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To: Commissioners, Commission on State Debt

Date: November 1, 2011

Re: Proposed Recommendations to Commission on State Debt

Background: The Commission on State Debt began its deliberations on September 9, 2011. The Commission has received intensive briefings from staff, consultants, and constituent groups. Although the State has approximately $17 billion in debt outstanding, there is currently no consensus on "how much is too much." Some Commission members consider the debt program, and the resulting construction on State infrastructure, as an important stimulus and employment tool. Because debt service payments on the State's debt affects the amount of dollars available for the operating budget, other members are concerned about these amounts crowding out other budgetary priorities and reducing financial flexibility. Debt service appropriations cannot be cut in response to revenue downturns.

A third view is that the acceleration in debt issuance over the past several years is a credit negative. Washington is considered a high debt state. Investors in the State's bonds remark that they have a limited appetite for the name. Going forward, the State may experience higher interest rates as the market tries to incent and entice investors by pricing bonds more cheaply (higher rates). This phenomenon does not happen overnight. It is more like the fabled frog in the pan of cool water gradually being heated to a boil. Think Greece.

The unprecedented economic and political environment we are currently experiencing colors this third view. Although conventional wisdom holds that municipalities rarely default, frequently we read news reports of Rhode Island embroiled in a pension shortfall, Harrisburg PA, proposing to declare bankruptcy, and closer to home, a public facilities district in Chelan County teetering on the verge of a bond default. The very public nature of the State's borrowing program with its involvement in transportation mega-projects suggests that it may become the target of a voter initiative.

The following recommendations are presented for discussion purposes with the express intent of moderating the pace of Washington State's debt issuance.

1. With respect to bonds secured by general state revenues (GSR): As shown on slide 28 of the October 6, 2011 presentation, for more than 16 years, debt service on GSR bonds was at or under 5% of the near General Fund. During the current biennium, the rate has jumped to 5.9% and is projected to go to 6%+ in the ensuing biennium. The rating agencies consider the 5% number to be a reasonable level considering infrastructure needs. As it rises above 5%, the question of financial flexibility in a downturn comes into relief. This proposal is to gradually and deliberately return to the 5% level. It will take legislative discipline and consensus, such as installing a 75% vote requirement on bond authorizations in either or both houses or a super-majority on the capital budget. A credible threat to use the item veto could also be employed.

2. With respect to bonds secured by the motor vehicle fuel tax (MVFT): Due to the number of transportation mega-projects underway, a flood of MVFT bonds is being issued. Half a billion dollars worth of MVFT bonds were delivered to investors on Halloween for the SR 520 bridge project. For decades, the par amount of MVFT bonds issued was completely manageable. Concern about a debt limitation for MVFT bonds was rarely expressed. However, a debt limit does exist—in Article VIII, Section 1(g) of the State Constitution: **"Provided that the Legislature shall, at all times, provide sufficient revenues from such sources to pay principal and interest due on all obligations for which said source of revenue is pledged."** Remember the Chelan County public facilities district mentioned above? A gas tax increase might be required on an emergent basis during this period of mega-projects. As electric/hybrid vehicles become more accepted by consumers, as federal automobile fuel standards are raised, and if the price of gasoline suppresses demand, each item is a marginal reduction in MVFT revenue available.

This proposal is to apply either a legal coverage ratio to net revenue after distributions (termed "adjusted gross fuel tax"), or a percentage limit on the proportion of MVFT revenue required for debt service. A legal coverage ratio is the amount of adjusted gross fuel tax divided by debt service. The proportion of MVFT revenue required for debt service is the inverse of the coverage computation. Note the change in coverage over the past 10 years. Coverage has declined by over half. The proportion of MVFT revenue required for debt service has more than doubled.

Fiscal Year 2000		**Fiscal Year 2011 Forecasted**	
Legal Coverage	5.95	Legal Coverage	2.84
Proportion	16.8%	Proportion	35.2%

Source: Office of the State Treasurer

An issuer is promising its investors through bond covenants that a debt service cushion will be maintained. <u>It is proposed that these covenants be authorized by statute and placed in the bond resolution(s)</u>. Washington's MVFT-GO financing is a well-known and strong credit so a prudent legal coverage ratio to be determined on adjusted gross fuel tax is proposed. Approaching this coverage level would generate a conversation between the Legislature and WSDOT about providing more revenue per Article VIII, Sec. 1(g) or modifications to size or timing of projects. Obviously, this proposal or alternatives to it need more deliberation than is available to the current Commission.

3. Continue the life of the State Commission on Debt. The State's debt program is not an area of business in which we need unintended consequences. The HJR 52 debt limit has worked well for 40 years. If there is a possibility that it is to be changed, a lot more than 3 months of intermittent meetings is required. The Commission needs a technical committee of experts from our legal community and a representative from the AG to review solutions. The Treasurer can float various proposals among investment banks, investors, and ratings agencies with which he deals to check market acceptance. This will minimize undue influence. The "non-expert" Commission membership should be reconfigured to include House and Senate leadership as well as Transportation Committee members.