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## New Mexico; Miscellaneous Tax

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# New Mexico; Miscellaneous Tax

## Credit Profile

US\$199.165 mil severance tax bnds ser 2014A due 07/01/2024

*Long Term Rating*

AA/Stable

New

## Rationale

Standard & Poor's Ratings Services has assigned its 'AA' long-term rating and stable outlook to New Mexico's series 2014A severance tax bonds.

At the same time, Standard & Poor's affirmed its 'AA' long-term and underlying ratings on the state's \$663 million parity senior severance tax bonds outstanding, and its 'AA-' rating on the state's \$73 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 2.85x pro forma senior-lien maximum annual debt service (MADS) coverage by fiscal 2013 severance tax revenues, and 2.62x 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
- Declining debt service schedule and rapid debt amortization, with \$133 million of outstanding principal to be retired in July 2014 and all principal to be retired by 2024.

Mitigating these credit strengths are:

- 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, as demonstrated by a large one-year 32% decline in severance tax receipts in fiscal 2010 and a 26% increase in 2012; and
- State geographic limitations in serving natural gas markets that might be distant from the state.

We understand that the proceeds of the series 2014A 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. Oil (63% of projected fiscal 2014 severance taxes), natural gas (32%), and coal (2.5%) are the major severance tax revenue generators. Carbon dioxide, copper, potash, and other minerals account for the balance. Fiscal 2013 severance taxes alone produced 2.85x pro forma senior-lien MADS coverage, with MADS expected in fiscal 2016. Not including interest or other earnings, we calculate that the state's fiscal 2013 forecast of severance tax revenues alone will cover combined senior- and subordinate-lien MADS 2.62x. In addition, the state realized \$6.7 million of investment earnings in its bond fund in fiscal 2013. Using total pledged 2013

revenues as the state calculates coverage, including interest earnings and other financing sources, would bring senior-lien MADS coverage to 2.91x and combined senior and subordinate MADS coverage to 2.68x.

In our opinion, state severance tax revenues are cyclical. In fiscal 2010, pledged severance tax revenue declined 32%, primarily the result of lower natural gas production and prices. Severance tax revenue increased 4.7% in fiscal 2011 and 26.2% in fiscal 2012 followed by another 10.5% decline in fiscal 2013. 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 as natural gas prices have declined. Currently, New Mexico projects 15% growth in severance tax receipts in fiscal 2014, with subsequent annual declines in pledged taxes between 1.6% and 2.7% through 2018 to \$439 million.

DSC will also improve as debt is retired. Senior-lien annual debt service declines to \$92.9 million by fiscal 2020 from \$145.5 million in 2016, and entirely matures in fiscal 2025. Subordinate-lien debt service also declines and entirely matures in fiscal 2021. New Mexico has a history of issuing similar sized additional severance tax bonds once a year as part of its normal overall capital plan, although it did not sell a severance tax bond 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 during our two-year outlook horizon because 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 potential cyclicity in severance tax revenues, as demonstrated by the decline in tax 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 and the potential for additional bonding constrains 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. In fiscal 2013, \$112 million of senior short-term notes were issued, and \$167.8 million of supplemental short term notes.

## **Mineral Production And Reserves**

New Mexico oil production has benefited from increased production in the same Permian Basin, shared with Texas (Texas' oil production has increased for the same reason), while natural gas largely comes from the separate San Juan basin. The state taxes -non-tribal 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 \$2.3 million in fiscal 2013, the same as in fiscal 2012.

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. Deductions have ranged from 17% of gross value in fiscal 2006 to 24% in fiscal 2013 and forecasted fiscal 2014 through 2018. New Mexico forecasts average weighted natural gas sales prices to rise gradually in the next five years despite recent price declines due to recovery in the national economy and environmental preference for natural gas-fired power plants. The fiscal 2013 weighted average price of \$4.40 per thousand cubic feet was lower than \$5.00 in fiscal 2012 and \$5.50 in 2011. (State

natural gas prices are higher than elsewhere in the country due to the presence of valuable liquids in well production that are used for gas additives and other purposes.) The fall in natural gas prices since 2009 is largely the result of increased national gas production due to new "fracking" technology. As a result of declining natural gas prices, gas production has declined and new natural gas well completions have plummeted. New natural gas well completions within New Mexico dropped to only 248 in 2013 from a peak of 1,775 in 2005, albeit with greater gas production per well due to new horizontal drilling techniques. Due to improvements in the national economy, the state projects that natural gas prices will rise to \$5.35 by 2018, and that natural gas severance tax receipts will fall to \$148 million in fiscal 2018 from \$156.4 million in fiscal 2014, due in part to lower forecasted gas sales as well as a higher proportion of deductions particularly related to rising pipeline transportation rates in the San Juan Basin.

State natural gas prices are more affected by increases in national production than oil prices are affected by increases in national oil production, because natural gas is less transportable than oil. While natural gas prices reflect national supply and demand, oil prices are more reflective of world supply and demand. As a result, oil prices have held up and increases in oil production have resulted in the state's mix of severance taxes becoming increasingly more weighted towards oil production. The ratio of oil prices to natural gas prices has shifted to 20:1 currently from 9:1 in 2007. The number of new oil wells in the state has increased from 702 in 2002 to 1,304 in 2013, although this is a decrease from 1,588 new wells in 2011.

New Mexico's current consensus revenue forecast for oil projects average oil prices to decline from \$93 per barrel in fiscal 2014 to \$83.50 in 2017 and 2018, and oil severance tax receipts to fall to \$276 million in 2018 from \$308 million in 2014 while oil barrels sold remains relatively stable. Oil severance tax rates are 3.75% of value, with reduced rate exceptions for certain categories of production.

Coal severance taxes are a minimal 2.5% of projected fiscal 2014 severance tax revenue. After a number of years of stable revenues, net coal severance tax declined 41.2% in fiscal 2011. 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, which reduced the effective tax rate per ton of coal to 1.36% in 2013 from 3.1% in 2010. In fiscal 2012, coal severance tax fell another 12.3% to \$10.9 million due to the interplay of a lower effective tax rate, a slight decrease in coal tonnage, and an increase in the price of coal. In fiscal 2013, only 893 thousand tons of coal were still subject to the surcharge, or 4% of 22.6 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. The state projects coal severance tax receipts to decline gradually over time due to increased competition from other energy sources and environmental concerns.

The state reports that there have been no recent significant changes in severance tax rates, or legislative proposals in the last session to change rates. However, one county without mineral production has recently banned oil and gas fracking and drilling, and certain other counties that do not have significant current production have considered similar bans.

## Related Criteria And Research

### Related Criteria

USPF Criteria: Special Tax Bonds, June 13, 2007

Ratings Detail (As Of May 19, 2014)		
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
<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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