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## Summary:

# New Mexico; Appropriations; General Obligation

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## Summary:

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| Credit Profile | | |
|---|---|---|
| US$150.0 mil Capital Projects GO bnds ser 2015 due 03/01/2025 | | |
| *Long Term Rating* | AA+/Negative | New |
| New Mexico GO | | |
| *Long Term Rating* | AA+/Negative | Affirmed |

## Rationale

Standard & Poor's Ratings Services assigned its 'AA+' long-term rating on New Mexico's series 2015 capital projects general obligation (GO) bonds. At the same time, Standard & Poor's affirmed its 'AA+' long-term rating on the state's GO debt outstanding. In addition, Standard & Poor's affirmed its 'AA' rating on certain series 2008 Grant County, N.M. bonds secured by annual state appropriations. The outlook on all ratings is negative.

Under our state criteria methodology, our overall state score of '1.9' would be associated with a 'AA' indicative GO bond credit level. However, as permitted in our criteria, the final state rating can be within one notch of the indicative credit level, based on the state's position relative to all other states. We have rated New Mexico's GO bonds 'AA+', which in our view is warranted by what we consider the state's strong government framework and demonstrated structurally balanced budget management as well as the existence of two large permanent funds that receive mineral-related tax revenues and whose corpus is restricted. These funds serve as endowments, with a total net asset market value combined of $18.9 billion at fiscal year-end June 30, 2014. Although discretionary appropriation of the corpus of the funds is not accessible pursuant to the state's constitution, the funds generate interest income for New Mexico's general and public education needs, which in our opinion lends additional strength to the credit. We also believe that New Mexico's budget management and government framework have allowed the state to maintain historical budget balance and reserve levels, as reported, consistent with a 'AA+' rated state.

In addition to the above strengths, our rating reflects what we consider New Mexico's:

- Maintenance of good reserve levels on a budgetary basis, with a focus on structural balance;
- Relative revenue diversity, despite some economic dependence on the government and energy sectors; and
- Moderate debt levels with rapid amortization.

These strengths are somewhat mitigated by what we view as New Mexico's weak pension funding levels and per capita income levels that remain below the nation.

The full faith and credit of the state, including an unlimited ad valorem tax on taxable property, secures the bonds. New Mexico annually levies property taxes sufficient to meet the next three debt service payments on its GO debt, which provide protection against delinquent tax payments. Net taxable value in the state has grown an average of 4.4% per year in the past decade, including a 7.0% year-over-year decline in 2010, and rose 3.7% in 2014, to $56.7

billion. Part of the swing in valuation in 2010 is attributable to changes in oil and gas valuations and an earlier court ruling that required a retroactive reassessment of residential property value in Bernalillo County. Although potential changes in taxable value could reduce New Mexico's GO bonding capacity, the unlimited ad valorem tax pledge requires property tax rates for the state's GO debt to rise to offset any value declines. Standard & Poor's understands that New Mexico will use series 2015 GO bond proceeds to provide funds for construction, acquisition, and improvement of senior citizen centers and library acquisitions, as well as for higher education and special and tribal schools improvements and acquisitions.

Fiscal 2015 revenue through January 2015 is tracking slightly higher than budget, due primarily to higher-than-forecast gross receipts and corporate income taxes. Actual revenue collections from mineral production tax and federal mineral leasing royalties through January are also tracking higher than forecast related to some one-time revenue and lagged collections from late fiscal 2014 when oil prices were higher. However, the consensus revenue forecast incorporates a drop-off of mineral-related revenue for the rest of fiscal 2015.

In February, the state consensus revenue estimating group revised its general fund revenue forecast to incorporate lower oil prices as well as gross receipts and income taxes that have been tracking higher than previously estimated. For fiscal years 2015 and 2016, the revised consensus revenue estimate lowers the assumed oil price by $10 compared with the December 2014 forecast and assumed $61 and $56 per barrel oil prices, respectively, reflecting New Mexico oil prices, which are well below West Texas Intermediate oil prices. The revenue estimate now projects 2% year-over-year revenue growth in fiscal 2016 to $6.2 billion, which is $58 million lower than estimated in December. The decline in total fiscal 2016 general fund revenue is primarily driven by a forecast cumulative 27% decline since fiscal 2014 for energy-related revenue flowing directly into the general fund, partially mitigated by a projected 11% cumulative growth in combined gross receipts and income tax revenue. Direct revenue to the general fund from oil and gas receipts, which does not include certain severance taxes and certain other land trust income that flow to the state's permanent funds, represents about 14% of the state's fiscal 2016 forecasted general fund revenue, down from 19% of fiscal 2014 unaudited general fund revenue. We believe the slow forecasted overall revenue growth is reasonable, despite falling energy prices, given a recent pick-up in economic growth after several years of stagnation related to the recession and federal sequestration. Potential risks to the revenue forecast include continued declines in mineral prices, slower-than-expected economic growth, and the potential expiration of gaming compacts between New Mexico and several tribes at the end of fiscal 2015.The state also estimates it could lose about $20 million of recurring general fund revenue on average per year, assuming no changes to current law, if the New Mexico Supreme Court upholds an appellate court decision that limits the state's ability to adjust for erroneous gross receipts tax revenue distributions to local governments after one year.

Constitutional provisions that funnel certain oil and gas receipts into the state's permanent funds help to somewhat insulate the general fund from falling energy prices. New Mexico uses annual receipts from an oil and gas severance tax for capital and severance bond debt service expenditures and deposits surplus severance tax revenue into the severance tax permanent fund. The state also deposits mineral production royalties, leases, and land sale proceeds into the land grant management permanent fund. Distributions from each of the permanent funds to the general fund are constitutionally limited to 4.7% and 5.5%, respectively. Investment income from the funds in the past couple years has been sufficient to cover these distributions. Estimated distributions to the general fund from permanent fund interest earnings reflect a combined 11.0% of the state's fiscal 2015 general fund revenue and 12.5% of the fiscal 2016 revenue forecast. New Mexico's structural budgetary balance positions the state well to confront depressed energy prices and slow economic growth in the near term, although a prolonged downturn could affect employment and ultimately other state revenue. According to estimates by the New Mexico Tax Research Institute, the indirect relationship of oil prices on state gross receipts taxes, incomes taxes, and sales taxes from oil and gas production represent another 5.6% of the state's general fund budget.

New Mexico's estimated general fund budgetary reserve levels at the end of fiscal 2014 (including operating, appropriation contingency, tax stabilization, and tobacco settlement permanent funds) represented about $636 million, or 10.8% of recurring general fund expenditures, excluding about $220 million set aside in the operating reserve for various contingent liabilities -- including $73 million to offset uncollectible Medicaid receivables, contingencies related to federal special education funding maintenance of effort requirements, reduced tobacco settlement distributions, and an additional $101 million to mitigate potential losses in the state's cash position related to the reconciliation of previous cash transactions back to 2006. In addition to these risks and overall uncertainty related to the magnitude of potential future restatements of the state's general fund operating reserve position, the state also has contingent liabilities associated with up to $100 million of previously denied job-credits claims that could also reduce available reserves. New Mexico also faces several lawsuits challenging the state's funding of public education on the basis of sufficiency and equity.

The executive budget for fiscal 2016 proposes $6.29 billion in recurring general fund appropriations, which is 2.3% above fiscal 2015 recurring spending levels and in line with December 2014 revenue forecasts that were available at the time the budget was proposed. The budget prioritizes spending growth in kindergarten to grade 12 public education, slight increased general fund costs for Medicaid related to the Affordable Care Act expansion and the "woodwork" effect, and some slight additional spending at the department of corrections for rising caseloads and for programs at the Children, Youth and Families Department. The governor also proposes using $105 million of reported reserves in fiscal 2015 for nonrecurring appropriations for economic development incentives as well as information technology and research projects. The legislative finance committee's budget also recommends increased fiscal 2016 spending for public education, primarily for teacher salaries and to address dropout and truancy rates. Although New Mexico does not have a formal reserve target, it has previously informally targeted and maintained at least a 10% budgetary basis general fund reserve level as a percent of recurring general fund appropriations. However, both the executive and legislative budget recommendations project total budgetary reserves, excluding contingencies described above, that represent about 8% of recurring appropriations which departs from the 10% informal target. Although we still consider 8% reserve levels strong, we would consider significant ongoing deterioration in reported reserves further departing from the state's informal targeted reserve levels as a credit pressure given the level of uncertainty in New Mexico's financial position and the state's greater reliance on volatile mineral revenue.

State employment rose only 0.6% in 2013 and IHS Global Insight Inc. estimates employment only grew 0.38% in 2014, below the national rate of 1.7%, reflecting the state's reliance on federal government spending and the recent federal spending sequestration. Although New Mexico's annual unemployment rate remained below that of the nation's for 2013, state unemployment has been rising and, at 6.1% in December 2014, was above the U.S. level of 5.6% reflecting relatively weak annual state employment growth. In the third quarter of 2014, state employment growth picked up slightly compared to the previous year, with job growth in the leisure and hospitality services, retail and finance sectors. Based on IHS Global Insight estimates, we project state employment growth will accelerate after 2014, although it will remain below that of the nation annually through 2016 when New Mexico is expected to reach prerecession peak employment. State population growth trends have been above the U.S. between 2000 and 2010, although growth has slowed relative to that of the nation in 2012 and 2013 totaling 2.09 million in 2013. The proportion of the population of nonworking age is also somewhat high at 64.2% compared with that of the nation at 59.8% in 2013. Prolonged declines in oil and gas prices could depress the state's energy sector and reduce revenue to the general fund and, although direct employment in the mining sector comprises a relatively small 3% of state employment, it represents a larger share of employment than it does nationally.

Standard & Poor's deems New Mexico's financial management practices "good" under its Financial Management Assessment (FMA) methodology. An FMA of good indicates financial practices are good, well embedded, and likely sustainable.

The state's total tax-supported debt outstanding in fiscal 2013 -- including GO, severance tax, gas tax bonds for the department of transportation, and various state tax-secured debt and loans included in the New Mexico Finance Authority's (NMFA) public project revolving fund -- is what we consider moderate at $1,338 per capita and 3.7% of personal income. Amortization of principal on all governmental tax-supported debt, including transportation debt, appropriation-secured debt, and state loans in NMFA's public project revolving fund, is rapid with about 81% of principal retired within 10 years. We estimate the state's debt burden in fiscal 2014 and after this issuance remains relatively stable given limited debt issuance and rapid amortization. Total GO debt is limited to a maximum of 1% of net taxable value and GO debt issuance requires a majority vote of the electorate. Pursuant to its debt policy, the state amortizes all GO debt and severance tax debt over what we view as a very rapid 10 years.

At the same time, New Mexico's annual pension contributions, which are set by statute, have been below the actuarial annually required contributions for years. In 2013, we calculate the combined unfunded actuarial accrued pension liability (pension UAAL) represented a high $5,381 per capita and high 14.8% of personal income. Recent legislation implementing pension reform lowered the unfunded liability and slightly improved funded ratios. In fiscal 2014, while the pension UAAL fell slightly, we calculate it remained high at about $5,000 per capita and 14% of personal income. The fiscal 2014 combined pension funds' actuarial liabilities funding level has improved to 70% on an actuarial basis from 67% in fiscal 2013, according to our calculations, although still what we consider low. We consider the state's $3.7 billion unfunded other postemployment benefit (OPEB) liabilities to be moderate at about $1,631 per capita in fiscal 2014. There is an OPEB trust fund with $381.9 million of assets as of Oct. 31, 2014. The fiscal 2014 OPEB annual required contribution was about $368 million of which 40.6% was funded. The legislature previously passed phased-in increases to the contributions to the Retiree Health Care Fund beginning July 1, 2012; however, the 2014 legislature did not pass additional proposed increases to the employee and employer contributions to extend solvency of the plan to 2040.

Under our State Ratings Methodology, we have assigned New Mexico a total score of '1.9' on a four-point scale whereby '1.0' is the strongest and '4.0' is the weakest.

For additional information on the state's GO credit characteristics, see the full report published in Nov. 26, 2014, on

RatingsDirect.

## Outlook

We base our negative outlook on New Mexico's relatively weak economic recovery after the recession with some dependence on government and energy sectors that, particularly with depressed energy prices, could dampen future economic growth. The outlook also reflects recent findings in the state's audited comprehensive annual financial report that highlight weak centralized cash management and accounting processes and that create some uncertainty surrounding New Mexico's consolidated financial position. We understand the state is in the process of analyzing historical transactions before February 2013 as part of its cash management remediation initiative and that officials expect full implementation of new software that will automate compilation of information into the state's financial accounting system by the end of fiscal 2015. New Mexico has already set aside $101 million of its fund balance as a contingency for uncertainty related to the future result of the remediation effort. Should the state correct its processes in the next two years to provide confirmed reserve and cash balance levels in line with current estimates, we could revise the outlook back to stable. However, should material weaknesses in internal controls persist or if New Mexico were to significantly restate its reserve or cash position below historically good levels, we could lower the rating. Although we expect the state will adjust its budget to maintain structural balance as it has done historically, the rating could also be pressured downward if continued slow economic growth, declining energy prices, and cost pressures create significant budget gaps with overdependence on one-time solutions. Revenue declines larger than forecast without timely adjustment or reliance on uncertain reserves could result in a lower rating.

## Related Criteria And Research

### Related Criteria

- USPF Criteria: State Ratings Methodology, Jan. 3, 2011
- USPF Criteria: Appropriation-Backed Obligations, June 13, 2007
- USPF Criteria: Financial Management Assessment, June 27, 2006

### Related Research

- U.S. State And Local Government Credit Conditions Forecast, Dec. 10, 2014

| Ratings Detail (As Of February 12, 2015) | | |
|---|---|---|
| **Grant Cnty, New Mexico** | | |
| New Mexico | | |
| Grant Cnty (New Mexico) lease approp (Ft. Bayard Proj) ser 2008 | | |
| *Long Term Rating* | AA/Negative | Affirmed |
| Grant Cnty (New Mexico) lease approp (Ft. Bayard Proj) ser 2008 (ASSURED GTY) (SEC MKT) | | |
| *Unenhanced Rating* | AA(SPUR)/Negative | Affirmed |

Many issues are enhanced by bond insurance.

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