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RUC & STATE ISSUED BONDS

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RUC and State-Issued Bonds |

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PREFACE

The purpose of this report is to provide information for the Washington Road Usage Charge Steering Committee's consideration as they begin to deliberate whether or how the State of Washington could transition to a per-mile fee system as a future replacement for the state's motor fuels tax (gas tax).

The information contained in this report examines issues related to the state's issuance of bonds that pledge motor vehicle fuel tax (gas tax) revenues, and the effects on both outstanding bonds and future issuances if the State of Washington transitions from the gas tax to a new funding system that collects a road usage charge (RUC), which is a per-mile charge, in its place.

This report is being presented to the Steering Committee as a draft version for review and discussion at its upcoming meeting on March 14, 2019. This and all other reports will remain in draft form and are open for Committee and stakeholder comments until one week before the next Steering Committee meeting (scheduled for May 2, 2019).

For this report, all footnotes and citations appear at the bottom of the page to improve readability. A key to terms used in this report is provided at the outset.

GLOSSARY

Bonds: an instrument of indebtedness that represents a loan made by investors to a borrower (the state). Bonds are a form of borrowing.

Constitution: unless otherwise noted, this refers to the Constitution of the state of Washington.

Full faith, credit and taxing power: refers to the authority of the State of Washington to make an unconditional promise to repay debt by exercising the state's power to raise general tax revenue as necessary to meet its financial obligation. Also known as a "full faith and credit" pledge.

Gas tax: the motor vehicle fuel tax and special fuels tax imposed as an excise tax on motor fuels in the state. In this report, "gas tax" is used in reference to motor vehicle fuel tax revenue.

GO: Shorthand for a general obligation pledge of the State of Washington to repay debt by exercising the state's power to raise general tax revenue as necessary. A GO pledge is backed by the full faith, credit and taxing power granted to the State of Washington in the Washington constitution.

Highway-related bonds: use of the proceeds of highway-related bonds is limited to *all eligible expenditures of state gas tax revenue*, which includes construction, maintenance, operations, and administration of all public roadways (whether state or local) including the state ferry system.

Highway system: means all public roadways in Washington (whether state or local) and the state's marine highway (ferry) system.

MVFT: Motor Vehicle Fuel Tax (commonly known as the "gas tax"). In this report, "MVFT" is used when describing bonds that are secured by a pledge this tax source.

OST: Office of the State Treasurer for the State of Washington.

Revenue bonds: bonds that are secured by and to be repaid from revenue derived from the revenues of a specific project.

RUC: road usage charge, a per-mile charge collected for every mile traveled by a vehicle that is subject to the RUC.

VLF: Vehicle License Fee. The fee paid by vehicle owners to properly register their car. The fee is collected at the time of initial registration, and annually thereafter upon registration renewal. This fee is distinct from other types of vehicle fees that are paid annually (such as passenger vehicle weight fees, or the motor vehicle excise tax (MVET), which is a tax based on the value of the vehicle).

VP GO bonds: Various Purpose General Obligation bonds mean bonds issued by the State of Washington to fund general government programs and projects. These are sometimes referred to as "General Fund" or "GF" bonds.

WSTC: Washington State Transportation Commission.

EXECUTIVE SUMMARY

Since 2012, the Washington Road Usage Charge Steering Committee has been investigating the road usage charge (RUC) as a potential replacement for the state's motor vehicle fuel tax ("gas tax"). The work includes an assessment of the financial implications of switching from the gas tax to RUC, including the effect on repaying outstanding and/or authorized but unissued state bonds that are secured by the gas tax as the primary source of repayment to bondholders.

The state constitution, legislative bond authorizations, and legally-binding covenants with bondholders each require that the gas tax remain in place in sufficient amounts to repay the principle and interest due until these bonds have been fully repaid. The state currently has over $7 billion of MVFT backed bonds outstanding. Each series has different maturity dates for when the bonds will be fully retired. The most recently issued bonds are not schedule for retirement until 2044. As the state sells new MVFT bonds, such as those authorized by the Nickle or TPA authorizations, to finance highway-related projects, the new bond issuances will further extend the time period that the gas tax must remain in place to repay the debt in due course.

In 2014, the legislature directed the Steering Committee (with assistance from the Washington State Department of Transportation (WSDOT) and the Office of the State Treasurer (OST)) to explore how the state could replace the gas tax with RUC without violating the legal requirement that sufficient gas tax revenue be available at all times to repay the bonds.

The Steering Committee had two initial ideas for what could be done with the outstanding MVFT bonds to allow the state to repeal the gas tax. However, both of these early ideas – imposing RUC in lieu of the gas tax and using the revenue to pay outstanding MVFT bonds, or refinancing the outstanding MVFT bonds and replacing them with new bonds secured by RUC revenue – proved to be financially impractical (and potentially unlawful, depending on how these strategies would be applied).

As part of their review, OST identified two potential pathways forward that would allow the state to phase out, over time, its reliance on the gas tax and instead leverage future RUC revenue. The most promising of these options, which is reflected in the structure of the Connecting Washington authorization, is to implement RUC as a mileage-based vehicle licensing fee (VLF). Just like the gas tax, a VLF is given special treatment under the Washington constitution: proceeds from the fee can only be spent for highway-related purposes (VLF is subject to Amendment 18), and bonds secured by and repaid from the fee are excluded from the state's constitutional debt limit, enabling highway-related projects to be financed without any potential displacement of other important state capital projects competing for funding under the debt limit.

When originally presented at a 2014 Steering Committee meeting, members were left confused about this option. They had a misimpression that the state gas tax must continue to be collected *in the same amount in perpetuity*, with no possibility that it could be phased out even in the mid-or-longer term. For this reason, the Steering Committee flagged this issue for further review as part of its future policy work plan.

Since this option was first presented in 2014, the legislature and OST have created a framework for how future highway-related debt could be issued. The Connecting Washington transportation funding package passed by the legislature in 2015 authorized the issuance of $5.3 billion of new bonds that will be secured by a pledge of both the gas tax and VLFs. If RUC is implemented in Washington as a VLF, RUC revenue could be used for repayment of these bonds. Although these new bonds will also be secured by a pledge of the gas tax as a source of repayment, as RUC matures to become a more robust, reliable revenue source, over time the reliance on gas tax revenues can be eased. Although this is a long-term strategy (state-issued bonds are typically repaid over 25 years), this model offers a legal, orderly, and fiscally practical approach if the state wishes to transition away from the gas tax and increase reliance on mileage-based fees to fund and finance the public highway system.

A second (but much more costly) alternative originally identified by OST back in 2014 involves the issuance of bonds backed only by RUC revenue – with no other source or pledge of the state's full faith and credit. While revenue bonds have the advantage of not being subject to the state's constitutional debt limit, these bonds would have much higher borrowing costs. RUC revenue that must be spent on the higher interest and borrowing costs means less revenue available to fund operations, maintenance and to construct projects.

Additional options – including those originally suggested back in 2014 – were analyzed. These other options range from highly conceptual (using RUC as a pay-as-you-go funding mechanism and relying on special gas tax levies for future highway-related borrowing), to fiscally impractical (the accelerated retirement of existing MVFT bonds), to prohibited under law (repealing the gas tax now and paying off existing bonds with RUC). These other approaches are described but sequestered in a separate back section of this paper to help ensure they will not be confused with the most legally, fiscally and practically viable option of implementing RUC as a new mileage-based vehicle license fee that is dedicated for the operations, maintenance and upkeep of the state's public highway network.

1 BACKGROUND AND ISSUES RAISED

1.1 Introduction

This report examines: near-term issues if the state transitions away from reliance on the gas tax to a road usage charge (RUC); and also longer-term issues related to the State's ability to issue future highway-related bonds without the gas tax supplying the majority source of repayment for those bonds.

Two primary issues are addressed, restated as questions:

1. How can the gas tax be reduced or repealed while there are outstanding MVFT bonds that specifically pledge repayment from gas tax revenue?
2. Can a RUC be structured so that any future bond issuances backed by RUC are not constrained by the state's constitutional debt limit, or in the alternative, what other revenue sources can support future highway construction bond issuances without creating a structure that is subject to the state's constitutional debt limit?

1.2 Background: State issuance of bonds pledging the gas tax (MVFT bonds)

To help pay for the construction and upkeep of the highway system, for many decades the State of Washington has bonds secured by the state's motor vehicle fuel tax (MVFT, also known as the gas tax) as a primary source of repayment[1]. As an additional measure of assurance to bond buyers, the state's full faith and credit is pledged as well[2]. Bonds that contain a promise to be repaid from two legally distinct sources of revenue are often referred to as "double-barrel" bonds.

[1] Forthcoming bond issuances will pledge several sources of revenue as a first pledge, before pledging the state's full faith and credit. Each of these revenues constituting the first pledge are ones that are restricted to highway expenditures under Art. II. Sec. 40 of the state constitution (also known as Amendment 18). Revenue of this type must be placed into a "special fund" (i.e., the Motor Vehicle Fund) to help ensure the revenue will only be used for highway purposes, which specifically includes repayment of bonds.

[2] Pledging the full faith, credit and taxing power of the state means that the State of Washington is making an unconditional guarantee to repay the bonds from its general revenue sources if necessary, in the event the primary pledged revenues (i.e., the gas tax and other Amendment 18 restricted revenues) cannot be levied in sufficient amounts to fully repay bondholders.

Because the state's MVFT bonds are (a) backed by a historically-reliable revenue source, that is (b) constitutionally restricted from being diverted for non-highway uses, and further backed by (c) an unconditional further pledge of the state's full faith and credit, the bonds are sold at some of the most favorable rates available. If any of these three key features are removed, the amount of money investors are willing to pay for the bonds will decline, translating into increased interest costs for the state. The higher the interest rates on the bonds, the more state revenue that will be consumed by debt service (repayment) instead of constructing projects.

Once bonds are purchased, bondholders retain a legal right to repayment in accordance with the terms of the bond issuance. The exact contractual language is contained in bond covenants, which are legally-enforceable promises made by the bond issuer, the State of Washington. If any of the underlying terms of this binding contract with the state are changed, the bondholders can pursue legal remedies, including obtaining a court order to block any of the State's attempted changes that would adversely affect bondholders' rights.

To date, the State of Washington has issued several different series of highway-related bonds, with approximately $8 billion still outstanding[3], with varying repayment periods. Most of these bonds are secured by gas tax revenues, either as a first pledge or as a supplemental pledge[4]. As a result, once required debt service payments are taken into consideration, a very large percentage of the state's gas tax revenue must be spent on repaying bondholders.

Issue: Can RUC replace the gas tax when bonds pledging the gas tax are still outstanding?

For purposes of conducting the basic assessment of RUC, the Steering Committee has assumed that a future RUC system will replace the state's gas tax in full. Yet, given the level of MVFT bond payments still outstanding, the key question is: how can the gas tax

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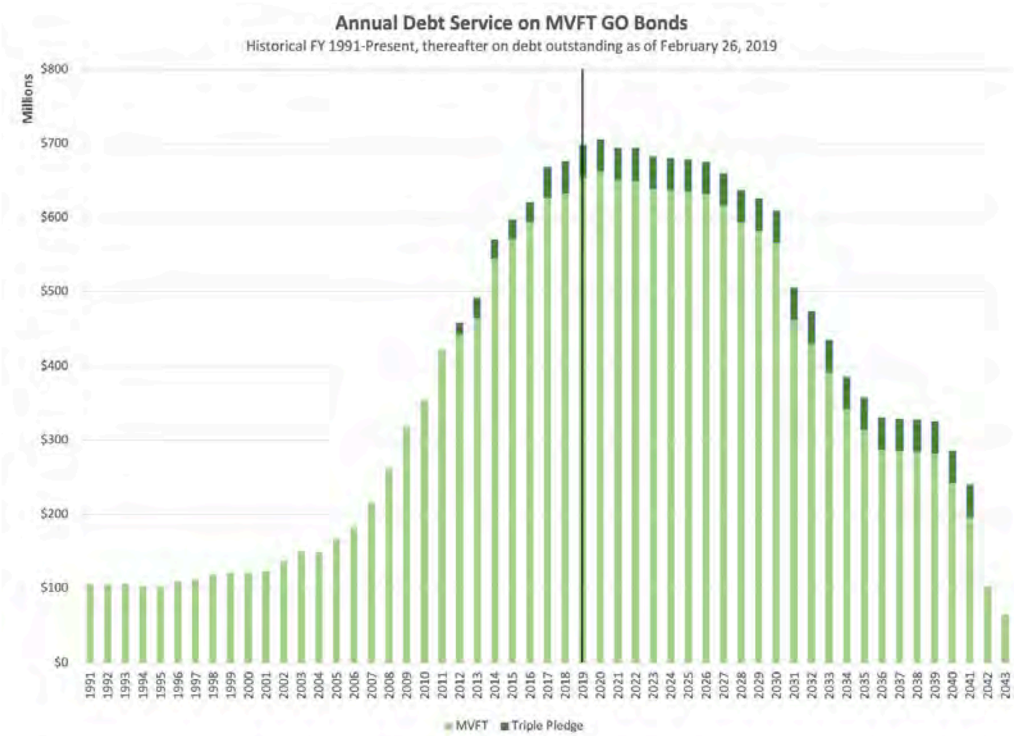
[3] In addition, OST estimates an additional $5.3 billion in Connecting Washington bonds are forthcoming.
[4] For example, SR 520 toll bridge bonds pledges revenue from bridge tolls first, then the gas tax, and then the State's full faith and credit.

be replaced with RUC when the bond covenants specifically pledge the gas tax as a source of repayment to bond holders?

Although this threshold question must consider both legal and fiscal aspects, potential remedies can be found in the operational design -- how a future RUC system might be structured and implemented over a specific period of time. These underlying legal and fiscal questions will impact whether or how the gas tax might be eliminated -- partially, in full, or over a period of time -- in the state of Washington. As described in section 2, the Connecting Washington transportation financing structure is a promising approach.

Figure 1. Debt service obligations for bonds secured by the state gas tax, as of February 2019



1.3 Background: The State of Washington's constitutional debt limit

Issue: can RUC revenue be pledged to repay highway-related bonds without impacting other state capital projects?

A second issue related to the ability of RUC to replace the gas tax as the predominant source of highway funding is the extent to which RUC revenues can be pledged for the repayment of *future* highway-related bonds, much in the way Washington's gas tax is bonded against today. There are both legal and practical considerations to this question.

Legal considerations

From a legal standpoint, there are no restrictions or prohibitions on the ability of government to pledge a road usage charge as a source of security and repayment for state-issued bonds. However, when potential RUC-backed revenue bonds are compared against typical highway-related bonds that pledge gas tax revenue for repayment, important legal differences emerge.

The Washington state Constitution[5] places a number of limits on the issuance of state debt. For example, the Constitution limits state debt to a repayment term that is not to exceed 30 years[6]; requires a supermajority vote of the legislature to authorize the issuance of debt[7]; and contains other provisions relating to sale procedures and refinancing of the debt. In addition, the Constitution limits the aggregate maximum annual debt service on state debt that can be incurred to a six-year rolling average that cannot currently exceed 8.25% of general state revenues[8]. This section of the state Constitution also contains details about specific types of revenues and debt that are exempt from the debt limit. Among the exclusions are debt obligations payable from:

> "... (1) Fees collected by the state as license fees for motor vehicles; (2) *Excise taxes collected by the state on the sale, distribution or use of motor vehicle fuel*; and (3) Interest on the permanent common school fund;"[9].

[5] There are statutory provisions that also regulate the state's borrowing. RCW 39.42.070.
[6] Const. art. VIII, Section 1(a) limits state-issued debt to 30 years. There does not appear to be any term limits on the repayment of county or municipal debt.
[7] Const. art. VIII, Sec. 1(i).
[8] Const. art. VIII, Section 1 (b), and RCW 39.42.070.
[9] Const. art. VIII, Section 1 (g).

This provision effectively allows the state to issue highway-related bonds secured by a gas tax pledge, and as a secondary source of repayment, general state revenues[10], without having these bonds count against the constitutional 8.25% state debt limit.

There are at least two benefits to bonds that are backed by both gas tax revenue and general state revenues. First, as "double-barrel" bonds, the bonds can be sold to investors on more favorable terms for the state, typically in the form of lower interest rates paid to bondholders. Second, because bonds that pledge the gas tax are not subject to the state's constitutional debt limit, the state can proceed with highway-related construction programs without being constrained by the debt limit, and importantly, without displacing (or squeezing out) other important capital construction projects that must be funded within the limit.

In contrast, unless RUC is structured to qualify as one of the revenue sources not subject to the debt limit, the state's full faith and credit cannot be added without the bonds being counted against the debt limit[11]. Given the frequent concerns about the ability of the state to meet its capital construction and preservation needs even without including transportation-related debt, it seems unlikely that policymakers will be willing to displace other general government capital projects in order to enhance RUC bonds with a pledge of the state's full faith and credit.

Practical considerations

Beyond the legal considerations, bonds that pledge only RUC revenues as the source of repayment could face challenges in the bond market, certainly in the near-term. First, as a new revenue source, there is no established history of revenue collection that can be examined in Washington or anywhere else in the United States to develop an investment-grade[12] revenue forecast for RUC. As is the case with other bonds that

[10] To be precise, the Constitution allows the state to pledge its full faith, credit and taxing power to guarantee the repayment of any obligation payable from these three sources – vehicle license fees, motor vehicle fuel taxes, and the common school fund. As applied, this means the state would be required to supplement gas tax revenue with general state revenues if the former is insufficient to make scheduled debt payments.

[11] Another alternative is to amend the Washington Constitution to add RUC as a fourth type of revenue exempt from the debt limit.

[12] Most bonds sold in the market undergo an assessment by private companies (rating agencies) to assess the quality (i.e., relative risk to investors) of the proposed bonds. The three most prominent rating agencies are Moody's, Standard and Poor, and Fitch. Collectively, these three agencies are estimated to rate 95% of all issuances.

propose new and unproven revenue sources, absent an additional pledged source of revenue (such as the state's unconditional promise to pay from general tax revenues), credit ratings on RUC revenue bonds will be judged a riskier investment.

Second, at least in the near term, there are questions about how robust a revenue source RUC will be for borrowing purposes. If RUC fully replaces the gas tax, owners of approximately seven million vehicles will be required to report their vehicle mileage and pay RUC. The expected number of non-compliant drivers is presently unknown, and difficult to forecast until a live operational tax collection system is implemented or at least tested on a broad scale. Until RUC has been operational for several years, bonds pledging only RUC revenue will be viewed as a riskier investment when compared to other tax-exempt municipal bonds backed by more traditional revenue sources. The rating agencies can be expected to grade any proposed RUC revenue bonds according to this risk. Until RUC revenues have an established history of revenue collection – including a track record for compliance, evasion and administrative costs – they are unlikely to earn a credit rating that would be acceptable to municipal bond buyers.

The one approach that could overcome these early-year challenges to bonding against RUC revenue would be to design and implement RUC as a mileage-based vehicle license fee, as contemplated by the Connecting Washington bond authorization. A second (but much more costly) approach would be to issue stand-alone RUC revenue bonds. If structured properly, these RUC revenue bonds won't count against the debt limit.

The following section examines these two alternatives in more detail.

2 OPTIONS FOR TRANSITIONING AWAY FROM THE GAS TAX TO RUC WHILE MEETING THE STATE'S FUTURE BORROWING NEEDS

For both legal and practical reasons, there does not appear to be any feasible way to send the current MVFT bonds into an early retirement by replacing those bonds with new RUC bonds or by making debt service payments using RUC revenue and while simultaneously eliminating the gas tax (see discussion in Appendix A for more detail). Thus, the two primary options highlighted in this section assume that all outstanding bonds that have pledged the gas tax *will be repaid according to their original terms, conditions and schedule*[13].

Can the gas tax ever be phased out?

Important wording is contained in Art. VIII, section 1(g), as it illuminates a possible pathway forward on how the state might be able to transition, over a longer period of time, to reduce gas tax revenues (the important text is italicized and underscored below for emphasis). The state may

> "…pledge its full faith, credit, and taxing power to guarantee the payment of any obligation payable from revenues received from any of the following sources: (1) Fees collected by the state as license fees for motor vehicles; (2) Excise taxes collected by the state on the sale, distribution or use of motor vehicle fuel; and (3) Interest on the permanent common school fund: *Provided*, *that the legislature shall, at all times, provide <u>sufficient revenues</u> from <u>such sources</u> to <u>pay the principal and interest due</u> on all obligations for which said source of revenue is pledged.*"

[13] An exception would be if the OST decides to refinance eligible issuances for reasons wholly unrelated to RUC. Typically, outstanding bond issuances are refinanced only when there is a clear financial advantaged to be gained by the state.

The Constitution does *not* require the state to impose the gas tax in perpetuity, nor does it require the state to impose that tax beyond what is needed to repay the bonds that are secured by the gas tax. Rather, the Constitution requires that the legislature at all times (a) provide *sufficient* revenue, (b) from "*such sources*" (i.e., from the pledged revenue source, the gas tax), (c) *to pay the principal and interest due* on the MVFT bonds.

Can RUC be bonded outside the state debt limit, similar to the gas tax?

The state Constitution lists specifics types of revenue that can be leveraged outside of the constitutional debt limit. The types relevant for this report[14] that are considered outside of the debt limit are: fees collected by the state as license fees for motor vehicles[15]; excise taxes collected by the state on the sale, distribution or use of motor vehicle fuel (i.e., the gas tax)[16]; and fees from the ownership or operation of any undertaking, facility, or project[17].

A sustainable transportation fiscal policy model for the future could be crafted around: (a) reductions in collection of gas tax revenue as MVFT-bond debt service requirements lessen; (b) expansion of RUC collections commensurate with the eventual tapering off of gas tax collections; and (c) paying for future highway-related bonds by leveraging *multiple revenue sources* that are constitutionally dedicated to highway purposes and exempt from the constitutional debt limit. Considerations include:

- **Impact on other projects or programs**: can the revenue be bonded in a way that does not adversely impact other important public projects or programs, in light of the state's constitutional debt limit?
- **Sufficiency**: will the revenue be legally sufficient, (that is, generating enough net revenue to ensure repayment of principal and interest in due course), but also practically sufficient – able to generate enough construction funding to fulfill legislative goals?

[14] Other types of revenue that are not relevant for this inquiry are gifts, grants, aid, donations, etc. from the federal government or private sources; retirement system funds; performance bonds; proceeds from the common school fund; and proceeds from the sale of bonds themselves. See Washington Const. Art. VIII, Sec. 1(c).
[15] Washington Const. Art. VIII, Sec. 1(g)(1).
[16] Washington Const. Art. VIII, Sec. 1(g)(2).
[17] Washington Const. Art. VIII, Sec. 1(c).

- **Cost effectiveness**: will the costs associated with leveraging the revenue be acceptable relative to the total amount of funding that would be generated?

The two most feasible approaches are described below and analyzed with these considerations in mind.

2.1 RUC implemented as a vehicle license fee (VLF)

As noted above, bonds secured by a pledge of license fees on motor vehicles (VLF) are exempt from the state's debt limit. A road usage charge could be designed, implemented and administered in the form of a mileage-based license fee, either replacing or supplementing the current flat-rate annual license fee collected for all vehicles registered in the state. Specific design requirements to implement RUC as a VLF will be explored and discussed at either the June or September meeting if the Steering Committee finds this approach worthy of more detailed analysis. This approach was originally identified by the OST in their 2014 analysis. Other states considering per-mile fees are investigating or testing mileage-based registration fees[18].

To legally qualify as a fee (rather than a more generally applied tax), it is important that RUC be designed and implemented so that the fee (or charge) is collected strictly for the upkeep, maintenance and operation of the state's highway facilities. If the highway system in the state is more precisely defined and classified as a public "facility," a fee imposed in an amount reasonably calibrated to pay for the ongoing cost of operating and maintaining that facility can be legally characterized as a "facility fee" or charge. Classifying (or recognizing) roadway networks as public facilities (or utilities) has been suggested by others[19], and implemented at the municipal level (although city "street utility fees" were subsequently repealed due to other legal defects related to how the fees were calculated and imposed)[20].

[18] Wisconsin was the first state to research and outline this approach in 2012. See Wisconsin Transportation Finance and Policy Commission report, *Keep Wisconsin Moving*, at pages 106-108. More recently, Missouri explored this option as part of their federal Surface Transportation System Funding Alternatives (STSFA) grant.

[19] C.f., *Taxes vs. Fees: A Curious Confusion*, Hugh D. Spitzer, Gonzaga L. Rev Vol. 38:2, 335.; *Rethinking California's Highways as Public Utilities*, Robert Poole, The Press-Enterprise, July 28, 2018.

[20] In *Covell v. City of Seattle*, 127 Wn.2d 874 (1995), the Washington Supreme Court struck down the City of Seattle's street utility fee because the fee was imposed as a de facto property tax, and as such required to be apportioned based on value. Other cities that had imposed a street utility fee in the same manner repealed their fees rather than face potential legal challenges.

If implemented as a VLF, RUC revenue (and bonds leveraged) would not count against the state debt limit. As a result, there should be no impact to other state capital projects or programs that would be competing for funding under the debt limit. Legislative bond authorizations to finance the Connecting Washington transportation projects adopt a very similar approach. Once issued, the bonds will be secured by both the gas tax and vehicle fees – both sources exempt from the state debt limit – and contain a secondary pledge of the state's full faith and credit.

To pass the legal sufficiency test, in the early years while RUC is a relatively new and unproven source of revenue, other revenue sources that also provide the constitutional exemption – other types of vehicle fees and the gas tax – would need to be retained in sufficient amounts to ensure repayment of principle and interest on these bonds. However, over the longer-term RUC could be expanded to collect mileage-based license fees from a broader classification of vehicles. As RUC revenue increases, the reliance on the gas tax and other fees can be diminished as RUC proves capable of generating sufficient revenue to make debt service payments on these new "triple-pledged" bonds. If the legislature decides to implement RUC on only a very small classification of vehicles to start (say, for example, only certain types of plug-in electric vehicles), the revenue to be generated would be very modest, perhaps no more than $3-$5 million per year in the short run[21]. By itself, this amount is far too small to support (and justify) the issuance of bonds. However, if RUC is included as one of a handful of revenue sources pledged to repay bonds (similar to the Connecting Washing bond authorization), the lack of robust RUC revenue in the early years will be less of a concern. As RUC grows to apply to a larger number of vehicles, the revenue generated will grow significantly, and may eventually become the primary source of repayment for these triple-pledged bonds.

If RUC is structured and implemented as a VLF, the state's full faith, credit and taxing power can be pledged as well, which will provide much better borrowing terms for the state than if the bonds were issued as stand-alone revenue bonds (discussed as the second alternative, in 2.2 below).

[21] The amount of revenue collected would also be greatly affected by the per-mile rate that is set.

This basic structure that pledges multiple sources of constitutionally protected revenues, with a pledge of the state's full faith and credit, is how OST and the legislature intend to issue bonds to fund the Connecting Washington program that calls for extensive transportation project investments.

***Conclusion**: RUC can be structured and administered as a vehicle license fee, which would allow bonds secured by such revenues to remain outside of the state debt limit, as has been assumed in forthcoming issuances of Connecting Washington bonds. Since bonding with a new type of fee can present challenges in the bond market, the marketability of the bonds is greatly enhanced by pledging other Amendment 18 restricted revenue (gas tax, other vehicle license fees) as well as a pledge of the state's full faith and credit.*

2.2 RUC revenue bonds

The second alternative that would allow RUC-pledged bonds to be issued outside of the debt limit is to impose RUC as a "fee or revenue derived from the ownership or operation of any undertaking, facility or project." The Constitution exempts such fees or revenue from debt limit calculations[22]. In this scenario, RUC bonds would be considered stand-alone revenue bonds, where the sole source of repayment is from revenue generated by operation of the project or facility (here, operation of the highway system in the state).

While RUC revenue bonds could be exempt from the debt limit, in their 2014 analysis, OST pointed out some of the market challenges that face governments when issuing straight revenue bonds. In short, due to their limited revenue stream and lack of collection history, these bonds will carry higher borrowing costs[23]. .

***Conclusion**: RUC can be structured and imposed as a facility fee, where the state highway system is defined and operated as a public facility. Bonds secured by revenues derived from these fees would not be subject to the state debt limit; however, these*

[22] Art. VIII, Section 1 (c)
[23] See *Fiscal Implications of a Potential Transition to Road Usage Charges: Preliminary Analysis*, Office of the State Treasurer, September 25, 2014, at slide 12.

RUC revenue bonds will be more costly to issue and carry other requirements, such as mandatory reserve funds, that will constrain the total bond proceeds available.

3 POSSIBLE PATHWAY FORWARD

As MVFT bond issuances are eventually paid off with the gas tax, the amount of gas tax revenue required to satisfy the constitutional test that "sufficient revenue" be maintained to repay principle and interest on outstanding bonds will similarly decline (see chart on page 11 that shows MVFT debt service requirements tapering off over time). This would allow the legislature to legally reduce the gas tax rate, so long as the state does not incur any new debt obligations that would require increases or extensions of the gas tax[24]. To backfill for the diminished gas tax revenue, RUC revenues could be proportionately increased by expanding the class of vehicles that would then pay RUC instead of the gas tax.

While this option does not offer any opportunity to reduce or eliminate the gas tax in the short term, lower gas tax collections might be legally permissible in the future, when the first tranche of MVFT bonds that pledged a five-cent gas tax increment begin to be repaid[25].

To ensure that RUC can grow to become a viable source of financing for future state-issued bonds, RUC could be implemented as a Vehicle License Fee, where the amount of the fee is based on miles traveled. Public highways in the state should be designated (or at least treated) as a type of public facility or utility and managed so that usage fees are reasonably calculated to cover the cost of operations, maintenance and upkeep of the system.

For the state's more immediate borrowing needs, RUC could be pledged for the repayment of highway-related bonds, along with the gas tax and other vehicle license fees, backed with a pledge of the state's full faith and credit, as envisioned by the Connecting Washington authorization. This will allow the state to borrow outside of the constraints of the debt limit, and at favorable interest rates, similar to the state's existing

[24] In addition to the 2015 Connecting Washington bond authorization, there is $1.6 billion in authorized but unissued Transportation Partnership Account bonds, and approximately $200 million remaining in Nickel Package bonds.
[25] The "nickel package" was essentially a five-cent increase in the state gas tax, enacted in 2003. Gas tax revenue attributable to this increase was dedicated for the repayment of a specific list of transportation capital construction projects financed with a special issuance of MVFT bonds ("nickel bonds"). The largest number of "nickel package" bonds are currently scheduled for retirement in approximately 2030. In passing the five-cent increase, the legislature mandated that this 5-cent gas tax increase be repealed "when bonds for transportation 2003 projects are retired". See RCW 82.38.030 (3).

MVFT bonds. Over time, as RUC matures and more vehicles are subject to paying RUC, the source of repayment on these new “triple pledge” bonds can be adjusted so that RUC grows into the primary source of repayment, allowing the state to transition away from reliance on the gas tax.

APPENDIX A

A.1 Options previously considered (and rejected)

A.1.1 Keep in place already-issued MVFT bonds but use RUC revenue to make debt service payments?

Theoretically, the State might be able to use RUC revenue to make scheduled debt service payments on outstanding MVFT bonds[26]. However, since the Constitution (and the bond covenants) require that the gas tax remain in place in sufficient amounts to make these same payments, there's no important reason to attempt such a revenue swap if the gas tax must remain in place anyway. Additionally, this option is probably not viable after considering the costs, complications and exposure to law suits that might ensue.

Conclusion: *making scheduled debt service payments on outstanding MVFT bonds with RUC revenue instead of gas tax revenue is financially and procedurally impractical; and if state gas tax revenues are significantly reduced by the legislature, bondholders might still take legal action.*

A.1.2 Refinance all outstanding MVFT bonds by reissuing the debt with RUC revenue bonds?

One approach suggested by the WA RUC Steering Committee was to pay off the outstanding MVFT bonds by issuing a new bond series that instead pledges only RUC revenue. This was found unfeasible because the transaction costs and expected higher interest rates on the bonds would be prohibitively expensive for the State of Washington. Furthermore, a significant percentage of the bonds would have to be issued as taxable bonds, rather than as tax-exempt, further driving up costs and the likelihood of legal challenge from bondholders. Other insurmountable problems include

[26] Although early analysis leaned toward declaring this a legal impossibility, upon further review (and careful rewording of the issue) it was acknowledged that such a scheme might be possible, as a similar situation exists with respect to financing the Tacoma Narrows Bridge. However, the complications involved in such an ex post facto scheme, combined with the fact that this scheme would not result in the ability of the legislature to repeal the gas tax, makes this option impractical.

the expected low marketability of bonds where the source of repayment (RUC) is still unproven, and complications relating to the constitutional debt limit.

***Conclusion**: financially infeasible (and procedurally challenging if not legally impossible).*

A.2 Other options not analyzed in detail

A.2.1 Accelerated repayment of outstanding MVFT bonds?

Not analyzed as a separate option is early retirement of MVFT bonds – basically accelerated repayment – in order to speed up a transition to RUC. This strategy could be applied regardless whether the gas tax tapers down or whether RUC collections increase. The most significant (and obvious) constraint: this strategy assumes that "extra money" is available to spend on paying off bonds earlier than scheduled. While a gradual implementation of RUC may indeed net the state additional revenue, the amount is expected to be modest in the start-up phase, growing as either the legislature expands the classification of vehicles that would be subject to paying RUC, or alternatively, through natural attrition and replacement of the state's vehicle fleet over time as vehicle manufacturers continue to switch powertrains and fuel sources to hybrid and plug-in electric technologies. Either way, there would not appear to be sufficient "extra money" from either RUC in the early years, or from any other obvious source, to comfortably allow the legislature to accelerate repayment for early retirement of MVFT bonds.

A.3 Other strategies for future transportation borrowing and cash management

A.3.1 Phase in RUC over time as MVFT bonds are paid off and the gas tax is phased out, but limit RUC to "pay-as-you-go" financing, relying on other sources to leverage new highway construction bonds.

This transportation funding strategy would rely on RUC as the primary source for all state highway related funding, except for periodic large capital improvement programs that require debt financing (and thus, long-term debt service payments). This represents a bit of a transportation funding paradigm shift, as ongoing expenses of planning, operating, repairing and maintaining the state highway system would be funded from RUC on a cash (or pay-as-you-go, or "PAYGO") basis; and state highway capital improvement programs would be funded through discreet tax or fee levies that tightly control the allowable expenditures and limit the duration of the levy.

In 2018, debt service on outstanding MVFT bonds was approximately $680 million. However, estimated gas tax revenue collections for that same year were approximately $1.7 billion. Even with one of the highest transportation debt portfolios in the nation, Washington's annual debt service requirements still did not occupy the majority share of the gas tax (debt service was about 40% of 2018 gas tax revenue[27]).. The remaining 60% of gas tax revenue is allocated on a cash basis to numerous other highway-related projects and programs throughout the state – including direct distributions to city and county government for their roadway needs. If RUC is eventually capable of generating enough revenue to backfill these PAYGO projects, programs and distributions, it's possible for the gas tax to be reduced proportionately. Using this simplistic example from 2018, RUC would need to generate about $1.02 billion annually, while the gas tax would need to generate about $680 million to meet the requirement for sufficient revenue to pay principle and interest due on outstanding MVFT bonds. Extending this example further, this would mean, in theory, the gas tax could be reduced to 29.6 cents per gallon instead of the current 49.4 cents. As MVFT bonds are paid off in the mid and longer term, the gas tax could continue to decline until phased out completely.

Relying on RUC as a PAYGO funding mechanism could happen gradually, over time, as the revenue source becomes more robust and predictable. In this option, since RUC is not designed to be leveraged, any concerns about its impact on the debt limit and other state capital programs disappears. Also, since there would be no near-term need to generate sufficient revenues to support bond issuances, there is no pressure to accelerate the transition to RUC in order to be able to sell new highway construction bonds. Cost effectiveness of RUC-backed bonds are also a moot issue.

[27] 2019 Debt Affordability Study, Office of the State Treasurer. Last accessed February 27, 2019 at https://tre.wa.gov/wp-content/uploads/2019-Debt-Affordability-Study.pdf

The remaining issue, then, is when debt-financed highway construction projects are necessary, what revenue source would be pledged to repay the debt, if not RUC?

A.3.2 Special gas tax levy to support major highway construction initiatives

The notion of using the state gas tax as a “new” source to support highway construction bonds takes some nuanced explanation. Historically in Washington, gas taxes have been imposed and increased to fund all sorts of highway-related projects and programs – not just to pay for large debt-financed capital construction initiatives. As the state began to experience rapid population and economic growth in the 1990’s (and continuing through 2018), the travel demand, wear and tear on the state highway and ferry system has outpaced available revenues. To help catch up on the backlog of needed highway construction projects, the state has increasingly resorted to debt financing, primarily funded with periodic increases in the state gas tax. However, even when large, debt-financed transportation investments have been made, the revenue resulting from the concurrent increases in the gas tax has generated funds in excess of what is required simply for debt service on the highway construction bonds. The revenue is sometimes used for related pre-construction activities (such as right of way acquisition), but also used to fund other pressing needs that do not necessarily require large, immediate infusions of cash that must be generated through bond sales.

In the future, if RUC evolves to become a predominant funding source for the basic operation, maintenance and preservation of the highway system (or “facility”), when major highway improvement projects are required, the projects could be grouped together and funded with a special gas tax levy that would be strictly dedicated to the delivery of those specific projects, and financed from a new series of highway construction bonds that pledge the revenues from the special gas tax levy. Meanwhile, RUC would continue to serve as a PAYGO source of funding for the majority of highway-related spending (including cash distributions to cities and counties). If this special gas tax levy was strictly limited to these purposes and set to expire upon repayment of the bonds, there may be greater public acceptance for the tax. This approach would most closely resemble how many local governments or special purpose districts fund their maintenance, operations and capital improvements: base-level taxes or fees provide ongoing funding for maintenance and operations; and a more limitedscope capital improvement levy to fund one-time (but high cost) construction projects, with the levy expiring upon repayment of the capital bonds.

In Washington, the nearest analog in recent state transportation budgets might be the 2003 “Nickel” package, which raised the state gas tax by 5 cents; bonded that revenue to pay for a discreet list of projects that were specifically identified in the bond authorization; and required that the 5 cent gas tax increase expire once that specific bond issuance is paid off.

Conclusion*: RUC could someday evolve to provide enough funding to pay for all cash-basis highway-related projects and programs, while high-cost highway construction projects that require bond proceeds could be financed with a limited duration gas tax levy. This approach is similar to how many municipalities and special purpose districts fund their operations, maintenance and capital improvements, and may be found more acceptable to the public.*