MOODY'S
INVESTORS SERVICE

New Issue: Moody's assigns Aa1/Aa2 to New Mexico's senior/subordinate severance tax bonds; outlook stable

Global Credit Research - 15 Jul 2015

$856M severance tax bonds outstanding

NEW MEXICO (STATE OF)
State Governments (including Puerto Rico and US Territories)
NM

Moody's Rating

ISSUE		RATING
Supplemental Severance Tax Bonds, Series 2015B		Aa2
Sale Amount	$75,000,000	
Expected Sale Date	08/03/15	
Rating Description	Special Tax: Non-Sales/Non-Transportation	
Severance Tax Bonds, Series 2015A		Aa1
Sale Amount	$139,170,000	
Expected Sale Date	08/03/15	
Rating Description	Special Tax: Non-Sales/Non-Transportation	

Moody's Outlook STA

NEW YORK, July 15, 2015 --Moody's Investors Service has assigned a Aa1 rating to the State of New Mexico's Severance Tax Bonds (senior lien), Series 2015A, and a Aa2 rating to the state's Supplemental Severance Tax Bonds (subordinate lien), Series 2015B. The bonds are expected to be issued in the amounts of $139 million and $75 million, respectively. Following this issuance, the state will have $728 million senior lien bonds outstanding, all rated Aa1, and $128 million subordinate severance tax bonds outstanding, all rated Aa2.

SUMMARY RATING RATIONALE

The senior and subordinate bonds are secured by a first and second lien, respectively, on severance taxes on deposit in and interest earnings of the Bonding Fund. The ratings reflect the volatility of the pledged revenue stream, which consists primarily of taxes on the production of natural gas and oil in the state, offset by coverage levels well in excess of the additional bonds tests, requirements to maintain 12 months' debt service on deposit in the Bonding Fund, and the rapid payout of outstanding bonds.

OUTLOOK

The outlook on the Severance Tax Bond ratings is stable, reflecting the rapid payout on the bonds and the expectation the state will not leverage severance tax beyond current levels.

WHAT COULD MAKE THE RATING GO UP

* Structural changes that strengthen the program, such as an increase in the additional bonds tests.

WHAT COULD MAKE THE RATING GO DOWN

* Deterioration in coverage as a result of new declines in severance tax revenues, new tax credits, or leveraging tax revenues beyond the 2.90 to 3.0 times level seen with recent issuances.

* Debt policy changes that weaken the program, such as lengthening maturities.

STRENGTHS

* Payout is rapid; bonds are issued with a maximum 10-year maturity, and annual debt service declines steeply from fiscal year 2017 to final maturity in 2025.

* The state has not leveraged revenues to the additional bonds test, resulting in stronger coverage of peak debt service.

* Constitutional provisions offset the absence of a reserve fund - the state must maintain 12 months' debt service requirements in the Bonding Fund before excess revenues can be transferred to the Permanent Fund or, via the issuance of short-term notes, utilized for capital spending.

* No operating claims compete for the pledged revenues - surplus revenues not needed for debt service on the bonds are transferred to the Severance Tax Permanent Fund or used for capital spending.

CHALLENGES

* Pledged severance taxes are volatile due to dominance of oil and gas, and sensitivity to production levels and commodity prices.

* Additional bonds tests are relatively weak compared to similarly rated bonds: 2.0 times coverage for senior bonds and 1.6 times coverage for subordinate bonds.

RECENT DEVELOPMENTS

Recent developments are incorporated in the Detailed Rating Rationale.

DETAILED RATING RATIONALE

TAX BASE AND NATURE OF PLEDGE-- PLEDGED SEVERANCE TAX REVENUES ARE VOLATILE, SENSITIVE TO COMMODITY PRICES AND PRODUCTION

Severance taxes consist of taxes on the extraction of minerals in the state, primarily oil and natural gas. In fiscal 2015, severance taxes on oil and natural gas accounted for 97.6% of total severance tax revenues.

Revenues are highly sensitive to the prices of oil and natural gas, the level of production, changes in production technology, and additions to and depletion of reserves. Oil and gas prices generally increase over time, but in the short term are highly sensitive to national and global economic trends, as well as geopolitical events. Severance tax revenues have also been negatively affected at times by tax credits enacted for production on tribal land and to encourage increased production.

The volatility of severance tax revenues was demonstrated by a dramatic 32.2% decline in fiscal 2010 and an 11.7% decline in fiscal 2013. Large decreases have generally been followed by large increases. The recent decline in oil and gas prices resulted in a estimated drop of 7.7% in fiscal 2015, which ended June 30, and a projected drop of 20.9% in 2016.

Despite this volatility, the long-term trend in pledged revenue has been moderately positive. The compound average growth rate in Bonding Fund receipts from 2005 to 2015 was 2.1%. In the past 10 years, large declines in revenues have usually been followed by large increases. For example, the decline in 2010 was followed by a 21.5% increase in 2012 and the decline in 2013 was followed by a 27.7% increase in 2014. The state expects that revenues will increase by 8.9% in 2017 and 4.0% in 2018 as oil prices begin to increase.

DEBT SERVICE COVERAGE AND REVENUE METRICS-- COVERAGE LEVELS ARE STRONG, WELL ABOVE ADDITIONAL BONDS TESTS

Severance taxes are deposited upon receipt in the Bonding Fund. The senior and subordinate bonds are secured by a first and a second lien, respectively, on severance taxes and interest earnings of the Bonding Fund. The additional bonds tests are weak relative to comparably rated bonds. The test for additional senior lien bonds is 2.00 times coverage of MADS by actual revenues in the fiscal year preceding issuance. The test for additional subordinate-lien bonds is 1.60 times MADS on senior and subordinate bonds combined. Special tax bonds rated in the Aa category typically have an additional bonds test of 2.5 to 4.0 times.

The state has not leveraged severance taxes to the additional bonds test levels. Current coverage on the senior bonds ranged from 3.31 to 4.28 times from 2011 to 2015; current coverage on senior and subordinate bonds combined ranged from 2.84 to 3.81 times over the same period. Actual fiscal 2015 revenues provide 3.48 times coverage of peak debt service on the senior lien bonds and 3.07 times coverage on peak debt service of senior and subordinate bonds combined.

Liquidity

The flow of severance tax revenues and the required balances in the Bonding Fund provide ample liquidity for the payment of principal and interest.

DEBT AND LEGAL COVENANTS-STRONG DEBT MANAGEMENT AND CONSTITUTIONAL REQUIREMENTS OFFSET VOLATILITY OF PLEDGED REVENUES

Debt Structure

The volatility of the pledged revenue stream is substantially counterbalanced by strong debt management practices, particularly the state's practice of limiting the maturity of severance tax-backed bonds to 10 years. Payout is quite rapid and annual debt service requirements decline quickly from fiscal 2017 through final maturity in 2025. As a result of this structure, severance taxes could decline significantly for multiple years without any shortfall in the amounts required for debt service.

There is no debt service reserve for the bonds. However, the state constitution requires that on June 30 and December 31, all monies in the Bonding Fund in excess of the next 12 months' scheduled debt service be transferred to the state's Severance Tax Permanent Fund. The 12 months' debt service requirement in effect provides an ample reserve for the bonds, especially given the debt structure. Once revenues are transferred to the Permanent Fund, they are not available for debt service on the bonds.

In addition to the senior and subordinate bonds, the state also issues short-term (one- to five-day) notes secured by severance tax revenues. The notes are purchased by the State Treasurer. The purpose of these notes is to capture excess severance tax revenues that otherwise would be transferred to the Severance Tax Permanent Fund and redirect them to current capital needs. In effect, the state is able to use excess severance tax revenues for pay-go capital. The issuance of these notes does not reduce debt service coverage or weaken the security of the bonds, as it only reduces the amount of monies that would otherwise be transferred to the Permanent Fund.

Debt-Related Derivatives

New Mexico has no derivatives related to its severance tax bonds. The New Mexico Department of Transportation has $420 million in interest-rate swaps related to its variable rate transportation revenue bonds issued through the New Mexico Finance Authority. The swaps hedge interest rate risk but add counterparty risk and make it difficult for the department to reduce its variable rate exposure. The termination value for the swaps as of November 10, 2014, was $106.6 million. DOT maintains a $50 million line of credit with Bank of America, N.A. to meet any collateral posting requirements on the swaps.

Pensions and OPEB

The state's pensions are primarily provided through the multi-employer Public Employees Retirement Association (PERA). PERA's funding levels have declined in recent years due to investment losses and changes in its earnings assumption. Moody's three-year adjusted net pension liability (ANPL) for the state through 2013 is $6.5 billion. This ANPL equaled 48.9% of fiscal 2013 revenues, slightly below the 52.8% median for all US states. The state also reports a UAAL for other post-employment benefits (OPEB) of approximately $3.4 billion. The UAAL represents 29.6% of state governmental revenues, above the 15.7% median for all US states. Pensions and OPEB are not a major factor in the special tax methodology.

MANAGEMENT AND GOVERNANCE

While the state has several strong governance practices including a consensus revenue forecasting process, multi-year revenue and expenditure projections, and timely budget adoption, its financial reporting has numerous weaknesses. Historically, the financial statements in New Mexico's Comprehensive Annual Financial Report (CAFR) were not audited. The statements were only "reviewed," which indicates a substantially lower standard of verification. In addition, the CAFRs have not always been released on a timely basis. The fiscal year 2011 CAFR was not released until June 2012, 11 months after the end of the fiscal year. The 2012 CAFR was not released until August 2013, 13 months after the end of the fiscal year.

Fiscal year 2013 marked some progress for the state's financial reporting. For the first time the CAFR was audited. Nevertheless, significant weaknesses remain. The audit contained numerous findings related to cash reconciliations and consolidations. And the CAFR was still not timely. The state is committed to a number of initiatives to eliminate the findings and improve the timeliness of the CAFR. It has also established a $100 million reserve to cover adjustments necessary to resolve the cash reconciliation discrepancies. Moody's expects that the state will make continued improvement in its financial reporting.

The state does provide timely, audited financial statements for its major agencies and for its statutory General Fund. The statutory General Fund, also known as the "Component Appropriation Accounts" or the "Component Appropriation Funds," is not exactly equivalent to the GAAP-basis General Fund shown in the CAFR. In particular, it excludes certain departmental revenue accounts that are included in the GAAP General Fund. Even so, the two representations of the General Fund have tracked very closely. These agency statements provide sufficient verified information to evaluate the state's financial performance, but the absence of timely, unqualified comprehensive statements remains a weakness.

KEY SCORECARD STATISTICS

Additional Bonds Test: 2.0 times (senior)/1.6 times (subordinate).

Debt Service Reserve Fund: None.

MADS Coverage: 3.48 times (senior)/3.07 times (senior plus subordinate combined).

OBLIGOR PROFILE

New Mexico is the 36th-largest state by population, at 2.1 million. Its state gross domestic product, $92.2 billion, is 37th-largest. The state's wealth levels are below average, with per capita personal income equal to 81.5% of the US level and a poverty rate among the highest for US states.

LEGAL SECURITY

The senior lien bonds (called "Severance Tax Bonds") and the subordinate lien bonds (called "Supplemental Severance Tax Bonds") are secured by a first and second lien, respectively, on severance taxes on deposit in and interest earnings of the Bonding Fund.

USE OF PROCEEDS

Proceeds of the Series 2015A bonds will fund general government capital projects. Proceeds of the Series 2015B bonds will fund public education facilities projects.

PRINCIPAL METHODOLOGY

The principal methodology used in this rating was US Public Finance Special Tax Methodology published in January 2014. Please see the Credit Policy page on www.moodys.com for a copy of this methodology.

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