	26,088	(40,708)	(156.0)	(42,103)
Total State Operations	**2,140,469**	**2,386,599**	**20,782,420**	**21,080,417**	**(297,997)**	**(1.4)**	**17,335,469**
LOCAL ASSISTANCE (c)							
Public Schools - K-12	2,912,062	2,526,273	30,344,931	30,446,977	(102,046)	(0.3)	29,301,775
Community Colleges	349,924	277,897	3,374,509	3,321,353	53,156	1.6	3,159,487
Debt Service-School Building Bonds	-	-	-	-	-	-	-
Contributions to State Teachers' Retirement System	-	-	968,957	968,957	-	-	870,541
Other Education	202,606	182,151	1,871,030	2,194,857	(323,827)	(14.8)	1,267,049
School Facilities Aid	-	-	-	-	-	-	-
Dept. of Corrections and Rehabilitation	8,643	2,945	204,061	218,134	(14,073)	(6.5)	167,271
Dept. of Alcohol and Drug Program	-	304	210	-	210	-	(800)
Health Care Services and Public Health:							
Medical Assistance Program	1,242,613	1,148,416	13,395,762	12,714,191	681,571	5.4	12,640,265
Other Health Care Services/Public Health	8,629	39,700	123,533	42,522	81,011	190.5	60,568
Developmental Services - Regional Centers	425,654	125,387	2,419,748	2,397,726	22,022	0.9	2,341,200
Department of State Hospitals	-	-	-	-	-	-	-
Dept. of Social Services:							
SSI/SSP/IHSS	228,144	344,271	3,487,288	3,687,604	(200,316)	(5.4)	3,399,834
CalWORKs	(4,740)	128,652	316,314	382,498	(66,184)	(17.3)	1,137,502
Other Social Services	125,584	142,089	487,576	527,887	(40,311)	(7.6)	506,839
Tax Relief	-	-	207,878	209,870	(1,992)	(0.9)	210,867
Other Local Assistance	70,597	61,844	1,633,281	1,965,257	(331,976)	(16.9)	1,386,551
Total Local Assistance	**5,569,716**	**4,979,929**	**58,835,078**	**59,077,833**	**(242,755)**	**(0.4)**	**56,448,949**

See notes on page B1.

(Continued)

SCHEDULE OF CASH DISBURSEMENTS (Continued)
(Amounts in thousands)

	Month of February		July 1 through February 28					
			2015					2014
					Actual Over or (Under) Estimate			
	2015	2014	Actual	Estimate (a)	Amount		%	Actual
CAPITAL OUTLAY	**1,556**	**925**	**149,845**	**156,941**	**(7,096)**		**(4.5)**	**133,645**
NONGOVERNMENTAL (c)								
Transfer to Special Fund for Economic Uncertainties	-	-	-	-	-		-	122,900
Transfer to Budget Stabilization Account	-	-	1,606,422	1,606,422	-	(g)	-	-
Transfer to Other Funds	-	47,245	802,687	747,412	55,275		7.4	462,199
Transfer to Revolving Fund	5,899	34	7,473	-	7,473		-	7,078
Advance:								
MediCal Provider Interim Payment	-	-	-	-	-		-	(1,000,000)
State-County Property Tax Administration Program	(11,325)	(24,505)	38,793	-	38,793		-	8,541
Social Welfare Federal Fund	(1)	(28,001)	(101,821)	-	(101,821)		-	(18,250)
Local Governmental Entities	-	-	(1,161)	-	(1,161)		-	29,087
Tax Relief and Refund Account	-	-	-	-	-		-	-
Counties for Social Welfare	-	-	(282,612)	(274,133)	(8,479)		3.1	(315,672)
Total Nongovernmental	**(5,427)**	**(5,227)**	**2,069,781**	**2,079,701**	**(9,920)**		**(0.5)**	**(704,117)**
Total Disbursements	**$ 7,706,314**	**$ 7,362,226**	**$ 81,837,124**	**$ 82,394,892**	**$ (557,768)**		**(0.7)**	**$ 73,213,946**
TEMPORARY LOANS								
Special Fund for Economic Uncertainties	$ -	$ -	$ 449,700	$ 449,700	$ -		-	$ 122,900
Budget Stabilization Account	-	-	1,606,422	1,606,422	-	(g)	-	-
Outstanding Registered Warrants Account	-	-	-	-	-		-	-
Other Internal Sources	1,117,270	1,489,004	7,001,782	11,859,874	(4,858,092)		(41.0)	6,082,033
Revenue Anticipation Notes	-	-	2,800,000	2,800,000	-	(f)	-	5,500,000
Net Increase / (Decrease) Loans	**1,117,270**	**$ 1,489,004**	**$ 11,857,904**	**$ 16,715,996**	**$ (4,858,092)**		**(29.1)**	**$ 11,704,933**

See notes on page B1.

(Concluded)

(THIS PAGE INTENTIONALLY LEFT BLANK)

APPENDIX B

STATE OF CALIFORNIA COMPREHENSIVE ANNUAL FINANCIAL REPORT FOR THE FISCAL YEAR ENDED JUNE 30, 2013

(THIS PAGE INTENTIONALLY LEFT BLANK)

State of California

Comprehensive Annual Financial Report

For the Fiscal Year Ended June 30, 2013

Controller *John Chiang*

California State Controller's Office

STATE OF CALIFORNIA

COMPREHENSIVE ANNUAL FINANCIAL REPORT

For the Year Ended
June 30, 2013

Prepared by
The Office of the State Controller

JOHN CHIANG
California State Controller

Contents

INTRODUCTORY SECTION

California State Controller's Transmittal Letter iii
Certificate of Achievement for Excellence in Financial Reporting viii
Principal Officials of the State of California ix
Organization Chart of the State of California x

FINANCIAL SECTION

Independent Auditor's Report 2
Management's Discussion and Analysis 5

BASIC FINANCIAL STATEMENTS

GOVERNMENT-WIDE FINANCIAL STATEMENTS

Statement of Net Position 30
Statement of Activities 34

FUND FINANCIAL STATEMENTS

Balance Sheet – Governmental Funds 38
Reconciliation of the Governmental Funds Balance Sheet to the Statement of Net Position 40
Statement of Revenues, Expenditures, and Changes in Fund Balances – Governmental Funds 42
Reconciliation of the Statement of Revenues, Expenditures, and Changes in Fund Balances of Governmental Funds to the Statement of Activities 44
Statement of Net Position – Proprietary Funds 46
Statement of Revenues, Expenses, and Changes in Fund Net Position – Proprietary Funds 52
Statement of Cash Flows – Proprietary Funds 54
Statement of Fiduciary Net Position – Fiduciary Funds and Similar Component Units 58
Statement of Changes in Fiduciary Net Position – Fiduciary Funds and Similar Component Units 59

DISCRETELY PRESENTED COMPONENT UNITS FINANCIAL STATEMENTS

Statement of Net Position – Discretely Presented Component Units – Enterprise Activity 62
Statement of Activities – Discretely Presented Component Units – Enterprise Activity 66

NOTES TO THE FINANCIAL STATEMENTS

Notes to the Financial Statements – Index 69
Notes to the Financial Statements 73

REQUIRED SUPPLEMENTARY INFORMATION

Schedule of Funding Progress 190
Infrastructure Assets Using the Modified Approach 191
Budgetary Comparison Schedule – General Fund and Major Special Revenue Funds 194
Reconciliation of Budgetary Basis Fund Balances of the General Fund and the Major Special Revenue Funds to GAAP Basis Fund Balances 197
Notes to the Required Supplementary Information 197

COMBINING FINANCIAL STATEMENTS AND SCHEDULES – NONMAJOR AND OTHER FUNDS

Nonmajor Governmental Funds 203
Combining Balance Sheet 206
Combining Statement of Revenues, Expenditures, and Changes in Fund Balances 210
Budgetary Comparison Schedule – Budgetary Basis 214
Internal Service Funds 217
Combining Statement of Net Position 218
Combining Statement of Revenues, Expenses, and Changes in Fund Net Position 220
Combining Statement of Cash Flows 222
Nonmajor Enterprise Funds 227
Combining Statement of Net Position 228
Combining Statement of Revenues, Expenses, and Changes in Fund Net Position 232
Combining Statement of Cash Flows 234
Private Purpose Trust Funds 239
Combining Statement of Fiduciary Net Position 240
Combining Statement of Changes in Fiduciary Net Position 241
Fiduciary Funds and Similar Component Units – Pension and Other Employee Benefit Trust Funds 243
Combining Statement of Fiduciary Net Position 244
Combining Statement of Changes in Fiduciary Net Position 245

Agenda Funds 247
Combining Statement of Fiduciary Assets and Liabilities 248
Combining Statement of Changes in Fiduciary Assets and Liabilities 250
Nonmajor Component Units 253
Combining Statement of Net Position 254
Combining Statement of Activities 256

STATISTICAL SECTION

Financial Trends 261
Schedule of Net Position by Component 262
Schedule of Changes in Net Position 264
Schedule of Fund Balances – Governmental Funds 268
Schedule of Changes in Fund Balances – Governmental Funds 270
Revenue Capacity 273
Schedule of Revenue Base 274
Schedule of Revenue Payers by Industry/Income Level 278
Schedule of Personal Income Tax Rates 280
Debt Capacity 283
Schedule of Ratios of Outstanding Debt by Type 284
Schedule of Ratios of General Bonded Debt Outstanding 286
Schedule of General Obligation Bonds Outstanding 288
Schedule of Pledged Revenue Coverage 289
Demographic and Economic Information 293
Schedule of Demographic and Economic Indicators 294
Schedule of Employment by Industry 296
Operating Information 297
Schedule of Full-time Equivalent State Employees by Function 298
Schedule of Operating Indicators by Function 300
Schedule of Capital Asset Statistics by Function 304
Acknowledgements 308

This page intentionally left blank.

Introductory Section

JOHN CHIANG

California State Controller

JOHN CHIANG
California State Controller

April 21, 2014

To the Citizens, Governor, and Members
of the Legislature of the State of California:

I am pleased to submit the State of California Comprehensive Annual Financial Report (CAFR) for the fiscal year ended June 30, 2013. This report meets the requirements of Government Code section 12460 for an annual report prepared strictly in accordance with accounting principles generally accepted in the United States of America (GAAP) and contains information to help readers gain a reasonable understanding of the State's financial activities.

The State's management assumes responsibility for the accuracy, completeness, and fairness of information presented in the CAFR, including all disclosures, based upon a comprehensive framework of internal controls established for this purpose. The internal control structure is designed to provide reasonable, but not absolute, assurance that the financial statements are free of material misstatements. The objective of these controls is to ensure compliance with legal provisions embodied in the annual appropriated budget approved by the Legislature and Governor.

The California State Auditor has issued an unqualified opinion on the financial statements for the year ended June 30, 2013, in accordance with auditing standards generally accepted in the United States of America and Government Auditing Standards issued by the Comptroller General of the United States.

The State of California is also required to undergo an annual single audit in conformity with the provisions of the United States Office of Management and Budget's Circular A-133, Audits of States, Local Governments, and Non-Profit Organizations. This report is issued separately.

The State's Management's Discussion and Analysis (MD&A) immediately follows the independent auditor's report and contains an introduction, overview, and analysis of the financial statements. The MD&A complements this letter of transmittal and should be read in conjunction with it.

The Profile of the Government

The State of California was admitted to the Union on September 9, 1850. The State's population, per the 2010 census, is more than 37 million residents. The State's government is divided into three branches: Executive, Legislative, and Judicial. Executive power is vested in the Governor. Other members of the executive branch include the Lieutenant Governor, Attorney General, Secretary of State, State Treasurer, State Controller, Insurance Commissioner, and the State Superintendent of Public Instruction. All officers of the executive branch are elected to a four-year term. The Legislative branch of government is the State's law-making authority, and is made up of two houses: the Senate and the Assembly. The Judicial branch is charged with interpreting the laws of the State of California. It provides settlement of disputes between parties in controversy, determines the guilt or innocence of those accused of violating laws, and protects the rights of Californians.

California's government includes control agencies that help to regulate internal governmental operations. These include the State Controller's Office, the State's independent fiscal watchdog, which ensures that the State's budget is spent properly, offers fiscal guidance to local governments, and uncovers fraud and abuse of taxpayer dollars. The Department of Finance is part of the Executive branch of government; it establishes fiscal policies to carry out the State's programs and serves as the Governor's chief fiscal policy advisor. The California State Auditor promotes the efficient and effective management of public funds through independent evaluations of state and local governments.

The State of California provides a wide range of services to its citizens, including social services, health and human services; kindergarten through 12th grades (K-12) and higher education and business and transportation, consumer services, general government, and correctional programs. The State is also financially accountable for legally-separate entities (component units) that provide post-education programs, promote agricultural activities and financial assistance to small business, and finance coastal and inland urban waterfront restoration projects. These component units are separately reported in the State's financial statements. The State, through its related organizations (organizations for which primary government is not financially accountable), provides services such as the operation of the statewide energy transmission grid; earthquake insurance for homeowners and renters; workers' compensation insurance; health insurance for individuals, families, and employees of small businesses; financing for pollution control facilities, and for acquiring, constructing, and equipping health facilities; and loans to students attending public and private nonprofit colleges and universities. The financial information of these institutions is not included in the State's financial statements.

The State Legislature approves an annual budget that contains estimates of revenues and expenditures for the ensuing fiscal year. This budget is the result of negotiations between the Governor and the Legislature. The State Controller's Office is statutorily responsible for controlling revenues due the primary government and for expenditures of each appropriation contained in the budget. The State's annual budget is submitted no later than January 10 preceding the beginning of the fiscal year on July 1, and must be approved by the Legislature by June 15 each year. This annual budget serves as the foundation for the State's financial planning and control. Additional information on the budgetary basis of accounting can be found in Note 2, Budgetary and Legal Compliance, and in the Required Supplementary Information section of CAFR that follows the Notes to the Financial Statements.

Overview of the State

The State of California is ranked first in population and third in land area in the U.S., and contains some of the most renowned resources and riches in the world. It is home to the most productive agricultural counties in the nation, with more than 80,000 farms and ranches contributing more than $44 billion annually to its agricultural industry. California has the largest and most diverse natural and cultural heritage of any state in the nation. In 2011, California's national parks generated nearly $1.2 billion in economic benefit to the State from non-local visitor spending. California's Gross Domestic Product (GDP) makes up more than 13% of the United States' total GDP and ranks in the top ten in the world economy. The five largest sectors of California's economy in terms of jobs are trade, transportation, and utilities; government; professional and business services; education and health services; and leisure and hospitality.

Financial Condition

Overview of State Economy for 2013

The U.S. economy completed its fourth year of recovery as California ended its fiscal year on June 30, 2013. National growth was slow, with real gross domestic product (GDP) up a modest 1.6%. Despite limited support from the rest of the country, a rebound in California's housing market, tourism, and other key sectors allowed the State to post a solid gain for the year.

California's job market improved significantly, with nonfarm employment in June 2013 increasing by 1.5%, or 220,000 jobs over the prior year. Job gains were widespread, with particularly large numerical and percentage increases in construction, leisure and hospitality, business and professional services, private education, and health care.

The public sector and manufacturing were the primary areas showing job losses. The general improvement in the labor market was strong enough to push the unemployment rate down more than two full percentage points, from 10.6% in June 2012 to 8.5% as of June 2013. California ended the fiscal year on June 30, 2013, with solid economic progress. While more growth is needed to drive the jobless rate lower and improve incomes for all, substantial gains are being achieved.

Long-term Financial Planning

The following are some of the long-term financial planning initiatives that California's government has instituted or intends to institute in upcoming years that will impact the State's long-term financial goals.

- Proposition 98, approved by voters in November 1988, funds preschools, K-12 education, the California Community Colleges, and other state education programs. The Governor's 2013-14 Budget provides $2.7 billion in additional funding, a 5% increase from the revised current-year level of $56.2 billion from Proposition 98. Refer to the MD&A for details.

- The California Department of Transportation has undertaken several major projects for the next five years approximating more than $4.5 billion. These include high-occupancy vehicle lanes, and the reconstruction, rehabilitation, widening, and realignment of several highways and state routes.

- The Governor has proposed a $23 billion plan to build infrastructure that will carry water to the Bay Area and Southern California to better serve the cities and farms in the State. Twin tunnels would carry water from Northern California to the South, reducing Delta pumping, helping to restore the Delta ecosystem and provide a more reliable source of water.

- A proposal for a constitutional amendment to strengthen California's Budget Stabilization Fund, known as the rainy day fund, will be placed on the ballot by members of the California State Assembly in November of 2014. The goal is to increase the size of the State's rainy day fund from 5% of General Fund revenue to 10%, and to set limits on how the funds are used.

Budget Outlook

2013-14 Fiscal Year

California's 2013-14 Budget was enacted on June 27, 2013. The Budget presents a multi-year balanced budget plan, maintains a $1.1 billion reserve, and pays down budgetary debt. The General Fund revenues and transfers are estimated to be $97.9 billion, with estimated expenditures of $96.3 billion, resulting in a surplus of $1.6 billion at the end of the 2013-14 fiscal year.

2014-15 Fiscal Year

The Governor released his proposed 2014-15 Budget on January 10, 2014, initiating a multi-year plan that is balanced, pays off past budgetary debt, and saves for the future. Using targeted expenditures, the Budget continues last year's investments in education and health and human services; while making new investments in programs designed to reduce global warming and ensure a sustainable water policy. The Budget commits $670 million in new General Fund spending to expand Medi-Cal benefits; increases the minimum wage to $10 per hour by 2016; boosts grant funding for CalWORKS; and spends $64.6 billion in deferred maintenance on California's aging infrastructure over five years. An additional $815 million is targeted for state parks, local streets and roads, K-12 schools, courts, prisons, hospitals, and other state facilities. Budgetary borrowing will be reduced by $12 billion this year, with the goal of eliminating borrowing by fiscal year 2017-18. Spending cuts and voter-approved temporary taxes will provide a $20 billion reduction in the annual deficit. The Budget will repay the $100 million Cap and Trade loan, $340 million in transportation loans, and $1.6 billion in Economic Recovery Bonds issued since 2001. One-time revenues will be used to strengthen the Budget Stabilization Fund (also known as the Rainy Day Fund) instead of using those revenues for permanent programs; and a constitutional amendment to strengthen the Fund will mitigate long-term liabilities and potential future decreases in revenue.

Awards and Acknowledgments

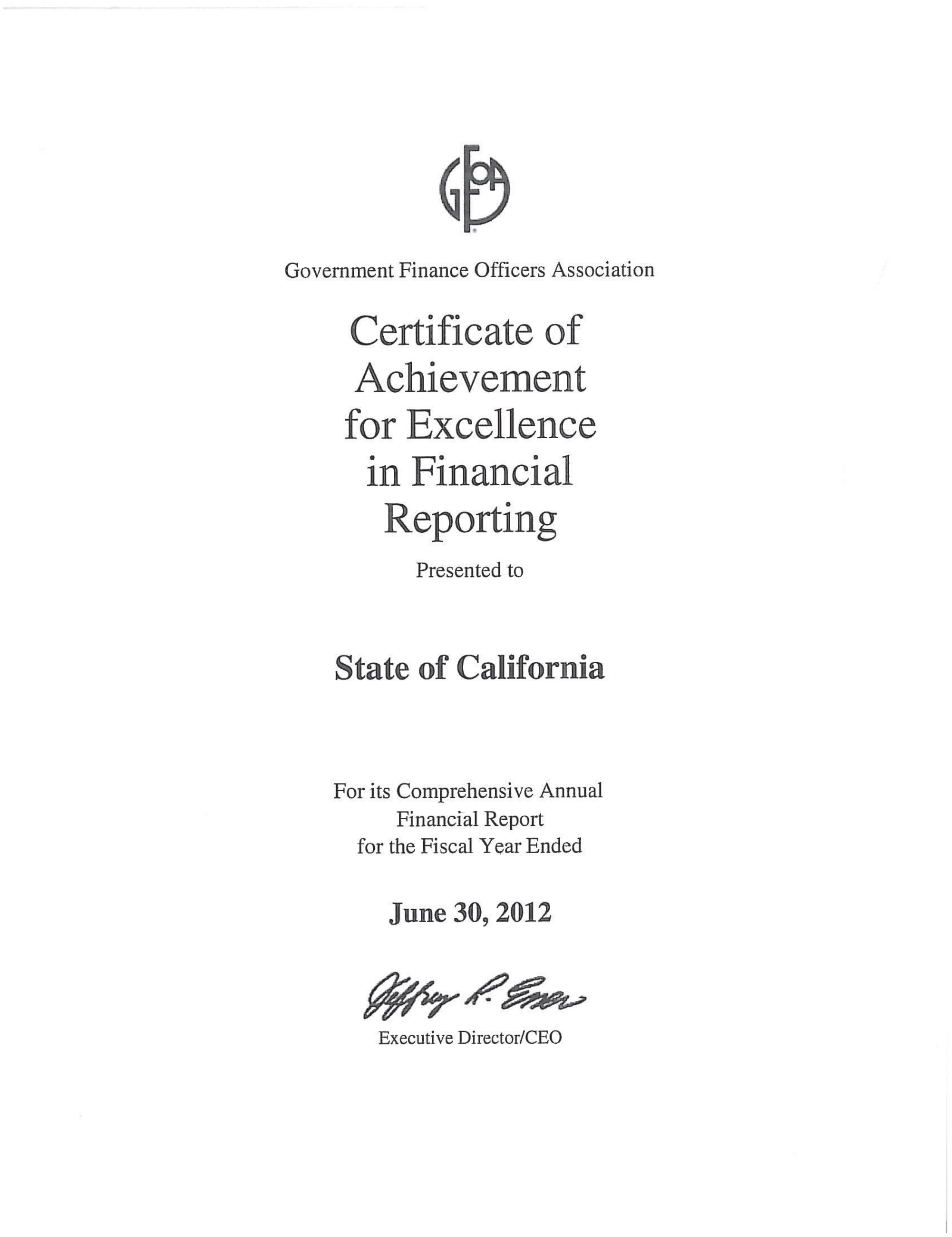
The Government Finance Officers Association of the United States and Canada (GFOA) awarded a Certificate of Achievement for Excellence in Financial Reporting to the State of California for its comprehensive annual financial report for the fiscal year ended June 30, 2012. In order to be awarded a Certificate of Achievement, a government must publish an easily readable and efficiently organized comprehensive annual financial report. This report must satisfy both generally accepted accounting principles and applicable legal requirements. A Certificate of Achievement is valid for a period of one year only.

The preparation of this report would not have been possible without the skill, effort, and dedication of the entire staff of the State Controller's Office. We wish to thank all government departments for their assistance in providing the data necessary to prepare this report. Credit also is due to the California State Auditor and their audit staff for their continuing support for maintaining the highest standards of professionalism in the management of the State's finances.

Sincerely,

Original signed by:

JOHN CHIANG
California State Controller



Government Finance Officers Association

Certificate of Achievement for Excellence in Financial Reporting

Presented to

State of California

For its Comprehensive Annual
Financial Report
for the Fiscal Year Ended

June 30, 2012

Jeffrey R. Esser
Executive Director/CEO

Principal Officials of the State of California

Executive Branch

Edmund G. Brown, Jr.
Governor

Gavin Newsom
Lieutenant Governor

John Chiang
State Controller

Kamala D. Harris
Attorney General

Bill Lockyer
State Treasurer

Debra Bowen
Secretary of State

Tom Torlakson
Superintendent of Public Instruction

Dave Jones
Insurance Commissioner

Board of Equalization
Betty T. Yee, Member, First District
George Runner, Member, Second District
Michelle Steel, Member, Third District
Jerome E. Horton, Member, Fourth District

Legislative Branch

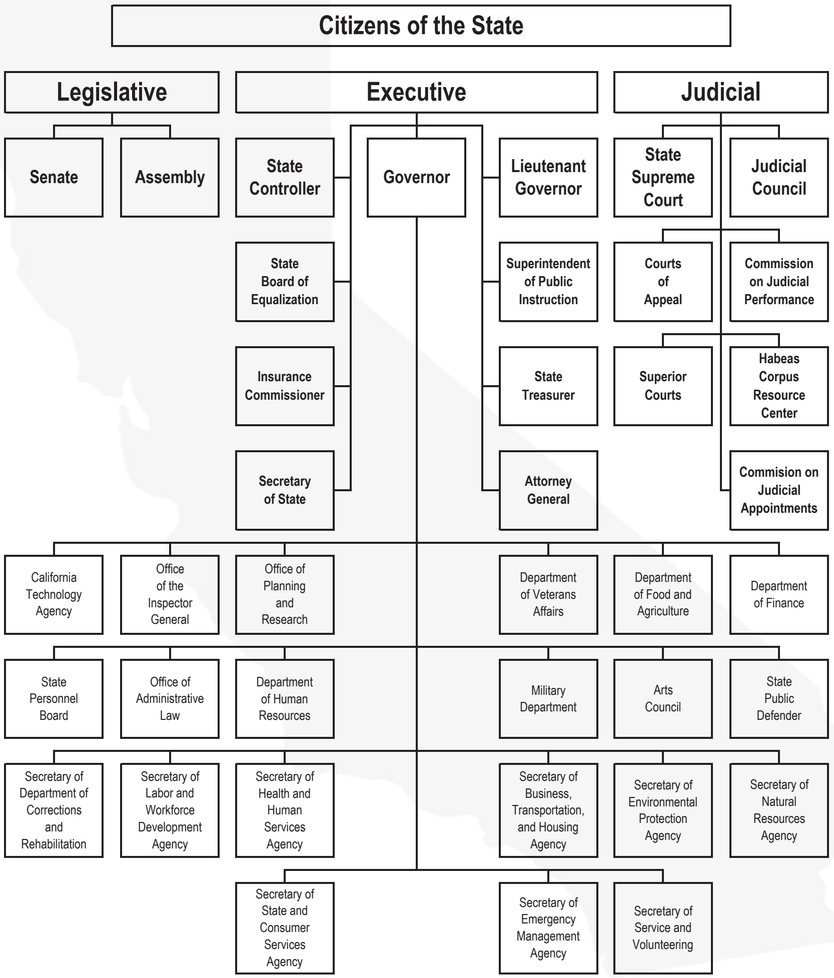
Darrell Steinberg
President pro Tempore, Senate

John A. Pérez
Speaker of the Assembly

Judicial Branch

Tani Cantil-Sakauye
Chief Justice, State Supreme Court

Organization Chart of the State of California


Citizens of the State
Legislative
Executive
Judicial
Senate
Assembly
State Controller
Governor
Lieutenant Governor
State Supreme Court
Judicial Council
State Board of Equalization
Superintendent of Public Instruction
Courts of Appeal
Commission on Judicial Performance
Insurance Commissioner
State Treasurer
Superior Courts
Habeas Corpus Resource Center
Secretary of State
Attorney General
Commision on Judicial Appointments
California Technology Agency
Office of the Inspector General
Office of Planning and Research
Department of Veterans Affairs
Department of Food and Agriculture
Department of Finance
State Personnel Board
Office of Administrative Law
Department of Human Resources
Military Department
Arts Council
State Public Defender
Secretary of Department of Corrections and Rehabilitation
Secretary of Labor and Workforce Development Agency
Secretary of Health and Human Services Agency
Secretary of Business, Transportation, and Housing Agency
Secretary of Environmental Protection Agency
Secretary of Natural Resources Agency
Secretary of State and Consumer Services Agency
Secretary of Emergency Management Agency
Secretary of Service and Volunteering

This page intentionally left blank.

Financial Section

California
State Auditor

Elaine M. Howle State Auditor
Doug Cordiner Chief Deputy

Independent Auditor's Report

THE GOVERNOR AND THE LEGISLATURE OF THE
STATE OF CALIFORNIA

Report on the Financial Statements

We have audited the accompanying financial statements of the governmental activities, the business-type activities, the aggregate discretely presented component units, each major fund, and the aggregate remaining fund information of the State of California, as of and for the year ended June 30, 2013, and the related notes to the financial statements, which collectively comprise the State'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 did not audit the following significant amounts in the financial statements:

Government-wide Financial Statements

- Certain enterprise funds that, in the aggregate, represent 86 percent of the assets and deferred outflows, and 32 percent of the revenues of the business-type activities.

- The University of California and the California Housing Finance Agency that represent 93 percent of the assets and deferred outflows, and 92 percent of the revenues of the discretely presented component units.

Fund Financial Statements

- The following major enterprise funds: Electric Power fund, Water Resources fund, Public Building Construction fund, State Lottery fund, and California State University fund.

- The Golden State Tobacco Securitization Corporation, the Public Employees' Retirement, the State Teachers' Retirement, the State Water Pollution Control, and the 1943 Veterans Farm and Home Building funds, that represent 85 percent of the assets and deferred outflows, and 51 percent of the additions, revenues and other financing sources of the aggregate remaining fund information.

- The discretely presented component units noted above.

The related financial statements were audited by other auditors whose reports have been furnished to us, and our opinions, insofar as they relate to the amounts included for those funds and entities, are based on the reports of the other auditors. We conducted our audit in accordance with 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 of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. The financial statements of the Golden State Tobacco Securitization Corporation, the Public Building Construction, the Public Employees' Retirement, the State Lottery, the Water Resources and the 1943 Veterans Farm and Home Building funds were not audited in accordance with *Government Auditing Standards*.

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 estimates made by management, as well as evaluating the overall financial statement 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, based on our audit and the reports of other auditors, the financial statements referred to above present fairly, in all material respects, the respective financial position of the governmental activities, the business-type activities, the aggregate discretely presented component units, each major fund, and the aggregate remaining fund information of the State of California, as of June 30, 2013, 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 State of America require that the discussion and analysis by management, schedule of funding progress, infrastructure information, budgetary comparison information, reconciliation of budgetary and GAAP-basis fund balances, and related notes 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 which 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 and the other auditors 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 the 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 the State's basic financial statements. The introductory section, combining financial statements, and statistical section are presented for purposes of additional analysis and are not a required part of the basic financial statements.

The combining financial statements are the responsibility of management and were derived from, and relate 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 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 by us and other auditors. In our opinion, based on our audit, the procedures as described above, and the reports of other auditors, the combining financial statements are fairly stated, in all material respects, in relation to the basic financial statements as a whole.

The introductory and statistical sections have not been subjected to the auditing procedures applied in the audit of the basic financial statements, and accordingly, we do not express an opinion or provide any assurance on them.

Other Reporting Required by Government Auditing Standards

In accordance with *Government Auditing Standards*, we will issue a separate report on our consideration of the State's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, and other matters. The purpose of that report is 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 State's internal control over financial reporting and compliance.

CALIFORNIA STATE AUDITOR

John F. Collins II

JOHN F. COLLINS II, CPA
Deputy State Auditor

April 16, 2014

Management's Discussion and Analysis

The following Management's Discussion and Analysis is a required supplement to the State of California's financial statements. It describes and analyzes the financial position of the State, providing an overview of the State's activities for the year ended June 30, 2013. There were significant accounting changes and restatements in fiscal year 2012-13 which are described in Note 1L. All comparisons between fiscal year 2012 and 2013 are based on restated amounts for fiscal year 2012. We encourage readers to consider the information we present here in conjunction with the information presented in the Controller's letter of transmittal at the front of this report and in the State's financial statements and notes, which follow this section.

Financial Highlights – Primary Government

Government-wide Highlights

During the 2012-13 fiscal year, California made solid economic progress and ended on more stable fiscal footing. The State's general revenues increased by $14.6 billion (13.9%) over the prior year. Expenses for the State's governmental activities also increased but were less than revenues received, resulting in a $8.5 billion decrease in governmental activities' net deficit position. Total revenues and transfers for the State's business-type activities surpassed expenses by $1.4 billion in fiscal year 2012-13. Revenues exceeded expenses resulting in a 70.9% decrease in the total net deficit position for governmental and business-type activities over the 2011-12 fiscal year.

Net Position – The primary government's net deficit position as of June 30, 2013, was $4.1 billion. After the total net deficit position is reduced by $86.6 billion for net investment in capital assets and by $29.5 billion for restricted net position, the resulting unrestricted net position totals a negative $120.2 billion. Restricted net position is dedicated for specified uses and is not available to fund current activities. Almost half of the negative $120.2 billion consists of $59.1 billion in outstanding bonded debt issued to build capital assets for school districts and other local governmental entities. The bonded debt reduces the unrestricted net position; however, local governments, not the State, record the capital assets that would offset this reduction.

Fund Highlights

Governmental Funds – As of June 30, 2013, the primary government's governmental funds reported a combined ending fund balance of $12.2 billion, an increase of $8.0 billion from the prior fiscal year. The unrestricted fund balance, comprised of committed, assigned, and unassigned balances, was negative $12.2 billion. The nonspendable and restricted fund balances were $155 million and $24.3 billion, respectively.

Proprietary Funds – As of June 30, 2013, the primary government's proprietary funds reported combined ending net position of $4.3 billion, an increase of $1.0 billion from the prior fiscal year. After the total net position is reduced by $1.8 billion for net investment in capital assets, expendable restrictions of $5.2 billion, and nonexpendable restrictions of $21 million, the unrestricted net position totals a negative $2.7 billion.

Noncurrent Assets and Liabilities

As of June 30, 2013, the primary government's noncurrent assets totaled $145.1 billion, of which $118.6 billion is related to capital assets. State highway infrastructure assets of $64.6 billion represent the largest portion of the State's capital assets.

The primary government's noncurrent liabilities totaled $164.3 billion, which consists of $80.1 billion in general obligation bonds, $31.7 billion in revenue bonds, and $52.5 billion in all other noncurrent liabilities. During the 2012-13 fiscal year, the primary government's noncurrent liabilities increased by $626 million (0.4%) over the prior fiscal year. This increase was primarily the result of a $3.5 billion decrease in loans payable, an increase of $3.3 billion in net other postemployment benefits obligations, an increase of $563 million for revenue bonds payable and an increase of $502 million for certificates of participation, commercial paper, and other borrowings.

Overview of the Financial Statements

This discussion and analysis is an introduction to the section presenting the State's basic financial statements, which includes four components: (1) government-wide financial statements, (2) fund financial statements, (3) discretely presented component units financial statements, and (4) notes to the financial statements. This report also contains required supplementary information and combining financial statements and schedules.

Government-wide Financial Statements

Government-wide financial statements are designed to provide readers with a broad overview of the State's finances. The government-wide financial statements do not include fiduciary programs and activities of the primary government and component units because fiduciary resources are not available to support state programs.

To help readers assess the State's economic condition at the end of the fiscal year, the statements provide both short-term and long-term information about the State's financial position. These statements are prepared using the economic resources measurement focus and the accrual basis of accounting, similar to methods used by most businesses. These statements take into account all revenues and expenses connected with the fiscal year, regardless of when the State received or paid the cash. The government-wide financial statements include two statements: the Statement of Net Position and the Statement of Activities.

- The *Statement of Net Position* presents all of the State's assets and liabilities and reports the difference between the two as net position. Over time, increases or decreases in net position indicate whether the financial position of the State is improving or deteriorating.

- The *Statement of Activities* presents information showing how the State's net position changed during the most recent fiscal year. The State reports changes in net position as soon as the event giving rise to the change occurs, regardless of the timing of the related cash flows. Thus, this statement reports revenues and expenses for some items that will result in cash flows in future fiscal periods (e.g., uncollected taxes and earned but unused vacation leave). This statement also presents a comparison between direct expenses and program revenues for each function of the State.

The government-wide financial statements separate into different columns the three types of state programs and activities: governmental activities, business-type activities, and component units.

- *Governmental activities* are mostly supported by taxes, such as personal income and sales and use taxes, and intergovernmental revenues, primarily federal grants. Most services and expenses normally associated with state government fall into this activity category, including health and human services, education (public kindergarten through 12th grade [K-12] schools and institutions of higher education), business and transportation, correctional programs, general government, resources, state and consumer services, and interest on long-term debt.

- *Business-type activities* typically recover all or a significant portion of their costs through user fees and charges to external users of goods and services. The business-type activities of the State of California include providing unemployment insurance programs, providing housing loans to California veterans, providing water to local water districts, providing building aid to school districts, providing services to California State University students, leasing public assets, selling California State Lottery tickets, and selling electric power. These activities are carried out with minimal financial assistance from the governmental activities or general revenues of the State.

- *Component units* are organizations that are legally separate from the State, but are at the same time related to the State financially (i.e., the State is financially accountable for them) or the nature of their relationship with the State is so significant that their exclusion would cause the State's financial statements to be misleading or incomplete. The State's financial statements include the information for blended, fiduciary, and discretely presented component units.

  - *Blended component units*, although legally separate entities, are in substance a part of the primary government's operations. Therefore, for reporting purposes, the State integrates data from blended component units into the appropriate funds. The Golden State Tobacco Securitization Corporation and certain building authorities that are blended component units of the State are included in the governmental activities.

  - *Fiduciary component units* are legally separate from the primary government but, due to their fiduciary nature, are included with the primary government's fiduciary funds. The Public Employees' Retirement System and the State Teachers' Retirement System are fiduciary component units that are included with the State's pension and other employee benefit trust funds, which are not included in the government-wide financial statements.

  - *Discretely presented component units* are legally separate from the primary government and provide services to entities and individuals outside the primary government. The activities of discretely presented component units are presented in a single column in the government-wide financial statements.

Information regarding obtaining financial statements of the individual component units is available from the State Controller's Office, Division of Accounting and Reporting, P.O. Box 942850, Sacramento, California 94250-5872.

Fund Financial Statements

Fund financial statements are provided for governmental funds, proprietary funds, fiduciary funds and similar component units, and discretely presented component units. 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 State of California, like other state and local governments, uses fund accounting to ensure and demonstrate compliance with finance-related legal and contractual requirements. Following are general descriptions of the three types of funds:

- *Governmental funds* are used to account for essentially the same functions that are reported as governmental activities in the government-wide financial statements. However, unlike the government-wide financial statements, governmental fund financial statements focus on short-term inflows and outflows of spendable resources, as well as on balances of spendable resources available at the end of the fiscal year. Such information may be useful in evaluating a government's short-term financing requirements. This approach is known as the *flow of current financial resources measurement* focus and the *modified accrual basis of accounting*. These governmental fund statements provide a detailed short-term view of the State's finances, enabling readers to determine whether adequate financial resources exist to meet the State's current needs.

  Because governmental fund financial statements provide a narrower focus than do government-wide financial statements, it is useful to compare governmental fund statements to the governmental activities information presented in the government-wide financial statements. By doing so, readers may better understand the long-term impact of the government's short-term financing decisions. Reconciliations located on the pages immediately following the fund statements show the differences between the government-wide statements and the governmental fund Balance Sheet and the governmental fund Statement of Revenues, Expenditures, and Changes in Fund Balances. Primary differences between the government-wide and fund statements relate to noncurrent assets, such as land and buildings, and noncurrent liabilities, such as bonded debt and amounts owed for compensated absences and capital lease obligations, which are reported in the government-wide statements but not in the fund-based statements.

- *Proprietary funds* show activities that operate more like those found in the private sector. The State of California has two proprietary fund types: enterprise funds and internal service funds.

  - *Enterprise funds* record activities for which a fee is charged to external users; they are presented as business-type activities in the government-wide financial statements.

  - *Internal service funds* accumulate and allocate costs internally among the State of California's various functions. For example, internal service funds provide information technology, printing, fleet management, and architectural services primarily for state departments. As a result, their activity is considered governmental.

- *Fiduciary funds* account for resources held for the benefit of parties outside the State. Fiduciary funds and the activities of fiduciary component units are not reflected in the government-wide financial statements because the resources of these funds are not available to support State of California programs. The accounting used for fiduciary funds and similar component units is similar to that used for proprietary funds.

Discretely Presented Component Units Financial Statements

The State has financial accountability for discretely presented component units, which have certain independent qualities and operate in a similar manner as private-sector businesses. The activities of the discretely presented component units are classified as enterprise activities.

Notes to the Financial Statements

The notes to the financial statements in this publication provide additional information that is essential for a full understanding of the data provided in the government-wide and fund financial statements. The notes to the financial statements, which describe particular accounts in more detail, are located immediately following the discretely presented component units' financial statements.

Required Supplementary Information

A section of required supplementary information follows the notes to the basic financial statements in this publication. This section includes a schedule of funding progress for certain pension and other postemployment benefit trust funds, information on infrastructure assets based on the modified approach, a budgetary comparison schedule, and a reconciliation of the budgetary basis and the GAAP basis fund balances for the major governmental funds presented in the governmental fund financial statements.

Combining Financial Statements and Schedules

The Combining Financial Statements and Schedules – Nonmajor and Other Funds section presents combining statements that provide separate financial statements for nonmajor governmental funds, nonmajor proprietary funds, fiduciary funds, and nonmajor component units. The basic financial statements present only summary information for these activities.

Government-wide Financial Analysis

Net Position

The primary government's combined net deficit position (governmental and business-type activities) decreased by 70.9%, from $14.0 billion as restated at June 30, 2012, to $4.1 billion a year later.

The primary government's $86.6 billion investment in capital assets, such as land, buildings, equipment, and infrastructure (roads, bridges, and other immovable assets) comprise a significant portion of its net position. This amount of capital assets is net of any outstanding debt used to acquire those assets. The State uses capital assets when providing services to citizens; consequently, these assets are not available for future spending. Although the State's investment in capital assets is reported net of related debt, the resources needed to repay this debt must come from other sources because the State cannot use the capital assets themselves to pay off the liabilities.

Another $29.5 billion of the primary government's net position represents resources that are externally restricted as to how they may be used, such as resources pledged to debt service. Internally imposed earmarking of resources is not presented in this publication as restricted net position. As of June 30, 2013, governmental activities reported an unrestricted net deficit of $117.4 billion and business type activities showed an unrestricted net deficit of $2.8 billion.

A large portion of the unrestricted net deficit of governmental activities consists of $59.1 billion in outstanding bonded debt issued to build capital assets for school districts and other local governmental entities. Because the State does not own these capital assets, neither the assets nor the related bonded debt is included in the portion of net position reported as "net investment in capital assets." Instead, the bonded debt is reported as a non-current liability that reduces the State's unrestricted net deficit. Readers can expect to see a continued deficit in the unrestricted section of net position of governmental activities as long as the State has significant outstanding obligations for school districts and other local governmental entities.

Table 1 presents condensed financial information derived from the Statement of Net Position for the primary government.

Table 1

Net Position – Primary Government
June 30, 2012 and 2013
(amounts in millions)

	Governmental Activities		Business-type Activities		Total	
	2013	**2012**	**2013**	**2012**	**2013**	**2012**
ASSETS						
Current and other assets	$ 55,358	$ 52,262	$ 34,996	$ 35,025	$ 90,354	$ 87,287
Capital assets	108,668	104,757	9,959	8,871	118,627	113,628
Total assets	**164,026**	**157,019**	**44,955**	**43,896**	**208,981**	**200,915**
DEFERRED OUTFLOWS OF RESOURCES	**911**	**963**	**480**	**363**	**1,391**	**1,326**
Total assets and deferred outflows of resources	**$164,937**	**$157,982**	**$ 45,435**	**$44,259**	**$210,372**	**$202,241**
LIABILITIES						
Noncurrent liabilities	$ 128,052	$ 126,896	$ 36,282	$ 36,812	$ 164,334	$ 163,708
Other liabilities	44,863	47,587	4,616	4,763	49,479	52,350
Total liabilities	**172,915**	**174,483**	**40,898**	**41,575**	**213,813**	**216,058**
DEFERRED INFLOWS OF RESOURCES	**159**	**147**	**471**	**—**	**630**	**147**
Total liabilities and deferred inflows of resources	**173,074**	**174,630**	**41,369**	**41,575**	**214,443**	**216,205**
NET POSITION						
Net investment in capital assets	84,931	80,769	1,719	1,561	86,650	82,330
Restricted	24,316	24,872	5,172	4,593	29,488	29,465
Unrestricted	(117,384)	(122,289)	(2,825)	(3,470)	(120,209)	(125,759)
Total net position (deficit)	**(8,137)**	**(16,648)**	**4,066**	**2,684**	**(4,071)**	**(13,964)**
Total liabilities, deferred inflows of resources, and net position	**$ 164,937**	**$ 157,982**	**$ 45,435**	**$ 44,259**	**$ 210,372**	**$ 202,241**

Changes in Net Position

The expenses of the primary government totaled $224.9 billion for the year ended June 30, 2013. Of this amount, $115.5 billion (51.4%) was funded with program revenues (charges for services or program-specific grants and contributions), leaving $109.4 billion to be funded with general revenues (mainly taxes). The primary government's general revenues of $119.3 billion were more than the residual expenses. As a result, the total net deficit position decreased by $9.9 billion, or 70.9%.

Table 2 presents condensed financial information derived from the Statement of Activities for the primary government.

Table 2

Changes in Net Position – Primary Government
Years ended June 30, 2012 and 2013
(amounts in millions)

	Governmental Activities		Business-type Activities		Total	
	2013	**2012**	**2013**	**2012**	**2013**	**2012**
REVENUES						
Program Revenues:						
Charges for services	$ 23,102	$ 19,813	$28,379	$ 31,981	$ 51,481	$ 51,794
Operating grants and contributions	60,944	58,577	1,323	1,250	62,267	59,827
Capital grants and contributions	1,669	2,193	142	—	1,811	2,193
General Revenues:						
Taxes	118,645	104,256	—	—	118,645	104,256
Investment and interest	57	72	—	—	57	72
Miscellaneous	552	372	—	—	552	372
Total revenues	**204,969**	**185,283**	**29,844**	**33,231**	**234,813**	**218,514**
EXPENSES						
Program Expenses:						
General government	15,390	12,607	—	—	15,390	12,607
Education	50,586	51,288	—	—	50,586	51,288
Health and human services	94,070	89,940	—	—	94,070	89,940
Resources	5,671	5,951	—	—	5,671	5,951
State and consumer services	1,475	1,241	—	—	1,475	1,241
Business and transportation	12,836	13,720	—	—	12,836	13,720
Correctional programs	10,082	10,344	—	—	10,082	10,344
Interest on long-term debt	4,350	4,560	—	64	4,350	4,624
Electric Power	—	—	488	915	488	915
Water Resources	—	—	1,127	1,048	1,127	1,048
Public Buildings Construction	—	—	410	404	410	404
State Lottery	—	—	4,499	4,432	4,499	4,432
Unemployment Programs	—	—	17,599	21,112	17,599	21,112
California State University System	—	—	6,197	6,114	6,197	6,114
Nonmajor enterprise	—	—	140	184	140	184
Total expenses	**194,460**	**189,651**	**30,460**	**34,273**	**224,920**	**223,924**
Excess (deficiency) before transfers	**10,509**	**(4,368)**	**(616)**	**(1,042)**	**9,893**	**(5,410)**
Transfers	(1,998)	(2,031)	1,998	2,031	—	—
Change in net position	**8,511**	**(6,399)**	**1,382**	**989**	**9,893**	**(5,410)**
Net position, beginning (restated)	**(16,648)**	**(10,249)**	**2,684**	**1,695**	**(13,964)**	**(8,554)**
Net position (deficits), ending	**$ (8,137)**	**$ (16,648)**	**$ 4,066**	**$ 2,684**	**$ (4,071)**	**$ (13,964)**

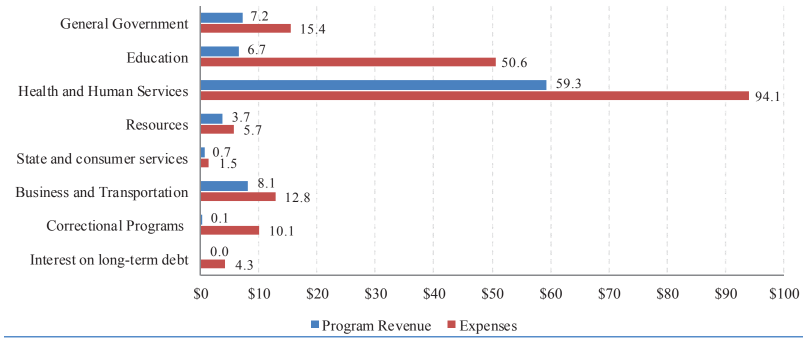
Governmental Activities

Governmental activities' expenses and transfers totaled $196.5 billion. Program revenues totaling $85.7 billion, including $62.6 billion received in federal grants, funded 43.6% of expenses and transfers, leaving $110.8 billion to be funded with general revenues (mainly taxes). General revenues for governmental activities totaled $119.3 billion and the governmental activities' total net deficit position decrease of $16.6 billion at the end of fiscal year 2011-12 to $8.1 billion for the year ended June 30, 2013, a decrease of $8.5 billion (51.1%).

Chart 1 presents a comparison of governmental activities' expenses by program, with related revenues.

Chart 1

Expenses and Program Revenues – Governmental Activities
Year ended June 30, 2013
(amounts in billions)



For the year ended June 30, 2013, total state tax revenues collected for governmental activities increased by $14.4 billion (14.6%) over the prior year. Personal income taxes increased by $13.1 billion (24.2%) as a result of improving California employment rates; the passage of Proposition 30, which increased personal income tax on earnings above $250,000 and increased capital gains taxes from a surging stock market; and increasing home prices. The state sales and use tax collection increased by $2.6 billion (8.4%) due to the 0.25% increase in the sales tax resulting from the passage of Proposition 30, increased consumer spending, increased consumer confidence in the improving economy, and a reduction in the unemployment rate which resulted in more disposable income for California households. However, corporate taxes decreased by $1.3 billion (15.5%).

Overall expenses for governmental activities increased by $4.8 billion (2.5%) from the prior year. The largest increase of expenditures, $4.1 billion (4.6%), was attributable to health and human services, the majority of which is attributable to the Department of Health Care Services, which includes Medi-Cal services. The 2012-13 fiscal year budget proposed an increase of $9.3 billion over the 2011-12 Budget for Medi-Cal services. The growth in spending for the Department of Health Care Services was due to an increased caseload, the increased utilization of services, and the rising costs of those services. General government expenditures increased by $2.8 billion (22.1%), the largest portion of which was attributable to Local Government financing.

Charts 2 and 3 present the percentage of total expenses for each governmental activities program and the percentage of total revenues by source.

Chart 2

Expenses by Program
Year ended June 30, 2013
(as a percent)

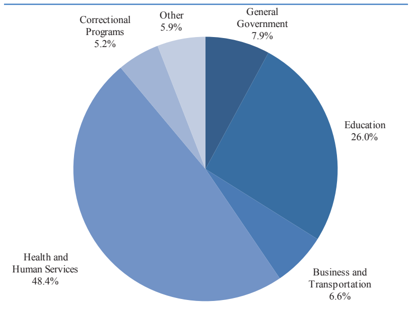
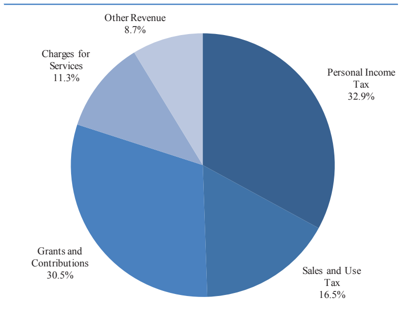


Chart 3

Revenues by Source
Year ended June 30, 2013
(as a percent)



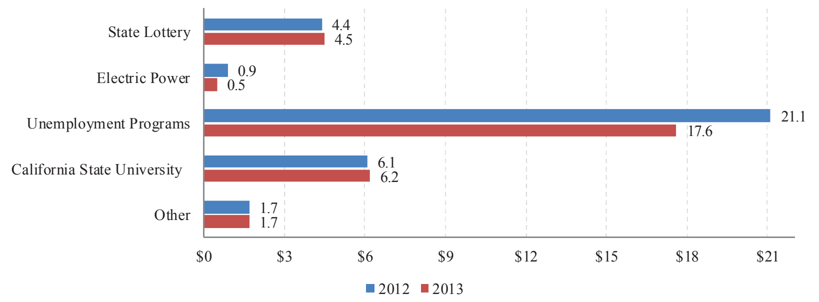
Business-type Activities

Business-type activities expenses totaled $30.5 billion. Program revenues of $29.9 billion, primarily generated from charges for services, and $2.0 billion in transfers were sufficient to cover these expenses. Consequently, business-type activities' total net position increased by $1.4 billion, or 51.5%, during the year ended June 30, 2013.

Chart 4 presents a two-year comparison of the expenses of the State's business-type activities.

Chart 4

Expenses – Business-type Activities – Two-year Comparison
Years ended June 30, 2012 and 2013
(amounts in billions)



Fund Financial Analysis

The State's governmental funds had an $8.0 billion increase in fund balance over the prior year's restated ending fund balance. Some proprietary funds' net position increased, as their revenues exceeded expenses for the fiscal year 2012-13. The Unemployment Programs Fund incurred the largest decrease in net deficit position of $999 million.

Governmental Funds

The governmental funds' Balance Sheet reported $64.2 billion in assets, $51.9 billion in liabilities and deferred inflows of resources, and $12.2 billion in fund balance as of June 30, 2013. Total assets of governmental funds decreased by 1.7%, while total liabilities decreased by 18.6%, primarily resulting in a total fund balance increase of 8.0 billion (190.4%) over the prior fiscal year. This is the result of decrease in liabilities of governmental fund by $11.4 billion. In prior years, the General Fund had to rely heavily on internal borrowing from the State's other funds to meet its payment obligations. However, by June 30, 2013, long-term borrowing had decreased by $4.1 billion to $6.5 billion.

Within the governmental funds' total fund balance, $155 million is classified as nonspendable because this amount consists of long-term interfund receivables and loans receivable, or due to legal or contractual requirements. Additionally, $24.3 billion is classified as restricted for specific programs by external constraints such as debt covenants and contractual obligations, or by constitutional provisions or enabling legislation. Furthermore, of the total fund balance, $2.3 billion is classified as committed for specific purposes and $209 million is classified as assigned for specific purposes. The unassigned balance of the governmental funds is a negative $14.8 billion.

The Statement of Revenues, Expenditures, and Changes in Fund Balances of the governmental funds reports $204.9 billion in revenues, $202.1 billion in expenditures, and a net $5.2 billion in receipts from other financing sources. The ending fund balance of the governmental funds for the year ended June 30, 2013, was $12.2 billion, a $8.0 billion increase over the prior year's restated ending fund balance of $4.2 billion. The reason for the change in the fund balance was a net decrease in liabilities from the prior year.

Personal income taxes, which account for 56.9% of tax revenues and 32.9% of total governmental fund revenues, increased by $13.0 billion from the prior fiscal year. Sales and use taxes, which account for 28.6% of tax revenues and 16.5% of total governmental fund revenues, increased by $2.7 billion over the prior fiscal year. Corporation taxes, which account for 6.1% of tax revenues and 3.5% of total governmental fund revenues, decreased by $1.3 billion from the prior fiscal year. Governmental fund expenditures increased by $6.5 billion over the prior fiscal year. General obligation bonds and commercial paper of $4.0 billion were issued during the 2012-13 fiscal year; however, this was $127 million less than the amount issued in the prior fiscal year.

The State's major governmental funds are the General Fund, the Federal Fund, the Transportation Fund, and the Environmental and Natural Resources Fund. The General Fund ended the fiscal year with a fund deficit of $14.3 billion. The Federal Fund, the Transportation Fund, and the Environmental and Natural Resources Fund ended the fiscal year with fund balances of $198 million, $7.2 billion, and $7.8 billion, respectively. The nonmajor governmental funds ended the year with a total fund balance of $11.3 billion.

General Fund: As shown on the Balance Sheet, the General Fund (the State's main operating fund) ended the fiscal year with assets and deferred outflows of resources of $15.6 billion; liabilities and deferred inflows of resources of $29.9 billion; and nonspendable, restricted, and committed fund balances of $140 million, $179 million, and $23 million, respectively, leaving the General Fund with a negative unassigned fund balance of $14.6 billion. Total assets and deferred outflows of resources of the General Fund increased by $1.3 billion (8.9%) over the prior fiscal year while the total liabilities and deferred inflows of resources of the General Fund decreased by $7.4 billion (19.9%). Total fund deficit decreased by $8.7 billion (37.9%).

As shown on the Statement of Revenues, Expenditures, and Changes in Fund Balances of the governmental funds, the General Fund had an excess of revenues over expenditures of $9.3 billion ($99.4 billion in revenues and $90.1 billion in expenditures). Approximately 94.5% of General Fund revenue ($93.9 billion) is derived from the State's largest three taxes – personal income taxes ($66.2 billion), sales and use taxes ($20.4 billion), and corporation taxes ($7.3 billion). A total of $175 million in revenue is included in the General Fund in compliance with GASB, Statement 54. These revenues are not considered General Fund revenues for any budgetary purposes or for the Budgetary/Legal Basis Annual Report. Most of these revenues ($170 million) are from unemployment programs.

During the 2012-13 fiscal year, total General Fund revenue increased by $12.8 billion (14.8%). This is primarily a result of the net increase in personal income taxes of $12.6 billion (23.6%). Revenue from sales and use taxes also increased by $1.8 billion (9.7%) However, corporation taxes decreased by $1.3 billion (15.7%).

General Fund expenditures increased by $1.8 billion (2.1%). The largest increase was in general government program expenditures which were up $1.6 billion over the prior year. The General Fund's ending fund balance for the year ended June 30, 2013 was a negative $14.3 billion, a decrease of $8.4 billion from the prior year's restated ending fund deficit of $22.7 billion.

Federal Fund: This fund reports federal grant revenues and related expenditures to support the grant programs. The largest of these programs is health and human services, which accounted for $49.7 billion (80.4%) of the total $61.8 billion in fund expenditures. The Medical Assistance program and the Temporary Assistance for Needy Families program are included in this program area. Education programs also constituted a large part of the Federal Fund expenditures amounting to $6.6 billion (10.7%). The Federal Fund's revenues increased by $1.8 billion, which was approximately the same amount of increase in combined expenditures and transfers, resulting in a $37 million fund balance increase from the prior year's ending fund balance of $161 million.

Transportation Fund: This fund accounts for fuel taxes, bond proceeds, and other revenues used primarily for highway and passenger rail construction. The Transportation Fund's revenues increased by 0.6% and expenditures increased by 3.2%. Other financing sources provided net receipts of $2.0 billion. The Transportation Fund ended the fiscal year with a $7.2 billion fund balance, an increase of $504 million over the prior year.

Environmental and Natural Resources Fund: This fund accounts for fees, bond proceeds, and other revenues that are used for maintaining the State's natural resources and improving the environmental quality of its air, land, and water. Other financing sources provided net receipts of $440 million. The Environmental and Natural Resources Fund ended the fiscal year with a $7.8 billion fund balance, a decrease of $148 million (1.9%) from the prior year.

Proprietary Funds

Enterprise Funds: The total net position of the enterprise funds at June 30, 2013, was $4.1 billion—$1.4 billion greater than the prior year's restated ending net position of $2.7 billion. Some enterprise funds recorded an increase in net position during the 2012 13 fiscal year. The Unemployment Programs Fund had a decrease in its net deficit position of $999 million. The net position increased in Nonmajor Enterprise Funds ($203 million) and the Public Buildings Construction Fund ($198 million).

As shown on the Statement of Net Position of the proprietary funds, the total assets and deferred outflows of resources of the enterprise funds were $45.9 billion as of June 30, 2013. Of this amount, current assets totaled $14.1 billion, noncurrent assets totaled $31.3 billion and deferred outflows of resources totaled $480 million. The largest changes in asset account balances were a $1.6 billion increase in cash and pooled investments and a $834 million decrease in interfund receivables. The total liabilities and deferred inflows of resources of the enterprise funds were $41.9 billion. The largest liabilities of the enterprise funds are $24.1 billion of revenue bonds payable and $8.6 billion of noncurrent loans payable. During the 2012-13 fiscal year, the State continued to obtain loans from the U.S Department of Labor to cover deficits in the Unemployment Programs Fund. The balance due on these loans as of June 30, 2013, was $8.6 billion.

Total net position consisted of four segments: a nonexpendable restricted net position of $21 million, a restricted expendable net position of $5.2 billion, net investment in capital assets of $1.7 billion, and an unrestricted net deficit of $2.8 billion.

As shown on the Statement of Revenues, Expenses, and Changes in Fund Net Position of the proprietary funds, the enterprise funds ended the year with operating revenues of $27.4 billion, operating expenses of $27.8 billion, and net expenses from other transactions of $311 million. The largest sources of operating revenue were unemployment and disability insurance receipts of $18.6 billion in the Unemployment Programs Fund and lottery ticket sales of $4.4 billion collected by the State Lottery Fund. The unemployment and disability insurance receipts in the Unemployment Programs Fund decreased by $3.4 billion from $21.9 billion in fiscal year 2011-12. These receipts came primarily from the federal government unemployment account to pay unemployment and disability benefits. The largest operating expenses were distributions to beneficiaries of $17.3 billion by the Unemployment Programs Fund and personal services of $3.8 billion by the California State University Fund.

Internal Service Funds: The total net position of the internal service funds was $252 million as of June 30, 2013. The net position consists of two segments: net investment in capital assets of $127 million and unrestricted net position of $125 million.

Fiduciary Funds

The State of California has four types of fiduciary funds: private purpose trust funds, pension and other employee benefit trust funds, investment trust funds, and agency funds. The private purpose trust funds ended the fiscal year with net position of $5.2 billion. The pension and other employee benefit trust funds ended the fiscal year with net position of $443.2 billion. The State's only investment trust fund, the Local Agency Investment Fund, ended the fiscal year with net position of $21.2 billion. Agency funds act as clearing accounts and thus do not have a net position.

For the year ended June 30, 2013, the fiduciary funds' combined net position was $469.5 billion, a $41.7 billion increase from the prior-year net position. The net position increased primarily because contributions received and investment income in pension and other employee benefit trust funds exceeded payments made to participants.

The Economy for the Year Ending June 30, 2013

The U.S. economy completed its fourth year of recovery as California ended its fiscal year on June 30, 2013. National growth was slow, with real gross domestic product (GDP) up a modest 1.6%. Despite limited support from the rest of the country, a rebound in California's housing market, tourism, and other key sectors allowed the State to post a solid gain for the year.

California's total personal income reached $1.79 trillion in fiscal year 2012-13, accounting for more than one out of every eight dollars earned nationally. The state registered a 4.5% income rise during the year, beating the 3.5% rise in the nation as a whole.

Housing staged a sharp recovery, with a 33.5% surge in the median price of a single-family existing home over the 12 months ended June 2013. For the 2012-13 fiscal year, housing permits totaled 69,401 units, a 41.5% increase over the 49,041 permits issued in the prior year. Pent-up demand was evident in other areas as well. Auto sales, for example, increased sharply with registrations climbing 12.5% to 850,712 for the year in total.

California's job market improved significantly, with nonfarm employment in June 2013 220,000, or 1.5%, above the level of the prior year. Job gains were widespread, with particularly large numerical and percentage increases in construction, leisure and hospitality, business and professional services, education, and health care and social assistance. The public sector and manufacturing were the primary areas showing job losses. The general improvement in the labor market was strong enough to push the unemployment rate down more than two full percentage points, from 10.6% in June 2012 to 8.5% as of June 2013.

California ended its fiscal year on June 30, 2013, with solid economic progress. While more growth is needed to drive the jobless rate lower and improve incomes for all, substantial gains are being achieved.

General Fund Budget Highlights

The original General Fund budget of $97.6 billion was reduced by $720 million. This decrease is mainly the result of reductions in funding to education programs per Section 12.42 of the 2012 Budget Act, as well as other reductions in education and State and consumer services, and the increases in health and human services and other general government expenditures. The Judicial Branch absorbed $344 million of the increase in other general government expenditures. During the 2012-13 fiscal year, General Fund actual budgetary basis expenditures were $95.9 billion, $1.0 billion less than the final budgeted amounts.

Table 3 presents a summary of the General Fund original and final budgets.

Table 3

General Fund Original and Final Budgets
Year ended June 30, 2013
(amounts in millions)

	Original	Final	Increase/ (Decrease)
Budgeted amounts			
State and consumer services	$ 1,335	$ 682	$ (653)
Business and transportation	90	90	—
Resources	941	1,177	236
Health and human services	26,658	27,395	737
Correctional programs	8,821	8,700	(121)
Education	50,128	48,788	(1,340)
General government:			—
Tax relief	439	439	—
Debt service	4,436	4,439	3
Other general government	4,786	5,204	418
Total	**$ 97,634**	**$ 96,914**	**$ (720)**

Capital Assets and Debt Administration

Capital Assets

The State's investment in capital assets for its governmental and business-type activities as of June 30, 2013, amounted to $118.6 billion (net of accumulated depreciation). This investment in capital assets includes land, state highway infrastructure, collections, buildings and other depreciable property, and construction in progress. Depreciable property includes buildings, improvements other than buildings, equipment, personal property, intangible assets, certain infrastructure assets, certain books, and other capitalized and depreciable property. Infrastructure assets, such as roads and bridges, are items that normally are immovable and can be preserved for a greater number of years than can most capital assets.

Table 4 presents a summary of the primary government's capital assets for governmental and business-type activities.

Table 4

Capital Assets
Year ended June 30, 2013
(amounts in millions)

	Governmental Activities	Business-type Activities	Total
Land	$ 17,602	$ 217	$ 17,819
State highway infrastructure	64,620	—	64,620
Collections – nondepreciable	23	6	29
Buildings and other depreciable property	25,614	11,264	36,878
Intangible assets – amortizable	986	174	1,160
Less: accumulated depreciation/amortization	(11,166)	(4,693)	(15,859)
Construction in progress	9,905	2,587	12,492
Intangible assets – nonamortizable	1,084	404	1,488
Total	**$ 108,668**	**$ 9,959**	**$ 118,627**

As of June 30, 2013, the State had $118.6 billion in net capital assets, of which $64.6 billion was state highway infrastructure. This total represents an increase of $2.1 billion in infrastructure capital assets from fiscal year 2011-12.

Note 7, Capital Assets, includes additional information on the State's capital assets.

Modified Approach for Infrastructure Assets

The State uses the modified approach to report the cost of its infrastructure assets (state roadways and bridges). Under the modified approach, the State does not report depreciation expense for its roads and bridges but capitalizes all costs that add to their capacity and efficiency. All maintenance and preservation costs are expensed and not capitalized. Under the modified approach, the State maintains an asset management system to demonstrate that the infrastructure is preserved at or above established condition levels. During the 2012-13 fiscal year, the actual amount spent on preservation was 23.5% of the estimated budgeted amount needed to maintain the infrastructure assets at the established condition levels. Although the amount spent fell short of the budgeted amount, the assessed conditions of the State's bridges and roadways are better than the established condition baselines. The State is responsible for maintaining 49,718 lane miles and 13,071 bridges.

The Required Supplementary Information includes additional information on how the State uses the modified approach for infrastructure assets; it also presents the established condition standards, condition assessments, and preservation costs.

Debt Administration

At June 30, 2013, the primary government had total bonded debt outstanding of $116.5 billion. Of this amount, $83.2 billion (71.4%) represents general obligation bonds, which are backed by the full faith and credit of the State. Included in the $83.2 billion of general obligation bonds is $5.2 billion of Economic Recovery bonds that are secured by a pledge of revenues derived from dedicated sales and use taxes. The current portion of general obligation bonds outstanding is $3.1 billion and the long-term portion is $80.1 billion. The remaining $33.3 billion (28.6%) of bonded debt outstanding represents revenue bonds, which are secured solely by specified revenue sources. The current portion of revenue bonds outstanding is $1.6 billion and the long-term portion is $31.7 billion.

Table 5 presents a summary of the primary government's long-term obligations for governmental and business-type activities.

Table 5

Long-term Obligations
Year ended June 30, 2013
(amounts in millions)

	Governmental Activities	Business-type Activities	Total
Government-wide noncurrent liabilities			
General obligation bonds	$ 79,306	$ 826	$ 80,132
Revenue bonds	7,581	24,079	31,660
Certificates of participation and commercial paper	530	77	607
Capital lease obligations	4,920	847	5,767
Net other postemployment benefits obligation	15,559	510	16,069
Proposition 98 funding guarantee	1,914	—	1,914
Mandated costs	6,697	—	6,697
Loans payable	—	8,585	8,585
Other noncurrent liabilities	11,545	1,358	12,903
Total noncurrent liabilities	128,052	36,282	164,334
Current portion of long-term obligations	4,182	2,244	6,426
Total long-term obligations	**$ 132,234**	**$ 38,526**	**$ 170,760**

During the year ended June 30, 2013, the primary government's total long-term obligations increased by $1.8 billion over the prior year's restated balance. Governmental activities net other postemployment benefits obligation had the largest increase ($3.1 billion), but other notable increases occurred in general obligation bonds payable, commercial paper payable, mandated costs, and capital lease obligations. The largest decrease was in loans payable ($3.5 billion). During the fiscal year, the State issued $3.3 billion in new general obligation bonds for public education facilities, transportation projects, housing and emergency shelters, various water and flood control projects, and to refund outstanding general obligation bonds and commercial paper. The net other postemployment benefits obligation increased because the State does not fully fund the annual cost of these benefits.

Note 10, Long-term Obligations, and Notes 11 through 17 include additional information on the State's long-term obligations.

In January 2013, Standard and Poor's raised its rating on the State's general obligation bond to "A" from "A-" citing the State's improved fiscal condition and cash position, and the State's projections of a structurally balanced budget through the next several years. During the fiscal year 2012-13, the ratings from the other two credit rating agencies remained unchanged as follows: Moody's Investors Service – "A1" and Fitch – "A-".

Recent Economic Condition and Future Budgets

Recent Economic Condition

California's economy continued to grow during the first six months of fiscal year 2013-14, which began on July 1, 2013. Employment expanded, the jobless rate fell, incomes grew, and the housing market strengthened. An improving economy also bolstered the State's financial position, with strong gains in the State's principal revenue sources.

During the first six months of fiscal year 2013-14, California added 153,000 to nonfarm payrolls. Compared with the prior year, nonfarm employment as of December 2013 was up by 236,000 jobs. The year-over-year 1.6% increase matched the gain recorded nationally.

California's jobless rate fell to a seasonally adjusted 8.3% in December 2013. This represented a 1.5 percentage point drop from the 9.8% recorded at the end of the prior year.

All major industry groups in the private sector added jobs in 2013. Construction hiring produced 29,000 new jobs in 2013, representing a gain of 4.8%. In contrast to the job gains in the private sector over the year, government payrolls contracted by 18,000, or 0.8%. Job losses occurred at the federal, state, and local level.

Total personal income in the State reached an annualized rate of $1.82 trillion in the third quarter of calendar year 2013, representing a gain of 3.4% over the prior year. Total wages and salaries advanced by 3.8%, while nonfarm proprietors' incomes jumped by 6.9%.

The housing market continued to strengthen in the July through December period of 2013. The supply of foreclosures and "short" sales (sales of homes at prices below the value of the mortgage) was at the lowest level since before the financial crisis of 2008. The median price of an existing single-family home reached $438,000 in California at the end of 2013, a gain of nearly 20% over the prior year's levels.

California's state coffers benefited from the economic gains as well as tax increases approved by voters in November 2012. Total General Fund revenues reached $42 billion in the first six months of fiscal year 2013-14. This represented a gain of $3.9 billion, or 10% over the first six months of the prior fiscal year. Personal income, sales taxes, and corporate revenues all contributed to the gain.

Risks, including higher interest rates, swings in stock prices, international instability, and the implications of California's drought persist; however, advances in technology, foreign trade, construction activity, and tourism bode well for the state's continued economic expansion.

California's 2013-14 Budget

California's 2013-14 Budget Act was enacted on June 27, 2013. The Budget Act appropriated $145.3 billion: $96.3 billion from the General Fund, $42.0 billion from special funds, and $7.0 billion from bond funds. The General Funds' budgeted expenditures increased $620 million (0.6%) over last year's General Fund budget. The General Fund's available resources were projected to be $97.1 billion, resulting in a projected reserve for economic uncertainties of $1.1 billion. General Fund revenues come predominantly from taxes, with personal income taxes expected to provide 62.6% of total revenue. California's major taxes (personal income, sales and use, and corporation taxes) are projected to supply approximately 95.1% of the General Fund's resources in the 2013-14 fiscal year.

Two years of significant reductions in state spending, combined with the first year of a temporary seven-year income tax increase and four-year sales tax increase, resulted in the State's most fiscally sound financial condition in over a decade. For the first time since fiscal year 2007-08, the State ended the prior fiscal year with a positive General Fund reserve balance, approximately $254 million, and is projected to end the 2013-14 fiscal year with a reserve balance of $1.1 billion. Two significant aspects of the 2013-14 fiscal year budget are the substantial allocation of General Fund money to education, $50.6 billion (52.5%), and Health and Human Services, $28.1 billion (29.2%).

The Budget increased K-12 funding levels, boosting spending per student by $1,045 in 2013-14 and by $2,835 through 2016-17. Also included was a one-time allocation of $1.25 billion for implementation of the Common Core State Standards in K-12 schools. The 2013 Budget addressed previous cuts to higher education by increasing funding between $1,649 and $2,491 per student through 2016-17.

The spending plan for fiscal year 2013-14 includes $20.7 billion of General Fund money for health programs. This $1.2 billion increase over 2012-13 primarily addresses implementation of the Patient Protection and Affordable Care Act (ACA), as well as increases in caseload and the need for health services. The State of California elected to expand Medi-Cal eligibility to include over one million adults with incomes up to 133% of the federal poverty level. Federal funds totaling $1.7 billion will also be directed to providing health coverage to the expanded Medi-Cal population.

Another significant area of General Fund expenditures is the State's Judiciary and Criminal Justice programs. The General Fund provided $9.2 billion for Corrections and Rehabilitation and $1.2 billion for the Judicial Branch. The Budget also reflects increased employee compensation costs. An increase of $600 million from prior year mirrors increased costs associated with the end of state employee furloughs in June 2013. New bargaining agreements reached in fiscal year 2013-14 resulted in salary increases for much of the State's workforce, and rising health care costs have necessitated the need for the State to pay increased premiums for 14 of the state's 21 bargaining units, as well as the State's managerial and supervisorial employees.

The fiscal year 2013-14 Budget is part of a multiyear plan that is balanced and maintains a reserve. Since the passage of this Budget Act, state revenues have exceeded estimates used in preparing the Budget. As of December 1, 2013, revenues were $270 million more than projected. At the same time, disbursements were $126 million below forecast. The State's budget picture, in terms of the difference between receipts and disbursements, was at least $396 million better than expected.

California's 2014-15 Budget

The Governor released his proposed 2014-15 Budget on January 10, 2014. The proposed budget continues Governor Brown's multi-year financial plan for the State of California that is balanced, maintains a $1.0 million reserve, contributes to the Budget Stabilization Account, and pays down budgetary debt from past years. For the second consecutive year, the General Fund will begin the fiscal year with a surplus rather than a deficit. The General Fund began with a surplus balance of $2.5 billion at the beginning of fiscal year 2013-14; it is projected to begin fiscal year 2014-15 with a surplus of approximately $4.2 billion. The 2014-15 Budget directs $1.6 billion to the Budget Stabilization Account, to prepare for the State's next budget shortfall, as mandated by Proposition 58, the California Balanced Budget Act, which was approved by voters in 2004. The 2014-15 Budget also honors the California Balanced Budget Act by directing $1.6 billion to retire the remaining Economic Recovery Bonds that were approved by voters in 2004 and removing that debt obligation. The improving economy will allow California to adhere to the mandates of Proposition 58 and still provide a surplus for the State's General Fund going into the 2015-16 fiscal year.

The 2014-15 Governor's Budget projects that General Fund revenues and transfers will be $104.5 billion and expenditures will be approximately $106.8 billion, with an estimated $1.9 billion year-end balance. Proposed 2014-15 General Fund revenues and transfers are 4.4% more than the revised 2013-14 estimate of $100.1 billion, while the 2014-15 expenditures are 8.5% greater than the revised 2013-14 estimate of $98.5 billion.

Personal Income Tax, which is projected to increase by $5.5 billion (8.5%) compared to the prior year, represents the major component of the $5.9 billion General Fund revenue increase. Projected increases in Sales and Use Tax of $1.2 billion (5.0%) and Corporation Tax of $0.7 billion (8.9%) also contribute to the 5.9% increase in General Fund Revenue projections. Reflecting the Governor's intent to reinvest in education, the fiscal year 2014-15 budget expenditures of $106.8 billion include $45.2 billion (42.4%) for K-12 funding and $12.4 billion (11.6%) for higher education programs. The increased funding of education is attributable to the passage, in November 2012, of the Governor's initiative, Proposition 30, Temporary Taxes to Fund Education. The funding level for K-12 students is estimated to increase by more than $2,188 per student in 2014-15 over 2011-12 levels. Increased funding for higher education is intended to provide stable funding growth over multiple years and eliminate the need for further tuition increases in both the University of California and the California State University systems. Medi-Cal, the budget's second largest program, is projected to increase spending 4.1% from $16.2 billion in 2013-14 to $16.9 billion in 2014-15. Growth in Medi-Cal General Fund expenditures has been reduced through the use of other funding sources, including the Gross Premiums Tax (authorized from 2009-10 to 2012-13), the Managed Care Organization Tax (authorized in 2013-14), the Hospital Quality Assurance Fee (first authorized in 2011-12), and Medicaid waivers that allow claiming of federal funds for state-only health care costs. In addition, the Medi-Cal program was expanded in two ways. The mandatory expansion simplified eligibility, enrollment, and retention rules, making it easier to get on and stay on the program. The optional expansion extended eligibility to adults without children and parent and caretaker relatives with incomes up to 138% of the federal poverty level.

According to the Legislative Analyst's Office (LAO), California's nonpartisan fiscal and policy advisor, the State's budgetary condition is currently stronger than at any point in the past decade. The State's structural deficit has been corrected, with projected revenues greater than current spending commitments. Economic growth in future years is forecasted to continue. However, the LAO has stated that although the Governor's fiscal year 2014-15 budget projects a large surplus, the State's continued fiscal recovery is dependent on a number of assumptions, leaving open the possibility of an economic downturn and a return to operating deficits.

Requests for Information

The State Controller's Office designed this financial report to provide interested parties with a general overview of the State of California's finances. Address questions concerning the information provided in this report or requests for additional information to the State Controller's Office, Division of Accounting and Reporting, P.O. Box 942850, Sacramento, California 94250-5872. This report is also available on the Controller's Office website at www.sco.ca.gov.

This page intentionally left blank.

This page intentionally left blank.

Basic Financial Statements

This page intentionally left blank.

Government-wide Financial Statements

Statement of Net Position

June 30, 2013

(amounts in thousands)

	Primary Government			
	Governmental Activities	**Business-type Activities**	**Total**	**Component Units**
ASSETS				
Current assets:				
Cash and pooled investments	$ 20,761,086	$ 5,368,975	$ 26,130,061	$ 2,068,054
Amount on deposit with U.S. Treasury	—	39,963	39,963	—
Investments	645,053	2,235,832	2,880,885	5,821,945
Restricted assets:				
Cash and pooled investments	—	3,199,349	3,199,349	90,659
Investments	—	—	—	11,636
Due from other governments	—	20,448	20,448	—
Net investment in direct financing leases	—	474,005	474,005	—
Receivables (net)	14,660,902	1,938,215	16,599,117	3,943,566
Internal balances	(486,406)	486,406	—	—
Due from primary government	—	—	—	209,125
Due from other governments	13,562,020	362,014	13,924,034	438,815
Prepaid items	109,692	50,937	160,629	1,168
Inventories	84,910	17,975	102,885	185,991
Recoverable power costs (net)	—	111,000	111,000	—
Other current assets	201,636	14,000	215,636	279,558
Total current assets	49,538,893	14,319,119	63,858,012	13,050,517
Noncurrent assets:				
Restricted assets:				
Cash and pooled investments	—	1,041,986	1,041,986	34,218
Investments	—	406,401	406,401	14,498
Loans receivable	—	325,930	325,930	—
Investments	—	1,268,777	1,268,777	24,510,217
Net investment in direct financing leases	—	7,519,404	7,519,404	—
Receivables (net)	1,971,742	303,120	2,274,862	1,424,281
Loans receivable	3,832,981	3,765,274	7,598,255	4,936,915
Recoverable power costs (net)	—	5,083,000	5,083,000	—
Long-term prepaid charges	14,264	930,066	944,330	17,728
Capital assets:				
Land	17,602,055	216,888	17,818,943	970,706
State highway infrastructure	64,619,437	—	64,619,437	—
Collections – nondepreciable	22,645	6,051	28,696	362,373
Buildings and other depreciable property	25,613,649	11,264,411	36,878,060	41,343,421
Intangible assets – amortizable	986,184	174,045	1,160,229	674,542
Less: accumulated depreciation/amortization	(11,165,562)	(4,693,059)	(15,858,621)	(18,892,317)
Construction in progress	9,905,330	2,587,131	12,492,461	2,917,542
Intangible assets – nonamortizable	1,084,328	403,979	1,488,307	5,131
Other noncurrent assets	—	32,830	32,830	333,470
Total noncurrent assets	114,487,053	30,636,234	145,123,287	58,652,725
Total assets	**164,025,946**	**44,955,353**	**208,981,299**	**71,703,242**
DEFERRED OUTFLOWS OF RESOURCES	**911,178**	**480,308**	**1,391,486**	**177,546**
Total assets and deferred outflows of resources	**$ 164,937,124**	**$ 45,435,661**	**$ 210,372,785**	**$ 71,880,788**

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

	Primary Government			
	Governmental Activities	**Business-type Activities**	**Total**	**Component Units**
LIABILITIES				
Current liabilities:				
Accounts payable	$ 23,635,118	$ 557,290	$ 24,192,408	$ 2,442,417
Due to component units	209,125	—	209,125	—
Due to other governments	6,667,161	160,908	6,828,069	595
Revenues received in advance	1,417,508	292,745	1,710,253	1,057,211
Tax overpayments	5,780,193	—	5,780,193	—
Deposits	382,376	—	382,376	754,640
Contracts and notes payable	22	—	22	10,382
Unclaimed property liability	853,438	—	853,438	—
Interest payable	1,167,137	200,767	1,367,904	72,671
Securities lending obligations	—	—	—	1,468,772
Benefits payable	—	763,914	763,914	—
Current portion of long-term obligations	4,182,125	2,244,037	6,426,162	2,289,737
Other current liabilities	568,810	396,303	965,113	2,872,686
Total current liabilities	44,863,013	4,615,964	49,478,977	10,969,111
Noncurrent liabilities:				
Benefits payable	—	—	—	—
Loans payable	—	8,585,318	8,585,318	—
Lottery prizes and annuities	—	707,781	707,781	—
Compensated absences payable	4,115,601	189,208	4,304,809	249,007
Certificates of participation, commercial paper and other borrowings	530,499	77,220	607,719	63,170
Capital lease obligations	4,919,996	847,352	5,767,348	2,743,813
General obligation bonds payable	79,305,707	825,868	80,131,575	—
Revenue bonds payable	7,580,922	24,079,026	31,659,948	17,249,244
Net other postemployment benefits obligation	15,559,232	510,229	16,069,461	7,719,066
Pollution remediation obligation	973,957	15,107	989,064	66,523
Revenues received in advance	—	11,439	11,439	—
Other noncurrent liabilities	15,066,215	433,261	15,499,476	5,493,392
Total noncurrent liabilities	128,052,129	36,281,809	164,333,938	33,584,215
Total liabilities	**172,915,142**	**40,897,773**	**213,812,915**	**44,553,326**
DEFERRED INFLOWS OF RESOURCES	**158,942**	**471,436**	**630,378**	**34,056**
Total liabilities and deferred inflows of resources	**$ 173,074,084**	**$ 41,369,209**	**$ 214,443,293**	**$ 44,587,382**

(continued)

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

Statement of Net Position (continued)

June 30, 2013

(amounts in thousands)

	Primary Government			
	Governmental Activities	**Business-type Activities**	**Total**	**Component Units**
NET POSITION				
Net investment in capital assets	$ 84,931,030	$ 1,718,648	$ 86,649,678	$ 12,477,905
Restricted:				
Nonexpendable – endowments	—	20,627	20,627	4,784,010
Expendable:				
Endowments and gifts	—	—	—	8,156,534
Business and transportation	10,085,253	6,663	10,091,916	—
Resources	5,737,364	788,558	6,525,922	—
Health and human services	2,850,447	150,776	3,001,223	—
Education	917,534	68,520	986,054	1,723,537
General government	3,913,748	658,461	4,572,209	—
Unemployment programs	—	3,433,770	3,433,770	—
State and consumer services	808,465	31,011	839,476	—
Correctional programs	3,102	14,156	17,258	—
Indenture	—	—	—	347,318
Statute	—	—	—	1,348,884
Other purposes	—	—	—	21,814
Total expendable	24,315,913	5,151,915	29,467,828	11,598,087
Unrestricted	(117,383,903)	(2,824,738)	(120,208,641)	(1,566,596)
Total net position (deficit)	**(8,136,960)**	**4,066,452**	**(4,070,508)**	**27,293,406**
Total liabilities, deferred inflows of resources, and net position	**$ 164,937,124**	**$ 45,435,661**	**$ 210,372,785**	**$ 71,880,788**

(concluded)

This page intentionally left blank.

Statement of Activities

Year Ended June 30, 2013

(amounts in thousands)

		Program Revenues			Net (Expenses) Revenues and Changes in Net Position			
					Primary Government			
			Operating	Capital				
		Charges	Grants and	Grants and	Governmental	Business-type		Component
FUNCTIONS/PROGRAMS	**Expenses**	**for Services**	**Contributions**	**Contributions**	**Activities**	**Activities**	**Total**	**Units**
Primary government								
Governmental activities:								
General government	$ 15,390,100	$ 6,196,586	$ 1,026,673	$ —	$ (8,166,841)		$ (8,166,841)	
Education	50,586,387	64,480	6,587,898	—	(43,934,009)		(43,934,009)	
Health and human services	94,069,749	8,761,781	50,490,448	—	(34,817,520)		(34,817,520)	
Resources	5,670,922	3,269,315	387,861	—	(2,013,746)		(2,013,746)	
State and consumer services	1,475,486	682,503	35,515	—	(757,468)		(757,468)	
Business and transportation	12,836,192	4,082,616	2,331,983	1,669,021	(4,752,572)		(4,752,572)	
Correctional programs	10,081,736	45,153	83,158	—	(9,953,425)		(9,953,425)	
Interest on long-term debt	4,349,632	—	—	—	(4,349,632)		(4,349,632)	
Total governmental activities	194,460,204	23,102,434	60,943,536	1,669,021	(108,745,213)		(108,745,213)	
Business-type activities:								
Electric Power	488,000	488,000	—	—		$ —	—	
Water Resources	1,127,195	1,127,195	—	—		—	—	
Public Buildings Construction	410,404	616,041	—	—		205,637	205,637	
State Lottery	4,499,451	4,445,921	—	—		(53,530)	(53,530)	
Unemployment Programs	17,599,219	18,597,962	—	—		998,743	998,743	
California State University	6,196,541	2,891,432	1,323,345	481		(1,981,283)	(1,981,283)	
High Technology Education	6,568	5,585	—	—		(983)	(983)	
State Water Pollution Control Revolving	3,698	60,173	—	141,823		198,298	198,298	
Housing Loan	70,356	66,050	—	—		(4,306)	(4,306)	
Other enterprise programs	58,578	80,540	—	—		21,962	21,962	
Total business-type activities	30,460,010	28,378,899	1,323,345	142,304		(615,462)	(615,462)	
Total primary government	**$ 224,920,214**	**$ 51,481,333**	**$ 62,266,881**	**$ 1,811,325**	**(108,745,213)**	**(615,462)**	**(109,360,675)**	
Component Units								
University of California	$ 27,630,059	$ 15,325,540	$ 7,655,258	$ 256,670				$ (4,392,591)
California Housing Finance Agency	432,710	39,976	38,624	—				(354,110)
Nonmajor component units	1,938,919	1,022,680	546,344	17,350				(352,545)
Total component units	**$ 30,001,688**	**$ 16,388,196**	**$ 8,240,226**	**$ 274,020**				**(5,099,246)**
General revenues:								
Personal income taxes					67,502,738	—	67,502,738	—
Sales and use taxes					33,839,065	—	33,839,065	—
Corporation taxes					7,289,910	—	7,289,910	—
Motor vehicle excise tax					5,219,605	—	5,219,605	—
Insurance taxes					2,295,579	—	2,295,579	—
Other taxes					2,498,248	—	2,498,248	—
Investment and interest (loss)					57,285	—	57,285	2,115,480
Escheat					551,580	—	551,580	—
Other					—	—	—	2,806,319
Transfers					(1,997,759)	1,997,759	—	—
Total general revenues and transfers					**117,256,251**	**1,997,759**	**119,254,010**	**4,921,799**
Change in net position					8,511,038	1,382,297	9,893,335	(177,447)
Net position – beginning					(16,647,998) *	2,684,155 *	**(13,963,843)** *	**27,470,853** *
Net position (deficit) – ending					**$ (8,136,960)**	**$ 4,066,452**	**$ (4,070,508)**	**$ 27,293,406**

* Restated

This page intentionally left blank.

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

Fund Financial Statements

Balance Sheet

Governmental Funds

June 30, 2013
(amounts in thousands)

	General	Federal	Transportation	Environmental and Natural Resources	Nonmajor Governmental	Total
ASSETS						
Cash and pooled investments	$ 847,892	$ 273,649	$ 2,874,361	$ 5,795,662	$ 10,028,511	$ 19,820,075
Investments	—	—	—	—	645,053	645,053
Receivables (net)	12,650,495	950	1,060,292	505,457	2,296,978	16,514,172
Due from other funds	764,705	—	1,165,809	437,182	1,385,006	3,752,702
Due from other governments	1,151,555	11,805,801	78,522	56,924	461,258	13,554,060
Interfund receivables	53,767	—	3,610,076	535,477	1,668,970	5,868,290
Loans receivable	165,643	186,236	—	1,023,710	2,457,392	3,832,981
Other assets	11,538	96,907	86,567	—	6,624	201,636
Total assets	**15,645,595**	**12,363,543**	**8,875,627**	**8,354,412**	**18,949,792**	**64,188,969**
DEFERRED OUTFLOWS OF RESOURCES	—	—	—	—	—	—
Total assets and deferred outflows of resources	**$ 15,645,595**	**$ 12,363,543**	**$ 8,875,627**	**$ 8,354,412**	**$ 18,949,792**	**$ 64,188,969**
LIABILITIES						
Accounts payable	$ 1,657,644	$ 1,229,107	$ 416,912	$ 328,034	$ 985,702	$ 4,617,399
Due to other funds	11,661,164	8,338,802	167,876	16,766	2,103,637	22,288,245
Due to component units	169,215	—	909	2,011	36,988	209,123
Due to other governments	703,684	2,498,737	450,840	26,668	3,040,211	6,720,140
Interfund payables	6,435,046	—	2,648	10,979	6,117	6,454,790
Revenues received in advance	717,370	76,533	60,155	143,835	89,586	1,087,479
Tax overpayments	5,780,193	—	—	—	—	5,780,193
Deposits	2,194	—	4,518	325	374,578	381,615
Interest payable	—	4,123	—	—	126,633	130,756
Unclaimed property liability	853,438	—	—	—	—	853,438
General obligation bonds payable	—	—	—	—	500,470	500,470
Other liabilities	550,494	18,288	284,387	7,918	156,323	1,017,410
Total liabilities	**28,530,442**	**12,165,590**	**1,388,245**	**536,536**	**7,420,245**	**50,041,058**
DEFERRED INFLOWS OF RESOURCES	**1,369,609**	—	**256,685**	—	**272,641**	**1,898,935**
Total liabilities and deferred inflows of resources	**29,900,051**	**12,165,590**	**1,644,930**	**536,536**	**7,692,886**	**51,939,993**
FUND BALANCES						
Nonspendable	140,107	—	—	—	15,022	155,129
Restricted	178,643	197,953	7,190,847	6,962,098	9,786,372	24,315,913
Committed	22,879	—	49,410	863,648	1,404,977	2,340,914
Assigned	—	—	—	—	209,171	209,171
Unassigned	(14,596,085)	—	(9,560)	(7,870)	(158,636)	(14,772,151)
Total fund balances (deficit)	**(14,254,456)**	**197,953**	**7,230,697**	**7,817,876**	**11,256,906**	**12,248,976**
Total liabilities, deferred inflows of resources, and fund balances	**$ 15,645,595**	**$ 12,363,543**	**$ 8,875,627**	**$ 8,354,412**	**$ 18,949,792**	**$ 64,188,969**

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

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

Reconciliation of the Governmental Funds Balance Sheet to the Statement of Net Position

(amounts in thousands)

Total fund balances – governmental funds		**$ 12,248,976**
Amounts reported for governmental activities in the Statement of Net Position are different from those in the Governmental Funds Balance Sheet because:		
• The following capital assets used in governmental activities are not financial resources and, therefore, are not reported in the funds:		
Land	17,599,743	
State highway infrastructure	64,619,437	
Collections – nondepreciable	22,645	
Buildings and other depreciable property	24,979,827	
Intangible assets – amortizable	927,119	
Less: accumulated depreciation/amortization	(10,636,790)	
Construction in progress	9,904,097	
Intangible assets – nonamortizable	1,054,970	
		108,471,048
• State revenues that will be collected after year end, but are not available soon enough to pay for the current period expenditures and therefore are considered deferred inflows of resources in the funds.		1,898,935
• Internal service funds are used by management to charge the costs of certain activities, such as architectural, procurement, and technology services, to individual funds. The assets and liabilities of the internal service funds are included in governmental activities in the Statement of Net Position.		252,264
• Bond discounts and premiums are amortized over the life of the bonds and are included in the governmental activities in the Statement of Net Position.		(2,786,776)
• Deferred inflows and outflows of resources resulting from bond refunding gains and losses, respectively, are amortized over the life of the bonds are not reported in the funds.		825,043
• General obligation bonds and related accrued interest totaling $80,222,803, revenue bonds totaling $7,591,779, and certificates of participation and commercial paper totaling $538,593 are not due and payable in the current period and, therefore, are not reported in the funds.		(88,353,175)
• The following liabilities are not due and payable in the current period; therefore, adjustments to these liabilities are not reported in the funds:		
Compensated absences	(3,956,714)	
Capital leases	(5,319,487)	
Net other postemployment benefits obligation	(15,193,946)	
Mandated costs	(6,696,590)	
Workers' compensation	(3,059,052)	
Proposition 98 funding guarantee	(1,914,064)	
Net pension obligation	(3,278,775)	
Pollution remediation obligations	(1,009,216)	
Other noncurrent liabilities	(265,431)	
		(40,693,275)
Net position of governmental activities		**$ (8,136,960)**

This page intentionally left blank.

Statement of Revenues, Expenditures, and Changes in Fund Balances

Governmental Funds

Year Ended June 30, 2013

(amounts in thousands)

	General	Federal	Transportation	Environmental and Natural Resources	Nonmajor Governmental	Total
REVENUES						
Personal income taxes	$ 66,220,132	$ —	$ —	$ —	$ 1,204,444	$ 67,424,576
Sales and use taxes	20,429,772	—	640,106	—	12,800,083	33,869,961
Corporation taxes	7,261,910	—	—	—	—	7,261,910
Motor vehicle excise taxes	—	—	5,219,605	—	—	5,219,605
Insurance taxes	2,262,567	—	—	—	33,012	2,295,579
Other taxes	691,790	—	5,277	160,135	1,567,982	2,425,184
Intergovernmental	—	62,612,526	—	—	1,806,282	64,418,808
Licenses and permits	15,063	—	3,887,067	362,343	2,394,605	6,659,078
Charges for services	259,560	—	126,207	110,142	245,292	741,201
Fees	631,376	—	18,670	2,368,994	6,519,913	9,538,953
Penalties	151,782	30	50,227	30,763	901,349	1,134,151
Investment and interest	29,624	—	9,936	48,212	48,156	135,928
Escheat	551,580	—	—	—	—	551,580
Other	873,997	—	71,048	415,107	1,867,195	3,227,347
Total revenues	**99,379,153**	**62,612,556**	**10,028,143**	**3,495,696**	**29,388,313**	**204,903,861**
EXPENDITURES						
Current:						
General government	5,179,368	1,040,178	216,304	83,985	9,228,234	15,748,069
Education	41,556,256	6,587,056	2,407	6,628	1,540,416	49,692,763
Health and human services	28,164,652	49,667,993	2,708	72,696	16,713,581	94,621,630
Resources	1,144,918	364,516	234,150	3,360,639	214,109	5,318,332
State and consumer services	657,983	35,432	97,866	59,907	408,204	1,259,392
Business and transportation	5,978	3,895,122	10,708,313	7,395	391,863	15,008,671
Correctional programs	8,301,061	80,362	—	—	1,299,663	9,681,086
Capital outlay	710,440	—	314	223,610	287,978	1,222,342
Debt service:						
Bond and commercial paper retirement	1,297,473	70,990	265,085	245,228	3,310,374	5,189,150
Interest and fiscal charges	3,096,851	13,306	7,756	23,913	1,221,434	4,363,260
Total expenditures	**90,114,980**	**61,754,955**	**11,534,903**	**4,084,001**	**34,615,856**	**202,104,695**
Excess (deficiency) of revenues over (under) expenditures	9,264,173	857,601	(1,506,760)	(588,305)	(5,227,543)	2,799,166
OTHER FINANCING SOURCES (USES)						
General obligation bonds and commerical paper issued	—	—	2,539,270	46,740	1,452,085	4,038,095
Refunding debt issued	—	—	318,385	563,970	3,524,010	4,406,365
Payment to refund long-term debt	—	—	(101,880)	(405,160)	(2,440,605)	(2,947,645)
Premium on bonds issued	379,293	—	48,499	78,964	457,455	964,211
Remarketing bonds issued	—	—	—	—	228,000	228,000
Payment to remarketing agent	—	—	—	—	(226,968)	(226,968)
Capital leases	710,440	—	—	—	—	710,440
Transfers in	1,011,257	—	3,995	187,423	1,755,087	2,957,762
Transfers out	(2,890,451)	(820,967)	(797,402)	(31,984)	(357,950)	(4,898,754)
Total other financing sources (uses)	**(789,461)**	**(820,967)**	**2,010,867**	**439,953**	**4,391,114**	**5,231,506**
Net change in fund balances	8,474,712	36,634	504,107	(148,352)	(836,429)	8,030,672
Fund balances (deficit) – beginning	**(22,729,168)** *	**161,319**	**6,726,590**	**7,966,228** *	**12,093,335** *	**4,218,304** *
Fund balances (deficit) – ending	**$ (14,254,456)**	**$ 197,953**	**$ 7,230,697**	**$ 7,817,876**	**$ 11,256,906**	**$ 12,248,976**

* Restated

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

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

Reconciliation of the Statement of Revenues, Expenditures, and Changes in Fund Balances of Governmental Funds to the Statement of Activities

(amounts in thousands)

Net change in fund balances – total governmental funds		**$ 8,030,672**
Amounts reported for governmental activities in the Statement of Activities are different from those in the Statement of Revenues, Expenditures, and Changes in Fund Balances of Governmental Funds because:		
• Governmental funds report capital outlays as expenditures. However, in the Statement of Activities, the cost of those assets is allocated over their estimated useful lives as depreciation expense. In the current year, these amounts are:		
Depreciation expense, net of asset disposal	(360,351)	
Disposal of assets	(2,159,283)	
Purchase of assets	6,406,086	
		3,886,452
• Some revenues in the Statement of Activities do not provide current financial resources, and therefore, are unavailable in governmental funds. Revenues related to prior periods that became available during the current period are reported in the governmental funds. This amount is the net adjustment.		65,143
• Internal service funds are used by management to charge the costs of certain activities, such as architectural, procurement, and technology services, to individual funds. The net revenue (expense) of the internal service funds is reported with governmental activities.		(252,219)
• Bonds and other noncurrent financing instruments provide current financial resources to governmental funds in the form of debt, which increases long-term liabilities in the Statement of Net Position. Repayment of bond principal is an expenditure in the governmental funds, but the repayment reduces long-term liabilities in the Statement of Net Position. The following amounts represent the difference between proceeds and repayments:		
General obligation bonds	(1,001,934)	
Revenue bonds	237,312	
Certificates of participation and commercial paper	(492,315)	
		(1,256,937)
• The following expenses reported in the Statement of Activities do not require the use of current financial resources and, therefore, are not reported as expenditures in governmental funds:		
Compensated absences	(294,632)	
Capital leases	(383,286)	
Net other postemployment benefits obligation	(3,010,788)	
Mandated costs	(362,729)	
Workers' compensation	(237,549)	
Loans payable	2,032,275	
Proposition 98 funding guarantee	333,612	
Net pension obligation	(97,172)	
Pollution remediation obligations	33,831	
Other noncurrent liabilities	24,365	
		(1,962,073)
Change in net position of governmental activities		**$ 8,511,038**

This page intentionally left blank.

Statement of Net Position

Proprietary Funds

June 30, 2013

(amounts in thousands)

	Business-type Activities – Enterprise Funds								Governmental Activities
	Electric Power	Water Resources	Public Buildings Construction	State Lottery	Unemployment Programs	California State University	Nonmajor Enterprise	Total	Internal Service Funds
ASSETS									
Current assets:									
Cash and pooled investments	$ —	$ 544,738	$ —	$ 342,925	$ 3,135,982	$ 533,042	$ 812,288	$ 5,368,975	$ 941,011
Amount on deposit with U.S. Treasury	—	—	—	—	39,963	—	—	39,963	—
Investments	—	—	—	133,867	—	2,101,965	—	2,235,832	—
Restricted assets:									
Cash and pooled investments	764,000	—	2,400,778	—	—	—	34,571	3,199,349	—
Due from other governments	—	—	—	—	—	—	20,448	20,448	—
Net investment in direct financing leases	—	—	443,707	—	—	10,992	19,306	474,005	—
Receivables (net)	—	92,373	197,801	362,744	1,275,655	161,990	46,115	2,136,678	45,665
Due from other funds	4,000	899	30,134	277	22,416	436	2,332	60,494	310,889
Due from other governments	—	20,227	—	—	137,425	—	204,361	362,013	7,964
Prepaid items	—	—	—	5,768	5,223	39,945	1	50,937	109,692
Inventories	—	7,413	—	7,863	—	—	2,699	17,975	84,910
Recoverable power costs (net)	111,000	—	—	—	—	—	—	111,000	—
Other current assets	14,000	—	—	—	—	—	—	14,000	—
Total current assets	893,000	665,650	3,072,420	853,444	4,616,664	2,848,370	1,142,121	14,091,669	1,500,131
Noncurrent assets:									
Restricted assets:									
Cash and pooled investments	637,000	76,825	328,122	—	—	39	—	1,041,986	—
Investments	300,000	74,001	21,738	—	—	—	10,662	406,401	—
Loans receivable	—	—	—	—	—	—	325,930	325,930	—
Investments	—	—	—	828,347	—	417,729	22,701	1,268,777	—
Net investment in direct financing leases	—	—	7,148,043	—	—	371,361	—	7,519,404	—
Receivables	—	—	—	—	30,476	272,644	—	303,120	—
Interfund receivables	—	91,517	—	—	611,690	—	5,600	708,807	16,975
Loans receivable	—	16,468	—	—	—	87,171	3,661,635	3,765,274	—
Recoverable power costs (net)	5,083,000	—	—	—	—	—	—	5,083,000	—
Long-term prepaid charges	—	897,370	10,912	19,413	—	—	2,371	930,066	—
Capital assets:									
Land	—	136,797	—	6,469	—	72,350	1,272	216,888	2,312
Collections – nondepreciable	—	—	—	—	—	6,051	—	6,051	—
Buildings and other depreciable property	—	4,880,380	—	142,820	17,726	6,205,510	17,975	11,264,411	633,822
Intangible assets – amortizable	—	36,768	—	—	12,279	123,648	1,350	174,045	59,065
Less: accumulated depreciation/amortization	—	(2,366,429)	—	(67,038)	(9,052)	(2,233,612)	(16,928)	(4,693,059)	(528,772)
Construction in progress	—	498,350	1,701,212	—	—	387,569	—	2,587,131	1,233
Intangible assets – nonamortizable	—	142,099	—	—	255,008	6,691	181	403,979	29,358
Other noncurrent assets	—	—	—	—	—	17,329	15,501	32,830	—
Total noncurrent assets	6,020,000	4,484,146	9,210,027	930,011	918,127	5,734,480	4,048,250	31,345,041	213,993
Total assets	**6,913,000**	**5,149,796**	**12,282,447**	**1,783,455**	**5,534,791**	**8,582,850**	**5,190,371**	**45,436,710**	**1,714,124**
DEFERRED OUTFLOWS OF RESOURCES	**106,000**	**124,591**	**213,937**	—	—	**32,020**	**3,760**	**480,308**	—
Total assets and deferred outflows of resources	**$ 7,019,000**	**$ 5,274,387**	**$ 12,496,384**	**$ 1,783,455**	**$ 5,534,791**	**$ 8,614,870**	**$ 5,194,131**	**$ 45,917,018**	**$ 1,714,124**

(continued)

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

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

Statement of Net Position (continued)

Proprietary Funds

June 30, 2013

(amounts in thousands)

			Business-type Activities – Enterprise Funds						Governmental Activities
	Electric Power	Water Resources	Public Buildings Construction	State Lottery	Unemployment Programs	California State University	Nonmajor Enterprise	Total	Internal Service Funds
LIABILITIES									
Current liabilities:									
Accounts payable	$ 9,000	$ 106,490	$ 200,200	$ 60,505	$ 7,200	$ 169,394	$ 4,120	$ 556,909	$ 264,732
Due to other funds	—	49,172	19,421	375,155	35,056	—	2,934	481,738	107,471
Due to component units	—	—	—	—	—	—	—	—	2
Due to other governments	—	98,753	11,782	—	50,313	—	60	160,908	1,280
Revenues received in advance	—	—	5,790	3,141	39,060	244,712	42	292,745	331,582
Deposits	—	—	—	—	—	—	—	—	761
Contracts and notes payable	—	—	—	—	—	—	—	—	10,715
Interest payable	52,000	13,741	122,314	—	—	—	12,712	200,767	—
Benefits payable	—	—	—	—	763,914	—	—	763,914	—
Current portion of long-term obligations	702,000	192,872	534,853	491,123	—	284,978	38,211	2,244,037	17,985
Other current liabilities	2,000	—	—	—	44,718	349,569	16	396,303	9,113
Total current liabilities	765,000	461,028	894,360	929,924	940,261	1,048,653	58,095	5,097,321	743,641
Noncurrent liabilities:									
Interfund payables	—	—	—	—	—	—	—	—	139,282
Loans payable	—	—	—	—	8,585,318	—	—	8,585,318	—
Lottery prizes and annuities	—	—	—	707,781	—	—	—	707,781	—
Compensated absences payable	487	33,305	—	7,816	55,296	89,528	2,776	189,208	162,900
Certificates of participation, commercial paper, and other borrowings	—	50,505	—	—	—	26,715	—	77,220	—
Capital lease obligations	—	—	—	—	—	847,352	—	847,352	—
General obligation bonds payable	—	241,835	—	—	—	—	584,033	825,868	—
Revenue bonds payable	6,249,000	2,479,684	11,221,620	—	—	3,649,307	479,415	24,079,026	—
Net other postemployment benefits obligation	4,513	140,470	—	33,788	105,661	219,018	6,779	510,229	365,286
Pollution remediation obligations	—	15,107	—	—	—	—	—	15,107	—
Revenues received in advance	—	—	—	—	—	11,439	—	11,439	—
Other noncurrent liabilities	—	175,589	—	2,078	—	180,234	75,360	433,261	50,751
Total noncurrent liabilities	6,254,000	3,136,495	11,221,620	751,463	8,746,275	5,023,593	1,148,363	36,281,809	718,219
Total liabilities	**7,019,000**	**3,597,523**	**12,115,980**	**1,681,387**	**9,686,536**	**6,072,246**	**1,206,458**	**41,379,130**	**1,461,860**
DEFERRED INFLOWS OF RESOURCES	—	471,436	—	—	—	—	—	471,436	—
Total liabilities and deferred inflows of resources	**$ 7,019,000**	**$ 4,068,959**	**$ 12,115,980**	**$ 1,681,387**	**$ 9,686,536**	**$ 6,072,246**	**$ 1,206,458**	**$ 41,850,566**	**$ 1,461,860**

(continued)

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

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

Statement of Net Position (continued)

Proprietary Funds

June 30, 2013

(amounts in thousands)

			Business-type Activities – Enterprise Funds						Governmental Activities
	Electric Power	**Water Resources**	**Public Buildings Construction**	**State Lottery**	**Unemployment Programs**	**California State University**	**Nonmajor Enterprise**	**Total**	**Internal Service Funds**
NET POSITION									
Investment in capital assets	$ —	$ 785,460	$ —	$ 82,252	$ 275,960	$ 572,160	$ 2,816	$ 1,718,648	$ 127,459
Restricted:									
Nonexpendable – endowments	—	—	—	—	—	20,627	—	20,627	—
Expendable:									
Construction	—	419,968	373,608	—	—	20,567	—	814,143	—
Debt service	—	—	6,796	—	—	3,819	190,146	200,761	—
Security for revenue bonds	—	—	—	—	—	—	346,377	346,377	—
Lottery	—	—	—	102,068	—	—	—	102,068	—
Unemployment programs	—	—	—	—	3,433,769	—	—	3,433,769	—
Other purposes	—	—	—	—	—	44,134	210,662	254,796	—
Total expendable	—	419,968	380,404	102,068	3,433,769	68,520	747,185	5,151,914	—
Unrestricted	—	—	—	(82,252)	(7,861,474)	1,881,317	3,237,672	(2,824,737)	124,805
Total net position (deficit)	**—**	**1,205,428**	**380,404**	**102,068**	**(4,151,745)**	**2,542,624**	**3,987,673**	**4,066,452**	**252,264**
Total liabilities, deferred inflows of resources, and net position	**$ 7,019,000**	**$ 5,274,387**	**$ 12,496,384**	**$ 1,783,455**	**$ 5,534,791**	**$ 8,614,870**	**$ 5,194,131**	**$ 45,917,018**	**$ 1,714,124**

(concluded)

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

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

Statement of Revenues, Expenses, and Changes in Fund Net Position

Proprietary Funds

Year Ended June 30, 2013

(amounts in thousands)

									Governmental Activities
			Business-type Activities – Enterprise Funds						
	Electric Power	Water Resources	Public Buildings Construction	State Lottery	Unemployment Programs	California State University	Nonmajor Enterprise	Total	Internal Service Funds
OPERATING REVENUES									
Unemployment and disability insurance	$ —	$ —	$ —	$ —	$ 18,590,498	$ —	$ —	$ 18,590,498	$ —
Lottery ticket sales	—	—	—	4,445,873	—	—	—	4,445,873	—
Power sales	(402,000)	146,277	—	—	—	—	—	(255,723)	—
Student tuition and fees	—	—	—	—	—	2,081,251	—	2,081,251	—
Services and sales	—	980,918	—	—	—	437,981	92,695	1,511,594	2,327,546
Investment and interest	—	—	1,628	—	—	—	108,593	110,221	—
Rent	—	—	468,618	—	—	—	7,241	475,859	—
Grants and contracts	—	—	—	—	—	91,361	—	91,361	—
Other	—	—	145,795	—	—	187,155	2,139	335,089	—
Total operating revenues	**(402,000)**	**1,127,195**	**616,041**	**4,445,873**	**18,590,498**	**2,797,748**	**210,668**	**27,386,023**	**2,327,546**
OPERATING EXPENSES									
Lottery prizes	—	—	—	2,652,095	—	—	—	2,652,095	—
Power purchases (net of recoverable power costs)	(426,000)	258,899	—	—	—	—	—	(167,101)	—
Personal services	—	273,393	—	56,781	188,418	3,837,959	13,980	4,370,531	863,255
Supplies	—	—	—	13,581	63	1,089,908	—	1,103,552	10,411
Services and charges	18,000	290,345	13,479	456,647	85,773	—	63,847	928,091	1,599,644
Depreciation	—	85,236	—	5,980	1,636	249,917	551	343,320	49,162
Scholarships and fellowships	—	—	—	—	—	826,933	—	826,933	—
Distributions to beneficiaries	—	—	—	—	17,323,329	—	—	17,323,329	—
Interest expense	—	—	395,073	—	—	—	54,192	449,265	—
Amortization (recovery) of long-term prepaid charges	—	—	1,852	—	—	—	255	2,107	—
Other	—	—	—	—	—	—	871	871	—
Total operating expenses	**(408,000)**	**907,873**	**410,404**	**3,185,084**	**17,599,219**	**6,004,717**	**133,696**	**27,832,993**	**2,522,472**
Operating income (loss)	6,000	219,322	205,637	1,260,789	991,279	(3,206,969)	76,972	(446,970)	(194,926)
NONOPERATING REVENUES (EXPENSES)									
Donations and grants	—	—	—	—	—	1,323,345	—	1,323,345	—
Private gifts	—	—	—	—	—	47,861	—	47,861	—
Investment and interest income	890,000	—	—	—	7,464	41,522	1,661	940,647	765
Interest expense and fiscal charges	(896,000)	(53,492)	—	(52,309)	—	(191,824)	(533)	(1,194,158)	(394)
Lottery payments for education	—	—	—	(1,262,058)	—	—	—	(1,262,058)	—
Other	—	(165,830)	—	48	—	4,301	(4,952)	(166,433)	(897)
Total nonoperating revenues (expenses)	**(6,000)**	**(219,322)**	**—**	**(1,314,319)**	**7,464**	**1,225,205**	**(3,824)**	**(310,796)**	**(526)**
Income (loss) before capital contributions and transfers	—	—	205,637	(53,530)	998,743	(1,981,764)	73,148	(757,766)	(195,452)
Capital contributions	—	—	—	—	—	481	141,823	142,304	—
Transfers in	—	—	202	—	—	2,034,055	—	2,034,257	4,730
Transfers out	—	—	(8,172)	—	—	(16,540)	(11,786)	(36,498)	(61,497)
Change in net position	—	—	197,667	(53,530)	998,743	36,232	203,185	1,382,297	(252,219)
Total net position (deficit) – beginning	**—**	**1,205,428**	**182,737** *	**155,598**	**(5,150,488)**	**2,506,392** *	**3,784,488** *	**2,684,155** *	**504,483**
Total net position (deficit) – ending	**$ —**	**$ 1,205,428**	**$ 380,404**	**$ 102,068**	**$ (4,151,745)**	**$ 2,542,624**	**$ 3,987,673**	**$ 4,066,452**	**$ 252,264**

* Restated

Statement of Cash Flows

Proprietary Funds

Year Ended June 30, 2013

(amounts in thousands)

			Business-type Activities – Enterprise Funds						Governmental Activities
	Electric Power	Water Resources	Public Buildings Construction	State Lottery	Unemployment Programs	California State University	Nonmajor Enterprise	Total	Internal Service Funds
CASH FLOWS FROM OPERATING ACTIVITIES									
Receipts from customers/employers	$ (371,000)	$ 1,088,771	$ 844,190	$ 4,407,307	$ 18,343,035	$ 2,495,410	$ 367,013	$ 27,174,726	$ 2,487,452
Receipts from interfund services provided	—	—	—	—	4,723	—	418	5,141	40,781
Payments to suppliers	(73,000)	(438,273)	(3,894)	(185,080)	(78,639)	(1,089,009)	(67,487)	(1,935,382)	(1,489,656)
Payments to employees	(6,000)	(273,393)	—	(43,282)	(157,691)	(3,782,921)	(10,993)	(4,274,280)	(769,523)
Payments for interfund services used	—	—	—	(18,752)	(9,613)	(1,124)	(519)	(30,008)	(203,270)
Payments for Lottery prizes	—	—	—	(2,929,425)	—	—	—	(2,929,425)	—
Claims paid to other than employees	—	—	—	(302,965)	(17,285,755)	—	—	(17,588,720)	—
Other receipts (payments)	21,000	2,709	(256,203)	142,755	53,598	(600,141)	(27,430)	(663,712)	(11,631)
Net cash provided by (used in) operating activities	**(429,000)**	**379,814**	**584,093**	**1,070,558**	**869,658**	**(2,977,785)**	**261,002**	**(241,660)**	**54,153**
CASH FLOWS FROM NONCAPITAL FINANCING ACTIVITIES									
Changes in interfund payables and loans payable	—	—	—	—	(691,850)	(422)	5	(692,267)	(612)
Receipts of bond charges	869,000	—	—	—	—	—	—	869,000	—
Retirement of general obligation bonds	—	—	—	—	—	—	(286,894)	(286,894)	—
Retirement of revenue bonds	(574,000)	—	—	—	—	—	(78,755)	(652,755)	—
Interest paid on operating debt	(341,000)	—	—	—	—	—	—	(341,000)	(3)
Transfers in	—	—	202	—	—	1,986,671	—	1,986,873	4,730
Transfers out	—	—	(8,172)	—	—	—	(15,987)	(24,159)	(61,497)
Grants received / (provided)	—	—	—	—	—	1,491,288	—	1,491,288	—
Lottery payments for education	—	—	—	(1,187,366)	—	—	—	(1,187,366)	—
Net cash provided by (used in) noncapital financing activities	**(46,000)**	**—**	**(7,970)**	**(1,187,366)**	**(691,850)**	**3,477,537**	**(381,631)**	**1,162,720**	**(57,382)**
CASH FLOWS FROM CAPITAL AND RELATED FINANCING ACTIVITIES									
Changes in interfund payables and loans payable	—	—	—	—	—	—	189	189	—
Acquisition of capital assets	—	(200,249)	(1,370,049)	(3,102)	(52,889)	(416,056)	(692)	(2,043,037)	(60,928)
Proceeds from sale of capital assets	—	—	—	4	—	236	47	287	1,349
Proceeds from notes payable and commercial paper	—	121,961	—	—	—	19,585	—	141,546	—
Principal paid on notes payable and commercial paper	—	(100,239)	—	—	—	—	—	(100,239)	(10,912)
Proceeds from capital leases	—	—	—	—	—	22,601	—	22,601	—
Payment on capital debt and leases	—	—	—	—	—	(370,200)	—	(370,200)	—
Retirement of general obligation bonds	—	(59,455)	—	—	—	—	—	(59,455)	—
Proceeds from revenue bonds	—	899,887	1,274,119	—	—	564,631	—	2,738,637	—
Retirement of revenue bonds	—	(756,280)	(554,985)	—	—	(313,843)	—	(1,625,108)	—
Interest paid	—	(160,668)	—	—	—	—	—	(160,668)	(392)
Grants received	—	—	—	—	—	21,380	216,705	238,085	—
Net cash provided by (used in) capital and related financing activities	**—**	**(255,043)**	**(650,915)**	**(3,098)**	**(52,889)**	**(471,666)**	**216,249**	**(1,217,362)**	**(70,883)**
CASH FLOWS FROM INVESTING ACTIVITIES									
Purchase of investments	—	(302,608)	—	(119,590)	—	(12,283,345)	—	(12,705,543)	—
Proceeds from maturity and sale of investments	—	302,608	—	275,316	17,101	12,178,674	6,559	12,780,258	—
Change in interfund receivables and loans receivable	—	2,674	—	93,928	901,244	121,176	33,400	1,152,422	281,065
Earnings (loss) on investments	11,000	8,468	—	23,800	7,464	43,148	1,709	95,589	823
Net cash provided by (used in) investing activities	**11,000**	**11,142**	**—**	**273,454**	**925,809**	**59,653**	**41,668**	**1,322,726**	**281,888**
Net increase (decrease) in cash and pooled investments	(464,000)	135,913	(74,792)	153,548	1,050,728	87,739	137,288	1,026,424	207,776
Cash and pooled investments – beginning	**1,865,000**	**485,650**	**2,803,692**	**189,377**	**2,085,254**	**445,342**	**709,571**	**8,583,886**	**733,235**
Cash and pooled investments – ending	**$ 1,401,000**	**$ 621,563**	**$ 2,728,900**	**$ 342,925**	**$ 3,135,982**	**$ 533,081**	**$ 846,859**	**$ 9,610,310**	**$ 941,011**

(continued)

Statement of Cash Flows (continued)

Proprietary Funds

Year Ended June 30, 2013

(amounts in thousands)

			Business-type Activities – Enterprise Funds						Governmental Activities
	Electric Power	Water Resources	Public Buildings Construction	State Lottery	Unemployment Programs	California State University	Nonmajor Enterprise	Total	Internal Service Funds
RECONCILIATION OF OPERATING INCOME (LOSS) TO NET CASH PROVIDED BY (USED IN) OPERATING ACTIVITIES									
Operating income (loss)	$ 6,000	$ 219,322	$ 205,637	$ 1,260,789	$ 991,279	$ (3,206,969)	$ 76,972	$ (446,970)	$ (194,926)
Adjustments to reconcile operating income (loss) to net cash provided by (used in) operating activities:									
Interest expense on operating debt	—	—	—	—	—	—	—	—	(114)
Depreciation	—	85,236	—	5,980	1,636	249,917	551	343,320	49,162
Provisions and allowances	—	—	—	(11,426)	—	—	—	(11,426)	—
Accretion of capital appreciation bonds	—	—	—	—	—	—	3,936	3,936	—
Amortization of premiums and discounts	—	—	(28,468)	—	—	—	47	(28,421)	—
Amortization of long-term prepaid charges	—	9,362	22,679	—	—	—	4,359	36,400	—
Other	—	2,709	1,523	99	—	—	(6,874)	(2,543)	—
Change in assets and liabilities:									
Receivables	—	18,274	—	(48,165)	23,262	(58,027)	1,699	(62,957)	88,163
Due from other funds	—	—	(23,295)	—	14,469	(1,124)	5,865	(4,085)	(124,743)
Due from other governments	—	(4,440)	—	—	81,942	—	1,036	78,538	1,120
Prepaid items	—	—	—	(18,356)	—	(68,303)	11	(86,648)	(6,909)
Inventories	—	22,240	—	84	—	—	593	22,917	6,454
Net investment in direct financing leases	—	—	399,823	—	—	—	19,342	419,165	—
Recoverable power costs (net)	(421,000)	—	—	—	—	—	—	(421,000)	—
Other current assets	35,000	—	—	—	180	—	4,201	39,381	43
Loans receivable	—	—	—	—	—	—	184,463	184,463	—
Other noncurrent assets	—	—	—	(3,553)	—	—	—	(3,553)	—
Accounts payable	(49,000)	55,258	175	17,699	7,197	11,654	(2,070)	40,913	108,193
Due to other funds	—	15,148	(361)	(5,671)	6,350	—	(2,453)	13,013	(23,771)
Due to component units	—	—	—	—	—	—	—	—	(1,032)
Due to other governments	—	(43,295)	(323)	—	1,501	—	(302)	(42,419)	1,218
Deposits	—	—	—	—	—	762	(71)	691	(6,922)
Interest payable	—	—	6,690	—	—	—	(100)	6,590	296
Other current liabilities	—	—	—	580	(55,734)	59,198	(7,574)	(3,530)	5,566
Interfund payables	—	—	—	—	—	—	—	—	(29)
Current portion of revenues received in advance	—	—	13	311	(270,725)	—	(9)	(270,410)	58,584
Benefits payable	—	—	—	—	37,574	5,505	82	43,161	36,187
Lottery prizes and annuities	—	—	—	(134,695)	—	—	—	(134,695)	—
Compensated absences payable	—	—	—	—	9,354	1,217	100	10,671	17,543
Long-term portion of revenue received in advance	—	—	—	—	—	(16,202)	(212)	(16,414)	—
Other noncurrent liabilities	—	—	—	6,882	21,373	44,587	(22,590)	50,252	40,070
Total adjustments	(435,000)	160,492	378,456	(190,231)	(121,621)	229,184	184,030	205,310	249,079
Net cash provided by (used in) operating activities	**$ (429,000)**	**$ 379,814**	**$ 584,093**	**$ 1,070,558**	**$ 869,658**	**$ (2,977,785)**	**$ 261,002**	**$ (241,660)**	**$ 54,153**
Noncash investing, capital, and financing activities									
Interest accreted on annuitized prizes	$ —	$ —	$ —	$ 49,777	$ —	$ —	$ —	$ 49,777	$ —
Interest accreted on zero coupon bonds	—	—	—	16,035	—	—	—	16,035	—
Unclaimed Lottery prizes directly allocated to Education Fund	—	—	—	22,313	—	—	—	22,313	—
Unrealized gain (loss) on investment	—	—	—	(42,158)	—	—	—	(42,158)	—
Amortization of prepaid interest related to capital lease obligations	—	—	—	—	—	2,795	—	2,795	—
Contributed capital assets	—	—	—	—	—	19,015	—	19,015	—
Acquisition of capital assets through capital lease	—	—	—	—	—	1,390	—	1,390	—
Change in accrued capital assets purchases	—	—	—	—	—	(5,889)	—	(5,889)	—
Gifts in-kind	—	—	—	—	—	502	—	502	—
Amortization of loss on debt refundings	—	—	—	—	—	10,594	—	10,594	—
Amortization of bond premium and discount	—	36,885	—	—	—	(8,199)	—	28,686	—
Principal retirements of long-term debt on proceeds received from issuance of bonds	—	632,125	—	—	—	—	—	632,125	—
Other miscellaneous noncash transactions	—	—	—	—	—	5,259	—	5,259	15,144

(concluded)

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

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

Statement of Fiduciary Net Position

Fiduciary Funds and Similar Component Units

June 30, 2013
(amounts in thousands)

	Private Purpose Trust	Pension and Other Employee Benefit Trust	Investment Trust Local Agency Investment	Agency
ASSETS				
Cash and pooled investments	$ 99,345	$ 4,640,690	$ 21,193,406	$ 3,968,545
Investments, at fair value:				
Short-term	—	8,741,312	—	—
Equity securities	2,600,359	227,650,389	—	—
Debt securities	1,591,782	84,719,163	—	—
Real estate	165,882	51,196,862	—	—
Other	698,174	66,268,645	—	—
Securities lending collateral	—	40,497,424	—	—
Total investments	5,056,197	479,073,795	—	—
Receivables (net)	6,014	5,127,682	32,164	1,477,731
Due from other funds	2	482,303	—	18,271,064
Due from other governments	—	18,018	—	21,048
Prepaid items	—	—	—	12,033
Interfund receivables	—	—	—	—
Loans receivable	—	23,042	—	7,153
Other assets	210,418	949,551	—	87
Total assets	**5,371,976**	**490,315,081**	**21,225,570**	**23,757,661**
DEFERRED OUTFLOWS OF RESOURCES	—	—	—	—
Total assets and deferred outflows of resources	**5,371,976**	**490,315,081**	**21,225,570**	**$ 23,757,661**
LIABILITIES				
Accounts payable	6,372	2,597,584	382	$ 10,084,927
Due to other governments	—	79	13,088	11,702,335
Tax overpayments	—	—	—	684
Benefits payable	—	2,488,929	—	220,767
Revenues received in advance	—	—	—	18,501
Deposits	210,418	—	—	989,518
Securities lending obligations	—	40,272,852	—	—
Loans payable	—	937,494	—	—
Other liabilities	530	837,652	—	740,929
Total liabilities	**217,320**	**47,134,590**	**13,470**	**23,757,661**
DEFERRED INFLOWS OF RESOURCES	—	—	—	—
Total liabilities and deferred inflows of resources	**217,320**	**47,134,590**	**13,470**	**$ 23,757,661**
NET POSITION				
Held in trust for pension benefits, pool participants, and other purposes	**$ 5,154,656**	**$ 443,180,491**	**$ 21,212,100**	

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

Statement of Changes in Fiduciary Net Position

Fiduciary Funds and Similar Component Units

Year Ended June 30, 2013
(amounts in thousands)

	Private Purpose Trust	Pension and Other Employee Benefit Trust	Investment Trust Local Agency Investment
ADDITIONS			
Contributions:			
Employer	$ —	$ 13,025,787	$ —
Plan member	—	7,049,253	—
Total contributions	—	20,075,040	—
Investment income:			
Net appreciation (depreciation) in fair value of investments	288,283	44,767,618	—
Interest, dividends, and other investment income	165,302	10,666,103	64,143
Less: investment expense	(4,519)	(3,039,584)	—
Net investment income	449,066	52,394,137	64,143
Receipts from depositors	2,525,632	—	22,937,870
Other	—	22,988	—
Total additions	**2,974,698**	**72,492,165**	**23,002,013**
DEDUCTIONS			
Distributions paid and payable to participants	—	28,743,752	62,497
Refunds of contributions	—	430,234	—
Administrative expense	1	587,692	1,646
Interest expense	—	187,084	—
Payments to and for depositors	2,485,162	673,609	23,609,233
Total deductions	**2,485,163**	**30,622,371**	**23,673,376**
Change in net position	489,535	41,869,794	(671,363)
Net position – beginning	**4,665,121**	**401,310,697** *	**21,883,463**
Net position – ending	**$ 5,154,656**	**$ 443,180,491**	**$ 21,212,100**

* Restated

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

This page intentionally left blank.

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

Discretely Presented Component Units Financial Statements

Statement of Net Position

Discretely Presented Component Units – Enterprise Activity

June 30, 2013

(amounts in thousands)

	University of California	California Housing Finance Agency	Nonmajor Component Units	Total
ASSETS				
Current assets:				
Cash and pooled investments	$ 334,008	$ 1,273,366	$ 460,680	$ 2,068,054
Investments	5,294,206	137,625	390,114	5,821,945
Restricted assets:				
Cash and pooled investments	—	—	90,659	90,659
Investments	—	—	11,636	11,636
Receivables (net)	3,432,089	209,477	302,000	3,943,566
Due from primary government	209,112	—	13	209,125
Due from other governments	438,815	—	—	438,815
Prepaid items	—	409	759	1,168
Inventories	185,991	—	—	185,991
Other current assets	235,440	4,100	40,018	279,558
Total current assets	10,129,661	1,624,977	1,295,879	13,050,517
Noncurrent assets:				
Restricted assets:				
Cash and pooled investments	—	—	34,218	34,218
Investments	—	—	14,498	14,498
Investments	22,431,417	489,991	1,588,809	24,510,217
Receivables (net)	1,139,619	—	284,662	1,424,281
Loans receivable	—	4,631,407	305,508	4,936,915
Long-term prepaid charges	—	17,728	—	17,728
Capital assets:				
Land	840,050	—	130,656	970,706
Collections – nondepreciable	354,109	—	8,264	362,373
Buildings and other depreciable property	39,381,859	2,104	1,959,458	41,343,421
Intangible assets – amortizable	654,373	—	20,169	674,542
Less: accumulated depreciation/amortization	(17,948,712)	(1,142)	(942,463)	(18,892,317)
Construction in progress	2,898,206	—	19,336	2,917,542
Intangible assets – nonamortizable	—	—	5,131	5,131
Other noncurrent assets	268,614	20,556	44,300	333,470
Total noncurrent assets	50,019,535	5,160,644	3,472,546	58,652,725
Total assets	**60,149,196**	**6,785,621**	**4,768,425**	**71,703,242**
DEFERRED OUTFLOWS OF RESOURCES	**45,758**	**126,717**	**5,071**	**177,546**
Total assets and deferred outflows of resources	**$ 60,194,954**	**$ 6,912,338**	**$ 4,773,496**	**$ 71,880,788**

(continued)

Statement of Net Position (continued)

Discretely Presented Component Units – Enterprise Activity

June 30, 2013
(amounts in thousands)

	University of California	California Housing Finance Agency	Nonmajor Component Units	Total
LIABILITIES				
Current liabilities:				
Accounts payable	$ 2,231,145	$ 116,555	$ 94,717	$ 2,442,417
Due to other governments	—	595	—	595
Revenues received in advance	994,580	—	62,631	1,057,211
Deposits	509,090	244,112	1,438	754,640
Contracts and notes payable	—	2,888	7,494	10,382
Interest payable	—	70,690	1,981	72,671
Securities lending obligations	1,468,772	—	—	1,468,772
Benefits payable	—	—	—	—
Current portion of long-term obligations	2,072,009	110,346	107,382	2,289,737
Other current liabilities	2,748,119	85	124,482	2,872,686
Total current liabilities	10,023,715	545,271	400,125	10,969,111
Noncurrent liabilities:				
Compensated absences payable	237,331	—	11,676	249,007
Certificates of participation, commercial paper, and other borrowings	—	—	63,170	63,170
Capital lease obligations	2,394,586	—	349,227	2,743,813
Revenue bonds payable	12,091,416	4,791,094	366,734	17,249,244
Net other postemployment benefits obligation	7,577,366	18,685	123,015	7,719,066
Pollution remediation obligation	66,523	—	—	66,523
Other noncurrent liabilities	4,876,948	250,587	365,857	5,493,392
Total noncurrent liabilities	27,244,170	5,060,366	1,279,679	33,584,215
Total liabilities	**37,267,885**	**5,605,637**	**1,679,804**	**44,553,326**
DEFERRED INFLOWS OF RESOURCES	**31,575**	**—**	**2,481**	**34,056**
Total liabilities and deferred inflows of resources	**37,299,460**	**5,605,637**	**1,682,285**	**44,587,382**
NET POSITION				
Investment in capital assets	11,954,384	980	522,541	12,477,905
Restricted:				
Nonexpendable – endowments	3,916,721	—	867,289	4,784,010
Expendable:				
Endowments and gifts	8,149,631	—	6,903	8,156,534
Education	947,426	—	776,111	1,723,537
Indenture	—	347,318	—	347,318
Employee benefits	—	—	—	—
Workers' compensation liability	—	—	—	—
Statute	—	1,070,365	278,519	1,348,884
Other purposes	—	—	21,814	21,814
Total expendable	9,097,057	1,417,683	1,083,347	11,598,087
Unrestricted	(2,072,668)	(111,962)	618,034	(1,566,596)
Total net position	**22,895,494**	**1,306,701**	**3,091,211**	**27,293,406**
Total liabilities, deferred inflows of resources, and net position	**$ 60,194,954**	**$ 6,912,338**	**$ 4,773,496**	**$ 71,880,788**

(concluded)

Statement of Activities

Discretely Presented Component Units – Enterprise Activity

Year Ended June 30, 2013

(amounts in thousands)

	University of California	California Housing Finance Agency	Nonmajor Component Units	Total
OPERATING EXPENSES				
Personal services	$ 17,299,665	$ 29,853	$ 463,575	$ 17,793,093
Scholarships and fellowships	591,610	—	51,153	642,763
Supplies	2,465,149	—	9,326	2,474,475
Services and charges	281,276	50,472	1,241,747	1,573,495
Department of Energy laboratories	1,026,088	—	—	1,026,088
Depreciation	1,555,254	284	69,848	1,625,386
Distributions to beneficiaries	—	—	—	—
Interest expense and fiscal charges	669,538	171,835	38,253	879,626
Amortization of long-term prepaid charges	—	68,613	—	68,613
Grants provided	286,222	—	—	286,222
Other	3,455,257	111,653	65,017	3,631,927
Total operating expenses	**27,630,059**	**432,710**	**1,938,919**	**30,001,688**
PROGRAM REVENUES				
Charges for services	15,325,540	39,976	1,022,680	16,388,196
Operating grants and contributions	7,655,258	38,624	546,344	8,240,226
Capital grants and contributions	256,670	—	17,350	274,020
Total program revenues	**23,237,468**	**78,600**	**1,586,374**	**24,902,442**
Net revenues (expenses)	(4,392,591)	(354,110)	(352,545)	(5,099,246)
GENERAL REVENUES				
Investment and interest income (loss)	1,687,977	264,168	163,335	2,115,480
Other	2,355,795	39,275	411,249	2,806,319
Total general revenues	**4,043,772**	**303,443**	**574,584**	**4,921,799**
Change in net position	(348,819)	(50,667)	222,039	(177,447)
Net position – beginning	**23,244,313** *	**1,357,368**	**2,869,172** *	**27,470,853** *
Net position – ending	**$ 22,895,494**	**$ 1,306,701**	**$ 3,091,211**	**$ 27,293,406**

* Restated

This page intentionally left blank.

Notes to the Financial Statements – Index

Note 1. Summary of Significant Accounting Policies 73

A. Reporting Entity 73
1. Blended Component Units 73
2. Fiduciary Component Units 74
3. Discretely Presented Component Units 75
4. Joint Venture 76
5. Related Organizations 76
B. Government-wide and Fund Financial Statements 78
C. Measurement Focus and Basis of Accounting 81
1. Government-wide Financial Statements 81
2. Fund Financial Statements 81
D. Inventories 82
E. Deposits and Investments 82
F. Net Investment in Direct Financing Leases 82
G. Long-term Prepaid Charges 82
H. Capital Assets 82
I. Long-term Obligations 83
J. Compensated Absences 84
K. Net Position and Fund Balance 84
L. Restatement of Beginning Fund Balances and Net Position 86
M. Guaranty Deposits 90
N. Deferred Outflows and Deferred Inflows of Resources 90
O. Abnormal Fund Balances 90
P. Nonmajor Enterprise Segment Information 90

Note 2. Budgetary and Legal Compliance 91

A. Budgeting and Budgetary Control 91
B. Legal Compliance 91

Note 3. Deposits and Investments ... 92
A. Primary Government ... 92
1. Interest Rate Risk ... 96
2. Credit Risk ... 98
3. Concentration of Credit Risk ... 99
4. Custodial Credit Risk ... 100
B. Fiduciary Funds ... 100
1. Interest Rate Risk ... 103
2. Credit Risk ... 106
3. Concentration of Credit Risk ... 107
4. Custodial Credit Risk ... 107
5. Foreign Currency Risk ... 107
C. Discretely Presented Component Units ... 110
1. Interest Rate Risk ... 111
2. Credit Risk ... 116
3. Concentration of Credit Risk ... 117
4. Custodial Credit Risk ... 117
5. Foreign Currency Risk ... 117
Note 4. Accounts Receivable ... 120
Note 5. Restricted Assets ... 122
Note 6. Net Investment in Direct Financing Leases ... 123
Note 7. Capital Assets ... 124
Note 8. Accounts Payable ... 126
Note 9. Short-term Financing ... 128
Note 10. Long-term Obligations ... 128
Note 11. Certificates of Participation ... 132
Note 12. Commercial Paper and Other Long-term Borrowings ... 132
Note 13. Leases ... 133
Note 14. Commitments ... 135

Note 15. General Obligation Bonds ... 137
A. Variable-rate General Obligation Bonds ... 137
B. Economic Recovery Bonds ... 138
C. Mandatory Tender Bonds ... 138
D. Build America Bonds ... 139
E. Debt Service Requirements ... 139
F. General Obligation Bond Defeasances ... 139
1. Current Year ... 139
2. Prior Years ... 140
Note 16. Revenue Bonds ... 140
A. Governmental Activities ... 140
B. Business-type Activities ... 141
C. Discretely Presented Component Units ... 141
D. Revenue Bond Defeasances ... 143
1. Current Year–Governmental Activities ... 143
2. Current Year–Business-type Activities ... 143
3. Current Year–Discretely Presented Component Units ... 144
4. Prior Years ... 144
Note 17. Derivative Financial Instruments ... 145
A. Primary Government ... 147
1. Natural Gas Swaps and Options ... 147
B. Fiduciary Funds ... 148
C. Discretely Presented Component Unit – University of California ... 154
D. Discretely Presented Component Unit – California Housing Finance Agency ... 157
Note 18. Interfund Balances and Transfers ... 160
A. Interfund Balances ... 160
B. Interfund Transfers ... 166
Note 19. Fund Balances, Fund Deficits, and Endowments ... 168
A. Fund Balances ... 168
B. Fund Deficits ... 170
C. Discretely Presented Component Unit Endowments and Gifts ... 170
Note 20. Risk Management ... 171

Note 21. Deferred Outflows of Resources and Deferred Inflows of Resources Including Service Concession Arrangements 173

1. Deferred Outflows of Resources 173
2. Deferred Inflows of Resources 173

Note 22. No Commitment Debt 175

Note 23. Contingent Liabilities 175

A. Litigation 175
B. Federal Audit Exceptions 177

Note 24. Pension Trusts 178

A. Public Employees' Retirement Fund 178
1. Fund Information 178
2. Employer's Information 179
B. Teachers' Retirement Fund 180

Note 25. Postemployment Health Care Benefits 183

Note 26. Subsequent Events 186

A. Debt Issuances 186
B. Cash Management 187
C. Other 187

Notes to the Financial Statements

NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The accompanying financial statements present information on the financial activities of the State of California over which the Governor, the Legislature, and other elected officials have direct or indirect governing and fiscal control. These financial statements have been prepared in conformity with accounting principles generally accepted in the United States of America (GAAP). The provisions of the following Governmental Accounting Standards Board (GASB) Statements have been implemented for the year ended June 30, 2013:

GASB Statement No. 60, *Accounting and Financial Reporting for Service Concession Arrangements; improves financial reporting by addressing issues relating to service concession arrangements which are a type of public-private or public-public partnership;*

GASB Statement No. 61, *The Financial Reporting Entity: Omnibus—an amendment of GASB Statements No. 14 and No. 34; modifies certain requirements for inclusion of component units (legally separate organizations) in the financial reporting entity;*

GASB Statement No. 62, *Codification of Accounting and Financial Reporting Guidance Contained in Pre-November 30, 1989, Financial Accounting Standards Board (FASB) and American Institute of Certified Public Accountants (AICPA) Pronouncements*; *improves financial reporting by contributing to GASB's efforts to codify all sources of GAAP for state and local governments so that they derive from a single source;*

GASB Statement No. 63, *Financial Reporting of Deferred Outflows of Resources, Deferred Inflows of Resources, and Net Position*; *provides financial reporting guidance for deferred outflows of resources and deferred inflows of resources and their effect on government's net position; and*

GASB Statement No. 65, *Items Previously Reported as Assets and Liabilities; establishes accounting and financial reporting standards that reclassify as deferred outflows of resources or deferred inflows of resources, certain items that were previously reported as assets and liabilities and recognizes, as outflows of resources or inflows of resources, certain items that were previously reported as assets and liabilities.*

A. Reporting Entity

These financial statements present the primary government of the State and its component units. The **primary government** consists of all funds, organizations, institutions, agencies, departments, and offices that are not legally separate from the State. **Component units** are organizations that are legally separate from the State, but for which the State is financially accountable or organizations whose relationship with the State is such that exclusion would cause the State's financial statements to be misleading. Following is information on the blended, fiduciary, and discretely presented component units of the State.

1. Blended Component Units

Blended component units, although legally separate entities, are in substance part of the primary government's operations. Therefore, data from these blended component units are integrated into the appropriate funds for reporting purposes.

Building authorities are blended component units because they have been created through the use of joint exercise-of-powers agreements with various cities to finance the construction of state buildings. The building authorities are reported as capital projects funds. As a result, capital lease arrangements between the building authorities and the State have been eliminated from the financial statements. Instead, only the underlying capital assets and the debt used to acquire them are reported in the government-wide financial statements. For information regarding obtaining copies of the financial statements of the building authorities, contact the State Controller's Office, Division of Accounting and Reporting, P.O. Box 942850, Sacramento, California 94250-5872.

The *Golden State Tobacco Securitization Corporation (GSTSC)* is a not-for-profit corporation established through legislation in September 2002 solely for the purpose of purchasing Tobacco Settlement Revenues from the State. The five voting members of the State Public Works Board serve ex officio as the directors of the corporation. GSTSC is authorized to issue bonds as necessary to provide sufficient funds for carrying out its purpose. GSTSC is reported in the combining statements in the Nonmajor Governmental Funds section as a special revenue fund. For information regarding obtaining copies of the financial statements of GSTSC, contact the Department of Finance, Natural Resources, Energy, Environmental, and Capital Outlay Section, 915 L Street, 9th Floor, Sacramento, California 94814.

2. Fiduciary Component Units

The State has two legally separate fiduciary component units that administer pension and other employee benefit trust funds. The State appoints a voting majority of the board members of both plans which, due to their fiduciary nature, are presented in the Fiduciary Fund Statements as pension and other employee benefit trust funds, along with other primary government fiduciary funds.

The *California Public Employees' Retirement System (CalPERS)* administers pension plans for state employees, non-teaching school employees, and employees of California public agencies. Its Board of Administration has plenary authority and fiduciary responsibility for the investment of monies and the administration of the plan. CalPERS administers the following seven pension and other employee benefits trust funds: the Public Employees' Retirement Fund, the Judges' Retirement Fund, the Judges' Retirement Fund II, the Legislators' Retirement Fund, the State Peace Officers' and Firefighters' Defined Contribution Plan Fund, the Public Agency Deferred Compensation Plan, and the public employee Supplemental Contributions Program Fund. Copies of CalPERS' separately issued financial statements may be obtained in writing from the California Public Employees' Retirement System, Fiscal Services Division, P.O. Box 942703, Sacramento, California 94229-2703.

The *California State Teachers' Retirement System (CalSTRS)* administers pension benefit plans for California public school teachers and certain other employees of the public school system. The State is financially accountable for CalSTRS. CalSTRS administers four pension and other employee benefit trust funds, the Defined Benefit Program, the Defined Benefit Supplement Program, the Cash Balance Benefit Program, and the Replacement Benefit Program. Copies of CalSTRS' separately issued financial statements may be obtained from the California State Teachers' Retirement System, P.O. Box 15275, Sacramento, California 95851-0275.

3. Discretely Presented Component Units

Enterprise activity of discretely presented component units is reported in a separate column in the government-wide financial statements. Discretely presented component units are legally separate from the primary government and primarily provide services to entities and individuals outside the primary government. Discretely presented component units that report enterprise activity include the University of California, the California Housing Finance Agency, and nonmajor component units.

The *University of California* was founded in 1868 as a public, state-supported, land grant institution. It was written into the State Constitution of 1879 as a public trust to be administered by a governing board, the Regents of the University of California (Regents). The University of California is a component unit of the State because the State appoints a voting majority of the Regents and provides financial assistance to the University. The University of California offers defined benefit pension plans and defined contribution pension plans to its employees through the University of California Retirement System (UCRS), a fiduciary responsibility of the Regents. The financial information of the UCRS is not included in the financial statements of this report due to its fiduciary nature. Copies of the University of California's financial statements may be obtained from the University of California, 1111 Franklin Street, Oakland, California 94607-5200.

The *California Housing Finance Agency (CalHFA)* was created by the Zenovich-Moscone-Chacon Housing and Home Finance Act, as amended. CalHFA's purpose is financing the housing needs of persons and families of low and moderate income. It is a component unit of the State because the State appoints a voting majority of CalHFA's governing board and appoints the executive director who administers the day-to-day operations. Copies of CalHFA's financial statements may be obtained from the California Housing Finance Agency, P.O. Box 4034, Sacramento, California 95812.

State legislation created various nonmajor component units to provide certain services outside the primary government and to provide certain private and public entities with a low-cost source of financing for programs deemed to be in the public interest. California State University auxiliary organizations are considered component units because they exist entirely or almost entirely for the direct benefit of the universities. The remaining nonmajor component units are considered component units because the majority of members of their governing boards are appointed by or are members of the primary government, and the primary government can impose its will on the entity or the entity provides a specific financial benefit to or imposes a financial burden on the primary government. For information regarding obtaining copies of the financial statements of these component units, contact the State Controller's Office, Division of Accounting and Reporting, P.O. Box 942850, Sacramento, California 94250-5872.

The nonmajor component units are:

> The *California Alternative Energy and Advanced Transportation Financing Authority*, which provides financing for alternative energy and advanced transportation technologies;
>
> The *California Infrastructure and Economic Development Bank*, which provides financing for business development and public improvements;
>
> *California State University auxiliary organizations*, which provide services primarily to university students through foundations, associated student organizations, student unions, food service entities, book stores, and similar organizations;
>
> *District agricultural associations*, which exhibit all of the industries, industrial enterprises, resources, and products of the state (the district agricultural association's financial report is as of and for the year ended December 31, 2012);

The Public Employees' Contingency Reserve, which provides health benefit plans for state employees and annuitants;

The *University of California Hastings College of the Law*, which was established as the law department of the University of California to provide legal education programs and operates independently under its own board of directors. The college has a discretely presented component unit, the Foundation, which provides private sources of funds for academic programs, scholarships, and faculty research;

The *State Assistance Fund for Enterprise, Business and Industrial Development Corporation*, which provides financial assistance to small business; and

The *California Urban Waterfront Area Restoration Financing Authority*, which provides financing for coastal and inland urban waterfront restoration projects.

The following entities were previously reported as Component Units but have been reclassified as Related Organization due to changes in their reporting requirements pursuant to implementation of GASB Statement No. 61, *The Financial Reporting Entity: Omnibus—an amendment of GASB Statements No. 14 and No. 34:*

1. State Compensation Insurance Fund
2. California Pollution Control Financing Authority
3. California Health Facilities Financing Authority
4. California School Finance Authority
5. California Educational Facilities Authority

4. Joint Venture

A joint venture is an entity resulting from a contractual arrangement; it is owned, operated, or governed by two or more participants as a separate and specific activity subject to joint control. In such an arrangement, the participants retain an ongoing financial interest or an ongoing financial responsibility in the entity. These entities are not part of the primary government or a component unit.

The State participates in a joint venture called the *Capitol Area Development Authority (CADA)*. CADA was created in 1978 by the joint exercise of powers agreement between the primary government and the City of Sacramento for the location of state buildings and other improvements. CADA is a public entity, separate from the primary government and the city, and is administered by a board of five members: two appointed by the primary government, two appointed by the city, and one appointed by the affirmative vote of at least three of the other four members of the board. The primary government designates the chairperson of the board. Although the primary government does not have an equity interest in CADA, it does have an ongoing financial interest. The primary government subsidizes CADA's operations by leasing land to CADA without consideration; however, the primary government is not obligated to do so. At June 30, 2013, CADA had total assets of $33 million, total liabilities of $20 million, and total net position of $13 million. Total revenues for the fiscal year were $10 million and expenses were $11 million, resulting in a decrease in net position of $400 thousand. Because the primary government does not have equity interest in CADA, CADA's financial information is not included in the financial statements of this report. Separately issued financial statements may be obtained from the Capitol Area Development Authority, 1522 14th Street, Sacramento, California 95814-5958.

5. Related Organizations

A related organization is an organization for which a primary government is accountable because that government appoints a voting majority of the organization's governing board, but for which it is not financially accountable.

Chapter 854 of the Statutes of 1996 created an *Independent System Operator (ISO)*, a state-chartered, nonprofit market institution. The ISO provides centralized control of the statewide electrical transmission grid to ensure the efficient use and reliable operation of the transmission system. The ISO is governed by a five-member board, the members of which are appointed by the Governor and confirmed by the Senate. The State's accountability for this institution does not extend beyond making the initial oversight board appointments. Because the primary government is not financially accountable for the ISO, the financial information of this institution is not included in the financial statements of this report. For information regarding obtaining copies of the financial statements of the ISO, contact the State Controller's Office, Division of Accounting and Reporting, P.O. Box 942850, Sacramento, California 94250-5872.

The *California Earthquake Authority (CEA)*, a legally separate organization, offers earthquake insurance for California homeowners, renters, condominium owners, and mobile home owners. A three-member board of state-elected officials governs the CEA. The State's accountability for this institution does not extend beyond making the appointments. Because the primary government is not financially accountable for the CEA, the financial information of this institution is not included in the financial statements of this report. For information regarding obtaining copies of the financial statements of the CEA, contact the California Earthquake Authority, 801 K Street, Suite 1000, Sacramento, California 95814.

The *State Compensation Insurance Fund* (*State Fund*) was established by the State of California through legislation enacted in 1913 to provide an available market for workers' compensation insurance to employees located in California. State Fund operates in competition with other insurance carriers to serve California businesses. The State appoints all eleven members of the State Fund's governing board. The State's accountability for this institution does not extend beyond making the initial oversight board appointments. Because the primary government is not financially accountable for the State Fund, the financial information of this institution is not included in the financial statement of this report. For information regarding obtaining copies of the financial statements of the State Fund, contact State Compensation Insurance Fund, 333 Bush Street, 8th Floor, San Francisco, California 94104.

The *California Health Benefit Exchange (the Exchange),* an independent public entity, offers new health insurance to individuals, families, and small businesses. A five-member board of state-elected officials governs the Exchange. The State's accountability for this institution does not extend beyond making the appointments. Because the primary government is not financially accountable for the Exchange, the financial information of this institution is not included in the financial statements of this report. For information regarding obtaining copies of the financial statements of the Exchange, contact Covered California, P.O. Box 989725, West Sacramento, California 95798-9725.

The *California Pollution Control Financing Authority (CPCFA)* was created through the California Pollution Control Financing Authority Act of 1972. The CPCFA is a legally separate entity that provides financing for pollution control facilities. A three-member board of state-elected officials governs the CPCFA. The State's accountability for this institution does not extend beyond making the appointments. Because the primary government is not financially accountable for the CPCFA, the financial information of this institution is not included in the financial statements of this report. For information regarding obtaining copies of the financial statements of the CPCFA, contact the State Treasurer's Office, 915 Capitol Mall, Room 457, Sacramento, California 95814.

The *California Health Facilities Financing Authority (CHFFA)* was established by the State of California through legislation enacted in 1979. The CHFFA is a legally separate entity that provides financing for the construction, equipping, and acquisition of health facilities. A nine-member board of state-elected officials and appointees govern the CHFFA. The State's accountability for this institution does not extend beyond making the appointments. Because the primary government is not financially accountable for the CHFFA, the financial information of this institution is not included in the financial statements of this report. For information regarding obtaining copies of the financial statements of the CHFFA, contact the State Treasurer's Office, 915 Capitol Mall, Suite 590, Sacramento, California 95814.

The *California Educational Facilities Authority (CEFA)* was created by the Board of Control Approval in 1974. The CEFA is a legally separate entity established to issue revenue bonds to finance loans for students attending public and private colleges and universities, and to assist private educational institutions of higher learning in financing the expansion and construction of educational facilities. A five-member board of state-elected officials and appointees govern the CEFA. The State's accountability for this institution does not extend beyond making the appointments. Because the primary government is not financially accountable for the CEFA, the financial information of this institution is not included in the financial statements of this report. For information regarding obtaining copies of the financial statements for the CEFA, contact the State Treasurer's Office, 915 Capitol Mall, Suite 590, Sacramento, California 95814.

The *California School Finance Authority (CSFA)* was created in 1985. The CSFA is a legally separate entity that provides loans to school and community college districts to assist them in obtaining equipment and facilities. A three-member board of state officials governs the CSFA. The State's accountability for this institution does not extend beyond making the appointments. Because the primary government is not financially accountable for the CSFA, the financial information for this institution is not included in the financial statements of this report. For information regarding obtaining copies of the financial statements of the CSFA, contact the State Treasurer's Office, 304 South Broadway, Suite 550, Los Angeles, California 90013.

B. Government-wide and Fund Financial Statements

Government-wide financial statements (the Statement of Net Position and the Statement of Activities) give information on all the nonfiduciary activities of the primary government and its component units. The primary government is reported separately from legally separate component units for which the State is financially accountable. Within the primary government, the State's governmental activities, which are normally supported by taxes and intergovernmental revenues, are reported separately from business-type activities, which rely to a significant extent on fees and charges for support. The effect of interfund activity has been removed from the statements, with the exception of amounts between governmental and business-type activities, which are presented as internal balances and transfers. Centralized services provided by the General Fund for other funds are charged as direct costs to the funds that received those services. Also, the General Fund recovers the cost of centralized services provided to federal programs from the federal government.

The Statement of Net Position reports all of the financial and capital resources of the government as a whole in a format in which assets and deferred outflows of resources equal liabilities and deferred inflows of resources, plus net position. The Statement of Activities demonstrates the degree to which the expenses of a given function are offset by program revenues. Program revenues include charges to customers who purchase, use, or directly benefit from goods, services, or privileges provided by a given function. Program revenues also include grants and contributions that are restricted to meeting the operational or capital requirements of a particular function. Taxes and other items that are not program-related are reported as general revenues.

Fund financial statements are provided for governmental funds, proprietary funds, fiduciary funds and similar component units, and discretely presented component units. A fund is a fiscal and accounting entity with a self-balancing set of accounts. Fund accounting segregates funds according to their intended purpose and is used to aid management in demonstrating compliance with finance-related legal and contractual provisions. The State maintains the minimum number of funds consistent with legal and managerial requirements. Fiduciary funds, although excluded from the government-wide statements, are included in the fund financial statements. Major governmental and enterprise funds are reported in separate columns in the fund financial statements. Nonmajor governmental and proprietary funds are grouped into separate columns. Discretely presented component unit statements, which follow the fiduciary fund statements, also separately report the enterprise activity of the major discretely presented component units. In this report, the enterprise activity of nonmajor discretely presented component units is grouped in a separate column.

Governmental fund types are used primarily to account for activities primarily supported by taxes, grants, and similar revenue sources.

The State reports the following major governmental funds:

The *General Fund* is the main operating fund of the State. It accounts for transactions related to resources obtained and used for those services that do not need to be accounted for in another fund.

The *Federal Fund* accounts for the receipt and use of grants, entitlements, and shared revenues received from the federal government.

The *Transportation Fund* accounts for fuel taxes, including the State's diesel, motor vehicle, and fuel use taxes; bond proceeds; automobile registration fees; and other revenues that are used for transportation purposes, including highway and passenger rail construction and transportation safety programs.

The *Environmental and Natural Resources Fund* accounts for fees, bond proceeds, and other revenues that are used for maintaining the State's natural resources and improving the environmental quality of its air, land, and water.

Proprietary fund types focus on the determination of operating income, changes in net position, financial position, and cash flows.

Proprietary funds distinguish operating revenues and expenses from nonoperating items. Operating revenues and expenses generally result from providing services and producing and delivering goods in connection with a proprietary fund's principal ongoing operations. Operating expenses include the cost of sales and services, administrative expenses, and depreciation on capital assets. All revenues and expenses not meeting this definition are reported as nonoperating revenues and expenses.

For its proprietary funds, the State applies all applicable GASB pronouncements. The State adopted the provisions of GASB Statement No. 62, *Codification of Accounting and Financial Reporting Guidance Contained in Pre-November 30, 1989 FASB and AICPA Pronouncements* during the year ending June 30, 2013.

The State has two proprietary fund types: enterprise funds and internal service funds.

Enterprise funds record business-type activity for which a fee is charged to external users for goods and services. In addition, the State is required to report activities as enterprise funds in the context of the activity's principal revenue sources when any of the following criteria are met:

- The activity's debt is secured solely by fees and charges of the activity;
- There is a legal requirement to recover costs; or
- The pricing policies of fees and charges are designed to recover costs.

The State reports the following major enterprise funds:

The *Electric Power Fund* accounts for the acquisition and resale of electric power to retail end-use customers.

The *Water Resources Fund* accounts for charges to local water districts and the sale of excess power to public utilities.

The *Public Buildings Construction Fund* accounts for rental charges from the lease of public assets.

The *State Lottery Fund* accounts for the sale of California State Lottery (Lottery) tickets and the Lottery's payments for education.

The *Unemployment Programs Fund* accounts for employer and worker contributions used for payments of unemployment insurance and disability benefits.

The *California State University Fund* accounts for student fees and other receipts from gifts, bequests, donations, federal and state grants, and loans that are used for educational purposes.

Nonmajor enterprise funds account for additional operations that are financed and operated in a manner similar to private business enterprises.

Additionally, the State reports *internal service funds* as a proprietary fund type with governmental activity. Internal service funds account for goods or services provided to other agencies, departments, or governments on a cost-reimbursement basis. The goods and services provided include: architectural services, construction and improvements, printing and procurement services, goods produced by inmates of state prisons, data processing services, and administrative services related to water delivery. Internal service funds are included in the governmental activities at the government-wide level.

Fiduciary fund types are used to account for assets held by the State. The State acts as a trustee or as an agent for individuals, private organizations, other governments, or other funds. Fiduciary funds, including fiduciary component units, are not included in the government-wide financial statements.

The State has the following four fiduciary fund types:

Private purpose trust funds account for all trust arrangements, other than those properly reported in pension or investment trust funds, whereby principal and income benefit individuals, private organizations, or other governments. The following are the State's largest private purpose trust funds:

The *Scholarshare Program Trust Fund* accounts for money received from participants to fund their beneficiaries' higher education expenses at certain postsecondary educational institutions.

The *Unclaimed Property Fund* accounts for unclaimed money and properties held in trust by the State. Unclaimed property is remitted to the General Fund where it can be used by the State until it is claimed.

Pension and other employee benefit trust funds of the primary government and fiduciary component units account for transactions, assets, liabilities, and net position available for plan benefits of the retirement systems and for other employee benefit programs.

An *investment trust fund* accounts for the deposits, withdrawals, and earnings of the Local Agency Investment Fund, an external investment pool for local governments and public agencies.

Agency funds account for assets held by the State, which acts as an agent for individuals, private organizations, or other governments. The following are the State's largest agency funds:

The *Receipting and Disbursing Fund* accounts for the collection and disbursement of revenues and receipts on behalf of local governments. This fund also accounts for receipts from numerous state funds, typically for the purpose of writing a single warrant when the warrant is funded by multiple funding sources.

The *Deposit Fund* accounts for various deposits, such as those from condemnation and litigation proceedings.

Discretely presented component units consist of certain organizations that have enterprise activity. The enterprise activity component units are the University of California, the California Housing Finance Agency, and nonmajor component units. In this report, all of the enterprise activity of the discretely presented component units is reported in a separate column in the government-wide financial statements and on separate pages following the fund financial statements.

C. Measurement Focus and Basis of Accounting

1. Government-wide Financial Statements

The government-wide financial statements are reported using the economic resources measurement focus and the accrual basis of accounting. Revenues are recorded when they are earned and expenses are recorded when a liability is incurred, regardless of the timing of related cash flows. Grants and similar transactions are recognized as revenue as soon as all eligibility requirements imposed by the provider have been met.

2. Fund Financial Statements

The measurement focus and basis of accounting for the fund financial statements vary with the type of fund. **Governmental fund types** are presented using the current financial resources measurement focus. With this measurement focus, operating statements present increases and decreases in net current assets; the unreserved fund balance is a measure of available spendable resources.

The accounts of the governmental fund types are reported using the modified accrual basis of accounting. Under the modified accrual basis, revenues are recorded as they become measurable and available, and expenditures are recorded at the time the liabilities are incurred. The State records revenue sources when they are earned or when they are due, provided they are measurable and available within the ensuing 12 months. Principal tax revenues susceptible to accrual are recorded as taxpayers earn income (personal income and corporation taxes), as sales are made (consumption and use taxes), and as the taxable event occurs (miscellaneous taxes), net of estimated tax overpayments.

Proprietary fund types, the **investment trust fund**, **private purpose trust funds**, and **pension and other employee benefit trust funds** are accounted for using the economic resources measurement focus. **Agency funds** are custodial in nature and do not measure the results of operations.

The accounts of the proprietary fund types, the investment trust fund, private purpose trust funds, pension and other employee benefit trust funds, and agency funds are reported using the accrual basis of accounting. Under the accrual basis, most transactions are recorded when they occur, regardless of when cash is received or disbursed.

Lottery revenue and the related prize expenses are recognized when sales are made. Certain prizes are payable in deferred installments. Such liabilities are recorded at the present value of amounts payable in the future.

For purposes of the Statement of Cash Flows, all cash and pooled investments in the State Treasurer's pooled investment program are considered to be cash and cash equivalents.

Discretely presented component units are accounted for using the economic resources measurement focus and the accrual basis of accounting.

D. Inventories

Inventories of supplies are reported at cost and inventories held for resale are stated at the lower of average cost or market. In the government-wide financial statements, inventories for both governmental and business-type activities are expensed when they are consumed and unused inventories are reported as an asset on the Statement of Net Position. In the fund financial statements, governmental funds report inventories as expenditures when purchased, and proprietary funds report inventories as expenditures when consumed. The discretely presented component units have inventory policies similar to those of the primary government.

E. Deposits and Investments

The State reports investments at fair value, as prescribed by GAAP. Additional information on the State's investments can be found in Note 3, Deposits and Investments.

F. Net Investment in Direct Financing Leases

The State Public Works Board, an agency that accounts for its activities as an enterprise fund, has entered into lease-purchase agreements with various other primary government agencies, the University of California, and certain local agencies. The payments from these leases are used to satisfy the principal and interest requirements of revenue bonds issued by the State Public Works Board to finance the cost of projects such as acquisition and construction of facilities and equipment. Upon expiration of these leases, title to the facilities and projects transfers to the primary government agency, the University of California, or the local agency. The State Public Works Board records the net investment in direct financing leases at the net present value of the minimum lease payments.

California State University Systems (CSU) accounts for its lease activities in the California State University Trust Fund, a major enterprise fund, has entered into 30-year capital lease agreements with certain auxiliary organizations. These agreements lease existing and newly constructed facilities to the auxiliary organizations. A portion of the proceeds from certain revenue bonds issued by CSU were used to finance the construction of these facilities.

G. Long-term Prepaid Charges

The long-term prepaid charges account in the enterprise funds primarily represents operating and maintenance costs that will be recognized in the Water Resources Fund as expenses over the remaining life of long-term state water supply contracts. These costs are billable in future years. In addition, the account includes unbilled interest earnings on unrecovered capital costs that are recorded as long-term prepaid charges. These charges are recognized when billed in the future years under the terms of water supply contracts. The long-term prepaid charges for the Public Buildings Construction Fund include prepaid insurance costs. Long-term prepaid charges are also included in the State Lottery Fund and nonmajor enterprise funds. These prepaid costs are incurred in connection with certain contracts that extend beyond a one-year period, which are amortized as expenses over the remaining life of the contracts.

Bond issuance costs were previously reported as deferred charges. Per GASB 65, these costs should be expensed as incurred, excluding the insurance costs. For fiscal year 2012-13, bond issuance costs are expensed in the State of California's financial statements.

H. Capital Assets

Capital assets are categorized into land, state highway infrastructure, collections, buildings and other depreciable property, intangible assets, and construction in progress. The buildings and other depreciable property account includes buildings, improvements other than buildings, equipment, certain infrastructure assets, certain books, and other capitalized and depreciable property. Intangible assets include computer software, land use rights, patents, copyrights, and trademarks. The value of the capital assets, including the related accumulated depreciation and amortization, is reported in the applicable governmental, business-type, or component unit activities columns in the Government-wide Statement of Net Position.

The primary government has a large collection of historical and contemporary treasures that have important documentary and artistic value. These assets are not capitalized or depreciated because they are cultural resources and cannot reasonably be valued and/or the assets have inexhaustible useful lives. These treasures and works of art include furnishings, portraits and other paintings, books, statues, photographs, and miscellaneous artifacts. These collections meet the conditions for exemption from capitalization because the collections are: held for public exhibition, education, or research in furtherance of public service, rather than financial gain; protected, kept unencumbered, cared for, and preserved; and are subject to an organizational policy that requires the proceeds from sales of collection items to be used to acquire other items for collections.

In general, capital assets of the primary government are defined as assets that have a normal useful life of at least one year and a unit cost of at least $5,000. These assets are recorded at historical cost or estimated historical cost, including all costs related to the acquisition. Donated capital assets are recorded at the fair market value on the date the gift was received. Major capital asset outlays are capitalized as projects are constructed.

Buildings and other depreciable or amortizable capital assets are depreciated using the straight line method with no salvage value for governmental activities. Generally, buildings and other improvements are depreciated over 40 years, equipment is depreciated over five years, and intangible assets are amortized over 10 to 20 years. Depreciable or amortizable assets of business-type activities are depreciated or amortized using the straight-line method over their estimated useful or service lives, ranging from three to 100 years.

California has elected to use the modified approach for capitalizing the infrastructure assets of the state highway system. The state highway system is maintained by the California Department of Transportation. By using the modified approach, the infrastructure assets of the state highway system are not depreciated and all expenditures made for those assets, except for additions and improvements, are expensed in the period incurred. All additions and improvements made after June 30, 2001, are capitalized. All infrastructure assets that are related to projects completed prior to July 1, 2001, are recorded at the historical costs contained in annual reports of the American Association of State Highway and Transportation Officials and the Federal Highway Administration.

The capital assets of the discretely presented component units are reported at cost at the date of acquisition or at fair market value at the date of donation, in the case of gifts. They are depreciated or amortized over their estimated useful service lives.

I. Long-term Obligations

Long-term obligations consist of certain unmatured general obligation bonds, certain unmatured revenue bonds, capital lease obligations, certificates of participation, commercial paper, the net pension obligation of the pension and other employee benefit trust funds, the net other postemployment benefits obligation, the liability for employees' compensated absences and workers' compensation claims, pollution remediation obligations, amounts owed for lawsuits, reimbursement for costs mandated by the State, the outstanding Proposition 98 funding guarantee owed to schools, the liability for Lottery prizes and annuities, loans from other governments and fiduciary funds, and the primary government's share of the University of California pension liability that is due in more than one year. In the government-wide financial statements, current and noncurrent obligations are reported as liabilities in the applicable governmental activities, business-type activities, and component units columns of the Statement of Net Position.

Pollution remediation obligations are recorded by the State when one or more of the GASB Statement No. 49 obligating events have occurred and when a reasonable estimate of the remediation cost is available. These liabilities are measured using actual contract costs, where no change in cost is expected, or the expected cash flow technique. The remediation obligation estimates that appear in this report are subject to change over time. Cost may vary due to price fluctuations, changes in technology, changes in potential responsible parties, results of environmental studies, changes to statutes or regulations and other factors that could result in revisions to these estimates. Prospective recoveries from responsible parties may reduce the State's obligation.

Bond premiums and discounts for business-type activities and component units are generally deferred and amortized over the life of the bonds. In these instances, bonds payable are reported net of the applicable premium and discount. Bond premiums and discounts for governmental activities are reported as other financing sources (uses) in the fund financial statements. However, in the government-wide financial statements, the bonds payable for governmental activities is reported net of the applicable unamortized premium and discount.

With approval in advance from the Legislature, certain authorities and state agencies may issue revenue bonds. Principal and interest on revenue bonds are payable from the pledged revenues of the respective funds, building authorities, and agencies. The General Fund has no legal liability for payment of principal and interest on revenue bonds. With the exception of certain special revenue funds (Transportation and the Golden State Tobacco Securitization Corporation) and the building authorities' capital projects funds, the liability for revenue bonds is recorded in the respective fund.

J. Compensated Absences

The government-wide financial statements report both the current and the noncurrent liabilities for compensated absences, which are vested unpaid vacation, annual leave, and other paid leave programs. However, unused sick-leave balances are not included in the compensated absences because they do not vest to employees. In the fund financial statements for governmental funds, only the compensated absences for employees that have left state service and have unused reimbursable leave at year end would be included. The amounts of vested unpaid vacation and annual leave accumulated by state employees are accrued in proprietary funds when incurred. In the discretely presented component units, the compensated absences are accounted for in the same manner as in the proprietary funds of the primary government.

K. Net Position and Fund Balance

The difference between fund assets, deferred outflows of resources, liabilities, and deferred inflows of resources is called "net position" on the government-wide financial statements, the proprietary and fiduciary fund statements, and the component unit statements; it is called "fund balance" on the governmental fund statements. The government-wide financial statements include the following categories of net position:

Net investment in capital assets, represents capital assets, net of accumulated depreciation, reduced by the outstanding principal balances of debt attributable to the acquisition, construction, or improvement of those assets.

Restricted net position results from transactions with purpose restrictions and is designated as either *nonexpendable* or *expendable*. *Nonexpendable restricted net* position is subject to externally imposed restrictions that must be retained in perpetuity. *Expendable restricted net* position is subject to externally imposed restrictions that can be fulfilled by actions of the State. As of June 30, 2013, the government-wide financial statements show restricted net position for the primary government of $29.5 billion, of which $6.7 billion is due to enabling legislation.

Unrestricted net position is neither restricted nor invested in capital assets.

In the fund financial statements, proprietary funds include categories of net position similar to those in the government-wide statements. The fund balance amounts for governmental funds are reported as nonspendable, restricted, committed, assigned, or unassigned in accordance with GASB Statement No. 54.

Nonspendable fund balances include amounts that cannot be spent because they are not in spendable form (inventories; prepaid amounts; long-term portion of loans or notes receivable; or property held for resale unless the proceeds are restricted, committed, or assigned) or they are legally or contractually required to remain intact, such as a principal balance in a permanent fund.

Restricted fund balances have constraints placed upon the use of the resources either by an external party (creditors, grantors, contributors, or laws or regulations of other governments) or by law through a constitutional provision or enabling legislation.

Committed fund balances can be used only for specific purposes pursuant to constraints imposed by a formal action of the State's highest level of decision-making authority. Those committed amounts cannot be used for any other purpose unless the State removes or changes the specified use by taking the same type of action. The formal action that commits a fund balance to a specific purpose should occur prior to the end of the reporting period, but the amount subject to the constraint may be determined in a subsequent period. Committed fund balance should incorporate contractual obligations to the extent that existing resources in the fund have been specifically committed for use in satisfying those contractual requirements.

Assigned fund balances include amounts that are constrained by the State's intent to be used for a specific purpose, but are neither restricted nor committed. For governmental funds other than the General Fund, this is the residual amount of the fund that is not classified as nonspendable and is neither restricted nor committed.

The *Unassigned* fund balance is the residual amount of the General Fund not included in the four classifications described above. In other governmental funds where expenditures incurred for specific purposes exceed amounts restricted, committed, or assigned to those purposes, a negative unassigned fund balance may need to be reported.

Fiduciary fund net position is amounts held in trust for benefits and other purposes.

L. Restatement of Beginning Fund Balances and Net Position

Schedule of Restatement of Beginning Fund Balances and Net Position
(amounts in thousands)

Fund Financial Statements

Governmental Funds		
Major Governmental Funds		
General Fund		
Fund balances as of June 30, 2012, as previously reported	$	(22,961,288)
Overstatement of 2011-12 General Fund expenditures		232,120
Fund balances as of July 1, 2012, as restated	**$**	**(22,729,168)**
Environmental and Natural Resources		
Fund balances as of June 30, 2012, as previously reported	$	7,965,054
GASB 61 adjustments		1,174
Fund balances as of July 1, 2012, as restated	**$**	**7,966,228**
Nonmajor Governmental Funds		
Fund balances as of June 30, 2012, as previously reported	$	11,943,613
Deferred payroll adjustment		11
Reclass from agency fund to special revenue fund		149,711
Fund balances as of July 1, 2012, as restated	**$**	**12,093,335**
Enterprise Funds		
Major Enterprise Funds		
California State University		
Net position as of June 30, 2012, as previously reported	$	2,564,751
GASB 61 adjustments		(58,359)
Net position as of July 1, 2012, as restated	**$**	**2,506,392**
Public Buildings Construction Fund		
Net position as of June 30, 2012, as previously reported	$	239,458
GASB 65 adjustments		(56,721)
Net position as of July 1, 2012, as restated	**$**	**182,737**
Nonmajor Enterprise Funds		
Net position as of June 30, 2012, as previously reported	$	3,792,279
GASB 65 adjustments		(7,791)
Net position as of July 1, 2012, as restated	**$**	**3,784,488**

Fund Financial Statements (continued)

Fiduciary Funds		
Pension and other Employee Benefit Trust		
Net position as of June 30, 2012, as previously reported	$	401,333,900
CalPERS Defined Contribution Pension Plan adjustments		(23,203)
Net position as of July 1, 2012, as restated	**$**	**401,310,697**
Discretely Presented Component Units		
Major Component Units		
University of California		
Net position as of June 30, 2012, as previously reported	$	23,404,025
Change in accounting policy		(159,712)
Net position as of July 1, 2012, as restated	**$**	**23,244,313**
Nonmajor Component Units		
Net position as of June 30, 2012, as previously reported	$	2,915,162
GASB 45 adjustments		(362)
GASB 61 adjustments		(39,366)
GASB 65 adjustments		(6,540)
Other adjustments		278
Net position as of July 1, 2012, as restated	**$**	**2,869,172**
Eliminated Major Component Units		
State Compensation Insurance		
Net position as of June 30, 2012, as previously reported	$	7,083,903
GASB 61 adjustments		(7,083,903)
Net position as of July 1, 2012, as restated	**$**	**—**
Public Employees' Benefits		
Net position as of June 30, 2012, as previously reported	$	301,826
GASB 61 adjustments		(301,826)
Net position as of July 1, 2012, as restated	**$**	**—**

Schedule of Restatement of Beginning Fund Balances and Net Position (continued)

(amounts in thousands)

Government-wide Financial Statements

Governmental Activities

Net position as of June 30, 2012, as previously reported	$	(18,257,716)
GASB 61 adjustments		(6,044)
GASB 65 adjustments		(194,668)
General Fund balance adjustment		232,120
Nonmajor Governmental Fund balance adjustment		149,722
Overstatement of 2011-12 capital leases		240,140
Various capital assets adjustments		1,293,866
Increase in pollution remediation obligation		(105,417)
Other adjustments		(1)
Net position as of July 1, 2012, as restated	**$**	**(16,647,998)**

Business-type Activities

Net position as of June 30, 2012, as previously reported	$	2,807,029
GASB 61 adjustments		(58,359)
GASB 65 adjustments		(64,512)
Other adjustments		(3)
Net position as of July 1, 2012, as restated	**$**	**2,684,155**

Component Units

Net position as of June 30, 2012, as previously reported	$	35,062,284
GASB 45 adjustments		(362)
GASB 61 adjustments		(7,425,095)
GASB 65 adjustments		(6,540)
Adjustments due to change in accounting policy		(159,712)
Other adjustments		278
Net position as of July 1, 2012, as restated	**$**	**27,470,853**

This page intentionally left blank.

M. Guaranty Deposits

The State is custodian of guaranty deposits held to protect consumers, to secure the State's deposits in financial institutions, and to ensure payment of taxes and fulfillment of obligations to the State. Guaranty deposits of securities and other properties are not shown on the financial statements.

N. Deferred Outflows and Deferred Inflows of Resources

The government-wide and fund-based financial statements report deferred outflows of resources and deferred inflows of resources.

Deferred outflows of resources are consumption of assets by the primary government and its component units that are applicable to future reporting periods. Deferred outflows of resources are presented separately after "Total Assets" in the State's financial statements.

Deferred inflows of resources are acquisition of assets by the primary government and its component units that are applicable to future reporting periods. Deferred inflows of resources are presented separately after "Total Liabilities" in the State's financial statements.

Additional information on the State's deferred outflows of resources and deferred inflows of resources can be found in Note 21: *Deferred Outflows of Resources and Deferred Inflows of Resources Including Service Concession Arrangements*.

O. Abnormal Fund Balances

In fiscal year 2012-13, Water Resources Electric Power fund had a net refund of $405 million for power charges revenue. The refund resulted from lower power sales, return of prior year over-collection, and return of reserves, as lower levels of reserve were required. During the fiscal year 2012-13, the fund returned $449 million through adjustments to power charges and separate monthly payments to ratepayers.

P. Nonmajor Enterprise Segment Information

Two nonmajor enterprise fund segments are displayed discretely in the Combining Statement of Net Position; the Combining Statement of Revenues, Expenses, and Changes in Fund Net Position; and the Statement of Cash Flows in the Nonmajor Enterprise Funds. A segment is an identifiable activity reported as or within an enterprise fund or another stand-alone entity for which debt is outstanding and a revenue stream has been pledged in support of that debt. In addition, to qualify as a segment, an activity must be subject to an external requirement to separately account for revenues, expenses, gains and losses, assets and deferred outflows of resources, and liabilities and deferred inflows of resources. All of the activities reported for the fund segments listed below meet these requirements.

> *State Water Pollution Control Revolving Fund*: Interest charged on loans to communities for construction of water pollution control facilities and projects.
>
> *Housing Loan Fund*: Interest payments from low-interest, long-term farm and home mortgage loan contracts to eligible veterans living in California.

NOTE 2: BUDGETARY AND LEGAL COMPLIANCE

A. Budgeting and Budgetary Control

The State's annual budget is prepared primarily on a modified accrual basis for governmental funds. The Governor recommends a budget for approval by the Legislature each year. This recommended budget includes estimated revenues; however, revenues are not included in the annual budget bill adopted by the Legislature. Under state law, the State cannot adopt a spending plan that exceeds estimated revenues.

Under the State Constitution, money may be drawn from the treasury only through a legal appropriation. The appropriations contained in the Budget Act, as approved by the Legislature and signed by the Governor, are the primary sources of annual expenditure authorizations and establish the legal level of control for the annual operating budget. The budget can be amended throughout the year by special legislative action, budget revisions by the Department of Finance, or executive orders of the Governor. Amendments to the original budget for the year ended June 30, 2013, were legally made, and they had the effect of decreased spending authority for the Budgetary/Legal Basis reported General Fund and Transportation Funds, and increased spending authority for the Environmental and Natural Resources Funds.

Appropriations are generally available for expenditure or encumbrance either in the year appropriated or for a period of three years if the legislation does not specify a period of availability. At the end of the availability period, the encumbering authority for the unencumbered balance lapses. Some appropriations continue indefinitely, while others are available until fully spent. Generally, encumbrances must be liquidated within two years from the end of the period in which the appropriation is available. If the encumbrances are not liquidated within this additional two-year period, the spending authority for these encumbrances lapses.

B. Legal Compliance

State agencies are responsible for exercising basic budgetary control and ensuring that appropriations are not overspent. The State Controller's Office is responsible for overall appropriation control and does not allow expenditures in excess of authorized appropriations.

Financial activities are mainly controlled at the appropriation level but can vary, depending on the presentation and wording contained in the Budget Act. The Budget Act appropriations are identified by department, reference item, and fund. The annual appropriated budget may establish detailed allocations to specific programs, projects, or sources of reimbursement within an appropriation. The Department of Finance can authorize adjustments between the detail allocations but cannot increase the amount of the overall appropriation. While the financial activities are controlled at various levels, the legal level of budgetary control—the extent to which management may amend the budget without seeking approval of the governing body—has been established in the Budget Act for the annual operating budget.

NOTE 3: DEPOSITS AND INVESTMENTS

The State Treasurer administers a single pooled investment program comprising both an internal investment pool and an external investment pool (the Local Agency Investment Fund). A single portfolio of investments exists, with all participants having an undivided interest in the portfolio. Both pools are administered in the same manner, as described below.

As required by generally accepted accounting principles, certain risk disclosures are included in this note to the extent that the risks exist at the date of the Statement of Net Position. Disclosure of the following risks is included:

Interest Rate Risk is the risk that the value of fixed-income securities will decline because of changing interest rates. The prices of fixed-income securities with longer time to maturity tend to be more sensitive to changes in interest rates than those with shorter durations.

Credit Risk is the risk that a debt issuer will fail to pay interest or principal in a timely manner, or that negative perceptions of the issuer's ability to make these payments will cause security prices to decline.

Custodial Credit Risk is the risk that, in the event a financial institution or counterparty fails, the investor will not be able to recover the value of deposits, investments, or collateral.

Concentration of Credit Risk is the risk of loss attributed to the magnitude of an investor's holdings in a single issuer.

Foreign Currency Risk is the risk that changes in exchange rates will adversely affect the fair value of an investment or a deposit.

A. Primary Government

The State's pooled investment program and certain funds of the primary government are allowed by state statutes, bond resolutions, and investment policy resolutions to invest in United States government securities, federal agency securities, negotiable certificates of deposit, bankers' acceptances, commercial paper, corporate bonds, bank notes, other debt securities, repurchase agreements, reverse repurchase agreements, and other investments.

Certain discretely presented component units participate in the State Treasurer's Office pooled investment program. As of June 30, 2013, the discretely presented component units accounted for approximately 2.8% of the State Treasurer's pooled investment portfolio. This program enables the State Treasurer's Office to combine available cash from all funds and to invest cash that exceeds current needs.

Both deposits and investments are included in the State's investment program. For certain banks, the State Treasurer's Office maintains cash deposits that cover uncleared checks deposited in the State's accounts and that earn income which compensates the banks for their services.

Demand and time deposits held by financial institutions as of June 30, 2013, totaling approximately $6.8 billion, were insured by federal depository insurance or by collateral held by the State Treasurer's Office or an agent of the State Treasurer's Office in the State's name. The California Government Code requires that collateral pledged for demand and time deposits be deposited with the State Treasurer.

As of June 30, 2013, the State Treasurer's Office had on deposit with a fiscal agent amounts totaling $28 million related to principal and interest payments to bondholders. These deposits were insured by federal depository insurance or by collateral held by an agent of the State Treasurer's Office in the State's name.

The State Treasurer's Office reports its investments at fair value. The fair value of securities in the State Treasurer's pooled investment program generally is based on quoted market prices. The State Treasurer's Office performs a quarterly fair market valuation of the pooled investment program portfolio. In addition, the State Treasurer's Office performs a monthly fair market valuation of all securities held against carrying cost. These valuations are posted to the State Treasurer's Office website at www.treasurer.ca.gov. As of June 30, 2013, the weighted average maturity of the securities in the pooled investment program administered by the State Treasurer's Office was approximately 284 days. Weighted average maturity is the average number of days, given a dollar-weighted value of individual investments, that the securities in the portfolio have remaining from evaluation date to stated maturity.

The Pooled Money Investment Board provides oversight of the State Treasurer's pooled investment program. The purpose of the board is to design and administer an effective cash management and investment program, using all monies flowing through the State Treasurer's Office bank accounts and keeping all available funds invested in a manner consistent with the goals of safety, liquidity, and yield. The Pooled Money Investment Board is comprised of the State Treasurer as chair, the State Controller, and the Director of Finance. This board designates the amounts of money available for investment. The State Treasurer is charged with making the actual investment transactions for this program. This investment program is not registered with the Securities and Exchange Commission as an investment company.

The value of the deposits in the State Treasurer's pooled investment program, including the Local Agency Investment Fund, is equal to the dollars deposited in the program. The fair value of the position in the program may be greater or less than the value of the deposits, with the difference representing the unrealized gain or loss. As of June 30, 2013, this difference was immaterial to the valuation of the program. The pool is run with "dollar-in, dollar-out" participation. There are no share-value adjustments to reflect changes in fair value.

Certain funds have elected to participate in the pooled investment program even though they have the authority to make their own investments. Others may be required by legislation to participate in the program; as a result, the deposits of these funds or accounts may be considered involuntary. However, these funds or accounts are part of the State's reporting entity. The remaining participation in the pool, the Local Agency Investment Fund, is voluntary.

Certain funds that have deposits in the State Treasurer's pooled investment program do not receive the interest earnings on their deposits. Instead, by law, the earnings are to be assigned to the State's General Fund. Most of the $26 million in interest revenue received by the General Fund from the pooled investment program in the 2012-13 fiscal year was earned on balances in these funds.

The State Treasurer's pooled investment program values participants' shares on an amortized cost basis. Specifically, the program distributes income to participants quarterly, based on their relative participation during the quarter. This participation is calculated based on (1) realized investment gains and losses calculated on an amortized cost basis, (2) interest income based on stated rates (both paid and accrued), (3) amortization of discounts and premiums on a straight-line basis, and (4) investment and administrative expenses. This amortized cost method differs from the fair value method used to value investments in these financial statements; the amortized cost method is not designed to distribute to participants all unrealized gains and losses in the fair value of the pool's investments. Because the total difference between the fair value of the investments in the pool and the value distributed to pool participants using the amortized cost method described above is not material, no adjustment was made to the financial statements. The State Treasurer's Office also reports participant fair value as a ratio of amortized cost on a quarterly basis. The State Treasurer's Office has not provided or obtained a legally binding guarantee to support the principal invested in the investment program.

As of June 30, 2013, structured notes and medium-term, asset-backed securities comprised approximately 1.88% of the pooled investments. A significant portion of the structured notes consisted of corporate floating-rate certificates of deposit. For the corporate floating-rate securities held in the portfolio during the fiscal year, the interest received by the State Treasurer's pooled investment program rose or fell as the underlying index rate rose or fell. The portion representing the asset-backed securities consists of mortgage-backed securities, Small Business Administration (SBA) pools, and asset-backed commercial paper. The mortgage-backed securities are called real estate mortgage investment conduits (REMICs), and are securities backed by pools of mortgages. The REMICs in the State's portfolio have a fixed principal payment schedule. A portion of the asset-backed securities consisted of floating-rate SBA notes. For floating-rate SBA notes held in the portfolio during the fiscal year, the interest received by the State Treasurer's pooled investment program rose or fell as the underlying index rate rose or fell. The structure of the floating-rate notes in the State Treasurer's pooled investment program portfolio provided a hedge against the risk of increasing interest rates. A portion of the asset-backed portfolio holdings was short-term, asset-backed commercial paper (ABCP), which represented 0.08% of pooled investments.

Enterprise funds and special revenue funds also make separate investments, which are presented at fair value.

Table 1 identifies the investment types that are authorized by the California Government Code and the State Treasurer's Office investment policy for the pooled investment program.

Table 1

Authorized Investments

Authorized Investment Type	Maximum Maturity[1]	Maximum Percentage of Portfolio [1]	Maximum Investment in One Issuer [1]	Credit Rating
U.S. Treasury securities	5 years	N/A	N/A	N/A
Federal agency and supranational securities	5 years	N/A	N/A	N/A
Certificates of deposit	5 years	N/A	N/A	N/A
Bankers acceptances	180 days	N/A	N/A	N/A
Commercial paper	180 days	30%	10% of issuer's outstanding commercial paper	A-2/P-2/F-2 [2]
Corporate bonds/notes	5 years	N/A	N/A	A-/A3/A- [3]
Repurchase agreements	1 year	N/A	N/A	N/A
Reverse repurchase agreements	1 year	10%	N/A	N/A

[1] Limitations are pursuant to the State Treasurer's Office Investment Policy for the Pooled Money Investment Account.

[2] The State Treasurer's Office Investment Policy for the Pooled Money Investment Account is more restrictive than the Government Code, which allows investments rated A-3/P-3/F-3.

[3] The Government Code requires that a security fall within the top three ratings of a nationally recognized rating service.

N/A Neither the Government Code nor the State Treasure's Office Investment Policy for the Pooled Money Investment Account sets limits for this investment type.

1. Interest Rate Risk

Table 2 presents the interest rate risk of the primary government's investments.

Table 2

Schedule of Investments – Primary Government – Interest Rate Risk
June 30, 2013
(amounts in thousands)

	Interest Rates [1]	Maturity	Fair Value at Year End	Weighted Average Maturity (in years)
Pooled investments				
U.S. Treasury bills and notes	0.10 - 1.35	53 days - 3.34 years	$ 35,901,748	1.03
U.S. agency bonds and discount notes	0.09 - 0.45	61 days - 2.71 years	3,474,691	0.66
Supranational debentures and discount notes (IBRD)	0.14 - 0.51	149 days - 169 days	450,283	0.46
Small Business Administration loans	0.25 - 1.38	0.25 years	510,254	0.25 [2]
Mortgage-backed securities [3]	5.23 - 6.00	1.59 years - 2.92 years	208,754	2.33
Certificates of deposit	0.09 - 0.46	1 day - 1.25 years	9,266,791	0.16
Commercial paper	0.05 - 0.23	1 day - 155 days	4,254,013	0.07
Total pooled investments			**54,066,534** [4]	
Other primary government investments				
U.S. Treasuries and agencies			2,118,611	2.42
Commercial paper			273,325	0.69
Guaranteed investment contracts			207,850	8.72
Corporate debt securities			837,379	2.23
Repurchase agreements			21,887 [5]	0.00
Other			1,097,011	3.55
Total other primary government investments			**4,556,063**	
Funds outside primary government included in pooled investments				
Less: investment trust funds			21,193,406	
Less: other trust and agency funds			2,037,587	
Less: discretely presented component units			1,649,993	
Total primary government investments			**$ 33,741,611**	

[1] These numbers represent high and low interest rates for each investment type.

[2] In calculating SBA holdings' weighted average maturity, the State Treasurer's Office assumes that stated maturity is the quarterly reset date.

[3] These securities are issued by U.S. government agencies such as the Federal National Mortgage Association.

[4] Total pooled investments does not include certain assets of the State's pooled investment program. The other assets include $4.5 billion of time deposits and $287 million of internal loans to state funds.

[5] These repurchase agreements of the California State University mature in one day.

Table 3 identifies the debt securities that are highly sensitive to interest rate fluctuations (to a greater degree than already indicated in the information provided previously).

Table 3

Schedule of Highly Sensitive Investments in Debt Securities – Primary Government – Interest Rate Risk
June 30, 2013
(amounts in thousands)

	Fair Value at Year End	Percent of Total Pooled Investments
Pooled investments		
Mortgage-backed		
Federal National Mortgage Association Collateralized Mortgage Obligations	$ 208,754	0.39 %

These mortgage-backed securities entitle the purchaser to receive a share of the cash flows, such as principal and interest payments, from a pool of mortgages. Mortgage securities are sensitive to interest rate changes because principal prepayments either increase (in a low interest rate environment) or decrease (in a high interest rate environment). A change, up or down, in the payment rate will result in a change in the security yield.

2. Credit Risk

Table 4 presents the credit risk of the primary government's debt securities.

Table 4

Schedule of Investments in Debt Securities – Primary Government – Credit Risk
June 30, 2013
(amounts in thousands)

Credit Rating as of Year End		
Short-term	**Long-term**	**Fair Value**
Pooled investments [1]		
A-1+/P-1/F-1+	AAA/Aaa/AAA	$ 9,347,697
A-1/P-1/F-1	AA/Aa/AA	7,798,080
A-2/P-2/F-2	A/A/A	300,000
Not rated		208,754
Not applicable		36,412,003
Total pooled investments		**$ 54,066,534** [2]
Other primary government investments		
A-1+/P-1/F-1+	AAA/Aaa/AAA	$ 1,114,284
A-1/P-1/F-1	AA/Aa/AA	1,267,919
A-2/P-2/F-2	A/A/A	1,104,617
A-3/P-3/F-3	BBB/Baa/BBB	—
B/NP/B	BB/Ba/BB	—
Not rated		525,009
Not applicable		544,234
Total other primary government investments		**$ 4,556,063**

[1] The State Treasurer's Office uses Standard & Poor's, Moody's, and Fitch Ratings services. Securities are classified by the lowest rating of the three agencies.

[2] Total pooled investments does not include certain assets of the State's pooled investment program. The other assets include time deposits of $4.5 billion, for which credit risk is mitigated by collateral that the State holds for them, and $287 million in loans to state funds for which external credit risk is not applicable because they are internal loans.

3. Concentration of Credit Risk

The investment policy of the State Treasurer's Office contains no limitations on the amount that can be invested in any one issuer beyond those limitations stipulated in the California Government Code. Table 5 identifies debt securities in any one issuer (other than U.S. Treasury securities) that represent 5% or more of the State Treasurer's investments, or of the separate investments of other primary government funds.

Table 5

Schedule of Investments – Primary Government – Concentration of Credit Risk
June 30, 2013
(amounts in thousands)

Issuer	Investment Type	Reported Amount	Percent of Total Pooled/Agency Investments
California State University			
Federal National Mortgage Association	U.S. agency securities	$ 218,223	8.66 %
Federal Home Loan Mortgage Corporation	U.S. agency securities	199,935	7.93
Federal Home Loans Bank Office of Finance	U.S. agency securities	192,634	7.65
Federal Farm Credit Banks Consolidated Systemwide Bonds	U.S. agency securities	159,879	6.35
California State Lottery			
State of California	Municipal securities	$ 205,304	21.34 %
Commonwealth of Massachusetts	Municipal securities	66,312	6.89
Golden State Tobacco Securitization Corporation			
Federal Home Loan Mortgage Corporation	U.S. agency securities	$ 127,004	25.42 %
Standard Chartered Bank	Commercial paper	125,002	25.02
Caisse Des Depots ET	Commercial paper	124,007	24.82
Department of Water Resources Electric Power Fund			
Federal Home Loan Mortgage Corporation	U.S. agency securities	$ 100,000	33.33 %
Assured Guaranty Municipal Corporation	Guaranteed investment contracts	100,000	33.33
Royal Bank of Canada	Guaranteed investment contracts	100,000	33.33
State Water Resources Development System			
Federal National Mortgage Association	U.S. agency securities	$ 74,001	100.00 %

4. Custodial Credit Risk

The State of California has a deposit policy for custodial credit risk that requires deposits held by financial institutions to be insured by federal depository insurance or secured by collateral. As of June 30, 2013, one guaranteed investment contract of the Electric Power Fund in the amount of $100 million was uninsured and uncollateralized.

B. Fiduciary Funds

The fiduciary funds include pension and other employee benefit trust funds of the following fiduciary funds and component units: the California Public Employees' Retirement System (CalPERS), the California State Teachers' Retirement System (CalSTRS), the fund for the California Scholarshare program, and various other funds. CalPERS and CalSTRS account for 97% of these separately invested funds. CalPERS and CalSTRS exercise their authority under the State Constitution and invest in stocks, bonds, mortgages, real estate, and other investments, including derivative instruments.

CalPERS reports investments in securities at fair value, generally based on published market prices and quotations from pricing vendors. Many factors are considered in arriving at fair value. Real estate investments are held either directly, in separate accounts, or as a limited partnership or in a joint venture or commingled fund. Properties owned directly or in a joint venture are subject to independent third-party appraisals. Short-term investments are reported at fair value or cost, or amortized cost that approximates fair value. For investments where no readily ascertainable market value exists, management, in consultation with its investment advisors, determines the fair values for the individual investments.

CalSTRS also reports investments at fair value, generally based on published market prices and quotations from pricing vendors for securities. Real estate equity investment fair values are estimated by third-party advisors or operating partners based upon general market and property specific assumptions that are reviewed and approved by CalSTRS management. Short-term investments are reported at fair value or at cost or amortized cost, which approximates fair value. Fair value for commingled funds is based on information provided by the applicable general partner. Private equity partnerships are valued using their respective Net Asset Value (NAV), calculated in accordance with the general partners' fair valuation policy as of the measurement date, and are audited annually. CalSTRS receives these audited financial statements including valuation results from the general partners. CalSTRS reviews valuation policies for a sample of general partners on a periodic basis. The most significant input into the NAV of such an entity is the fair value of its investment holdings. These holdings are valued by the general partners on a quarterly or semi-annual basis. For private equity investments and other investments for which no readily ascertainable market value exists, CalSTRS management, in consultation with its investment advisors, has determined the fair value for the individual investments. Purchases and sales are recorded on the trade date.

The State Constitution, state statutes, and board policies permit CalPERS and CalSTRS to lend their securities to broker-dealers and other entities with a simultaneous agreement to return the collateral for the same securities in the future. Third-party securities lending agents are under contract to lend domestic and international equity and debt securities. For CalPERS, collateral, in the form of cash or other securities, is required at 102% and 105% of the fair value of domestic and international securities loaned, respectively. For CalSTRS, collateral, in the form of cash or other securities, is required at 102% and 105% of the fair value of domestic securities and international equity securities loaned, respectively. For non-U.S. debt securities loaned, CalSTRS requires 102% of the fair value of the loaned securities. CalPERS management believes that CalPERS has minimized its credit risk exposure by requiring the borrowers to provide collateral greater than 100% of the market value of the securities loaned. The securities loaned are priced daily. Securities on loan by CalPERS can be recalled on demand by CalPERS, and loans of securities may be terminated by CalPERS or the borrower.

For CalPERS, the cash collateral at June 30, 2013, had an aggregate weighted average maturity (to final maturity) of 400 days and duration of 10 days. State Street Bank & Trust and eSecLending, LLC had weighted average maturity (to final maturity) of 33 and 205 days, respectively.

For CalSTRS, collateral received on each security loan was placed in investments that, at June 30, 2013, had a 28-day weighted duration difference between the investments and loans. Most of CalSTRS' security loans can be terminated on demand by CalSTRS or the borrower. CalSTRS is not permitted to pledge or sell non-cash collateral securities received unless the borrower defaults. The contracts with the security lending agents require the agents to indemnify CalSTRS if the borrowers fail to return the securities (or if the collateral is not sufficient to replace the securities lent) or if the borrowers fail to pay CalSTRS for income distributions by the securities' issuers while the securities are on loan.

Table 6 presents the investments, including derivative instruments, of the fiduciary funds by investment type.

Table 6

Schedule of Investments – Fiduciary Funds
June 30, 2013
(amounts in thousands)

	Fair Value
Investment Type	
Equity securities	$ 230,250,748
Debt securities*	95,052,257
Mutual funds	292,393
Real estate	51,362,744
Inflation assets	10,338,702
Insurance contracts	698,174
Private equity	54,612,006
Securities lending collateral	40,497,424
Other	1,025,544
Total investments	**$ 484,129,992**

* Debt securities include short-term investments not included in cash and pooled investments.

This page intentionally left blank.

1. Interest Rate Risk

CalPERS and CalSTRS manage the interest rate risk inherent in their investment portfolios by measuring the effective or option-adjusted duration of the portfolio. The CalPERS investment policies require the option-adjusted duration of the total fixed-income portfolio to stay within 10% of the option-adjusted duration of its benchmark. All individual portfolios are required to maintain a specific level of risk relative to their benchmark. The CalSTRS investment guidelines allow the core long-term investment grade portfolios the discretion to deviate within plus or minus 20% (0.80 to 1.20) of the weighted average effective duration of the performance benchmark. The permissible range of deviation for the weighted average effective duration within the opportunistic strategy portfolios is negotiated with each manager and detailed within their respective investment guidelines. The CalSTRS investment guidelines state that the average maturity of the short-term fixed-income portfolio shall be managed such that it will not exceed 180 days.

Table 7 presents the interest rate risk of the fixed-income securities of these fiduciary funds.

Table 7

Schedule of Investments in Fixed–Income Securities – Fiduciary Funds – Interest Rate Risk
June 30, 2013
(amounts in thousands)

	Fair Value at Year End	Effective Duration (in years) [1]
California Public Employees' Retirement Fund [2]		
U.S. Treasuries and agencies	$ 24,270,732	9.13
Mortgages	11,788,729	4.75
Corporate	10,816,633	9.73
Asset-backed	6,973,386	8.48
Commercial paper	1,250,974	0.02
Municipal	15,622	8.58
International	6,240,593	9.94
Swaps	(43,972)	1.12
Private placement	2,917	2.61
No effective duration	7,516,464	N/A
Total	**$ 68,832,078**	

[1] Effective duration is described in the paragraph preceding this table.

[2] Includes investments of fiduciary funds and certain discretely presented component units that CalPERS administers.

Table 7 (Continued)

Schedule of Investments in Fixed–Income Securities – Fiduciary Funds – Interest Rate Risk

June 30, 2013
(amounts in thousands)

	Fair Value at Year End	Effective Duration (in years) [1]
California State Teachers' Retirement System		
Long-term fixed-income investments		
U.S. Government and agency obligations	$ 8,058,069	4.82
Credit obligations	6,418,989	6.39
Corporate high yield	1,893,429	3.95
Leveraged loans	396,632	0.33
Debt core plus	2,915,137	5.19
Special situations	144,892	0.07
Commercial mortgage-backed securities	581,189	3.10
Mortgage-backed securities	7,371,226	4.58
Total	**$ 27,779,563**	

	0-30 days	31-90 days	91-120 days	121-180 days	181-365 days	366+ days	Fair Value at Year End
Short-term fixed-income investments							
Money market securities	$ 1,159,202	$ 574,005	$ 25,005	$ 97,399	$ —	$ —	$ 1,855,611
Credit obligations	199,967	300,187	24,970	5,135	33,603	—	563,862
U.S. Government and agency obligations	250,423	79,995	85,706	70,077	547,492	257,098	1,290,791
Securitized obligations	157,737	45,707	—	10,867	14,986	—	229,297
Total	**$ 1,767,329**	**$ 999,894**	**$ 135,681**	**$ 183,478**	**$ 596,081**	**$ 257,098**	**$ 3,939,561**

	0-1 day	2-6 days	7-29 days	30-59 days	60-89 days	90+ days	Fair Value at Year End
Securities lending collateral							
Money markets securities	$ 59,782	$ 3,560,213	$ 4,176,367	$ 2,494,463	$ 1,301,237	$ 520,029	$ 12,112,091
Credit obligations	—	175,005	1,574,204	885,496	804,483	76,705	3,515,893
U.S. Government and agency obligations	—	676,250	30,000	—	—	360,815	1,067,065
Securitized obligations	—	—	4,967,932	243,457	194,713	195,409	5,601,511
Total	**$ 59,782**	**$ 4,411,468**	**$ 10,748,503**	**$ 3,623,416**	**$ 2,300,433**	**$ 1,152,958**	**$ 22,296,560**

[1] Effective duration is described in the paragraph preceding this table.

2. Credit Risk

The CalPERS investment policies require that 89% of the total fixed-income portfolio be invested in investment-grade securities. Investment-grade securities are those fixed-income securities with a Moody's rating of Aaa to Baa or a Standard and Poor's rating of AAA to BBB. Each portfolio is required to maintain a specified risk level. The CalSTRS investment guidelines require that, at the time of purchase, at least 95% of the corporate securities comprising the credit portion of the core fixed-income portfolio be rated Baa3/BBB-/BBB- or better by two out of the three nationally recognized statistical rating organizations (NRSROs), such as Moody's Investors Service, Inc., Standard and Poor's Rating Service, or Fitch Ratings. For CalSTRS, the ratings used to determine the quality of the individual securities are the ratings with the highest degree of risk. Furthermore, the total position of the outstanding debt of any one private or commercial mortgage-backed and asset-backed securities issuer shall be limited to 10% of the market value of the portfolio. Obligations of other issuers are held to a 5% per issuer limit (at the time of purchase) of the market value of any individual portfolio. The investment guidelines for CalSTRS include an allocation to opportunistic strategies, a portion of which is managed externally and allows for the purchase of bonds rated below investment grade. Limitations on the amount of debt of any one issuer an investment manager may hold are negotiated on a manager-by-manager basis.

Table 8 presents the credit risk of the fixed-income securities of these fiduciary funds.

Table 8

Schedule of Investments in Fixed-Income Securities – Fiduciary Funds – Credit Risk
June 30, 2013
(amounts in thousands)

Credit Rating as of Year End		
Short-term	**Long-term**	**Fair Value**
A-1+/P-1/F-1+	AAA/Aaa/AAA	$ 14,017,812
A-1/P-1/F-1	AA/Aa/AA	20,642,907
A-2/P-2/F-2	A/A/A	7,766,254
A-3/P-3/F-3	BBB/Baa/BBB	11,148,720
B/NP/B	BB/Ba/BB	2,003,767
B/NP/B	B/B/B	1,803,704
C/NP/C	CCC/Caa/CCC	797,422
C/NP/C	CC/Ca/CC	51,975
C/NP/C	C/C/C	7,233
D/NP/D	D/D/D	27,432
Withdrawn		161,777
Not rated		44,896,586
Not applicable		34,282,152
Total fixed-income securities		**$ 137,607,741**

3. Concentration of Credit Risk

The Scholarshare Program Trust Fund held $698 million in insurance contracts of TIAA-CREF Life Insurance Company; this amount represented 14% of the fund's total investments as of June 30, 2013.

CalPERS and CalSTRS did not have investments in a single issuer that represented 5% or more of total fair value of all investments.

4. Custodial Credit Risk

CalPERS' investments at June 30, 2013, were not exposed to custodial risk. As of June 30, 2013, all of CalSTRS' non-cash investments, other than Pension2 investments, are held in CalSTRS' and/or its nominee's name and are not exposed to custodial credit risk. CalPERS and CalSTRS have no general policies relating to custodial credit risk.

5. Foreign Currency Risk

At June 30, 2013, CalPERS and CalSTRS held $78.4 billion and $30.4 billion, respectively, in investments, including derivative instruments, subject to foreign currency risk. CalPERS' asset allocation and investment policies allow for active and passive investments in international securities. CalPERS' policy for total global equity specifies investment in international equities be based on market capitalization. For total fixed-income, 10% is targeted for investment in international securities. Real assets and private equity do not have a target allocation for international investment. CalPERS uses a currency overlay program to reduce risk by hedging approximately 15% of its total exposure to international currencies. CalSTRS enters into currency forwards and contracts to protect the value of its non-dollar public and private equity assets against a strengthening U.S. dollar, while recognizing opportunities for additional return (alpha) generation within the currency markets. The position range has been designed to allow for some degree of symmetry around the underlying exposure to the foreign-denominated assets within CalSTRS in order to protect the translation value of the assets against a strengthening U.S. dollar and to enhance returns in a declining U.S. dollar environment. As a result, the position range is -25% to 50% of the total notional value of the non-U.S. public and non-U.S. private (i.e., private equity and real estate) equity portfolios.

Table 9 (next page) identifies the investments, including derivative instruments, of the fiduciary funds that are subject to foreign currency risk. Derivative instruments are included in the amounts reported under equity, fixed-income, and forward contracts.

Table 9

Schedule of Investments – Fiduciary Funds – Foreign Currency Risk

June 30, 2013
(amounts in thousands of U.S. dollars at fair value)

Currency	Cash	Equity	Alternative	Fixed Income	Real Estate	Spot Contracts	Forward Contracts	Total
Argentine Peso	$ —	$ —	$ —	$ —	$ —	$ —	$ 4	$ 4
Australian Dollar	29,694	4,890,535	—	175,066	209,224	—	53,970	5,358,489
Bermuda Dollar	—	3,292	—	—	—	—	—	3,292
Brazilian Real	5,752	1,697,051	—	79,649	1,145,374	(5)	532	2,928,353
British Pound Sterling	85,073	13,435,847	1,031	1,515,787	274,143	431	27,077	15,339,389
Canadian Dollar	44,805	5,958,847	185,759	234,298	597,809	13	34,061	7,055,592
Cayman Islands Dollar	—	5,084	—	—	—	—	—	5,084
Chilean Peso	245	249,108	—	987	—	—	(232)	250,108
Chinese Yuan	—	3,643	—	—	679,066	—	486	683,195
Colombian Peso	20	64,181	—	—	—	(20)	55	64,236
Czech Koruna	189	68,592	—	9,498	—	—	733	79,012
Danish Krone	1,251	895,733	—	10,544	—	—	(3,183)	904,345
Egyptian Pound	11,773	46,706	—	—	—	—	(2)	58,477
Euro	328,321	24,410,720	3,351,690	2,597,692	738,749	601	32,546	31,460,319
Guatemalan Quetzal	—	—	—	—	72,029	—	—	72,029
Hong Kong Dollar	27,144	4,391,995	—	—	415,541	2	(115)	4,834,567
Hungarian Forint	353	129,148	—	—	—	—	75	129,576
Indian Rupee	7,029	1,131,475	—	68	383,684	(99)	434	1,522,591
Indonesian Rupiah	1,459	580,827	—	—	—	(6)	916	583,196
Israeli Shekel	1,474	307,458	—	—	—	—	(473)	308,459
Japanese Yen	159,730	16,724,947	84,710	909,686	279,406	1,020	(18,867)	18,140,632
Kazakhstan Tenge	—	—	—	—	—	—	1	1
Korean Won	—	5,035	—	—	—	—	—	5,035
Malaysian Ringgit	876	469,335	—	—	22,221	6	448	492,886
Mexican Peso	5,029	680,019	—	165,770	179,333	7	(1,790)	1,028,368
Moroccan Dirham	18	4,060	—	—	—	—	(229)	3,849
New Romanian Leu	—	—	—	—	—	—	(2)	(2)
New Russian Ruble	—	3,480	—	—	225,238	7	3	228,728
New Taiwan Dollar	2,002	1,873,153	—	—	—	—	245	1,875,400
New Turkish Lira	114	214,762	—	—	—	—	—	214,876
New Zealand Dollar	500	119,667	—	61,343	—	—	(749)	180,761
Norwegian Krone	4,028	687,890	—	33,929	2,530	—	4,550	732,927
Pakistan Rupee	172	62,463	—	—	—	—	—	62,635
Peruvian Nouveau Sol	49	6,310	—	—	—	6	21	6,386
Philippine Peso	303	217,689	—	—	—	—	(640)	217,352
Polish Zloty	156	226,354	—	50,175	—	—	134	276,819
Singapore Dollar	2,878	1,159,550	—	5,560	8,888	(9)	4,127	1,180,994
South African Rand	2,242	1,466,853	—	5,719	—	17	661	1,475,492
South Korean Won	3,550	2,641,084	—	—	—	30	(172)	2,644,492
Sri Lanka Rupee	3	—	—	—	123,069	—	—	123,072
Swedish Krona	3,315	1,977,295	—	52,197	—	—	11,822	2,044,629
Swiss Franc	1,429	5,213,058	—	499	—	(6)	(4,166)	5,210,814
Thailand Baht	4,862	713,374	—	—	—	(31)	14	718,219
Tunisian Dinar	—	—	—	—	—	—	32	32
Turkish Lira	1,369	452,638	—	—	—	(12)	(106)	453,889
UAE Dirham	740	55,294	—	—	—	—	—	56,034
U.S. Dollar	—	737,552	—	—	—	—	—	737,552
Total investments subject to foreign currency risk	**$ 737,947**	**$ 93,982,104**	**$ 3,623,190**	**$ 5,908,467**	**$ 5,356,304**	**$ 1,952**	**$ 142,221**	**$ 109,752,185**

C. Discretely Presented Component Units

The discretely presented component units consist of the University of California (University) and its foundations and the California Housing Finance Agency (CalHFA), and various funds that constitute 7% of the total investments of discretely presented component units. State law, bond resolutions, and investment policy resolutions allow component units to invest in U.S. government securities, state and municipal securities, commercial paper, corporate bonds, investment agreements, real estate, and other investments. Additionally, a portion of the cash and pooled investments of CalHFA, and other component units is invested in the State Treasurer's pooled investment program.

The investments of the University, a discretely presented component unit, are primarily stated at fair value. Investments authorized by the regents include equity securities, fixed-income securities, and certain other asset classes. The equity portion of the investment portfolio includes domestic and foreign common and preferred stocks, which may be included in actively or passively managed strategies, along with a modest exposure to private equities. Private equities include venture capital partnerships, buy-outs, and international funds. The fixed-income portion of the investment portfolio may include both domestic and foreign securities, as well as certain securitized investments including mortgage-backed and asset-backed securities. Deposits with the State of California are valued at contract value, which the University believes approximates fair value. Absolute return strategies, incorporating short sales, plus derivative positions to implement or hedge an investment position, are also authorized. Where donor agreements have placed constraints on allowable investments, assets associated with endowments are invested in accordance with the terms of the agreements.

The University participates in a securities lending program as a means to augment income. Campus foundations' investments that are invested with the University and managed by the University's Chief Investment Officer are included in the University's investment pools that participate in a securities lending program. The campus foundations' allocated share of the program's cash collateral received, investment of cash collateral, and collateral held for securities lending is determined based upon the foundations' equity in the investment pools. The board of trustees for each campus foundation may also authorize participation in a direct securities lending program. The University loans securities to selected brokerage firms and receives collateral that equals or exceeds the fair value of such investments during the period of the loan. Collateral may be cash or securities issued by the U.S. government or its agencies, or the sovereign or provincial debt of foreign countries. Securities collateral cannot be pledged or sold by the University unless the borrower defaults. Loans of domestic equities and all fixed-income securities are initially collateralized at 102% of the fair value of the securities loaned. Loans of foreign equities are initially collateralized at 105%. All borrowers are required to provide additional collateral by the next business day if the value falls to less than 100% of the fair value of the securities loaned. The University earns interest and dividends on the collateral held during the loan period, as well as a fee from the brokerage firm, and it is obligated to pay a fee and a rebate to the borrower. The University receives the net investment income. As of June 30, 2013, the University had insignificant exposure to borrower default because the amounts that it owed the borrowers were substantially the same as the amounts the borrowers owed the University. The University is indemnified by its lending agents against any losses incurred as a result of borrower default.

Securities loans immediately terminate upon notice by either the University or the borrower. Cash collateral is invested by the University's lending agents in short-term investment pools in the University's name, with guidelines approved by the University. As of June 30, 2013, the securities in these pools had a weighted average maturity of 44 days.

Table 10 presents the investments, including derivative instruments, of the discretely presented component units by investment type.

Table 10

Schedule of Investments – Discretely Presented Component Units
June 30, 2013
(amounts in thousands)

Investment Type		Fair Value
Equity securities	$	3,421,693
Debt securities*		14,268,479
Investment contracts		105,614
Mutual funds		7,662,271
Real estate		725,786
Money market securities		1,389,147
Private equity		1,149,616
Mortgage loans		161,308
Securities lending collateral		1,468,865
Invested for others		(2,430,055)
Other		2,435,572
Total investments	**$**	**30,358,296**

* Debt securities include short-term investments not included in cash and pooled investments.

1. Interest Rate Risk

Interest rate risk for the University's short-term investment pool is managed by constraining the maturity of all individual securities to be less than five and one-half years. There is no restriction on weighted average maturity of the portfolio, as it is managed relative to the liquidity demands of the investors. Portfolio guidelines for the fixed-income portion of the University's general endowment pool limit weighted average effective duration to the effective duration of the Citigroup Large Pension Fund Index and Lehman Aggregate Index, plus or minus 20%.

Table 11 presents the interest rate risk of the fixed-income or variable-income securities of the major discretely presented component units.

Table 11

Schedule of Investments in Fixed-Income or Variable-Income Securities – Discretely Presented Component Units – Interest Rate Risk

June 30, 2013

(amounts in thousands)

	University of California		University of California Foundations		California Housing Finance Agency	
Investment Type	**Fair Value at Year End**	**Effective Duration[1]**	**Fair Value at Year End**	**Effective Duration[1]**	**Fair Value at Year End**	**Effective Duration [1]**
U.S. Treasury bills, notes, and bonds	$ 492,681	0.80	$ 320,825	1.60	$ —	—
U.S. Treasury strips	88,985	9.50	161	—	—	—
U.S. Treasury inflation-protected securities	151,225	7.00	—	—	—	—
U.S. government-backed securities	—	—	1,361	3.20	—	—
U.S. government-backed asset-backed securities	—	—	582	7.10	—	—
Corporate bonds	6,276,076	3.70	52,915	4.50	—	—
Commercial paper	2,205,533	—	—	—	—	—
U.S. agencies	1,383,842	2.90	3,996	5.00	—	—
U.S. agencies asset-backed securities	283,169	4.50	76,387	4.20	—	—
Corporate asset-backed securities	107,456	2.10	38,176	—	—	—
Supranational/foreign	1,700,003	4.10	1,691	0.80	—	—
Corporate (foreign currency denominated)	39,199	2.90	—	—	—	—
U.S. bond funds	150,696	4.90	157,748	4.40	—	—
Non-U.S. bond funds	19,564	4.50	56,108	5.20	—	—
Money market funds	680,674	—	628,690	2.60	—	—
Mortgage loans	161,054	—	254	—	—	—
Forward contracts on a to-be-announced basis	(10,604)	1.80	(170)	—	—	—
U.S. Treasury and agency securities	—	—	—	—	489,991	16.00
Other	14,101	16.80	13,305	4.50	—	—
Total	**$ 13,743,654**		**$ 1,352,029**		**$ 489,991**	

[1] Effective duration is the approximate change in price of the security resulting from a 100 basis points (1 percentage point) change in the level of interest rates. It is not a measure of time.

Table 12 identifies the debt securities that are highly sensitive to interest rate fluctuations because of the existence of prepayment or conversion features, although the effective duration of these securities may be low.

Table 12

Schedule of Highly Sensitive Investments in Debt Securities – University of California and its Foundations – Interest Rate Risk
June 30, 2013
(amounts in thousands)

	University of California		University of California Foundations	
	Fair Value at Year End	**Effective Duration**	**Fair Value at Year End**	**Effective Duration**
Mortgage-Backed Securities These securities are primarily issued by the Federal National Mortgage Association (Fannie Mae), Government National Mortgage Association (Ginnie Mae) and Federal Home Loan Mortgage Corporation (Freddie Mac) and include short embedded prepayment options. Unanticipated prepayments by the obligees of the underlying asset reduce the total expected rate of return.	$ 334,374	4.10	$ 56,375	1.30
Collateralized Mortgage Obligations Collateralized mortgage obligations (CMOs) generate a return based upon either the payment of interest or principal on mortgages in an underlying pool. The relationship between interest rates and prepayments makes the fair value highly sensitive to changes in interest rates. In falling interest rate environments, the underlying mortgages are subject to a higher propensity of prepayments. In a rising interest rate environment, the underlying mortgages are subject to a lower propensity of prepayments.	70,482	4.00	27,905	0.50
Other Asset-Backed Securities Other asset-backed securities also generate a return based upon either the payment of interest or principal on obligations in an underlying pool, generally associated with auto loans or credit cards. As with CMOs, the relationship between interest rates and prepayments makes the fair value highly sensitive to changes in interest rates.	23,663	1.20	9,168	1.20
Variable-Rate Securities These securities are investments with terms that provide for the adjustment of their interest rates on set dates and are expected to have fair values that will be relatively unaffected by interest rate changes. Variable-rate securities may have limits on how high or low the interest rate may change. These constraints may affect the market value of the security.	7,196	2.30	—	—
Callable Bonds Although bonds are issued with clearly defined maturities, an issuer may be able to redeem, or call, a bond earlier than its maturity date. The university must then replace the called bond with a bond that may have a lower yield than the original. The call feature causes the fair value to be highly sensitive to changes in interest rates.	1,915,506	4.60	551	2.30
Convertible Bonds Convertible bonds are fixed-income securities with coupon rates that tend to be lower than those in conventional debt issues. Consequently, an increase in the market's rate of interest causes a greater decline in the price of issues of convertible bonds than that of non-convertible bonds.	349	4.70	—	—

2. Credit Risk

The investment guidelines for the University's short-term investment pool provide that no more than 5% of the total market value of the pool's portfolio may be invested in securities rated below investment grade (BB, Ba, or lower). The average credit quality of the pool must be A or better and commercial paper must be rated at least A-1, P-1, or F-1. For its general endowment pool, the University uses a fixed-income benchmark, the Barclays Capital U.S. Aggregate Bond Index, comprising approximately 27.5% high grade corporate bonds and 31.4% mortgage/asset-backed securities, all of which carry some degree of credit risk. The remaining 41.1% are government-issued bonds. Credit risk in this pool is managed primarily by diversifying across issuers, and portfolio guidelines mandate that no more than 10% of the market value of fixed-income securities may be invested in issues with credit ratings below investment grade. Further, the weighted average credit rating must be A or higher.

Table 13 presents the credit risk of the fixed-income or variable-income securities of the major discretely presented component units.

Table 13

Schedule of Investments in Fixed-Income or Variable-Income Securities
Major Discretely Presented Component Units – Credit Risk
June 30, 2013
(amounts in thousands)

Credit Rating as of Year End		
Short-term	**Long-term**	**Fair Value**
A-1+	AAA	$ 282,419
A-1/P-1	AA2/AA	5,127,509
A-2	A2/A	3,791,788
A-3	BAA2/BBB	2,381,305
B	BA2/BB	315,441
B	B2/B	313,040
C	CC or below	84,197
Not rated		3,417,007
Total fixed-income securities		**$ 15,712,706**

3. Concentration of Credit Risk

Investment guidelines addressing concentration of credit risk related to the investment-grade fixed-income portion of the University's portfolio include a limit of no more than 3% of the portfolio's market value to be invested in any single issuer (except for securities issued by the U.S. government or its agencies). These same guidelines apply to the University's short-term investment pool. For high-yield and emerging market debt, the corresponding limit is 5%. Each campus foundation may have its own individual investment policy designed to limit exposure to a concentration of credit risk.

4. Custodial Credit Risk

The University's securities are registered in its name by the custodial bank as an agent for the University. Other types of investments represent ownership interests that do not exist in physical or book-entry form. As a result, custodial credit risk is remote.

5. Foreign Currency Risk

The University's portfolio guidelines for U.S. investment-grade fixed-income securities allow exposure to non-U.S. dollar denominated bonds up to 10% of the total portfolio market value. Exposure to foreign currency risk from these securities may be fully or partially hedged using forward foreign currency exchange contracts. Under the University's investment policies, such instruments are not permitted for speculative use or to create leverage.

Table 14 identifies the investments of the University of California, including its campus foundations, that are subject to foreign currency risk.

Table 14

Schedule of Investments – University of California and its Foundations – Foreign Currency Risk
June 30, 2013
(amounts in thousands of U.S. dollars at fair value)

Currency	Equity	Real Estate	Investment Derivatives	Fixed-Income	Total
Australian Dollar	$ 90,721	$ 1,021	$ 1,246	$ —	$ 92,988
Brazilian Real	—	—	—	4,718	4,718
British Pound Sterling	285,600	659	1,573	—	287,832
Canadian Dollar	109,096	—	582	—	109,678
Danish Krone	16,091	—	—	—	16,091
Euro	420,548	996	537	2,275	424,356
Hong Kong Dollar	59,945	2,457	—	—	62,402
Indonesian Rupiah	—	—	—	3,209	3,209
Japanese Yen	302,726	1,892	3,146	—	307,764
Malaysian Ringgit	—	—	—	3,573	3,573
Mexican Peso	—	—	—	4,638	4,638
New Russian Ruble	—	—	—	3,703	3,703
Norwegian Krone	13,656	—	—	—	13,656
Polish Zloty	—	—	—	3,450	3,450
Singapore Dollar	27,671	478	—	—	28,149
South African Rand	—	—	—	3,980	3,980
Swedish Krona	41,548	—	—	—	41,548
Swiss Franc	137,919	—	—	—	137,919
Turkish Lira	—	—	—	3,911	3,911
Other	52,309	3,328	460	5,742	61,839
Commingled currencies	1,390,125	—	—	65,225	1,455,350
Total investments subject to foreign currency risk	**$ 2,947,955**	**$ 10,831**	**$ 7,544**	**$ 104,424**	**$ 3,070,754**

This page intentionally left blank.

NOTE 4: ACCOUNTS RECEIVABLE

Table 15 presents the disaggregation of accounts receivable attributable to taxes, interest expense reimbursements, Lottery retailer collections, the California State University, and unemployment program receipts. Other receivables are for interest, gifts, grants, various fees, penalties, and other charges.

Table 15

Schedule of Accounts Receivable
June 30, 2013
(amounts in thousands)

	Taxes	Reimbursement of Accrued Interest Expense	Lottery Retailers	Unemployment Programs	California State University	Other	Total
Current governmental activities							
General Fund	$ 11,527,389	$ —	$ —	$ —	$ —	$ 1,123,106	$ 12,650,495
Federal Fund	—	—	—	—	—	950	950
Transportation Fund	625,823	—	—	—	—	434,469	1,060,292
Environmental and Natural Resources Fund	—	—	—	—	—	505,457	505,457
Nonmajor governmental funds	338,760	—	—	—	—	1,958,218	2,296,978
Internal service funds	—	—	—	—	—	45,665	45,665
Total current governmental activities	**$ 12,491,972**	**$ —**	**$ —**	**$ —**	**$ —**	**$ 4,067,865**	**$ 16,559,837**
Amounts not expected to be collected during the subsequent year (unavailable revenue)	**$ 1,704,409**	**$ —**	**$ —**	**$ —**	**$ —**	**$ 267,333** *	**$ 1,971,742**
Current business-type activities							
Water Resources Fund	$ —	$ —	$ —	$ —	$ —	$ 92,373	$ 92,373
Public Buildings Construction Fund	—	197,801	—	—	—	—	197,801
State Lottery Fund	—	—	362,744	—	—	—	362,744
Unemployment Programs Fund	—	—	—	1,275,655	—	—	1,275,655
California State University	—	—	—	—	161,990	—	161,990
Nonmajor enterprise funds	—	—	—	—	—	46,115	46,115
Adjustment:							
Account reclassification	—	(197,801)	—	—	—	(662)	(198,463)
Total current business-type activities	**$ —**	**$ —**	**$ 362,744**	**$ 1,275,655**	**$ 161,990**	**$ 137,826**	**$ 1,938,215**
Amounts not expected to be collected during the subsequent year (unavailable revenue)	**$ —**	**$ —**	**$ —**	**$ 30,476**	**$ 272,644**	**$ —**	**$ 303,120**

* This amount includes noncurrent receivables for Service Concession Arrangements.

NOTE 5: RESTRICTED ASSETS

Table 16 presents a summary of the legal restrictions placed on assets in the enterprise funds of the primary government and the discretely presented component units.

Table 16

Schedule of Restricted Assets
June 30, 2013
(amounts in thousands)

	Cash and Pooled Investments	Investments	Due From Other Governments	Loans Receivable	Total
Primary government					
Debt service	$ 1,718,509	$ 385,758	$ 20,448	$ 325,930	$ 2,450,645
Construction	2,292,203	11,889	—	—	2,304,092
Operations	228,000	—	—	—	228,000
Other	2,623	8,754	—	—	11,377
Total primary government	**4,241,335**	**406,401**	**20,448**	**325,930**	**4,994,114**
Discretely presented component units					
Debt service	124,877	26,134	—	—	151,011
Total discretely presented component units	**124,877**	**26,134**	**—**	**—**	**151,011**
Total restricted assets	**$ 4,366,212**	**$ 432,535**	**$ 20,448**	**$ 325,930**	**$ 5,145,125**

NOTE 6: NET INVESTMENT IN DIRECT FINANCING LEASES

The State Public Works Board, an agency that accounts for its activities as an enterprise fund, has entered into lease-purchase agreements with various other primary government agencies, the University of California, and certain local agencies. Payments from these leases will be used to satisfy the principal and interest requirements of revenue bonds issued by the State Public Works Board.

California State University (CSU) accounts for its lease activities in the California State University Trust Fund, a major enterprise fund, and has entered into capital lease agreements with certain auxiliary organizations. These agreements lease existing and newly constructed facilities to the auxiliary organizations. A portion of the proceeds from certain revenue bonds issued by CSU were used to finance the construction of these facilities.

Table 17 summarizes the minimum lease payments to be received by the primary government.

Table 17

Schedule of Minimum Lease Payments to be Received by the Primary Government
(amounts in thousands)

Year Ending June 30	Primary Government Agencies	University of California	California State University	Local Agencies	Total
2014	$ 627,900	$ 220,265	$ 29,402	$ 63,776	$ 941,343
2015	626,417	212,174	29,369	62,177	930,137
2016	622,440	178,630	26,753	53,892	881,715
2017	620,872	171,731	27,040	39,986	859,629
2018	590,803	188,278	27,122	32,698	838,901
2019-2023	2,339,505	857,584	141,276	77,765	3,416,130
2024-2028	1,854,657	600,460	148,792	63,379	2,667,288
2029-2033	1,186,734	416,440	131,503	39,021	1,773,698
2034-2038	270,758	59,510	42,746	—	373,014
2039-2043	—	—	23,190	—	23,190
2044-2046	—	—	8,986	—	8,986
Total minimum lease payments	**8,740,086**	**2,905,072**	**636,179**	**432,694**	**12,714,031**
Less: unearned income	3,334,459	1,029,616	253,826	102,721	4,720,622
Net investment in direct financing leases	**$ 5,405,627**	**$ 1,875,456**	**$ 382,353**	**$ 329,973**	**$ 7,993,409**

NOTE 7: CAPITAL ASSETS

Table 18 summarizes the capital activity for the primary government, which includes $8.0 billion in capital assets related to capital leases.

Table 18

Schedule of Changes in Capital Assets – Primary Government
June 30, 2013
(amounts in thousands)

	Beginning Balance (Restated)	Additions	Deductions	Ending Balance
Governmental activities				
Capital assets not being depreciated/amortized				
Land	$ 17,112,444 *	$ 525,776	$ 36,165	$ 17,602,055
State highway infrastructure	63,779,198 *	1,011,463	171,224	64,619,437
Collections	22,528	119	2	22,645
Construction in progress	8,625,913 *	2,760,311	1,480,894	9,905,330
Intangible assets	1,022,313 *	336,133	274,118	1,084,328
Total capital assets not being depreciated/amortized	**90,562,396**	**4,633,802**	**1,962,403**	**93,233,795**
Capital assets being depreciated/amortized				
Buildings and improvements	19,065,903 *	1,172,929	15,683	20,223,149
Infrastructure	718,155	23,209	2,872	738,492
Equipment and other assets	4,505,430 *	283,245	136,667	4,652,008
Intangible assets	678,786 *	382,689	75,291	986,184
Total capital assets being depreciated/amortized	**24,968,274**	**1,862,072**	**230,513**	**26,599,833**
Less accumulated depreciation/amortization for:				
Buildings and improvements	6,398,655 *	153,741	12,755	6,539,641
Infrastructure	293,242	34,811	2,717	325,336
Equipment and other assets	3,698,714 *	333,512	129,126	3,903,100
Intangible assets	383,381 *	60,184	46,080	397,485
Total accumulated depreciation/amortization	**10,773,992**	**582,248**	**190,678**	**11,165,562**
Total capital assets being depreciated/amortized, net	**14,194,282**	**1,279,824**	**39,835**	**15,434,271**
Governmental activities, capital assets, net	**$ 104,756,678**	**$ 5,913,626**	**$ 2,002,238**	**$ 108,668,066**
Business-type activities				
Capital assets not being depreciated/amortized				
Land	$ 216,206	$ 714	$ 32	$ 216,888
Collections	2,895	3,183	27	6,051
Construction in progress	1,766,234 *	1,050,892	229,995	2,587,131
Intangible assets	311,527 *	93,125	673	403,979
Total capital assets not being depreciated/amortized	**2,296,862**	**1,147,914**	**230,727**	**3,214,049**
Capital assets being depreciated/amortized				
Buildings and improvements	10,176,625	282,554	7,248	10,451,931
Infrastructure	205,836	30,315	2	236,149
Equipment and other assets	558,023 *	54,356	36,048	576,331
Intangible assets	158,518 *	17,008	1,481	174,045
Total capital assets being depreciated/amortized	**11,099,002**	**384,233**	**44,779**	**11,438,456**
Less accumulated depreciation/amortization for:				
Buildings and improvements	3,908,907	261,734	5,878	4,164,763
Infrastructure	46,490	14,958	2	61,446
Equipment and other assets	331,177	50,805	34,167	347,815
Intangible assets	104,500 *	15,823	1,288	119,035
Total accumulated depreciation/amortization	**4,391,074**	**343,320**	**41,335**	**4,693,059**
Total capital assets being depreciated/amortized, net	**6,707,928**	**40,913**	**3,444**	**6,745,397**
Business-type activities, capital assets, net	**$ 9,004,790**	**$ 1,188,827**	**$ 234,171**	**$ 9,959,446**

* Restated

Table 19 summarizes the depreciation expense charged to the activities of the primary government.

Table 19

Schedule of Depreciation Expense – Primary Government
June 30, 2013
(amounts in thousands)

	Amount
Governmental activities	
General government	$ 69,301
Education	127,941
Health and human services	42,647
Resources	31,985
State and consumer services	37,316
Business and transportation	101,286
Correctional programs	122,610
Internal service funds (charged to the activities that utilize the fund)	49,162
Total governmental activities	**582,248**
Business-type activities	**343,320**
Total primary government	**$ 925,568**

Table 20 summarizes the capital activity for discretely presented component units.

Table 20

Schedule of Changes in Capital Assets – Discretely Presented Component Units
June 30, 2013
(amounts in thousands)

	Beginning Balance	Additions	Deductions	Ending Balance
Capital assets not being depreciated/amortized				
Land	$ 902,283 *	$ 77,648	$ 9,225	$ 970,706
Collections	352,169	10,296	92	362,373
Construction in progress	2,805,485 *	131,798	19,741	2,917,542
Intangible assets	5,141 *	—	10	5,131
Total capital assets not being depreciated/amortized	**4,065,078**	**219,742**	**29,068**	**4,255,752**
Capital assets being depreciated/amortized				
Buildings and improvements	29,445,447 *	1,625,825	75,144	30,996,128
Infrastructure	656,560	10,244	5	666,799
Equipment and other depreciable assets	9,432,630 *	618,627	370,763	9,680,494
Intangible assets	490,308 *	207,741	23,507	674,542
Total capital assets being depreciated/amortized	**40,024,945**	**2,462,437**	**469,419**	**42,017,963**
Less accumulated depreciation/amortization for:				
Buildings and improvements	10,626,127 *	980,371	24,500	11,581,998
Infrastructure	283,069	22,839	—	305,908
Equipment and other depreciable assets	6,491,347 *	561,288	348,205	6,704,430
Intangible assets	259,251 *	60,888	20,158	299,981
Total accumulated depreciation/amortization	**17,659,794**	**1,625,386**	**392,863**	**18,892,317**
Total capital assets being depreciated/amortized, net	**22,365,151**	**837,051**	**76,556**	**23,125,646**
Capital assets, net	**$ 26,430,229**	**$ 1,056,793**	**$ 105,624**	**$ 27,381,398**

* Restated

NOTE 8: ACCOUNTS PAYABLE

Accounts payable are amounts due taxpayers, vendors, customers, beneficiaries, and employees related to different programs. Table 21 presents details related to accounts payable.

The adjustment for the fiduciary funds represents amounts due fiduciary funds that were reclassified as external payables on the government-wide Statement of Net Position.

Table 21

Schedule of Accounts Payable
June 30, 2013
(amounts in thousands)

	Education	Health and Human Services	Resources	Business and Transportation	General Government and Others	Total
Governmental activities						
General Fund	$ 256,569	$ 790,098	$ 109,922	$ 1	$ 501,054	$ 1,657,644
Federal Fund	173,190	336,586	63,558	548,733	107,040	1,229,107
Transportation Fund	9,578	17	4,516	388,510	14,291	416,912
Environmental and Natural Resources Fund	2,994	3,339	316,755	630	4,316	328,034
Nonmajor governmental funds	13,155	546,717	10,547	74,151	341,132	985,702
Internal service funds	—	—	17,329	—	247,403	264,732
Adjustment:						
Fiduciary funds	8,490,297	9,649,692	—	99,248	513,750	18,752,987
Total governmental activities	**$ 8,945,783**	**$ 11,326,449**	**$ 522,627**	**$ 1,111,273**	**$ 1,728,986**	**$ 23,635,118**
Business-type activities						
Electric Power Fund	$ —	$ —	$ 9,000	$ —	$ —	$ 9,000
Water Resources Fund	—	—	106,490	—	—	106,490
Public Buildings Construction Fund	—	—	—	—	200,200	200,200
State Lottery Fund	—	—	—	—	60,505	60,505
Unemployment Programs Fund	—	—	—	—	7,200	7,200
California State University	169,394	—	—	—	—	169,394
Nonmajor enterprise funds	1,000	109	8	—	3,003	4,120
Adjustment:						
Fiduciary funds	—	—	—	—	381	381
Total business-type activities	**$ 170,394**	**$ 109**	**$ 115,498**	**$ —**	**$ 271,289**	**$ 557,290**

NOTE 9: SHORT-TERM FINANCING

As part of its cash management program, the State regularly issues short-term obligations to meet cash flow needs. The State issues revenue anticipation notes (RANs) to partially fund timing differences between revenues and expenditures, because General Fund revenues and disbursements do not occur evenly throughout the fiscal year. If additional external cash flow borrowing is required, the State issues revenue anticipation warrants.

To fund cash flow needs for the 2012-13 fiscal year, the State issued $10.0 billion in RANs on August 16, 2012. The RANs were repaid during May and June of 2013.

NOTE 10: LONG-TERM OBLIGATIONS

As of June 30, 2013, the primary government had long-term obligations totaling $170.8 billion. Of that amount, $6.4 billion is due within one year. The largest changes in long-term obligations for governmental activities are a decrease of $3.1 billion in loans payable and an increase of $3.1 billion in net other postemployment benefits obligations. Other notable increases occurred in general obligation bonds payable and certificates of participation and commercial paper payable.

As of June 30, 2013, the pollution remediation obligations decreased by $34 million, to $1.0 billion. Under federal Superfund law, responsibility for pollution remediation is placed upon current and previous owners or operators of polluted sites. Currently, the State's most significant superfund site is the Stringfellow Class 1 Hazardous Waste Disposal Facility (Stringfellow) located in Riverside County. As of June 30, 2013, the State estimates that remediation costs at Stringfellow will total $378 million. At two other sites, Leviathan Mine and BKK Landfill, obligating events have occurred that will probably result in significant liability to the State, but reasonable estimates of the remediation costs cannot be made at this time. Currently, litigation is in process to determine the final terms of the settlement for Leviathan Mine, a superfund site. The State's activities at the site relate to water pollution remediation. BKK is a closed Class 1 landfill site at which the State is conducting post-closure care. In addition to superfund sites, the State's other pollution remediation efforts include underground storage tank removal and cleanup, cleanup of polluted groundwater, and contaminated soil removal and cleanup.

Not included in Note 10 are certain state mandated programs that are in the adjudication process. Until the Commission on State Mandates (CSM) rules on a test claim, and the claim's parameters and guidelines are established, expected costs cannot be reasonably determined; however, a positive finding for any of the claimants could individually or in aggregate pose a significant cost to the State.

The other long-term obligations for governmental activities consist of $3.3 billion for net pension obligations, $86 million owed for lawsuits, the University of California unfunded pension liability of $28 million, and the California Technology Agency notes payable of $27 million. The compensated absences will be liquidated by the General Fund, special revenue funds, capital projects funds, and internal service funds. Workers' compensation and capital leases will be liquidated by the General Fund, special revenue funds, and internal service funds. The General Fund will liquidate net pension obligations, the Proposition 98 funding guarantee, lawsuits, reimbursement of costs incurred by local agencies and school districts for costs mandated by the State, and the University of California pension liability.

The largest changes in business-type long-term obligations are a decrease of $384 million for loans payable to the U.S. Department of Labor to cover shortfalls in the Unemployment Programs Fund and a decrease of $232 million in general obligation bonds payable.

This page intentionally left blank.

Table 22 summarizes the changes in long-term obligations during the year ended June 30, 2013.

Table 22

Schedule of Changes in Long-term Obligations
(amounts in thousands)

	Balance			Balance	Due Within	Noncurrent
	July 1, 2012	**Additions**	**Deductions**	**June 30, 2013**	**One Year**	**Liabilities**
Governmental activities						
Loans payable	$ 3,131,365	$ —	$ 3,131,365	$ —	$ —	$ —
Compensated absences payable	3,820,093 *	1,771,537	1,456,529	4,135,101	19,500	4,115,601
Certificates of participation and commercial paper	43,228 *	643,865	148,500	538,593	8,094	530,499
Accreted interest	3,050	184	3,234	—	—	—
Certificates of participation and commercial paper payable	46,278 *	644,049	151,734	538,593	8,094	530,499
Capital lease obligations	4,936,200 *	710,440	327,153	5,319,487	399,491	4,919,996
General obligation bonds	79,447,815	7,417,170	7,176,540	79,688,445	2,900,795	76,787,650
Premiums/discounts/other	1,929,179 *	903,130	174,543	2,657,766	139,709	2,518,057
General obligation bonds payable	81,376,994 *	8,320,300	7,351,083	82,346,211	3,040,504	79,305,707
Revenue bonds	7,558,970	375,105	726,158	7,207,917	158,398	7,049,519
Accreted interest	334,176	49,686	—	383,862	—	383,862
Premiums/discounts/other	108,800 *	56,019	21,545	143,274	(4,267)	147,541
Revenue bonds payable	8,001,946 *	480,810	747,703	7,735,053	154,131	7,580,922
Net other postemployment benefits obligation	12,472,425 *	4,768,897	1,682,090	15,559,232	—	15,559,232
Pollution remediation obligations	1,043,047 *	35,028	68,859	1,009,216	35,259	973,957
Proposition 98 funding guarantee	2,247,676	134,862	468,474	1,914,064	—	1,914,064
Mandated costs	6,414,082	416,988	80,221	6,750,849	54,259	6,696,590
Workers' compensation	3,202,772	754,641	449,937	3,507,476	413,644	3,093,832
Other long-term obligations	3,368,459	328,503	277,990	3,418,972	57,243	3,361,729
Total governmental activities	**$ 130,061,337**	**$ 18,366,055**	**$ 16,193,138**	**$ 132,234,254**	**$ 4,182,125**	**$ 128,052,129**
Business-type activities						
Loans payable	$ 8,968,936	$ —	$ 383,618	$ 8,585,318	$ —	$ 8,585,318
Lottery prizes and annuities	1,306,053	2,844,588	2,951,737	1,198,904	491,123	707,781
Compensated absences payable	297,336	137,887	121,090	314,133	124,925	189,208
Certificates of participation and commercial paper	67,325	149,366	139,131	77,560	340	77,220
Capital lease obligations	817,687	92,184	—	909,871	62,519	847,352
General obligation bonds	1,119,935	—	231,655	888,280	61,185	827,095
Premiums/discounts/other	(1,301)	74	—	(1,227)	—	(1,227)
General obligation bonds payable	1,118,634	74	231,655	887,053	61,185	825,868
Revenue bonds	24,482,048	3,022,400	3,041,490	24,462,958	1,338,210	23,124,748
Premiums/discounts/other	912,690	343,367	160,886	1,095,171	140,893	954,278
Revenue bonds payable	25,394,738	3,365,767	3,202,376	25,558,129	1,479,103	24,079,026
Net other postemployment benefits obligation	410,782	157,165	57,718	510,229	—	510,229
Other long-term obligations	526,167 *	46,563	88,081	484,649	24,842	459,807
Total business-type activities	**$ 38,907,658**	**$ 6,793,594**	**$ 7,175,406**	**$ 38,525,846**	**$ 2,244,037**	**$ 36,281,809**

* Restated

NOTE 11: CERTIFICATES OF PARTICIPATION

Table 23 shows debt service requirements for certificates of participation, which are financed by lease payments from governmental activities. The certificates of participation were used to finance the acquisition and construction of a state office building.

Table 23

Schedule of Debt Service Requirements for Certificates of Participation – Primary Government
(amounts in thousands)

Year Ending June 30	Principal	Interest	Total
2014	$ 8,140	$ 1,503	$ 9,643
2015	8,565	1,075	9,640
2016	11,915	625	12,540
Total	**$ 28,620**	**$ 3,203**	**$ 31,823**

NOTE 12: COMMERCIAL PAPER AND OTHER LONG-TERM BORROWINGS

The primary government has two commercial paper borrowing programs: a general obligation commercial paper program and an enterprise fund commercial paper program for the Department of Water Resources. Under the general obligation and enterprise fund programs, commercial paper (new issuance or rollover notes) may be issued at the prevailing market rate, not to exceed 11%, for periods not to exceed 270 days from the date of issuance. The proceeds from the initial issuance of commercial paper are restricted primarily for construction costs of general obligation bond program projects and certain state water projects. For both commercial paper borrowing programs, the commercial paper is retired by the issuance of long-term debt, so commercial paper is considered a noncurrent liability.

To provide liquidity for the programs, the State has entered into revolving credit agreements with commercial banks. The current "Letter of Credit" agreements for the general obligation commercial paper program, effective December 21, 2011, authorize the issuance of notes in an aggregate principal amount not to exceed $1.6 billion. As of June 30, 2013, the general obligation commercial paper program had $510 million in outstanding commercial paper notes for governmental activities. The current agreement for the enterprise fund commercial paper program authorizes the issuance of notes in an aggregate principal amount not to exceed $140 million. As of June 30, 2013, the enterprise fund commercial paper program had $51 million in outstanding notes.

The primary government has a revenue bond anticipation note (BAN) program that consists of borrowing for capital improvements on certain California State University campuses. As of June 30, 2013, $27 million in outstanding BANs existed in anticipation of the primary government issuing revenue bonds to the public.

The University of California, a discretely presented component unit, has established a $2.0 billion commercial paper program with tax-exempt and taxable components. The program is supported by available investments in the University's investment pools. Commercial paper may be issued by the University to provide for interim/permanent financing for capital projects and interim financing for equipment and working capital. Commercial paper is collateralized by a pledge of the net revenues derived from the University's ownership or operation of the projects financed—not by any encumbrance, mortgage, or other pledge of property—and does not constitute a general obligation of the University. At June 30, 2013, outstanding tax-exempt and taxable commercial paper totaled $55 million and $1.3 billion, respectively. The University has other borrowings consisting of contractual obligations resulting from the acquisition of land or buildings and the construction and renovation of certain facilities. Outstanding borrowings under these uncollateralized financing agreements for the period ending June 30, 2013, total $262 million for general corporate purposes and $15 million for interim financing.

NOTE 13: LEASES

The aggregate amount of lease commitments for facilities and equipment of the primary government in effect as of June 30, 2013, was approximately $10.7 billion. Primary government leases that are classified as operating leases, in accordance with the applicable standards, contain clauses providing for termination. Operating lease expenditures are recognized as being incurred over the lease term. It is expected that, in the normal course of business, most of these operating leases will be replaced by similar leases.

The total present value of minimum capital lease payments for the primary government is comprised of $6.2 billion. Note 10, Long-term Obligations, reports the additions and deductions of capital lease obligations. Also reported in Note 10 are the current and noncurrent portions of the capital lease obligations. Lease expenditures for the year ended June 30, 2013, amounted to approximately $1.0 billion.

Included in the capital lease commitments are lease-purchase agreements, amounting to a present value of net minimum lease payments of $5.6 billion that certain state agencies have entered into with the State Public Works Board, an enterprise fund agency. This amount represents 90.6% of the total present value of minimum capital lease payments of the primary government. Also included in the capital lease commitments are some lease-purchase agreements to acquire equipment.

The capital lease commitments do not include $309 million in lease-purchase agreements with building authorities that are blended component units. These building authorities acquire or develop office buildings and then lease the facilities to state agencies. Upon expiration of the lease, title passes to the primary government. The costs of the buildings and the related outstanding revenue bonds and certificates of participation are reported in the government-wide financial statements. Accordingly, the lease receivables or capital lease obligations associated with these buildings are not included in the financial statements.

Table 24 summarizes future minimum lease commitments of the primary government.

Table 24

Schedule of Future Minimum Lease Commitments – Primary Government
(amounts in thousands)

Year Ending June 30	Operating Leases	Capital Leases	Total
2014	$ 279,348	$ 728,216	$ 1,007,564
2015	188,056	714,784	902,840
2016	125,375	698,504	823,879
2017	80,589	682,721	763,310
2018	40,063	657,030	697,093
2019-2023	79,622	2,595,057	2,674,679
2024-2028	14,924	2,038,819	2,053,743
2029-2033	11,578	1,362,162	1,373,740
2034-2038	3,063	362,421	365,484
2039-2043	1,567	9,715	11,282
2044-2048	498	—	498
2049-2053	352	—	352
2054-2058	114	—	114
2059-2063	52	—	52
2064-2068	32	—	32
2069-2073	33	—	33
2074-2078	32	—	32
2079-2083	33	—	33
2084-2088	32	—	32
2089-2093	33	—	33
2094-2098	32	—	32
2099-2103	3	—	3
Total minimum lease payments	**$ 825,431**	**9,849,429**	**$ 10,674,860**
Less: amount representing interest		3,620,071	
Present value of net minimum lease payments		**$ 6,229,358**	

The aggregate amount of the major discretely presented component units' lease commitments for land, facilities, and equipment in effect as of June 30, 2013, was approximately $4.5 billion. Table 25 presents the future minimum lease commitments for the University of California. Operating lease expenditures for the year ended June 30, 2013, amounted to approximately $168 million for major discretely presented component units.

Table 25

Schedule of Future Minimum Lease Commitments – Major Discretely Presented Component Units
(amounts in thousands)

	University of California		
Year Ending June 30	Capital	Operating	Total
2014	$ 313,074	$ 120,281	$ 433,355
2015	267,337	97,810	365,147
2016	239,951	80,610	320,561
2017	235,463	65,363	300,826
2018	228,809	54,160	282,969
2019-2023	1,072,137	131,171	1,203,308
2024-2028	785,675	7,223	792,898
2029-2033	596,047	4,932	600,979
2034-2038	129,122	4,898	134,020
2039-2043	30,977	1,651	32,628
2044-2048	3,968	—	3,968
Total minimum lease payments	**3,902,560**	**$ 568,099**	**$ 4,470,659**
Less: amount representing interest	1,316,171		
Present value of net minimum lease payments	**$ 2,586,389**		

NOTE 14: COMMITMENTS

As of June 30, 2013, the primary government had commitments of $7.0 billion for certain highway construction projects. The primary government also had commitments of $773 million for various education programs, $489 million for terrorism prevention and disaster preparedness response projects, $329 million for services provided under various public health programs, $291 million for services under the workforce development program, $202 million for community service programs, $126 million for services provided under the welfare program, $40 million for services provided under the child support program, and $33 million for services provided under the rehabilitation program.

The primary government had other commitments, totaling $7.6 billion that are not included as a liability on the Balance Sheet or the Statement of Net Position. The $7.6 billion in commitments includes grant agreements totaling approximately $5.5 billion to reimburse other entities for construction projects for school building aid, parks, transportation-related infrastructure, housing, and other improvements; and to reimburse counties and cities for costs associated with various programs. Any assets that have been constructed will not belong to the primary government, whose payments are contingent upon the other entities entering into construction contracts. The $7.6 billion in commitments includes $363 million in undisbursed loan commitments for various programs aimed at providing housing and emergency shelter to persons in need. In addition, the $7.6 billion in commitments includes $113 million in long-term contracts to purchase power. These contracts qualify for the Normal Purchase Normal Sale (NPNS) exception under GASB Statement No. 53 and, therefore, are not included on the Statement of Net Position of the Electric Power Fund nor disclosed in Note 17.

The $7.6 billion in commitments also includes contracts of $861 million for the construction of water projects and the purchase and transmission of power that are not included as a liability on the Statement of Net Position of the Water Resources Fund. Included in this amount are certain power purchase, sale, and exchange contracts. These contracts had a positive fair value of $72,000 as of June 30, 2013. The primary government had commitments of $214 million for California State University (CSU) construction projects. CSU participates in forward-purchase contracts of natural gas and electricity. As of June 30, 2013, CSU's obligation under these special purchase arrangements requires it to purchase at fixed prices an estimated total of $26 million in electricity through March 2014 and $35 million in natural gas through June 2017. The primary government also had commitments of $5 million to veterans for the purchase of properties under contracts of sale. The California State Lottery Commission had commitments of $533 million, of which $530 million is for gaming and telecommunication systems and services and $3 million is for a construction contract. These are long-term projects, and all of the contracts' needs may not have been defined. The projects will be funded with existing and future program resources or with the proceeds of revenue and general obligation bonds.

As of June 30, 2013, the primary government encumbered expenditures of $658 million for the General Fund, $3.9 billion for the Transportation Fund, $1.2 billion for the Environmental and Natural Resources Fund, and $708 million for the nonmajor governmental funds. See Note 2A for an explanation of the primary government's policy concerning encumbrances.

As of June 30, 2013, the discretely presented component units had other commitments that are not included as liabilities on the Statement of Net Position. The University of California had authorized construction projects totaling $3.4 billion. The University also made commitments to invest in certain investment partnerships pursuant to provisions in the various partnership agreements. These commitments totaled $700 million as of June 30, 2013. The California Housing Finance Agency had no outstanding commitments to provide loans under its housing programs. The California Public Employees' Retirement System had capital commitments to private equity funds of $12.4 billion and commitments to purchase real estate equity of $8.0 billion that remained unfunded and not recorded as liabilities on the Statement of Net Position of the fiduciary component unit.

NOTE 15: GENERAL OBLIGATION BONDS

The State Constitution permits the primary government to issue general obligation bonds for specific purposes and in such amounts as approved by a two-thirds vote of both houses of the Legislature and by a majority of voters in a general or direct primary election. The debt service for general obligation bonds is appropriated from the General Fund. Under the State Constitution, the General Fund is used first to support the public school system and public institutions of higher education; the General Fund can then be used to service the debt on outstanding general obligation bonds. Enterprise funds and certain other funds reimburse the General Fund for any debt service it provides on their behalf. General obligation bonds that are directly related to, and are expected to be paid from, the resources of enterprise funds are included as a liability of such funds in the financial statements. However, the General Fund may be liable for the payment of any principal and interest on these bonds that is not met from the resources of such funds.

As of June 30, 2013, the State had $79.7 billion in outstanding general obligation bonds related to governmental activities and $888 million related to business-type activities. In addition, $30.5 billion of long-term general obligation bonds had been authorized but not issued, of which $29.2 billion is related to governmental activities and $1.3 billion is related to business-type activities. The total amount authorized but not issued includes $17.9 billion authorized by the applicable finance committees for issuance in the form of commercial paper notes. Of this amount, $510 million in general obligation indebtedness in the form of commercial paper notes was not yet retired by long-term bonds.

A. Variable-rate General Obligation Bonds

The State issues both fixed and variable-rate general obligation bonds. As of June 30, 2013, the State had $2.7 billion of variable-rate general obligation bonds outstanding, consisting of $814 million in daily rate bonds with credit enhancement and $1.7 billion in weekly rate bonds with credit enhancement, and $198 million in weekly rate bonds without credit enhancement. The interest rates associated with the credit enhanced bonds are determined by the remarketing agents to be the lowest rate that would allow the bonds to sell on the effective date of such rate at a price (without regard to accrued interest) equal to 100% of the principal amount. The interest rates associated with the unenhanced bonds are determined by the Securities Industry and Financial Markets Association (SIFMA) Index rate then in effect plus a pre-determined spread (SIFMA Index Floating Rate Bonds). The interest on all variable-rate bonds is paid on the first business day of each calendar month.

The credit enhanced bonds are secured by letters of credit which secure payment of principal and interest on the bonds. The State has entered into different credit agreements with various banks for each series of credit enhanced bonds. Under these credit agreements, the credit providers agree to pay all principal and interest payments or the commitment amounts to the bondholders; the State is then required to reimburse the credit providers for the amounts paid. In return, the credit providers are compensated with commitment fees that are calculated as a percentage of the bank commitment amounts. The bondholders have the right to tender the bonds daily if the bonds are in a daily rate mode and weekly if the bonds are in a weekly rate mode. Upon a tender, the remarketing agent will attempt to remarket the bonds to a new investor. If the remarketing of the bonds is unsuccessful, the bonds will enter into a bank bond period and accrue interest at higher rates— which cannot exceed 11% as permitted by law until remarketed or redeemed. If the bonds cannot be remarketed and remain in a bank bond period ranging from 45 days to 180 days, the bonds will be subject to term loan payment in 12 equal quarterly installments under the terms stated in the credit agreements. The term loan period may exceed the expiration dates of the credit agreements. The bonds may be remarketed at any time during the bank bond or term loan period. There were no bank bonds during fiscal year 2012 - 2013.

The letters of credit for the variable-rate bonds issued during the 2002-03 fiscal year have expiration dates of November 21, 2014; December 1, 2014; October 15, 2015; and October 16, 2015. The letters of credit for the variable-rate bonds issued during the 2004-05 fiscal year have expiration dates of April 6, 2015; October 12, 2015; and October 15, 2015. The letters of credit for the variable-rate bonds issued during the 2005-06 fiscal year have expiration dates of November 12, 2013; April 11, 2014; and November 10, 2014. The Series 2012A SIFMA Index floating rate bonds have a mandatory purchase date of May 1, 2015. The Series 2012B SIFMA Index floating rate bonds have final maturities from 2017 to 2020.

Based on the schedules provided in the Official Statements, sinking fund deposits for the variable-rate general obligation bonds will be set aside in a mandatory sinking fund at the beginning of each of the following fiscal years: the 2015-16 through 2033-34 fiscal years and the 2039-40 fiscal year. The deposits set aside in any fiscal year may be applied, with approval of the State Treasurer and the appropriate bond finance committees, to the redemption of any other general obligation bonds then outstanding. To the extent that the deposit is not applied by January 31 of each fiscal year, the variable-rate general obligation bonds will be redeemed in whole or in part on an interest payment date in that fiscal year.

B. Economic Recovery Bonds

In 2004, voters approved the one-time issuance of Economic Recovery Bonds. The debt service for these bonds is payable from and secured by amounts available in the Economic Recovery Bond Sinking Fund, a debt service fund that consists primarily of revenues from a dedicated sales tax. However, the General Fund may be liable for the payment of any principal and interest on the bonds that cannot be paid from the Economic Recovery Bond Sinking Fund.

As of June 30, 2013, the State had $5.2 billion in Economic Recovery Bonds outstanding. Of the $5.2 billion outstanding, bonds totaling $260 million are variable-rate bonds in the daily-rate mode and $500 million are mandatory tender bonds. The interest rates associated with the daily rates are determined by the remarketing agents to be the lowest rates that would enable them to sell the bonds for delivery on the effective date of such rate at a price (without regard to accrued interest) equal to 100% of the principal amount. The interest is paid on the first business day of each calendar month. As described in the Official Statement for the variable-rate bonds, payment of principal, interest, and purchase price upon tender, is secured by direct-pay letters of credit. The State reimburses its credit providers for any amounts paid. Different credit providers exist for each series of variable-rate bonds outstanding. The expiration date for these letters of credit is June 13, 2014.

C. Mandatory Tender Bonds

Of the $5.2 billion in outstanding Economic Recovery Bonds, $500 million are mandatory tender bonds and have an interest rate reset date of July 1, 2014. At that time, the bonds are subject to mandatory tender for purchase at a price equal to 100% of the principal amount, plus accrued interest, without premium. Upon mandatory tender, the State will seek to remarket these bonds. The debt service requirements published in the Official Statement differ from the calculation included in Table 26 because the statement presumes a successful remarketing at an interest rate of 4% per year. The debt service calculation in Table 26 uses the interest rates in effect at year-end, which are the same interest rates in effect until the applicable reset date. In the event of a failed remarketing, the State is required to return all tendered bonds to their initial purchasers and pay an annual interest rate of 11% until the bonds are successfully remarketed.

In May 2012, the State issued $100 million in General Obligation Kindergarten-University Public Education Facilities Refunding Bonds, Series 2012A (SIFMA Index Floating Rate Bonds). The mandatory bonds have an initial SIFMA scheduled mandatory purchase date of May 1, 2015. The bonds will bear interest at a per annum interest rate, determined weekly (not to exceed 11%), and equal to the sum of the SIFMA Index rate in effect and the applicable SIFMA spread of 0.68%. In the event of unsuccessful remarketing of all the outstanding bonds on the initial SIFMA scheduled mandatory purchase date, the bonds will enter into a SIFMA delayed remarketing period and the bonds will accrue interest at a higher rate to be paid by the State until remarketed or redeemed. Starting six months after the SIFMA— scheduled mandatory purchase date, the bonds will be subject to special mandatory redemption in 20 equal quarterly installments.

D. Build America Bonds

As of June 30, 2013, the State had $13.5 billion in taxable various-purpose general obligation bonds outstanding that were issued as "Build America Bonds" under the American Recovery and Reinvestment Act of 2009 (ARRA) signed into law on February 17, 2009. The bonds will mature between 2020 and 2040. Pursuant to the ARRA, the State receives a cash subsidy payment from the United States Treasury equal to 35% of the interest payable by the State on the Build America Bonds on or near each interest payment date. The American Taxpayer Relief Act of 2012 effective March 1, 2013, reduced the Build America Bonds subsidy by 8.7% for the federal fiscal year ending September 30, 2013. The cash payment does not constitute a full faith and credit guarantee of the United States Government, but is required to be paid by the United States Treasury under the ARRA. The cash subsidy payments received are deposited into the state treasury.

E. Debt Service Requirements

Table 26 shows the debt service requirements for all general obligation bonds as of June 30, 2013. The estimated debt service requirements for the $2.7 billion variable-rate general obligation bonds and the $260 million variable-rate Economic Recovery Bonds are calculated using the actual interest rates in effect on June 30, 2013. The amounts do not reflect any interest subsidy under the Build America Bond program or any other offsets to general fund costs of debt service.

Table 26

Schedule of Debt Service Requirements for General Obligation Bonds
(amounts in thousands)

Year Ending	Governmental Activities			Business-type Activities		
June 30	Principal	Interest	Total	Principal	Interest	Total
2014	$ 2,900,795	$ 4,089,281	$ 6,990,076	$ 61,185	$ 38,861	$ 100,046
2015	3,136,045	3,993,769	7,129,814	77,565	35,964	113,529
2016	3,303,620	3,865,978	7,169,598	75,620	32,851	108,471
2017	2,757,990	3,711,780	6,469,770	61,895	30,150	92,045
2018	2,823,120	3,594,810	6,417,930	60,655	27,463	88,118
2019-2023	15,340,120	15,734,172	31,074,292	129,790	109,911	239,701
2024-2028	11,180,185	12,693,358	23,873,543	67,940	91,029	158,969
2029-2033	12,820,465	9,823,751	22,644,216	204,940	58,805	263,745
2034-2038	15,570,625	5,852,792	21,423,417	98,285	22,243	120,528
2039-2043	9,855,480	1,398,049	11,253,529	50,405	3,550	53,955
Total	**$79,688,445**	**$64,757,740**	**$144,446,185**	**$ 888,280**	**$ 450,827**	**$1,339,107**

F. General Obligation Bond Defeasances

1. Current Year

On October 4, 2012, the primary government issued $776 million in general obligation refunding bonds to current and advance refund $867 million in outstanding general obligation bonds maturing in 2013 to 2031. As a result, the refunded bonds are defeased and the liability for those bonds has been removed from the financial statements.

The refunding decreased overall debt service by $155 million and resulted in an economic gain of $117 million. The economic gain is the difference between the present value of the old debt service requirements and the present value of the new debt service requirements, discounted at 2.93% per year over the life of the new bonds.

On November 1, 2012, the primary government issued $539 million in general obligation refunding bonds to current and advance refund $583 million in outstanding general obligation bonds maturing in 2020 to 2032. As a result, the refunded bonds are defeased and the liability for those bonds has been removed from the financial statements. The refunding decreased overall debt service by $165 million and resulted in an economic gain of $119 million. The economic gain is the difference between the present value of the old debt service requirements and the present value of the new debt service requirements, discounted at 3.01% per year over the life of the new bonds.

On March 27, 2013, the primary government issued $1.1 billion in general obligation refunding bonds to current and advance refund $1.2 billion in outstanding general obligation bonds maturing in 2014 to 2033. As a result, the refunded bonds are defeased and the liability for those bonds has been removed from the financial statements. The refunding decreased overall debt service by $224 million and resulted in an economic gain of $169 million. The economic gain is the difference between the present value of the old debt service requirements and the present value of the new debt service requirements, discounted at 3.11% per year over the life of the new bonds.

On March 27, 2013, the primary government issued $277 million in general obligation refunding bonds to current refund $277 million in outstanding mandatory tender general obligation bonds maturing in 2039. As a result, the refunded bonds are defeased and the liability for those bonds has been removed from the financial statements. The purpose of this refunding was to restructure the debt of the State.

On April 23, 2013, the primary government issued $1.4 billion in general obligation refunding bonds to current and advance refund $1.5 billion in outstanding general obligation bonds maturing in 2013 to 2033. As a result, the refunded bonds are defeased and the liability for those bonds has been removed from the financial statements. The refunding decreased overall debt service by $315 million and resulted in an economic gain of $237 million. The economic gain is the difference between the present value of the old debt service requirements and the present value of the new debt service requirements, discounted at 2.94% per year over the life of the new bonds.

2. Prior Years

In prior years, the primary government placed the proceeds of the refunding bonds in a special irrevocable escrow trust account with the State Treasury to provide for all future debt service payments on defeased bonds. The assets of the trust accounts and the liability for defeased bonds are not included in the State's financial statements. As of June 30, 2013, the outstanding balance of general obligation bonds defeased in prior years was approximately $4.9 billion.

NOTE 16: REVENUE BONDS

A. Governmental Activities

The State Treasurer is authorized by state law to issue Federal Highway Grant Anticipation Revenue Vehicles (GARVEE bonds). The purpose of these bonds is to accelerate the funding and construction of critical transportation infrastructure projects in order to provide congestion relief benefits to the public significantly sooner than with traditional funding mechanisms. These bonds are secured and payable from the annual federal appropriation for the State’s federal-aid transportation projects. The primary government has no legal liability for the payment of principal and interest on these revenue bonds. Total principal and interest remaining on the bonds is $226 million, payable through 2020. In addition, the California Alternative Energy and Advanced Transportation Financing Authority is authorized to issue Clean Renewable Energy Bonds to fund the acquisition and installation of certain transportation-related solar energy facilities located throughout the state. Both of these bonds fund activity in the Transportation Fund and are included in the governmental activities column of the government-wide Statement of Net Position.

The Golden State Tobacco Securitization Corporation (GSTSC), a blended component unit, is authorized by state law to issue asset-backed bonds to purchase the State’s rights to future revenues from the Master Settlement Agreement with participating tobacco companies. These bonds are secured by and payable solely from future Tobacco Settlement Revenue and interest earned on that revenue. The primary government has no legal liability for the payment of principal and interest on the bonds; provided that, in connection with the issuance of the 2005 Bonds and the 2013 Bonds that refunded a portion of the 2005 Bonds, the Legislature has annually granted a General Fund appropriation for payment of debt service in the event tobacco settlement revenues and other available amounts prove insufficient to make these payments during the next succeeding fiscal year. However, the use of the appropriated monies has never been required. Total principal and interest remaining on all asset-backed bonds is $19.3 billion, payable through 2047. All of the Tobacco Settlement Revenue and interest has been pledged in support of these asset-backed bonds. Principal and interest paid in the current year totaled $932 million, while Tobacco Settlement Revenue and interest earned totaled $555 million. These bonds are included in the governmental activities column of the government-wide Statement of Net Position.

Under state law, certain building authorities may issue revenue bonds. These bonds are issued for the purpose of constructing state office buildings. Leases with state agencies pay the principal and interest on the revenue bonds issued by the building authorities. The primary government has no legal liability for the payment of principal and interest on these revenue bonds. These revenue bonds are included in the governmental activities column of the government-wide Statement of Net Position.

B. Business-type Activities

Revenue bonds that are directly related to, and are expected to be paid from, the resources of enterprise funds are included in the accounts of such funds. Principal and interest on revenue bonds are payable from the pledged revenues of the respective funds of agencies that issued the bonds. The General Fund has no legal liability for payment of principal and interest on revenue bonds.

Revenue bonds to acquire, construct, or renovate state facilities or to refund outstanding revenue bonds in advance of maturity are issued for water resources, public buildings construction, financing of electric power purchases for resale to utility customers, and certain nonmajor enterprise funds.

C. Discretely Presented Component Units

The University of California issues revenue bonds to finance various auxiliary, administrative, academic, medical center, and research facilities. The revenue bonds are not collateralized by any encumbrance, mortgage, or other pledge of property except pledged revenues, and do not constitute general obligations of the University.

Under state law, the California Housing Finance Agency (CalHFA) issues fixed- and variable-rate revenue bonds to fund loans to qualified borrowers for single-family houses and multifamily developments. Variable-rate debt is typically related to remarketed rates or common indices, such as the SIFMA or the London Interbank Offered Rate (LIBOR) and is reset periodically. CalHFA issues both federally taxable and tax-exempt bonds. The bonds issued by CalHFA are payable solely from and collateralized by revenues and other pledged assets.

Table 27 shows outstanding revenue bonds of the primary government and the discretely presented component units.

Table 27

Schedule of Revenue Bonds Outstanding
June 30, 2013
(amounts in thousands)

Primary government	
Governmental activities	
Transportation Fund	$ 227,886
Nonmajor governmental funds	
Golden State Tobacco Securitization Corporation Fund	7,185,762
Building authorities	321,405
Total governmental activities	**7,735,053**
Business-type activities	
Electric Power Fund	6,951,000
Water Resources Fund	2,594,459
Public Buildings Construction Fund	11,756,473
California State University	3,738,697
Nonmajor enterprise funds	517,500
Total business-type activities	**25,558,129**
Total primary government	**33,293,182**
Discretely presented component units	
University of California	12,801,508
California Housing Finance Agency	4,899,970
Nonmajor component units	382,174
Total discretely presented component units	**18,083,652**
Total	**$ 51,376,834**

Table 28 shows the debt service requirements for fixed-rate and variable-rate bonds. It excludes certain unamortized refunding costs, premiums, discounts, and other costs that are included in Table 27.

Table 28

Schedule of Debt Service Requirements for Revenue Bonds
(amounts in thousands)

	Primary Government				Discretely Presented Component Units	
Year Ending June 30	Governmental Activities		Business-type Activities			
	Principal	Interest	Principal	Interest*	Principal	Interest*
2014	$ 158,398	$ 350,681	$ 1,338,210	$ 1,197,986	$ 654,161	$ 795,433
2015	132,848	342,952	1,405,425	1,135,303	396,103	765,942
2016	70,973	336,423	1,493,415	1,070,249	446,987	743,498
2017	107,213	332,910	1,554,375	1,000,572	423,416	721,169
2018	88,988	327,648	1,611,765	926,167	428,417	698,753
2019-2023	461,328	1,570,793	7,460,488	3,449,345	2,803,720	3,150,819
2024-2028	791,964	1,658,847	4,067,145	2,042,169	2,661,734	2,531,030
2029-2033	775,760	1,348,169	3,393,135	1,030,137	3,028,880	1,886,242
2034-2038	1,425,390	1,603,159	1,815,025	286,963	2,855,257	1,223,788
2039-2043	—	818,939	315,380	34,282	2,287,268	648,567
2044-2048	3,578,917	3,701,239	8,595	391	724,132	339,695
2049-2053	—	—	—	—	91,435	215,351
2054-2112	—	—	—	—	860,000	2,464,948
Total	**$ 7,591,779**	**$ 12,391,760**	**$ 24,462,958**	**$ 12,173,564**	**$ 17,661,510**	**$ 16,185,235**

* Includes interest on variable-rate bonds based on rates in effect on June 30, 2013.

D. Revenue Bond Defeasances

1. Current Year–Governmental Activities

On April 9, 2013, Enhanced Tobacco Settlement Asset-backed Bonds, Series 2013A, were issued to partially refund, on a current basis, a portion of the remaining outstanding bonds of the 2005A Bonds. On April 9, 2013, $375,105,000 principal value in current interest bonds with maturity dates ranging from June 1, 2017 through June 1, 2030 were sold at a $56,019,304 premium to partially refund $419,885,000 in principal value of Series 2005A bonds maturing in June 1, 2013, 2017, 2018, 2019, 2020, 2021, 2029, and 2030. The Golden State Tobacco Securitization Corporation completed the refunding to reduce debt service payments by $44,780,000 in aggregate and to obtain an economic gain (difference between the present value of the old and new debt service payments) of $1,268,860 in aggregate.

2. Current Year–Business-type Activities

In 2012-13, the Department of Water Resources issued $657 million in water system revenue bonds. The bonds proceeds were used to refund $632 million of outstanding water system revenue bonds. The proceeds were deposited into an escrow account to provide for all future debt service payments on the refunded bonds. As a result, the bonds are considered defeased and the liability for those bonds has been removed from the financial statements. This refunding will decrease debt service payments by $93 million over the life of the bonds and will result in an economic gain of $77 million for the refunded bonds. These water system revenue bonds are reported in the Water Resources Fund.

For the year ended June 30, 2013, the State Public Works Board issued $506 million in lease revenue refunding bonds. The bonds proceeds were used to refund $577 million in outstanding lease revenue bonds. The proceeds were deposited into an escrow account to provide for all future debt service payments on the refunded bonds. As a result, the bonds are considered defeased and the liability for those bonds has been removed from the financial statements. This refunding will decrease debt service payments by $95 million over the next 10 years and will result in an economic gain of $75 million for the refunded bonds. These lease revenue bonds are reported in the Public Buildings Construction Fund.

In August 2012, California State University issued $436 million in Systemwide Revenue Bonds refunding bonds to partially defease certain outstanding Systemwide Revenue Bonds. A portion of the proceeds were deposited into an escrow account to provide for all future debt service payments on the refunded bonds. As a result, the bonds are considered defeased and the liability for those bonds has been removed from the financial statements. This refunding will decrease debt service payments by $80 million over the life of the bonds and will result in an economic gain of $53 million for the refunded bonds.

3. Current Year–Discretely Presented Component Units

In July 2012, Limited Project Revenue Bonds totaling $1.0 billion, including $899 million in tax-exempt and $101 million in taxable bonds, were issued. Proceeds including a bond premium of $153 million were used to finance certain facilities and projects of the University and refund $854 million of outstanding Limited Project Revenue Bonds and outstanding General Revenue Bonds. The bonds mature at various dates through 2042. The tax-exempt bonds have a stated weighted average interest rate of 4.9%. The taxable bonds have a stated weighted average interest rate of 4.1%. The deferred premium will be amortized as a reduction to interest expense over the term of the bonds.

In October 2012, General Revenue Bonds totaling $2 million, consisting of Taxable Clean Renewable Energy Bonds, were issued to pay for project construction and issuance costs. The bonds mature in 2022 and have a stated interest rate of 3%. The expected cash subsidy payment from the United States Treasury is equal to 100% of the posted tax credit rate.

In March 2013, General Revenue Bonds totaling $1.3 billion, including $806 million in tax-exempt and $501 million in taxable bonds, were issued. Proceeds including a bond premium of $137 million were used to refund $1.4 billion outstanding General Revenue Bonds. The bonds mature at various dates through 2039. The tax-exempt bonds have a stated weighted average interest rate of 4.7%. The taxable bonds have a stated weighted average interest rate of 3.5%. The deferred premium will be amortized as a reduction to interest expense over the term of the bonds.

In March 2013, General Revenue Bonds totaling $287 million in taxable fixed-rate notes were issued. Proceeds were used to refund $287 million of outstanding General Revenue Bonds. The taxable fixed-rate notes have a stated interest rate of 1.8%, maturing in 2019.

4. Prior Years

In prior years, the primary government defeased certain bonds by placing the proceeds of new bonds in irrevocable trust accounts to provide for all future debt service requirements. Accordingly, the assets and liabilities for these defeased bonds are not included in the financial statements. As of June 30, 2013, the outstanding balance of revenue bonds defeased in prior years was $1.4 billion for business-type activities. All previously defeased revenue bonds for governmental activities were redeemed by June 30, 2013.

In prior years, the University of California, a discretely presented component unit, defeased certain bonds. Investments that have maturities and interest rates sufficient to fund retirement of defeased liabilities are being held in irrevocable trusts for the debt service payments. Accordingly, the assets of the trust accounts and the liabilities for the defeased bonds are not included in the State's financial statements. As of June 30, 2013, the outstanding balance of University revenue bonds defeased in prior years was $227 million.

NOTE 17: DERIVATIVE FINANCIAL INSTRUMENTS

Certain primary government business-type activities and discretely presented component units use derivatives—including futures, forward contracts, options, and interest rate swap contracts—as a substitute for investment in equity and fixed-income securities to reduce the effect of fluctuating foreign currencies on foreign currency-denominated investments or to limit its exposure of variable-rate bonds to changes in market interest rates.

A futures contract is an agreement between two parties to buy and sell a security, financial index, interest rate, or foreign currency at a set price on a future date. Futures contracts are standardized contracts that can be easily bought and sold and are exchange-traded. A futures contract obligates a buyer to purchase the commodity or financial instrument and a seller to sell it, unless an offsetting contract is entered into to offset one's obligation. The resources or obligations acquired through these contracts are usually terminated by entering into offsetting contracts.

Forward contracts are similar to futures contracts, although they are not exchange-traded. One example of a forward contract is a foreign currency exchange contract used to hedge against foreign currency exchange rate risks on non-U.S. dollar-denominated investment securities and to increase or decrease exposure to various foreign currencies.

Rights and warrants provide the holder with the right, but not the obligation, to buy a stock at a predetermined price for a finite period of time. Warrants usually have a longer time period to expiration. The holder of a right or warrant is permitted to buy at a price that may be below the actual market price for that stock. Warrants and rights cease to exist and become worthless if not used by their expiration date.

An option contract gives the State the right, but not the obligation, to buy or sell a financial instrument or commodity at a fixed price during a specified period for a nonrefundable fee.

The State considers its futures, forward contracts, and options to be investment derivatives. A swap is a contractual agreement to exchange future cash flows. These cash flows may be either fixed or variable and may be either received or paid. The State holds interest rate swaps as both investment derivatives and hedging derivatives.

Table 29 shows debt service requirements as of June 30, 2013, for variable-rate debt included in Table 28, as well as net swap payments, assuming that current interest rates remain the same for their terms. As interest rates vary, variable-rate bond interest payments and net swap payments will vary.

Table 29

Schedule of Debt Service and Swap Requirements for Variable-rate Revenue Bonds
(amounts in thousands)

	Discretely Presented Component Units			
Year Ending June 30	**Principal**	**Interest***	**Interest-Rate* Swap Net**	**Total**
2014	$ 15,790	$ 6,497	$ 80,000	$ 102,287
2015	15,975	6,150	73,971	$ 96,096
2016	19,350	6,154	68,355	$ 93,859
2017	21,080	6,132	63,220	$ 90,432
2018	29,525	6,118	58,744	$ 94,387
2019-2023	232,825	29,722	239,574	$ 502,121
2024-2028	235,770	27,898	175,020	$ 438,688
2029-2033	448,515	25,678	111,015	$ 585,208
2034-2038	371,377	23,382	45,833	$ 440,592
2039-2043	735,788	9,278	10,224	$ 755,290
2044-2048	17,120	206	2,266	$ 19,592
Total	**$ 2,143,115**	**$ 147,215**	**$ 928,222**	**$ 3,218,552**

* Based on rates in effect on June 30, 2013.

A. Primary Government

The Department of Water Resources (DWR) is party to natural gas hedging positions that are considered to be derivatives. Table 30 summarizes the fair values, classification, and notional amounts outstanding for the DWR's natural gas hedges accounted for as derivative financial instruments.

Table 30

Schedule of Fair Values and Notional Amounts – Electric Power Fund
June 30, 2013
(dollars in thousands)

	Classification	**Fair Value**	**Notional Amount (in MMBtu)** [1]
Effective hedges			
Natural gas swaps	Other current liabilities	$ (2,000)	460,000
Total effective hedges		**$ (2,000)**	

[1] Millions of British thermal units.

1. Natural Gas Swaps and Options

As of June 30, 2013, DWR no longer has outstanding natural gas option contracts. In prior years, DWR entered into natural gas hedge contracts, futures, and options to hedge the cost of natural gas. All natural gas options were treated as derivatives and classified as investment derivatives.

The DWR no longer has any forward natural gas purchase contracts. In prior years, most of the DWR's natural gas purchases were treated as Normal Purchase Normal Sale (NPNS) contracts and were not recorded prior to settlement. Natural gas forwards not qualifying as NPNS were recorded at fair value on the Statement of Net Position. Changes in the fair value of derivatives that are classified as investment derivatives are included as investment income or loss on the Statement of Revenues, Expenses, and Changes in Fund Net Position.

Fair Value: The reported fair values from Table 30 above were determined based on quoted market prices for similar financial instruments.

Credit Risk: The DWR's open natural gas hedge positions at June 30, 2013, have been entered into through the DWR's brokerage accounts and the associated clearing accounts have collateral requirements that limit the DWR's counterparty credit risk.

Termination Risk: With regards to gas hedge agreements, the DWR or the counterparty may terminate an agreement if the other party fails to perform under the terms of the contract. In addition, the agreements allow either party to terminate in the event of a significant loss of creditworthiness by the other party. If a termination were to occur, the DWR or the counterparty would owe the other a payment equal to the fair value of the open positions.

B. Fiduciary Funds

Under the State Constitution and statutory provisions governing the investment authority of the California Public Employees' Retirement System (CalPERS), CalPERS holds investments in swaps, options, futures, rights, and warrants and enters into forward foreign currency exchange contracts. The fair value of options, futures, rights, and warrants is determined based on quoted market prices. The fair value of derivative investments that are not exchange traded, such as swaps, is determined by an external pricing service using various proprietary methods, based on the type of derivative instrument. Futures contracts are marked-to-market at the end of each trading day and the settlement of gains or losses occur on the following business day through the movement of variation margins. Over the counter derivatives, such as swaps, generally reset monthly and the settlement of gains or losses occur the following business day. Currency forward contracts roll quarterly, updating the contract exchange rate. The fair value of international currency forwards represents the unrealized gain or loss on the related contracts, which is calculated as the difference between the contract exchange rate and the exchange rate at the end of the reporting period.

The California State Teachers' Retirement System (CalSTRS) also holds investments in derivative instruments. CalSTRS' investments that are not exchange traded, such as credit default swaps and interest rate swaps, are valued using methods employed for debt securities. Futures contracts are financial instruments that derive their value from underlying indices or reference rates and are marked-to-market at the end of each trading day. Daily settlement of gains or losses occurs on the following business day. As a result, the derivative instruments themselves have no fair value at June 30, 2013, or at the end of any trading day. Daily settlement of gains and losses is a risk control measure to limit counterparty credit risk. Futures variation margin amounts are settled each trading day and are recognized as net appreciation or depreciation in fair value of investments as they are incurred.

CalSTRS holds foreign currency forwards, which are obligations to buy or sell a currency at a specified exchange rate and quantity on a specific future date. The fair value of foreign currency forwards is the unrealized gain or loss calculated based on the difference between the specified exchange rate and the closing forward rate at June 30, 2013.

This page intentionally left blank.

All fiduciary fund derivative instruments are included in the investments disclosed in Note 3, Deposits and Investments. Changes in fair value are recorded as net appreciation or depreciation in fair value of investments in the Statement of Changes in Fiduciary Net Position. Table 31 presents the net appreciation (depreciation) in fair value, the fair values, and notional amounts of derivative instruments outstanding of these fiduciary funds.

Table 31

Schedule of Changes in Fair Values, Fair Values, and Notional Amounts – Fiduciary Funds
June 30, 2013
(dollars in thousands)

	Net Appreciation				
	(Depreciation)		Fair Value	Notional	
Investment Type	in Fair Value	Classification	Amount	Dollars	Units/Shares
Commodity futures long	$ (23,856)	Equity securities	$ —	$ —	—
Commodity futures long	(1,010)	Futures	—	28,073	—
Commodity futures short	(10,501)	Equity securities	—	—	—
Credit default swaps	(128)	Debt securities	(663)	39,969	—
Credit default swaps bought	(1,265)	Debt securities	(29)	12,800	—
Credit default swaps written	706	Debt securities	(104)	14,043	—
Fixed-income futures long	(7,963)	Equity securities	—	—	490,578
Fixed-income futures short	18,011	Equity securities	—	—	(522,652)
Fixed-income options bought	568	Equity securities	—	—	—
Fixed-income options written	(25,892)	Equity securities	(8,164)	—	(289,244)
Foreign currency forwards	32,091	Foreign currency contracts	13,151	9,265,383	—
Foreign currency options bought	413	Equity securities	—	—	—
Foreign currency options written	66	Equity securities	(59)	—	(3,424)
Foreign exchange forwards	382,233	Investment sales/purchases	129,070	23,450,446	—
Futures (domestic and foreign)	49,728	Futures	—	301,589	—
Futures options bought	(27,431)	Equity securities	877	—	4,600
Futures options written	25,358	Equity securities	(2,380)	—	(15,300)
Index futures long	2,338,736	Equity securities	—	—	71,240
Index options bought	(15,939)	Equity securities	—	—	150,000
Index options written	68,372	Equity securities	(1)	—	(150,000)
Interest rate swaps	(2,944)	Debt securities	—	—	—
Options	(5,008)	Debt securities	36,135 [1]	208,461	—
Pay fixed interest rate swaps	379	Debt securities	3,206	100,800	—
Receive fixed interest rate swaps	(1,724)	Debt securities	(1,796)	72,953	—
Rights	(10,953)	Equity securities	3,074	—	14,990
Rights	(4,369)	Equity securities	897	—	1,438 *
Total return bond swaps	(37,338)	Debt securities	(3,655)	4,156,814	—
Warrants	11,517	Equity securities	13,494	—	9,398
Warrants	956	Equity securities	1,174	—	269 *
Total	**$ 2,752,813**		**$ 184,227**	**$ 37,651,331**	**(238,107)**

[1] The total options of $36,135 is comprised of options bought and options written of $55,023 and $(18,888), respectively.

* Items with an asterisk are shares and those without are units.

Interest Rate Risk: Table 32 describes the maturity periods of the derivative instruments during which these fiduciary funds were exposed to interest rate risk.

Table 32

Schedule of Derivative Instruments Subject to Interest Rate Risk – Fiduciary Funds
June 30, 2013
(amounts in thousands)

	Fair	Investment Maturities (in years)		
Investment Type	Value	Under 1	1-10	10+
Credit default swaps	$ (663)	$ —	$ (663)	$ —
Credit default swaps bought	(29)	(2)	(27)	—
Credit default swaps written	(104)	—	(104)	—
Fixed-income options	33,000	—	33,000	—
Fixed-income options written	(8,164)	(8,164)	—	—
Pay fixed-interest-rate swaps	3,206	—	3,206	—
Receive fixed-interest-rate swaps	(1,796)	—	(1,971)	175
Total return bond swaps	(3,655)	(3,655)	—	—
Total	**$ 21,795**	**$ (11,821)**	**$ 33,441**	**$ 175**

Table 33 details the reference rate, fair value, and notional amount of the derivative instruments held by these fiduciary funds that were highly sensitive to changes in interest rate risk.

Table 33

Schedule of Derivative Instruments Highly Sensitive to Interest Rate Changes – Fiduciary Funds
June 30, 2013
(amounts in thousands)

Investment Type	Reference Rate	Fair Value	Notional Amount
Interest-rate swaps	Receive variable 3-month LIBOR[1], pay fixed 1.694%	$ 2,251	$ 29,720
	Receive variable 3-month LIBOR, pay fixed 1.400%	73	30,600
	Receive variable 3-month LIBOR, pay fixed 0.985%	592	27,220
	Receive variable 3-month LIBOR, pay fixed 0.764%	290	13,260
	Receive fixed 2.000%, pay variable 6-month LIBOR	175	10,872
	Receive fixed 1.000%, pay variable 6-month LIBOR	3	9,765
	Receive fixed 3.795%, pay variable 3-month BKBM[3]	(144)	2,471
	Receive fixed 2.0425%, pay variable 3-month LIBOR	(581)	10,850
	Receive fixed 0.430%, pay variable 3-month LIBOR	(9)	16,370
	Receive fixed 5.750%, pay variable 1-month TIIE[2]	(897)	15,201
	Receive fixed 5.750%, pay variable 1-month TIIE	(346)	5,865
	Receive fixed 5.500%, pay variable 1-month TIIE	3	1,559
Subtotal Interest-rate swaps		**$ 1,410**	**$ 173,753**
Fixed-income options			
Bought:	Swaption 10YR RTP Jan 23 3.9 PUT	$ 7,551	$ 100,000
	Swaption 10YR RTP May 23 4.06 PUT	13,990	200,000
	Swaption 10YR RTP Sept 19 3.13 PUT	28,625	250,000
Written:	Swaption 10YR RTP Jan 15 3.54 PUT	(3,729)	(100,000)
	Swaption 10YR RTP May 15 4.0575 PUT	(7,373)	(250,000)
	Swaption 10YR RTP May 15 4.025 PUT	(6,064)	(200,000)
Subtotal Fixed-income options		**$ 33,000**	**$ —**
Return bond swaps	Receive fixed 0.08%, pay fixed 0.00%	$ (624)	$ 266,544
	Receive fixed 0.07%, pay fixed 0.00%	(828)	353,994
	Receive fixed 0.00%, pay fixed 0.80%	(1,709)	1,232,297
	Receive fixed 0.00%, pay fixed 0.07%	(818)	2,165,395
	Receive fixed 0.00%, pay fixed 0.00%	324	138,584
Subtotal Return bond swaps		**$ (3,655)**	**$ 4,156,814**
Total		**$ 30,755**	**$ 4,330,567**

[1] London Interbank Offered Rate (LIBOR)
[2] Tasa de Interes Interbancaria de Equilibrio (TIIE)
[3] New Zealand's Bank Bill Benchmark (BKBM)

Credit Risk: With all over-the-counter derivatives, such as swaps and currency forwards, CalPERS is exposed to counterparty risk. CalPERS seeks to control this risk through counterparty credit evaluations and approvals, counterparty credit limits, posting collateral exposure and monitoring procedures.

Table 34 details the counterparty, percent of net exposure, and credit ratings for the derivative instruments held by CalPERS that were subject to credit risk.

Table 34

Schedule of Derivative Instruments Subject to Credit Risk – California Public Employees' Retirement System
June 30, 2013

Counterparty	Percent of Net Exposure	S&P Ratings	Fitch Ratings	Moody's Ratings
Bank of America, N.A.	22.42 %	A	A	A3
JP Morgan Chase Bank, N.A. New York	15.66	A+	A+	Aa3
HSBC Bank USA	8.67	AA-	AA-	A1
Goldman Sachs International	8.60	A-	A	A3
Commonwealth Bank of Australia Sydney	7.23	AA-	AA-	Aa2
Bank of New York	4.67	A+	AA-	Aa3
Barclays Bank PLC Wholesale	4.66	A+	A	A2
Royal Bank of Canada	3.88	AA-	AA	Aa3
Citibank, N.A.	3.85	A	A	A3
BNP Paribas SA	3.17	A+	A+	A2
Morgan Stanley Capital Services Inc.	2.38	A-	A	Baa1
Royal Bank of Scotland PLC	2.36	A	A	A3
UBS AG	1.95	A	A	A2
Societe Generale	1.94	A	A+	A2
Standard Chartered Bank	1.91	AA-	AA-	A1
Deutsche Bank AG London	1.66	A+	A+	A2
JP Morgan Securities Inc.	1.13	A	A+	A2
Credit Suisse International	1.06	A+	A	A1
Goldman Sachs + CO	0.74	A-	A	A3
Credit Suisse London Branch (GFX)	0.42	A+	A	A1
UBS AG London	0.33	A	A	A2
Credit Suisse Securities (USA) LLC	0.28	A+	A	A1
JP Morgan	0.28	A	A+	A2
Canadian Imperial Bank of Commerce	0.16	A+	AA-	Aa3
Deutsche Bank Securities	0.15	A+	A+	A2
Citigroup	0.13	A-	A	Baa2
Westpac Banking Corp	0.12	AA-	AA-	Aa2
BNP Finance	0.10	A+	A+	A2
Barclays Capital	0.03	A+	A	A2
Goldman Sachs Capital Markets LP	0.03	A-	A	A3
JP Morgan Chase Bank, N.A. London	0.02	A+	A+	Aa3
JP Morgan Chase Bank	0.01	A+	A+	Aa3
Barclays Bank CME	0.00 [1]	A+	A	A2

[1] The Percentage of Net Exposure for Conterparty Barclays Bank CME is less than 0.01%.

In cases where a wholly owned broker-dealer subsidiary does not engage the rating companies for a stand-alone rating, the subsidiary is assigned the parent-company rating, as the broker-dealer is an integral part of their business model(s). With the exception of foreign currency forwards, it is CalSTRS' practice to require counterparty collateral posting provisions in its non-exchange-traded derivative instruments where doing so is consistent with market practice. As of June 30, 2013, the aggregate amount of cash collateral held at CalSTRS on behalf of the non-exchange-traded derivatives was $35 million. The aggregate fair value of investment derivative instruments in an asset position subject to counterparty credit risk at June 30, 2013, was $22 million. This represents the maximum loss that would be recognized at the reporting date if all counterparties failed to perform as contracted.

Table 35 depicts the counterparty credit ratings of CalSTRS non-exchange traded investment derivative instruments outstanding and subject to loss at June 30, 2013. The ratings used to determine the quality of the individual counterparty are the ratings with the highest degree of risk supplied by two nationally recognized statistical rating organizations (NRSROs).

Table 35

Schedule of Counterparty Credit Rating – California State Teachers' Retirement System
June 30, 2013
(amounts in thousands)

Ratings	Credit Default Swaps	Foreign Currency Forwards	Total
AA	$ —	$ 2,483	$ 2,483
A	312	19,223	19,535
Subtotal investments in asset position	**312**	**21,706**	**22,018**
Investments in liability position	(975)	(8,555)	(9,530)
Total investments in asset/ (liability) position	**$ (663)**	**$ 13,151**	**$ 12,488**

C. Discretely Presented Component Unit – University of California

The University of California, a discretely presented component unit, holds investment derivatives in futures, forward contracts, options, and interest-rate swap contracts. The Board of Trustees for each campus foundation may also authorize derivatives within their investment policy. The University enters into futures contracts for the purpose of acting as a substitute for investment in equity and fixed-income securities. The University also holds interest-rate swaps which are derivative instruments that meet the criteria for an effective hedge. Certain interest-rate swaps are considered hybrid instruments because, at the time of execution, the fixed-rate on each of the swaps was off-market and the University received an up-front payment. These swaps are comprised of derivative instruments, at-the-market swaps that are an effective hedge, and companion investments (a borrowing represented by up-front payment). The unamortized amount of the borrowing under the companion instrument was $29 million at June 30, 2013. Derivatives are recorded at fair value as either assets or liabilities in the Statement of Net Position. Certain derivatives are determined to be hedging derivatives and are designated as either a fair value or cash-flow hedge. Under hedge accounting, changes in the fair value of hedging derivatives are considered to be deferred inflows (for hedging derivatives with positive fair values) or deferred outflows (for hedging derivatives with negative fair values) in the Statement of Net Position. Changes in the fair value of derivatives that are not hedging derivatives are reported as net appreciation or depreciation of investments in the Statement of Activities.

Table 36 summarizes the fair value balances and notional amounts of derivative instruments outstanding, categorized by type, and the changes in fair value of such derivatives.

Table 36

Schedule of Changes in Fair Values, Fair Values, and Notional Amounts – University of California
June 30, 2013
(amounts in thousands)

	Changes in Fair Value	Classification	Fair Value	Notional Amount
Investment derivatives				
Domestic equity futures contracts long	$ (7,460)	Investments	$ (2,470)	$ 603,484
Domestic equity futures contracts short	69	Investments	6	(1,200)
Foreign equity futures contracts long	97,622	Investments	493	52,193
Foreign equity futures contracts short	(181)	Investments	—	—
Foreign currency exchange contracts long	6,185	Investments	(296)	2,109,761
Foreign currency exchange contracts short	29,183	Investments	6,947	(16,323,059)
Swaps fixed interest rate	8,968	Investments	(21,367)	550,000
Swaps total return equity	(19)	Investments	(79)	7
Stock rights/warrants	286	Investments	5,179	609
Options/swap	(458)	Investments	983	3,781
Total investment derivatives	**$ 134,195**		**$ (10,604)**	**$ (13,004,424)**
Cash flow hedges				
Interest-rate swaps		Other noncurrent		
Pay fixed, receive variable	$ 23,737	assets (liabilities)	$ (45,758)	$ 204,995

Table 29 presents the State's debt service requirements and net swap payments as of June 30, 2013. Included in these amounts are the University's principal, variable interest, and interest-rate net swap payments in the amounts of $879 million, $124 million, and $136 million, respectively.

Objective and Terms: As a means to lower the University's borrowing costs when compared against fixed-rate bonds at the time of issuance, the University entered into interest-rate swap agreements in connection with some of its variable-rate Medical Center Pooled Revenue Bonds. The University has determined that a portion of its interest-rate swaps are derivative instruments that meet the criteria for an effective hedge.

Fair Value: The swaps have an estimated negative fair value of $46 million as of June 30, 2013. The fair value was estimated by financial institutions or independent advisors using available quoted market prices or discounted expected future net cash flows.

Table 37 summarizes the terms and fair value of the swap agreements.

Table 37

Schedule of Terms and Fair Values of Swap Agreements
June 30, 2013
(amounts in thousands)

Swap Termination Date	Effective Date	Outstanding Notional Amount at June 30, 2013	Fair Value at June 30, 2013	Fixed Rate Paid by University of California	Variable Rate Received by University of California	Counterparty Credit Ratings (Moody's, S&P's)
2032	2007	$ 80,220	$ (11,135)	3.5897 %	58% of 1-Month LIBOR* + 0.48%	Baa2, A-
2030 through 2043	2008	124,775	(34,623)	4.6359	67% of 3-Month LIBOR* + 0.69%**	A2, A+
Total		**$ 204,995**	**$ (45,758)**			

* London Interbank Offered Rate (LIBOR)
** Weighted average spread

Interest Rate Risk: There is a risk that the value of the interest-rate swaps will decline because of changing interest rates. The values of the interest-rate swaps with longer maturities tend to be more sensitive to changing interest rates and, therefore, are more volatile than those with shorter maturities.

Basis Risk: The University is exposed to basis risk whenever the interest rates on the bonds are reset. The interest rate on the bonds is a tax-exempt interest rate, while the variable receipt rate on the interest-rate swaps is taxable. However, there is no basis or tax risk related to the swap with the $125 million notional amount because the variable rate the University pays to the bond holders matches the variable-rate payments received from the swap counterparty and the interest rates are reset at the same intervals.

Termination Risk: The University is exposed to risk in the event of nonperformance by counterparties in an adverse market resulting in cancellation of the synthetic interest rate and returning the interest-rate payments to the variable interest rates on the bonds. In addition, depending on the agreement, certain swaps may be terminated if the counterparty's credit quality rating, as issued by Moody's or Standard & Poor's, falls below certain thresholds. At termination, the University may also owe a termination payment if there is a realized loss based on the fair value of the interest-rate swap.

Credit Risk: The University could be exposed to credit risk if the interest-rate swap counterparties to the contracts are unable to meet the terms of the contracts. Contracts with positive fair values are exposed to credit risk. The University faces a maximum possible loss equivalent to the amount of the derivative's fair value, less any collateral held by the University provided by the counterparty. Contracts with negative fair values are not exposed to credit risk. There are no collateral requirements related to the interest-rate swap with the $80 million notional amount. Depending on the fair value related to the swap with the $125 million notional amount, the University may be entitled to receive collateral from the counterparty to the extent the positive fair value exceeds $35 million, or be obligated to provide collateral to the counterparty if the negative fair value of the swap exceeds $75 million or the cash and investments held by the medical centers fall below $250 million. As of June 30, 2013, no collateral was required.

D. Discretely Presented Component Unit – California Housing Finance Agency

The California Housing Finance Agency (CalHFA), a discretely presented component unit, holds interest-rate swaps that are derivative instruments. As of June 30, 2013, the accumulated decrease or increase in the fair value of the effective swaps is reported as deferred outflow of resources or as deferred inflow of resources, respectively, in the Statement of Net Position. Alternatively, the gain or loss on the fair value of the ineffective swaps is reported as other general revenues in the Statement of Activities. CalHFA did not pay or receive any cash when the swap transactions were initiated except for in-substance assignments. Except as discussed under the following *Rollover Risk* section, CalHFA's swap agreements contain scheduled reductions to outstanding notional amounts that are expected to approximately follow scheduled or anticipated reductions in the associated bonds payable.

Table 38 summarizes the swap fair value activity in the Statement of Net Position and the Statement of Activities.

Table 38

Schedule of Swap Agreement Fair Value – California Housing Finance Agency
June 30, 2013
(amounts in thousands)

	Amount
Statement of Net Position:	
Other noncurrent assets	$ 137
Deferred outflows of resources	126,717
Other noncurrent liabilities	217,718
Statement of Activities:	
Other general revenues (expenses)	(6,124)

Table 29 presents the State's debt service requirements and net swap payments as of June 30, 2013. Included in these amounts are CalHFA's principal, variable interest, and interest-rate net swap payments in the amounts of $1.3 billion, $23 million, and $793 million, respectively.

Objective: CalHFA has entered into interest-rate swap agreements with various counterparties to protect itself against rising rates by providing synthetic fixed rates for a like amount of variable-rate bond obligations. The majority of CalHFA's interest-rate swap transactions are structured to pay a fixed rate of interest while receiving a variable rate of interest, with some exceptions. CalHFA has used multiple swap formulas. As of June 30, 2013, the formulas for the swap portfolio used the SIFMA, the one-month LIBOR, the three-month LIBOR, and the six-month LIBOR rates. The swap formula will continue to be monitored for its effectiveness in case CalHFA chooses to enter into any future interest-rate swaps. In addition, CalHFA holds eight basis swaps as a means to change the variable-rate formula received from counterparties for the $190 million outstanding notional amount from 65% of LIBOR to varying floating rates.

Terms, Fair Value, and Credit Risk: CalHFA uses 11 counterparties for its interest-rate swap transactions. All of CalHFA's interest-rate swap agreements require CalHFA to post collateral if its general obligation credit ratings, as issued by Moody's and Standard & Poor's, fall below a certain level or if the fair value of the swaps breach a certain threshold. The collateral can be posted in several forms in the amount of the fair value of the interest-rate swaps. If CalHFA does not post collateral, the interest-rate swap can be terminated by the counterparty. As of June 30, 2013, CalHFA had total cash and fair value of mortgage-backed securities posted as collateral with swap counterparties of $3 million and $59 million, respectively, in other assets and investments in the Statement of Net Position. As of June 30, 2013, CalHFA's swap portfolio has an aggregate negative fair value of $218 million, due to a decline in interest rates. Fair values are as reported by CalHFA's counterparties and are estimated using the zero-coupon method. As CalHFA's swap portfolio has an aggregate negative fair value, CalHFA has no net exposure to credit risk. CalHFA has 88 swap transactions, with outstanding notional amounts of $1.9 billion, with effective dates from April 6, 2000, to November 1, 2009, and scheduled termination dates from August 1, 2014, to August 1, 2042. Standard & Poor's credit ratings for these counterparties range from BBB to AA-; Moody's credit ratings range from Baa2 to Aa1.

Interest Rate Risk: CalHFA is exposed to interest rate risk on its fixed-payer swaps. As the LIBOR or the SIFMA swap index decreases, CalHFA's net payments on the swaps increase.

Basis Risk: CalHFA's swaps contain the risk that the floating-rate component of the swap will not match the floating rate of the underlying bonds. This risk arises because floating rates paid by swap counterparties are based on indices that consist of market-wide averages, while interest paid on CalHFA's variable-rate bonds is specific to individual bond issues. CalHFA's variable-rate tax-exempt bonds trade at a slight discount to the SIFMA index. For swaps associated with tax-exempt bonds for which CalHFA receives a variable-rate payment based on a percentage of LIBOR, CalHFA is exposed to basis risk if the relationship between SIFMA and LIBOR converges. As of June 30, 2013, the SIFMA rate was .06%, the one-month LIBOR was .19%, the three-month LIBOR was .27%, and the six-month LIBOR was .41%.

Termination Risk: Counterparties to CalHFA's interest-rate swaps have termination rights that require settlement payments by either CalHFA or the counterparty, based on the fair value of the swap at the date of termination.

Rollover Risk: CalHFA is exposed to rollover risk on interest-rate swaps that are hedges of debt that mature or may be terminated prior to the maturity of the hedged debt. When these swaps terminate, CalHFA will be re-exposed to the risks being hedged by the swaps.

This page intentionally left blank.

NOTE 18: INTERFUND BALANCES AND TRANSFERS

A. Interfund Balances

Table 39 represents short-term interfund receivables and payables resulting from the time lag between the dates on which goods and services are delivered and the dates on which payments between entities are made. In addition, interfund borrowing, mainly from nonmajor governmental funds and fiduciary funds, is used to meet temporary imbalances of receipts and disbursements in the General Fund.

Table 39 presents the amounts due from and due to other funds.

Table 39

Schedule of Due From Other Funds and Due To Other Funds
June 30, 2013
(amounts in thousands)

	Due To													
Due From	**General Fund**	**Transportation Fund**	**Environmental and Natural Resources Fund**	**Nonmajor Governmental Fund**	**Electric Power Fund**	**Water Resources Fund**	**Public Buildings Construction Fund**	**State Lottery Fund**	**Unemployment Programs Fund**	**California State University Fund**	**Nonmajor Enterprise Funds**	**Internal Service Funds**	**Fiduciary Funds**	**Total (Liability)**
Governmental funds														
General Fund	$ —	$ 79,304	$ 323,442	$ 775,315	$ —	$ —	$ —	$ —	$ —	$ —	$ —	$ 112,743	$ 10,370,360	$ 11,661,164
Federal Fund	361,133	1,047,110	51,140	153,847	—	—	—	—	20,708	—	1,617	44,860	6,658,387	8,338,802
Transportation Fund	—	—	38,402	45,705	—	—	283	—	—	—	—	28,240	55,246	167,876
Environmental and Natural Resources Fund	—	—	—	99	—	—	—	—	—	—	15	16,539	113	16,766
Nonmajor governmental funds	341,939	22,878	18,715	16,156	—	—	—	—	—	436	148	35,172	1,668,193	2,103,637
Total governmental funds (Asset)	**703,072**	**1,149,292**	**431,699**	**991,122**	—	—	**283**	—	**20,708**	**436**	**1,780**	**237,554**	**18,752,299**	**22,288,245**
Enterprise funds														
Water Resources Fund	—	—	—	—	—	—	—	—	—	—	—	49,172	—	49,172
Public Buildings Construction Fund	563	—	—	—	—	—	—	—	—	—	—	18,488	370	19,421
State Lottery Fund	155	—	—	375,000	—	—	—	—	—	—	—	—	—	375,155
Unemployment Programs Fund	34,561	—	—	—	—	—	—	—	—	—	—	495	—	35,056
Nonmajor enterprise funds	2,509	—	156	217	—	—	—	—	—	—	—	41	11	2,934
Total enterprise funds (Asset)	**37,788**	—	**156**	**375,217**	—	—	—	—	—	—	—	**68,196**	**381**	**481,738**
Internal service funds	**23,845**	**16,517**	**5,327**	**18,667**	**4,000**	**899**	**29,851**	**277**	**1,708**	—	**552**	**5,139**	**689**	**107,471**
Total primary government (Asset)	**$ 764,705**	**$ 1,165,809**	**$ 437,182**	**$ 1,385,006**	**$ 4,000**	**$ 899**	**$ 30,134**	**$ 277**	**$ 22,416**	**$ 436**	**$ 2,332**	**$ 310,889**	**$ 18,753,369**	**$ 22,877,454**

Interfund receivables and payables are the result of interfund loans that are not expected to be repaid within one year. In addition to the temporary interfund cash-flow borrowing shown in Table 39, annual enacted budgets provide for long-term loans from many of the State's special funds—mainly the Transportation Fund, Environmental and Natural Resources Funds, and nonmajor governmental funds—to the General Fund. The $3.6 billion in Transportation Fund loans payable from the General Fund also includes $1.1 billion in deferred Proposition 42 transfers for traffic congestion relief and other direct loans from the Traffic Congestion Relief Program. Table 40 presents the interfund receivables and payables.

Table 40

Schedule of Interfund Receivables and Payables

June 30, 2013

(amounts in thousands)

	Interfund Payables								
Interfund Receivables	**General Fund**	**Transportation Fund**	**Environmental and Natural Resources Fund**	**Nonmajor Governmental Funds**	**Water Resources Fund**	**Unemployment Programs Fund**	**Nonmajor Enterprise Funds**	**Internal Service Funds**	**Total**
Governmental funds									
General Fund	$ —	$ 3,606,097	$ 535,477	$ 1,668,798	$ —	$ 611,690	$ 5,600	$ 7,384	$ 6,435,046
Transportation Fund	—	—	—	—	—	—	—	2,648	2,648
Environmental and Natural Resources Fund	7,000	3,979	—	—	—	—	—	—	10,979
Nonmajor governmental funds	6,117	—	—	—	—	—	—	—	6,117
Total governmental funds	**13,117**	**3,610,076**	**535,477**	**1,668,798**	**—**	**611,690**	**5,600**	**10,032**	**6,454,790**
Internal service funds	**40,650**	**—**	**—**	**172**	**91,517**	**—**	**—**	**6,943**	**139,282**
Total primary government	**$ 53,767**	**$ 3,610,076**	**$ 535,477**	**$ 1,668,970**	**$ 91,517**	**$ 611,690**	**$ 5,600**	**$ 16,975**	**$ 6,594,072**

The amount shown as due from primary government and due to component units represent short-term receivables and payables between the primary government and component units resulting from the time lag between the dates on which goods and services are provided and received and the dates on which payments between entities are made.

Table 41 presents the amounts due from the primary government and due to component units.

Table 41

Schedule of Due From Primary Government and Due To Component Units
June 30, 2013
(amounts in thousands)

	Due To		
	Component Units		
Due From	**University of California**	**Nonmajor Component Units**	**Total**
Governmental funds			
General Fund	$ 169,215	$ —	$ 169,215
Transportation Fund	909	—	909
Environmental and Natural Resources Fund	2,000	11	2,011
Nonmajor governmental funds	36,988	—	36,988
Total governmental funds	**209,112**	**11**	**209,123**
Internal service funds	**—**	**2**	**2**
Total primary government	**$ 209,112**	**$ 13**	**$ 209,125**

This page intentionally left blank.

B. Interfund Transfers

Transfers move money collected by one fund to another fund, which then disburses it as required by law. The General Fund and certain other funds transfer money to support various programs accounted for in other funds. The largest transfer from the General Fund was $2.0 billion to California State University (a major enterprise fund). The State Highway Account transferred $678 million of weight fee revenues to the Transportation Debt Service Fund for reimbursement of debt service costs. The Federal Fund transferred $640 million to the General Fund for administration of the Unemployment Insurance Program.

Table 42 presents interfund transfers of the primary government.

Table 42

Schedule of Interfund Transfers
June 30, 2013
(amounts in thousands)

	Transferred To							
Transferred From	**General Fund**	**Transportation Fund**	**Environmental and Natural Resources Funds**	**Nonmajor Governmental Funds**	**Public Buildings Construction Fund**	**California State University Fund**	**Internal Service Funds**	**Total**
Governmental funds								
General Fund	$ —	$ —	$ 853	$ 855,543	$ —	$ 2,034,055	$ —	$ 2,890,451
Federal Fund	640,445	—	150,415	30,108	—	—	—	820,968
Transportation Fund	69,136	—	10,909	717,356	—	—	—	797,401
Environmental and Natural Resources Fund	11,210	3,979	—	16,794	—	—	—	31,983
Nonmajor governmental funds	254,297	16	25,246	78,391	—	—	—	357,950
Total governmental funds	**975,088**	**3,995**	**187,423**	**1,698,192**	**—**	**2,034,055**	**—**	**4,898,753**
Public Buildings Construction Fund	**8,172**	**—**	**—**	**—**	**—**	**—**	**—**	**8,172**
California State Univeristy Fund	**—**	**—**	**—**	**16,540**	**—**	**—**	**—**	**16,540**
Nonmajor enterprise funds	**11,584**	**—**	**—**	**—**	**202**	**—**	**—**	**11,786**
Internal service funds	**16,413**	**—**	**—**	**40,354**	**—**	**—**	**4,730**	**61,497**
Total primary government	**$ 1,011,257**	**$ 3,995**	**$ 187,423**	**$ 1,755,086**	**$ 202**	**$ 2,034,055**	**$ 4,730**	**$ 4,996,748**

NOTE 19: FUND BALANCES, FUND DEFICITS, AND ENDOWMENTS

A. Fund Balances

The fund balance amounts for governmental funds have been reclassified in accordance with GASB Statement No. 54. As a result, amounts previously reported as reserved and unreserved are now reported as nonspendable, restricted, committed, assigned, or unassigned. See Note 1K for the new fund balance classifications as defined by GASB. For purposes of reporting in the State's CAFR, the following are the State's policies based on its interpretation of GASB Statement No. 54.

Committed fund balance: The highest level of decision-making authority within California statewide government is the California Legislature. The formal action required to establish, modify, or rescind a fund balance commitment is a statute that becomes law after a bill is passed. Commitments of fund balance, approved by State Legislative action, must be in place prior to the end of the State's fiscal year. The California State Legislature is made up of two houses: the Senate and the Assembly. Both houses must approve a bill. If both houses approve a bill, it then goes to the Governor. The Governor has three choices: the Governor can sign the bill into law, allow it to become law without his or her signature, or veto it. A governor's veto can be overridden by a two-thirds vote in each house.

Assigned fund balance: California does not have a formal policy to delegate authority to assign resources. However, fund balance can be classified as assigned when a purchase order creates an outstanding encumbrance amount unless the purchase order relates to restricted or committed resources. Furthermore, all resources in governmental funds, other than the General Fund, that are not restricted, committed, or nonspendable are classified as assigned.

Fund balance spending order: For the purpose of reporting fund balance in the CAFR under GASB Statement No. 54, the State considers resources to be spent in the following order when an expenditure is incurred for which these classifications are available: restricted, committed, assigned, and unassigned.

Table 43 presents the composition of the fund balance of the governmental funds.

Table 43

Schedule of Fund Balance by Function
June 30, 2013
(amounts in thousands)

	General Fund	Federal Fund	Transportation Fund	Environmental and Natural Resources Fund	Nonmajor Governmental Funds
Nonspendable					
Long-term interfund receivables	$ 53,767	$ —	$ —	$ —	$ —
Long-term loans receivable	86,340	—	—	—	—
Other	—	—	—	—	15,022
Total nonspendable	**140,107**	—	—	—	**15,022**
Restricted					
General government	5,835	—	—	12,477	3,708,845
Education	79,303	296	4,784	—	833,151
Health and human services	87,381	257	—	1,198,829	1,563,980
Resources	247	10,809	—	5,648,940	77,368
State and consumer services	5,877	—	220,829	57,542	524,217
Business and transportation	—	186,591	6,965,234	44,310	3,075,709
Correctional programs	—	—	—	—	3,102
Total restricted	**178,643**	**197,953**	**7,190,847**	**6,962,098**	**9,786,372**
Committed					
General government	13,616	—	—	25,749	260,580
Education	1,301	—	—	—	34,728
Health and human services	7,962	—	1,926	—	236,333
Resources	—	—	13	819,971	729,645
State and consumer services	—	—	—	17,928	52,359
Business and transportation	—	—	47,471	—	76,380
Correctional programs	—	—	—	—	14,952
Total committed	**22,879**	—	**49,410**	**863,648**	**1,404,977**
Assigned – General government	—	—	—	—	209,171
Unassigned	**(14,596,085)**	—	**(9,560)**	**(7,870)**	**(158,636)**
Total fund balances (deficit)	**$ (14,254,456)**	**$ 197,953**	**$ 7,230,697**	**$ 7,817,876**	**$ 11,256,906**

B. Fund Deficits

Table 44 shows the funds that had deficits.

Table 44

Schedule of Fund Deficits
June 30, 2013
(amounts in thousands)

	Governmental Funds	Enterprise Funds
General Fund	$ 14,254,456	$ —
Unemployment Programs Fund	—	4,151,745
Total fund deficits	**$ 14,254,456**	**$ 4,151,745**

C. Discretely Presented Component Unit Endowments and Gifts

The University of California, a discretely presented component unit, administers certain restricted nonexpendable, restricted expendable, and unrestricted endowments that are included in the related net position categories of the government-wide and fund financial statements. As of June 30, 2013, the total value of restricted endowments and gifts was $12.1 billion and unrestricted endowments and gifts was $1.6 billion. The University's policy is to retain realized and unrealized appreciation on investments with the endowment after an annual income distribution. The net appreciation available to meet future spending needs upon approval by the Board of Regents amounted to $1.7 billion at June 30, 2013. The portion of investment returns earned on endowments and distributed each year to support current operations is based on a rate approved by the Board of Regents. In addition, the California State University Auxiliary Organizations and the University of California Hastings College of the Law, nonmajor component units, have restricted nonexpendable and restricted expendable endowments of $867 million and $7 million, respectively.

NOTE 20: RISK MANAGEMENT

The primary government has elected, with a few exceptions, to be self-insured against loss or liability. The primary government generally does not maintain reserves. Losses are covered by appropriations from each fund responsible for payment in the year in which the payment occurs. The State is permissively self-insured and barring any extraordinary catastrophic event, the potential amount of loss faced by the State is not considered material in relation to the primary government's financial position. Generally, the exceptions are when a bond resolution or a contract requires the primary government to purchase commercial insurance for coverage against property loss or liability. There have been no significant reductions in insurance coverage from the prior year. In addition, no insurance settlement in the last three years has exceeded insurance coverage. All claim payments are on a "pay-as-you-go" basis, with workers' compensation benefits for self-insured agencies initially being paid by the State Compensation Insurance Fund.

The discounted liability for unpaid self-insurance claims of the primary government is estimated to be $3.5 billion as of June 30, 2013. This estimate is based primarily on actuarial reviews of the State's workers' compensation program and includes indemnity payments to claimants, as well as all other costs of providing workers' compensation benefits, such as medical care and rehabilitation. The estimate also includes the liability for unpaid services fees, industrial disability leave benefits, and incurred-but-not-reported amounts. The estimated total liability of approximately $5.0 billion is discounted to $3.5 billion using a 3.5% interest rate. Of the total, $414 million is a current liability, of which $270 million is included in the General Fund, $141 million in the special revenue funds, and $3 million in the internal service funds. The remaining $3.1 billion is reported as other noncurrent liabilities in the government-wide Statement of Net Position.

The University of California, a discretely presented component unit, is self-insured or insured through a wholly-owned captive insurance company for medical malpractice, workers' compensation, employee health care, and general liability claims. These risks are subject to various claim and aggregate limits, with excess liability coverage provided by an independent insurer. Liabilities are recorded when it is probable that a loss has occurred and the amount of the loss can be reasonably estimated. These losses include an estimate for claims that have been incurred but not reported. The estimated liabilities are based on an independent actuarial determination of the anticipated future payments, discounted at rates ranging from 2% to 5%.

Table 45 shows the changes in the self-insurance claims liability for the primary government and the discretely presented component units.

Table 45

Schedule of Changes in Self-Insurance Claims
Years ended June 30
(amounts in thousands)

	Primary Government		Discretely Presented Component Unit University of California	
	2013	**2012**	**2013**	**2012**
Unpaid claims, beginning	$ 3,204,635 *	$ 3,031,926 *	$ 599,176	$ 589,076
Incurred claims	754,641	554,701 *	421,832	347,331
Claim payments	(449,721)	(381,992) *	(389,210)	(337,231)
Unpaid claims, ending	**$ 3,509,555**	**$ 3,204,635** *	**$ 631,798**	**$ 599,176**

* Restated

NOTE 21: DEFERRED OUTFLOWS OF RESOURCES AND DEFERRED INFLOWS OF RESOURCES INCLUDING SERVICE CONCESSION ARRANGEMENTS

The GASB identified transactions relating to deferred outflows of resources and deferred inflows of resources through GASB Statement Nos. 53, 60, 63 and 65. The State of California early implemented GASB Statement No. 65 (GASB 65), *Items Previously Reported as Assets and Liabilities*, for the fiscal year beginning July 1, 2012.

The following discretely presented component units also early implemented GASB 65: California Infrastructure and Economic Development Bank, and California State University Auxiliary Organizations.

Certain transactions that were previously reported as assets and liabilities are now reclassified as deferred outflows of resources and deferred inflows of resources pursuant to GASB 65.

1. Deferred Outflows of Resources

The State of California's deferred outflows of resources consist of the following transactions:

- Loss on Refunding of Debt – Refunding of some previously outstanding general obligation bonds and revenue bonds resulted in losses for governmental activities, business-type activities and component units for the fiscal year 2012-13. These losses reported as deferred outflows of resources will be recognized as a component of interest expense in a systematic and rational manner over the remaining life of the old debt or the life of the new debt, whichever is shorter.

- Derivative Instrument – Negative changes in the fair value of hedging derivatives are reported as deferred outflows of resources. The business-type activities and component units reported decreases in fair value of hedging derivatives.

2. Deferred Inflows of Resources

The State of California's deferred inflows of resources consist of the following transactions:

- Service Concession Arrangements – The State and its component units have entered into service concession arrangements with third parties for park facility services, student housing, and certain other services. For the fiscal year 2012-13, the primary government and component units reported deferred inflow of resources from service concession arrangements.

  GASB Statement No. 60 (GASB 60), *Accounting and Financial Reporting for Service Concessions Arrangements,* is effective beginning July 1, 2012, for the State's fiscal reporting period. A service concession arrangement is an arrangement between a transferor (State) and an operator (State or non-governmental entity), where rights and obligations to provide services through the use of public assets are transferred to an operator by the transferor, in exchange for significant consideration, and the operator is compensated by fees collected from third parties. GASB requires retrospective application of GASB 60 for all periods presented.

  The State entered into various service concessions arrangements with independent third parties to develop, equip, operate, and maintain nonexclusive concessions at park grounds in exchange for fixed installment payments, for a fixed period of time. These third parties are compensated by user fees. These existing facilities are reported as capital assets by the State, the present value of installment payments are reported as receivables and a corresponding deferred inflow of resources is reported in the government-wide Statement of Net Position. The State reserves the right to provide or modify the types of goods and services provided by the operator to ensure that the public receives fair pricing, proper service and appropriate quality. The State is not obligated by the debts of the operator in the event of a default, nor does the State guarantee minimum revenue to the operator.

University of California, reported as a discretely presented component unit, has entered into service concession arrangements with third parties for student housing and certain other faculty and student services. Under these arrangements, the University enters into ground leases with third parties at minimal or no cost, and gives the third party the right to construct, operate, and maintain a facility, primarily for the benefit of students and faculty, at competitive rates. Rate increases for use of the facilities are subject to certain constraints, and ownership of the facilities reverts to the University upon expiration of the ground lease. The facilities are reported as capital assets by the University when placed in service, and a corresponding deferred inflow of resources is reported. The University has not provided guarantees on financing obtained by the third parties under these arrangements.

- Gain from Refunding of Debt – Refunding of some previously outstanding general obligation bonds and revenue bonds resulted in gains for governmental activities and discretely presented component units for the fiscal year 2012-13. These gains reported as deferred inflows of resources will be recognized as a component of interest expense in a systematic and rational manner over the remaining life of the old debt or the life of the new debt, whichever is shorter

- Other Deferred Inflows of Resources – Revenues generated from current rates from regulated business-type activities intended to recover costs that are expected to be incurred in the future.

In the fund financial statements, governmental funds reported deferred inflows of resources of $1.9 billion because this amount represents revenues that will be collected after year end, but are not available soon enough to pay for the current period expenditures. For deferred outflows and inflows of resources at the government-wide level, see table below.

Table 46

Schedule of Deferred Inflows of Resources and Deferred Outflows of Resources

(amounts in thousands)

	Primary Government			
	Governmental Activities	Business-Type Activities	Total	Component Units
Deferred Outflows of Resources:				
Deferred loss on refundings	911,178	478,308	$ 1,389,486	$ 5,071
Decrease in fair value of hedging derivatives	—	2,000	2,000	172,475
Total Deferred Outflows of Resources	**911,178**	**480,308**	**1,391,486**	**177,546**
Deferred Inflows of Resources:				
Deferred gain on refundings	(86,135)	—	(86,135)	(2,481)
Service concession arrangements	(72,807)	—	(72,807)	(31,575)
Other deferred inflows	—	(471,436)	(471,436)	—
Total Deferred Inflows of Resources	**$ (158,942)**	**$ (471,436)**	**$ (630,378)**	**$ (34,056)**

NOTE 22: NO COMMITMENT DEBT

Certain debt of the nonmajor component units is issued to finance activities such as the promotion of renewable energy sources and financing for economic development projects. This debt is secured solely by the credit of private and public entities and is administered by trustees independent of the State. As of June 30, 2013, these component units had $4.2 billion of debt outstanding, which is not debt of the State.

The conduit obligations outstanding for California Housing Finance Agency (CalHFA), a major component unit, amounted to $320 million, which is not debt of the State. CalHFA reported offsetting assets and liabilities related to these obligations. The net impact on net position is zero.

NOTE 23: CONTINGENT LIABILITIES

A. Litigation

The primary government is a party to numerous legal proceedings, many of which are not unusual for governmental operations. To the extent they existed, the following were accrued as a liability in the government-wide financial statements: legal proceedings that were decided against the primary government before June 30, 2013; legal proceedings that were in progress as of June 30, 2013, and were settled or decided against the primary government as of April 16, 2014; and legal proceedings having a high probability of resulting in a decision against the primary government as of April 16, 2014, and for which amounts could be estimated. In the governmental fund financial statements, the portion of the liability that is expected to be paid within the next 12 months is recorded as a liability of the fund from which payment will be made. In the proprietary fund financial statements, the entire liability is recorded in the fund from which payment will be made.

In addition, the primary government is involved in certain other legal proceedings that, if decided against the primary government, may impair its revenue sources or require it to make significant expenditures. Because of the prospective nature of these proceedings, no provision for the potential liability has been made in the financial statements.

Following are the more significant lawsuits pending against the primary government.

The primary government is a defendant in two cases, *Bakersfield Mall, LLC v. Franchise Tax Board*, and *CA–Centerside II, LLC v. Franchise Tax Board*, both regarding the constitutionality of a fee imposed on limited liability companies (LLC). In *Bakersfield Mall, LLC v. Franchise Tax Board* the plaintiff contends that not all of its income is derived within the State and, therefore, not all income should be subject to the LLC fee. The second case, *CA–Centerside II, LLC v. Franchise Tax Board*, alleges that the LLC fee is unconstitutional regarding any activities, whether in-state or out-of-state.

In a previously settled case, *Northwest Energetic Services, LLC v. Franchise Tax Board*, the Court of Appeal found the fee unconstitutional only as applied to the plaintiff. The primary government has already begun to pay refunds to LLCs with the same facts as Northwest that have no income earned inside California. In another recently settled case, *Ventas Finance I, LLC v. Franchise Tax Board*, the Court of Appeal also ruled that the fee is unconstitutional as applied to the plaintiff, but it awarded only a partial refund because Ventas received income from both inside and outside of California. *Bakersfield Mall, LLC v. Franchise Tax Board* raised the same constitutional issues as Northwest and Ventas, but initially pertained to LLCs that conduct business solely within California. Bakersfield Mall, LLC later amended its complaint to reflect the fact that not all of its income is derived within the state, making it similar to the Ventas case. This plaintiff also intended to bring a class action suit for refund on behalf of all similarly situated LLCs and to declare the LLC fee unconstitutional. However, the Court of Appeal ruled that Bakersfield Mall, LLC did not follow mandatory class action claim procedures. *CA–Centerside II, LLC v. Franchise Tax Board* raised the same constitutional issues as the Bakersfield case, and alleges that the LLC fee is unconstitutional regarding any activities, whether in-state or out-of-state. Actual and expected future claims for refunds from LLCs are estimated to be as high as $1.2 billion. In addition, plaintiffs will, in all likelihood, seek a large award of attorneys' fees (approximately $500 million) in these cases, should they prevail.

The primary government is a defendant in two cases, *Harley-Davidson, Inc. and Subsidiaries v. Franchise Tax Board* and *Abercrombie & Fitch Co. & Subsidiaries v. Franchise Tax Board,* both regarding the constitutionality of Revenue and Taxation code section 25101.15 allowing intrastate unitary businesses the option of reporting the income of various entities within the unitary business on either a separate or combined basis. Both plaintiffs claim, among other things, that section 25101.15 is discriminatory and they should be allowed to report the income of their business entities on a separate basis. The State is vigorously defending the constitutionality of section 25101.15. In Harley-Davidson, the Franchise Tax Board successfully demurred to the cause of action alleging that section 25101.15 was unconstitutionally discriminatory. Judgment on the entire case has been granted in favor of the board and the taxpayers have appealed. In Abercrombie, a trial has been set in February of 2015. If the plaintiffs prevail, the State would refund Harley-Davidson approximately $2 million plus interest and Abercrombie approximately $182 thousand plus interest from the General Fund. In addition, if the courts determine that section 25101.15 is unconstitutionally discriminatory, the potential total refunds to other taxpayers are unknown but could be substantial. The potential loss of future revenue, unless the Legislature were to act to address the alleged constitutional violation, would be even more substantial, as such a ruling could significantly diminish the State's ability to tax income apportionable to California under existing law.

The primary government is defendant in six cases, *Kimberly-Clark Worldwide, Inc. et al. v. Franchise Tax Board, Gillette Company v. Franchise Tax Board, Proctor & Gamble v. Franchise Tax Board, Sigma-Aldrich*, *Inc. v. Franchise Tax Board, RB Holdings (USA), Inc. v. Franchise Tax Board,* and *Jones Apparel Group Inc. v. Franchise Tax Board*, regarding the application of California's double-weighted sales factor apportionment formula under Revenue and Taxation Code section 25128. Plaintiffs contend that the single-weighted sales factor apportionment specified in Section 25128 prior to amendment was contained within the Multistate Tax Compact (Compact) and therefore cannot be modified without repealing the legislation that enacted the Compact. The State contends that California properly amended section 25128 to its understanding of the Compact. The parties have completed briefing in the California Supreme Court and await a hearing date. The total amount of tax refunds at issue in these six cases is approximately $40 million. An adverse ruling in these cases would affect multiple taxpayers and create potential exposure to refund claims in excess of $750 million.

The primary government is the defendant in numerous cases regarding the Governor's executive orders directing the furlough, without pay, of state employees. The first executive order, issued on December 19, 2008, directed furloughs two days per month, effective February 1, 2009, through June 30, 2010. The second order, issued on July 1, 2009, required a third furlough day per month, effective through June 30, 2010. On July 28, 2010, the Governor issued a new executive order requiring furloughs for three days per month beginning August 1, 2010, until a new 2010-11 fiscal year budget was adopted and the Director of Finance determined that the State had sufficient cash flow to pay for essential services. Furloughs officially ended for all Service Employees International Union represented state employees in November 2010 and for all remaining bargaining units in April 2011. Most cases related to the furloughs have been settled or dismissed with only five cases still pending. Neither the outcome nor the estimated potential loss for the remaining cases can be determined at this time.

The primary government is the defendant in a case, *Santa Clarita Valley Sanitation District of LA County (the District) v. Commission on State Mandates*, regarding a 2008 resolution by the Regional Water Quality Control Board for the Los Angeles Region (the Board) that imposed limits on chloride concentrations in water processed by the District's two water reclamation plants. The District alleges that the resolution created a reimbursable state mandate under Government Code section 17514 and article XII B, section 6, of the California Constitution. The District challenged the Board's resolution in a test claim before the California Commission on State Mandates (the Commission). In a January 31, 2014 decision, the Commission ruled the Board's resolution did not constitute a reimbursable state-mandated program under the California Constitution or Government Code. The District filed a petition for administrative mandate seeking review of the Commission's decision. The estimated potential loss is about $6.5 million for costs incurred by petitioners to date and about $250 million in increased expenditures. Since this case is a test claim, other districts could also bring claims for reimbursement under the same theory.

The primary government is a party to the *Washington Mutual, Inc., et al. United States Bankruptcy Court* case. The case involves the propriety of tax refund claims submitted by Washington Mutual and its affiliates for multiple tax years through 2008. The underlying dispute centers on the taxpayer's claims of tax benefits arising from its use of certain net operating losses, Registered Investment Companies, Real Estate Investment Trusts, etc. A settlement agreement in the case is pending. The estimated potential loss is $223.5 million.

B. Federal Audit Exceptions

The primary government receives substantial funding from the federal government in the form of grants and other federal assistance. The primary government, the University of California, CalHFA, and certain nonmajor discretely presented component units are entitled to these resources only if they comply with the terms and conditions of the grants and contracts and with the applicable federal laws and regulations; they may spend these resources only for eligible purposes. If audits disclose exceptions, the primary government, the University of California, CalHFA, and certain nonmajor discretely presented component units may incur a liability to the federal government.

NOTE 24: PENSION TRUSTS

Two retirement systems, the California Public Employees' Retirement System (CalPERS) and the California State Teachers' Retirement System (CalSTRS), which are fiduciary component units, are included in the pension and other employee benefit trust funds column of the fiduciary funds and similar component units' financial statements. The investments of the fiduciary component units are presented in Table 6 in Note 3, Deposits and Investments.

The California Legislature passed and the Governor signed the "Public Employees' Pension Reform Act of 2013" (PEPRA) on September 12, 2012. PEPRA contained a number of provisions intended to reduce future pension obligations. PEPRA primarily affects new pension plan members who are enrolled for the first time after December 31, 2012. The financial impact will be gradually realized as total pension costs and the employer share of those costs decrease.

CalPERS administers four defined benefit retirement plans: the Public Employees' Retirement Fund, the Judges' Retirement Fund, the Judges' Retirement Fund II, and the Legislators' Retirement Fund. CalPERS also administers three defined contribution plans: the State Peace Officers' and Firefighters' Defined Contribution Plan Fund, the Public Agency Deferred Compensation Plan, and the public employee Supplemental Contributions Program Fund. The predominance of both assets and liabilities reside in the Public Employees' Retirement Fund for which detail will be provided. CalPERS issues a publicly available financial report that includes financial statements and required supplementary information for these plans. This report may be obtained by writing to the California Public Employees' Retirement System, Fiscal Services Division, P.O. Box 942703, Sacramento, California 94229-2703 or by visiting the CalPERS website at www.CalPERS.ca.gov.

CalPERS uses the accrual basis of accounting. Member contributions are recognized in the period in which the contributions are earned. Employer contributions are recorded when earned and the employer has made a formal commitment to provide the contributions. Benefits and refunds in the defined benefit plans are recognized when due and payable in accordance with the terms of each plan.

CalSTRS administers four defined benefit retirement plans within the State Teachers' Retirement Plan: the Defined Benefit Program, the Defined Benefit Supplement Program, the Cash Balance Benefit Program, and the Replacement Benefit Program. CalSTRS issues a publicly available financial report that includes financial statements and required supplementary information for these plans. This report may be obtained from the California State Teachers' Retirement System, P.O. Box 15275, Sacramento, California 95851-0275 or by visiting the CalSTRS website at www.CalSTRS.com.

CalSTRS uses the accrual basis of accounting. Member contributions are recognized in the period in which the contributions are earned. Employer and primary government contributions are recognized when earned and when the employer or the primary government has made a formal commitment to provide the contributions. Benefits and refunds are recognized when due and payable, in accordance with the retirement and benefits programs.

A. Public Employees' Retirement Fund

1. Fund Information

Plan Description: CalPERS administers the Public Employees' Retirement Fund (PERF), which is an agent multiple-employer and cost-sharing defined benefit retirement plan. Employers participating in the PERF include the primary government and certain discretely presented component units, 61 school employers, and 1,520 public agencies as of June 30, 2013.

The amount by which the actuarial accrued liability exceeded the actuarial value of assets in the PERF for the primary government and other participating agencies was $57.4 billion at June 30, 2012, as a result of the difference between the actuarial value of assets of $283.0 billion and the actuarial accrued liability of $340.4 billion. Contributions are either actuarially determined or determined by statute.

2. Employer's Information

Plan Description: The primary government and certain discretely presented component units contribute to the PERF. CalPERS act as a common investment and administrative agent of the primary government and the other member agencies. The primary government employees served by the PERF include: first-tier and second-tier miscellaneous and industrial employees, California Highway Patrol employees, peace officers and firefighters, and other safety members. In the June 30, 2012 actuarial valuation, the payroll for primary government employees covered by the PERF for the 2011-12 fiscal year was $15.7 billion.

All employees in a covered class of employment who work half-time or more are eligible to participate in the PERF. The PERF provides benefits based on members' years of service, age, final compensation, and benefit formula. Vesting occurs after five years or after ten years for second-tier employees. The PERF provides death, disability, and survivor benefits. The benefit provisions are established by statute.

Funding Policy: Benefits are funded by contributions from members and the primary government and by earnings from investments. Member and primary government contributions are a percentage of applicable member compensation. Member rates are defined by law and based on the primary government's benefit formulas. The primary government contribution rates are determined by periodic actuarial valuations or by statute.

Employees, with the exception of employees in the second-tier plans and the State's Alternate Retirement Program, contribute to the fund based on the required contribution rates. The contribution rates of active plan members are based on a percentage of salary over a monthly base compensation ranging from $0 to $863. Employees' required contributions vary from 5.0% to 11.0% of their salary over the base compensation amount.

All of the primary government employees served by the PERF are now covered by group term life insurance.

Table 47 shows the required employer contribution rates for the primary government.

Table 47

Schedule of Required Employer Contribution Rates for the Primary Government – By Member Category

Year Ended June 30, 2013

	Normal Cost	Unfunded Liability	Group Term Life Benefit	Total Rate
Miscellaneous members				
First tier	8.370 %	12.057 %	0.076 %	20.503 %
Second tier	8.324	12.057	0.076	20.457
Industrial (first and second tier)	11.220	5.082	0.000	16.302
California Highway Patrol	14.162	19.540	0.026	33.728
Peace officers and firefighters	16.458	13.813	0.026	30.297
Other safety members	12.740	4.738	0.025	17.503

For the year ended June 30, 2013, the annual pension cost (APC) and the amount of contributions made by the primary government were each $3.2 billion. The APC and the percentage of APC contributed for the last three years are shown in Table 48. Actuarial valuations of the PERF are performed annually. Information from the last valuation, which was performed as of June 30, 2012, is also shown in Table 48.

The Schedule of Funding Progress, presented as required supplementary information (RSI) following the notes to the financial statements, presents multiyear trend information about whether the actuarial value of plan assets is increasing or decreasing over time relative to the actuarial accrued liability for benefits.

B. Teachers' Retirement Fund

Plan Description: CalSTRS administers the Teachers' Retirement Fund, which is an employee benefit trust fund created to finance the State Teachers' Retirement Plan (STRP). The STRP is a defined benefit pension plan that provides for retirement, disability, and survivor benefits. Four programs comprise the STRP: the Defined Benefit (DB) Program, the Defined Benefit Supplement (DBS) Program, the Cash Balance (CB) Benefit Program, and the Replacement Benefit (RB) Program. The STRP is a cost-sharing, multiple-employer, defined-benefit retirement plan that provides pension benefits to teachers and certain other employees of the California public school system.

Membership in the DB Program is mandatory for all employees meeting the eligibility requirements. The DB Program provides benefits based on a member's age, final compensation, and years of service. Vesting occurs after five years. In addition, the retirement program provides benefits to members upon disability and to survivors upon the death of eligible members. The Teachers' Retirement Law establishes the benefits for the DB Program. At June 30, 2013, the DB Program had 1,659 contributing employers and as of June 30, 2012, had 421,499 active and 178,655 inactive program members and 262,038 benefit recipients. The primary government is a nonemployer contributor to the DB Program. The payroll for employees covered by the DB Program for the year ended June 30, 2013, was approximately $26.2 billion.

Membership in the DBS Program is automatic for all members of the DB Program. The DBS Program provides benefits based on the amount of funds contributed. Vesting in the DBS Program occurs automatically with vesting in the DB Program. The Teachers' Retirement Law establishes the benefits for the DBS Program. The primary government does not contribute to the DBS Program.

The CB Benefit Program is designed for employees of California public schools who are hired to perform creditable service for less than 50% of the full-time equivalent for the position. Employer participation in the CB Benefit Program is optional. However, if the employer elects to offer the CB Benefit Program, each eligible employee will automatically be covered by the CB Benefit Program unless the member elects to participate in the DB Program or an alternative plan provided by the employer within 60 days of hire or the election period determined by the employer. At June 30, 2013, the CB Benefit Program had 31 contributing school districts and 33,710 contributing participants.

The RB Program is a qualified excess benefits arrangement for DB Program members that is administered through a separate pension trust apart from the other three STRP programs and was established in accordance with Internal Revenue Code Section 415(m). Internal Revenue Code Section 415(b) imposes a dollar limit on the annual retirement benefits an individual may receive from a qualified defined benefit pension plan. The program is funded as needed. Monthly contributions that would otherwise be credited to the DB program are instead credited to the RB Program to fund monthly program costs. Monthly employer contributions are received and paid to members in amounts equal to the benefits not paid as a result of Internal Revenue Code Section 415(b), subject to withholding for any applicable income or employment taxes. At June 30, 2013, the RB Program had 267 participants.

Funding Policy: DB Program benefits are funded by contributions from members, employers, the primary government, and earnings from investments. Members and employers contribute a percentage of applicable member earnings. The Teachers' Retirement Law governs member rates, employer contribution rates, and primary government contributions.

The DB Program, under the CalSTRS 2% at 60, contribution rate for members is 8.00% of creditable compensation, while under the CalSTRS 2% at 62, the contribution rate for members is 50% of the normal cost of their retirement plan, which resulted in an 8.00% contribution rate of creditable compensation for the fiscal year 2012-13. The employer contribution rate is 8.25% of creditable compensation. In fiscal year 2012-13, the General Fund contribution was 2.017% of total creditable compensation of the fiscal year ending in the prior calendar year. Education Code section 22955(b) states that the General Fund will contribute additional quarterly payments at a contribution rate of 0.524% of creditable earnings of the fiscal year ending in the immediately preceding calendar year when there is an unfunded actuarial obligation or a normal cost deficit. The percentage is adjusted up to 0.25% per year to reflect the contributions required to fund the unfunded actuarial obligation or the normal cost deficit. However, the transfer may not exceed 1.505% of creditable compensation from the immediately preceding calendar year. The normal cost deficit is the difference between the normal cost rate and the member and employer contributions. Based on the most recent actuarial valuation, as of June 30, 2012, there is no normal cost deficit, but there was an unfunded obligation for benefits in place as of July 1, 1990. Therefore, the General Fund is required to contribute the additional quarterly payments at a contribution rate of 1.024% starting October 1, 2013.

The DBS Program member contribution rate for service in excess of one year within one fiscal year is 8.0% and the employer rate is 8.0%.

For the year ended June 30, 2013, the APC for the DB Program was approximately $6.6 billion; the employer and primary government contributions were approximately $2.2 billion and $733 million, respectively. The APC and the percentage of APC contributed for the last three years are shown in Table 48. Actuarial valuations of the DB Program are performed annually. Information from the last valuation is shown in Table 48.

Table 48

Actuarial Information – Pension Trusts – Public Employees' Retirement Fund and State Teachers' Retirement Defined Benefit Program Fund
Valuation Date As Indicated

	Public Employees' Retirement Fund	**State Teachers' Retirement Defined Benefit Program Fund [1]**
Last actuarial valuation	June 30, 2012	June 30, 2012
Actuarial cost method	Individual Entry Age Normal	Entry Age Normal
Amortization method	Level % of Payroll, Closed	Level % of Payroll, Open
Remaining amortization period	18 - 23 years	30 years
Asset valuation method	Smoothed Market Value	Expected Value, With 33% Adjustment to Market Value
Actuarial assumption		
Investment rate of return	7.50 %	7.50 %
Projected salary increase	3.20-19.70	3.75
Includes inflation at	2.75	3.00
Post-retirement benefit increases	2.00 - 3.00	2.00
Annual pension costs (in millions)		
Year ended 6/30/11	$ 3,277	$ 5,985
Year ended 6/30/12	2,928	6,230
Year ended 6/30/13	3,236	6,629
Percent contribution		
Year ended 6/30/11	100 %	47 %
Year ended 6/30/12	100	46
Year ended 6/30/13	100	44
Funding as of last valuation (in millions)		
Actuarial value – assets	$ 106,145	$ 144,232
Actuarial accrued liabilities (AAL) – entry age	134,314	214,765
Unfunded actuarial accrued liability (UAAL)	28,169	70,533
Covered payroll	15,680	26,404
Funded ratio	79.0 %	67.2 %
UAAL as percent of covered payroll	179.6 %	267.1 %

[1] The State is a non-employer contributor to the State Teachers' Retirement Defined Benefit Program Fund, a cost-sharing multiple-employer plan. The annual pension cost includes the amount related to both the State and the local government employers. According to the provisions of the Teacher's Retirement Law, and the related Education Codes, the State and local government employers contributed $733 million and $2.2 billion, respectively, for the year ending June 30, 2013. Based on the most recent actuarial valuation, dated June 30, 2012, current statutory contributions are sufficient to fund normal costs but are not expected to be sufficient to amortize the unfunded actuarial obligation. However, future estimates of the actuarial unfunded obligation may change due to market performance, legislative actions, and other experience that may differ from the actuarial assumptions.

NOTE 25: POSTEMPLOYMENT HEALTH CARE BENEFITS

State of California Other Postemployment Benefits Plan

Plan Description: The primary government and certain discretely presented component units provide health benefits (medical and prescription drug benefits) and dental benefits to annuitants of retirement systems through a substantive single-employer defined benefit plan to which the primary government contributes as an employer (State substantive plan). The primary government also offers life insurance, long-term care, and vision benefits to retirees; however, because these benefits are completely paid for by the retirees, the primary government has no liability. The discretely presented component units represent 0.25% of plan participation. The design of health and dental benefit plans can be amended by the California Public Employees' Retirement System (CalPERS) Board of Administration and the California Department of Human Resources (CalHR, formerly known as the Department of Personnel Administration), respectively. Employer and retiree contributions are governed by the primary government and can be amended by the primary government through the Legislature. The plan contributes to the California Employers' Retiree Benefit Trust Fund (CERBTF). The CERBTF is a self-funded trust fund for the prefunding of health, dental, and other non-pension benefits. CalPERS reports on the CERBTF as part of its annual financial statements, which can be downloaded from the CalPERS website at www.CalPERS.ca.gov.

Fifty-eight county superior courts (trial courts) are included in the primary government. However, each trial court is a separate employer for GASB Statement No. 45 reporting purposes. Forty-nine trial courts have a single-employer defined benefit plan; these plans have separate biennial actuarial valuations. One trial court (San Diego) has a cost-sharing multiple-employer defined benefit plan. Eight trial courts (Alameda, Del Norte, Fresno, Mendocino, Modoc, San Benito, San Bernardino, and Stanislaus) have no plan. Forty-five plans are not accounted for in a trust fund and do not issue separate reports.

To be eligible for these benefits, primary government first-tier plan annuitants must retire on or after age 50 with at least five years of service, and second-tier plan annuitants must retire on or after attaining age 55 with at least 10 years of service. In addition, annuitants must retire within 120 days of separation from employment to be eligible to receive these benefits. During the 2012-13 fiscal year, approximately 163,100 annuitants were enrolled to receive health benefits and approximately 135,100 annuitants were enrolled to receive dental benefits. As of July 1, 2011, the most recent actuarial valuation date, the trial courts had approximately 3,400 enrolled retirees and spouses.

Funding Policy: The contribution requirements of plan members and the State are established and may be amended by the Legislature. In accordance with the California Government Code, the State generally pays 100% of the health insurance cost for annuitants, plus 90% of the additional premium required for the enrollment of family members of annuitants. Although the California Government Code does not specify the State's contribution toward dental insurance costs, the State generally pays all or a portion of the dental insurance cost for annuitants, depending upon the completed years of credited state service at retirement and the dental coverage selected by the annuitant. The State funds the cost of providing health and dental insurance to annuitants primarily on a pay-as-you-go basis with a small amount of prefunding for California Highway Patrol members. The maximum 2013 monthly State contribution was $622 for one-party coverage, $1,183 for two-party coverage, and $1,515 for family coverage.

Each of the trial courts determines its respective retirees' benefits and benefit levels as well as the funding policy for its respective plan. Forty-four trial courts fund retirees' benefits on a pay-as-you-go basis. The 2011 monthly contribution rate for the trial courts with single-employer defined benefit plans, the latest year for which information is available, ranged from zero to $2,215, with the average being $690. Two trial courts (Lassen and Yolo) contribute at least the annual required contribution (ARC) of the employer, an amount actuarially determined in accordance with the parameters of GASB Statement No. 45. The ARC represents a level of funding that, if paid on an ongoing basis, is projected to cover normal cost each year and amortize any unfunded actuarial liabilities (or funding excess) over a period not to exceed 30 years. Orange contributes 3.5% of payroll, with at least the ARC contributed each year. Sonoma contributes 20% of the ARC to another postemployment benefit (OPEB) trust and pays a portion of benefit payments directly from trial court assets. Santa Clara contributes approximately 20% of the ARC to a Santa Clara County-established OPEB irrevocable trust, where the contribution is then pooled with County trust assets. San Diego, a cost-sharing multiple-employer defined benefit plan, had a contribution rate of 1.91% of annual covered pension payroll. For the year ended June 30, 2013, the State contributed $1.8 billion toward annuitants' health and dental benefits. Of this amount, the trial courts represent $33 million and certain discretely presented component units represent $5 million.

Annual OPEB Cost and Net OPEB Obligation: The State's annual OPEB cost (expense) is calculated based on the ARC. Table 49 presents the State's OPEB cost, the percentage of annual OPEB cost contributed to the plan, and the net OPEB obligation for the year ended June 30, 2013, and the two preceding years, including trial courts.

Table 49

Schedule of Annual OPEB Cost, Percentage of Annual OPEB Cost Contributed, and Net OPEB Obligation

(amounts in thousands)

Fiscal Year Ended	Annual OPEB Cost	Percentage of Annual OPEB Cost Contributed	Net OPEB Obligation
June 30, 2011	$ 4,359,929	36.70 %	$ 10,357,406
June 30, 2012	4,837,769	36.20	13,440,768
June 30, 2013	4,992,924	35.33	16,267,964

Table 50 presents the components of the State's net OPEB obligation to the OPEB plan, including trial courts.

Table 50

Schedule of Net OPEB Obligation

June 30, 2013
(amounts in thousands)

	Amount
Annual required contribution	$ 4,925,460
Interest on net OPEB obligation	586,532
Adjustment to annual required contribution	(519,068)
Annual OPEB cost	**4,992,924**
Contributions made	(1,763,872)
Increase in net OPEB obligation	3,229,052
Net OPEB obligation – beginning of year	**13,038,912** *
Net OPEB obligation – end of year	**$ 16,267,964**

* Beginning balance restated by $402 million due to elimination of discretely presented component units (GASB 61).

Funded Status and Funding Progress: As of June 30, 2013—the most recent actuarial valuation date for the State substantive plan—the actuarial accrued liability (AAL) for benefits was $64.6 billion, and the actuarial value of assets was $10 million, resulting in an unfunded actuarial accrued liability (UAAL) of $64.6 billion. The covered payroll (annual payroll of active employees covered by the plan) was $18.1 billion, and the ratio of the UAAL to the covered payroll was 358%.

For the trial courts, as of July 1, 2011—the most recent actuarial valuation date—the AAL for benefits was $1.4 billion and the actuarial value of assets was $17 million, resulting in an UAAL of $1.4 billion. The covered payroll was $922 million and the ratio of the UAAL to covered payroll was 148%.

Actuarial valuations of an ongoing plan involve estimates of the value of reported amounts and assumptions about the probability of occurrence of events far into the future. Examples include assumptions about mortality and the healthcare cost trend. Amounts determined regarding the plan's funded status and the employer's annual required contributions are subject to continual revision as actual results are compared with past expectations and new estimates are made about the future. The schedule of funding progress, presented as required supplementary information following the notes to the financial statements, presents multiyear trend information about whether the actuarial value of plan assets is increasing or decreasing over time relative to the actuarial accrued liabilities for benefits.

Actuarial Methods and Assumptions: Projections of benefits for financial reporting purposes are based on the substantive plan (the plan as understood by the employer and the plan members) and include the types of benefits provided at the time of each valuation and the historical pattern of sharing of benefit costs between the employer and plan members to that point. The actuarial methods and assumptions used are consistent with a long-term perspective.

In the June 30, 2013 State substantive plan actuarial valuation, the individual entry age normal cost method was used. The actuarial assumptions included a 4.25% investment rate of return and an annual health care cost trend rate of actual increases for 2014 and 8.50% in 2015, initially, reduced to an ultimate rate of 4.50% after six years. Both rates included a 2.75% annual inflation assumption. Annual wage inflation is assumed to be 3.00%. The UAAL is being amortized as a level percentage of projected payroll on an open basis over 30 years.

In the July 1, 2011 biennial actuarial valuations, the entry age normal cost method was used for 48 of the trial courts, while Shasta used the projected unit credit cost method. The actuarial assumptions included a 3.75% investment rate of return for 42 trial courts. There are seven other trial courts with investment rates of return ranging from 4.50% to 7.50%. The actuarial assumptions included an annual health care cost trend rate of 6.00% for most trial courts initially, reduced incrementally, to an ultimate trend rate of 4.50% after seven years. Annual inflation and payroll growth are assumed to be 3.00% and 3.25%, respectively, for most trial courts. The UAAL is amortized on an open basis over 30 years as a level percentage of payroll for 44 trial courts, and level dollar amount for one court (Shasta). Two other trial courts, Alpine and Orange, are amortizing using the level dollar amount over 26 years on a closed basis. The Yolo and Lassen trial courts amortize on the level percentage of payroll on a closed basis for 27 years and one year, respectively.

The University of California (University) is the employer providing OPEB benefits through its Retirement Health Plan to its eligible retirees and their families. As the University is the employer providing these benefits, the State will not be reporting these benefits in Note 25 or the Required Supplementary Information. Information regarding the University and references to its financial statements can be found in Note 1, Section A-3.

NOTE 26: SUBSEQUENT EVENTS

The following information describes significant events that occurred subsequent to June 30, 2013, but prior to the date of the auditor's report.

A. Debt Issuances

Between September 2013 and March 2014, the primary government issued $5.2 billion in general obligation bonds to finance or refinance capital facilities or other voter-approved costs for public purposes, including clean air; transportation; higher education facilities; highway safety, traffic reduction, air quality, and port security; kindergarten-university public education facilities; and stem cell research.

In August 2013, the California State University (CSU) issued $309 million in revenue bonds to refund outstanding Systemwide Revenue Bonds Series 2005A and 2005C and other outstanding bond indebtedness by an auxiliary organization. Between July and September 2013, the CSU issued a combined total of $79 million in Bond Anticipation Notes (BANs) for the Student Health & Counseling Center at the San Jose campus and for student housing at the Bakersfield, Northridge, and San Diego campuses.

In August 2013, the Regents of the University of California, a discretely presented component unit, issued $650 million in revenue bonds to finance the East Campus Bed Tower project at UC San Diego Medical Center as well as other projects at UC Irvine Medical Center, UC Davis Medical Center and UCLA Medical Center. In October 2013, the Regents issued $2.5 billion in general revenue bonds to refinance the acquisition and construction of University facilities through the refunding of the outstanding Lease Revenue Bonds issued by the State Public Works Board of the State of California on behalf of the University. In April 2014, the Regents issued $970 million in general revenue bonds to finance or refinance the acquisition and construction of University facilities.

Between October 2013 and April 2014, the State Public Works Board issued a combined total of $1.9 billion in lease revenue bonds to finance and refinance the cost of design and/or construction of various projects for the benefit of the Department of Corrections and Rehabilitation, California State University, Department of Food and Agriculture, and Judicial Council of California.

In March 2014, the Department of Water Resources issued $161 million in water system revenue bonds to fund construction of certain Water System Projects, to refund outstanding water revenue commercial paper notes, to fund a deposit to the Debt Service Reserve Account, to fund interest on a portion of the bonds, and to pay the related issuance costs.

On September 1, 2013, the Department of Veterans Affairs voluntarily redeemed $44 million of general obligation bonds.

B. Cash Management

In August 2013, the State issued $5.5 billion of Revenue Anticipation Notes to fund the State's cash management needs for the 2013-14 fiscal year and to support the cash flow needs of the General Fund.

C. Other

In October 2013, the Governor signed into law Senate Bill No. 13. This legislation amends the Public Employees' Pension Reform Act of 2013 (PEPRA) correcting or clarifying several provisions including those related to new judges' retirement benefits. Key provisions of this legislation include requiring that new judges be subject to an employee contribution rate of at least 50% of the normal cost, and it corrected a requirement that new judges are not subject to the PEPRA retirement formulas. This law also provides clarification about accumulated additional contributions being used to calculate one of the benefit options for CalPERS safety members eligible for the industrial disability retirement benefits and who retire on or after January 1, 2013.

As of September 30, 2013, the cities of San Bernardino and Stockton are still seeking financial relief under Chapter 9 of the Federal Bankruptcy Code having filed for relief in the prior year, while the city of Mammoth Lakes has resolved its bankruptcy issues. The two local governments provide retirement benefits through CalPERS. One of the two cities met its pension obligations and remitted annual contributions during fiscal year 2012-13, while the other ceased paying its annual contributions for a period of time during the year and was approximately $14 million in arrears as of June 30, 2013. These local governments have yet to obtain confirmation of their final bankruptcy plans, and therefore, the outcome and the impact of the bankruptcy proceedings, at these stages of the cases, are unknown.

California's demand for unemployment insurance benefits required additional loans from the U.S. Department of Labor during the 2013-14 fiscal year. As of June 30, 2013, the State had $8.6 billion in outstanding loans from the U.S. Department of Labor which were used to cover deficits in the Unemployment Programs Fund. As of April 16, 2014, the State had an outstanding loan balance of $10.1 billion, and it expects to request additional loans throughout 2014.

In August 2013, Fitch Ratings raised its rating on the State's general obligation bonds to "A" from "A-" citing the State's institutional changes to fiscal management and its ongoing economic and revenue recovery. Fitch Ratings also raised its rating on State Public Works Board bonds to "A-" from "BBB+".

In November 2013, December 2013, and February 2014, the primary government substituted or extended the letters of credit for certain series of variable rate general obligation bonds and commercial paper notes to take advantage of lower letter of credit commitment fees. As a result of the letter of credit substitution or extension, new letter of credit and reimbursement agreements were entered into with expiration dates in 2016 and 2017. Also due to the substitution, Moody, Standard & Poor's Rating Services, and Fitch Rating raised ratings on various bond series and Fitch lowered its rating on other bonds.

In December 2013 and February 2014, the primary government removed one and added two letter of credit bank facilities to the commercial paper program, and new letter of credit and reimbursement agreements were entered into with expiration dates in 2016 and 2017. The commercial paper lines had a net increase from $1.6 billion to $1.7 billion.

This page intentionally left blank.

Required Supplementary Information

Schedule of Funding Progress

(amounts in millions)

Public Employees' Retirement Fund - Primary Government

Actuarial Valuation Date	Actuarial Value of Assets (a)	Actuarial Accrued Liability (b)	Unfunded Actuarial Accrued Liability (UAAL) (b - a)	Funded Ratio (a / b)	Covered Payroll (c)	UAAL as a Percentage of Covered Payroll ((b - a) / c)
June 30, 2010	$ 97,346	$ 121,446	$ 24,100	80.2 %	$ 16,281	148.0 %
June 30, 2011	102,452	129,648	27,196	79.0	16,212	167.7
June 30, 2012	106,145	134,314	28,169	79.0	15,680	179.6

State Teachers' Retirement Defined Benefit Program

Actuarial Valuation Date	Actuarial Value of Assets (a)	Actuarial Accrued Liability (b)	Unfunded Actuarial Accrued Liability (UAAL) (b - a)	Funded Ratio (a / b)	Covered Payroll (c)	UAAL as a Percentage of Covered Payroll ((b - a) / c)
June 30, 2010	$ 140,291	$ 196,315	$ 56,024	71.5 %	$ 26,275	213.2 %
June 30, 2011	143,930	207,770	63,840	69.3	26,592	240.1
June 30, 2012	144,232	214,765	70,533	67.2	26,404	267.1

Other Postemployment Benefit Plan

Actuarial Valuation Date	Actuarial Value of Assets (a)	Actuarial Accrued Liability (b)	Unfunded Actuarial Accrued Liability (UAAL) (b - a)	Funded Ratio (a / b)	Covered Payroll (c)	UAAL as a Percentage of Covered Payroll ((b - a) / c)
State substantive plan						
June 30, 2011	$ 7	$ 62,144	$ 62,137	0.0 %	$ 18,010	345.0 %
June 30, 2012	8	63,845	63,837	0.0	18,710	341.2
June 30, 2013	10	64,584	64,574	0.0	18,060	357.6
Trial Courts [1]						
July 1, 2007	—	1,291	1,291	0.0 %	989	130.6 %
July 1, 2009	9	1,493	1,484	0.6	1,009	147.0
July 1, 2011	17	1,385	1,368	1.2	922	148.4

[1] The trial courts reporting is based on 49 individual biennial actuarial valuations as of July 1, 2011.

Note: The University of California (UC) is the employer providing OPEB benefits through its Retirement Health and Welfare Plans to its eligible retirees and their families. As UC is the employer providing these benefits, the State will not be reporting these benefits in Note 25 or the Required Supplementary Information. Information regarding the University of California and references to their financial statements can be found in Note 1, Section A-3.

Infrastructure Assets Using the Modified Approach

Pursuant to Governmental Accounting Standards Board (GASB) Statement No. 34, the State uses the modified approach to report the cost of its infrastructure assets (state roadways and bridges). Under the modified approach, the State does not report depreciation expense for roads and bridges but capitalizes all costs that add to the capacity and efficiency of State-owned roads and bridges. All maintenance and preservation costs are expensed and not capitalized.

A. Infrastructure Asset Reporting Categories

The infrastructure assets reported in the State's financial statements for the fiscal year ending June 30, 2013, are in the following categories and amounts: state highway infrastructure (completed highway projects) totaling $63.4 billion, land purchased for highway projects totaling $12.8 billion, and infrastructure construction-in-progress (uncompleted highway projects) totaling $8.3 billion.

Donation and Relinquishment: Donation and relinquishment activity affects the inventory of statewide lane miles, land, and/or bridges as adjustments to the infrastructure assets and/or land balance in the State's financial statements. For the fiscal year ending June 30, 2013, donations are $6 million of infrastructure land, and relinquishments are $66 million of state highway infrastructure and $13 million of infrastructure land, respectively.

B. Condition Baselines and Assessments

1. Bridges

The State uses the Bridge Health Index (BHI)—a numerical rating scale from 0 to 100 that uses element-level inspection data—to determine the aggregate condition of its bridges. The inspection data is based on the American Association of State Highway Transportation Officials' "Guide to Commonly Recognized Structural Elements."

From a deterioration standpoint, the BHI represents the remaining asset value of the bridge. A new bridge that has 100% of its asset value has a BHI of 100. As a bridge deteriorates over time, it loses asset value, as represented by a decline in its BHI. When a deteriorated bridge is repaired, it will regain some (or all) of its asset value and its BHI will increase.

The State's established condition baseline and actual BHI for fiscal years 2010-11 through 2012-13 are shown in the following table:

Fiscal Year Ending June 30	Established BHI Baseline*	Actual BHI
2011	80.0	94.3
2012	80.0	94.5
2013	80.0	94.8

* The actual statewide Bridge Health Index (BHI) should not be lower than the minimum BHI established by the State.

The following table provides details on the State's actual BHI as of June 30, 2013:

BHI Description	Bridge Count	Percent	Network BHI
Excellent	6,952	53.19 %	99.9
Good	4,716	36.08	96.6
Acceptable	760	5.81	85.4
Fair	156	1.19	73.6
Poor	116	0.89	66.2
Does not carry traffic	371	2.84	93.1
Total	**13,071**	**100.00 %**	

2. Roadways

The State conducts a periodic pavement condition survey, which evaluates ride quality and structural integrity and identifies the number of distressed lane miles. The State classifies its roadways' pavement condition by the following descriptions:

1. Excellent/good condition – minor or no potholes or cracks
2. Fair condition – moderate potholes or cracks
3. Poor condition – significant or extensive potholes or cracks

Statewide lane miles are considered "distressed lane miles" if they are in either fair or poor condition. The actual distressed lane miles are compared to the established condition baseline to ensure that the baseline is not exceeded.

The State's established condition baseline and actual distressed lane miles from the last three complete pavement-condition surveys are shown in the following table:

Condition Assessment Date [1]	Established Condition Baseline Distressed Lane Miles (maximum) [2]	Actual Distressed Lane Miles	Actual Distressed Lane Miles as Percent of Total Lane Miles
March 2008	18,000	12,998	26.3 %
December 2011 [3]	18,000	12,333	24.9
December 2013	18,000	7,820	15.7

[1] Condition assessment for the State's established condition baseline and actual distressed lane miles is being reported as of the *State of the Pavement* report publication date.

[2] The actual statewide distressed lane miles should not exceed the maximum distressed lane miles established by the State.

[3] The State's compliance with GASB 34, which requires a road condition assessment every three years, temporarily lapsed in March 2011. A survey was completed in December 2011 and the State will continue to use the modified approach for roadways.

The following table provides details on the State's actual distressed lane miles as of the last complete pavement-condition survey.

Pavement Condition	Lane Miles	Distressed Lane Miles
Excellent/Good	41,898	—
Fair	2,483	2,483
Poor	5,337	5,337
Total	49,718	7,820

C. Budgeted and Actual Preservation Costs

The estimated budgeted preservation costs represent the preservation projects approved by the California Transportation Commission and the State's scheduled preservation work for each fiscal year. The actual preservation costs represent the cumulative cost to date for the projects approved and work scheduled in each fiscal year.

The State's budgeted and actual preservation cost information for the most recent and four previous fiscal years is shown in the following table:

Fiscal Year Ending June 30	Estimated Budgeted Preservation Costs (in millions)	Actual Preservation Costs (in millions)
2009	$ 2,910	$ 1,821
2010	2,162	694
2011	2,802	1,358
2012	2,722	1,504
2013	1,598	375

Budgetary Comparison Schedule

General Fund and Major Special Revenue Funds

Year Ended June 30, 2013
(amounts in thousands)

	General				Federal				Transportation			
	Budgeted Amounts		Actual	Variance With	Budgeted Amounts		Actual	Variance With	Budgeted Amounts		Actual	Variance With
	Original	Final	Amounts	Final Budget	Original	Final	Amounts	Final Budget	Original	Final	Amounts	Final Budget
REVENUES												
Corporation tax	$ 7,580,000	$ 7,509,000	$ 7,459,443	$ (49,557)	$ —	$ —	$ —	$ —	$ —	$ —	$ —	$ —
Intergovernmental	—	—	—	—	55,499,998	55,499,998	55,499,998	—	—	—	—	—
Cigarette and tobacco taxes	91,000	91,000	90,005	(995)	—	—	—	—	—	—	—	—
Inheritance, estate, and gift taxes	45,000	—	—	—	—	—	—	—	—	—	—	—
Insurance gross premiums tax	2,022,000	2,156,000	2,221,317	65,317	—	—	—	—	—	—	—	—
Vehicle license fees	25,718	28,718	26,445	(2,273)	—	—	—	—	—	—	—	—
Motor vehicle fuel tax	—	—	—	—	—	—	—	—	5,545,016	5,618,575	5,492,850	(125,725)
Personal income tax	60,647,000	63,901,000	65,443,286	1,542,286	—	—	—	—	—	—	—	—
Retail sales and use taxes	20,714,000	20,240,000	20,414,799	174,799	—	—	—	—	—	—	—	—
Other major taxes and licenses	321,200	326,200	357,632	31,432	—	—	—	—	3,724,808	3,705,494	3,735,168	29,674
Other revenues	2,148,454	2,195,082	2,404,834	209,752	32	32	32	—	380,656	426,382	370,121	(56,261)
Total revenues	**93,594,372**	**96,447,000**	**98,417,761**	**1,970,761**	**55,500,030**	**55,500,030**	**55,500,030**	—	**9,650,480**	**9,750,451**	**9,598,139**	**(152,312)**
EXPENDITURES												
State and consumer services	1,335,204	681,611	661,143	20,468	35,434	35,434	35,434	—	111,168	109,814	97,820	11,994
Business and transportation	90,476	90,456	90,407	49	3,556,096	3,556,096	3,556,096	—	10,929,923	10,888,601	9,165,455	1,723,147
Resources	940,947	1,177,395	1,161,104	16,291	363,775	363,775	363,775	—	156,155	154,388	151,482	2,906
Health and human services	26,658,419	27,395,474	26,999,956	395,518	41,078,078	41,078,078	41,078,078	—	3,365	3,323	2,846	476
Correctional programs	8,820,897	8,700,193	8,500,608	199,585	80,364	80,364	80,364	—	—	—	—	—
Education	50,127,515	48,787,555	48,686,126	101,429	6,964,294	6,964,294	6,964,294	—	980	2,587	2,467	120
General government:												
Tax relief	438,852	438,852	427,285	11,567	—	—	—	—	2,103	2,103	2,103	—
Debt service	4,435,522	4,438,663	4,394,324	44,339	—	—	—	—	2,408	2,886	1,441	1,445
Other general government	4,786,351	5,204,292	4,987,016	217,276	702,040	702,040	702,040	—	487,274	516,898	498,131	18,767
Total expenditures	**97,634,183**	**96,914,491**	**95,907,969**	**1,006,522**	**52,780,081**	**52,780,081**	**52,780,081**	—	**11,693,376**	**11,680,600**	**9,921,745**	**1,758,855**
OTHER FINANCING SOURCES (USES)												
Transfers from other funds	—	—	2,047,256	—	—	—	12,583,101	—	—	—	14,455,171	—
Transfers to other funds	—	—	(344,599)	—	—	—	(15,280,390)	—	—	—	(16,264,844)	—
Other additions and deductions	—	—	1,681,288	—	—	—	(22,628)	—	—	—	(1,114,596)	—
Total other financing sources (uses)	—	—	**3,383,945**	—	—	—	**(2,719,917)**	—	—	—	**(2,924,269)**	—
Excess (deficiency) of revenues and other sources over (under) expenditures and other uses	—	—	5,893,737	—	—	—	32	—	—	—	(3,247,875)	—
Fund balances - beginning	—	—	**(1,608,600)**	—	—	—	**10,737**	—	—	—	**25,690,829**	—
Fund balances - ending	$ —	$ —	**$ 4,285,137**	$ —	$ —	$ —	**$ 10,769**	$ —	$ —	$ —	**$ 22,442,954**	$ —

(continued)

Budgetary Comparison Schedule (continued)

General Fund and Major Special Revenue Funds

Year Ended June 30, 2013
(amounts in thousands)

	Environmental and Natural Resources			
	Budgeted Amounts		Actual	Variance With
	Original	Final	Amounts	Final Budget
REVENUES				
Corporation tax	$ —	$ —	$ —	$ —
Intergovernmental	—	—	—	—
Cigarette and tobacco taxes	—	—	—	—
Inheritance, estate, and gift taxes	—	—	—	—
Insurance gross premiums tax	—	—	—	—
Vehicle license fees	—	—	—	—
Motor vehicle fuel tax	—	—	—	—
Personal income tax	—	—	—	—
Retail sales and use taxes	—	—	—	—
Other major taxes and licenses	148,326	148,326	148,326	—
Other revenues	3,175,948	3,175,948	3,175,948	—
Total revenues	**3,324,274**	**3,324,274**	**3,324,274**	—
EXPENDITURES				
State and consumer services	83,374	83,216	67,297	15,919
Business and transportation	5,668	5,666	5,666	—
Resources	4,494,202	4,502,774	3,761,481	741,293
Health and human services	220,228	219,550	115,043	104,507
Correctional programs	—	—	—	—
Education	8,166	8,165	8,025	140
General government:				
Tax relief	—	—	—	—
Debt service	—	—	—	—
Other general government	95,621	97,358	84,575	12,783
Total expenditures	**4,907,259**	**4,916,729**	**4,042,087**	**874,642**
OTHER FINANCING SOURCES (USES)				
Transfers from other funds	—	—	483,438	—
Transfers to other funds	—	—	(380,327)	—
Other additions and deductions	—	—	160,218	—
Total other financing sources (uses)	—	—	**263,329**	—
Excess (deficiency) of revenues and other sources over (under) expenditures and other uses	—	—	(454,484)	—
Fund balances - beginning	—	—	**12,479,726**	—
Fund balances - ending	$ —	$ —	**$ 12,025,242**	$ —

(concluded)

Reconciliation of Budgetary Basis Fund Balances of the General Fund and the Major Special Revenue Funds to GAAP Basis Fund Balances

June 30, 2013
(amounts in thousands)

		Special Revenue Funds		
	General	Federal	Transportation	Environmental and Natural Resources
Budgetary fund balance reclassified into GAAP statement fund structure	**$ 4,285,137**	**$ 10,769**	**$ 22,442,954**	**$ 12,025,242**
Basis difference:				
Interfund receivables	53,767	—	3,610,076	535,477
Loans receivable	165,643	186,236	—	1,023,710
Interfund payables	(6,435,046)	—	(2,648)	(10,979)
Escheat property	(905,203)	—	—	—
Bonds authorized but unissued	—	—	(17,805,340)	(5,905,460)
Tax revenues	283,600	—	—	—
GASB 54 classification changes	85,562	1,738	—	—
Other	6,075	—	(839,405)	156,953
Timing difference:				
Liabilities budgeted in subsequent years	(11,793,991)	(790)	(174,940)	(7,067)
GAAP fund balance (deficit), June 30, 2013	**$ (14,254,456)**	**$ 197,953**	**$ 7,230,697**	**$ 7,817,876**

Notes to the Required Supplementary Information

Budgetary Comparison Schedule

The State annually reports its financial condition based on a Generally Accepted Accounting Principles (GAAP) basis and on the State's budgetary provisions (budgetary basis). The Budgetary Comparison Schedule, General Fund and Major Special Revenue Funds reports the original budget, the final budget, the actual expenditures, and the variance between the final budget and the actual expenditures, using the budgetary basis of accounting.

On the budgetary basis, individual appropriations are charged as expenditures when commitments for goods and services are incurred. However, for financial reporting purposes, the State reports expenditures based on the year in which goods and services are received. The Budgetary Comparison Schedule includes all of the current-year expenditures for the General Fund and major special revenue funds as well as related appropriations that are typically legislatively authorized annually, continually, or by project. On a budgetary basis, adjustments for encumbrances are budgeted under other general government, while the encumbrances relate to all programs' expenditures.

The Budgetary Comparison Schedule is not presented in this document at the legal level of budgetary control because such a presentation would be extremely lengthy and cumbersome. The State of California prepares a separate report, the Comprehensive Annual Financial Report Supplement, which includes statements that demonstrate compliance with the legal level of budgetary control in accordance with Government Accounting Standards Board's (GASB) Codification of Governmental Accounting and Financial Reporting Standards, Section 2400.121. This report includes the comparison of the annual appropriated budget with expenditures at the legal level of control. A copy of the Comprehensive Annual Financial Report Supplement is available upon request from the State Controller's Office, Division of Accounting and Reporting, P.O. Box 942850, Sacramento, California 94250-5872.

Reconciliation of Budgetary With GAAP Basis

The reconciliation of budgetary basis fund balances of the General Fund and the major special revenue funds to GAAP basis fund balances are presented on the previous page and are explained in the following paragraphs.

The beginning fund balances on the budgetary basis are calculated using prior year revenue adjustments and prior year expenditure adjustments. A prior year revenue adjustment occurs when the actual amount received in the current year differs from the amount of revenue accrued in the prior year. A prior year expenditure adjustment results when the actual amount paid in the current year differs from the prior year accrual for appropriations for which the ability to encumber funds has lapsed in previous periods. The beginning fund balance on a GAAP basis is not affected by these adjustments.

Basis Difference

Interfund Receivables and Loans Receivable: Loans made to other funds or to other governments are normally recorded as either expenditures or transfers on a budgetary basis. However, in accordance with GAAP, these loans are recorded as assets. The adjustments related to interfund receivables caused a $54 million increase to the fund balance in the General Fund, a $3.6 billion increase to the fund balance in the Transportation Fund, and a $535 million increase to the fund balance in Environmental and Natural Resources Fund. The adjustments related to loans receivable caused increases of $166 million in the General Fund, $186 million in the Federal Fund, and $1.0 billion in Environmental and Natural Resources Fund.

Interfund Payables: Loans received from other funds or from other governments are normally recorded as either revenues or transfers on a budgetary basis. However, in accordance with GAAP, these loans are recorded as liabilities. The adjustments related to interfund payables caused a $6.4 billion decrease to the budgetary fund balance in the General Fund, $3 million decrease to the Transportation Fund, and $11 million decrease to the Environmental and Natural Resources Fund.

Escheat Property: A liability for the estimated amount of escheat property expected to ultimately be reclaimed and paid is not reported on a budgetary basis. The liability is required to be reported on a GAAP basis. This adjustment caused a $905 million decrease to the General Fund balance.

Bonds Authorized but Unissued: In the year that general obligation bonds are authorized by the voters, the full amount authorized is recognized as revenue on a budgetary basis. In accordance with GAAP, only the amount of bonds issued each year is reported as an other financing source. The adjustments related to bonds authorized but unissued caused a $17.8 billion decrease to the fund balance in the Transportation Fund and a $5.9 billion decrease in Environmental and Natural Resources Fund.

Tax Revenues: Estimated tax payments are accrued on a budgetary basis pursuant to Chapter 751, Statutes of 2008. However, in accordance with GAAP, tax payments are accrued based on the portion of estimated net final payments related to the fiscal year. This adjustment caused a fund balance increase of $284 million in the General Fund.

GASB Statement No. 54 Classification Changes: The fund balance amounts for governmental funds have been reclassified in accordance with GASB Statement No. 54. Additional information on GASB Statement No. 54 can be found in Note 1, Summary of Significant Accounting Policies, Section K. These reclassifications caused fund balance increases of $86 million in the General Fund and $2 million in the Federal Fund. The $86 million of fund balance is not considered part of the General Fund for any budgetary purposes or for the Budgetary/Legal Basis Annual Report.

Other: Certain other adjustments and reclassifications are necessary in order to present the financial statements in accordance with GAAP. The other adjustments caused a fund balance increase of $6 million in the General Fund, a fund balance decrease of $839 million in the Transportation Fund, and a $157 million increase in Environmental and Natural Resources Fund.

Timing Difference

Liabilities Budgeted in Subsequent Years: On a budgetary basis, the primary government does not accrue liabilities for which there is no existing appropriation or no currently available appropriation. The adjustments made to account for these liabilities in accordance with GAAP caused fund balance decreases of $11.7 billion in the General Fund, $790 thousand in the Federal Fund, $175 million in the Transportation Fund, and $7 million in the Environmental and Natural Resources Fund. The large decrease in the General Fund primarily consists of $4.2 billion for deferred apportionment payments to K-12 schools and community colleges, $2.7 billion for medical assistance, $2.2 billion in tax overpayments, $732 million for June 2013 payroll that was deferred to July 2013, and $431 million for pension contributions.

This page intentionally left blank.

Combining Financial Statements and Schedules – Nonmajor and Other Funds

This page intentionally left blank.

Nonmajor Governmental Funds

Nonmajor governmental funds account for the State's activities that do not meet the criteria of a major governmental fund. Following are brief descriptions of nonmajor governmental funds.

Special revenue funds account for the proceeds of specific revenue sources, other than debt service or capital projects, that are restricted or committed to expenditures for specific purposes.

The **Business and Professions Regulatory and Licensing Fund** accounts for fees and other revenues charged for regulating and licensing specific industries, professions, and vocations.

The **Financing for Local Governments and the Public Fund** accounts for taxes, fees, bond proceeds, and other revenues that are used to finance the construction and maintenance of parks, jails, and other public and local government programs.

The **Cigarette and Tobacco Tax Fund** accounts for a surtax on cigarette and tobacco products that is used for various health programs.

The **Local Revenue and Public Safety Fund** accounts for vehicle license fees and a 1.5625% state sales tax that is dedicated to local governments for realigning costs from the State to local governments and a 0.5% state sales tax that is dedicated to local governments to fund public safety programs.

The **Health Care Related Programs Fund** accounts for fees, taxes, bond proceeds, transfers from the Federal Trust Fund and other state funds, and other revenues that are used for the Medi-Cal and Healthy Families programs, medical research, and other health and human services programs.

The **Trial Courts Fund** accounts for the various fees collected by the courts, maintenance of effort payments from the counties, transfers in from the General Fund, and trial court operating costs.

The **Golden State Tobacco Securitization Corporation Fund** is a blended component unit that accounts for the receipt of Tobacco Revenue Settlements pledged for the payment of debt service.

The **Other Special Revenue Programs Fund** accounts for all other proceeds of revenue sources, other than debt service or capital projects, that are restricted or committed to expenditures for specific purposes.

(continued)

(continued)

Debt service funds account for and report financial resources that are restricted, committed, or assigned for the payment of principal and interest on general long-term obligations.

The **Economic Recovery Bond Sinking Fund** accounts for General Fund transfers, proceeds from sale of surplus property, and the 0.25% sales and use tax revenue collected for the payment of principal, interest, and other related costs of the Economic Recovery Bonds.

The **Transportation Debt Service Fund** accounts for Transportation Fund transfers used for the payment of principal and interest related to various transportation related general obligation bonds.

Capital projects funds account for and report financial resources that are restricted, committed, or assigned to expenditure for capital outlays, including the acquisition or construction of capital facilities and other capital assets.

The **Higher Education Construction Fund** accounts for bond proceeds used to construct state colleges and universities.

The **Hospital Construction Fund** accounts for bond proceeds that are used to construct hospitals.

The **Local Government Construction Fund** accounts for bond proceeds that are used to construct schools, libraries, and other major capital facilities for local governments.

Building authorities are blended component units that are created by joint-powers agreements between local governments and the State or other local governments for the purpose of financing the construction of state buildings. The funds account for bond proceeds used to finance and construct state buildings and parking facilities.

Other capital projects funds account for transactions related to resources that are restricted, committed, or assigned to expenditure for capital outlays, including the acquisition or construction of capital facilities and other capital assets.

This page intentionally left blank.

Combining Balance Sheet

Nonmajor Governmental Funds

June 30, 2013
(amounts in thousands)

	Special Revenue			Special Revenue					
	Business and Professions Regulatory and Licensing	**Financing for Local Governments and the Public**	**Cigarette and Tobacco Tax**	**Local Revenue and Public Safety**	**Health Care Related Programs**	**Trial Courts**	**Golden State Tobacco Securitization Corporation**	**Other Special Revenue Programs**	**Total Nonmajor Special Revenue**
ASSETS									
Cash and pooled investments	$ 875,117	$ 1,130,632	$ 421,986	$ 2,047,633	$ 525,140	$ 1,042,934	$ 165,639	$ 1,672,141	$ 7,881,222
Investments	—	—	—	—	—	145,432	499,621	—	645,053
Receivables (net)	71,941	35,982	337,988	93,901	1,285,959	312,329	51	158,827	2,296,978
Due from other funds	201,477	224,345	257	217,528	203,230	107,587	—	391,941	1,346,365
Due from other governments	14,513	359,390	—	5	2,165	26,116	—	56,561	458,750
Interfund receivables	327,492	216,078	—	—	12,000	440,000	—	673,400	1,668,970
Loans receivable	191,160	2,228,221	—	—	23,827	—	—	14,184	2,457,392
Other assets	413	—	—	—	—	6,211	—	—	6,624
Total assets	**1,682,113**	**4,194,648**	**760,231**	**2,359,067**	**2,052,321**	**2,080,609**	**665,311**	**2,967,054**	**16,761,354**
DEFERRED OUTFLOWS OF RESOURCES	—	—	—	—	—	—	—	—	—
Total assets and deferred outflows of resources	**$ 1,682,113**	**$ 4,194,648**	**$ 760,231**	**$ 2,359,067**	**$ 2,052,321**	**$ 2,080,609**	**$ 665,311**	**$ 2,967,054**	**$ 16,761,354**
LIABILITIES									
Accounts payable	$ 43,438	$ 89,267	$ 86,137	$ 42	$ 403,463	$ 210,880	$ 334	$ 147,438	$ 980,999
Due to other funds	28,888	386,779	31,179	36,834	1,262,307	19,455	—	335,076	2,100,518
Due to component units	—	—	32,901	—	—	—	—	4,087	36,988
Due to other governments	566	187,141	65,924	2,275,554	4,337	126,847	—	375,396	3,035,765
Interfund payables	1,283	—	—	—	—	—	—	4,834	6,117
Revenues received in advance	34,205	1,591	—	—	7,942	15,543	—	30,305	89,586
Deposits	400	—	—	—	—	356,832	—	17,346	374,578
Interest payable	—	—	—	—	—	—	—	—	—
General obligation bonds payable	—	—	—	—	—	—	—	—	—
Other liabilities	43,039	359	—	—	—	98,595	—	14,330	156,323
Total liabilities	**151,819**	**665,137**	**216,141**	**2,312,430**	**1,678,049**	**828,152**	**334**	**928,812**	**6,780,874**
DEFERRED INFLOWS OF RESOURCES	—	—	**272,641**	—	—	—	—	—	**272,641**
Total liabilities and deferred inflows of resources	**151,819**	**665,137**	**488,782**	**2,312,430**	**1,678,049**	**828,152**	**334**	**928,812**	**7,053,515**
FUND BALANCES									
Nonspendable	—	—	—	—	—	15,022	—	—	15,022
Restricted	866,646	3,232,254	271,458	15,814	446,164	980,790	664,977	1,771,171	8,249,274
Committed	663,648	309,691	—	30,823	71,779	47,474	—	269,593	1,393,008
Assigned	—	—	—	—	—	209,171	—	—	209,171
Unassigned	—	(12,434)	(9)	—	(143,671)	—	—	(2,522)	(158,636)
Total fund balances	**1,530,294**	**3,529,511**	**271,449**	**46,637**	**374,272**	**1,252,457**	**664,977**	**2,038,242**	**9,707,839**
Total liabilities, deferred inflows of resources, and fund balances	**$ 1,682,113**	**$ 4,194,648**	**$ 760,231**	**$ 2,359,067**	**$ 2,052,321**	**$ 2,080,609**	**$ 665,311**	**$ 2,967,054**	**$ 16,761,354**

(continued)

Combining Balance Sheet (continued)

Nonmajor Governmental Funds

June 30, 2013

(amounts in thousands)

	Debt Service			Capital Projects						
	Economic Recovery Bond Sinking	Transportation Debt Service	Total Nonmajor Debt Service	Higher Education Construction	Hospital Construction	Local Government Construction	Building Authorities	Other Capital Projects	Total Nonmajor Capital Projects	Total Nonmajor Governmental
ASSETS										
Cash and pooled investments	$ 1,281,783	$ —	$ 1,281,783	$ 234,856	$ 62,032	$ 449,643	$ 61,755	$ 57,220	$ 865,506	$ 10,028,511
Investments	—	—	—	—	—	—	—	—	—	645,053
Receivables (net)	—	—	—	—	—	—	—	—	—	2,296,978
Due from other funds	8,000	—	8,000	79	47	417	19,872	10,226	30,641	1,385,006
Due from other governments	—	—	—	—	—	2,508	—	—	2,508	461,258
Interfund receivables	—	—	—	—	—	—	—	—	—	1,668,970
Loans receivable	—	—	—	—	—	—	—	—	—	2,457,392
Other assets	—	—	—	—	—	—	—	—	—	6,624
Total assets	**1,289,783**	**—**	**1,289,783**	**234,935**	**62,079**	**452,568**	**81,627**	**67,446**	**898,655**	**18,949,792**
DEFERRED OUTFLOWS OF RESOURCES	—	—	—	—	—	—	—	—	—	—
Total assets and deferred outflows of resources	**$ 1,289,783**	**$ —**	**$ 1,289,783**	**$ 234,935**	**$ 62,079**	**$ 452,568**	**$ 81,627**	**$ 67,446**	**$ 898,655**	**$ 18,949,792**
LIABILITIES										
Accounts payable	$ 718	$ —	$ 718	$ 3,196	$ 60	$ —	$ —	$ 729	$ 3,985	$ 985,702
Due to other funds	—	—	—	605	—	2,512	—	2	3,119	2,103,637
Due to component units	—	—	—	—	—	—	—	—	—	36,988
Due to other governments	—	—	—	—	—	4,446	—	—	4,446	3,040,211
Interfund payables	—	—	—	—	—	—	—	—	—	6,117
Revenues received in advance	—	—	—	—	—	—	—	—	—	89,586
Deposits	—	—	—	—	—	—	—	—	—	374,578
Interest payable	123,727	—	123,727	—	—	—	2,906	—	2,906	126,633
General obligation bonds payable	500,470	—	500,470	—	—	—	—	—	—	500,470
Other liabilities	—	—	—	—	—	—	—	—	—	156,323
Total liabilities	**624,915**	**—**	**624,915**	**3,801**	**60**	**6,958**	**2,906**	**731**	**14,456**	**7,420,245**
DEFERRED INFLOWS OF RESOURCES	—	—	—	—	—	—	—	—	—	**272,641**
Total liabilities and deferred inflows of resources	**624,915**	**—**	**624,915**	**3,801**	**60**	**6,958**	**2,906**	**731**	**14,456**	**7,692,886**
FUND BALANCES										
Nonspendable	—	—	—	—	—	—	—	—	—	15,022
Restricted	664,868	—	664,868	231,134	62,019	445,610	78,721	54,746	872,230	9,786,372
Committed	—	—	—	—	—	—	—	11,969	11,969	1,404,977
Assigned	—	—	—	—	—	—	—	—	—	209,171
Unassigned	—	—	—	—	—	—	—	—	—	(158,636)
Total fund balances	**664,868**	**—**	**664,868**	**231,134**	**62,019**	**445,610**	**78,721**	**66,715**	**884,199**	**11,256,906**
Total liabilities, deferred inflows of resources, and fund balances	**$ 1,289,783**	**$ —**	**$ 1,289,783**	**$ 234,935**	**$ 62,079**	**$ 452,568**	**$ 81,627**	**$ 67,446**	**$ 898,655**	**$ 18,949,792**

(concluded)

Combining Statement of Revenues, Expenditures, and Changes in Fund Balances

Nonmajor Governmental Funds

Year Ended June 30, 2013 (amounts in thousands)	Special Revenue			Special Revenue					
	Business and Professions Regulatory and Licensing	**Financing for Local Governments and the Public**	**Cigarette and Tobacco Tax**	**Local Revenue and Public Safety**	**Health Care Related Programs**	**Trial Courts**	**Golden State Tobacco Securitization Corporation**	**Other Special Revenue Programs**	**Total Nonmajor Special Revenue**
REVENUES									
Personal income taxes	$ —	$ 1,204,444	$ —	$ —	$ —	$ —	$ —	$ —	$ 1,204,444
Sales and use taxes	—	—	—	11,356,474	—	—	—	—	11,356,474
Insurance taxes	—	—	—	—	33,012	—	—	—	33,012
Other taxes	96,129	702,242	769,338	—	—	—	—	273	1,567,982
Intergovernmental	—	932,051	—	—	57,971	816,260	—	—	1,806,282
Licenses and permits	342,398	18,290	—	2,023,380	—	—	—	10,537	2,394,605
Charges for services	39,344	2,615	711	—	110	50,809	—	151,703	245,292
Fees	892,114	414	37	—	4,034,237	669,755	—	923,356	6,519,913
Penalties	6,305	10,754	—	—	10,246	521,416	—	352,628	901,349
Investment and interest	6,285	4,916	1,162	642	9,279	2,762	958	12,154	38,158
Other	11,634	32,548	—	—	404,959	163,120	554,434	691,084	1,857,779
Total revenues	**1,394,209**	**2,908,274**	**771,248**	**13,380,496**	**4,549,814**	**2,224,122**	**555,392**	**2,141,735**	**27,925,290**
EXPENDITURES									
Current:									
General government	558,103	790,611	17,028	3,889,269	14,774	2,832,716	—	825,677	8,928,178
Education	18,021	368	36,104	—	197,079	—	—	6,197	257,769
Health and human services	256,509	2,265,518	529,337	8,357,100	4,695,332	—	—	609,785	16,713,581
Resources	58,785	77,916	12,037	—	134	—	—	46,664	195,536
State and consumer services	261,756	—	—	—	—	210	—	146,238	408,204
Business and transportation	198,377	184,405	—	—	—	—	—	9,081	391,863
Correctional programs	—	138,290	—	1,127,139	—	—	—	34,234	1,299,663
Capital outlay	—	7	—	—	—	—	—	—	7
Debt service:									
Bond and commercial paper retirement	—	25,510	—	—	354,270	—	623,510	197,993	1,201,283
Interest and fiscal charges	—	449	—	—	2,132	—	308,056	—	310,637
Total expenditures	**1,351,551**	**3,483,074**	**594,506**	**13,373,508**	**5,263,721**	**2,832,926**	**931,566**	**1,875,869**	**29,706,721**
Excess (deficiency) of revenues over (under) expenditures	42,658	(574,800)	176,742	6,988	(713,907)	(608,804)	(376,174)	265,866	(1,781,431)
OTHER FINANCING SOURCES (USES)									
General obligation bonds and commercial paper issued	—	—	—	—	306,215	—	—	—	306,215
Refunding debt issued	—	23,475	—	—	276,920	—	375,105	—	675,500
Payment to refund long-term debt	—	(710)	—	—	—	—	—	—	(710)
Premium on bonds issued	—	3,194	—	—	1,235	—	56,019	—	60,448
Remarketing bonds issued	—	—	—	—	228,000	—	—	—	228,000
Payment to remarketing agent	—	—	—	—	(226,968)	—	—	—	(226,968)
Transfers in	9,400	297,408	1	2,247	206,527	419,996	—	25,829	961,408
Transfers out	(61,307)	(133,593)	(77,851)	1	(17,500)	—	—	(67,607)	(357,857)
Total other financing sources (uses)	**(51,907)**	**189,774**	**(77,850)**	**2,248**	**774,429**	**419,996**	**431,124**	**(41,778)**	**1,646,036**
Net change in fund balances	(9,249)	(385,026)	98,892	9,236	60,522	(188,808)	54,950	224,088	(135,395)
Fund balances – beginning	**1,539,543**	**3,914,537**	**172,557**	**37,401**	**313,750**	**1,441,265** *	**610,027**	**1,814,154**	9,843,234 *
Fund balances – ending	**$ 1,530,294**	**$ 3,529,511**	**$ 271,449**	**$ 46,637**	**$ 374,272**	**$ 1,252,457**	**$ 664,977**	**$ 2,038,242**	**$ 9,707,839**

* Restated

(continued)

Combining Statement of Revenues, Expenditures, and Changes in Fund Balances (continued)

Nonmajor Governmental Funds

Year Ended June 30, 2013

(amounts in thousands)

	Debt Service			Capital Projects						
	Economic Recovery Bond Sinking	Transportation Debt Service	Total Nonmajor Debt Service	Higher Education Construction	Hospital Construction	Local Government Construction	Building Authorities	Other Capital Projects	Total Nonmajor Capital Projects	Total Nonmajor Governmental
REVENUES										
Personal income taxes	$ —	$ —	$ —	$ —	$ —	$ —	$ —	$ —	$ —	$ 1,204,444
Sales and use taxes	1,443,609	—	1,443,609	—	—	—	—	—	—	12,800,083
Insurance taxes	—	—	—	—	—	—	—	—	—	33,012
Other taxes	—	—	—	—	—	—	—	—	—	1,567,982
Intergovernmental	—	—	—	—	—	—	—	—	—	1,806,282
Licenses and permits	—	—	—	—	—	—	—	—	—	2,394,605
Charges for services	—	—	—	—	—	—	—	—	—	245,292
Fees	—	—	—	—	—	—	—	—	—	6,519,913
Penalties	—	—	—	—	—	—	—	—	—	901,349
Investment and interest	2,369	—	2,369	925	555	5,895	197	57	7,629	48,156
Other	8,037	—	8,037	—	—	—	105	1,274	1,379	1,867,195
Total revenues	**1,454,015**	**—**	**1,454,015**	**925**	**555**	**5,895**	**302**	**1,331**	**9,008**	**29,388,313**
EXPENDITURES										
Current:										
General government	19,062	—	19,062	—	279,030	—	—	1,964	280,994	9,228,234
Education	—	—	—	—	—	1,282,647	—	—	1,282,647	1,540,416
Health and human services	—	—	—	—	—	—	—	—	—	16,713,581
Resources	—	—	—	—	—	—	—	18,573	18,573	214,109
State and consumer services	—	—	—	—	—	—	—	—	—	408,204
Business and transportation	—	—	—	—	—	—	—	—	—	391,863
Correctional programs	—	—	—	—	—	—	—	—	—	1,299,663
Capital outlay	—	—	—	236,018	489	18,563	—	32,901	287,971	287,978
Debt service:										
Bond and commercial paper retirement	1,178,735	151,886	1,330,621	372,085	—	330,230	38,400	37,755	778,470	3,310,374
Interest and fiscal charges	250,472	525,838	776,310	16,398	—	98,917	18,390	782	134,487	1,221,434
Total expenditures	**1,448,269**	**677,724**	**2,125,993**	**624,501**	**279,519**	**1,730,357**	**56,790**	**91,975**	**2,783,142**	**34,615,856**
Excess (deficiency) of revenues over (under) expenditures	5,746	(677,724)	(671,978)	(623,576)	(278,964)	(1,724,462)	(56,488)	(90,644)	(2,774,134)	(5,227,543)
OTHER FINANCING SOURCES (USES)										
General obligation bonds and commercial paper issued	—	—	—	290,690	10,500	844,680	—	—	1,145,870	1,452,085
Refunding debt issued	—	—	—	549,275	—	2,260,055	—	39,180	2,848,510	3,524,010
Payment to refund long-term debt	—	—	—	(279,375)	—	(2,155,570)	—	(4,950)	(2,439,895)	(2,440,605)
Premium on bonds issued	—	—	—	68,583	—	324,117	—	4,307	397,007	457,455
Remarketing bonds issued	—	—	—	—	—	—	—	—	—	228,000
Payment to remarketing agent	—	—	—	—	—	—	—	—	—	(226,968)
Transfers in	—	677,724	677,724	16,540	—	—	53,244	46,171	115,955	1,755,087
Transfers out	—	—	—	—	—	—	—	(93)	(93)	(357,950)
Total other financing sources (uses)	**—**	**677,724**	**677,724**	**645,713**	**10,500**	**1,273,282**	**53,244**	**84,615**	**2,067,354**	**4,391,114**
Net change in fund balances	5,746	—	5,746	22,137	(268,464)	(451,180)	(3,244)	(6,029)	(706,780)	(836,429)
Fund balances – beginning	**659,122**	**—**	**659,122**	**208,997**	**330,483** *	**896,790**	**81,965**	**72,744**	**1,590,979**	12,093,335 *
Fund balances – ending	**$ 664,868**	**$ —**	**$ 664,868**	**$ 231,134**	**$ 62,019**	**$ 445,610**	**$ 78,721**	**$ 66,715**	**$ 884,199**	**$ 11,256,906**

* Restated

(concluded)

Budgetary Comparison Schedule

Budgetary Basis

Nonmajor Governmental Funds

Year Ended June 30, 2013
(amounts in thousands)

	Budget Amounts	Actual Amounts	Variance With Final Budget
REVENUES			
Cigarette and tobacco taxes	$ 500,140	$ 500,140	$ —
Vehicle license fees	1,498,470	1,498,470	—
Personal income tax	1,204,444	1,204,444	—
Retail sales and use taxes	12,800,256	12,800,256	—
Other major taxes and licenses	35,724	35,724	—
Other revenues	12,528,734	12,528,734	—
Total revenues	**28,567,768**	**28,567,768**	—
EXPENDITURES			
State and consumer services	470,499	424,553	45,946
Business and transportation	853,173	843,964	9,209
Resources	266,905	212,260	54,645
Health and human services	25,659,235	19,712,511	5,946,724
Correctional programs	32,477	31,210	1,267
Education	1,291,834	1,223,379	68,455
General government	9,936,469	9,733,693	202,776
Total expenditures	**38,510,592**	**32,181,570**	**6,329,022**
OTHER FINANCING SOURCES (USES)			
Transfers from other funds	—	21,698,047	—
Transfers to other funds	—	(20,409,763)	—
Other additions and deductions	—	392,365	—
Total other financing sources (uses)	—	**1,680,649**	—
Excess (deficiency) of revenues and other sources over (under) expenditures and other uses	—	(1,933,153)	—
Fund balances – beginning	—	**13,587,479**	—
Fund balances – ending	$ —	**$ 11,654,326**	$ —

This page intentionally left blank.

This page intentionally left blank.

Internal Service Funds

Internal service funds account for state activities that provide goods and services to other state departments or agencies on a cost reimbursement basis. Following are brief descriptions of the internal service funds.

The **Architecture Revolving Fund** accounts for charges for the costs of architectural services, construction, and improvements.

The **Service Revolving Fund** accounts for charges for printing and procurement services rendered by the Department of General Services for state departments and other public entities.

The **Prison Industries Fund** accounts for charges for goods produced by inmates in state prisons that are sold to state departments and other governmental entities.

The **Office of Systems Integration Fund** accounts for project management service costs associated with automation projects for the Department of Social Services and the Employment Development Department.

The **Technology Services Revolving Fund** accounts for charges for technology services performed for various state, federal, and local government entities by the California Technology Agency.

The **Water Resources Revolving Fund** accounts for charges for administrative services related to water delivery provided by the Department of Water Resources to federal, state, and local government agencies.

Other internal service program funds account for all other goods and services provided to other agencies, departments, or governments on a cost-reimbursement basis.

Combining Statement of Net Position

Internal Service Funds

June 30, 2013
(amounts in thousands)

	Architecture Revolving	Service Revolving	Prison Industries	Office of Systems Integration	Technology Services Revolving	Water Resources Revolving	Other Internal Service Programs	Total
ASSETS								
Current assets:								
Cash and pooled investments	$ 256,790	$ 112,102	$ 169,364	$ 25,086	$ 42,202	$ 10,971	$ 324,496	$ 941,011
Receivables (net)	80	14,269	1,589	4	5,823	21,313	2,587	45,665
Due from other funds	19,985	15,922	4,582	93,371	40,158	69,576	67,295	310,889
Due from other governments	—	7,166	204	—	529	—	65	7,964
Prepaid items	10,408	83,634	181	301	479	11,465	3,224	109,692
Inventories	—	9,072	40,809	—	33,832	1,197	—	84,910
Total current assets	287,263	242,165	216,729	118,762	123,023	114,522	397,667	1,500,131
Noncurrent assets:								
Interfund receivables	—	—	—	—	—	—	16,975	16,975
Capital assets:								
Land	—	—	—	—	—	—	2,312	2,312
Buildings and other depreciable property	409	132,168	150,562	—	309,957	29,037	11,689	633,822
Intangible assets – amortizable	—	7,552	3,672	—	47,830	—	11	59,065
Less: accumulated depreciation/amortization	(409)	(119,210)	(112,372)	—	(260,898)	(29,037)	(6,846)	(528,772)
Construction in progress	—	—	1,122	—	—	—	111	1,233
Intangible assets – non-amortizable	—	—	—	—	—	—	29,358	29,358
Total noncurrent assets	—	20,510	42,984	—	96,889	—	53,610	213,993
Total assets	**287,263**	**262,675**	**259,713**	**118,762**	**219,912**	**114,522**	**451,277**	**1,714,124**
DEFERRED OUTFLOWS OF RESOURCES	—	—	—	—	—	—	—	—
Total assets and deferred outflows of resources	**$ 287,263**	**$ 262,675**	**$ 259,713**	**$ 118,762**	**$ 219,912**	**$ 114,522**	**$ 451,277**	**$ 1,714,124**
LIABILITIES								
Current liabilities:								
Accounts payable	$ 12,162	$ 24,188	$ 9,314	$ 118,739	$ 18,339	$ 17,329	$ 64,661	$ 264,732
Due to other funds	2	73,792	6,236	23	327	930	26,161	107,471
Due to component units	—	—	—	—	—	—	2	2
Due to other governments	—	—	—	—	1,198	32	50	1,280
Revenues received in advance	278,365	21,793	1,985	—	—	81	29,358	331,582
Deposits	—	476	—	—	—	—	285	761
Contracts and notes payable	—	22	—	—	10,693	—	—	10,715
Current portion of long-term obligations	—	—	13,017	—	4,277	—	691	17,985
Other liabilities	1,657	19	1,046	—	—	1,633	4,758	9,113
Total current liabilities	292,186	120,290	31,598	118,762	34,834	20,005	125,966	743,641
Noncurrent liabilities:								
Interfund payables	—	4,382	—	—	1,863	95,215	37,822	139,282
Compensated absences payable	9,243	71,829	—	—	21,344	56,982	3,502	162,900
Net other postemployment benefits obligation	11,205	190,755	39,449	7,550	55,866	—	60,461	365,286
Other noncurrent liabilities	954	18,950	13,343	—	17,504	—	—	50,751
Total noncurrent liabilities	21,402	285,916	52,792	7,550	96,577	152,197	101,785	718,219
Total liabilities	**313,588**	**406,206**	**84,390**	**126,312**	**131,411**	**172,202**	**227,751**	**1,461,860**
DEFERRED INFLOWS OF RESOURCES	—	—	—	—	—	—	—	—
Total liabilities and deferred inflows of resources	**313,588**	**406,206**	**84,390**	**126,312**	**131,411**	**172,202**	**227,751**	**1,461,860**
NET POSITION								
Investment in capital assets	—	20,510	29,984	—	70,257	—	6,708	127,459
Unrestricted	(26,325)	(164,041)	145,339	(7,550)	18,244	(57,680)	216,818	124,805
Total net position (deficits)	**(26,325)**	**(143,531)**	**175,323**	**(7,550)**	**88,501**	**(57,680)**	**223,526**	**252,264**
Total liabilities, deferred inflows of resources, and net position	**$ 287,263**	**$ 262,675**	**$ 259,713**	**$ 118,762**	**$ 219,912**	**$ 114,522**	**$ 451,277**	**$ 1,714,124**

Combining Statement of Revenues, Expenses, and Changes in Fund Net Position

Internal Service Funds

Year Ended June 30, 2013

(amounts in thousands)

	Architecture Revolving	Service Revolving	Prison Industries	Office of Systems Integration	Technology Services Revolving	Water Resources Revolving	Other Internal Service Programs	Total
OPERATING REVENUES								
Services and sales	$ 179,143	$ 728,317	$ 214,724	$ 292,264	$ 313,156	$ 306,128	$ 293,814	$ 2,327,546
Total operating revenues	**179,143**	**728,317**	**214,724**	**292,264**	**313,156**	**306,128**	**293,814**	**2,327,546**
OPERATING EXPENSES								
Personal services	29,013	250,525	59,454	229	139,381	355,126	29,527	863,255
Supplies	—	—	2,187	—	—	7,185	1,039	10,411
Services and charges	150,389	500,884	140,353	299,585	176,774	(77)	331,736	1,599,644
Depreciation	—	10,819	6,195	—	30,506	1,098	544	49,162
Total operating expenses	**179,402**	**762,228**	**208,189**	**299,814**	**346,661**	**363,332**	**362,846**	**2,522,472**
Operating income (loss)	(259)	(33,911)	6,535	(7,550)	(33,505)	(57,204)	(69,032)	(194,926)
NONOPERATING REVENUES (EXPENSES)								
Investment and interest income	—	—	209	—	143	—	413	765
Interest expense and fiscal charges	—	—	(2)	—	(392)	—	—	(394)
Other	—	—	(792)	—	(105)	—	—	(897)
Total nonoperating revenues (expenses)	**—**	**—**	**(585)**	**—**	**(354)**	**—**	**413**	**(526)**
Income (loss) before capital contributions and transfers	(259)	(33,911)	5,950	(7,550)	(33,859)	(57,204)	(68,619)	(195,452)
Transfers in	—	—	—	—	4,730	—	—	4,730
Transfers out	—	(46,270)	(13,000)	—	—	—	(2,227)	(61,497)
Change in net position	(259)	(80,181)	(7,050)	(7,550)	(29,129)	(57,204)	(70,846)	(252,219)
Total net position (deficit) – beginning	**(26,066)**	**(63,350)**	**182,373**	**—**	**117,630**	**(476)**	**294,372**	**504,483**
Total net position (deficit) – ending	**$ (26,325)**	**$ (143,531)**	**$ 175,323**	**$ (7,550)**	**$ 88,501**	**$ (57,680)**	**$ 223,526**	**$ 252,264**

Combining Statement of Cash Flows

Internal Service Funds

Year Ended June 30, 2013
(amounts in thousands)

	Architecture Revolving	Service Revolving	Prison Industries	Office of Systems Integration	Technology Services Revolving	Water Resources Revolving	Other Internal Service Programs	Total
CASH FLOW FROM OPERATING ACTIVITIES								
Receipts from customers	$ 209,380	$ 762,493	$ 212,243	$ 299,589	$ 334,845	$ 346,229	$ 322,673	$ 2,487,452
Receipts from interfund services provided	5,843	1,319	8,266	—	—	7,275	18,078	40,781
Payments to suppliers	(162,636)	(467,476)	(141,148)	(213,625)	(188,959)	138	(315,950)	(1,489,656)
Payments to employees	(27,445)	(208,629)	(51,546)	—	(126,113)	(344,905)	(10,885)	(769,523)
Payments for interfund services used	—	(31,941)	(11,146)	(85,012)	(7,524)	(23,744)	(43,903)	(203,270)
Other receipts (payments)	144	1,321	(114)	(535)	—	527	(12,974)	(11,631)
Net cash provided by (used in) operating activities	**25,286**	**57,087**	**16,555**	**417**	**12,249**	**(14,480)**	**(42,961)**	**54,153**
CASH FLOWS FROM NONCAPITAL FINANCING ACTIVITIES								
Change in interfund payables and loans payable	—	(536)	—	—	—	(76)	—	(612)
Interest paid on operating debt	—	—	(3)	—	—	—	—	(3)
Transfers in	—	—	—	—	4,730	—	—	4,730
Transfers out	—	(46,270)	(13,000)	—	—	—	(2,227)	(61,497)
Net cash provided by (used in) noncapital financing activities	**—**	**(46,806)**	**(13,003)**	**—**	**4,730**	**(76)**	**(2,227)**	**(57,382)**
CASH FLOWS FROM CAPITAL AND RELATED FINANCING ACTIVITIES								
Acquisition of capital assets	—	(6,559)	(6,026)	—	(17,455)	(1,098)	(29,790)	(60,928)
Proceeds from sale of capital assets	—	615	734	—	—	—	—	1,349
Principal paid on notes payable and commercial paper	—	—	—	—	(10,912)	—	—	(10,912)
Interest paid	—	—	—	—	(392)	—	—	(392)
Net cash used in capital and related financing activities	**—**	**(5,944)**	**(5,292)**	**—**	**(28,759)**	**(1,098)**	**(29,790)**	**(70,883)**
CASH FLOWS FROM INVESTING ACTIVITIES								
Changes in interfund receivables and loans receivable	25,525	35,643	57,836	8,468	17,806	—	135,787	281,065
Earnings on investments	—	—	234	—	176	—	413	823
Net cash provided by (used in) investing activities	**25,525**	**35,643**	**58,070**	**8,468**	**17,982**	**—**	**136,200**	**281,888**
Net increase (decrease) in cash and pooled investments	50,811	39,980	56,330	8,885	6,202	(15,654)	61,222	207,776
Cash and pooled investments – beginning	**205,979**	**72,122**	**113,034**	**16,201**	**36,000**	**26,625**	**263,274**	**733,235**
Cash and pooled investments – ending	**$ 256,790**	**$ 112,102**	**$ 169,364**	**$ 25,086**	**$ 42,202**	**$ 10,971**	**$ 324,496**	**$ 941,011**

(continued)

Combining Statement of Cash Flows (continued)

Internal Service Funds

Year Ended June 30, 2013
(amounts in thousands)

	Architecture Revolving	Service Revolving	Prison Industries	Office of Systems Integration	Technology Services Revolving	Water Resources Revolving	Other Internal Service Programs	Total
RECONCILIATION OF OPERATING INCOME (LOSS) TO NET CASH PROVIDED BY (USED IN) OPERATING ACTIVITIES								
Operating income (loss)	$ (259)	$ (33,911)	$ 6,535	$ (7,550)	$ (33,505)	$ (57,204)	$ (69,032)	$ (194,926)
Adjustments to reconcile operating income (loss) to net cash provided by operating activities:								
Interest expense on operating debt	—	—	(114)	—	—	—	—	(114)
Depreciation	—	10,819	6,195	—	30,506	1,098	544	49,162
Change in assets, deferred outflows of resources, and liabilities, deferred inflows of resources:								
Receivables	1,174	34,001	(182)	7,325	6,265	40,079	(499)	88,163
Due from other funds	6,018	(9,958)	(1,980)	(84,952)	7,998	(17,399)	(24,470)	(124,743)
Due from other governments	372	509	27	—	205	—	7	1,120
Prepaid items	(10,381)	(3,369)	80	(22)	1,012	4,461	1,310	(6,909)
Inventories	—	13,893	885	—	(7,933)	(391)	—	6,454
Other current assets	—	—	—	—	43	—	—	43
Accounts payable	(1,863)	22,884	(9,472)	85,982	(7,484)	3,176	14,970	108,193
Due to other funds	(175)	(20,664)	6,236	(60)	782	930	(10,820)	(23,771)
Due to component units	—	—	—	(535)	—	14	(511)	(1,032)
Due to other governments	—	—	—	—	1,198	—	20	1,218
Deposits	—	(240)	—	—	—	—	(6,682)	(6,922)
Contracts and notes payable	—	—	—	—	—	—	—	—
Current portion of revenues received in advance	29,063	175	—	—	(34)	22	29,358	58,584
Interest payable	—	—	296	—	—	—	—	296
Other current liabilities	(228)	(138)	882	—	—	513	4,537	5,566
Interfund payables	—	—	—	—	(29)	—	—	(29)
Benefits payables	—	36,531	—	—	(344)	—	—	36,187
Compensated absences payable	(98)	6,555	246	—	(824)	10,221	1,443	17,543
Capital lease obligations	—	—	—	—	—	—	—	—
Other noncurrent liabilities	1,663	—	6,921	229	14,393	—	16,864	40,070
Total adjustments	25,545	90,998	10,020	7,967	45,754	42,724	26,071	249,079
Net cash provided by (used in) operating activities	**$ 25,286**	**$ 57,087**	**$ 16,555**	**$ 417**	**$ 12,249**	**$ (14,480)**	**$ (42,961)**	**$ 54,153**
								(concluded)
Noncash investing, capital, and financing activities								
Capital acquisitions financed through notes payable	$ —	$ —	$ —	$ —	$ —	$ —	$ 15,144	$ 15,144

This page intentionally left blank.

Nonmajor Enterprise Funds

Enterprise funds account for operations that are financed and operated in a manner similar to private business enterprises, where the costs of providing goods or services to the general public on a continuing basis are intended to be financed or recovered primarily through user charges. Following are brief descriptions of nonmajor enterprise funds.

The **High Technology Education Fund** accounts for construction and renovation of public buildings for educational and research purposes related to specific fields of high technology.

The **State Water Pollution Control Revolving Fund** accounts for loans to finance the construction of publicly owned water pollution control facilities.

The **Housing Loan Fund** accounts for financing and contracts for the sale of properties to eligible California veterans.

Other enterprise program funds account for all other goods or services provided to the general public on a continuing basis when all or most of the cost involved is to be financed by user charges, or when periodic measurement of the results of operations is appropriate for management control, accountability, capital maintenance, public policy, or other purposes.

Combining Statement of Net Position

Nonmajor Enterprise Funds

June 30, 2013
(amounts in thousands)

	High Technology Education	State Water Pollution Control	Housing Loan	Other Enterprise Programs	Total
ASSETS					
Current assets:					
Cash and pooled investments	$ —	$ 375,782	$ 191,748	$ 244,758	$ 812,288
Restricted assets:					
Cash and pooled investments	20,414	14,157	—	—	34,571
Due from other governments	—	20,448	—	—	20,448
Net investment in direct financing leases	19,306	—	—	—	19,306
Receivables (net)	3,396	—	42,438	281	46,115
Due from other funds	19	1,862	117	334	2,332
Due from other governments	—	203,078	—	1,283	204,361
Prepaid items	—	—	—	1	1
Inventories	—	—	—	2,699	2,699
Other current assets	—	—	—	—	—
Total current assets	43,135	615,327	234,303	249,356	1,142,121
Noncurrent assets:					
Restricted assets:					
Cash and pooled investments	—	—	—	—	—
Investments	10,662	—	—	—	10,662
Loans receivable	—	325,930	—	—	325,930
Investments	—	—	22,701	—	22,701
Net investment in direct financing leases	—	—	—	—	—
Interfund receivables	—	4,000	—	1,600	5,600
Loans receivable	—	2,655,430	885,163	121,042	3,661,635
Long-term prepaid charges	—	—	2,371	—	2,371
Capital assets:					
Land	—	—	443	829	1,272
Buildings and other depreciable property	—	—	16,132	1,843	17,975
Intangible assets – amortizable	—	—	—	1,350	1,350
Less: accumulated depreciation/amortization	—	—	(15,712)	(1,216)	(16,928)
Intangible assets – non-amortizable	—	—	—	181	181
Other noncurrent assets	—	—	15,501	—	15,501
Total noncurrent assets	10,662	2,985,360	926,599	125,629	4,048,250
Total assets	**53,797**	**3,600,687**	**1,160,902**	**374,985**	**5,190,371**
DEFERRED OUTFLOWS OF RESOURCES	**3,760**	—	—	—	**3,760**
Total assets and deferred outflows of resources	**$ 57,557**	**$ 3,600,687**	**$ 1,160,902**	**$ 374,985**	**$ 5,194,131**

(continued)

Combining Statement of Net Position (continued)

Nonmajor Enterprise Funds

June 30, 2013

(amounts in thousands)

	High Technology Education	State Water Pollution Control	Housing Loan	Other Enterprise Programs	Total
LIABILITIES					
Current liabilities:					
Accounts payable	$ —	$ 4	$ 201	$ 3,915	$ 4,120
Due to other funds	—	156	166	2,612	2,934
Due to other governments	—	57	—	3	60
Revenues received in advance	—	6	—	36	42
Deposits	—	—	—	—	—
Interest payable	106	566	12,040	—	12,712
Current portion of long-term obligations	23,466	14,619	100	26	38,211
Other current liabilities	—	—	—	16	16
Total current liabilities	23,572	15,408	12,507	6,608	58,095
Noncurrent liabilities:					
Compensated absences payable	—	—	—	2,776	2,776
General obligation bonds payable	—	—	584,033	—	584,033
Revenue bonds payable	—	59,236	420,179	—	479,415
Net other postemployment benefits obligation	—	—	1,316	5,463	6,779
Other noncurrent liabilities	—	—	—	75,360	75,360
Total noncurrent liabilities	—	59,236	1,005,528	83,599	1,148,363
Total liabilities	**23,572**	**74,644**	**1,018,035**	**90,207**	**1,206,458**
DEFERRED INFLOWS OF RESOURCES	—	—	—	—	—
Total liabilities and deferred inflows of resources	**23,572**	**74,644**	**1,018,035**	**90,207**	**1,206,458**
NET POSITION					
Investment in capital assets	—	—	863	1,953	2,816
Restricted – expendable:					
Debt service	33,985	14,157	142,004	—	190,146
Security for revenue bonds	—	346,377	—	—	346,377
Other purposes	—	—	—	210,662	210,662
Total expendable	33,985	360,534	142,004	210,662	747,185
Unrestricted	—	3,165,509	—	72,163	3,237,672
Total net position	**33,985**	**3,526,043**	**142,867**	**284,778**	**3,987,673**
Total liabilities, deferred inflows of resources, and net position	**$ 57,557**	**$ 3,600,687**	**$ 1,160,902**	**$ 374,985**	**$ 5,194,131**

(concluded)

Combining Statement of Revenues, Expenses, and Changes in Fund Net Position

Nonmajor Enterprise Funds

Year Ended June 30, 2013
(amounts in thousands)

	High Technology Education	State Water Pollution Control	Housing Loan	Other Enterprise Programs	Total
OPERATING REVENUES					
Services and sales	$ —	$ 8,531	$ 6,707	$ 77,457	$ 92,695
Investment and interest	136	50,680	57,533	244	108,593
Rent	5,449	—	—	1,792	7,241
Other	—	—	1,635	504	2,139
Total operating revenues	**5,585**	**59,211**	**65,875**	**79,997**	**210,668**
OPERATING EXPENSES					
Personal services	—	184	7,685	6,111	13,980
Services and charges	—	1,199	10,684	51,964	63,847
Depreciation	—	—	48	503	551
Interest expense	6,568	—	47,624	—	54,192
Amortization (recovery) of long-term prepaid charges	—	—	255	—	255
Other	—	871	—	—	871
Total operating expenses	**6,568**	**2,254**	**66,296**	**58,578**	**133,696**
Operating income (loss)	(983)	56,957	(421)	21,419	76,972
NONOPERATING REVENUES (EXPENSES)					
Investment and interest income	—	962	175	524	1,661
Interest expense and fiscal charges	—	(533)	—	—	(533)
Other	—	(911)	(4,060)	19	(4,952)
Total nonoperating revenues (expenses)	—	**(482)**	**(3,885)**	**543**	**(3,824)**
Income (loss) before capital contributions and transfers	(983)	56,475	(4,306)	21,962	73,148
Capital contributions	—	141,823	—	—	141,823
Transfers out	(202)	—	—	(11,584)	(11,786)
Change in net position	(1,185)	198,298	(4,306)	10,378	203,185
Total net position – beginning	**35,170** *	**3,327,745**	**147,173** *	**274,400**	**3,784,488** *
Total net position – ending	**$ 33,985**	**$ 3,526,043**	**$ 142,867**	**$ 284,778**	**3,987,673**

* Restated

Combining Statement of Cash Flows

Nonmajor Enterprise Funds

Year Ended June 30, 2013

(amounts in thousands)

	High Technology Education	State Water Pollution Control	Housing Loan	Other Enterprise Programs	Total
CASH FLOWS FROM OPERATING ACTIVITIES					
Receipts from customers/employers	$ —	$ 53,573	$ 235,124	$ 78,316	$ 367,013
Receipts from interfund services provided	—	57	7	354	418
Payments to suppliers	—	(2,360)	(17,070)	(48,057)	(67,487)
Payments to employees	—	(184)	(6,051)	(4,758)	(10,993)
Payments for interfund services used	—	(6)	(5)	(508)	(519)
Claims paid to other than employees	—	—	—	—	—
Other receipts (payments)	23,167	(35,343)	12,711	(27,965)	(27,430)
Net cash provided by (used in) operating activities	**23,167**	**15,737**	**224,716**	**(2,618)**	**261,002**
CASH FLOWS FROM NONCAPITAL FINANCING ACTIVITIES					
Change in interfund payables and loans payable	—	—	—	5	5
Proceeds from general obligation bonds	—	—	—	—	—
Retirement of general obligation bonds	—	(114,695)	(172,199)	—	(286,894)
Retirement of revenue bonds	(22,275)	(4,925)	(51,555)	—	(78,755)
Interest paid on operating debt	—	—	—	—	—
Grant provided	—	—	—	—	—
Transfers in	—	—	—	—	—
Transfers out	(202)	(4,000)	(202)	(11,583)	(15,987)
Net cash provided by (used in) noncapital financing activities	**(22,477)**	**(123,620)**	**(223,956)**	**(11,578)**	**(381,631)**
CASH FLOWS FROM CAPITAL AND RELATED FINANCING ACTIVITIES					
Changes in interfund payables and loans payable	—	—	—	189	189
Acquisition of capital assets	—	—	(316)	(376)	(692)
Proceeds from sale of capital assets	—	—	—	47	47
Grants received	—	216,705	—	—	216,705
Net cash provided by (used in) capital and related financing activities	**—**	**216,705**	**(316)**	**(140)**	**216,249**
CASH FLOWS FROM INVESTING ACTIVITIES					
Proceeds from maturity and sale of investments	—	—	6,559	—	6,559
Change in interfund receivables and loans receivable	—	6,584	12,646	14,170	33,400
Earnings on investments	—	983	202	524	1,709
Net cash provided by (used in) investing activities	**—**	**7,567**	**19,407**	**14,694**	**41,668**
Net increase (decrease) in cash and pooled investments	690	116,389	19,851	358	137,288
Cash and pooled investments – beginning	**19,724**	**273,550**	**171,897**	**244,400**	**709,571**
Cash and pooled investments – ending	**$ 20,414**	**$ 389,939**	**$ 191,748**	**$ 244,758**	**$ 846,859**

(continued)

Combining Statement of Cash Flows (continued)

Nonmajor Enterprise Funds

Year Ended June 30, 2013

(amounts in thousands)

	High Technology Education	State Water Pollution Control	Housing Loan	Other Enterprise Programs	Total
RECONCILIATION OF OPERATING INCOME (LOSS) TO					
NET CASH PROVIDED BY (USED IN) OPERATING ACTIVITIES					
Operating income (loss)	$ (983)	$ 56,957	$ (421)	$ 21,419	$ 76,972
Adjustments to reconcile operating income (loss) to net cash provided by operating activities:					
Depreciation	—	—	48	503	551
Accretion of capital appreciation bonds	—	—	3,936	—	3,936
Provisions and allowances	—	—	—	—	—
Amortization of discounts	47	—	—	—	47
Amortization of long-term prepaid charges	4,104	—	255	—	4,359
Other	747	(7,639)	—	18	(6,874)
Change in assets, deferred outflows of resources, and liabilities, deferred inflows of resources:					
Receivables	1	—	1,422	276	1,699
Due from other funds	9	(37)	2,775	3,118	5,865
Due from other governments	—	660	15	361	1,036
Prepaid items	—	—	—	11	11
Inventories	—	—	—	593	593
Net investment in direct financing leases	19,342	—	—	—	19,342
Other current assets	—	—	2,061	2,140	4,201
Loans receivable	—	(33,789)	219,637	(1,385)	184,463
Interfund receivables	—	—	—	—	—
Accounts payable	—	4	(3,023)	949	(2,070)
Due to other funds	—	(207)	(2,370)	124	(2,453)
Due to other governments	—	—	—	(302)	(302)
Deposits	—	—	—	(71)	(71)
Current portion of revenues received in advance	—	—	—	(9)	(9)
Interest payable	(100)	—	—	—	(100)
Other current liabilities	—	—	154	(7,728)	(7,574)
Benefits payable	—	—	—	82	82
Compensated absences payable	—	—	—	100	100
Long-term portion of revenues received in advance	—	(212)	—	—	(212)
Other noncurrent liabilities	—	—	227	(22,817)	(22,590)
Total adjustments	24,150	(41,220)	225,137	(24,037)	184,030
Net cash provided by (used in) operating activities	**$ 23,167**	**$ 15,737**	**$ 224,716**	**$ (2,618)**	**$ 261,002**

(concluded)

This page intentionally left blank.

Private Purpose Trust Funds

Private purpose trust funds account for all trust arrangements, other than those properly reported in pension and other employee benefit trust funds or investment trust funds, under which both principal and income benefit individuals, private organizations, or other governments. Following are brief descriptions of private purpose trust funds.

The **Scholarshare Program Trust Fund** accounts for money received from participants to fund their beneficiaries' higher-education expenses at certain postsecondary educational institutions.

The **Unclaimed Property Fund** accounts for unclaimed money and properties held in trust by the State.

Other private purpose trust funds account for other assets held in a trustee capacity when both principal and income benefit individuals, private organizations, or other governments.

Combining Statement of Fiduciary Net Position

Private Purpose Trust Funds

June 30, 2013

(amounts in thousands)

	Scholarshare Program Trust	Unclaimed Property	Other Private Purpose Trust	Total
ASSETS				
Cash and pooled investments	$ 1	$ 97,748	$ 1,596	$ 99,345
Investments, at fair value:				
Equity securities	2,600,359	—	—	2,600,359
Debt securities	1,591,782	—	—	1,591,782
Real estate	165,882	—	—	165,882
Other	698,174	—	—	698,174
Total investments	5,056,197	—	—	5,056,197
Receivables (net)	5,760	254	—	6,014
Due from other funds	—	—	2	2
Interfund receivables	—	—	—	—
Other assets	—	210,418	—	210,418
Total assets	**5,061,958**	**308,420**	**1,598**	**5,371,976**
DEFERRED OUTFLOWS OF RESOURCES	—	—	—	—
Total assets and deferred outflows of resources	**$ 5,061,958**	**$ 308,420**	**$ 1,598**	**$ 5,371,976**
LIABILITIES				
Accounts payable	$ 6,180	$ —	$ 192	$ 6,372
Deposits	—	210,418	—	210,418
Other liabilities	—	55	475	530
Total liabilities	**6,180**	**210,473**	**667**	**217,320**
DEFERRED INFLOWS OF RESOURCES	—	—	—	—
Total liabilities and deferred inflows of resources	**6,180**	**210,473**	**667**	**217,320**
NET POSITION				
Held in trust for benefits and other purposes	**$ 5,055,778**	**$ 97,947**	**$ 931**	**$ 5,154,656**

Combining Statement of Changes in Fiduciary Net Position

Private Purpose Trust Funds

Year Ended June 30, 2013

(amounts in thousands)

	Scholarshare Program Trust	Unclaimed Property	Other Private Purpose Trust	Total
ADDITIONS				
Investment income:				
Net appreciation (depreciation) in fair value of investments	$ 288,283	$ —	$ —	$ 288,283
Interest, dividends, and other investment income	165,302	—	—	165,302
Less: investment expense	(4,519)	—	—	(4,519)
Net investment income	449,066	—	—	449,066
Receipts from depositors	2,351,936	173,416	280	2,525,632
Total additions	**2,801,002**	**173,416**	**280**	**2,974,698**
DEDUCTIONS				
Administrative expenses	—	—	1	1
Payments to and for depositors	2,246,548	238,287	327	2,485,162
Total deductions	**2,246,548**	**238,287**	**328**	**2,485,163**
Change in net position	554,454	(64,871)	(48)	489,535
Net position – beginning	**4,501,324**	**162,818**	**979**	**4,665,121**
Net position – ending	**$ 5,055,778**	**$ 97,947**	**$ 931**	**$ 5,154,656**

This page intentionally left blank.

Fiduciary Funds and Similar Component Units – Pension and Other Employee Benefit Trust Funds

Pension and other employee benefit trust funds account for transactions, assets, liabilities, and net position available for pension and other employee benefits of the two public employees' retirement systems that are fiduciary component units and for other primary government employee benefit programs. Following are brief descriptions of pension and other employee benefit trust funds.

The **Public Employees' Retirement Fund** is administered by the California Public Employees' Retirement System (CalPERS) and accounts for the employee and employer contributions of the agent multiple-employer retirement plan that provides pension benefits to employees of the State of California, non-teaching school employees, and employees of California public agencies.

The **State Teachers' Retirement Fund** is administered by the California State Teachers' Retirement System (CalSTRS) and accounts for the employee, employer, and primary government contributions of the cost-sharing multiple-employer retirement plan that provides pension benefits to teachers and certain other employees of the California public school system.

The **Deferred Compensation Fund** accounts for moneys withheld from the salaries of participants per the Internal Revenue Code sections 401(k), 457, and 403(b). The moneys are invested until the employee retires or resigns, at which time all money withdrawn, including investment income, is subject to income taxes.

Other pension and other employee benefit trust funds account for funds contributed to smaller retirement plans and programs:

The Public Employees' Health Care Benefits Fund, the Teachers' Health Benefits Fund, the Judges' Retirement Fund, the Judges' Retirement Fund II, the Legislators' Retirement Fund, the State Peace Officers' and Firefighters' Defined Contribution Plan Fund, the Supplemental Contributions Program Fund, the Boxers' Pension Fund, and the Flexelect Benefit Fund.

Combining Statement of Fiduciary Net Position

Fiduciary Funds and Similar Component Units – Pension and Other Employee Benefit Trust Funds

June 30, 2013
(amounts in thousands)

	Public Employees' Retirement	State Teachers' Retirement	Deferred Compensation	Other Pension and Other Employee Benefit Trust	Total
ASSETS					
Cash and pooled investments	$ 2,572,223	$ 1,966,231	$ 18,637	$ 83,599	$ 4,640,690
Investments, at fair value:					
Short-term	6,508,352	1,992,333	148,792	91,835	8,741,312
Equity securities	131,631,222	86,932,597	6,609,082	2,477,488	227,650,389
Debt securities	51,645,943	28,868,737	3,350,185	854,298	84,719,163
Real estate	27,079,239	23,807,028	12,064	298,531	51,196,862
Other	41,444,382	23,946,481	489,136	388,646	66,268,645
Securities lending collateral	17,142,084	23,215,906	6,965	132,469	40,497,424
Total investments	275,451,222	188,763,082	10,616,224	4,243,267	479,073,795
Receivables (net)	1,885,322	3,189,527	17,405	35,428	5,127,682
Due from other funds	431,176	51,100	16	11	482,303
Due from other governments	—	18,010	8	—	18,018
Loans receivable	—	23,042	—	—	23,042
Other assets	710,722	238,829	—	—	949,551
Total assets	**281,050,665**	**194,249,821**	**10,652,290**	**4,362,305**	**490,315,081**
DEFERRED OUTFLOWS OF RESOURCES	—	—	—	—	—
Total assets and deferred outflows of resources	**$ 281,050,665**	**$ 194,249,821**	**$ 10,652,290**	**$ 4,362,305**	**$ 490,315,081**
LIABILITIES					
Accounts payable	$ 9,529	$ 2,583,166	$ 3,113	$ 1,776	$ 2,597,584
Due to other governments	—	78	—	1	79
Benefits payable	1,416,951	1,050,631	—	21,347	2,488,929
Securities lending obligations	16,888,638	23,246,453	6,882	130,879	40,272,852
Loans payable	—	937,494	—	—	937,494
Other liabilities	745,643	83,090	4,246	4,673	837,652
Total liabilities	**19,060,761**	**27,900,912**	**14,241**	**158,676**	**47,134,590**
DEFERRED INFLOWS OF RESOURCES	—	—	—	—	—
Total liabilities and deferred inflows of resources	**19,060,761**	**27,900,912**	**14,241**	**158,676**	**47,134,590**
NET POSITION					
Held in trust for benefits and other purposes	**$ 261,989,904**	**$ 166,348,909**	**$ 10,638,049**	**$ 4,203,629**	**$ 443,180,491**

Combining Statement of Changes in Fiduciary Net Position

Fiduciary Funds and Similar Component Units – Pension and Other Employee Benefit Trust Funds

Year Ended June 30, 2013
(amounts in thousands)

	Public Employees' Retirement	State Teachers' Retirement	Deferred Compensation	Other Pension and Other Employee Benefit Trust	Total
ADDITIONS					
Contributions:					
Employer	$ 8,123,833	$ 3,618,397	$ 761	$ 1,282,796	$ 13,025,787
Plan member	3,896,078	2,336,731	760,395	56,049	7,049,253
Total contributions	12,019,911	5,955,128	761,156	1,338,845	20,075,040
Investment income:					
Net appreciation (depreciation) in fair value of investments	28,011,736	16,225,186	151,781	378,915	44,767,618
Interest, dividends, and other investment income	4,947,074	4,819,536	897,073	2,420	10,666,103
Less: investment expense	(2,674,003)	(362,284)	(1,158)	(2,139)	(3,039,584)
Net investment income	30,284,807	20,682,438	1,047,696	379,196	52,394,137
Other	7,176	1,241	10,281	4,290	22,988
Total additions	**42,311,894**	**26,638,807**	**1,819,133**	**1,722,331**	**72,492,165**
DEDUCTIONS					
Distributions to beneficiaries	16,635,263	11,361,557	26,257	720,675	28,743,752
Refunds of contributions	242,595	104,994	82,587	58	430,234
Administrative expense	426,077	141,404	11,854	8,357	587,692
Interest expense	—	—	—	187,084	187,084
Payments to and for depositors	—	—	637,744	35,865	673,609
Total deductions	**17,303,935**	**11,607,955**	**758,442**	**952,039**	**30,622,371**
Change in net position	25,007,959	15,030,852	1,060,691	770,292	41,869,794
Net position – beginning	**236,981,945**	**151,318,057**	**9,577,358 ***	**3,433,337**	**401,310,697 ***
Net position – ending	**$ 261,989,904**	**$ 166,348,909**	**$ 10,638,049**	**$ 4,203,629**	**$ 443,180,491**

* Restated

This page intentionally left blank.

Agency Funds

Agency funds account for the receipt and disbursement of various taxes, deposits, deductions, and property collected by the State, acting in the capacity of an agent, for distribution to other governmental units or other organizations. Following are brief descriptions of agency funds.

The **Receipting and Disbursing Fund** accounts for the collection and disbursement of revenues and receipts on behalf of local governments. This fund also accounts for receipts from many state funds, typically for the purpose of writing a single warrant when the warrant is funded by multiple funding sources.

The **Deposit Fund** accounts for various deposits, such as those from condemnation and litigation proceedings.

Other agency activity funds account for other assets held by the State, which acts as an agent for individuals, private organizations, and other governments.

Combining Statement of Fiduciary Assets and Liabilities

Agency Funds

June 30, 2013

(amounts in thousands)

	Receipting and Disbursing	Deposit	Other Agency Activities	Total
ASSETS				
Cash and pooled investments	$ 2,369,714	$ 1,569,454	$ 29,377	$ 3,968,545
Receivables (net)	1,377,732	98,485	1,514	1,477,731
Due from other funds	18,212,542	57,832	690	18,271,064
Due from other governments	20,763	285	—	21,048
Prepaid Items	11,867	166	—	12,033
Interfund receivables	—	—	—	—
Loans receivable	—	—	7,153	7,153
Other assets	55	32	—	87
Total assets	**$ 21,992,673**	**$ 1,726,254**	**$ 38,734**	**$ 23,757,661**
LIABILITIES				
Accounts payable	$ 10,013,095	$ 69,213	$ 2,619	$ 10,084,927
Due to other governments	11,685,759	1,910	14,666	11,702,335
Tax overpayments	684	—	—	684
Benefits payable	220,767	—	—	220,767
Revenues received in advance	17,688	813	—	18,501
Deposits	40,547	943,471	5,500	989,518
Other liabilities	14,133	710,847	15,949	740,929
Total liabilities	**$ 21,992,673**	**$ 1,726,254**	**$ 38,734**	**$ 23,757,661**

This page intentionally left blank.

Combining Statement of Changes in Fiduciary Assets and Liabilities

Agency Funds

Year Ended June 30, 2013

(amounts in thousands)

Receipting and Disbursing Fund

	Balance July 1, 2012	Additions	Deductions	Balance June 30, 2013
ASSETS				
Cash and pooled investments	$ 925,523	$ 144,758,225	$ 143,314,034	$ 2,369,714
Receivables (net)	1,072,884	5,064,338	4,759,490	1,377,732
Due from other funds	21,578,395	15,272,958	18,638,811	18,212,542
Due from other governments	22,239	34,511	35,987	20,763
Prepaid items	24,517	—	12,650	11,867
Interfund receivables	885,790	—	885,790	—
Other assets	55	—	—	55
Total assets	**$ 24,509,403**	**$ 165,130,032**	**$ 167,646,762**	**$ 21,992,673**
LIABILITIES				
Accounts payable	$ 8,481,795	$ 40,696,975	$ 39,165,675	$ 10,013,095
Due to other governments	15,720,870	27,942,862	31,977,973	11,685,759
Tax overpayments	4,386	70,156	73,858	684
Benefits payable	199,087	4,794,397	4,772,717	220,767
Revenues received in advance	17,248	461	21	17,688
Deposits	69,578	155,612	184,643	40,547
Other liabilities	16,439	58,787	61,093	14,133
Total liabilities	**$ 24,509,403**	**$ 73,719,250**	**$ 76,235,980**	**$ 21,992,673**

Deposit Fund

	Balance July 1, 2012	Additions	Deductions	Balance June 30, 2013
ASSETS				
Cash and pooled investments	$ 1,212,067	$ 22,024,684	$ 21,667,297	$ 1,569,454
Receivables (net)	67,885	294,946	264,346	98,485
Due from other funds	73,910	39,221	55,299	57,832
Due from other governments	37,572	765	38,052	285
Prepaid items	1,702	2,252	3,788	166
Interfund receivables	159,708	—	159,708	—
Other assets	30	16	14	32
Total assets	**$ 1,552,874**	**$ 22,361,884**	**$ 22,188,504**	**$ 1,726,254**
LIABILITIES				
Accounts payable	$ 42,224	$ 1,174,423	$ 1,147,434	$ 69,213
Due to other governments	2,884	1,611	2,585	1,910
Revenues received in advance	1,457	117	761	813
Deposits	731,030	1,405,957	1,193,516	943,471
Other liabilities	775,279	18,549,946	18,614,378	710,847
Total liabilities	**$ 1,552,874**	**$ 21,132,054**	**$ 20,958,674**	**$ 1,726,254**

Other Agency Activity Funds

	Balance July 1, 2012	Additions	Deductions	Balance June 30, 2013
ASSETS				
Cash and pooled investments	$ 35,393	$ 6,113	$ 12,129	$ 29,377
Receivables (net)	1,510	4	—	1,514
Due from other funds	764	—	74	690
Interfund receivables	5,429	—	5,429	—
Loans receivable	7,942	—	789	7,153
Total assets	**$ 51,038**	**$ 6,117**	**$ 18,421**	**$ 38,734**
LIABILITIES				
Accounts payable	$ 4,672	$ —	$ 2,053	$ 2,619
Due to other governments	26,042	2	11,378	14,666
Deposits	6,343	3	846	5,500
Other liabilities	13,981	1,968	—	15,949
Total liabilities	**$ 51,038**	**$ 1,973**	**$ 14,277**	**$ 38,734**

Total

	Balance July 1, 2012	Additions	Deductions	Balance June 30, 2013
ASSETS				
Cash and pooled investments	$ 2,172,983	$ 166,789,022	$ 164,993,460	$ 3,968,545
Receivables (net)	1,142,279	5,359,288	5,023,836	1,477,731
Due from other funds	21,653,069	15,312,179	18,694,184	18,271,064
Due from other governments	59,811	35,276	74,039	21,048
Prepaid items	26,219	2,252	16,438	12,033
Interfund receivables	1,050,927	—	1,050,927	—
Loans receivable	7,942	—	789	7,153
Other assets	85	16	14	87
Total assets	**$ 26,113,315**	**$ 187,498,033**	**$ 189,853,687**	**$ 23,757,661**
LIABILITIES				
Accounts payable	$ 8,528,691	$ 41,871,398	$ 40,315,162	$ 10,084,927
Due to other governments	15,749,796	27,944,475	31,991,936	11,702,335
Tax overpayments	4,386	70,156	73,858	684
Benefits payable	199,087	4,794,397	4,772,717	220,767
Revenues received in advance	18,705	578	782	18,501
Deposits	806,951	1,561,572	1,379,005	989,518
Other liabilities	805,699	18,610,701	18,675,471	740,929
Total liabilities	**$ 26,113,315**	**$ 94,853,277**	**$ 97,208,931**	**$ 23,757,661**

This page intentionally left blank.

Nonmajor Component Units

Nonmajor component units are legally separate entities that are discretely presented in the State's financial statements in accordance with Generally Accepted Accounting Principles (GAAP). The inclusion of component units in the State's financial statements reflects the State's financial accountability or relationships with these organizations such that exclusion would cause the State's financial statements to be misleading. Following are brief descriptions of nonmajor consolidated component unit segments.

California State University Auxiliary Organizations provide services primarily to university students through foundations, associated student organizations, student unions, food service entities, book stores, and similar organizations.

Financing Authorities provide financing for transportation, business development and public improvements, and coastal and inland urban waterfront restoration projects. These agencies include: California Alternative Energy and Advanced Transportation Financing Authority, California Infrastructure and Economic Development Bank, and the California Urban Waterfront Area Restoration Financing Authority.

District Agricultural Associations were created to exhibit all of the industries, industrial enterprises, resources, and products of the state. The financial information presented is as of and for the year ended December 31, 2012.

Other component units provide legal education programs, financial assistance to businesses, and health benefits for state employees and annuitants. These entities include: University of California Hastings College of the Law; State Assistance Fund for Enterprise, Business and Industrial Development Corporation; and Public Employees' Contingency Reserve.

Combining Statement of Net Position

Nonmajor Component Units

June 30, 2013

(amounts in thousands)

	Financing Authorities	California State University Auxiliary Organizations	District Agricultural Associations	Other Component Units	Total
ASSETS					
Current assets:					
Cash and pooled investments	$ 3,024	$ 371,574	$ 70,846	$ 15,236	$ 460,680
Investments	—	382,026	1,975	6,113	390,114
Restricted assets:					
Cash and pooled investments	79,554	—	7,620	3,485	90,659
Investments	4,333	—	7,303	—	11,636
Receivables (net)	17,773	272,146	4,689	7,392	302,000
Due from primary government	13	—	—	—	13
Prepaid items	2	—	628	129	759
Inventories	—	—	—	—	—
Other current assets	—	39,822	196	—	40,018
Total current assets	104,699	1,065,568	93,257	32,355	1,295,879
Noncurrent assets:					
Restricted assets:					
Cash and pooled investments	—	34,218	—	—	34,218
Investments	9,798	—	4,700	—	14,498
Investments	—	1,528,714	—	60,095	1,588,809
Receivables (net)	—	270,473	—	14,189	284,662
Loans receivable	301,502	—	—	4,006	305,508
Long-term prepaid charges	—	—	—	—	—
Capital assets:					
Land	—	105,671	19,896	5,089	130,656
Collections – nondepreciable	—	8,264	—	—	8,264
Buildings and other depreciable property	8,784	1,127,018	683,761	139,895	1,959,458
Intangible assets – amortizable	8,286	10,790	—	1,093	20,169
Less: accumulated depreciation/ amortization	(16,742)	(474,067)	(400,468)	(51,186)	(942,463)
Construction in progress	—	14,077	5,259	—	19,336
Intangible assets – nonamortizable	49	5,082	—	—	5,131
Other noncurrent assets	—	35,877	329	8,094	44,300
Total noncurrent assets	311,677	2,666,117	313,477	181,275	3,472,546
Total assets	**416,376**	**3,731,685**	**406,734**	**213,630**	**4,768,425**
DEFERRED OUTFLOWS OF RESOURCES	**—**	**5,071**	**—**	**—**	**5,071**
Total assets and deferred outflows of resources	**$ 416,376**	**$ 3,736,756**	**$ 406,734**	**$ 213,630**	**$ 4,773,496**

	Financing Authorities	California State University Auxiliary Organizations	District Agricultural Associations	Other Component Units	Total
LIABILITIES					
Current liabilities:					
Accounts payable	$ 57	$ 80,300	$ 6,559	$ 7,801	$ 94,717
Revenue received in advance	—	59,420	2,337	874	62,631
Deposits	—	—	1,071	367	1,438
Contracts and notes payable	—	1,910	121	5,463	7,494
Interest payable	1,406	—	575	—	1,981
Current portion of long-term obligations	5,745	97,025	3,334	1,278	107,382
Other current liabilities	6,656	113,834	3,992	—	124,482
Total current liabilities	13,864	352,489	17,989	15,783	400,125
Noncurrent liabilities:					
Compensated absences payable	378	3,524	7,371	403	11,676
Certificates of participation, commercial paper, and other borrowings	—	63,170	—	—	63,170
Capital lease obligations	—	349,216	11	—	349,227
Net other postemployment benefits obligation	1,009	105,018	5,341	11,647	123,015
Revenue bonds payable	117,939	198,360	28,075	22,360	366,734
Other noncurrent liabilities	1,459	340,368	15,738	8,292	365,857
Total noncurrent liabilities	120,785	1,059,656	56,536	42,702	1,279,679
Total liabilities	**134,649**	**1,412,145**	**74,525**	**58,485**	**1,679,804**
DEFERRED INFLOWS OF RESOURCES	**—**	**2,481**	**—**	**—**	**2,481**
Total liabilities and deferred inflows of resources	**134,649**	**1,414,626**	**74,525**	**58,485**	**1,682,285**
NET POSITION					
Investment in capital assets	297	182,928	267,305	72,011	522,541
Restricted:					
Nonexpendable – endowment	—	847,651	—	19,638	867,289
Expendable:					
Endowments and gifts	—	—	—	6,903	6,903
Education	—	759,064	—	17,047	776,111
Statute	278,519	—	—	—	278,519
Other purposes	2,969	—	20,138	(1,293)	21,814
Total expendable	281,488	759,064	20,138	22,657	1,083,347
Unrestricted	(58)	532,487	44,766	40,839	618,034
Total net position	**281,727**	**2,322,130**	**332,209**	**155,145**	**3,091,211**
Total liabilities, deferred inflows of resources, and net position	**$ 416,376**	**$ 3,736,756**	**$ 406,734**	**$ 213,630**	**$ 4,773,496**

Combining Statement of Activities

Nonmajor Component Units

Year Ended June 30, 2013

(amounts in thousands)

	Financing Authorities	California State University Auxiliary Organizations	District Agricultural Associations	Other Component Units	Total
OPERATING EXPENSES					
Personal services	$ 2,295	$ 373,776	$ 53,986	$ 33,518	$ 463,575
Scholarships and fellowships	—	49,111	—	2,042	51,153
Supplies	—	—	—	9,326	9,326
Services and charges	86,552	985,671	134,889	34,635	1,241,747
Depreciation	835	46,612	19,119	3,282	69,848
Interest expense and fiscal charges	5,380	29,547	1,621	1,705	38,253
Amortization of long-term prepaid charges	—	—	—	—	—
Other	57	62,169	146	2,645	65,017
Total operating expenses	**95,119**	**1,546,886**	**209,761**	**87,153**	**1,938,919**
PROGRAM REVENUES					
Charges for services	86,144	672,899	203,218	60,419	1,022,680
Operating grants and contributions	—	535,906	—	10,438	546,344
Capital grants and contributions	—	17,021	50	279	17,350
Total program revenues	**86,144**	**1,225,826**	**203,268**	**71,136**	**1,586,374**
Net revenues (expenses)	(8,975)	(321,060)	(6,493)	(16,017)	(352,545)
GENERAL REVENUES					
Investment and interest income (loss)	10,483	144,343	74	8,435	163,335
Other	2,184	397,163	5,997	5,905	411,249
Total general revenues	**12,667**	**541,506**	**6,071**	**14,340**	**574,584**
Change in net position	3,692	220,446	(422)	(1,677)	222,039
Net position – beginning	**278,035** *	**2,101,684** *	**332,631** *	**156,822** *	**2,869,172** *
Net position – ending	**$ 281,727**	**$ 2,322,130**	**$ 332,209**	**$ 155,145**	**$ 3,091,211**

* Restated

This page intentionally left blank.

This page intentionally left blank.

Statistical Section

This page intentionally left blank.

Financial Trends

Financial trend schedules contain trend information to help the reader understand how the State's financial performance and well-being have changed over time. This section includes the following financial trend schedules:

Schedule of Net Position by Component
Schedule of Changes in Net Position
Schedule of Fund Balances-Governmental Funds
Schedule of Changes in Fund Balances-Governmental Funds

Sources: The information in the following schedules is derived from the State's Comprehensive Annual Financial Reports.

Schedule of Net Position by Component

For the Past Ten Fiscal Years

(accrual basis of accounting, amounts in thousands)

	2004	2005	2006	2007	2008	2009	2010	2011[2]	2012	2013
Governmental activities										
Net investment in capital assets	$ 77,734,545	$ 79,579,676	$ 83,489,137	$ 81,352,744	$ 84,255,048	$ 83,285,184	$ 84,085,632	$ 85,460,957	$ 80,768,527	$ 84,931,030
Restricted	7,126,013	7,631,057	8,431,279	10,543,602	10,148,648	8,391,814	14,987,867	27,865,821	24,871,510	24,315,913
Unrestricted [1]	(52,897,395)	(52,631,090)	(54,710,847)	(56,519,478)	(69,346,950)	(86,302,434)	(103,272,097)	(123,783,314)	(123,897,753)	(117,383,903)
Total governmental activities net position	**$ 31,963,163**	**$ 34,579,643**	**$ 37,209,569**	**$ 35,376,868**	**$ 25,056,746**	**$ 5,374,564**	**$ (4,198,598)**	**$ (10,456,536)**	**$ (18,257,716)**	**$ (8,136,960)**
Business-type activities										
Net investment in capital assets	$ 1,058,136	$ 836,524	$ 818,405	$ 208,268	$ 49,510	$ (130,634)	$ 89,334	$ 1,382,957	$ 1,561,258	$ 1,718,648
Nonexpendable	—	—	—	—	—	—	—	21,812	21,584	20,627
Restricted	5,667,623	7,235,373	8,722,865	8,574,932	6,853,621	3,855,051	3,404,682	3,615,945	4,571,036	5,151,915
Unrestricted	1,316,631	1,566,246	1,801,304	2,430,492	3,009,297	717,740	(4,250,609)	(4,214,494)	(3,346,849)	(2,824,738)
Total business-type activities net position	**$ 8,042,390**	**$ 9,638,143**	**$ 11,342,574**	**$ 11,213,692**	**$ 9,912,428**	**$ 4,442,157**	**$ (756,593)**	**$ 806,220**	**$ 2,807,029**	**$ 4,066,452**
Primary government										
Net investment in capital assets	$ 78,792,681	$ 80,416,200	$ 84,307,542	$ 81,561,012	$ 84,304,558	$ 83,154,550	$ 84,174,966	$ 86,843,914	$ 82,329,785	$ 86,649,678
Nonexpendable	—	—	—	—	—	—	—	21,812	21,584	20,627
Restricted	12,793,636	14,866,430	17,154,144	19,118,534	17,002,269	12,246,865	18,392,549	31,481,766	29,442,546	29,467,828
Unrestricted [2]	(51,580,764)	(51,064,844)	(52,909,543)	(54,088,986)	(66,337,653)	(85,584,694)	(107,522,706)	(127,997,808)	(127,244,602)	(120,208,641)
Total primary government net position	**$ 40,005,553**	**$ 44,217,786**	**$ 48,552,143**	**$ 46,590,560**	**$ 34,969,174**	**$ 9,816,721**	**$ (4,955,191)**	**$ (9,650,316)**	**$ (15,450,687)**	**$ (4,070,508)**

[1] Unrestricted net position reflects a negative balance because of outstanding bonded debt issued to build capital assets for school districts and other local governmental entities.

[2] In fiscal year 2011, the net position of the governmental funds and enterprise funds changed primarily as a result of the reclassification of $1.2 billion beginning net position of the California State University Fund from governmental activities to an enterprise fund.

Schedule of Changes in Net Position

For the Past Ten Fiscal Years

(accrual basis of accounting, amounts in thousands)

	2004	2005	2006	2007	2008	2009	2010	2011[3]	2012	2013
Governmental activities										
Expenses										
General government[1]	$ 11,017,624	$ 10,965,932	$ 10,379,122	$ 14,261,590	$ 13,187,080	$ 13,895,948	$ 12,454,969	$ 13,520,557	$ 14,411,737	$ 15,390,100
Education	51,457,841	53,152,986	62,652,997	61,542,105	65,130,420	65,643,486	61,764,385	56,486,944	51,288,647	50,586,387
Health and human services	60,020,524	62,016,344	65,763,380	69,979,980	74,309,784	79,077,015	80,799,454	92,475,364	89,939,730	94,069,749
Resources	4,436,309	4,160,949	4,161,814	5,316,769	6,333,252	5,626,359	6,019,104	5,853,278	5,950,635	5,670,922
State and consumer services	1,029,460	1,038,327	595,602	1,214,740	1,129,063	1,518,402	979,962	1,405,019	1,241,269	1,475,486
Business and transportation	7,579,221	7,142,209	8,809,236	9,763,200	13,068,043	11,980,315	14,155,767	11,119,644	13,719,927	12,836,192
Correctional programs	6,214,862	6,611,219	7,299,124	8,945,325	10,504,182	10,835,203	10,310,229	10,295,564	10,343,574	10,081,736
Interest on long-term debt	1,737,696	2,408,246	2,893,537	2,596,316	4,184,631	3,801,283	4,146,259	4,377,064	4,365,181	4,349,632
Total expenses	**143,493,537**	**147,496,212**	**162,554,812**	**173,620,025**	**187,846,455**	**192,378,011**	**190,630,129**	**195,533,434**	**191,260,700**	**194,460,204**
Program revenues										
Charges for services:										
General government[1]	4,386,968	4,733,155	4,620,030	4,495,166	4,404,126	4,781,126	4,918,132	5,057,082	6,841,334	6,196,586
Education	2,631,859	2,936,693	3,360,919	2,689,906	3,343,205	3,483,072	4,231,692	110,423	81,212	64,480
Health and human services	1,751,752	3,280,970	4,554,673	4,751,011	5,191,548	4,256,069	3,769,794	8,471,261	4,940,650	8,761,781
Resources	1,544,260	1,934,532	2,198,886	2,110,593	2,648,952	2,578,738	2,597,712	2,797,264	2,866,232	3,269,315
State and consumer services	496,561	601,322	640,088	704,512	692,348	658,486	654,034	660,196	724,222	682,503
Business and transportation	2,295,747	2,541,072	3,776,098	4,040,268	3,987,958	4,210,461	5,420,261	4,010,433	4,342,668	4,082,616
Correctional programs	13,915	12,354	37,203	30,821	27,702	21,592	18,097	14,981	16,757	45,153
Operating grants/contributions	41,072,413	41,135,441	42,254,065	43,440,102	45,849,413	57,828,622	75,469,783	67,849,215	58,777,006	60,943,536
Capital grants/contributions	916,961	1,090,419	1,272,506	1,164,526	1,207,101	1,142,691	962,388	1,272,326	2,193,189	1,669,021
Total program revenues	**55,110,436**	**58,265,958**	**62,714,468**	**63,426,905**	**67,352,353**	**78,960,857**	**98,041,893**	**90,243,181**	**80,783,270**	**85,714,991**
Total governmental activities net program expenses	**(88,383,101)**	**(89,230,254)**	**(99,840,344)**	**(110,193,120)**	**(120,494,102)**	**(113,417,154)**	**(92,588,236)**	**(105,290,253)**	**(110,477,430)**	**(108,745,213)**
General revenues and other changes in net position										
General revenues:										
Personal income taxes	37,926,550	42,504,352	51,251,266	53,272,229	55,355,266	45,709,344	43,866,857	51,719,107	54,368,347	67,502,738
Sales and use taxes	28,651,768	32,488,563	34,162,177	35,427,013	34,856,824	31,244,979	33,784,106	33,521,221	31,216,438	33,839,065
Corporation taxes	9,027,816	11,174,937	10,735,792	11,211,267	11,207,468	10,741,140	9,472,611	9,384,416	8,629,935	7,289,910
Motor vehicle excise taxes[4]	—	—	—	—	—	—	—	—	5,263,435	5,219,605
Insurance taxes	2,119,315	2,231,060	2,212,916	2,165,567	2,190,870	2,063,555	2,235,251	2,311,880	2,408,473	2,295,579
Other taxes[4]	2,329,987	2,507,729	2,099,075	5,939,890	5,594,970	5,264,685	5,234,531	7,768,010	2,368,748	2,498,248
Investment and interest	155,430	289,363	504,655	730,066	639,059	175,584	114,933	62,946	72,237	57,285
Escheat	598,681	525,897	291,549	334,002	282,287	315,642	149,996	229,146	372,215	551,580
Other	87,663	—	—	—	—	—	—	—	—	—
Transfers	32,965	27,727	23,259	29,855	54,994	21,015	(13,441,875)	(3,251,598)	(2,031,032)	(1,997,759)
Nonoperating grants and gifts	—	—	—	—	—	—	—	—	—	—
Special item[2]	—	—	1,218,311	—	—	—	—	—	—	—
Total general revenues and other changes in net position	**80,930,175**	**91,749,628**	**102,499,000**	**109,109,889**	**110,181,738**	**95,535,944**	**81,416,410**	**101,745,128**	**102,668,796**	**117,256,251**
Total governmental activities change in net position	**$ (7,452,926)**	**$ 2,519,374**	**$ 2,658,656**	**$ (1,083,231)**	**$ (10,312,364)**	**$ (17,881,210)**	**$ (11,171,826)**	**$ (3,545,125)**	**$ (7,808,634)**	**$ 8,511,038**

(continued)

[1] Tax relief program expenses and revenue reported separately prior to fiscal year 2009 are now included with general government.

[2] In fiscal year 2006, a related organization assumed debt on the State's behalf.

[3] In fiscal year 2011, the California State University Fund was reclassified from a governmental fund to an enterprise fund.

[4] Motor vehicle excise taxes, reported separately in fiscal year 2012 due to material increases, were included with "Other taxes" in prior years.

Schedule of Changes in Net Position (continued)

For the Past Ten Fiscal Years

(accrual basis of accounting, amounts in thousands)

	2004	2005	2006	2007	2008	2009	2010	2011[3]	2012	2013
Business-type activities										
Expenses										
Electric Power	$ 5,203,000	$ 5,655,000	$ 5,342,000	$ 5,865,000	$ 5,362,000	$ 4,560,000	$ 3,908,000	$ 2,317,000	$ 915,000	$ 488,000
Water Resources	731,099	731,393	949,691	951,590	1,009,214	914,837	1,069,662	1,115,793	1,047,574	1,127,195
Public Buildings Construction	296,502	299,900	334,094	334,777	371,904	420,465	494,332	390,173	403,853	410,404
State Lottery	3,347,644	3,493,984	3,911,717	3,470,615	3,173,060	3,069,365	3,166,447	3,507,524	4,431,709	4,499,451
Unemployment Programs	10,271,962	8,939,654	8,584,521	9,136,218	10,622,582	19,609,068	29,614,598	25,619,138	21,111,658	17,599,219
California State University[3]	—	—	—	—	—	—	—	5,851,355	6,181,397	6,196,541
High Technology Education	37,261	33,690	30,871	22,704	16,916	15,590	15,025	9,590	7,778	6,568
Toll Facilities	18,968	20,861	18,265	—	—	—	—	—	—	—
State University Dormitory Building Maintenance and Equipment	426,187	449,080	491,914	844,798	699,018	486,349	856,106	—	—	—
State Water Pollution Control Revolving	15,131	14,638	20,427	12,702	13,056	12,261	16,893	10,953	8,780	3,698
School Building Aid	—	—	—	—	—	—	—	—	—	—
Housing Loan	173,629	142,085	138,988	127,206	132,101	130,777	122,114	104,667	89,570	70,356
Other enterprise programs	98,654	86,612	113,976	141,859	122,921	147,441	130,329	118,006	78,601	58,578
Total expenses	**20,620,037**	**19,866,897**	**19,936,464**	**20,907,469**	**21,522,772**	**29,366,153**	**39,393,506**	**39,044,199**	**34,275,920**	**30,460,010**
Program revenues										
Charges for services:										
Electric Power	5,203,000	5,655,000	5,342,000	5,865,000	5,362,000	4,560,000	3,908,000	2,317,000	915,000	488,000
Water Resources	714,647	750,282	949,691	951,590	1,009,214	914,837	1,069,662	1,115,793	1,047,574	1,127,195
Public Building Construction	307,910	315,718	384,442	396,895	384,816	366,151	430,069	456,467	428,260	616,041
State Lottery	3,143,408	3,512,126	3,740,041	3,461,699	3,242,828	3,051,320	3,145,259	3,484,689	4,484,291	4,445,921
Unemployment Programs	9,631,916	10,459,688	10,263,447	9,017,969	8,829,018	14,273,975	11,255,098	24,678,783	21,947,781	18,597,962
California State University[3]	—	—	—	—	—	—	—	2,505,545	2,915,123	2,891,432
High Technology Education	34,052	36,737	26,508	22,966	20,600	15,975	13,015	10,498	8,452	5,585
Toll Facilities	121	66	21	—	—	—	—	—	—	—
State University Dormitory Building Maintenance and Equipment	250,208	395,396	512,231	554,851	640,208	811,454	599,571	—	—	—
State Water Pollution Control Revolving	51,687	55,218	64,740	78,564	71,404	59,923	56,121	55,957	57,540	60,173
Housing Loan	143,805	121,063	127,733	130,293	130,139	109,636	85,321	89,224	84,830	66,050
Other enterprise programs	114,081	115,901	129,048	134,018	137,476	124,952	98,957	105,676	74,693	80,540
Operating grants/contributions	—	—	—	—	—	—	—	1,216,808	1,249,995	1,323,345
Capital grants/contributions	47,528	73,182	56,942	182,989	189,064	71,882	91,808	86,272	106,057	142,304
Total program revenues	**19,642,363**	**21,490,377**	**21,596,844**	**20,796,834**	**20,016,767**	**24,360,105**	**20,752,881**	**36,122,712**	**33,319,596**	**29,844,548**
Total business-type activities net program revenues (expenses)	**(977,674)**	**1,623,480**	**1,660,380**	**(110,635)**	**(1,506,005)**	**(5,006,048)**	**(18,640,625)**	**(2,921,487)**	**(956,324)**	**(615,462)**
Other changes in net position										
Transfers	(32,965)	(27,727)	(23,259)	(29,855)	(54,994)	(21,015)	13,441,875	3,251,598	2,031,032	1,997,759
Total business-type activities changes in net position	**(1,010,639)**	**1,595,753**	**1,637,121**	**(140,490)**	**(1,560,999)**	**(5,027,063)**	**(5,198,750)**	**330,111**	**1,074,708**	**1,382,297**
Total primary government changes in net position	**$ (8,463,565)**	**$ 4,115,127**	**$ 4,295,777**	**$ (1,223,721)**	**$ (11,873,363)**	**$ (22,908,273)**	**$ (16,370,576)**	**$ (3,215,014)**	**$ (6,733,926)**	**$ 9,893,335**

(concluded)

Schedule of Fund Balances - Governmental Funds

For the Past Ten Fiscal Years

(modified accrual basis of accounting, amounts in thousands)

	2004	2005	2006	2007	2008	2009	2010	2011[1]	2012	2013
General Fund										
Reserved	$ 1,691,034	$ 1,597,085	$ 1,999,953	$ 2,596,537	$ 2,113,149	$ 2,260,504	$ 1,320,782	$ —	$ —	$ —
Unreserved	(3,231,734)	(1,410,228)	672,862	(4,504,075)	(6,282,018)	(18,344,400)	(20,929,640)	—	—	—
Nonspendable	—	—	—	—	—	—	—	148,019	7,614	140,107
Restricted	—	—	—	—	—	—	—	156,496	80,849	178,643
Committed	—	—	—	—	—	—	—	29,850	19,600	22,879
Unassigned	—	—	—	—	—	—	—	(20,273,606)	(23,069,351)	(14,596,085)
Total General Fund	**$ (1,540,700)**	**$ 186,857**	**$ 2,672,815**	**$ (1,907,538)**	**$ (4,168,869)**	**$ (16,083,896)**	**$ (19,608,858)**	**$ (19,939,241)**	**$ (22,961,288)**	**$ (14,254,456)**
All other governmental funds										
Reserved	$ 14,625,056	$ 14,924,365	$ 16,198,481	$ 21,955,300	$ 19,512,083	$ 27,465,566	$ 41,087,578	$ —	$ —	$ —
Unreserved, reported in:										
Special revenue funds	(1,343,432)	(329,018)	(806,558)	(914,843)	(1,817,290)	(3,539,254)	(8,554,611)	—	—	—
Capital projects funds	(226,919)	(403,106)	(882,550)	(1,128,608)	(837,349)	686,113	838,879	—	—	—
Nonspendable	—	—	—	—	—	—	—	39,448	—	15,022
Restricted	—	—	—	—	—	—	—	27,709,325	24,790,661	24,137,270
Committed	—	—	—	—	—	—	—	2,701,702	2,109,089	2,318,035
Assigned	—	—	—	—	—	—	—	268,888	3	209,171
Unassigned	—	—	—	—	—	—	—	(21,847)	(103,177)	(176,066)
Total all other governmental funds	**$ 13,054,705**	**$ 14,192,241**	**$ 14,509,373**	**$ 19,911,849**	**$ 16,857,444**	**$ 24,612,425**	**$ 33,371,846**	**$ 30,697,516**	**$ 26,796,576**	**$ 26,503,432**

Note: In fiscal year 2011, the State implemented GASB Statement No. 54, which significantly changed the fund balance classifications. Fiscal year 2011 fund balance classifications are not comparable to prior years' classifications.

[1] In fiscal year 2011, the California State University Fund, which consisted of $1.2 billion beginning fund balance, was reclassified from a governmental fund to an enterprise fund.

Schedule of Changes in Fund Balances - Governmental Funds

For the Past Ten Fiscal Years

(modified accrual basis of accounting, amounts in thousands)

	2004	2005	2006	2007	2008	2009	2010	2011[3]	2012	2013
Revenues										
Personal income taxes	$ 37,722,839	$ 42,595,352	$ 50,798,418	$ 53,289,524	$ 55,197,062	$ 45,482,726	$ 43,884,798	$ 51,691,153	$ 54,442,733	$ 67,424,576
Sales and use taxes	28,685,600	32,201,242	34,300,402	35,451,311	34,764,651	31,425,308	33,696,412	33,488,805	31,205,183	33,869,961
Corporation taxes	8,379,316	11,191,937	10,709,792	11,210,267	11,201,468	10,738,140	9,467,611	9,433,416	8,609,935	7,261,910
Motor vehicle excise taxes [4]	—	—	—	—	—	—	—	—	5,263,435	5,219,605
Insurance taxes	2,119,315	2,231,060	2,212,916	2,165,567	2,190,870	2,063,555	2,235,251	2,311,881	2,408,473	2,295,579
Other taxes [4]	2,422,326	2,482,335	2,367,670	5,800,027	5,675,894	5,245,416	5,235,801	7,829,662	2,306,717	2,425,184
Intergovernmental	42,918,982	42,933,381	45,466,185	46,442,519	48,969,006	61,053,091	79,183,291	69,160,916	62,235,671	64,418,808
Licenses and permits	3,469,741	4,954,025	5,125,223	5,266,142	5,326,854	5,805,369	6,900,747	6,767,437	6,600,001	6,659,078
Charges for services	919,280	949,147	1,002,410	911,387	1,025,569	986,773	974,181	1,008,647	728,980	741,201
Fees and penalties	4,662,893	5,388,332	6,008,306	6,093,948	6,800,633	6,204,288	7,291,894	10,262,387	8,315,452	10,673,104
Investment and interest	377,694	576,097	1,058,119	1,555,202	1,591,025	1,108,058	281,881	212,116	175,898	135,928
Escheat	598,681	525,897	291,549	334,002	282,287	315,642	149,996	229,146	372,215	551,580
Other	2,999,820	3,755,426	4,518,621	3,732,591	4,265,010	3,933,035	3,555,282	2,941,484	2,542,505	3,227,347
Total revenues	**135,276,487**	**149,784,231**	**163,859,611**	**172,252,487**	**177,290,329**	**174,361,401**	**192,857,145**	**195,337,050**	**185,207,198**	**204,903,861**
Expenditures										
General government [1]	11,012,217	10,647,740	9,394,308	14,062,920	12,745,860	13,075,901	12,036,503	12,997,651	13,484,305	15,748,069
Education	49,526,563	52,242,779	59,768,677	61,103,008	64,367,612	63,857,066	59,229,726	55,547,139	50,362,337	49,692,763
Health and human services	59,820,274	62,015,628	65,968,433	70,157,806	74,102,708	78,731,136	80,321,470	91,941,309	89,473,391	94,621,630
Resources	3,686,083	4,077,102	4,296,715	5,191,078	6,123,609	5,209,684	5,456,904	5,254,757	5,358,575	5,318,332
State and consumer services	935,427	973,466	1,111,128	1,214,752	1,239,397	1,266,068	1,088,494	1,183,536	1,219,499	1,259,392
Business and transportation	9,119,237	8,556,618	10,370,589	11,485,069	14,747,506	13,803,518	14,083,790	13,181,390	15,684,611	15,008,671
Correctional programs	6,236,725	6,658,614	7,552,790	9,030,299	9,972,507	9,883,593	9,553,992	9,253,791	9,805,846	9,681,086
Capital outlay	1,245,871	1,534,150	2,128,050	1,345,021	1,724,074	1,432,376	1,691,674	1,128,011	1,296,413	1,222,342
Debt service:										
Bond and commercial paper retirement	1,384,595	3,672,119	6,375,607	5,691,791	8,970,533	5,131,600	3,259,203	3,118,906	4,435,992	5,189,150
Interest and fiscal charges	1,686,776	2,243,764	3,135,763	2,881,849	3,394,433	3,584,358	4,022,922	4,355,110	4,453,643	4,363,260
Total expenditures	**144,653,768**	**152,621,980**	**170,102,060**	**182,163,593**	**197,388,239**	**195,975,300**	**190,744,678**	**197,961,600**	**195,574,612**	**202,104,695**
Excess (deficiency) of revenuesover (under) expenditures	(9,377,281)	(2,837,749)	(6,242,449)	(9,911,106)	(20,097,910)	(21,613,899)	2,112,467	(2,624,550)	(10,367,414)	2,799,166
Other financing sources (uses)										
General obligation bonds and commercial paper issued	18,385,480	5,058,339	7,750,500	9,040,500	14,193,760	16,764,085	12,039,472	4,525,000	4,165,515	4,038,095
Revenue bonds issued	4,347,570	99,250	—	—	—	97,635	—	—	—	—
Refunding/remarketing debt issued	1,183,875	1,937,430	5,086,944	9,098,376	1,798,685	—	4,176,050	—	4,300,555	4,406,365
Payment to refund/remarket long-term debt	(1,183,875)	(1,937,430)	(4,561,944)	(7,840,621)	(1,844,006)	—	(4,221,604)	—	(4,508,834)	(2,947,645)
Premium on bonds issued [2]	—	—	—	—	295,439	126,107	267,980	32,607	667,931	964,211
Proceeds from loans	—	—	—	—	—	—	1,996,737	35,538	—	—
Remarketing bonds issued	—	—	—	—	—	—	—	—	—	228,000
Payment to remarketing agent	—	—	—	—	—	—	—	—	—	(226,968)
Capital leases [3]	85,390	414,738	748,037	178,936	268,686	364,813	811,816	204,631	528,804	710,440
Transfers in	18,475,032	4,580,201	5,137,895	9,311,462	11,414,132	6,776,476	6,548,447	8,705,229	5,523,644	2,957,762
Transfers out	(18,428,564)	(4,546,792)	(5,113,107)	(9,242,771)	(11,336,764)	(6,689,658)	(19,952,766)	(11,902,800)	(7,499,131)	(4,898,754)
Total other financing sources	**22,864,908**	**5,605,736**	**9,048,325**	**10,545,882**	**14,789,932**	**17,439,458**	**1,666,132**	**1,600,205**	**3,178,484**	**5,231,506**
Net change in fund balances	**$ 13,487,627**	**$ 2,767,987**	**$ 2,805,876**	**$ 634,776**	**$ (5,307,978)**	**$ (4,174,441)**	**$ 3,778,599**	**$ (1,024,345)**	**$ (7,188,930)**	**$ 8,030,672**
Debt service as a percentage of noncapital expenditures	2.2%	3.9%	5.7%	4.8%	6.4%	4.5%	3.9%	3.8%	4.6%	4.7%

[1] Tax relief program expenditures reported separately prior to fiscal year 2009 are now included with general government.

[2] Prior to fiscal year 2008, premiums on bonds issued were netted against debt service interest and fiscal charges.

[3] In fiscal year 2011, the California State University Fund was reclassified from governmental to enterprise funds.

[4] Motor vehicle excise taxes, reported separately in fiscal year 2012 due to material increases, were included with "Other taxes" in prior years.

This page intentionally left blank.

Revenue Capacity

Revenue Capacity schedules contain information to help the reader assess the State's capacity to raise revenue and the sources of that revenue. This section includes the following revenue capacity schedules:

Schedule of Revenue Base
Schedule of Revenue Payers by Industry/Income Level
Schedule of Personal Income Tax Rates

Schedule of Revenue Base

For Calendar Years 2003 - 2012

(amounts in thousands)

	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Personal Income by Industry (all items restated as footnoted) [1]										
Farm earnings	$ 10,149,144	$ 12,322,441	$ 12,293,569	$ 10,502,907	$ 12,863,086	$ 11,085,040	$ 12,113,883	$ 12,558,578	$ 15,963,083	$ 15,397,106
Forestry, fishing, and other natural resources	4,838,326	5,331,993	5,339,115	6,116,391	6,290,825	6,246,343	6,186,842	6,755,433	6,999,774	7,665,873
Mining	2,454,166	3,043,884	3,424,350	4,165,716	4,176,079	6,137,776	4,001,812	5,096,307	6,335,937	7,093,438
Construction and utilities	70,499,066	78,395,855	83,618,710	88,980,284	84,564,689	76,420,871	63,197,385	58,649,664	61,149,733	65,647,157
Manufacturing	107,818,914	113,513,422	117,172,067	122,221,954	124,743,305	122,398,174	113,550,660	116,654,266	121,252,922	125,431,487
Wholesale trade	44,907,733	47,426,933	50,650,796	54,563,086	58,429,762	57,825,332	52,404,954	53,723,531	57,703,195	60,511,865
Retail trade	68,201,732	70,709,198	73,222,053	75,203,986	75,582,973	69,431,469	66,343,554	67,719,513	71,050,317	74,397,524
Transportation and warehousing	27,583,181	29,474,520	30,154,175	31,590,984	32,795,496	32,245,224	30,317,861	31,150,908	33,849,219	35,609,912
Information, finance, and insurance	114,338,117 [4]	118,260,450	123,945,321	128,625,537	131,864,820	126,478,186	122,516,361	125,703,887	131,159,277	137,756,005
Real estate	29,904,716 [4]	30,162,482	29,850,744	27,920,809	21,197,560	21,710,392	19,822,942	20,739,227	25,398,367	26,878,559
Services	329,550,288	345,170,969	361,037,583	389,466,019	409,544,951	428,824,425	411,832,095	422,938,817	450,701,318	483,720,459
Federal, civilian	18,896,328	19,821,318	20,755,835	20,982,637	21,589,829	22,361,701	23,436,141	25,989,622	26,307,794	26,411,778
Military	10,978,513	11,932,082	12,363,045	12,811,960	13,447,301	14,560,195	15,558,706	16,264,215	16,046,524	16,053,477
State and local government	141,047,243	148,987,870	155,403,203	164,369,561	176,578,878	184,905,822	184,050,302	185,107,938	188,626,644	190,531,554
Other [2]	272,336,182	287,055,121	316,942,856	361,929,686	390,771,107	415,650,947	411,096,112	430,096,567	470,659,596	494,933,087
Total personal income	**$ 1,253,503,649**	**$ 1,321,608,538**	**$ 1,396,173,422**	**$ 1,499,451,517**	**$ 1,564,440,661**	**$ 1,596,281,897**	**$ 1,536,429,610**	**$ 1,579,148,473**	**$ 1,683,203,700**	**$ 1,768,039,281**
Average effective rate [3]	4.3%	4.5%	4.6%	5.1%	5.0%	5.7%	5.2%	4.7%	5.3%	5.0%

(continued)

Source: Bureau of Economic Analysis, U.S. Department of Commerce

[1] 2003-2012 information updated.

[2] Other personal income includes dividends, interest, rental income, residence adjustment, government transfers for individuals, and deductions for social insurance.

[3] The total direct rate for personal income is not available. The average effective rate equals personal income tax revenue divided by adjusted gross income.

[4] Not restated - all other amounts restated due to a comprehensive revision by the Bureau of Economic Analysis.

Schedule of Revenue Base (continued)

For Calendar Years 2003 - 2012

(amounts in thousands)

	2003	2004	2005	2006	2007	2008	2009 [1]	2010	2011	2012
Taxable Sales by Industry										
Retail										
Apparel	$ 15,179,710	$ 16,957,137	$ 18,712,125	$ 19,829,416	$ 20,855,890	$ 22,120,094	$ —	$ —	$ —	$ —
General merchandise	50,550,818	53,939,532	56,787,153	59,264,894	59,897,350	56,425,472	—	—	—	—
Specialty	45,191,191	48,961,996	52,376,758	54,695,680	34,122,471	27,380,740	—	—	—	—
Food	19,407,823	19,825,771	21,128,469	21,864,179	22,461,059	21,504,308	—	—	—	—
Restaurant and bars	40,049,699	43,275,038	46,412,847	49,229,418	51,658,575	52,051,404	—	—	—	—
Household	15,104,217	16,405,347	17,388,704	17,383,449	16,720,852	17,199,187	—	—	—	—
Building materials	28,200,869	34,154,543	36,152,218	36,163,326	32,656,324	26,647,007	—	—	—	—
Automotive	94,766,776	103,528,856	112,167,922	115,154,535	117,864,918	106,555,420	—	—	—	—
Other	11,765,951	13,124,468	14,681,929	15,481,675	30,787,663	27,434,795	—	—	—	—
Business and personal service	21,648,470	22,306,787	23,090,910	23,650,322	23,355,672	22,045,958	—	—	—	—
All other	118,230,944	127,597,308	138,005,393	146,935,543	150,669,375	152,289,155	—	—	—	—
Total taxable sales	**$ 460,096,468**	**$ 500,076,783**	**$ 536,904,428**	**$ 559,652,437**	**$ 561,050,149**	**$ 531,653,540**	**$ —**	**$ —**	**$ —**	**$ —**
Direct sales tax rate [2]	5.00%	5.25% [3]	5.25%	5.25%	5.25%	5.25%	—	—	—	—
Taxable Sales by Industry (Using NAICS Codes) [1]										
Retail and Food Services										
Motor vehicle and parts dealers	$ —	$ —	$ —	$ —	$ —	$ —	$ 44,488,198	$ 47,355,568	$ 53,303,501	$ 61,547,848
Furniture and home furnishings stores	—	—	—	—	—	—	8,481,020	8,742,984	9,280,688	9,937,187
Electronics and appliance stores	—	—	—	—	—	—	13,384,338	13,749,019	14,297,402	14,744,723
Building materials, garden equipment and supplies	—	—	—	—	—	—	23,978,313	24,750,865	26,064,428	27,438,083
Food and beverage	—	—	—	—	—	—	22,546,285	22,787,407	23,606,132	24,511,714
Health and personal care stores	—	—	—	—	—	—	9,244,958	9,525,910	10,309,491	10,787,801
Gasoline stations	—	—	—	—	—	—	39,077,835	45,226,491	55,210,076	58,006,168
Clothing and clothing accessories stores	—	—	—	—	—	—	25,641,272	27,267,430	29,600,057	32,357,516
Sporting goods, hobby, book and music stores	—	—	—	—	—	—	10,294,172	10,365,480	10,602,711	10,751,814
General merchandise stores	—	—	—	—	—	—	44,921,639	46,323,804	48,219,018	49,996,451
Miscellaneous store retailers	—	—	—	—	—	—	16,385,169	16,569,690	17,187,402	17,880,765
Nonstore retailers	—	—	—	—	—	—	2,849,864	2,830,615	3,081,188	4,375,432
Food services and drinking places	—	—	—	—	—	—	49,921,543	51,282,453	54,755,944	59,037,320
All other outlets	—	—	—	—	—	—	145,278,339	150,570,269	165,050,017	177,014,427
Total taxable sales	**$ —**	**$ —**	**$ —**	**$ —**	**$ —**	**$ —**	**$ 456,492,945**	**$ 477,347,985**	**$ 520,568,055**	**$ 558,387,249**
Direct sales tax rate [2]	—	—	—	—	—	—	6.25% [4]	6.25%	6.25% [5]	6.25%

(concluded)

Source: California State Board of Equalization (BOE)

[1] Due to BOE's conversion from business coding to North American Industry Classification System (NAICS) coding for the reporting of Taxable Sales by Industry, industry level data for 2009 and forward is not comparable to that reported for prior years. The NAICS conversion process for over one million permit holders was not completed until the end of 2008, so 2009 was the first year BOE used the new format with NAICS codes.

[2] The direct sales tax rate used is the state tax rate that provides revenue to the State's General Fund and debt service fund. It does not include the 1% local tax rate that is allocated to cities and counties.

[3] Rate change was effective on July 1, 2004.

[4] Rate change was effective on April 1, 2009.

[5] Rate change was effective on July 1, 2011.

Schedule of Revenue Payers by Industry/Income Level

For Calendar Years 2003 and 2011

Personal Income Tax Filers and Liability by Income Level [1]

	2003			
	Number of Filers	Percent of Total	Tax Liability [2]	Percent of Total
Under $ 5,000	1,092,578	8.0 %	$ 4,143	0.0 %
5,000 to 9,999	1,163,134	8.6	10,875	0.0
10,000 to 14,999	1,175,473	8.6	23,910	0.1
15,000 to 19,999	1,138,717	8.4	66,120	0.2
20,000 to 24,999	1,053,396	7.7	133,129	0.4
25,000 to 29,999	883,616	6.5	188,941	0.6
30,000 to 39,999	1,514,637	11.1	612,337	2.0
40,000 to 49,999	1,154,203	8.5	858,009	2.9
50,000 to 99,999	2,877,717	21.1	5,444,012	17.9
$100,000 and over	1,570,885	11.5	23,032,746	75.9
Total	**13,624,356**	**100.0 %**	**$ 30,374,222**	**100.0 %**

	2011			
	Number of Filers	Percent of Total	Tax Liability [2]	Percent of Total
Under $ 5,000	1,160,598	7.7 %	$ 7,876	0.0 %
5,000 to 9,999	1,159,492	7.7	8,857	0.0
10,000 to 14,999	1,291,501	8.6	11,652	0.0
15,000 to 19,999	1,243,767	8.3	35,697	0.1
20,000 to 24,999	1,062,962	7.1	77,142	0.2
25,000 to 29,999	911,530	6.0	130,546	0.3
30,000 to 39,999	1,516,999	10.1	447,136	1.0
40,000 to 49,999	1,191,296	7.9	705,585	1.6
50,000 to 99,999	3,123,472	20.8	5,322,636	12.1
$100,000 and over	2,380,742	15.8	37,174,234	84.7
Total	**15,042,359**	**100.0 %**	**$ 43,921,361**	**100.0 %**

Source: California Franchise Tax Board

[1] For California resident tax returns. Calendar year 2011 is the most recent year for which data are available.

[2] Amounts in thousands.

For Calendar Years 2003 and 2012

Sales Tax Permits and Tax Liability by Industry

	2003 (Using Business Codes) [1]			
	Number of Permits [2]	Percent of Total	Tax Liability	Percent of Total
Retail				
Apparel	36,328	3.5 %	$ 758,986	3.3 %
General merchandise	14,385	1.4	2,527,541	11.0
Specialty	195,033	19.0	2,259,560	9.8
Food	24,707	2.4	970,391	4.2
Restaurant and bars	80,933	7.9	2,002,485	8.7
Household	30,603	3.0	755,211	3.3
Building materials	10,266	1.0	1,410,043	6.1
Automotive	35,018	3.4	4,738,339	20.6
Other	22,073	2.2	588,298	2.6
Business and personal service	102,801	10.0	1,082,424	4.7
All other	474,316	46.2	5,911,547	25.7
Total	**1,026,463**	**100.0 %**	**$ 23,004,825**	**100.0 %**

	2012 (Using NAICS Codes) [1]			
	Number of Permits [2]	Percent of Total	Tax Liability [3]	Percent of Total
Retail and Food Services				
Motor vehicle and parts dealers	33,767	3.4 %	$ 3,846,741	11.0 %
Furniture and home furnishings stores	18,587	1.9	621,074	1.8
Electronics and appliance stores	23,301	2.4	921,545	2.6
Building materials, garden equipment & supplies	17,236	1.8	1,714,880	4.9
Food and beverage	31,900	3.3	1,531,982	4.4
Health and personal care stores	24,427	2.5	674,238	1.9
Gasoline stations	9,990	1.0	3,625,386	10.4
Clothing and clothing accessories stores	70,775	7.2	2,022,345	5.8
Sporting goods, hobby, book & music stores	29,246	3.0	671,988	1.9
General merchandise stores	17,163	1.8	3,124,778	9.0
Miscellaneous store retailers	117,979	12.1	1,117,548	3.2
Nonstore retailers	167,568	17.1	273,465	0.8
Food services and drinking places	94,453	9.6	3,689,833	10.6
All other outlets	321,897	32.9	11,063,402	31.7
Total	**978,289**	**100.0 %**	**$ 34,899,205**	**100.0 %**

Source: State Board of Equalization (BOE)

[1] Due to BOE's conversion from business coding to North American Industry Classification System (NAICS) coding for the reporting of Taxable Sales by Industry, industry level data for 2009 and forward is not comparable to that reported for prior years. The NAICS conversion process for over one million permit holders was not completed until the end of 2008, so 2009 was the first year BOE used the new format with NAICS codes.

[2] As of July 1.

[3] Calculated by multiplying the taxable sales by industry shown on page 277 by the direct sales tax rate. Amounts in thousands.

Schedule of Personal Income Tax Rates

For Calendar Years 2003 - 2012

Married Filing Jointly and Surviving Spouse

	2003	2004	2005 [1]	2006	2007	2008	2009 [2]	2010 [2]	2011	2012
Tax Rate	Income Level	Income Level	Income Level	Income Level	Income Level	Income Level	Income Level	Income Level	Income Level	Income Level
1.0	Up to $11,924	Up to $12,294	Up to $12,638	Up to $13,244	Up to $13,654	Up to $14,336	Up to $14,120	Up to $14,248	Up to $14,632	Up to $14,910
2.0	11,924 - 28,266	12,294 - 29,142	12,638 - 29,958	13,244 - 31,963	13,654 - 32,370	14,336 - 33,988	14,120 - 33,478	14,248 - 33,780	14,632 - 34,692	14,910 - 35,352
4.0	28,266 - 44,612	29,142 - 45,994	29,958 - 47,282	31,963 - 49,552	32,370 - 51,088	33,988 - 53,642	33,478 - 52,838	33,780 - 53,314	34,692 - 54,754	35,352 - 55,794
6.0	44,612 - 61,930	45,994 - 63,850	47,282 - 65,638	49,552 - 68,788	51,088 - 70,920	53,642 - 74,466	52,838 - 73,350	53,314 - 74,010	54,754 - 76,008	55,794 - 77,452
8.0	61,930 - 78,266	63,850 - 80,692	65,638 - 82,952	68,788 - 86,934	70,920 - 89,628	74,466 - 94,110	73,350 - 92,698	74,010 - 93,532	76,008 - 96,058	77,452 - 97,884
9.3	$78,266 and over	$80,692 and over	82,952 - 999,999	86,934 - 999,999	89,628 - 999,999	94,110 - 999,999	92,698 - 999,999	93,532 - 999,999	96,058 - 999,999	97,884 - 500,000
10.3	—	—	$1 million and over	$1 million and over	$1 million and over	$1 million and over	$1 million and over	$1 million and over	$1 million and over	500,000 - 600,000
11.3	—	—	—	—	—	—	—	—	—	600,000 - $1million
12.3	—	—	—	—	—	—	—	—	—	$1 million and over

Single and Married Filing Separately

	2003	2004	2005 [1]	2006	2007	2008	2009 [2]	2010 [2]	2011	2012
Tax Rate	Income Level	Income Level	Income Level	Income Level	Income Level	Income Level	Income Level	Income Level	Income Level	Income Level
1.0	Up to $5,962	Up to $6,147	Up to $6,319	Up to $6,622	Up to $6,827	Up to $7,168	Up to $7,060	Up to $7,124	Up to $7,316	Up to $7,455
2.0	5,962 - 14,133	6,147 - 14,571	6,319 - 14,979	6,622 - 15,698	6,827 - 16,185	7,168 - 16,994	7,060 - 16,739	7,124 - 16,890	7,316 - 17,346	7,455 - 17,676
4.0	14,133 - 22,306	14,571 - 22,997	14,979 - 23,641	15,698 - 24,776	16,185 - 25,544	16,994 - 26,821	16,739 - 26,419	16,890 - 26,657	17,346 - 27,377	17,676 - 27,897
6.0	22,306 - 30,965	22,997 - 31,925	23,641 - 32,819	24,776 - 34,394	25,544 - 35,460	26,821 - 37,233	26,419 - 36,675	26,657 - 37,005	27,377 - 38,004	27,897 - 38,726
8.0	30,965 - 39,133	31,925 - 40,346	32,819 - 41,476	34,394 - 43,467	35,460 - 44,814	37,233 - 47,055	36,675 - 46,349	37,005 - 46,766	38,004 - 48,029	38,726 - 48,942
9.3	$39,133 and over	$40,346 and over	41,476 - 999,999	43,467 - 999,999	44,814 - 999,999	47,055 - 999,999	46,349- 999,999	46,766 - 999,999	48,029 - 999,999	48,942 - 250,000
10.3	—	—	$1 million and over	$1 million and over	$1 million and over	$1 million and over	$1 million and over	$1 million and over	$1 million and over	250,000 - 300,000
11.3	—	—	—	—	—	—	—	—	—	300,000 - 500,000
12.3	—	—	—	—	—	—	—	—	—	$500,000 and over

Head of Household

	2003	2004	2005 [1]	2006	2007	2008	2009 [2]	2010 [2]	2011	2012
Tax Rate	Income Level	Income Level	Income Level	Income Level	Income Level	Income Level	Income Level	Income Level	Income Level	Income Level
1.0	Up to $11,930	Up to $12,300	Up to $12,644	Up to $13,251	Up to $13,662	Up to $14,345	Up to $14,130	Up to $14,257	Up to $14,642	Up to $14,920
2.0	11,930 - 28,267	12,300 - 29,143	12,644 - 29,959	13,251 - 31,397	13,662 - 32,370	14,345 - 33,989	14,130 - 33,479	14,257 - 33,780	14,642 - 34,692	14,920 - 35,351
4.0	28,267 - 36,437	29,143 - 37,567	29,959 - 38,619	31,397 - 40,473	32,370 - 41,728	33,989 - 43,814	33,479 - 43,157	33,780 - 43,545	34,692 - 44,721	35,351 - 45,571
6.0	36,437 - 45,096	37,567 - 46,494	38,619 - 47,796	40,473 - 50,090	41,728 - 51,643	43,814 - 54,225	43,157 - 53,412	43,545 - 53,893	44,721 - 55,348	45,571 - 56,400
8.0	45,096 - 53,267	46,494 - 54,918	47,796 - 56,456	50,090 - 59,166	51,643 - 61,000	54,225 - 64,050	53,412 - 63,089	53,893 - 63,657	55,348 - 65,376	56,400 - 66,618
9.3	$53,267 and over	$54,918 and over	56,456 - 999,999	59,166 - 999,999	61,000 - 999,999	64,050 - 999,999	63,089 - 999,999	63,657 - 999,999	65,376 - 999,999	66,618 - 340,000
10.3	—	—	$1 million and over	$1 million and over	$1 million and over	$1 million and over	$1 million and over	$1 million and over	$1 million and over	340,00 - 408,000
11.3	—	—	—	—	—	—	—	—	—	408,000 - 680,000
12.3	—	—	—	—	—	—	—	—	—	$680,000 and over

Source: California Franchise Tax Board

[1] Beginning in 2005, there is an additional tax of 1% on taxable income over $1 million for the expansion of mental health services.

[2] In 2009 and 2010, tax rates increased by 0.25% for all income levels.

Average Effective Rate

(amounts in thousands)

	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Personal income tax revenue [1]	$ 32,661,274	$ 37,722,839	$ 42,595,352	$ 50,798,418	$ 53,289,524	$ 55,197,062	$ 45,482,726	$ 43,884,798	$ 51,691,153	$ 54,442,733
Adjusted gross income [2]	762,491,998	841,229,496	932,142,017	990,695,484	1,059,967,500	972,420,100	881,160,200	939,888,500	980,167,100	1,087,823,400
Average effective rate [3]	4.3%	4.5%	4.6%	5.1%	5.0%	5.7%	5.2%	4.7%	5.3%	5.00%

[1] Personal income tax revenue is reported on a fiscal year basis.

[2] Source: California Franchise Tax Board. Fiscal year 2012 information reflects returns processed as of December 2013.

[3] The average effective rate equals personal income tax revenue divided by adjusted gross income.

This page intentionally left blank.

Debt Capacity

Debt Capacity schedules contain information to help the reader understand the State's outstanding debt, the capacity to repay that debt, and the ability to issue additional debt in the future. This section includes the following debt capacity schedules:

Schedule of Ratios of Outstanding Debt by Type
Schedule of Ratios of General Bonded Debt Outstanding
Schedule of General Obligation Bonds Outstanding
Schedule of Pledged Revenue Coverage

Sources: Unless otherwise noted, the information in the following schedules is derived from the State's Comprehensive Annual Financial Report.

Schedule of Ratios of Outstanding Debt by Type

For the Past Ten Fiscal Years

(amounts in thousands, except per capita)

	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Governmental activities										
General obligation bonds [1]	$ 43,924,636	$ 45,541,417	$ 47,003,817	$ 50,269,442	$ 56,424,532	$ 68,653,507	$ 77,745,789	$ 79,469,085	$ 81,060,111	$ 82,346,211
Revenue bonds	8,101,855	8,068,980	7,300,638	8,009,784	7,811,832	7,767,855	7,611,939	7,511,092	7,421,198	7,735,053
Certificates of participation and commercial paper	849,360	752,013	923,890	1,358,051	1,736,089	1,407,908	1,342,119	1,335,340	46,098	538,593
Capital lease obligations	3,745,410	3,918,560	4,466,828	4,346,179	4,376,410	4,456,039	4,967,290	4,882,233	5,176,341	5,319,487
Total governmental activities	**56,621,261**	**58,280,970**	**59,695,173**	**63,983,456**	**70,348,863**	**82,285,309**	**91,667,137**	**93,197,750**	**93,703,748**	**95,939,344**
Business-type activities										
General obligation bonds [1]	2,215,800	2,090,105	1,963,305	1,954,220	1,907,243	1,702,377	1,477,663	1,218,639	1,118,634	887,053
Revenue bonds	22,239,016	22,943,536	22,812,509	22,934,094	23,003,097	23,053,114	24,538,094	23,290,315	24,790,918	25,558,129
Certificates of participation and commercial paper	97,179	51,093	231,121	179,782	67,204	51,307	64,518	139,974	67,325	77,560
Total business-type activities	**24,551,995**	**25,084,734**	**25,006,935**	**25,068,096**	**24,977,544**	**24,806,798**	**26,080,275**	**24,648,928**	**25,976,877**	**26,522,742**
Total primary government	**$ 81,173,256**	**$ 83,365,704**	**$ 84,702,108**	**$ 89,051,552**	**$ 95,326,407**	**$ 107,092,107**	**$ 117,747,412**	**$ 117,846,678**	**$ 119,680,625**	**$ 122,462,086**
Debt as a percentage of personal income [2]	6.6%	6.4%	6.1%	6.0%	6.1%	6.7%	7.8%	7.5%	7.3%	6.9%
Amount of debt per capita [3]	$ 2,294	$ 2,332	$ 2,354	$ 2,457	$ 2,608	$ 2,906	$ 3,176	$ 3,159	$ 3,186	$ 3,234

Note: Details regarding the State's outstanding debt can be found in Notes 10 through 16 of the financial statements.

[1] Prior to fiscal year 2008, net unamortized bond premiums and refunding losses were not included.

[2] Ratio calculated using personal income data shown on pages 294 and 295 for the prior calendar year.

[3] Amount calculated using population data shown on pages 294 and 295 for the prior calendar year.

Schedule of Ratios of General Bonded Debt Outstanding

For the Past Ten Fiscal Years

(amounts in thousands, except per capita)

	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Net general bonded debt										
General obligation bonds [1]	$ 35,244,356	$ 36,735,442	$ 39,034,092	$ 43,234,702	$ 47,828,805	$ 61,724,439	$ 71,284,447	$ 73,516,674	$ 75,791,795	$ 78,001,049
Economic Recovery bonds	10,896,080	10,896,080	9,933,030	8,988,960	10,502,970	8,631,445	7,939,005	7,171,050	6,386,950	5,232,215
Less: restricted debt service fund	—	—	212,883	792,841	552,326	894	113,172	143,777	330,297	278,425
Net Economic Recovery bonds	10,896,080	10,896,080	9,720,147	8,196,119	9,950,644	8,630,551	7,825,833	7,027,273	6,056,653	4,953,790
Net general bonded debt	**$ 46,140,436**	**$ 47,631,522**	**$ 48,754,239**	**$ 51,430,821**	**$ 57,779,449**	**$ 70,354,990**	**$ 79,110,280**	**$ 80,543,947**	**$ 81,848,448**	**$ 82,954,839**
Net general bonded debt as a percentage of personal income [2]	3.7%	3.6%	3.5%	3.4%	3.7%	4.4%	5.2%	5.1%	5.0%	4.7%
Amount of net general bonded debt per capita [3]	$ 1,304	$ 1,332	$ 1,355	$ 1,419	$ 1,581	$ 1,909	$ 2,134	$ 2,159	$ 2,179	$ 2,190

Note: Details regarding the State's outstanding debt can be found in Notes 10 through 16 of the financial statements.

[1] Prior to fiscal year 2008, net unamortized bond premiums and refunding losses were not included.

[2] Ratio calculated using personal income data shown on pages 294 and 295 for the prior calendar year.

[3] Amount calculated using population data shown on pages 294 and 295 for the prior calendar year.

Schedule of General Obligation Bonds Outstanding

June 30, 2013

(amounts in thousands)

Governmental activity		
California Clean Water, Clean Air, Safe Neighborhood Parks and Coastal Protection	$	2,221,035
California Library Construction and Renovation		297,275
California Park and Recreational Facilities		14,725
California Parklands		3,270
California Safe Drinking Water		63,660
California Stem Cell Research and Cures		1,197,440
California Wildlife, Coastal, and Park Land Conservation		134,890
Children's Hospital		1,193,655
Class Size Reduction Public Education Facilities		6,287,305
Clean Air and Transportation Improvement		883,585
Clean Water		12,465
Clean Water and Water Conservation		5,235
Clean Water and Water Reclamation		24,330
Community Parklands		3,475
County Correctional Facility Capital Expenditure		19,780
County Correctional Facility Capital Expenditure and Youth Facility		87,210
Disaster Preparedness and Flood Prevention		2,244,880
Earthquake Safety and Public Building Rehabilitation		105,555
Economic Recovery		5,232,215
Fish and Wildlife Habitat Enhancement		5,755
Higher Education Facilities		458,675
Highway Safety, Traffic Reduction, Air Quality, and Port Security		10,903,425
Housing Emergency Shelter		3,026,490
Housing and Homeless		1,855
Kindergarten-University Public Education Facilities		31,200,735
Lake Tahoe Acquisitions		450
New Prison Construction		60,265
Passenger Rail and Clean Air		79,720
Public Education Facilities		1,598,290
Safe, Clean, Reliable Water Supply		653,820
Safe Drinking Water, Clean Water, Watershed Protection, and Flood Protection		1,499,865
Safe Drinking Water, Water Quality and Supply, Flood Control, River and Coastal Protection		2,411,205
Safe Neighborhood Parks		1,606,800
Safe, Reliable High-Speed Passenger Train		703,530
School Building and Earthquake		17,305
School Facilities		1,315,000
Seismic Retrofit		1,281,790
State School Building Lease-Purchase		—
State, Urban, and Coastal Park		4,680
Veterans' Homes		35,205
Voting Modernization		52,035
Water Conservation		25,695
Water Conservation and Water Quality		37,090
Water Security, Clean Drinking Water, Coastal and Beach Protection		2,676,780
Total governmental activity		**79,688,445**
Business-type activity		
California Water Resources Development		302,920
Veterans Farm and Home Building		585,360
Total business-type activity		**888,280**
Total general obligation bonds		**80,576,725**
Unamortized bond premium/discount/other		2,656,539
Total general obligation bonds payable	**$**	**83,233,264**

Source: California State Treasurer's Office

Schedule of Pledged Revenue Coverage

For the Past Ten Fiscal Years

(amounts in thousands)

				Net Revenue	**Debt Service Requirements[3]**			
	June 30	**Gross Revenue[1]**	**Operating Expenses[2]**	**Available for Debt Service**	**Principal**	**Interest**	**Total**	**Coverage**
Housing Loans	2004	138,438	19,439	118,999	28,665	43,683	72,348	1.64
	2005	121,063	27,687	93,376	90,970	34,813	125,783	0.74
	2006	127,733	25,654	102,079	25,715	34,949	60,664	1.68
	2007	130,128	19,062	111,066	292,461	33,959	326,420	0.34
	2008	130,139	21,263	108,876	56,225	33,333	89,558	1.22
	2009	109,636	21,838	87,798	22,205	33,699	55,904	1.57
	2010	85,321	16,404	68,917	111,085	34,874	145,959	0.47
	2011	89,224	15,802	73,422	130,770	32,619	163,389	0.45
	2012	84,830	20,322	64,508	88,105	24,914	113,019	0.57
	2013	66,050	18,369	47,681	51,554	16,271	67,825	0.70
Water Resources	2004	714,647	495,616	219,031	52,335	74,698	127,033	1.72
	2005	750,282	501,225	249,057	56,645	54,246	110,891	2.25
	2006	949,691	721,541	228,150	55,461	49,785	105,246	2.17
	2007	951,590	694,060	257,530	70,860	123,376	194,236	1.33
	2008	989,275	773,362	215,913	100,945	114,213	215,158	1.00
	2009	914,837	694,598	220,239	80,347	130,219	210,566	1.04
	2010	1,042,843	837,459	205,384	97,360	124,296	221,656	0.93
	2011	1,096,196	880,540	215,656	108,870	117,668	226,538	0.95
	2012	1,045,812	852,404	193,408	116,150	121,804	237,954	0.81
	2013	1,127,195	822,637	304,558	124,155	145,660	269,815	1.13
Water Pollution Control	2004	51,687	4,059	47,628	—	10,923	10,923	4.36
	2005	55,218	4,082	51,136	21,425	10,424	31,849	1.61
	2006	64,740	10,615	54,125	22,185	9,812	31,997	1.69
	2007	78,564	3,387	75,177	22,850	9,178	32,028	2.35
	2008	71,404	4,521	66,883	23,585	8,422	32,007	2.09
	2009	59,923	4,416	55,507	22,930	7,747	30,677	1.80
	2010	53,365	9,880	43,485	23,655	6,928	30,583	1.42
	2011	49,585	4,876	44,709	24,390	5,996	30,386	1.47
	2012	50,183	2,849	47,334	24,285	4,984	29,269	1.62
	2013	51,642	1,055	50,587	45,755	533	46,288	1.09

(continued)

Source: California State Controller's Office

[1] Total gross revenues include non-operating interest revenue. Building authorities' revenue includes operating transfers in. The nature of the revenue pledged for each type of debt is as follows: investment and interest earnings for Housing Loans bonds and Water Pollution Control bonds; charges for services and sales for Water Resources bonds; power sales revenue for Electric Power bonds; rental revenue for Public Building Contruction bonds, and High Technology Education bonds; CSU Channel Island Financing Authority bonds, and building authorities bonds; residence fees for California State University bonds; tobacco settlements and investment earnings for the Golden State Tobacco Securitization Corporation bonds; and federal transportation funds for Grant Anticipation Revenue Vehicles.

[2] Total operating expenses are exclusive of depreciation, interest expense, and amortization (recovery) of long term prepaid charges. Prior to fiscal year 2012, bond issuance costs were amortized over the term of the bond. Beginning fiscal year 2012, bond issuance costs are operating expenses in the fiscal year incurred.

[3] Debt service requirements include principal and interest of revenue bonds.

[4] All revenue bonds have been redeemed.

[5] The only source of state revenue to pay these bonds is federal transportation funds, and the state obligation to pay debt service on these bonds is limited to and dependent on receipt of the federal funds.

[6] In fiscal year 2011, the California State University Fund was reclassified from a government fund to an enterprise fund.

Schedule of Pledged Revenue Coverage (continued)

For the Past Ten Fiscal Years

(amounts in thousands)

					Debt Service Requirements[3]			
	June 30	Gross Revenue[1]	Operating Expenses[2]	Net Revenue Available for Debt Service	Principal	Interest	Total	Coverage
Electric Power	2004	$ 5,203,000	$ 4,308,000	$ 895,000	$ 180,000	$ 465,000	$ 645,000	1.39
	2005	5,655,000	4,714,000	941,000	388,000	480,000	868,000	1.08
	2006	5,342,000	4,370,000	972,000	436,000	466,000	902,000	1.08
	2007	5,865,000	4,843,000	1,022,000	447,000	448,000	895,000	1.14
	2008	5,362,000	4,323,000	1,039,000	470,000	447,000	917,000	1.13
	2009	4,560,000	3,604,000	956,000	493,000	399,000	892,000	1.07
	2010	3,908,000	3,007,000	901,000	518,000	373,000	891,000	1.01
	2011	2,317,000	1,427,000	890,000	460,000	344,000	804,000	1.11
	2012	915,000	29,000	886,000	556,000	354,000	910,000	0.97
	2013	488,000	(408,000)	896,000	574,000	341,000	915,000	0.98
Public Buildings Construction	2004	$ 307,910	$ 18,480	$ 289,430	$ 560,964	$ 271,836	$ 832,800	0.35
	2005	315,718	13,837	301,881	290,210	279,474	569,684	0.53
	2006	384,442	9,832	374,610	332,345	318,098	650,443	0.58
	2007	396,895	3,699	393,196	365,953	324,246	690,199	0.57
	2008	384,816	33,566	351,250	342,582	331,355	673,937	0.52
	2009	366,151	78,489	287,662	360,559	335,248	695,807	0.41
	2010	430,069	120,565	309,504	377,998	367,055	745,053	0.42
	2011	423,775	507	423,268	394,490	383,185	777,675	0.54
	2012	426,960	13,211	413,749	405,585	384,400	789,985	0.52
	2013	616,041	13,479	602,562	554,985	395,073	950,058	0.63
High Technology Education	2004	$ 34,052	$ 4,050	$ 30,002	$ 35,865	$ 32,975	$ 68,840	0.44
	2005	36,737	3,107	33,630	37,060	30,387	67,447	0.50
	2006	26,508	2,489	24,019	36,910	19,422	56,332	0.43
	2007	22,966	1,514	21,452	25,624	21,062	46,686	0.46
	2008	20,600	3,511	17,089	22,265	13,344	35,609	0.48
	2009	15,975	3,837	12,138	36,730	11,704	48,434	0.25
	2010	13,015	5,009	8,006	19,665	9,977	29,642	0.27
	2011	10,498	681	9,817	19,995	8,878	28,873	0.34
	2012	8,452	—	8,452	21,105	7,754	28,859	0.29
	2013	5,585	—	5,585	22,275	6,568	28,843	0.19
California State University[6]	2004	$ 250,208	$ 172,910	$ 77,298	$ 113,658	$ 49,167	$ 162,825	0.47
	2005	395,396	302,275	93,121	90,025	52,696	142,721	0.65
	2006	512,231	303,261	208,970	109,354	91,876	201,230	1.04
	2007	554,851	689,223	(134,372)	99,598	31,149	130,747	(1.03)
	2008	640,209	511,895	128,314	105,229	115,928	221,157	0.58
	2009	811,454	261,628	549,826	43,572	129,238	172,810	3.18
	2010	599,572	577,765	21,807	47,815	151,988	199,803	0.11
	2011	3,722,414	5,455,059	(1,732,645)	56,344	172,231	228,575	(7.58)
	2012	4,165,118	5,770,880	(1,605,762)	138,535	174,914	313,449	(5.12)
	2013	4,215,258	5,754,800	(1,539,542)	99,340	181,969	281,309	(5.47)
CSU Channel Island Financing Authority[4]	2004	5,449	—	5,449	—	4,205	4,205	1.30
	2005	8,149	10	8,139	—	5,541	5,541	1.47
	2006	8,377	11	8,366	—	6,123	6,123	1.37
	2007	7,397	8	7,389	—	6,951	6,951	1.06
	2008	245	13	232	—	556	556	0.42
Building Authorities	2004	$ 82,823	$ —	$ 82,823	$ 40,600	$ 40,403	$ 81,003	1.02
	2005	86,624	—	86,624	42,296	38,994	81,290	1.07
	2006	94,985	—	94,985	43,862	81,253	125,115	0.76
	2007	81,342	68	81,274	45,437	29,228	74,665	1.09
	2008	79,077	68	79,009	47,475	27,260	74,735	1.06
	2009	78,733	68	78,665	48,594	25,028	73,622	1.07
	2010	76,535	—	76,535	50,948	34,058	85,006	0.90
	2011	63,168	—	63,168	51,957	20,071	72,028	0.88
	2012	57,386	—	57,386	36,473	22,889	59,362	0.97
	2013	53,441	—	53,441	38,400	18,390	56,790	0.94
Golden State Tobacco Securitization Corporation	2004	$ 427,159	$ 367	$ 426,792	$ 60,427	$ 298,708	$ 359,135	1.19
	2005	427,159	305	426,854	55,500	330,652	386,152	1.11
	2006	396,987	—	396,987	61,320	307,824	369,144	1.08
	2007	413,246	—	413,246	133,555	276,965	410,520	1.01
	2008	445,097	—	445,097	129,120	326,631	455,751	0.98
	2009	493,448	—	493,448	116,960	320,679	437,639	1.12
	2010	393,487	—	393,487	138,260	316,038	454,298	0.87
	2011	361,974	—	361,974	60,230	315,268	375,498	0.96
	2012	368,853	—	368,853	65,765	312,815	378,580	0.97
	2013	555,392	—	555,392	623,510	308,056	931,566	0.60
Toll Bridge Seismic Retrofit[4]	2004	$ 139,366	$ 119,141	$ 20,225	$ —	$ 28,615	$ 28,615	0.71
	2005	131,791	97,386	34,405	—	28,615	28,615	1.20
Grant Anticipation Revenue Vehicles[5]	2004	$ 13,150	$ —	$ 13,150	$ —	$ 13,150	$ 13,150	1.00
	2005	65,134	—	65,134	41,545	23,589	65,134	1.00
	2006	72,338	—	72,338	47,845	24,493	72,338	1.00
	2007	72,149	—	72,149	49,190	22,959	72,149	1.00
	2008	71,945	—	71,945	50,985	20,960	71,945	1.00
	2009	77,193	—	77,193	55,275	21,918	77,193	1.00
	2010	83,272	—	83,272	62,335	20,937	83,272	1.00
	2011	84,294	—	84,294	64,785	19,509	84,294	1.00
	2012	84,290	—	84,290	67,730	16,560	84,290	1.00
	2013	84,296	—	84,296	70,990	13,306	84,296	1.00

(concluded)

This page intentionally left blank.

Demographic and Economic Information

The ***demographic and economic*** schedules contain trend information to help the reader understand the environment in which the State's financial activities occur. This section includes the following demographic and economic schedules:

Schedule of Demographic and Economic Indicators
Schedule of Employment by Industry

Schedule of Demographic and Economic Indicators

For Calendar Years 2003 - 2012

	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Population (in thousands)										
California	35,389	35,753	35,986	36,247	36,553	36,856	37,077	37,309	37,570	37,872
% Change	1.3%	1.0%	0.7%	0.7%	0.8%	0.8%	0.6%	0.6%	0.7%	0.8%
United States	290,326	293,046	295,753	298,593	301,580	304,375	307,007	309,330	311,592	313,874
% Change	0.9%	0.9%	0.9%	1.0%	1.0%	0.9%	0.9%	0.8%	0.7%	0.7%
Total personal income (in millions)										
California	$ 1,232,981	$ 1,312,227	$ 1,387,661	$ 1,495,533	$ 1,566,400	$ 1,610,698	$ 1,516,677	$ 1,564,209	$ 1,645,138	$ 1,768,039
% Change	3.8%	6.4%	5.7%	7.8%	4.7%	2.8%	-5.8%	3.1%	5.2%	7.5%
United States	$ 9,369,072	$ 9,928,790	$ 10,476,669	$ 11,256,516	$ 11,900,562	$ 12,451,660	$ 11,852,715	$ 12,308,496	$ 12,949,905	$ 13,729,063
% Change	3.5%	6.0%	5.5%	7.4%	5.7%	4.6%	-4.8%	3.8%	5.2%	6.0%
Per capita personal income										
California [1]	$ 34,841	$ 36,703	$ 38,561	$ 41,259	$ 42,853	$ 43,702	$ 40,906	$ 41,926	$ 43,789	$ 46,477
% Change	2.5%	5.3%	5.1%	7.0%	3.9%	2.0%	-6.4%	2.5%	4.4%	6.1%
United States [1]	$ 32,271	$ 33,881	$ 35,424	$ 37,699	$ 39,461	$ 40,909	$ 38,607	$ 39,791	$ 41,560	$ 43,735
% Change	2.6%	5.0%	4.6%	6.4%	4.7%	3.7%	-5.6%	3.1%	4.4%	5.2%
Labor force and employment (in thousands)										
California										
Civilian labor force	17,391	17,444	17,545	17,687	17,921	18,203	18,208	18,316	18,385	18,511
Employed	16,200	16,355	16,592	16,821	16,961	16,890	16,145	16,052	16,227	16,740
Unemployed	1,191	1,090	953	865	960	1,313	2,064	2,265	2,158	1,771
Unemployment rate	6.8%	6.2%	5.4%	4.9%	5.4%	7.2%	11.3%	12.4%	11.7%	9.6%
United States unemployment rate	6.0%	5.5%	5.1%	4.6%	4.6%	5.8%	9.3%	9.6%	8.9%	8.1%

Source: Economic Research Unit, California Department of Finance; Bureau of Economic Analysis, United States Department of Commerce; Labor Market Information Division, Employment Development Department; Bureau of Labor Statistics, United States Department of Labor.

[1] Calculated by dividing total personal income by population.

Schedule of Employment by Industry

For Calendar Years 2003 and 2012

	2003		**2012**	
	Employees	**Percent of Total State Employment**	**Employees**	**Percent of Total State Employment**
Industry				
Services	5,532,500	37.7%	6,219,000	42.0%
Government				
Federal	199,400	1.3%	188,600	1.3%
Military	55,900	0.4%	61,200	0.4%
State and Local	2,080,700	14.2%	2,125,200	14.4%
Retail trade	1,588,400	10.8%	1,561,800	10.5%
Manufacturing	1,544,500	10.5%	1,252,800	8.5%
Information, finance, and insurance	1,082,700	7.4%	954,100	6.4%
Construction and utilities	852,200	5.8%	646,800	4.4%
Wholesale trade	647,400	4.4%	676,800	4.6%
Transportation and warehousing	425,200	2.9%	427,200	2.9%
Farming	375,100	2.5%	402,500	2.7%
Real estate	272,200	1.9%	250,900	1.7%
Natural resources and mining	22,200	0.2%	30,100	0.2%
Total	**14,678,400**	**100.0%**	**14,797,000**	**100.0%**

Source: Labor Market Information Division, California Employment Development Department

Operating Information

The ***operating information*** schedules assist the reader in evaluating the size, efficiency, and effectiveness of the State's government. This section includes the following operating information schedules:

Schedule of Full-time Equivalent State Employees by Function
Schedule of Operating Indicators by Function
Schedule of Capital Asset Statistics by Function

Schedule of Full-Time Equivalent State Employees by Function

For the Past Ten Fiscal Years

	General		Health and		State and	Business,		
			Human		Consumer	Transportation	Correctional	
	Government	Education	Services	Resources	Services	and Housing	Programs	Total
Fiscal Year								
2004	20,661	122,040	49,868	19,343	15,039	41,448	48,461	316,860
2005	19,884	119,162	50,490	18,935	15,023	41,450	48,740	313,684
2006	20,336	121,973	49,569	19,076	15,126	41,342	50,171	317,593
2007	21,035	134,974	49,533	19,677	15,530	41,314	53,321	335,384
2008	21,825	134,832	49,330	20,868	15,840	42,139	58,284	343,118
2009	22,347	135,720	50,996	21,985	16,350	42,254	60,957	350,609
2010	30,390	133,642	43,663	22,223	15,868	40,590	59,401	345,777
2011	32,535	138,017	48,638	23,611	17,043	44,844	67,272	371,959

					Business,[3]			
			Health and		Consumer			
	General[2]		Human		Services,		Correctional	
Fiscal Year	Government	Education	Services	Resources	and Housing	Transportation[4]	Programs	Total
2012[1, 5]	44,673	131,039	46,431	24,199	6,236	41,758	62,472	356,808
2013[1, 5]	43,241	132,493	43,431	23,796	5,395	39,222	58,743	346,321

Source: Annual Governor’s Budget Summary, California Department of Finance

Note: The number of full-time equivalent employees is calculated by counting each person who works full time as one full-time equivalent and those who work part time as fractional equivalents based on time worked.

[1] Under the Governor's 2012 Reorganization Plan No. 2, significant reorganizations take place effective July 1, 2013, which impacts General Government; Business, Consumer Services, and Housing; and Transportation. Beginning fiscal year 2011-12, budget information is reported under the new sections, and is not comparable to that of prior years.

[2] Effective July 1, 2013, the Government Operations Agency, which will include but is not limited to Franchise Tax Board, Department of General Services, and Public Employees' Retirement System, is created and added to General Government. In the 2013-14 Governor's Budget, budget information for General Government is being retroactively stated for fiscal year 2011-12 and fiscal year 2012-13 to include Government Operations.

[3] Effective July 1, 2013, under Governor's 2012 Reorganization Plan No. 2, the majority of business and housing components under the previously reported Business, Transportation and Housing merged with the State and Consumer Services. In the 2013-14 Governor's Budget, budget information for Business, Consumer Services, and Housing is being retroactively stated for fiscal year 2011-12 and fiscal year 2012-13.

[4] Effective July 1, 2013, portions of the previously reported Business, Transportation and Housing is reorganized as the Transportation Agency under the Governor's 2012 Reorganization Plan No. 2. In the 2013-14 Governor's Budget, budget information for Transportation is being retroactively stated for fiscal year 2011-12 and fiscal year 2012-13.

[5] The number of positions include 120 legislators and staff at the Legislative Counsel Bureau. They do not include the Legislature's staff and Legislative Analyst's Office.

This page intentionally left blank.

Schedule of Operating Indicators by Function

For the Past Ten Fiscal Years

	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
General Government										
State Lottery										
Total revenue [1]	$ 2,974	$ 3,334	$ 3,585	$ 3,318	$ 3,050	$ 2,955	$ 3,041	$ 3,439	$ 4,371	$ 4,446
Allocation to Education Fund [1]	$ 1,044	$ 1,149	$ 1,259	$ 1,177	$ 1,069	$ 1,028	$ 1,072	$ 1,103	$ 1,300	$ 1,262
Judicial Council of California										
Supreme Court [2]										
Cases filed	8,564	8,990	9,261	8,988	10,521	9,274	9,562	10,145	9,237	N/A
Cases disposed	8,565	8,535	9,878	9,247	10,440	9,513	9,439	10,063	9,739	N/A
Courts of Appeal										
Notices of appeal filed [3]										
Civil	6,484	6,142	6,018	6,116	5,913	5,958	6,122	6,258	6,505	N/A
Criminal	6,625	6,312	6,516	6,508	6,681	6,819	6,857	6,877	6,387	N/A
Juvenile	2,703	2,626	2,715	2,880	2,900	2,858	2,759	2,106	2,830	N/A
Trial Courts										
Total civil cases [4, 10]										
Filings	1,503,419	1,426,822	1,418,722	1,462,820	1,582,092	1,729,648	1,647,817	1,574,569	1,464,629	N/A
Dispositions	1,360,908	1,304,924	1,267,534	1,286,736	1,280,184	1,537,243	1,530,502	1,599,388	1,436,399	N/A
Department of Food and Agriculture										
Milk production (million lbs) [5]	36,465	37,564	38,830	40,683	41,203	39,512	40,385	41,462	41,801	N/A
Farm land (thousand acres) [5]	26,400	25,900	25,700	25,400	25,400	25,400	25,400	25,400	25,400	N/A
Education										
Public Colleges and Universities										
Fall enrollment										
Community Colleges [10]	1,577,296	1,578,573	1,614,689	1,694,796	1,793,508	1,795,969	1,747,239	1,655,081	1,582,186	1,520,472
California State University	395,825	405,282	417,156	433,017	437,008	433,054	412,372	426,534	436,560	N/A
University of California	207,909	209,080	214,298	220,034	226,040	230,528	234,464	236,691	238,686	N/A
K-12 Schools										
Fall enrollment										
Public	6,299,015	6,322,217	6,312,103	6,286,943	6,275,469	6,252,011	6,190,425	6,217,002	6,220,993	6,226,989
Private	599,605	591,056	594,597	583,794	564,734	536,393	531,111	515,143	497,019	516,119

(continued)

Source: California State Lottery; Judicial Council of California; U.S. Department of Agriculture, National Agricultural Statistics Service; California Departments of Finance, Education, Public Health, Motor Vehicles, Transportation, and Corrections and Rehabilitation; Employment Development Department; Department of Fish and Wildlife; California Energy Commission; Franchise Tax Board; and Department of the California Highway Patrol.

[1] Dollars in millions.
[2] Includes death penalty cases, habeas related to automatic appeals, petitions for review, original proceedings, and state bar matters.
[3] Includes only one notice of appeal per case.
[4] Includes personal injury, property damage, wrongful death, small claims, family law, probate, and other cases.
[5] Data based on calendar year.
[6] Total nonfarm and farm.
[7] Items reported by license year as of December, 2013.
[8] Data compiled from a 10% sample of California licensed drivers.
[9] A center-line mile is measured by the yellow dividing strip that runs down the middle of the road, regardless of the number of lanes on each side.
[10] Some prior years were updated based on more current information.

N/A=Not available

* Projected

Schedule of Operating Indicators by Function (continued)

For the Past Ten Fiscal Years

	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Health and Human Services										
Department of Public Health										
Vital statistics										
Live births [5]	544,685	548,700	562,157	566,137	551,567	526,774	509,979	502,023	503,788	506,125 *
Department of Social Services										
Total Food Stamp households (avg per month)	722,519	792,617	809,782	823,335	892,992	1,067,358	1,340,857	1,576,042	1,757,387	1,898,283
Employment Development Department										
Number of employed [5, 6, 10]	15,126,100	15,440,600	15,613,300	15,691,100	15,142,000	14,326,300	14,476,400	14,614,600	15,240,400	N/A
Resources										
Department of Fish and Game										
Sport fishing licenses sold [7, 10]	2,929,204	2,870,727	2,924,325	3,003,783	2,857,236	2,838,776	2,410,008	2,483,680	2,580,763	2,531,361
Hunting licenses sold [7, 10]	1,593,517	1,625,078	1,655,760	1,718,657	1,670,190	1,679,864	1,677,864	1,863,198	1,988,531	1,966,580
California Energy Commission										
Electrical energy generation plus net imports (gigawatt hours) [10]	290,211	289,177	298,454	304,823	307,428	298,996	291,130	293,652	301,966	N/A
State and Consumer Services										
Franchise Tax Board										
Personal Income Tax [5]										
Number of tax returns filed	13,832,810	14,087,896	14,382,675	15,016,273	14,806,335	14,638,204	14,814,427	15,042,359	N/A	N/A
Taxable income [1]	$ 695,075	$ 767,877	$ 812,008	$ 872,869	$ 799,490	$ 729,658	$ 794,758	$ 838,347	N/A	N/A
Total tax liability [1]	$ 36,093	$ 43,131	$ 45,716	$ 49,693	$ 41,676	$ 38,870	$ 44,472	$ 43,921	N/A	N/A
Corporation Tax [5]										
Number of tax returns filed	616,805	651,060	684,363	709,937	722,358	727,675	738,224	754,315	N/A	N/A
Income reported for taxation [1]	$ 82,328	$ 115,474	$ 140,325	$ 121,843	$ 67,921	$ 55,367	$ 96,965	$ 93,456	N/A	N/A
Total tax liability [1]	$ 7,123	$ 8,680	$ 9,992	$ 9,414	$ 9,106	$ 7,858	$ 8,604	$ 7,808	N/A	N/A
Business and Transportation										
Department of Motor Vehicles										
Motor vehicle registration	33,289,925	33,363,963	33,882,029	32,047,124	31,920,649	31,799,398	31,987,821	31,802,483	31,946,422	N/A
License issued by age [5,8]										
Under age 18	287,800	277,168	268,199	262,415	244,481	229,545	218,997	227,069	499,145	N/A
Between 18-80	22,073,101	22,155,604	22,450,786	22,804,927	22,922,361	22,910,011	23,001,119	23,150,222	23,188,635	N/A
Over age 80	482,340	494,577	518,102	562,518	552,150	560,491	579,397	579,207	602,508	N/A
California Highway Patrol										
Total number of DUI arrests [5]	94,023	89,946	94,251	92,270	97,019	95,135	89,814	86,901	79,993	31,573
Department of Transportation										
Highway center-line miles-rural [5,9]	11,380	11,090	10,821	10,830	10,811	10,808	10,785	10,780	10,784	N/A
Highway center-line miles-urban [5,9]	3,829	4,123	4,422	4,439	4,393	4,384	4,375	4,353	4,363	N/A
Correctional Programs										
Department of Corrections and Rehabilitation										
Division of Adult Institutions										
Institution population at December 31 each year	162,687	166,723	171,310	170,452	170,283	167,922	162,200	147,181	132,768	134,333
Division of Juvenile Justice										
Institution population at June 30 each year	4,067	3,348	2,962	2,531	1,877	1,589	1,474	1,263	922	712

(concluded)

Schedule of Capital Asset Statistics by Function

For the Past Ten Fiscal Years

	2004 [1]	2005	2006	2007	2008	2009	2010	2011	2012	2013
General Government										
Department of Food and Agriculture										
Vehicles and mobile equipment [5]	929	903	907	915	818	803	746	809	804	792
Square footage of structures (in thousands)	467	467	453	453	453	466	466	466	466	455
Department of Justice										
Vehicles and mobile equipment	967	969	968	966	826	870	816	677	531	527
Department of Military										
Vehicles and mobile equipment	155	152	210	182	206	182	208	249	233	211
Square footage of structures (in thousands)	5,218	3,348	3,388	3,388	3,387	3,383	3,154	3,530	3,511	3,623
Department of Veterans Affairs										
Veterans homes	3	3	3	3	3	5	6	6	6	8
Vehicles and mobile equipment	157	139	111	248	251	120	113	132	143	267
Square footage of structures (in thousands)	1,598	1,598	1,598	1,598	1,598	1,683	1,600	2,086	2,086	2,488
Education										
California State University										
Vehicles and mobile equipment [2, 5]	N/A	N/A	601	3,343	3,994	4,015	4,338	4,415	4,415	4,466
Campuses	23	23	23	23	23	23	23	23	23	23
Square footage of structures (in thousands)	58,983	59,588	59,921	62,198	63,971	66,686	69,049	71,287	73,785	73,866
Health and Human Services										
Department of Developmental Services										
Vehicles and mobile equipment	900	836	655	829	839	701	569	818	789	632
Developmental centers	7	7	7	7	7	7	5	5	5	4
Square footage of structures (in thousands)	5,160	5,185	5,181	5,181	5,186	5,187	5,185	5,294	5,294	5,279
Department of State Hospitals [6]										
Vehicles and mobile equipment	438	439	655	629	638	658	665	709	718	699
State hospitals	4	4	5	5	5	5	5	5	5	7
Square footage of structures (in thousands)	4,628	4,626	4,673	6,359	6,364	6,348	6,331	6,331	6,336	6,457

(continued)

Sources: California Department of General Services (DGS)

[1] For fiscal year 2004, the square footage of structures information is from November 2004 because June 2004 information is not available.

[2] Prior to fiscal year 2006, DGS did not require California State University to report its vehicles.

[3] In 2008, California Highway Patrol purchased numerous vehicles, and in their physical count also included motorcycles, which had not been reported for previous years.

[4] In fiscal year 2006, Department of Corrections and Rehabilitation merged with Department of Youth Authority.

[5] For fiscal year 2008, DGS was not able to obtain complete data from the agency.

[6] In 2012, portions of the Department of Mental Health became the Department of State Hospitals.

N/A = not available

Schedule of Capital Asset Statistics by Function (continued)

For the Past Ten Fiscal Years

	2004 [1]	2005	2006	2007	2008	2009	2010	2011	2012	2013
Resources										
Department of Fish and Game										
Vehicles and mobile equipment	2,754	3,157	3,182	3,311	2,868	3,640	2,630	3,180	3,012	2,896
Square footage of structures (in thousands)	1,108	1,108	1,112	1,120	1,192	1,269	1,301	1,313	1,317	1,317
Department of Forestry and Fire										
Vehicles and mobile equipment	3,079	3,016	2,572	2,945	3,043	3,067	2,598	2,804	2,810	2,845
Square footage of structures (in thousands)	3,892	3,892	3,885	3,883	3,869	3,851	3,947	3,943	3,935	3,641
Department of Parks and Recreation										
Vehicles and mobile equipment	2,709	3,044	2,742	2,988	3,023	3,220	3,102	3,715	4,200	3,311
State Parks	277	278	278	276	279	278	278	279	280	280
Acres of state park land (in thousands)	1,488	1,506	1,552	1,235	1,248	1,331	1,365	1,334	1,333	1,590
Square footage of structures (in thousands)	6,510	6,348	6,350	6,350	6,350	6,350	6,350	6,433	6,623	6,598
State Lands Commission										
Vehicles and mobile equipment	56	56	49	51	49	57	47	50	42	42
Acres of land (in thousands)	4,498	4,498	4,496	4,492	4,491	4,491	4,491	4,491	4,491	4,489
State and Consumer Services										
Department of Consumer Affairs										
Vehicles and mobile equipment	646	628	1,050	640	726	718	574	578	574	518
Department of General Services										
Vehicles and mobile equipment	6,895	6,883	6,894	7,330	7,558	6,736	5,761	5,670	4,991	5,226
Square footage of structures (in thousands)	15,981	15,995	17,350	18,084	18,084	18,084	18,394	18,602	19,180	19,098
Business and Transportation										
California Highway Patrol										
Vehicles and mobile equipment [3]	3,933	3,930	4,105	4,655	5,228	5,914	5,422	5,337	5,013	5,341
Square footage of structures (in thousands)	1,146	1,147	1,087	1,110	1,118	1,118	1,135	1,135	1,149	1,149
Department of Motor Vehicles										
Vehicles and mobile equipment	395	395	373	458	434	417	366	366	366	294
Square footage of structures (in thousands)	1,853	1,853	1,827	1,866	1,848	1,855	1,855	1,842	1,842	1,842
Department of Transportation										
Vehicles and mobile equipment	11,039	10,856	11,048	11,130	11,098	13,346	11,302	12,759	12,690	11,767
Square footage of structures (in thousands)	6,274	6,284	6,632	6,618	6,229	6,434	6,444	6,519	8,131	8,170
Correctional Programs										
Department of Corrections and Rehabilitation										
Vehicles and mobile equipment [5]	7,189	7,006	6,451	6,657	7,908	7,778	5,787	5,985	5,952	5,156
Prisons and juvenile facilities [4]	32	32	32	41	41	39	39	39	39	37
Square footage of structures (in thousands)	40,483	40,472	40,622	40,777	40,831	40,852	41,228	41,399	41,399	40,606

(concluded)

STATE OF CALIFORNIA

Office of the State Controller

JOHN CHIANG
California State Controller

Executive Office

Collin Wong-Martinusen
Chief of Staff

George Lolas
Chief Operating Officer

Division of Accounting and Reporting

Casandra Moore-Hudnall, CPA
Division Chief

Liz Cornell, CPA
Assistant Division Chief

Beverly Englund, CPA
Bureau Chief

State Government Reporting

Managers

Renee Davenport
Dana Parker
Emmanuel Lasu
Dee Ranaweera, CPA
Saleshni Singh
Jodi Rivera

Supervisors

Silvia Kalman
Sharon Wurst

Staff:

Barbara Beck, CPA
Maisha Bullock
Perry Darden
Janet Delorey
Godwin Ekine
Judy Eng
Jim Graham
Yolanda Green
Matthew Haber
Robert Holpuch
Kathy Howton
Jenny Jones
Lilian Le
Grace Lee
Judy Lee
Will LeMarQuand
Bing Leng
Cecilia Li-Szeto
Gary Marshall
TuongKhanh Nguyen
Sheri Noss
Allen Nunley
Randy Phan
Kitipong Punnikul
Samprit Shergill, CPA
Janti Tam
Randall Taylor
Scott Taylor, CPA
Sang Chol Thompson
Perry Tseng-Liu

Financial Information Systems and Technology

Bureau Chief
Carlos Diaz

Supervisor
Rod Renteria

Staff:

Ross Boyer
Larry Butler
Daniel Castro
Matt Harada
Marcelino Hernandez
Jason Kronemeyer
Eric Pecoraro
Miguel Quistian
Carl Walker
Thomas Wong

Editors

Terrie Chrysler
Teresa Moraga
Estelle Manticas

Special Thanks to:

Teri Carlson, CPA
Cathy Leal
Alan Davis
Julie Talbot, CPA
Sandra Foster, CPA

Office of California State Controller John Chiang
Division of Accounting and Reporting
P.O. Box 942850
Sacramento, CA 94250
(916) 445-2636

(THIS PAGE INTENTIONALLY LEFT BLANK)

APPENDIX C

TOBACCO CONSUMPTION REPORT

(THIS PAGE INTENTIONALLY LEFT BLANK)

A Forecast of
U.S. Cigarette
Consumption
(2015-2045) for
The Golden State Tobacco Securitization Corporation

Submitted to:

The Golden State Tobacco Securitization Corporation

Prepared by:

IHS Global Inc.

March 13, 2015

James Diffley
Senior Director

IHS Global Inc.
1650 Arch Street, Suite 2000
Philadelphia, PA 191035

(215) 789-7422

Copyright © 2015 IHS Global Inc.

Executive Summary

IHS Global Insight has developed a cigarette consumption model based on historical U.S. data between 1965 and 2013. This econometric model, coupled with our long term forecast of the U.S. economy, has been used to project total U.S. cigarette consumption from 2015 through 2045. Our forecast indicates that total consumption in 2045 will be 104.0 billion cigarettes (or 104.6 billion including roll-your-own tobacco equivalents), a 61% decline from the 2014 level. From 2015 through 2045 the average annual rate of decline is projected to be approximately 3.0%.

Our model was constructed based on widely accepted economic principles and IHS Global Insight's considerable experience in building econometric forecasting models. A review of the economic research literature indicates that our model is consistent with the prevalent consensus among economists concerning cigarette demand. We considered the impact of demographics, cigarette prices, disposable income, employment and unemployment, industry advertising expenditures, the future effect of the incidence of smoking amongst underage youth, and qualitative variables that captured the impact of anti-smoking regulations, legislation, health warnings, and the availability of alternative tobacco and nicotine products. After extensive analysis, we found the following variables to be effective in building an empirical model of adult per capita cigarette consumption: real cigarette prices, real per capita disposable personal income, the impact of workplace smoking restrictions first instituted widely in the 1980s, the stricter restrictions on smoking in public places instituted over the last decade, and the trend over time in individual behavior and preferences. This forecast is based on reasonable assumptions regarding the future paths of these factors.

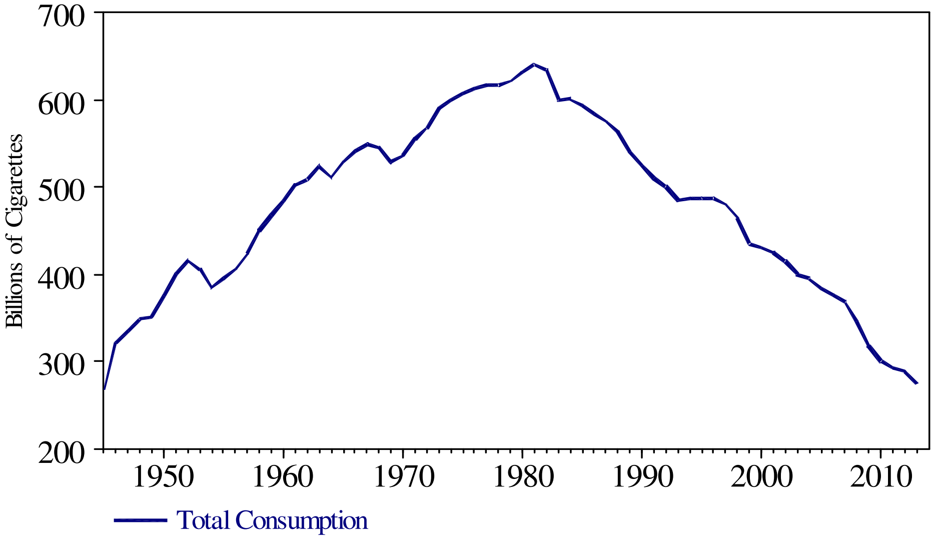
Disclaimer

The forecasts included in this report, including, but not limited to, those regarding future cigarette consumption, are estimates, which have been prepared on the basis of certain assumptions and hypotheses. No representation or warranty of any kind is or can be made with respect to the accuracy or completeness of, and no representation or warranty should be inferred from, these forecasts. The cigarette consumption forecast contained in this report is based upon assumptions as to future events and, accordingly, is subject to varying degrees of uncertainty. Some assumptions inevitably will not materialize and, additionally, unanticipated events and circumstances may occur. Therefore, for example, actual cigarette consumption inevitably will vary from the forecasts included in this report and the variations may be material and adverse.

Cigarette Use in the United States

People have used tobacco products for centuries. Tobacco was first brought to Europe from America in the late 15th century and became America's major cash crop in the 17th and 18th centuries[1]. Prior to 1900, tobacco was most frequently used in pipes, cigars, and snuff. With the widespread production of manufactured cigarettes (as opposed to hand-rolled cigarettes) in the United States in the early 20th century, cigarette consumption expanded dramatically. Consumption is defined as taxable U.S. consumer sales, plus shipments to overseas armed forces, ship stores, Puerto Rico, and other U.S. possessions, and small tax-exempt categories[2] as reported by the Bureau of Alcohol, Tobacco, Firearms, and Explosives. The USDA, which has compiled data on cigarette consumption between 1900 and 2007, reports that consumption grew from 2.5 billion cigarettes in 1900 to a peak of 640 billion in 1981[3]. Consumption declined in the 1980s, 1990s, and 2000s, reaching a level of 465 billion cigarettes in 1998 and decreased to less than 400 billion cigarettes in 2003[4] and under 300 billion in 2011[5]. Cigarette consumption has now declined through three decades, reversing four decades of increases from the 1940s.

Historical U.S. Cigarette Consumption: 1945-2013
Number of Cigarettes (Billions)



[1] *Source*: "Tobacco Timeline," Gene Borio (1998).

[2] Bureau of Alcohol, Tobacco, Firearms, and Explosives reports as categories such as transfer to export warehouses, use of the U.S., and personal consumption/experimental.

[3] *Source*: "Tobacco Situation and Outlook", U.S. Department of Agriculture-Economic Research Service, September 1999 (USDA-ERS).

[4] *Source*: USDA-ERS. April 2005.

[5] *Source*: US Tobacco and Tax Bureau, MSAI

While the historical trend in consumption prior to 1981 was increasing, there was a decline in cigarette consumption of 9.8% during the Great Depression between 1931 and 1932. Notwithstanding, this steep decline, consumption rapidly increased after 1932, exceeding previous levels by 1934. Following the release of the Surgeon General's Report in 1964, cigarette consumption continued to increase at an average annual rate of 1.2% between 1965 and 1981. Between 1981 and 1990, however, U.S. cigarette consumption declined at an average annual rate of 2.2%. From 1990 to 1998, the average annual rate of decline in cigarette consumption was 1.5%; but for 1998 the decline increased to 3.1% and increased further to 6.5% for 1999. These declines are correlated with large price increases in 1998 and 1999 following the Master Settlement Agreement ("MSA") and previously settled states agreements. In 2000 and 2001, the rate of decline moderated, to 1.2%. In the early part of the decade, coincident with a large number of state excise tax increases, the rate of decline accelerated in 2002 and 2003 to an annual rate of 3.0%. The decline moderated for the next four years, through 2007, averaging 2.3%.

The rate of decline accelerated dramatically beginning in 2008, with a 3.8% decline in the number of cigarettes (including roll-your-own equivalents to cigarettes as defined by the MSA at 0.0325 ounces of loose tobacco per cigarette) for that year, 9.1% in 2009, and 6.4% in 2010 before finally decelerating to 2.8% in 2011 and 2.0% in 2012.

There was a confluence of factors which led to the dramatically reduced consumption in 2009. First, indoor smoking bans spread rapidly across the country in the latter half of the decade. We now estimate that their impact on decreased smoking and cigarette consumption was approximately 6 billion cigarettes ("sticks") in 2009. Second, the latter months of 2008 saw a very deep recession. Our model projects that, given the lower realized levels of household income in 2009, consumption was negatively impacted by about 8 billion sticks. Third, the increase in the federal excise tax to $1.01 per pack, effective April 1, 2009 decreased cigarette demand by about 10 billion in 2009 according to our model of price elasticity. Fourth, the acceleration, prompted by the recession, of state excise tax increases similarly reduced consumption by a further 4 billion.

In 2013 the decline sharpened to nearly 5%. This decline has been attributed by the industry to a weak economy, the rapid increase in usage of electronic cigarettes, and to an unfavorable comparison with a surprisingly strong 2012. In addition, some of the decline was due to a reduction in wholesale inventories late in the year, some of which was reversed in 2014. Full year 2014 shipments reported by MSAI were 3.2% lower than 2013, with actual consumption net of the inventory change estimated to be down 3.4%.

The following table sets forth United States domestic cigarette consumption, with and without roll-your-own equivalents, for the seventeen years ended December 31, 2014[6].

[6] *Source:* National Association of Attorneys General, USDA-ERS, estimates by IHS Global. USDA estimates for 2004, 2005, and 2006 diverge significantly from estimates based on independent data from the industry and from the US Tobacco and Tax Bureau. In 2004, the manufacturers report domestic shipments of 394.5 billion, and the TTB reports a total of 397.7 billion. These contrast with a USDA estimate of 388 billion. In 2005, the manufacturers report 381.7 billion, TTB reports 381.1 billion, and

The data in this table vary from statistics on cigarette shipments in the United States. While this Report is based on consumption, payments made under the MSA dated November 23, 1998 between certain cigarette manufacturers and certain settling states are computed based in part on shipments in or to the fifty United States, the District of Columbia and Puerto Rico. The quantities of cigarettes shipped and cigarettes consumed may not match at any given point in time as a result of various factors such as inventory adjustments, but are substantially the same when compared over a period of time.

U.S. Cigarette Consumption

Year Ended December 31,	Consumption (Billions of Cigarettes)	Percentage Change	Consumption (Billions of Cigarettes with roll-your-own equivalents)	Percentage Change
2014	266	-3.18	267	-3.26
2013	274	-4.86	276	-4.86
2012	288	-1.85	290	-1.97
2011	294	-2.58	296	-2.77
2010	301	-5.52	305	-6.36
2009	319	-8.03	325	-9.09
2008	348	-4.35	358	-3.79
2007	368	-2.28	372	-4.97
2006	377	-1.93	391	0.26
2005	384	-2.69	390	-3.51
2004	395	-1.28	404	0.09
2003	400	-3.66	404	-3.30
2002	415	-2.35	418	-2.68
2001	425	-1.16	429	-1.51
2000	430	-1.15	436	-1.30
1999	435	-6.45	442	
1998	465	-3.13		

USDA 376 billion. In 2006, the manufacturers report 372.5 billion, TTB reports 380.9 billion, and USDA 372 billion. The USDA has discontinued this service, publishing its final report on October 24, 2007.

The U.S. Cigarette Industry

The domestic cigarette market is an oligopoly in which, according to MSAI, the three leading manufacturers accounted for 85.0% of U.S. shipments in 2014, down from 85.4% in 2013. According to the National Association of Attorneys General, the three leading manufacturers accounted for 84.9% of U.S. shipments in 2013, up from 84.5% in 2012 and 2011, and 83.6% in 2010. These top companies are Philip Morris USA, Reynolds American Inc. (following the merger of RJ Reynolds and Brown & Williamson in 2004), and Lorillard. (In July 2014 Reynolds American initiated a purchase of Lorillard.) These companies commanded 47.4%, 23.1%, and 14.6%, respectively of the domestic market in 2014[7]. The market share of the leading manufacturers has declined from over 96% in 1998 due to inroads by smaller manufacturers and importers following the MSA and other state settlement agreements.

The United States government has raised revenue through tobacco taxes since the Civil War. Although the federal excise taxes have risen through the years, excise taxes as a percentage of total federal revenue had fallen from 3.4% in 1950 to approximately 0.4% prior to the 2009 federal excise tax increase. In fiscal year 2014, the federal government received $13.6 billion in excise tax revenue from tobacco sales. In addition, state governments also raised significant revenues, $16.5 billion in fiscal year 2014 from excise taxes. Cigarettes constitute the majority of these sales, which also include cigars and other tobacco products.

Survey of the Economic Literature on Smoking

Many organizations have conducted studies on U.S. cigarette consumption. These studies have utilized a variety of methods to estimate levels of smoking, including interviews and/or written questionnaires. Although these studies have tended to produce varying estimates of consumption levels due to a number of factors—including different survey methods and different definitions of smoking—taken together such studies provide a general approximation of consumption levels and trends. Set forth below is a brief summary of some of the more recent studies on cigarette consumption levels.

Incidence of Smoking

Approximately 42.1 million American adults were current smokers in 2013, representing approximately 17.8% of the population age 18 and older, a decline from 18.1% in 2012, and from 19.3% in 2010, according to a Centers for Disease Control and Prevention ("CDC") study[8] released in 2014. This survey defines "current smokers" as those persons who have smoked at least 100 cigarettes in their lifetime and who smoked every day or some days at the time of the survey. Although the percentage of adults who smoke (incidence) declined from 42.4% in 1965 to 25.5% in 1990 and 24.1% in 1998, the

[7] IHS Global Insight calculation based on industry shipments data.

[8] *Source*: CDC. Morbidity and Mortality Weekly Report. "Current Cigarette Smoking Among Adults – United States, 2005-2012". November, 2014.

incidence rate has declined relatively slowly since 1998. The decline had accelerated between 2002, when the incidence rate was 22.5%, to 2004, when the incidence rate dropped to 20.9%, though it remained as high as 20.6% in 2009. The 2014 report also indicated that the percentage of smokers who smoked less than 30 cigarettes per day had declined from 12.6% to 7.0% since 2005.

The CDC, in September 2011, released the results of a study of quitting smoking[9]. It found that, in 2010, 68.8% of smokers wanted to stop smoking, 52.4% had made a quit attempt in the past year, 6.2% had recently quit, 48.3% had been advised by a health professional to quit, and 31.7% had used counseling and/or medications when they tried to quit. In January 2014 the CDC released further results indicating the quit rates had increased to 52.9% for attempts made in the past year.

A recent trend, likely influenced by extensive indoor smoking bans in the U.S., is growing numbers of "light smokers", those who smoke just a few cigarettes per day. Thus the decline in the overall prevalence of smoking has slowed while the rate of decline of the volume of cigarettes consumed has accelerated. In a similar fashion electronic cigarettes have replaced cigarette consumption in locations subject to indoor smoking bans.

Youth Smoking

Certain studies have focused in whole or in part on youth cigarette consumption. Surveys of youth typically define a "current smoker" as a person who has smoked a cigarette on one or more of the 30 days preceding the survey. The CDC's Youth Risk Behavior Survey ("YRBS") estimated that from 1991 to 1999 incidence among high school students (grades 9 through 12) rose from 27.5% to 34.8%, representing an increase of 26.5%. By 2003, incidence had fallen to 21.9%, a decline of 37.1% over four years. The rate of decline has continued, though at a slower pace. By 2011, the prevalence was 18.1%.[10]

According to the Monitoring the Future Study, a school-based study of cigarette consumption and drug use conducted by the Institute for Social Research at the University of Michigan, smoking incidence over the prior 30 days among eighth, tenth, and twelfth graders were sharply lower in 2014 than in 2013, continuing trends that began in 1996. Smoking incidence in all grades is well below where it was in 1991, having fallen below that mark in 2001 for eighth graders and in 2002 for tenth and twelfth graders.

[10] *Source*: CDC. Morbidity and Mortality Weekly Report. “Tobacco Use Among Adults – United States, 2010”. September, 2011.

Prevalence of Cigarette Use Among 8th, 10th, and 12th Graders

Grade	1991 (%)	2012 (%)	2013 (%)	2014 (%)	'91-'14 Change (%)
8th	14.3	4.9	4.5	4.0	-72.0%
10th	20.8	10.8	9.1	7.2	-65.4%
12th	28.3	17.1	16.3	13.6	-51.9%

The Study also reports on marijuana use among teens which exceeds tobacco use. At the same time a number of states have, or are considering, relaxing the legal prohibition on marijuana use. The effects of legalized marijuana on cigarette use had been studied, in Australia following their legalization. That study concluded that marijuana was, if anything, complementary to cigarette smoking, more likely to result in an increase in tobacco use. However, a recent study published in the journal, Addictive Behaviors, found that one of the chemical compounds found in marijuana can decrease the craving for nicotine and hence potentially help smokers quit tobacco use.

The 2013 National Survey on Drug Use and Health (formerly called National Household Survey on Drug Abuse) conducted by the Substance Abuse and Mental Health Services Administration of the United States Department of Health and Human Services ("SAMHSA") estimated that approximately 55.8 million Americans age 12 and older were current cigarette smokers (defined by this survey to mean they had smoked cigarettes at least once during the 30 days prior to the interview). The survey found that an estimated 5.6% of youths age 12 to 17 were current cigarette smokers in 2013, down from 8.4% in 2010 and 13.0% in 2002.

The CDC reported on November 13, 2014 that the National Youth Tobacco Survey found that in 2013 the prevalence of tobacco product use among middle and high school students was 6.5% and 22.9%, respectively. These rates decreased from 2011 when they were 6.7% and 23.3%, respectively.

These surveys all indicate that youth smoking, which had increased during the 1990s following two decades of decline, is again decreasing. In most of the nation the minimum legal age to purchase cigarettes is 18. In 2013 New York City increased that age to 21, and in February 2015 Cambridge and Framingham, MA did so as well. A similar proposal to raise the smoking age to 21 has also been introduced in the California, Colorado, Hawaii, Missouri, New York State, New Jersey, Rhode Island, Utah, Vermont, and Washington legislatures, in the Council of the District of Columbia, and in Suffolk County, New York. Four states Alabama, Alaska, New Jersey, and Utah, and three New York counties currently set the minimum age at 19. On March 12, 2015 the Institute of Medicine of the National Academy of Sciences released a report recommending that the minimum age of legal access to tobacco products be raised to 21. The report concluded that raising the minimum legal age to 21 would likely decrease smoking prevalence by 12% among today's teenagers when they become adults.

Price Elasticity of Cigarette Demand

The price elasticity of demand reflects the impact of changes in price on the demand for a product. Cigarette price elasticities from recent conventional research studies have generally fallen between an interval of -0.3 to -0.5 (In other words, as the price of cigarettes increases by 1.0% the quantity demanded decreases by 0.3% to 0.5%). A few researchers have estimated price elasticity as high as -1.23. Research focused on youth smoking has found price elasticity levels of up to -1.41.

Two studies published by the National Bureau of Economic Research examine the price elasticity of youth smoking. In their study on youth smoking in the United States, Gruber and Zinman estimate an elasticity of smoking participation (defined as smoking any cigarettes in the past 30 days) of –0.67 for high school seniors in the period 1991 to 1997.[11] That is, a 1% increase in cigarette prices would result in a decrease of 0.67% in the number of those seniors who smoked. The study's findings state that the drop in cigarette prices in the early 1990's can explain 26% of the upward trend in youth smoking during the same period. The study also found that price has little effect on the smoking habits of younger teens (8th grade through 11th grade), but that youth access restrictions have a significant impact on limiting the extent to which younger teens smoke. Tauras and Chaloupka also found an inverse relationship between price and cigarette consumption among high school seniors.[12] The price elasticity of cessation for males averaged 1.12 and for females averaged 1.19 in this study. These estimates imply that a 1% increase in the real price of cigarettes will result in an increase in the probability of smoking cessation for high school senior males and females of 1.12% and 1.19%, respectively. A study utilizing more recent data, from 1975 to 2003, by Grossman, estimated an elasticity of smoking participation of just -0.12.[13] Nevertheless it concludes that price increases subsequent to the 1998 MSA explain almost the entire 12% drop in youth smoking over that time.

In another study, Czart et al. (2001) looked at several factors which they felt could influence smoking among college students. These factors included price, school policies regarding tobacco use on campus, parental education levels, student income, student marital status, sorority/fraternity membership, and state policies regarding smoking. The authors considered two ways in which smoking behavior could be affected: (1) smoking participation; and (2) the amount of cigarettes consumed per smoker. The results of the study suggest that, (1) the average estimated price elasticity of smoking participation is –0.26, and (2), the average conditional demand elasticity is –0.62. These results indicate

[11] *Source*: Gruber, Jonathon and Zinman, Jonathon. "Youth Smoking in the U.S.:Evidence and Implications". Working Paper No. W7780. National Bureau of Economic Research. 2000.

[12] Source: Tauras, John A. and Chaloupka, Frank, J.. "Determinants of Smoking Cessation: An Analysis of Young Adult Men and Women". Working Paper No. W7262. National Bureau of Economic Research. 1999.

[13] Michael Grossman. "Individual Behaviors and Substance Use: The Role of Price". Working Paper No. W10948. National Bureau of Economic Research. December 2004.

that a 1% increase in cigarette prices, will reduce smoking participation among college students by 0.26% and will reduce the level of smoking among current college students by 0.62%.[14]

Tauras et al. (2001) conducted a study that looked at the effects of price on teenage smoking initiation.[15] The authors used data from the Monitoring the Future study which examines smoking habits, among other things, of 8th, 10th, and 12th graders. They defined smoking initiation in three different ways: smoking any cigarettes in the last 30 days, smoking at least one to five cigarettes per day on average, or smoking at least one-half pack per day on average. The results suggest that the estimated price elasticities of initiation are –0.27 for any smoking, -0.81 for smoking at least one to five cigarettes, and –0.96 for smoking at least one-half pack of cigarettes. These results above indicate that a 10% increase in the price of cigarettes will decrease the probability of smoking initiation between approximately 3% and 10% depending on how initiation is defined. In a related study, Powell et al. (2003) estimated a price elasticity of youth smoking participation of –0.46, implying that a 1% increase in price leads to a 0.46% reduction in smoking participation.[16]

In conclusion, economic research suggests the demand for cigarettes is price inelastic, with an elasticity generally found to be between –0.3 and -0.5.

Nicotine Replacement Products

Nicotine replacement products, such as Nicorette Gum and Nicoderm patches, are used to aid those who are attempting to quit smoking. Before 1996, these products were only available with a doctor's prescription. Currently, they are available as over-the-counter products. Many researchers now recommend that those trying to quit smoking use a variety of these methods in combination.

One study, by Hu et al., examines the effects of nicotine replacement products on cigarette consumption in the United States.[17] One of the results of the study found that, "a 0.076% reduction in cigarette consumption is associated with the availability of nicotine patches after 1992." In 2002, the Food and Drug Administration ("FDA") approved the Commit lozenge for over-the-counter sale. This product is similar to the gum and patch nicotine replacement products. NicoBloc, a liquid applied to cigarettes which blocks tar and nicotine from being inhaled, is another cessation product on the market since 2003.

[14] Czart et al. "The impact of prices and control policies on cigarette smoking among college students". Contemporary Economic Policy. Western Economic Association. Copyright April 2001.

[15] Tauras et al. "Effects of Price and Access Laws on Teenage Smoking Initiation: A National Longitudinal Analysis". University of Chicago Press. Copyright 2001.

[16] Powell et al. "Peer Effects, Tobacco Control Policies, and Youth Smoking Behavior". Impacteen. February 2003.

[17] Hu et al. "Cigarette consumption and sales of nicotine replacement products". TC Online. Tobacco Control. Summer 2000. http:\\tc.bmjjournals.com.

Zyban is a non-nicotine drug that has been available since 2000. It has been shown to be effective when combined with intensive behavioral support.[18]

In 2006, the FDA approved varenicline, a Pfizer product marketed as Chantix, for use as a prescription medicine. It is intended to satisfy nicotine cravings without being pleasurable or addictive. The drug binds to the same brain receptor as nicotine. Tests indicate that it is more effective as a cessation aid than Zyban. Pfizer introduced Chantix with a novel marketing program, GETQUIT, an integrated consumer support system which emphasizes personalized treatment advice with regular phone and e-mail contact. The drug debuted with strong sales in 2007, but suffered a reversal the following year due to safety concerns. It has since seen increased sales and marketing success. Free & Clear, a provider of tobacco treatment services, reported in June 2008, that Chantix has achieved higher average quit rates than Zyban, patches, gum, and lozenges. Though Pfizer reported additional positive results in 2009, the FDA required that Pfizer update the Chantix label with the most restrictive, "Black Box", safety labeling describing the risks. But the FDA does conclude: "The Agency continues to believe that the drug's benefits outweigh the risks and the current warnings in the Chantix label are appropriate." These warnings include changes in behavior, hostility, agitation, depressed mood, and suicidal thoughts or actions, as well as serious skin reactions and heart and blood vessel problems. Nevertheless the FDA said on October 24, 2011 that it will continue to evaluate the risk of mood changes and other psychiatric events associated with its use. In March 2013, researchers at the University of Texas M.D. Anderson Cancer Center reported a better quitting experience with varenicline than other treatments. In September 2013 researchers in a Pfizer sponsored study concluded that the drug does help some patients with depression or mood disorders to quit smoking without worsening symptoms of depression or anxiety. Also, in October 2013 researchers at the University of Bristol reported in the British Medical Journal that cessation drugs do not increase suicide risk.

The Mayo Clinic is conducting a study combining Chantix with bupropion (the generic version of Zyban). The study has shown higher smoking abstinence rates compared to the use of Chantix alone (37% vs. 28% after 26 weeks).

In September 2011, the New England Journal of Medicine reported positive smoking cessation efficacy and safety tests for Cytisine, an inexpensive compound long sold in Eastern Europe as Tabex, as a cessation aid.

Several new drugs may also appear on the market in the near future. In 2005, Cytos Biotechnology AG announced the successful completion of Phase II testing of a virus-based vaccine, genetically engineered to attract an immune system response against nicotine and its effects. In 2007 the company entered into a partnership with Novartis to commercialize the drug, NIC002, but a subsequent Phase II trial was unsuccessful. Novartis though has continued study and commenced a new Phase II trial in November 2011. In 2011 the FDA cleared an Investigational New Drug Application to conduct a

[18] Roddy, Elin. "Bupropion and Other Non-nicotine Pharmacotherapies". *British Medical Journal.* 28 February 2004.

Phase II-B trial of X-22, a smoking cessation kit of very low nicotine cigarettes made by the 22nd Century Group. In 2012, a team from Weill Cornell Medical College reported the development of an anti-nicotine vaccine using a genetically engineered virus. The vaccine was successful in test with mice, though it will take several years before it can be tested in humans. Most recently, in January 2015 a team from the Scripps Research Institute reported in the Journal of Medicinal Chemistry that a new vaccine design had yielded positive results and recommended its further development. It is expected that products such as these and others will continue to be developed and that their introduction and use will contribute to the trend decline in smoking. Our forecast includes a strong negative trend in smoking rates which incorporates the influence of these factors.

Further aiding sales of these products is the decision by 45 state Medicaid programs to offer cessation benefits to Medicaid beneficiaries. And at least ten states (California, Colorado, Maryland, New Jersey, New Mexico, New York, North Dakota, Oregon, Rhode Island, and Vermont) have established minimum standards for private insurance coverage of cessation products and services. Most recently, in October 2010, Medicare coverage was expanded to provide cessation counseling to seniors without tobacco-related disease. The Affordable Care Act now mandates that new private health insurance plans cover tobacco cessation, and effective January 2014, that tobacco cessation medications can no longer be excluded from state Medicaid coverage.

Electronic Cigarettes

Electronic cigarettes, which according to the participating manufacturers are not subject to the MSA, have also gained in popularity in recent years. NJOY, Vapor, Logic, and Blu, are marketing and advertising extensively across the US. Sales in 2013 have been estimated to be as much as $1.5 billion, and increasing rapidly. The CDC in September 2014 reported survey results that indicate 8.5% of the adult population, and 36.5% of smokers, had tried e-cigarettes at some time. These were almost quadruple estimates in 2010. Lorillard acquired Blu Ecigs in 2012, though it is expected to sell the brand to Imperial Tobacco in 2015. Reynolds began a national roll-out of VUSE in June 2014 and has stated that it intends to remain focused on VUSE’s growth and expansion nationwide. Altria had introduced its own brands as well in 2014, and completed its nationwide launch of e-vapor products in the fourth quarter.

They are, on one hand, alternatives to cigarettes as smokers cope with indoor bans, but also cessation devices whose nicotine content can be controlled. In 2010 the U.S. Court of Appeals for the District of Columbia Circuit ruled that the FDA could not regulate electronic cigarettes as a drug, rather it must regulate them as tobacco products. It is unclear what actions the FDA may take towards electronic cigarettes in the future. Their role though in smoking, and smoking cessation, is ambiguous. On the one hand they can be used as a cessation device weaning a smoker away from cigarettes. In this case, as a substitute for cigarettes, they result in lower cigarette consumption. On the other hand, they can, in the presence of indoor smoking bans, allow smokers to maintain a nicotine habit or addiction, offsetting some of the ban's effectiveness in reducing smoking and consumption of cigarettes. In this case electronic cigarettes are complements to cigarettes. Indoor smoking restrictions have reduced the consumption of cigarettes and created a demand for electronic cigarettes. But electronic cigarettes themselves do not further reduce consumption except to the extent that they are substitutes for cigarette usage. Nevertheless, a 2013 study in the United Kingdom found that 76% of e-cigarette users said they started using their devices to replace cigarettes entirely. And results of a trial in Italy, published by the journal PLOS One in June 2013, found that 8.7% of electronic cigarette users stopped smoking cigarettes. In September 2013, The Lancet published a New Zealand study which concluded that smoking cessation attempts using e-cigarettes were at least as effective as those using nicotine patches. (In a sample the quit rate after six months with e-cigarettes was 7.3%, versus 5.8% with patches).

The American Legacy Foundation conducted a 2013 survey which found, as part of the 41% of smokers who intended to quit smoking in 2014, 12% planned to switch to e-cigs. A Centers for Disease Control and Prevention study published in the November 15th, 2013 issue of Morbidity and Mortality Weekly Report says that according to data from the National Youth Tobacco Survey of middle school and high school students in the US, e-cig use among middle school students increased from 0.6% in 2011 to 1.1% in 2012. Among high school students the prevalence increased from 1.5% in 2011 to 2.8% in 2012. In October 2013 a study at the University of Oklahoma Health Science Center concluded that e-cigarettes do not appear to entice teens to try smoking tobacco. In 2014 University College of London researchers indicated finding that e-cigarettes were 60% more effective than over-the-counter nicotine replacement therapies. . In August 2014 Kantar Media reported survey results indicating that almost 6 million adults in the US use e-cigs, and that of the adults who used a cessation product in the past year, 57% chose e-cigarettes. In December 2014, the Monitoring the Future Study surveyed teens use of e-cigarettes, and found that in 2014, more 8th, 10th, and 12th graders used e-cigarettes than traditional cigarettes. A study of college students published in the December 2014 American Journal of Preventative Medicine concluded that its results refuted the claim that electronic cigarettes are a gateway to smoking.

For the consumer, e-cigs are a less expensive alternative as they are not taxed as cigarettes. (Minnesota has imposed a 95% tax on the wholesale cost however, and North Carolina in 2014 added a 5 cent per millimeter tax on liquid nicotine, and about a dozen states are considering some form of taxation.) A cartridge and battery for an electronic cigarette would cost less than half as much as an equivalent pack of cigarettes in a average tax state.

Researchers have reported several safety concerns with the products, including concerns on the variability in delivered nicotine content. The U.S. Department of Transportation is proposing a ban on electronic cigarettes on all flights to and from the U.S., a prohibition already enacted by Amtrak on its trains. The states of North Dakota, New Jersey, and Utah prohibit e-cigarette use in workplaces, restaurants, and bars. Arkansas, Colorado, Delaware, New Hampshire, Oklahoma, and Oregon restrict e-cig use at state workplaces and school grounds. And there are, based on data from the American Nonsmokers' Rights Foundation ("ANRF"), e-cigarette restrictions at indoor smokefree venues in 274 localities in the US. In 2014, Chicago, New York, and San Francisco have extended public places smoking bans to include e-cigs. In September 2013 forty state attorneys general sent a letter to the Food and Drug Administration (FDA) urging the agency to regulate electronic cigarettes in the same way it regulates tobacco products. In 2014 the state of Rhode Island banned e-cig sales to those under 18 years of age.

The FDA in April 2014 proposed rules on regulation of additional tobacco products, notably including e-cigarettes, and is taking public comments now. Under the proposed rule, makers of newly deemed tobacco products would register and report product ingredients, refrain from marketing until after FDA review, and make claims of reduced risk only after FDA confirmation that evidence supports such claims, and that the product will benefit public health. Minimum age restrictions and health warning requirements would also be applied to the deemed products. In August 2014, the American health Association backed the use of e-cigarettes as a last resort (after other cessation methods) to help smokers quit.

In August 2013 the Consumer Advocates for Smoke-free Alternatives Association released a study it funded by the Drexel University School of Public Health. It found that chemicals in electronic cigarettes (e-cigarettes) pose no health concern for users or bystanders.

In a related development in 2015, Reynolds is introducing a new cigarette, REVO, which heats tobacco rather than burning it and emitting smoke. The company touts new tobacco sorting technology in its efforts to develop reduced-risk products. Reynolds has stated that it hopes that REVO will appeal to smokers who do not like e-cigarettes but would like an alternative to traditional smoking. The MSA does cover these products should they displace any conventional cigarette sales.

Workplace Restrictions

In their 1996 study on the effect of workplace smoking bans on cigarette consumption, Evans, Farrelly, and Montgomery found that between 1986 and 1993 smoking participation rates among workers fell 2.6% more than non-workers.[19] Their results suggest that workplace smoking bans reduce smoking prevalence by five percentage points and reduce consumption by smokers nearly 10%. The authors also found a positive correlation between hours worked and the impact on smokers in workplaces that have smoking bans. The more hours per day a smoker spent working in a smoking restricted environment, the greater the decline in the quantity of cigarettes that smoker consumed.

[19] *Source*: Evans, William N.; Farrelly, Matthew C.; and Montgomery, Edward. "Do Workplace Smoking Bans Reduce Smoking*?"*. Working Paper No. W5567, National Bureau of Economic Research, 1996.

Factors Affecting Cigarette Consumption

Most empirical studies have found a common set of variables that are relevant in building a model of cigarette demand. These conventional analyses usually evaluate one or more of the following factors: (i) general population growth, (ii) price increases, (iii) changes in disposable income, (iv) youth consumption, (v) trend over time, (vi) workplace smoking bans, (vii) smoking bans in public places, (viii) nicotine dependence and (ix) health warnings. While some of these factors were not found to have a measurable impact on changes in demand for cigarettes, all of these factors are thought to affect smoking in some manner and to be incorporated into current levels of consumption.

Price Elasticity of Demand. Cigarette price elasticities from recent conventional research studies have generally fallen between an interval of -0.3 to -0.5. Based on Global Insight's multivariate regression analysis using U.S. data from 1965 to 2012, the long-run price elasticity of consumption for the entire population is -0.33; a 1.0% increase in the price of cigarettes decreases consumption by 0.33%.

In 1998, the average price of a pack of cigarettes in the U.S. in nominal terms was $2.20. This increased to $2.88 per pack in 1999, representing a nominal growth in the price of cigarettes of 30.9% from 1998. During 1999, consumption declined by 6.45%. This was primarily due to a $0.45 per pack increase in November 1998 which was intended to offset the costs of the MSA and agreements with previously settled states.

Over the next several years the cigarette manufacturers continued to increase wholesale prices, and state excise taxes rose dramatically across the nation. By 2008 the weighted average state excise tax was $1.23 per pack and cigarette prices averaged $5 per pack.

The 2008-2009 recession and its stress on state budget revenues prompted acceleration in excise tax increases, as sixteen states increased taxes, resulting in an average tax of $1.34 at the end of 2009. In 2010, Hawaii, New Mexico, New York, South Carolina, Utah, and Washington, raised taxes. In 2011, excise tax increases went into effect in Connecticut, again in Hawaii, and in Vermont. In 2012, Illinois, by $1.00 per pack, and Rhode Island, by $0.04 per pack, raised cigarette excise taxes.

In 2013, Cook County, Illinois increased its cigarette excise tax by $1.00 per pack, and in November of that year Chicago increased its excise tax by $0.50 to push city, county, and state taxes in Chicago to $7.17 per pack. Also in 2013, cigarette excise tax increases were enacted in Minnesota, by $1.60 per pack, Massachusetts, by $1.00 per pack, Oregon, by $0.13 per pack effective January 1, 2014, and in New Hampshire, by $0.10 per pack. The average state tax rate in December 2014 was $1.53. Puerto Rico in 2013 also enacted plans to increase its excise taxes in 2014 and 2015. In November 2013 New York City passed an ordinance that set a minimum retail price of a pack of cigarettes at $10.50, and prohibited the use of coupons and promotions to discount that price. Tobacco companies and retail trade groups asked a Federal court in January to block the law. Excise tax increase legislation has been introduced in the Maryland legislature in 2014. In September 2014, the City of Philadelphia enacted a $2.00 per pack tax. In 2015, the

Governors of Kansas, Louisiana, Nevada, and Washington have proposed excise tax increases, and proposals to increase excise taxes have been introduced in 16 other states.

The federal excise tax had remained constant, at $0.39 per pack, from 2002 until 2009 when the U.S. Congress adopted legislation which raised the tax by $0.62, to $1.01, effective April 1, 2009. As a result the total state and federal excise tax now equals $2.54 on average in the U.S. In 2011 a U.S. senate bill was sponsored by 14 Democrats and would have raised the excise tax to $2.01 per pack, but it was not successful. On January 22, 2013 Senator Tom Harkin introduced legislation, the Healthy Lifestyles and Prevention America Act, which would double the Federal excise tax on cigarettes and roll-your-own tobacco and increase the tax on smokeless tobacco products. President Obama's 2016 federal budget proposal includes an increase in the Federal Excise Tax to $1.95 per pack, and indexes the rate to inflation.

Purchases of roll-your-own cigarette tobacco were discouraged by 2009 legislation, as its excise tax was raised substantially. But the excise tax changes also had the effect of encouraging the use of pipe tobacco, combined with the availability of roll-your-own machines to circumvent the higher excise taxes. Legislation introduced by Senator Richard Durbin on January 31, 2013, the Tobacco Tax Equity Act, would similarly equalize Federal excise tax rates on all tobacco products.

During much of the period following the MSA, the major manufacturers refrained from wholesale price increases, and also actively pursued extensive promotional and dealer and retailer discounting programs which served to hold down retail prices. They did this in part due to the state tax increases, but primarily to maintain their market share from its erosion by a deep discount segment which grew rapidly following the MSA. The major manufacturers were finally successful in stemming the increase in the deep discount market share, which stabilized in 2004. The major manufacturers have raised prices or reduced discounts and promotions in each year since 2004. In 2014, for instance, Altria raised its brands prices increased by $0.13. The average price, including excise taxes in January 2015 was $7.46 per pack.

Over the longer term our forecast expects price increases to continue to exceed the general rate of inflation due to increases in the manufacturers' prices as well as further increases in excise taxes.

Premium brands are typically $1.00 to $2.00 more expensive per pack than discount brands, allowing a margin for consumers to switch to less costly discount brands in the event of price increases. The increasing availability of cigarette outlets on Indian reservations, where some sales are typically exempt from taxes, provides another opportunity for consumers to reduce the cost of smoking. Similarly, Internet sales of cigarettes grew rapidly, though credit card companies and shippers including the U.S. Postal Service have now put significant restrictions on shipping of cigarettes, and the federal government has enacted the Prevent All Cigarette Trafficking ("PACT") Act which requires the collection of all applicable taxes on Internet and mail-order cigarette shipments. Under the MSA volume adjustments to payments are based on the quantity (and not the price or type) of cigarettes shipped. The availability of lower price alternatives lessens the negative impact of price increases on cigarette volume, but it may negatively impact MSA receipts if non-participating manufacturers gain sales.

***Changes in Disposable Incom*e**. Analyses from many conventional models also include the effect of real personal disposable income. Most studies have found cigarette consumption in the United States increases as disposable income increases.[20] However, a few studies found cigarette consumption decreases as disposable income increases.[21] Based on our multivariate regression analysis the income elasticity of consumption is 0.27; a 1.0% increase in real disposable income per capita increases per capita cigarette consumption by 0.27%. In normal periods of economic growth this factor contributes a positive impact to cigarette demand, offsetting some of the negative impacts previously discussed. However, with the recession of 2008-2009 this factor also impacted cigarette demand and consumption in a negative way.

Youth Consumption. The number of teenagers who smoke is another likely determinant of future adult consumption. While this variable has been largely ignored in empirical studies of cigarette consumption,[22] almost all adult smokers first use cigarettes by high school, and very little first use occurs after age 20.[23] One study examines the effects of youth smoking on future adult smoking.[24] The study found that between 25% and 50% of any increase or decrease in youth smoking would persist into adulthood. According to the study, several factors may alter future correlation between youth and adult smoking: there are better means for quitting smoking than in the past, and there are more workplace bans in effect that those who are currently in their teen years will face as they age.

We have compiled U.S. data from the CDC that measures the incidence of smoking in the 12-17 age group as the percentage of the population in this category that first become daily smokers. This percentage, after falling since the early 1970s, began to increase in 1990 and increased through the decade. We assume that this recent trend peaked in the late 1990s and youth smoking has resumed its longer term decline.

In 2012, the Surgeon General issued a report, "Preventing Tobacco Use among Youth and Young Adults". Among its major conclusions were, 1) that prevention efforts must focus on both adolescents and young adults, 2) that advertising and promotional activities by tobacco companies have been shown to cause the onset and continuation of smoking among youth, 3) that after years of steady progress, declines in tobacco use by the young have slowed, and 4) that coordinated, multi-component interventions that combine mass media campaigns, price increases, school-based programs, and community wide smoke-free policies and norms are effective in reducing tobacco use. Also in 2012 the CDC

[20] Ippolito, et al.; Fuji.

[21] Wasserman, et al.; Townsend et al.

[22] Except for those such as Wasserman, et al. that studied the price elasticity for different age groups.

[23] *Source*: Surgeon General's 1994 Report, "Preventing Tobacco Use Among Young People."

[24] *Source*: Gruber, Jonathon and Zinman, Jonathon. "Youth Smoking in the U.S.:Evidence and Implications". Working Paper No. W7780, National Bureau of Economic Research, 2000.

produced a mass-media advertising campaign featuring graphic descriptions of the adverse health effects of smoking. In August 2012 the CDC declared the campaign a major success, as the agency concluded that the ads helped to double the amount of calls to their telephone quit line. New CDC campaigns, with graphic adverse health images began in March 2013, and again in July 2014. In September 2013 the CDC announced survey results which concluded that cessation attempts increased from 31.1% to 34.8% of smokers who had seen the graphic ads, which the CDC extrapolated to 100,000 sustained quitters, approximately 0.25% of US smokers. In November 2013 the journal Tobacco Control published research from the University of Illinois at Chicago which concluded that the FDA has underestimated the impact of graphic labels. Examining the experience in Canada the researchers concluded that graphic warning labels reduced smoking rates in Canada by 3% to 5%.

Trend Over Time. Since 1964 there has been a significant decline in adult per capita cigarette consumption. The Surgeon General's health warning (1964) and numerous subsequent health warnings, together with the increased health awareness of the population over the past thirty years, may have contributed to decreases in cigarette consumption levels. If, as we assume, the awareness of the adult population continues to change in this way, overall consumption of cigarettes will decline gradually over time. Our analysis includes a time trend variable in order to capture the impact of these changing health trends and the effects of other such variables, which are difficult to quantify.

Health Warnings. Categorical variables also have been used to capture the effect of different time periods on cigarette consumption. For example, some researchers have identified the United States Surgeon General's Report in 1964 and subsequent mandatory health warnings on cigarette packages as turning points in public attitudes and knowledge of the health effects of smoking. The Cigarette Labeling and Advertising Act of 1965 required a health warning to be placed on all cigarette packages sold in the United States beginning January 1, 1966. The Public Health Smoking Act of 1969 required all cigarette packages sold in the United States to carry an updated version of the warning, stating that it was a Surgeon General's warning, beginning November 1, 1970. The Comprehensive Smoking Education Act of 1984 led to even more specific health warnings on cigarette packages. The Family Smoking Prevention and Tobacco Control Act requires that cigarette packages have larger and more visible graphic health warnings. Regulations that were to go into effect in September 2012 mandated that a series of nine graphic health warnings must appear on the upper portion of the front and rear panels of each cigarette package and comprise at least the top 50 percent of these panels. Five manufacturers challenged the implementation of these new warnings on First Amendment grounds, and on November 7, 2011 a federal judge issued a preliminary injunction blocking the FDA requirement. The judge ruled that the labels were not factual, but rather, "…calculated to provoke the viewer to quit…." In 2012 a federal judge in Washington blocked the new requirement, while an appeals court in Ohio ruled to uphold parts of the Act. In March 2013 the Attorney General decided not to ask the U.S. Supreme Court to review the case. Instead the FDA announced on March 19, 2013 that it would undertake research to support new rulemaking. On April 22, 2013 the Supreme Court upheld the provisions of the 2009 law, allowing the FDA to develop and implement new graphic warning labels.

At least six states, Alabama, Georgia, Idaho, Kentucky, South Carolina, and West Virginia, charge higher health insurance premiums to state employee smokers than non-smokers, and a number of states have implemented legislation that allows employers to provide incentives to employees who do not smoke. Several large corporations, including Meijer Inc., Gannett Co., American Financial Group Inc., Bank One, JP Morgan Chase, PepsiCo Inc., Northwest Airlines, Safeway, Tribune Co., and Whirlpool, are now charging smokers higher premiums.

In September 2014, CVS Caremark ceased selling cigarettes at its nationwide chain of more than 7,600 pharmacy stores.

Smoking Bans in Public Places. Beginning in the 1970s numerous states have passed laws banning smoking in public places as well as private workplaces. In September 2003 Alabama joined the other 49 states and the District of Columbia in requiring smoke-free indoor air to some degree or in some public places.[25]

The most comprehensive bans, extending to restaurants and bars, have been enacted since 1998 in 39 states and a number of large cities. Restrictions to all workplaces, restaurants, and bars cover 65.2% of the U.S, according to the ANRF. In 2012 North Dakota became the most recent state to adopt these bans in public places. In 2015, smoking ban legislation has been introduced in Kentucky, and New Orleans has passed an ordinance banning smoking in bars and casinos.

The ANRF documents clean indoor air ordinances by local governments throughout the U.S. As of January 1, 2015, there were 4,177 municipalities with indoor smoking restrictions. Of these, 961 local governments required non-hospitality workplaces to be 100% smoke-free while 1,001 governments required 100% smoke-free conditions in restaurants, and 872 required the same for bars. The number of such ordinances has grown rapidly in the past two decades. The ordinances completely restricting smoking in restaurants and bars have generally appeared in the past decade. In 1993 only 13 municipalities prohibited all smoking in restaurants, and 6 in bars.[26]

Based on the regression analysis using data from 1965 to 2013, the restrictions on workplace smoking that proliferated in the 1980s appear to have an independent effect on per capita cigarette consumption. We estimate that the restrictions instituted beginning in the late 1970s have reduced smoking by about 2%. However, the timing of the restrictions within and across states makes such statistical identification difficult. Bauer, et al. estimates that U.S. workers in smoke-free workplaces from 1993 to 2001 decreased

[25] *Source*: American Lung Association. "State Legislated Actions on Tobacco Issues". 2002.
[26] *Source:* American Nonsmokers' Rights Foundation. http://www.no-smoke.org. July 2013.

their average daily consumption by 2.6 cigarettes.[27] Research in Canada, by the Ontario Tobacco Research Unit, concludes that consumption drops in workplaces where smoking is banned, by almost five cigarettes per person per day. Tauras, in a study based on a large survey of smokers, found that the more restrictive smoke-free air laws decrease average smoking, but have little influence on prevalence.[28] The study predicts that moving from no smoking restrictions at all to the most restrictive bans reduces average smoking from 5% to 8%.

The extension of the indoor bans to restaurants and bars in the last decade began largely in the Northeast and did not appear, in our econometric analysis, to have a significant independent impact on smoking there. However, with data available from later in the decade across a wider geography, econometric analysis reveals that the bans did have a significant impact and we have added a variable quantifying the effect in our consumption model.

The first extensive outdoor smoking restrictions were instituted in March 2006 in Calabasas, California. The cities of Los Angeles and Oakland, Contra Costa County, and the California municipalities of Belmont, Beverly Hills, Campbell, Concord, Dublin, El Cajon, Emeryville, Hayward, Loma Linda, Santa Cruz, Santa Monica, and Walnut Creek have also established extensive outdoor restrictions, as have Boulder, Colorado, and Davis County and the City of Murray in Utah. In 2007, San Diego City and Los Angeles, Santa Cruz and San Mateo Counties banned smoking at beaches and parks, joining over 30 other Southern California cities in prohibiting smoking on the beach. In 2011 the New York City Council approved a bill to ban smoking in all city parks, beaches and pedestrian plazas. That ban went into effect on May 23, 2011. In January 2014 a smoking ban went into effect in Boston’s parks, and on Hawaii's beaches. According to ANRF, as of January 2015, 1,037 municipalities prohibit smoking in city parks, and 223 municipalities mandate smoke-free city beaches.

Additional restrictions are being placed in residential units as well. First, many hotels, including the Marriott, Sheraton, and Westin chains have adopted completely smoke-free room standards. And multi-family residential buildings have been increasingly subject to restrictions, beginning in 2008 in the California cities of Belmont and Calabasas, which have approved ordinances which restrict smoking anywhere in the city except for single-family detached homes. Alameda, Oakland, Pasadena, Santa Monica, and Thousand Oaks are among eight other California cities with such extensive bans. In September 2011 Sonoma County imposed a similar ban, effective June 2012. In August 2011 the California Legislature passed legislation enabling landlords to ban smoking in residential rental units. In June 2012, the Towbes Group of Santa Barbara became the largest apartment portfolio, with 2,000 units, to impose a smoking ban. In April 2013 California Assembly Bill 746 was defeated; it would have prohibited smoking in, and within 20 feet

[27] Bauer, Hyland, Li, Steger, and Cummings. "A Longitudinal Assessment of the Impact of Smoke-Free Worksite Policies on Tobacco Use". American Journal of Public Health. June 2005

[28] Tauras, John A. "Smoke-Free Air Laws, Cigarette Prices, and Adult Cigarette Demand" Economic Inquiry, April 2006.

of entrances of, condominiums, duplexes, and apartment units throughout the state. A similar bill has also been introduced in Massachusetts.

New York City's first non-smoking apartment building opened in late 2009. Many landlords and condominium associations in California, and in New York City, have also established smoke-free apartment policies. Most recently Related Companies, which manages 40,000 rental units, announced a ban on smoking for all new tenants. In July 2011 the San Antonio Housing Authority announced a ban, effective in January 2012, on smoking in its 6,175 rental units. Similar bans went into effect in 2012 for public housing in Boston and Minneapolis.

New Jersey has prohibited smoking in college dormitories since 2005. At least 1,514 colleges nationwide now prohibit smoking everywhere on campus. In 2013 the California and Louisiana state college and university systems have banned tobacco use, joining Arkansas and Oklahoma with no-smoking restrictions at public colleges and universities, and Iowa, which prohibits smoking at all colleges and universities. Twenty-one states have banned smoking, indoors and outdoors, at state prisons. In February 2015 smoking will be prohibited in all federal prisons. Arkansas, California, Louisiana, Maine, Puerto Rico, Texas, and Rockland County, NY now prohibit smoking in a car where there are children present, and similar legislation has been proposed in Florida, Illinois, Maryland, New York, Ohio, Oregon, Utah, Vermont, Virginia, and other states.

In June 2006, the Office of The Surgeon General released a report, "The Health Consequences of Involuntary Exposure to Tobacco Smoke". It is a comprehensive review of health effects of involuntary exposure to tobacco smoke. It concludes definitively that secondhand smoke causes disease and adverse respiratory effects. It also concludes that policies creating completely smoke-free environments are the most economical and efficient approaches to providing protection to non-smokers. We expect that the report will strengthen arguments in favor of further smoking restrictions across the country. Further ammunition for activists for smoke-free environments was provided by the California Environmental Protection Agency Air Resources Board, which in 2006 declared environmental tobacco smoke to be a toxic air contaminant.

Smokeless Tobacco Products. Unlike electronic cigarettes, smokeless tobacco products have been available for centuries. As cigarette consumption expanded in the last century, the use of smokeless products declined. Chewing tobacco and snuff are the most significant components. Snuff is a ground or powdered form of tobacco that is placed under the lip to dissolve. It delivers nicotine effectively to the body. Moist snuff is both smoke-free and potentially spit-free. Chewing tobacco and dry snuff consumption had been declining in the U.S. into this century, but moist snuff consumption has increased at an annual rate of more than 5% since 2002. Snuff is now being marketed to adult cigarette smokers as an alternative to cigarettes. UST (purchased by Altria in 2009), was the largest producer of moist smokeless tobacco, and explicitly targeted adult smoker conversion in its growth strategy over the last decade. As with e-cigarettes, the leading cigarette manufacturers soon themselves added smokeless products, responding to both the proliferation of indoor smoking bans and to a perception that smokeless use is a less harmful mode of tobacco and nicotine usage than cigarettes. Philip Morris USA now markets Marlboro Snus which has experienced sales growth of over 6% annually into 2012, and Reynolds American has enjoyed similar gains with one of its smokeless products, Camel Snus.

In 2011, according to SAMHSA's National Survey on Drug Use & Health, 3.2% of adults used smokeless tobacco products. And young adults were twice as likely to use smokeless products. A Massachusetts survey in 2011 found that 29% of male smokers aged 18-24 in snus test markets had tried snus products.

Advocates of the use of snuff as part of a harm reduction strategy point to Sweden, where "snus", a moist snuff manufactured by Swedish Match, use has increased sharply since 1970, and where cigarette smoking incidence among males has declined to levels well below that of other countries. A review of the literature on the Swedish experience concludes that snus, relative to cigarettes, delivers lower concentrations of some harmful chemicals, and does not appear to cause cancer or respiratory diseases. They conclude that snus use appears to have contributed to the unusually low rates of smoking among Swedish men.[29] The Sweden experience is unique, even with respect to its Northern European neighbors. It is not clear whether it could be replicated elsewhere. A May 2008 study using data from the 2000 National Health Interview Survey reports that U.S. men who used smokeless tobacco as a smoking cessation method achieved significantly higher quit rates than those who used other cessation aids.[30] A 2009 study concluded however that young males who used smokeless tobacco products were more likely to be concurrent smokers.[31] Public health advocates in the U.S. emphasize that smokeless use results in both nicotine dependence and increased risks of oral cancer among other health concerns. Snuff use is also often criticized as a gateway to cigarette use.

Nicotine Dependence. Nicotine is widely believed to be an addictive substance. The Surgeon General[32] and the American Medical Association[33] (AMA) both conclude that nicotine is an addictive drug that produces dependence. The American Psychiatric Association has determined that cigarette smoking causes nicotine dependence in smokers and nicotine withdrawal in those who stop smoking. The American Medical Association Council on Scientific Affairs found that one-third to one-half of all people who experiment with smoking become smokers.

[29] Foulds, Ramstrom, Burke, and Fagerstrom. "Effect of Smokeless Tobacco (Snus) on Smoking and Public Health in Sweden". Tobacco Control. Vol. 12, 2003.

[30] Rodu and Phillips, "Switching to Smokeless Tobacco as a Smoking Cessation Method: Evidence form the 2000 National Health Interview Survey". Harm Reduction Journal. 23 May 2008.

[31] Tomar, Alpert, and Connolly, "Patterns of Dual Use of Cigarettes and Smokeless Tobacco among US Males: Findings from National Surveys". Tobacco Control. 11 December 2009.

[32] *Source:* Surgeon General’s 1988 Report, “The Health Consequences of Smoking – Nicotine Addiction”.

[33] *Source*: Council on Scientific Affairs, “Reducing the Addictiveness of Cigarettes," Report to the AMA House of Delegates, June 1998.

Regulation. Since June 22, 2009 when President Obama signed the Family Smoking Prevention and Tobacco Contrrol Act, the FDA has had broad authority over the sale, distribution, and advertising of tobacco products. Such legislation significantly restricts tobacco marketing and sales to youth, requires the disclosure of cigarette ingredients, bigger and bolder health warnings, and bans labels thought to be deceptive, such as "light", and "low-tar" from cigarettes.

A significant issue before the FDA is the role of menthol cigarettes. It has been argued that menthol flavoring serves as an inducement to youth smoking and that its prevalence is especially high among minority groups, raising a call for a ban on its manufacture and sale. The FDA has established a working group to study the issue. Menthol cigarette sales represent approximately 30% of total cigarette sales. Moreover, menthol smoking rates have increased among young adults during the past decade. In September 2012 the American Journal of Public Health published the first peer-reviewed data on menthol smokers. It reported the results of a national survey of those smokers showing that nearly 40% of menthol smokers say they would quit smoking if menthol cigarettes were no longer available. While an outright ban would no doubt prompt a significant number of these smokers to switch to other brands, any significant amount of quitting as a result would have a large negative effect on total consumption and sales. This survey suggests that the effect might be as large as a 12% reduction in cigarette consumption.

The FDA, in July 2013, released its review, "Preliminary Scientific Evaluation of the Possible Public Health Effects of Menthol Versus Nonmenthol Cigarettes". It concluded that menthol in cigarettes is likely to be associated with, first, altered physiological responses to tobacco smoke, second, increased dependence, third, reduced success in smoking cessation, and fourth, increased smoking initiation by youth. Though the report did not constitute a decision about regulatory action, the FDA did conclude that it is likely that menthol cigarettes pose a public health risk above that seen with nonmenthol cigarettes. In August 2013 the American Academy of Family Physicians advocated a menthol ban in an open letter to the Food and Drug Administration. And in November 2013 twenty-five state attorneys general asked U.S. public health regulators to ban menthol cigarettes.

In 2011 the FDA's Tobacco Products Scientific Advisory Committee ("TPSAC") determined that menthol use is most prevalent among younger smokers, and among African Americans. It concludes that the availability of menthol cigarettes more likely than not: 1.) increases experimentation and regular smoking, 2.) increases the likelihood and degree of addiction in youth smokers and, 3.) results in lower likelihood of smoking cessation success in African Americans. TPSAC continued to study the issue in 2014. The FDA submitted a draft report of its independent review of research related to the effects of menthol in cigarettes on public health, if any, to an external peer review panel in July 2011, adding that after peer review, the results and the preliminary scientific assessment will be available for public comment in the Federal Register. In addition TPSAC has initiated discussions on the nature and impact of dissolvable tobacco products on public health.

Whether FDA regulation will result in a significantly faster rate of decline of smoking in the U.S. cannot be determined at this time. But it clearly does have that potential if regulators take an aggressive and effective approach towards that goal. One of the most profound actions it is empowered to take is to mandate the reduction of nicotine levels in cigarettes. It will surely study the issue, perhaps opting to phase out nicotine, the addictive factor in cigarettes over some time period. The smaller manufacturers believe, on the other hand, that FDA regulation will strengthen the role of the major producers, as it raises costs of compliance and narrows price gaps of discount cigarettes. In October 2011, the FDA and the U.S. National Institutes of Health announced a national study of the effects of new tobacco regulation on smokers. The study will examine, by following more than 40,000 smokers, susceptibility to tobacco use, use patterns, resulting health problems, and will evaluate how regulations affect tobacco-related attitudes and behaviors. In January 2013 a state legislator in Oregon took an unprecedented step in cigarette regulation by introducing a bill which would make nicotine a controlled substance, requiring a doctor's prescription.

Research has indicated, and our model incorporates, a negative impact on cigarette consumption due to tobacco tax increases, and a negative trend decline in levels of smoking since the Surgeon General’s 1964 warning, subsequent anti-smoking initiatives, and regulations which restrict smoking. Our model and forecast acknowledges the efficacy of these activities in reducing smoking and assumes that the effectiveness of such anti-smoking efforts will continue. For instance, in 2001, Canada required cigarette labels to include large graphic depictions of adverse health consequences of smoking. Recent research suggests that these warnings have some effectiveness, as one-fifth of the participants in a survey reported smoking less as a result of the labels.[34] More recent survey research has found that smokers were more likely to say they wanted to quit after having seen such graphic images. As the prevalence of smoking declines, it is likely that the achievement of further declines will require either a greater level of spending, or more effective programs. This is the common economic principle of diminishing returns**.**

[34] Hammond, Fong, McDonald, Brown, and Cameron. "Graphic Canadian Warning Labels and Adverse Outcomes: Evidence from Canadian Smokers". *American Journal of Public Health.* August 2004.

An Empirical Model of Cigarette Consumption

An econometric model is a set of mathematical equations which statistically best describes the available historical data. It can be applied, with assumptions on the projected path of independent explanatory variables, to predict the future path of the dependent variable being studied, in this case adult per capita cigarette consumption. After extensive analysis of available data measuring all of the above-mentioned factors which influence smoking, we found the following variables to be effective in building an empirical model of adult per capita cigarette consumption for the United States:

1) the real price of cigarettes
2) the level of real disposable income per capita
3) the impact of restrictions on smoking in public places
4) the trend over time in individual behavior and preferences

We used the tools of standard multivariate regression analysis to determine the nature of the economic relationship between these variables and adult per capita cigarette consumption in the U.S. Then, using that relationship, along with IHS Global Insight's standard population growth forecast, we projected actual cigarette consumption (in billions of cigarettes) out to 2045. It should also be noted that since our entire dataset incorporates the effect of the Surgeon General's health warning (1964), the impact of that variable too is accounted for in the forecast. Similarly the effect of nicotine dependence is incorporated into our entire dataset and influences the trend decline.

Using U.S. data from 1965 through 2013 on the variables described above, we developed the following regression equation.

log (per capita consumption) = 54.1

- 0.024 * trend

- 0.223 * log (cigarette price)

- 0.104 * log (cigarette price last year)

+ 0.274 * log (per capita disposable income)

- 0.001 * percentage of U.S. with strong indoor smoking ban

- 0.002 * percentage of U.S. with strong indoor smoking ban last year.

This model has an R-square in excess of 0.99, meaning that it explains more than 99 percent of the variation in U.S. adult per capita cigarette consumption over the 1965 to

2013 period. In terms of explanatory power this indicates a very strong model with a high level of statistical significance.

According to the regression equation specified above, cigarette consumption per capita (CPC) displays a trend decline of 2.4% per year. The trend reflects the impact of a systematic change in the underlying data that is **not** explained by the included explanatory variables. In the case of cigarette consumption, the systematic change is in public attitudes toward smoking. The trend may also reflect the cumulative impact of health warnings, advertising restrictions, and other variables which are statistically insignificant when viewed in isolation. Some of the impact of the availability of e-cigarettes may be captured here, though it is also captured in the indoor smoking ban terms. This trend, primarily due to an increase in the health-conscious proportion of the population averse to smoking, would by itself account for 90.3% of the variation in consumption. This coefficient is estimated such that a statistical confidence interval of 95% for its value is from 0.0195 to 0.0269 (1.95% to 2.69%). This implies that there is a probability of 5% that the trend rate of decline is outside this range.

Forecast Assumptions

Our forecast is based on assumptions regarding the future path of the explanatory variables in the regression equation. Projections of U.S. population and real per capita personal disposable income are standard IHS Global forecasts. Annual population growth is projected to average 0.7%, and real per capita personal disposable income is projected to increase over the long term at just over 2.1% per year.

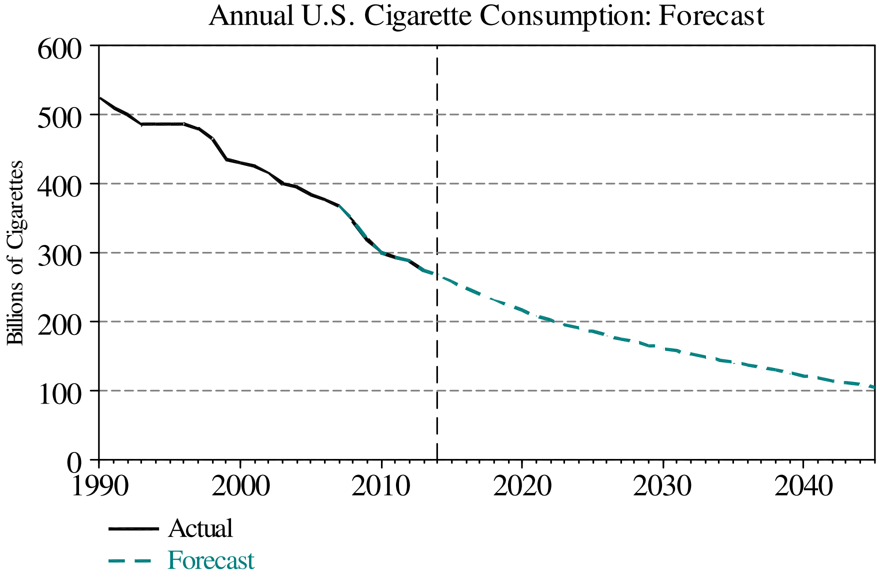
The projection of the real price of cigarettes is based upon its past behavior with an adjustment for the shock to prices due to the MSA and other state settlement agreements and subsequent excise tax increases. Cigarette prices increased dramatically in November 1998, as manufacturers raised prices by $0.45 per pack. Subsequent increases by the manufacturers and numerous federal and state hikes in excise taxes brought prices to an average of $3.84 per pack in 2004, to $4.04 in 2005, to $4.18 in 2006, $4.47 in 2007, $4.75 in 2008, and to $5.99 in 2009, $6.62 in 2010, $6.85 in 2011, $7.00 in 2012, $7.19 in 2013, and $7.40 in 2014. Our forecast assumptions have incorporated price increases in excess of general inflation to offset excise and other taxes. Relative to other goods, cigarette prices will rise by an average of 1.9% per year over the long term. The average real increase over the 30 years ending 1998 was 1.48% per year.

President Obama's 2016 federal budget proposal included an increase in the Federal Excise Tax to $1.95 per pack. Our model predicts that, if enacted, the tax increase would reduce cigarette consumption by an additional 4.5%, resulting in a total decline of approximately 8% in the first year after enactment.

In addition, we assume that the prevalence of indoor and outdoor restrictions on smoking will continue to increase. It is assumed that by 2020 100% of states and municipalities will completely restrict smoking in workplaces, restaurants and bars. At the same time, outdoor and residential restrictions will proliferate over this, and the following decades. These bans are assumed to be as effective in reducing smoking as the indoor bans.

Forecast of Cigarette Consumption

The graph below illustrates total actual and projected cigarette consumption in the United States.



In addition to the expected trend decline in cigarette consumption, the sharp upward shock to cigarette prices in late 1998 and 1999 contributed to a 6.5% reduction in consumption in 1999. The rate of decline moderated considerably in the following years, averaging 2.1% from 1999 to 2007, before accelerating sharply in 2008.

The economic downturn in the US in 2008 turned into the deepest since the 1930s, with sharply negative effects on household disposable income. At the same time a rapid increase in gasoline and energy prices significantly reduced the discretionary spending of consumers. In addition, cigarette price increases continued, the federal excise tax was raised dramatically, and indoor smoking bans continued to proliferate. Consumption fell by nearly 4% in 2008 and by over 9% in 2009. Cigarette shipment declines moderated after 2010, and in 2012 the rate of decline was slightly less than 2%. (Roll-your-own tobacco had represented as much as 3% of tobacco volume under the MSA, but has declined in volume by over 70% since 2008, after federal excise taxes were substantially increased.)

In 2013, shipments reported by MSAI were 4.6% lower than a year ago. For the full year US Tobacco and Tax Bureau (TTB) reports shipments 4.8% lower than in 2012. Weak per capita disposable income growth was responsible for part of the decline. In addition the manufacturers reported that wholesale inventories declined by 1.4 billion sticks during the year. On February 10, RAI reported that MSAI estimated shipments in 2014 of 264.6 billion sticks, a 3.2% decline from 2013. The decline in consumption of cigarettes was somewhat greater however, as inventories were rebuilt by 0.7 billion sticks to offset the 2013 decline. TTB has reported, on March 10, that 2014 shipments through December declined 4.1% compared with 2013. This is significantly greater than the full year decline reported by the manufacturers, and follows a series of volatile monthly tax reports, where year to date declines varied from 3.7% in October to 4.7% in November. The 2014 estimate in this report is based upon the MSAI measure.

Over the longer term our model includes estimates of the negative impact of indoor smoking bans, which we anticipate will ultimately be enacted in all states. For instance, in 2011 legislation to establish indoor bans in Texas and Louisiana made significant advances before being defeated. We also assume that stringent restrictions on smoking will continue to be enacted, including their gradual extension to outdoor public places, as well as to private indoor residential spaces such as in multi-family housing.

From 2015 through 2045 the average annual rate of decline is projected to be 3.0%.

Forecast U.S. Consumption of Cigarettes

	Total Consumption	Decline Rate	Consumption including Roll-Your-Own	Decline Rate
	(billions)	*(%)*	*(billions)*	*(%)*
2009	318.7	-8.1%	325.0	-9.1%
2010	300.8	-5.6%	304.1	-6.4%
2011	293.3	-2.5%	296.0	-2.7%
2012	287.9	-1.9%	290.1	-2.0%
2013	274.4	-4.8%	276.2	-4.9%
2014	265.6	-3.2%	267.2	-3.3%
		FORECAST		
2015	255.8	-3.7%	257.3	-3.7%
2016	246.9	-3.5%	248.4	-3.5%
2017	238.0	-3.6%	239.5	-3.6%
2018	229.5	-3.6%	230.9	-3.6%
2019	221.5	-3.5%	222.8	-3.5%
2020	214.1	-3.4%	215.4	-3.4%
2021	207.0	-3.3%	208.3	-3.3%
2022	200.5	-3.1%	201.7	-3.1%
2023	194.5	-3.0%	195.7	-3.0%
2024	188.9	-2.9%	190.0	-2.9%
2025	183.6	-2.8%	184.7	-2.8%
2026	178.7	-2.7%	179.7	-2.7%
2027	173.9	-2.7%	175.0	-2.7%
2028	169.3	-2.7%	170.3	-2.7%
2029	164.8	-2.7%	165.7	-2.7%
2030	160.3	-2.7%	161.3	-2.7%
2031	156.0	-2.7%	157.0	-2.7%
2032	151.9	-2.7%	152.8	-2.7%
2033	147.7	-2.7%	148.6	-2.7%
2034	143.6	-2.8%	144.4	-2.8%
2035	139.6	-2.8%	140.4	-2.8%
2036	135.7	-2.8%	136.5	-2.8%
2037	131.9	-2.8%	132.7	-2.8%
2038	128.1	-2.8%	128.9	-2.8%
2039	124.4	-2.9%	125.2	-2.9%
2040	120.8	-2.9%	121.5	-2.9%
2041	117.3	-2.9%	118.0	-2.9%
2042	113.9	-2.9%	114.5	-2.9%
2043	110.5	-3.0%	111.1	-3.0%
2044	107.2	-3.0%	107.8	-3.0%
2045	104.0	-3.0%	104.6	-3.0%

Comparison With Prior Forecasts

In April 2013 IHS Global presented a similar study, "A Forecast of U.S. Cigarette Consumption (2012-2045) for the Tobacco Settlement Financing Corporation." That report projected consumption in 2045 of 105.7 billion cigarettes (including roll-your-own equivalents), reflecting an average decline rate of 3.0%. The current forecast projects an average decline rate of 3.0% through 2045, to an annual consumption level of 104.6 billion. The difference, 1.1 billion, is primarily due to weaker than expected consumption in 2013.

APPENDIX D

MASTER SETTLEMENT AGREEMENT

(THIS PAGE INTENTIONALLY LEFT BLANK)

MASTER SETTLEMENT AGREEMENT

(AS AMENDED BY THE ADDENDUM OF CLARIFICATIONS)

TABLE OF CONTENTS

Page

MASTER SETTLEMENT AGREEMENT

TABLE OF CONTENTS

Page

I. RECITALS 1
II. DEFINITIONS 1
(a) "Account" 1
(b) "Adult" 1
(c) "Adult-Only Facility" 1
(d) "Affiliate" 1
(e) "Agreement" 1
(f) "Allocable Share" 1
(g) "Allocated Payment" 2
(h) "Bankruptcy" 2
(i) "Brand Name" 2
(j) "Brand Name Sponsorship" 2
(k) "Business Day" 2
(l) "Cartoon" 2
(m) "Cigarette" 2
(n) "Claims" 2
(o) "Consent Decree" 3
(p) "Court" 3
(q) "Escrow" 3
(r) "Escrow Agent" 3
(s) "Escrow Agreement" 3
(t) "Federal Tobacco Legislation Offset" 3
(u) "Final Approval" 3
(v) "Foundation" 3
(w) "Independent Auditor" 3
(x) "Inflation Adjustment" 3
(y) "Litigating Releasing Parties Offset" 3
(z) "Market Share" 3
(aa) "MSA Execution Date" 3
(bb) "NAAG" 3
(cc) "Non-Participating Manufacturer" 3
(dd) "Non-Settling States Reduction" 3
(ee) "Notice Parties" 3
(ff) "NPM Adjustment" 3
(gg) "NPM Adjustment Percentage" 3
(hh) "Original Participating Manufacturers" 3
(ii) "Outdoor Advertising" 3
(jj) "Participating Manufacturer" 4
(kk) "Previously Settled States Reduction" 4
(ll) "Prime Rate" 4
(mm) "Relative Market Share" 4
(nn) "Released Claims" 4
(oo) "Released Parties" 4
(pp) "Releasing Parties" 5
(qq) "Settling State" 5
(rr) "State" 5
(ss) "State-Specific Finality" 5
(tt) "Subsequent Participating Manufacturer" 5
(uu) "Tobacco Product Manufacturer" 5
(vv) "Tobacco Products" 5
(ww) "Tobacco-Related Organizations" 5
(xx) "Transit Advertisements" 5

(yy) "Underage" 6
(zz) "Video Game Arcade" 6
(aaa) "Volume Adjustment" 6
(bbb) "Youth" 6
III. PERMANENT RELIEF 6
(a) Prohibition on Youth Targeting 6
(b) Ban on Use of Cartoons 6
(c) Limitation of Tobacco Brand Name Sponsorships 6
(d) Elimination of Outdoor Advertising and Transit Advertisements 7
(e) Prohibition on Payments Related to Tobacco Products and Media 7
(f) Ban on Tobacco Brand Name Merchandise 7
(g) Ban on Youth Access to Free Samples 8
(h) Ban on Gifts to Underage Persons Based on Proofs of Purchase 8
(i) Limitation on Third-Party Use of Brand Names 8
(j) Ban on Non-Tobacco Brand Names 8
(k) Minimum Pack Size of Twenty Cigarettes 8
(l) Corporate Culture Commitments Related to Youth Access and Consumption 8
(m) Limitations on Lobbying 9
(n) Restriction on Advocacy Concerning Settlement Proceeds 9
(o) Dissolution of The Tobacco Institute, Inc., the Council for Tobacco Research-U.S.A., Inc. and the Center for Indoor Air Research, Inc. 9
(p) Regulation and Oversight of New Tobacco-Related Trade Associations 10
(q) Prohibition on Agreements to Suppress Research 10
(r) Prohibition on Material Misrepresentations 10
IV. PUBLIC ACCESS TO DOCUMENTS 11
V. TOBACCO CONTROL AND UNDERAGE USE LAWS 12
VI. ESTABLISHMENT OF A NATIONAL FOUNDATION 12
(a) Foundation Purposes 12
(b) Base Foundation Payments 12
(c) National Public Education Fund Payments 12
(d) Creation and Organization of the Foundation 13
(e) Foundation Affiliation 13
(f) Foundation Functions 13
(g) Foundation Grant-Making 13
(h) Foundation Activities 14
(i) Severance of this Section 14
VII. ENFORCEMENT 14
(a) Jurisdiction 14
(b) Enforcement of Consent Decree 14
(c) Enforcement of this Agreement 14
(d) Right of Review 15
(e) Applicability 15
(f) Coordination of Enforcement 15
(g) Inspection and Discovery Rights 15
VIII. CERTAIN ONGOING RESPONSIBILITIES OF THE SETTLING STATES 15
IX. PAYMENTS 16
(a) All Payments Into Escrow 16
(b) Initial Payments 16
(c) Annual Payments and Strategic Contribution Payments 16
(d) NPM Adjustment for Subsequent Participating Manufacturers 17
(e) Supplemental Payments 21
(f) Payment Responsibility 21
(g) Corporate Structures 21
(h) Accrual of Interest 21
(i) Payments by Subsequent Participating Manufacturers 21
(j) Order of Application of Allocations, Offsets, Reductions and Adjustments 22
X. EFFECT OF FEDERAL TOBACCO-RELATED LEGISLATION 23

XI. CALCULATION AND DISBURSEMENT OF PAYMENTS 24
(a) Independent Auditor to Make All Calculations 24
(b) Identity of Independent Auditor 24
(c) Resolution of Disputes 24
(d) General Provisions as to Calculation of Payments 24
(e) General Treatment of Payments 26
(f) Disbursements and Charges Not Contingent on Final Approval 26
(g) Payments to be Made Only After Final Approval 28
(h) Applicability to Section XVII Payments 28
(i) Miscalculated or Disputed Payments 28
(j) Payments After Applicable Condition 29
XII. SETTLING STATES' RELEASE, DISCHARGE AND COVENANT 30
(a) Release 30
(b) Released Claims Against Released Parties 31
XIII. CONSENT DECREES AND DISMISSAL OF CLAIMS 32
XIV. PARTICIPATING MANUFACTURERS' DISMISSAL OF RELATED LAWSUITS 33
XV. VOLUNTARY ACT OF THE PARTIES 33
XVI. CONSTRUCTION 33
XVII. RECOVERY OF COSTS AND ATTORNEYS' FEES 33
XVIII. MISCELLANEOUS 34
(a) Effect of Current or Future Law 34
(b) Limited Most-Favored Nation Provision 34
(c) Transfer of Tobacco Brands 35
(d) Payments in Settlement 35
(e) No Determination or Admission 35
(f) Non-Admissibility 35
(g) Representations of Parties 35
(h) Obligations Several, Not Joint 35
(i) Headings 36
(j) Amendment and Waiver 36
(k) Notices 36
(l) Cooperation 36
(m) Designees to Discuss Disputes 36
(n) Governing Law 36
(o) Severability 36
(p) Intended Beneficiaries 37
(q) Counterparts 37
(r) Applicability 37
(s) Preservation of Privilege 37
(t) Non-Release 37
(u) Termination 37
(v) Freedom of Information Requests 37
(w) Bankruptcy 37
(x) Notice of Material Transfers 39
(y) Entire Agreement 39
(z) Business Days 39
(aa) Subsequent Signatories 39
(bb) Decimal Places 39
(cc) Regulatory Authority 39
(dd) Successors 39
(ee) Export Packaging 39
(ff) Actions Within Geographic Boundaries of Settling States 39
(gg) Notice to Affiliates 39
EXHIBIT A STATE ALLOCATION PERCENTAGES A-1
EXHIBIT B FORM OF ESCROW AGREEMENT B-1
EXHIBIT C FORMULA FOR CALCULATING INFLATION ADJUSTMENTS C-1
EXHIBIT D LIST OF LAWSUITS D-1

TABLE OF CONTENTS
(continued)

Page

EXHIBIT E FORMULA FOR CALCULATING VOLUME ADJUSTMENTS E-1
EXHIBIT F POTENTIAL LEGISLATION NOT TO BE OPPOSED F-1
EXHIBIT G OBLIGATIONS OF THE TOBACCO INSTITUTE UNDER THE MASTER SETTLEMENT AGREEMENT G-1
EXHIBIT H DOCUMENT PRODUCTION H-1
EXHIBIT I INDEX AND SEARCH FEATURES FOR DOCUMENT WEBSITE I-1
EXHIBIT J TOBACCO ENFORCEMENT FUND PROTOCOL J-1
EXHIBIT K MARKET CAPITALIZATION PERCENTAGES K-1
EXHIBIT L MODEL CONSENT DECREE L-1
EXHIBIT M LIST OF PARTICIPATING MANUFACTURERS' LAWSUITS AGAINST THE SETTLING STATES M-1
EXHIBIT N LITIGATING POLITICAL SUBDIVISIONS N-1
EXHIBIT O MODEL STATE FEE PAYMENT AGREEMENT O-1
EXHIBIT P NOTICES P-1
EXHIBIT Q 1996 AND 1997 DATA Q-1
EXHIBIT R EXCLUSION OF CERTAIN BRAND NAMES R-1
EXHIBIT S DESIGNATION OF OUTSIDE COUNSEL S-1
EXHIBIT T MODEL STATUTE T-1
EXHIBIT U STRATEGIC CONTRIBUTION FUND PROTOCOL U-1

MASTER SETTLEMENT AGREEMENT

This Master Settlement Agreement is made by the undersigned Settling State officials (on behalf of their respective Settling States) and the undersigned Participating Manufacturers to settle and resolve with finality all Released Claims against the Participating Manufacturers and related entities as set forth herein. This Agreement constitutes the documentation effecting this settlement with respect to each Settling State, and is intended to and shall be binding upon each Settling State and each Participating Manufacturer in accordance with the terms hereof.

I. RECITALS

WHEREAS, more than 40 States have commenced litigation asserting various claims for monetary, equitable and injunctive relief against certain tobacco product manufacturers and others as defendants, and the States that have not filed suit can potentially assert similar claims;

WHEREAS, the Settling States that have commenced litigation have sought to obtain equitable relief and damages under state laws, including consumer protection and/or antitrust laws, in order to further the Settling States' policies regarding public health, including policies adopted to achieve a significant reduction in smoking by Youth;

WHEREAS, defendants have denied each and every one of the Settling States' allegations of unlawful conduct or wrongdoing and have asserted a number of defenses to the Settling States' claims, which defenses have been contested by the Settling States;

WHEREAS, the Settling States and the Participating Manufacturers are committed to reducing underage tobacco use by discouraging such use and by preventing Youth access to Tobacco Products;

WHEREAS, the Participating Manufacturers recognize the concern of the tobacco grower community that it may be adversely affected by the potential reduction in tobacco consumption resulting from this settlement, reaffirm their commitment to work cooperatively to address concerns about the potential adverse economic impact on such community, and will, within 30 days after the MSA Execution Date, meet with the political leadership of States with grower communities to address these economic concerns;

WHEREAS, the undersigned Settling State officials believe that entry into this Agreement and uniform consent decrees with the tobacco industry is necessary in order to further the Settling States' policies designed to reduce Youth smoking, to promote the public health and to secure monetary payments to the Settling States; and

WHEREAS, the Settling States and the Participating Manufacturers wish to avoid the further expense, delay, inconvenience, burden and uncertainty of continued litigation (including appeals from any verdicts), and, therefore, have agreed to settle their respective lawsuits and potential claims pursuant to terms which will achieve for the Settling States and their citizens significant funding for the advancement of public health, the implementation of important tobacco-related public health measures, including the enforcement of the mandates and restrictions related to such measures, as well as funding for a national Foundation dedicated to significantly reducing the use of Tobacco Products by Youth;

NOW, THEREFORE, BE IT KNOWN THAT, in consideration of the implementation of tobacco-related health measures and the payments to be made by the Participating Manufacturers, the release and discharge of all claims by the Settling States, and such other consideration as described herein, the sufficiency of which is hereby acknowledged, the Settling States and the Participating Manufacturers, acting by and through their authorized agents, memorialize and agree as follows:

II. DEFINITIONS

(a) "Account" has the meaning given in the Escrow Agreement.

(b) "Adult" means any person or persons who are not Underage.

(c) "Adult-Only Facility" means a facility or restricted area (whether open-air or enclosed) where the operator ensures or has a reasonable basis to believe (such as by checking identification as required under state law, or by checking the identification of any person appearing to be under the age of 27) that no Underage person is present. A facility or restricted area need not be permanently restricted to Adults in order to constitute an Adult-Only Facility, provided that the operator ensures or has a reasonable basis to believe that no Underage person is present during the event or time period in question.

(d) "Affiliate" means a person who directly or indirectly owns or controls, is owned or controlled by, or is under common ownership or control with, another person. Solely for purposes of this definition, the terms "owns," "is owned" and "ownership" mean ownership of an equity interest, or the equivalent thereof, of 10 percent or more, and the term "person" means an individual, partnership, committee, association, corporation or any other organization or group of persons.

(e) "Agreement" means this Master Settlement Agreement, together with the exhibits hereto, as it may be amended pursuant to subsection XVIII(j).

(f) "Allocable Share" means the percentage set forth for the State in question as listed in Exhibit A hereto, without regard to any subsequent alteration or modification of such State's percentage share agreed to by or among any States; or, solely for the purpose of calculating payments under subsection IX(c)(2) (and corresponding payments under subsection

IX(i)), the percentage disclosed for the State in question pursuant to subsection IX(c)(2)(A) prior to June 30, 1999, without regard to any subsequent alteration or modification of such State's percentage share agreed to by or among any States.

(g) "Allocated Payment" means a particular Settling State's Allocable Share of the sum of all of the payments to be made by the Original Participating Manufacturers in the year in question pursuant to subsections IX(c)(1) and IX(c)(2), as such payments have been adjusted, reduced and allocated pursuant to clause "First" through the first sentence of clause "Fifth" of subsection IX(j), but before application of the other offsets and adjustments described in clauses "Sixth" through "Thirteenth" of subsection IX(j).

(h) "Bankruptcy" means, with respect to any entity, the commencement of a case or other proceeding (whether voluntary or involuntary) seeking any of (1) liquidation, reorganization, rehabilitation, receivership, conservatorship, or other relief with respect to such entity or its debts under any bankruptcy, insolvency or similar law now or hereafter in effect; (2) the appointment of a trustee, receiver, liquidator, custodian or similar official of such entity or any substantial part of its business or property; (3) the consent of such entity to any of the relief described in (1) above or to the appointment of any official described in (2) above in any such case or other proceeding involuntarily commenced against such entity; or (4) the entry of an order for relief as to such entity under the federal bankruptcy laws as now or hereafter in effect. Provided, however, that an involuntary case or proceeding otherwise within the foregoing definition shall not be a "Bankruptcy" if it is or was dismissed within 60 days of its commencement.

(i) "Brand Name" means a brand name (alone or in conjunction with any other word), trademark, logo, symbol, motto, selling message, recognizable pattern of colors, or any other indicia of product identification identical or similar to, or identifiable with, those used for any domestic brand of Tobacco Products. Provided, however, that the term "Brand Name" shall not include the corporate name of any Tobacco Product Manufacturer that does not after the MSA Execution Date sell a brand of Tobacco Products in the States that includes such corporate name.

(j) "Brand Name Sponsorship" means an athletic, musical, artistic, or other social or cultural event as to which payment is made (or other consideration is provided) in exchange for use of a Brand Name or Names (1) as part of the name of the event or (2) to identify, advertise, or promote such event or an entrant, participant or team in such event in any other way. Sponsorship of a single national or multi-state series or tour (for example, NASCAR (including any number of NASCAR races)), or of one or more events within a single national or multi-state series or tour, or of an entrant, participant, or team taking part in events sanctioned by a single approving organization (e.g., NASCAR or CART), constitutes one Brand Name Sponsorship. Sponsorship of an entrant, participant, or team by a Participating Manufacturer using a Brand Name or Names in an event that is part of a series or tour that is sponsored by such Participating Manufacturer or that is part of a series or tour in which any one or more events are sponsored by such Participating Manufacturer does not constitute a separate Brand Name Sponsorship. Sponsorship of an entrant, participant, or team by a Participating Manufacturer using a Brand Name or Names in any event (or series of events) not sponsored by such Participating Manufacturer constitutes a Brand Name Sponsorship. The term "Brand Name Sponsorship" shall not include an event in an Adult-Only Facility.

(k) "Business Day" means a day which is not a Saturday or Sunday or legal holiday on which banks are authorized or required to close in New York, New York.

(l) "Cartoon" means any drawing or other depiction of an object, person, animal, creature or any similar caricature that satisfies any of the following criteria:

(1) the use of comically exaggerated features;

(2) the attribution of human characteristics to animals, plants or other objects, or the similar use of anthropomorphic technique; or

(3) the attribution of unnatural or extrahuman abilities, such as imperviousness to pain or injury, X-ray vision, tunneling at very high speeds or transformation.

The term "Cartoon" includes "Joe Camel," but does not include any drawing or other depiction that on July 1, 1998, was in use in any State in any Participating Manufacturer's corporate logo or in any Participating Manufacturer's Tobacco Product packaging.

(m) "Cigarette" means any product that contains nicotine, is intended to be burned or heated under ordinary conditions of use, and consists of or contains (1) any roll of tobacco wrapped in paper or in any substance not containing tobacco; or (2) tobacco, in any form, that is functional in the product, which, because of its appearance, the type of tobacco used in the filler, or its packaging and labeling, is likely to be offered to, or purchased by, consumers as a cigarette; or (3) any roll of tobacco wrapped in any substance containing tobacco which, because of its appearance, the type of tobacco used in the filler, or its packaging and labeling, is likely to be offered to, or purchased by, consumers as a cigarette described in clause (1) of this definition. The term "Cigarette" includes "roll-your-own" (i.e., any tobacco which, because of its appearance, type, packaging, or labeling is suitable for use and likely to be offered to, or purchased by, consumers as tobacco for making cigarettes). Except as provided in subsections II(z) and II(mm), 0.0325 ounces of "roll-your-own" tobacco shall constitute one individual "Cigarette."

(n) "Claims" means any and all manner of civil (i.e., non-criminal): claims, demands, actions, suits, causes of action, damages (whenever incurred), liabilities of any nature including civil penalties and punitive damages, as well as costs, expenses and attorneys' fees (except as to the Original Participating Manufacturers' obligations under section XVII), known or unknown, suspected or unsuspected, accrued or unaccrued, whether legal, equitable, or statutory.

(o) "Consent Decree" means a state-specific consent decree as described in subsection XIII(b)(1)(B) of this Agreement.

(p) "Court" means the respective court in each Settling State to which this Agreement and the Consent Decree are presented for approval and/or entry as to that Settling State.

(q) "Escrow" has the meaning given in the Escrow Agreement.

(r) "Escrow Agent" means the escrow agent under the Escrow Agreement.

(s) "Escrow Agreement" means an escrow agreement substantially in the form of Exhibit B.

(t) "Federal Tobacco Legislation Offset" means the offset described in section X.

(u) "Final Approval" means the earlier of:

(1) the date by which State-Specific Finality in a sufficient number of Settling States has occurred; or

(2) June 30, 2000.

For the purposes of this subsection (u), "State-Specific Finality in a sufficient number of Settling States" means that State-Specific Finality has occurred in both:

(A) a number of Settling States equal to at least 80% of the total number of Settling States; and

(B) Settling States having aggregate Allocable Shares equal to at least 80% of the total aggregate Allocable Shares assigned to all Settling States.

Notwithstanding the foregoing, the Original Participating Manufacturers may, by unanimous written agreement, waive any requirement for Final Approval set forth in subsections (A) or (B) hereof.

(v) "Foundation" means the foundation described in section VI.

(w) "Independent Auditor" means the firm described in subsection XI(b).

(x) "Inflation Adjustment" means an adjustment in accordance with the formulas for inflation adjustments set forth in Exhibit C.

(y) "Litigating Releasing Parties Offset" means the offset described in subsection XII(b).

(z) "Market Share" means a Tobacco Product Manufacturer's respective share (expressed as a percentage) of the total number of individual Cigarettes sold in the fifty United States, the District of Columbia and Puerto Rico during the applicable calendar year, as measured by excise taxes collected by the federal government and, in the case of sales in Puerto Rico, arbitrios de cigarillos collected by the Puerto Rico taxing authority. For purposes of the definition and determination of "Market Share" with respect to calculations under subsection IX(i), 0.09 ounces of "roll your own" tobacco shall constitute one individual Cigarette; for purposes of the definition and determination of "Market Share" with respect to all other calculations, 0.0325 ounces of "roll your own" tobacco shall constitute one individual Cigarette.

(aa) "MSA Execution Date" means November 23, 1998.

(bb) "NAAG" means the National Association of Attorneys General, or its successor organization that is directed by the Attorneys General to perform certain functions under this Agreement.

(cc) "Non-Participating Manufacturer" means any Tobacco Product Manufacturer that is not a Participating Manufacturer.

(dd) "Non-Settling States Reduction" means a reduction determined by multiplying the amount to which such reduction applies by the aggregate Allocable Shares of those States that are not Settling States on the date 15 days before such payment is due.

(ee) "Notice Parties" means each Participating Manufacturer, each Settling State, the Escrow Agent, the Independent Auditor and NAAG.

(ff) "NPM Adjustment" means the adjustment specified in subsection IX(d).

(gg) "NPM Adjustment Percentage" means the percentage determined pursuant to subsection IX(d).

(hh) "Original Participating Manufacturers" means the following: Brown & Williamson Tobacco Corporation, Lorillard Tobacco Company, Philip Morris Incorporated and R.J. Reynolds Tobacco Company, and the respective successors of each of the foregoing. Except as expressly provided in this Agreement, once an entity becomes an Original Participating Manufacturer, such entity shall permanently retain the status of Original Participating Manufacturer.

(ii) "Outdoor Advertising" means (1) billboards, (2) signs and placards in arenas, stadiums, shopping malls and Video Game Arcades (whether any of the foregoing are open air or enclosed) (but not including any such sign or placard located in an Adult-Only Facility), and (3) any other advertisements placed (A) outdoors, or (B) on the inside surface of a window facing outward. Provided, however, that the term "Outdoor Advertising" does not mean (1) an advertisement on the outside of a Tobacco Product manufacturing facility; (2) an individual advertisement that does not occupy an area larger than 14 square feet (and that neither is placed in such proximity to any other such advertisement so as to create a single "mosaic"-type advertisement larger than 14 square feet, nor functions solely as a segment of a larger advertising unit or series), and that is placed (A) on the outside of any retail establishment that sells Tobacco Products (other than solely through a vending machine), (B) outside (but on the property of) any such establishment, or (C) on the inside surface of a window facing outward in any such establishment; (3) an advertisement inside a retail establishment that sells Tobacco Products (other than solely through a vending machine) that is not placed on the inside surface of a window facing outward; or (4) an outdoor advertisement at the site of an event to be held at an Adult-Only Facility that is placed at such site during the period the facility or enclosed area constitutes an Adult-Only Facility, but in no event more than 14 days before the event, and that does not advertise any Tobacco Product (other than by using a Brand Name to identify the event).

(jj) "Participating Manufacturer" means a Tobacco Product Manufacturer that is or becomes a signatory to this Agreement, provided that (1) in the case of a Tobacco Product Manufacturer that is not an Original Participating Manufacturer, such Tobacco Product Manufacturer is bound by this Agreement and the Consent Decree (or, in any Settling State that does not permit amendment of the Consent Decree, a consent decree containing terms identical to those set forth in the Consent Decree) in all Settling States in which this Agreement and the Consent Decree binds Original Participating Manufacturers (provided, however, that such Tobacco Product Manufacturer need only become bound by the Consent Decree in those Settling States in which the Settling State has filed a Released Claim against it), and (2) in the case of a Tobacco Product Manufacturer that signs this Agreement after the MSA Execution Date, such Tobacco Product Manufacturer, within a reasonable period of time after signing this Agreement, makes any payments (including interest thereon at the Prime Rate) that it would have been obligated to make in the intervening period had it been a signatory as of the MSA Execution Date. "Participating Manufacturer" shall also include the successor of a Participating Manufacturer. Except as expressly provided in this Agreement, once an entity becomes a Participating Manufacturer such entity shall permanently retain the status of Participating Manufacturer. Each Participating Manufacturer shall regularly report its shipments of Cigarettes in or to the fifty United States, the District of Columbia and Puerto Rico to Management Science Associates, Inc. (or a successor entity as set forth in subsection (mm)). Solely for purposes of calculations pursuant to subsection IX(d), a Tobacco Product Manufacturer that is not a signatory to this Agreement shall be deemed to be a "Participating Manufacturer" if the Original Participating Manufacturers unanimously consent in writing.

(kk) "Previously Settled States Reduction" means a reduction determined by multiplying the amount to which such reduction applies by 12.4500000%, in the case of payments due in or prior to 2007; 12.2373756%, in the case of payments due after 2007 but before 2018; and 11.0666667%, in the case of payments due in or after 2018.

(ll) "Prime Rate" shall mean the prime rate as published from time to time by the Wall Street Journal or, in the event the Wall Street Journal is no longer published or no longer publishes such rate, an equivalent successor reference rate determined by the Independent Auditor.

(mm) "Relative Market Share" means an Original Participating Manufacturer's respective share (expressed as a percentage) of the total number of individual Cigarettes shipped in or to the fifty United States, the District of Columbia and Puerto Rico by all the Original Participating Manufacturers during the calendar year immediately preceding the year in which the payment at issue is due (regardless of when such payment is made), as measured by the Original Participating Manufacturers' reports of shipments of Cigarettes to Management Science Associates, Inc. (or a successor entity acceptable to both the Original Participating Manufacturers and a majority of those Attorneys General who are both the Attorney General of a Settling State and a member of the NAAG executive committee at the time in question). A Cigarette shipped by more than one Participating Manufacturer shall be deemed to have been shipped solely by the first Participating Manufacturer to do so. For purposes of the definition and determination of "Relative Market Share," 0.09 ounces of "roll your own" tobacco shall constitute one individual Cigarette.

(nn) "Released Claims" means:

(1) for past conduct, acts or omissions (including any damages incurred in the future arising from such past conduct, acts or omissions), those Claims directly or indirectly based on, arising out of or in any way related, in whole or in part, to (A) the use, sale, distribution, manufacture, development, advertising, marketing or health effects of, (B) the exposure to, or (C) research, statements, or warnings regarding, Tobacco Products (including, but not limited to, the Claims asserted in the actions identified in Exhibit D, or any comparable Claims that were, could be or could have been asserted now or in the future in those actions or in any comparable action in federal, state or local court brought by a Settling State or a Releasing Party (whether or not such Settling State or Releasing Party has brought such action)), except for claims not asserted in the actions identified in Exhibit D for outstanding liability under existing licensing (or similar) fee laws or existing tax laws (but not excepting claims for any tax liability of the Tobacco-Related Organizations or of any Released Party with respect to such Tobacco-Related Organizations, which claims are covered by the release and covenants set forth in this Agreement);

(2) for future conduct, acts or omissions, only those monetary Claims directly or indirectly based on, arising out of or in any way related to, in whole or in part, the use of or exposure to Tobacco Products manufactured in the ordinary course of business, including without limitation any future Claims for reimbursement of health care costs allegedly associated with the use of or exposure to Tobacco Products.

(oo) "Released Parties" means all Participating Manufacturers, their past, present and future Affiliates, and the respective divisions, officers, directors, employees, representatives, insurers, lenders, underwriters, Tobacco-Related Organizations, trade associations, suppliers, agents, auditors, advertising agencies, public relations entities, attorneys, retailers and distributors of any Participating Manufacturer or of any such Affiliate (and the predecessors, heirs, executors, administrators, successors and assigns of each of the foregoing). Provided, however, that "Released Parties" does not include any person or entity (including, but not limited to, an Affiliate) that is itself a Non-Participating Manufacturer at any time after the MSA Execution Date, unless such person or entity becomes a Participating Manufacturer.

(pp) "Releasing Parties" means each Settling State and any of its past, present and future agents, officials acting in their official capacities, legal representatives, agencies, departments, commissions and divisions; and also means, to the full extent of the power of the signatories hereto to release past, present and future claims, the following: (1) any Settling State's subdivisions (political or otherwise, including, but not limited to, municipalities, counties, parishes, villages, unincorporated districts and hospital districts), public entities, public instrumentalities and public educational institutions; and (2) persons or entities acting in a parens patriae, sovereign, quasi-sovereign, private attorney general, qui tam, taxpayer, or any other capacity, whether or not any of them participate in this settlement, (A) to the extent that any such person or entity is seeking relief on behalf of or generally applicable to the general public in such Settling State or the people of the State, as opposed solely to private or individual relief for separate and distinct injuries, or (B) to the extent that any such entity (as opposed to an individual) is seeking recovery of health-care expenses (other than premium or capitation payments for the benefit of present or retired state employees) paid or reimbursed, directly or indirectly, by a Settling State.

(qq) "Settling State" means any State that signs this Agreement on or before the MSA Execution Date. Provided, however, that the term "Settling State" shall not include (1) the States of Mississippi, Florida, Texas and Minnesota; and (2) any State as to which this Agreement has been terminated.

(rr) "State" means any state of the United States, the District of Columbia, the Commonwealth of Puerto Rico, Guam, the Virgin Islands, American Samoa, and the Northern Marianas.

(ss) "State-Specific Finality" means, with respect to the Settling State in question:

(1) this Agreement and the Consent Decree have been approved and entered by the Court as to all Original Participating Manufacturers, or, in the event of an appeal from or review of a decision of the Court to withhold its approval and entry of this Agreement and the Consent Decree, by the court hearing such appeal or conducting such review;

(2) entry by the Court has been made of an order dismissing with prejudice all claims against Released Parties in the action as provided herein; and

(3) the time for appeal or to seek review of or permission to appeal ("Appeal") from the approval and entry as described in subsection (1) hereof and entry of such order described in subsection (2) hereof has expired; or, in the event of an Appeal from such approval and entry, the Appeal has been dismissed, or the approval and entry described in (1) hereof and the order described in subsection (2) hereof have been affirmed in all material respects by the court of last resort to which such Appeal has been taken and such dismissal or affirmance has become no longer subject to further Appeal (including, without limitation, review by the United States Supreme Court).

(tt) "Subsequent Participating Manufacturer" means a Tobacco Product Manufacturer (other than an Original Participating Manufacturer) that: (1) is a Participating Manufacturer, and (2) is a signatory to this Agreement, regardless of when such Tobacco Product Manufacturer became a signatory to this Agreement. "Subsequent Participating Manufacturer" shall also include the successors of a Subsequent Participating Manufacturer. Except as expressly provided in this Agreement, once an entity becomes a Subsequent Participating Manufacturer such entity shall permanently retain the status of Subsequent Participating Manufacturer, unless it agrees to assume the obligations of an Original Participating Manufacturer as provided in subsection XVIII(c).

(uu) "Tobacco Product Manufacturer" means an entity that after the MSA Execution Date directly (and not exclusively through any Affiliate):

(1) manufactures Cigarettes anywhere that such manufacturer intends to be sold in the States, including Cigarettes intended to be sold in the States through an importer (except where such importer is an Original Participating Manufacturer that will be responsible for the payments under this Agreement with respect to such Cigarettes as a result of the provisions of subsections II(mm) and that pays the taxes specified in subsection II(z) on such Cigarettes, and provided that the manufacturer of such Cigarettes does not market or advertise such Cigarettes in the States);

(2) is the first purchaser anywhere for resale in the States of Cigarettes manufactured anywhere that the manufacturer does not intend to be sold in the States; or

(3) becomes a successor of an entity described in subsection (1) or (2) above.

The term "Tobacco Product Manufacturer" shall not include an Affiliate of a Tobacco Product Manufacturer unless such Affiliate itself falls within any of subsections (1) - (3) above.

(vv) "Tobacco Products" means Cigarettes and smokeless tobacco products.

(ww) "Tobacco-Related Organizations" means the Council for Tobacco Research-U.S.A., Inc., The Tobacco Institute, Inc. ("TI"), and the Center for Indoor Air Research, Inc. ("CIAR") and the successors, if any, of TI or CIAR.

(xx) "Transit Advertisements" means advertising on or within private or public vehicles and all advertisements placed at, on or within any bus stop, taxi stand, transportation waiting area, train station, airport or any similar location. Notwithstanding the foregoing, the term "Transit Advertisements" does not include (1) any advertisement placed in, on or outside the premises of any retail establishment that sells Tobacco Products (other than solely through a vending machine) (except if such individual advertisement (A) occupies an area larger than 14 square feet; (B) is placed in such proximity to any other such advertisement so as to create a single "mosaic"-type advertisement larger than 14 square feet; or (C) functions solely as a segment of a larger advertising unit or series); or (2) advertising at the site of an event to be held at an Adult-Only Facility that is placed at such site during the period the facility or enclosed area constitutes an Adult-Only Facility, but in no event more than 14 days before the event, and that does not advertise any Tobacco Product (other than by using a Brand Name to identify the event).

(yy) "Underage" means younger than the minimum age at which it is legal to purchase or possess (whichever minimum age is older) Cigarettes in the applicable Settling State.

(zz) "Video Game Arcade" means an entertainment establishment primarily consisting of video games (other than video games intended primarily for use by persons 18 years of age or older) and/or pinball machines.

(aaa) "Volume Adjustment" means an upward or downward adjustment in accordance with the formula for volume adjustments set forth in Exhibit E.

(bbb) "Youth" means any person or persons under 18 years of age.

III. PERMANENT RELIEF

(a) Prohibition on Youth Targeting. No Participating Manufacturer may take any action, directly or indirectly, to target Youth within any Settling State in the advertising, promotion or marketing of Tobacco Products, or take any action the primary purpose of which is to initiate, maintain or increase the incidence of Youth smoking within any Settling State.

(b) Ban on Use of Cartoons. Beginning 180 days after the MSA Execution Date, no Participating Manufacturer may use or cause to be used any Cartoon in the advertising, promoting, packaging or labeling of Tobacco Products.

(c) Limitation of Tobacco Brand Name Sponsorships.

(1) Prohibited Sponsorships. After the MSA Execution Date, no Participating Manufacturer may engage in any Brand Name Sponsorship in any State consisting of:

(A) concerts; or

(B) events in which the intended audience is comprised of a significant percentage of Youth; or

(C) events in which any paid participants or contestants are Youth; or

(D) any athletic event between opposing teams in any football, basketball, baseball, soccer or hockey league.

(2) Limited Sponsorships.

(A) No Participating Manufacturer may engage in more than one Brand Name Sponsorship in the States in any twelve-month period (such period measured from the date of the initial sponsored event).

(B) Provided, however, that

(i) nothing contained in subsection (2)(A) above shall require a Participating Manufacturer to breach or terminate any sponsorship contract in existence as of August 1, 1998 (until the earlier of (x) the current term of any existing contract, without regard to any renewal or option that may be exercised by such Participating Manufacturer or (y) three years after the MSA Execution Date); and

(ii) notwithstanding subsection (1)(A) above, Brown & Williamson Tobacco Corporation may sponsor either the GPC country music festival or the Kool jazz festival as its one annual Brand Name Sponsorship permitted pursuant to subsection (2)(A) as well as one Brand Name Sponsorship permitted pursuant to subsection (2)(B)(i).

(3) Related Sponsorship Restrictions. With respect to any Brand Name Sponsorship permitted under this subsection (c):

(A) advertising of the Brand Name Sponsorship event shall not advertise any Tobacco Product (other than by using the Brand Name to identify such Brand Name Sponsorship event);

(B) no Participating Manufacturer may refer to a Brand Name Sponsorship event or to a celebrity or other person in such an event in its advertising of a Tobacco Product;

(C) nothing contained in the provisions of subsection III(e) of this Agreement shall apply to actions taken by any Participating Manufacturer in connection with a Brand Name Sponsorship permitted pursuant to the provisions of subsections (2)(A) and (2)(B)(i); the Brand Name Sponsorship permitted by subsection (2)(B)(ii) shall be subject to the restrictions of subsection III(e) except that such restrictions shall not prohibit use of the Brand Name to identify the Brand Name Sponsorship;

(D) nothing contained in the provisions of subsections III(f) and III(i) shall apply to apparel or other merchandise: (i) marketed, distributed, offered, sold, or licensed at the site of a Brand Name Sponsorship permitted pursuant to subsections (2)(A) or (2)(B)(i) by the person to which the relevant Participating Manufacturer has provided payment in exchange for the use of the relevant Brand Name in the Brand Name Sponsorship or a third-party that does not receive payment from the relevant Participating Manufacturer (or any Affiliate of such Participating Manufacturer) in connection with the marketing, distribution, offer, sale or license of such apparel or other merchandise; or (ii) used at the site of a Brand Name Sponsorship permitted pursuant to subsection (2)(A) or (2)(B)(i) (during such event) that are not distributed (by sale or otherwise) to any member of the general public; and

(E) nothing contained in the provisions of subsection III(d) shall: (i) apply to the use of a Brand Name on a vehicle used in a Brand Name Sponsorship; or (ii) apply to Outdoor Advertising advertising the Brand Name Sponsorship, to the extent that such Outdoor Advertising is placed at the site of a Brand Name Sponsorship no more than 90 days before the start of the initial sponsored event, is removed within 10 days after the end of the last sponsored event, and is not prohibited by subsection (3)(A) above.

(4) Corporate Name Sponsorships. Nothing in this subsection (c) shall prevent a Participating Manufacturer from sponsoring or causing to be sponsored any athletic, musical, artistic, or other social or cultural event, or any entrant, participant or team in such event (or series of events) in the name of the corporation which manufactures Tobacco Products, provided that the corporate name does not include any Brand Name of domestic Tobacco Products.

(5) Naming Rights Prohibition. No Participating Manufacturer may enter into any agreement for the naming rights of any stadium or arena located within a Settling State using a Brand Name, and shall not otherwise cause a stadium or arena located within a Settling State to be named with a Brand Name.

(6) Prohibition on Sponsoring Teams and Leagues. No Participating Manufacturer may enter into any agreement pursuant to which payment is made (or other consideration is provided) by such Participating Manufacturer to any football, basketball, baseball, soccer or hockey league (or any team involved in any such league) in exchange for use of a Brand Name.

(d) Elimination of Outdoor Advertising and Transit Advertisements. Each Participating Manufacturer shall discontinue Outdoor Advertising and Transit Advertisements advertising Tobacco Products within the Settling States as set forth herein.

(1) Removal. Except as otherwise provided in this section, each Participating Manufacturer shall remove from within the Settling States within 150 days after the MSA Execution Date all of its (A) billboards (to the extent that such billboards constitute Outdoor Advertising) advertising Tobacco Products; (B) signs and placards (to the extent that such signs and placards constitute Outdoor Advertising) advertising Tobacco Products in arenas, stadiums, shopping malls and Video Game Arcades; and (C) Transit Advertisements advertising Tobacco Products.

(2) Prohibition on New Outdoor Advertising and Transit Advertisements. No Participating Manufacturer may, after the MSA Execution Date, place or cause to be placed any new Outdoor Advertising advertising Tobacco Products or new Transit Advertisements advertising Tobacco Products within any Settling State.

(3) Alternative Advertising. With respect to those billboards required to be removed under subsection (1) that are leased (as opposed to owned) by any Participating Manufacturer, the Participating Manufacturer will allow the Attorney General of the Settling State within which such billboards are located to substitute, at the Settling State's option, alternative advertising intended to discourage the use of Tobacco Products by Youth and their exposure to second-hand smoke for the remaining term of the applicable contract (without regard to any renewal or option term that may be exercised by such Participating Manufacturer). The Participating Manufacturer will bear the cost of the lease through the end of such remaining term. Any other costs associated with such alternative advertising will be borne by the Settling State.

(4) Ban on Agreements Inhibiting Anti-Tobacco Advertising. Each Participating Manufacturer agrees that it will not enter into any agreement that prohibits a third party from selling, purchasing or displaying advertising discouraging the use of Tobacco Products or exposure to second-hand smoke. In the event and to the extent that any Participating Manufacturer has entered into an agreement containing any such prohibition, such Participating Manufacturer agrees to waive such prohibition in such agreement.

(5) Designation of Contact Person. Each Participating Manufacturer that has Outdoor Advertising or Transit Advertisements advertising Tobacco Products within a Settling State shall, within 10 days after the MSA Execution Date, provide the Attorney General of such Settling State with the name of a contact person to whom the Settling State may direct inquiries during the time such Outdoor Advertising and Transit Advertisements are being eliminated, and from whom the Settling State may obtain periodic reports as to the progress of their elimination.

(6) Adult-Only Facilities. To the extent that any advertisement advertising Tobacco Products located within an Adult-Only Facility constitutes Outdoor Advertising or a Transit Advertisement, this subsection (d) shall not apply to such advertisement, provided such advertisement is not visible to persons outside such Adult-Only Facility.

(e) Prohibition on Payments Related to Tobacco Products and Media. No Participating Manufacturer may, beginning 30 days after the MSA Execution Date, make, or cause to be made, any payment or other consideration to any other person or entity to use, display, make reference to or use as a prop any Tobacco Product, Tobacco Product package, advertisement for a Tobacco Product, or any other item bearing a Brand Name in any motion picture, television show, theatrical production or other live performance, live or recorded performance of music, commercial film or video, or video game ("Media"); provided, however, that the foregoing prohibition shall not apply to (1) Media where the audience or viewers are within an Adult-Only Facility (provided such Media are not visible to persons outside such Adult-Only Facility); (2) Media not intended for distribution or display to the public; or (3) instructional Media concerning non-conventional cigarettes viewed only by or provided only to smokers who are Adults.

(f) Ban on Tobacco Brand Name Merchandise. Beginning July 1, 1999, no Participating Manufacturer may, within any Settling State, market, distribute, offer, sell, license or cause to be marketed, distributed, offered, sold or licensed (including, without limitation, by catalogue or direct mail), any apparel or other merchandise (other than Tobacco Products, items the sole function of which is to advertise Tobacco Products, or written or electronic publications) which bears a Brand Name. Provided, however, that nothing in this subsection shall (1) require any Participating Manufacturer to breach or terminate any licensing agreement or other contract in existence as of June 20, 1997 (this exception shall not apply beyond the current term of any existing contract, without regard to any renewal or option term that may be exercised by such Participating Manufacturer); (2) prohibit the distribution to any Participating Manufacturer's employee who is not Underage of any item described above that is intended for the personal use of such an employee; (3) require any Participating Manufacturer to retrieve, collect or otherwise recover any item that prior to the MSA Execution Date was marketed, distributed, offered, sold, licensed, or caused to be marketed, distributed, offered, sold or licensed by such Participating Manufacturer; (4) apply to coupons or other items used by Adults solely in connection with the purchase of Tobacco Products; or (5) apply to apparel or other merchandise used within an Adult-Only Facility that is not distributed (by sale or otherwise) to any member of the general public.

(g) Ban on Youth Access to Free Samples. After the MSA Execution Date, no Participating Manufacturer may, within any Settling State, distribute or cause to be distributed any free samples of Tobacco Products except in an Adult-Only Facility. For purposes of this Agreement, a "free sample" does not include a Tobacco Product that is provided to an Adult in connection with (1) the purchase, exchange or redemption for proof of purchase of any Tobacco Products (including, but not limited to, a free offer in connection with the purchase of Tobacco Products, such as a "two-for-one" offer), or (2) the conducting of consumer testing or evaluation of Tobacco Products with persons who certify that they are Adults.

(h) Ban on Gifts to Underage Persons Based on Proofs of Purchase. Beginning one year after the MSA Execution Date, no Participating Manufacturer may provide or cause to be provided to any person without sufficient proof that such person is an Adult any item in exchange for the purchase of Tobacco Products, or the furnishing of credits, proofs-of-purchase, or coupons with respect to such a purchase. For purposes of the preceding sentence only, (1) a driver's license or other government-issued identification (or legible photocopy thereof), the validity of which is certified by the person to whom the item is provided, shall by itself be deemed to be a sufficient form of proof of age; and (2) in the case of items provided (or to be redeemed) at retail establishments, a Participating Manufacturer shall be entitled to rely on verification of proof of age by the retailer, where such retailer is required to obtain verification under applicable federal, state or local law.

(i) Limitation on Third-Party Use of Brand Names. After the MSA Execution Date, no Participating Manufacturer may license or otherwise expressly authorize any third party to use or advertise within any Settling State any Brand Name in a manner prohibited by this Agreement if done by such Participating Manufacturer itself. Each Participating Manufacturer shall, within 10 days after the MSA Execution Date, designate a person (and provide written notice to NAAG of such designation) to whom the Attorney General of any Settling State may provide written notice of any such third-party activity that would be prohibited by this Agreement if done by such Participating Manufacturer itself. Following such written notice, the Participating Manufacturer will promptly take commercially reasonable steps against any such non-de minimis third-party activity. Provided, however, that nothing in this subsection shall require any Participating Manufacturer to (1) breach or terminate any licensing agreement or other contract in existence as of July 1, 1998 (this exception shall not apply beyond the current term of any existing contract, without regard to any renewal or option term that may be exercised by such Participating Manufacturer); or (2) retrieve, collect or otherwise recover any item that prior to the MSA Execution Date was marketed, distributed, offered, sold, licensed or caused to be marketed, distributed, offered, sold or licensed by such Participating Manufacturer.

(j) Ban on Non-Tobacco Brand Names. No Participating Manufacturer may, pursuant to any agreement requiring the payment of money or other valuable consideration, use or cause to be used as a brand name of any Tobacco Product any nationally recognized or nationally established brand name or trade name of any non-tobacco item or service or any nationally recognized or nationally established sports team, entertainment group or individual celebrity. Provided, however, that the preceding sentence shall not apply to any Tobacco Product brand name in existence as of July 1, 1998. For the purposes of this subsection, the term "other valuable consideration" shall not include an agreement between two entities who enter into such agreement for the sole purpose of avoiding infringement claims.

(k) Minimum Pack Size of Twenty Cigarettes. No Participating Manufacturer may, beginning 60 days after the MSA Execution Date and through and including December 31, 2001, manufacture or cause to be manufactured for sale in any Settling State any pack or other container of Cigarettes containing fewer than 20 Cigarettes (or, in the case of roll-your-own tobacco, any package of roll-your-own tobacco containing less than 0.60 ounces of tobacco). No Participating Manufacturer may, beginning 150 days after the MSA Execution Date and through and including December 31, 2001, sell or distribute in any Settling State any pack or other container of Cigarettes containing fewer than 20 Cigarettes (or, in the case of roll-your-own tobacco, any package of roll-your-own tobacco containing less than 0.60 ounces of tobacco). Each Participating Manufacturer further agrees that following the MSA Execution Date it shall not oppose, or cause to be opposed (including through any third party or Affiliate), the passage by any Settling State of any legislative proposal or administrative rule applicable to all Tobacco Product Manufacturers and all retailers of Tobacco Products prohibiting the manufacture and sale of any pack or other container of Cigarettes containing fewer than 20 Cigarettes (or, in the case of roll-your-own tobacco, any package of roll-your-own tobacco containing less than 0.60 ounces of tobacco).

(l) Corporate Culture Commitments Related to Youth Access and Consumption. Beginning 180 days after the MSA Execution Date each Participating Manufacturer shall:

promulgate or reaffirm corporate principles that express and explain its commitment to comply with the provisions of this Agreement and the reduction of use of Tobacco Products by Youth, and clearly and regularly communicate to its employees and customers its commitment to assist in the reduction of Youth use of Tobacco Products;

designate an executive level manager (and provide written notice to NAAG of such designation) to identify methods to reduce Youth access to, and the incidence of Youth consumption of, Tobacco Products; and

encourage its employees to identify additional methods to reduce Youth access to, and the incidence of Youth consumption of, Tobacco Products.

(m) Limitations on Lobbying. Following State-Specific Finality in a Settling State:

(1) No Participating Manufacturer may oppose, or cause to be opposed (including through any third party or Affiliate), the passage by such Settling State (or any political subdivision thereof) of those state or local legislative proposals or administrative rules described in Exhibit F hereto intended by their terms to reduce Youth access to, and the incidence of Youth consumption of, Tobacco Products. Provided, however, that the foregoing does not prohibit any Participating Manufacturer from (A) challenging enforcement of, or suing for declaratory or injunctive relief with respect to, any such legislation or rule on any grounds; (B) continuing, after State-Specific Finality in such Settling State, to oppose or cause to be opposed, the passage during the legislative session in which State-Specific Finality in such Settling State occurs of any specific state or local legislative proposals or administrative rules introduced prior to the time of State-Specific Finality in such Settling State; (C) opposing, or causing to be opposed, any excise tax or income tax provision or user fee or other payments relating to Tobacco Products or Tobacco Product Manufacturers; or (D) opposing, or causing to be opposed, any state or local legislative proposal or administrative rule that also includes measures other than those described in Exhibit F.

(2) Each Participating Manufacturer shall require all of its officers and employees engaged in lobbying activities in such Settling State after State-Specific Finality, contract lobbyists engaged in lobbying activities in such Settling State after State-Specific Finality, and any other third parties who engage in lobbying activities in such Settling State after State-Specific Finality on behalf of such Participating Manufacturer ("lobbyist" and "lobbying activities" having the meaning such terms have under the law of the Settling State in question) to certify in writing to the Participating Manufacturer that they:

(A) will not support or oppose any state, local or federal legislation, or seek or oppose any governmental action, on behalf of the Participating Manufacturer without the Participating Manufacturer's express authorization (except where such advance express authorization is not reasonably practicable);

(B) are aware of and will fully comply with this Agreement and all laws and regulations applicable to their lobbying activities, including, without limitation, those related to disclosure of financial contributions. Provided, however, that if the Settling State in question has in existence no laws or regulations relating to disclosure of financial contributions regarding lobbying activities, then each Participating Manufacturer shall, upon request of the Attorney General of such Settling State, disclose to such Attorney General any payment to a lobbyist that the Participating Manufacturer knows or has reason to know will be used to influence legislative or administrative actions of the state or local government relating to Tobacco Products or their use. Disclosures made pursuant to the preceding sentence shall be filed in writing with the Office of the Attorney General on the first day of February and the first day of August of each year for any and all payments made during the six month period ending on the last day of the preceding December and June, respectively, with the following information: (1) the name, address, telephone number and e-mail address (if any) of the recipient; (2) the amount of each payment; and (3) the aggregate amount of all payments described in this subsection (2)(B) to the recipient in the calendar year; and

(C) have reviewed and will fully abide by the Participating Manufacturer's corporate principles promulgated pursuant to this Agreement when acting on behalf of the Participating Manufacturer.

(3) No Participating Manufacturer may support or cause to be supported (including through any third party or Affiliate) in Congress or any other forum legislation or rules that would preempt, override, abrogate or diminish such Settling State's rights or recoveries under this Agreement. Except as specifically provided in this Agreement, nothing herein shall be deemed to restrain any Settling State or Participating Manufacturer from advocating terms of any national settlement or taking any other positions on issues relating to tobacco.

(n) Restriction on Advocacy Concerning Settlement Proceeds. After the MSA Execution Date, no Participating Manufacturer may support or cause to be supported (including through any third party or Affiliate) the diversion of any proceeds of this settlement to any program or use that is neither tobacco-related nor health-related in connection with the approval of this Agreement or in any subsequent legislative appropriation of settlement proceeds.

(o) Dissolution of The Tobacco Institute, Inc., the Council for Tobacco Research-U.S.A., Inc. and the Center for Indoor Air Research, Inc.

(1) The Council for Tobacco Research-U.S.A., Inc. ("CTR") (a not-for-profit corporation formed under the laws of the State of New York) shall, pursuant to the plan of dissolution previously negotiated and agreed to between the Attorney General of the State of New York and CTR, cease all operations and be dissolved in accordance with the laws of the State of New York (and with the preservation of all applicable privileges held by any member company of CTR).

(2) The Tobacco Institute, Inc. ("TI") (a not-for-profit corporation formed under the laws of the State of New York) shall, pursuant to a plan of dissolution to be negotiated by the Attorney General of the State of New York and the Original Participating Manufacturers in accordance with Exhibit G hereto, cease all operations and be dissolved in

accordance with the laws of the State of New York and under the authority of the Attorney General of the State of New York (and with the preservation of all applicable privileges held by any member company of TI).

(3) Within 45 days after Final Approval, the Center for Indoor Air Research, Inc. ("CIAR") shall cease all operations and be dissolved in a manner consistent with applicable law and with the preservation of all applicable privileges (including, without limitation, privileges held by any member company of CIAR).

(4) The Participating Manufacturers shall direct the Tobacco-Related Organizations to preserve all records that relate in any way to issues raised in smoking-related health litigation.

(5) The Participating Manufacturers may not reconstitute CTR or its function in any form.

(6) The Participating Manufacturers represent that they have the authority to and will effectuate subsections (1) through (5) hereof.

(p) Regulation and Oversight of New Tobacco-Related Trade Associations.

(1) A Participating Manufacturer may form or participate in new tobacco-related trade associations (subject to all applicable laws), provided such associations agree in writing not to act in any manner contrary to any provision of this Agreement. Each Participating Manufacturer agrees that if any new tobacco-related trade association fails to so agree, such Participating Manufacturer will not participate in or support such association.

(2) Any tobacco-related trade association that is formed or controlled by one or more of the Participating Manufacturers after the MSA Execution Date shall adopt by-laws governing the association's procedures and the activities of its members, board, employees, agents and other representatives with respect to the tobacco-related trade association. Such by-laws shall include, among other things, provisions that:

(A) each officer of the association shall be appointed by the board of the association, shall be an employee of such association, and during such officer's term shall not be a director of or employed by any member of the association or by an Affiliate of any member of the association;

(B) legal counsel for the association shall be independent, and neither counsel nor any member or employee of counsel's law firm shall serve as legal counsel to any member of the association or to a manufacturer of Tobacco Products that is an Affiliate of any member of the association during the time that it is serving as legal counsel to the association; and

(C) minutes describing the substance of the meetings of the board of directors of the association shall be prepared and shall be maintained by the association for a period of at least five years following their preparation.

(3) Without limitation on whatever other rights to access they may be permitted by law, for a period of seven years from the date any new tobacco-related trade association is formed by any of the Participating Manufacturers after the MSA Execution Date the antitrust authorities of any Settling State may, for the purpose of enforcing this Agreement, upon reasonable cause to believe that a violation of this Agreement has occurred, and upon reasonable prior written notice (but in no event less than 10 Business Days):

(A) have access during regular office hours to inspect and copy all relevant non-privileged, non-work-product books, records, meeting agenda and minutes, and other documents (whether in hard copy form or stored electronically) of such association insofar as they pertain to such believed violation; and

(B) interview the association's directors, officers and employees (who shall be entitled to have counsel present) with respect to relevant, non-privileged, non-work-product matters pertaining to such believed violation.

Documents and information provided to Settling State antitrust authorities shall be kept confidential by and among such authorities, and shall be utilized only by the Settling States and only for the purpose of enforcing this Agreement or the criminal law. The inspection and discovery rights provided to the Settling States pursuant to this subsection shall be coordinated so as to avoid repetitive and excessive inspection and discovery.

(q) Prohibition on Agreements to Suppress Research. No Participating Manufacturer may enter into any contract, combination or conspiracy with any other Tobacco Product Manufacturer that has the purpose or effect of: (1) limiting competition in the production or distribution of information about health hazards or other consequences of the use of their products; (2) limiting or suppressing research into smoking and health; or (3) limiting or suppressing research into the marketing or development of new products. Provided, however, that nothing in this subsection shall be deemed to (1) require any Participating Manufacturer to produce, distribute or otherwise disclose any information that is subject to any privilege or protection; (2) preclude any Participating Manufacturer from entering into any joint defense or joint legal interest agreement or arrangement (whether or not in writing), or from asserting any privilege pursuant thereto; or (3) impose any affirmative obligation on any Participating Manufacturer to conduct any research.

(r) Prohibition on Material Misrepresentations. No Participating Manufacturer may make any material misrepresentation of fact regarding the health consequences of using any Tobacco Product, including any tobacco additives, filters, paper or other ingredients. Nothing in this subsection shall limit the exercise of any First Amendment right or the assertion of any defense or position in any judicial, legislative or regulatory forum.

IV. PUBLIC ACCESS TO DOCUMENTS

(a) After the MSA Execution Date, the Original Participating Manufacturers and the Tobacco-Related Organizations will support an application for the dissolution of any protective orders entered in each Settling State's lawsuit identified in Exhibit D with respect only to those documents, indices and privilege logs that have been produced as of the MSA Execution Date to such Settling State and (1) as to which defendants have made no claim, or have withdrawn any claim, of attorney-client privilege, attorney work-product protection, common interest/joint defense privilege (collectively, "privilege"), trade-secret protection, or confidential or proprietary business information; and (2) that are not inappropriate for public disclosure because of personal privacy interests or contractual rights of third parties that may not be abrogated by the Original Participating Manufacturers or the Tobacco-Related Organizations.

(b) Notwithstanding State-Specific Finality, if any order, ruling or recommendation was issued prior to September 17, 1998 rejecting a claim of privilege or trade-secret protection with respect to any document or documents in a lawsuit identified in Exhibit D, the Settling State in which such order, ruling or recommendation was made may, no later than 45 days after the occurrence of State-Specific Finality in such Settling State, seek public disclosure of such document or documents by application to the court that issued such order, ruling or recommendation and the court shall retain jurisdiction for such purposes. The Original Participating Manufacturers and Tobacco-Related Organizations do not consent to, and may object to, appeal from or otherwise oppose any such application for disclosure. The Original Participating Manufacturers and Tobacco-Related Organizations will not assert that the settlement of such lawsuit has divested the court of jurisdiction or that such Settling State lacks standing to seek public disclosure on any applicable ground.

(c) The Original Participating Manufacturers will maintain at their expense their Internet document websites accessible through "TobaccoResolution.com" or a similar website until June 30, 2010. The Original Participating Manufacturers will maintain the documents that currently appear on their respective websites and will add additional documents to their websites as provided in this section IV.

(d) Within 180 days after the MSA Execution Date, each Original Participating Manufacturer and Tobacco-Related Organization will place on its website copies of the following documents, except as provided in subsections IV(e) and IV(f) below:

(1) all documents produced by such Original Participating Manufacturer or Tobacco-Related Organization as of the MSA Execution Date in any action identified in Exhibit D or any action identified in section 2 of Exhibit H that was filed by an Attorney General. Among these documents, each Original Participating Manufacturer and Tobacco-Related Organization will give the highest priority to (A) the documents that were listed by the State of Washington as trial exhibits in the State of Washington v. American Tobacco Co., et al., No. 96-2-15056-8 SEA (Wash. Super. Ct., County of King); and (B) the documents as to which such Original Participating Manufacturer or Tobacco-Related Organization withdrew any claim of privilege as a result of the re-examination of privilege claims pursuant to court order in State of Oklahoma v. R.J. Reynolds Tobacco Company, et al., CJ-96-2499-L (Dist. Ct., Cleveland County);

(2) all documents that can be identified as having been produced by, and copies of transcripts of depositions given by, such Original Participating Manufacturer or Tobacco-Related Organization as of the MSA Execution Date in the litigation matters specified in section 1 of Exhibit H; and

(3) all documents produced by such Original Participating Manufacturer or Tobacco-Related Organization as of the MSA Execution Date and listed by the plaintiffs as trial exhibits in the litigation matters specified in section 2 of Exhibit H.

(e) Unless copies of such documents are already on its website, each Original Participating Manufacturer and Tobacco-Related Organization will place on its website copies of documents produced in any production of documents that takes place on or after the date 30 days before the MSA Execution Date in any federal or state court civil action concerning smoking and health. Copies of any documents required to be placed on a website pursuant to this subsection will be placed on such website within the later of 45 days after the MSA Execution Date or within 45 days after the production of such documents in any federal or state court action concerning smoking and health. This obligation will continue until June 30, 2010. In placing such newly produced documents on its website, each Original Participating Manufacturer or Tobacco-Related Organization will identify, as part of its index to be created pursuant to subsection IV(h), the action in which it produced such documents and the date on which such documents were added to its website.

(f) Nothing in this section IV shall require any Original Participating Manufacturer or Tobacco-Related Organization to place on its website or otherwise disclose documents that: (1) it continues to claim to be privileged, a trade secret, confidential or proprietary business information, or that contain other information not appropriate for public disclosure because of personal privacy interests or contractual rights of third parties; or (2) continue to be subject to any protective order, sealing order or other order or ruling that prevents or limits a litigant from disclosing such documents.

(g) Oversized or multimedia records will not be required to be placed on the Website, but each Original Participating Manufacturers and Tobacco-Related Organizations will make any such records available to the public by placing copies of them in the document depository established in The State of Minnesota, et al. v. Philip Morris Incorporated, et al., C1-94-8565 (County of Ramsey, District Court, 2d Judicial Cir.).

(h) Each Original Participating Manufacturer will establish an index and other features to improve searchable access to the document images on its website, as set forth in Exhibit I.

(i) Within 90 days after the MSA Execution Date, the Original Participating Manufacturers will furnish NAAG with a project plan for completing the Original Participating Manufacturers' obligations under subsection IV(h) with respect to documents currently on their websites and documents being placed on their websites pursuant to subsection IV(d). NAAG may engage a computer consultant at the Original Participating Manufacturers' expense for a period not to exceed two years and at a cost not to exceed $100,000. NAAG's computer consultant may review such plan and make recommendations consistent with this Agreement. In addition, within 120 days after the completion of the Original Participating Manufacturers' obligations under subsection IV(d), NAAG's computer consultant may make final recommendations with respect to the websites consistent with this Agreement. In preparing these recommendations, NAAG's computer consultant may seek input from Settling State officials, public health organizations and other users of the websites.

(j) The expenses incurred pursuant to subsection IV(i), and the expenses related to documents of the Tobacco-Related Organizations, will be severally shared among the Original Participating Manufacturers (allocated among them according to their Relative Market Shares). All other expenses incurred under this section will be borne by the Original Participating Manufacturer that incurs such expense.

V. TOBACCO CONTROL AND UNDERAGE USE LAWS

Each Participating Manufacturer agrees that following State-Specific Finality in a Settling State it will not initiate, or cause to be initiated, a facial challenge against the enforceability or constitutionality of such Settling State's (or such Settling State's political subdivisions') statutes, ordinances and administrative rules relating to tobacco control enacted prior to June 1, 1998 (other than a statute, ordinance or rule challenged in any lawsuit listed in Exhibit M).

VI. ESTABLISHMENT OF A NATIONAL FOUNDATION

(a) Foundation Purposes. The Settling States believe that a comprehensive, coordinated program of public education and study is important to further the remedial goals of this Agreement. Accordingly, as part of the settlement of claims described herein, the payments specified in subsections VI(b), VI(c), and IX(e) shall be made to a charitable foundation, trust or similar organization (the "Foundation") and/or to a program to be operated within the Foundation (the "National Public Education Fund"). The purposes of the Foundation will be to support (1) the study of and programs to reduce Youth Tobacco Product usage and Youth substance abuse in the States, and (2) the study of and educational programs to prevent diseases associated with the use of Tobacco Products in the States.

(b) Base Foundation Payments. On March 31, 1999, and on March 31 of each subsequent year for a period of nine years thereafter, each Original Participating Manufacturer shall severally pay its Relative Market Share of $25,000,000 to fund the Foundation. The payments to be made by each of the Original Participating Manufacturers pursuant to this subsection (b) shall be subject to no adjustments, reductions, or offsets, and shall be paid to the Escrow Agent (to be credited to the Subsection VI(b) Account), who shall disburse such payments to the Foundation only upon the occurrence of State-Specific Finality in at least one Settling State.

(c) National Public Education Fund Payments.

(1) Each Original Participating Manufacturer shall severally pay its Relative Market Share of the following base amounts on the following dates to the Escrow Agent for the benefit of the Foundation's National Public Education Fund to be used for the purposes and as described in subsections VI(f)(1), VI(g) and VI(h) below: $250,000,000 on March 31, 1999; $300,000,000 on March 31, 2000; $300,000,000 on March 31, 2001; $300,000,000 on March 31, 2002; and $300,000,000 on March 31, 2003, as such amounts are modified in accordance with this subsection (c). The payment due on March 31, 1999 pursuant to this subsection (c)(1) is to be credited to the Subsection VI(c) Account (First). The payments due on or after March 31, 2000 pursuant to this subsection VI(c)(1) are to be credited to the Subsection VI(c) Account (Subsequent).

(2) The payments to be made by the Original Participating Manufacturers pursuant to this subsection (c), other than the payment due on March 31, 1999, shall be subject to the Inflation Adjustment, the Volume Adjustment and the offset for miscalculated or disputed payments described in subsection XI(i).

(3) The payment made pursuant to this subsection (c) on March 31, 1999 shall be disbursed by the Escrow Agent to the Foundation only upon the occurrence of State-Specific Finality in at least one Settling State. Each remaining payment pursuant to this subsection (c) shall be disbursed by the Escrow Agent to the Foundation only when State-Specific Finality has occurred in Settling States having aggregate Allocable Shares equal to at least 80% of the total aggregate Allocable Shares assigned to all States that were Settling States as of the MSA Execution Date.

(4) In addition to the payments made pursuant to this subsection (c), the National Public Education Fund will be funded (A) in accordance with subsection IX(e), and (B) through monies contributed by other entities directly to the Foundation and designated for the National Public Education Fund ("National Public Education Fund Contributions").

(5) The payments made by the Original Participating Manufacturers pursuant to this subsection (c) and/or subsection IX(e) and monies received from all National Public Education Fund Contributions will be deposited and invested in accordance with the laws of the state of incorporation of the Foundation.

(d) Creation and Organization of the Foundation. NAAG, through its executive committee, will provide for the creation of the Foundation. The Foundation shall be organized exclusively for charitable, scientific, and educational purposes within the meaning of Internal Revenue Code section 501(c)(3). The organizational documents of the Foundation shall specifically incorporate the provisions of this Agreement relating to the Foundation, and will provide for payment of the Foundation's administrative expenses from the funds paid pursuant to subsection VI(b) or VI(c). The Foundation shall be governed by a board of directors. The board of directors shall be comprised of eleven directors. NAAG, the National Governors' Association ("NGA"), and the National Conference of State Legislatures ("NCSL") shall each select from its membership two directors. These six directors shall select the five additional directors. One of these five additional directors shall have expertise in public health issues. Four of these five additional directors shall have expertise in medical, child psychology, or public health disciplines. The board of directors shall be nationally geographically diverse.

(e) Foundation Affiliation. The Foundation shall be formally affiliated with an educational or medical institution selected by the board of directors.

(f) Foundation Functions. The functions of the Foundation shall be:

(1) carrying out a nationwide sustained advertising and education program to (A) counter the use by Youth of Tobacco Products, and (B) educate consumers about the cause and prevention of diseases associated with the use of Tobacco Products;

(2) developing and disseminating model advertising and education programs to counter the use by Youth of substances that are unlawful for use or purchase by Youth, with an emphasis on reducing Youth smoking; monitoring and testing the effectiveness of such model programs; and, based on the information received from such monitoring and testing, continuing to develop and disseminate revised versions of such model programs, as appropriate;

(3) developing and disseminating model classroom education programs and curriculum ideas about smoking and substance abuse in the K-12 school system, including specific target programs for special at-risk populations; monitoring and testing the effectiveness of such model programs and ideas; and, based on the information received from such monitoring and testing, continuing to develop and disseminate revised versions of such model programs or ideas, as appropriate;

(4) developing and disseminating criteria for effective cessation programs; monitoring and testing the effectiveness of such criteria; and continuing to develop and disseminate revised versions of such criteria, as appropriate;

(5) commissioning studies, funding research, and publishing reports on factors that influence Youth smoking and substance abuse and developing strategies to address the conclusions of such studies and research;

(6) developing other innovative Youth smoking and substance abuse prevention programs;

(7) providing targeted training and information for parents;

(8) maintaining a library open to the public of Foundation-funded studies, reports and other publications related to the cause and prevention of Youth smoking and substance abuse;

(9) tracking and monitoring Youth smoking and substance abuse, with a focus on the reasons for any increases or failures to decrease Youth smoking and substance abuse and what actions can be taken to reduce Youth smoking and substance abuse;

(10) receiving, controlling, and managing contributions from other entities to further the purposes described in this Agreement; and

(11) receiving, controlling, and managing such funds paid by the Participating Manufacturers pursuant to subsections VI(b) and VI(c) above.

(g) Foundation Grant-Making. The Foundation is authorized to make grants from the National Public Education Fund to Settling States and their political subdivisions to carry out sustained advertising and education programs to (1) counter the use by Youth of Tobacco Products, and (2) educate consumers about the cause and prevention of diseases associated with the use of Tobacco Products. In making such grants, the Foundation shall consider whether the Settling State or political subdivision applying for such grant:

(1) demonstrates the extent of the problem regarding Youth smoking in such Settling State or political subdivision;

(2) either seeks the grant to implement a model program developed by the Foundation or provides the Foundation with a specific plan for such applicant's intended use of the grant monies, including demonstrating such applicant's ability to develop an effective advertising/education campaign and to assess the effectiveness of such advertising/education campaign;

(3) has other funds readily available to carry out a sustained advertising and education program to (A) counter the use by Youth of Tobacco Products, and (B) educate consumers about the cause and prevention of diseases associated with the use of Tobacco Products; and

(4) is a Settling State that has not severed this section VI from its settlement with the Participating Manufacturers pursuant to subsection VI(i) below, or is a political subdivision in such a Settling State.

(h) Foundation Activities. The Foundation shall not engage in, nor shall any of the Foundation's money be used to engage in, any political activities or lobbying, including, but not limited to, support of or opposition to candidates, ballot initiatives, referenda or other similar activities. The National Public Education Fund shall be used only for public education and advertising regarding the addictiveness, health effects, and social costs related to the use of tobacco products and shall not be used for any personal attack on, or vilification of, any person (whether by name or business affiliation), company, or governmental agency, whether individually or collectively. The Foundation shall work to ensure that its activities are carried out in a culturally and linguistically appropriate manner. The Foundation's activities (including the National Public Education Fund) shall be carried out solely within the States. The payments described in subsections VI(b) and VI(c) above are made at the direction and on behalf of Settling States. By making such payments in such manner, the Participating Manufacturers do not undertake and expressly disclaim any responsibility with respect to the creation, operation, liabilities, or tax status of the Foundation or the National Public Education Fund.

(i) Severance of this Section. If the Attorney General of a Settling State determines that such Settling State may not lawfully enter into this section VI as a matter of applicable state law, such Attorney General may sever this section VI from its settlement with the Participating Manufacturers by giving written notice of such severance to each Participating Manufacturer and NAAG pursuant to subsection XVIII(k) hereof. If any Settling State exercises its right to sever this section VI, this section VI shall not be considered a part of the specific settlement between such Settling State and the Participating Manufacturers, and this section VI shall not be enforceable by or in such Settling State. The payment obligation of subsections VI(b) and VI(c) hereof shall apply regardless of a determination by one or more Settling States to sever section VI hereof; provided, however, that if all Settling States sever section VI hereof, the payment obligations of subsections (b) and (c) hereof shall be null and void. If the Attorney General of a Settling State that severed this section VI subsequently determines that such Settling State may lawfully enter into this section VI as a matter of applicable state law, such Attorney General may rescind such Settling State's previous severance of this section VI by giving written notice of such rescission to each Participating Manufacturer and NAAG pursuant to subsection XVIII(k). If any Settling State rescinds such severance, this section VI shall be considered a part of the specific settlement between such Settling State and the Participating Manufacturers (including for purposes of subsection (g)(4)), and this section VI shall be enforceable by and in such Settling State.

VII. ENFORCEMENT

(a) Jurisdiction. Each Participating Manufacturer and each Settling State acknowledge that the Court: (1) has jurisdiction over the subject matter of the action identified in Exhibit D in such Settling State and over each Participating Manufacturer; (2) shall retain exclusive jurisdiction for the purposes of implementing and enforcing this Agreement and the Consent Decree as to such Settling State; and (3) except as provided in subsections IX(d), XI(c) and XVII(d) and Exhibit O, shall be the only court to which disputes under this Agreement or the Consent Decree are presented as to such Settling State. Provided, however, that notwithstanding the foregoing, the Escrow Court (as defined in the Escrow Agreement) shall have exclusive jurisdiction, as provided in section 15 of the Escrow Agreement, over any suit, action or proceeding seeking to interpret or enforce any provision of, or based on any right arising out of, the Escrow Agreement.

(b) Enforcement of Consent Decree. Except as expressly provided in the Consent Decree, any Settling State or Released Party may apply to the Court to enforce the terms of the Consent Decree (or for a declaration construing any such term) with respect to alleged violations within such Settling State. A Settling State may not seek to enforce the Consent Decree of another Settling State; provided, however, that nothing contained herein shall affect the ability of any Settling State to (1) coordinate state enforcement actions or proceedings, or (2) file or join any amicus brief. In the event that the Court determines that any Participating Manufacturer or Settling State has violated the Consent Decree within such Settling State, the party that initiated the proceedings may request any and all relief available within such Settling State pursuant to the Consent Decree.

(c) Enforcement of this Agreement.

(1) Except as provided in subsections IX(d), XI(c), XVII(d) and Exhibit O, any Settling State or Participating Manufacturer may bring an action in the Court to enforce the terms of this Agreement (or for a declaration construing any such term ("Declaratory Order")) with respect to disputes, alleged violations or alleged breaches within such Settling State.

(2) Before initiating such proceedings, a party shall provide 30 days' written notice to the Attorney General of each Settling State, to NAAG, and to each Participating Manufacturer of its intent to initiate proceedings pursuant to this subsection. The 30-day notice period may be shortened in the event that the relevant Attorney General reasonably determines that a compelling time-sensitive public health and safety concern requires more immediate action.

(3) In the event that the Court determines that any Participating Manufacturer or Settling State has violated or breached this Agreement, the party that initiated the proceedings may request an order restraining such violation or breach, and/or ordering compliance within such Settling State (an "Enforcement Order").

(4) If an issue arises as to whether a Participating Manufacturer has failed to comply with an Enforcement Order, the Attorney General for the Settling State in question may seek an order for interpretation or for monetary, civil contempt or criminal sanctions to enforce compliance with such Enforcement Order.

(5) If the Court finds that a good-faith dispute exists as to the meaning of the terms of this Agreement or a Declaratory Order, the Court may in its discretion determine to enter a Declaratory Order rather than an Enforcement Order.

(6) Whenever possible, the parties shall seek to resolve an alleged violation of this Agreement by discussion pursuant to subsection XVIII(m) of this Agreement. In addition, in determining whether to seek an Enforcement Order, or in determining whether to seek an order for monetary, civil contempt or criminal sanctions for any claimed violation of an Enforcement Order, the Attorney General shall give good-faith consideration to whether the Participating Manufacturer that is claimed to have violated this Agreement has taken appropriate and reasonable steps to cause the claimed violation to be cured, unless such party has been guilty of a pattern of violations of like nature.

(d) Right of Review. All orders and other judicial determinations made by any court in connection with this Agreement or any Consent Decree shall be subject to all available appellate review, and nothing in this Agreement or any Consent Decree shall be deemed to constitute a waiver of any right to any such review.

(e) Applicability. This Agreement and the Consent Decree apply only to the Participating Manufacturers in their corporate capacity acting through their respective successors and assigns, directors, officers, employees, agents, subsidiaries, divisions, or other internal organizational units of any kind or any other entities acting in concert or participation with them. The remedies, penalties and sanctions that may be imposed or assessed in connection with a breach or violation of this Agreement or the Consent Decree (or any Declaratory Order or Enforcement Order issued in connection with this Agreement or the Consent Decree) shall only apply to the Participating Manufacturers, and shall not be imposed or assessed against any employee, officer or director of any Participating Manufacturer, or against any other person or entity as a consequence of such breach or violation, and the Court shall have no jurisdiction to do so.

(f) Coordination of Enforcement. The Attorneys General of the Settling States (through NAAG) shall monitor potential conflicting interpretations by courts of different States of this Agreement and the Consent Decrees. The Settling States shall use their best efforts, in cooperation with the Participating Manufacturers, to coordinate and resolve the effects of such conflicting interpretations as to matters that are not exclusively local in nature.

(g) Inspection and Discovery Rights. Without limitation on whatever other rights to access they may be permitted by law, following State-Specific Finality in a Settling State and for seven years thereafter, representatives of the Attorney General of such Settling State may, for the purpose of enforcing this Agreement and the Consent Decree, upon reasonable cause to believe that a violation of this Agreement or the Consent Decree has occurred, and upon reasonable prior written notice (but in no event less than 10 Business Days): (1) have access during regular office hours to inspect and copy all relevant non-privileged, non-work-product books, records, meeting agenda and minutes, and other documents (whether in hard copy form or stored electronically) of each Participating Manufacturer insofar as they pertain to such believed violation; and (2) interview each Participating Manufacturer's directors, officers and employees (who shall be entitled to have counsel present) with respect to relevant, non-privileged, non-work-product matters pertaining to such believed violation. Documents and information provided to representatives of the Attorney General of such Settling State pursuant to this section VII shall be kept confidential by the Settling States, and shall be utilized only by the Settling States and only for purposes of enforcing this Agreement, the Consent Decree and the criminal law. The inspection and discovery rights provided to such Settling State pursuant to this subsection shall be coordinated through NAAG so as to avoid repetitive and excessive inspection and discovery.

VIII. CERTAIN ONGOING RESPONSIBILITIES OF THE SETTLING STATES

(a) Upon approval of the NAAG executive committee, NAAG will provide coordination and facilitation for the implementation and enforcement of this Agreement on behalf of the Attorneys General of the Settling States, including the following:

(1) NAAG will assist in coordinating the inspection and discovery activities referred to in subsections III(p)(3) and VII(g) regarding compliance with this Agreement by the Participating Manufacturers and any new tobacco-related trade associations.

(2) NAAG will convene at least two meetings per year and one major national conference every three years for the Attorneys General of the Settling States, the directors of the Foundation and three persons designated by each Participating Manufacturer. The purpose of the meetings and conference is to evaluate the success of this Agreement and coordinate efforts by the Attorneys General and the Participating Manufacturers to continue to reduce Youth smoking.

(3) NAAG will periodically inform NGA, NCSL, the National Association of Counties and the National League of Cities of the results of the meetings and conferences referred to in subsection (a)(2) above.

(4) NAAG will support and coordinate the efforts of the Attorneys General of the Settling States in carrying out their responsibilities under this Agreement.

(5) NAAG will perform the other functions specified for it in this Agreement, including the functions specified in section IV.

(b) Upon approval by the NAAG executive committee to assume the responsibilities outlined in subsection VIII(a) hereof, each Original Participating Manufacturer shall cause to be paid, beginning on December 31, 1998, and on December 31 of each year thereafter through and including December 31, 2007, its Relative Market Share of $150,000 per year to the Escrow Agent (to be credited to the Subsection VIII(b) Account), who shall disburse such monies to NAAG within 10 Business Days, to fund the activities described in subsection VIII(a).

(c) The Attorneys General of the Settling States, acting through NAAG, shall establish a fund ("The States' Antitrust/Consumer Protection Tobacco Enforcement Fund") in the form attached as Exhibit J, which will be maintained by such Attorneys General to supplement the Settling States' (1) enforcement and implementation of the terms of this Agreement and the Consent Decrees, and (2) investigation and litigation of potential violations of laws with respect to Tobacco Products, as set forth in Exhibit J. Each Original Participating Manufacturer shall on March 31, 1999, severally pay its Relative Market Share of $50,000,000 to the Escrow Agent (to be credited to the Subsection VIII(c) Account), who shall disburse such monies to NAAG upon the occurrence of State-Specific Finality in at least one Settling State. Such funds will be used in accordance with the provisions of Exhibit J.

IX. PAYMENTS

(a) All Payments Into Escrow. All payments made pursuant to this Agreement (except those payments made pursuant to section XVII) shall be made into escrow pursuant to the Escrow Agreement, and shall be credited to the appropriate Account established pursuant to the Escrow Agreement. Such payments shall be disbursed to the beneficiaries or returned to the Participating Manufacturers only as provided in section XI and the Escrow Agreement. No payment obligation under this Agreement shall arise (1) unless and until the Escrow Court has approved and retained jurisdiction over the Escrow Agreement or (2) if such approval is reversed (unless and until such reversal is itself reversed). The parties agree to proceed as expeditiously as possible to resolve any issues that prevent approval of the Escrow Agreement. If any payment (other than the first initial payment under subsection IX(b)) is delayed because the Escrow Agreement has not been approved, such payment shall be due and payable (together with interest at the Prime Rate) within 10 Business Days after approval of the Escrow Agreement by the Escrow Court.

(b) Initial Payments. On the second Business Day after the Escrow Court approves and retains jurisdiction over the Escrow Agreement, each Original Participating Manufacturer shall severally pay to the Escrow Agent (to be credited to the Subsection IX(b) Account (First)) its Market Capitalization Percentage (as set forth in Exhibit K) of the base amount of $2,400,000,000. On January 10, 2000, each Original Participating Manufacturer shall severally pay to the Escrow Agent its Relative Market Share of the base amount of $2,472,000,000. On January 10, 2001, each Original Participating Manufacturer shall severally pay to the Escrow Agent its Relative Market Share of the base amount of $2,546,160,000. On January 10, 2002, each Original Participating Manufacturer shall severally pay to the Escrow Agent its Relative Market Share of the base amount of $2,622,544,800. On January 10, 2003, each Original Participating Manufacturer shall severally pay to the Escrow Agent its Relative Market Share of the base amount of $2,701,221,144. The payments pursuant to this subsection (b) due on or after January 10, 2000 shall be credited to the Subsection IX(b) Account (Subsequent). The foregoing payments shall be modified in accordance with this subsection (b). The payments made by the Original Participating Manufacturers pursuant to this subsection (b) (other than the first such payment) shall be subject to the Volume Adjustment, the Non-Settling States Reduction and the offset for miscalculated or disputed payments described in subsection XI(i). The first payment due under this subsection (b) shall be subject to the Non-Settling States Reduction, but such reduction shall be determined as of the date one day before such payment is due (rather than the date 15 days before).

(c) Annual Payments and Strategic Contribution Payments.

(1) On April 15, 2000 and on April 15 of each year thereafter in perpetuity, each Original Participating Manufacturer shall severally pay to the Escrow Agent (to be credited to the Subsection IX(c)(1) Account) its Relative Market Share of the base amounts specified below, as such payments are modified in accordance with this subsection (c)(1):

Year	Base Amount
2000	$4,500,000,000
2001	$5,000,000,000
2002	$6,500,000,000
2003	$6,500,000,000
2004	$8,000,000,000
2005	$8,000,000,000
2006	$8,000,000,000
2007	$8,000,000,000
2008	$8,139,000,000
2009	$8,139,000,000
2010	$8,139,000,000
2011	$8,139,000,000
2012	$8,139,000,000
2013	$8,139,000,000
2014	$8,139,000,000
2015	$8,139,000,000
2016	$8,139,000,000
2017	$8,139,000,000
2018 and each year thereafter	$9,000,000,000

The payments made by the Original Participating Manufacturers pursuant to this subsection (c)(1) shall be subject to the Inflation Adjustment, the Volume Adjustment, the Previously Settled States Reduction, the Non-Settling States Reduction, the NPM Adjustment, the offset for miscalculated or disputed payments described in subsection XI(i), the Federal Tobacco Legislation Offset, the Litigating Releasing Parties Offset, and the offsets for claims over described in subsections XII(a)(4)(B) and XII(a)(8).

(2) On April 15, 2008 and on April 15 of each year thereafter through 2017, each Original Participating Manufacturer shall severally pay to the Escrow Agent (to be credited to the Subsection IX(c)(2) Account) its Relative Market Share of the base amount of $861,000,000, as such payments are modified in accordance with this subsection (c)(2). The payments made by the Original Participating Manufacturers pursuant to this subsection (c)(2) shall be subject to the Inflation Adjustment, the Volume Adjustment, the NPM Adjustment, the offset for miscalculated or disputed payments described in subsection XI(i), the Federal Tobacco Legislation Offset, the Litigating Releasing Parties Offset, and the offsets for claims over described in subsections XII(a)(4)(B) and XII(a)(8). Such payments shall also be subject to the Non-Settling States Reduction; provided, however, that for purposes of payments due pursuant to this subsection (c)(2) (and corresponding payments by Subsequent Participating Manufacturers under subsection IX(i)), the Non-Settling States Reduction shall be derived as follows: (A) the payments made by the Original Participating Manufacturers pursuant to this subsection (c)(2) shall be allocated among the Settling States on a percentage basis to be determined by the Settling States pursuant to the procedures set forth in Exhibit U, and the resulting allocation percentages disclosed to the Escrow Agent, the Independent Auditor and the Original Participating Manufacturers not later than June 30, 1999; and (B) the Non-Settling States Reduction shall be based on the sum of the Allocable Shares so established pursuant to subsection (c)(2)(A) for those States that were Settling States as of the MSA Execution Date and as to which this Agreement has terminated as of the date 15 days before the payment in question is due.

(d) Non-Participating Manufacturer Adjustment.

(1) Calculation of NPM Adjustment for Original Participating Manufacturers. To protect the public health gains achieved by this Agreement, certain payments made pursuant to this Agreement shall be subject to an NPM Adjustment. Payments by the Original Participating Manufacturers to which the NPM Adjustment applies shall be adjusted as provided below:

(A) Subject to the provisions of subsections (d)(1)(C), (d)(1)(D) and (d)(2) below, each Allocated Payment shall be adjusted by subtracting from such Allocated Payment the product of such Allocated Payment amount multiplied by the NPM Adjustment Percentage. The "NPM Adjustment Percentage" shall be calculated as follows:

(i) If the Market Share Loss for the year immediately preceding the year in which the payment in question is due is less than or equal to 0 (zero), then the NPM Adjustment Percentage shall equal zero.

(ii) If the Market Share Loss for the year immediately preceding the year in which the payment in question is due is greater than 0 (zero) and less than or equal to 16 2/3 percentage points, then the NPM Adjustment Percentage shall be equal to the product of (x) such Market Share Loss and (y) 3 (three).

(iii) If the Market Share Loss for the year immediately preceding the year in which the payment in question is due is greater than 16 2/3 percentage points, then the NPM Adjustment Percentage shall be equal to the sum of (x) 50 percentage points and (y) the product of (*1*) the Variable Multiplier and (*2*) the result of such Market Share Loss minus 16 2/3 percentage points.

(B) Definitions:

(i) "Base Aggregate Participating Manufacturer Market Share" means the result of (x) the sum of the applicable Market Shares (the applicable Market Share to be that for 1997) of all present and former Tobacco Product Manufacturers that were Participating Manufacturers during the entire calendar year immediately preceding the year in which the payment in question is due minus (y) 2 (two) percentage points.

(ii) "Actual Aggregate Participating Manufacturer Market Share" means the sum of the applicable Market Shares of all present and former Tobacco Product Manufacturers that were Participating Manufacturers during the entire calendar year immediately preceding the year in which the payment in question is due (the applicable Market Share to be that for the calendar year immediately preceding the year in which the payment in question is due).

(iii) "Market Share Loss" means the result of (x) the Base Aggregate Participating Manufacturer Market Share minus (y) the Actual Aggregate Participating Manufacturer Market Share.

(iv) "Variable Multiplier" equals 50 percentage points divided by the result of (x) the Base Aggregate Participating Manufacturer Market Share minus (y) 16 2/3 percentage points.

(C) On or before February 2 of each year following a year in which there was a Market Share Loss greater than zero, a nationally recognized firm of economic consultants (the "Firm") shall determine whether the disadvantages experienced as a result of the provisions of this Agreement were a significant factor contributing to the Market Share Loss for the year in question. If the Firm determines that the disadvantages experienced as a result of the provisions of this Agreement were a significant factor contributing to the Market Share Loss for the year in question, the NPM Adjustment described in subsection IX(d)(1) shall apply. If the Firm determines that the disadvantages experienced as a result of the provisions of this Agreement were not a significant factor contributing to the Market Share Loss for the year in question, the NPM Adjustment described in subsection IX(d)(1) shall not apply. The Original Participating Manufacturers, the Settling States, and the Attorneys General for the Settling States shall cooperate to ensure that the determination described in this subsection (1)(C) is timely made. The Firm shall be acceptable to (and the principals responsible for this assignment shall be acceptable to) both the Original Participating Manufacturers and a majority of those Attorneys General who are both the

Attorney General of a Settling State and a member of the NAAG executive committee at the time in question (or in the event no such firm or no such principals shall be acceptable to such parties, National Economic Research Associates, Inc., or its successors by merger, acquisition or otherwise ("NERA"), acting through a principal or principals acceptable to such parties, if such a person can be identified and, if not, acting through a principal or principals identified by NERA, or a successor firm selected by the CPR Institute for Dispute Resolution). As soon as practicable after the MSA Execution Date, the Firm shall be jointly retained by the Settling States and the Original Participating Manufacturers for the purpose of making the foregoing determination, and the Firm shall provide written notice to each Settling State, to NAAG, to the Independent Auditor and to each Participating Manufacturer of such determination. The determination of the Firm with respect to this issue shall be conclusive and binding upon all parties, and shall be final and non-appealable. The reasonable fees and expenses of the Firm shall be paid by the Original Participating Manufacturers according to their Relative Market Shares. Only the Participating Manufacturers and the Settling States, and their respective counsel, shall be entitled to communicate with the Firm with respect to the Firm's activities pursuant to this subsection (1)(C).

(D) No NPM Adjustment shall be made with respect to a payment if the aggregate number of Cigarettes shipped in or to the fifty United States, the District of Columbia and Puerto Rico in the year immediately preceding the year in which the payment in question is due by those Participating Manufacturers that had become Participating Manufacturers prior to 14 days after the MSA Execution Date is greater than the aggregate number of Cigarettes shipped in or to the fifty United States, the District of Columbia, and Puerto Rico in 1997 by such Participating Manufacturers (and any of their Affiliates that made such shipments in 1997, as demonstrated by certified audited statements of such Affiliates' shipments, and that do not continue to make such shipments after the MSA Execution Date because the responsibility for such shipments has been transferred to one of such Participating Manufacturers). Measurements of shipments for purposes of this subsection (D) shall be made in the manner prescribed in subsection II(mm); in the event that such shipment data is unavailable for any Participating Manufacturer for 1997, such Participating Manufacturer's shipment volume for such year shall be measured in the manner prescribed in subsection II(z).

(2) Allocation among Settling States of NPM Adjustment for Original Participating Manufacturers.

(A) The NPM Adjustment set forth in subsection (d)(1) shall apply to the Allocated Payments of all Settling States, except as set forth below.

(B) A Settling State's Allocated Payment shall not be subject to an NPM Adjustment: (i) if such Settling State continuously had a Qualifying Statute (as defined in subsection (2)(E) below) in full force and effect during the entire calendar year immediately preceding the year in which the payment in question is due, and diligently enforced the provisions of such statute during such entire calendar year; or (ii) if such Settling State enacted the Model Statute (as defined in subsection (2)(E) below) for the first time during the calendar year immediately preceding the year in which the payment in question is due, continuously had the Model Statute in full force and effect during the last six months of such calendar year, and diligently enforced the provisions of such statute during the period in which it was in full force and effect.

(C) The aggregate amount of the NPM Adjustments that would have applied to the Allocated Payments of those Settling States that are not subject to an NPM Adjustment pursuant to subsection (2)(B) shall be reallocated among all other Settling States pro rata in proportion to their respective Allocable Shares (the applicable Allocable Shares being those listed in Exhibit A), and such other Settling States' Allocated Payments shall be further reduced accordingly.

(D) This subsection (2)(D) shall apply if the amount of the NPM Adjustment applied pursuant to subsection (2)(A) to any Settling State plus the amount of the NPM Adjustments reallocated to such Settling State pursuant to subsection (2)(C) in any individual year would either (i) exceed such Settling State's Allocated Payment in that year, or (ii) if subsection (2)(F) applies to the Settling State in question, exceed 65% of such Settling State's Allocated Payment in that year. For each Settling State that has an excess as described in the preceding sentence, the excess amount of NPM Adjustment shall be further reallocated among all other Settling States whose Allocated Payments are subject to an NPM Adjustment and that do not have such an excess, pro rata in proportion to their respective Allocable Shares, and such other Settling States' Allocated Payments shall be further reduced accordingly. The provisions of this subsection (2)(D) shall be repeatedly applied in any individual year until either (i) the aggregate amount of NPM Adjustments has been fully reallocated or (ii) the full amount of the NPM Adjustments subject to reallocation under subsection (2)(C) or (2)(D) cannot be fully reallocated in any individual year as described in those subsections because (x) the Allocated Payment in that year of each Settling State that is subject to an NPM Adjustment and to which subsection (2)(F) does not apply has been reduced to zero, and (y) the Allocated Payment in that year of each Settling State to which subsection (2)(F) applies has been reduced to 35% of such Allocated Payment.

(E) A "Qualifying Statute" means a Settling State's statute, regulation, law and/or rule (applicable everywhere the Settling State has authority to legislate) that effectively and fully neutralizes the cost disadvantages that the Participating Manufacturers experience vis-à-vis Non-Participating Manufacturers within such Settling State as a result of the provisions of this Agreement. Each Participating Manufacturer and each Settling State agree that the model statute in the form set forth in Exhibit T (the "Model Statute"), if enacted without modification or addition (except for particularized state procedural or technical requirements) and not in conjunction with any other legislative or regulatory proposal, shall constitute a Qualifying Statute. Each Participating Manufacturer agrees to support the enactment of such Model Statute if such Model

Statute is introduced or proposed (i) without modification or addition (except for particularized procedural or technical requirements), and (ii) not in conjunction with any other legislative proposal.

(F) If a Settling State (i) enacts the Model Statute without any modification or addition (except for particularized state procedural or technical requirements) and not in conjunction with any other legislative or regulatory proposal, (ii) uses its best efforts to keep the Model Statute in full force and effect by, among other things, defending the Model Statute fully in any litigation brought in state or federal court within such Settling State (including litigating all available appeals that may affect the effectiveness of the Model Statute), and (iii) otherwise complies with subsection (2)(B), but a court of competent jurisdiction nevertheless invalidates or renders unenforceable the Model Statute with respect to such Settling State, and but for such ruling the Settling State would have been exempt from an NPM Adjustment under subsection (2)(B), then the NPM Adjustment (including reallocations pursuant to subsections (2)(C) and (2)(D)) shall still apply to such Settling State's Allocated Payments but in any individual year shall not exceed 65% of the amount of such Allocated Payments.

(G) In the event a Settling State proposes and/or enacts a statute, regulation, law and/or rule (applicable everywhere the Settling State has authority to legislate) that is not the Model Statute and asserts that such statute, regulation, law and/or rule is a Qualifying Statute, the Firm shall be jointly retained by the Settling States and the Original Participating Manufacturers for the purpose of determining whether or not such statute, regulation, law and/or rule constitutes a Qualifying Statute. The Firm shall make the foregoing determination within 90 days of a written request to it from the relevant Settling State (copies of which request the Settling State shall also provide to all Participating Manufacturers and the Independent Auditor), and the Firm shall promptly thereafter provide written notice of such determination to the relevant Settling State, NAAG, all Participating Manufacturers and the Independent Auditor. The determination of the Firm with respect to this issue shall be conclusive and binding upon all parties, and shall be final and non-appealable; provided, however, (i) that such determination shall be of no force and effect with respect to a proposed statute, regulation, law and/or rule that is thereafter enacted with any modification or addition; and (ii) that the Settling State in which the Qualifying Statute was enacted and any Participating Manufacturer may at any time request that the Firm reconsider its determination as to this issue in light of subsequent events (including, without limitation, subsequent judicial review, interpretation, modification and/or disapproval of a Settling State's Qualifying Statute, and the manner and/or the effect of enforcement of such Qualifying Statute). The Original Participating Manufacturers shall severally pay their Relative Market Shares of the reasonable fees and expenses of the Firm. Only the Participating Manufacturers and Settling States, and their respective counsel, shall be entitled to communicate with the Firm with respect to the Firm's activities pursuant to this subsection (2)(G).

(H) Except as provided in subsection (2)(F), in the event a Qualifying Statute is enacted within a Settling State and is thereafter invalidated or declared unenforceable by a court of competent jurisdiction, otherwise rendered not in full force and effect, or, upon reconsideration by the Firm pursuant to subsection (2)(G) determined not to constitute a Qualifying Statute, then such Settling State's Allocated Payments shall be fully subject to an NPM Adjustment unless and until the requirements of subsection (2)(B) have been once again satisfied.

(3) Allocation of NPM Adjustment among Original Participating Manufacturers. The portion of the total amount of the NPM Adjustment to which the Original Participating Manufacturers are entitled in any year that can be applied in such year consistent with subsection IX(d)(2) (the "Available NPM Adjustment") shall be allocated among them as provided in this subsection IX(d)(3).

(A) The "Base NPM Adjustment" shall be determined for each Original Participating Manufacturer in such year as follows:

(i) For those Original Participating Manufacturers whose Relative Market Shares in the year immediately preceding the year in which the NPM Adjustment in question is applied exceed or are equal to their respective 1997 Relative Market Shares, the Base NPM Adjustment shall equal 0 (zero).

(ii) For those Original Participating Manufacturers whose Relative Market Shares in the year immediately preceding the year in which the NPM Adjustment in question is applied are less than their respective 1997 Relative Market Shares, the Base NPM Adjustment shall equal the result of (x) the difference between such Original Participating Manufacturer's Relative Market Share in such preceding year and its 1997 Relative Market Share multiplied by both (y) the number of individual Cigarettes (expressed in thousands of units) shipped in or to the United States, the District of Columbia and Puerto Rico by all the Original Participating Manufacturers in such preceding year (determined in accordance with subsection II(mm)) and (z) $20 per each thousand units of Cigarettes (as this number is adjusted pursuant to subsection IX(d)(3)(C) below).

(iii) For those Original Participating Manufacturers whose Base NPM Adjustment, if calculated pursuant to subsection (ii) above, would exceed $300 million (as this number is adjusted pursuant to subsection IX(d)(3)(C) below), the Base NPM Adjustment shall equal $300 million (or such adjusted number, as provided in subsection IX(d)(3)(C) below).

(B) The share of the Available NPM Adjustment each Original Participating Manufacturer is entitled to shall be calculated as follows:

(i) If the Available NPM Adjustment the Original Participating Manufacturers are entitled to in any year is less than or equal to the sum of the Base NPM Adjustments of all Original Participating

Manufacturers in such year, then such Available NPM Adjustment shall be allocated among those Original Participating Manufacturers whose Base NPM Adjustment is not equal to 0 (zero) pro rata in proportion to their respective Base NPM Adjustments.

(ii) If the Available NPM Adjustment the Original Participating Manufacturers are entitled to in any year exceeds the sum of the Base NPM Adjustments of all Original Participating Manufacturers in such year, then (x) the difference between such Available NPM Adjustment and such sum of the Base NPM Adjustments shall be allocated among the Original Participating Manufacturers pro rata in proportion to their Relative Market Shares (the applicable Relative Market Shares to be those in the year immediately preceding such year), and (y) each Original Participating Manufacturer's share of such Available NPM Adjustment shall equal the sum of *(1)* its Base NPM Adjustment for such year, and *(2)* the amount allocated to such Original Participating Manufacturer pursuant to clause (x).

(iii) If an Original Participating Manufacturer's share of the Available NPM Adjustment calculated pursuant to subsection IX(d)(3)(B)(i) or IX(d)(3)(B)(ii) exceeds such Original Participating Manufacturer's payment amount to which such NPM Adjustment applies (as such payment amount has been determined pursuant to step B of clause "Seventh" of subsection IX(j)), then *(1)* such Original Participating Manufacturer's share of the Available NPM Adjustment shall equal such payment amount, and *(2)* such excess shall be reallocated among the other Original Participating Manufacturers pro rata in proportion to their Relative Market Shares.

(C) Adjustments:

(i) For calculations made pursuant to this subsection IX(d)(3) (if any) with respect to payments due in the year 2000, the number used in subsection IX(d)(3)(A)(ii)(z) shall be $20 and the number used in subsection IX(d)(3)(A)(iii) shall be $300 million. Each year thereafter, both these numbers shall be adjusted upward or downward by multiplying each of them by the quotient produced by dividing (x) the average revenue per Cigarette of all the Original Participating Manufacturers in the year immediately preceding such year, by (y) the average revenue per Cigarette of all the Original Participating Manufacturers in the year immediately preceding such immediately preceding year.

(ii) For purposes of this subsection, the average revenue per Cigarette of all the Original Participating Manufacturers in any year shall equal (x) the aggregate revenues of all the Original Participating Manufacturers from sales of Cigarettes in the fifty United States, the District of Columbia and Puerto Rico after Federal excise taxes and after payments pursuant to this Agreement and the tobacco litigation Settlement Agreements with the States of Florida, Mississippi, Minnesota and Texas (as such revenues are reported to the United States Securities and Exchange Commission ("SEC") for such year (either independently by the Original Participating Manufacturer or as part of consolidated financial statements reported to the SEC by an Affiliate of the Original Participating Manufacturers) or, in the case of an Original Participating Manufacturer that does not report income to the SEC, as reported in financial statements prepared in accordance with United States generally accepted accounting principles and audited by a nationally recognized accounting firm), divided by (y) the aggregate number of the individual Cigarettes shipped in or to the United States, the District of Columbia and Puerto Rico by all the Original Participating Manufacturers in such year (determined in accordance with subsection II(mm)).

(D) In the event that in the year immediately preceding the year in which the NPM Adjustment in question is applied both (x) the Relative Market Share of Lorillard Tobacco Company (or of its successor) ("Lorillard") was less than or equal to 20.0000000%, and (y) the number of individual Cigarettes shipped in or to the United States, the District of Columbia and Puerto Rico by Lorillard (determined in accordance with subsection II(mm)) (for purposes of this subsection (D), "Volume") was less than or equal to 70 billion, Lorillard's and Philip Morris Incorporated's (or its successor's) ("Philip Morris") shares of the Available NPM Adjustment calculated pursuant to subsections (3)(A)-(C) above shall be further reallocated between Lorillard and Philip Morris as follows (this subsection (3)(D) shall not apply in the year in which either of the two conditions specified in this sentence is not satisfied):

(i) Notwithstanding subsections (A)-(C) of this subsection (d)(3), but subject to further adjustment pursuant to subsections (D)(ii) and (D)(iii) below, Lorillard's share of the Available NPM Adjustment shall equal its Relative Market Share of such Available NPM Adjustment (the applicable Relative Market Share to be that in the year immediately preceding the year in which such NPM Adjustment is applied). The dollar amount of the difference between the share of the Available NPM Adjustment Lorillard is entitled to pursuant to the preceding sentence and the share of the Available NPM Adjustment it would be entitled to in the same year pursuant to subsections (d)(3)(A)-(C) shall be reallocated to Philip Morris and used to decrease or increase, as the case may be, Philip Morris's share of the Available NPM Adjustment in such year calculated pursuant to subsections (d)(3)(A)-(C).

(ii) In the event that in the year immediately preceding the year in which the NPM Adjustment in question is applied either (x) Lorillard's Relative Market Share was greater than 15.0000000% (but did not exceed 20.0000000%), or (y) Lorillard's Volume was greater than 50 billion (but did not exceed 70 billion), or both, Lorillard's share of the Available NPM Adjustment calculated pursuant to subsection (d)(3)(D)(i) shall be reduced by a percentage equal to the greater of (*1*) 10.0000000% for each percentage point (or fraction thereof) of excess of such Relative Market Share over 15.0000000% (if any), or (*2*) 2.5000000% for each billion (or fraction thereof) of excess of such Volume over 50 billion (if any). The dollar amount by which Lorillard's share of the Available NPM Adjustment is reduced in any year pursuant to this subsection (D)(ii) shall be reallocated to Philip Morris and used to increase Philip Morris's share of the Available NPM Adjustment in such year.

In the event that in any year a reallocation of the shares of the Available NPM Adjustment between Lorillard and Philip Morris pursuant to this subsection (d)(3)(D) results in Philip Morris's share of the Available NPM Adjustment in such year exceeding the greater of (x) Philip Morris's Relative Market Share of such Available NPM Adjustment (the applicable Relative Market Share to be that in the year immediately preceding such year), or (y) Philip Morris's share of the Available NPM Adjustment in such year calculated pursuant to subsections (d)(3)(A)-(C), Philip Morris's share of the Available NPM Adjustment in such year shall be reduced to equal the greater of (x) or (y) above. In such instance, the dollar amount by which Philip Morris's share of the Available NPM Adjustment is reduced pursuant to the preceding sentence shall be reallocated to Lorillard and used to increase Lorillard's share of the Available NPM Adjustment in such year.

(iv) In the event that either Philip Morris or Lorillard is treated as a Non-Participating Manufacturer for purposes of this subsection IX(d)(3) pursuant to subsection XVIII(w)(2)(A), this subsection (3)(D) shall not be applied, and the Original Participating Manufacturers' shares of the Available NPM Adjustment shall be determined solely as described in subsections (3)(A)-(C).

(4) NPM Adjustment for Subsequent Participating Manufacturers. Subject to the provisions of subsection IX(i)(3), a Subsequent Participating Manufacturer shall be entitled to an NPM Adjustment with respect to payments due from such Subsequent Participating Manufacturer in any year during which an NPM Adjustment is applicable under subsection (d)(1) above to payments due from the Original Participating Manufacturers. The amount of such NPM Adjustment shall equal the product of (A) the NPM Adjustment Percentage for such year multiplied by (B) the sum of the payments due in the year in question from such Subsequent Participating Manufacturer that correspond to payments due from Original Participating Manufacturers pursuant to subsection IX(c) (as such payment amounts due from such Subsequent Participating Manufacturer have been adjusted and allocated pursuant to clauses "First" through "Fifth" of subsection IX(j)). The NPM Adjustment to payments by each Subsequent Participating Manufacturer shall be allocated and reallocated among the Settling States in a manner consistent with subsection (d)(2) above.

(e) Supplemental Payments. Beginning on April 15, 2004, and on April 15 of each year thereafter in perpetuity, in the event that the sum of the Market Shares of the Participating Manufacturers that were Participating Manufacturers during the entire calendar year immediately preceding the year in which the payment in question would be due (the applicable Market Share to be that for the calendar year immediately preceding the year in which the payment in question would be due) equals or exceeds 99.0500000%, each Original Participating Manufacturer shall severally pay to the Escrow Agent (to be credited to the Subsection IX(e) Account) for the benefit of the Foundation its Relative Market Share of the base amount of $300,000,000, as such payments are modified in accordance with this subsection (e). Such payments shall be utilized by the Foundation to fund the national public education functions of the Foundation described in subsection VI(f)(1), in the manner described in and subject to the provisions of subsections VI(g) and VI(h). The payments made by the Original Participating Manufacturers pursuant to this subsection shall be subject to the Inflation Adjustment, the Volume Adjustment, the Non-Settling States Reduction, and the offset for miscalculated or disputed payments described in subsection XI(i).

(f) Payment Responsibility. The payment obligations of each Participating Manufacturer pursuant to this Agreement shall be the several responsibility only of that Participating Manufacturer. The payment obligations of a Participating Manufacturer shall not be the obligation or responsibility of any Affiliate of such Participating Manufacturer. The payment obligations of a Participating Manufacturer shall not be the obligation or responsibility of any other Participating Manufacturer. Provided, however, that no provision of this Agreement shall waive or excuse liability under any state or federal fraudulent conveyance or fraudulent transfer law. Any Participating Manufacturer whose Market Share (or Relative Market Share) in any given year equals zero shall have no payment obligations under this Agreement in the succeeding year.

(g) Corporate Structures. Due to the particular corporate structures of R.J. Reynolds Tobacco Company ("Reynolds") and Brown & Williamson Tobacco Corporation ("B&W") with respect to their non-domestic tobacco operations, Reynolds and B&W shall be severally liable for their respective shares of each payment due pursuant to this Agreement up to (and their liability hereunder shall not exceed) the full extent of their assets used in and earnings derived from, the manufacture and/or sale in the States of Tobacco Products intended for domestic consumption, and no recourse shall be had against any of their other assets or earnings to satisfy such obligations.

(h) Accrual of Interest. Except as expressly provided otherwise in this Agreement, any payment due hereunder and not paid when due (or payments requiring the accrual of interest under subsection XI(d)) shall accrue interest from and including the date such payment is due until (but not including) the date paid at the Prime Rate plus three percentage points.

(i) Payments by Subsequent Participating Manufacturers.

(1) A Subsequent Participating Manufacturer shall have payment obligations under this Agreement only in the event that its Market Share in any calendar year exceeds the greater of *(1)* its 1998 Market Share or *(2)* 125 percent of its 1997 Market Share (subject to the provisions of subsection (i)(4)). In the year following any such calendar year, such Subsequent Participating Manufacturer shall make payments corresponding to those due in that same following year from the Original Participating Manufacturers pursuant to subsections VI(c) (except for the payment due on March 31, 1999), IX(c)(1), IX(c)(2) and IX(e). The amounts of such corresponding payments by a Subsequent Participating Manufacturer are in addition to the corresponding payments that are due from the Original Participating Manufacturers and shall be determined as described in subsections (2) and (3) below. Such payments by a Subsequent Participating Manufacturer shall (A) be due on the same dates as the corresponding payments are due from Original Participating Manufacturers; (B) be for the same

purpose as such corresponding payments; and (C) be paid, allocated and distributed in the same manner as such corresponding payments.

(2) The base amount due from a Subsequent Participating Manufacturer on any given date shall be determined by multiplying (A) the corresponding base amount due on the same date from all of the Original Participating Manufacturers (as such base amount is specified in the corresponding subsection of this Agreement and is adjusted by the Volume Adjustment (except for the provisions of subsection (B)(ii) of Exhibit E), but before such base amount is modified by any other adjustments, reductions or offsets) by (B) the quotient produced by dividing (i) the result of (x) such Subsequent Participating Manufacturer's applicable Market Share (the applicable Market Share being that for the calendar year immediately preceding the year in which the payment in question is due) minus (y) the greater of *(1)* its 1998 Market Share or *(2)* 125 percent of its 1997 Market Share, by (ii) the aggregate Market Shares of the Original Participating Manufacturers (the applicable Market Shares being those for the calendar year immediately preceding the year in which the payment in question is due).

(3) Any payment due from a Subsequent Participating Manufacturer under subsections (1) and (2) above shall be subject (up to the full amount of such payment) to the Inflation Adjustment, the Non-Settling States Reduction, the NPM Adjustment, the offset for miscalculated or disputed payments described in subsection XI(i), the Federal Tobacco Legislation Offset, the Litigating Releasing Parties Offset and the offsets for claims over described in subsections XII(a)(4)(B) and XII(a)(8), to the extent that such adjustments, reductions or offsets would apply to the corresponding payment due from the Original Participating Manufacturers. Provided, however, that all adjustments and offsets to which a Subsequent Participating Manufacturer is entitled may only be applied against payments by such Subsequent Participating Manufacturer, if any, that are due within 12 months after the date on which the Subsequent Participating Manufacturer becomes entitled to such adjustment or makes the payment that entitles it to such offset, and shall not be carried forward beyond that time even if not fully used.

(4) For purposes of this subsection (i), the 1997 (or 1998, as applicable) Market Share (and 125 percent thereof) of those Subsequent Participating Manufacturers that either (A) became a signatory to this Agreement more than 60 days after the MSA Execution Date or (B) had no Market Share in 1997 (or 1998, as applicable), shall equal zero.

(j) Order of Application of Allocations, Offsets, Reductions and Adjustments. The payments due under this Agreement shall be calculated as set forth below. The "base amount" referred to in clause "First" below shall mean (1) in the case of payments due from Original Participating Manufacturers, the base amount referred to in the subsection establishing the payment obligation in question; and (2) in the case of payments due from a Subsequent Participating Manufacturer, the base amount referred to in subsection (i)(2) for such Subsequent Participating Manufacturer. In the event that a particular adjustment, reduction or offset referred to in a clause below does not apply to the payment being calculated, the result of the clause in question shall be deemed to be equal to the result of the immediately preceding clause. (If clause "First" is inapplicable, the result of clause "First" will be the base amount of the payment in question prior to any offsets, reductions or adjustments.)

First: the Inflation Adjustment shall be applied to the base amount of the payment being calculated;

Second: the Volume Adjustment (other than the provisions of subsection (B)(iii) of Exhibit E) shall be applied to the result of clause "First";

Third: the result of clause "Second" shall be reduced by the Previously Settled States Reduction;

Fourth: the result of clause "Third" shall be reduced by the Non-Settling States Reduction;

Fifth: in the case of payments due under subsections IX(c)(1) and IX(c)(2), the results of clause "Fourth" for each such payment due in the calendar year in question shall be apportioned among the Settling States pro rata in proportion to their respective Allocable Shares, and the resulting amounts for each particular Settling State shall then be added together to form such Settling State's Allocated Payment. In the case of payments due under subsection IX(i) that correspond to payments due under subsections IX(c)(1) or IX(c)(2), the results of clause "Fourth" for all such payments due from a particular Subsequent Participating Manufacturer in the calendar year in question shall be apportioned among the Settling States pro rata in proportion to their respective Allocable Shares, and the resulting amounts for each particular Settling State shall then be added together. (In the case of all other payments made pursuant to this Agreement, this clause "Fifth" is inapplicable.);

Sixth: the NPM Adjustment shall be applied to the results of clause "Fifth" pursuant to subsections IX(d)(1) and (d)(2) (or, in the case of payments due from the Subsequent Participating Manufacturers, pursuant to subsection IX(d)(4));

Seventh: in the case of payments due from the Original Participating Manufacturers to which clause "Fifth" (and therefore clause "Sixth") does not apply, the result of clause "Fourth" shall be allocated among the Original Participating Manufacturers according to their Relative Market Shares. In the case of payments due from the Original Participating Manufacturers to which clause "Fifth" applies: (A) the Allocated Payments of all Settling States determined pursuant to clause "Fifth" (prior to reduction pursuant to clause "Sixth") shall be added together; (B) the resulting sum shall be allocated among the Original Participating Manufacturers according to their Relative Market Shares and subsection (B)(iii) of Exhibit E hereto (if such subsection is applicable); (C) the Available NPM Adjustment (as determined pursuant to clause "Sixth") shall be allocated among the Original Participating Manufacturers pursuant to subsection IX(d)(3); (D) the respective result of step (C) above for each Original Participating Manufacturer shall be subtracted from the respective result of step (B) above for such Original Participating Manufacturer; and (E) the resulting payment amount due from each Original Participating Manufacturer shall then be allocated among the Settling States in proportion to the respective results of clause "Sixth" for each Settling State. The offsets described in clauses "Eighth" through "Twelfth" shall then be applied separately against each Original Participating Manufacturer's resulting payment shares (on a Settling State by Settling State basis) according to each Original Participating Manufacturer's separate entitlement to such offsets, if any, in the calendar year in question. (In the case of payments due from Subsequent Participating Manufacturers, this clause "Seventh" is inapplicable.)

Eighth: the offset for miscalculated or disputed payments described in subsection XI(i) (and any carry-forwards arising from such offset) shall be applied to the results of clause "Seventh" (in the case of payments due from the Original Participating Manufacturers) or to the results of clause "Sixth" (in the case of payments due from Subsequent Participating Manufacturers);

Ninth: the Federal Tobacco Legislation Offset (including any carry-forwards arising from such offset) shall be applied to the results of clause "Eighth";

Tenth: the Litigating Releasing Parties Offset (including any carry-forwards arising from such offset) shall be applied to the results of clause "Ninth";

Eleventh: the offset for claims over pursuant to subsection XII(a)(4)(B) (including any carry-forwards arising from such offset) shall be applied to the results of clause "Tenth";

Twelfth: the offset for claims over pursuant to subsection XII(a)(8) (including any carry-forwards arising from such offset) shall be applied to the results of clause "Eleventh"; and

Thirteenth: in the case of payments to which clause "Fifth" applies, the Settling States' allocated shares of the payments due from each Participating Manufacturer (as such shares have been determined in step (E) of clause "Seventh" in the case of payments from the Original Participating Manufacturers or in clause "Sixth" in the case of payments from the Subsequent Participating Manufacturers, and have been reduced by clauses "Eighth" through "Twelfth") shall be added together to state the aggregate payment obligation of each Participating Manufacturer with respect to the payments in question. (In the case of a payment to which clause "Fifth" does not apply, the aggregate payment obligation of each Participating Manufacturer with respect to the payment in question shall be stated by the results of clause "Eighth.")

X. EFFECT OF FEDERAL TOBACCO-RELATED LEGISLATION

(a) If federal tobacco-related legislation is enacted after the MSA Execution Date and on or before November 30, 2002, and if such legislation provides for payment(s) by any Original Participating Manufacturer (whether by settlement payment, tax or any other means), all or part of which are actually made available to a Settling State ("Federal Funds"), each Original Participating Manufacturer shall receive a continuing dollar-for-dollar offset for any and all amounts that are paid by such Original Participating Manufacturer pursuant to such legislation and actually made available to such Settling State (except as described in subsections (b) and (c) below). Such offset shall be applied against the applicable Original Participating Manufacturer's share (determined as described in step E of clause "Seventh" of subsection IX(j)) of such Settling State's Allocated Payment, up to the full amount of such Original Participating Manufacturer's share of such Allocated Payment (as such share had been reduced by adjustment, if any, pursuant to the NPM Adjustment and has been reduced by offset, if any, pursuant to the offset for miscalculated or disputed payments). Such offset shall be made against such Original Participating Manufacturer's share of the first Allocated Payment due after such Federal Funds are first available for receipt by such Settling State. In the event that such offset would in any given year exceed such Original Participating Manufacturer's share of such Allocated Payment: (1) the offset to which such Original Participating Manufacturer is entitled under this section in such year shall be the full amount of such Original Participating Manufacturer's share of such Allocated Payment, and (2) all amounts not offset by reason of subsection (1) shall carry forward and be offset in the following year(s) until all such amounts have been offset.

(b) The offset described in subsection (a) shall apply only to that portion of Federal Funds, if any, that are either unrestricted as to their use, or restricted to any form of health care or to any use related to tobacco (including, but not limited to, tobacco education, cessation, control or enforcement) (other than that portion of Federal Funds, if any, that is specifically applicable to tobacco growers or communities dependent on the production of tobacco or Tobacco Products). Provided, however, that the offset described in subsection (a) shall not apply to that portion of Federal Funds, if any, whose receipt by such Settling State is conditioned upon or appropriately allocable to:

(1) the relinquishment of rights or benefits under this Agreement (including the Consent Decree); or

(2) actions or expenditures by such Settling State, unless:

(A) such Settling State chooses to undertake such action or expenditure;

(B) such actions or expenditures do not impose significant constraints on public policy choices; or

(C) such actions or expenditures are both: (i) related to health care or tobacco (including, but not limited to, tobacco education, cessation, control or enforcement) and (ii) do not require such Settling State to expend state matching funds in an amount that is significant in relation to the amount of the Federal Funds made available to such Settling State.

(c) Subject to the provisions of subsection IX(i)(3), Subsequent Participating Manufacturers shall be entitled to the offset described in this section X to the extent that they are required to pay Federal Funds that would give rise to an offset under subsections (a) and (b) if paid by an Original Participating Manufacturer.

(d) Nothing in this section X shall (1) reduce the payments to be made to the Settling States under this Agreement other than those described in subsection IX(c) (or corresponding payments under subsection IX(i)) of this Agreement; or (2) alter the Allocable Share used to determine each Settling State's share of the payments described in subsection IX(c) (or corresponding payments under subsection IX(i)) of this Agreement. Nothing in this section X is intended to or shall reduce the total amounts payable by the Participating Manufacturers to the Settling States under this Agreement by an amount greater than the amount of Federal Funds that the Settling States could elect to receive.

XI. CALCULATION AND DISBURSEMENT OF PAYMENTS

(a) Independent Auditor to Make All Calculations.

(1) Beginning with payments due in the year 2000, an Independent Auditor shall calculate and determine the amount of all payments owed pursuant to this Agreement, the adjustments, reductions and offsets thereto (and all resulting carry-forwards, if any), the allocation of such payments, adjustments, reductions, offsets and carry-forwards among the Participating Manufacturers and among the Settling States, and shall perform all other calculations in connection with the foregoing (including, but not limited to, determining Market Share, Relative Market Share, Base Aggregate Participating Manufacturer Market Share and Actual Aggregate Participating Manufacturer Market Share). The Independent Auditor shall promptly collect all information necessary to make such calculations and determinations. Each Participating Manufacturer and each Settling State shall provide the Independent Auditor, as promptly as practicable, with information in its possession or readily available to it necessary for the Independent Auditor to perform such calculations. The Independent Auditor shall agree to maintain the confidentiality of all such information, except that the Independent Auditor may provide such information to Participating Manufacturers and the Settling States as set forth in this Agreement. The Participating Manufacturers and the Settling States agree to maintain the confidentiality of such information.

(2) Payments due from the Original Participating Manufacturers prior to January 1, 2000 (other than the first payment due pursuant to subsection IX(b)) shall be based on the 1998 Relative Market Shares of the Original Participating Manufacturers or, if the Original Participating Manufacturers are unable to agree on such Relative Market Shares, on their 1997 Relative Market Shares specified in Exhibit Q.

(b) Identity of Independent Auditor. The Independent Auditor shall be a major, nationally recognized, certified public accounting firm jointly selected by agreement of the Original Participating Manufacturers and those Attorneys General of the Settling States who are members of the NAAG executive committee, who shall jointly retain the power to replace the Independent Auditor and appoint its successor. Fifty percent of the costs and fees of the Independent Auditor (but in no event more than $500,000 per annum), shall be paid by the Fund described in Exhibit J hereto, and the balance of such costs and fees shall be paid by the Original Participating Manufacturers, allocated among them according to their Relative Market Shares. The agreement retaining the Independent Auditor shall provide that the Independent Auditor shall perform the functions specified for it in this Agreement, and that it shall do so in the manner specified in this Agreement.

(c) Resolution of Disputes. Any dispute, controversy or claim arising out of or relating to calculations performed by, or any determinations made by, the Independent Auditor (including, without limitation, any dispute concerning the operation or application of any of the adjustments, reductions, offsets, carry-forwards and allocations described in subsection IX(j) or subsection XI(i)) shall be submitted to binding arbitration before a panel of three neutral arbitrators, each of whom shall be a former Article III federal judge. Each of the two sides to the dispute shall select one arbitrator. The two arbitrators so selected shall select the third arbitrator. The arbitration shall be governed by the United States Federal Arbitration Act.

(d) General Provisions as to Calculation of Payments.

(1) Not less than 90 days prior to the scheduled due date of any payment due pursuant to this Agreement ("Payment Due Date"), the Independent Auditor shall deliver to each other Notice Party a detailed itemization of all information required by the Independent Auditor to complete its calculation of (A) the amount due from each Participating Manufacturer with respect to such payment, and (B) the portion of such amount allocable to each entity for whose benefit such payment is to be made. To the extent practicable, the Independent Auditor shall specify in such itemization which Notice Party is requested to produce which information. Each Participating Manufacturer and each Settling State shall use its best efforts to promptly supply all of the required information that is within its possession or is readily available to it to the Independent Auditor, and in any event not less than 50 days prior to such Payment Due Date. Such best efforts obligation shall be continuing in the case of information that comes within the possession of, or becomes readily available to, any Settling State or Participating Manufacturer after the date 50 days prior to such Payment Due Date.

(2) Not less than 40 days prior to the Payment Due Date, the Independent Auditor shall deliver to each other Notice Party (A) detailed preliminary calculations ("Preliminary Calculations") of the amount due from each Participating Manufacturer and of the amount allocable to each entity for whose benefit such payment is to be made, showing all applicable offsets, adjustments, reductions and carry-forwards and setting forth all the information on which the Independent Auditor relied in preparing such Preliminary Calculations, and (B) a statement of any information still required by the Independent Auditor to complete its calculations.

(3) Not less than 30 days prior to the Payment Due Date, any Participating Manufacturer or any Settling State that disputes any aspect of the Preliminary Calculations (including, but not limited to, disputing the methodology that the Independent Auditor employed, or the information on which the Independent Auditor relied, in preparing such calculations) shall notify each other Notice Party of such dispute, including the reasons and basis therefor.

(4) Not less than 15 days prior to the Payment Due Date, the Independent Auditor shall deliver to each other Notice Party a detailed recalculation (a "Final Calculation") of the amount due from each Participating Manufacturer, the amount allocable to each entity for whose benefit such payment is to be made, and the Account to which such payment is to be credited, explaining any changes from the Preliminary Calculation. The Final Calculation may include estimates of amounts in the circumstances described in subsection (d)(5).

(5) The following provisions shall govern in the event that the information required by the Independent Auditor to complete its calculations is not in its possession by the date as of which the Independent Auditor is required to provide either a Preliminary Calculation or a Final Calculation.

(A) If the information in question is not readily available to any Settling State, any Original Participating Manufacturer or any Subsequent Participating Manufacturer, the Independent Auditor shall employ an assumption as to the missing information producing the minimum amount that is likely to be due with respect to the payment in question, and shall set forth its assumption as to the missing information in its Preliminary Calculation or Final Calculation, whichever is at issue. Any Original Participating Manufacturer, Subsequent Participating Manufacturer or Settling State may dispute any such assumption employed by the Independent Auditor in its Preliminary Calculation in the manner prescribed in subsection (d)(3) or any such assumption employed by the Independent Auditor in its Final Calculation in the manner prescribed in subsection (d)(6). If the missing information becomes available to the Independent Auditor prior to the Payment Due Date, the Independent Auditor shall promptly revise its Preliminary Calculation or Final Calculation (whichever is applicable) and shall promptly provide the revised calculation to each Notice Party, showing the newly available information. If the missing information does not become available to the Independent Auditor prior to the Payment Due Date, the minimum amount calculated by the Independent Auditor pursuant to this subsection (A) shall be paid on the Payment Due Date, subject to disputes pursuant to subsections (d)(6) and (d)(8) and without prejudice to a later final determination of the correct amount. If the missing information becomes available to the Independent Auditor after the Payment Due Date, the Independent Auditor shall calculate the correct amount of the payment in question and shall apply any overpayment or underpayment as an offset or additional payment in the manner described in subsection (i).

(B) If the information in question is readily available to a Settling State, Original Participating Manufacturer or Subsequent Participating Manufacturer, but such Settling State, Original Participating Manufacturer or Subsequent Participating Manufacturer does not supply such information to the Independent Auditor, the Independent Auditor shall base the calculation in question on its best estimate of such information, and shall show such estimate in its Preliminary Calculation or Final Calculation, whichever is applicable. Any Original Participating Manufacturer, Subsequent Participating Manufacturer or Settling State (except the entity that withheld the information) may dispute such estimate employed by the Independent Auditor in its Preliminary Calculation in the manner prescribed in subsection (d)(3) or such estimate employed by the Independent Auditor in its Final Calculation in the manner prescribed in subsection (d)(6). If the withheld information is not made available to the Independent Auditor more than 30 days prior to the Payment Due Date, the estimate employed by the Independent Auditor (as revised by the Independent Auditor in light of any dispute filed pursuant to the preceding sentence) shall govern the amounts to be paid on the Payment Due Date, subject to disputes pursuant to subsection (d)(6) and without prejudice to a later final determination of the correct amount. In the event that the withheld information subsequently becomes available, the Independent Auditor shall calculate the correct amount and shall apply any overpayment or underpayment as an offset or additional payment in the manner described in subsection (i).

(6) Not less than five days prior to the Payment Due Date, each Participating Manufacturer and each Settling State shall deliver to each Notice Party a statement indicating whether it disputes the Independent Auditor's Final Calculation and, if so, the disputed and undisputed amounts and the basis for the dispute. Except to the extent a Participating Manufacturer or a Settling State delivers a statement indicating the existence of a dispute by such date, the amounts set forth in the Independent Auditor's Final Calculation shall be paid on the Payment Due Date. Provided, however, that (A) in the event that the Independent Auditor revises its Final Calculation within five days of the Payment Due Date as provided in subsection (5)(A) due to receipt of previously missing information, a Participating Manufacturer or Settling State may dispute such revision pursuant to the procedure set forth in this subsection (6) at any time prior to the Payment Due Date; and (B) prior to the date four years after the Payment Due Date, neither failure to dispute a calculation made by the Independent Auditor nor actual agreement with any calculation or payment to the Escrow Agent or to another payee shall waive any Participating Manufacturer's or Settling State's rights to dispute any payment (or the Independent Auditor's calculations with respect to any payment) after the Payment Due Date. No Participating Manufacturer and no Settling State shall have a right to raise any dispute with respect to any payment or calculation after the date four years after such payment's Payment Due Date.

(7) Each Participating Manufacturer shall be obligated to pay by the Payment Due Date the undisputed portion of the total amount calculated as due from it by the Independent Auditor's Final Calculation. Failure to pay such portion shall render the Participating Manufacturer liable for interest thereon as provided in subsection IX(h) of this Agreement, in addition to any other remedy available under this Agreement.

(8) As to any disputed portion of the total amount calculated to be due pursuant to the Final Calculation, any Participating Manufacturer that by the Payment Due Date pays such disputed portion into the Disputed Payments Account (as defined in the Escrow Agreement) shall not be liable for interest thereon even if the amount disputed was in fact properly due and owing. Any Participating Manufacturer that by the Payment Due Date does not pay such disputed portion into the Disputed Payments Account shall be liable for interest as provided in subsection IX(h) if the amount disputed was in fact properly due and owing.

(9) On the same date that it makes any payment pursuant to this Agreement, each Participating Manufacturer shall deliver a notice to each other Notice Party showing the amount of such payment and the Account to which such payment is to be credited.

(10) On the first Business Day after the Payment Due Date, the Escrow Agent shall deliver to each other Notice Party a statement showing the amounts received by it from each Participating Manufacturer and the Accounts credited with such amounts.

(e) General Treatment of Payments. The Escrow Agent may disburse amounts from an Account only if permitted, and only at such time as permitted, by this Agreement and the Escrow Agreement. No amounts may be disbursed to a Settling State other than funds credited to such Settling State's State-Specific Account (as defined in the Escrow Agreement). The Independent Auditor, in delivering payment instructions to the Escrow Agent, shall specify: the amount to be paid; the Account or Accounts from which such payment is to be disbursed; the payee of such payment (which may be an Account); and the Business Day on which such payment is to be made by the Escrow Agent. Except as expressly provided in subsection (f) below, in no event may any amount be disbursed from any Account prior to Final Approval.

(f) Disbursements and Charges Not Contingent on Final Approval. Funds may be disbursed from Accounts without regard to the occurrence of Final Approval in the following circumstances and in the following manner:

(1) Payments of Federal and State Taxes. Federal, state, local or other taxes imposed with respect to the amounts credited to the Accounts shall be paid from such amounts. The Independent Auditor shall prepare and file any tax returns required to be filed with respect to the escrow. All taxes required to be paid shall be allocated to and charged against the Accounts on a reasonable basis to be determined by the Independent Auditor. Upon receipt of written instructions from the Independent Auditor, the Escrow Agent shall pay such taxes and charge such payments against the Account or Accounts specified in those instructions.

(2) Payments to and from Disputed Payments Account. The Independent Auditor shall instruct the Escrow Agent to credit funds from an Account to the Disputed Payments Account when a dispute arises as to such funds, and shall instruct the Escrow Agent to credit funds from the Disputed Payments Account to the appropriate payee when such dispute is resolved with finality. The Independent Auditor shall provide the Notice Parties not less than 10 Business Days prior notice before instructing the Escrow Agent to disburse funds from the Disputed Payments Account.

(3) Payments to a State-Specific Account. Promptly following the occurrence of State-Specific Finality in any Settling State, such Settling State and the Original Participating Manufacturers shall notify the Independent Auditor of such occurrence. The Independent Auditor shall promptly thereafter notify each Notice Party of such State-Specific Finality and of the portions of the amounts in the Subsection IX(b) Account (First), Subsection IX(b) Account (Subsequent), Subsection IX(c)(1) Account and Subsection IX(c)(2) Account, respectively (as such Accounts are defined in the Escrow Agreement), that are at such time held in such Accounts for the benefit of such Settling State, and which are to be transferred to the appropriate State-Specific Account for such Settling State. If neither the Settling State in question nor any Participating Manufacturer disputes such amounts or the occurrence of such State-Specific Finality by notice delivered to each other Notice Party not later than 10 Business Days after delivery by the Independent Auditor of the notice described in the preceding sentence, the Independent Auditor shall promptly instruct the Escrow Agent to make such transfer. If the Settling State in question or any Participating Manufacturer disputes such amounts or the occurrence of such State-Specific Finality by notice delivered to each other Notice Party not later than 10 Business Days after delivery by the Independent Auditor of the notice described in the second sentence of this subsection (f)(3), the Independent Auditor shall promptly instruct the Escrow Agent to credit the amount disputed to the Disputed Payments Account and the undisputed portion to the appropriate State-Specific Account. No amounts may be transferred or credited to a State-Specific Account for the benefit of any State as to which State-Specific Finality has not occurred or as to which this Agreement has terminated.

(4) Payments to Parties other than Particular Settling States.

(A) Promptly following the occurrence of State-Specific Finality in one Settling State, such Settling State and the Original Participating Manufacturers shall notify the Independent Auditor of such occurrence. The Independent Auditor shall promptly thereafter notify each Notice Party of the occurrence of State-Specific Finality in at least one Settling State and of the amounts held in the Subsection VI(b) Account, Subsection VI(c) Account (First), and Subsection VIII(c) Account (as such Accounts are defined in the Escrow Agreement), if any. If neither any of the Settling States nor any of the Participating Manufacturers disputes such amounts or disputes the occurrence of State-Specific Finality in one Settling State, by notice delivered to each Notice Party not later than ten Business Days after delivery by the Independent Auditor of the notice described in the preceding sentence, the Independent Auditor shall promptly instruct the Escrow Agent to disburse the funds held in such Accounts to the Foundation or to the Fund specified in subsection VIII(c), as appropriate. If any Settling State or Participating Manufacturer disputes such amounts or the occurrence of such State-Specific Finality by notice delivered to each other Notice Party not later than 10 Business Days after delivery by the Independent Auditor of the notice described in the second sentence of this subsection (4)(A), the Independent Auditor shall promptly instruct the Escrow Agent to credit the amounts disputed to the Disputed Payments Account and to disburse the undisputed portion to the Foundation or to the Fund specified in subsection VIII(c), as appropriate.

(B) The Independent Auditor shall instruct the Escrow Agent to disburse funds on deposit in the Subsection VIII(b) Account and Subsection IX(e) Account (as such Accounts are defined in the Escrow Agreement) to NAAG or to the Foundation, as appropriate, within 10 Business Days after the date on which such amounts were credited to such Accounts.

(C) Promptly following the occurrence of State-Specific Finality in Settling States having aggregate Allocable Shares equal to at least 80% of the total aggregate Allocable Shares assigned to all States that were Settling States as of the MSA Execution Date, the Settling States and the Original Participating Manufacturers shall notify the Independent Auditor of such occurrence. The Independent Auditor shall promptly thereafter notify each Notice Party of the occurrence of such State-Specific Finality and of the amounts held in the Subsection VI(c) Account (Subsequent) (as such Account is defined in the Escrow Agreement), if any. If neither any of the Settling States nor any of the Participating Manufacturers disputes such amounts or disputes the occurrence of such State-Specific Finality, by notice delivered to each Notice Party not later than 10 Business Days after delivery by the Independent Auditor of the notice described in the preceding sentence, the Independent Auditor shall promptly instruct the Escrow Agent to disburse the funds held in such Account to the Foundation. If any Settling State or Participating Manufacturer disputes such amounts or the occurrence of such State-Specific Finality by notice delivered to each other Notice Party not later than 10 Business Days after delivery by the Independent Auditor of the notice described in the second sentence of this subsection (4)(C), the Independent Auditor shall promptly instruct the Escrow Agent to credit the amounts disputed to the Disputed Payments Account and to disburse the undisputed portion to the Foundation.

(5) Treatment of Payments Following Termination.

(A) As to amounts held for Settling States. Promptly upon the termination of this Agreement with respect to any Settling State (whether or not as part of the termination of this Agreement as to all Settling States) such State or any Participating Manufacturer shall notify the Independent Auditor of such occurrence. The Independent Auditor shall promptly thereafter notify each Notice Party of such termination and of the amounts held in the Subsection IX(b) Account (First), the Subsection IX(b) Account (Subsequent), the Subsection IX(c)(1) Account, the Subsection IX(c)(2) Account, and the State-Specific Account for the benefit of such Settling State. If neither the State in question nor any Participating Manufacturer disputes such amounts or the occurrence of such termination by notice delivered to each other Notice Party not later than 10 Business Days after delivery by the Independent Auditor of the notice described in the preceding sentence, the Independent Auditor shall promptly instruct the Escrow Agent to transfer such amounts to the Participating Manufacturers (on the basis of their respective contributions of such funds). If the State in question or any Participating Manufacturer disputes the amounts held in the Accounts or the occurrence of such termination by notice delivered to each other Notice Party not later than 10 Business Days after delivery by the Independent Auditor of the notice described in the second sentence of this subsection (5)(A), the Independent Auditor shall promptly instruct the Escrow Agent to transfer the amount disputed to the Disputed Payments Account and the undisputed portion to the Participating Manufacturers (on the basis of their respective contributions of such funds).

(B) As to amounts held for others. If this Agreement is terminated with respect to all of the Settling States, the Original Participating Manufacturers shall promptly notify the Independent Auditor of such occurrence. The Independent Auditor shall promptly thereafter notify each Notice Party of such termination and of the amounts held in the Subsection VI(b) Account, the Subsection VI(c) Account (First), the Subsection VIII(b) Account, the Subsection VIII(c) Account and the Subsection IX(e) Account. If neither any such State nor any Participating Manufacturer disputes such amounts or the occurrence of such termination by notice delivered to each other Notice Party not later than 10 Business Days after delivery by the Independent Auditor of the notice described in the preceding sentence, the Independent Auditor shall promptly instruct the Escrow Agent to transfer such amounts to the Participating Manufacturers (on the basis of their respective contributions of such funds). If any such State or any Participating Manufacturer disputes the amounts held in the Accounts or the occurrence of such termination by notice delivered to each other Notice Party not later than 10 Business Days after delivery by the Independent Auditor of the notice described in the second sentence of this subsection (5)(B), the Independent Auditor shall promptly instruct the Escrow Agent to credit the amount disputed to the Disputed Payments Account and transfer the undisputed portion to the Participating Manufacturers (on the basis of their respective contribution of such funds).

(C) As to amounts held in the Subsection VI(c) Account (Subsequent). If this Agreement is terminated with respect to Settling States having aggregate Allocable Shares equal to more than 20% of the total aggregate Allocable Shares assigned to those States that were Settling States as of the MSA Execution Date, the Original Participating Manufacturers shall promptly notify the Independent Auditor of such occurrence. The Independent Auditor shall promptly thereafter notify each Notice Party of such termination and of the amounts held in the Subsection VI(c) Account (Subsequent) (as defined in the Escrow Agreement). If neither any such State with respect to which this Agreement has terminated nor any Participating Manufacturer disputes such amounts or the occurrence of such termination by notice delivered to each other Notice Party not later than 10 Business Days after delivery by the Independent Auditor of the notice described in the preceding sentence, the Independent Auditor shall promptly instruct the Escrow Agent to transfer such amounts to the Participating Manufacturers (on the basis of their respective contributions of such funds). If any such State or any Participating Manufacturer disputes the amounts held in the Account or the occurrence of such termination by notice delivered to each other Notice Party not later than 10 Business Days after delivery by the Independent Auditor of the notice described in the second sentence of this subsection (5)(C), the Independent Auditor shall promptly instruct the Escrow Agent to credit the amount disputed to the Disputed Payments Account and transfer the undisputed portion to the Participating Manufacturers (on the basis of their respective contribution of such funds).

(6) Determination of amounts paid or held for the benefit of each individual Settling State. For purposes of subsections (f)(3), (f)(5)(A) and (i)(2), the portion of a payment that is made or held for the benefit of each individual Settling State shall be determined: (A) in the case of a payment credited to the Subsection IX(b) Account (First) or the Subsection IX(b) Account (Subsequent), by allocating the results of clause "Eighth" of subsection IX(j) among those Settling States who were Settling States at the time that the amount of such payment was calculated, pro rata in proportion to their respective Allocable Shares; and (B) in the case of a payment credited to the Subsection IX(c)(1) Account or the Subsection IX(c)(2) Account, by the results of clause "Twelfth" of subsection IX(j) for each individual Settling State. Provided, however, that, solely for purposes of subsection (f)(3), the Settling States may by unanimous agreement agree on a different method of allocation of amounts held in the Accounts identified in this subsection (f)(6).

(g) Payments to be Made Only After Final Approval. Promptly following the occurrence of Final Approval, the Settling States and the Original Participating Manufacturers shall notify the Independent Auditor of such occurrence. The Independent Auditor shall promptly thereafter notify each Notice Party of the occurrence of Final Approval and of the amounts held in the State-Specific Accounts. If neither any of the Settling States nor any of the Participating Manufacturers disputes such amounts, disputes the occurrence of Final Approval or claims that this Agreement has terminated as to any Settling State for whose benefit the funds are held in a State-Specific Account, by notice delivered to each Notice Party not later than 10 Business Days after delivery by the Independent Auditor of such notice of Final Approval, the Independent Auditor shall promptly instruct the Escrow Agent to disburse the funds held in the State-Specific Accounts to (or as directed by) the respective Settling States. If any Notice Party disputes such amounts or the occurrence of Final Approval, or claims that this Agreement has terminated as to any Settling State for whose benefit the funds are held in a State-Specific Account, by notice delivered to each other Notice Party not later than 10 Business Days after delivery by the Independent Auditor of such notice of Final Approval, the Independent Auditor shall promptly instruct the Escrow Agent to credit the amounts disputed to the Disputed Payments Account and to disburse the undisputed portion to (or as directed by) the respective Settling States.

(h) Applicability to Section XVII Payments. This section XI shall not be applicable to payments made pursuant to section XVII; provided, however, that the Independent Auditor shall be responsible for calculating Relative Market Shares in connection with such payments, and the Independent Auditor shall promptly provide the results of such calculation to any Original Participating Manufacturer or Settling State that requests it do so.

(i) Miscalculated or Disputed Payments.

(1) Underpayments.

(A) If information becomes available to the Independent Auditor not later than four years after a Payment Due Date, and such information shows that any Participating Manufacturer was instructed to make an insufficient payment on such date ("original payment"), the Independent Auditor shall promptly determine the additional payment owed by such Participating Manufacturer and the allocation of such additional payment among the applicable payees. The Independent Auditor shall then reduce such additional payment (up to the full amount of such additional payment) by any adjustments or offsets that were available to the Participating Manufacturer in question against the original payment at the time it was made (and have not since been used) but which such Participating Manufacturer was unable to use against such original payment because such adjustments or offsets were in excess of such original payment (provided that any adjustments or offsets used against such additional payment shall reduce on a dollar-for-dollar basis any remaining carry-forward held by such Participating Manufacturer with respect to such adjustment or offset). The Independent Auditor shall then add interest at the Prime Rate (calculated from the Payment Due Date in question) to the additional payment (as reduced pursuant to the preceding sentence), except that where the additional payment owed by a Participating Manufacturer is the result of an underpayment by such Participating Manufacturer caused by such Participating Manufacturer's withholding of information as described in subsection (d)(5)(B), the applicable interest rate shall be that described in subsection IX(h). The Independent Auditor shall promptly give notice of the additional payment owed by the Participating Manufacturer in question (as reduced and/or increased as described above) to all Notice Parties, showing the new information and all calculations. Upon receipt of such notice, any Participating Manufacturer or Settling State may dispute the Independent Auditor's calculations in the manner described in subsection (d)(3), and the Independent Auditor shall promptly notify each Notice Party of any subsequent revisions to its calculations. Not more than 15 days after receipt of such notice (or, if the Independent Auditor revises its calculations, not more than 15 days after receipt of the revisions), any Participating Manufacturer and any Settling State may dispute the Independent Auditor's calculations in the manner prescribed in subsection (d)(6). Failure to dispute the Independent Auditor's calculations in this manner shall constitute agreement with the Independent Auditor's calculations, subject to the limitations set forth in subsection (d)(6). Payment of the undisputed portion of an additional payment shall be made to the Escrow Agent not more than 20 days after receipt of the notice described in this subsection (A) (or, if the Independent Auditor revises its calculations, not more than 20 days after receipt of the revisions). Failure to pay such portion shall render the Participating Manufacturer liable for interest thereon as provided in subsection IX(h). Payment of the disputed portion shall be governed by subsection (d)(8).

(B) To the extent a dispute as to a prior payment is resolved with finality against a Participating Manufacturer: (i) in the case where the disputed amount has been paid into the Disputed Payments Account pursuant to subsection (d)(8), the Independent Auditor shall instruct the Escrow Agent to transfer such amount to the applicable payee Account(s); (ii) in the case where the disputed amount has not been paid into the Disputed Payments Account and the dispute was identified prior to the Payment Due Date in question by delivery of a statement pursuant to subsection (d)(6) identifying such dispute, the Independent Auditor shall calculate interest on the disputed amount from the Payment Due Date in question (the applicable interest rate to be that provided in subsection IX(h)) and the allocation of such amount and interest among the applicable payees, and shall provide notice of the amount owed (and the identity of the payor and payees) to all Notice Parties; and (iii) in all other cases, the procedure described in subsection (ii) shall apply, except that the applicable interest rate shall be the Prime Rate.

(2) Overpayments.

(A) If a dispute as to a prior payment is resolved with finality in favor of a Participating Manufacturer where the disputed amount has been paid into the Disputed Payments Account pursuant to subsection (d)(8), the Independent Auditor shall instruct the Escrow Agent to transfer such amount to such Participating Manufacturer.

(B) If information becomes available to the Independent Auditor not later than four years after a Payment Due Date showing that a Participating Manufacturer made an overpayment on such date, or if a dispute as to a prior payment is resolved with finality in favor of a Participating Manufacturer where the disputed amount has been paid but not into the Disputed Payments Account, such Participating Manufacturer shall be entitled to a continuing dollar-for-dollar offset as follows:

(i) offsets under this subsection (B) shall be applied only against eligible payments to be made by such Participating Manufacturer after the entitlement to the offset arises. The eligible payments shall be: in the case of offsets arising from payments under subsection IX(b) or IX(c)(1), subsequent payments under any of such subsections; in the case of offsets arising from payments under subsection IX(c)(2), subsequent payments under such subsection or, if no subsequent payments are to be made under such subsection, subsequent payments under subsection IX(c)(1); in the case of offsets arising from payments under subsection IX(e), subsequent payments under such subsection or subsection IX(c); in the case of offsets arising from payments under subsection VI(c), subsequent payments under such subsection or, if no subsequent payments are to be made under such subsection, subsequent payments under any of subsection IX(c)(1), IX(c)(2) or IX(e); in the case of offsets arising from payments under subsection VIII(b), subsequent payments under such subsection or, if no subsequent payments are to be made under such subsection, subsequent payments under either subsection IX(c)(1) or IX(c)(2); in the case of offsets arising from payments under subsection VIII(c), subsequent payments under either subsection IX(c)(1) or IX(c)(2); and, in the case of offsets arising from payments under subsection IX(i), subsequent payments under such subsection (consistent with the provisions of this subsection (B)(i)).

(ii) in the case of offsets to be applied against payments under subsection IX(c), the offset to be applied shall be apportioned among the Settling States pro rata in proportion to their respective shares of such payments, as such respective shares are determined pursuant to step E of clause "Seventh" (in the case of payments due from the Original Participating Manufacturers) or clause "Sixth" (in the case of payments due from the Subsequent Participating Manufacturers) of subsection IX(j) (except where the offset arises from an overpayment applicable solely to a particular Settling State).

(iii) the total amount of the offset to which a Participating Manufacturer shall be entitled shall be the full amount of the overpayment it made, together with interest calculated from the time of the overpayment to the Payment Due Date of the first eligible payment against which the offset may be applied. The applicable interest rate shall be the Prime Rate (except that, where the overpayment is the result of a Settling State's withholding of information as described in subsection (d)(5)(B), the applicable interest rate shall be that described in subsection IX(h)).

(iv) an offset under this subsection (B) shall be applied up to the full amount of the Participating Manufacturer's share (in the case of payments due from Original Participating Manufacturers, determined as described in the first sentence of clause "Seventh" of subsection IX(j) (or, in the case of payments pursuant to subsection IX(c), step D of such clause)) of the eligible payment in question, as such payment has been adjusted and reduced pursuant to clauses "First" through "Sixth" of subsection IX(j), to the extent each such clause is applicable to the payment in question. In the event that the offset to which a Participating Manufacturer is entitled under this subsection (B) would exceed such Participating Manufacturer's share of the eligible payment against which it is being applied (or, in the case where such offset arises from an overpayment applicable solely to a particular Settling State, the portion of such payment that is made for the benefit of such Settling State), the offset shall be the full amount of such Participating Manufacturer's share of such payment and all amounts not offset shall carry forward and be offset against subsequent eligible payments until all such amounts have been offset.

(j) Payments After Applicable Condition. To the extent that a payment is made after the occurrence of all applicable conditions for the disbursement of such payment to the payee(s) in question, the Independent Auditor shall instruct the Escrow Agent to disburse such payment promptly following its deposit.

XII. SETTLING STATES' RELEASE, DISCHARGE AND COVENANT

(a) Release.

(1) Upon the occurrence of State-Specific Finality in a Settling State, such Settling State shall absolutely and unconditionally release and forever discharge all Released Parties from all Released Claims that the Releasing Parties directly, indirectly, derivatively or in any other capacity ever had, now have, or hereafter can, shall or may have.

(2) Notwithstanding the foregoing, this release and discharge shall not apply to any defendant in a lawsuit settled pursuant to this Agreement (other than a Participating Manufacturer) unless and until such defendant releases the Releasing Parties (and delivers to the Attorney General of the applicable Settling State a copy of such release) from any and all Claims of such defendant relating to the prosecution of such lawsuit.

(3) Each Settling State (for itself and for the Releasing Parties) further covenants and agrees that it (and the Releasing Parties) shall not after the occurrence of State-Specific Finality sue or seek to establish civil liability against any Released Party based, in whole or in part, upon any of the Released Claims, and further agrees that such covenant and agreement shall be a complete defense to any such civil action or proceeding.

(4) (A) Each Settling State (for itself and for the Releasing Parties) further agrees that, if a Released Claim by a Releasing Party against any person or entity that is not a Released Party (a "non-Released Party") results in or in any way gives rise to a claim-over (on any theory whatever other than a claim based on an express written indemnity agreement) by such non-Released Party against any Released Party (and such Released Party gives notice to the applicable Settling State within 30 days of the service of such claim-over (or within 30 days after the MSA Execution Date, whichever is later) and prior to entry into any settlement of such claim-over), the Releasing Party: (i) shall reduce or credit against any judgment or settlement such Releasing Party may obtain against such non-Released Party the full amount of any judgment or settlement such non-Released Party may obtain against the Released Party on such claim-over; and (ii) shall, as part of any settlement with such non-Released Party, obtain from such non-Released Party for the benefit of such Released Party a satisfaction in full of such non-Released Party's judgment or settlement against the Released Party.

(B) Each Settling State further agrees that in the event that the provisions of subsection (4)(A) do not fully eliminate any and all liability of any Original Participating Manufacturer (or of any person or entity that is a Released Party by virtue of its relation to any Original Participating Manufacturer) with respect to claims-over (on any theory whatever other than a claim based on an express written indemnity agreement) by any non-Released Party to recover in whole or in part any liability (whether direct or indirect, or whether by way of settlement (to the extent that such Released Party has given notice to the applicable Settling State within 30 days of the service of such claim-over (or within 30 days after the MSA Execution Date, whichever is later) and prior to entry into any settlement of such claim-over), judgment or otherwise) of such non-Released Party to any Releasing Party arising out of any Released Claim, such Original Participating Manufacturer shall receive a continuing dollar-for-dollar offset for any amounts paid by such Original Participating Manufacturer (or by any person or entity that is a Released Party by virtue of its relation to such Original Participating Manufacturer) on any such liability against such Original Participating Manufacturer's share (determined as described in step E of clause "Seventh" of subsection IX(j)) of the applicable Settling State's Allocated Payment, up to the full amount of such Original Participating Manufacturer's share of such Allocated Payment each year, until all such amounts paid on such liability have been offset. In the event that the offset under this subsection (4) with respect to a particular Settling State would in any given year exceed such Original Participating Manufacturer's share of such Settling State's Allocated Payment (as such share had been reduced by adjustment, if any, pursuant to the NPM Adjustment, and has been reduced by offsets, if any, pursuant to the offset for miscalculated or disputed payments, the Federal Tobacco Legislation Offset and the Litigating Releasing Parties Offset): (i) the offset to which such Original Participating Manufacturer is entitled under this subsection in such year shall be the full amount of such Original Participating Manufacturer's share of such Allocated Payment; and (ii) all amounts not offset by reason of subsection (i) shall carry forward and be offset in the following year(s) until all such amounts have been offset.

(C) Each Settling State further agrees that, subject to the provisions of section IX(i)(3), each Subsequent Participating Manufacturer shall be entitled to the offset described in subsection (B) above to the extent that it (or any person or entity that is a Released Party by virtue of its relationship with such Subsequent Participating Manufacturer) has paid on liability that would give rise to an offset under such subsection if paid by an Original Participating Manufacturer.

(5) This release and covenant shall not operate to interfere with a Settling State's ability to enforce as against any Participating Manufacturer the provisions of this Agreement, or with the Court's ability to enter the Consent Decree or to maintain continuing jurisdiction to enforce such Consent Decree pursuant to the terms thereof. Provided, however, that neither subsection III(a) or III(r) of this Agreement nor subsection V(A) or V(I) of the Consent Decree shall create a right to challenge the continuation, after the MSA Execution Date, of any advertising content, claim or slogan (other than use of a Cartoon) that was not unlawful prior to the MSA Execution Date.

(6) The Settling States do not purport to waive or release any claims on behalf of Indian tribes.

(7) The Settling States do not waive or release any criminal liability based on federal, state or local law.

(8) Notwithstanding the foregoing (and the definition of Released Parties), this release and covenant shall not apply to retailers, suppliers or distributors to the extent of any liability arising from the sale or distribution of Tobacco Products of, or the supply of component parts of Tobacco Products to, any non-Released Party.

(A) Each Settling State (for itself and for the Releasing Parties) agrees that, if a claim by a Releasing Party against a retailer, supplier or distributor that would be a Released Claim but for the operation of the preceding sentence results in or in any way gives rise to a claim-over (on any theory whatever) by such retailer, supplier or distributor against any Released Party (and such Released Party gives notice to the applicable Settling State within 30 days of the service of such claim-over (or within 30 days after the MSA Execution Date, whichever is later) and prior to entry into any settlement of such claim-over), the Releasing Party: (i) shall reduce or credit against any judgment or settlement such Releasing Party may obtain against such retailer, supplier or distributor the full amount of any judgment or settlement such retailer, supplier or distributor may obtain against the Released Party on such claim-over; and (ii) shall, as part of any settlement with such retailer, supplier or distributor, obtain from such retailer, supplier or distributor for the benefit of such Released Party a satisfaction in full of such retailer's, supplier's or distributor's judgment or settlement against the Released Party.

(B) Each Settling State further agrees that in the event that the provisions of subsection (8)(A) above do not fully eliminate any and all liability of any Original Participating Manufacturer (or any person or entity that is a Released Party by virtue of its relationship to an Original Participating Manufacturer) with respect to claims-over (on any theory whatever) by any such retailer, supplier or distributor to recover in whole or in part any liability (whether direct or indirect, or whether by way of settlement (to the extent that such Released Party has given notice to the applicable Settling State within 30 days of the service of such claim-over (or within 30 days after the MSA Execution Date, whichever is later) and prior to entry into any settlement of such claim-over), judgment or otherwise) of such retailer, supplier or distributor to any Releasing Party arising out of any claim that would be a Released Claim but for the operation of the first sentence of this subsection (8), such Original Participating Manufacturer shall receive a continuing dollar-for-dollar offset for any amounts paid by such Original Participating Manufacturer (or by any person or entity that is a Released Party by virtue of its relation to such Original Participating Manufacturer) on any such liability against such Original Participating Manufacturer's share (determined as described in step E of clause "Seventh" of subsection IX(j)) of the applicable Settling State's Allocated Payment, up to the full amount of such Original Participating Manufacturer's share of such Allocated Payment each year, until all such amounts paid on such liability have been offset. In the event that the offset under this subsection (8) with respect to a particular Settling State would in any given year exceed such Original Participating Manufacturer's share of such Settling State's Allocated Payment (as such share had been reduced by adjustment, if any, pursuant to the NPM Adjustment, and has been reduced by offsets, if any, pursuant to the offset for miscalculated or disputed payments, the Federal Tobacco Legislation Offset, the Litigating Releasing Parties Offset and the offset for claims-over under subsection XII(a)(4)(B)): (i) the offset to which such Original Participating Manufacturer is entitled under this subsection in such year shall be the full amount of such Original Participating Manufacturer's share of such Allocated Payment; and (ii) all amounts not offset by reason of clause (i) shall carry forward and be offset in the following year(s) until all such amounts have been offset.

(C) Each Settling State further agrees that, subject to the provisions of subsection IX(i)(3), each Subsequent Participating Manufacturer shall be entitled to the offset described in subsection (B) above to the extent that it (or any person or entity that is a Released Party by virtue of its relationship with such Subsequent Participating Manufacturer) has paid on liability that would give rise to an offset under such subsection if paid by an Original Participating Manufacturer.

(9) Notwithstanding any provision of law, statutory or otherwise, which provides that a general release does not extend to claims which the creditor does not know or suspect to exist in its favor at the time of executing the release, which if known by it must have materially affected its settlement with the debtor, the releases set forth in this section XII release all Released Claims against the Released Parties, whether known or unknown, foreseen or unforeseen, suspected or unsuspected, that the Releasing Parties may have against the Released Parties, and the Releasing Parties understand and acknowledge the significance and consequences of waiver of any such provision and hereby assume full responsibility for any injuries, damages or losses that the Releasing Parties may incur.

(b) Released Claims Against Released Parties. If a Releasing Party (or any person or entity enumerated in subsection II(pp), without regard to the power of the Attorney General to release claims of such person or entity) nonetheless attempts to maintain a Released Claim against a Released Party, such Released Party shall give written notice of such potential claim to the Attorney General of the applicable Settling State within 30 days of receiving notice of such potential claim (or within 30 days after the MSA Execution Date, whichever is later) (unless such potential claim is being maintained by such Settling State). The Released Party may offer the release and covenant as a complete defense. If it is determined at any point in such action that the release of such claim is unenforceable or invalid for any reason (including, but not limited to, lack of authority to release such claim), the following provisions shall apply:

(1) The Released Party shall take all ordinary and reasonable measures to defend the action fully. The Released Party may settle or enter into a stipulated judgment with respect to the action at any time in its sole discretion, but in such event the offset described in subsection (b)(2) or (b)(3) below shall apply only if the Released Party obtains the relevant Attorney General's consent to such settlement or stipulated judgment, which consent shall not be unreasonably withheld. The Released Party shall not be entitled to the offset described in subsection (b)(2) or (b)(3) below if such Released Party failed to take ordinary and reasonable measures to defend the action fully.

(2) The following provisions shall apply where the Released Party is an Original Participating Manufacturer (or any person or entity that is a Released Party by virtue of its relationship with an Original Participating Manufacturer):

(A) In the event of a settlement or stipulated judgment, the settlement or stipulated amount shall give rise to a continuing offset as such amount is actually paid against the full amount of such Original Participating Manufacturer's share (determined as described in step E of clause "Seventh" of subsection IX(j)) of the applicable Settling State's Allocated Payment until such time as the settlement or stipulated amount is fully credited on a dollar-for-dollar basis.

(B) Judgments (other than a default judgment) against a Released Party in such an action shall, upon payment of such judgment, give rise to an immediate and continuing offset against the full amount of such Original Participating Manufacturer's share (determined as described in subsection (A)) of the applicable Settling State's Allocated Payment, until such time as the judgment is fully credited on a dollar-for-dollar basis.

(C) Each Settling State reserves the right to intervene in such an action (unless such action was brought by the Settling State) to the extent authorized by applicable law in order to protect the Settling State's interest under this Agreement. Each Participating Manufacturer agrees not to oppose any such intervention.

(D) In the event that the offset under this subsection (b)(2) with respect to a particular Settling State would in any given year exceed such Original Participating Manufacturer's share of such Settling State's Allocated Payment (as such share had been reduced by adjustment, if any, pursuant to the NPM Adjustment, and has been reduced by offsets, if any, pursuant to the Federal Tobacco Legislation Offset and the offset for miscalculated or disputed payments): (i) the offset to which such Original Participating Manufacturer is entitled under this subsection (2) in such year shall be the full amount of such Original Participating Manufacturer's share of such Allocated Payment; and (ii) all amounts not offset by reason of clause (i) shall carry forward and be offset in the following year(s) until all such amounts have been offset.

(3) The following provisions shall apply where the Released Party is a Subsequent Participating Manufacturer (or any person or entity that is a Released Party by virtue of its relationship with a Subsequent Participating Manufacturer): Subject to the provisions of subsection IX(i)(3), each Subsequent Participating Manufacturer shall be entitled to the offset as described in subsections (2)(A)-(C) above against payments it otherwise would owe under section IX(i) to the extent that it (or any person or entity that is a Released Party by virtue of its relationship with such Subsequent Participating Manufacturer) has paid on a settlement, stipulated judgment or judgment that would give rise to an offset under such subsections if paid by an Original Participating Manufacturer.

XIII. CONSENT DECREES AND DISMISSAL OF CLAIMS

(a) Within 10 days after the MSA Execution Date (or, as to any Settling State identified in the Additional States provision of Exhibit D, concurrently with the filing of its lawsuit), each Settling State and each Participating Manufacturer that is a party in any of the lawsuits identified in Exhibit D shall jointly move for a stay of all proceedings in such Settling State's lawsuit with respect to the Participating Manufacturers and all other Released Parties (except any proceeding seeking public disclosure of documents pursuant to subsection IV(b)). Such stay of a Settling State's lawsuit shall be dissolved upon the earlier of the occurrence of State-Specific Finality or termination of this Agreement with respect to such Settling State pursuant to subsection XVIII(u)(1).

(b) Not later than December 11, 1998 (or, as to any Settling State identified in the Additional States provision of Exhibit D, concurrently with the filing of its lawsuit):

(1) each Settling State that is a party to a lawsuit identified in Exhibit D and each Participating Manufacturer will:

(A) tender this Agreement to the Court in such Settling State for its approval; and

(B) tender to the Court in such Settling State for entry a consent decree conforming to the model consent decree attached hereto as Exhibit L (revisions or changes to such model consent decree shall be limited to the extent required by state procedural requirements to reflect accurately the factual setting of the case in question, but shall not include any substantive revision to the duties or obligations of any Settling State or Participating Manufacturer, except by agreement of all Original Participating Manufacturers); and

(2) each Settling State shall seek entry of an order of dismissal of claims dismissing with prejudice all claims against the Participating Manufacturers and any other Released Party in such Settling State's action identified in Exhibit D. Provided, however, that the Settling State is not required to seek entry of such an order in such Settling State's action against such a Released Party (other than a Participating Manufacturer) unless and until such Released Party has released the Releasing Parties (and delivered to the Attorney General of such Settling State a copy of such release) (which release shall be effective upon the occurrence of State-Specific Finality in such Settling State, and shall recite that in the event this Agreement is terminated with respect to such Settling State pursuant to subsection XVIII(u)(1) the Released Party agrees that the order of dismissal shall be null and void and of no effect) from any and all Claims of such Released Party relating to the prosecution of such action as provided in subsection XII(a)(2).

XIV. PARTICIPATING MANUFACTURERS' DISMISSAL OF RELATED LAWSUITS

(a) Upon State-Specific Finality in a Settling State, each Participating Manufacturer will dismiss without prejudice (and without costs and fees) the lawsuit(s) listed in Exhibit M pending in such Settling State in which the Participating Manufacturer is a plaintiff. Within 10 days after the MSA Execution Date, each Participating Manufacturer and each Settling State that is a party in any of the lawsuits listed in Exhibit M shall jointly move for a stay of all proceedings in such lawsuit. Such stay of a lawsuit against a Settling State shall be dissolved upon the earlier of the occurrence of State-Specific Finality in such Settling State or termination of this Agreement with respect to such Settling State pursuant to subsection XVIII(u)(1).

(b) Upon State-Specific Finality in a Settling State, each Participating Manufacturer will release and discharge any and all monetary Claims against such Settling State and any of such Settling State's officers, employees, agents, administrators, representatives, officials acting in their official capacity, agencies, departments, commissions, divisions and counsel relating to or in connection with the lawsuit(s) commenced by the Attorney General of such Settling State identified in Exhibit D.

(c) Upon State-Specific Finality in a Settling State, each Participating Manufacturer will release and discharge any and all monetary Claims against all subdivisions (political or otherwise, including, but not limited to, municipalities, counties, parishes, villages, unincorporated districts and hospital districts) of such Settling State, and any of their officers, employees, agents, administrators, representatives, officials acting in their official capacity, agencies, departments, commissions, divisions and counsel arising out of Claims that have been waived and released with continuing full force and effect pursuant to section XII of this Agreement.

XV. VOLUNTARY ACT OF THE PARTIES

The Settling States and the Participating Manufacturers acknowledge and agree that this Agreement is voluntarily entered into by each Settling State and each Participating Manufacturer as the result of arm's-length negotiations, and each Settling State and each Participating Manufacturer was represented by counsel in deciding to enter into this Agreement. Each Participating Manufacturer further acknowledges that it understands that certain provisions of this Agreement may require it to act or refrain from acting in a manner that could otherwise give rise to state or federal constitutional challenges and that, by voluntarily consenting to this Agreement, it (and the Tobacco-Related Organizations (or any trade associations formed or controlled by any Participating Manufacturer)) waives for purposes of performance of this Agreement any and all claims that the provisions of this Agreement violate the state or federal constitutions. Provided, however, that nothing in the foregoing shall constitute a waiver as to the entry of any court order (or any interpretation thereof) that would operate to limit the exercise of any constitutional right except to the extent of the restrictions, limitations or obligations expressly agreed to in this Agreement or the Consent Decree.

XVI. CONSTRUCTION

(a) No Settling State or Participating Manufacturer shall be considered the drafter of this Agreement or any Consent Decree, or any provision of either, for the purpose of any statute, case law or rule of interpretation or construction that would or might cause any provision to be construed against the drafter.

(b) Nothing in this Agreement shall be construed as approval by the Settling States of any Participating Manufacturer's business organizations, operations, acts or practices, and no Participating Manufacturer may make any representation to the contrary.

XVII. RECOVERY OF COSTS AND ATTORNEYS' FEES

(a) The Original Participating Manufacturers agree that, with respect to any Settling State in which the Court has approved this Agreement and the Consent Decree, they shall severally reimburse the following "Governmental Entities": (1) the office of the Attorney General of such Settling State; (2) the office of the governmental prosecuting authority for any political subdivision of such Settling State with a lawsuit pending against any Participating Manufacturer as of July 1, 1998 (as identified in Exhibit N) that has released such Settling State and such Participating Manufacturer(s) from any and all Released Claims (a "Litigating Political Subdivision"); and (3) other appropriate agencies of such Settling State and such Litigating Political Subdivision, for reasonable costs and expenses incurred in connection with the litigation or resolution of claims asserted by or against the Participating Manufacturers in the actions set forth in Exhibits D, M and N; provided that such costs and expenses are of the same nature as costs and expenses for which the Original Participating Manufacturers would reimburse their own counsel or agents (but not including costs and expenses relating to lobbying activities).

(b) The Original Participating Manufacturers further agree severally to pay the Governmental Entities in any Settling State in which State-Specific Finality has occurred an amount sufficient to compensate such Governmental Entities for time reasonably expended by attorneys and paralegals employed in such offices in connection with the litigation or resolution of claims asserted against or by the Participating Manufacturers in the actions identified in Exhibits D, M and N (but not including time relating to lobbying activities), such amount to be calculated based upon hourly rates equal to the market rate in such Settling State for private attorneys and paralegals of equivalent experience and seniority.

(c) Such Governmental Entities seeking payment pursuant to subsection (a) and/or (b) shall provide the Original Participating Manufacturers with an appropriately documented statement of all costs, expenses and attorney and paralegal time for which payment is sought, and, solely with respect to payments sought pursuant to subsection (b), shall do so no earlier than the date on which State-Specific Finality occurs in such Settling State. All amounts to be paid pursuant to subsections (a) and (b) shall be subject to reasonable verification if requested by any Original Participating Manufacturer; provided, however, that nothing contained in this subsection (c) shall constitute, cause, or require the performance of any act that would constitute any waiver (in whole or in part) of any attorney-client privilege, work product protection or common interest/joint prosecution privilege. All such amounts to be paid pursuant to subsections (a) and (b) shall be subject to an aggregate cap of $150 million for all Settling States, shall be paid promptly following submission of the appropriate documentation (and the completion of any verification process), shall be paid separately and apart from any other amounts due pursuant to this Agreement, and shall be paid severally by each Original Participating Manufacturer according to its Relative Market Share. All amounts to be paid pursuant to subsection (b) shall be paid to such Governmental Entities in the order in which State-Specific Finality has occurred in such Settling States (subject to the $150 million aggregate cap).

(d) The Original Participating Manufacturers agree that, upon the occurrence of State-Specific Finality in a Settling State, they will severally pay reasonable attorneys' fees to the private outside counsel, if any, retained by such Settling State (and each Litigating Political Subdivision, if any, within such Settling State) in connection with the respective actions identified in Exhibits D, M and N and who are designated in Exhibit S for each Settling State by the relevant Attorney General (and for each Litigating Political Subdivision, as later certified in writing to the Original Participating Manufacturers by the relevant governmental prosecuting authority of each Litigating Political Subdivision) as having been retained by and having represented such Settling State (or such Litigating Political Subdivision), in accordance with the terms described in the Model Fee Payment Agreement attached as Exhibit O.

XVIII. MISCELLANEOUS

(a) Effect of Current or Future Law. If any current or future law includes obligations or prohibitions applying to Tobacco Product Manufacturers related to any of the provisions of this Agreement, each Participating Manufacturer shall comply with this Agreement unless compliance with this Agreement would violate such law.

(b) Limited Most-Favored Nation Provision.

(1) If any Participating Manufacturer enters into any future settlement agreement of other litigation comparable to any of the actions identified in Exhibit D brought by a non-foreign governmental plaintiff other than the federal government ("Future Settlement Agreement"):

(A) before October 1, 2000, on overall terms more favorable to such governmental plaintiff than the overall terms of this Agreement (after due consideration of relevant differences in population or other appropriate factors), then, unless a majority of the Settling States determines that the overall terms of the Future Settlement Agreement are not more favorable than the overall terms of this Agreement, the overall terms of this Agreement will be revised so that the Settling States will obtain treatment with respect to such Participating Manufacturer at least as relatively favorable as the overall terms provided to any such governmental plaintiff; provided, however, that as to economic terms this Agreement shall not be revised based on any such Future Settlement Agreement if such Future Settlement Agreement is entered into after: (i) the impaneling of the jury (or, in the event of a non-jury trial, the commencement of trial) in such litigation or any severed or bifurcated portion thereof; or (ii) any court order or judicial determination relating to such litigation that (x) grants judgment (in whole or in part) against such Participating Manufacturer; or (y) grants injunctive or other relief that affects the assets or on-going business activities of such Participating Manufacturer in a manner other than as expressly provided for in this Agreement; or

(B) on or after October 1, 2000, on non-economic terms more favorable to such governmental plaintiff than the non-economic terms of this Agreement, and such Future Settlement Agreement includes terms that provide for the implementation of non-economic tobacco-related public health measures different from those contained in this Agreement, then this Agreement shall be revised with respect to such Participating Manufacturer to include terms comparable to such non-economic terms, unless a majority of the Settling States elects against such revision.

(2) If any Settling State resolves by settlement Claims against any Non-Participating Manufacturer after the MSA Execution Date comparable to any Released Claim, and such resolution includes overall terms that are more favorable to such Non-Participating Manufacturer than the terms of this Agreement (including, without limitation, any terms that relate to the marketing or distribution of Tobacco Products and any term that provides for a lower settlement cost on a per pack sold basis), then the overall terms of this Agreement will be revised so that the Original Participating Manufacturers will obtain, with respect to that Settling State, overall terms at least as relatively favorable (taking into account, among other things, all payments previously made by the Original Participating Manufacturers and the timing of any payments) as those obtained by such Non-Participating Manufacturer pursuant to such resolution of Claims. The foregoing shall include but not be limited: (a) to the treatment by any Settling State of a Future Affiliate, as that term is defined in agreements between any of the Settling States and Brooke Group Ltd., Liggett & Myers Inc. and/or Liggett Group, Inc. ("Liggett"), whether or not such Future Affiliate is merged with, or its operations combined with, Liggett or any Affiliate thereof; and (b) to any application of the terms of any such agreement (including any terms subsequently negotiated pursuant to any such agreement) to a brand of Cigarettes (or tobacco-related assets) as a result of the purchase by or sale to Liggett of such brand or assets or as a result of any combination of ownership among Liggett and any entity that manufactures Tobacco Products. Provided, however, that revision of this Agreement pursuant to this subsection (2) shall not be required by virtue of the subsequent entry into this Agreement by a Tobacco Product Manufacturer that has not become a Participating Manufacturer as of the MSA Execution Date. Notwithstanding the provisions of subsection XVIII(j), the provisions of this subsection XVIII(b)(2) may be waived by (and only by) unanimous agreement of the Original Participating Manufacturers.

(3) The parties agree that if any term of this Agreement is revised pursuant to subsection (b)(l) or (b)(2) above and the substance of such term before it was revised was also a term of the Consent Decree, each affected Settling State and each affected Participating Manufacturer shall jointly move the Court to amend the Consent Decree to conform the terms of the Consent Decree to the revised terms of the Agreement.

(4) If at any time any Settling State agrees to relieve, in any respect, any Participating Manufacturer's obligation to make the payments as provided in this Agreement, then, with respect to that Settling State, the terms of this Agreement shall be revised so that the other Participating Manufacturers receive terms as relatively favorable.

(c) Transfer of Tobacco Brands. No Original Participating Manufacturer may sell or otherwise transfer or permit the sale or transfer of any of its Cigarette brands, Brand Names, Cigarette product formulas or Cigarette businesses (other than a sale or transfer of Cigarette brands or Brand Names to be sold, product formulas to be used, or Cigarette businesses to be conducted, by the acquiror or transferee exclusively outside of the States) to any person or entity unless such person or entity is an Original Participating Manufacturer or prior to the sale or acquisition agrees to assume the obligations of an Original Participating Manufacturer with respect to such Cigarette brands, Brand Names, Cigarette product formulas or businesses. No Participating Manufacturer may sell or otherwise transfer any of its Cigarette brands, Brand Names, Cigarette product formulas or Cigarette businesses (other than a sale or transfer of Cigarette brands or Brand Names to be sold, Cigarette product formulas to be used, or businesses to be conducted, by the acquiror or transferee exclusively outside of the States) to any person or entity unless such person or entity is or becomes prior to the sale or acquisition a Participating Manufacturer. In the event of any such sale or transfer of a Cigarette brand, Brand Name, Cigarette product formula or Cigarette business by a Participating Manufacturer to a person or entity that within 180 days prior to such sale or transfer was a Non-Participating Manufacturer, the Participating Manufacturer shall certify to the Settling States that it has determined that such person or entity has the capability to perform the obligations under this Agreement. Such certification shall not survive beyond one year following the date of any such transfer. Each Original Participating Manufacturer certifies and represents that, except as provided in Exhibit R, it (or a wholly owned Affiliate) exclusively owns and controls in the States the Brand Names of those Cigarettes that it currently manufactures for sale (or sells) in the States and that it has the capacity to enter into an effective agreement concerning the sale or transfer of such Brand Names pursuant to this subsection XVIII(c). Nothing in this Agreement is intended to create any right for a State to obtain any Cigarette product formula that it would not otherwise have under applicable law.

(d) Payments in Settlement. All payments to be made by the Participating Manufacturers pursuant to this Agreement are in settlement of all of the Settling States' antitrust, consumer protection, common law negligence, statutory, common law and equitable claims for monetary, restitutionary, equitable and injunctive relief alleged by the Settling States with respect to the year of payment or earlier years, except that no part of any payment under this Agreement is made in settlement of an actual or potential liability for a fine, penalty (civil or criminal) or enhanced damages or is the cost of a tangible or intangible asset or other future benefit.

(e) No Determination or Admission. This Agreement is not intended to be and shall not in any event be construed or deemed to be, or represented or caused to be represented as, an admission or concession or evidence of (1) any liability or any wrongdoing whatsoever on the part of any Released Party or that any Released Party has engaged in any of the activities barred by this Agreement; or (2) personal jurisdiction over any person or entity other than the Participating Manufacturers. Each Participating Manufacturer specifically disclaims and denies any liability or wrongdoing whatsoever with respect to the claims and allegations asserted against it by the Attorneys General of the Settling States and the Litigating Political Subdivisions. Each Participating Manufacturer has entered into this Agreement solely to avoid the further expense, inconvenience, burden and risk of litigation.

(f) Non-Admissibility. The settlement negotiations resulting in this Agreement have been undertaken by the Settling States and the Participating Manufacturers in good faith and for settlement purposes only, and no evidence of negotiations or discussions underlying this Agreement shall be offered or received in evidence in any action or proceeding for any purpose. Neither this Agreement nor any public discussions, public statements or public comments with respect to this Agreement by any Settling State or Participating Manufacturer or its agents shall be offered or received in evidence in any action or proceeding for any purpose other than in an action or proceeding arising under or relating to this Agreement.

(g) Representations of Parties. Each Settling State and each Participating Manufacturer hereby represents that this Agreement has been duly authorized and, upon execution, will constitute a valid and binding contractual obligation, enforceable in accordance with its terms, of each of them. The signatories hereto on behalf of their respective Settling States expressly represent and warrant that they have the authority to settle and release all Released Claims of their respective Settling States and any of their respective Settling States' past, present and future agents, officials acting in their official capacities, legal representatives, agencies, departments, commissions and divisions, and that such signatories are aware of no authority to the contrary. It is recognized that the Original Participating Manufacturers are relying on the foregoing representation and warranty in making the payments required by and in otherwise performing under this Agreement. The Original Participating Manufacturers shall have the right to terminate this Agreement pursuant to subsection XVIII(u) as to any Settling State as to which the foregoing representation and warranty is breached or not effectively given.

(h) Obligations Several, Not Joint. All obligations of the Participating Manufacturers pursuant to this Agreement (including, but not limited to, all payment obligations) are intended to be, and shall remain, several and not joint.

(i) Headings. The headings of the sections and subsections of this Agreement are not binding and are for reference only and do not limit, expand or otherwise affect the contents or meaning of this Agreement.

(j) Amendment and Waiver. This Agreement may be amended by a written instrument executed by all Participating Manufacturers affected by the amendment and by all Settling States affected by the amendment. The terms of any such amendment shall not be enforceable in any Settling State that is not a signatory to such amendment. The waiver of any rights conferred hereunder shall be effective only if made by written instrument executed by the waiving party or parties. The waiver by any party of any breach of this Agreement shall not be deemed to be or construed as a waiver of any other breach, whether prior, subsequent or contemporaneous, nor shall such waiver be deemed to be or construed as a waiver by any other party.

(k) Notices. All notices or other communications to any party to this Agreement shall be in writing (including, but not limited to, facsimile, telex, telecopy or similar writing) and shall be given at the addresses specified in Exhibit P (as it may be amended to reflect any additional Participating Manufacturer that becomes a party to this Agreement after the MSA Execution Date). Any Settling State or Participating Manufacturer may change or add the name and address of the persons designated to receive notice on its behalf by notice given (effective upon the giving of such notice) as provided in this subsection.

(l) Cooperation. Each Settling State and each Participating Manufacturer agrees to use its best efforts and to cooperate with each other to cause this Agreement and the Consent Decrees to become effective, to obtain all necessary approvals, consents and authorizations, if any, and to execute all documents and to take such other action as may be appropriate in connection herewith. Consistent with the foregoing, each Settling State and each Participating Manufacturer agrees that it will not directly or indirectly assist or encourage any challenge to this Agreement or any Consent Decree by any other person, and will support the integrity and enforcement of the terms of this Agreement and the Consent Decrees. Each Settling State shall use its best efforts to cause State-Specific Finality to occur as to such Settling State.

(m) Designees to Discuss Disputes. Within 14 days after the MSA Execution Date, each Settling State's Attorney General and each Participating Manufacturer shall provide written notice of its designation of a senior representative to discuss with the other signatories to this Agreement any disputes and/or other issues that may arise with respect to this Agreement. Each Settling State's Attorney General shall provide such notice of the name, address and telephone number of the person it has so designated to each Participating Manufacturer and to NAAG. Each Participating Manufacturer shall provide such notice of the name, address and telephone number of the person it has so designated to each Settling State's Attorney General, to NAAG and to each other Participating Manufacturer.

(n) Governing Law. This Agreement (other than the Escrow Agreement) shall be governed by the laws of the relevant Settling State, without regard to the conflict of law rules of such Settling State. The Escrow Agreement shall be governed by the laws of the State in which the Escrow Court is located, without regard to the conflict of law rules of such State.

(o) Severability.

(1) Sections VI, VII, IX, X, XI, XII, XIII, XIV, XVI, XVIII(b), (c), (d), (e), (f), (g), (h), (o), (p), (r), (s), (u), (w), (z), (bb), (dd), and Exhibits A, B, and E hereof ("Nonseverable Provisions") are not severable, except to the extent that severance of section VI is permitted by Settling States pursuant to subsection VI(i) hereof. The remaining terms of this Agreement are severable, as set forth herein.

(2) If a court materially modifies, renders unenforceable, or finds to be unlawful any of the Nonseverable Provisions, the NAAG executive committee shall select a team of Attorneys General (the "Negotiating Team") to attempt to negotiate an equivalent or comparable substitute term or other appropriate credit or adjustment (a "Substitute Term") with the Original Participating Manufacturers. In the event that the court referred to in the preceding sentence is located in a Settling State, the Negotiating Team shall include the Attorney General of such Settling State. The Original Participating Manufacturers shall have no obligation to agree to any Substitute Term. If any Original Participating Manufacturer does not agree to a Substitute Term, this Agreement shall be terminated in all Settling States affected by the court's ruling. The Negotiating Team shall submit any proposed Substitute Term negotiated by the Negotiating Team and agreed to by all of the Original Participating Manufacturers to the Attorneys General of all of the affected Settling States for their approval. If any affected Settling State does not approve the proposed Substitute Term, this Agreement in such Settling State shall be terminated.

(3) If a court materially modifies, renders unenforceable, or finds to be unlawful any term of this Agreement other than a Nonseverable Provision:

(A) The remaining terms of this Agreement shall remain in full force and effect.

(B) Each Settling State whose rights or obligations under this Agreement are affected by the court's decision in question (the "Affected Settling State") and the Participating Manufacturers agree to negotiate in good faith a Substitute Term. Any agreement on a Substitute Term reached between the Participating Manufacturers and the Affected Settling State shall not modify or amend the terms of this Agreement with regard to any other Settling State.

(C) If the Affected Settling State and the Participating Manufacturers are unable to agree on a Substitute Term, then they will submit the issue to non-binding mediation. If mediation fails to produce agreement to a Substitute Term, then that term shall be severed and the remainder of this Agreement shall remain in full force and effect.

(4) If a court materially modifies, renders unenforceable, or finds to be unlawful any portion of any provision of this Agreement, the remaining portions of such provision shall be unenforceable with respect to the affected Settling State unless a Substitute Term is arrived at pursuant to subsection (o)(2) or (o)(3) hereof, whichever is applicable.

(p) Intended Beneficiaries. No portion of this Agreement shall provide any rights to, or be enforceable by, any person or entity that is not a Settling State or a Released Party. No Settling State may assign or otherwise convey any right to enforce any provision of this Agreement.

(q) Counterparts. This Agreement may be executed in counterparts. Facsimile or photocopied signatures shall be considered as valid signatures as of the date affixed, although the original signature pages shall thereafter be appended.

(r) Applicability. The obligations and duties of each Participating Manufacturer set forth herein are applicable only to actions taken (or omitted to be taken) within the States. This subsection (r) shall not be construed as extending the territorial scope of any obligation or duty set forth herein whose scope is otherwise limited by the terms hereof.

(s) Preservation of Privilege. Nothing contained in this Agreement or any Consent Decree, and no act required to be performed pursuant to this Agreement or any Consent Decree, is intended to constitute, cause or effect any waiver (in whole or in part) of any attorney-client privilege, work product protection or common interest/joint defense privilege, and each Settling State and each Participating Manufacturer agrees that it shall not make or cause to be made in any forum any assertion to the contrary.

(t) Non-Release. Except as otherwise specifically provided in this Agreement, nothing in this Agreement shall limit, prejudice or otherwise interfere with the rights of any Settling State or any Participating Manufacturer to pursue any and all rights and remedies it may have against any Non-Participating Manufacturer or other non-Released Party.

(u) Termination.

(1) Unless otherwise agreed to by each of the Original Participating Manufacturers and the Settling State in question, in the event that (A) State-Specific Finality in a Settling State does not occur in such Settling State on or before December 31, 2001; or (B) this Agreement or the Consent Decree has been disapproved by the Court (or, in the event of an appeal from or review of a decision of the Court to approve this Agreement and the Consent Decree, by the court hearing such appeal or conducting such review), and the time to Appeal from such disapproval has expired, or, in the event of an Appeal from such disapproval, the Appeal has been dismissed or the disapproval has been affirmed by the court of last resort to which such Appeal has been taken and such dismissal or disapproval has become no longer subject to further Appeal (including, without limitation, review by the United States Supreme Court); or (C) this Agreement is terminated in a Settling State for whatever reason (including, but not limited to, pursuant to subsection XVIII(o) of this Agreement), then this Agreement and all of its terms (except for the non-admissibility provisions hereof, which shall continue in full force and effect) shall be canceled and terminated with respect to such Settling State, and it and all orders issued by the courts in such Settling State pursuant hereto shall become null and void and of no effect.

(2) If this Agreement is terminated with respect to a Settling State for whatever reason, then (A) the applicable statute of limitation or any similar time requirement shall be tolled from the date such Settling State signed this Agreement until the later of the time permitted by applicable law or for one year from the date of such termination, with the effect that the parties shall be in the same position with respect to the statute of limitation as they were at the time such Settling State filed its action, and (B) the parties shall jointly move the Court for an order reinstating the actions and claims dismissed pursuant to sections XIII and XIV hereof, with the effect that the parties shall be in the same position with respect to those actions and claims as they were at the time the action or claim was stayed or dismissed.

(v) Freedom of Information Requests. Upon the occurrence of State-Specific Finality in a Settling State, each Participating Manufacturer will withdraw in writing any and all requests for information, administrative applications, and proceedings brought or caused to be brought by such Participating Manufacturer pursuant to such Settling State's freedom of information law relating to the subject matter of the lawsuits identified in Exhibit D.

(w) Bankruptcy. The following provisions shall apply if a Participating Manufacturer both enters Bankruptcy and at any time thereafter is not timely performing its financial obligations as required under this Agreement:

(1) In the event that both a number of Settling States equal to at least 75% of the total number of Settling States and Settling States having aggregate Allocable Shares equal to at least 75% of the total aggregate Allocable Shares assigned to all Settling States deem (by written notice to the Participating Manufacturers other than the bankrupt Participating Manufacturer) that the financial obligations of this Agreement have been terminated and rendered null and void as to such bankrupt Participating Manufacturer (except as provided in subsection (A) below) due to a material breach by such Participating Manufacturer, whereupon, with respect to all Settling States:

(A) all agreements, all concessions, all reductions of Releasing Parties' Claims, and all releases and covenants not to sue, contained in this Agreement shall be null and void as to such Participating Manufacturer. Provided, however, that (i) all reductions of Releasing Parties' Claims, and all releases and covenants not to sue, contained in this Agreement shall remain in full force and effect as to all persons or entities (other than the bankrupt Participating Manufacturer itself or any person or entity that, as a result of the Bankruptcy, obtains domestic tobacco assets of such

Participating Manufacturer (unless such person or entity is itself a Participating Manufacturer)) who (but for the first sentence of this subsection (A)) would otherwise be Released Parties by virtue of their relationship with the bankrupt Participating Manufacturer; and (ii) in the event a Settling State asserts any Released Claim against a bankrupt Participating Manufacturer after the termination of this Agreement with respect to such Participating Manufacturer as described in this subsection (1) and receives a judgment, settlement or distribution arising from such Released Claim, then the amount of any payments such Settling State has previously received from such Participating Manufacturer under this Agreement shall be applied against the amount of any such judgment, settlement or distribution (provided that in no event shall such Settling State be required to refund any payments previously received from such Participating Manufacturer pursuant to this Agreement);

(B) the Settling States shall have the right to assert any and all claims against such Participating Manufacturer in the Bankruptcy or otherwise without regard to any limits otherwise provided in this Agreement (subject to any and all defenses against such claims);

(C) the Settling States may exercise all rights provided under the federal Bankruptcy Code (or other applicable bankruptcy law) with respect to their Claims against such Participating Manufacturer, including the right to initiate and complete police and regulatory actions against such Participating Manufacturer pursuant to the exceptions to the automatic stay set forth in section 362(b) of the Bankruptcy Code (provided, however, that such Participating Manufacturer may contest whether the Settling State's action constitutes a police and regulatory action); and

(D) to the extent that any Settling State is pursuing a police and regulatory action against such Participating Manufacturer as described in subsection (1)(C), such Participating Manufacturer shall not request or support a request that the Bankruptcy court utilize the authority provided under section 105 of the Bankruptcy Code to impose a discretionary stay on the Settling State's action. The Participating Manufacturers further agree that they will not request, seek or support relief from the terms of this Agreement in any proceeding before any court of law (including the federal bankruptcy courts) or an administrative agency or through legislative action, including (without limitation) by way of joinder in or consent to or acquiescence in any such pleading or instrument filed by another.

(2) Whether or not the Settling States exercise the option set forth in subsection (1) (and whether or not such option, if exercised, is valid and enforceable):

(A) In the event that the bankrupt Participating Manufacturer is an Original Participating Manufacturer, such Participating Manufacturer shall continue to be treated as an Original Participating Manufacturer for all purposes under this Agreement except (i) such Participating Manufacturer shall be treated as a Non-Participating Manufacturer (and not as an Original Participating Manufacturer or Participating Manufacturer) for all purposes with respect to subsections IX(d)(1), IX(d)(2) and IX(d)(3) (including, but not limited to, that the Market Share of such Participating Manufacturer shall not be included in Base Aggregate Participating Manufacturer Market Share or Actual Aggregate Participating Manufacturer Market Share, and that such Participating Manufacturer's volume shall not be included for any purpose under subsection IX(d)(1)(D)); (ii) such Participating Manufacturer's Market Share shall not be included as that of a Participating Manufacturer for the purpose of determining whether the trigger percentage specified in subsection IX(e) has been achieved (provided that such Participating Manufacturer shall be treated as an Original Participating Manufacturer for all other purposes with respect to such subsection); (iii) for purposes of subsection (B)(iii) of Exhibit E, such Participating Manufacturer shall continue to be treated as an Original Participating Manufacturer, but its operating income shall be recalculated by the Independent Auditor to reflect what such income would have been had such Participating Manufacturer made the payments that would have been due under this Agreement but for the Bankruptcy; (iv) for purposes of subsection XVIII(c), such Participating Manufacturer shall not be treated as an Original Participating Manufacturer or as a Participating Manufacturer to the extent that after entry into Bankruptcy it becomes the acquiror or transferee of Cigarette brands, Brand Names, Cigarette product formulas or Cigarette businesses of any Participating Manufacturer (provided that such Participating Manufacturer shall continue to be treated as an Original Participating Manufacturer and Participating Manufacturer for all other purposes under such subsection); and (v) as to any action that by the express terms of this Agreement requires the unanimous agreement of all Original Participating Manufacturers.

(B) In the event that the bankrupt Participating Manufacturer is a Subsequent Participating Manufacturer, such Participating Manufacturer shall continue to be treated as a Subsequent Participating Manufacturer for all purposes under this Agreement except (i) such Participating Manufacturer shall be treated as a Non-Participating Manufacturer (and not as a Subsequent Participating Manufacturer or Participating Manufacturer) for all purposes with respect to subsections IX(d)(1), (d)(2) and (d)(4) (including, but not limited to, that the Market Share of such Participating Manufacturer shall not be included in Base Aggregate Participating Manufacturer Market Share or Actual Aggregate Participating Manufacturer Market Share, and that such Participating Manufacturer's volume shall not be included for any purpose under subsection IX(d)(1)(D)); (ii) such Participating Manufacturer's Market Share shall not be included as that of a Participating Manufacturer for the purpose of determining whether the trigger percentage specified in subsection IX(e) has been achieved (provided that such Participating Manufacturer shall be treated as a Subsequent Participating Manufacturer for all other purposes with respect to such subsection); and (iii) for purposes of subsection XVIII(c), such Participating Manufacturer shall not be treated as a Subsequent Participating Manufacturer or as a Participating Manufacturer to the extent that after entry into Bankruptcy it becomes the acquiror or transferee of Cigarette brands, Brand Names, Cigarette product formulas or Cigarette businesses of any Participating Manufacturer (provided that such Participating Manufacturer shall continue to be treated as a Subsequent Participating Manufacturer and Participating Manufacturer for all other purposes under such subsection).

(C) Revision of this Agreement pursuant to subsection XVIII(b)(2) shall not be required by virtue of any resolution on an involuntary basis in the Bankruptcy of Claims against the bankrupt Participating Manufacturer.

(x) Notice of Material Transfers. Each Participating Manufacturer shall provide notice to each Settling State at least 20 days before consummating a sale, transfer of title or other disposition, in one transaction or series of related transactions, of assets having a fair market value equal to five percent or more (determined in accordance with United States generally accepted accounting principles) of the consolidated assets of such Participating Manufacturer.

(y) Entire Agreement. This Agreement (together with any agreements expressly contemplated hereby and any other contemporaneous written agreements) embodies the entire agreement and understanding between and among the Settling States and the Participating Manufacturers relating to the subject matter hereof and supersedes (l) all prior agreements and understandings relating to such subject matter, whether written or oral, and (2) all purportedly contemporaneous oral agreements and understandings relating to such subject matter.

(z) Business Days. Any obligation hereunder that, under the terms of this Agreement, is to be performed on a day that is not a Business Day shall be performed on the first Business Day thereafter.

(aa) Subsequent Signatories. With respect to a Tobacco Product Manufacturer that signs this Agreement after the MSA Execution Date, the timing of obligations under this Agreement (other than payment obligations, which shall be governed by subsection II(jj)) shall be negotiated to provide for the institution of such obligations on a schedule not more favorable to such subsequent signatory than that applicable to the Original Participating Manufacturers.

(bb) Decimal Places. Any figure or percentage referred to in this Agreement shall be carried to seven decimal places.

(cc) Regulatory Authority. Nothing in section III of this Agreement is intended to affect the legislative or regulatory authority of any local or State government.

(dd) Successors. In the event that a Participating Manufacturer ceases selling a brand of Tobacco Products in the States that such Participating Manufacturer owned in the States prior to July 1, 1998, and an Affiliate of such Participating Manufacturer thereafter and after the MSA Execution Date intentionally sells such brand in the States, such Affiliate shall be considered to be the successor of such Participating Manufacturer with respect to such brand. Performance by any such successor of the obligations under this Agreement with respect to the sales of such brand shall be subject to court-ordered specific performance.

(ee) Export Packaging. Each Participating Manufacturer shall place a visible indication on each pack of Cigarettes it manufactures for sale outside of the fifty United States and the District of Columbia that distinguishes such pack from packs of Cigarettes it manufactures for sale in the fifty United States and the District of Columbia.

(ff) Actions Within Geographic Boundaries of Settling States. To the extent that any provision of this Agreement expressly prohibits, restricts, or requires any action to be taken "within" any Settling State or the Settling States, the relevant prohibition, restriction, or requirement applies within the geographic boundaries of the applicable Settling State or Settling States, including, but not limited to, Indian country or Indian trust land within such geographic boundaries.

(gg) Notice to Affiliates. Each Participating Manufacturer shall give notice of this Agreement to each of its Affiliates.

IN WITNESS WHEREOF, each Settling State and each Participating Manufacturer, through their fully authorized representatives, have agreed to this Agreement.

[Signatures Intentionally Omitted]

EXHIBIT A
STATE ALLOCATION PERCENTAGES

State	Percentage
Alabama	1.6161308%
Alaska	0.3414187%
Arizona	1.4738845%
Arkansas	0.8280661%
California	12.7639554%
Colorado	1.3708614%
Connecticut	1.8565373%
Delaware	0.3954695%
D.C.	0.6071183%
Florida	0.0000000%
Georgia	2.4544575%
Hawaii	0.6018650%
Idaho	0.3632632%
Illinois	4.6542472%
Indiana	2.0398033%
Iowa	0.8696670%
Kansas	0.8336712%
Kentucky	1.7611586%
Louisiana	2.2553531%
Maine	0.7693505%
Maryland	2.2604570%
Massachusetts	4.0389790%
Michigan	4.3519476%
Minnesota	0.0000000%
Mississippi	0.0000000%
Missouri	2.2746011%
Montana	0.4247591%
Nebraska	0.5949833%
Nevada	0.6099351%
New Hampshire	0.6659340%
New Jersey	3.8669963%
New Mexico	0.5963897%
New York	12.7620310%
North Carolina	2.3322850%
North Dakota	0.3660138%
Ohio	5.0375098%
Oklahoma	1.0361370%
Oregon	1.1476582%
Pennsylvania	5.7468588%
Rhode Island	0.7189054%
South Carolina	1.1763519%
South Dakota	0.3489458%
Tennessee	2.4408945%
Texas	0.0000000%
Utah	0.4448869%
Vermont	0.4111851%
Virginia	2.0447451%
Washington	2.0532582%
West Virginia	0.8864604%
Wisconsin	2.0720390%
Wyoming	0.2483449%
American Samoa	0.0152170%
N. Mariana Isld.	0.0084376%
Guam	0.0219371%
U.S. Virgin Isld.	0.0173593%
Puerto Rico	1.1212774%
Total	100.0000000%

EXHIBIT B
FORM OF ESCROW AGREEMENT

This Escrow Agreement is entered into as of _______________, 1998 by the undersigned State officials (on behalf of their respective Settling States), the undersigned Participating Manufacturers and ____________________ as escrow agent (the "Escrow Agent").

WITNESSETH:

WHEREAS, the Settling States and the Participating Manufacturers have entered into a settlement agreement entitled the "Master Settlement Agreement" (the "Agreement"); and

WHEREAS, the Agreement requires the Settling States and the Participating Manufacturers to enter into this Escrow Agreement.

NOW, THEREFORE, the parties hereto agree as follows:

SECTION 1. *Appointment of Escrow Agent.*

The Settling States and the Participating Manufacturers hereby appoint ______________________ to serve as Escrow Agent under this Agreement on the terms and conditions set forth herein, and the Escrow Agent, by its execution hereof, hereby accepts such appointment and agrees to perform the duties and obligations of the Escrow Agent set forth herein. The Settling States and the Participating Manufacturers agree that the Escrow Agent appointed under the terms of this Escrow Agreement shall be the Escrow Agent as defined in, and for all purposes of, the Agreement.

SECTION 2. *Definitions.*

(a) Capitalized terms used in this Escrow Agreement and not otherwise defined herein shall have the meaning given to such terms in the Agreement.

(b) "Escrow Court" means the court of the State of New York to which the Agreement is presented for approval, or such other court as agreed to by the Original Participating Manufacturers and a majority of those Attorneys General who are both the Attorney General of a Settling State and a member of the NAAG executive committee at the time in question.

SECTION 3. *Escrow and Accounts.*

(a) All funds received by the Escrow Agent pursuant to the terms of the Agreement shall be held and disbursed in accordance with the terms of this Escrow Agreement. Such funds and any earnings thereon shall constitute the "Escrow" and shall be held by the Escrow Agent separate and apart from all other funds and accounts of the Escrow Agent, the Settling States and the Participating Manufacturers.

(b) The Escrow Agent shall allocate the Escrow among the following separate accounts (each an "Account" and collectively the "Accounts"):

Subsection VI(b) Account

Subsection VI(c) Account (First)

Subsection VI(c) Account (Subsequent)

Subsection VIII(b) Account

Subsection VIII(c) Account

Subsection IX(b) Account (First)

Subsection IX(b) Account (Subsequent)

Subsection IX(c)(1) Account

Subsection IX(c)(2) Account

Subsection IX(e) Account

Disputed Payments Account

State-Specific Accounts with respect to each Settling State in which
State-Specific Finality occurs.

(c) All amounts credited to an Account shall be retained in such Account until disbursed therefrom in accordance with the provisions of this Escrow Agreement pursuant to (i) written instructions from the Independent Auditor; or (ii) written instructions from all of the following: all of the Original Participating Manufacturers; all of the Subsequent Participating Manufacturers that contributed to such amounts in such Account; and all of the Settling States (collectively, the "Escrow Parties"). In the event of a conflict, instructions pursuant to clause (ii) shall govern over instructions pursuant to clause (i).

(d) On the first Business Day after the date any payment is due under the Agreement, the Escrow Agent shall deliver to each other Notice Party a written statement showing the amount of such payment (or indicating that no payment was made, if such is the case), the source of such payment, the Account or Accounts to which such payment has been credited, and the payment instructions received by the Escrow Agent from the Independent Auditor with respect to such payment.

(e) The Escrow Agent shall comply with all payment instructions received from the Independent Auditor unless before 11:00 a.m. (New York City time) on the scheduled date of payment it receives written instructions to the contrary from all of the Escrow Parties, in which event it shall comply with such instructions.

(f) On the first Business Day after disbursing any funds from an Account, the Escrow Agent shall deliver to each other Notice Party a written statement showing the amount disbursed, the date of such disbursement and the payee of the disbursed funds.

SECTION 4. *Failure of Escrow Agent to Receive Instructions.*

In the event that the Escrow Agent fails to receive any written instructions contemplated by this Escrow Agreement, the Escrow Agent shall be fully protected in refraining from taking any action required under any section of this Escrow Agreement other than Section 5 until such written instructions are received by the Escrow Agent.

SECTION 5. *Investment of Funds by Escrow Agent.*

The Escrow Agent shall invest and reinvest all amounts from time to time credited to the Accounts in either (i) direct obligations of, or obligations the principal and interest on which are unconditionally guaranteed by, the United States of America; (ii) repurchase agreements fully collateralized by securities described in clause (i) above; (iii) money market accounts maturing within 30 days of the acquisition thereof and issued by a bank or trust company organized under the laws of the United States of America or of any of the 50 States thereof (a "United States Bank") and having combined capital, surplus and undistributed profits in excess of $500,000,000; or (iv) demand deposits with any United States Bank having combined capital, surplus and undistributed profits in excess of $500,000,000. To the extent practicable, monies credited to any Account shall be invested in such a manner so as to be available for use at the times when monies are expected to be disbursed by the Escrow Agent and charged to such Account. Obligations purchased as an investment of monies credited to any Account shall be deemed at all times to be a part of such Account and the income or interest earned, profits realized or losses suffered with respect to such investments (including, without limitation, any penalty for any liquidation of an investment required to fund a disbursement to be charged to such Account), shall be credited or charged, as the case may be, to, such Account and shall be for the benefit of, or be borne by, the person or entity entitled to payment from such Account. In choosing among the investment options described in clauses (i) through (iv) above, the Escrow Agent shall comply with any instructions received from time to time from all of the Escrow Parties. In the absence of such instructions, the Escrow Agent shall invest such sums in accordance with clause (i) above. With respect to any amounts credited to a State-Specific Account, the Escrow Agent shall invest and reinvest all amounts credited to such Account in accordance with the law of the applicable Settling State to the extent such law is inconsistent with this Section 5.

SECTION 6. *Substitute Form W-9; Qualified Settlement Fund.*

Each signatory to this Escrow Agreement shall provide the Escrow Agent with a correct taxpayer identification number on a substitute Form W-9 or if it does not have such a number, a statement evidencing its status as an entity exempt from back-up withholding, within 30 days of the date hereof (and, if it supplies a Form W-9, indicate thereon that it is not subject to backup withholding). The escrow established pursuant to this Escrow Agreement is intended to be treated as a Qualified Settlement Fund for federal tax purposes pursuant to Treas. Reg. § 1.468B-l. The Escrow Agent shall comply with all applicable tax filing, payment and reporting requirements, including, without limitation, those imposed under Treas. Reg. § 1.468B, and if requested to do so shall join in the making of the relation-back election under such regulation.

SECTION 7. *Duties and Liabilities of Escrow Agent.*

The Escrow Agent shall have no duty or obligation hereunder other than to take such specific actions as are required of it from time to time under the provisions of this Escrow Agreement, and it shall incur no liability hereunder or in connection herewith for anything whatsoever other than any liability resulting from its own gross negligence or willful misconduct. The Escrow Agent shall not be bound in any way by any agreement or contract between the Participating Manufacturers and the Settling States (whether or not the Escrow Agent has knowledge thereof) other than this Escrow Agreement, and the only duties and responsibilities of the Escrow Agent shall be the duties and obligations specifically set forth in this Escrow Agreement.

SECTION 8. *Indemnification of Escrow Agent.*

The Participating Manufacturers shall indemnify, hold harmless and defend the Escrow Agent from and against any and all losses, claims, liabilities and reasonable expenses, including the reasonable fees of its counsel, which it may suffer or incur in connection with the performance of its duties and obligations under this Escrow Agreement, except for those losses, claims, liabilities and expenses resulting solely and directly from its own gross negligence or willful misconduct.

SECTION 9. *Resignation of Escrow Agent.*

The Escrow Agent may resign at any time by giving written notice thereof to the other parties hereto, but such resignation shall not become effective until a successor Escrow Agent, selected by the Original Participating Manufacturers and the Settling States, shall have been appointed and shall have accepted such appointment in writing. If an instrument of acceptance by a successor Escrow Agent shall not have been delivered to the resigning Escrow Agent within 90 days after the giving of such notice of resignation, the resigning Escrow Agent may, at the expense of the Participating Manufacturers (to be shared according to their pro rata Market Shares), petition the Escrow Court for the appointment of a successor Escrow Agent.

SECTION 10. *Escrow Agent Fees and Expenses.*

The Participating Manufacturers shall pay to the Escrow Agent its fees as set forth in Appendix A hereto as amended from time to time by agreement of the Original Participating Manufacturers and the Escrow Agent. The Participating Manufacturers shall pay to the Escrow Agent its reasonable fees and expenses, including all reasonable expenses, charges, counsel fees, and other disbursements incurred by it or by its attorneys, agents and employees in the performance of its duties and obligations under this Escrow Agreement. Such fees and expenses shall be shared by the Participating Manufacturers according to their pro rata Market Shares.

SECTION 11. *Notices.*

All notices, written instructions or other communications to any party or other person hereunder shall be given in the same manner as, shall be given to the same person as, and shall be effective at the same time as provided in subsection XVIII(k) of the Agreement.

SECTION 12. *Setoff; Reimbursement*.

The Escrow Agent acknowledges that it shall not be entitled to set off against any funds in, or payable from, any Account to satisfy any liability of any Participating Manufacturer. Each Participating Manufacturer that pays more than its pro rata Market Share of any payment that is made by the Participating Manufacturers to the Escrow Agent pursuant to Section 8, 9 or 10 hereof shall be entitled to reimbursement of such excess from the other Participating Manufacturers according to their pro rata Market Shares of such excess.

SECTION 13. *Intended Beneficiaries; Successors.*

No persons or entities other than the Settling States, the Participating Manufacturers and the Escrow Agent are intended beneficiaries of this Escrow Agreement, and only the Settling States, the Participating Manufacturers and the Escrow Agent shall be entitled to enforce the terms of this Escrow Agreement. Pursuant to the Agreement, the Settling States have designated NAAG and the Foundation as recipients of certain payments; for all purposes of this Escrow Agreement, the Settling States shall be the beneficiaries of such payments entitled to enforce payment thereof. The provisions of this Escrow Agreement shall be binding upon and inure to the benefit of the parties hereto and, in the case of the Escrow Agent and Participating Manufacturers, their respective successors. Each reference herein to the Escrow Agent or to a Participating Manufacturer shall be construed as a reference to its successor, where applicable.

SECTION 14. *Governing Law.*

This Escrow Agreement shall be construed in accordance with and governed by the laws of the State in which the Escrow Court is located, without regard to the conflicts of law rules of such state.

SECTION 15. *Jurisdiction and Venue.*

The parties hereto irrevocably and unconditionally submit to the continuing exclusive jurisdiction of the Escrow Court for purposes of any suit, action or proceeding seeking to interpret or enforce any provision of, or based on any right arising out of, this Escrow Agreement, and the parties hereto agree not to commence any such suit, action or proceeding except in the Escrow Court. The parties hereto hereby irrevocably and unconditionally waive any objection to the laying of venue of any such suit, action or proceeding in the Escrow Court and hereby further irrevocably waive and agree not to plead or claim in the Escrow Court that any such suit, action or proceeding has been brought in an inconvenient forum.

SECTION 16. *Amendments.*

This Escrow Agreement may be amended only by written instrument executed by all of the parties hereto that would be affected by the amendment. The waiver of any rights conferred hereunder shall be effective only if made in a written instrument executed by the waiving party. The waiver by any party of any breach of this Agreement shall not be deemed to be or construed as a waiver of any other breach, whether prior, subsequent or contemporaneous, of this Escrow Agreement, nor shall such waiver be deemed to be or construed as a waiver by any other party.

SECTION 17. *Counterparts.*

This Agreement may be signed in any number of counterparts, each of which shall be an original, with the same effect as if the signatures thereto and hereto were upon the same instrument. Delivery by facsimile of a signed counterpart shall be deemed delivery for purposes of acknowledging acceptance hereof; however, an original executed Escrow Agreement must promptly thereafter be delivered to each party.

SECTION 18. *Captions.*

The captions herein are included for convenience of reference only and shall be ignored in the construction and interpretation hereof.

SECTION 19. *Conditions to Effectiveness.*

This Escrow Agreement shall become effective when each party hereto shall have signed a counterpart hereof. The parties hereto agree to use their best efforts to seek an order of the Escrow Court approving, and retaining continuing jurisdiction over, the Escrow Agreement as soon as possible, and agree that such order shall relate back to, and be deemed effective as of, the date this Escrow Agreement became effective.

SECTION 20. *Address for Payments*.

Whenever funds are under the terms of this Escrow Agreement required to be disbursed to a Settling State, a Participating Manufacturer, NAAG or the Foundation, the Escrow Agent shall disburse such funds by wire transfer to the account specified by such payee by written notice delivered to all Notice Parties in accordance with Section 11 hereof at least five Business Days prior to the date of payment. Whenever funds are under the terms of this Escrow Agreement required to be disbursed to any other person or entity, the Escrow Agent shall disburse such funds to such account as shall have been specified in writing by the Independent Auditor for such payment at least five Business Days prior to the date of payment.

SECTION 21. *Reporting*.

The Escrow Agent shall provide such information and reporting with respect to the escrow as the Independent Auditor may from time to time request.

IN WITNESS WHEREOF, the parties have executed this Escrow Agreement as of the day and year first hereinabove written.

[Signature Blocks]

Appendix A

Schedule Of Fees And Expenses

EXHIBIT C
FORMULA FOR CALCULATING
INFLATION ADJUSTMENTS

(1) Any amount that, in any given year, is to be adjusted for inflation pursuant to this Exhibit (the "Base Amount") shall be adjusted upward by adding to such Base Amount the Inflation Adjustment.

(2) The Inflation Adjustment shall be calculated by multiplying the Base Amount by the Inflation Adjustment Percentage applicable in that year.

(3) The Inflation Adjustment Percentage applicable to payments due in the year 2000 shall be equal to the greater of 3% or the CPI%. For example, if the Consumer Price Index for December 1999 (as released in January 2000) is 2% higher than the Consumer Price Index for December 1998 (as released in January 1999), then the CPI% with respect to a payment due in 2000 would be 2%. The Inflation Adjustment Percentage applicable in the year 2000 would thus be 3%.

(4) The Inflation Adjustment Percentage applicable to payments due in any year after 2000 shall be calculated by applying each year the greater of 3% or the CPI% on the Inflation Adjustment Percentage applicable to payments due in the prior year. Continuing the example in subsection (3) above, if the CPI% with respect to a payment due in 2001 is 6%, then the Inflation Adjustment Percentage applicable in 2001 would be 9.1800000% (an additional 6% applied on the 3% Inflation Adjustment Percentage applicable in 2000), and if the CPI% with respect to a payment due in 2002 is 4%, then the Inflation Adjustment Percentage applicable in 2002 would be 13.5472000% (an additional 4% applied on the 9.1800000% Inflation Adjustment Percentage applicable in 2001).

(5) "Consumer Price Index" means the Consumer Price Index for All Urban Consumers as published by the Bureau of Labor Statistics of the U.S. Department of Labor (or other similar measures agreed to by the Settling States and the Participating Manufacturers).

(6) The "CPI%" means the actual total percent change in the Consumer Price Index during the calendar year immediately preceding the year in which the payment in question is due.

(7) Additional Examples.

(A) Calculating the Inflation Adjustment Percentages:

Payment Year	Hypothetical CPI%	Percentage to be applied on the Inflation Adjustment Percentage for the prior year (i.e., the greater of 3% or the CPI%)	Inflation Adjustment Percentage
2000	2.4%	3.0%	3.0000000%
2001	2.1%	3.0%	6.0900000%
2002	3.5%	3.5%	9.8031500%
2003	3.5%	3.5%	13.6462603%
2004	4.0%	4.0%	18.1921107%
2005	2.2%	3.0%	21.7378740%
2006	1.6%	3.0%	25.3900102%

(B) Applying the Inflation Adjustment:

Using the hypothetical Inflation Adjustment Percentages set forth in section (7)(A):

-- the subsection IX(c)(1) base payment amount for 2002 of $6,500,000,000 as adjusted for inflation would equal $7,137,204,750;

-- the subsection IX(c)(1) base payment amount for 2004 of $8,000,000,000 as adjusted for inflation would equal $9,455,368,856;

-- the subsection IX(c)(1) base payment amount for 2006 of $8,000,000,000 as adjusted for inflation would equal $10,031,200,816.

EXHIBIT D
LIST OF LAWSUITS

1. Alabama
Blaylock et al. v. American Tobacco Co. et al.,
Circuit Court, Montgomery County, No. CV-96-1508-PR

2. Alaska
State of Alaska v. Philip Morris, Inc., et al., Superior Court, First Judicial District of Juneau, No. IJU-97915 CI (Alaska)

3. Arizona
State of Arizona v. American Tobacco Co., Inc., et al., Superior Court, Maricopa County, No. CV-96-14769 (Ariz.)

4. Arkansas
State of Arkansas v. The American Tobacco Co., Inc., et al., Chancery Court, 6th Division, Pulaski County, No. IJ 97-2982 (Ark.)

5. California
People of the State of California et al. v. Philip Morris, Inc., et al., Superior Court, Sacramento County, No. 97-AS-30301

6. Colorado
State of Colorado et al., v. R.J. Reynolds Tobacco Co., et al., District Court, City and County of Denver, No. 97CV3432 (Colo.)

7. Connecticut
State of Connecticut v. Philip Morris, et al., Superior Court, Judicial District of Waterbury No. X02 CV96-0148414S (Conn.)

8. Georgia
State of Georgia et al. v. Philip Morris, Inc., et al., Superior Court, Fulton County, No. CA E-61692 (Ga.)

9. Hawaii
State of Hawaii v. Brown & Williamson Tobacco Corp., et al., Circuit Court, First Circuit, No. 97-0441-01 (Haw.)

10. Idaho
State of Idaho v. Philip Morris, Inc., et al., Fourth Judicial District, Ada County, No. CVOC 9703239D (Idaho)

11. Illinois
People of the State of Illinois v. Philip Morris et al., Circuit Court of Cook County, No. 96-L13146 (Ill.)

12. Indiana
State of Indiana v. Philip Morris, Inc., et al., Marion County Superior Court, No. 49D 07-9702-CT-000236 (Ind.)

13. Iowa
State of Iowa v. R.J. Reynolds Tobacco Company et al., Iowa District Court, Fifth Judicial District, Polk County, No. CL71048 (Iowa)

14. Kansas
State of Kansas v. R.J. Reynolds Tobacco Company, et al., District Court of Shawnee County, Division 2, No. 96-CV-919 (Kan.)

15. Louisiana
Ieyoub v. The American Tobacco Company, et al., 14th Judicial District Court, Calcasieu Parish, No. 96-1209 (La.)

16. Maine
State of Maine v. Philip Morris, Inc., et al., Superior Court, Kennebec County, No. CV 97-134 (Me.)

17. Maryland
Maryland v. Philip Morris Incorporated, et al., Baltimore City Circuit Court, No. 96-122017-CL211487 (Md.)

18. Massachusetts
Commonwealth of Massachusetts v. Philip Morris Inc., et al., Middlesex Superior Court, No. 95-7378 (Mass.)

19. Michigan
Kelley v. Philip Morris Incorporated, et al., Ingham County Circuit Court, 30th Judicial Circuit, No. 96-84281-CZ (Mich.)

20. Missouri
State of Missouri v. American Tobacco Co., Inc. et al., Circuit Court, City of St. Louis, No. 972-1465 (Mo.)

21. Montana
State of Montana v. Philip Morris, Inc., et al., First Judicial Court, Lewis and Clark County, No. CDV 9700306-14 (Mont.)

22. Nebraska
State of Nebraska v. R.J. Reynolds Tobacco Co., et al., District Court, Lancaster County, No. 573277 (Neb.)

23. Nevada
Nevada v. Philip Morris, Incorporated, et al., Second Judicial Court, Washoe County, No. CV97-03279 (Nev.)

24. New Hampshire
New Hampshire v. R.J. Reynolds, Tobacco Co., et al., New Hampshire Superior Court, Merrimack County, No. 97-E-165 (N.H.)

25. New Jersey
State of New Jersey v. R.J. Reynolds Tobacco Company, et al., Superior Court, Chancery Division, Middlesex County, No. C-254-96 (N.J.)

26. New Mexico
State of New Mexico, v. The American Tobacco Co., et al., First Judicial District Court, County of Santa Fe, No. SF-1235 c (N.M.)

27. New York State
State of New York et al. v. Philip Morris, Inc., et al., Supreme Court of the State of New York, County of New York, No. 400361/97 (N.Y.)

28. Ohio
State of Ohio v. Philip Morris, Inc., et al., Court of Common Pleas, Franklin County, No. 97CVH055114 (Ohio)

29. Oklahoma
State of Oklahoma, et al. v. R.J. Reynolds Tobacco Company, et al., District Court, Cleveland County, No. CJ-96-1499-L (Okla.)

30. Oregon
State of Oregon v. The American Tobacco Co., et al., Circuit Court, Multnomah County, No. 9706-04457 (Or.)

31. Pennsylvania
Commonwealth of Pennsylvania v. Philip Morris, Inc., et al., Court of Common Pleas, Philadelphia County, April Term 1997, No. 2443

32. Puerto Rico
Rossello, et al. v. Brown & Williamson Tobacco Corporation, et al., U.S. District Court, Puerto Rico, No. 97-1910JAF

33. Rhode Island
State of Rhode Island v. American Tobacco Co., et al., Rhode Island Superior Court, Providence, No. 97-3058 (R.I.)

34. South Carolina
State of South Carolina v. Brown & Williamson Tobacco Corporation, et al., Court of Common Pleas, Fifth Judicial Circuit, Richland County, No. 97-CP-40-1686 (S.C.)

35. South Dakota
State of South Dakota, et al. v. Philip Morris, Inc., et al., Circuit Court, Hughes County, Sixth Judicial Circuit, No. 98-65 (S.D.)

36. Utah
State of Utah v. R.J. Reynolds Tobacco Company, et al., U.S. District Court, Central Division, No. 96 CV 0829W (Utah)

37. Vermont
State of Vermont v. Philip Morris, Inc., et al., Chittenden Superior Court, Chittenden County, No. 744-97 (Vt.) and 5816-98 (Vt.)

38. Washington
State of Washington v. American Tobacco Co. Inc., et al., Superior Court of Washington, King County, No. 96-2-1505608SEA (Wash.)

39. West Virginia
McGraw, et al. v. The American Tobacco Company, et al., Kanawha County Circuit Court, No. 94-1707 (W. Va.)

40. Wisconsin
State of Wisconsin v. Philip Morris Inc., et al., Circuit Court, Branch 11, Dane County, No. 97-CV-328 (Wis.)

Additional States

For each Settling State not listed above, the lawsuit or other legal action filed by the Attorney General or Governor of such Settling State against *Participating* Manufacturers in the Court in such Settling State prior to 30 days after the MSA Execution Date asserting Released Claims.

EXHIBIT E
FORMULA FOR CALCULATING VOLUME ADJUSTMENTS

Any amount that by the terms of the Master Settlement Agreement is to be adjusted pursuant to this Exhibit E (the "Applicable Base Payment") shall be adjusted in the following manner:

(A) In the event the aggregate number of Cigarettes shipped in or to the fifty United States, the District of Columbia, and Puerto Rico by the Original Participating Manufacturers in the Applicable Year (as defined hereinbelow) (the "Actual Volume") is greater than 475,656,000,000 Cigarettes (the "Base Volume"), the Applicable Base Payment shall be multiplied by the ratio of the Actual Volume to the Base Volume.

(B) In the event the Actual Volume is less than the Base Volume,

i. The Applicable Base Payment shall be reduced by subtracting from it the amount equal to such Applicable Base Payment multiplied both by 0.98 and by the result of (i) 1(one) minus (ii) the ratio of the Actual Volume to the Base Volume.

ii. Solely for purposes of calculating volume adjustments to the payments required under subsection IX(c)(1), if a reduction of the Base Payment due under such subsection results from the application of subparagraph (B)(i) of this Exhibit E, but the Original Participating Manufacturers' aggregate operating income from sales of Cigarettes for the Applicable Year in the fifty United States, the District of Columbia, and Puerto Rico (the "Actual Operating Income") is greater than $7,195,340,000 (the "Base Operating Income") (such Base Operating Income being adjusted upward in accordance with the formula for inflation adjustments set forth in Exhibit C hereto beginning December 31, 1996 to be applied for each year after 1996) then the amount by which such Base Payment is reduced by the application of subsection (B)(i) shall be reduced (but not below zero) by the amount calculated by multiplying (i) a percentage equal to the aggregate Allocable Shares of the Settling States in which State-Specific Finality has occurred by (ii) 25% of such increase in such operating income. For purposes of this Exhibit E, "operating income from sales of Cigarettes" shall mean operating income from sales of Cigarettes in the fifty United States, the District of Columbia, and Puerto Rico: (a) before goodwill amortization, trademark amortization, restructuring charges and restructuring related charges, minority interest, net interest expense, non-operating income and expense, general corporate expenses and income taxes; and (b) excluding extraordinary items, cumulative effect of changes in method of accounting and discontinued operations -- all as such income is reported to the United States Securities and Exchange Commission ("SEC") for the Applicable Year (either independently by the Participating Manufacturer or as part of consolidated financial statements reported to the SEC by an Affiliate of such Participating Manufacturer) or, in the case of an Original Participating Manufacturer that does not report income to the SEC, as reported in financial statements prepared in accordance with U.S. generally accepted accounting principles and audited by a nationally recognized accounting firm. For years subsequent to 1998, the determination of the Original Participating Manufacturers' aggregate operating income from sales of Cigarettes shall not exclude any charges or expenses incurred or accrued in connection with this Agreement or any prior settlement of a tobacco and health case and shall otherwise be derived using the same principles as were employed in deriving such Original Participating Manufacturers' aggregate operating income from sales of Cigarettes in 1996.

iii. Any increase in a Base Payment pursuant to subsection (B)(ii) above shall be allocated among the Original Participating Manufacturers in the following manner:

(1) only to those Original Participating Manufacturers whose operating income from sales of Cigarettes in the fifty United States, the District of Columbia and Puerto Rico for the year for which the Base Payment is being adjusted is greater than their respective operating income from such sales of Cigarettes (including operating income from such sales of any of their Affiliates that do not continue to have such sales after the MSA Execution Date) in 1996 (as increased for inflation as provided in Exhibit C hereto beginning December 31, 1996 to be applied for each year after 1996); and

(2) among the Original Participating Manufacturers described in paragraph (1) above in proportion to the ratio of (x) the increase in the operating income from sales of Cigarettes (as described in paragraph (1)) of the Original Participating Manufacturer in question, to (y) the aggregate increase in the operating income from sales of Cigarettes (as described in paragraph (1)) of those Original Participating Manufacturers described in paragraph (1) above.

(C) "Applicable Year" means the calendar year immediately preceding the year in which the payment at issue is due, regardless of when such payment is made.

(D) For purposes of this Exhibit, shipments shall be measured as provided in subsection II(mm).

EXHIBIT F
POTENTIAL LEGISLATION NOT TO BE OPPOSED

1. Limitations on Youth access to vending machines.
2. Inclusion of cigars within the definition of tobacco products.
3. Enhancement of enforcement efforts to identify and prosecute violations of laws prohibiting retail sales to Youth.
4. Encouraging or supporting use of technology to increase effectiveness of age-of-purchase laws, such as, without limitation, the use of programmable scanners, scanners to read drivers' licenses, or use of other age/ID data banks.
5. Limitations on promotional programs for non-tobacco goods using tobacco products as prizes or give-aways.
6. Enforcement of access restrictions through penalties on Youth for possession or use.
7. Limitations on tobacco product advertising in or on school facilities, or wearing of tobacco logo merchandise in or on school property.
8. Limitations on non-tobacco products which are designed to look like tobacco products, such as bubble gum cigars, candy cigarettes, etc.

EXHIBIT G
OBLIGATIONS OF THE TOBACCO INSTITUTE
UNDER THE MASTER SETTLEMENT AGREEMENT

(a) Upon court approval of a plan of dissolution The Tobacco Institute ("TI") will:

(1) Employees. Promptly notify and arrange for the termination of the employment of all employees; provided, however, that TI may continue to engage any employee who is (A) essential to the wind-down function as set forth in section (g) herein; (B) reasonably needed for the sole purpose of directing and supporting TI's defense of ongoing litigation; or (C) reasonably needed for the sole purpose of performing the Tobacco Institute Testing Laboratory's (the "TITL") industry-wide cigarette testing pursuant to the Federal Trade Commission (the "FTC") method or any other testing prescribed by state or federal law as set forth in section (h) herein.

(2) Employee Benefits. Fund all employee benefit and pension programs; provided, however, that unless ERISA or other federal or state law prohibits it, such funding will be accomplished through periodic contributions by the Original Participating Manufacturers, according to their Relative Market Shares, into a trust or a like mechanism, which trust or like mechanism will be established within 90 days of court approval of the plan of dissolution. An opinion letter will be appended to the dissolution plan to certify that the trust plan is not inconsistent with ERISA or employee benefit pension contracts.

(3) Leases. Terminate all leaseholds at the earliest possible date pursuant to the leases; provided, however, that TI may retain or lease anew such space (or lease other space) as needed for its wind-down activities, for TITL testing as described herein, and for subsequent litigation defense activities. Immediately upon execution of this Agreement, TI will provide notice to each of its landlords of its desire to terminate its lease with such landlord, and will request that the landlord take all steps to re-lease the premises at the earliest possible date consistent with TI's performance of its obligations hereunder. TI will vacate such leasehold premises as soon as they are re-leased or on the last day of wind-down, whichever occurs first.

(b) Assets/Debts. Within 60 days after court approval of a plan of dissolution, TI will provide to the Attorney General of New York and append to the dissolution plan a description of all of its assets, its debts, tax claims against it, claims of state and federal governments against it, creditor claims against it, pending litigation in which it is a party and notices of claims against it.

(c) Documents. Subject to the privacy protections provided by New York Public Officers Law §§ 91-99, TI will provide a copy of or otherwise make available to the State of New York all documents in its possession, excluding those that TI continues to claim to be subject to any attorney-client privilege, attorney work product protection, common interest/joint defense privilege or any other applicable privilege (collectively, "privilege") after the re-examination of privilege claims pursuant to court order in State of Oklahoma v. R.J. Reynolds Tobacco Company, et al., CJ-96-2499-L (Dist. Ct., Cleveland County) (the "Oklahoma action"):

(1) TI will deliver to the Attorney General of the State of New York a copy of the privilege log served by it in the Oklahoma action. Upon a written request by the Attorney General, TI will deliver an updated version of its privilege log, if any such updated version exists.

(2) The disclosure of any document or documents claimed to be privileged will be governed by section IV of this Agreement.

(3) At the conclusion of the document production and privilege logging process, TI will provide a sworn affidavit that all documents in its possession have been made available to the Attorney General of New York except for documents claimed to be privileged, and that any privilege logs that already exist have been made available to the Attorney General.

(d) Remaining Assets. On mutual agreement between TI and the Attorney General of New York, a not-for-profit health or child welfare organization will be named as the beneficiary of any TI assets that remain after lawful transfers of assets and satisfaction of TI's employee benefit obligations and any other debts, liabilities or claims.

(e) Defense of Litigation. Pursuant to Section 1006 of the New York Not-for-Profit Corporations Law, TI will have the right to continue to defend its litigation interests with respect to any claims against it that are pending or threatened now or that are brought or threatened in the future. TI will retain sole discretion over all litigation decisions, including, without limitation, decisions with respect to asserting any privileges or defenses, having privileged communications and creating privileged documents, filing pleadings, responding to discovery requests, making motions, filing affidavits and briefs, conducting party and non-party discovery, retaining expert witnesses and consultants, preparing for and defending itself at trial, settling any claims asserted against it, intervening or otherwise participating in litigation to protect interests that it deems significant to its defense, and otherwise directing or conducting its defense. Pursuant to existing joint defense agreements, TI may continue to assist its current or former members in defense of any litigation brought or threatened against them. TI also may enter into any new joint defense agreement or agreements that it deems significant to its defense of pending or threatened claims. TI may continue to engage such employees as reasonably needed for the sole purpose of directing and supporting its defense of ongoing litigation. As soon as TI has no litigation pending against it, it will dissolve completely and will cease all functions consistent with the requirements of law.

(f) No public statement. Except as necessary in the course of litigation defense as set forth in section (e) above, upon court approval of a plan of dissolution, neither TI nor any of its employees or agents acting in their official capacity on behalf of TI will issue any statements, press releases, or other public statement concerning tobacco.

(g) Wind-down. After court approval of a plan of dissolution, TI will effectuate wind-down of all activities (other than its defense of litigation as described in section (e) above) expeditiously, and in no event later than 180 days after the date of court approval of the plan of dissolution. TI will provide monthly status reports to the Attorney General of New York regarding the progress of wind-down efforts and work remaining to be done with respect to such efforts.

(h) TITL. Notwithstanding any other provision of this Exhibit G or the dissolution plan, TI may perform TITL industry-wide cigarette testing pursuant to the FTC method or any other testing prescribed by state or federal law until such function is transferred to another entity, which transfer will be accomplished as soon as practicable but in no event more than 180 days after court approval of the dissolution plan.

(i) Jurisdiction. After the filing of a Certificate of Dissolution, pursuant to Section 1004 of the New York Not-for-Profit Corporation Law, the Supreme Court for the State of New York will have continuing jurisdiction over the dissolution of TI and the winding-down of TI's activities, including any litigation-related activities described in subsection (e) herein.

(j) No Determination or Admission. The dissolution of TI and any proceedings taken hereunder are not intended to be and shall not in any event be construed as, deemed to be, or represented or caused to be represented by any Settling State as, an admission or concession or evidence of any liability or any wrongdoing whatsoever on the part of TI, any of its current or former members or anyone acting on their behalf. TI specifically disclaims and denies any liability or wrongdoing whatsoever with respect to the claims and allegations asserted against it by the Attorneys General of the Settling States.

(k) Court Approval. The Attorney General of the State of New York and the Original Participating Manufacturers will prepare a joint plan of dissolution for submission to the Supreme Court of the State of New York, all of the terms of which will be agreed on and consented to by the Attorney General and the Original Participating Manufacturers consistent with this schedule. The Original Participating Manufacturers and their employees, as officers and directors of TI, will take whatever steps are necessary to execute all documents needed to develop such a plan of dissolution and to submit it to the court for approval. If any court makes any material change to any term or provision of the plan of dissolution agreed upon and consented to by the Attorney General and the Original Participating Manufacturers, then:

(1) the Original Participating Manufacturers may, at their election, nevertheless proceed with the dissolution plan as modified by the court; or

(2) if the Original Participating Manufacturers elect not to proceed with the court-modified dissolution plan, the Original Participating Manufacturers will be released from any obligations or undertakings under this Agreement or this schedule with respect to TI; provided, however, that the Original Participating Manufacturers will engage in good faith negotiations with the New York Attorney General to agree upon the term or terms of the dissolution plan that the court may have modified in an effort to agree upon a dissolution plan that may be resubmitted for the court's consideration.

EXHIBIT H
DOCUMENT PRODUCTION

Section 1.

(a) Philip Morris Companies, Inc., et al., v. American Broadcasting Companies, Inc., et al., At Law No. 760CL94X00816-00 (Cir. Ct., City of Richmond)

(b) Harley-Davidson v. Lorillard Tobacco Co., No. 93-947 (S.D.N.Y.)

(c) Lorillard Tobacco Co. v. Harley-Davidson, No. 93-6098 (E.D. Wis.)

(d) Brown & Williamson v. Jacobson and CBS, Inc., No. 82-648 (N.D. Ill.)

(e) The FTC investigations of tobacco industry advertising and promotion as embodied in the following cites:

46 FTC 706
48 FTC 82
46 FTC 735
47 FTC 1393
108 F. Supp. 573
55 FTC 354
56 FTC 96
79 FTC 255
80 FTC 455
Investigation #8023069
Investigation #8323222

Each Original Participating Manufacturer and Tobacco-Related Organization will conduct its own reasonable inquiry to determine what documents or deposition testimony, if any, it produced or provided in the above-listed matters.

Section 2.

(a) State of Washington v. American Tobacco Co., et al., No. 96-2-15056-8 SEA (Wash. Super. Ct., County of King)

(b) In re Mike Moore, Attorney General, ex rel, State of Mississippi Tobacco Litigation, No. 94-1429 (Chancery Ct., Jackson, Miss.)

(c) State of Florida v. American Tobacco Co., et al., No. CL 95-1466 AH (Fla. Cir. Ct., 15th Judicial Cir., Palm Beach Co.)

(d) State of Texas v. American Tobacco Co., et al., No. 5-96CV-91 (E.D. Tex.)

(e) Minnesota v. Philip Morris et al., No. C-94-8565 (Minn. Dist. Ct., County of Ramsey)

(f) Broin v. R.J. Reynolds, No. 91-49738 CA (22) (11th Judicial Ct., Dade County, Florida)

EXHIBIT I
INDEX AND SEARCH FEATURES FOR DOCUMENT WEBSITE

(a) Each Original Participating Manufacturer and Tobacco-Related Organization will create and maintain on its website, at its expense, an enhanced, searchable index, as described below, using Alta-Vista or functionally comparable software, for all of the documents currently on its website and all documents being placed on its website pursuant to section IV of this Agreement.

(b) The searchable indices of documents on these websites will include:

(1) all of the information contained in the 4(b) indices produced to the State Attorneys General (excluding fields specific only to the Minnesota action other than "request number");

(2) the following additional fields of information (or their substantial equivalent) to the extent such information already exists in an electronic format that can be incorporated into such an index:

Document ID	Master ID
Other Number	Document Date
Primary Type	Other Type
Person Attending	Person Noted
Person Author	Person Recipient
Person Copied	Person Mentioned
Organization Author	Organization Recipient
Organization Copied	Organization Mentioned
Organization Attending	Organization Noted
Physical Attachment 1	Physical Attachment 2
Characteristics	File Name
Site	Area
Verbatim Title	Old Brand
Primary Brand	Mentioned Brand
Page Count	

(c) Each Original Participating Manufacturer and Tobacco-Related Organization will add, if not already available, a user-friendly document retrieval feature on the Website consisting of a "view all pages" function with enhanced image viewer capability that will enable users to choose to view and/or print either "all pages" for a specific document or "page-by-page".

(d) Each Original Participating Manufacturer and Tobacco-Related Organizations will provide at its own expense to NAAG a copy set in electronic form of its website document images and its accompanying subsection IV(h) index in ASCII-delimited form for all of the documents currently on its website and all of the documents described in subsection IV(d) of this Agreement. The Original Participating Manufacturers and Tobacco-Related Organizations will not object to any subsequent distribution and/or reproduction of these copy sets.

EXHIBIT J
TOBACCO ENFORCEMENT FUND PROTOCOL

The States' Antitrust/Consumer Protection Tobacco Enforcement Fund ("Fund") is established by the Attorneys General of the Settling States, acting through NAAG, pursuant to section VIII(c) of the Agreement. The following shall be the primary and mandatory protocol for the administration of the Fund.

Section A
Fund Purpose

Section 1

The monies to be paid pursuant to section VIII(c) of the Agreement shall be placed by NAAG in a new and separate interest bearing account, denominated the States' Antitrust/ Consumer Protection Tobacco Enforcement Fund, which shall not then or thereafter be commingled with any other funds or accounts. However, nothing herein shall prevent deposits into the account so long as monies so deposited are then lawfully committed for the purpose of the Fund as set forth herein.

Section 2

A committee of three Attorneys General ("Special Committee") shall be established to determine disbursements from the account, using the process described herein. The three shall be the Attorney General of the State of Washington, the Chair of NAAG's antitrust committee, and the Chair of NAAG's consumer protection committee. In the event that an Attorney General shall hold either two or three of the above stated positions, that Attorney General may serve only in a single capacity, and shall be replaced in the remaining positions by first, the President of NAAG, next by the President-Elect of NAAG and if necessary the Vice-President of NAAG.

Section 3

The purpose of the Fund is: (1) to enforce and implement the terms of the Agreement, in particular, by partial payment of the monetary costs of the Independent Auditor as contemplated by the Agreement; and (2) to provide monetary assistance to the various states' attorneys general: (A) to investigate and/or litigate suspected violations of the Agreement and/or Consent Decree; (B) to investigate and/or litigate suspected violations of state and/or federal antitrust or consumer protection laws with respect to the manufacture, use, marketing and sales of tobacco products; and (C) to enforce the Qualifying Statute ("Qualifying Actions"). The Special Committee shall entertain requests only from Settling States for disbursement from the fund associated with a Qualifying Action ("Grant Application").

Section B
Administration Standards Relative to Grant Applications

Section 1

The Special Committee shall not entertain any Grant Application to pay salaries or ordinary expenses of regular employees of any Attorney General's office.

Section 2

The affirmative vote of two or more of the members of the Special Committee shall be required to approve any Grant Application.

Section 3

The decision of the Special Committee shall be final and non-appealable.

Section 4

The Attorney General of the State of Washington shall be chair of the Special Committee and shall annually report to the Attorneys General on the requests for funds from the Fund and the actions of the Special Committee upon the requests.

Section 5

When a Grant Application to the Fund is made by an Attorney General who is then a member of the Special Committee, such member will be temporarily replaced on the Committee, but only for the determination of such Grant Application. The remaining members of the Special Committee shall designate an Attorney General to replace the Attorney General so disqualified, in order to consider the application.

Section 6

The Fund shall be maintained in a federally insured depository institution located in Washington, D.C. Funds may be invested in federal government-backed vehicles. The Fund shall be regularly reported on NAAG financial statements and subject to annual audit.

Section 7

Withdrawals from and checks drawn on the Fund will require at least two of three authorized signatures. The three persons so authorized shall be the executive director, the deputy director, and controller of NAAG.

Section 8

The Special Committee shall meet in person or telephonically as necessary to determine whether a grant is sought for assistance with a Qualifying Action and whether and to what extent the Grant Application is accepted. The chair of the

Special Committee shall designate the times for such meetings, so that a response is made to the Grant Application as expeditiously as practicable.

Section 9

The Special Committee may issue a grant from the Fund only when an Attorney General certifies that the monies will be used in connection with a Qualifying Action, to wit: (A) to investigate and/or litigate suspected violations of the Agreement and/or Consent Decree; (B) to investigate and/or litigate suspected violations of state and/or federal antitrust or consumer protection laws with respect to the manufacture, use, marketing and sales of tobacco products; and (C) to enforce the Qualifying Statute. The Attorney General submitting such application shall further certify that the entire grant of monies from the Fund will be used to pay for such investigation and/or litigation. The Grant Application shall describe the nature and scope of the intended action and use of the funds which may be granted.

Section 10

To the extent permitted by law, each Attorney General whose Grant Application is favorably acted upon shall promise to pay back to the Fund all of the amounts received from the Fund in the event the state is successful in litigation or settlement of a Qualifying Action. In the event that the monetary recovery, if any, obtained is not sufficient to pay back the entire amount of the grant, the Attorney General shall pay back as much as is permitted by the recovery. In all instances where monies are granted, the Attorney General(s) receiving monies shall provide an accounting to NAAG of all disbursements received from the Fund no later than the 30th of June next following such disbursement.

Section 11

In addition to the repayments to the Fund contemplated in the preceding section, the Special Committee may deposit in the Fund any other monies lawfully committed for the precise purpose of the Fund as set forth in section A(3) above. For example, the Special Committee may at its discretion accept for deposit in the Fund a foundation grant or court-ordered award for state antitrust and/or consumer protection enforcement as long as the monies so deposited become part of and subject to the same rules, purposes and limitations of the Fund.

Section 12

The Special Committee shall be the sole and final arbiter of all Grant Applications and of the amount awarded for each such application, if any.

Section 13

The Special Committee shall endeavor to maintain the Fund for as long a term as is consistent with the purpose of the Fund. The Special Committee will limit the total amount of grants made to a single state to no more than $500,000.00. The Special Committee will not award a single grant in excess of $200,000.00, unless the grant involves more than one state, in which case, a single grant so made may not total more than $300,000.00. The Special Committee may, in its discretion and by unanimous vote, decide to waive these limitations if it determines that special circumstances exist. Such decision, however, shall not be effective unless ratified by a two-thirds majority vote of the NAAG executive committee.

Section C
Grant Application Procedures

Section 1

This Protocol shall be transmitted to the Attorneys General within 90 days after the MSA Execution Date. It may not be amended unless by recommendation of the NAAG executive committee and majority vote of the Settling States. NAAG will notify the Settling States of any amendments promptly and will transmit yearly to the attorneys general a statement of the Fund balance and a summary of deposits to and withdrawals from the Fund in the previous calendar or fiscal year.

Section 2

Grant Applications must be in writing and must be signed by the Attorney General submitting the application.

Section 3

Grant Applications must include the following:

(A) A description of the contemplated/pending action, including the scope of the alleged violation and the area (state/regional/multi-state) likely to be affected by the suspected offending conduct.

(B) A statement whether the action is actively and currently pursued by any other Attorney General or other prosecuting authority.

(C) A description of the purposes for which the monies sought will be used.

(D) The amount requested.

(E) A directive as to how disbursements from the Fund should be made, e.g., either directly to a supplier of services (consultants, experts, witnesses, and the like), to the Attorney General's office directly, or in the case of multi-state action, to one or more Attorneys General's offices designated as a recipient of the monies.

(F) A statement that the applicant Attorney(s) General will, to the extent permitted by law, pay back to the Fund all, or as much as is possible, of the monies received, upon receipt of any monetary recovery obtained in the contemplated/pending litigation or settlement of the action.

(G) A certification that no part of the grant monies will be used to pay the salaries or ordinary expenses of any regular employee of the office of the applicant(s) and that the grant will be used solely to pay for the stated purpose.

(H) A certification that an accounting will be provided to NAAG of all monies received by the applicant(s) by no later than the 30th of June next following any receipt of such monies.

Section 4

All Grant Applications shall be submitted to the NAAG office at the following address: National Association of Attorneys General, 750 1st Street, NE, Suite 1100, Washington D.C. 20002.

Section 5

The Special Committee will endeavor to act upon all complete and properly submitted Grant Applications within 30 days of receipt of said applications.

Section D
Other Disbursements from the Fund

Section 1

To enforce and implement the terms of the Agreement, the Special Committee shall direct disbursements from the Fund to comply with the partial payment obligations set forth in section XI of the Agreement relative to costs of the Independent Auditor. A report of such disbursements shall be included in the accounting given pursuant to section C(1) above.

Section E
Administrative Costs

Section 1

NAAG shall receive from the Fund on July 1, 1999 and on July 1 of each year thereafter an administrative fee of $100,000 for its administrative costs in performing its duties under the Protocol and this Agreement. The NAAG executive committee may adjust the amount of the administrative fee in extraordinary circumstances.

EXHIBIT K
MARKET CAPITALIZATION PERCENTAGES

Philip Morris Incorporated	68.0000000%
Brown & Williamson Tobacco Corporation	17.9000000%
Lorillard Tobacco Company	7.3000000%
R.J. Reynolds Tobacco Company	6.8000000%
Total	100.0000000%

EXHIBIT L
MODEL CONSENT DECREE

IN THE [XXXXXX] COURT OF THE STATE OF [XXXXXX]
IN AND FOR THE COUNTY OF [XXXXX]

- x

CAUSE NO. XXXXXX

STATE OF [XXXXXXXXXXX],
Plaintiff,
v.
[XXXXXX XXXXX XXXX], et al.,
Defendants.

- x

CONSENT DECREE AND FINAL JUDGMENT

WHEREAS, Plaintiff, the State of [name of Settling State], commenced this action on [date], [by and through its Attorney General [name]], pursuant to [her/his/its] common law powers and the provisions of [state and/or federal law];

WHEREAS, the State of [name of Settling State] asserted various claims for monetary, equitable and injunctive relief on behalf of the State of [name of Settling State] against certain tobacco product manufacturers and other defendants;

WHEREAS, Defendants have contested the claims in the State's complaint [and amended complaints, if any] and denied the State's allegations [and asserted affirmative defenses];

WHEREAS, the parties desire to resolve this action in a manner which appropriately addresses the State's public health concerns, while conserving the parties' resources, as well as those of the Court, which would otherwise be expended in litigating a matter of this magnitude; and

WHEREAS, the Court has made no determination of any violation of law, this Consent Decree and Final Judgment being entered prior to the taking of any testimony and without trial or final adjudication of any issue of fact or law;

NOW, THEREFORE, IT IS HEREBY ORDERED, ADJUDGED AND DECREED, AS FOLLOWS:

I. JURISDICTION AND VENUE

This Court has jurisdiction over the subject matter of this action and over each of the Participating Manufacturers. Venue is proper in this [county/district].

II. DEFINITIONS

The definitions set forth in the Agreement (a copy of which is attached hereto) are incorporated herein by reference.

III. APPLICABILITY

A. This Consent Decree and Final Judgment applies only to the Participating Manufacturers in their corporate capacity acting through their respective successors and assigns, directors, officers, employees, agents, subsidiaries, divisions, or other internal organizational units of any kind or any other entities acting in concert or participation with them. The remedies, penalties and sanctions that may be imposed or assessed in connection with a violation of this Consent Decree and Final Judgment (or any order issued in connection herewith) shall only apply to the Participating Manufacturers, and shall not be imposed or assessed against any employee, officer or director of any Participating Manufacturer, or against any other person or entity as a consequence of such violation, and there shall be no jurisdiction under this Consent Decree and Final Judgment to do so.

B. This Consent Decree and Final Judgment is not intended to and does not vest standing in any third party with respect to the terms hereof. No portion of this Consent Decree and Final Judgment shall provide any rights to, or be enforceable by, any person or entity other than the State of [name of Settling State] or a Released Party. The State of [name of Settling State] may not assign or otherwise convey any right to enforce any provision of this Consent Decree and Final Judgment.

IV. VOLUNTARY ACT OF THE PARTIES

The parties hereto expressly acknowledge and agree that this Consent Decree and Final Judgment is voluntarily entered into as the result of arm's-length negotiation, and all parties hereto were represented by counsel in deciding to enter into this Consent Decree and Final Judgment.

V. INJUNCTIVE AND OTHER EQUITABLE RELIEF

Each Participating Manufacturer is permanently enjoined from:

A. Taking any action, directly or indirectly, to target Youth within the State of [name of Settling State] in the advertising, promotion or marketing of Tobacco Products, or taking any action the primary purpose of which is to initiate, maintain or increase the incidence of Youth smoking within the State of [name of Settling State].

B. After 180 days after the MSA Execution Date, using or causing to be used within the State of [name of Settling State] any Cartoon in the advertising, promoting, packaging or labeling of Tobacco Products.

C. After 30 days after the MSA Execution Date, making or causing to be made any payment or other consideration to any other person or entity to use, display, make reference to or use as a prop within the State of [name of Settling State] any Tobacco Product, Tobacco Product package, advertisement for a Tobacco Product, or any other item bearing a Brand Name in any Media; provided, however, that the foregoing prohibition shall not apply to (1) Media where the audience or viewers are within an Adult-Only Facility (provided such Media are not visible to persons outside such Adult-Only Facility); (2) Media not intended for distribution or display to the public; (3) instructional Media concerning non-conventional cigarettes viewed only by or provided only to smokers who are Adults; and (4) actions taken by any Participating Manufacturer in connection with a Brand Name Sponsorship permitted pursuant to subsections III(c)(2)(A) and III(c)(2)(B)(i) of the Agreement, and use of a Brand Name to identify a Brand Name Sponsorship permitted by subsection III(c)(2)(B)(ii).

D. Beginning July 1, 1999, marketing, distributing, offering, selling, licensing or causing to be marketed, distributed, offered, sold, or licensed (including, without limitation, by catalogue or direct mail), within the State of [name of Settling State], any apparel or other merchandise (other than Tobacco Products, items the sole function of which is to advertise Tobacco Products, or written or electronic publications) which bears a Brand Name. Provided, however, that nothing in this section shall (1) require any Participating Manufacturer to breach or terminate any licensing agreement or other contract in existence as of June 20, 1997 (this exception shall not apply beyond the current term of any existing contract, without regard to any renewal or option term that may be exercised by such Participating Manufacturer); (2) prohibit the distribution to any Participating Manufacturer’s employee who is not Underage of any item described above that is intended for the personal use of such an employee; (3) require any Participating Manufacturer to retrieve, collect or otherwise recover any item that prior to the MSA Execution Date was marketed, distributed, offered, sold, licensed or caused to be marketed, distributed, offered, sold or licensed by such Participating Manufacturer; (4) apply to coupons or other items used by Adults solely in connection with the purchase of Tobacco Products; (5) apply to apparel or other merchandise used within an Adult-Only Facility that is not distributed (by sale or otherwise) to any member of the general public; or (6) apply to apparel or other merchandise (a) marketed, distributed, offered, sold, or licensed at the site of a Brand Name Sponsorship permitted pursuant to subsection III(c)(2)(A) or III(c)(2)(B)(i) of the Agreement by the person to which the relevant Participating Manufacturer has provided payment in exchange for the use of the relevant Brand Name in the Brand Name Sponsorship or a third-party that does not receive payment from the relevant Participating Manufacturer (or any Affiliate of such Participating Manufacturer) in connection with the marketing, distribution, offer, sale or license of such apparel or other merchandise, or (b) used at the site of a Brand Name Sponsorship permitted pursuant to subsections III(c)(2)(A) or III(c)(2)(B)(i) of the Agreement (during such event) that are not distributed (by sale or otherwise) to any member of the general public.

E. After the MSA Execution Date, distributing or causing to be distributed within the State of [name of Settling State] any free samples of Tobacco Products except in an Adult-Only Facility. For purposes of this Consent Decree and Final Judgment, a “free sample” does not include a Tobacco Product that is provided to an Adult in connection with (1) the purchase, exchange or redemption for proof of purchase of any Tobacco Products (including, but not limited to, a free offer in connection with the purchase of Tobacco Products, such as a “two-for-one” offer), or (2) the conducting of consumer testing or evaluation of Tobacco Products with persons who certify that they are Adults.

F. Using or causing to be used as a brand name of any Tobacco Product pursuant to any agreement requiring the payment of money or other valuable consideration, any nationally recognized or nationally established brand name or trade name of any non-tobacco item or service or any nationally recognized or nationally established sports team, entertainment group or individual celebrity. Provided, however, that the preceding sentence shall not apply to any Tobacco Product brand name in existence as of July 1, 1998. For the purposes of this provision, the term “other valuable consideration” shall not include an agreement between two entities who enter into such agreement for the sole purpose of avoiding infringement claims.

G. After 60 days after the MSA Execution Date and through and including December 31, 2001, manufacturing or causing to be manufactured for sale within the State of [name of Settling State] any pack or other container of Cigarettes containing fewer than 20 Cigarettes (or, in the case of roll-your-own tobacco, any package of roll-your-own tobacco containing less than 0.60 ounces of tobacco); and, after 150 days after the MSA Execution Date and through and including December 31, 2001, selling or distributing within the State of [name of Settling State] any pack or other container of Cigarettes containing fewer than 20 Cigarettes (or, in the case of roll-your-own tobacco, any package of roll-your-own tobacco containing less than 0.60 ounces of tobacco).

H. Entering into any contract, combination or conspiracy with any other Tobacco Product Manufacturer that has the purpose or effect of: (1) limiting competition in the production or distribution of information about health hazards or other consequences of the use of their products; (2) limiting or suppressing research into smoking and health; or (3) limiting or suppressing research into the marketing or development of new products. Provided, however, that nothing in the preceding sentence shall be deemed to (1) require any Participating Manufacturer to produce, distribute or otherwise disclose any information that is subject to any privilege or protection; (2) preclude any Participating Manufacturer from entering into any joint defense or joint legal interest agreement or arrangement (whether or not in writing), or from asserting any privilege pursuant thereto; or (3) impose any affirmative obligation on any Participating Manufacturer to conduct any research.

I. Making any material misrepresentation of fact regarding the health consequences of using any Tobacco Product, including any tobacco additives, filters, paper or other ingredients. Provided, however, that nothing in the preceding sentence shall limit the exercise of any First Amendment right or the assertion of any defense or position in any judicial, legislative or regulatory forum.

VI. MISCELLANEOUS PROVISIONS

A. Jurisdiction of this case is retained by the Court for the purposes of implementing and enforcing the Agreement and this Consent Decree and Final Judgment and enabling the continuing proceedings contemplated herein. Whenever possible, the State of [name of Settling State] and the Participating Manufacturers shall seek to resolve any issue that may exist as to compliance with this Consent Decree and Final Judgment by discussion among the appropriate designees named pursuant to subsection XVIII(m) of the Agreement. The State of [name of Settling State] and/or any Participating Manufacturer may apply to the Court at any time for further orders and directions as may be necessary or appropriate for the implementation and enforcement of this Consent Decree and Final Judgment. Provided, however, that with regard to subsections V(A) and V(I) of this Consent Decree and Final Judgment, the Attorney General shall issue a cease and desist demand to the Participating Manufacturer that the Attorney General believes is in violation of either of such sections at least ten Business Days before the Attorney General applies to the Court for an order to enforce such subsections, unless the Attorney General reasonably determines that either a compelling time-sensitive public health and safety concern requires more immediate action or the Court has previously issued an Enforcement Order to the Participating Manufacturer in question for the same or a substantially similar action or activity. For any claimed violation of this Consent Decree and Final Judgment, in determining whether to seek an order for monetary, civil contempt or criminal sanctions for any claimed violation, the Attorney General shall give good-faith consideration to whether: (1) the Participating Manufacturer that is claimed to have committed the violation has taken appropriate and reasonable steps to cause the claimed violation to be cured, unless that party has been guilty of a pattern of violations of like nature; and (2) a legitimate, good-faith dispute exists as to the meaning of the terms in question of this Consent Decree and Final Judgment. The Court in any case in its discretion may determine not to enter an order for monetary, civil contempt or criminal sanctions.

B. This Consent Decree and Final Judgment is not intended to be, and shall not in any event be construed as, or deemed to be, an admission or concession or evidence of (1) any liability or any wrongdoing whatsoever on the part of any Released Party or that any Released Party has engaged in any of the activities barred by this Consent Decree and Final Judgment; or (2) personal jurisdiction over any person or entity other than the Participating Manufacturers. Each Participating Manufacturer specifically disclaims and denies any liability or wrongdoing whatsoever with respect to the claims and allegations asserted against it in this action, and has stipulated to the entry of this Consent Decree and Final Judgment solely to avoid the further expense, inconvenience, burden and risk of litigation.

C. Except as expressly provided otherwise in the Agreement, this Consent Decree and Final Judgment shall not be modified (by this Court, by any other court or by any other means) unless the party seeking modification demonstrates, by clear and convincing evidence, that it will suffer irreparable harm from new and unforeseen conditions. Provided, however, that the provisions of sections III, V, VI and VII of this Consent Decree and Final Judgment shall in no event be subject to modification without the consent of the State of [name of Settling State] and all affected Participating Manufacturers. In the event that any of the sections of this Consent Decree and Final Judgment enumerated in the preceding sentence are modified by this Court, by any other court or by any other means without the consent of the State of [name of Settling State] and all affected Participating Manufacturers, then this Consent Decree and Final Judgment shall be void and of no further effect. Changes in the economic conditions of the parties shall not be grounds for modification. It is intended that the Participating Manufacturers will comply with this Consent Decree and Final Judgment as originally entered, even if the Participating Manufacturers’ obligations hereunder are greater than those imposed under current or future law (unless compliance with this Consent Decree and Final Judgment would violate such law). A change in law that results, directly or indirectly, in more favorable or beneficial treatment of any one or more of the Participating Manufacturers shall not support modification of this Consent Decree and Final Judgment.

D. In any proceeding which results in a finding that a Participating Manufacturer violated this Consent Decree and Final Judgment, the Participating Manufacturer or Participating Manufacturers found to be in violation shall pay the State’s costs and attorneys’ fees incurred by the State of [name of Settling State] in such proceeding.

E. The remedies in this Consent Decree and Final Judgment are cumulative and in addition to any other remedies the State of [name of Settling State] may have at law or equity, including but not limited to its rights under the Agreement. Nothing herein shall be construed to prevent the State from bringing an action with respect to conduct not released pursuant to the Agreement, even though that conduct may also violate this Consent Decree and Final Judgment. Nothing in this Consent Decree and Final Judgment is intended to create any right for [name of Settling State] to obtain any Cigarette product formula that it would not otherwise have under applicable law.

F. No party shall be considered the drafter of this Consent Decree and Final Judgment for the purpose of any statute, case law or rule of interpretation or construction that would or might cause any provision to be construed against the drafter. Nothing in this Consent Decree and Final Judgment shall be construed as approval by the State of [name of Settling State] of the Participating Manufacturers' business organizations, operations, acts or practices, and the Participating Manufacturers shall make no representation to the contrary.

G. The settlement negotiations resulting in this Consent Decree and Final Judgment have been undertaken in good faith and for settlement purposes only, and no evidence of negotiations or discussions underlying this Consent Decree and Final Judgment shall be offered or received in evidence in any action or proceeding for any purpose. Neither this Consent Decree and Final Judgment nor any public discussions, public statements or public comments with respect to this Consent Decree and Final Judgment by the State of [name of Settling State] or any Participating Manufacturer or its agents shall be offered or received in evidence in any action or proceeding for any purpose other than in an action or proceeding arising under or relating to this Consent Decree and Final Judgment.

H. All obligations of the Participating Manufacturers pursuant to this Consent Decree and Final Judgment (including, but not limited to, all payment obligations) are, and shall remain, several and not joint.

I. The provisions of this Consent Decree and Final Judgment are applicable only to actions taken (or omitted to be taken) within the States. Provided, however, that the preceding sentence shall not be construed as extending the territorial scope of any provision of this Consent Decree and Final Judgment whose scope is otherwise limited by the terms thereof.

J. Nothing in subsection V(A) or V(I) of this Consent Decree shall create a right to challenge the continuation, after the MSA Execution Date, of any advertising content, claim or slogan (other than use of a Cartoon) that was not unlawful prior to the MSA Execution Date.

K. If the Agreement terminates in this State for any reason, then this Consent Decree and Final Judgment shall be void and of no further effect.

VII. FINAL DISPOSITION

A. The Agreement, the settlement set forth therein, and the establishment of the escrow provided for therein are hereby approved in all respects, and all claims are hereby dismissed with prejudice as provided therein.

B. The Court finds that the person[s] signing the Agreement have full and complete authority to enter into the binding and fully effective settlement of this action as set forth in the Agreement. The Court further finds that entering into this settlement is in the best interests of the State of [name of Settling State].

LET JUDGMENT BE ENTERED ACCORDINGLY

DATED this _____ day of ______________, 1998.

EXHIBIT M
LIST OF PARTICIPATING MANUFACTURERS' LAWSUITS AGAINST THE SETTLING STATES

1. Philip Morris, Inc., et al. v. Margery Bronster, Attorney General of the State of Hawaii, In Her Official Capacity, Civ. No. 96-00722HG, United States District Court for the District of Hawaii

2. Philip Morris, Inc., et al. v. Bruce Botelho, Attorney General of the State of Alaska, In His Official Capacity, Civ. No. A97-0003CV, United States District Court for the District of Alaska

3. Philip Morris, Inc., et al. v. Scott Harshbarger, Attorney General of the Commonwealth of Massachusetts, In His Official Capacity, Civ. No. 95-12574-GAO, United States District Court for the District of Massachusetts

4. Philip Morris, Inc., et al. v. Richard Blumenthal, Attorney General of the State of Connecticut, In His Official Capacity, Civ. No. 396CV01221 (PCD), United States District Court for the District of Connecticut

5. Philip Morris, et al. v. William H. Sorrell, et al., No. 1:98-ev-132, United States District Court for the District of Vermont

EXHIBIT N
LITIGATING POLITICAL SUBDIVISIONS

1. City of New York, et al. v. The Tobacco Institute, Inc. et al., Supreme Court of the State of New York, County of New York, Index No. 406225/96

2. County of Erie v. The Tobacco Institute, Inc. et al., Supreme Court of the State of New York, County of Erie, Index No. I 1997/359

3. County of Los Angeles v. R.J. Reynolds Tobacco Co. et al., San Diego Superior Court, No. 707651

4. The People v. Philip Morris, Inc. et al., San Francisco Superior Court, No. 980864

5. County of Cook v. Philip Morris, Inc. et al., Circuit Court of Cook County, Ill., No. 97-L-4550

EXHIBIT O
MODEL STATE FEE PAYMENT AGREEMENT

This STATE Fee Payment Agreement (the "STATE Fee Payment Agreement") is entered into as of _________, _____ between and among the Original Participating Manufacturers and STATE Outside Counsel (as defined herein), to provide for payment of attorneys' fees pursuant to Section XVII of the Master Settlement Agreement (the "Agreement").

WITNESSETH:

WHEREAS, the State of STATE and the Original Participating Manufacturers have entered into the Agreement to settle and resolve with finality all Released Claims against the Released Parties, including the Original Participating Manufacturers, as set forth in the Agreement; and

WHEREAS, Section XVII of the Agreement provides that the Original Participating Manufacturers shall pay reasonable attorneys' fees to those private outside counsel identified in Exhibit S to the Agreement, pursuant to the terms hereof;

NOW, THEREFORE, BE IT KNOWN THAT, in consideration of the mutual agreement of the State of STATE and the Original Participating Manufacturers to the terms of the Agreement and of the mutual agreement of STATE Outside Counsel and the Original Participating Manufacturers to the terms of this STATE Fee Payment Agreement, and such other consideration described herein, the Original Participating Manufacturers and STATE Outside Counsel agree as follows:

SECTION 1. *Definitions*.

All definitions contained in the Agreement are incorporated by reference herein, except as to terms specifically defined herein.

(a) "*Action*" means the lawsuit identified in Exhibit D, M or N to the Agreement that has been brought by or against the State of STATE [or Litigating Political Subdivision].

(b) "*Allocated Amount*" means the amount of any Applicable Quarterly Payment allocated to any Private Counsel (including STATE Outside Counsel) pursuant to section 17 hereof.

(c) "*Allocable Liquidated Share*" means, in the event that the sum of all Payable Liquidated Fees of Private Counsel as of any date specified in section 8 hereof exceeds the Applicable Liquidation Amount for any payment described therein, a percentage share of the Applicable Liquidation Amount equal to the proportion of (i) the amount of the Payable Liquidated Fee of STATE Outside Counsel to (ii) the sum of Payable Liquidated Fees of all Private Counsel.

(d) "*Applicable Liquidation Amount*" means, for purposes of the payments described in section 8 hereof —

(i) for the payment described in subsection (a) thereof, $125 million;

(ii) for the payment described in subsection (b) thereof, the difference between (A) $250 million and (B) the sum of all amounts paid in satisfaction of all Payable Liquidated Fees of Outside Counsel pursuant to subsection (a) thereof;

(iii) for the payment described in subsection (c) thereof, the difference between (A) $250 million and (B) the sum of all amounts paid in satisfaction of all Payable Liquidated Fees of Outside Counsel pursuant to subsections (a) and (b) thereof;

(iv) for the payment described in subsection (d) thereof, the difference between (A) $250 million and (B) the sum of all amounts paid in satisfaction of all Payable Liquidated Fees of Outside Counsel pursuant to subsections (a), (b) and (c) thereof;

(v) for the payment described in subsection (e) thereof, the difference between (A) $250 million and (B) the sum of all amounts paid in satisfaction of all Payable Liquidated Fees of Outside Counsel pursuant to subsections (a), (b), (c) and (d) thereof;

(vi) for each of the first, second and third quarterly payments for any calendar year described in subsection (f) thereof, $62.5 million; and

(vii) for each of the fourth calendar quarterly payments for any calendar year described in subsection (f) thereof, the difference between (A) $250 million and (B) the sum of all amounts paid in satisfaction of all Payable Liquidated Fees of Outside Counsel with respect to the preceding calendar quarters of the calendar year.

(e) "*Application*" means a written application for a Fee Award submitted to the Panel, as well as all supporting materials (which may include video recordings of interviews).

(f) "*Approved Cost Statement*" means both (i) a Cost Statement that has been accepted by the Original Participating Manufacturers; and (ii) in the event that a Cost Statement submitted by STATE Outside Counsel is disputed, the determination by arbitration pursuant to subsection (b) of section 19 hereof as to the amount of the reasonable costs and expenses of STATE Outside Counsel.

(g) "*Cost Statement*" means a signed and attested statement of reasonable costs and expenses of Outside Counsel for any action identified on Exhibit D, M or N to the Agreement that has been brought by or against a Settling State or Litigating Political Subdivision.

(h) "*Designated Representative*" means the person designated in writing, by each person or entity identified in Exhibit S to the Agreement [by the Attorney General of the State of STATE or as later certified in writing by the governmental prosecuting authority of the Litigating Political Subdivision], to act as their agent in receiving payments from the Original Participating Manufacturers for the benefit of STATE Outside Counsel pursuant to sections 8, 16 and 19 hereof, as applicable.

(i) "*Director*" means the Director of the Private Adjudication Center of the Duke University School of Law or such other person or entity as may be chosen by agreement of the Original Participating Manufacturers and the Committee described in the second sentence of paragraph (b)(ii) of section 11 hereof.

(j) "*Eligible Counsel*" means Private Counsel eligible to be allocated a part of a Quarterly Fee Amount pursuant to section 17 hereof.

(k) "*Federal Legislation*" means federal legislation that imposes an enforceable obligation on Participating Defendants to pay attorneys' fees with respect to Private Counsel.

(l) "*Fee Award*" means any award of attorneys' fees by the Panel in connection with a Tobacco Case.

(m) "*Liquidated Fee*" means an attorneys' fee for Outside Counsel for any action identified on Exhibit D, M or N to the Agreement that has been brought by or against a Settling State or Litigating Political Subdivision, in an amount agreed upon by the Original Participating Manufacturers and such Outside Counsel.

(n) "*Outside Counsel*" means all those Private Counsel identified in Exhibit S to the Agreement.

(o) "*Panel*" means the three-member arbitration panel described in section 11 hereof.

(p) "*Party*" means (i) STATE Outside Counsel and (ii) an Original Participating Manufacturer.

(q) "*Payable Cost Statement*" means the unpaid amount of a Cost Statement as to which all conditions precedent to payment have been satisfied.

(r) "*Payable Liquidated Fee*" means the unpaid amount of a Liquidated Fee as to which all conditions precedent to payment have been satisfied.

(s) "*Previously Settled States*" means the States of Mississippi, Florida and Texas.

(t) "*Private Counsel*" means all private counsel for all plaintiffs in a Tobacco Case (including STATE Outside Counsel).

(u) "*Quarterly Fee Amount*" means, for purposes of the quarterly payments described in sections 16, 17 and 18 hereof —

(i) for each of the first, second and third calendar quarters of any calendar year beginning with the first calendar quarter of 1999 and ending with the third calendar quarter of 2008, $125 million;

(ii) for each fourth calendar quarter of any calendar year beginning with the fourth calendar quarter of 1999 and ending with the fourth calendar quarter of 2003, the sum of (A) $125 million and (B) the difference, if any, between (*1*) $375 million and (*2*) the sum of all amounts paid in satisfaction of all Fee Awards of Private Counsel during such calendar year, if any;

(iii) for each fourth calendar quarter of any calendar year beginning with the fourth calendar quarter of 2004 and ending with the fourth calendar quarter of 2008, the sum of (A) $125 million; (B) the difference between (*1*) $375 million; and (*2*) the sum of all amounts paid in satisfaction of all Fee Awards of Private Counsel during such calendar year, if any; and (C) the difference, if any, between (*1*) $250 million and (*2*) the product of (*a*) .2 (two tenths) and (*b*) the sum of all amounts paid in satisfaction of all Liquidated Fees of Outside Counsel pursuant to section 8 hereof, if any;

(iv) for each of the first, second and third calendar quarters of any calendar year beginning with the first calendar quarter of 2009, $125 million; and

(v) for each fourth calendar quarter of any calendar year beginning with the fourth calendar quarter of 2009, the sum of (A) $125 million and (B) the difference, if any, between (*1*) $375 million and (*2*) the sum of all amounts paid in satisfaction of all Fee Awards of Private Counsel during such calendar year, if any.

(v) *"Related Persons"* means each Original Participating Manufacturer's past, present and future Affiliates, divisions, officers, directors, employees, representatives, insurers, lenders, underwriters, Tobacco-Related Organizations, trade associations, suppliers, agents, auditors, advertising agencies, public relations entities, attorneys, retailers and distributors (and the predecessors, heirs, executors, administrators, successors and assigns of each of the foregoing).

(w) "*State of STATE*" means the [applicable Settling State or the Litigating Political Subdivision], any of its past, present and future agents, officials acting in their official capacities, legal representatives, agencies, departments, commissions and subdivisions.

(x) "*STATE Outside Counsel*" means all persons or entities identified in Exhibit S to the Agreement by the Attorney General of State of STATE [or as later certified by the office of the governmental prosecuting authority for the Litigating Political Subdivision] as having been retained by and having represented the STATE in connection with the Action, acting collectively by unanimous decision of all such persons or entities.

(y) "*Tobacco Case*" means any tobacco and health case (other than a non-class action personal injury case brought directly by or on behalf of a single natural person or the survivor of such person or for wrongful death, or any non-class action consolidation of two or more such cases).

(z) *"Unpaid Fee"* means the unpaid portion of a Fee Award.

SECTION 2. *Agreement to Pay Fees*.

The Original Participating Manufacturers will pay reasonable attorneys' fees to STATE Outside Counsel for their representation of the State of STATE in connection with the Action, as provided herein and subject to the *Code of Professional Responsibility* of the American Bar Association. Nothing herein shall be construed to require the Original Participating Manufacturers to pay any attorneys' fees other than (i) a Liquidated Fee or a Fee Award and (ii) a Cost Statement, as provided herein, nor shall anything herein require the Original Participating Manufacturers to pay any Liquidated Fee, Fee Award or Cost Statement in connection with any litigation other than the Action.

SECTION 3. *Exclusive Obligation of the Original Participating Manufacturers*.

The provisions set forth herein constitute the entire obligation of the Original Participating Manufacturers with respect to payment of attorneys' fees of STATE Outside Counsel (including costs and expenses) in connection with the Action and the exclusive means by which STATE Outside Counsel or any other person or entity may seek payment of fees by the Original Participating Manufacturers or Related Persons in connection with the Action. The Original Participating Manufacturers shall have no obligation pursuant to Section XVII of the Agreement to pay attorneys' fees in connection with the Action to any counsel other than STATE Outside Counsel, and they shall have no other obligation to pay attorneys' fees to or otherwise to compensate STATE Outside Counsel, any other counsel or representative of the State of STATE or the State of STATE itself with respect to attorneys' fees in connection with the Action.

SECTION 4. *Release*.

(a) Each person or entity identified in Exhibit S to the Agreement by the Attorney General of the State of STATE [or as certified by the office of the governmental prosecuting authority for the Litigating Political Subdivision] hereby irrevocably releases the Original Participating Manufacturers and all Related Persons from any and all claims that such person or entity ever had, now has or hereafter can, shall or may have in any way related to the Action (including but not limited to any negotiations related to the settlement of the Action). Such release shall not be construed as a release of any person or entity as to any of the obligations undertaken herein in connection with a breach thereof.

(b) In the event that STATE Outside Counsel and the Original Participating Manufacturers agree upon a Liquidated Fee pursuant to section 7 hereof, it shall be a precondition to any payment by the Original Participating Manufacturers to the Designated Representative pursuant to section 8 hereof that each person or entity identified in Exhibit S to the Agreement by the Attorney General of the State of STATE [or as certified by the office of the governmental prosecuting authority for the Litigating Political Subdivision] shall have irrevocably released all entities represented by STATE Outside Counsel in the Action, as well as all persons acting by or on behalf of such entities (including the Attorney General [or the office of the governmental prosecuting authority] and each other person or entity identified on Exhibit S to the Agreement by the Attorney General [or the office of the governmental prosecuting authority]) from any and all claims that such person or entity ever had, now has or hereafter can, shall or may have in any way related to the Action (including but not limited to any negotiations related to the settlement of the Action). Such release shall not be construed as a release of any person or entity as to any of the obligations undertaken herein in connection with a breach thereof.

SECTION 5. *No Effect on STATE Outside Counsel's Fee Contract*.

The rights and obligations, if any, of the respective parties to any contract between the State of STATE and STATE Outside Counsel shall be unaffected by this STATE Fee Payment Agreement except (a) insofar as STATE Outside Counsel grant the release described in subsection (b) of section 4 hereof; and (b) to the extent that STATE Outside Counsel receive any payments in satisfaction of a Fee Award pursuant to section 16 hereof, any amounts so received shall be credited, on a dollar-for-dollar basis, against any amount payable to STATE Outside Counsel by the State of STATE [or the Litigating Political Subdivision] under any such contract.

SECTION 6. *Liquidated Fees*.

(a) In the event that the Original Participating Manufacturers and STATE Outside Counsel agree upon the amount of a Liquidated Fee, the Original Participating Manufacturers shall pay such Liquidated Fee, pursuant to the terms hereof.

(b) The Original Participating Manufacturers' payment of any Liquidated Fee pursuant to this STATE Fee Payment Agreement shall be subject to (i) satisfaction of the conditions precedent stated in section 4 and paragraph (c)(ii) of section 7 hereof; and (ii) the payment schedule and the annual and quarterly aggregate national caps specified in sections 8 and 9 hereof, which shall apply to all payments made with respect to Liquidated Fees of all Outside Counsel.

SECTION 7. *Negotiation of Liquidated Fees*.

(a) If STATE Outside Counsel seek to be paid a Liquidated Fee, the Designated Representative shall so notify the Original Participating Manufacturers. The Original Participating Manufacturers may at any time make an offer of a Liquidated Fee to the Designated Representative in an amount set by the unanimous agreement, and at the sole discretion, of the Original Participating Manufacturers and, in any event, shall collectively make such an offer to the Designated Representative no more than 60 Business Days after receipt of notice by the Designated Representative that STATE Outside

Counsel seek to be paid a Liquidated Fee. The Original Participating Manufacturers shall not be obligated to make an offer of a Liquidated Fee in any particular amount. Within ten Business Days after receiving such an offer, STATE Outside Counsel shall either accept the offer, reject the offer or make a counteroffer.

(b) The national aggregate of all Liquidated Fees to be agreed to by the Original Participating Manufacturers in connection with the settlement of those actions indicated on Exhibits D, M and N to the Agreement shall not exceed one billion two hundred fifty million dollars ($1,250,000,000).

(c) If the Original Participating Manufacturers and STATE Outside Counsel agree in writing upon a Liquidated Fee:

(i) STATE Outside Counsel shall not be eligible for a Fee Award;

(ii) such Liquidated Fee shall not become a Payable Liquidated Fee until such time as (A) State-Specific Finality has occurred in the State of STATE; (B) each person or entity identified in Exhibit S to the Agreement by the Attorney General of the State of STATE [or as certified by the office of the governmental prosecuting authority of the Litigating Political Subdivision] has granted the release described in subsection (b) of section 4 hereof; and (C) notice of the events described in subparagraphs (A) and (B) of this paragraph has been provided to the Original Participating Manufacturers.

(iii) payment of such Liquidated Fee pursuant to sections 8 and 9 hereof (together with payment of costs and expenses pursuant to section 19 hereof), shall be STATE Outside Counsel's total and sole compensation by the Original Participating Manufacturers in connection with the Action.

(d) If the Original Participating Manufacturers and STATE Outside Counsel do not agree in writing upon a Liquidated Fee, STATE Outside Counsel may submit an Application to the Panel for a Fee Award to be paid as provided in sections 16, 17 and 18 hereof.

SECTION 8. *Payment of Liquidated Fee*.

In the event that the Original Participating Manufacturers and STATE Outside Counsel agree in writing upon a Liquidated Fee, and until such time as the Designated Representative has received payments in full satisfaction of such Liquidated Fee —

(a) On February 1, 1999, if the Liquidated Fee of STATE Outside Counsel became a Payable Liquidated Fee before January 15, 1999, each Original Participating Manufacturer shall severally pay to the Designated Representative its Relative Market Share of the lesser of (i) the Payable Liquidated Fee of STATE Outside Counsel, (ii) $5 million or (iii) in the event that the sum of all Payable Liquidated Fees of all Outside Counsel as of January 15, 1999 exceeds the Applicable Liquidation Amount, the Allocable Liquidated Share of STATE Outside Counsel.

(b) On August 1, 1999, if the Liquidated Fee of STATE Outside Counsel became a Payable Liquidated Fee on or after January 15, 1999 and before July 15, 1999, each Original Participating Manufacturer shall severally pay to the Designated Representative its Relative Market Share of the lesser of (i) the Payable Liquidated Fee of STATE Outside Counsel, (ii) $5 million or (iii) in the event that the sum of all Payable Liquidated Fees of all Outside Counsel that became Payable Liquidated Fees on or after January 15, 1999 and before July 15, 1999 exceeds the Applicable Liquidation Amount, the Allocable Liquidated Share of STATE Outside Counsel.

(c) On December 15, 1999, if the Liquidated Fee of STATE Outside Counsel became a Payable Liquidated Fee on or after July 15, 1999 and before December 1, 1999, each Original Participating Manufacturer shall severally pay to the Designated Representative its Relative Market Share of the lesser of (i) the Payable Liquidated Fee of STATE Outside Counsel, (ii) $5 million or (iii) in the event that the sum of all Payable Liquidated Fees of all Outside Counsel that became Payable Liquidated Fees on or after July 15, 1999 and before December 1, 1999 exceeds the Applicable Liquidation Amount, the Allocable Liquidated Share of STATE Outside Counsel.

(d) On December 15, 1999, if the Liquidated Fee of STATE Outside Counsel became a Payable Liquidated Fee before December 1, 1999, each Original Participating Manufacturer shall severally pay to the Designated Representative its Relative Market Share of the lesser of (i) the Payable Liquidated Fee of STATE Outside Counsel, or (ii) $5 million or (iii) in the event that the sum of all Payable Liquidated Fees of all Outside Counsel that become Payable Liquidated Fees before December 1, 1999 exceeds the Applicable Liquidation Amount, the Allocable Liquidated Share of STATE Outside Counsel.

(e) On December 15, 1999, if the Liquidated Fee of STATE Outside Counsel became a Payable Liquidated Fee before December 1, 1999, each Original Participating Manufacturer shall severally pay to the Designated Representative its Relative Market Share of the lesser of (i) the Payable Liquidated Fee of STATE Outside Counsel or (ii) in the event that the sum of all Payable Liquidated Fees of all Outside Counsel that became Payable Liquidated Fees before December 1, 1999 exceeds the Applicable Liquidation Amount, the Allocable Liquidated Share of STATE Outside Counsel.

(f) On the last day of each calendar quarter, beginning with the first calendar quarter of 2000 and ending with the fourth calendar quarter of 2003, if the Liquidated Fee of STATE Outside Counsel became a Payable Liquidated Fee at least 15 Business Days prior to the last day of each such calendar quarter, each Original Participating Manufacturer shall severally pay to the Designated Representative its Relative Market Share of the lesser of (i) the Payable Liquidated Fee of STATE Outside Counsel or (ii) in the event that the sum of all Payable Liquidated Fees of all Outside Counsel as of the date 15 Business Days prior to the date of the payment in question exceeds the Applicable Liquidation Amount, the Allocable Liquidated Share of STATE Outside Counsel.

SECTION 9. *Limitations on Payments of Liquidated Fees*.

Notwithstanding any other provision hereof, all payments by the Original Participating Manufacturers with respect to Liquidated Fees shall be subject to the following:

(a) Under no circumstances shall the Original Participating Manufacturers be required to make any payment that would result in aggregate national payments of Liquidated Fees:

(i) during 1999, totaling more than $250 million;

(ii) with respect to any calendar quarter beginning with the first calendar quarter of 2000 and ending with the fourth calendar quarter of 2003, totaling more than $62.5 million, except to the extent that a payment with respect to any prior calendar quarter of any calendar year did not total $62.5 million; or

(iii) with respect to any calendar quarter after the fourth calendar quarter of 2003, totaling more than zero.

(b) The Original Participating Manufacturers' obligations with respect to the Liquidated Fee of STATE Outside Counsel, if any, shall be exclusively as provided in this STATE Fee Payment Agreement, and notwithstanding any other provision of law, such Liquidated Fee shall not be entered as or reduced to a judgment against the Original Participating Manufacturers or considered as a basis for requiring a bond or imposing a lien or any other encumbrance.

SECTION 10. *Fee Awards*.

(a) In the event that the Original Participating Manufacturers and STATE Outside Counsel do not agree in writing upon a Liquidated Fee as described in section 7 hereof, the Original Participating Manufacturers shall pay, pursuant to the terms hereof, the Fee Award awarded by the Panel to STATE Outside Counsel.

(b) The Original Participating Manufacturers' payment of any Fee Award pursuant to this STATE Fee Payment Agreement shall be subject to the payment schedule and the annual and quarterly aggregate national caps specified in sections 17 and 18 hereof, which shall apply to:

(i) all payments of Fee Awards in connection with an agreement to pay fees as part of the settlement of any Tobacco Case on terms that provide for payment by the Original Participating Manufacturers or other defendants acting in agreement with the Original Participating Manufacturers (collectively, "Participating Defendants") of fees with respect to any Private Counsel, subject to an annual cap on payment of all such fees; and

(ii) all payments of attorneys' fees (other than fees for attorneys of Participating Defendants) pursuant to Fee Awards for activities in connection with any Tobacco Case resolved by operation of Federal Legislation.

SECTION 11. *Composition of the Panel*.

(a) The first and the second members of the Panel shall both be permanent members of the Panel and, as such, will participate in the determination of all Fee Awards. The third Panel member shall not be a permanent Panel member, but instead shall be a state-specific member selected to determine Fee Awards on behalf of Private Counsel retained in connection with litigation within a single state. Accordingly, the third, state-specific member of the Panel for purposes of determining Fee Awards with respect to litigation in the State of STATE shall not participate in any determination as to any Fee Award with respect to litigation in any other state (unless selected to participate in such determinations by such persons as may be authorized to make such selections under other agreements).

(b) The members of the Panel shall be selected as follows:

(i) The first member shall be the natural person selected by Participating Defendants.

(ii) The second member shall be the person jointly selected by the agreement of Participating Defendants and a majority of the committee described in the fee payment agreements entered in connection with the settlements of the Tobacco Cases brought by the Previously Settled States. In the event that the person so selected is unable or unwilling to continue to serve, a replacement for such member shall be selected by agreement of the Original Participating Manufacturers and a majority of the members of a committee composed of the following members: Joseph F. Rice, Richard F. Scruggs, Steven W. Berman, Walter Umphrey, one additional representative, to be selected in the sole discretion of NAAG, and two representatives of Private Counsel in Tobacco Cases, to be selected at the sole discretion of the Original Participating Manufacturers.

(iii) The third, state-specific member for purposes of determining Fee Awards with respect to litigation in the State of STATE shall be a natural person selected by STATE Outside Counsel, who shall notify the Director and the Original Participating Manufacturers of the name of the person selected.

SECTION 12. *Application of STATE Outside Counsel*.

(a) STATE Outside Counsel shall make a collective Application for a single Fee Award, which shall be submitted to the Director. Within five Business Days after receipt of the Application by STATE Outside Counsel, the Director shall serve the Application upon the Original Participating Manufacturers and the STATE. The Original Participating Manufacturers shall submit all materials in response to the Application to the Director by the later of (i) 60 Business Days after service of the Application upon the Original Participating Manufacturers by the Director, (ii) five Business Days after the date of State-Specific Finality in the State of STATE or (iii) five Business Days after the date on which notice of the name of the third, state-specific panel member described in paragraph (b)(iii) of section 11 hereof has been provided to the Director and the Original Participating Manufacturers.

(b) The Original Participating Manufacturers may submit to the Director any materials that they wish and, notwithstanding any restrictions or representations made in any other agreements, the Original Participating Manufacturers shall be in no way constrained from contesting the amount of the Fee Award requested by STATE Outside Counsel. The Director, the Panel, the State of STATE, the Original Participating Manufacturers and STATE Outside Counsel shall preserve the confidentiality of any attorney work-product materials or other similar confidential information that may be submitted.

(c) The Director shall forward the Application of STATE Outside Counsel, as well as all written materials relating to such Application that have been submitted by the Original Participating Manufacturers pursuant to subsection (b) of this section, to the Panel within five Business Days after the later of (i) the expiration of the period for the Original Participating Manufacturers to submit such materials or (ii) the earlier of (A) the date on which the Panel issues a Fee Award with respect to any Application of other Private Counsel previously forwarded to the Panel by the Director or (B) 30 Business Days after the forwarding to the Panel of the Application of other Private Counsel most recently forwarded to the Panel by the Director. The Director shall notify the Parties upon forwarding the Application (and all written materials relating thereto) to the Panel.

(d) In the event that either Party seeks a hearing before the Panel, such Party may submit a request to the Director in writing within five Business Days after the forwarding of the Application of STATE Outside Counsel to the Panel by the Director, and the Director shall promptly forward the request to the Panel. If the Panel grants the request, it shall promptly set a date for hearing, such date to fall within 30 Business Days after the date of the Panel's receipt of the Application.

SECTION 13. *Panel Proceedings.*

The proceedings of the Panel shall be conducted subject to the terms of this Agreement and of the Protocol of Panel Procedures attached as an Appendix hereto.

SECTION 14. *Award of Fees to STATE Outside Counsel.*

The members of the Panel will consider all relevant information submitted to them in reaching a decision as to a Fee Award that fairly provides for full reasonable compensation of STATE Outside Counsel. In considering the amount of the Fee Award, the Panel shall not consider any Liquidated Fee agreed to by any other Outside Counsel, any offer of or negotiations relating to any proposed liquidated fee for STATE Outside Counsel or any Fee Award that already has been or yet may be awarded in connection with any other Tobacco Case. The Panel shall not be limited to an hourly-rate or lodestar analysis in determining the amount of the Fee Award of STATE Outside Counsel, but shall take into account the totality of the circumstances. The Panel's decisions as to the Fee Award of STATE Outside Counsel shall be in writing and shall report the amount of the fee awarded (with or without explanation or opinion, at the Panel's discretion). The Panel shall determine the amount of the Fee Award to be paid to STATE Outside Counsel within the later of 30 calendar days after receiving the Application (and all related materials) from the Director or 15 Business Days after the last date of any hearing held pursuant to subsection (d) of section 12 hereof. The Panel's decision as to the Fee Award of STATE Outside Counsel shall be final, binding and non-appealable.

SECTION 15. *Costs of Arbitration.*

All costs and expenses of the arbitration proceedings held by the Panel, including costs, expenses and compensation of the Director and of the Panel members (but not including any costs, expenses or compensation of counsel making applications to the Panel), shall be borne by the Original Participating Manufacturers in proportion to their Relative Market Shares.

SECTION 16. *Payment of Fee Award of STATE Outside Counsel.*

On or before the tenth Business Day after the last day of each calendar quarter beginning with the first calendar quarter of 1999, each Original Participating Manufacturer shall severally pay to the Designated Representative its Relative Market Share of the Allocated Amount for STATE Outside Counsel for the calendar quarter with respect to which such quarterly payment is being made (the "Applicable Quarter").

SECTION 17. *Allocated Amounts of Fee Awards.*

The Allocated Amount for each Private Counsel with respect to any payment to be made for any particular Applicable Quarter shall be determined as follows:

(a) The Quarterly Fee Amount shall be allocated equally among each of the three months of the Applicable Quarter. The amount for each such month shall be allocated among those Private Counsel retained in connection with Tobacco Cases settled before or during such month (each such Private Counsel being an "Eligible Counsel" with respect to such monthly amount), each of which shall be allocated a portion of each such monthly amount up to (or, in the event that the sum of all Eligible Counsel's respective Unpaid Fees exceeds such monthly amount, in proportion to) the amount of such Eligible Counsel's Unpaid Fees. The monthly amount for each month of the calendar quarter shall be allocated among those Eligible Counsel having Unpaid Fees, without regard to whether there may be Eligible Counsel that have not yet been granted or denied a Fee Award as of the last day of the Applicable Quarter. The allocation of subsequent Quarterly Fee Amounts for the calendar year, if any, shall be adjusted, as necessary, to account for any Eligible Counsel that are granted Fee Awards in a subsequent quarter of such calendar year, as provided in paragraph (b)(ii) of this section.

(b) In the event that the amount for a given month is less than the sum of the Unpaid Fees of all Eligible Counsel:

(i) in the case of the first quarterly allocation for any calendar year, such monthly amount shall be allocated among all Eligible Counsel for such month in proportion to the amounts of their respective Unpaid Fees.

(ii) in the case of a quarterly allocation after the first quarterly allocation, the Quarterly Fee Amount shall be allocated among only those Private Counsel, if any, that were Eligible Counsel with respect to any monthly amount for any prior quarter of the calendar year but were not allocated a proportionate share of such monthly amount (either because such Private Counsel's applications for Fee Awards were still under consideration as of the last day of the calendar quarter containing the month in question or for any other reason), until each such Eligible Counsel has been allocated a proportionate share of all such prior monthly payments for the calendar year (each such share of each such Eligible Counsel being a "Payable Proportionate Share"). In the event that the sum of all Payable Proportionate Shares exceeds the Quarterly Fee Amount, the Quarterly Fee Amount shall be allocated among such Eligible Counsel on a monthly basis in proportion to the amounts of their respective Unpaid Fees (without regard to whether there may be other Eligible Counsel with respect to such prior monthly amounts that have not yet been granted or denied a Fee Award as of the last day of the Applicable Quarter). In the event that the sum of all Payable Proportionate Shares is less than the Quarterly Fee Amount, the amount by which the Quarterly Fee Amount exceeds the sum of all such Payable Proportionate Shares shall be allocated among each month of the calendar quarter, each such monthly amount to be allocated among those Eligible Counsel having Unpaid Fees in proportion to the amounts of their respective Unpaid Fees (without regard to whether there may be Eligible Counsel that have not yet been granted or denied a Fee Award as of the last day of the Applicable Quarter).

(c) Adjustments pursuant to subsection (b)(ii) of this section 17 shall be made separately for each calendar year. No amounts paid in any calendar year shall be subject to refund, nor shall any payment in any given calendar year affect the allocation of payments to be made in any subsequent calendar year.

SECTION 18. *Credits to and Limitations on Payment of Fee Awards.*

Notwithstanding any other provision hereof, all payments by the Original Participating Manufacturers with respect to Fee Awards shall be subject to the following:

(a) Under no circumstances shall the Original Participating Manufacturers be required to make payments that would result in aggregate national payments and credits by Participating Defendants with respect to all Fee Awards of Private Counsel:

(i) during any year beginning with 1999, totaling more than the sum of the Quarterly Fee Amounts for each calendar quarter of the calendar year, excluding certain payments with respect to any Private Counsel for 1998 that are paid in 1999; and

(ii) during any calendar quarter beginning with the first calendar quarter of 1999, totaling more than the Quarterly Fee Amount for such quarter, excluding certain payments with respect to any Private Counsel for 1998 that are paid in 1999.

(b) The Original Participating Manufacturers' obligations with respect to the Fee Award of STATE Outside Counsel, if any, shall be exclusively as provided in this STATE Fee Payment Agreement, and notwithstanding any other provision of law, such Fee Award shall not be entered as or reduced to a judgment against the Original Participating Manufacturers or considered as a basis for requiring a bond or imposing a lien or any other encumbrance.

SECTION 19. *Reimbursement of Outside Counsel's Costs.*

(a) The Original Participating Manufacturers shall reimburse STATE Outside Counsel for reasonable costs and expenses incurred in connection with the Action, provided that such costs and expenses are of the same nature as costs and expenses for which the Original Participating Manufacturers ordinarily reimburse their own counsel or agents. Payment of any Approved Cost Statement pursuant to this STATE Fee Payment Agreement shall be subject to (i) the condition precedent of approval of the Agreement by the Court for the State of STATE and (ii) the payment schedule and the aggregate national caps specified in subsection (c) of this section, which shall apply to all payments made with respect to Cost Statements of all Outside Counsel.

(b) In the event that STATE Outside Counsel seek to be reimbursed for reasonable costs and expenses incurred in connection with the Action, the Designated Representative shall submit a Cost Statement to the Original Participating Manufacturers. Within 30 Business Days after receipt of any such Cost Statement, the Original Participating Manufacturers shall either accept the Cost Statement or dispute the Cost Statement, in which event the Cost Statement shall be subject to a full audit by examiners to be appointed by the Original Participating Manufacturers (in their sole discretion). Any such audit will be completed within 120 Business Days after the date the Cost Statement is received by the Original Participating Manufacturers. Upon completion of such audit, if the Original Participating Manufacturers and STATE Outside Counsel cannot agree as to the appropriate amount of STATE Outside Counsel's reasonable costs and expenses, the Cost Statement and the examiner's audit report shall be submitted to the Director for arbitration before the Panel or, in the event that STATE Outside Counsel and the Original Participating Manufacturers have agreed upon a Liquidated Fee pursuant to section 7 hereof, before a separate three-member panel of independent arbitrators, to be selected in a manner to be agreed to by STATE Outside Counsel and the Original Participating Manufacturers, which shall determine the amount of STATE Outside Counsel's reasonable costs and expenses for the Action. In determining such reasonable costs and expenses, the members of the arbitration panel shall be governed by the Protocol of Panel Procedures attached as an Appendix hereto. The amount of

STATE Outside Counsel's reasonable costs and expenses determined pursuant to arbitration as provided in the preceding sentence shall be final, binding and non-appealable.

(c) Any Approved Cost Statement of STATE Outside Counsel shall not become a Payable Cost Statement until approval of the Agreement by the Court for the State of STATE. Within five Business Days after receipt of notification thereof by the Designated Representative, each Original Participating Manufacturer shall severally pay to the Designated Representative its Relative Market Share of the Payable Cost Statement of STATE Outside Counsel, subject to the following:

(i) All Payable Cost Statements of Outside Counsel shall be paid in the order in which such Payable Cost Statements became Payable Cost Statements.

(ii) Under no circumstances shall the Original Participating Manufacturers be required to make payments that would result in aggregate national payments by Participating Defendants of all Payable Cost Statements of Private Counsel in connection with all of the actions identified in Exhibits D, M and N to the Agreement, totaling more than $75 million for any given year.

(iii) Any Payable Cost Statement of Outside Counsel not paid during the year in which it became a Payable Cost Statement as a result of paragraph (ii) of this subsection shall become payable in subsequent years, subject to paragraphs (i) and (ii), until paid in full.

(d) The Original Participating Manufacturers' obligations with respect to reasonable costs and expenses incurred by STATE Outside Counsel in connection with the Action shall be exclusively as provided in this STATE Fee Payment Agreement, and notwithstanding any other provision of law, any Approved Cost Statement determined pursuant to subsection (b) of this section (including any Approved Cost Statement determined pursuant to arbitration before the Panel or the separate three-member panel of independent arbitrators described therein) shall not be entered as or reduced to a judgment against the Original Participating Manufacturers or considered as a basis for requiring a bond or imposing a lien or any other incumbrance.

SECTION 20. *Distribution of Payments among STATE Outside Counsel*.

(a) All payments made to the Designated Representative pursuant to this STATE Fee Payment Agreement shall be for the benefit of each person or entity identified in Exhibit S to the Agreement by the Attorney General of the State of STATE [or as certified by the governmental prosecuting authority of the Litigating Political Subdivision], each of which shall receive from the Designated Representative a percentage of each such payment in accordance with the fee sharing agreement, if any, among STATE Outside Counsel (or any written amendment thereto).

(b) The Original Participating Manufacturers shall have no obligation, responsibility or liability with respect to the allocation among those persons or entities identified in Exhibit S to the Agreement by the Attorney General of the State of STATE [or as certified by the governmental prosecuting authority of the Litigating Political Subdivision], or with respect to any claim of misallocation, of any amounts paid to the Designated Representative pursuant to this STATE Fee Payment Agreement.

SECTION 21. *Calculations of Amounts*.

All calculations that may be required hereunder shall be performed by the Original Participating Manufacturers, with notice of the results thereof to be given promptly to the Designated Representative. Any disputes as to the correctness of calculations made by the Original Participating Manufacturers shall be resolved pursuant to the procedures described in Section XI(c) of the Agreement for resolving disputes as to calculations by the Independent Auditor.

SECTION 22. *Payment Responsibility*.

(a) Each Original Participating Manufacturer shall be severally liable for its share of all payments pursuant to this STATE Fee Payment Agreement. Under no circumstances shall any payment due hereunder or any portion thereof become the joint obligation of the Original Participating Manufacturers or the obligation of any person other than the Original Participating Manufacturer from which such payment is originally due, nor shall any Original Participating Manufacturer be required to pay a portion of any such payment greater than its Relative Market Share.

(b) Due to the particular corporate structures of R. J. Reynolds Tobacco Company ("Reynolds") and Brown & Williamson Tobacco Corporation ("Brown & Williamson") with respect to their non-domestic tobacco operations, Reynolds and Brown & Williamson shall each be severally liable for its respective share of each payment due pursuant to this STATE Fee Payment Agreement up to (and its liability hereunder shall not exceed) the full extent of its assets used in, and earnings and revenues derived from, its manufacture and sale in the United States of Tobacco Products intended for domestic consumption, and no recourse shall be had against any of its other assets or earnings to satisfy such obligations.

SECTION 23. *Termination*.

In the event that the Agreement is terminated with respect to the State of STATE pursuant to Section XVIII(u) of the Agreement (or for any other reason) the Designated Representative and each person or entity identified in Exhibit S to the Agreement by the Attorney General of the State of STATE [or as certified by the governmental prosecuting authority of the Litigating Political Subdivision] shall immediately refund to the Original Participating Manufacturers all amounts received under this STATE Fee Payment Agreement.

SECTION 24. *Intended Beneficiaries*.

No provision hereof creates any rights on the part of, or is enforceable by, any person or entity that is not a Party or a person covered by either of the releases described in section 4 hereof, except that sections 5 and 20 hereof create rights on the part of, and shall be enforceable by, the State of STATE. Nor shall any provision hereof bind any non-signatory or determine, limit or prejudice the rights of any such person or entity.

SECTION 25. *Representations of Parties*.

The Parties hereto hereby represent that this STATE Fee Payment Agreement has been duly authorized and, upon execution, will constitute a valid and binding contractual obligation, enforceable in accordance with its terms, of each of the Parties hereto.

SECTION 26. *No Admission*.

This STATE Fee Payment Agreement is not intended to be and shall not in any event be construed as, or deemed to be, an admission or concession or evidence of any liability or wrongdoing whatsoever on the part of any signatory hereto or any person covered by either of the releases provided under section 4 hereof. The Original Participating Manufacturers specifically disclaim and deny any liability or wrongdoing whatsoever with respect to the claims released under section 4 hereof and enter into this STATE Fee Payment Agreement for the sole purposes of memorializing the Original Participating Manufacturers' rights and obligations with respect to payment of attorneys' fees pursuant to the Agreement and avoiding the further expense, inconvenience, burden and uncertainty of potential litigation.

SECTION 27. *Non-admissibility*.

This STATE Fee Payment Agreement having been undertaken by the Parties hereto in good faith and for settlement purposes only, neither this STATE Fee Payment Agreement nor any evidence of negotiations relating hereto shall be offered or received in evidence in any action or proceeding other than an action or proceeding arising under this STATE Fee Payment Agreement.

SECTION 28. *Amendment and Waiver*.

This STATE Fee Payment Agreement may be amended only by a written instrument executed by the Parties. The waiver of any rights conferred hereunder shall be effective only if made by written instrument executed by the waiving Party. The waiver by any Party of any breach hereof shall not be deemed to be or construed as a waiver of any other breach, whether prior, subsequent or contemporaneous, of this STATE Fee Payment Agreement.

SECTION 29. *Notices*.

All notices or other communications to any party hereto shall be in writing (including but not limited to telex, facsimile or similar writing) and shall be given to the notice parties listed on Schedule A hereto at the addresses therein indicated. Any Party hereto may change the name and address of the person designated to receive notice on behalf of such Party by notice given as provided in this section including an updated list conformed to Schedule A hereto.

SECTION 30. *Governing Law*.

This STATE Fee Payment Agreement shall be governed by the laws of the State of STATE without regard to the conflict of law rules of such State.

SECTION 31. *Construction*.

None of the Parties hereto shall be considered to be the drafter hereof or of any provision hereof for the purpose of any statute, case law or rule of interpretation or construction that would or might cause any provision to be construed against the drafter hereof.

SECTION 32. *Captions*.

The captions of the sections hereof are included for convenience of reference only and shall be ignored in the construction and interpretation hereof.

SECTION 33. *Execution of STATE Fee Payment Agreement*.

This STATE Fee Payment Agreement may be executed in counterparts. Facsimile or photocopied signatures shall be considered valid signatures as of the date hereof, although the original signature pages shall thereafter be appended to this STATE Fee Payment Agreement.

SECTION 34. *Entire Agreement of Parties*.

This STATE Fee Payment Agreement contains an entire, complete and integrated statement of each and every term and provision agreed to by and among the Parties with respect to payment of attorneys' fees by the Original Participating Manufacturers in connection with the Action and is not subject to any condition or covenant, express or implied, not provided for herein.

IN WITNESS WHEREOF, the Parties hereto, through their fully authorized representatives, have agreed to this STATE Fee Payment Agreement as of this __th day of ________, 1998.

[SIGNATURE BLOCK]

APPENDIX
to MODEL FEE PAYMENT AGREEMENT

PROTOCOL OF PANEL PROCEEDINGS

This Protocol of procedures has been agreed to between the respective parties to the STATE Fee Payment Agreement, and shall govern the arbitration proceedings provided for therein.

SECTION 1. *Definitions*.

All definitions contained in the STATE Fee Payment Agreement are incorporated by reference herein.

SECTION 2. *Chairman*.

The person selected to serve as the permanent, neutral member of the Panel as described in paragraph (b)(ii) of section 11 of the STATE Fee Payment Agreement shall serve as the Chairman of the Panel.

SECTION 3. *Arbitration Pursuant to Agreement*.

The members of the Panel shall determine those matters committed to the decision of the Panel under the STATE Fee Payment Agreement, which shall govern as to all matters discussed therein.

SECTION 4. *ABA Code of Ethics*.

Each of the members of the Panel shall be governed by the *Code of Ethics for Arbitrators in Commercial Disputes* prepared by the American Arbitration Association and the American Bar Association (the "*Code of Ethics*") in conducting the arbitration proceedings pursuant to the STATE Fee Payment Agreement, subject to the terms of the STATE Fee Payment Agreement and this Protocol. Each of the party-appointed members of the Panel shall be governed by Canon VII of the *Code of Ethics*. No person may engage in any *ex parte* communications with the permanent, neutral member of the Panel selected pursuant to paragraph (b)(ii) of section 11, in keeping with Canons I, II and III of the *Code of Ethics*.

SECTION 5. *Additional Rules and Procedures*.

The Panel may adopt such rules and procedures as it deems necessary and appropriate for the discharge of its duties under the STATE Fee Payment Agreement and this Protocol, subject to the terms of the STATE Fee Payment Agreement and this Protocol.

SECTION 6. *Majority Rule*.

In the event that the members of the Panel are not unanimous in their views as to any matter to be determined by them pursuant to the STATE Fee Payment Agreement or this Protocol, the determination shall be decided by a vote of a majority of the three members of the Panel.

SECTION 7. *Application for Fee Award and Other Materials*.

(a) The Application of STATE Outside Counsel and any materials submitted to the Director relating thereto (collectively, "submissions") shall be forwarded by the Director to each of the members of the Panel in the manner and on the dates specified in the STATE Fee Payment Agreement.

(b) All materials submitted to the Director by either Party (or any other person) shall be served upon all Parties. All submissions required to be served on any Party shall be deemed to have been served as of the date on which such materials have been sent by either (i) hand delivery or (ii) facsimile and overnight courier for priority next-day delivery.

(c) To the extent that the Panel believes that information not submitted to the Panel may be relevant for purposes of determining those matters committed to the decision of the Panel under the terms of the STATE Fee Payment Agreement, the Panel shall request such information from the Parties.

SECTION 8. *Hearing*.

Any hearing held pursuant to section 12 of the STATE Fee Payment Agreement shall not take place other than in the presence of all three members of the Panel upon notice and an opportunity for the respective representatives of the Parties to attend.

SECTION 9. *Miscellaneous*.

(a) Each member of the Panel shall be compensated for his services by the Original Participating Manufacturers on a basis to be agreed to between such member and the Original Participating Manufacturers.

(b) The members of the Panel shall refer all media inquiries regarding the arbitration proceeding to the respective Parties to the STATE Fee Payment Agreement and shall refrain from any comment as to the arbitration proceedings to be conducted pursuant to the STATE Fee Payment Agreement during the pendency of such arbitration proceedings, in keeping with Canon IV(B) of the *Code of Ethics*.

EXHIBIT P
NOTICES

[Intentionally Omitted]

EXHIBIT Q
1996 AND 1997 DATA

(1) 1996 Operating Income

Original Participating Manufacturer	Operating Income
Brown & Williamson Tobacco Corp.	$801,640,000
Lorillard Tobacco Co.	$719,100,000
Philip Morris Inc.	$4,206,600,000
R.J. Reynolds Tobacco Co.	$1,468,000,000
Total (Base Operating Income)	$7,195,340,000

(2) 1997 volume (as measured by shipments of Cigarettes)

Original Participating Manufacturer	Number of Cigarettes
Brown & Williamson Tobacco Corp.*	78,911,000,000
Lorillard Tobacco Co.	42,288,000,000
Philip Morris Inc.	236,203,000,000
R.J. Reynolds Tobacco Co.	118,254,000,000
Total (Base Volume)	475,656,000,000

(3) 1997 volume (as measured by excise taxes)

Original Participating Manufacturer	Number of Cigarettes
Brown & Williamson Tobacco Corp.*	78,758,000,000
Lorillard Tobacco Co.	42,315,000,000
Philip Morris Inc.	236,326,000,000
R.J. Reynolds Tobacco Co.	119,099,000,000

* The volume includes 2,847,595 pounds of "roll your own" tobacco converted into the number of Cigarettes using 0.0325 ounces per Cigarette conversion factor.

EXHIBIT R
EXCLUSION OF CERTAIN BRAND NAMES

Brown & Williamson Tobacco Corporation

GPC
State Express 555
Riviera

Philip Morris Incorporated

Players
B&H
Belmont
Mark Ten
Viscount
Accord
L&M
Lark
Rothman's
Best Buy
Bronson
F&L
Genco
GPA
Gridlock
Money
No Frills
Generals
Premium Buy
Shenandoah
Top Choice

Lorillard Tobacco Company

None

R.J. Reynolds Tobacco Company

Best Choice
Cardinal
Director's Choice
Jacks
Rainbow
Scotch Buy
Slim Price
Smoker Friendly
Valu Time
Worth

EXHIBIT S
DESIGNATION OF OUTSIDE COUNSEL

[Intentionally Omitted]

EXHIBIT T
MODEL STATUTE

Section __. Findings and Purpose.[1]

(a) Cigarette smoking presents serious public health concerns to the State and to the citizens of the State. The Surgeon General has determined that smoking causes lung cancer, heart disease and other serious diseases, and that there are hundreds of thousands of tobacco-related deaths in the United States each year. These diseases most often do not appear until many years after the person in question begins smoking.

(b) Cigarette smoking also presents serious financial concerns for the State. Under certain health-care programs, the State may have a legal obligation to provide medical assistance to eligible persons for health conditions associated with cigarette smoking, and those persons may have a legal entitlement to receive such medical assistance.

(c) Under these programs, the State pays millions of dollars each year to provide medical assistance for these persons for health conditions associated with cigarette smoking.

(d) It is the policy of the State that financial burdens imposed on the State by cigarette smoking be borne by tobacco product manufacturers rather than by the State to the extent that such manufacturers either determine to enter into a settlement with the State or are found culpable by the courts.

(e) On _______, 1998, leading United States tobacco product manufacturers entered into a settlement agreement, entitled the "Master Settlement Agreement," with the State. The Master Settlement Agreement obligates these manufacturers, in return for a release of past, present and certain future claims against them as described therein, to pay substantial sums to the State (tied in part to their volume of sales); to fund a national foundation devoted to the interests of public health; and to make substantial changes in their advertising and marketing practices and corporate culture, with the intention of reducing underage smoking.

(f) It would be contrary to the policy of the State if tobacco product manufacturers who determine not to enter into such a settlement could use a resulting cost advantage to derive large, short-term profits in the years before liability may arise without ensuring that the State will have an eventual source of recovery from them if they are proven to have acted culpably. It is thus in the interest of the State to require that such manufacturers establish a reserve fund to guarantee a source of compensation and to prevent such manufacturers from deriving large, short-term profits and then becoming judgment-proof before liability may arise.

Section __. Definitions.

(a) "Adjusted for inflation" means increased in accordance with the formula for inflation adjustment set forth in Exhibit C to the Master Settlement Agreement.

(b) "Affiliate" means a person who directly or indirectly owns or controls, is owned or controlled by, or is under common ownership or control with, another person. Solely for purposes of this definition, the terms "owns," "is owned" and "ownership" mean ownership of an equity interest, or the equivalent thereof, of ten percent or more, and the term "person" means an individual, partnership, committee, association, corporation or any other organization or group of persons.

(c) "Allocable share" means Allocable Share as that term is defined in the Master Settlement Agreement.

(d) "Cigarette" means any product that contains nicotine, is intended to be burned or heated under ordinary conditions of use, and consists of or contains (1) any roll of tobacco wrapped in paper or in any substance not containing tobacco; or (2) tobacco, in any form, that is functional in the product, which, because of its appearance, the type of tobacco used in the filler, or its packaging and labeling, is likely to be offered to, or purchased by, consumers as a cigarette; or (3) any roll of tobacco wrapped in any substance containing tobacco which, because of its appearance, the type of tobacco used in the filler, or its packaging and labeling, is likely to be offered to, or purchased by, consumers as a cigarette described in clause (1) of this definition. The term "cigarette" includes "roll-your-own" (i.e., any tobacco which, because of its appearance, type, packaging, or labeling is suitable for use and likely to be offered to, or purchased by, consumers as tobacco for making cigarettes). For purposes of this definition of "cigarette," 0.09 ounces of "roll-your-own" tobacco shall constitute one individual "cigarette."

(e) "Master Settlement Agreement" means the settlement agreement (and related documents) entered into on _______, 1998 by the State and leading United States tobacco product manufacturers.

(f) "Qualified escrow fund" means an escrow arrangement with a federally or State chartered financial institution having no affiliation with any tobacco product manufacturer and having assets of at least $1,000,000,000 where such arrangement requires that such financial institution hold the escrowed funds' principal for the benefit of releasing parties and prohibits the tobacco product manufacturer placing the funds into escrow from using, accessing or directing the use of the funds' principal except as consistent with section ___(b)-(c) of this Act.

(g) "Released claims" means Released Claims as that term is defined in the Master Settlement Agreement.

(h) "Releasing parties" means Releasing Parties as that term is defined in the Master Settlement Agreement.

[1] [A State may elect to delete the "findings and purposes" section in its entirety. Other changes or substitutions with respect to the "findings and purposes" section (except for particularized state procedural or technical requirements) will mean that the statute will no longer conform to this model.]

(i) “Tobacco Product Manufacturer” means an entity that after the date of enactment of this Act directly (and not exclusively through any affiliate):

(1) manufactures cigarettes anywhere that such manufacturer intends to be sold in the United States, including cigarettes intended to be sold in the United States through an importer (except where such importer is an original participating manufacturer (as that term is defined in the Master Settlement Agreement) that will be responsible for the payments under the Master Settlement Agreement with respect to such cigarettes as a result of the provisions of subsections II(mm) of the Master Settlement Agreement and that pays the taxes specified in subsection II(z) of the Master Settlement Agreement, and provided that the manufacturer of such cigarettes does not market or advertise such cigarettes in the United States);

(2) is the first purchaser anywhere for resale in the United States of cigarettes manufactured anywhere that the manufacturer does not intend to be sold in the United States; or

(3) becomes a successor of an entity described in paragraph (1) or (2).

The term “Tobacco Product Manufacturer” shall not include an affiliate of a tobacco product manufacturer unless such affiliate itself falls within any of (1) - (3) above.

(j) “Units sold” means the number of individual cigarettes sold in the State by the applicable tobacco product manufacturer (whether directly or through a distributor, retailer or similar intermediary or intermediaries) during the year in question, as measured by excise taxes collected by the State on packs (or “roll-your-own” tobacco containers) bearing the excise tax stamp of the State. The [fill in name of responsible state agency] shall promulgate such regulations as are necessary to ascertain the amount of State excise tax paid on the cigarettes of such tobacco product manufacturer for each year.

Section __. Requirements.

Any tobacco product manufacturer selling cigarettes to consumers within the State (whether directly or through a distributor, retailer or similar intermediary or intermediaries) after the date of enactment of this Act shall do one of the following:

(a) become a participating manufacturer (as that term is defined in section II(jj) of the Master Settlement Agreement) and generally perform its financial obligations under the Master Settlement Agreement; or

(b) (1) place into a qualified escrow fund by April 15 of the year following the year in question the following amounts (as such amounts are adjusted for inflation) --

1999: $.0094241 per unit sold after the date of enactment of this Act;[2]

2000: $.0104712 per unit sold after the date of enactment of this Act;[3]

for each of 2001 and 2002: $.0136125 per unit sold after the date of enactment of this Act;

for each of 2003 through 2006: $.0167539 per unit sold after the date of enactment of this Act;

for each of 2007 and each year thereafter: $.0188482 per unit sold after the date of enactment of this Act.

(2) A tobacco product manufacturer that places funds into escrow pursuant to paragraph (1) shall receive the interest or other appreciation on such funds as earned. Such funds themselves shall be released from escrow only under the following circumstances --

(A) to pay a judgment or settlement on any released claim brought against such tobacco product manufacturer by the State or any releasing party located or residing in the State. Funds shall be released from escrow under this subparagraph (i) in the order in which they were placed into escrow and (ii) only to the extent and at the time necessary to make payments required under such judgment or settlement;

(B) to the extent that a tobacco product manufacturer establishes that the amount it was required to place into escrow in a particular year was greater than the State’s allocable share of the total payments that such manufacturer would have been required to make in that year under the Master Settlement Agreement (as determined pursuant to section IX(i)(2) of the Master Settlement Agreement, and before any of the adjustments or offsets described in section IX(i)(3) of that Agreement other than the Inflation Adjustment) had it been a participating manufacturer, the excess shall be released from escrow and revert back to such tobacco product manufacturer; or

(C) to the extent not released from escrow under subparagraphs (A) or (B), funds shall be released from escrow and revert back to such tobacco product manufacturer twenty-five years after the date on which they were placed into escrow.

(3) Each tobacco product manufacturer that elects to place funds into escrow pursuant to this subsection shall annually certify to the Attorney General [or other State official] that it is in compliance with this subsection. The Attorney General [or other State official] may bring a civil action on behalf of the State against any tobacco product manufacturer that fails to place into escrow the funds required under this section. Any tobacco product manufacturer that fails in any year to place into escrow the funds required under this section shall --

(A) be required within 15 days to place such funds into escrow as shall bring it into compliance with this section. The court, upon a finding of a violation of this subsection, may impose a civil penalty [to be paid to the general fund of the state] in an amount not to exceed 5 percent of the amount improperly withheld from escrow per day of the violation and in a total amount not to exceed 100 percent of the original amount improperly withheld from escrow;

(B) in the case of a knowing violation, be required within 15 days to place such funds into escrow as shall bring it into compliance with this section. The court, upon a finding of a knowing violation of this subsection, may impose a civil penalty [to be paid to the general fund of the state] in an amount not to exceed 15 percent of the amount improperly withheld from escrow per day of the violation and in a total amount not to exceed 300 percent of the original amount improperly withheld from escrow; and

(C) in the case of a second knowing violation, be prohibited from selling cigarettes to consumers within the State (whether directly or through a distributor, retailer or similar intermediary) for a period not to exceed 2 years.

Each failure to make an annual deposit required under this section shall constitute a separate violation.[4]

[2] [All per unit numbers subject to verification]

[3] [The phrase “after the date of enactment of this Act” would need to be included only in the calendar year in which the Act is enacted.]

[4] [A State may elect to include a requirement that the violator also pay the State’s costs and attorney’s fees incurred during a successful prosecution under this paragraph (3).]

EXHIBIT U
STRATEGIC CONTRIBUTION FUND PROTOCOL

The payments made by the Participating Manufacturers pursuant to section IX(c)(2) of the Agreement ("Strategic Contribution Fund") shall be allocated among the Settling States pursuant to the process set forth in this Exhibit U.

Section 1

A panel committee of three former Attorneys General or former Article III judges ("Allocation Committee") shall be established to determine allocations of the Strategic Contribution Fund, using the process described herein. Two of the three members of the Allocation Committee shall be selected by the NAAG executive committee. Those two members shall choose the third Allocation Committee member. The Allocation Committee shall be geographically and politically diverse.

Section 2

Within 60 days after the MSA Execution Date, each Settling State will submit an itemized request for funds from the Strategic Contribution Fund, based on the criteria set forth in Section 4 of this Exhibit U.

Section 3

The Allocation Committee will determine the appropriate allocation for each Settling State based on the criteria set forth in Section 4 below. The Allocation Committee shall make its determination based upon written documentation.

Section 4

The criteria to be considered by the Allocation Committee in its allocation decision include each Settling State's contribution to the litigation or resolution of state tobacco litigation, including, but not limited to, litigation and/or settlement with tobacco product manufacturers, including Liggett and Myers and its affiliated entities.

Section 5

Within 45 days after receiving the itemized requests for funds from the Settling States, the Allocation Committee will prepare a preliminary decision allocating the Strategic Contribution Fund payments among the Settling States who submitted itemized requests for funds. All Allocation Committee decisions must be by majority vote. Each Settling State will have 30 days to submit comments on or objections to the draft decision. The Allocation Committee will issue a final decision allocating the Strategic Contribution Fund payments within 45 days.

Section 6

The decision of the Allocation Committee shall be final and non-appealable.

Section 7

The expenses of the Allocation Committee, in an amount not to exceed $100,000, will be paid from disbursements from the Subsection VIII(c) Account.

APPENDIX E

NPM ADJUSTMENT STIPULATED PARTIAL SETTLEMENT AND AWARD AND SETTLEMENT TERM SHEET

(THIS PAGE INTENTIONALLY LEFT BLANK)

E-SERVICE
50918545
Mar 12 2013
03:57PM
File & ServeXpress™

Hon. Fern M. Smith (Ret.)
JAMS
Two Embarcadero Center, Suite 1500
San Francisco, CA 94111
Telephone: (415) 982-5267
Fax: (415) 982-5287
ARBITRATOR

ARBITRATION

In the 2003 NPM Adjustment Proceedings	**JAMS Ref No. 1100053390** **STIPULATED PARTIAL SETTLEMENT AND AWARD**

The signatory Participating Manufacturers ("PMs") and 19 of the States and Territories that are parties to this Arbitration have agreed to a Term Sheet to settle their dispute concerning the 2003 NPM Adjustment. The Term Sheet is attached as Exhibit A to this Stipulated Partial Settlement and Award, including an addendum reflecting the parallel provisions that the Term Sheet requires for Subsequent Participating Manufacturers ("SPMs").

The States and Territories that have signed the Term Sheet are Alabama, Arizona, Arkansas, California, Georgia, Kansas, Louisiana, Michigan, Nebraska, Nevada, New Hampshire, New Jersey, North Carolina, Tennessee, Virginia, West Virginia, Wyoming, the District of Columbia and Puerto Rico. This Stipulated Partial Settlement and Award refers to these States and Territories as "Signatory States" and to the PMs and the Signatory States collectively as the "Settling Parties."

32 of the States and Territories that are parties to this Arbitration have not signed the Term Sheet, and 27 of them have objected to the Term Sheet on a number of grounds. This

Stipulated Partial Settlement and Award refers to the Settling States that have not signed the Term Sheet as Non-Signatory States and to the 27 States that have objected as Objecting States.

The Panel heard initial presentations from the Settling Parties and the Objecting States regarding the Term Sheet and the objections at a two-day status conference on January 22-23, 2013. At that conference, the Panel made clear that it would neither "approve" the Term Sheet nor mediate a settlement, but that it would consider entering a stipulated partial award. The Settling Parties then jointly submitted a proposed stipulated partial award to whose entry they agreed. The Panel has reviewed that proposed award, has reviewed extensive briefs and supporting materials filed by the Settling Parties and the Objecting States, and has heard argument on the issues at a hearing on March 7-8, 2013. The Panel now awards as follows.

I. The Panel's Jurisdiction

1. The Panel has jurisdiction to enter this Stipulated Partial Settlement and Award and to rule on the objections as part of its jurisdiction over the 2003 NPM Adjustment dispute. As the Panel has previously explained, its jurisdiction under Section XI(c) of the MSA and the court orders compelling arbitration includes "all issues 'related to'" the 2003 NPM Adjustment dispute, including, but not limited to, whether or not the States diligently enforced their Qualifying Statutes for the year 2003. Order Re: Jurisdictional Objections, at 7, 13 (Lexis ID #34056745).

2. The MSA provides that this arbitration is "governed by the . . . Federal Arbitration Act." MSA § XI(c). Once a dispute is committed to arbitration under the FAA, "the arbitrators normally have the authority to decide all matters necessary to dispose of the claim." *Ross Brothers Constr. Co. v. International Steel Servs.*, 283 F.3d 867, 875 (7th Cir. 2002); *see*

Ansari v. Qwest Commc'n Corp., 414 F.3d 1214, 1220-21 (10th Cir. 2005); *Shaw's Supermarkets, Inc. v. United Food & Commercial Workers,* 321 F.3d 251, 254 (1st Cir. 2003).

3. This includes authority to interpret and apply the parties' contract, to resolve any "issues relating to the substance of the dispute," and to decide "procedural questions ancillary to the substantive one." *United Paperworkers Int'l. Union v. Misco, Inc.*, 484 U.S. 29, 38 (1987); *Shaw's Supermarkets,* 321 F.3d at 254; *Nat'l Cas. Co. v. First State Ins. Grp.*, 430 F.3d 492, 499-500 (1st Cir. 2005). It also includes authority to determine the existence or effect of a settlement of the dispute. *United Steel Workers Int'l Union v. TriMas Corp.*, 531 F.3d 531, 539 (7th Cir. 2008).

4. The Panel has jurisdiction to rule on the issues raised concerning the MSA reallocation provisions and to determine how the 2003 NPM Adjustment will be allocated among the Non-Signatory States in light of the settlement. These are issues that are a central part of the 2003 NPM Adjustment dispute before the Panel and that involve interpretation of the MSA. The Panel has previously resolved issues concerning the reallocation provisions in the related context of "no contest" determinations, and no party disputed that the Panel had jurisdiction to do so. Order Re: PMs' Motion For Clarification on No-Contest Issue, at 18 (Lexis ID #38479237) ("No-Contest Order"). The Panel's jurisdiction to interpret and determine the operation of the reallocation provisions is no less where a State is no longer contested because of a settlement.

5. The Panel also has jurisdiction to incorporate and direct the Independent Auditor to implement those provisions of the settlement that govern the amount and mechanism of monetary payments as among the Settling Parties, specifically the amounts to be received by the PMs and the Disputed Payments Account ("DPA") funds to be released. These are integral provisions to the Settling Parties' settlement of the 2003 NPM Adjustment dispute in this

Arbitration. As these provisions would need to be applied and administered by the Independent Auditor, as the Objecting States object that the Independent Auditor may not implement them, and as the Panel has jurisdiction under Section XI(c) of the MSA to give direction to the Independent Auditor, it falls within the Panel's authority to rule on the objections and to provide appropriate direction to the Independent Auditor so that the Settling Parties will know whether their settlement will be given effect.

6. That the direction to the Independent Auditor includes implementation of the referenced settlement provisions as they pertain to years beyond 2003 does not necessarily take the Panel beyond its jurisdiction. Parties frequently enter into settlements that cover more than the claim they are litigating or arbitrating at the moment. Tribunals have jurisdiction to issue orders approving or giving effect to such broader settlements even where they would lack jurisdiction to adjudicate the additional claims being resolved. *Abramson v. Pennwood Inv. Corp.*, 392 F.2d 759, 762 (2d Cir. 1968); *F.M. v. Palm Beach County*, 912 F. Supp. 514, 515 (S.D. Fla. 1995), *aff'd*, 84 F.3d 438 (11th Cir. 1996) (summary order). Such jurisdiction exists even in the class-action context, where courts are asked not only to formally "approve" the settlement but also to render it binding on absent class members. *Nottingham Partners v. Trans-Lux Corp.*, 925 F.2d 29, 34 (1st Cir. 1991); *In re Corrugated Container Antitrust Litig.*, 643 F.2d 195, 221 (5th Cir. 1981).

7. Here, moreover, the Panel is not "approving" the Term Sheet, much less rendering it binding on absent class members. It is just giving effect to the Settling Parties' agreed settlement payments as among themselves, by directing the Independent Auditor to implement the settlement provisions at issue. In doing so, the Panel is not assessing the merits of any NPM Adjustment dispute, including particularly questions of diligence or non-diligence for

any years other than 2003. Instead, the Objecting States' objections to these settlement provisions are based on legal arguments regarding MSA interpretive issues that are the same as to 2003 as to subsequent years.

8. Finally, even if there any were question about the Panel's jurisdiction to give that direction as to post-2003 years, the Settling Parties can agree to give the Panel jurisdiction to do so, as long as the Panel concludes (as it has) that the direction to the Independent Auditor does not adversely affect the legal rights of the Non-Signatory States. The Settling Parties have informed the Panel that they confer the Panel with the jurisdiction necessary to enter this Stipulated Partial Settlement and Award and agree to the Panel's exercising such jurisdiction.

II. Scope of Stipulated Partial Settlement and Award

1. This Stipulated Partial Settlement and Award among the PMs and Signatory States resolves with finality the Settling Parties' dispute concerning the 2003 NPM Adjustment and certain subsequent years as to limited issues and provides direction to the Independent Auditor concerning releases from the DPA and amounts to be received by the PMs pursuant to the settlement.

2. This Stipulated Partial Settlement and Award is limited to: (a) incorporating the provisions of the Term Sheet that govern the amount and mechanism of monetary payments (amounts to be received by the PMs and the DPA funds to be released) as among the Settling Parties;[1] (b) directing the Independent Auditor to implement those provisions; (c) ruling how the 2003 NPM Adjustment will be allocated in light of the settlement among the Non-Signatory States that did not diligently enforce a Qualifying Statute during 2003; and (d) ruling on the objections raised by the Objecting States.

[1] These are Term Sheet §§ I, II, III.B.1, III.B.3-4, III.C.1, IV.A, IV.H, IV.I, IV.J.3, IV.K, Appendix A and the SPM addendum to the Term Sheet.

III. Directions To The Independent Auditor

1. The Independent Auditor is directed to implement the provisions of the Term Sheet incorporated in Section II above.

2. In implementing those provisions, the Independent Auditor will order the release of funds from the DPA as described in the Term Sheet and specified below, and allocate the released funds as described in the Term Sheet and specified below. In so doing, the Independent Auditor will ensure that the Non-Signatory States' aggregate Allocable Share of both the NPM Adjustment funds now in the DPA (principal and earnings) and the additional amounts to be paid into the DPA under the first sentence of Paragraph 5 of Appendix A to the Term Sheet remains in the DPA. The Independent Auditor will also apply the amounts to be received by the PMs as described in the Term Sheet and specified below. In so doing, the Independent Auditor will ensure that no part of those amounts are allocated to the Non-Signatory States.

3. The Independent Auditor will, in performing the duties under Paragraphs 1-2 above, (a) order the release of the funds in the DPA as provided by Paragraphs 5-7 of Appendix A to the Term Sheet, (b) allocate those released DPA funds solely among the Signatory States in the manner provided by Paragraph 6 of Appendix A to the Term Sheet and as they direct, (c) apply the amounts the PMs are to receive under § I of the Term Sheet and Paragraphs 1-3 and 7-8 of Appendix A to the Term Sheet and allocate those amounts among the PMs as they direct, (d) allocate those amounts solely among the Signatory States as they direct in the manner provided by § I.B of the Term Sheet and Paragraphs 4 and 6 of Appendix A to the Term Sheet, (e) apply the amounts the PMs are to receive under §§ II, III.B and III.C of the Term Sheet, allocate those amounts among the PMs as they direct, and allocate those amounts solely among the Signatory States in the manner provided by those provisions, and (f) make all calculations and

determinations required of it under the provisions of the Term Sheet incorporated in Section II of this Stipulated Partial Settlement and Award. These directions apply as to the parallel provisions for SPMs in the SPM addendum to the Term Sheet.

4. Based on the current Signatory States, the Independent Auditor's performance of the above requirements in connection with the April 2013 MSA payment will include:

(a) ordering that [$1,760,176,204.21] NPM Adjustment funds (plus the accumulated earnings thereon) be released from the DPA and that [$2,483,161,178.12] NPM Adjustment funds (plus the accumulated earnings thereon) will remain in the DPA. These amounts are based upon payment into the DPA of the amounts required to be paid under the first sentence of Paragraph 5 of Appendix A to the Term Sheet and are subject to each Signatory State's right under Paragraph 5 of Appendix A to the Term Sheet to defer the release of its DPA funds;[2]

(b) allocating the amount released solely among the Signatory States as they direct, except for $10 million that will be allocated to the Data Clearinghouse as provided by § I.A.3 of the Term Sheet;

(c) applying a credit of [$815,937,317.90] to the Original Participating Manufacturers' ("OPMs") MSA payment due on April 15, 2013[3] and allocating that credit among the OPMs as they direct; and

(d) allocating that credit solely among the Signatory States as they direct in the manner provided by Paragraph 4 of the Appendix A to the Term Sheet.

[2] [The numbers in this Paragraph 4 and Paragraph 6 below are subject to verification by the parties and Independent Auditor as being consistent with the provisions of Paragraphs 2-3, as the Independent Auditor has broader access to the relevant data, including the precise amount of NPM Adjustment funds in the DPA. The numbers are also subject to change if additional parties join the settlement.]

[3] Parallel credits for the SPMs are included in the SPM Appendix attached hereto. [Note: The amounts in Paragraph 4(c) and the SPM Appendix assume that the 2012 NPM Adjustment is identical to the 2011 NPM Adjustment and will need to be revised once the Independent Auditor calculates the actual 2012 NPM Adjustment in the upcoming weeks.]

(e) These instructions would be subject to change if additional States join the settlement. The Independent Auditor will act in accordance with Paragraphs 2-3 and the provisions of the Term Sheet referenced in Section II of this Stipulated Partial Settlement and Award in implementing the Stipulated Partial Settlement and Award as to MSA payments after April 2013 and as to the SPMs' MSA payments due on April 15, 2013.

5. There are NPM Adjustment amounts that are not yet in the DPA because the PMs' right to pay them into the DPA has not yet accrued: for example, the 2010-2012 NPM Adjustments for the OPMs, the 2012 NPM Adjustment for SPMs, and the NPM Adjustments for subsequent years for all PMs. The Term Sheet provides that the Signatory States' Allocable Shares of these amounts will not be held in the DPA, except as provided in § IV.A of the Term Sheet with respect to NPM Adjustments for 2015 and subsequent years. Unless the second exception in § IV.A of the Term Sheet applies, the Independent Auditor will instruct the PMs to deposit the Signatory States' Allocable Shares of these amounts into the DPA and will then promptly order the release of those Shares allocated as follows: (a) with respect to the 2010-14 NPM Adjustments, in the manner provided by Paragraph 6(ii) of Appendix A to the Term Sheet or as the Signatory States direct; and (b) with respect to the NPM Adjustments for 2015 and subsequent years, among the Signatory States and PMs in the manner provided by §§ IV.A and IV.J.3 of the Term Sheet, and (in the case of funds released to the Signatory States) as the Signatory States direct and (in the case of funds released to the PMs) as the PMs direct. If a PM also pays the Non-Signatory States' Allocable Shares of its portion of an NPM Adjustment covered by this Paragraph into the DPA, the Independent Auditor will ensure that only the Signatory States' aggregate Allocable Share of the amount deposited is released and that the Non-Signatory States' aggregate Allocable Share of the amount deposited remains in the DPA.

6. The Independent Auditor's performance of the requirements of Paragraph 5 in connection with the April 2013 MSA payment will include: (a) instructing the OPMs to deposit into the DPA the Signatory States' Allocable Shares of the 2010 NPM Adjustment for the OPMs, which based on the current Signatory States equals [$322,970,319.02]; (b) promptly ordering the release of that amount allocated among the Signatory States in the manner provided by Paragraph 6(ii) of Appendix A to the Term Sheet or as the Signatory States direct; and (c) if an OPM also pays the Non-Signatory States' Allocable Shares of its portion of the 2010 NPM Adjustment into the DPA, ensuring that only the Signatory States' aggregate Allocable Share of the amount deposited is released and that the Non-Signatory States' aggregate Allocable Share of the amount deposited remains in the DPA. These instructions would be subject to change if additional States join the settlement. The Independent Auditor will act in accordance with Paragraph 5 as to the SPMs in connection with the April 2013 MSA payment.

IV. Operation of MSA Reallocation Provisions

1. In light of the settlement, the 2003 NPM Adjustment will be allocated among the Non-Signatory States as follows. The dollar amount of the 2003 NPM Adjustment will be reduced by a percentage equal to the aggregate Allocable Shares of the Signatory States as of the date of the Panel's Final Award (as of the date of this Stipulated Partial Settlement and Award, that percentage is 41.9964405%). The Independent Auditor will treat the Signatory States as not subject to the 2003 NPM Adjustment for purposes of Section IX(d)(2)(B)-(C) of the MSA. The Signatory States' shares of the 2003 NPM Adjustment, as that Adjustment amount is reduced as provided above, will be governed by the reallocation provisions of Sections IX(d)(2) and IX(d)(4) of the MSA, and will thus be reallocated among all Non-Signatory States that did not diligently enforce a Qualifying Statute during 2003 as provided in those provisions. The

maximum portion of the 2003 NPM Adjustment that can be applied to a Non-Signatory State remains as provided by Section IX(d)(2)(D) of the MSA.

2. This judgment reduction is appropriate and adequate under the MSA and governing law. Where multiple parties have a potential shared contractual obligation and some of them settle and some do not, the non-settling parties cannot necessarily block the settlement, but may be entitled to a judgment reduction. The "three standard methods for reducing judgment against non-settling defendants after a partial settlement" are "*pro rata* (court divides the amount of the total judgment by the number of settling and non-settling defendants, regardless of each defendant's culpability), proportionate fault (after a partial settlement and trial of the nonsettling defendants, the jury determines the relative culpability of all the defendants and the non-settling defendant pays a commensurate percentage of the total judgment), and *pro tanto* (the court reduces the non-settling defendant's liability for the judgment against him by the amount previously paid by the settling defendants, without regard to proportionate fault)." *In re Enron Corp. Secs., Deriv. & ERISA Litig.*, 2008 U.S. Dist. Lexis 48516, at *20-21 (S.D. Tex. 2008); *see In re Masters Mates & Pilots Pens. Pl. Litig.*, 957 F.2d 1020, 1028 (2d Cir. 1992); *In re Jiffy Lube Secs. Litig.*, 927 F.2d 155, 160-61 & n.3 (4th Cir. 1991).

3. Where non-settling defendants are given the protection of the applicable judgment-reduction method required under the contract and law, they are not prejudiced by the partial settlement. *See, e.g.*, *Enron*, 2008 U.S. Dist. Lexis 48516, at *60-61; *Eichenholtz v. Brennan*, 52 F.3d 478, 486-87 (3d Cir. 1996).

4. Under Paragraph 1, the Non-Signatory States receive the *pro rata* reduction, under which the dollar amount of the 2003 NPM Adjustment will be reduced by a percentage equal to the aggregate Allocable Shares of the Signatory States. Construing the parties' contract,

the Panel concludes that the MSA reallocation provisions indicate that the *pro rata* method is appropriate. These provisions use the specific term "pro rata," stating that the shares of diligent States are to be "reallocated among all other Settling States *pro rata* in proportion to their respective Allocable Shares." MSA § IX(d)(2)(C) (emphasis added); *see also* MSA § IX(d)(2)(D) ("pro rata in proportion to their respective Allocable Shares"). More fundamentally, the MSA also provides that the reallocation is not done on a relative fault basis. The amount of a diligent State's share that is reallocated is its *pro rata* share of the whole, not an amount derived from its particular fault level. Likewise, the amount of reallocated share that a non-diligent State receives is derived from its *pro rata* share of the liable States, not its fault level. If the reallocation of diligent States' shares is done on a *pro rata* basis in this way, the Panel reads the MSA as likewise meaning that a judgment reduction arising from some States' settlement of the diligent enforcement issue should be *pro rata* as well.

V. Objections of Objecting States

1. The Objecting States contend that the Term Sheet violates their rights under the MSA. While no party has claimed that the Term Sheet is not a good faith settlement, the Objecting States object to a number of its provisions, including the provisions for release of DPA funds and its lack of terms addressing how the reallocation provisions of the MSA (§§ IX(d)(2) and IX(d)(4)) would apply to the Signatory States' Allocable Shares of the NPM Adjustment. The Objecting States claim the Term Sheet's DPA provisions and its potential effect on the reallocation provisions adversely affect them. They also claim that these and other Term Sheet provisions constitute an amendment to the MSA that would require their consent under MSA § XVIII(j).

2. After reviewing the Objecting States' arguments and submissions, the Panel concludes that the objections are not grounds that bar entry of the Stipulated Partial Settlement and Award or that otherwise bar the Settling Parties from proceeding with the settlement pursuant to the Term Sheet.

3. The "general rule ... is that a non-settling party does not have standing to object to a settlement between other parties." *Jamie S. v. Milwaukee Pub. Schs.*, 668 F.3d 481, 501 (7th Cir. 2012). Non-settling parties have standing only if they allege the settlement creates "plain legal prejudice" to their rights. That standard is satisfied, for example, where the non-settling parties allege that the settlement strips them of a legal claim or cause of action. Importantly, however, that standard is not satisfied where the non-settling parties instead allege merely that the settlement denies them special benefits or imposes practical disadvantages on them. *See, e.g., id.*; *In re Integra Realty Resources, Inc.*, 262 F.3d 1089, 1102-03 (10th Cir. 2001); *In re Vitamins Antitrust Class Actions*, 215 F.3d 26, 28-31 (D.C. Cir. 2000); *Agretti v. ANR Freight Sys., Inc.*, 982 F.2d 242, 246-48 (7th Cir. 1992).

4. The Panel concludes that the Stipulated Partial Settlement and Award and the Term Sheet do not legally prejudice or adversely affect the Non-Signatory States. The Panel reasons as follows:

DPA. It is undisputed that, under the MSA, the PMs have the right of first recovery for NPM Adjustment funds in the DPA. *See* Order re: Transfers From DPA, at 2 (Lexis ID #37754064); *see also* MSA §§ XI(f)(2), XI(i)(1)(B). Under the Term Sheet, the PMs have waived that right for the Signatory States, allowing the Signatory States to recover their Allocable Share of those DPA funds. *See* Term Sheet Appendix ¶¶ 5-6.

The PMs' limited DPA waiver for the Signatory States in no way prejudices the Non-Signatory States, legally or otherwise. The Non-Signatory States have no entitlement to the favorable treatment that the PMs have afforded the Signatory States as part of the consideration for settling their dispute. Nor will that favorable treatment harm the Non-Signatory States. They have failed to demonstrate any reasonable likelihood that they will recover less from the DPA than they would have recovered absent the settlement. Moreover, the PMs have expressly committed that, if any Non-Signatory State ever later demonstrates that it is at risk of recovering less from the DPA than it would have recovered from the DPA absent the settlement, the PMs will allow that State to recover the extra amount from the DPA and will themselves recover any resulting unpaid share of the NPM Adjustment through an appropriate credit against the next year's annual payment.

Reallocation. The operation of the MSA reallocation provisions with respect to the 2003 NPM Adjustment will be as provided in Section IV. As described in Section IV, this provides the Non-Signatory States with appropriate and adequate protection under the MSA and the law from potential prejudice arising from the settlement's removal of the Signatory States from further contribution towards the 2003 NPM Adjustment.

The Panel does not agree with the Objecting States' contention that all Signatory States must be treated as non-diligent for purposes of the 2003 NPM Adjustment. There is no basis in the facts to assume that every Signatory State was non-diligent in 2003. Moreover, the Objecting States' position does not reflect any of the three standard methods of judgment reduction. Such an assumption would produce a considerably larger reduction in the Non-Signatory States' potential obligations than any of the standard methods. It is also contrary to the underlying principle of judgment reduction that, because a settlement is not tantamount to an admission of liability, settling defendants are not regarded as necessarily culpable or liable.

The Objecting States argue that the MSA reallocation provisions must be wholly inapplicable to a State's share unless there is an actual determination that the State was diligent. They claim that any approach by which any State's share is otherwise subject to reallocation is an "amendment" to the MSA requiring their consent. But the MSA does not directly speak as to the process to be used when some States settle diligent enforcement and some do not. It is thus within the Panel's jurisdiction to interpret the contract in light of governing law to determine what the appropriate process and judgment reduction is where there is a partial settlement of diligent enforcement involving fewer than all of the States. *United Paperworkers*, 484 U.S. at 38. There is thus no "amendment" to the MSA in the Panel doing so. Should any Objecting State, found by the Panel to be non-diligent, have a good faith belief that the *pro rata* deduction does not adequately compensate them for a Signatory State's removal from the re-allocation pool, their relief, if any, is by appeal to their individual MSA court. The cut-off date for inter-state suits set forth in the Panel's "no contest" order, is not applicable to such procedure.

Other objections. None of the Term Sheet's provisions imposes new legal obligations on the Non-Signatory States or deprives those States of existing legal rights. Thus, to the extent that the Objecting States object to the Term Sheet in other respects than those discussed above, the Panel hereby concludes that the Objecting States have not suffered "plain legal prejudice" from and are not adversely affected by the Term Sheet.

6. Neither this Stipulated Partial Settlement and Award nor the Term Sheet constitutes an amendment to the MSA that requires the consent of any Non-Signatory States under MSA § XVIII(j). As a threshold matter, the Term Sheet is not an "amendment" of the

MSA at all. Rather, it is a *settlement* of disputes that have arisen under the MSA as written, which does not address the procedures to be used should partial settlements take place. In any event, even if an amendment were involved, the MSA provides that it only must be signed by "all Participating Manufacturers affected by the amendment and by all Settling States affected by the amendment." MSA § XVIII(j). The Panel construes the term "affected by" to mean "materially prejudiced by." For the reasons discussed above, none of the Term Sheet's provisions "affect" the Non-Signatory States within the meaning of the contract. The only States bound by any terms in the Term Sheet are the Signatory States, i.e. the ones that have signed it, including, but not limited to, definitional changes regarding "Units Sold" or other terms in the MSA.

//

//

//

//

//

//

//

//

//

//

//

//

//

VI. Conclusion

This Stipulated Partial Settlement and Award is entered on the Panel's understanding based on the representation of the Settling Parties that: (a) the second sentence of § IV.F of the Term Sheet regarding Panel oversight of the documentation process is not operative and (b) this Stipulated Partial Settlement and Award satisfies the condition in § IV.E.2 of the Term Sheet regarding a Panel order as to the Term Sheet, such t~~hat the Term Sheet is now binding on all~~ signatories.[4]

SO ORDERED.

Dated: March 12, 2013

_______s/William G. Bassler_______
The Honorable William G. Bassler
Arbitrator

______s/Abner J. Mikva________
The Honorable Abner J. Mikva
Arbitrator

Fern M Smith
The Honorable Fern M. Smith
Chairperson

[4] As of this date, the Participating Manufacturers that are signatories to the Term Sheet are: Philip Morris USA Inc., R.J. Reynolds Tobacco Co., Lorillard Tobacco Co., Commonwealth Brands, Inc., Compania Industrial de Tabacos Monte Paz, S.A., Daughters & Ryan, Inc., Ets L Lacroix Fils S.A. (Belgium), Farmer's Tobacco Co. of Cynthiana, Inc., House of Prince A/S, Imperial Tobacco Limited/ITL (UK), Imperial Tobacco Mullingar (Ireland), Imperial Tobacco Polska S.A. (Poland), Imperial Tobacco Production Ukraine, Imperial Tobacco Sigara ve Tutunculuk Sanayi Ve Ticaret S.A. (Turkey), Japan Tobacco International U.S.A., Inc., King Maker Marketing, Inc., Kretek International, Liggett Group LLC, Lignum-2, Inc., OOO Tabaksfacrik Reemtsma Wolga (Russia), Peter Stokkebye Tobaksfabrik A/S, Premier Manufacturing, Inc., P.T. Djarum, Reemtsma Cigarettenfacbriken GmbH (Reemtsma), Santa Fe Natural Tobacco Company, Inc., Scandinavian Tobacco Group Lane Ltd (formerly Lane Limited), Sherman 1400 Broadway N.Y.C., Inc., Societe National d'Exploitation Industrielle des Tabacs et Allumettes (SEITA), Top Tobacco, L.P., Van Nelle Tabak Nederland B.V. (Netherlands), Vector Tobacco Inc., Von Eicken Group.

E-SERVICE
50918545
Mar 12 2013
03:57PM
File & ServeXpress

SPM APPENDIX

As directed by section III, paragraphs (2) and (3), of the Stipulated Partial Award, amounts to be credited to SPMs' April 15, 2013 payments are: [1]

Commonwealth Brands, Inc.	$	16,817,216
Compania Industrial de Tabacos Monte Paz, S.A.	$	156,667
Daughters & Ryan, Inc.	$	57,811
House of Prince A/S	$	979,764
Japan Tobacco International U.S.A., Inc.	$	1,632,410
King Maker Marketing, Inc.	$	1,723,694
Kretek International	$	255,848
Lane Limited	$	175,007
Lignum-2, Inc.	$	388,979
Peter Stokkebye Tobaksfabrik A/S	$	297,081
Premier Manufacturing, Inc.	$	1,332,213
P.T. Djarum	$	893,022
Reemtsma Cigarettenfabriken GmbH (Reemtsma)	$	60
Santa Fe Natural Tobacco Company, Inc.	$	2,405,747
Sherman 1400 Broadway N.Y.C., Inc.	$	250,061
Top Tobacco, L.P.	$	2,832,749
U.S. Flue-Cured Tobacco Growers, Inc.	$	676,935
Von Eicken Group	$	27,963

Some SPMs do not have an MSA payment due in 2013 sufficient to absorb the credit listed above. The Auditor shall permit any such SPM to carry forward its credit to April 15, 2013 payments for use in future years. Alternatively, if such SPM and any other PM jointly notify the Independent Auditor that the credit to be applied in 2013 has been transferred from the SPM to the other PM (the "transferee PM"), the Auditor shall credit the amount otherwise due the SPM with respect to its April 15, 2013 above to the transferee PM.

[1] Note: The amounts in this Appendix assume that the 2012 NPM Adjustment is identical to the 2011 NPM Adjustment and will need to be revised once the Independent Auditor calculates the actual 2012 NPM Adjustment. The numbers in this Appendix remain subject to verification. These numbers would be subject to change if the identity of the Signatory States changes.

November 14, 2012

TERM SHEET

I. ACCRUED CLAIMS FOR 2003 TO 2011 AND 2012 NPM ADJUSTMENT

Accrued claims relating to the NPM Adjustment disputes for 2003 to 2011 and the 2012 NPM Adjustment would be handled as follows:

A. The basic methodology from the August 2010 MOU would be retained, with the following adjustments:

1. All amounts related to the 2010, 2011 and 2012 NPM Adjustments would be added to the terms of the settlement.

2. The settlement value would be increased from 29.5% to a percentage ranging from 37.5% to 46%. The applicable percentage within that range depends on the aggregate Allocable Share of the signatory Settling States as follows:

Aggregate Allocable Share	Settlement Value Percentage
80% or more	37.5%
75-79.9%	38.5%
70-74.9%	39.5%
65-69.9%	40.5%
60-64.9%	42.5%
55-59.9%	44.5%
50-54.9%	46%

Appendix A sets forth the reference date for determining the aggregate Allocable Share and the increased settlement value applicable to States that sign this Term Sheet after December 14, 2012 (or, in the case of States with December hearing dates, after the start of their hearing).

3. The amount contributed to fund the Data Clearinghouse would be reduced from $20,000,000 to $10,000,000.

B. The signatory Settling States would allocate the settlement amounts (either the application of the credits to the PMs or the receipt of amounts released from the DPA, or both) among themselves so as to fully compensate those signatory Settling States whose diligent enforcement for 2003 was uncontested for their share of the 2003 NPM Adjustment, plus interest.

C. These provisions would be implemented as provided in Appendix A.

II. TRANSITION

A. There will be a two-year transition period covering sales years 2013-2014 during which the revised NPM Adjustment will operate as follows.

B. The revised adjustment for non-SET-paid sales under Section III.C will not apply for those years. The revised adjustment for SET-paid sales under Section III.B will apply for those years, except for the final sentence of Section III.B.2.c and the tribal tax clause of footnote 1.

C. In addition, for each of those years, the signatory PMs will receive the amounts detailed in Section II.A.3 of the MOU, except that the percentage in (a) of that Section will be 25% and the Market Share Loss referred to in (a)-(d) of that Section will be the 2011 Market Share Loss.

III. NPM ADJUSTMENT FOR SUBSEQUENT YEARS

A. The terms of the MOU would be abandoned and replaced with the adjustments outlined herein.

B. SET-Paid NPM Sales[1]

1. *Adjustment.* Each year, an adjustment will be applied to a signatory Settling State's share of the OPMs' MSA Payment equal to the adjustment amount for each non-compliant NPM cigarette on which SET is paid in the state. The adjustment amount will be three times the per-cigarette escrow deposit rate in the Model Escrow Statute for the year of the sale, including the inflation adjustment in the statute. There will be a proportional adjustment for each signatory SPM in proportion to the size of its MSA payment for that year.

2. *Meaning of non-compliant NPM cigarettes.* Non-compliant NPM cigarettes are SET-paid NPM cigarettes as to which escrow was (i) not deposited at the Escrow Statute rate or (ii) released or refunded except as provided in the Escrow Statute as amended by Allocable Share Repeal. The term non-compliant NPM cigarettes does not include:

a. cigarettes on which the escrow was deposited at the statutory rate by either: (i) the NPM or any other entity liable for such payments under the laws of the individual signatory Settling State, or (ii) a person or entity in the distribution chain on behalf of such NPM or other entity liable for such payments under such laws, so long as such state did not release or refund any part of the deposit, unless released pursuant to the terms of the Escrow Statute, as amended by Allocable Share Repeal;

b. cigarettes on which a signatory Settling State recovered at the statutory rate on an escrow bond posted pursuant to the laws of that

[1] SET includes state cigarette excise tax or other state tax on the distribution or sale of cigarettes (other than a state or local sales tax that is applicable to consumer products generally and is not in lieu of an excise tax), and, for NPM cigarettes sold after 2014, an excise or other tax imposed by a state- or federally-recognized tribe on the distribution or sale of cigarettes. Except if otherwise indicated, references to "NPM sales," "NPM cigarettes" and "NPM volume" in this Term Sheet refer to NPM Cigarettes, with the term "Cigarette" having the meaning given in the MSA.

state, so long as such state did not release or refund any part of the deposit so recovered, unless released pursuant to the terms of the Escrow Statute, as amended by Allocable Share Repeal;

c. cigarettes as to which the state is barred from requiring escrow deposits from all entities liable for such payments under its individual state law, and from recovery on a remaining escrow bond, by an automatic stay or subsequent order in a federal bankruptcy proceeding or by order of a court of competent jurisdiction that requiring escrow deposits is barred by federal or state constitutional law (other than state constitutional provisions added or amended after the signature date of this document or state constitutional law as it may impact or be applied in relation to sovereign immunity or other Native American issues) or federal statutory or common law, so long as: (i) the state opposes and appeals the stay or order,[2] and (ii) the NPM and brand at issue were properly on the state's approved-for-sale directory, either in accordance with the terms of Complementary Legislation or pursuant to the order of a court of competent jurisdiction barring removal of the NPM or brand from that directory, within 30 days prior to the time of sale. This paragraph only applies to signatory Settling States that have requirements in effect that the NPM in question post a bond in at least the amount described in section 17(b) of the Appendix to the MOU and that importers are jointly and severally liable for escrow deposits due from an NPM with respect to NPM cigarettes that they import; or

d. SET-paid NPM cigarettes sold after 2014 in a signatory Settling State on which escrow was timely deposited in an amount equal to or greater than the Escrow Statute rate, but as to which the State releases a portion of such amount not to exceed 50% of the Escrow Statute rate pursuant to a tribal compact to a federally recognized tribe (or tribe that was recognized by that State as of January 1, 2012) with a reservation in that State where each of the following is true: (i) the release occurs no earlier than one year after the deposit is made, (ii) the cigarettes on which the escrow is released were sold in retail transactions to consumers on that tribe's reservation, (iii) the money released is provided to the tribe itself and used solely for public safety on such tribe's reservation and/or social services for tribal members (e.g., health care, education) and not for any function that could directly or indirectly promote or reduce the costs of cigarette production, marketing or sales, (iv) the money released is not used in any way for the benefit of an NPM or to facilitate NPM sales, (v) the compact makes the requirements of Section IV.L applicable to the tribe, and the tribe is in conformity with such

[2] Subject to any limitation arising from Rule 11 or similar state ethical rules.

requirements, and (vi) the State has amended its Escrow Statute to remove the NPM's right to reversion and interest as to (but only as to) the escrow to be released in conformity with the above requirements.[3] Provided, however, that (i) a signatory Settling State may not release more than $1 million in escrow as described in this paragraph in any year to all tribes collectively; and (ii) in the event a court strikes down a signatory Settling State's removal of the NPMs' right to reversion and interest described in (vi) above, such State may pay to tribes the amounts authorized under the remainder of this paragraph out of its general fund (subject to all other conditions and limits set forth above). A State that releases escrow as described in this paragraph has the responsibility of ensuring that (i)-(vi) and the terms of the preceding sentence are met.

3. *Safe Harbor*. No adjustments under this section will be applied to a signatory Settling State for any year in which the state demonstrated (a) that escrow was deposited on at least 96% of all NPM cigarettes sold in the state during that year on which SET was paid in the state, or (b) that 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.

4. *Timing*. The adjustment amount with respect to a signatory Settling State will be applied to that state's share of the signatory PMs' next annual MSA Payment. If a stay or order, as referenced *supra*, is reversed or otherwise becomes no longer operative and escrow is not then deposited on the cigarettes at issue, the adjustment on those cigarettes will be applied to that state's share of the signatory PMs' next annual MSA Payment unless a further stay or order is entered. Adjustment amounts applied to a state's share will be subject to appropriate repayments by the signatory PMs if escrow is deposited on the cigarettes at issue after application of the adjustment.

5. *Process*. The process will be as specified in Sections II.B.5 and IV.B of the MOU. The final settlement agreement will include provisions as to communication of information to the Data Clearinghouse.

C. Non-SET-Paid NPM Sales

1. Non-SET-Paid NPM Sales would be handled as to the signatory Settling States per the terms of the MSA, with the following adjustments:

[3] This paragraph applies only with respect to cigarettes of NPMs that existed in the U.S. market as of June 1, 2012 and does not apply with respect to cigarettes of NPMs that entered the U.S. market after that date. In addition, this paragraph does not apply where any NPM involved in the production, distribution or sale of the cigarettes at issue is one (or an affiliate or successor of one) affiliated with the tribe (or any members of the tribe) to which the escrow would be released. For purposes of this paragraph, a tribe with reservation land located in more than one State is considered to have a reservation in, and to be eligible for release of escrow from, only the State in which the largest portion of its reservation land is located.

a. The total NPM Adjustment liability (if any) of each signatory Settling State under the original formula for a year would be reduced by a percentage. The percentage would equal the sum of (i) the percentage represented by the fraction of the total SET-paid NPM volume in the MSA States divided by nationwide FET-paid NPM volume for that year;[4] plus (ii) in the case of a signatory Settling State that has, as of January 1 of the year at issue, executed documentation approving the PSS amendment, the percentage represented by the fraction of (x) the total equity-fee-paid NPM sales in those PSS that had in effect for the entire year at issue an NPM equity fee law that, by its terms, imposed a per-pack fee equal to or greater than 90% of the escrow rate for sales made that year under the Escrow Statute on all cigarette sales in such state that it has the authority under federal law to tax, divided by (y) nationwide FET-paid NPM volume.[5]

b. The liability reduction under paragraph (a) would be effectuated by each signatory Settling State that is found non-diligent and allocated a share of the NPM Adjustment amount receiving a reimbursement by the signatory PMs through the methodology detailed in Paragraph 3(a) of the Agreement Regarding Arbitration.

2. The Diligent Enforcement standard applies to all FET-paid NPM sales that the State reasonably could have known about and on which such State has the authority under federal law to tax or collect escrow, including (i) all

[4] The total SET-paid NPM volume in the MSA States will be calculated as follows. SET-paid NPM volume in a signatory Settling State will be the number of SET-paid NPM sales in that State in that year as determined through the process described in Section III.B.5. SET-paid NPM volume in a non-signatory Settling State will be NPM sales in that State in that year on which the State's cigarette excise tax was paid (or on which another state tax on the distribution or sale of cigarettes or an excise or other tax imposed by a tribe was paid if that State in that year treated NPM sales on which such tax was paid as fully subject to the escrow requirement under that State's Escrow Statute). For a non-signatory Settling State, such volume will be as reported by that State under the Significant Factor procedures agreement (or other agreement among the parties as to the Significant Factor issue for that year), provided that any signatory PM or signatory Settling State may challenge that reported volume in the arbitration referenced in Sections III.C.4 and IV.J.1 as an inaccurate measure of the volume described in the preceding sentence. In the event of such a challenge, the arbitration panel's determination of the volume will be final and binding on all signatory PMs and signatory Settling States. References to "FET" include arbitrios de cigarillos in Puerto Rico.

[5] The final settlement agreement will include provisions addressing how the information for calculating the total equity-fee-paid NPM sales in each such PSS will be obtained. The current fee laws in MS and MN will be deemed to meet the requirements of clause (x) even though they otherwise would not so long as the per pack amount in effect under them remains at least as large as it is now. The signatory PMs further agree to the following: (i) the signatory OPMs agree to support the enactment in FL and TX of legislation meeting the requirements of clause (x) provided that such legislation is not in conjunction with any other legislative proposal and does not contain any provision that applies to the OPMs or their products or businesses; (ii) if the PSS amendment has become effective, the signatory SPMs agree not to oppose the enactment in FL and TX of legislation meeting the requirements of clause (x) provided that such legislation is not in conjunction with any other legislative proposal; and (iii) if a signatory PM supports the enactment in FL or TX of an equity fee law that does not meet the requirements of clause (x) and such law is enacted, the law will be deemed to meet the requirements of clause (x) as to that signatory PM (and, if enactment of the law was supported by signatory PMs with more than 60% Market Share, the law will be deemed to meet the requirements of clause (x) as to all signatory PMs).

such sales made via the Internet, (ii) all such tribal sales or sales on tribal lands, and (iii) all such sales that may otherwise constitute contraband.[6]

3. Factors relevant to the Diligent Enforcement determination include, but are not limited to: (i) whether the number of NPM sales in the State that were SET-paid and addressed under Section III.B was reduced by virtue of a policy or agreement not to require/collect SET or enforce an SET stamping requirement, or an indifference to SET collection or to enforcement of an SET stamping requirement; and/or (ii) whether the actual number of SET-paid NPM sales in the State during that year was significantly greater than the number of such sales addressed under Section III.B.[7]

4. The signatory Settling States agree that diligent enforcement will be determined as to them in a single arbitration each year. Future arbitrations under this Term Sheet would be governed by the arbitration terms outlined within the MOU, except to the extent necessary for a future merged arbitration to proceed as described in Section IV.J.1 below.

5. The signatory Settling States and the PMs will continue to discuss in good faith on an ongoing basis whether there are other actions that they can reasonably take to prevent non-SET-paid NPM sales.

IV. OTHER TERMS

A. *Withholding/Disputed Payment Accounts.* Except as provided in Section J below, the PMs will not withhold or pay into the DPA based on a dispute arising out of the revised NPM Adjustment, except if the dispute was noticed for arbitration by the PM over one year prior to the payment date and the arbitration has not begun despite good faith efforts by the PM.

B. *Most Favored Nations.* The MFN clause provided within the MOU would be retained.

C. *RYO.* Those terms relating to RYO in the MOU as to applying the SET-paid sales provision to RYO would be retained (i.e., it applies if tax other than SET is paid, and whether or not the state law requires that the containers be stamped). The signatory Settling States and the signatory PMs will continue to discuss in good faith on an ongoing basis the issues of pipe tobacco being sold for use as RYO and of cigarette rolling machines being located at retail establishments and clubs.

D. *Office.* Those terms of the MOU designating an office within each signatory Settling State as a point-of-contact on tobacco-related matters would be retained.

[6] The following are exempt from the Diligent Enforcement standard: (i) NPM cigarette sales on a federal installation in a transaction that is exempt from state taxation under federal law, and (ii) NPM cigarette sales on a tribe's reservation by an entity owned and operated by that tribe or member of that tribe to a consumer who is an adult member of that tribe in a transaction that is exempt from state taxation under federal law.

[7] A finding referenced in (ii) will not increase the adjustment applicable to the State under Section III.B or the reduction under Section III.C.1(a)(i).

E. *Conditions of Settlement.* The terms of this Term Sheet are conditioned upon: (1) joinder by a critical mass of PMs and a critical mass of Settling States by December 14, 2012; and (2) approval of this Term Sheet's terms by the Arbitration Panel. On December 17, 2012, each party that has signed this Term Sheet will determine, in each party's sole discretion, whether a critical mass of PMs and Settling States have joined such that it will proceed with the settlement, provided that the signatory PMs agree that a critical mass of Settling States will have joined if the aggregate Allocable Share of the Settling States that sign this Term Sheet by December 14, 2012 and determine to proceed with the settlement on December 17, 2012 is 50% or more and such States include the States that participated directly in the drafting of this Term Sheet (AZ, AR, CA, MI, NE, NV, TN). If the settlement proceeds, additional Settling States and PMs may join the settlement following December 14, 2012 by signing this Term Sheet or the final settlement agreement up to the end date of the last individual State diligent enforcement hearing in the 2003 Arbitration, although they will have different payment obligations or payment rights as detailed in Appendix A. Settling States may join the settlement after the end date of the last individual State diligent enforcement hearing in the 2003 Arbitration if the signatory PMs, in their sole discretion, agree. PMs may join the settlement after the end date of the last individual State diligent enforcement hearing in the 2003 Arbitration if the signatory Settling States, in their sole discretion, agree.

F. *Settlement Agreement.* The parties will cooperate in the drafting and execution of a comprehensive final settlement agreement incorporating the terms of this Term Sheet, as well as all other customary terms and conditions acceptable to the parties. The documentation process will be subject to the oversight of the Arbitration Panel. Pending the execution of the final settlement agreement, this Term Sheet is binding on all signatories provided the conditions of Section IV.E are met.

G. *Necessary legislation.* All signatory Settling States must have the Escrow Statute, Complementary Legislation and Allocable Share Repeal in full force and effect. A signatory Settling State that does not currently have Allocable Share Repeal in full force and effect will have until the end of 2013 to put it into full force and effect. If it does not do so, starting with NPM cigarettes sold in 2014, NPM cigarettes on which that State releases escrow that would not be released under Allocable Share Repeal will be treated as non-compliant NPM cigarettes under Section II.B.

H. *Significant Factor.* The signatory Settling States agree that the significant factor condition to the NPM Adjustment is no longer operative as to them. Beginning for 2022, no NPM Adjustment will be applicable to the signatory Settling States for any year in which NPM Market Share is 3% or less.[8]

I. *Profit Adjustment.* The final settlement agreement will include appropriate provisions ensuring that the OPMs will not be subject to a profit adjustment under

[8] This Section does not affect the calculation of the amount of the NPM Adjustment under the MSA or this Term Sheet applicable to the signatory Settling States for any year in which NPM Market Share is greater than 3%.

Section B(ii) of Exhibit E arising from payments under Sections I-II being concentrated or recognized in less than 10 years.

J. *Relation with non-joining States.* If there are Settling States that are not signatory Settling States and the parties agree to proceed with the settlement:

1. The parties will cooperate in merging the arbitration under Section III.C.4 for a year with the diligent enforcement arbitration under Section XI(c) of the MSA as to non-joining States for that year.

2. The 2015 arbitration under Section III.C will not commence until the 2015 diligent enforcement arbitration begins as to non-joining States. The provisions of Section III.B will continue to apply on the schedule described in that Section.

3. In the interim, the signatory Settling States and the PMs will split the amounts at issue under III.C for 2015 and each subsequent year on a 50-50 basis, subject to repayment without interest by the PMs or credit without interest by the signatory Settling States after the arbitration for that year concludes. No more than 1 year would be subject to repayment or credit in any one year.

4. Notwithstanding the above, the PMs would have the right to commence the 2015 arbitration under Section III.C as to the signatory Settling States in advance of the above schedule if the volume of non-SET-paid NPM sales exceeds 9 billion cigarettes in each of any two years. After the first such year, the PMs and signatory Settling States would discuss measures that could be taken to avoid such sales. Notwithstanding the above, the signatory Settling States would have the right to commence the 2015 arbitration under Section III.C. as to the PMs in advance of the above schedule if the volume of non-SET-paid NPM sales is less than 2 billion cigarettes in each of any two years. Any early commencement under this paragraph requires the unanimous approval of the signatory members of the side seeking early commencement.

K. *Cap of MSA payment.* A signatory Settling State may not be subject to a total NPM Adjustment under this Term Sheet for a year in excess of its total MSA payment for that year.

L. *Taxes.* If a signatory Settling State has a law, regulation, systematic policy, compact or agreement with respect to taxes (applicability, amount, collection or refund) or stamping that is different for any NPM cigarettes than any PM cigarettes or a law, regulation, systematic policy, compact or agreement with respect to stamping that does not set forth specific requirements regarding when and what stamps are required, the law, regulation, systematic policy, compact or agreement will be relevant to the Diligent Enforcement determination.[9] In addition, if the difference between NPM and PM cigarettes with respect to taxes or stamping is material, the reduction in liability described in Section III.C.1(a)(i) will not be applied with respect to that State (if found non-exempt from the NPM Adjustment) for a year in which the difference is in effect.

M. *Additional Legislation.* If requested by a signatory Settling State, the PMs will support the enactment of legislation, provided that such legislation is not in conjunction with any other legislative proposal and contains no deviation of substance from the model language referred to below, which: (i) permits the release of taxpayer-confidential information to the Data Clearinghouse for the purpose of fulfilling its responsibilities under the settlement; (ii) imposes the bonding requirement described in Section III.B.2.c above, (iii) imposes the joint-and-several liability requirement described in Section III.B.2.c above, (iv) modifies the Escrow Statute in a manner consistent with Section III.C.2-3 above with respect to the subjects described in those Sections, and/or (v) permits a compact meeting the conditions described in Section III.B.2.d above and modifies the Escrow Statute in the manner described in Section III.B.2.d(vi) above. The final settlement agreement will include model language for the above modifications (including appropriate severability language) that signatory Settling States may choose, at their option, to use, and the PMs agree that the model language (or language containing no material deviation of substance from it) will not affect the status of a signatory Settling State's Escrow Statute as a Qualifying or Model Statute or any prior agreement to that effect. In addition, if requested by a signatory Settling State, the PMs will not oppose the Model Legislation set forth in Appendix A to the MOU. The signatory Settling States and the signatory PMs will continue to discuss in good faith on an ongoing basis support for other appropriate legislative enactments that would enhance enforcement of and/or improve compliance with the escrow requirement and for legislation prohibiting or limiting the sale of cigarettes to any consumer who is not in the physical presence of the seller at the time of sale.

N. *Potential New Participating Manufacturers.* Subject to the condition specified in the last sentence of this section, the PMs agree to waive rights under Section XVIII(b) of the MSA as to NPMs signing the MSA and becoming a Participating Manufacturer without making back-payments for sales in prior years that would otherwise be required under Section II(jj) of the MSA and/or without making full escrow deposits on such prior sales, provided that the following conditions are met: (i) the NPM signs the MSA within 120 days of the execution of the final settlement agreement; (ii) the NPM turns over the full amount on deposit in its existing escrow accounts to the Settling States; (iii) all other MSA terms are applicable to the NPM and the NPM waives any claim of immunity from enforcement of its MSA obligations; (iv) the NPM agrees to the other customary terms and conditions, apart from back-payments and escrow deposits, that the States have required for new

[9] This does not include (i) taxes or stamping requirements that differ for reservation sales and non-reservation sales provided that the taxes and stamping requirements applicable to reservation and non-reservation sales respectively are the same for both PM and NPM sales, or (ii) requirements that NPM cigarettes bear a stamp of a different color solely for purposes of identification.

Participating Manufacturers (including quarterly payments and de-listing); and (v) the NPM agrees that substantial non-compliance with its MSA obligations during the first five years after joining the MSA in the absence of a good-faith dispute would trigger the back-payment obligations that would otherwise have been required of it. The PMs do not waive rights under Section XVIII(b) of the MSA as to a new Participating Manufacturer's performance of its MSA obligations going forward. This section is conditioned upon the delivery to the PMs within 60 days of the execution of the final settlement agreement a binding agreement executed by all Settling States and the Foundation that NPMs that sign the MSA pursuant to this provision without making full back-payments will not be considered Participating Manufacturers for purposes of Section IX(e) of the MSA.[10]

O. *Release of Escrow*. Except pursuant to the unanimous consent of the signatory PMs, signatory Settling States will not release or refund escrow deposited for the resolved years 1999-2012 or transition years 2013-2014 except to a State or as provided in the Escrow Statute as amended by Allocable Share Repeal. Any release or refund of escrow deposited for subsequent years will be addressed as provided in Section III.B for SET-paid NPM sales and as provided in Section III.C and the Diligent Enforcement standard for non-SET-paid NPM sales.

[10] This provision does not apply to any entity that had previously agreed to sign the MSA and to make any back-payments. The PMs retain their rights under Section XVIII(b) of the MSA as to any such entity.

APPENDIX A:

1. The OPMs receive a total amount equal to (a) the aggregate Allocated Settlement Percentage of the signatory Settling States multiplied by $6.52 billion; and (b) the aggregate Allocated Settlement Percentage of the signatory Settling States multiplied by the OPMs' full 2010-12 NPM Adjustments. Each signatory Settling State's Allocated Settlement Percentage equals the product of its Allocable Share percentage and the applicable settlement value percentage under Paragraph 2.[11]

2. (A) For Settling States that sign this Term Sheet by 6:00 P.M. PST on the initial sign-on date and determine to proceed with the settlement on December 17, 2012, the applicable settlement value percentage is that reflected in the grid below, with the aggregate Allocable Share being the aggregate Allocable Share of the Settling States that sign this Term Sheet by the Reference Date and proceed with the settlement:

Aggregate Allocable Share	Settlement Value Percentage
80% or more	37.5%
75-79.9%	38.5%
70-74.9%	39.5%
65-69.9%	40.5%
60-64.9%	42.5%
55-59.9%	44.5%
50-54.9%	46%

Except as provided below, the initial sign-on date is December 14, 2012. For Settling States whose individual State diligent enforcement hearing in the 2003 Arbitration is scheduled to begin in December 2012 (WA, AZ and CO), the initial sign-on date is the day preceding the beginning of its hearing unless the beginning of its hearing is deferred until after December 14, 2012. At the present time, WA and AZ have agreed to such deferral, and their initial sign-on date will be December 14, 2012 so long as the Panel approves the deferral.

(B) For Settling States that sign this Term Sheet (or, in the case of Settling States that do not sign this Term Sheet, the final settlement agreement) after the initial sign-on date, the applicable settlement value percentage is 59%. The signatory PMs, in their sole discretion, may waive all or part of the increase above the applicable settlement value percentage under subparagraph (A) as to such a State without triggering the MFN clause in this Term Sheet and without any obligation to provide a similar waiver to any other State.[12]

(C) The Reference Date is December 21, 2012. A Settling State that signs this

[11] References to a State's "Allocable Share" percentage in this Term Sheet are to the percentage set forth for that State as listed in Exhibit A of the MSA.

[12] Approval by signatory PMs representing at least 85% Market Share in 2011 will be sufficient for this waiver and will bind the remaining signatory PMs.

Term Sheet after the initial sign-on date but by the Reference Date will be counted as part of the aggregate Allocable Share under subparagraph (A) whether or not the signatory PMs waived the increased percentage applicable to such State under subparagraph (B).

3. (A) The amount under Paragraph 1 will be provided by the OPMs receiving credits reflecting the total amount specified in Paragraph 1 (the "Total OPM Amount"). Subject to Section IV.I, the credits will be applied as follows: (i) 50% of the Total OPM Amount as a credit against the OPMs' MSA annual payment due in April 2013; and (ii) a [__]% reduction in the OPMs' MSA annual payment under Section IX(c)(1) of the MSA due in each of April 2014-2017, plus interest on the amount of each reduction (except as provided in the accompanying footnote) at the Prime Rate calculated from April 15, 2013.[13]

(B) The amount of the percentage in subparagraph (A)(ii) will be the percentage that, when applied to the OPMs' estimated MSA annual payments due in April 2014-2017 (the estimate being after the Inflation Adjustment, Volume Adjustment and Previously Settled States Reduction, but before the remaining adjustments, reductions and offsets under the MSA), yields a total reduction equal to 50% of the Total OPM Amount. (For example, if 50% of the Total OPM Amount were $1 billion and the OPMs' estimated MSA annual payments for 2014-2017 (as adjusted as specified above) were $5 billion per year, the percentage in subparagraph (A)(ii) would be 5%.) The percentage will be filled in with respect to the MSA annual payment due in April 2014 pursuant to these specifications as of the Reference Date (once the Total OPM Amount is known), subject to change in the event additional Settling States sign this Term Sheet or the final settlement agreement after the Reference Date. With respect to each of the reductions to the MSA annual payments due in April 2015-2017, the percentage will be recalculated annually on October 15 of the year prior to the year the payment is due (for example, on October 15, 2014 for the MSA annual payment due in April 2015) to reflect the percentage that, when applied to an estimate of the OPMs' next annual payment based upon inflation and volume in the first 9 months of the year prior to the year the payment is due, yields a reduction equal to 12.5% of the Total OPM Amount.[14]

(C) The final settlement agreement will include provisions that will apply in the event the Total OPM Amount increases after the Auditor's Final Calculation of the MSA annual payment due on April 15, 2013 as a result of increased State

[13] Interest will only be paid on the portion of each reduction that exceeds 20% of the signatory Settling States' aggregate Allocable Share of amounts previously withheld by an OPM and paid into the DPA pursuant to Paragraph 5.

[14] The reductions to be applied in 2014-2017 do not count in calculating the NPM Adjustment or toward the cap in Section IV.K (the final settlement agreement will include provisions addressing how the OPMs will receive the funds at issue if such a State does not have a sufficient MSA payment remaining in any such year to apply the reductions due that year). In addition, the final settlement agreement will include provisions regarding the accrual of the reductions.

participation after that date and that specify how the increased part of that Amount will be provided to the OPMs. Unless the parties agree otherwise, those provisions will be consistent with the principles of this Appendix, including providing for payment of 50% of the increased part of that Amount by first-available credit and of the remaining 50% by reduction.

(D) Each credit and reduction will be allocated among the OPMs as directed by the OPMs.

4. The credit and reductions under Paragraph 3 will be allocated solely among the signatory Settling States and will not be allocated to the Allocated Payment of any non-signatory Settling State. Except as provided in Section I.B or as may be agreed upon by the parties in the final settlement agreement, the credit and each of the reductions will be allocated among the signatory Settling States in proportion to their respective Shares. A signatory Settling State's "Share" means the percentage yielded by dividing its Allocated Settlement Percentage by the aggregate Allocated Settlement Percentages of all signatory Settling States.[15]

5. Any OPM that withheld amounts with respect to an NPM Adjustment will pay that amount into the DPA by seven days after approval of this Term Sheet's terms by the Arbitration Panel. Each OPM that paid amounts attributed to the 2003, 2004, 2006, 2007, 2008 or 2009 NPM Adjustments into the DPA (including previously withheld amounts paid into the DPA pursuant to the preceding sentence) will, as of the date it receives confirmation from the Independent Auditor that it will apply all of the credits and reductions described in Paragraphs 1-3 and allocate them as described in Paragraphs 4 and 6, instruct the Escrow Agent and the Independent Auditor to release to the signatory Settling States from the DPA an amount equal to the total amounts attributed to such NPM Adjustments (plus the accumulated earnings thereon) multiplied by the aggregate Allocable Share percentage of the signatory Settling States, less amounts allocated to the Data Clearinghouse per Section I.A.3 above. Individual signatory Settling States may choose to have their DPA releases spread over 2013-2017. This would not affect any credits, adjustments or other calculations.

6. The signatory Settling States and OPMs will jointly instruct the Escrow Agent and Independent Auditor: (i) to apply all of the credits and reductions described in Paragraphs 1-3, and to allocate them among the OPMs as described in Paragraph 3

[15] Subject to the limits specified below, a signatory Settling State that signs this Term Sheet by the Reference Date may elect, by notice to the parties no later than the Reference Date, for its Share of the Total OPM Amount to be applied entirely as a credit against the OPMs' MSA annual payment due in April 2013. In that event, the overall amounts of the respective credit and reductions under Paragraph 3 will not change, but the credit and reductions will be allocated among the signatory Settling States differently so that (i) each electing State is allocated a portion of the April 2013 credit equal to its Share of the Total OPM Amount and is allocated none of the 2014-2017 reductions, and (ii) each other signatory Settling State is allocated a lower portion of the April 2013 credit and a corresponding higher portion of each of the 2014-2017 reductions as necessary to fulfill the provisions of Paragraph 4. Unless the OPMs agree otherwise, the election right will not be available if it would result in a profit adjustment under Section B(ii) of Exhibit E of the MSA or if it is not possible to apply the preceding sentence because too many signatory Settling States have already sought to make that election.

and solely among the signatory Settling States as described in Paragraph 4; and (ii) to allocate the amount released from the DPA under Paragraph 5 solely among the signatory Settling States in proportion to their respective Allocable Shares, except for those amounts allocated to the Data Clearinghouse.

7. There will be parallel provisions for SPMs so that each signatory SPM receives the same (*i.e.,* no greater) relative payment amounts on the same general timetable and makes the same relative releases (including amounts paid into the DPA attributed to the 2010-11 NPM Adjustments) through an equivalent process.

8. The remaining methodology in the August 2010 MOU would be retained, including as to SPMs that withheld funds (including in excess of their total payment amounts under this Term Sheet), SPMs that are not current on their undisputed or adjudicated MSA payment amounts or that expressly waived or assigned Adjustment claims, and late-joining Settling States or PMs. Late-joining Settling States would be eligible to join subject to the provisions of Section IV.E, but their payment amount would be as provided in Paragraph 2. Any late-joining OPM will be treated in the same manner as a late-joining SPM was to have been treated under the August 2010 MOU. A PM or Settling State that signs this Term Sheet after the initial sign-on date (for PMs, 6:00 P.M. PST on December 14, 2012; for States, as provided in Paragraph 2) will be considered late-joining, provided that, in the case of a late-joining Settling State, the signatory PMs may waive all or part of the increased payment from that State as provided in Paragraph 2.

SPM ADDENDUM

The following reflects the parties' agreement as to the parallel provisions under Paragraph 7 of Appendix A with respect to the individual SPMs listed in Exhibit A hereto. [1]

1. Each listed SPM will receive a total amount equal to (a) the aggregate Allocated Settlement Percentage of the signatory Settling States multiplied by the amount listed for that SPM in the attached Exhibit A; and (b) the aggregate Allocated Settlement Percentage of the signatory Settling States multiplied by that SPM's full 2010-12 NPM Adjustments.

2. Each listed SPM that paid amounts attributed to any of the 2003, 2004 or 2006-2011 NPM Adjustments into the DPA, will, as of the date it receives confirmation from the Independent Auditor that it will apply all of the credits, payments, and reductions described in Paragraph 4 below (or in the case of Liggett and Vector, Paragraph 5 below) and allocate them consistent with Paragraphs 4 and 6 of Appendix A and Paragraph 3 below, instruct the Escrow Agent and the Independent Auditor to release to the signatory Settling States from the DPA an amount equal to the total amounts attributed to such NPM Adjustments (plus the accumulated earnings thereon) multiplied by the aggregate Allocable Share percentage of the signatory Settling States.

3. The parallel provisions to Paragraphs 4 and 6 of Appendix A will include provisions for instructions to the Escrow Agent and Independent Auditor (i) to apply all of the credits, payments, and reductions described in Paragraphs 4 and 5 below and to allocate them solely among the signatory Settling States; (ii) to allocate amounts paid or released by each SPM solely among the signatory Settling States; and (iii) to recognize and apply the provisions regarding carryforward and transfer of credits described in footnote 2 below.

4. The amount under Paragraph 1 will be provided by each listed SPM (except for Liggett and Vector) receiving credits reflecting the total amount specified for that SPM in Paragraph 1 in one of the following three ways:

(i) the SPM receiving its full amount under Paragraph 1 as a credit against its MSA annual payment under Section IX(c)(1) of the MSA due in April 2013;

(ii) the SPM receiving (a) 50% of its amount under Paragraph 1 as a credit against its MSA annual payment under Section IX(c)(1) of the MSA due in April 2013; and (b) a [__]% reduction in its MSA annual payment under Section IX(c)(1) of the MSA due in each of April 2014-2017, plus interest on the amount of each reduction at the Prime Rate calculated from April 15, 2013; or

[1] The definitions in the Term Sheet and Appendix A apply to this Addendum. References to Appendix A are to Appendix A to the Term Sheet.

(iii) the SPM receiving (a) 30% of its amount under Paragraph 1 as a credit against its MSA annual payment under Section IX(c)(1) of the MSA due in April 2013, and (b) a [__]% reduction in the SPM's MSA annual payment under Section IX(c)(1) of the MSA due in each of April 2014-2016, plus interest on the amount of each reduction for the years 2014, 2015, and 2016 at the Prime Rate calculated from April 15, 2013.

(iv) The option in subparagraph (iii) is available only if enough listed SPMs have selected options (i) or (ii) above such that, in combination with the amounts that would be credited in 2013 under subparagraph (iii)(a), at least 50% of the aggregate amounts due to all listed SPMs under Paragraph 1 are credited in 2013. For purposes of this calculation, the amounts for Liggett and Vector under Paragraph 1 will be deemed credited in 2013, although those amounts will be conferred as provided in Paragraph 5 below.

(v) The percentages in subparagraphs (ii) and (iii) will be the percentage that, when applied to the listed SPM's estimated MSA annual payments due in April 2014-2017 (in the case of subparagraph (ii)) or April 2014-2016 (in the case of subparagraph (iii)), in each case with the estimate being after the Inflation Adjustment and Volume Adjustment but before the remaining adjustments, reductions and offsets under the MSA, yields a total reduction equal to 50% of the amount due the listed SPM under Paragraph 1 (in the case of subparagraph (ii)) or 70% of the amount due the listed SPM under Paragraph 1 (in the case of subparagraph (iii)). The percentages will be filled in with respect to the MSA annual payment due in April 2014 pursuant to these specifications as of the Reference Date (once the amount due the listed SPM under Paragraph 1 is known), subject to change in the event additional Settling States sign this Term Sheet or the final settlement agreement after the Reference Date. With respect to each of the reductions to the MSA annual payments due after April 2014, the percentage will be recalculated annually on October 15 of the year prior to the year the payment is due (for example, on October 15, 2014 for the MSA annual payment due in April 2015) to reflect the percentage that, when applied to an estimate of the listed SPM's next annual payment based upon inflation and volume in the first 9 months of the year prior to the year the payment is due, yields a reduction equal to 12.5% of the amount due the listed SPM under Paragraph 1 (in the case of subparagraph (ii)) or 23.3333333% of the amount due the listed SPM under Paragraph 1 (in the case of subparagraph (iii)). [2]

[2] The reductions to be applied in 2014-2017 do not count in calculating the NPM Adjustment or toward the cap in Section IV.K (the final settlement agreement will include provisions addressing how the SPMs will receive the funds at issue if such a State does not have a sufficient MSA payment remaining in any such year to apply the reductions due that year). In addition, the final settlement agreement will include provisions regarding the accrual of the reductions. A listed SPM that has no MSA payment obligation in 2013 against which the credit under Paragraph 4 due in 2013 may be applied, or whose MSA payment obligation for 2013 is less than the amount of the credit to which it is entitled that year under Paragraph 4 may, if it chooses, carry the unused portion of the credit forward and apply it in future years or may transfer the unused portion of the credit to another PM that may apply such credit against its own payment. An

5. With respect to Liggett and Vector, which withheld certain funds, the amount under Paragraph 1 will be handled pursuant to this Paragraph. Liggett and Vector will receive no credit against their MSA payments and instead will receive the benefit of the settlement and address previously withheld amounts for the 2004-2010 adjustments as follows. No later than April 15, 2013, each of those companies will pay to the signatory Settling States the excess of (a) $44,098,572 (for Liggett) or $2,624,625 (for Vector) multiplied by the aggregate Allocable Share percentage of the signatory Settling States; over (b) the amount to which that company is entitled under Paragraph 1; plus (c) 12.8090288% of $27,185,288 (for Liggett) or $1,834,639 (for Vector) multiplied by the aggregate Allocable Share percentage of the signatory Settling States. Following these payments, the amount Liggett and Vector have withheld with respect to NPM Adjustments shall be reduced by $44,098,572 (for Liggett) and $2,624,625 (for Vector) multiplied by the aggregate Allocable Share percentage of the signatory Settling States, plus the amount of all accrued interest on those amounts, reflecting the settlement between Liggett and Vector and the Signatory States with respect to those States' Allocable Share of the NPM Adjustment claims. With respect to the 2003, 2007 (for Vector), 2011, and 2012 NPM Adjustments, Liggett and Vector will be governed by Paragraph 2.

6. With respect to Farmers Tobacco Company of Cynthiana, Inc., which withheld certain funds, the amount under Paragraph 1 will be handled pursuant to this Paragraph. Farmers Tobacco will receive no credit against its MSA payments and instead will receive the benefit of the settlement and address previously withheld amounts for the 2003-2009 adjustments as follows. No later than April 15, 2013, Farmers Tobacco will pay to the signatory Settling States the excess of (a) $20,028,552 multiplied by the aggregate Allocable Share percentage of the signatory Settling States; over (b) the amount to which Farmers Tobacco is entitled under Paragraph 1. Following these payments, the amount Farmers Tobacco has withheld with respect to NPM Adjustments shall be reduced by $20,028,552 multiplied by the aggregate Allocable Share percentage of the signatory Settling States, plus the amount of all accrued interest on those amounts, reflecting the settlement between Farmers Tobacco and the Signatory States with respect to those States' Allocable Share of the NPM Adjustment claims. (The amount for Farmers Tobacco in Exhibit A referenced in Paragraph 1(a) is not multiplied by 112.8090288%.) [1]

SPM that is not current on its undisputed or adjudicated payment obligations under the MSA or any amendment to the MSA, or that has been delisted by any State as of August 31, 2012 for failure to generally perform its MSA financial obligations when due, shall (in addition to treatment specified under the term sheet and Appendix A) not be entitled to carry the unused portion of the credit forward or transfer it to another PM, and any amounts to be received by such an SPM under the Term Sheet, and any amounts transferred to it under this footnote, will be applied to its unpaid obligations and will not otherwise be credited to that SPM except to the extent such amounts exceed the signatory Settling States' aggregate Allocable Share of such unpaid obligations.

[1] The numbers in Exhibit A and Paragraphs 5 and 6 remain subject to verification.

7. The final settlement agreement will include provisions that will apply in the event the amounts due the SPMs under Paragraph 1 increase after the Auditor's Final Calculation of the MSA annual payment due on April 15, 2013 as a result of increased State participation after that date and that specify how the increased part of that Amount will be provided to each SPM. Unless the parties agree otherwise, those provisions will be consistent with the principles of this Addendum. Also, this Addendum may be supplemented to address additional SPMs joining the Term Sheet.

EXHIBIT A

Formula derivation:		
OPM NPM Adjustments 2003-2009	$	5,779,679,225
OPM Amount Specified in App. A, ¶ 1	$	6,520,000,000
Percent by which OPM Amount Specified in App. A, ¶ 1 exceeds 2003-2009 Adjustments		12.8090288%

SPM (to be verified)		**NPM Adj. 2003-2009**		**112.8090288% of NPM Adj 2003-09 (¶ 1 amount)**
Commonwealth Brands, Inc.	$	201,218,098	$	226,992,182
Compania Industrial de Tabacos Monte Paz, S.A.	$	468,522	$	528,536
Daughters & Ryan, Inc.	$	269,022	$	303,481
Farmers Tobacco of Cynthiana	$	20,028,552	$	20,028,552
House of Prince A/S	$	4,495,813	$	5,071,683
Japan Tobacco International U.S.A., Inc.	$	3,888,474	$	4,386,550
King Maker Marketing, Inc.	$	7,257,720	$	8,187,364
Kretek International	$	1,158,476	$	1,306,866
Lane Limited	$	803,048	$	905,911
Liggett Group LLC	$	37,006,861	$	41,747,081
Lignum-2, Inc.	$	1,138,201	$	1,283,994
Peter Stokkebye Tobaksfabrik A/S	$	1,229,041	$	1,386,469
Premier Manufacturing, Inc.	$	4,945,073	$	5,578,489
P.T. Djarum	$	4,143,605	$	4,674,360
Reemtsma Cigarettenfabriken GmbH (Reemtsma)	$	275	$	311
Santa Fe Natural Tobacco Company, Inc.	$	19,446,985	$	21,937,955
Sherman 1400 Broadway N.Y.C., Inc.	$	885,232	$	998,621
Top Tobacco, L.P.	$	12,941,925	$	14,599,660
Vector Tobacco Inc.	$	2,141,354	$	2,415,641
Von Eicken Group	$	118,127	$	133,257
U.S. Flue Cured Tobacco Growers, Inc.	$	1,751,910	$	1,976,312
Total	$	325,336,312	$	364,443,024

8/27/10
CONFIDENTIAL
SETTLEMENT DISCUSSIONS ONLY

MEMORANDUM OF UNDERSTANDING

The following is a Memorandum of Understanding ("MOU") containing the principal terms of a comprehensive settlement of the NPM Adjustment dispute, including resolution of the 2003-2009 NPM Adjustments (the "Accrued Claims") and revision of the NPM Adjustment for subsequent years. The MOU is binding on all signatories, provided that both the MOU and the settlement are conditioned on joinder by a critical mass of PMs, and by a critical mass of Settling States as provided in Section IV.C.4 below.[1] The parties contemplate the prompt drafting and execution of a comprehensive final settlement agreement that will incorporate the terms of this MOU, as well as other customary terms and conditions acceptable to the parties.

I. ACCRUED CLAIMS AND 2010 NPM ADJUSTMENT

The 2003-2010 NPM Adjustments will be resolved with respect to all Settling States that join the Settlement ("Joining States") as provided in Section IV.C.4 on the following basis:

A. Refunds and Reductions

The PMs that join the settlement ("PMs") shall receive reductions of MSA payments as follows:

1. The OPMs shall receive a total amount, in the form of reductions and retained withheld payments as specified below, equal to (a) the aggregate Allocated Settlement Percentage of all Joining States multiplied by $6.422 billion; and (b) the aggregate Allocated Settlement Percentage of all Joining States multiplied by the OPMs' full 2010 NPM Adjustment under the original formula. Each Joining State's Allocated Settlement Percentage shall equal the product of its Allocable Share percentage and (x) 29.5% in the case of Joining States that sign this MOU by October 1, 2010, or (y) 59% in the case of Joining States that sign this MOU after October 1, 2010, but before execution of the final settlement agreement.

2. The amount under Paragraph 1 will be provided to the OPMs by their receiving a credit against their MSA annual payment due in April 2011 in the total amount specified in Paragraph 1 less the Joining States' aggregate Allocable Share percentage of the $419.8 million withheld by R.J. Reynolds Tobacco Company with respect to the 2006 NPM Adjustment. The Joining States waive and release any claim or right to their aggregate Allocable Share percentage of the $419.8 million withheld by R.J. Reynolds Tobacco Company with respect to the 2006 NPM Adjustment.

3. Each OPM that paid amounts attributed to the 2003, 2004, 2006 or 2007 NPM Adjustments into the Disputed Payments Account will, as of the date that the credit under Paragraph 2 is actually received, instruct the Escrow Agent and the Independent Auditor to release to the Joining States from that Account an amount equal to the total amounts attributed to such NPM Adjustments (plus the accumulated earnings thereon) multiplied by the aggregate

[1] This draft term sheet is being prepared by the PMs' and the States' respective negotiating teams for presentation to their respective clients. It has not been approved by any PM or any State.

Allocable Share percentage of all Joining States, less amounts allocated pursuant to Paragraph 4(c). The parties will cooperate in taking available steps to allow the credit and release to occur as soon as possible following execution of the final settlement agreement, including in advance of April 15, 2011.

4. The Joining States and OPMs will jointly instruct the Escrow Agent and Independent Auditor:

(a) To recognize and apply the credits described in Paragraphs 1-2 and to allocate the credits solely among the Joining States pro rata, in proportion to their respective Allocated Settlement Percentages.

(b) To allocate the amount released from the Disputed Payments Account under Paragraph 3 solely among the Joining States pro rata, in proportion to their respective Allocable Shares.

(c) To allocate up to $20 million of the accumulated earnings in the Disputed Payments Account on funds to be released from that Account pursuant to Paragraph 3 to a tax-exempt account to be identified by the Joining States to fund the Data Clearinghouse as provided in Section IV.A.

5. The OPMs and Joining States will jointly seek a ruling from the Panel that the Escrow Agent and Independent Auditor are to act in accordance with the instructions described in Paragraph 4. Obtaining such a ruling is a condition to the settlement.

6. There will be parallel provisions for SPMs that provide for each SPM that signs this MOU by October 1, 2010 to receive the same (*i.e.*, no greater) relative payment amounts, and for each SPM that signs this MOU after October 1, 2010 to receive 50% of the same (*i.e.*, no greater) relative payment amounts, in each case subject to the same conditions.[2] There will also be parallel provisions for SPMs to Paragraphs 4 and 5.

B. Release or Reduction in the Case of Certain SPMs

Notwithstanding the foregoing, any SPM that has expressly waived or assigned to the Settling States any claim to an NPM Adjustment for any year shall not be entitled to any release or reduction related to that year pursuant to Section A.

[2] These conditions include release of funds and earnings in the Disputed Payments Account corresponding to Paragraph 3 and re-payment of withheld amounts on the 2003-2009 NPM Adjustments to the extent greater than the payment amount the SPM is to receive under this MOU, in each case as of the later of the date the payment amount corresponding to Paragraph 2 is actually received by the SPM or the date of the final settlement agreement. Where a PM is not current on its undisputed or adjudicated payment obligations under the MSA or any amendment to the MSA, any amounts to be received by it under this MOU will be applied to such unpaid obligations and will not otherwise be credited to that PM except to the extent such amounts exceed the Joining States' aggregate Allocable Share of such unpaid obligations.

II. NPM ADJUSTMENT FOR SUBSEQUENT YEARS

The following revised NPM Adjustment will apply to the Joining States in lieu of the original NPM Adjustment.

A. Transition

1. There will be a two-year transition period covering sales years 2011-2012 during which the revised NPM Adjustment will operate as follows.

2. The revised adjustment for stamped NPM sales described in Section B will apply.

3. The revised adjustment for unstamped NPM sales described in Section C will not apply until sales year 2013. Instead, the OPMs would receive for each of 2011 and 2012:

(a) 15% of the NPM Adjustment under the original formula up to the amount of the 2009 Market Share Loss multiplied by the aggregate Allocable Share percentage of all Joining States;

(b) 30% of any part of the NPM Adjustment under the original formula arising from NPM sales of 1 to 100 million cigarettes above the 2009 Market Share Loss, multiplied by the aggregate Allocable Share percentage of all Joining States;

(c) 40% of any part of the NPM Adjustment under the original formula arising from NPM sales of 100 million to 200 million cigarettes above the 2009 Market Share Loss, multiplied by the aggregate Allocable Share percentage of all Joining States; and

(d) 50 % of any part of the NPM Adjustment under the original formula arising from NPM sales of more than 200 million cigarettes above the 2009 Market Share Loss, multiplied by the aggregate Allocable Share percentage of all Joining States.

Each SPM that joins the settlement would receive proportional adjustments in proportion to the size of its MSA payment for that year.

4. If a Joining State does not have the mandatory provisions of the model legislation (or their functional equivalent) in full force and effect throughout any year following 2012,[3] the PMs will designate for that year either (a) that the State will remain subject to the revised NPM Adjustment under this settlement or (b) that the State will be subject to the original NPM Adjustment formula and arbitration process. If the PMs designate a State for the second option for a year, the State and the PMs will cooperate in the prompt commencement and conduct of that arbitration process; the State may exempt itself from the original NPM Adjustment for that

[3] For a description of the model legislation and associated terms, see Section III below.

year if it demonstrates to the arbitration panel that it diligently enforced its Escrow Statute during that year, but the diligent enforcement requirement will be construed as including the obligations of licensing, stamping and reporting set forth in the mandatory provisions of the model legislation that the State was to have enacted under the settlement and the State may not contend that non-collection of state excise tax or absence of an excise tax stamp on NPM cigarettes removes those cigarettes from the diligent enforcement requirement.[4] For purposes of Section II.C.6, a Joining State that is subject to the original NPM Adjustment under the second option will be treated as a Non-Joining State.[5]

5. Except as provided in Paragraph 6 and Section IV.C.6, the PMs may not designate the second option under Paragraph 4 as to any Joining State for a year in which that State (a) has all of the mandatory provisions of the model legislation (or their functional equivalent) in full force and effect throughout that year except for one or more of the tribal provisions; and (b) represents to the PMs (i) that no federally or state-recognized Indian tribe within its geographic boundaries, no entity owned or operated by such a tribe or member of that tribe on Indian Country, and no entity that the State knows or reasonably should know claims sovereign immunity by virtue of tribal status, membership in such a tribe, ownership or operation by such a tribe or member of that tribe or relationship to such a tribe or member of that tribe participated in the manufacture, sale or distribution of cigarettes during that year, and (ii) that cigarettes were not manufactured, sold or distributed on or from such a tribe's Indian Country during that year. If the representation is inaccurate,[6] the OPMs will be entitled to receive from that State the excess of (x) what they would have received as to that State under the original NPM Adjustment for that year if that State did not diligently enforce a Qualifying Statute during that year and the significant factor issue for that year had been resolved in the PMs' favor over (y) the amount the OPMs received as to that State under the revised NPM Adjustment under settlement for that year, and each SPM will be entitled to the similar excess in proportion to the size of its MSA payment for that year.

[4] If the PMs designate a State for the second option, the significant factor requirement for application of the NPM Adjustment will be applicable only if there are Non-Joining States that are contesting the significant factor issue for that year.

[5] Because of biennial legislative sessions, there will be a potential third transition-period year covering sales year 2013 for the following five States: Arkansas, Montana, Nevada, North Dakota and Oregon. As to any of these five States that does not believe that it has the mandatory provisions of the model legislation (or their functional equivalent) in full force and effect as of December 2012, for 2013: (1) the PMs may not designate the second option described in this Paragraph as to that State on the ground that it does not have the mandatory provisions of the model legislation (or their functional equivalent) in full force and effect throughout 2013; (2) the revised adjustment for stamped sales described in Section B will apply as to that State; (3) the PMs will receive such State's Allocable Share of the amounts detailed in Paragraph 3 for 2013; and (4) the revised adjustment for unstamped NPM sales described in Section C will not apply as to that State for 2013, but that revised adjustment will apply to all other Joining States for 2013 (with no reduction in any adjustment under Section II.C.4(e) reflecting the Section's inapplicability to one or more of the five States). If any of these five States believes on or before December 31, 2012 that it has the mandatory provisions of the model legislation (or their functional equivalent) in full force and effect, it shall promptly notify all parties of that belief. The third transition-period year will not apply as to any of the five States that provides such a notice.

[6] A State may not maintain that the representation was accurate on the ground that it did not know or should not reasonably have known that the entity at issue claimed sovereign immunity if either that is not true or the entity raises a sovereign immunity claim and the State does not contest that claim in court or the entity prevails with finality in whole or in part on it.

6. Any Joining State that believes it needs rating agency approval (or other approval in connection with MSA bonds) to enter the settlement shall disclose that to the PMs and other Joining States at the time of signing this MOU. If such a Joining State does not obtain such approval by the end of the transition period, it will refund or credit additional amounts to the PMs (*i.e.*, in addition to its share of the payments under Section I and Paragraph 3) equal to its Allocated Settlement Percentage of the total amounts specified in Sections I.A.1 and I.A.6 and its Allocable Share of the adjustments due under Paragraph 3. Such a Joining State will also be treated under the second option of Paragraph 4 for each year beginning with sales year 2013 until it obtains such approval. If a Joining State does not disclose a need for rating agency approval (or other approval in connection with MSA bonds) to the PMs prior to signing this MOU and thereafter contends that it needs such approval, it will be treated both (i) as a State that signed this MOU after October 1, 2010 and (ii) as provided in the preceding three sentences until it obtains such approval. A Joining State that does not sign the PSS credit amendment by January 1, 2011 will (i) make the refund or credit described in the second sentence of this Paragraph and (ii) be treated under Paragraph 4 for each year beginning with sales year 2013 until it signs that amendment.

B. Adjustment for Stamped NPM Sales

1. *Adjustment.* Except as provided in Section B.3, each year beginning for sales year 2011 an adjustment will be applied to a Joining State's share of the OPMs' MSA payment equal to the adjustment amount for each non-compliant NPM cigarette sold in a pack bearing a stamp of that State.[7] The adjustment amount will be three (3) times the per-cigarette escrow deposit rate in the Model Escrow Statute for the year of sale (including the inflation adjustment in the Statute). There will be a proportional adjustment for each SPM in proportion to the size of its MSA payment for that year.

2. *Meaning of non-compliant NPM cigarettes.* Non-compliant NPM cigarettes are stamped NPM cigarettes as to which escrow was not deposited at the Escrow Statute rate. Escrow is considered deposited on a cigarette only if (a) it was deposited at the Escrow Statute rate by the NPM or by entities other than the NPM that are liable for escrow payments on the cigarette at issue under the model legislation or (b) the State recovered on an escrow bond posted by the NPM in the amount of escrow due on the cigarette at issue; provided that the State did not release or refund any part of the deposit or the recovery on the bond except as provided in the Model Escrow Statute (as amended by Allocable Share Repeal) or as set forth in subparagraph (x) below (if applicable). In addition, the term non-compliant cigarettes does not include:

> (x) As to States that have the tribal provisions of the model legislation (or their functional equivalent) in full force and effect, NPM cigarettes meeting the definition of the limited exempt NPM sales set forth in those provisions upon which escrow is deposited at the Escrow Statute rate, but as to which the State then properly refunded the escrow in accordance with the process set forth in those provisions.

[7] The term "cigarette" has the meaning given in the MSA except as provided below. References to "stamps" include any of the stamps permitted under the model legislation.

(y) As to States that have Sections 16-18 of the model legislation (or their functional equivalent) in full force and effect, NPM cigarettes as to which the State is barred from requiring escrow deposits from all entities liable for escrow payments on those cigarettes under the model legislation, and from recovery on a remaining escrow bond posted by the NPM, by an automatic stay or subsequent order in a federal bankruptcy proceeding or by order of a court of competent jurisdiction that requiring escrow deposits is barred by federal or state constitutional law (other than state constitutional provisions added or to the extent amended after September 1, 2010 or state constitutional law as it may impact or be applied in relation to sovereign immunity or other Native American issues) or federal statutory or common law, so long as (i) the State opposes and appeals the stay or order, (ii) the State has not contended after execution of the final settlement agreement that the escrow requirement does not apply to or cannot be enforced with respect to any NPM cigarettes required to bear a stamp under the model legislation and has opposed any such contention by any other person or entity, and (iii) the NPM and brand at issue were properly on the State's approved directory, either in accordance with the terms of Complementary Legislation or pursuant to the order of a court of competent jurisdiction barring removal of the NPM or brand from that directory, within 30 days prior the time of sale.[8] This subparagraph does not apply with respect to the cigarettes of any NPM that the State in question has not required to post a bond in at least the amount set forth in Section 17(b) of the model legislation, including because the bond provision as enacted does not apply to that NPM..

Subparagraphs (x) and (y) do not apply to any State that does not have the mandatory provisions of the model legislation in full force and effect.

3. *Safe Harbor*. No adjustment under this Section B will be applied to a State for any year as to which the State demonstrates either (a) that escrow was deposited on at least 96% of all NPM cigarettes sold in the State during that year in packs bearing the State's stamps (other than packs meeting the conditions of Paragraph 2(y), if applicable to the State in question); or (b) that the number of NPM cigarettes sold in the State during that year in packs bearing the State's stamps on which escrow was not deposited does not exceed 2 million cigarettes.

4. *Timing*. The adjustment amount with respect to a State will be applied to that State's share of the PMs' next annual MSA payment. As to NPM cigarettes to which Paragraph 2(y) applies, if the stay or order is reversed or otherwise becomes no longer operative and escrow is not then deposited on the cigarettes at issue, the adjustment on those cigarettes will be applied to that State's share of the PMs' next annual MSA payment unless a further stay or order is entered meeting the provisions of Paragraph 2(y). Adjustment amounts applied to a State's share will be subject to appropriate repayments by the PMs if escrow is deposited on the cigarettes at issue after application of the adjustment.

5. *Data Clearinghouse*. Except as provided in Section IV.B below, the calculations and determinations required under this Section B will be made by the Data Clearinghouse as

[8] The requirements of clauses (i) and (ii) are subject to any limitation arising from Rule 11 or similar state ethical rules.

agreed to by the parties. The Data Clearinghouse will then communicate its calculations and determinations to the Independent Auditor for it to incorporate into its payment calculations.

C. Adjustment for Unstamped NPM Sales

1. Each year beginning for sales year 2013, the Data Clearinghouse will calculate the total number of unstamped NPM sales in the MSA States. This will be done by starting with the nationwide NPM FET-paid[9] sales and subtracting (a) the total number of NPM sales in the Previously Settled States and (b) the total number of stamped NPM sales in the MSA States. Nationwide NPM FET-paid sales will be the sum of NPM FET-paid sales reported by all NPMs (or their importers) to TTB or U.S. Customs, unless such sum is more than 5% different from the sum of all FET-paid sales minus the sum of PM FET-paid sales, in which case the Data Clearinghouse will determine the accurate amount of nationwide NPM FET-paid sales.[10] NPM sales in the Previously Settled States will be determined by the Data Clearinghouse on the basis of NPM reports, other data supplied by the parties and other data obtained by the Data Clearinghouse, but will presumptively be 6.5 billion unless the Data Clearinghouse finds that there is clear and convincing evidence that the sales are at a materially different level. The total number of stamped NPM sales in the MSA States will be the sum of stamped NPM sales in the Joining States and NPM sales bearing the excise tax stamp (or, with respect to a Non-Joining State that does not have excise tax stamps, the similar indicia used by that State) of a Non-Joining State.[11]

2. If the number of unstamped NPM sales in the MSA States as determined pursuant to Paragraph 1 does not exceed Threshold A, then no further action will be taken for that year under the following Paragraphs. Threshold A will be, for 2013, 10% of the number of total NPM sales in the MSA States (stamped plus unstamped) as determined pursuant to Paragraph 1, and will decline by a percentage point per year until it reaches 5%.

3. If the number of unstamped NPM sales in the MSA States exceeds Threshold A but is below Threshold B, the following will take place:

(a) The Data Clearinghouse will determine the nature of the sales at issue to the extent reliable information permits, including which NPM manufactured the cigarettes, in which MSA States they were sold and in what amounts in each such State. The Data Clearinghouse will take into account, but not be limited to, assessment of reports under the model legislation (including corrected reports generated by state

[9] References to "FET" include arbitrios de cigarillos in Puerto Rico.

[10] Beginning for 2015, the percentage used in this sentence will be reduced to 2.5%. If reports from all NPMs to TTB are not available, the sum of the available reports will be used unless such sum is more than the applicable percentage different from the sum of all FET-paid sales minus the sum of PM FET-paid sales.

[11] If a Non-Joining State does not cooperate in producing this information to the Data Clearinghouse in a timely manner, the Data Clearinghouse will estimate the stamped NPM volume in that State using the most recent information for stamped or SET-paid NPM sales produced by that State pursuant to the NPM Procedures Agreement and other data submitted by the parties.

enforcement measures and license revocations), PACT Act reports and any reports or information submitted by the PMs pursuant to the settlement.[12]

(b) After these determinations have been made, the Joining States and the PMs will negotiate in good faith to identify: (i) whether there are further measures that are not available under the model legislation that a Joining State could reasonably take to prevent unstamped NPM sales in that State; and (ii) whether the PMs could reasonably report further data consistent with existing confidentiality laws and contract provisions that would assist the Joining States in preventing such sales.

(c) If the PMs or Joining States either dispute a determination pursuant to Paragraph 3(a) or cannot reach agreement pursuant to Paragraph 3(b), the disputes would be submitted to non-binding arbitration as described in Section IV.B. In resolving disputes under Paragraph 3(b), the arbitrators would identify any additional measures or reporting that meets the standard described in that Paragraph and recommend their adoption by the party involved. Each Joining State and each PM would have the option of implementing measures or reporting recommended to it going forward.

(d) A Joining State may offer evidence to the PMs, the Data Clearinghouse or the arbitrators that escrow was deposited within the meaning of Section II.B.2 on some or all of the unstamped NPM sales at issue.[13]

(e) The States would not be subject to any adjustment under this Section C unless Threshold B is exceeded.

4. If the number of unstamped NPM sales in the MSA States as determined pursuant to Paragraph 1 exceeds Threshold B, the following would apply. Threshold B will be, for 2013, 20% of the number of total NPM sales in the MSA States (stamped plus unstamped) as determined pursuant to Paragraph 1, and will decline by two percentage points per year until it reaches 10%.[14]

(a) The same determination described in Paragraph 3(a).

[12] The Data Clearinghouse will not use any sources of information other than the listed sources in the first year of the other sources' introduction absent agreement otherwise by the parties. Information considered by the Data Clearinghouse will be available to the parties in connection with arbitrations under Section IV.B, subject to appropriate confidentiality protections.

[13] For purposes of this subparagraph and Paragraph 4(g), escrow deposits for an NPM's sales in a State will be assigned first to stamped sales of that NPM's brands in the State except to the extent that the State proves that such deposits are properly assigned to unstamped sales of that NPM's brands in the State.

[14] Threshold B (and the threshold for unidentified NPM sales in the first sentence of Paragraph 4(e)) are the levels at which the applicable potential adjustments are triggered; where triggered, the adjustments apply to NPM cigarettes within the category at issue both above and below the thresholds. The thresholds for the safe harbors in Paragraph 4(d) and Section II.B.3 are the levels at which the applicable safe harbors are triggered; where the safe harbor is not triggered, the adjustments apply to NPM cigarettes within the category at issue both above and below the thresholds.

(b) The same good faith negotiations described in Paragraph 3(b). If the PMs and the Joining States cannot reach agreement on the matters described in Paragraph 3(b), the dispute will be submitted to non-binding arbitration as provided in Paragraph 3(c).

(c) If the PMs or the Joining States dispute a determination pursuant to Paragraph 4(a) or if there are disputes under Paragraph 1 or Paragraph 4(d)-(f), the disputes would be submitted to binding arbitration as described in Section IV.B.

(d) As to unstamped NPM sales in the MSA States identified by the Data Clearinghouse/arbitration as having been sold in a particular Joining State, if the arbitrators determine that the State could have prevented the sales either under the mandatory/reciprocity provisions of the model legislation or if it had implemented measures previously recommended to it under prior agreements or arbitral rulings, a per-cigarette adjustment for the preventable sales would be applied to that State's share of the OPMs' MSA payment of three (3) times the per-cigarette escrow deposit rate in the Model Escrow Statute for the year of sale (including the inflation adjustment in the Statute) and there would be a further proportional adjustment for each SPM in proportion to the size of its MSA payment. No adjustment under this subparagraph (d) will be applied to a Joining State for any year as to which the number of unstamped NPM sales identified by the Data Clearinghouse/arbitration as having been sold in that State are less than the greater of (i) 1 million cigarettes or (ii) 3% of all NPM cigarettes sold during that year in the State (stamped and unstamped) so long as that is not more than 5 million cigarettes.

(e) If the Data Clearinghouse/arbitration does not identify the State of sale of more than 5% of all unstamped NPM sales in the MSA States or sale of more than 150 million unstamped NPM cigarettes ("Unidentified NPM sales"), whichever is less, the following would apply. For the first 25% of Unidentified NPM sales, there would be a per-cigarette adjustment to the OPMs' MSA payment of three (3) times the per-cigarette escrow deposit rate in the Model Escrow Statute for the year of sale (including the inflation adjustment in the Statute) and a proportional adjustment for each SPM in proportion to the size of its MSA payment. This adjustment would be shared among all Joining States ("shared amount"). For the remaining 75% of Unidentified NPM sales, there would be a further per-cigarette adjustment for the OPMs of four (4) times the per-cigarette escrow deposit rate in the Model Escrow Statute (including the inflation adjustment in the Statute) and a proportional adjustment for each SPMs in proportion to the size of its MSA payment allocated among each Joining State that the arbitrators determine (i) did not have the mandatory/reciprocity provisions of the model legislation (or their functional equivalent) in full force and effect throughout the sales year, (ii) failed to implement measures previously recommended to it under prior agreements or arbitral rulings, or (iii) did not demonstrate to the arbitration panel that it took the steps and measures available under the model legislation and that there is no reason to believe that Unidentified NPM sales took place in the State during that year that it could have prevented either under the mandatory/reciprocity provisions of the model legislation or if it had implemented measures previously recommended to it under prior agreements or arbitral rulings ("additional amount"). All other Joining States would not share in this additional amount.

(f) If the arbitrators determine that a PM (i) failed to implement reporting previously recommended to it under prior agreements or arbitral rulings pursuant to Paragraph 3(b)-(c), or (ii) distributed more than 1 million of its cigarettes in a Joining State through direct sale to a contract distributor more than 21 days after receiving notice that the contract distributor's license was revoked by that State pursuant to the model legislation (or its functional equivalent), then the PM waives any adjustment under this Paragraph 4 for the year at issue.

(g) A Joining State that is subjected to an adjustment under Paragraph 4(d) may demonstrate that escrow was deposited within the meaning of Section II.B.2 on some or all of the unstamped NPM sales at issue and the adjustment would be reduced accordingly.

5. The States and the PMs would continue to discuss in good faith on an ongoing basis whether there are other actions that they can reasonably take to prevent unstamped NPM sales.

6. If the OPMs receive an NPM Adjustment under the original NPM Adjustment provision against a Non-Joining State(s) with finality for any year after sales year 2012 and the sum of such Adjustment plus the total adjustments received with finality for that year by the OPMs under the revised NPM Adjustment set forth in Sections B and C above exceed the maximum NPM Adjustment for that year for the OPMs under the original NPM Adjustment provision, then the OPMs will refund the excess to the Joining States. If an SPM receives an NPM Adjustment under the original NPM Adjustment provision against a Non-Joining State(s) with finality for any year after sales year 2012 and the sum of such Adjustment plus the total adjustments received with finality for that year by that SPM under the revised NPM Adjustment set forth in Sections B and C above exceed the maximum NPM Adjustment for that year for that SPM under the original NPM Adjustment provision, then that SPM will refund the excess to the Joining States.

7. Except as provided in Section IV.B, the calculations and determinations required under this Section C will be made by the Data Clearinghouse as agreed to by the parties. The Data Clearinghouse will then communicate its calculations and determinations to the parties and the Independent Auditor for any further proceedings described above or for incorporation into the PMs' payment calculations.

III. LEGISLATION

A. As used in this MOU, the mandatory provisions of the model legislation include: (1) the Model Escrow Statute, Complementary Legislation and Allocable Share Repeal; (2) the provisions of the model legislation attached hereto as Appendix A that are identified as mandatory; and (3) in the case of any Joining State that, in the year at issue, has a federally or state-recognized Indian tribe within its geographic boundaries or provides for a different level of taxation or has a different stamping requirement/policy for cigarettes based on their sale by or other connection with Native American tribes or tribal entities, the provisions of the model legislation that are identified as tribal.

B. A provision of the model legislation will be deemed to be in full force and effect if either (1) the State enacts that provision of model legislation without modification or addition except for particularized state procedural or technical requirements and not in conjunction with any other legislative or regulatory proposal (except for other model legislation provisions or additional legislation that the PMs may agree can be enacted in conjunction with the model legislation) and that provision remains in full force and effect, or (2) the State has or puts in place the functional equivalent of that provision through legislation or regulation and that legislation or regulation remains in full force and effect.

C. At each Joining State's option, the PMs will upon request discuss in good faith with a Joining State prior to enactment or promulgation of proposed legislation or regulation an agreement as to whether the proposal constitutes the functional equivalent of the provision of the model legislation at issue.

D. Disputes about whether a Joining State has a provision of the model legislation or its functional equivalent in full force and effect will be submitted to binding arbitration as described in Section IV.B.

E. The PMs will support the enactment of legislation described in Paragraph B.1 if introduced or proposed (1) without modification or addition (except for particularized procedural or technical requirements) and (2) not in conjunction with any other legislative proposal (except for other model legislation provisions or additional legislation that the PMs may agree can be enacted in conjunction with the model legislation).

F. Each Joining State will disclose to the PMs any modification of any provision of the model legislation or functional equivalent that is subsequently made, whether by amendment or separate legislation or regulation.

IV. PROCESS

A. Data Clearinghouse

The Data Clearinghouse will be a firm that has both forensic acccounting and analytical qualifications that is jointly retained by the parties. The Clearinghouse, in consultation with the parties, will also employ or contract with a person with extensive legal qualifications, who will make the determinations concerning legal issues involved in application of Section II.B.2(x)-(y) (other than issues regarding whether a State has provisions of the model legislation or their functional equivalent in full force and effect). The final settlement agreement will set forth (1) detailed qualifications for the entity and its employees/contractors who will work on the matters described herein, (2) the process for retaining the entity, (3) the process for submission of information to and raising issues with the entity and for the entity's decisionmaking, and (4) the types of information to be submitted to and considered by the entity. The first $5 million of funding for the Data Clearinghouse shall be paid from the earnings or principal of the amount allocated under Section I.A.4(c), and the reasonable costs will thereafter be paid 50% by the PMs and 50% by the Joining States.

B. Arbitration

1. Disputes specified in Sections II.C.3(c), II.C.(4)(b), II.C.4(c) and III.D will be submitted to arbitration as described in those Sections. In addition, disputes arising from calculations or determinations of the Data Clearinghouse that involve over $10 million or 10% of the affected States' Allocated Payments for that year, whichever is less, and disputes regarding whether a representation described in this MOU was inaccurate will be submitted to binding arbitration. The parties will cooperate in the prompt commencement and conduct of the arbitrations, as set forth in Paragraph 3, and may agree to pursue mediation in lieu of arbitration. The foregoing is not intended to alter or amend Section XI(c) of the MSA.

2. Any Joining State and any PM that is affected by the dispute may participate in the arbitration concerning that dispute and in the selection of the panel as provided in Paragraph 3. The arbitration will be before a single panel to address both common and state-specific issues. If a State has issues specific to that state, it may submit those to the panel for determination. The panel shall decide all issues necessary to resolve the dispute and shall not lack jurisdiction or the duty to do so because of the failure of a Joining State or PM to participate. Unless specified otherwise by the arbitration panel, the rulings of the panel in binding arbitrations will be binding on all parties to the settlement, whether or not they participated in the arbitration or in the selection of the panel. Unless specified otherwise by the arbitration panel, any additional measures or reporting recommended by the panel in non-binding arbitrations under Section II.C.3(c) will be treated as having been recommended to all Joining States (in the case of additional measures) and PMs (in the case of reporting), whether or not they participated in the arbitration or in the selection of the panel.

3. The arbitration panel will be selected as follows. The participating PMs (collectively) and the participating Joining States (collectively) will each select one neutral arbitrator chosen from JAMS (unless the parties agree to a substitute) within 90 days of the sending of the initial arbitration notice by a party under this Section. If the 90-day period expires without a side having selected its arbitrator, JAMS (unless the parties agree to a substitute) will choose the arbitrator for that side. Within 60 days of the selection of the two arbitrators, those two arbitrators will choose the third neutral arbitrator, who shall be a retired Article III federal judge. Once selected, the panel will establish a scheduling order either as agreed to by the parties or if not agreed, as determined by the panel. That panel shall hear all disputes to be submitted to arbitration under Paragraph 1 for the year in question.

C. Other

1. *Withholding/Disputed Payments Account.* The PMs will not withhold or pay into the Disputed Payments Account based on a dispute arising out of the revised NPM Adjustment except if the dispute was noticed for arbitration by the PM over one year prior to the payment date and the arbitration has not begun despite good faith efforts by the PM.

2. *Most Favored Nations.*

(a) If one or more PMs that join the settlement enter into a separate settlement agreement with a Settling State that resolves the 2003 NPM Adjustment as to that State prior to a determination in the current Arbitration as to whether that State diligently enforced a Qualifying Statute during 2003, and such settlement includes overall terms more favorable to such Settling State than the terms of this settlement applicable to Joining States that sign this MOU by October 1, 2010, then the overall terms of this settlement will be revised as to all Joining States that sign this MOU by October 1, 2010 so that they will obtain from the PM(s) party to such separate settlement agreement overall terms as favorable as those obtained by such Settling State;[15] provided, however, that revision will not be required by virtue of an agreement by a PM to accept a compact described in Paragraph 6 as to a State or by virtue of the provisions of footnote 5.

(b) If one or more Joining States enter into a separate settlement agreement with a PM (whether a signatory to this settlement or not) that resolves the 2003 NPM Adjustment as to that State prior to a determination in the current Arbitration as to whether that State diligently enforced a Qualifying Statute during 2003, and such settlement includes overall terms more favorable to such PM than the terms of this settlement, then the overall terms of this settlement will be revised as to all PMs that sign this MOU by October 1, 2010 so that they will obtain from the Joining State(s) party to such separate settlement agreement overall terms as relatively favorable as those obtained by such PM.

3. *RYO.* The settlement agreement will contain the provisions necessary to implement the terms and intent of this MOU fully as to RYO. These provisions will include: (a) provisions that make the provisions of Section II.B applicable to SET (or equivalent tax) paid RYO in the case of Joining States that do not require that RYO containers be stamped; (b) that, for any Joining State that does not require that RYO containers be stamped, the mandatory provisions of the model legislation include provisions sufficient to require NPMs to make escrow deposits at the Escrow Statute rate on RYO sales in the State; and (c) provisions for non-binding arbitration as described in Section IV.B in the event that non-SET (or equivalent tax) paid NPM RYO sales exceed 4 million pounds in a year; in such an arbitration, the arbitrators would identify any further measures that are not available under the model legislation that a Joining State could reasonably take to prevent non-SET (or equivalent tax) paid NPM RYO sales in that State and recommend their adoption, and any such recommended measures would be treated as recommended measures under Section II.C.3(c) and Section II.C.4(b).

4. *Joinder.* This MOU and the settlement are conditioned on joinder by a critical mass of PMs and by a critical mass of Settling States by October 1, 2010. By October 1, 2010 , the Joining States will inform the PM negotiating team of the identity of the Settling States that have signed this MOU. By October 1, 2010, the PMs will inform the State negotiating team of

[15] References to settling or resolving the 2003 NPM Adjustment as to a Settling State do not include determinations by a PM not to contest that State's diligent enforcement claim for 2003 unless the PM received consideration from that State in return for such determination.

the identity of the PMs that have signed this MOU. On October 4, 2010, the parties who have signed this MOU by October 1, 2010 will determine, in each party's sole discretion, whether a critical mass of Settling States (in the case of a PM) and PMs (in the case of a State) have signed this MOU such that the settlement will proceed. Any Settling State or Participating Manufacturer may sign this MOU by October 1, 2010, and if the settlement proceeds after that date, up until execution of the final settlement agreement by delivering a copy signed by its authorized representative to the following persons: Elli Leibenstein, Esq., Kirkland & Ellis LLP, 300 North LaSalle, Chicago, IL 60654; David Cookson, Esq., Office of the Attorney General, State of Nebraska, 2115 State Capitol, Lincoln, NE 68509. After execution of the final settlement agreement, the parties agree to cooperate in the addition of further parties to the agreement. If the PMs enter into an agreement with a Settling State that has not signed this MOU under which such Settling State agrees to a revised NPM Adjustment that contains no material deviation of substance as to the applicable years from the provisions of Sections II.B, II.C, III, IV.A, IV.B and IV.C.3 of this MOU (as those Sections are reflected in the final settlement agreement), the Joining States will not object to such Settling State being considered a Joining State for purposes of those Sections for such years, although such agreement may give rise to a revision under Paragraph 2(a) if its terms and timing are as described in that Paragraph.

5. *Office.* Each Joining State shall identify or establish an office, department or other point of contact to which information regarding potential violations of the provisions of the model legislation (or its functional equivalent), the Model Escrow Statute, Complementary Legislation and Allocable Share Repeal, as enacted in each such Joining State, can be reported by consumers, retailers, wholesalers, jobbers, manufacturers or others involved with the manufacture, distribution or sale of cigarettes. Each Joining State shall report publicly, to the extent permissible under any applicable confidentiality restrictions, the reports made and the actions, if any, taken to address each such report.

6. *Compacts.* Each Joining States represents that it has no compacts or treaties with Indian tribes or tribal entities or tribal members that are inconsistent with any of the provisions of this MOU or the mandatory or tribal provisions of the model legislation, except as may have been disclosed to and accepted by the PMs, and that it will not enter into any such compacts or treaties after signing this MOU. A Joining State will be treated under Section II.A.4 for each year beginning with sales year 2013 in which the representation is inaccurate.

7. *Adjustment.* The Joining States and OPMs agree that the proper interpretation of the MSA is that the OPMs may exclude amounts received or retained pursuant to Section I from operating income for purposes of Section B(ii) of Exhibit E to the MSA, irrespective of how the OPMs account for such amounts in their financial statements. The Joining States and OPMs further agree to jointly urge the Independent Auditor not to treat amounts received or retained pursuant to Section I as operating income for purposes of Section B(ii) of Exhibit E to the MSA. Should the Independent Auditor nonetheless calculate an increase in MSA payments for the OPMs pursuant to Section B(ii) of Exhibit E to the MSA despite this paragraph, the Joining States agree to waive the right to receive their portion of any such increase in MSA payments and, if necessary, provide an affected OPM an additional credit against its April 2011 annual MSA payment to offset the Joining States' portion of any such increase in MSA payments.

8. *Sales "in" a State; "Original" NPM Adjustment.* As used in this MOU, cigarettes are sold in the State in or into which they are sold for consumption. References to the "original" NPM Adjustment or the "original" NPM Adjustment formula mean the NPM Adjustment under MSA §§ IX(d)(1)(A)-(B) (as to OPMs), IX(d)(4) (as to SPMs) and IX(j) as they existed immediately prior to this MOU on the assumption (unless stated otherwise) that the NPM Adjustment applies under MSA § IX(d)(1)(C)-(D) and that the full amount of such Adjustment can be allocated under MSA § IX(d)(2).

9. *Independent Auditor.* The parties will instruct the Independent Auditor to act in conformity with the settlement agreement as to the Joining States and PMs.

10. *Settlement Agreement.* The parties will cooperate in the drafting and execution of a comprehensive final settlement agreement incorporating the terms of this MOU, as well as other customary terms and conditions acceptable to the parties, by December 3, 2010 or as soon as possible thereafter. The documentation process will be subject to the oversight of the Panel.

Agreed and accepted

Party: ____________________

By: ____________________

Title: ____________________

Date: ____________________

Appendix A -- Model Legislation

MANDATORY

Sec. [1]. Restrictions on Transactions in Unstamped Cigarettes.

(a) Cigarettes may be sold in, into or from the State only in packages.

(b) Except as provided in this Section, all packages of cigarettes sold in or into the State shall bear a stamp permitted under Section [4] and no person may sell, transport or cause to be transported unstamped cigarettes in, into or from, or possess unstamped cigarettes in, the State.

(c) No person other than a stamping agent may affix a stamp listed in Section [4] to any package. A stamping agent must affix the appropriate stamp under Section [4] to the package containing any unstamped cigarettes it acquires prior to selling those cigarettes in or into the State. Stamping agents may sell cigarettes in or into the State, may purchase cigarettes for re-sale in or into the State, and may affix a stamp listed in Section [4] to a package only if (i) the manufacturer and brand family of the cigarettes are listed on the state directory at the time of stamping and (ii) the stamping agent is the manufacturer or importer of the cigarettes or purchased the cigarettes directly from the manufacturer or importer of the cigarettes.

(d) A manufacturer or importer may possess, transport or cause to be transported unstamped cigarettes that it manufactures or imports. A manufacturer or importer may sell its unstamped cigarettes in or into the State to a stamping agent under the following circumstances: (i) the manufacturer and brand family of the cigarettes are at the time of sale listed on the state directory; or (ii) if the manufacturer and brand family of the cigarettes are not at the time of sale listed on the state directory, only if (A) the stamping agent is authorized to affix the stamp of or, where permitted under subsection (e) pay the taxes imposed by, another State on whose directory the manufacturer and brand family of the cigarettes are listed at the time of sale, (B) the stamping agent would be permitted to re-sell the cigarettes from this State into that other State under subsection (e) and (C) the stamping agent receiving the cigarettes holds a directory license from [name of State agency] pursuant to Section [2(c)] and has given at least 5 days notice to [name of State agency] before the cigarettes are transferred.

(e) A manufacturer or importer may sell its cigarettes from this State into another State only if the sale is to a person authorized by the law of the other State to affix the stamp required by the other State prior to re-sale or the manufacturer or importer first affixes the stamp required by the other State to the package containing the cigarettes. Any other stamping agent may sell cigarettes from this State into another State only if it first affixes the stamp required by the other State to the package containing the cigarettes. If the law of the other State permits the sale of the cigarettes to consumers in a package not bearing a stamp, a manufacturer, importer or stamping agent may sell cigarettes into the other State without a stamp only if (i) it first pays any excise, use or similar tax imposed on the cigarettes by the other State or (ii) in the case of sale by a manufacturer or importer, the sale is to a person authorized by the law of the other State to pay such tax and the manufacturer or importer reports the name and address of the recipient and the quantity and brand of the cigarettes to the taxing authority of the other State by 15 days following the end of the month in which the sale was made. Notwithstanding the above, a person may not sell cigarettes from this State into another State if the sale would violate the law of the other State, or affix the stamp required by the other State or pay the excise, use or similar tax imposed by the other State if doing so would violate the law of the other State.

(f) A manufacturer or importer may sell unstamped cigarettes as permitted under subsection (d) or (e) through its sales entity affiliate. If the manufacturer or importer does so: (i) it may sell or otherwise transfer the unstamped cigarettes to its sales entity affiliate in connection with the sale; (ii) the sales entity affiliate may sell, possess, transport or cause to be transported the unstamped cigarettes in connection with the sale to the same extent as the manufacturer or importer could under this Section if it were making the sale directly; (iii) in the case of sales permitted under subsection (d), the stamping agent will be deemed to have purchased the cigarettes directly from the manufacturer or importer; and (iv) in the case of sales permitted under subsection (e), the sales entity affiliate may act for the manufacturer or importer in affixing the stamp required by the other State or paying the taxes imposed by the other State prior to the sale, in lieu of the manufacturer or importer doing so itself, to the same extent as the manufacturer or importer could do so. A manufacturer or importer shall notify [name of State agency] prior to beginning selling cigarettes through its sales entity affiliate under this subsection. Such notification shall identify the sales entity affiliate, certify the facts that the manufacturer or importer believes qualify it as a sales entity affiliate as defined in this Act, and be updated promptly in the event of any changes.

(g) A stamping agent may possess unstamped cigarettes for sale in or into the State provided that (i) it is permitted to purchase, sell and affix a stamp to the package containing such cigarettes under subsection (b) and (ii) it affixes the appropriate stamp under Section [4] to the package containing such cigarettes within 15 days of receipt of the cigarettes and prior to selling the cigarettes in or into the State. This requirement shall not apply to a manufacturer, importer or sales entity affiliate that is a stamping agent to the extent it is selling, transferring, transporting, causing to be transported or possessing unstamped cigarettes as permitted under this Section.

(h) Except as provided below, a stamping agent may possess unstamped cigarettes for sale from this State into another State provided that (i) it affixes the stamp required by the other State to the package containing the cigarettes, or if permitted under subsection (e), pays any excise or similar tax imposed on the cigarettes by the other State, within 15 days of receipt of the cigarettes and prior to selling the cigarettes in or into the other State; and (ii) neither the sale nor the affixing of the stamp or payment of taxes would violate the law of the other State. A stamping agent may not purchase or possess unstamped cigarettes in this State for sale into another State where the manufacturer and brand family of the cigarettes are not at the time of sale listed on this State's directory unless it holds a directory license pursuant to Section 2(c). The requirements of this subsection shall not apply to a manufacturer, importer or sales entity affiliate that is a stamping agent to the extent it is selling, transferring, transporting, causing to be transported or possessing unstamped cigarettes as permitted under this Section.

(i) A stamping agent may transfer, transport or cause to be transported unstamped cigarettes that it owns and is permitted to possess under subsections (g) or (h) from one of its facilities in this State to another of its facilities. If the facility to which the cigarettes are transferred is located in this State or the cigarettes are to be re-sold in this State, the applicable time period for affixing a stamp or payment of tax under those subsections shall remain in effect and shall continue to run from the date of the stamping agent's original receipt of the cigarettes. If the facility to which the cigarettes are transferred is located outside of this State, the stamping agent shall report the quantity and brand of the cigarettes to the [name of State agency] and the taxing authority of the other State by 15 days following the end of the month in which the transfer was made. Notwithstanding the above, a stamping agent may not transfer cigarettes from this State into another State if the transfer would violate the law of the other State.

(j) A common carrier or contract carrier may possess and transport unstamped cigarettes in connection with a sale or other transfer permitted under subsections (d)-(f) or (i), if the common carrier or contract carrier has in its possession documents establishing that title to the unstamped cigarettes remains with the manufacturer, importer or stamping agent or bills of lading or other shipping documents establishing that it is delivering the cigarettes on behalf of a person authorized to sell or transfer the unstamped cigarettes under subsections (d)-(f) or (i) and, in each case, such documents list the name and address of the person to whom the cigarettes are being delivered. A public warehouse may possess unstamped cigarettes on behalf of a manufacturer, importer or stamping agent if the public warehouse maintains records to show receipt from a person authorized to sell or transfer the unstamped cigarettes under subsections (d)-(f), provided that in the case of a stamping agent this shall not extend the 15-day period for affixing of stamps or payment of taxes under subsections (g) or (h).

(k) Manufacturers and importers and their contractors, agents, common carriers or contract carriers may possess, transport or cause to be transported unstamped cigarettes in, into or from this State for use in connection with consumer testing permitted under the law of the State in which the testing is to be done, provided that (i) such cigarettes are not currently commercially marketed in the United States, (ii) the manufacturer pays applicable State excise taxes on such cigarettes by return, (iii) in the case of a non-participating manufacturer, the non-participating manufacturer makes escrow payments on such cigarettes under [cross-reference State's escrow statute] and Section [5], or, in the case of a participating manufacturer, such cigarettes are included in its volume for purposes of the Master Settlement Agreement (as defined in [cross-reference to complementary law]); (iv) the cigarettes are provided at no cost to the consumer testing participants; and (v) and the quantity of cigarettes so used by a manufacturer or importer for consumer testing shall not exceed a reasonable quantity.

(l) A person shall not be subject to penalty under this Act for possession of up to 600 cigarettes bearing the stamp of another State for consumption by that person or that person's family if the cigarettes are physically brought into the State by such person or a member of that person's family. *[Note: States may reduce the number below 600.]*

(m) No person may sell cigarettes or cigarette inputs to, or purchase cigarettes from, any person in another State if the sale or purchase would violate the law of the other State.

Sec. [2]. Stamping Agent Licenses

(a) Any manufacturer, importer, sales entity affiliate, wholesaler or retailer that engages in the business of selling cigarettes may apply to be licensed as a stamping agent, in accordance with this Section [2]. A license shall be issued by [name of State agency] to an applicant upon the applicant's (i) meeting all requirements in [cross-reference existing requirements for its particular license]; (ii) certifying on a form prescribed by [name of State agency] that it will comply with the requirements in Section [3]; (iii) consenting to the jurisdiction of the State to enforce the requirements of this Act, and waiving any claim of sovereign immunity to the contrary; (iv) waiving any confidentiality laws as necessary to permit the [name of State agency] to create and make available the list described in subsection (b) and to share information reported under this Act and [cross-reference other State reporting requirements] with the taxing or law enforcement authorities of other States or with [insert reference to Data Clearinghouse]; and (v) in the case of an applicant located outside of the State, designating an agent in the State for service of process in connection with enforcement of this Act.

(b) The [name of State agency] shall list on its website the names of all persons licensed as stamping agents under this Section [2]. Manufacturers, importers and sales entity affiliates shall be entitled to rely upon the list in selling cigarettes as provided in Section [1].

(c) A manufacturer, importer, sales entity affiliate, wholesaler or retailer that engages in the business of selling cigarettes that holds a valid stamping agent license under subsection (a) may apply for a directory license allowing it to purchase or possess in the State cigarettes of a manufacturer or brand family not at the time of purchase listed on the state directory for sale into another State where permitted under Section 1. A directory license shall be issued by [name of State agency] to an applicant upon the applicant's (i) demonstrating that it holds a valid license under subsection (a), (ii) providing a certification by an officer thereof on a form prescribed by [name of State agency] that any cigarettes of a manufacturer or brand family not listed on the state directory will be purchased or possessed solely for sale or transfer into another State as permitted by Section 1; and (iii) waiving any confidentiality laws as necessary to permit the [name of State agency] to create and make available the list described in subsection (e). The directory license shall remain in effect for a period of one year.

(d) No directory license may be issued to a person that acted inconsistently with a certification it previously made under subsection (c).

(e) The [name of State agency] shall list on its website the names of all persons holding a directory license. Manufacturers, importers, sales entity affiliates and stamping agents shall be entitled to rely upon the list in selling cigarettes as provided in Section [1].

Sec. [3]. Licensed stamping agents; requirements.

Each stamping agent shall:

(a) Comply with Section [1] with regard to affixing stamps;

(b) Comply with Section [4] and [cross-reference applicable tax law provisions] with regard to which stamp to affix;

(c) Pay to the State all taxes applicable under [cross-reference applicable tax law provisions] to cigarettes it sells or present documentation demonstrating that such taxes were paid prior to the sale;

(d) Provide complete and accurate reports as required under Sections [6], [6A] and [8]; and

(e) Certify quarterly that it has complied with all requirements of this Act.

Sec. [4]. Required stamps.

[This section will need to be customized for each State depending upon its tax policy. States will be permitted to include (i) a regular excise tax stamp, (ii) a tax-exempt stamp, (iii) a tribal tax stamp or (iv) another type of stamp representing a specified level of tax different from the regular excise tax; provided that, in the case of stamps within (ii), (iii) or (iv), the State sets forth specific requirements regarding the circumstances when the stamps are permitted and those requirements are the same as to all manufacturers' cigarettes.]

Sec. [5]. Relationship with escrow and complementary laws.

(a) The definition of "units sold" under Section [_] of [cross-reference State's escrow statute] shall include all non-participating manufacturer cigarettes that are required to be sold in a package bearing a stamp permitted under Section [4] or are described in Section [1(k)].

(b) All escrow deposits under [cross-reference State's escrow statute] shall be made on a quarterly basis, no later than 30 days after the end of each calendar quarter in which the sales are made. Each failure to make a full quarterly installment deposit shall constitute a separate violation of [cross-reference State's escrow statute].

(c) The [name of State agency] shall promptly review the amount deposited by each non-participating manufacturer for each calendar quarter against the reports received under Sections [6-8] and other information, and shall invoice each non-participating manufacturer for which it concludes that an additional deposit was owed.

(d) The [name of State agency] shall promptly remove from the state directory any non-participating manufacturer and its brand families where that non-participating manufacturer fails to make or have made on its behalf deposits equal to the full amount owed for a quarter as of the date due under subsection (b). [Cross-reference existing state complementary legislation regarding process protections.]

(e) An importer shall be jointly and severally liable for escrow deposits due from a non-participating manufacturer with respect to non-participating manufacturer cigarettes that it imports.

(f) As a condition to being listed and having its brand families listed on the state directory, a manufacturer must certify annually that it holds a valid permit under 26 U.S.C. § 5713 and provide a copy of such permit to [name of State agency];

(g) The [name of State agency] shall promulgate rules and regulations necessary to implement subsections (a)-(f).

Sec. [6]. Stamping Agent Reports.

Each stamping agent shall, within 15 days following the end of each month, file a report on a form to be prescribed by the [name of State agency] and certify to the State that the report is complete and accurate. The report shall contain, in addition to any further information that the [name of State agency] may reasonably require to assist it in enforcing this Act and [cross-reference State's escrow statute, contraband law and tax law], the following information:

(a) the total number of cigarettes acquired by the stamping agent during that month for sale in or into the State or for sale from this State into another State, sold in or into the State by the stamping agent during that month, and held in inventory in the State or for sale into the State by the stamping agent as of [the last Friday of that month/the end of the month], in each case identifying by name and number of cigarettes (i) the manufacturers of those cigarettes and (ii) the brand families of those cigarettes; and *[Note: State may choose the inventory date.]*

(b) the total number of stamps under Section [4] it affixed during that month, and identifying (i) how many of each type of stamp it affixed by number and total dollar amount of tax paid, (ii) the total number of cigarettes contained in the packages to which it affixed each respective type of tax stamp and (iii) by name and number of cigarettes, the manufacturers and brand families of the packages to which it affixed each respective type of tax stamp.

(c) In the case of a stamping agent that is a manufacturer or importer, reports under subsection (a) shall not include cigarettes it sold to a stamping agent as permitted under Section [1(d)(i)] and that it separately reports pursuant to Section [7]. In the case of a stamping agent that is a retailer, reports under subsection (a) do not have to include cigarettes contained in packages that bore a stamp permitted under Section [4] at the time the stamping agent received them and that the stamping agent then sold at retail.

(d) The [name of State agency] may share the information reported under this section with the taxing or law enforcement authorities of this State or other States or with [insert reference to Data Clearinghouse] as provided in [insert reference to settlement agreement and related documents regarding Data Clearinghouse].

Sec. [6A]. Reports of Cigarettes not on State Directory.

Any person that during a month acquired, purchased, sold, possessed, transferred, transported or caused to be transported in or into this State cigarettes of a manufacturer or brand family that were not on the State directory at the time shall, within 15 days following the end of that month, file a report on a form to be prescribed by the [name of State agency] and certify to the State that the report is complete and accurate. The report shall contain, in addition to any further information that the [name of State agency] may reasonably require to assist it in enforcing this Act and [cross-reference State's escrow statute, contraband law and tax law], the following information:

(a) the total number of those cigarettes, in each case identifying by name and number of cigarettes (i) the manufacturers of those cigarettes, (ii) the brand families of those cigarettes, (iii) in the case of a sale or transfer, the name and address of the recipient of those cigarettes, (iv) in the case of an acquisition or purchase, the name and address of the seller or sender of those cigarettes, and (v) the other State(s) on whose directory the manufacturer and brand family of those cigarettes were listed at the time and whose stamps the person is authorized to affix, or where permitted under Section [1(e)] whose taxes the person is authorized to pay; and

(b) in the case of acquisition, purchase or possession, the details of the person's subsequent sale or transfer of those cigarettes, identifying by name and number of cigarettes (i) the brand families of those cigarettes, (ii) the date of the sale or transfer, (iii) the name and address of the recipient, (iii) the number of stamps of each other State that the person affixed to the packages containing those cigarettes during that month, (iv) the total number of cigarettes contained in the packages to which it affixed each respective other State's stamp, (v) by name and number of cigarettes, the manufacturers and brand families of the packages to which it affixed each respective other State's stamp and (vi) a certification that it reported each sale or transfer to the taxing authority of the other State by 15 days following the end of the month in which the sale or transfer was made and attaching a copy of all such reports. If the subsequent sale or transfer were from this State into another State in packages not bearing a stamp of the other State, the report shall also contain the information described in Section [8(b)(iii).]

(c) Reports under this Section shall be in addition to reports under Sections 6, 7 or 8.

(d) The [name of State agency] may share the information reported under this section with the taxing or law enforcement authorities of this State or other States or with [insert reference to Data Clearinghouse] as provided in [insert reference to settlement agreement and related documents regarding Data Clearinghouse].

Sec. [7]. Manufacturer and Importer Reports.

(a) Each manufacturer and importer that sells cigarettes in or into the State shall, within 15 days following the end of each month, file a report on a form to be prescribed by the [name of State agency] and certify to the State that the report is complete and accurate.

(b) The report shall contain the following information: the total number of cigarettes sold by that manufacturer or importer in or into the State during that month, and identifying by name and number of cigarettes (i) the manufacturers of those cigarettes, (ii) the brand families of those cigarettes and (iii) the purchasers of those cigarettes. A manufacturer's or importer's report shall include cigarettes sold in or into the State through its sales entity affiliate.

(c) The requirements of subsection (a) shall be satisfied and no further report shall be required under this Section with respect to cigarettes if the manufacturer or importer timely submits to [name of State agency already receiving reports under 15 U.S.C. § 376] the report or reports required to be submitted by it with respect to those cigarettes under 15 U.S.C. § 376 to [State agency] and certifies to the State that the reports are complete and accurate.

(d) Upon request by [name of State agency] a manufacturer or importer will subject to this Section will provide copies of similar reports that it filed in other States.

(e) Each manufacturer and importer that sells cigarettes in or into the State shall either: (i) submit its federal returns, as defined below, to [name of State agency] by 60 days after the close of the quarter in which the returns were filed or (ii) submit to the United States Treasury a request or consent under Internal Revenue Code Section 6103(c) authorizing the Alcohol and Tobacco Tax and Trade Bureau and, in the case of a foreign manufacturer or importer, the U.S. Customs Service to disclose the manufacturer's or importer's federal returns, as defined below, to [name of State agency] as of 60 days after the close of the quarter in which the returns were filed.

(f) The [name of State agency] may share the information reported under this section with the taxing or law enforcement authorities of this State or other States or with [insert reference to Data Clearinghouse] as provided in [insert reference to settlement agreement and related documents regarding Data Clearinghouse].

Sec. [8]. Out of State Sales Reports.

(a) Any person that sells cigarettes from this State into another State shall, within 15 days following the end of each month, file a report on a form to be prescribed by the [name of State agency] and certify to the State that the report is complete and accurate.

(b) The report shall contain the following information:

(i) the total number of cigarettes sold from this State into another State by the person during that month, identifying by name and number of cigarettes (A) the manufacturers of those cigarettes, (B) the brand families of those cigarettes and (C) the name and address of the each recipient of those cigarettes;

(ii) the number of stamps of each other State the person affixed to the packages containing those cigarettes during that month, the total number of cigarettes contained in the packages to which it affixed each respective other State's stamp and by name and number of cigarettes, the manufacturers and brand families of the packages to which it affixed each respective other State's stamp; and

(iii) if the person sold cigarettes during that month from this State into another State in packages not bearing a stamp of the other State, (A) the total number of cigarettes contained in such packages, identifying by name and number of cigarettes, the manufacturers of those cigarettes, the brand families of those cigarettes and the name and address of each recipient of those cigarettes; and (B) the person's basis for belief that such State permits the sale of the cigarettes to consumers in a package not bearing a stamp, and the amount of excise, use or similar tax imposed on the cigarettes by paid by the person to such State on the cigarettes, provided that manufacturers and importers need include the information described in this clause (B) only as to cigarettes not sold to a person authorized by the law of the other State to affix the stamp required by the other State or, where permitted under Section [1(e)], to a person authorized by the law of the other State to pay the excise, use or similar tax imposed on the cigarettes by the other State.

(c) In the case of a manufacturer or importer, the report shall include cigarettes sold from this State into another State through its sales entity affiliate. A sales entity affiliate shall file a separate report under this Section only to the extent that it sold cigarettes from this State into another State not separately reported under this Section by its affiliated manufacturer or importer.

(d) The report shall also attach reports filed under Sections 1(e) and 1(i) with [name of State agency] or the taxing authority of another State.

(e) The [name of State agency] may share the information reported under this section with the taxing or law enforcement authorities of this State or other States or with [insert reference to Data Clearinghouse] as provided in [insert reference to settlement agreement and related documents regarding Data Clearinghouse].

Sec. [9]. Revocation of License and Removal from State Directory; penalties.

[Note: the penalties for violation of an Optional or Tribal provision are to be included only where the State has enacted the corresponding Optional or Tribal provision.]

(a) The license of a stamping agent shall be subject to termination if it

(i) fails to provide a report required under Section [6], [6A] or [8] or a certification as provided in Section 3(e);

(ii) files an incomplete or inaccurate report or files an inaccurate certification;

(iii) fails to pay taxes as provided in Section 3(c) or deposit escrow as provided in Section 16;

(iv) sells cigarettes in or into the State in a package that bears a stamp permitted under Section [4] that is not the correct stamp under [cross-reference applicable tax law provisions] and provides for a lower level of tax than the correct stamp;

(v) sells unstamped cigarettes in, into or from the State or possesses unstamped cigarettes in the State except as provided in Section [1];

(vi) purchases, sells in or into the State, or affixes a tax stamp to a package containing, cigarettes of a manufacturer or brand family that is not at the time listed on the State directory, or possesses such cigarettes more than [10-20] days after receiving notice that the manufacturer or brand family is not on the State directory, except as expressly permitted under this Act; or

(vii) purchases or sells cigarettes in violation of Sections [1, 9(d) or 20].

(b) In the case of a failure under subsection (a)(i)-(iv) that was not knowing or intentional, the stamping agent shall be entitled to cure the failure during the period set forth in Section [10(a)]. The license of a stamping agent that fully cures the failure during that period shall not be terminated on account of that failure. *[Note: A State may use a different cure period or mechanism if not more favorable to the stamping agent.]*

(c) In the case of a knowing or intentional failure under subsection (a)(i)-(iv), or of any violation described in subsection (a)(v)-(vi), the stamping agent shall for a first violation be subject to a civil penalty of up to $1,000 and be guilty of a [Class IV] misdemeanor and for a second or subsequent violation be subject to a civil penalty of up to $5,000 per violation and be guilty of a [Class II] misdemeanor. In the case of violations described in subsection (a)(iv)-(vi), each sale constitutes a separate offense. *[Note: criminal penalties are optional.]*

(d) The [name of State agency] shall promptly remove any stamping agent whose license is terminated from the list required by Section [4(b)] and shall publish a notice of the termination on [State agency's] website and send notice of the termination to all stamping agents and to all persons listed on the state directory. Beginning 10 days following the publication and sending of such notice, no person may sell cigarettes to, or purchase cigarettes from, the stamping agent whose license has been terminated.

(e) If a stamping agent whose license has been terminated is a manufacturer of cigarettes, it and its brand families shall be removed from the State directory.

(f) A stamping agent whose license is terminated shall eligible for reinstatement:

(i) 90 days following the termination, in the case of a first failure under subsection (a)(i)-(iv) that was not knowing or intentional;

(ii) 180 days following the termination, in the case of a second failure under subsection (a)(i)-(iv) that was not knowing or intentional;

(iii) one year following the termination, in the case of a third or subsequent failure under subsection (a)(i)-(iv) that was not knowing or intentional;

(iv) one year following the termination, in the case of a first knowing or intentional failure under subsection (a)(i)-(iv) or violation described in subsection (a)(v)-(vii); and

(v) three years following the termination, in the case of a second of subsequent knowing or intentional failure under subsection (a)(i)-(iv) or violation described in subsection (a)(v)-(vii).

[Note: A State may use different reinstatement periods if not more favorable to the stamping agent.]

(g) A manufacturer that fails to file a complete and accurate report required under Section 7 or 8 shall be entitled to cure the failure during the period set forth in Section [10(g)]. If the manufacturer fails to fully cure the failure during that period, it and its brand families shall be removed from the State directory.

(h) A manufacturer that knowingly or intentionally sells cigarettes in violation of Section [1, 9(d) or 20] and its brand families shall be removed from the State directory.

(i) A non-participating manufacturer whose total nationwide reported sales on which federal excise tax [or, in the case of sales in Puerto Rico, arbitrios de cigarillos] is paid exceed the sum of its nationwide reports under [cross-reference PACT Act] and any intrastate sales reports by more than 5 percent of its total sales or [1] million cigarettes, whichever is less, shall be subject to removal from the State directory unless it cures or satisfactorily explains the discrepancy within the time period set forth in Section [10(g)].

(j) Any person that is not a stamping agent or manufacturer that fails to file a complete and accurate report required under Section 7 or 8 shall be entitled to cure the failure during the period set forth in Section [10(j)]. If the person fails to fully cure the failure during that period, it shall be subject to a civil penalty of up to $1,000 per violation and shall be ineligible to hold any license of the State regarding cigarette sales until the date specified by subsection (f) for violations of subsection (a)(i).

(k) A directory license shall be subject to termination if the licensee acts inconsistently with its certification under Section [2(c)] or violates any provision of this Act

(l) Any person that knowingly or intentionally sells cigarettes in violation of Section [1, 9(d) or 20], or that knowingly or intentionally sells cigarettes in or into the State in a package that bears a stamp permitted under Section [4] that is not the correct stamp under [cross-reference applicable tax law provisions] and provides for a lower level of tax than the correct stamp, shall for a first violation be subject to a civil penalty of up to $1,000 and be guilty of a [Class IV] misdemeanor and for a second or subsequent violation be subject to a civil penalty of up to $5,000 per violation and be guilty of a [Class II] misdemeanor. Each sale constitutes a separate violation. *[Note: criminal penalties are optional.]*

Sec. [10]. Procedure.

[Note: States may use provisions of their existing administrative procedure act or similar process laws or regulations so long as they are comparable to, and not substantially more favorable to the stamping agent, manufacturer or other person than, the corresponding provision below. States may use provisions of their Complementary Legislation instead of subsections (f)-(i) if those provisions are fully applicable to the grounds for removal in this model legislation. The procedures for violations of, or termination or removal under, Optional or Tribal provision are to be included only where the State has enacted the corresponding Optional or Tribal provision.]

(a) The [name of State agency] shall provide a notice of termination to any stamping agent whose license it determines is subject to termination under Sections [9] or [18]. The notice shall state the grounds for the termination and inform the stamping agent that, except as provided in subsection (b), its license will be terminated 30 days following the date of the notice.

(b) During the [30] days following the date of the notice, the stamping agent may (i) in the case of a failure under Section [9(a)(i)-(iv)] that was not knowing or intentional, fully cure the failure or (ii) submit documentation to the [name of State agency] demonstrating that its determination described in the notice was incorrect. Unless the [name of State agency] determines that the stamping agent has satisfied either (i) or (ii), the license of such stamping agent shall be terminated 30 days following the date of the notice.

(c) A stamping agent whose license is terminated shall have an opportunity for a hearing before [name of State agency] within 30 days following the license termination. The [name of State agency] shall reverse the termination if it determines that the stamping agent has demonstrated that its license was not subject to termination.

(d) A stamping agent that unsuccessfully challenges a license termination either in a hearing under subsection (c) or in court shall pay the State's reasonable costs and attorney's fees incurred in contesting the challenge. *[Note: This provision is optional.]*

(e) If for any reason during the period from 30 days after the date of the notice until a final judgment, the termination is stayed or suspended, then the [name of State agency] shall promptly reinstate that stamping agent to the list required by Section [2(b)] during the time of the stay or suspension, but shall note the fact of the stay on that list and shall send notice of the stay to all persons described in Section [9(d)]. Any person that sells cigarettes to, or purchases cigarettes from, that stamping agent after the earlier of receiving notice of the stay of termination or 10 days after the fact of the stay was noted on the list under Section [2(b)], shall be jointly and severally liable for any taxes applicable to such cigarettes under [cross-reference applicable tax law provisions] and for any escrow due on such cigarettes under [cross-reference State's escrow statute] during the period of the stay if the stay is subsequently lifted and the termination reinstated. The periods of time for reinstatement under Section [9(f)] shall be tolled during the period in which a stay of termination is in effect.

(f) The [name of State agency] shall provide a notice of removal to any manufacturer that it determines should be removed or have any of its brand families removed from the State directory under Sections [9] or [18]. The notice shall state the grounds for the removal and inform the manufacturer that, except as provided in subsection (g), it or its brand families will be removed from the State directory 30 days following the date of the notice.

(g) During the 30 days following the date of the notice, the manufacturer may (i) fully cure the failure or violation or (ii) submit documentation to the [name of State agency] demonstrating that its determination described in the notice was incorrect. Unless the [name of State agency] determines that the manufacturer has satisfied either (i) or (ii), it or its brand families will be removed from the State directory 30 days following the date of the notice.

(h) A manufacturer that is removed or has any of its brand families removed the State directory shall have an opportunity for a hearing before [name of State agency] within 30 days following the removal. The [name of State agency] shall reinstate the manufacturer and its brand families to the State directory if it determines that the manufacturer has demonstrated that it and its brand families were not subject to removal from the State directory.

(i) A manufacturer that unsuccessfully challenges a removal either in a hearing under subsection (h) or in court shall pay the State's reasonable costs and attorney's fees incurred in contesting the challenge. *[Note: This provision is optional.]*

(j) [Parallel provisions to (a)-(d) for importers or other persons subject to penalty under Section 9(j).]

(k) [Parallel provisions to (a)-(d) for directory licensees.]

(l) Each person may provide a name and address to which notices under this Section and Sections [9], [18] and [20(j)] are to be sent. Notice periods under this Section run from the date of notice sent to such name and address or, in the case of a person that does not provide a name and address, the last known company address.

Sec. [11]. Contraband Product.

Any cigarettes or cigarette inputs sold, possessed, transported, caused to be transported or purchased in violation of this Act shall be deemed to be contraband and shall be subject to seizure and forfeiture to the State. Any cigarettes or cigarette inputs forfeited to the State under this Section shall be destroyed or used for law enforcement purposes and then destroyed. *[Note: If the state has a general statutory provision on contraband cigarettes, include the following: "Any cigarettes that are contraband under this Section shall also be contraband within the meaning of [cross-reference general state cigarette contraband statute]."]*

Sec. [12]. Roll Your Own Tobacco.

[This will need to be customized for each State depending on how it taxes RYO. The provisions will need to be sufficient to provide for the application and transposition of all provisions of this Act other than the stamping requirement to RYO, including the requirement that NPMs make escrow payments on all RYO sales in the State. and, in the case of States that tax RYO but do not require stamping of RYO containers, provisions that transpose the provisions of this Act to RYO on which tax is due.]

Sec. [13]. Regulations.

The [name of State agency] may promulgate rules and regulations necessary and proper to effect the purposes of or enforce this Act.

Sec. [14]. Severability.

The provisions of this Act shall be severable.

Sec. [15]. Definitions.

[Note: Definitions used only in Optional or Tribal provisions are mandatory only where the State has enacted the corresponding Optional or Tribal provision.]

(_) "Brand family" has the meaning set forth in [cross-reference State complementary legislation definition].

(_) "Cigarette" means a cigarette within the meaning set forth in [cross-reference State escrow statute definition] that is subject to federal excise tax.[1] The term "cigarette" as used in this Act and [cross-reference State escrow statute definition] shall follow the interpretation of the term "cigarette" and "roll your own" used by the Alcohol and Tobacco Tax and Trade Bureau.

(_) "Cigarette inputs" means any machinery or other component parts typically used in the manufacture of cigarettes, including, without limitation, tobacco whether processed or unprocessed, cigarette papers and tubes, cigarette filters or any component parts intended for use in the making of cigarette filters, and any machinery typically used in the making of cigarettes.

[1] Note: this definition would need to be revised in Puerto Rico and the territories as FET is not due on sales in those jurisdictions.

(_) References to “days” refer to calendar days unless specified otherwise.

(_) “Federal returns” mean all federal excise tax returns and all monthly operational reports on Alcohol and Tobacco Tax and Trade Bureau Form 5210.5, and all adjustments, changes and amendments to the foregoing.

(_) “Importer” means any person in the United States to whom non-tax-paid cigarettes manufactured in a foreign country are shipped or consigned; any person who removes cigarettes for sale or consumption in the United States from a customs bonded manufacturing warehouse; and any person who smuggles or otherwise unlawfully brings cigarettes into the United States.

(_) “Indian tribe” means any Indian tribe, band, nation, Alaska Native village or other organized group or community that is recognized as eligible for the special programs and services provided by the United States to Indians because of their status as Indians under the laws of the United States.

(_) A “knowing or intentional” violation or failure is one where the person knowingly or intentionally engaged in conduct without a good faith belief that the conduct was consistent with the provision of this Act at issue. *[Note: State may use an existing definition of these terms if the definition is similar.]*

(_) “Manufacturer” means a person that manufactures, fabricates, or assembles cigarettes.

(_) “Non-participating manufacturer” means a manufacturer that is not a participating manufacturer.

(_) “Non-participating manufacturer cigarettes” means cigarettes (i) of a brand family that is not included in the certification of a participating manufacturer under [cross-reference State complementary legislation] or (ii) that are subject to the escrow requirement under [cross-reference State escrow statute] because the participating manufacturer in whose certification the brand family is included is not generally performing its financial obligations under the Master Settlement Agreement.

(_) “Package” means any pack or other container on which a stamp could be applied consistent with and as required by this Act that contains one or more individual cigarettes for sale. Nothing in this Act shall alter any other applicable requirement with respect to the minimum number of cigarettes that may be contained in a pack or other container of cigarettes. References to “package” do not include a container of multiple packages.

(_) “Participating manufacturer” has the meaning set forth in [cross-reference State complementary legislation].

(_) "Person" means any natural person, trustee, company, partnership, corporation or other legal entity, including any Indian tribe or instrumentality thereof or any member of an Indian tribe.

(_) "Purchase" means any acquisition in any manner or by means for any consideration. The term includes transporting or receiving product in connection with a purchase.

(_) "Qualified Tribal Lands" means any lands both (i) title to which is either in trust by the United States for the benefit of any Indian tribe or individual or held by any Indian tribe or individual subject to restriction by the United States against alienation and (ii) over which an Indian tribe exercises governmental power.

(_) "Retailer" means a person that sells cigarettes for consumption or use by the purchaser.

(_) "Sale" or "sell" means any transfer, exchange or barter in any manner or by any means for any consideration. The term includes distributing or shipping product in connection with a sale.

(_) References to a sale "in" or "into" a State refer to the State of the destination point of the product in the sale, without regard to where title was transferred. References to a sale "from" a State refer to the sale of cigarettes that are located in that State to the destination in question, without regard to where title was transferred.

(_) "Sales Entity Affiliate" means an entity that (1) sells cigarettes that it acquires directly from a manufacturer or importer and (2) is affiliated with that manufacturer or importer. Entities are affiliated with each other if one directly, or indirectly through one or more intermediaries, controls or is controlled by or is under common control with the other. Unless provided otherwise, references to "manufacturer" or "importer" include any sales entity affiliate of that manufacturer or importer.

(_) "Shortfall Amount" means the difference between (1) the full amount of the deposit required to be made by a non-participating manufacturer for a calendar quarter under Section [5(b)] and (2) the sum of (i) any amounts pre-collected by a stamping agent and deposited into escrow for that calendar quarter on behalf of the non-participating manufacturer under Section [16(c)], (ii) the amount deposited into escrow by the non-participating manufacturer for that calendar quarter under Section [5(b)], (iii) any amounts deposited into escrow for that calendar quarter under Section [5(e)] by an importer on such non-participating manufacturer's cigarettes, and (iv) any amounts collected by the State for that calendar quarter under the bond posted by the non-participating manufacturer under Section [17]. The Shortfall Amount, if any, for a non-participating manufacturer for a calendar quarter shall be calculated by [State agency] within 15 days following the date on which the State determines the amount it will collect on the bond posted by the non-participating manufacturer as provided in Section [17]. *[Note: This definition concerns two optional provisions. If a State enacts one of these provisions, but not the other, the definition will need to be modified.]*

(_) "Stamping agent" means a manufacturer, importer or wholesaler that holds a valid license under Section [2] of this Act.

(_) References to a "State" or this "State" includes all land that is within the borders of the State, including all Qualified Tribal Lands and any other lands held by or on behalf of an Indian tribe within that State's borders. References to sales in, into or from a State include any sales in, into or from Qualified Tribal Lands or any other lands held by or on behalf of an Indian tribe within that State's borders. References to possession in a State include possession on Qualified Tribal Lands or any other lands held by or on behalf of an Indian tribe within that State's borders. Reference to another "State" or other "States" include the District of Columbia, Puerto Rico and the territories of the United States.

(_) "State directory" or "directory" means the directory compiled by the [name of State agency] under [cross-reference State complementary legislation] or, in the case of references to another State's directory, the directory compiled under the similar law in that other State.

(_) "Unstamped cigarettes" means any cigarettes that are not contained in a package bearing a stamp permitted under Section [4].

(_) "Wholesaler" means a person that purchases cigarettes for sale or resale but does not include any person when and to the extent such person is acting as a manufacturer, importer, or retailer.

OPTIONAL

Sec. [16]. Additional responsibility for escrow deposits.

(a) A stamping agent shall be responsible for escrow deposits required under [cross-reference State's escrow statute] and Section [5] in the event it receives notice from [State agency] that there is a Shortfall Amount with respect to non-participating manufacturer cigarettes stamped by it.

(b) The liability of a stamping agent for escrow deposits shall be calculated as follows: If there is a Shortfall Amount for a non-participating manufacturer for a calendar quarter, each stamping agent that sold cigarettes of that non-participating manufacturer during the calendar quarter shall deposit into such escrow account as shall be designated by the State an amount equal to the applicable Shortfall Amount multiplied by a fraction, the numerator of which is the number of cigarettes of that non-participating manufacturer sold in or into the State by the stamping agent during that calendar quarter and the denominator of which is the total number of cigarettes of that non-participating manufacturer sold by all stamping agents in or into the State during that calendar quarter. Provided, that any non-participating manufacturer cigarettes sold in or into the State by a stamping agent during the calendar quarter on which the stamping agent collected and deposited the required escrow deposit amount on or before the due date for deposits for that quarter under Section [5(b)] shall be excluded from both the numerator and the denominator of the fraction in the immediately preceding sentence. To the extent a stamping agent makes payments with respect to a Shortfall Amount under this subsection, such stamping agent shall have a claim against the non-participating manufacturer for such amount.

(c) A stamping agent is authorized to require a non-participating manufacturer to pre-pay the escrow deposit amount to the stamping agent, for deposit by the stamping agent on behalf of the non-participating manufacturer into an escrow account designated by the State, as a condition of the stamping agent's agreement to purchase cigarettes of that non-participating manufacturer.

Sec. [17]. Bond.

[Note: A State may also enact a bond requirement that is broader than the following if it wants broader application of Section II.B.2(y) of the MOU.]

(a) A non-participating manufacturer shall post a bond for the benefit of the State if (i) its cigarettes were not sold in the State during any one of the four preceding calendar quarters, (ii) it or any person affiliated with it failed to make a full and timely escrow deposit due under [cross-reference State's escrow statute] or Section [5] during any of the five preceding calendar years, unless the failure was not knowing or reckless and was promptly cured upon notice, or (iii) it or any person affiliated with it, or any of its brands or brands of a person affiliated with it, were removed from the state directory of any State during any of the five preceding calendar years, unless the removal were determined to have been erroneous or illegal. Entities are affiliated with each other if one directly, or indirectly through one or more intermediaries, controls or is controlled by or is under common control with the other.

(b) The bond shall be posted at least 10 days in advance of each calendar quarter as a condition to the non-participating manufacturer and its brand families being included in the state directory for that quarter. The amount of the bond shall be the greater of (i) the greatest required escrow amount due from the non-participating manufacturer or its predecessor for any of the 12 preceding calendar quarters or (ii) $25,000.

(c) If a non-participating manufacturer that posted a bond has failed to make or have made on its behalf deposits equal to the full amount owed for a quarter within 15 days following the due date for the quarter under Section [5(b)], the State may execute upon the bond in the amount equal to any remaining amount of the escrow due. Amounts the State collects on a bond shall be deposited into the State treasury and shall reduce the amount of escrow due from that non-participating manufacturer in the dollar amount collected. Escrow obligations above the amount collected on the bond remain due from that non-participating manufacturer and, as provided in Sections [5(e)] and [16], from the importers and stamping agents that sold its cigarettes during that calendar quarter.

(d) The [name of State agency] shall promulgate rules and regulations necessary to implement subsections (a)-(c).

Sec. [18]. Reciprocity.

(a) The license of a stamping agent may be subject to termination if its similar license is terminated in any other state based on acts or omissions that would, if done in this State, be grounds for license termination under this Section, unless the stamping agent demonstrates that its termination in the other State was effected without due process. A stamping agent whose license is terminated under this subsection shall be eligible for reinstatement upon the earlier of the date specified by Section 9(f) for the act or omission in question or reinstatement of its license by the other State.

(b) A manufacturer and its brand families may be removed from the State directory if it is removed from the directory of another State based on acts or omissions that would, if done in this State, be grounds for removal from the State directory under this Section or [cross-reference State complementary legislation], unless the manufacturer demonstrates that its removal from the other State's directory was effected without due process. A manufacturer that is removed from the State directory under this subsection shall be eligible for reinstatement upon the earlier of the date on which it cures the violation or is reinstated to the directory in the other State.

(c) The applicable procedures under Section 10 shall apply to terminations and removals under this Section.

TRIBAL

Sec. [19]. Refunds of State Excise Taxes and Escrow Deposits.

(a) A person that paid taxes applicable under [cross-reference applicable tax law provisions] on cigarettes sold in an exempt transaction shall be eligible for a refund of the taxes paid on those cigarettes. A person that deposited escrow due under [cross-reference State's escrow statute] on cigarettes sold in an exempt transaction shall be eligible for a release of the escrow deposited on those cigarettes.

(b) Only the following cigarette sales are exempt transactions:

(i) Cigarette sales on a federal installation in a transaction that is exempt from state taxation under federal law.

(ii) Cigarette sales on an Indian tribe's Qualified Tribal Lands by a retail outlet or other entity owned and operated by that tribe or a tribal member for official tribal use or to a consumer who is an adult enrolled member of that tribe domiciled on that tribe's Qualified Tribal Lands.

(c) Except as provided in subsection (f), the person seeking a refund of taxes or release of escrow must submit an application to [name of State agency] providing documentation sufficient to demonstrate (i) that the cigarettes were sold in a package bearing the correct stamp permitted under Section [4] and, as to refund of taxes, that the stamp was one that required payment of tax, (ii) that the person paid the applicable taxes or deposited the escrow in question, (iii) that the cigarettes were sold in an exempt transaction, (iv) as to release of escrow, that the cigarettes were non-participating manufacturer cigarettes, and (v) that the person has not obtained the refund or release on the cigarettes previously. The documentation shall include, in addition to information necessary to meet the requirements listed above and any other information that the [name of State agency] may reasonably require, documents showing the identity of the seller and purchaser and the places of shipment and delivery of the cigarettes. The [name of State agency] shall verify the accuracy and completeness of the required documentation and information before granting the requested refund.

(d) If a meritorious refund claim under subsection (c) is not paid within 60 days of submission of the required documentation, the refund shall include interest at the prime rate from the date of submission of the required documentation.

(e) The total number of cigarettes found to be sold in exempt transactions under subsection (b)(ii) in any year on an Indian tribe's Qualified Tribal Lands shall not exceed 14,600 cigarettes times the number of enrolled adult members of that tribe domiciled on its Qualified Tribal Lands during the preceding calendar year. The [name of State agency] shall not permit (i) refunds of taxes paid on cigarettes claimed to be sold in exempt transactions under subsection (b)(ii) on that tribe's Qualified Tribal Lands in excess of that total number; or (ii) release of escrow deposited on a non-participating manufacturer's cigarettes claimed to be sold in exempt transactions under subsection (b)(ii) on that tribe's Qualified Tribal Lands in excess of that total number times the market share percentage of that non-participating manufacturer on that tribe's Qualified Tribal Lands during that year.

(f) As to refunds of taxes, the [name of State agency] and an Indian tribe may agree upon a refund formula to operate in lieu of application for refunds under subsection (c). The aggregate refund provided to an Indian tribe under a formula for a year shall not exceed the lesser of (i) the aggregate tax paid by entities owned and operated by that tribe or member of that tribe on cigarettes sold in exempt transactions under subsection (b)(ii) on that tribe's Qualified Tribal Lands during that year or (ii) the aggregate tax due under [cross-reference tax law provision applicable to tribal sales on Qualified Tribal Lands] on the number of cigarettes that would be used during that year by enrolled adult members of that tribe domiciled on that tribe's Qualified Tribal Lands during the preceding calendar year based on the national average smoking incidence for all adults and the national average annual cigarettes used by an adult smoker, in each case as published most recently by the Centers for Disease Control. Refunds of taxes under subsection (c) shall not be available for cigarettes sold in exempt transactions on the Qualified Tribal Lands of an Indian tribe that agrees upon a refund formula under this subsection.

(g) As to release of escrow, the [name of State agency] and an Indian tribe may agree upon a refund formula to operate in lieu of application for releases under subsection (c) if the formula meets the requirements of this subsection. The formula shall assign to the tribe credits for release of escrow that the tribe may allocate among non-participating manufacturers that sold cigarettes on that tribe's Qualified Tribal Lands during that year. The aggregate credits provided to an Indian tribe under a formula for a year shall not exceed the aggregate escrow deposit due under [cross-reference State's escrow statute] on the number of non-participating manufacturer cigarettes represented by the product of (i) the number of cigarettes that would be used during that year by enrolled adult members of that tribe domiciled on that tribe's Qualified Tribal Lands during the prior calendar year based on the national average smoking incidence for all adults and the national average annual cigarettes used by an adult smoker, in each case as published most recently by the Centers for Disease Control, times (ii) the aggregate national market share percentage of non-participating manufacturers for the preceding calendar year, as determined by the [independent auditor under the master settlement agreement/Data Clearinghouse]. A non-participating manufacturer allocated a credit by an Indian tribe under a formula shall be entitled to a release of escrow deposited by it or on its behalf for cigarette sales in or into the State during that year in the amount of the credit, provided that no non-participating manufacturer shall be entitled to a release in excess of the total escrow deposited by it or on its behalf for cigarette sales in or into the State during that year. Releases of escrow under subsection (c) shall not be available for cigarettes sold in exempt transactions on the Qualified Tribal Lands of an Indian tribe that agrees upon a refund formula under this subsection.

(h) In order for an Indian tribe, entities owned and operated by that tribe or a member of that tribe, or persons doing business with that tribe or such entities to be entitled to a refund of taxes or release of escrow under this Section for cigarettes sold on that tribe's Qualified Tribal Lands during a year, the tribe shall provide documentation to the [name of State agency] by April 15 of that year sufficient to demonstrate the number of enrolled adult members of that tribe domiciled on its Qualified Tribal Lands during the preceding calendar year. The [name of State agency] shall verify the accuracy and completeness of the required documentation and information before granting the refunds or releases. For purposes of this subsection and subsections (e)-(g), a tribal member domiciled on Qualified Tribal Lands for part of a year counts as a fraction reflecting the portion of the year domiciled on those Lands. A formula under subsection (f) or (g) shall incorporate and be subject to the provisions of this subsection.

(i) Amounts the State collects on a bond under [cross-reference bond section] shall not be subject to release under this Section. References in this section to escrow deposited by a non-participating manufacturer or other person shall not include amounts collected by the State on a bond.

(j) The [name of State agency] shall promulgate rules and regulations necessary to implement this Section.

Sec. [20]. Effect of certain violations.

(a) The [name of State agency] shall list on its website any person that both (i) claims not to be subject, or holds itself out as not subject, to enforcement of any provision of this Act by reason of lack of jurisdiction of the State or sovereign immunity and (ii) the [name of State agency] has a reasonable basis to believe has not fully complied with any provision of this Act. The [name of State agency] shall promptly publish and regularly update the list of such persons on its website.

(b) The [name of State agency] shall not include on the list any person described in subsection (a) that submits an enforceable certification in accordance with rules or regulations to be promulgated by [name of State agency] that such person will not assert that it is not subject to enforcement of any provision of this Act based on an asserted lack of State jurisdiction or claim of sovereign immunity.

(c) Except as provided in subsection (d), it shall be unlawful for any person to sell cigarettes or cigarette inputs to, or purchase cigarettes from, any person that is on the list described in subsection (a). A supplier of cigarette inputs may obtain advance approval from [name of State agency] to sell inputs to a person on the list if the supplier demonstrates that the input will not be used for the manufacturing of cigarettes.

(d) Notwithstanding subsection (c), a person may sell cigarettes to, or purchase cigarettes from, persons on the list if the manufacturer and brand of such cigarettes is on the State directory and, prior to the sale or purchase, a stamping agent that is not on the list affixed a tax stamp permitted under Section [4] to the package containing such cigarettes.

(e) It shall be unlawful for any person that is on the list described in subsection (a) to sell, transport or cause to be transported cigarettes in or into this State unless (i) the manufacturer and brand of such cigarettes is on the State directory and (ii) prior to the sale or transport, a stamping agent that is not on the list affixed a tax stamp permitted under Section [4] to the package containing such cigarettes.

(f) The [name of State agency] shall provide a notice to any person that it determines should be placed on the list described in subsection (a). The notice shall state the grounds for the listing and inform the person that, except as provided in subsection (g), it will be placed on the list 30 days following the date of the notice.

[Note: As to subsections (f)-(h), States may use provisions of their existing administrative procedure act or similar process laws or regulations so long as they are comparable to, and not substantially more favorable to the listed person than, the corresponding provision in subsections (f)-(h).]

(g) During the 30 days following the date of the notice, the person may (i) submit the certification described in subsection (b) or (ii) submit documentation to the [name of State agency] demonstrating that its determination described in the notice was incorrect. Unless the [name of State agency] determines that the person has satisfied either (i) or (ii), it shall be placed on the list 30 days following the date of the notice.

(h) A person that is placed on the list shall have an opportunity for a hearing before [name of State agency] within 30 days. The [name of State agency] shall remove the person from the list if it determines that the person has demonstrated that its inclusion on the list was not proper under this Section.

(i) A person that unsuccessfully challenges being placed on the list either in a hearing under subsection (h) or in court shall pay the State's reasonable costs and attorney's fees incurred in contesting the challenge. *[Note: This provision is optional.]*

(j) If for any reason during the period from 30 days after the date of the notice until a final judgment, a person's placement on the list described in subsection (a) is stayed or suspended, then the [name of State agency] shall promptly remove that person from the list during the time of the stay or suspension, but shall note the fact of the stay on that list and shall send notice of the stay to all persons described in Section [9(d)]. Any person that sells cigarettes or cigarette inputs to, or purchases cigarettes from, that person after the earlier of receiving notice of the stay of listing or 10 days after the fact of the stay was noted on the list, shall be jointly and severally liable for any taxes applicable to such cigarettes under [cross-reference applicable tax law provisions] and for any escrow due on such cigarettes under [cross-reference State's escrow statute] during the period of the stay if the stay is subsequently lifted and the placement on the list reinstated.

Sec. [21]. Compacts.

Neither the State nor any agency or department thereof shall enter into any future agreement, compact or treaty with any Indian tribe that is inconsistent with the provisions of this Act.

(THIS PAGE INTENTIONALLY LEFT BLANK)

APPENDIX F-1

PROPOSED FORM OF OPINION OF TRANSACTION COUNSEL

[Closing Date]

Golden State Tobacco Securitization Corporation
c/o California Department of Finance
915 L Street, 9th Floor
Sacramento, CA 95814

Golden State Tobacco Securitization Corporation
Enhanced Tobacco Settlement Asset-Backed Bonds, Series 2015A
(Final Opinion)

Ladies and Gentlemen:

We have acted as transaction counsel to the Golden State Tobacco Securitization Corporation (the "Issuer") in connection with the issuance of $[Par Amount] aggregate principal amount of its Enhanced Tobacco Settlement Asset-Backed Bonds, Series 2015A (the "Bonds"), issued pursuant to an Indenture, dated as of September 1, 2003, as supplemented by the 2003B Supplement, dated as of September 1, 2003 (together, the "Original Indenture"), each between the Issuer and The Bank of New York Mellon Trust Company, N.A., (formerly known as The Bank of New York Trust Company, N.A., successor to BNY Western Trust Company), as trustee (the "Trustee"), as amended and supplemented by the First Supplemental Indenture, dated as of July 1, 2005 (the "First Supplemental Indenture"), between the Issuer and the Trustee, as further supplemented by the Second Supplemental Indenture, dated as of April 1, 2013 (the "Second Supplemental Indenture"), between the Issuer and the Trustee, and as further amended and supplemented by the Third Supplemental Indenture, dated as of April 1, 2015 (the "Third Supplemental Indenture" and together with the Original Indenture, the First Supplemental Indenture and the Second Supplemental Indenture, the "Indenture"), between the Issuer and the Trustee. Capitalized terms not otherwise defined herein shall have the meanings ascribed thereto in the Indenture.

In such connection, we have reviewed the Indenture; the Purchase and Sale Agreement, dated as of September 1, 2003, as amended by the First Supplemental Purchase and Sale Agreement dated as of July 1, 2005 and as further amended by the Second Supplemental Purchase and Sale Agreement dated as of April 1, 2015 (together, the "Purchase and Sale Agreement"), each between the Issuer and the California Infrastructure and Economic Development Bank (the "Bank"), acting for and on behalf of and as agent for the State of California (the "State"); the Tax Certificate of the Issuer and the Tax Certificate of the State, each dated the date hereof (collectively, the "Tax Certificates"); certificates of the Issuer, the Bank, the Trustee and others; opinions of the Attorney General of the State, counsel to the Bank, counsel to the Trustee and others; and such other documents, opinions and matters to the extent we deemed necessary to render the opinions set forth herein.

The opinions expressed herein are based on an analysis of existing laws, regulations, rulings and court decisions and cover certain matters not directly addressed by such authorities. Such opinions may be affected by actions taken or omitted or events occurring after the date hereof. We have not undertaken to determine, or to inform any person, whether any such actions are taken or omitted or events do occur or any other matters come to our attention after the date hereof. Accordingly, this letter speaks only as of its date and is not intended to, and may not, be relied upon or otherwise used in connection with any such actions, events or matters. We disclaim any obligation to update this letter. We have assumed the genuineness of all documents and signatures presented to us (whether as originals or as copies) and the due and legal execution and delivery thereof by, and validity against, any parties other than the Issuer. We have assumed, without undertaking to verify, the accuracy of the factual matters represented, warranted or certified in the documents, and of the legal conclusions contained in the opinions, referred to in the second paragraph hereof. Furthermore, we have assumed compliance with all covenants and agreements contained in the Indenture, the Purchase and Sale Agreement and the Tax Certificates, including (without limitation) covenants and agreements compliance with which is necessary to assure that future actions, omissions or events will not cause interest on the Bonds to be included in gross income for federal income tax purposes. We call attention to the fact that the rights and obligations under the Bonds, the Indenture, the Purchase and Sale Agreement and the Tax Certificates and their enforceability may be subject to bankruptcy, insolvency, receivership, reorganization, arrangement, fraudulent conveyance, moratorium and other laws relating to or affecting creditors' rights, to the application of equitable principles, to the exercise of judicial discretion in appropriate cases and to the limitations on legal remedies against entities such as the Issuer in the State. We express no opinion with respect to any indemnification, contribution, liquidated damages, penalty (including any remedy deemed to constitute a penalty), right of set-off, arbitration, judicial reference, choice of law, choice of forum, choice of venue, non-exclusivity of remedies, waiver or severability provisions contained in the foregoing documents, nor do we express any opinion with respect to the state or quality of title to or interest in any of the assets described in or as subject to the lien of the Indenture, or the accuracy or sufficiency of the description contained therein of, or the remedies available to enforce liens on, any such assets. Our services did not include financial or other non-legal advice. Finally, we undertake no responsibility for the accuracy, completeness or fairness of the Official Statement or other offering material relating to the Bonds and express no opinion with respect thereto.

Based on and subject to the foregoing, and in reliance thereon, as of the date hereof, we are of the following opinions:

1. The Issuer is duly organized and validly existing under the laws of the State.

2. The Indenture has been duly executed and delivered by the Issuer and is a valid and binding agreement of the Issuer. The Indenture creates a valid pledge of, and security interest in, the Collateral to secure the payment of the principal of and interest on the Bonds, subject to the provisions of the Indenture permitting the application thereof for the purposes and on the terms and conditions set forth in the Indenture.

3. The Bonds have been duly executed and delivered by the Issuer and are valid and binding limited obligations of the Issuer payable solely from the Collateral.

4. The Purchase and Sale Agreement has been duly executed and delivered by the Issuer and is a valid and binding agreement of the Issuer.

5. Interest on the Bonds is excluded from gross income for federal income tax purposes under Section 103 of the Internal Revenue Code of 1986. Interest on the Bonds is not a specific preference item for purposes of the federal individual or corporate alternative minimum taxes, although we observe that it is included in adjusted current earnings in calculating corporate alternative minimum taxable income. Interest on the Bonds is exempt from State of California personal income taxes. We express no opinion regarding other tax consequences related to the ownership or disposition of, or the amount, accrual or receipt of interest on, the Bonds.

Faithfully yours,

ORRICK, HERRINGTON & SUTCLIFFE LLP

per

APPENDIX F-2

PROPOSED FORM OF OPINION OF THE ATTORNEY GENERAL OF THE STATE

[Closing Date]

Golden State Tobacco Securitization Corporation
c/o California Department of Finance
915 L Street, 9th Floor
Sacramento, California 95814

Fitch Ratings
33 Whitehall Street
New York, New York 10004

Moody's Investors Service
7 World Trade Center
New York, New York 10007

Standard & Poor's Ratings Services
55 Water Street
New York, New York 10041

Citigroup Global Markets Inc.,
As Co-Representative of the Underwriters
444 South Flower Street
Los Angeles, California 90071

Barclays Capital Inc.
As Co-Representative of the Underwriters
745 Seventh Avenue
New York, New York 10019

Re: Golden State Tobacco Securitization Corporation
Enhanced Tobacco Settlement Asset–Backed Bonds, Series 2015A

Ladies and Gentlemen:

We have acted as counsel to the Treasurer of the State of California (the "State") in connection with certain matters relating to Golden State Tobacco Securitization Corporation's issuance of $__________ principal amount of its Enhanced Tobacco Settlement Asset-Backed Bonds, Series 2015A (the "Series 2015A Bonds").

We have examined (i)(a) the Master Settlement Agreement (the "MSA"), (b) the Memorandum of Understanding (the "MOU"), (c) the Agreement Regarding Interpretation of the Memorandum of Understanding, as amended (the "ARIMOU"), (d) the California Escrow Agreement, and (e) the Consent Decree and Final Judgment, as each of those documents is defined in Article 7 (commencing with Section 63049) of Chapter 2 of Division I of Title 6.7 of the California Government Code (the "Act"), (ii) the Modification No. __ to Wiring Instructions Information Form, dated __________, 2015, executed by us, from the State to the California escrow agent named in the California Escrow Agreement (the "Escrow Instructions"), (iii) the Purchase and Sale Agreement dated as of September 1, 2003, (the "Original Purchase and Sale Agreement") by and between the California Infrastructure and Economic Development Bank, as agent for the State of California (the "Bank"), and the Golden State Tobacco Securitization Corporation (the "Corporation"), (iv) the First Supplemental Purchase and Sale Agreement dated as of July 1, 2005, between the Bank and the Corporation (the "First Supplemental Purchase and Sale Agreement"), and (v) the Second Supplemental Purchase and Sale Agreement dated as of April 1, 2015, between the Bank and the Corporation (the "Second Supplemental Purchase and Sale Agreement"; the Original Purchase and Sale Agreement, as amended by the First Supplemental Purchase and Sale Agreement and the Second Supplemental Purchase and Sale Agreement, referred to as the "Purchase and Sale Agreement"). The Purchase and Sale Agreement, together with the MSA, the MOU, the ARIMOU, the Escrow Agreement, and the Escrow Instructions, are referred to herein as the "Tobacco Documents." We have also examined certifications of the Bank and the Corporation, opinions of Orrick, Herrington & Sutcliffe LLP, the opinion of the General Counsel of the California Infrastructure and Economic Development Bank (the "Infrastructure Bank") and such other documents, opinions and matters to the extent we deemed necessary to render the opinions set forth herein.

The opinions expressed herein are based on an analysis of existing laws, regulations, rulings and court decisions and cover certain matters not directly addressed by such authorities. Such opinions may be affected by actions taken or omitted or events occurring after the date hereof.

We have not undertaken to determine, or to inform any person, whether any such actions are taken or omitted or events do occur or any other matters come to our attention after the date hereof, and we disclaim any obligation to update this letter.

We have assumed the genuineness of all documents and signatures presented to us (whether as originals, copies or specimens), the due and legal execution and delivery thereof by, and validity against, any parties other than the State. We have assumed, without undertaking to verify, the accuracy of the factual matters represented, warranted or certified in the documents, and of the legal conclusions contained in the opinions, referred to in the second paragraph hereof. We have assumed the due authorization, execution, and delivery by the Infrastructure Bank of the Second Supplemental Purchase and Sale Agreement affirmed in the opinion of General Counsel of the Infrastructure Bank. We have assumed compliance with the covenants and agreements contained in the Tobacco Documents.

The rights and obligations under the Tobacco Documents and their enforceability may be (i) subject to or limited by bankruptcy, insolvency, reorganization, arrangement, fraudulent conveyance, moratorium or other similar laws relating to or affecting the rights of creditors generally, (ii) subject to the application of general principles of equity, (iii) subject to the exercise of judicial discretion in appropriate cases, and (iv) subject to the limitations on legal remedies against governmental entities in the State of California. We express no opinion with respect to any indemnification, contribution, penalty, choice of law, choice of venue, choice of forum, severability or waiver provisions contained in the Tobacco Documents. Our opinions are limited to the laws of the State of California. **We express no opinion with respect to the Series 2015A Bonds, Government Code section 63049.1, subdivision (b), and Section 4.07(b) of the Purchase and Sale Agreement. Notwithstanding any provision of the Act, including any provision limiting the power of the State to alter, limit or impair certain rights and remedies, nothing in this letter opines that the State is limited in the exercise of its legislative powers, subject to the provisions of Article I, section 10, of the United States Constitution and Article I, section 9, of the California Constitution limiting laws impairing the obligation of contracts.**

We undertake by this letter no responsibility for the accuracy, completeness or fairness of the Official Statement dated March ___, 2015, relating to the Series 2015A Bonds, or other offering material relating to the Series 2015A Bonds and express no opinion or belief herein with respect thereto.

We note that we are not counsel to the Bank or the Corporation and did not represent them or any parties other than the Treasurer in connection with the Series 2015A Bonds. Further, we were not and are not counsel to the parties to the Tobacco Documents other than the State and the Department of Health Services and did not represent any other such parties in connection with any matters relating to the Tobacco Documents.

Based on and subject to the foregoing, and in reliance thereon, as of the date hereof, we are of the following opinions:

1. The Consent Decree and Final Judgment (as defined in the Act), pursuant to which the MSA was approved in the State (the "Consent Decree") is in full force and effect and is a final and non-appealable court order.

2. The Act has been duly enacted by the State, is in full force and effect, and is valid with respect to all provisions thereof material to the subject matters of this opinion letter under the laws of the State, including the Constitution of the State, and the Constitution of the United States.

3. The Original Purchase and Sale Agreement, the First Supplemental Purchase and Sale Agreement, the MSA, the MOU, the ARIMOU, the Escrow Agreement, and the Escrow Instructions have been duly authorized, executed, and delivered by the State. The Tobacco Documents are valid and binding agreements of the State, enforceable against the State in accordance with their terms.

4. All authorizations, consents and approvals of California government bodies or regulatory authorities required for the execution by the State of the Tobacco Documents and performance by the State of its obligations under the Tobacco Documents have been made or obtained.

5. Article 3 of Chapter 1 of Part 3 (commencing with Section 104555) of Division 103 of the California Health and Safety Code (the "Model Statute"), has been duly enacted by the State and is in full force and effect.

This letter is being delivered to you and is solely for your benefit in connection with the issuance of the Series 2015A Bonds. This letter and the opinions expressed herein are not to be used, circulated, quoted or otherwise referred to or relied upon for any other purpose or by any other person, including without limitation the owners of the Series 2015A Bonds. Without limiting the foregoing, a copy of this letter may be included in the Series 2015A Bond issuance transcript of proceedings. Our engagement with respect to this matter has terminated as of the date hereof.

Sincerely,

____
Senior Assistant Attorney General

For KAMALA D. HARRIS
Attorney General

(THIS PAGE INTENTIONALLY LEFT BLANK)

APPENDIX G

CERTAIN INFORMATION RELATING TO THE DOMESTIC TOBACCO INDUSTRY

The following description of the domestic tobacco industry has been compiled from certain publicly available documents of the tobacco companies and their current or former parent companies, certain publicly available analyses of the tobacco industry and other public sources. Certain of those companies file annual, quarterly and certain other reports with the SEC. Such reports are available on the SEC's website (www.sec.gov) and upon request from the SEC's Investor Information Service, 100 F Street, NE, Washington, D.C. 20549 (phone: (800) SEC-0330 or (202) 551-5450; fax: (202) 343-1028; e-mail: publicinfo@sec.gov). The following information does not, nor is it intended to, provide a comprehensive description of the domestic tobacco industry, the business, legal and regulatory environment of the participants therein, or the financial performance or capability of such participants. Although the Issuer has no independent knowledge of any facts indicating that the following information is inaccurate in any material respect, the Issuer has not independently verified this information and cannot and does not warrant the accuracy or completeness of this information. To the extent that reports submitted to the MSA Auditor by the PMs pursuant to the requirements of the MSA provide information that is pertinent to the following discussion, including market share information, the California Attorney General has not consented to the release of such information pursuant to the confidentiality provisions of the MSA. Prospective investors in the Series 2015A Bonds should conduct their own independent investigations of the domestic tobacco industry to determine if an investment in the Series 2015A Bonds is consistent with their investment objectives.

MSA payments are computed based in part on cigarette shipments in or to the 50 states of the United States, the District of Columbia and Puerto Rico. The quantities of cigarettes shipped and cigarettes consumed within the 50 states of the United States, the District of Columbia and Puerto Rico may not match at any given point in time as a result of various factors, such as inventory adjustments, but are substantially the same when compared over a period of time.

Retail market share information, based upon shipments or sales as reported by the OPMs for purposes of their filings with the SEC, may be different from Relative Market Share for purposes of the MSA and the respective obligations of the PMs to contribute to Annual Payments and Strategic Contribution Fund Payments. The Relative Market Share information reported is confidential under the MSA, except to the extent reported by NAAG. See "SUMMARY OF THE MSA—Overview of Payments by the Participating Manufacturers; MSA Escrow Agent", "—Annual Payments" and "—Strategic Contribution Fund Payments". Additionally, aggregate market share information, based upon shipments as reported by Lorillard, Inc. (the parent company of Lorillard), Reynolds American Inc. (the parent company of Reynolds Tobacco) and Altria Group, Inc. (the parent company of Philip Morris) and reflected in the chart below entitled "Manufacturers' Domestic Market Share of Cigarettes" is different from that utilized in the bond structuring assumptions. See "TABLES OF PROJECTED PLEDGED TSRs, PROJECTION METHODOLOGY AND BOND STRUCTURING ASSUMPTIONS."

Industry Overview

As reported by NAAG, based upon OPM shipments reported to MSAI, the OPMs accounted for approximately 85.20% of the U.S. domestic cigarette market in sales year 2013 measuring roll-your-own cigarettes at 0.09 ounces per cigarette conversion rate and approximately 84.95% measuring roll-your-own cigarettes at 0.0325 ounces per cigarette conversion rate. However, according to publicly available documents of the OPMs, for calendar year 2014 the OPMs collectively accounted for approximately 92.5% of the domestic cigarette retail industry (with Philip Morris and Reynolds Tobacco measuring by sales, and Lorillard measuring by shipments), as discussed in "—Industry Market Share" below. The market for cigarettes in the U.S. divides generally into premium and discount sales. As reported by Lorillard, Inc. in its Form 10-K filed with the SEC for the calendar year 2014, the discount segment of the domestic tobacco industry represented approximately 26.1% of domestic tobacco sales for the year ended December 31, 2014 (compared to 26.5% for the calendar year 2013). According to Vector Group Ltd.'s Form 10-K filed with the SEC for the calendar year 2014, the strongest competition for market share in the discount segment has come from a group of smaller manufacturers and importers, most of which sell low quality, deep discount cigarettes, with data cited in such Form 10-K indicating that the discount market share of these smaller manufacturers and importers was approximately 34.1% in 2014, 33.7% in 2013, and 34.4% in 2012.

Philip Morris USA Inc. ("**Philip Morris**"), a wholly-owned subsidiary of Altria Group, Inc. ("**Altria**"), is the largest tobacco company in the U.S. Prior to a name change on January 27, 2003, Altria was named Philip Morris Companies Inc. In its Form 10-K filed with the SEC for the calendar year 2014, Altria reported that Philip Morris's domestic cigarette market share for the year ended December 31, 2014 was 50.9% (based on retail sales data from IRI/MSAI, a tracking service that uses a sample of stores and certain wholesale shipments to project market share and depict share trends), which represents an increase from its reported domestic market share of 50.7% for the year ended December 31, 2013. Philip Morris's major premium brands are Marlboro, Virginia Slims and Parliament (with Marlboro representing approximately 86% of Philip Morris's domestic cigarette shipment volume during 2014, according to Altria's Form 10-K filed with the SEC for the calendar year 2014). Marlboro is also the largest-selling cigarette brand in the U.S., with approximately 43.8% and 43.7% of the U.S. domestic retail share at December 31, 2014 and December 31, 2013, respectively, according to Altria's Form 10-K filed with the SEC for the calendar year 2014, and has been the world's largest-selling cigarette brand since 1972. Philip Morris's principal discount brands are Basic and L&M. In 2009, Altria acquired UST LLC, whose subsidiary, U.S. Smokeless Tobacco LLC ("**UST**"), is the largest producer of smokeless tobacco in the U.S.

Reynolds American Inc. ("**Reynolds American**") is the second-largest tobacco company in the U.S. Reynolds American became the parent company of R.J. Reynolds Tobacco Company ("**Reynolds Tobacco**") on July 30, 2004, following a transaction that combined Reynolds Tobacco and the U.S. operations of Brown & Williamson Tobacco Corporation ("**B&W**"), previously the third-largest tobacco company in the U.S., under the Reynolds Tobacco name. In connection with this merger, Reynolds American assumed all pre-merger liabilities, costs and expenses of B&W, including those related to the MSA and related agreements and with respect to pre-merger litigation of B&W. Reynolds American is also the parent company of American Snuff Co., owner of smokeless tobacco brands, and Santa Fe Natural Tobacco Company, Inc., both of which are SPMs.

In its Form 10-K filed with the SEC for the calendar year 2014, Reynolds American reported that Reynolds Tobacco's domestic retail cigarette market share at December 31, 2014 was 26.5% (measured by sales volume), which represents a decrease from the 26.6% market share at December 31, 2013. Reynolds Tobacco's major premium brands are Camel, Kool, Winston and Salem. Its discount brands include Doral and Pall Mall. Reynolds Tobacco's market share information is based on data from an

IRI/Capstone model ("**IRI/Capstone**"), which was designed to measure retail share in stores representing trade channels where the majority of tobacco industry products are sold and resource investments are made.

Lorillard, Inc., formerly a wholly-owned subsidiary of Loews Corporation prior to June 2008, is the parent company of Lorillard Tobacco Company ("**Lorillard**"), the third largest-tobacco company in the U.S. In its Form 10-K filed with the SEC for the calendar year 2014, Lorillard, Inc. reported that its domestic retail cigarette market share for the year ended December 31, 2014 was 15.1% (measured by wholesale shipment volume), which represents an increase from 14.8% for the year ended December 31, 2013. Lorillard's principal brands are Newport, Kent, True, Maverick and Old Gold. Its largest-selling brand is Newport, which accounted for approximately 88.6% of Lorillard's cigarette segment net sales for the year ended December 31, 2014, an increase from 88.3% for the year ended December 31, 2013, according to Lorillard, Inc.'s Form 10-K filed with the SEC for the calendar year 2014. On November 1, 2010, Lorillard began shipping its new non-menthol varieties of Newport, called Newport Non-Menthol Box and Newport Non-Menthol Box 100s. Market share data reported by Lorillard is based on Lorillard's proprietary retail shipment database administered by MSAI, which reflects shipments from wholesalers to retailers.

Reynolds American and Lorillard, Inc. announced on July 15, 2014 that the two companies have entered into a definitive agreement in which Reynolds American will acquire Lorillard, Inc. for approximately $27.4 billion, which is expected to create the second-largest tobacco company in the United States, and which is expected to control approximately one-third of the U.S. tobacco market. The terms of the transaction have been approved by the boards of directors of both companies, and both companies received shareholder approval on January 28, 2015. British American Tobacco Plc ("**British American**"), which owns 42% of Reynolds American, will maintain its 42% ownership of Reynolds American through an investment of approximately $4.7 billion. Reynolds American expects to benefit from the addition of Lorillard's Newport brand as a key component of its growth-brand strategy in the U.S. menthol category. In addition, Reynolds American and British American have agreed in principle to pursue an ongoing technology-sharing initiative for the development and commercialization of next-generation tobacco products, including heat-not-burn cigarettes and vapor products.

Reynolds American stated that it has also reached a deal for Imperial Tobacco Group PLC ("**Imperial Tobacco**") to purchase Reynolds American's Kool, Salem and Winston cigarette brands, Lorillard, Inc.'s Maverick cigarette brand and blu eCig electronic cigarette brand, and other assets, for $7.1 billion, in an effort to ease the antitrust scrutiny of the Reynolds American merger with Lorillard, Inc. Imperial Tobacco's shareholders approved the asset acquisition on January 28, 2015. The addition of these brands to Imperial Tobacco's U.S. operations will more than triple its share of the U.S. cigarette market and improve its position in the traditional tobacco products and e-cigarette categories, and is expected to elevate it to the status of a major U.S. competitor in the tobacco industry and the third-largest tobacco product company in the U.S. tobacco market. Pursuant to Section XVIII(c) of the MSA, which states that "[n]o Original Participating Manufacturer may sell or otherwise transfer or permit the sale or transfer of any of its Cigarette brands, Brand Names, Cigarette product formulas or Cigarette businesses … to any person or entity unless such person or entity is an Original Participating Manufacturer or prior to the sale or acquisition agrees to assume the obligations of an Original Participating Manufacturer with respect to such Cigarette brands, Brand Names, Cigarette product formulas or businesses," the OPM payment obligations under the MSA with respect to the cigarette brands, brand names, cigarette product formulas and businesses acquired by Imperial Tobacco will be assumed and continued by Imperial Tobacco.

These transactions are subject to various closing conditions, including regulatory approval. The companies have stated their expectations of the closings taking place in mid-2015, and at substantially the same time. According to Reynolds American's Form 10-K filed with the SEC for the calendar year 2014, the merger agreement between Reynolds American and Lorillard, Inc. contains certain termination rights, including the right of each party to terminate the merger agreement if the merger has not been completed by July 15, 2015, subject to an automatic six-month extension if, on July 15, 2015, the merger has not yet received antitrust approval or certain specified legal restraints are in place but all other closing conditions have been satisfied.

Several shareholders of both Lorillard, Inc. and Reynolds American filed suit to block the proposed merger, claiming breach of fiduciary duties by the respective companies. Lorillard, Inc. and Reynolds American have stated in their Forms 10-K filed with the SEC for the calendar year 2014 that both companies believe that the shareholders' claims seeking injunctive relief against the proposed merger are without merit. However, Lorillard, Inc. and Reynolds American have reported in their Forms 10-K filed with the SEC for the calendar year 2014 that to eliminate the burden, expense and uncertainties inherent in litigation, the companies have entered into memoranda of understanding pursuant to which the companies will negotiate in good faith to agree to a stipulation of settlement with the shareholders who had filed suit, although there can be no assurance that the parties will ultimately settle.

Based on the domestic retail market shares discussed above, the remaining share of the U.S. retail cigarette market for the calendar year 2014 was held by a number of other domestic and foreign cigarette manufacturers, including Liggett Group, LLC ("**Liggett**") (the operating successor to the Liggett & Myers Tobacco Company) and Vector Tobacco Inc. ("**Vector Tobacco**"), each wholly-owned subsidiaries of Vector Group Ltd. ("**Vector Group Ltd.**"), and Commonwealth Brands, Inc. ("**CBI**"), a wholly-owned subsidiary of Imperial Tobacco, which markets deep discount brands. Liggett, Vector Tobacco and CBI are SPMs under the MSA.

In its Form 10-K filed with the SEC for the calendar year 2014, Vector Group Ltd. reported that its subsidiary Liggett's domestic market share in calendar year 2014 was 3.4%, measured by MSAI shipment volume data (compared to 3.3% during 2013 and 3.5% during 2012). The domestic market share of Vector Group Ltd.'s subsidiary Vector Tobacco is negligible, as Vector Group Ltd. further reported in its Form 10-K filed with the SEC for the calendar year 2014 that Liggett's and Vector Tobacco's domestic shipments together accounted for 3.4% of the total cigarettes sold in the United States in 2014. Vector Group Ltd. also reported in its Form 10-K filed with the SEC for the calendar year 2014 that Liggett and Vector Tobacco are not required to make any payments under the MSA unless such company's market share exceeds approximately 1.65% and approximately 0.28%, respectively, of the U.S. cigarette market, and that Liggett's and Vector Tobacco's payments under the MSA are based on each respective company's incremental market share above the aforementioned minimum threshold applicable to each respective company. All of Liggett's unit sales volume for the calendar year 2014, and all years since 2004, were in the discount segment, and Liggett's share of the discount segment was 11.8% in 2014, 11.6% in 2013 and 12.1% in 2012, according to Vector Group Ltd.'s Form 10-K filed with the SEC for the calendar year 2014. Vector Group Ltd.'s brands include Liggett Select, Grand Prix, Eve, Pyramid, Eagle 20's (relaunched as a deep discount brand in January 2013) and USA.

Imperial Tobacco is listed on the London Stock Exchange and does not file quarterly or annual reports with the SEC. Imperial Tobacco did not disclose its market share of the U.S. cigarette market in its annual report for the fiscal year ended September 30, 2014. The brands of Imperial Tobacco's subsidiary CBI include USA Gold, Sonoma and Fortuna. As noted above, following the Reynolds American and Lorillard, Inc. merger, and the related divestiture of assets, Imperial Tobacco would gain the Kool, Salem, Winston and Maverick cigarette brands and the blu eCigs electronic cigarette brand and is expected to become the third-largest tobacco product company in the U.S. tobacco market.

Industry Market Share

The following table sets forth the approximate comparative positions of the leading producers of cigarettes in the U.S. tobacco industry, each of which is an OPM under the MSA. Individual and total domestic OPM market shares presented below are derived from the publicly available documents of the OPMs and, as a result of varying methodologies used by the OPMs to calculate market share, may not be comparable and may be inaccurate when combined as presented.

Manufacturers' Domestic Market Share of Cigarettes[1]

	Calendar Year				
Manufacturer	2010	2011	2012	2013	2014
Philip Morris	49.8%	49.0%	49.8%	50.6%	50.9%
Reynolds Tobacco	28.1	27.6	26.5	26.0	26.5
Lorillard[2]	12.9	14.1	14.4	14.9	15.1
Other[3]	9.2	9.3	9.3	8.5	7.5

[1] Aggregate market share as reported above is different from that utilized in the Collection Methodology and Assumptions. In addition, aggregate market share for a given year is as reported in SEC filings for such year and has not been restated due to changes in reporting for subsequent years, if any.

[2] Lorillard utilizes MSAI market share data in its SEC reports. MSAI divides the cigarette market into two price segments, the premium price segment and the discount or reduced price segment. MSAI's information relating to unit sales volume and market share of certain of the smaller, primarily deep discount, cigarette manufacturers is based on estimates derived by MSAI. Lorillard management has indicated that it believes that volume and market share information for the deep discount manufacturers may be understated (and, correspondingly, volume and market share information for the larger manufacturers may be overstated).

[3] The market share, other than the OPMs, has been determined by subtracting the total market share percentages of the OPMs as reported in their publicly available documents from 100%. Results may not be accurate and may not total 100% due to rounding and the differing sources and methodologies utilized to calculate market share.

Cigarette Shipment Trends

The following table sets forth the industry's approximate cigarette shipments in the U.S. for the eight years ended December 31, 2014. The MSA payments are calculated in part on shipments by the OPMs in or to the U.S. rather than consumption.

Years Ended December 31	Shipments (Billions of Cigarettes)[1]	Percent Change From Prior Year
2014	264.6	(3.2)%
2013	273.3	(4.6)
2012	286.5	(2.3)
2011	293.1	(3.5)
2010	303.7	(3.8)
2009	315.7	(8.6)
2008	345.3	(3.3)
2007	357.2	(5.0)

[1] As reported in SEC filings of the parent companies of Lorillard and Reynolds Tobacco, based on MSAI data.

The information in the foregoing table, which has been obtained from publicly available documents but has not been independently verified, may differ materially from the amounts used by the MSA Auditor for calculating Annual Payments and Strategic Contribution Fund Payments under the MSA.

According to Lorillard Inc.'s Form 10-K filed with the SEC for the calendar year 2014, domestic cigarette shipments have decreased at a compound annual rate of approximately 3.9% from 2004 through 2014.

According to data from NAAG, overall shipments dropped approximately 4.86% to 276.209 billion cigarettes in sales year 2013 from 290.307 billion cigarettes in sales year 2012 measuring roll-your-own tobacco sales at 0.0325 ounces per cigarette conversion rate (or approximately 4.80% to 275.021 billion cigarettes in sales year 2013 from 288.874 billion cigarettes in sales year 2012 measuring roll-your-own tobacco sales at 0.09 ounces per cigarette conversion rate). According to NAAG data, domestic U.S. cigarette shipments over the past 10 available reported sales years was approximately as set forth in the table below.

Sales Year	No. of Cigarettes (in billions) (with 0.0325 oz. RYO conversion)	% Change From Prior Year (with 0.0325 oz. RYO conversion)[1]	No. of Cigarettes (in billions) (with 0.09 oz. RYO conversion)	% Change From Prior Year (with 0.09 oz. RYO conversion)[1]
2013	276.209	(4.86)%	275.021	(4.80)%
2012	290.307	(1.97)	288.874	(1.90)
2011	296.129	(2.77)	294.454	(2.65)
2010	304.551	(6.36)	302.461	(5.83)
2009	325.226	(9.09)	321.180	(8.42)
2008	357.738	(3.79)	350.711	(4.14)
2007	371.833	(4.96)	365.875	(5.14)
2006	391.256	0.26	385.711	0.25
2005	390.250	(3.51)	384.766	(3.86)
2004	404.439	0.09	400.224	0.07

[1] Percentage change calculated after rounding of shipment volume.

According to data from the Department of Treasury, Alcohol and Tobacco Tax and Trade Bureau (the "**TTB**"), the overall quantity of cigarettes shipped domestically (not including a conversion for roll-your-own tobacco) dropped approximately 4.06% to approximately 262.681 billion cigarettes in 2014 from approximately 273.787 billion cigarettes in 2013. According to the TTB, the quantity of cigarettes shipped domestically for the past 10 calendar years was approximately as set forth in the table below.

Calendar Year	No. of Cigarettes (in billions)	Percent Change From Prior Year[1]
2014	262.681	(4.06)%
2013	273.787	(4.77)
2012	287.487	(1.80)
2011	292.769	(2.57)
2010	300.489	(5.52)
2009	318.029	(8.20)
2008	346.419	(4.22)
2007	361.665	(5.01)
2006	380.726	(0.10)
2005	381.107	(4.31)

[1] Percentage change calculated after rounding of shipment volume.

Physical Plant, Distribution, Competition and Raw Materials

The production facilities of the OPMs tend to be highly concentrated. For instance, all of the cigarette production of Lorillard comes from a single facility in North Carolina. The other OPMs also have limited production facilities and continue to consolidate their production facilities. Material damage to these facilities could materially impact overall cigarette production. A prolonged interruption in the manufacturing operations of the cigarette manufacturers could have a material adverse effect on the ability of the cigarette manufacturers to effectively operate their respective businesses.

Cigarette manufacturers sell tobacco products to wholesalers (including distributors), large retail organizations, including chain stores, and the armed services. However, certain stores have ceased the sale of tobacco products. On September 3, 2014, the national pharmacy chain CVS reportedly stopped selling all cigarettes and other tobacco products in all its stores (following a February 2014 announcement), citing that such sales were inconsistent with its mission. A group of U.S. Attorneys General have pressured large retail stores with pharmacies to take similar action, and in April 2014 several members of Congress called on these retailers to stop selling cigarettes and other items containing tobacco. The retail chain store Target had stopped selling tobacco products in 1996. Costco also reportedly has gradually removed tobacco products from approximately half of its U.S. locations, according to news reports in May 2014. In addition, in March 2014, the U.S. Navy reported that it was considering banning tobacco sales on all naval bases, but in May 2014 Congressional lawmakers approved a measure that would protect tobacco sales on military bases and ships. Cigarette manufacturers and their affiliates and licensees also market cigarettes and other tobacco products worldwide, directly or through export sales organizations and other entities with which they have contractual arrangements.

The domestic market for cigarettes is highly competitive. Competition is primarily based on a brand's price, including the level of discounting and other promotional activities, positioning, consumer loyalty, retail display, quality and taste. Promotional activities include, in certain instances, allowances, the distribution of incentive items, price reductions and other discounts. Considerable marketing support, merchandising display and competitive pricing are generally necessary to maintain or improve a brand's market position. Increased selling prices and taxes on cigarettes have resulted in additional price sensitivity of cigarettes at the consumer level and in a proliferation of discounts and of brands in the discount segment of the market. Generally, sales of cigarettes in the discount segment are not as profitable as those in the premium segment.

The tobacco products of the cigarette manufacturers and their affiliates and licensees are advertised and promoted through various media, although television and radio advertising of cigarettes is prohibited in the U.S. The domestic tobacco manufacturers have agreed to additional marketing restrictions in the U.S. as part of the MSA and other settlement agreements. They are still permitted, however, to conduct advertising campaigns in magazines, at retail cigarette locations, in direct mail campaigns targeted at adult smokers, and in other adult media.

E-Cigarettes

Numerous manufacturers have recently developed (or acquired) and are marketing "electronic cigarettes" (or "**e-cigarettes**"), which, while not tobacco products, are battery powered devices in the shape of a cigarette that vaporize liquid nicotine, which is then inhaled by the consumer. Because they do not contain or burn or heat tobacco, the manufacturers (and certain states, as noted below) do not deem e-cigarettes to constitute "cigarettes" within the meaning of the MSA, and e-cigarettes are currently not subject to the advertising restrictions to which tobacco products are subject. According to Lorillard, Inc. in its Form 10-K filed with the SEC for the calendar year 2014, the predominant forms of advertising and promotion in the electronic cigarette industry are television, print advertising, sampling events and web based advertising. There are currently over 450 e-cigarette brands on the market, and more than 7,000 available flavors of e-cigarettes, according to some estimates.

The parent companies of all three OPMs have launched e-cigarette brands. Lorillard's parent company reported in its SEC filings that on April 24, 2012, it acquired, through its subsidiaries, blu eCigs and other assets used in the manufacture, distribution, development, research, marketing, advertising and sale of electronic cigarettes. The acquisition provided Lorillard, Inc. with the blu eCigs brand and an e-cigarette product line. (Lorillard, Inc. also acquired the electronic cigarette business SKYCIG in October 2013, but distribution of SKYCIG e-cigarettes is currently limited to the United Kingdom.) Lorillard, Inc. reported in its Form 10-K filed with the SEC for the calendar year 2014 that it sells the blu eCigs electronic cigarettes to distributors (with approximately 400 direct buying customers providing blu eCigs to approximately 176,000 retail accounts in the U.S. as of December 31, 2014) as well as directly to consumers over the internet. Lorillard, Inc. further reported in its Form 10-K filed with the SEC for the calendar year 2014 that the method of distribution for many competing e-cigarette brands is predominately over the internet, with only a small but growing number of competitors currently having a significant presence at retail. The blu eCigs brand made up approximately 23.6% of the U.S. market in e-cigarettes at December 27, 2014, according to Lorillard, Inc.'s Form 10-K filed with the SEC for the calendar year 2014. As discussed above under "—Industry Overview", it is expected that Imperial Tobacco will purchase the blu eCigs brand in connection with the Reynolds American and Lorillard, Inc. merger. Reynolds American reported in October 2012 that it introduced an electronic cigarette, VUSE, in limited distribution. Reynolds American launched a revamped version of VUSE in Colorado retail outlets in July 2013 and expanded distribution into Utah in the first quarter of 2014. According to Reynolds American in its Form 10-K filed with the SEC for the calendar year 2014, the national expansion of VUSE began in 2014, and will continue into early 2015. Reynolds American has stated that it intends to remain focused on VUSE's growth and expansion nationwide, and that it is targeting existing smokers with VUSE and expects some smokers to give up traditional cigarettes in favor of VUSE. Altria's subsidiary Nu Mark LLC introduced e-vapor products under the "MarkTen" brand in Indiana and Arizona in 2013, and expanded MarkTen nationally during 2014, according to Altria in its Form 10-K filed with the SEC for the calendar year 2014. MarkTen is an e-cigarette that can be reused with a separate battery recharging kit and additional cartridges in both tobacco and menthol flavors. Altria has stated that the MarkTen's "Four Draw" technology is designed to give users a "more consistent experience" that closely resembles the draw of a traditional cigarette. In April 2014 Altria, through its Nu Mark subsidiary, acquired the e-vapor business of Green Smoke, Inc., an e-cigarette maker that sells both disposable and reusable products. In addition, Vector Group Ltd. reported in its Form 10-K filed with the SEC for the calendar year 2014 that its subsidiary Zoom E-Cigs LLC entered the U.S. e-cigarette market in limited retail distribution outlets in 2013 and expanded distribution in 2014.

The fastest growth in e-cigarettes comes from devices called "vaporizers", which are larger, customizable devices. They have larger batteries and cartridges, hold more liquid, produce larger vapor clouds and last longer. They allow users to mix and match hardware and refill cartridges with liquid bought in bulk, so that they are cheaper than e-cigarettes.

Altria reported in its Form 10-K filed with the SEC for the calendar year 2014 that Nu Mark estimates 2014 total consumer expenditures on e-vapor products to be approximately $2 billion based on annualized sales information. The CDC in September 2014 reported results of a survey that indicated that in 2013 approximately 8.5% of the adult population (representing approximately two-and-a-half times the 2010 estimates), and 36.5% of smokers (representing approximately four times the 2010 estimates), had tried e-cigarettes at some time. Altria reported in its Form 10-K filed with the SEC for the calendar year 2014 that it believes that nearly all adult smokers are aware of e-vapor products and approximately 60% have tried them. A report released by the CDC in August 2014 showed that more than a quarter of a million youth who had never smoked a cigarette used electronic cigarettes in 2013, and the CDC further reported in November 2014 that in 2013, 4.5% of high school students, or more than 750,000 youth, reported using e-cigarettes in the previous 30 days—triple the percentage who reported doing so in 2011. Furthermore, in December 2014 the University of Michigan's Survey for Research Center reported its findings that e-cigarette use exceeded traditional cigarette smoking among teens in 2014. In addition, it has been reported that increases in taxes on traditional cigarettes have caused an increase in the sale of e-cigarettes. Certain reports have predicted that sales of e-cigarettes could outpace traditional cigarettes before 2050. It has also been reported that e-cigarettes will capture more than half the smoking market within a decade. Growth in the electronic cigarette market may have an adverse effect on the tobacco-cigarette market.

On April 25, 2014, the FDA released proposed rules that would extend its regulatory authority to electronic cigarettes and certain other tobacco products under the FSPTCA. The proposed rules would require that electronic cigarette manufacturers (i) register with the FDA and report electronic cigarette product and ingredient listings; (ii) market new electronic cigarette products only after FDA review; (iii) only make direct and implied claims of reduced risk if the FDA confirms that scientific evidence supports the claim and that marketing the electronic cigarette product will benefit public health as a whole; (iv) not distribute free samples; (v) implement minimum age and identification restrictions to prevent sales to individuals under age 18; (vi) include a health warning; and (vii) not sell electronic cigarettes in vending machines, unless in a facility that never admits youth. Notably, the proposed rules do not restrict flavored products, online sales or advertising. The proposed regulation was initially subject to a 75-day public comment period, which was extended an additional 30 days, and closed on August 8, 2014, following which the FDA will finalize the proposed regulation. It is not known how long this regulatory process to finalize and implement the rules may take. Reynolds American stated in its Form 10-K filed with the SEC for the calendar year 2014 that a final rule is expected in 2015. On August 8, 2014, the attorneys general from 29 states urged the FDA to strengthen its proposed regulation on electronic cigarettes to better protect young people from nicotine addiction, requesting the FDA to prohibit flavors other than tobacco and menthol and to restrict advertising and marketing for e-cigarettes as strictly as it does for cigarettes. No assurance can be given that any regulation of e-cigarettes by the FDA will stop the trend of increased sales of e-cigarettes. In addition, on February 26, 2014, Senators Barbara Boxer, Dick Durbin, Tom Harkin, Richard Blumenthal and Edward Markey introduced legislation that would permit the FTC to determine what constitutes marketing e-cigarettes to children, and would allow the FTC to work with state attorneys general to enforce a ban on such marketing. There can be no assurance that such legislation will be enacted.

Electronic cigarettes are generally not subject to federal, state or local excise taxes. According to Reynolds American in its Form 10-K filed with the SEC for the calendar year 2014, as of December 31, 2014 only two states imposed a tax on e-cigarettes (Minnesota, which taxes e-cigarettes at the same rate as it taxes smokeless tobacco products, and North Carolina, which will tax e-cigarettes at the rate of $0.05 per fluid milliliter beginning June 2015). In addition, according to Reynolds American, as of December 31, 2014, 17 states had proposed taxing e-cigarettes on the same basis as other tobacco products, with such legislation failing in all 17 states, and one state (Missouri) adopted legislation that exempts e-cigarettes from taxation. In February 2014, several U.S. Senators introduced a bill that would bar companies from marketing e-cigarettes to minors and would give the Federal Trade Commission the authority to determine which advertisements target children. Bills have been introduced in various states that, if approved, would ban the sale of e-cigarettes to minors. Furthermore, three U.S. states (North Dakota, New Jersey and Utah) and 274 municipalities have banned the use of e-cigarettes in smoke-free venues, and 15 states have restricted e-cigarette use in other venues, according to the American Nonsmokers' Rights Foundation ("**ANRF**") as of January 1, 2015. On December 19, 2013, the New York City Council approved legislation that prohibits the use of electronic cigarettes in indoor public places and in places of employment (where smoking of traditional cigarettes is already prohibited). Chicago, Los Angeles, San Francisco and Philadelphia passed similar legislation in 2014. In January 2015, a bill was introduced in the State of California that seeks to ban the e-cigarettes in public places; a similar ban was proposed, also in January 2015, by the Governor of New York State. On June 10, 2014, seven U.S. Senators sent a letter urging the Department of Transportation to finalize rules proposed almost three years ago that would ban e-cigarette use on domestic flights and those to or from the United States.

In December 2014, Representatives Henry Waxman and Frank Pallone and Senator Dick Durbin sent letters to 29 Attorneys General urging them to classify electronic cigarettes as cigarettes under the MSA in order to prevent e-cigarette companies from targeting youth and getting them addicted to their products. In February 2015, eight Attorneys General sent a response letter stating their position that the MSA does not cover e-cigarettes. The State has not taken any position regarding the MSA's applicability to electronic cigarettes. A classification of e-cigarettes as cigarettes under the MSA could mitigate potential decreases in payments under the MSA due to declining consumption of traditional cigarettes if electronic cigarettes gain market share over traditional cigarettes. There can be no assurance that such classification will occur, and the nature and timing of any future amendments to the MSA, or interpretations under the MSA, cannot be predicted.

Smokeless Tobacco Products

Smokeless tobacco products, which are not "cigarettes" within the meaning of the MSA, have been available for centuries. Chewing tobacco and snuff are the most significant components of this market segment. Snuff is a ground or powdered form of tobacco that is placed under the lip to dissolve. It delivers nicotine effectively to the body. Moist snuff is both smoke-free and potentially spit-free. As cigarette consumption expanded in the last century, the use of smokeless products declined. Recently, however, the industry has expanded its smokeless tobacco products in response to the general decline in cigarette consumption, the proliferation of smoking bans and the perception that smokeless use is a less harmful mode of tobacco and nicotine usage than cigarettes. Snuff, for example, is now being marketed to adult cigarette smokers as an alternative to cigarettes. UST, the largest producer of moist smokeless tobacco (and a subsidiary of Altria, Philip Morris's parent company), which manufactures Copenhagen and Skoal smokeless products, among others, is explicitly targeting adult smoker conversion in its growth strategy. In 2006, the three largest U.S. cigarette manufacturers entered the market of smokeless tobacco products. Philip Morris introduced a snuff product, Taboka. Reynolds American acquired Conwood Company, L.P., the nation's second-largest smokeless-tobacco manufacturer, and introduced Camel Snus, a snuff product. Lorillard entered into an agreement with Swedish Match North America to develop smokeless products in the United States, which has since been discontinued. In addition, Lorillard announced in 2010 that it intended to enter certain test markets with a traditional moist snuff product to assess opportunities to broaden its product offerings, but it makes no mention of such in its recent SEC filings. Product development has continued, however, with the introduction by Philip Morris of Marlboro snus (a smokeless, spitless tobacco product that originated in Sweden) and snuff products. In October 2007, Altria announced that it would accelerate the development of snuff and less-harmful cigarettes to counter a decline in smoking. In January 2012 Altria announced that it entered into an agreement with Okono, an affiliate of Fertin Pharma, a Danish maker of nicotine chewing gum, to develop non-combustible tobacco products. In May 2012, Altria announced that its subsidiary Nu Mark LLC introduced Verve nicotine discs, a mint-flavored, chewable, disposable tobacco product that contains tobacco-derived nicotine. Furthermore, Altria reported in its Form 10-K filed with the SEC for the calendar year 2014 that in December 2013 its subsidiaries entered into an agreement with Philip Morris International Inc. providing for an exclusive license to Altria subsidiaries to sell two of Philip Morris International Inc.'s heated tobacco product technologies in the United States. Reynolds Tobacco announced in November 2014 that it would introduce in Wisconsin in January 2015 a product called REVO, a cigarette that uses a carbon tip to heat tobacco instead of burning it, releasing a tobacco-flavored vapor and not traditional cigarette smoke. Reynolds Tobacco has stated that it hopes that REVO will appeal to smokers who don't like e-cigarettes but would like an alternative to traditional smoking.

Advocates of the use of snuff as part of a tobacco harm reduction strategy point to Sweden, where use of "snus", a moist snuff manufactured by Swedish Match, has increased sharply since 1970, and where cigarette smoking incidence among males has declined to levels well below that of other countries. A review of the literature on the Swedish experience concludes that snus, relative to cigarettes, delivers lower concentrations of some harmful chemicals, and does not appear to cause cancer or respiratory diseases. They conclude that snus use appears to have contributed to the unusually low rates of smoking among Swedish men. The Sweden experience is unique, even with respect to its Northern European neighbors. It is not clear whether it could be replicated elsewhere. A May 2008 study using data from the 2000 National Health Interview Survey reports that U.S. men who used smokeless tobacco as a smoking cessation method achieved significantly higher quit rates than those who used other cessation aids. Public health advocates in the U.S. emphasize that smokeless use results in both nicotine dependence and increased risks of oral cancer among other health concerns. Snuff use is also often criticized as a gateway to cigarette use.

On June 10, 2014, Swedish Match submitted an application to the FDA to approve its snus products as "modified risk", and is seeking permission to remove one of the required health warnings from its packages. The FDA has one year to evaluate the application, and according to news reports, the FDA is planning to review the matter at an April 2015 meeting of the TPSAC.

In 2008, Fuisz Technologies formed a new firm, Fuisz Tobacco, to commercialize a film-based smokeless tobacco product. The thin film strip would be spitless and would dissolve entirely in the cheek. No developments have been reported on this product, but Fuisz Technologies announced in 2013 a patent for improved nicotine delivery from a tobacco pouch. In addition, Reynolds American has developed and is marketing Camel Sticks, a twisted, dissolvable stick made of tobacco, Camel Orbs, dissolvable tobacco tablets, and Camel Strips, dissolvable tobacco strips, each of which may be produced as flavored items.

As a result of these efforts, smokeless tobacco products have been increasing market share of tobacco products overall at the expense of the market share captured by cigarettes. According to Reynolds American, as reported in its Form 10-K filed with the SEC for the calendar year 2014, U.S. moist snuff retail volumes grew approximately 2% in 2014 and 5% in each of 2013 and 2012. Reynolds American further reported in such Form 10-K that moist snuff's growth is partially attributable to cigarette smokers switching from cigarettes to smokeless tobacco products or using both. Sales of moist snuff products have increased by 65.6% between 2005 and 2011, according to the National Center for Biotechnology Information. According to Altria's Form 10-K filed with the SEC for the calendar year 2014, smokeless tobacco products accounted for approximately 7.6% of Altria's tobacco product net revenues for the calendar year 2014, compared with approximately 7.5% for the calendar year 2013, and it estimates that its smokeless products category volume growth rate slowed to approximately 2% for 2014 as compared to approximately 5.5% for 2013. A June 2014 report by the CDC found that smokeless tobacco use among U.S. workers has remained relatively steady since 2005, with 2.7% of U.S. workers using smokeless tobacco products in 2005 and 3.0% of U.S. workers using smokeless tobacco products in 2010, while cigarette use has declined since 2005.

Smoking Cessation Products

A variety of smoking cessation products and services have developed to assist individuals to quit smoking. While some studies have shown that smokers who use a smoking cessation product to help them quit smoking are more likely to relapse, other studies have shown that these products and programs are effective, and that excise taxes and smoking restrictions and related tobacco regulation drive additional expenditures to the smoking cessation market. The smoking cessation industry is broadly divided into two segments, counseling services (e.g., individual, group, or telephone), and pharmacological treatments (both prescription and over-the-counter). Several large pharmaceutical companies, including GlaxoSmithKline, Johnson & Johnson, Novartis and Pfizer are significant participants in the smoking cessation market. The FDA has approved a variety of smoking cessation products and these products include prescription medicine, such as Nicotrol, Chantix, and Zyban, as well as over-the-counter products such as skin patches, lozenges and chewing gum. Electronic cigarettes and snus are viewed by some as alternatives to smoking that may lead to cigarette smoking cessation. Alternative therapies, such as psychotherapy and hypnosis, are also in use and available to individuals. The smoking cessation industry is a competitive market and new products, including sublingual wafers and bottled water containing nicotine, have been introduced in the last few years.

Private health insurance carriers are increasing premiums on smokers, which often are passed on by the employer to the smoker-employee. Certain of these and other health insurance policies, including Medicaid and Medicare, cover various forms of smoking cessation treatments, making smoking cessation treatments more affordable for covered smokers.

Results of a study by the CDC, released in November 2011, found that in 2010 68.8% of smokers wanted to stop smoking, 52.4% had made a quit attempt in the past year, 6.2% had recently quit, 48.3% had been advised by a health professional to quit, and 31.7% had used counseling and/or medications when they tried to quit. In January 2014 the CDC released further results indicating the quit rates had increased to 52.9% for attempts made in the past year. According to a report issued by the CDC in November 2014, the smoking rate for adults in the United States fell to 18% in 2013.

Gray Market

A price differential exists between cigarettes manufactured for sale abroad and cigarettes manufactured for U.S. sale. Such differential increases as excise taxes are increased. Consequently, a domestic gray market has developed in cigarettes manufactured for sale abroad, but instead are diverted for domestic sales that compete with cigarettes manufactured for domestic sale. The U.S. federal government and all states, except Massachusetts, have enacted legislation prohibiting the sale and distribution of gray market cigarettes. In addition, Reynolds American has reported that it has taken legal action against certain distributors and retailers who engage in such practices.

Regulatory Issues

Regulatory Restrictions and Legislative Initiatives

The tobacco industry is subject to a wide range of laws and regulations regarding the marketing, sale, taxation and use of tobacco products imposed by local, state, federal and foreign governments. Various state governments have adopted or are considering, among other things, legislation and regulations that would increase their excise taxes on cigarettes, restrict displays and advertising of tobacco products, establish ignition propensity standards for cigarettes, raise the minimum age to possess or purchase tobacco products, ban the sale of "flavored" cigarette brands, require the disclosure of ingredients used in the manufacture of tobacco products, impose restrictions on smoking in public and private areas, and restrict the sale of tobacco products directly to consumers or other unlicensed recipients, including over the Internet. Several states charge higher health insurance premiums to state employee smokers than non-smokers, and a number of states have implemented legislation that allows employers to provide incentives to employees who do not smoke. The Affordable Care Act allows insurance companies to charge smokers up to 50% higher premiums than non-smokers, and several large corporations are now charging smokers higher premiums.

Federal Regulation

In 1964, the Report of the Advisory Committee to the Surgeon General of the U.S. Public Health Service concluded that cigarette smoking was a health hazard of sufficient importance to warrant appropriate remedial action. Since this initial report in 1964, the Secretary of Health, Education and Welfare (now the Secretary of Health and Human Services) and the Surgeon General have issued a number of other reports that find the nicotine in cigarettes addictive and that link cigarette smoking and exposure to cigarette smoke with certain health hazards, including various types of cancer, coronary heart disease and chronic obstructive lung disease. These reports have recommended various governmental measures to reduce the incidence of smoking. In March 2012, the Surgeon General released a report on preventing tobacco use among youth and young adults.

During the past four decades, various laws affecting the cigarette industry have been enacted. Since 1966, federal law has required a warning statement on cigarette packaging. Since 1971, television and radio advertising of cigarettes has been prohibited in the U.S. Cigarette advertising in other media in the U.S. is required to include information with respect to the "tar" and nicotine yield of cigarettes, as well as a warning statement. In 1984, Congress enacted the Comprehensive Smoking Education Act. Among other things, the Smoking Education Act established an interagency committee on smoking and health that is charged with carrying out a program to inform the public of any dangers to human health presented by cigarette smoking; required a series of four health warnings to be printed on cigarette packages and advertising on a rotating basis; increased type size and area of the warning required in cigarette advertisements; and required that cigarette manufacturers provide annually, on a confidential basis, a list of ingredients added to tobacco in the manufacture of cigarettes to the Secretary of Health and Human Services.

In 1992, the federal Alcohol, Drug Abuse and Mental Health Act was signed into law. This act required states to adopt a minimum age of 18 for purchases of tobacco products and to establish a system to monitor, report and reduce the illegal sale of tobacco products to minors in order to continue receiving federal funding for mental health and drug abuse programs. Federal law prohibits smoking in scheduled passenger aircraft, and the U.S. Interstate Commerce Commission has banned smoking on buses transporting passengers interstate. Certain common carriers have imposed additional restrictions on passenger smoking. On March 31, 2010, President Obama signed into law the Prevent All Cigarette Trafficking (PACT) Act. This legislation, among other things, restricts the sale of tobacco products directly to consumers or unlicensed recipients, including over the Internet, through expanded reporting requirements, requirements for delivery and sales, and penalties. On November 4, 2011 a bill, the Smoke-Free Federal Buildings Act, was introduced in the U.S. House of Representatives to ban smoking in and 25 feet around all facilities owned or leased by the federal government, but was never enacted. A similar bill may be introduced in the future.

FSPTCA

The Family Smoking Prevention and Tobacco Control Act of 2009 ("**FSPTCA**") (amending the FDA's Food, Drug and Cosmetics Act), signed by President Obama on June 22, 2009, grants the FDA authority to regulate tobacco products. Among other provisions, the FSPTCA:

- establishes a Tobacco Products Scientific Advisory Committee ("**TPSAC**") to, among other things, evaluate the issues surrounding the use of menthol as a flavoring or ingredient in cigarettes within one year of such committee's establishment;

- grants the FDA the regulatory authority to consider and impose broad additional restrictions through a rule making process, including a ban on the use of menthol in cigarettes upon a finding that such a prohibition would be appropriate for the public health;

- requires larger and more severe health warnings on cigarette packs and cartons;

- bans the use of descriptors on tobacco products, such as "low tar" and "light";

- requires the disclosure of ingredients and additives to consumers;

- requires pre-market approval by the FDA for claims made with respect to reduced risk or reduced exposure products;

- allows the FDA to require the reduction of nicotine or any other compound in cigarettes;

- allows the FDA to mandate the use of reduced risk technologies in conventional cigarettes;

- permits inconsistent state regulation of the advertising or promotion of cigarettes and eliminates the existing federal preemption of such regulation; and

- allows the FDA to subject tobacco products that are modified or first introduced into the market after March 22, 2011 to application and premarket review and authorization requirements (the "**new product application process**") if the FDA does not find them to be "substantially equivalent" to products commercially marketed as of February 15, 2007, and to deny any such new product application thus preventing the distribution and sale of any product affected by such denial.

Since the passage of the FSPTCA, the FDA has taken the following actions:

- established the collection of user fees from the tobacco industry;
- created and staffed the TPSAC;
- selected the Director of the Center for Tobacco Products;
- announced and began enforcing a ban on fruit, candy or clove flavored cigarettes (menthol is currently exempted from this ban);
- issued guidance on registration and product listing;
- issued final rules restricting access and marketing of cigarettes and smokeless tobacco products to youth;
- issued a prohibition on misleading marketing terms ("Light," "Low," and "Mild") for tobacco products;
- required warning labels for smokeless tobacco products; and
- authorized the sale and marketing of new tobacco products and rejected applications to introduce certain new tobacco products into the market

Pursuant to requirements of the FSPTCA, the FDA issued a proposed rule in November 2010 to modify the required warnings that appear on cigarette packages and in cigarette advertisements. The new required warnings consist of nine new textual warning statements accompanied by color pictures depicting the negative health consequences of smoking. The warnings would appear on the upper portion of the front and rear panels of each cigarette package and comprise at least the top 50 percent of these panels, and would also appear in each cigarette advertisement and occupy at least 20 percent of the advertisement and be located at the top of the advertisement. The FDA took public comments on the proposed rule through January 2011, and in June 2011, the FDA unveiled nine new graphic health warnings that were required to appear on cigarette packages and advertisements no later than September 2012. As discussed below under "*—FSPTCA Litigation*," five tobacco companies in August 2011 filed a complaint against the FDA in the U.S. District Court for the District of Columbia challenging the FDA's rule requiring new textual and graphic warning labels on cigarette packaging and advertisements. The FDA is currently enjoined from enforcing the rule but has announced that it would undertake research to support and propose a new rulemaking on different warning labels consistent with the FSPTCA.

In July 2010, the TPSAC conducted hearings on the impact of dissolvable tobacco products and the use of menthol in cigarettes on public health. A report on these hearings was submitted to the FDA in 2011 and remains subject to continuing TPSAC hearings. Written comments regarding dissolvable tobacco products were submitted to the TPSAC ahead of its January 2012 meeting, at which the TPSAC continued its discussions of issues related to the nature and impact of dissolvable tobacco products on public health. The TPSAC's final report released to the FDA in March 2012 found that dissolvable tobacco products would reduce health risks compared to smoking cigarettes, but also have the potential to increase the number of tobacco users. The TPSAC could not reach any overall judgment as to whether or not the consequence of dissolvable tobacco products would be an increase or decrease in the number of people who successfully quit smoking. The FDA will consider the report and recommendations and determine what future action, if any, is warranted with respect to dissolvable tobacco products. There is no timeline or statutory requirement for the FDA to act on the TPSAC's recommendations.

The TPSAC or the Menthol Report Subcommittee held meetings throughout 2010 and 2011 to consider the issues surrounding the use of menthol in cigarettes. At its March 18, 2011 meeting, TPSAC presented its report and recommendations on menthol. The report's findings included that menthol likely increases experimentation and regular smoking, menthol likely increases the likelihood and degree of addiction for youth smokers, non-white menthol smokers (particularly African-Americans) are less likely to quit smoking and are less responsive to certain cessation medications, and consumers continue to believe that smoking menthol cigarettes is less harmful than smoking nonmenthol cigarettes as a result of the cigarette industry's historical marketing. TPSAC's overall recommendation to the FDA was that "removal of menthol cigarettes from the marketplace would benefit public health in the United States." The FDA submitted a draft report on its independent review of research related to the effects of menthol in cigarettes on public health, if any, to an external peer review panel in July 2011. The FDA stated that, after peer review, the results and the preliminary scientific assessment will be available for public comment in the Federal Register. At the July 21, 2011 meeting, TPSAC considered revisions to its report, and the voting members unanimously approved the final report for submission to the FDA with no change in its recommendation. On January 26, 2012, the FDA provided a second progress report on its review of the science related to menthol cigarettes. In its January 2012 update, the FDA stated that the "FDA submitted its report to external scientists for peer review, and the agency is revising its report based on their feedback." The FDA stated its intent to make the final report, along with the peer review scientists' feedback and the FDA's response to the feedback, available for public comment in the Federal Register. The FDA also indicated that it would consider any public comments to the final report, which "may provide additional evidence or emerging data." Based on those comments, together with the TPSAC report, the industry's perspective report and prior public comments, the FDA stated that it will consider the collective evidence and "possible actions related to the public health impact of menthol in cigarettes." On July 23, 2013, the FDA released its Independent Preliminary Scientific Evaluation of the Public Health Effects of Menthol Versus Non-menthol Cigarettes (the "**Preliminary Evaluation**") and peer comments for 60 days of public comment (such public comment period was subsequently extended for an additional 60 days to November 22, 2013), and issued an Advance Notice of Proposed Rulemaking seeking additional information to help the FDA make informed decisions about menthol in cigarettes. The Preliminary Evaluation found that although there is little evidence to suggest menthol cigarettes are more toxic than regular cigarettes, the mint flavor of menthol masks the harshness of tobacco, which makes it easier to become addicted and harder to quit, and increases smoking initiation among youth. The FDA concluded that menthol cigarettes likely pose a public health risk above that seen with non-menthol cigarettes. During the public comment period, the FDA was to consider all comments, data and research submitted to determine what regulatory action, if any, with respect to menthol cigarettes is appropriate, including the establishment of product standards. In the meantime it will conduct and support research on the differences between menthol and non-menthol cigarettes as they relate to menthol's likely impact on smoking cessation. The FDA is not required to follow the TPSAC's recommendations, and the FDA has not yet taken any action with respect to menthol use. As discussed below under "*—FSPTCA Litigation*", the court in *Lorillard, Inc. v. U.S. Food and Drug Administration* barred the FDA from relying on the TPSAC report on menthol.

Any ban or material limitation on the use of menthol in cigarettes could materially adversely affect the results of operations, cash flow and financial condition of the PMs, especially Lorillard, which is heavily dependent on sales of its *Newport* brand mentholated cigarettes. As discussed above under "—Industry Overview", it is expected that Reynolds American will acquire the Newport brand as part of its acquisition of Lorillard, Inc. According to Lorillard, Inc. in its Form 10-K filed with the SEC for the calendar year 2014, mentholated cigarettes are reported to have comprised 31.7% and 31.4% of the U.S. cigarette market for the years ended December 31, 2014 and 2013, respectively. Menthol smoking rates have also increased among young adults during the past decade.

In January 2011, the FDA issued guidance concerning reports that manufacturers must submit for certain FDA-regulated tobacco products that the manufacturer modified or introduced for the first time into the market after February 15, 2007. These reports must be reviewed by the FDA to determine if such tobacco products are "substantially equivalent" to products commercially available as of February 15, 2007. In general, in order to continue marketing these products sold before March 22, 2011, manufacturers of FDA-regulated tobacco products were required to send to the FDA a report demonstrating substantial equivalence by March 22, 2011. If the FDA ultimately makes such a determination, it could require the removal of such products or subject them to the new product application process and, if any such applications are denied, prevent the continued distribution and sale of such products. Manufacturers intending to introduce new products and certain modified products into the market after March 22, 2011 must submit a report to the FDA and obtain a "substantial equivalence order" from the FDA before introducing the products into the market. If the FDA declines to issue a so-called "substantial equivalence order" for a product or if the manufacturer itself determines that the product does not meet the substantial equivalence requirements, the product would need to undergo the new product application process.

Since the FSPTCA's enactment, the FDA has received thousands of applications for products that tobacco companies claimed were "substantially equivalent" to ones already on the market. The FDA announced on June 25, 2013 that it approved the applications and authorized the sale of two new non-menthol Newport cigarettes made by Lorillard (after determining that the cigarettes, while slightly different than previous products, would not pose new health issues) and rejected four other new tobacco products, based on new health concerns raised by some ingredients and a lack of detail about product design. It was the first instance of a federal agency rejecting an application by a tobacco manufacturer to bring a new tobacco product to the market based on the product's threat to public health. Four additional tobacco products were rejected by the FDA on August 28, 2013 because they were found to be "not substantially equivalent" to the predicate products to which they were compared, and in September 2013 four roll-your-own products were approved for marketing and sale by the FDA because the products were determined to be "substantially equivalent" to the predicate products to which they were compared. In February 2014, the FDA issued orders to prevent the further sale and distribution of four of the "not substantially equivalent" tobacco products that were currently on the market, marking the first time the FDA has used its authority to order a tobacco manufacturer to stop selling and distributing currently available tobacco products. In August 2014, the FDA ordered a tobacco product manufacturer to stop selling and distributing seven dissolvable tobacco products because they were not substantially equivalent to predicate products. According to the FDA, through the end of 2014, the FDA has issued 95 "substantially equivalent" orders, 38 "not substantially equivalent" orders, and 16 "refusal to accept" letters with respect to substantial equivalence; in addition, 508 reports regarding tobacco products were withdrawn by manufacturers.

On March 30, 2012 the FDA issued draft guidance on: (i) the reporting of harmful and potentially harmful constituents in tobacco products and tobacco smoke pursuant to the FSPTCA, and (ii) preparing and submitting applications for modified risk tobacco products pursuant to the FSPTCA.

On April 25, 2014, the FDA released proposed rules that would extend its regulatory authority to electronic cigarettes and certain other tobacco products under the FSPTCA. See "—E-Cigarettes" above.

On a going-forward basis, various provisions under the FSPTCA and regulations to be issued thereunder will become effective and will:

- require manufacturers to test ingredients and constituents identified by the FDA and disclose this information to the public;

- prohibit use of tobacco containing a pesticide chemical residue at a level greater than allowed under Federal law;

- establish "good manufacturing practices" to be followed at tobacco manufacturing facilities;

- authorize the FDA to place more severe restrictions on the advertising, marketing and sale of tobacco products;

- permit inconsistent state regulation of labeling and advertising and eliminate the existing federal preemption of such regulation;

- authorize the FDA to require the reduction of nicotine (though not to zero) and the reduction or elimination of other constituents; and

- grant the FDA the regulatory authority to impose broad additional restrictions.

The FDA reported in November 2011 that it issued approximately 1,200 warning letters to retailers in 15 states for violating Federal tobacco regulations since the FDA's Center for Tobacco Products began conducting retail inspections under the FSPTCA. Most of the letters were issued for selling tobacco products to minors. The FDA also reported that it had contracted with 37 states and the District of Columbia to conduct compliance checks in at least 20% of the stores in each state to ensure that the retailers are acting in compliance with the FDA's regulations concerning the sale of tobacco products.

FSPTCA Litigation

Tobacco manufacturers have filed suit regarding certain provisions of the FSPTCA and actions taken thereunder. In August 2009, a group of tobacco manufacturers (including Reynolds Tobacco and Lorillard) and a tobacco retailer filed a complaint against the United States of America in the United States District Court for the Western District of Kentucky, *Commonwealth Brands, Inc. v. U.S.*, 678 F.Supp.2d 512, in which they asserted that various provisions of the FSPTCA violate their free speech rights under the First Amendment, constitute an unlawful taking under the Fifth Amendment, and are an infringement on their Fifth Amendment due process rights. Plaintiffs sought a preliminary injunction and a judgment declaring the challenged provisions unconstitutional. Both plaintiffs and the government filed motions for summary judgment and on November 5, 2009, the district court denied certain plaintiffs' motion for preliminary injunction as to the modified risk tobacco products provision of the FSPTCA and in January 2010 granted partial summary judgment to plaintiffs on their claims that the ban on color and graphics in advertising and the ban on statements implying that tobacco products are safer due to FDA regulation violated their First Amendment speech rights. The district court granted partial summary judgment to the government on all other claims. Both parties appealed from the district court's order and on March 19, 2012, the United States Court of Appeals for the Sixth Circuit affirmed the district court's decision upholding the FSPTCA's restrictions on the marketing of modified-risk tobacco products, the FSPTCA's bans on event sponsorship, branding non-tobacco merchandise, and free sampling, and the requirement that tobacco manufacturers reserve significant packaging space for textual health warnings. The Sixth Circuit further affirmed the district court's grant of summary judgment to plaintiffs on the FSPTCA's restriction of tobacco advertising to black and white text, as well as the district court's decision to uphold the constitutionality of the color graphic and non-graphic warning label requirement. The Sixth Circuit reversed the district court's determination that the FSPTCA's restriction on statements regarding the relative safety of tobacco products based on FDA regulation is unconstitutional and its determination that the FSPTCA's ban on tobacco continuity programs is permissible under the First

Amendment. On May 31, 2012, the Sixth Circuit denied the plaintiffs' motion for rehearing en banc. On October 30, 2012, the plaintiffs filed a petition for writ of certiorari with the U.S. Supreme Court. The government declined to seek a petition for certiorari to the U.S. Supreme Court. The government did not appeal the part of the Court of Appeals ruling striking the FSPTCA's restriction of tobacco advertising to black and white text. On April 22, 2013, the U.S. Supreme Court denied plaintiffs' petition for certiorari.

In February 2011, Lorillard, along with Reynolds Tobacco, filed a lawsuit in the U.S. District Court for the District of Columbia, *Lorillard, Inc. v. U.S. Food and Drug Administration*, against the FDA challenging the composition of the TPSAC because of the FDA's appointment of certain voting members with significant financial conflicts of interest. Lorillard believes these members are financially biased because they regularly testify as expert witnesses against tobacco-product manufacturers, and because they are paid consultants for pharmaceutical companies that develop and market smoking-cessation products. The suit similarly challenges the presence of certain conflicted individuals on the Constituents Subcommittee of the TPSAC. The complaint sought a judgment (i) declaring that, among other things, the appointment of the conflicted individuals to the TPSAC (and its Constituents Subcommittee) was arbitrary, capricious, an abuse of discretion, and otherwise not in compliance with the law because it prevented the TPSAC from preparing a report that was unbiased and untainted by conflicts of interest, and (ii) enjoining the FDA from, among other things, relying on the TPSAC's report. The FDA filed a motion to dismiss this action, and on August 1, 2012, the court denied the FDA's motion to dismiss. The FDA filed its answer to the second amended complaint on October 12, 2012, and the case proceeded before the U.S. District Court for the District of Columbia. On June 21, 2013, the FDA filed a motion for summary judgment, and on July 19, 2013 Lorillard and Reynolds Tobacco filed a motion for summary judgment. On July 21, 2014, the district court granted plaintiffs' summary judgment motion, in part, and denied defendants' summary judgment motion, finding that three of the panel's members had conflicts of interest that biased them against the tobacco industry and that "the FDA's appointment of those members was arbitrary and capricious, in violation of the APA, and fatally tainted the composition of the TPSAC and its work product, including the Menthol Report." The court ordered the FDA to reconstitute the TPSAC so that it complies with the applicable ethics laws and barred the FDA from relying on the TPSAC 2011 report on menthol, which the court found to be, "at a minimum suspect, and at worst untrustworthy." The FDA appealed the district court's decision to the U.S. Court of Appeals for the District of Columbia in September 2014, and briefing on the appeal will be completed on May 2, 2015, according to Reynolds American's Form 10-K filed with the SEC for the calendar year 2014. On March 5, 2015, the FDA announced the resignation or termination of four members from the TPSAC and the addition of three members to the TPSAC, in response to the district court's order to reconstitute the committee. The FDA also announced that it would work expeditiously to fill the remaining vacancy.

On August 16, 2011, five tobacco companies (including OPMs Reynolds Tobacco and Lorillard as well as SPMs Commonwealth Brands, Inc., Liggett Group LLC, and Santa Fe Natural Tobacco Company, Inc.) filed a complaint against the FDA in the U.S. District Court for the District of Columbia, *R.J. Reynolds Tobacco Co. v. U.S. Food and Drug Administration*, challenging the FDA's rule requiring new textual and graphic warning labels on cigarette packaging and advertisements. The tobacco companies sought a declaratory judgment that the FDA's final rule violates the First Amendment and the Administrative Procedure Act (the "**APA**"), and declarative and injunctive relief that the new textual and graphic warnings will not become effective until 15 months after the FDA issues regulations "that are permissible under the United States Constitution and federal laws." The plaintiffs alleged that the FDA's final rule regarding textual and graphic warnings requires them "to become a mouthpiece for the Government's emotionally-charged anti-smoking message." The plaintiffs also contended that the FDA's warnings are unjustified and unduly burdensome, as they do not further any compelling governmental purpose and are "unlikely to have any material impact on consumer understanding of smoking risks, consumer intentions regarding smoking, or actual consumer smoking decisions." The FDA's final rule, according to the plaintiffs, "violates the First Amendment under any standard of review." In addition, the plaintiffs argued that the FDA acted arbitrarily and capriciously "by attempting to justify the Rule...on grounds that were illogical, contradictory, and without support in the regulatory record, and by employing different standards of analysis to comments supporting the rule than to comments opposing the rule." As a result, the plaintiffs alleged that the FDA's final rule "contravenes core requirements" of the APA. Furthermore, the Plaintiffs asserted that the FDA has not issued a legally valid rule and, therefore, the 15-month effective date for the new textual and graphic warnings cannot come into effect until the FDA complies accordingly. On September 9, 2011, the FDA asked the court to reject the plaintiffs' request for a preliminary injunction against the labeling regulation. On November 7, 2011, the U.S. District Court granted the plaintiffs' request to postpone the September 22, 2012 deadline for the regulations to take effect while the court reviews the rule's constitutionality. The FDA appealed the ruling. In December 2011, 24 state attorneys general filed a friend of the court brief with the U.S. Court of Appeals in support of the FDA's challenge of the ruling. Plaintiffs also moved in the district court for summary judgment in their favor. The FDA opposed plaintiffs' motion and has cross moved for summary judgment in its favor. The district court granted a motion to expedite consideration of the cross summary judgment motions. Oral argument on those motions was held on February 1, 2012, at which the U.S. District Court stated that the government had failed to show how graphic images met legal precedents requiring federally-imposed labeling to be factual and uncontroversial, and said the federal rule that requires such warnings may violate the free speech rights of tobacco companies. On February 29, 2012, the district court granted the plaintiffs' motion for summary judgment and entered an order permanently enjoining the FDA, until 15 months following the issuance of new regulations implementing Section 201(a) of the FSPTCA that are substantively and procedurally valid and permissible under the United States Constitution and federal law, from enforcing against plaintiffs the new textual and graphic warnings required by Section 201 (a) of the FSPTCA. The district court ruled that the mandatory graphic warnings violated the First Amendment by unconstitutionally compelling speech, and that the FDA had failed to carry both its burden of demonstrating a compelling interest for its rule requiring the textual and graphic warning labels and its burden of demonstrating that the rule is narrowly tailored to achieve a constitutionally permissible form of compelled commercial speech. The FDA filed an appeal with the U.S. Court of Appeals for the District of Columbia Circuit on March 4, 2012, and moved the appellate court to consolidate this appeal with the FDA's appeal of the preliminary injunction decision. The Court of Appeals granted the FDA's motion and heard argument on both appeals on April 10, 2012. On August 24, 2012, the Court of Appeals affirmed the district court's decision invalidating the graphic warning rule. On October 9, 2012, the FDA filed a motion for rehearing en banc with the Court of Appeals, and on December 5, 2012, the Court of Appeals denied the FDA's petition for a rehearing en banc. The FDA, on December 5, 2012, issued a notice announcing its intention to collect information from consumers to determine the effectiveness of graphic warning labels, in apparent response to the Court of Appeal's August 2012 affirmation of the invalidation of the graphic warning rule, in which it cited the absence of evidence that the chosen labels furthered the FDA's stated goal of encouraging cessation and discouraging initiation of smoking. On March 19, 2013, the FDA announced that it would not file a petition for a writ of certiorari with the U.S. Supreme Court, but instead would undertake research to support a new rulemaking on different warning labels consistent with the FSPTCA. The FDA has not provided a timeline for the revised labels.

Other Federal Regulation

In October 2011, the FDA and the National Institutes of Health (the "**NIH**") announced a joint national study called the "Tobacco Control Act National Longitudinal Study of Tobacco Users" to monitor and assess the behavioral and health impacts of new government tobacco regulations by following 40,000 users of tobacco products and those who are 12 and over who are at risk of using tobacco products. The study is being coordinated by researchers at the NIH's National Institute on Drug Abuse and the FDA's Center for Tobacco Products. According to the NIH, data is expected to be collected between 2013 and 2016. The results of the study will be used to guide the FDA in targeting effective actions to reduce the effects of smoking on public health.

In November 2011, the FDA announced its plans for an integrated anti-smoking campaign that targets teenagers, with a combined budget of up to $600 million over five years. As part of this campaign, the FDA announced in February 2014 that advertisements would run for at least one year under the $115 million "Real Cost" campaign that targets young people aged 12-17 years and shows the costs and health consequences associated with tobacco use. According to the FDA, future campaigns will target young adults aged 18-24 years and people who influence teens, including parents, family members and peers. Other audiences of special interest that are planned to be targeted in future campaigns include minorities, gays, people with disabilities, the military, pregnant women, people living in rural areas, and low-income people.

In March 2012, the CDC announced a 12-week graphic advertising campaign intended to shock smokers into quitting with stories of people damaged by tobacco products. It has been reported that the $54 million campaign was the largest and starkest anti-smoking push by the CDC and its first national advertising effort. The campaign's goal was to convince 500,000 people to try quitting smoking and 50,000 to quit long-term. In January 2014 the CDC announced the launch of another graphic anti-smoking campaign, showing in stark terms the negative health effects of smoking, which began in July 2014. The CDC's fiscal year 2015 budget submission included approximately $210.8 million for tobacco prevention and control, in order to continue the national tobacco education campaign that raises awareness about the health effects of tobacco use and prompts smokers to quit.

In November 2008, the FTC rescinded guidance it issued in 1966 which provided that tobacco manufacturers were allowed to make factual public statements concerning the tar, nicotine and carbon monoxide yields of their cigarettes without violating the Federal Trade Commission Act if they were based on the "**Cambridge Filter Method**." The Cambridge Filter Method is a machine-based test that "smokes" cigarettes according to a standard protocol and measures tar, nicotine and carbon monoxide yields. The FTC has determined that machine-based yields determined by the Cambridge Filter Method are relatively poor indicators of actual tar, nicotine and carbon monoxide exposure and may be misleading to individual consumers who rely on such information as indicators of the amount of tar, nicotine and carbon monoxide they will actually receive from smoking a particular cigarette and therefore do not provide a good basis for comparison among cigarettes. According to the FTC, this is primarily due to "smoker compensation," which is the tendency of smokers of lower nicotine rated cigarettes to alter their smoking behavior in order to obtain higher doses of nicotine. Now that the FTC has withdrawn its guidance, tobacco manufacturers may no longer make public statements that state or imply that the FTC has endorsed or approved the Cambridge Filter Method or other machine-based testing methods in determining the tar, nicotine and carbon monoxide yields of their cigarettes. Factual statements concerning cigarette yields are allowed by the FTC if they are truthful, non-misleading and adequately substantiated, which is the same basis on which the FTC evaluates other advertising or marketing claims that are subject to the FTC's jurisdiction. It is possible that the FTC's rescission of its guidance regarding the Cambridge Filter Method could be cited as support for allegations by plaintiffs in pending or future litigation, or could encourage additional litigation against cigarette manufacturers.

It has been reported that the U.S. Defense Department is reviewing its tobacco policies. A March 14, 2014 Defense Department memo encourages the services to eliminate tobacco sales and tobacco use on military bases, although it does not order specific actions. Defense Secretary Hagel has stated his support for a forcewide review of tobacco use and sales on military installations. The U.S. Navy is also reportedly pushing towards eliminating tobacco sales on all of its ships and bases, as well as Marine Corps facilities, but in May 2014 Congressional lawmakers approved a measure that would protect tobacco sales on military bases and ships. In July 2014, the Senate Appropriations defense subcommittee approved a defense spending bill that would eliminate the 25% discount that members of the armed services enjoy when buying tobacco products at commissaries and elsewhere.

Tobacco Quota Payments

A federal law enacted in October 2004 repealed the federal supply management program for tobacco growers and compensated tobacco quota holders and growers with payments to be funded by an assessment on tobacco manufacturers and importers. Cigarette manufacturers and importers were responsible for paying 91.6% of a $10.14 billion payment to tobacco quota holders and growers over a ten-year period, through 2014. The law provided that payments are based on shipments for domestic consumption. Those tobacco quota payments are now complete.

Excise Taxes

Cigarettes are subject to substantial excise taxes in the U.S. On February 4, 2009, President Obama signed into law, effective April 1, 2009, an increase of $0.62 in the excise tax per pack of cigarettes, bringing the total federal excise tax to $1.01 per pack, and significant tax increases on other tobacco products. The federal excise tax rate for snuff increased $0.925 per pound to $1.51 per pound. The federal excise tax on small cigars, defined as those weighing three pounds or less per thousand, increased by $48.502 per thousand to $50.33 per thousand. In addition, the federal excise tax rate for roll-your-own tobacco increased from $1.097 per pound to $24.78 per pound. President Obama's 2016 federal budget proposal, released in early February 2015, includes a proposed increase in the federal excise tax on a pack of cigarettes to $1.95 per pack (and proposed proportionate increases in all other tobacco product tax rates). Press reports have noted that many consumers who previously purchased roll-your-own tobacco began using pipe tobacco to roll their own cigarettes in order to avoid the new excise tax, as pipe tobacco excise taxes were unaffected, and using new, mechanized rolling machines to process cigarettes in bulk. Press reports have also noted that increased excise taxes have led to an increase in cigarette smuggling. According to Reynolds American in its Form 10-K filed with the SEC for the calendar year 2014, as a result of the tax disparity between cigarettes and loose tobacco created by the 2009 federal excise tax increase, the number of retailers selling loose tobacco and operating roll-your-own machines, allowing consumers to convert the loose tobacco into finished cigarettes, greatly increased. On July 6, 2012, President Obama signed into law a provision classifying retailers that operate roll-your-own machines as cigarette manufacturers, thus requiring those retailers to pay the same tax rate as other cigarette manufacturers. According to Reynolds American in its Form 10-K filed with the SEC for the calendar year 2014, as of December 31, 2014 25 states also had passed legislation classifying retailers operating roll-your-own machines as cigarette manufacturers.

All of the states, the District of Columbia, Puerto Rico, Guam and the Northern Mariana Islands currently impose cigarette taxes, which in 2014 ranged from $0.17 per pack in Missouri to $4.35 per pack in New York. Since January 1, 2002, 47 states, the District of Columbia and several U.S. territories have raised their cigarette taxes, many of them more than once. According to a report by the American Lung Association, in 2009, 14 states turned to cigarette taxes to increase revenue in response to record state deficits. As reported by Reynolds American's SEC filings and the American Lung Association's Tobacco Policy Project/State Legislated Actions on Tobacco Issues ("**SLATI**"), six states passed cigarette excise tax increases during 2010, two states (Connecticut and Vermont) passed cigarette excise tax increases during 2011, and in 2012, Illinois and Rhode Island enacted legislation to increase their cigarette excise taxes. Altria has reported that during 2013, Massachusetts, Minnesota, Oregon and Puerto Rico had enacted legislation to increase their cigarette taxes. In particular, Minnesota increased its cigarette excise tax in July 2013 by $1.60 per pack, and Massachusetts raised its excise tax by $1.00 per pack, effective July 31, 2013, bringing its tax to $3.51 per pack, the second highest in the country after New York. New Hampshire's cigarette tax also increased by $0.10 on August 1, 2013 due to legislation enacted in 2011. Altria reported in its Form 10-K filed with the SEC for the calendar year 2014 that during 2014, Vermont was the only state to have enacted a cigarette excise tax increase in 2014. In 2015, the Governors of Kansas, Louisiana, Nevada and Washington have proposed excise tax increases, and proposals to increase excise taxes have been introduced in 16 other states, according to the Tobacco Consumption Report. In California, Senator Richard Pan introduced a proposal in February 2015 that would impose an additional tax on the distribution of cigarettes at the rate of $0.10 for each cigarette distributed, which would be the equivalent of $2.00 per pack (in addition to the State's current $0.87 per pack excise tax). According to Reynolds American in its Form 10-K filed with the SEC for the calendar year 2014, as of December 31, 2014 the weighted average state cigarette excise tax per pack, calculated on a 12-month rolling average basis, was approximately $1.29. In addition to federal and state excise taxes, certain city and county governments also impose substantial excise taxes on tobacco products sold; for example, in October 2014, Philadelphia enacted a $2.00 per pack local cigarette excise tax. According to Lorillard, Inc. in its Form 10-K filed with the SEC for the calendar year 2014, combined state and local excise taxes ranged from $0.17 to $6.16 per pack of cigarettes in the calendar year 2014. Altria reported in its Form 10-K filed with the SEC for the calendar year 2014 that between the end of 1998 (the year in which the MSA was executed) and February 20, 2015, the weighted-average state and certain local cigarette excise taxes increased from $0.36 to $1.49 per pack. It is expected that states and local governments will continue to raise excise taxes on cigarettes in 2015 and future years. Forty-nine states and the District of Columbia also subject smokeless tobacco to excise taxes (with Pennsylvania, the singular state exception, considering such a tax during its 2015 legislative session, according to Reynolds American in its Form 10-K filed with the SEC for the calendar year 2014).

In 2004, Michigan imposed an equity assessment on NPMs selling cigarettes in that state. The purpose of the equity assessment is to fund enforcement and administration of Michigan's Qualifying Statute and Complementary Legislation. The assessment is required to be prepaid by March 1 of each year for all cigarettes that are anticipated to be sold in Michigan in the current calendar year. For each NPM, the prepayment amount is equal to the greater of (i) $10,000 or (2) the number of cigarettes that the Department of Treasury reasonably determines that the NPM will sell in Michigan in the current calendar year multiplied by 17.5 mills. Two Previously Settled States, Minnesota and Mississippi, also impose a fee on tobacco product manufacturers that have not signed such states' Previously Settled State Settlements: in Minnesota, a fee of $0.50 per pack of 20 cigarettes is imposed on non-settling manufacturers; and in Mississippi, a fee of $0.27 (adjusted for inflation) per pack of 20 cigarettes is imposed on non-settling manufacturers. In addition, Texas (a Previously Settled State) enacted legislation in June 2013 to apply a fee of $0.55 per pack for future health costs to tobacco manufacturers that did not join Texas' State Settlement Agreement. The tax took effect on September 1, 2013, but in November 2013, a district court judge in *Texas Small Tobacco Coalition. v. Combs* (Tex. Dist. Ct., Travis Cnty.) ruled that the tax violated the Equal and Uniform Taxation clause of the Texas Constitution. The Texas Comptroller of Public Accounts appealed this decision on November 13, 2013, and on August 15, 2014 the Texas Court of Appeals affirmed the district court judge's decision, holding that the tax violates the Texas Constitution, and enjoined Texas from collecting or assessing the tax. The State of Texas filed its petition for review with the Texas Supreme Court in October 2014, and according to Reynolds American in its Form 10-K filed with the SEC for the calendar year 2014, the manufacturers filed a response on February 4, 2015. Reynolds American reported in its Form 10-K filed with the SEC for the calendar year 2014 that a total of six states (including Texas) require NPMs to pay a fee on each pack of cigarettes sold in their state. See "BONDHOLDERS' RISKS—Potential Payment Decreases Under the Terms of the MSA."

In 2005, Minnesota enacted a 75-cent "health impact fee" on tobacco manufacturers for each pack of cigarettes sold, in order to recover Minnesota's health costs related to or caused by tobacco use. The imposition of this fee was contested by Philip Morris and upheld by the Minnesota Supreme Court as not in violation of Minnesota's settlement with the tobacco companies (and in February 2007, the U.S.

Supreme Court denied Philip Morris's petition for writ of certiorari). In 2013, however, the Minnesota legislature repealed the health impact fee (the bill cited the contemporaneous increase in the cigarette excise tax as offsetting the repeal of the health impact fee).

In November 2013, New York City passed an ordinance that set a minimum price of $10.50 for every pack of cigarettes sold in the City and prohibited the use of coupons or other promotional discounts to lower that price. On February 16, 2014, tobacco companies and trade groups representing cigarette retailers filed a motion for preliminary injunction in federal court to block that portion of the ordinance that prohibited the use of coupons and other promotional discounts (*National Association of Tobacco Outlets Inc. et al. v. City of New York et al.*), but in June 2014 the court upheld that portion of the ordinance.

Minimum Age to Possess or Purchase Tobacco Products

New York City, Suffolk County, New York, and Hawaii County, Hawaii have recently raised the minimum age to possess or purchase tobacco products to 21, among several other municipalities. According to the Tobacco Consumption Report, California, Missouri, New York State, the District of Columbia, New Jersey, Utah, Vermont, Colorado, Rhode Island, Hawaii and Washington State are considering proposals to raise the minimum age to 21. Four states, Alabama, Alaska, New Jersey, and Utah, and several New York counties currently set the minimum age at 19, according to the Tobacco Consumption Report. On March 12, 2015, the Institute of Medicine of the National Academy of Sciences released a report recommending that the minimum age of legal access to tobacco products be raised to 21. The report concluded that raising the minimum legal age to 21 would likely decrease smoking prevalence by 12% among today's teenagers when they become adults.

State and Local Regulation

Legislation imposing various restrictions on public smoking has been enacted in all of the states and many local jurisdictions. A number of states have enacted legislation designating a portion of increased cigarette excise taxes to fund either anti-smoking programs, healthcare programs or cancer research. In addition, educational and research programs addressing healthcare issues related to smoking are being funded from industry payments made or to be made under the MSA.

The FSPTCA substantially expanded federal tobacco regulation, but state regulation of tobacco is not necessarily preempted by federal law in this instance. Importantly, the FSPTCA specifically allows states and localities to impose restrictions on the time, place and manner, but not content, of advertising and promotion of tobacco products. The FSPTCA also eliminated the prior federal preemption of state regulation that, in certain circumstances, had been upheld by the U.S. Supreme Court.

In addition to the FSPTCA disclosure requirements and marketing and labeling restrictions, several states have enacted or proposed legislation or regulations that would require cigarette manufacturers to disclose the ingredients used in the manufacture of cigarettes to state health authorities. According to SLATI, six states currently require tobacco product disclosure information: Massachusetts and Texas require tobacco manufacturers to disclose any added constituent of tobacco products other than tobacco, water and reconstituted tobacco sheet made wholly from tobacco; Massachusetts, Texas and Utah require disclosure of the nicotine yield for each brand of cigarettes; Minnesota and Utah require tobacco manufacturers to disclose the presence of ammonia, any compound of ammonia, arsenic, cadmium, formaldehyde or lead in their unburned or burned states; New Hampshire requires its state Department of Health and Human Services to obtain from the Massachusetts Department of Public Health a list of additives for each brand of tobacco products sold; and Connecticut required its Commissioner of

Public Health to issue regulations concerning how the commissioner will obtain nicotine yield ratings for each brand of tobacco product.

In 2003, New York was the first state to pass legislation requiring the introduction of cigarettes with a lower likelihood of starting a fire. Cigarette manufacturers responded by designing cigarettes that would extinguish quicker when left unattended. Since then, according to SLATI, fire-safety standards for cigarettes identical to those of New York are in effect in all 50 states and the District of Columbia.

In July 2007, the State of Maine became the first state to enact a statute that prohibits the sale of cigarettes and cigars that have a characterizing flavor. The legislation defines characterizing flavor as "a distinguishable taste or aroma that is imparted to tobacco or tobacco smoke either prior to or during consumption, other than a taste or aroma from tobacco, menthol, clove, coffee, nuts or peppers." Since Maine's adoption of such legislation, other states, as well as certain counties and municipalities, have adopted laws prohibiting or restricting the sale of certain tobacco products containing "characterizing flavors." The scope of these laws varies from jurisdiction to jurisdiction; for example, some, but not all, of these laws exempt menthol from the definition of a "characterizing flavor," and certain laws apply to tobacco products other than cigarettes. The "characterizing flavor" ordinances in New York City and Providence, Rhode Island were each challenged on the grounds, among others, that the FSPTCA preempts such local laws. The U.S. Courts of Appeals for the Second Circuit and First Circuit have held that the FSPTCA does not preempt the New York City and Providence, Rhode Island ordinances, respectively. Bills banning "characterizing flavors" in tobacco products are pending in other jurisdictions, according to Reynolds American's Form 10-K filed with the SEC for the calendar year 2014.

According to ANRF, as of January 1, 2015, 40 states and territories have laws that require either 100% smoke-free non-hospitality workplaces or restaurants or bars (and only 15 states and territories do not have laws that require either 100% smoke-free non-hospitality workplaces or restaurants or bars, being Alabama, Alaska, Arkansas, Georgia, Guam, Kentucky, Mississippi, Missouri, Oklahoma, South Carolina, Tennessee, Texas, Virginia, West Virginia and Wyoming). Also according to ANRF, as of January 1, 2015, 26 states and territories have laws that require 100% smoke-free non-hospitality workplaces and restaurants and bars: Arizona, Delaware, Hawaii, Illinois, Iowa, Kansas, Maine, Maryland, Massachusetts, Michigan, Minnesota, Montana, Nebraska, New Jersey, New York, North Dakota, Ohio, Oregon, Puerto Rico, Rhode Island, South Dakota, the U.S. Virgin Islands, Utah, Vermont, Washington and Wisconsin. Restrictions in many jurisdictions also include a ban on outdoor smoking within a specified number of feet of the entrances of restaurants and other public places. ANRF also tracks clean indoor air ordinances by local governments throughout the U.S.: as of January 1, 2015, there were 1,183 municipalities with local laws that require 100% smoke-free non-hospitality workplaces or restaurants or bars, of which 697 municipalities (including the District of Columbia) have local laws that require 100% smoke-free non-hospitality workplaces and restaurants and bars. Most states without a statewide smoking ban have some local municipalities that have enacted smoking regulations. It is expected that these restrictions will continue to proliferate.

Smoking bans have also extended outdoors. According to ANRF, as of January 1, 2015:

- Puerto Rico prohibits smoking on beaches, Maine prohibits smoking on beaches in its state parks, and 223 municipalities specified that all city beaches and/or specifically named city beaches are smoke-free;

- Oklahoma prohibits smoking on state lands, Puerto Rico prohibits smoking in all parks, and 1,037 municipalities specified that all city parks and/or specifically named city parks are smoke-free;

- Hawaii, Maine, Michigan, Washington and Puerto Rico laws prohibit smoking in outdoor dining and bar patios, Iowa prohibits smoking in outdoor dining areas, and 322 municipalities have enacted laws for 100% smoke-free outdoor dining, while 170 municipalities have enacted laws for 100% smoke-free outdoor dining and bar patios; and

- Iowa, New York, Wisconsin, Guam and the U.S. Virgin Islands prohibit smoking in outdoor public transit waiting areas, and there are 373 municipalities with smoke-free outdoor public transit waiting area laws.

Smoking bans have also been enacted for smaller governmental and private entities. According to the ANRF, as of January 1, 2015, there are at least 1,514 100% smoke-free university and college campuses, and of these, 1,014 have a 100% tobacco-free policy and 587 prohibit the use of e-cigarettes anywhere on campus. The University of California implemented its system-wide smoke-free and tobacco-free policy effective January 1, 2014. ANRF further reports, as of January 1, 2015, that four national hospitals, clinics, insurers and health service companies, and at least 3,822 local and/or state hospitals, healthcare systems and clinics have adopted 100% smokefree grounds policies; that in July 2013 New York State enacted a law requiring 100% smokefree grounds of general hospitals; and that 33 municipalities have enacted laws specifically requiring 100% smokefree hospital grounds. In addition, ANRF reports as of January 1, 2015 that the Federal Bureau of Prisons prohibits the smoking of tobacco in any form in and on the grounds of its institutions and offices, that 21 states plus Puerto Rico are 100% smokefree indoors and outdoors, and that 28 other states ban smoking indoors in correctional facilities but allow smoking in outdoor areas. ANRF reports that as of January 1, 2015, five states and 123 municipalities have laws requiring that all hotel and motel rooms be 100% smoke-free. Finally, ANRF reports as of January 1, 2015 that 39 municipalities restrict or prohibit smoking in private units of market-rate multi-unit housing and 273 municipalities restrict or prohibit smoking in private units of public/affordable multi-unit housing.

In June 2006, the Office of the Surgeon General released a report, “The Health Consequences of Involuntary Exposure to Tobacco Smoke.” It is a comprehensive review of health effects of involuntary exposure to tobacco smoke. It concludes definitively that secondhand smoke causes disease and adverse respiratory effects. It also concludes that policies creating completely smoke-free environments are the most economical and efficient approaches to providing protection to non-smokers. On September 18, 2007, the Office of the Surgeon General released the report, “Children and Secondhand Smoke Exposure”, which concludes that many children are exposed to secondhand smoke in the home and that establishing a completely smoke-free home is the only way to eliminate secondhand smoke exposure in that setting. The Surgeon General also addressed the health risks of second-hand smoke in its 2010 report entitled “How Tobacco Smoke Can Cause Disease: The Biology and Behavioral Basis for Smoking-Attributable Disease.” On January 17, 2014, the Surgeon General issued an additional report that contends that smoking is linked to a higher number of deaths to Americans than previous estimates, that filtered cigarettes may increase the risk of certain diseases, and that cigarettes are a causal factor in certain conditions and diseases that had not previously been linked to cigarette smoking. These reports are expected to strengthen arguments in favor of further smoking restrictions across the country. Further, the California Environmental Protection Agency Air Resources Board declared environmental tobacco smoke to be a toxic air contaminant in 2006.

Voluntary Private Sector Regulation

In recent years, many employers have initiated programs restricting or eliminating smoking in the workplace and providing incentives to employees who do not smoke, including charging higher health insurance premiums to employees who smoke and refusing to hire people who do smoke, and many common carriers have imposed restrictions on passenger smoking more stringent than those required by governmental regulations. Similarly, many restaurants, hotels and other public facilities have imposed smoking restrictions or prohibitions more stringent than those required by governmental regulations, including outright bans. According to the Tobacco Consumption Report, New York City's first non-smoking apartment building opened in 2009, and many landlords and condominium associations in California and New York City have also established smoke-free apartment policies, including Related Companies, which manages 40,000 rental units and announced in June 2013 a ban on smoking in all its apartments across the country.

International Agreements

On March 1, 2003, the member nations of the World Health Organization concluded four years of negotiations on an international treaty, the Framework Convention on Tobacco Control (the "**FCTC**"), aimed at imposing greater legal liability on tobacco manufacturers, banning advertisements of tobacco products (especially to youths), raising taxes and requiring safety labeling and comprehensive listing of ingredients on packaging, among other things. The FCTC entered into force in February 2005. According to Lorillard, Inc.'s Form 10-K filed with the SEC for the calendar year 2014, 177 countries have become party to the FCTC. In November 2012, parties to the FCTC adopted the Protocol to Eliminate Illicit Trade in Tobacco Products, which was open for signature between January 2013 and January 2014. While the United States is a signatory of the FCTC, it is not currently a party to the agreement, as the agreement has not been submitted to, or ratified by, the United States Senate.

Civil Litigation

Overview

Legal proceedings or claims covering a wide range of matters are pending or threatened in various United States and foreign jurisdictions against the tobacco industry. Several types of claims are raised in these proceedings including, but not limited to, claims for product liability, consumer protection, antitrust, and reimbursement. Litigation is subject to many uncertainties and it is possible that there could be material adverse developments in pending or future cases. Damages claimed in some tobacco-related and other litigation are or can be significant and, in certain cases, range in the billions of dollars. It can be expected that at any time and from time to time there will be developments in the litigation presently pending and filing of new litigation that could materially adversely affect the business of the PMs and the market for or prices of securities such as the Series 2015A Bonds payable from tobacco settlement payments made under the MSA. Lorillard, Inc. reported in its Form 10-K filed with the SEC for the calendar year 2014 that, as of February 6, 2015, 7,209 product liability cases are pending against cigarette manufacturers in the United States. Many of these cases are "*Engle* Progeny Cases", described below (although many arose from one Florida federal court in 2009 severing the claims of approximately 4,400 *Engle* Progeny plaintiffs).

Altria reported in its Form 10-K filed with the SEC for the calendar year 2014 that after exhausting all appeals in cases resulting in adverse verdicts associated with tobacco-related litigation, since October 2004 Philip Morris has paid in the aggregate judgments (and related costs and fees) totaling approximately $266 million and interest totaling approximately $144 million as of December 31, 2014. Reynolds American reported in its Form 10-K filed with the SEC for the calendar year 2014 that Reynolds Tobacco as of December 31, 2014 had paid approximately $220 million since January 1, 2012 related to unfavorable smoking and health litigation judgments.

Plaintiffs assert a broad range of legal theories in these cases, including, among others, theories of negligence, fraud, misrepresentation, strict liability in tort, design defect, breach of warranty, enterprise liability (including claims asserted under RICO), civil conspiracy, intentional infliction of harm, injunctive relief, indemnity, restitution, unjust enrichment, public nuisance, unfair trade practices, claims based on antitrust laws and state consumer protection acts, and claims based on failure to warn of the harmful or addictive nature of tobacco products.

The MSA does not release the PMs from liability in individual plaintiffs' cases or in class action lawsuits. Plaintiffs in most of the cases seek unspecified amounts of compensatory damages and punitive damages that may range into the billions of dollars. Plaintiffs in some of the cases have sought treble damages, statutory damages, disgorgement of profits, equitable and injunctive relief, and medical monitoring, among other damages.

The list below specifies categories of tobacco-related cases pending against the tobacco industry. A summary description of each type of case follows the list.

Type of Case

Conventional Product Liability Cases
Engle Progeny Cases
West Virginia Individual Personal Injury Cases
Flight Attendant Cases
Class Action Cases
Reimbursement Cases
Tobacco-Related Antitrust Cases

Conventional Product Liability Cases. "**Conventional Product Liability Cases**" are brought by individuals who allege cancer or other health effects caused by smoking cigarettes, by using smokeless tobacco products, by addiction to tobacco, or by exposure to environmental tobacco smoke.

Engle Progeny Cases. "***Engle* Progeny Cases**" are brought by individuals who purport to be members of the decertified *Engle* class. These cases are pending in a number of Florida courts. The time period for filing *Engle* Progeny Cases expired in January 2008 and no additional cases may be filed. Some of the *Engle* Progeny cases were filed on behalf of multiple class members. Some of the courts hearing the cases filed by multiple class members severed these suits into separate individual cases. It is possible the remaining suits filed by multiple class members may also be severed into separate individual cases.

West Virginia Individual Personal Injury Cases. In a 1999 administrative order, the West Virginia Supreme Court of Appeals transferred to a single West Virginia court a group of cases brought by individuals who allege cancer or other health effects caused by smoking cigarettes, smoking cigars, or using smokeless tobacco products (the "**West Virginia Cases**"). The plaintiffs' claims alleging injury from smoking cigarettes were consolidated for trial. The plaintiffs' claims alleging injury from the use of other tobacco products have been severed from the consolidated cigarette claims and have not been consolidated for trial. The time for filing a case that could be consolidated for trial with the West Virginia Cases expired in 2000.

Flight Attendant Cases. "**Flight Attendant Cases**" are brought by non-smoking flight attendants alleging injury from exposure to environmental smoke in the cabins of aircraft. Plaintiffs in these cases may not seek punitive damages for injuries that arose prior to January 15, 1997. The time for filing Flight Attendant Cases expired in 2000 and no additional cases in this category may be filed.

Class Action Cases. "**Class Action Cases**" are purported to be brought on behalf of large numbers of individuals for damages allegedly caused by smoking, including "lights" Class Action Cases and Class Action Cases that seek court-supervised medical monitoring programs.

Reimbursement Cases. "**Reimbursement Cases**" are brought by or on behalf of entities seeking equitable relief and reimbursement of expenses incurred in providing health care to individuals who allegedly were injured by smoking. Plaintiffs in these cases have included the U.S. federal government, U.S. state and local governments, foreign governmental entities, hospitals or hospital districts, American Indian tribes, labor unions, private companies and private citizens. Included in this category is the suit filed by the federal government, *United States of America v. Philip Morris USA, Inc., et al.* (the "**DOJ Case**"), that sought to recover profits earned by the defendants and other equitable relief.

Tobacco-Related Antitrust Cases. In 2000 and 2001, a number of cases were brought against cigarette manufacturers alleging that defendants conspired to set the price of cigarettes in violation of federal and state antitrust and unfair business practices statutes ("**Tobacco-Related Antitrust Cases**"). Plaintiffs sought class certification on behalf of persons who purchased cigarettes directly or indirectly from one or more of the defendant cigarette manufacturers.

Conventional Product Liability Cases

According to Lorillard, Inc.'s Form 10-K filed with the SEC for the calendar year 2014, since January 1, 2010 verdicts have been returned in 12 Conventional Product Liability Cases against cigarette manufacturers. Juries found in favor of the plaintiffs in 7 of the 12 Conventional Product Liability Case trial verdicts rendered since January 1, 2010, according to Lorillard. In one such case, *Evans v. Lorillard Tobacco Co.* (Superior Court, Suffolk County, Massachusetts), the jury awarded in December 2010 $50 million in compensatory damages to the estate of a deceased smoker, $21 million in damages to the deceased smoker's son, and $81 million in punitive damages. Following a series of post-trial motions and appeals, Lorillard paid $79 million in damages and interest in October 2013 and the case is now concluded. The verdict in another case was affirmed on appeal in July 2013 and judgment has been satisfied and the case concluded; a third case's appeal remains pending; a fourth case concluded with an agreement between the parties and a satisfaction of judgment; and in a fifth case the verdict was affirmed on appeal in January 2015 and the defendant has satisfied the judgment. In a sixth case, *Schwarz v. Philip Morris Inc.* (Circuit Court, Multnomah County, Oregon), the jury awarded $168,500 in compensatory damages and $150 million in punitive damages in March 2002 to plaintiffs. In May 2002, the trial court reduced the punitive damages award to $100 million. In May 2006, the Oregon Court of Appeals affirmed the compensatory damages verdict, vacated the award of punitive damages and remanded the case to the trial court for a new trial limited to the determination of the amount of punitive damages, if any. In June 2006, the plaintiff petitioned the Oregon Supreme Court to review the portion of the court of appeals' decision reversing and remanding the case for a new trial on punitive damages, and in June 2010, the Oregon Supreme Court affirmed the court of appeals' decision and remanded the case to the trial court for a new trial limited to the question of punitive damages. In February 2012, the jury awarded plaintiffs $25 million in punitive damages. In March 2012, Philip Morris filed motions to set aside the verdict, for a new trial or, in the alternative, for a remittitur. The trial court denied these motions in May 2012, and in September 2012 Philip Morris filed a notice of appeal from the trial court's judgment with the Oregon Court of Appeals. On January 27, 2014, the plaintiff filed a motion to certify the appeal to the Oregon Supreme Court, which the Oregon Court of Appeals denied in March 2014. Oral argument at the Oregon Court of Appeals occurred in September 2014, according to Altria's Form 10-K filed with the SEC for the calendar year 2014. In a seventh case (*Major v. R.J. Reynolds Tobacco Co.*), a compensatory damage award of approximately $3,900,000 was entered against the defendant in August 2014. According to Lorillard Inc.'s Form 10-K filed with the SEC for the calendar year 2014, Lorillard filed a motion for a new trial in September 2014 and a motion for judgment notwithstanding the verdict, which the court denied in October 2014, and then Lorillard noticed an appeal in November 2014 to the California Second District Court of Appeal from the final judgment awarding compensatory damages.

Juries found in favor of the defendants in the five other Conventional Product Liability Cases since January 1, 2010, according to Lorillard. Three of these five cases have concluded. Plaintiffs in two of the cases did not pursue appeals, and the plaintiff in the third case noticed an appeal, which was affirmed in February 2013 and the plaintiff did not seek any further review. In the fourth case, *Hunter v. Philip Morris USA*, the court granted in December 2012 a post-trial motion for a new trial filed by the plaintiff, but withdrew the order at Philip Morris's motion for reconsideration. The plaintiff filed a petition for review of this decision with the Alaska Supreme Court, which denied the petition on April 30, 2013, and the plaintiff's appeal of the order denying the motion for a new trial remains pending. Oral argument of plaintiff's appeal occurred in September 2014, according to Altria's Form 10-K filed with the SEC for the calendar year 2014. In the fifth case the plaintiff noticed an appeal and the appellate court reversed the defense verdict and ordered the case returned to the trial court for a new trial.

In rulings addressing cases tried in earlier years, according to Lorillard, some appellate courts have reversed verdicts returned in favor of the plaintiffs in whole or in part, while other judgments that awarded damages to smokers have been affirmed on appeal. Manufacturers have exhausted their appeals and have been required to pay damages to plaintiffs in sixteen individual cases since 2001. Punitive damages were paid to the smokers in six of these cases.

Engle Progeny Cases

The case of *Engle v. R.J. Reynolds Tobacco Co., et al.* (Circuit Court, Dade County, Florida, filed May 5, 1994) was certified in 1996 as a class action on behalf of Florida residents, and survivors of Florida residents, who were injured or died from medical conditions allegedly caused by addiction to smoking. During the three-phase trial, a Florida jury awarded compensatory damages to three individuals and approximately $145 billion in punitive damages to the certified class. In *Engle v. Liggett Group, Inc.*, 945 So.2d 1246 (Fla. 2006), the Florida Supreme Court vacated the punitive damages award, determined that the case could not proceed further as a class action and ordered decertification of the class. The Florida Supreme Court also reinstated the compensatory damages awards to two of the three individuals whose claims were heard during the first phase of the *Engle* trial. These two awards totaled approximately $7 million, and according to Lorillard both verdicts were paid in February 2008.

The Florida Supreme Court's 2006 ruling also permitted *Engle* class members to file individual actions, including claims for punitive damages. The court further held that these individuals are entitled to rely on a number of the jury's findings in favor of the plaintiffs in the first phase of the *Engle* trial. These findings included that smoking cigarettes causes a number of diseases; that cigarettes are addictive or dependence-producing; and that the defendants were negligent, breached express and implied warranties, placed cigarettes on the market that were defective and unreasonably dangerous, and concealed or conspired to conceal the risks of smoking. The time period for filing *Engle* Progeny Cases expired in January 2008 and no additional cases may be filed. In 2009, the Florida Supreme Court rejected a petition that sought to extend the time for purported class members to file an additional lawsuit.

Engle Progeny Cases are pending in various Florida state and federal courts. Some of the *Engle* Progeny Cases were filed on behalf of multiple plaintiffs. Various courts have entered orders severing the cases filed by multiple plaintiffs into separate actions. In 2009, one Florida federal court entered orders that severed the claims of approximately 4,400 *Engle* Progeny plaintiffs, initially asserted in a small number of multi-plaintiff actions, into separate lawsuits. In some cases, spouses or children of alleged former class members have also brought derivative claims. In 2011, approximately 500 cases that were among the 4,400 cases severed into separate lawsuits in 2009, filed by family members of alleged former class members, were combined with the cases filed by the smoker from which the family members' claims purportedly derived. On August 1, 2013, Judge William G. Young of the District of Massachusetts took over responsibility for the *Engle* Progeny Cases in the Middle District of Florida, Jacksonville Division. Judge Young issued an order that day that called for three groups of cases to be prepared for trial on the following schedule: approximately 50 cases to be made trial ready by January 2, 2014, approximately 107 cases to be made trial ready by May 2014, and approximately 120 cases to be made trial ready by September 2, 2014. On January 17, 2014, Judge Young issued an order calling for an additional three groups of cases to be prepared for trial on the following schedule: approximately 200 cases to be made trial ready by January 2, 2015, approximately 150 cases to be made trial ready by April 1, 2015 and approximately 150 cases to be made trial ready by July 1, 2015. On June 23, 2014 Judge Young issued an order calling for an additional three groups of cases to be prepared for trial on the following schedule: approximately 146 cases to be made trial ready by January 4, 2016, approximately 144 cases to be made trial ready by May 1, 2016 and approximately 139 cases to be made trial ready by September 1, 2016. On November 4, 2014, 27 additional remaining cases were given September 1, 2016 trial readiness dates. Since the issuance of these orders, according to Lorillard, Inc. in its Form 10-K filed with the SEC for the calendar year 2014, 543 of the cases to be prepared for trial have been dismissed in their entirety. On October 31, 2014, the court assigned a magistrate judge with the responsibility of exploring the possibility of a global settlement of the remaining federal *Engle* Progeny Cases. The magistrate judge has the authority to hold hearings and conduct mediation sessions, but the magistrate judge's orders will not alter the current case management scheduling orders, according to Lorillard. On February 25, 2015 the three OPMs reached a tentative agreement for the settlement of certain federal *Engle* Progeny Cases pending against them, as discussed further below. Also, in October 2013 Vector Group Ltd. and Liggett Group, LLC reached an agreement (which is now final) resolving substantially all of the individual *Engle* Progeny Cases pending against them, as discussed further below.

Lorillard reported in its Form 10-K filed with the SEC for the calendar year 2014 that since January 2010 and through February 6, 2015, the United States District Court for the Middle District of Florida has dismissed a total of approximately 3,792 cases. In some instances, the plaintiffs whose cases were dismissed also were pursuing cases pending in other courts. In other instances, the attorneys who represented the plaintiffs asked the court to enter dismissal orders because they were no longer able to contact their clients. In January 2013, the court granted a motion by defendants and dismissed approximately 520 cases in which the plaintiffs were deceased at the time their personal injury lawsuits were filed. Plaintiffs appealed the dismissals of these 520 cases to the United States Court of Appeal for the Eleventh Circuit. In June 2013, the Court dismissed an additional approximately 440 cases for a variety of reasons. Plaintiffs have appealed the dismissal of approximately 70 of these cases, in which the plaintiffs were deceased at the time their personal injury lawsuits were filed or where the cases were barred by the statute of limitations. The Court granted plaintiffs' motion to consolidate the appeals from the January and June 2013 orders dismissing these groups of federal cases. On September 10, 2014, the Eleventh Circuit affirmed the dismissals in these consolidated appeals. On July 7, 2014 plaintiffs filed a notice of appeal to the United States Court of Appeals for the Eleventh Circuit from an order dismissing 14 cases for failure to produce signed authorizations, and that appeal remained pending as of February 6, 5015, according to Lorillard in its Form 10-K filed with the SEC for the calendar year 2014. Other courts, including state courts, have entered orders dismissing additional cases.

According to Lorillard, various intermediate state and federal Florida appellate courts have issued rulings that address the scope of the preclusive effect of the findings from the first phase of the *Engle* trial, including whether those findings relieve plaintiffs from the burden of proving certain legal elements of their claims. The Florida Supreme Court granted review in the *Douglas* case, in which a verdict awarding compensatory damages to the plaintiff was affirmed by an intermediate state Florida appellate court, to address the issue of whether a tobacco manufacturer's due process rights are violated by reliance upon the *Engle* Phase I findings. On March 14, 2013, the Florida Supreme Court ruled that application of the *Engle* Phase I findings to establish certain elements of plaintiffs' claims is not a violation of the *Engle* defendants' due process rights. In order to prevail on either strict liability or negligence claims, the Court found that an *Engle* plaintiff must establish (i) membership in the *Engle* class; (ii) that addiction to smoking the *Engle* defendants' cigarettes containing nicotine was a legal cause of the injuries the plaintiff alleged; and (iii) damages. On August 12, 2013, defendants filed a petition with the United States Supreme Court seeking review of the Florida Supreme Court's decision. This petition for review was denied on October 7, 2013. The due process issue was also on appeal in the United States Court of Appeals for the Eleventh Circuit in two cases that had been consolidated for appeal: *Duke* and *Walker*. On September 6, 2013, the United States Court of Appeals for the Eleventh Circuit affirmed the verdicts in these cases, holding that the judgment of the Florida Supreme Court in *Douglas* should be given full faith and credit, and that deference to the decision in *Douglas* did not violate the due process rights of the defendant. The defendant filed a petition for rehearing of the decision in *Duke* and *Walker* with the United States Court of Appeals for the Eleventh Circuit, and on October 31, 2013 the Eleventh Circuit again ruled on this petition that the use of Phase I *Engle* findings does not violate a tobacco manufacturer's due process rights. On November 7, 2013, the Court denied the defendant's petition for rehearing. On November 13, 2013, the defendant filed a second petition, seeking review of the October 31, 2013 opinion, and on January 6, 2014, the Court denied this petition. On March 28, 2014, the defendant in *Duke* and *Walker* filed a petition with the U.S. Supreme Court seeking to answer the question of whether the *Engle* Phase I findings can be applied to establish certain elements of plaintiffs' claims. On the same date, defendants filed similar petitions in the *Brown* case (an appeal from a Florida state court trial), as well as in eight other state court cases. The defendants requested that these petitions be held pending disposition of the *Duke*, *Walker* and *Brown* cases, and resolved in a similar manner. On June 9, 2014, the U.S. Supreme Court declined to accept review of the *Duke* and *Walker* cases, and declined to accept review of the *Brown* case and the eight other state court cases.

According to Lorillard, various courts, including appellate courts, have issued rulings that have addressed the conduct of the cases prior to trial. One intermediate Florida state appellate court ruled in 2011 that plaintiffs are permitted to assert a claim against a cigarette manufacturer even if the smoker did not smoke a brand sold by that manufacturer. Defendants' petition for review of this decision by the Florida Supreme Court was denied in August 2012. In March 2012, another intermediate state appellate court agreed with the 2011 ruling and reversed dismissals in a group of cases. In June and July 2013, the Florida Supreme Court denied defendants' petitions for review of the intermediate appellate court's decision in these cases. These rulings may limit the ability of the defendants to be dismissed from cases in which smokers did not use a cigarette manufactured by such defendant. In October 2012, the Florida First District Court of Appeal in one case affirmed the judgment awarding compensatory damages only; however, the appeals court certified to the Florida Supreme Court the question of whether *Engle* class members may pursue an award of punitive damages based on claims of negligence or strict liability. On February 28, 2014 the Florida Supreme Court announced that it would grant review of this case. In June 2013, the Florida Supreme Court reversed an intermediate state appellate court and held that a plaintiff's representative may continue to litigate an existing lawsuit after the original plaintiff has died. Defendants did not seek further review of this decision, according to Lorillard. In December 2013, the Florida First District Court of Appeal affirmed the summary judgments in favor of the defendants regarding three plaintiffs who had opted out of the *Engle* class and subsequently reapplied for admission. The court held that the Florida Supreme Court's decision in *Engle* did not provide any basis for the readmission of a former class member in the event that they had timely opted out of the class and did not initiate an individual action until after the statute of limitations had run. Separately, in September 2014, Judge Young in the Middle District of Florida, Jacksonville Division ruled that 91 *Engle* Progeny Cases, where a living plaintiff had timely filed an *Engle* Progeny Case prior to passing away but the decedent's personal representative did not amend the complaint to indicate the change in status before expiration of Florida's two-year limitations period for wrongful death claims, were not time-barred, and allowed the plaintiffs to amend their complaints to add wrongful-death claims or, in the alternative, survivorship claims.

According to Lorillard, tobacco manufacturing defendants face various other legal issues in connection with the *Engle* Progeny Cases that could materially affect the outcome of the *Engle* Progeny Cases. These legal issues include, but are not limited to, the application of the statute of limitations and statute of repose, the constitutionality of a cap on the amount of a bond necessary to obtain an automatic stay of a post-trial judgment, whether a judgment based on a claim of intentional conduct should be reduced by a jury's findings of comparative fault, whether damages can be awarded jointly and severally, and whether plaintiffs' strict liability and negligence claims are preempted by federal law. Lorillard reports that various intermediate Florida appellate courts and Florida federal courts have issued rulings on these issues.

Reynolds American reported in its Form 10-K filed with the SEC for the calendar year 2014 that as of December 31, 2014, 3,885 *Engle* Progeny cases were pending against Reynolds Tobacco or its affiliates or indemnitees, 697 of which were pending in federal court and 3,188 of which were pending in state court, together including approximately 4,959 plaintiffs. Lorillard, Inc. reported in its Form 10-K filed with the SEC for the calendar year 2014 that 3,612 *Engle* Progeny Cases were pending against Lorillard or Lorillard, Inc. as of February 6, 2015. Altria reported in its Form 10-K filed with the SEC for the calendar year 2014 that as of January 27, 2015, approximately 3,200 state court *Engle* Progeny Cases were pending against Philip Morris or Altria asserting individual claims by or on behalf of approximately 4,200 state court plaintiffs, and approximately 700 *Engle* Progeny Cases were pending against Philip Morris as of such date in federal district court asserting individual claims by or on behalf of a similar number of federal court plaintiffs.

Lorillard, Inc. reported in its Form 10-K filed with the SEC for the calendar year 2014 that as of February 6, 2015, verdicts had been returned in 21 *Engle* Progeny Cases in which Lorillard was a defendant and 132 *Engle* Progeny Cases in which neither Lorillard nor Lorillard, Inc. was a defendant at trial. Juries awarded compensatory damages to the plaintiffs in 16 of the 21 cases in which Lorillard was a defendant (and in 4 of these 16 cases, juries also awarded punitive damages from Lorillard), and in another case, the court entered an order following trial that awarded plaintiff compensatory damages. In one case in which Lorillard is the only defendant, *Alexander v. Lorillard Tobacco Co., et al*., the jury awarded plaintiff $20,000,000 in compensatory damages and $25,000,000 in punitive damages in February and March 2012. The jury apportioned 20% of the fault for the smoker's injuries to the smoker and 80% to Lorillard. In May 2012, the court granted a motion by Lorillard to lower the amount of compensatory damages and reduced the amount awarded to $10,000,000 from Lorillard, entering an amended final judgment that applied the jury's comparative fault determination to the court's award of compensatory damages, awarding the plaintiff $8,000,000 in compensatory damages and $25,000,000 in punitive damages, plus the statutory rate of interest. Lorillard noticed an appeal from the amended final judgment to the Florida Third District Court of Appeal. On September 4, 2013, the Florida Third District Court of Appeal affirmed the amended final judgment awarding compensatory and punitive damages. Lorillard's motion for rehearing of this decision was denied in October 2013. Lorillard filed a petition with the Florida Supreme Court seeking review of the intermediate appellate court decision in November 2013, which was denied on September 9, 2014. On September 23, 2014 Lorillard made a payment of approximately $39 million to resolve all damages, costs and fees and post-judgment interest, and plaintiff filed a satisfaction of judgment on September 29, 2014, which the court confirmed on October 3, 2014. The case is now concluded, according to Lorillard, Inc. in its Form 10-K filed with the SEC for the calendar year 2014.

Also according to Lorillard, of the 132 *Engle* Progeny Cases in which neither Lorillard nor Lorillard, Inc. was a defendant at trial, juries awarded compensatory damages and punitive damages in 44 of the trials. In 43 of those 44 trials, the amount of punitive damages awarded have totaled approximately $862.1 million and have ranged from $20,000 to $244 million. The trial in the other of those cases, *Robinson*, where a punitive damage verdict of $23.6 billion was reduced to approximately $17 million, is discussed below. In 36 of the trials, juries' awards were limited to compensatory damages. In the remaining trials, juries found in favor of the defendants. Post-trial motions challenging the verdicts in some cases and appeals from final judgments in some cases are pending before various Florida circuit and intermediate appellate courts. Lorillard, Inc. reported in its Form 10-K filed with the SEC for the calendar year 2014 that as of February 6, 2015, one verdict in favor of the defendants and four verdicts in favor of the plaintiff have been reversed on appeal and returned to the trial court for a new trial on all issues, and in ten cases, the appellate courts have ruled that the issue of damages awarded must be revisited by the trial court. Motions for rehearing of these appellate court rulings are pending in some cases.

According to Altria's Form 10-K filed with the SEC for the calendar year 2014, as of January 27, 2015, 70 federal and state *Engle* Progeny Cases involving Philip Morris have resulted in verdicts since the Florida Supreme Court's *Engle* decision, 36 of which were returned in favor of plaintiffs and 34 of which were returned in favor of Philip Morris. In one of the *Engle* Progeny Cases in which all 3 OPMs are defendants, *Calloway v. R.J. Reynolds Tobacco Company, et al.* (Circuit Court, Seventeenth Judicial Circuit, Broward County, Florida), the jury awarded plaintiff and a daughter of the decedent a total of $20,500,000 in compensatory damages. The jury apportioned 20.5% of the fault for the smoker's injuries to the smoker, 27% to Reynolds Tobacco, 25% to Philip Morris, 18% to Lorillard, and 9.5% to Liggett. The jury awarded a total punitive damages award from the defendants of $54,850,000. In August 2012, the court granted a post-trial motion by the defendants and lowered the compensatory damages award to $16,100,000. The court also ruled that the jury's finding on the plaintiff's percentage of comparative fault would not be applied to reduce the compensatory damage award because the jury found in favor of the plaintiff on her claims alleging intentional conduct. In August 2012, the court entered final judgment against defendants in the amount of $16,100,000 in compensatory damages and $54,850,000 in punitive damages, plus the statutory rate of interest, which is currently 4.75%. In September 2012, the defendants filed a notice of appeal to the Florida Fourth District Court of Appeal. The plaintiff filed a notice of cross-appeal, briefing with the Florida Fourth District Court of Appeal is complete, but oral argument has not yet been scheduled, according to Reynolds American in its Form 10-K filed with the SEC for the calendar year 2014.

In another *Engle* Progeny case, *Naugle v. Philip Morris*, a jury returned a verdict in November 2009 in favor of the plaintiff and against Philip Morris. The jury awarded approximately $56.6 million in compensatory damages and $244 million in punitive damages, allocating 90% of the fault to Philip Morris. In August 2010, the trial court entered an amended final judgment of approximately $12.3 million in compensatory damages and approximately $24.5 million in punitive damages. In June 2012, the Fourth District Court of Appeal affirmed the amended final judgment, and in July 2012, Philip Morris filed a motion for rehearing. In December 2012, the Fourth District withdrew its prior decision, reversed the verdict as to compensatory and punitive damages and returned the case to the trial court for a new trial on the question of damages. In December 2012, plaintiff filed a motion for rehearing en banc or for certification to the Florida Supreme Court, which was denied in January 2013. In February 2013, plaintiff and Philip Morris each filed a notice to invoke the discretionary jurisdiction of the Florida Supreme Court. In May 2013, the Florida Supreme Court consolidated the parties' petitions and ordered Philip Morris to show cause as to why the Florida Supreme Court's decision in *Douglas* is not controlling in this case. Philip Morris filed its response to the order in June 2013. Upon retrial on the question of damages, on October 16, 2013, the new jury awarded approximately $3.7 million in compensatory damages and $7.5 million in punitive damages. In May 2014, Philip Morris filed a notice of appeal to the Fourth District Court of Appeal and plaintiff cross-appealed, according to Altria's Form 10-K filed with the SEC for the calendar year 2014.

Recently, in yet another *Engle* Progeny Case, *Robinson v. R.J Reynolds*, on July 18, 2014 a jury in Escambia County, Florida rendered a verdict against Reynolds Tobacco and awarded plaintiff $16.9 million in compensatory damages and $23.6 billion in punitive damages for the lung cancer death of plaintiff's spouse who smoked Kool brand cigarettes for more than 20 years from age 13 to his death at age 36. Reynolds Tobacco filed a motion on July 28, 2014 to set aside the jury's verdict on the grounds that it was unconstitutionally disproportionate to plaintiff's actual damages. The court entered partial judgment on the compensatory damages against Reynolds Tobacco in the amount of $16.9 million on July 21, 2014. On January 27, 2015 the court denied the defendant's post-trial motions but granted the defendant's motion for remittitur of the punitive damages award, and the punitive damages award was remitted to approximately $16.9 million, according to Reynolds American in its Form 10-K filed with the SEC for the calendar year 2014.

A number of *Engle* Progeny Cases have been placed on courts' 2015 trial calendars; according to Reynolds American in its Form 10-K filed with the SEC for the calendar year 2014, there are 76 *Engle* Progeny Cases against Reynolds Tobacco and/or B&W set for trial through December 31, 2015 (but it is not known how many of these cases will actually be tried). Trial schedules are subject to change. It is not possible to predict whether some courts will implement procedures that consolidate multiple *Engle* Progeny Cases for trial, according to Lorillard, Inc. in its Form 10-K filed with the SEC for the calendar year 2014.

On February 25, 2015 Philip Morris announced that it and the two other OPMs Reynolds Tobacco and Lorillard had reached a tentative agreement in relation to a $100 million settlement to resolve approximately 415 *Engle* Progeny Cases pending against them in federal court. Under the agreement, there will be no new trials of *Engle* Progeny Cases brought by plaintiffs represented by the law firms of Motley Rice LLC or Lieff Cabraser Heimann & Bernstein LLP in federal court. Federal *Engle* Progeny Cases that are in trial and those that have already gone to verdict are not included in the agreement. *Engle* Progeny Cases pending in Florida state courts are also not part of the agreement. As reported by Philip Morris, the agreement is subject to final approval, and because the agreement contemplates participation by substantially all remaining federal court plaintiffs, the agreement will not become final unless there is full participation or the parties otherwise agree. The settlement will implement a model formula based on past trials and rulings to determine how much money each plaintiff could receive, subject to court approval. The U.S. District Court for the Middle District of Florida (the court that administers the federal *Engle* Progeny Cases) issued an order on February 25, 2015 staying all upcoming federal trials pending final approval of the agreement.

On October 23, 2013, Vector Group Ltd. announced that it and its subsidiary Liggett reached a comprehensive settlement (which is now final) resolving substantially all of the individual *Engle* Progeny Cases pending against them. Under the settlement, which did not require court approval, approximately 4,900 (out of approximately 5,300) individual *Engle* plaintiffs would dismiss their claims against Vector Group Ltd. and Liggett. Vector Group Ltd. recorded a charge of approximately $86 million for the year ended December 31, 2013 related to the settlement agreement. Pursuant to the terms of the agreement, Liggett will pay a total of $110 million, with approximately $61.6 million paid collectively in December 2013 and February 2014, and the balance to be paid in equal annual installments over the following 14 years.

In June 2009, Florida amended the security requirements for a stay of execution of any judgment during the pendency of appeal in *Engle* Progeny Cases. The amended statute provides for the amount of security for individual *Engle* Progeny Cases to vary within prescribed limits based on the number of adverse judgments that are pending on appeal at a given time. The required security decreases as the number of appeals increases to ensure that the total security posted or deposited does not exceed $200 million in the aggregate. This amended statute applies to all judgments entered on or after June 16, 2009.

The plaintiffs in some cases challenged the constitutionality of the amended statute. These motions were denied, withdrawn or declared moot. In January 2012, the Florida Supreme Court agreed to review one of the orders denying a challenge to the amended statute. In August 2012, the Florida Supreme Court dismissed the appeal as moot because the defendant had satisfied the judgment.

In 1999 Florida enacted a cap on certain punitive damages, and in February 2015 Florida Senator Garrett Richter proposed a bill that would apply that cap to all civil actions in which judgment has not been entered, regardless of the date on which the cause of action arose. No assurance can be given as to any future enactment of such bill.

Various *Engle* Progeny Cases in addition to the cases described herein are discussed in detail in the SEC filings of the parent companies of Lorillard, Philip Morris and Reynolds Tobacco.

West Virginia Cases

The West Virginia Cases were brought in a single West Virginia court by individuals who allege cancer or other health effects caused by smoking cigarettes, smoking cigars, or using smokeless tobacco products. In September 2000, there were approximately 1,250 West Virginia Cases, but approximately 645 West Virginia Cases were dismissed in their entirety before trial. The claims alleging injury from smoking cigarettes were consolidated for a multi-phase trial, the first phase of which began April 15, 2013 and concluded May 13, 2013. The order that consolidated the cases for trial, among other things, limited the consolidation to those cases that were filed by September 2000. No additional West Virginia Cases may be consolidated for trial with this group. On May 15, 2013, the jury found against plaintiffs on their claims against defendants for design defect, negligent design, failure to warn, intentional concealment and breach of express warranty, and the jury found for plaintiffs on their claim that all ventilated filter cigarettes manufactured and sold between 1964 and July 1, 1969 were defective because of a failure to instruct, but found that the defendants' conduct was not willful or wanton. On September 16, 2013, the court entered a judgment on the jury's Phase I verdict and entered a separate order denying the parties' post-trial motions. Plaintiffs filed a motion to alter or amend the judgment on September 24, 2013. On October 7, 2013, the court informed the parties that, on its own authority, it would vacate the September 16, 2013 judgment and order. On October 28, 2013 the court entered a new judgment and order, reciting that: (1) ventilated filter cigarettes the defendants manufactured and sold between 1964 and July 1, 1969, were found to be defective due to a failure to instruct consumers as to their use; (2) all other cigarettes manufactured and sold by defendants were not found to be defective; (3) defendants' conduct did not justify an award of punitive damages; (4) the claims of the individual plaintiffs remain to be decided consistent with the Phase I verdict; and (5) there is no just reason for delay in permitting any appellate rights of the parties to be perfected as to the verdict rendered and the court's order. The order also denied the parties' post-trial motions, entered final judgments against the plaintiffs in the approximately 645 West Virginia Cases that were dismissed before trial, and stated that those dismissal orders were final and available for the proper application of the appellate process. On November 26, 2013, plaintiffs filed a notice of appeal from the October 28, 2013 judgment and order in the Supreme Court of Appeals of West Virginia. In November 2014, the Supreme Court of Appeals of West Virginia affirmed the lower court's judgment and order in favor of the defendant tobacco companies. On November 26, 2014, the plaintiffs filed a petition for rehearing, asking the court to reconsider its ruling on one of the grounds the plaintiffs had raised on appeal, and on January 8, 2015 the court of appeals refused the petition for rehearing and on January 15, 2015 issued its mandate.

On December 17, 2014, in response to a request from the mass litigation panel, the defendants identified the 30 West Virginia Cases that they believe could be eligible to proceed to a Phase II trial on causation and damages in the remaining failure to instruct claim.

The trial court severed from the West Virginia Cases those claims alleging injury from the use of tobacco products other than cigarettes, including smokeless tobacco and cigars (the "**Severed West Virginia Claims**"). The Severed West Virginia Claims involve 30 plaintiffs, according to Lorillard. Twenty-eight of these plaintiffs have asserted both claims alleging that their injuries were caused by smoking cigarettes as well as claims alleging that their injuries were caused by using other tobacco products. The former claims were included in the consolidated trial of the West Virginia Cases, while the latter claims are among the Severed West Virginia Claims. Two plaintiffs have asserted only claims alleging that injuries were caused by using tobacco products other than cigarettes, and no part of their cases was included in the consolidated trial of the West Virginia Cases. According to Lorillard, Inc. in its Form 10-K filed with the SEC for the calendar year 2014, as of February 6, 2015, the Severed West Virginia Claims and the West Virginia Cases were not subject to a trial plan, and none was scheduled for trial as of February 6, 2015.

Flight Attendant Cases

Four cigarette manufacturers are the defendants in the pending Flight Attendant Cases. These suits were filed as a result of a settlement agreement by the parties in *Broin v. Philip Morris Companies, Inc., et al.* (Circuit Court, Miami-Dade County, Florida, filed October 31, 1991), a class action brought on behalf of flight attendants claiming injury as a result of exposure to environmental tobacco smoke. The settlement agreement, among other things, permitted the plaintiff class members to file these individual suits. These individuals may not seek punitive damages for injuries that arose prior to January 15, 1997. The period for filing Flight Attendant Cases expired in 2000 and no additional cases in this category may be filed.

The judges who have presided over the cases that have been tried have relied upon an order entered in October 2000 by the Circuit Court of Miami-Dade County, Florida. The October 2000 order has been construed by these judges as holding that the flight attendants are not required to prove the substantive liability elements of their claims for negligence, strict liability and breach of implied warranty in order to recover damages. The court further ruled that the trials of these suits are to address whether the plaintiffs' alleged injuries were caused by their exposure to environmental tobacco smoke and, if so, the amount of damages to be awarded.

Defendants have prevailed in seven of the eight cases in which verdicts have been returned, according to Lorillard. In one of the seven cases in which a defense verdict was returned, the court granted plaintiff's motion for a new trial and, following appeal, the case has been returned to the trial court for a second trial. The six remaining cases in which defense verdicts were returned are concluded. In the single trial decided for the plaintiff, *French v. Philip Morris Incorporated, et al.*, the jury awarded $5.5 million in damages. The court, however, reduced this award to $500,000. This verdict, as reduced by the trial court, was affirmed on appeal and the defendants have paid the award. According to Lorillard, Inc.'s Form 10-K filed with the SEC for the calendar year 2014, as of February 6, 2015, one of the Flight Attendant Cases was scheduled for trial.

Class Action Cases

In most of the class action cases, plaintiffs seek class certification on behalf of groups of cigarette smokers, or the estates of deceased cigarette smokers, who reside in the state in which the case is filed. According to Lorillard, cigarette manufacturers have defeated motions for class certification in a number of cases. Motions for class certification have also been ruled upon in some of the "lights" cases discussed below or in other types of class actions. In some of these cases, courts have denied class certification to the plaintiffs, while classes have been certified in other matters.

"Lights" Class Action Cases. According to Lorillard, Inc. in its Form 10-K filed with the SEC for the calendar year 2014, there are approximately 16 Class Action Cases in which plaintiffs' claims are based on the allegedly fraudulent marketing of "light" or "ultra-light" cigarettes. Classes have been certified in some of these cases. In one of the "lights" Class Action Cases, *Good v. Altria Group, Inc., et al.*, the U.S. Supreme Court ruled in December 2008 that neither the Federal Cigarette Labeling and Advertising Act nor the Federal Trade Commission's regulation of cigarettes' tar and nicotine disclosures preempts (or bars) certain of plaintiffs' claims. Although the Court rejected the argument that the Federal Trade Commission's actions were so extensive with respect to the descriptors that the state law claims were barred as a matter of federal law, the Court's decision was limited: it did not address the ultimate merits of plaintiffs' claim, the viability of the action as a class action, or other state law issues. The case was returned to the federal court in Maine and consolidated with other federal cases in a multidistrict litigation proceeding, discussed below. In June 2011, the plaintiffs voluntarily dismissed the case without prejudice after the district court denied plaintiffs' motion for class certification, concluding the litigation.

Since the December 2008 United States Supreme Court decision in *Good*, and through January 27, 2015, according to Altria's Form 10-K filed with the SEC for the calendar year 2014, 26 purported "Lights" class actions were served upon Philip Morris and, in certain cases, Altria. These cases were filed in 15 states, the U.S. Virgin Islands and the District of Columbia. All of these cases either were filed in federal court or were removed to federal court by Philip Morris and were transferred and consolidated by the Judicial Panel on Multidistrict Litigation ("**JPMDL**") before the United States District Court for the District of Maine for pretrial proceedings. In November 2010, the district court denied plaintiffs' motion for class certification in four cases, covering the jurisdictions of California, the District of Columbia, Illinois and Maine. These jurisdictions were selected by the parties as sample cases, with two selected by plaintiffs and two selected by defendants. Plaintiffs sought appellate review of this decision but, in February 2011, the United States Court of Appeals for the First Circuit denied plaintiffs' petition for leave to appeal. Later that year, plaintiffs in 13 cases voluntarily dismissed without prejudice their cases. In April 2012, the JPMDL remanded the remaining four cases back to the federal district courts in which the suits originated. These four cases were ultimately resolved in a manner favorable to Philip Morris, according to Altria's Form 10-K filed with the SEC for the calendar year 2014: in *Tang*, which was pending in the U.S. District Court for the Eastern District of New York, the plaintiffs voluntarily dismissed the case without prejudice in July 2012, concluding the litigation; in *Phillips*, which was pending in the U.S. District Court for the Northern District of Ohio, following the district court's denial of class certification, Philip Morris made an offer of judgment to resolve the case for $6,000, which plaintiff accepted, and the court dismissed the case; in *Cabbat*, the U.S. District Court for the District of Hawaii denied plaintiffs' class certification motion in January 2014, and after plaintiffs were unsuccessful in obtaining appellate review, in July 2014 the parties filed, and the court approved, a stipulation for dismissal with prejudice; and in *Wyatt*, the U.S. District Court for the Eastern District of Wisconsin denied plaintiffs' class certification motion in August 2013, and after plaintiffs were unsuccessful in obtaining appellate review, Philip Morris made an offer of judgment to resolve the case for $1,000, which plaintiff accepted in September 2014, and the district court dismissed the case in October 2014. As of January 27, 2015, according to Altria in its Form 10-K filed with the SEC for the calendar year 2014, in addition to the federal district court in the JPMDL proceeding, 18 courts in 19 "Lights" cases have refused to certify class actions, dismissed class action allegations, reversed prior class certification decisions or have entered judgment in favor of Philip Morris; and state courts trial courts have certified classes against Philip Morris in several jurisdictions.

On June 19, 2013, the Oregon Court of Appeals in *Pearson et al. v. Philip Morris Inc.* et al. reversed a Multnomah County Circuit judge's October 2005 decision that had granted summary judgment to Philip Morris and had dismissed a lawsuit filed against Philip Morris in 2002 by two Marlboro Lights smokers. The Court of Appeals ruled that plaintiffs' claims were not preempted by federal law as the circuit court had concluded and were not subject to dismissal on that basis. The Court of Appeals also ruled that the circuit court had erred in not allowing the case to proceed as a class-action suit on behalf of an alleged 100,000 Oregon smokers, and remanded the case to the trial court for further consideration of class certification. The plaintiffs allege, among other things, that Philip Morris violated the Oregon Unlawful Trade Practices Act by misrepresenting the tar and nicotine characteristics of Marlboro Lights and that, as result of such misrepresentations, plaintiffs had suffered economic losses. On July 17, 2013, Philip Morris filed a petition for reconsideration with the Oregon Court of Appeals, which was denied on August 23, 2013. On October 25, 2013 Philip Morris filed its petition for review to the Oregon Supreme Court, which the court accepted on January 16, 2014. Oral argument occurred in June 2014, according to Altria's Form 10-K filed with the SEC for the calendar year 2014.

The Price Case. In *Price, et al v. Philip Morris Inc.* (Circuit Court, Madison County, Illinois, filed February 10, 2000) the trial judge found in favor of the plaintiff class and awarded $7.1 billion in compensatory damages and $3 billion in punitive damages against Philip Morris in 2003. In December 2005, the Illinois Supreme Court issued its judgment reversing the trial court's judgment in favor of the plaintiffs and directing the trial court to dismiss the case. In December 2006, the defendant's motion to dismiss and for entry of final judgment was granted, and the case was dismissed with prejudice. In December 2008, plaintiffs filed with the trial court a petition for relief from the final judgment and sought to vacate the 2005 Illinois Supreme Court judgment, contending that the U.S. Supreme Court's December 2008 decision in *Good* demonstrated that the Illinois Supreme Court's decision was "inaccurate." In February 2009, the trial court granted Philip Morris's motion to dismiss plaintiffs' petition. In March 2009, the plaintiffs filed a notice of appeal with the Illinois Appellate Court, Fifth Judicial District. In February 2011, the Illinois Appellate Court, Fifth Judicial District reversed the trial court's dismissal of plaintiffs' petition and remanded for further proceedings, and on September 28, 2011, the Illinois Supreme Court denied Philip Morris' petition for leave to appeal that ruling. As a result, the case returned to the trial court for proceedings on whether the court should grant the plaintiffs' petition to reopen the prior judgment. In February 2012, plaintiffs filed an amended petition, which Philip Morris opposed. Subsequently, in responding to Philip Morris's opposition to the amended petition, plaintiffs asked the trial court to reinstate the original judgment. On December 12, 2012, the trial court denied the plaintiffs' request to reopen the prior judgment, and the plaintiffs filed a notice of appeal to the Fifth District Appellate Court on January 8, 2013. On January 23, 2013 Philip Morris filed a motion requesting that the Illinois State Supreme Court directly hear plaintiffs' appeal. On February 15, 2013, the Illinois State Supreme Court denied Philip Morris' motion for direct appeal. On April 29, 2014, the Fifth District Appellate Court reinstated the $10.1 billion 2003 verdict. Philip Morris appealed this reinstatement decision to the Illinois Supreme Court on May 13, 2014. On September 24, 2014 the Illinois Supreme Court agreed to hear the appeal, and the verdict has been stayed pending appeal. On February 9, 2015, the plaintiffs filed a new motion seeking recusal or disqualification of Justice Karmeier, one of the Illinois Supreme Court justices (following a September 2014 denial of a similar motion), alleging that the justice is biased in favor of defendant Philip Morris, according to Altria's Form 10-K filed with the SEC for the calendar year 2014.

In another "Lights" Class Action Case, *Larsen v. Philip Morris Inc.* (formerly *Craft v. Philip Morris Inc.*), a Missouri Court of Appeals in August 2005 affirmed a class certification order for current and former smokers of Marlboro Lights. (The class period is 1995 through 2003.) In June 2011, Philip Morris filed various summary judgment motions challenging the plaintiffs' claims. In August 2011, the trial court granted Philip Morris's motion for partial summary judgment, ruling that plaintiffs could not present a damages claim based on allegations that Marlboro Lights are more dangerous than Marlboro Reds, and denied Philip Morris's remaining summary judgment motions. Trial began in September 2011, and in October 2011 the trial court declared a mistrial after the jury failed to reach a verdict. In January 2014, the trial court reversed its prior ruling granting partial summary judgment against plaintiffs' "more dangerous" claim and allowed plaintiffs to pursue that claim. In October 2014, Philip Morris filed motions to decertify the class and for partial summary judgment on plaintiffs' "more dangerous" claim, and a re-trial in the *Larsen* case is scheduled to begin in February 2016, according to Altria in its Form 10-K filed with the SEC for the calendar year 2014.

In another "Lights" Class Action Case, *In Re Tobacco II Cases* (*Brown v. The American Tobacco Company, Inc., et al.*, Superior Court, San Diego County, California, JCCP 4042), the California Supreme Court in 2009 vacated an order that had previously decertified a class and returned *In Re Tobacco II* to the trial court for further activity. The class in *In Re Tobacco II* is composed of residents of California who smoked at least one of defendants' cigarettes between June 10, 1993 and April 23, 2001 and who were exposed to defendants' marketing and advertising activities in California. The trial court has permitted plaintiffs to assert claims based on the alleged misrepresentation, concealment and fraudulent marketing of "light" or "ultra-light" cigarettes. In May 2012, the court issued rulings that decertified the class on false statements concerning additives, nicotine manipulation and conspiracy to mislead concerning health risks of smoking. However, the court found that the class action could proceed as to the "light" claims, but that only one of the currently named plaintiffs was suitable to represent the class. In September 2012, the court entered an order that dismissed Lorillard, Reynolds Tobacco and all other defendants except Philip Morris from this case. Trial began April 15, 2013. On June 3, 2013, Philip Morris filed a motion to decertify the class. On September 24, 2013, the court issued a final Statement of Decision, in which the court found that Philip Morris violated California law and misrepresented the health benefits of its "light" cigarette, but that plaintiffs had not established a basis for relief and were thus not entitled to restitution or injunctive relief. On this basis, the court granted judgment for Philip Morris. The court also denied Philip Morris's motion to decertify the class. On October 15, 2013, the court entered final judgment in favor of Philip Morris. On November 8, 2013, plaintiffs moved for a new trial, which the court denied on December 12, 2013. On December 13, 2013, plaintiffs filed a notice of appeal of the final judgment, and the appeal remains pending, according to Lorillard, Inc.'s Form 10-K filed with the SEC for the calendar year 2014.

In November 2013, an Arkansas trial court approved class certification in a Marlboro Lights lawsuit, *Miner et al v. Philip Morris Cos. Inc*. Plaintiffs initially filed the lawsuit against Philip Morris in 2003, accusing the company of deceptive marketing practices in violation of the Arkansas Deceptive Business Practices Act. Plaintiffs alleged that Philip Morris violated the law by advertising Marlboro Lights as a safer alternative to regular cigarettes. Philip Morris filed a notice of appeal of the class certification ruling to the Arkansas Supreme Court in December 2013, and on February 26, 2015 the Arkansas Supreme Court ruled that the lawsuit can proceed as a class action.

Other Class Action Cases; Medical Monitoring. In one of the class actions, *Scott v. The American Tobacco Company, et al.* (District Court, Orleans Parish, Louisiana, filed May 24, 1996), a class was certified on behalf of certain cigarette smokers resident in the State of Louisiana who desired to participate in medical monitoring or smoking cessation programs and who began smoking prior to September 1, 1988, or who began smoking prior to May 24, 1996 and alleged that defendants undermined compliance with the warnings on cigarette packages. In *Scott*, trial was heard in two phases and at the conclusion of the first phase in July 2003, the jury rejected medical monitoring, the primary relief requested by plaintiffs, and returned sufficient findings in favor of the class to proceed to a Phase II trial on plaintiffs' request for a statewide smoking cessation program. Phase II of the trial, which concluded in May 2004, resulted in an award of $591 million to fund cessation programs for Louisiana smokers. In February 2007, the Louisiana Court of Appeal reduced the amount of the award by approximately $300 million; struck an award of prejudgment interest, which totaled approximately $440 million as of December 31, 2006; and limited class membership to individuals who began smoking by September 1, 1988, and whose claims accrued by September 1, 1988. The case was returned to the trial court, which subsequently entered an amended final judgment that ordered the defendants to pay approximately $264 million to fund a ten year, court-supervised smoking cessation program for the members of the certified class. The Louisiana Court of Appeal, Fourth Circuit, issued a decision in April 2010 that modified the trial court's 2008 amended final judgment, reducing the judgment amount to approximately $242 million to fund the court-supervised smoking cessation program. Both the Louisiana Supreme Court and the U.S. Supreme Court declined to review the case. In August 2011, following the exhaustion of all appeals, the defendants paid a total of approximately $280 million to satisfy the final judgment and the interest that was due. In May 2012, the parties reached a settlement on the amount of fees and costs to be awarded to plaintiffs' counsel. Plaintiffs agreed that any recovery of fees and costs would come from the court-supervised fund, not the defendants, and indicated they would seek approximately $114 million from the fund. In exchange, defendants agreed to waive 50% of their right to a refund of any unspent money in the fund after the 10-year program is completed. The agreement is not contingent on the trial court's granting plaintiffs' request for additional costs and fees. In December 2012, the court ratified and approved the agreement.

In addition to the *Scott* case, purported medical monitoring class actions have been brought by plaintiffs. In one such case, *Caronia, et al. v. Philip Morris USA,* the New York Court of Appeals on December 17, 2013, answering a question certified to it by the United States Court of Appeals for the Second Circuit, held that current or former smokers that have not been diagnosed with a smoking-related disease could not pursue an independent cause of action for medical monitoring in New York. On April 14, 2014, the Second Circuit affirmed the district court's dismissal of the entire case, including the independent claim for medical monitoring, and issued its mandate on May 5, 2014. In the other case, *Donovan v. Philip Morris*, the Supreme Judicial Court of Massachusetts, in answering questions certified to it by the district court, held in October 2009 that under certain circumstances state law recognizes a claim by individual smokers for medical monitoring despite the absence of an actual injury. The case was remanded to federal court for further proceedings. In June 2010, the district court granted in part the plaintiffs' motion for class certification, certifying the class as to plaintiffs' claims for breach of implied warranty and violation of the Massachusetts Consumer Protection Act, but denying certification as to plaintiffs' negligence claim. In July 2010, Philip Morris petitioned the U.S. Court of Appeals for the First Circuit for appellate review of the class certification decision. The petition was denied in September 2010. As a remedy, plaintiffs have proposed a 28-year medical monitoring program with an approximate cost of $190 million. In June 2011, plaintiffs filed various motions for summary judgment and to strike affirmative defenses, which the district court denied in March 2012 without prejudice. In October 2011, Philip Morris filed a motion for class decertification, which motion was denied in March 2012. In February 2013, the district court amended the class definition to extend to individuals who satisfy the class membership criteria through February 26, 2013, and to exclude any individual who was not a Massachusetts resident as of February 26, 2013. In January 2014, plaintiffs renewed their previously filed motions for partial summary judgment and to strike affirmative defenses, and in December 2014 the court issued its rulings on plaintiffs' previously-filed motions, granting and denying the motions in part. Trial in the *Donovan* case is scheduled for January 2016, according to Altria's Form 10-K filed with the SEC for the calendar year 2014.

Reimbursement Cases

Reimbursement Cases are brought by or on behalf of entities seeking equitable relief and reimbursement of expenses incurred in providing health care to individuals who allegedly were injured by smoking. Plaintiffs in these cases have included the U.S. federal government, U.S. state and local governments, foreign governmental entities, hospitals or hospital districts, American Indian tribes, labor unions, private companies and private citizens.

The DOJ Case. In August 2006, the U.S. District Court for the District of Columbia issued its final judgment and remedial order in the federal government's reimbursement suit, *United States of America v. Philip Morris*, which final judgment and remedial order concluded a bench trial that began in September 2004. The court determined in its final judgment and remedial order that the defendants violated certain provisions of the RICO statute, that there was a likelihood of present and future RICO violations, and that equitable relief was warranted. The government was not awarded monetary damages. The equitable relief included permanent injunctions that prohibit the defendants from engaging in any act of racketeering, as defined under RICO; from making any material false or deceptive statements concerning cigarettes; from making any express or implied statement about health on cigarette packaging or promotional materials (these prohibitions include a ban on using such descriptors as "low tar," "light," "ultra-light," "mild" or "natural"); from making any statements that "low tar," "light," "ultra-light," "mild" or "natural" or low-nicotine cigarettes may result in a reduced risk of disease; and from participating in the management or control of certain entities or their successors. The final judgment and remedial order also requires the defendants to make corrective statements on their websites, in certain media, in point-of-sale advertisements, and on cigarette package "onserts" (as described below). The final judgment and remedial order also requires defendants to make disclosures of disaggregated marketing data to the government, and to make document disclosures on a website and in a physical depository, and also prohibits each defendant that manufactures cigarettes from selling any of its cigarette brands or certain elements of its business unless certain conditions are met.

The final judgment and remedial order has not yet been fully implemented. Following trial, the final judgment and remedial order was stayed because the defendants, the government and several intervenors noticed appeals to the Circuit Court of Appeals for the District of Columbia. In May 2009, a three judge panel upheld substantially all of the District Court's final judgment and remedial order. In September 2009, the Court of Appeals denied defendants' rehearing petitions as well as their motion to vacate those statements in the appellate ruling that address defendants' marketing of "low tar" or "lights" cigarettes, to vacate those parts of the trial court's judgment on that issue, and to remand the case with instructions to deny as moot the government's allegations and requested relief regarding "lights" cigarettes. In June 2010, the U.S. Supreme Court denied all of the petitions for review of the case. The case was returned to the trial court for implementation of the Court of Appeals' directions in its 2009 ruling and for entry of an amended final judgment.

On November 27, 2012 the U.S. District Court for the District of Columbia entered an order prescribing the language that the defendants must include in the corrective statements that the defendants are to make on their websites and through other media. The court ordered that the corrective statements include statements to the effect that a federal court has ruled that the tobacco companies deliberately deceived the American public about the health effects of smoking and secondhand smoke and the addictiveness of smoking and nicotine, and deliberately deceived the American public by falsely selling and advertising low tar and light cigarettes as less harmful than regular cigarettes and by designing cigarettes to enhance the delivery of nicotine. In addition, the court ordered that the corrective statements contain statements including, among other things, that smoking kills on average 1,200 Americans every day, results in various detrimental health conditions and is highly addictive, that low tar and light cigarettes are not less harmful than regular cigarettes and cause some of the same detrimental health conditions that regular cigarettes cause, that tobacco companies intentionally designed cigarettes to make them more addictive, and that secondhand smoke causes lung cancer and coronary heart disease in adults who do not smoke. The court further directed the parties to engage in discussions to implement the publication of the corrective statements. In January 2013, defendants appealed to the U.S. Court of Appeals for the District of Columbia Circuit the district court's November 2012 order on the text of the corrective statements, claiming a violation of free speech rights. Defendants also filed a motion to hold the appeal in abeyance pending the completion of related proceedings in the district court regarding the implementation of the corrective statements. In February 2013, the Court of Appeals granted the defendants' motion to hold the case in abeyance pending the District Court's resolution of corrective statement implementation issues. On January 10, 2014, the U.S. government and the defendant tobacco companies filed a joint motion requesting that the district court enter a consent order addressing the implementation of the corrective statements remedy. On June 2, 2014, U.S. District Court for the District of Columbia approved the joint motion and issued a consent order, pursuant to which, for specified time periods following the date when all appeals are exhausted, corrective statements would be disseminated in newspapers (print and online), on television, on the tobacco companies' websites, and on "onserts" affixed to cigarette packs. The consent order did not resolve outstanding issues as to whether corrective statements must be posted in retail point-of-sale displays, and according to Lorillard, Inc. in its Form 10-K filed with the SEC for the calendar year 2014, as of February 6, 2015 the district court had not yet entered an amended final judgment regarding the point-of-sale displays.

The consent order provides that the parties do not waive or abandon any appeal or appellate rights or argument and that defendants reserve the right to challenge on appeal the content of the court-ordered corrective statements and the requirement that the court-ordered corrective statements appear in the multiple media referenced in the court's remedial order and in the consent order. The consent order further provides that defendants will not challenge on appeal the specific implementation executions in the consent order, that plaintiffs will not invoke defendants' agreement to the specific implementation executions in response to defendants' appellate challenge to the court-ordered corrective statements, and that should the language of the corrective statements be changed as a result of further litigation, the parties reserve the right to seek different requirements than those in the consent order. In addition, the consent order stays implementation of the corrective statements remedy until the exhaustion of the defendants' appeal challenging the constitutionality of the corrective statements.

On June 25, 2014, the defendants filed a notice of appeal of the consent order solely for the purpose of perfecting the U.S. Court of Appeals' jurisdiction over the pending appeal relating to the content of the corrective statements and, on July 2, 2014, moved to consolidate this appeal with the appeal filed in January 2013. On August 8, 2014, the U.S. Court of Appeals consolidated the appeal from the implementation order with the appeal previously held in abeyance from the court order dictating the language of the corrective statements, and oral argument for the appeal regarding the language of the corrective statements was scheduled for February 23, 2015, according to Reynolds American in its Form 10-K filed with the SEC for the calendar year 2014. The district court has not yet entered an amended final judgment addressing all of the directions from the Court of Appeals. Reynolds American has stated in its Form 10-K filed with the SEC for the calendar year 2014 that as of December 31, 2014 it has included an accrual of $10 million in its consolidated balance sheet for estimated costs of the corrective statements in connection with the DOJ Case.

Tobacco-Related Antitrust Cases

Indirect Purchaser Suits. According to Lorillard, approximately 30 antitrust suits were filed in 2000 and 2001 on behalf of putative classes of consumers in various state and federal courts against cigarette manufacturers. The suits all alleged that the defendants entered into agreements to fix the wholesale prices of cigarettes in violation of state antitrust laws which permit indirect purchasers, such as retailers and consumers, to sue under price fixing or consumer fraud statutes. More than 20 states permit such suits. Four indirect purchaser suits, in New York, Florida, New Mexico and Michigan, thereafter were dismissed by courts in those states. All other actions, except for a state court action in Kansas, were either voluntarily dismissed or dismissed by the courts.

In the Kansas case, *Smith v. Philip Morris Cos., Inc.*, the District Court of Seward County, Kansas certified a class of Kansas indirect purchasers in 2002. In July 2006, the court issued an order confirming that fact discovery was closed, with the exception of privilege issues that the court determined, based on a court special master's report, justified further fact discovery. In October 2007, the court denied all of the defendants' privilege claims, and the Kansas Supreme Court thereafter denied a petition seeking to overturn that ruling. On March 23, 2012, The District Court of Seward County granted the defendants' motions for summary judgment dismissing the Kansas suit. Plaintiff's motion for reconsideration was denied. On July 18, 2014, the Kansas Court of Appeals issued a ruling in which it affirmed the district court's order granting defendants' motions for summary judgment and dismissing plaintiffs' claims. The plaintiff filed a certiorari petition seeking review of the decision by the Kansas Supreme Court on August 18, 2014, and a response and a reply brief were subsequently filed, according to Lorillard Inc.'s Form 10-K filed with the SEC for the calendar year 2014.

For a discussion of other litigation involving claims of antitrust violations, such as *VIBO*, *Grand River* and *Freedom Holdings*, see "SUMMARY OF THE MSA—Litigation Challenging the MSA, the Qualifying Statutes and Related Legislation" herein.

Other Litigation

By way of example only, and not as an exclusive or complete list, the following are additional types of tobacco-related litigation which the tobacco industry is also the target of: (a) asbestos contribution cases, where asbestos manufacturers and related parties seek contribution or reimbursement where asbestos claims were allegedly caused in whole or in part by cigarette smoking, (b) patent infringement claims, (c) "ignition propensity cases" where wrongful death actions contend fires caused by cigarettes led to other individuals' deaths, (d) "filter cases" which mostly have been filed against Lorillard for alleged exposure to asbestos fibers there were incorporated into filter material used in one brand of cigarettes manufactured by Lorillard over 50 years ago, (e) claims related to smokeless tobacco products or electronic cigarettes, (f) ERISA claims, and (g) employment litigation claims.

Defenses

The PMs believe that they have valid defenses to the cases pending against them as well as valid bases for appeal should any adverse verdicts be returned against them. While PMs have indicated their intent to defend vigorously all tobacco products liability litigation, it is not possible to predict the outcome of any litigation. Litigation is subject to many uncertainties. Plaintiffs have prevailed in several cases, as noted herein, and it is possible that one or more of the pending actions could be decided unfavorably as to the PMs or the other defendants. The PMs may enter into discussions in an attempt to settle particular cases if the PMs believe it is appropriate to do so.

Some plaintiffs have been awarded damages from cigarette manufacturers at trial. While some of these awards have been overturned or reduced, other damages awards have been paid after the manufacturers have exhausted their appeals. These awards and other litigation activities against cigarette manufacturers and health issues related to tobacco products also continue to receive media attention. It is possible, for example, that the 2006 verdict in the DOJ case, which made many adverse findings regarding the conduct of the defendants, could form the basis of allegations by other plaintiffs or additional judicial findings against cigarette manufacturers. In addition, the U.S Supreme Court ruling in *Good v. Altria* could result in further "lights" litigation. Any such developments could have material adverse effects on the ability of the PMs to prevail in smoking and health litigation and could influence the filing of new suits against the PMs. The type or extent of litigation that could be brought against PMs in the future cannot be predicted.

The foregoing discussion of civil litigation against the tobacco industry is not exhaustive and is not based upon the examination or analysis by the Issuer of the court records of the cases mentioned or of any other court records. It is based on SEC filings by the OPMs and on other publicly available information published by the OPMs or others. Prospective purchasers of the Series 2015A Bonds are referred to the reports filed with the SEC by the OPMs and applicable court records for additional descriptions thereof.

Litigation is subject to many uncertainties. In its SEC filings, Reynolds American has stated that the possibility of material losses related to tobacco litigation is more than remote, but that generally, it is not possible to predict the outcome of the litigation or reasonably estimate the amount or range of any possible loss. This OPM has disclosed that notwithstanding the quality of defenses available to it and its affiliates in tobacco-related litigation matters, it is possible that its consolidated results of operations, cash flows or financial position could be materially adversely affected by the ultimate outcome of certain pending or future litigation matters or difficulties in obtaining the bonds required to stay execution of judgments on appeal. It can be expected that at any time and from time to time there will be developments in the litigation currently pending and filing of new litigation that could materially adversely affect the business of the PMs and the market for or prices of securities such as the Series 2015A Bonds payable from tobacco settlement payments made under the MSA.

(THIS PAGE INTENTIONALLY LEFT BLANK)

APPENDIX H

FORM OF CONTINUING DISCLOSURE CERTIFICATE

(THIS PAGE INTENTIONALLY LEFT BLANK)

CONTINUING DISCLOSURE CERTIFICATE
OF THE
GOLDEN STATE TOBACCO SECURITIZATION CORPORATION

This Continuing Disclosure Certificate (this “Disclosure Certificate”) is executed as of April 7, 2015, by the Golden State Tobacco Securitization Corporation (the “Issuer”) in connection with the issuance of $__________ Golden State Tobacco Securitization Corporation Enhanced Tobacco Settlement Asset-Backed Bonds, Series 2015A (the “Bonds”). The Bonds are being issued pursuant to an Indenture, dated as of September 1, 2003, as supplemented by the Series 2003B Supplement, dated as of September 1, 2003, each between the Issuer and The Bank of New York Mellon Trust Company, N.A. (formerly known as The Bank of New York Trust Company, N.A., successor to BNY Western Trust Company), as trustee (the “Trustee”), as amended and supplemented by the First Supplemental Indenture, dated as of July 1, 2005, between the Issuer and the Trustee, the Second Supplemental Indenture, dated as of April 1, 2013, and the Third Supplemental Indenture, dated as of April 1, 2015 (collectively, the “Indenture”). The Issuer covenants and agrees as follows:

SECTION 1. Nature of the Disclosure Certificate. This Disclosure Certificate is executed for the benefit of the Holders and Beneficial Owners (as defined below) of the Bonds from time to time, but shall not be deemed to create any monetary liability on the part of the Issuer to any persons, including Holders or Beneficial Owners of the Bonds based on the Rule (as defined below). The sole remedy in the event of any failure of the Issuer to comply with this Disclosure Certificate shall be an action to compel performance of any act required hereunder.

SECTION 2. Definitions. In addition to the definitions set forth in the Indenture, which apply to any capitalized term used in this Disclosure Certificate unless otherwise defined in this Section, the following capitalized terms shall have the following meanings:

“Annual Report” shall mean the Annual Report filed by the Issuer pursuant to and as described in Sections 3 and 4 of this Disclosure Certificate.

“Beneficial Owner” shall mean any person which has or shares the power, directly or indirectly, to make investment decisions concerning ownership of any Bonds (including persons holding Bonds through nominees, depositories or other intermediaries).

“Dissemination Agent” shall mean the Issuer, acting in its capacity as Dissemination Agent hereunder, or any successor Dissemination Agent designated in writing by the Issuer.

“Holder” shall mean any person listed on the registration books of the Issuer as the registered owner of any Bonds.

“Listed Events” shall mean any of the events listed in Section 5(a) of this Disclosure Certificate.

“MSRB” shall mean the Municipal Securities Rulemaking Board or any other entity designated or authorized by the SEC (as defined below) to receive reports or notices pursuant to the Rule (as defined below). Until otherwise designated by the MSRB or SEC, filings with the MSRB are to be made through the Electronic Municipal Market Access (EMMA) website of the MSRB, currently located at http://emma.msrb.org.

“Official Statement” shall mean the official statement relating to the Bonds, dated March ___, 2015.

"Rule" shall mean Rule 15c2-12(b)(5) adopted by the Securities and Exchange Commission under the Securities Exchange Act of 1934, as the same may be amended from time to time.

"SEC" shall mean the Securities and Exchange Commission.

SECTION 3. Provision of Annual Reports.

(a) The Issuer shall, not later than April 1 of each year in which the Bonds are outstanding, commencing April 1, 2016, provide to the MSRB an Annual Report consistent with the requirements of this Disclosure Certificate (an "Annual Report"); provided that the audited financial statements of the Issuer may be submitted separately from the balance of the Annual Report and later than the date required above for the filing of the Annual Report if they are not available by that date.

(b) If in any year the Issuer does not provide the Annual Report to the MSRB by the time specified in subsection (a) above, the Issuer shall instead file a notice with the MSRB stating that the Annual Report has not been timely completed and, if known, stating the date by which the Issuer expects to file the Annual Report. Giving of a notice under this subsection (b) shall not excuse failure to file the Annual Report pursuant to subsection (a) above.

(c) If the Dissemination Agent is not the Issuer, the Dissemination Agent shall:

(i) file a report with the Issuer certifying that the Annual Report has been filed pursuant to this Disclosure Certificate and listing the date of the filing; and

(ii) take any other actions mutually agreed to between the Dissemination Agent and the Issuer.

SECTION 4. Content of Annual Reports. The Annual Report shall consist of (a) audited financial statements of the Issuer for the preceding fiscal year. If the Issuer's audited financial statements are not available by the time the Annual Report is required to be filed pursuant to Section 3(a), the Annual Report shall contain unaudited financial statements and the audited financial statements shall be filed in the same manner as the Annual Report when they become available, (b) an update of operating data for the preceding fiscal year set forth under the column titled "Total Payments to Trustee" in the second table appearing under the heading "Projection of Payments to be Received by the Trustee" in "TABLES OF PROJECTED PLEDGED TSRs, PROJECTION METHODOLOGY AND BOND STRUCTURING ASSUMPTIONS" in the Official Statement, (c) the actual debt service coverage ratio for such preceding fiscal year, calculated as described in "TABLE OF PROJECTED AVAILABLE FUNDS AND DEBT SERVICE COVERAGE" in the Official Statement, and (d) information provided by the State of California to the Issuer as described in the Official Statement under "THE PURCHASE AND SALE AGREEMENT — Continuing Disclosure."

The Annual Report may consist of one or more documents. Any or all of the items listed above may be included in the Annual Report by reference to other documents which have been filed by the State with the MSRB, including any final offering circular or official statement. The Issuer shall clearly identify in the Annual Report each such document so included by reference.

SECTION 5. Reporting of Significant Events.

(a) Pursuant to the provisions of this Section 5, the Issuer shall give, or cause to be given, notice of the occurrence of any of the following events with respect to the Bonds:

(i) principal and interest payment delinquencies;

(ii) non-payment related defaults, if material;

(iii) unscheduled draws on debt service reserves reflecting financial difficulties;

(iv) unscheduled draws on credit enhancements reflecting financial difficulties;

(v) substitution of credit or liquidity providers, or their failure to perform;

(vi) adverse tax opinions, or the issuance by the Internal Revenue Service of proposed or final determination of taxability, Notices of Proposed Issue (IRS Form 5701-TEB) or other material notices or determinations with respect to the tax status of the Bonds or material events affecting the tax-exempt status of the Bonds;

(vii) modifications to rights of Bondholders, if material;

(viii) bond calls, if material, and tender offers;

(ix) defeasances;

(x) release, substitution or sale of property securing repayment of the Bonds, if material;

(xi) rating changes;

(xii) bankruptcy, insolvency, receivership or similar event of the Issuer (being considered to occur when any of the following occur: the appointment of a receiver, fiscal agent or similar officer for the Issuer in a proceeding under the U.S. Bankruptcy Code or in any other proceeding under state or federal law in which a court or governmental authority has assumed jurisdiction over substantially all of the assets or business of the Issuer, or if such jurisdiction has been assumed by leaving the existing governing body and officials or officers in possession but subject to the supervision and orders of a court or governmental authority, or the entry of an order confirming a plan of reorganization, arrangement or liquidation by a court or governmental authority having supervision or jurisdiction over substantially all of the assets or business of the Issuer);

(xiii) the consummation of a merger, consolidation, or acquisition involving an obligated person or the sale of all or substantially all of the assets of the obligated person, other than in the ordinary course of business, the entry into a definitive agreement to undertake such an action or the termination of a definitive agreement relating to any such actions, other than pursuant to its terms, if material; or

(xiv) appointment of a successor or additional trustee or the change of name of a trustee, if material.

(b) The Issuer shall timely file a notice of the occurrence of a Listed Event with the MSRB, but in no event in excess of ten business days after the occurrence of such Listed Event.

SECTION 6. Termination of Reporting Obligation. The Issuer's obligations under Sections 3, 4 and 5 of this Disclosure Certificate shall terminate upon the maturity, legal defeasance, prior redemption or acceleration of all of the outstanding Bonds. If such termination occurs prior to the final maturity of the Bonds, the Issuer shall give notice of such termination in the same manner as for a Listed Event under Section 5(b).

SECTION 7. Dissemination Agent. The Issuer may, from time to time, appoint or engage a Dissemination Agent to assist it in carrying out the obligations under this Disclosure Certificate, and may discharge any such Dissemination Agent, with or without appointing a successor Dissemination Agent. The Dissemination Agent shall not be responsible in any manner for the content of any notice or report prepared by the Issuer pursuant to this Disclosure Certificate. If at any time there is not any other designated Dissemination Agent, the Issuer shall be the Dissemination Agent. The initial Dissemination Agent shall be the Issuer.

SECTION 8. Amendment; Waiver. Notwithstanding any other provision of this Disclosure Certificate, the Issuer may amend or waive any provision of this Disclosure Certificate, provided that the following conditions are satisfied:

(a) If the amendment or waiver relates to the provisions of Sections 3(a), 4, or 5(a), it may only be made in connection with a change in circumstances that arises from a change in legal requirements, change in law, or change in the identity, nature or status of an obligated person with respect to the Bonds, or the type of business conducted;

(b) The undertaking, as amended or taking into account such waiver, would, in the opinion of nationally recognized bond counsel, have complied with the requirements of the Rule at the time of the original issuance of the Bonds, after taking into account any amendments or interpretations of the Rule, as well as any change in circumstances; and

(c) The amendment or waiver either (i) is approved by the Holders of 60% of the Bonds outstanding or (ii) does not, in the opinion of nationally recognized bond counsel, materially impair the interests of the Holders or Beneficial Owners of the Bonds.

In the event of any amendment or waiver of a provision of this Disclosure Certificate, the Issuer shall describe such amendment in the next Annual Report, and shall include, as applicable, a narrative explanation of the reason for the amendment or waiver and its impact on the type (or, in the case of a change of accounting principles, on the presentation) of financial information or operating data being presented by the Issuer. In addition, if the amendment relates to the accounting principles to be followed in preparing financial statements, (i) notice of such change shall be given in the same manner as for a Listed Event under Section 5(b) and (ii) the Annual Report for the year in which the change is made should present a comparison (in narrative form and also, if feasible, in quantitative form) between the financial statements as prepared on the basis of the new accounting principles and those prepared on the basis of the former accounting principles.

SECTION 9. Additional Information. Nothing in this Disclosure Certificate shall be deemed to prevent the Issuer from disseminating any other information, using the means of dissemination set forth in this Disclosure Certificate or any other means of communication, or including any other information in any Annual Report or notice of occurrence of a Listed Event, in addition to that which is required by this Disclosure Certificate. If the Issuer chooses to include any information in any Annual Report or notice of occurrence of a Listed Event in addition to that which is specifically required by this Disclosure Certificate, the Issuer shall not have any obligation under this Certificate to update such information or include it in any future Annual Report or notice of occurrence of a Listed Event.

SECTION 10. Beneficiaries. This Disclosure Certificate shall inure solely to the benefit of the Holders and Beneficial Owners from time to time of the Bonds, and shall create no rights in any other person or entity (except the right of the Issuer or any Bondholder or Beneficial Owner to enforce the provisions of this Disclosure Certificate on behalf of the Bondholders). This Disclosure Certificate is not intended to create any monetary rights on behalf of any person based upon the Rule.

SECTION 11. Partial Invalidity. If anyone or more of the agreements or covenants or portions thereof required hereby to be performed by or on the part of the Issuer shall be contrary to law, then such agreement or agreements, such covenant or covenants or such portions thereof shall be null and void and shall be deemed separable from the remaining agreements and covenant or portions thereof and shall in no way affect the validity hereof, and the Holders of the Bonds shall retain all the benefits afforded to them hereunder. The Issuer hereby declares that he would have executed and delivered this Disclosure Certificate and each and every other article, section, paragraph, subdivision, sentence, clause and phrase hereof irrespective of the fact that any one or more articles, sections, paragraphs, subdivisions, sentences, clauses or phrases hereof or the application thereof to any person or circumstance may be held to be unconstitutional, unenforceable or invalid.

SECTION 12. Governing Law. The laws of the State of California shall govern this Disclosure Certificate, the interpretation thereof and any right or liability arising hereunder. Any action or proceeding to enforce or interpret any provision of this Disclosure Certificate shall be brought, commenced or prosecuted in any court of the State of California located in Sacramento County, California.

IN WITNESS WHEREOF, the Issuer has executed this Disclosure Certificate as of the date first above written.

GOLDEN STATE TOBACCO SECURITIZATION
CORPORATION

By: ____________________________________
Title: Chief Deputy Director for State
Director of Finance, Michael
Cohen, as Authorized Director

APPENDIX I

SERIES 2005A BONDS TO BE REFUNDED

The Issuer expects to use a portion of the proceeds from the sale of the Series 2015A Bonds, together with amounts released from the Liquidity Reserve Account, the Supplemental Reserve Account and the Surplus Account, to refund on a current basis a portion equal to $1,959,775,000* aggregate principal amount of the Issuer's Series 2005A Bonds, listed below.

Series 2005A Bonds to be Refunded with Proceeds of the Series 2015A Bonds*

Due (June 1)	Amount Outstanding	Amount to be Refunded	Interest Rate	CUSIP Number[(1)]	Redemption Date
2035	$ 513,105,000	$ 443,105,000	5.000%	38122NGD8	June 1, 2015
2038	387,505,000	387,505,000	5.000	38122NGE6	June 1, 2015
2045	24,305,000	24,305,000	4.625	38122NGF3	June 1, 2015
2045	1,104,860,000	1,104,860,000	5.000	38122NGG1	June 1, 2015
Total	$2,029,775,000	$1,959,775,000			

(1) The CUSIP numbers shown above have been assigned by CUSIP Global Services, operated on behalf of the American Bankers Association by S&P Capital IQ, a division of McGraw Hill Financial Inc. The Issuer is not responsible for the selection of CUSIP numbers, nor is any representation made as to their correctness on any Refunded Bonds.

The Issuer may determine to refund Series 2005A Bonds other than those listed above and/or to refund principal amounts of the Series 2005A Bonds other than those listed above. The Series 2005A Bonds that the Issuer selects for defeasance on the Series 2015A Closing Date are referred to herein as the "**Refunded Bonds**".

On the date of delivery of the Series 2015A Bonds, the Issuer will enter into a refunding escrow agreement with the Trustee to provide for the refunding of the Refunded Bonds. The refunding escrow agreement will create an irrevocable trust fund, which is to be held by the Trustee and is to be applied to the payment of, and is pledged solely for the benefit of, the Refunded Bonds. The Issuer will deposit a portion of the proceeds from the sale of the Series 2015A Bonds and the amounts released from the Liquidity Reserve Account, the Supplemental Reserve Account and the Surplus Account into the trust fund in amounts that will be retained as cash or invested, at the direction of the Issuer, in Defeasance Collateral, in accordance with the Indenture, that matures or is subject to redemption at the option of the holder in amounts and bearing interest at rates sufficient without reinvestment (i) to redeem the Refunded Bonds on their respective redemption dates at their respective redemption price and (ii) to pay the interest on the Refunded Bonds through the respective redemption date.

Upon issuance of the Series 2015A Bonds, the Refunded Bonds will be irrevocably designated for redemption as described above, provision will be made in the refunding escrow agreement for the giving of notice of such redemption, and the Refunded Bonds shall not be redeemed other than as described above.

By virtue of the provision for payment of the Refunded Bonds upon redemption, together with the irrevocable deposit and application of monies and securities in the trust fund and certain other provisions of the refunding escrow agreement, the Refunded Bonds will be deemed to be no longer Outstanding under the Indenture and, except for purposes of any payment from such moneys and securities, shall no longer be secured by or entitled to the benefits of the Indenture.

* Preliminary, subject to change.

(THIS PAGE INTENTIONALLY LEFT BLANK)

APPENDIX J

LETTERS FROM CERTAIN UNDERWRITERS

(THIS PAGE INTENTIONALLY LEFT BLANK)

citi

February 9, 2015

Mr. Blake Fowler
Office of the Treasurer of the State of California
915 Capitol Mall, Room 261
Sacramento, CA 95814

RE: State of California – Enhanced Tobacco Settlement Asset-Backed Bonds (the “Bonds”)

Dear Mr. Fowler:

Citigroup Global Markets Inc. is providing the following language for inclusion in the Offering Statement.

Citigroup Global Markets Inc., an underwriter of the Bonds, has entered into a retail distribution agreement with UBS Financial Services Inc. (“UBSFS”). Under the distribution agreement, Citigroup Global Markets Inc. may distribute municipal securities to retail investors through the financial advisor network of UBSFS. As part of this arrangement, Citigroup Global Markets Inc. may compensate UBSFS for their selling efforts with respect to the Bonds.

Citigroup Global Markets Inc.

Cc: Greg Rogers, Golden State Tobacco Securitization Corporation

ACADEMY
SECURITIES

February 23, 2015

Mr. Blake Fowler, Director
Office of the Treasurer of the State of California
Public Finance Division
915 Capitol Mall, Room 261
Sacramento, CA 95814
Email: blake.fowler@treasurer.ca.gov

CC: Mr. Greg Rogers
Assistant Program Budget Manager
Golden State Tobacco Corporation
915 L Street, 9th Floor
Sacramento, CA 95814
Email: greg.rogers@dof.ca.gov

Re: GSTSC Enhanced Tobacco Settlement Asset-Backed Bonds Series 2015A

Dear Sirs:

Academy Securities, Inc., Co-Managing Underwriter of GSTSC Enhanced Tobacco Settlement Asset-Backed Bonds Series 2015A, intends to enter into distribution agreements (the "Distribution Agreements") with IFS Securities, COR Capital Markets, Sutter Securities Inc., BNY Mellon Capital Markets LLC, Ladenburg Thalmann & Co Inc., R. Seelaus & Co, Newbridge Independent Services, Ridgeway & Conger, Bonwick Capital Partners LLC, Celadon Financial Group, Capital Guardian LLC, National Securities Corp. for the retail distribution of certain municipal securities offerings, at the original issue prices. Pursuant to these Distribution Agreements (if applicable for this transaction), Academy Securities, Inc. may share a portion of its underwriting compensation with these firms.

ACADEMY SECURITIES, INC.

Blaylock BV
Blaylock Beal Van, LLC

February 19, 2015

Mr. Blake Fowler
Director, Public Finance Division
Office of the Treasurer of the State of California
915 Capitol Mall, Room 261
Sacramento, CA 95814

RE: Golden State Tobacco Securitization Corporation
Enhanced Tobacco Settlement Asset-Backed Bonds, Series 2015A

Dear Mr. Fowler:

Blaylock Beal Van, LLC, is providing the following language for inclusion in the Official Statement.

Blaylock Beal Van, LLC ("Blaylock Beal Van" or "BBV") has entered into a distribution agreement (the "Agreement") with TD Ameritrade, Inc. ("TD") for the retail distribution of certain municipal securities offerings underwritten by or allocated to Blaylock Beal Van, including the GSTSC Series 2015. Under the Agreement, Blaylock Beal Van will share with TD a portion of the underwriting compensation paid to BBV.

Sincerely,

Blaylock Beal Van, LLC

Cc: Greg Rogers, Golden State Tobacco Securitization Corporation

February 23, 2015

PiperJaffray®

Mr. Blake Fowler
Director of Public Finance
Office of the Treasurer of the State of California
Public Finance Division
915 Capital Mall, Room 261
Sacramento, CA 95814

**RE: GOLDEN STATE TOBACCO SECURITIZATION CORPORATION
ENHANCED TOBACCO SETTLEMENT ASSET-BACKED BONDS, SERIES 2015A**

Dear Mr. Fowler:

Piper Jaffray & Co. is providing the following language for inclusion in the Official Statement.

Piper Jaffray & Co. and Pershing LLC, a subsidiary of The Bank of New York Mellon Corporation, entered into an agreement (the "Agreement") which enables Pershing LLC to distribute certain new issue municipal securities underwritten by or allocated to Piper Jaffray & Co., including the Golden State Tobacco Securitization Corporation Enhanced Tobacco Settlement Asset-Backed Bonds, Series 2015 A (the "Bonds). Under the Agreement, Piper Jaffray & Co. will share with Pershing LLC a portion of the fee or commission paid to Piper Jaffray.

Additionally, Piper Jaffray & Co. has entered into an agreement with UnionBanc Investment Services LLC for retail distribution of certain municipal securities offerings, at the original offering prices. Pursuant to said agreement, if applicable to the Bonds, Piper Jaffray & Co. will share a portion of its underwriting compensation with respect to the Bonds with UnionBanc Investment Services LLC.

Sincerely,

Piper Jaffray & Co.

cc: Greg Rogers, Golden State Tobacco Securitization Corporation

PRAGER & CO., LLC

INVESTMENT BANKERS

February 20, 2015

Mr. Blake Fowler
Director, Public Finance Division
Office of the Treasurer of the State of California
915 Capital Mall, Room 110
Sacramento, CA 95814

Re: Golden State Tobacco Securitization Corporation Enhanced Tobacco Settlement Asset-Backed Bonds, Series 2015A

Dear Mr. Fowler:

Prager & Co., LLC, Co-Managing Underwriter for the Golden State Tobacco Securitization Corporation Enhanced Tobacco Settlement Asset-Backed Bonds, Series 2015A, has entered into a distribution agreement (the "Distribution Agreement") with HSBC Securities for the retail distribution of certain municipal securities offerings, at the original issue prices. Pursuant to the Distribution Agreement (if applicable for this transaction), Prager & Co., LLC may share a portion of its underwriting compensation with respect to the Golden State Tobacco Securitization Corporation Enhanced Tobacco Settlement Asset-Backed Bonds, Series 2015A with HSBC Securities.

Sincerely,
PRAGER & CO., LLC

Cc: Mr. Greg Rogers
Golden State Tobacco Securitization Corporation

February 23, 2015

Mr. Blake Fowler
Director, Public Finance
California State Treasurer’s Office
915 Capitol Mall C-15
Sacramento, California 95814

Mr. Greg Rogers
Director, Golden State Tobacco Corporation
California State Treasurer’s Office
915 Capitol Mall C-15
Sacramento, California 95814

Dear Sirs:

We are writing to thank you for the opportunity to serve as a selling group member on your upcoming Tobacco Securitization Asset-Backed Bond sale. Per your request, we would intend on utilizing retail distribution agreements with the following two firms and have provided the requested contact information for each.

Firm name:	Winslow Evans
Contact person:	Nomi Caperton, Managing Director, Fixed Income Trading
Telephone number:	617.896.3526
Email address:	ncaperton@e-winslow.com

Firm name:	Gates Capital Corporation
Contact person:	Young Whi Kim, Treasurer
Telephone number:	212.661.8686
Email address:	young.kim@gatescapital.com

Please let us know if you have questions. We look forward to the sale.

Warm regards,

Cristal Baron, President

WELLS FARGO SECURITIES

February 17, 2015

Mr. Blake Fowler
Director, Public Finance Division
Office of the Treasurer of the State of California
915 Capitol Mall, Room 261
Sacramento, CA 95814

Re: Golden State Tobacco Securitization Corporation, Enhanced Tobacco Settlement Asset-Backed Bonds, Series 2015A (the "Bonds")

Dear Mr. Fowler:

Wells Fargo Bank, National Association ("WFBNA"), one of the underwriters of the Bonds, has entered into an agreement (the "Distribution Agreement") with its affiliate, Wells Fargo Advisors, LLC ("WFA"), for the distribution of certain municipal securities offerings, including the Bonds. Pursuant to the Distribution Agreement, WFBNA will share a portion of its underwriting or remarketing agent compensation, as applicable, with respect to the Bonds with WFA. WFBNA also utilizes the distribution capabilities of its affiliates, Wells Fargo Securities, LLC ("WFSLLC") and Wells Fargo Institutional Securities, LLC ("WFIS"), for the distribution of municipal securities offerings, including the Bonds. In connection with utilizing the distribution capabilities of WFSLLC, WFBNA pays a portion of WFSLLC's expenses based on its municipal securities transactions. WFBNA, WFSLLC, WFIS, and WFA are each wholly-owned subsidiaries of Wells Fargo & Company.

Wells Fargo Securities is the trade name for certain securities-related capital markets and investment banking services of Wells Fargo & Company and its subsidiaries, including Wells Fargo Bank, National Association.

Wells Fargo Bank, National Association

CC: Greg Rogers, Golden State Tobacco Securitization Corporation

THE WILLIAMS CAPITAL GROUP

February 20, 2015

Mr. Blake Fowler, Director of Public Finance
Office of the Treasurer of the State of California
Public Finance Division
915 Capitol Mall, Room 261
Sacramento CA, 95814

RE: Golden State Tobacco Securitization Corporation
Enhanced Tobacco Settlement Asset-Backed Bonds
Series 2015A

Dear Mr. Fowler:

The Williams Capital Group, L.P., Co- Managing Underwriter on the Golden State Tobacco Securitization Corporation Enhanced Tobacco Settlement Asset-Backed Bonds Series 2015A has entered into negotiated dealer agreements ("Dealer Agreements") with E*Trade Securities LLC and TD Ameritrade for the retail distribution of certain securities offerings at the original issue prices. Pursuant to the Dealer Agreements (if applicable to this transaction), E*Trade Securities LLC and TD Ameritrade may purchase bonds from Williams Capital at the original issue price less a negotiated portion of the selling concession applicable to any bonds that such firm sells.

The Williams Capital Group, L.P.

cc: Greg Rodgers, Golden State Tobacco Securitization Corporation

APPENDIX K

INDEX OF DEFINED TERMS

Defined Term	Page
1934 Act	140
2014-2017 PM Credits	108
Accounts	134
Accreted Value	134
Act	S-2, 1
Actual Operating Income	61
Actual Volume	61
Allocable Share Release Amendment	71
Altria	G-2
Annual Payments	S-19
ANRF	G-11
APA	36, G-20
Arbitration Panel	26, 86
ARIMOU	S-2, 3
Authorized Officer	134
B&W	S-17, 2, G-2
Bankruptcy Code	45
Base Aggregate Participating Manufacturer Market Share	62, 84
Base Operating Income	61
Base Share	S-19, 59
Base Volume	61
Bekenton	98
Beneficial Owner	17
Bond Obligation	134
Bond Purchase Agreement	116
Bond Structuring Methodology	104
Bond Year	S-13
Bonds	S-2, 1
British American	G-3
Business Day	134
California Escrow Agent	S-2, 3
California Escrow Agent Fees	134
California Escrow Agreement	S-2, 3
California Local Government Escrow Account	S-21, 100
California State Government Escrow Account	S-21, 100
Cambridge Filter Method	G-22
Capital Appreciation Bond	134
CBI	G-4
CDC	34
CIEDB	S-2, 3
cigarette	59

Class Action Cases G-30
Code S-12, S-25
Collateral S-5, 4
Collection Methodology and Assumptions 104
Collections S-9
Collections Account S-9
Complementary Legislation 72
Continuing Disclosure Certificate 140
control 138
Conventional Product Liability Cases G-29
Conversion Date 134
Convertible Bond 135
Corporate Trust Office 135
Counsel 135
CPI 61
Current Interest Bond 135
Data Clearinghouse 90
Debt Service 135
Debt Service Account 135
debt service coverage ratio 22
Decree S-3, S-20, 99
Defeasance Collateral 135
Defeased Bonds 136
Deposit Date S-10
Direct Participants 16
Disputed Payments Account 25
Distribution Date S-7, 3
DOJ Case 34, G-30
DTC S-7, 11, 16
DTCC 17
e-cigarette 40
e-cigarettes G-9
electronic cigarette 40
Eligible Bank 136
Eligible Investments 136
EMMA S-25, 140
Engle Progeny Cases 31, G-29
Escrow Statute 69
ETS 30
Event of Default S-16, 130
FCTC G-28
FDA 32
FET 90
Fiduciary 138
Final Approval S-18, 67
First Supplemental Indenture S-1, 1

Fiscal Year 138
Fitch S-26, 144
Flight Attendant Cases G-29
Foundation 68
Freedom Holdings 30
FSPTCA 35, G-15
FTC 32
General Tobacco 33
Grand River 29
IHS Global S-23, 101
Imperial Tobacco S-17, G-3
Income Adjustment 61
Indenture S-1, 1
Indian Country 77
Indirect Participants 17
Inflation Adjustment 61
Initial Payments S-18
IRI/Capstone G-3
IRS 143
Issuer S-1, 1
Issuer Tax Certificate S-13, 138
JPMDL G-39
Lamont Financial 145
Liggett G-4
Liquidity Reserve Account S-8
Liquidity Reserve Requirement S-8, 11
Listed Event 140
Litigating Releasing Parties Offset 64
Litigation Expense Reimbursements 138
Lorillard S-17, 2, G-3
Lump Sum Payment S-10
Majority in Interest 138
Mandatory Sinking Fund Payment 138
Market Share S-19, 64
Master Indenture S-1, 1
Maturity Date S-7, 138
MFN 98
Model Statute 70
Moody's S-26, 143
MOU S-2, 3
MSA S-2, S-17, 2
MSA Auditor 27, 58
MSA Escrow Agent S-20, 58
MSA Escrow Agreement 58
MSAI S-22, 59
MSRB S-25, 140

NAAG ... S-22
NAFTA ... 29
National Escrow Agreement ... S-19
new product application process ... G-15
NIH ... G-21
Ninth Circuit ... 30, 81
non-compliant NPM cigarettes ... 89
non-contested states ... 27, 86
Non-Participating Manufacturers ... S-18, 2
Non-Released Parties ... 64
Non-SET-Paid NPM Sales ... 90
NP ... 79
NPM Adjustment ... 2, 26, 62
NPM Adjustment Settlement Term Sheet ... 27, 87
NPM Adjustment Stipulated Partial Settlement and Award ... 27, 87
NPMs ... S-18, 2, 26
Officer’s Certificate ... 138
Offset for Claims-Over ... 64
Offset for Miscalculated or Disputed Payments ... 63
Operating Cap ... S-12
Operating Contingency Account ... 138
Operating Expenses ... S-12
Opinion of Counsel ... 116
OPMs ... S-17, 2
Original Participating Manufacturers ... S-17, 2
Outstanding ... 138
Owners ... 12
Parker ... 80
Partial Lump Sum Payment ... S-10
Participating Jurisdictions ... S-21, 3
Participating Manufacturers ... S-18, 2
Paying Agent ... 139
Person ... 139
Philip Morris ... S-17, 2, G-2
Pledged Accounts ... S-5, 5
Pledged TSRs ... S-2, 3
PM Credits ... 108
PMs ... S-18, 2, 55
PRAG ... 145
Preliminary Evaluation ... G-17
Premium Bonds ... 142
Previously Settled State Settlements ... 33
Previously Settled States ... 55
Previously Settled States Reduction ... 61
Pro Rata ... S-17
PSS Credit Amendment ... 25, 62

Purchase and Sale Agreement....S-2, 3
Qualifying Statute.... 69
Rating Agencies....S-26, 49, 144
Rating Confirmation.... 116
Rebate Account.... 139
Rebate Requirement....S-12
Record Date.... 12
Reimbursement Cases....G-30
Relative Market Share....S-19, 59
Released Parties.... 57
Released Party.... 57
Releasing Parties.... 57
Relief Clause.... 98
Reserve Account.... 139
Reserve Facility.... 139
Reserve Requirement.... 139
Residual Certificate.... 139
Reynolds American....S-17, G-2
Reynolds Tobacco....S-17, 2, G-2
RICO.... 31
roll-your-own.... 60, 98
Rule.... 140
S&P....S-26, 143
SEC....S-25, 24, 140
Second Circuit.... 29
Second Supplemental Indenture....S-1, 1
Second Supplemental Purchase and Sale Agreement....S-2, 3
Serial Maturity.... 139
Series 2005A Bonds....S-1, 1
Series 2007 Bonds....S-3
Series 2007 Indenture.... 139
Series 2007 Pledged TSRs....S-3, 3, 139
Series 2007 Trustee....S-3, 3, 139
Series 2013A Bonds....S-2, 1
Series 2015A Bonds....S-1, 1
Series 2015A Closing Date....S-7
SET.... 89
SET-Paid NPM Sales.... 89
Settling States....S-17, 2
Severed West Virginia Claims....G-38
Sherman Act.... 29
significant factor agreement.... 95
Sixth Circuit.... 29
SLATI....G-23
Southern District.... 29
SPMs....S-18, 2, 55

State.......... S-2, 1
State Appropriations S-5, 5, 139
State GO Annual Report 141
State Lien 116
State Settlement Agreements 33
State-Specific Finality.......... 67
Strategic Contribution Fund Payments S-19
Subsequent Participating Manufacturers S-18, 2
Supplemental Indenture 140
Supplemental Reserve Account S-9, 11
Supplemental Reserve Requirement S-9, 11
Surplus Account.......... 139
Swap Contract.......... S-10, 140
Swap Payment.......... S-10, 140
Tax Obligations.......... S-12
Term Bond Maturity 140
Term Sheet Non-Signatories.......... 28, 87
Term Sheet Signatories 27, 87
Third Supplemental Indenture S-1, 1
Tobacco Assets S-2, 3
Tobacco Consumption Report S-23, 101
Tobacco Products.......... 68
Tobacco Settlement Revenues S-19
Tobacco-Related Antitrust Cases.......... G-30
Total Lump Sum Payment S-10
TPSAC 35, G-15
Transaction Documents 116
Tribe.......... 77
Trustee.......... S-1, 1
TSR Sale Date.......... S-2, 3
TSRs.......... S-19
TTB G-8
Underwriters 144
United States 59
units sold 73
UST G-2
Vector Group Ltd. G-4
Vector Tobacco.......... G-4
Verification Agent 144
VIBO 29
Volume Adjustment.......... 61
West Virginia Cases.......... G-29
Western District 80
Written Notice.......... 140

♻
FOR ADDITIONAL BOOKS: ELABRA.COM OR (888) 935-2272