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State of Washington
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December 15, 2014

Re: Fiscal Implications of a Potential Transition to Road Usage Charges

Executive Summary
In its 2013-15 transportation budget, the Legislature directed the Office of the State Treasurer to:

> *"…explore the fiscal implications with respect to outstanding motor vehicle fuel transportation bonds and to future transportation bond sales, relating to any reduction, refunding, crediting, or repeal of the motor vehicle fuel tax, in whole or in part, that may occur in a transition to a potential road usage charge by which transportation activities may be funded in the future. The exploration of fiscal implications must examine possible effects on the state credit rating, interest rates, and other factors that affect the cost of financing transportation projects..."*

A number of factors must be taken into account when exploring how to introduce and use a new, fee-based revenue stream such as a road usage charge – including the nature and size of the state's debt portfolio, the legal underpinnings of the state's use of debt financing to pay for transportation projects and the characteristics of the projected new revenue stream.

- Washington has used debt finance to pay for transportation projects at least since 1990. The reliance on bond proceeds increased substantially with fuel tax increases in 2003 and 2005. In keeping with Article II, Sec. 40 of the constitution, proceeds of Motor Vehicle Fuel Tax general obligation bonds (MVFT-GO) are used only for highway purposes.

- A special provision in the state constitution exempts MVFT-GO bonds from the constitutional debt limit that otherwise pertains to general obligation bonds issued for the state's capital budget – so long as there is enough MVFT revenue to cover the debt service.

- There are currently $7.1 billion MVFT-GO bonds outstanding with the longest maturities extending more than 25 years.

The Office of the State Treasurer has begun to explore the implications of a potential transition from MVFT revenues to road usage charges for funding transportation activities. Our preliminary findings include:

1. It will not be possible to significantly reduce MVFT revenues until all of the obligations on MVFT GO bonds have been met.
    - Outstanding MVFT GO bonds can only be repaid with MVFT revenues.

- Repealing the gas tax would be an unconstitutional impairment of the state's bond contract with owners of outstanding MVFT-GO bonds and violate the legislative commitment to provide MVFT revenues at all times to pay the debt service on those bonds.

- Refunding gas taxes to drivers who use the highway system may violate Article II, Section 40 which provides that gas taxes "must be used exclusively for highway purposes."

- Significant reductions or refunds of MVFT revenues could be seen by the market as a threat to the state's ability to consistently pay debt service on outstanding MVFT GO bonds, and thereby potentially imposing additional demands on the state's general fund. Unless successfully mitigated, these factors could negatively impact the state's credit ratings and consequently increase borrowing costs across the board.

2. It may be possible to leverage road usage charges for funding transportation projects at the state's lowest borrowing costs within the current constitutional framework.

    - If the road usage charges can be structured as motor vehicle license fees, the state could authorize a new series of bonds pledging *both* road usage charges and MVFT revenues, with an overall pledge of the state's full faith and credit, outside the state's debt limit. The state's capacity to issue transportation bonds would increase to the extent that new road usage charges exceed any declines in MVFT revenues.

    - This transition envisions using MVFT revenues to repay outstanding MVFT-GO bonds maintaining MVFT revenues to pay existing obligations and to support new bonds backed by both revenue streams.

3. Under current law, road usage charges which are not structured as motor vehicle license fees, could be leveraged – outside of the debt limit – only in the form of revenue bonds.

    - Revenue bonds, particularly those leveraging a new untested revenue stream, typically have higher borrowing costs, higher coverage requirements and credit enhancements.

I. How Does the Motor Vehicle Fuel Tax and the General Obligation Pledge Work?

Under Article VIII, Section 1(g) of the state constitution, 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 sufficient revenues from such sources to pay the principal and interest due on all obligations for which said source of revenue is pledged."* In this context, these bonds are not subject to the constitutional debt limit.

As a result, when MVFT-GO bonds are issued it is expected that MVFT revenue will at least equal the debt service over the life of the bonds. If the state's share of MVFT revenues were ever to prove insufficient to pay debt service on MVFT GO bonds, the payment of debt service on those bonds would take precedence over other uses of MVFT revenues, potentially interrupting distributions of MVFT revenues to counties, cities and towns or cutting spending elsewhere in the transportation budget.

Mindful of these constitutional provisions, the Legislature has adopted bond authorizations for MVFT-GO bonds that include a statutory commitment to continue to impose those excise taxes on motor vehicle and special fuels in amounts sufficient to pay, when due, the principal of and interest on all bonds issued under the authority of such legislation.

Similarly, the State Finance Committee's MVFT-GO authorizing resolutions also reflect this pledge. For example, Resolution 1149 from November 25, 2013 states in Section 6(b) that "the Legislature has agreed to continue to impose those excise taxes on motor vehicle and special fuels in amounts sufficient to pay, when due, the principal and interest on all bonds issued under the authority of the Bond Act."

All of these provisions have been disclosed in offering documents – which incorporates them directly into the contractual obligation made by the state to investors who have purchased the bonds.

- Repealing the gas tax would be an unconstitutional impairment of the state's bond contract with owners of outstanding MVFT-GO bonds. It would violate Article VIII, Section 1(g) of the constitution which conditions the state's ability to issue MVFT-GO bonds outside of the debt limit on the requirement that the legislature will provide revenues from such sources to pay debt service.

- MVFT revenues must be maintained at levels sufficient to meet all obligations over the life of the bonds.

- Refunding gas taxes to drivers who use the highway system may violate Article II, Section 40 which provides that gas taxes "must be used exclusively for highway purposes."

- Significant reductions or refunds of MVFT revenues could be seen by the market as a threat to the state's ability to consistently pay debt service on outstanding MVFT GO bonds, and thereby potentially imposing additional demands on the state's general fund. Unless successfully mitigated, these factors could negatively impact the state's credit ratings and consequently increase borrowing costs across the board.

Could MVFT obligations be terminated by refunding the portfolio of MVFT-GO bonds?

Technically, yes. But refunding the entire $7.1 billion portfolio would be costly, increasing principal and interest payments due on the portfolio. In addition, because of restrictions in the tax code, refunding all of the bonds would require the issuance of a significant amount of taxable refunding bonds. (Refunding bonds that have been previously refunded would represent a second advance refunding of outstanding tax-exempt bonds. This is prohibited under IRS tax code.)

Could the debt service obligations on MVFT-GO bonds be paid with other revenues, such as road usage charges?

No. Outstanding MVFT GO bonds can only be repaid with MVFT revenues, or technically, there must be sufficient MVFT revenues to cover total debt service payments. The state's contracts with bond holders do not allow the state to redefine the security pledge once the bonds have been issued.

II. Leveraging Road Usage Charges for Transportation Projects within the Constitutional Framework.

Our preliminary review of constitutional, statutory and contractual constraints suggests at least two ways in which the state could leverage road usage charges to fund transportation projects. The first requires structuring road usage charges as motor vehicle license fees. The second is revenue bonds, an approach with fewer constraints, but higher borrowing costs.

A. **Road Usage Charges** as Motor Vehicle License Fees

Under the state constitution, both motor vehicle license fees and motor vehicle fuel taxes can be treated as "revenues" for the payment of bonds to which the state's full faith, credit and taxing power may be pledged notwithstanding the state debt limit. Article VIII, Section 1(g) says that "…the state may pledge its full faith, credit, and taxing power to guarantee the payment of any obligation payable from revenues received from three different types of revenue sources: *license fees for motor vehicles*, excise taxes on motor vehicle fuel and interest on the permanent common school fund."

The state could authorize a new series of bonds pledging *both* motor vehicle license fees and MVFT revenues, with an overall pledge of the state's full faith and credit, outside the state's debt limit. The legislature would be required at all times to increase road usage fees and/or gas taxes to provide sufficient revenues to meet the debt service requirements on bonds to which those revenues are pledged. If road usage charges can be structured as a form of motor vehicle license fee, road usage charges could be a part of the licenses fees pledged jointly with MVFT revenues. The bonds would be outside of the constitutional debt limit and borrowing costs would be at the state's low general obligation rate. Bond capacity would increase to the extent that the pledged license fees exceed any reductions in MVFT revenues. (It may be necessary to structure the MVFT pledge on these bonds on a subordinate basis to the MVFT pledge on MVFT-GO bonds.)

Although a one-time refunding of the MVFT-GO portfolio is not feasible, the state could transition to these new bonds slowly by issuing these new bonds as MVFT-GO bond issuance is discontinued or tapers off. This is a long-term transition approach because final MVFT GO maturities extend through 2043.

Alternatively, a new bond act could authorize general obligation bonds secured first by motor vehicle license fees without a secondary pledge of motor vehicle fuel taxes. The financial feasibility of this approach depends on whether the new motor vehicle license fee revenue stream would be seen as sufficient to produce revenues necessary to meet the debt service requirements of bonds having that structure. In the early years, in particular, it may be very difficult to project the magnitude of these revenues. These bonds would be structured in the same manner as MVFT bonds, except that "license fees for motor vehicles" would replace "excise taxes on motor vehicle and special fuels". They would, of course, have the additional security provided by a pledge of the full faith, credit and taxing power of the state. Similar to MVFT GO bonds, capacity would be limited by projected and actual motor vehicle license fees.

Several factors must be considered when structuring road usage charges as motor vehicle license fees if the intent is to use this revenue stream to pay debt service on bonds backed by the state's general obligation pledge.

- *Motor Vehicle License Fees <u>not</u> Taxes* – From a constitutional perspective, it is important that any new license fees based on miles traveled be properly characterized as "fees" reasonably related to the costs and burdens imposed on state highways resulting from use of the highways by motor vehicles; the impositions should not be characterized as or understood to be "taxes."

- *New Fees Subject to Article II, Sec. 40* (18th Amendment) – Legal analysis indicates that to borrow against the new fee in this way outside the debt limit, restrictions on the use of the revenue from a new vehicle miles traveled fee would need to be consistent with uses of the motor vehicle fuel tax. Under the constitution, a new fee would need to reflect the benefits accruing to the users of the state highway system and the burdens on the state highway system produced by users of the state highway system.

- The state currently imposes a number of different types of motor vehicle license fees, including filing and service fees, certificate of title fees, license plate fees, vehicle license fees, vehicle weight fees, and permit and transfer fees. Some of these fees might be economically significant for bond financing purposes. Others might better be reserved for application to motor vehicle license fee program expenses. Any plans to leverage motor vehicle license fees intended to support highway bond debt service requirements would focus upon those license fees that produce substantial revenues for the state.

B. Revenue Bonds

Alternatively, the state could issue revenue bonds backed by road usage charges. This alternative should be considered if it is not desirable or feasible to structure road usage charges as license fees. Revenue bonds are not subject to the debt limit. However, issuance is often limited by a coverage ratio specifying the relationship between projected revenues and annual debt service. In addition, revenue bonds typically have higher borrowing costs. This type of bond issuance would bear the highest cost and offer relatively low bonding capacity as the revenue stream would be untested and initially difficult to project.

- Coverage ratios required to meet single-A or double-A rating categories will limit bond capacity.

- Revenue bonds are often supported by debt service reserve funds or other types of credit enhancement.

- Borrowing costs can be expected to exceed that of general obligation debt. The differential will depend on the security structure and the rating.

C. Other Alternatives

It is also possible to structure "triple pledge" bonds, or general obligation bonds first payable from road usage charges, next payable from motor vehicle fuel taxes, and finally payable from general state revenues pursuant to a pledge of the full faith, credit and taxing power of the state. These bonds would be outside of the debt limit and would benefit from the state's lower general obligation borrowing costs. However, the structure would not create new bond capacity as overall issuance would be constrained by the magnitude of current and projected MVFT revenues.

Exhibit A

The chart below shows debt service (principal and interest payments) on the State's Motor Vehicle Fuel Tax General Obligation bonds outstanding as of October 7, 2014. This represents the period of time over which the State will be required to collect motor vehicle fuel taxes to repay outstanding obligations and the magnitude of those debt service obligations.

The chart addresses the potential for shortening the term structure of the MVFT GO portfolio In this exercise we assume that bonds are refunded or called at the current call date which is typically ten years from the initial issuance date. As has been noted, some bonds are not refundable. The chart distinguishes between debt service on bonds that are callable or refundable and debt service on those on which principal and interest payments are fixed through the final maturity.

The aggregate values in each fiscal year show the debt service that must be paid if no bonds are refunded. For example, if no bonds are refunded with other resources, debt service exceeds $600 million per fiscal year through 2022 and then declines through the final maturity of 2043. If bonds are refunded with other revenues on their respective call dates, the term structure of the portfolio is shortened to the dark green and navy areas. However, the final maturity extends to 2041.