

## New Mexico; Miscellaneous Tax

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# New Mexico; Miscellaneous Tax

## Credit Profile

US\$70.635 mil severance tax bonds ser 2012A due 07/01/2022

Long Term Rating

AA/Stable

New

## Rationale

Standard & Poor's Ratings Services assigned its 'AA' long-term rating, and stable outlook, to New Mexico's series 2012A severance tax bonds. At the same time, Standard & Poor's affirmed its 'AA' long-term and underlying ratings on the state's \$638.8 million parity senior severance tax bonds outstanding, and its 'AA-' rating on the state's \$102.0 million subordinate supplemental severance tax bonds outstanding. The outlook on these bonds is stable.

The ratings reflect what we view as New Mexico's:

- Strong 2.89x senior-lien maximum annual debt service (MADS) coverage by fiscal 2011 severance tax revenues, and 2.43x coverage of combined senior and junior-lien MADS;
- Good additional bonds test (ABT) requiring at least 2.00x debt service coverage (DSC) to issue additional senior-lien bonds, and 1.60x DSC to issue additional subordinate long-term supplemental bonds; and
- A declining debt service schedule and rapid debt amortization, with all principal to be retired by 2022.

Mitigating these credit strengths are:

- A large, in our opinion, 32% decline in severance tax receipts in fiscal 2010, and what we view as the inherent instability associated with natural gas and oil prices and production levels, which account for the bulk of pledged revenues; and
- The state's geographic limitations in serving natural gas markets.

We understand that the proceeds of the series 2012A bonds will be used to fund various state capital improvements.

A lien on money deposited into the severance tax bonding fund, including net tax receipts generated from natural gas and oil and other severed natural resources in New Mexico, secures the senior severance tax bonds. The supplemental severance tax bonds are secured by a second lien on pledged revenues, after payment of senior bond and note debt service.

New Mexico levies severance taxes on a variety of minerals. The primary severance tax revenue generators are natural gas (about 44% of the state's projected fiscal 2012 severance tax receipts), oil (51%), and coal (5%). Fiscal 2011 severance taxes alone produced 2.89x senior-lien MADS coverage. In addition, the state realized \$18.1 million of investment earnings in its bond fund in fiscal 2011. Using total pledged 2011 revenues as the state calculates coverage, including interest earnings and other financing sources, would bring senior-lien MADS coverage to 3.12x.

Fiscal 2010 pledged severance tax revenue declined 32% to \$350 million, primarily the result of lower natural gas production and prices. Severance tax revenue increased 4.7% in fiscal 2011. New "fracking" technology has increased domestic natural gas and oil production. However, New Mexico believes this has caused uneven effects between the two commodities. State oil prices align more closely with international oil prices, since oil is a more transportable commodity, while natural gas prices depend more on domestic supply and demand, in addition to

nearby competition from Texas production. The result is that oil prices have remained relatively stable despite increased state production, while natural gas prices have fallen as a result of the increased supply due to the new technology. This has resulted in increased oil severance tax receipts, which have helped offset declines in severance tax from natural gas. Currently, New Mexico projects stabilized and slowly increasing oil and gas prices in the next few years. Not including interest or other earnings, we calculate that the state's fiscal 2012 forecast of severance tax revenues alone will cover senior-lien MADS 3.16x and combined senior- and subordinate-lien MADS 2.66x.

DSC will also improve as debt is retired. Senior-lien annual debt service declines to \$82.4 million by fiscal 2018 from \$126.9 million in 2013, and entirely matures in fiscal year 2022. Subordinate-lien debt service also declines and also entirely matures in 2021. Additional parity debt would need additional state legislative authorization in next year's legislature. New Mexico has a history of selling a severance tax bond each year as part of its overall capital plan, although it did not sell one in fiscal 2011.

The historical ABT of 2x DSC for the senior severance tax bonds limits the state's ability to issue parity debt. This test and a "best efforts" pledge to maintain annual deposits equal to 2x DSC are positive credit factors, in Standard & Poor's opinion. The ABT for the long-term supplemental severance tax bonds is 1.6x. New Mexico can also issue short-term severance tax notes maturing within the fiscal year if previous-year pledged deposits cover total combined debt service of senior, supplemental, and short-term bonds by at least 1.05x. The state typically issues these notes with a one-day maturity to the state treasurer to make funds available for capital projects, although notes can be issued for longer periods as long as they mature within the fiscal year. Tax revenues are collected monthly. There is no debt service reserve; however, to release excess funds on the day before semi-annual debt service is due there must be a balance in the bond fund equal to the next two semi-annual debt service payments.

## Outlook

The stable outlook reflects our expectation that, despite possible future bonding, DSC will remain strong in the next two years as the result of strong ABTs and a declining debt service schedule. We also expect natural gas and oil reserves will continue to be replenished to maintain sufficient production over the bonds' life and that severance tax collections will continue to provide good MADS coverage during the bonds' relatively short 10-year life, despite the decline in revenues in fiscal 2010. Should MADS coverage begin to approach the ABTs, a downward adjustment of the rating or outlook is possible. The volatility of the pledged revenue stream somewhat limits upward movement of the rating.

## Bond Provisions

The bonds are a special obligation of New Mexico, secured by deposits into the severance tax bonding fund. Such deposits include the net receipts of taxes levied on certain natural resources obtained from the ground in New Mexico and investment earnings on such deposits. According to the resolution, on Dec. 31 and June 30 of each fiscal year (the day before semi-annual debt service is scheduled to be due), the state transfers excess money--defined as amounts in excess of the next two semi-annual debt service payments on bonds payable from severance taxes--into the severance tax permanent fund. Money in the permanent fund is not available to pay debt service. There is no formal debt service reserve fund. In practice, just before Dec. 31 and June 30, state officials have historically issued short-term severance tax notes to the state treasurer, that mature within 24 hours, to cash-fund capital projects before transferring any surplus into the severance tax permanent fund.

State statute prohibits the New Mexico board of finance--which includes the governor, lieutenant governor, and state treasurer--from issuing additional senior long- and short-term severance tax bonds unless it can service total bonds outstanding by no more than 50% of the annual deposit into the severance tax bonding fund in the fiscal year preceding issuance, and total senior and long-term supplemental severance tax bonds by no more than 62.5% of the annual deposit--this is equivalent to a 2.0x ABT on the senior-lien bonds and a 1.6x ABT on the combined senior- and junior-lien bonds. In addition, the board covenants that New Mexico will use its best efforts to deposit into the bonding fund severance taxes that, when combined with other money in the fund, will equal at least 200% of principal and interest due in each fiscal year on the senior bonds. State officials can issue short-term supplemental tax notes maturing within the fiscal year if New Mexico can service total combined bonds outstanding by no more than 95% of the annual deposit into the severance tax bonding fund in the fiscal year preceding issuance.

## **Mineral Production And Reserves**

Natural gas (44% of projected fiscal 2012 severance taxes), oil (51%), and coal (5%) are New Mexico's major severance tax revenue generators. Carbon dioxide, copper, potash, and other minerals account for the balance. The state taxes non-Indian oil and gas production on tribal land. However, it allows a credit against state production and property taxes for similar taxes imposed by tribal governments for new wells drilled on or after July 1, 1995. The amount of the credit is 75% of the lesser of state taxes or tribal taxes imposed. If the applicable tribal taxes were raised after March 1, 1995, then the amount of New Mexico's credit is lowered. The state estimates that total credits claimed under this provision were about \$3.1 million in fiscal 2011.

New Mexico forecasts natural gas volume product production to decline by 3.4% in fiscal 2011, 5.3% in 2012, and 3.9% per year between 2013-2016; state officials also estimate that average gross gas prices for gas subject to taxation will decrease from \$5.49 per thousand square feet in 2011 to \$5.20 in 2012, and then increase gradually to \$6.15 by 2016. Natural gas severance tax rates are 3.75% of the value of production less deductions for the expense of transportation to the first point of sale, with greater reductions for certain categories of production. The state forecasts that the interplay between declining production and rising prices would produce increases in natural gas severance tax receipts in 2013, followed by moderate declines, to a level in 2016 that would be about the same, or just 0.08% below 2012's forecast level of revenues. In 2012, New Mexico forecasts natural gas severance taxes of \$174.98 million.

The most recent federal estimate of proven state natural gas reserves is for the end of calendar 2009. Proven reserves in 2009 were estimated at 16,644 billion cubic feet (bcf), a decrease of 106 bcf from 10 years before, the result of 15,344 bcf 10-year production and the replacement of about 99.3% of reserves through new discoveries and revised estimates. New Mexico estimates the 2009 reserve estimate represents a reserve-to-current production ratio of 12:1.

State forecasts expect oil production by volume to increase 1.0% in fiscal 2012, and then decline 0.8% in 2013, with following declines of 1.0% per year from 2014-2016. Official forecasts reflect an \$86.75 average price per barrel in 2012 compared with \$84.60 in 2011, and prices to rise to \$87.75 in 2013, \$88.50 in 2014, \$89.50 in 2015, and \$89.75 in 2016. Oil severance tax rates are 3.75% of value, with reduced rate exceptions for certain categories of production. The state projects oil severance tax revenues would stay relatively stable at about \$202 million-\$201 million between 2012-2016. New Mexico estimates that 2009 oil reserves, the most recent year estimated, represented approximately 13.2 years of production, assuming no new discovery. Higher oil prices have recently increased levels of oil production to a level more typical of the 1970s.

There was a significant decrease in coal tax severance tax revenues to \$12.4 million in 2011 from \$21.8 million in fiscal 2010. The state attributes this to the renegotiation of several long-term mine-mouth contracts. It has exempted new coal contracts from a coal surtax, so production from these mines has now become exempt from the surtax. Actual combined surface and underground coal tonnage mined in 2011 increased 4.3% from the year before, while the weighted average price of coal per ton went up to \$29.55 in 2011 from \$28.97 in 2010. In 2010, coal tonnage volume fell 8.9%, following an 11.8% increase in 2009. The effective average severance tax per ton of coal fell to 1.7% in 2011 from 3.1% of sales revenue in 2010 because of the smaller volume of coal subject to the surtax. In 2011, only 1.8 million tons of coal was still subject to the surcharge, out of 24.2 million total tons of coal mined, which we believe will likely limit future declines somewhat from additional surtax exemption as additional contracts come up for renewal. In 2010, 10 million tons of coal was subject to the surcharge, which is levied only on surface mined coal.

Other minerals that contribute to severance taxes include carbon dioxide, potash, copper, gold, silver, lead, zinc, molybdenum, and uranium (see table).

<b>New Mexico Severance Tax Bond Coverage</b>						
<b>(Mil. \$)</b>	<b>--Fiscal year ended June 30--</b>					
	<b>2012p</b>	<b>2011</b>	<b>2010</b>	<b>2009</b>	<b>2008</b>	<b>2007</b>
Pledged severance tax receipts*	400.6	366.7	350.1	516.3	511.8	452.9
% change	9.2	4.7	(32.2)	0.9	13.0	N.A.
Coverage of senior-lien MADS (x)	3.2	2.9	2.8	4.1	4.0	3.6
Coverage of combined senior and subordinate MADS (x)	2.7	2.4	2.3	3.4	3.4	3.0

\*Does not include bond fund investment earnings or certain other nontax bond fund receipts. MADS--Maximum annual debt service. P--Projected by the state. N.A.--Not available.

## Related Criteria And Research

USPF Criteria: Special Tax Bonds, June 13, 2007

<b>Ratings Detail (As Of May 10, 2012)</b>		
New Mexico severance tax		
<i>Long Term Rating</i>	AA/Stable	Affirmed
New Mexico severance tax		
<i>Long Term Rating</i>	AA/Stable	Affirmed
New Mexico supplemental severance tax		
<i>Long Term Rating</i>	AA-/Stable	Affirmed
New Mexico supplemental severance tax bnds rfdg ser 2008A-2		
<i>Long Term Rating</i>	AA-/Stable	Affirmed
<b>New Mexico severance tax</b>		
<i>Unenhanced Rating</i>	AA(SPUR)/Stable	Affirmed
<b>New Mexico supplemental severance tax</b>		
<i>Unenhanced Rating</i>	AA-(SPUR)/Stable	Affirmed

Many issues are enhanced by bond insurance.



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