

CREDIT OPINION

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New Issue

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State of New Mexico

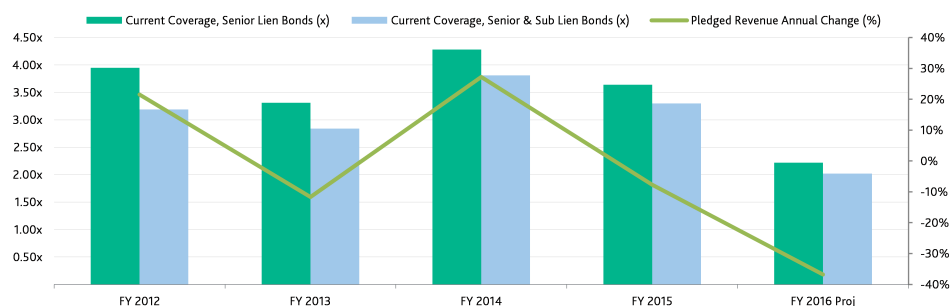
New Issue—Moody's Downgrades New Mexico Senior/Subordinate Severance Tax Bonds to Aa2/Aa3 from Aa1/Aa2; Outlook Negative

Summary Rating Rationale

Moody's Investors Service has downgraded the ratings on the State of New Mexico's Severance Tax Bonds (senior lien) to Aa2 from Aa1 and the ratings on its Supplemental Severance Tax Bonds (subordinate lien) to Aa3 from Aa2. At this time we have also assigned Aa2 ratings to the state's current offering of senior lien bonds: Severance Tax Bonds, Series 2016A; Severance Tax Bonds, Refunding Series 2016B; and Taxable Severance Tax Bonds, Series 2016C.

The downgrades are primarily attributable to the sharp reduction in coverage for the senior and subordinate lien bonds resulting from the decline in oil and gas prices and the expectation that coverage will not return to prior levels in the near term. The ratings also reflect the inherent volatility of the pledged revenue stream, which consists primarily of taxes on the production of natural gas and oil in the state; a conservative debt structure that features rapid payout of outstanding bonds; requirements to maintain 12 months' debt service on deposit in the Bonding Fund; and recent enhancements to the additional bonds tests, particularly the use of the lesser of prior year actual and current year projected revenues as the base for the debt service coverage calculations.

Exhibit 1

Falling Tax Revenues Drive Drop in Coverage


Sources: State of New Mexico; Moody's Investors Service.

Credit Strengths

- » Payout is rapid—bonds are issued with a maximum 10-year maturity, and annual debt service declines steadily from fiscal year 2017 to final maturity in 2026.
- » Statutory 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.
- » The state has recently enhanced the additional bonds tests, particular instituting the use of the lesser of prior year actual and current year projected revenues as the base for the debt service coverage calculations.
- » 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.

Credit Challenges

- » Coverage levels are low compared to comparably rated special tax bonds.
- » Pledged severance taxes are volatile due to dominance of oil and gas, and sensitivity to production levels and commodity prices.

Rating Outlook

The outlook on the severance tax bond ratings is negative, reflecting continued uncertainty about the trend of oil and gas prices, and their effect on severance tax revenues and coverage levels.

Factors that Could Lead to an Upgrade

- » Structural changes that strengthen the program, such as an increase in the MADS coverage requirements of the additional bonds tests.

Factors that Could Lead to a Downgrade

- » Deterioration in coverage as a result of further declines in severance tax revenues.
- » Debt policy changes that weaken the program, such as lengthening maturities.

Key Indicators

Exhibit 2

Debt Service Coverage Projected to Decline Significantly in 2016

New Mexico Severance Tax Bonds	FY 2012	FY 2013	FY 2014	FY 2015	FY 2016 Proj
Current Coverage, Senior Lien Bonds (x)	3.95x	3.31x	4.28x	3.64x	2.22x
Current Coverage, Senior & Sub Lien Bonds (x)	3.19x	2.84x	3.81x	3.30x	2.02x
Nominal Pledged Revenue (Mil.)	\$480	\$424	\$541	\$500	\$316
Pledged Revenue Annual Change (%)	21.5%	-11.7%	27.2%	-7.7%	-36.8%
Senior Lien Additional Bonds Test (x)	2.00x	2.00x	2.00x	2.00x	2.02x
Subordinate Lien Additional Bonds Test (x)	1.60x	1.60x	1.60x	1.60x	1.62x

Note: Additional bonds test will increase gradually to 2.10x and 1.66 times in 2019; see report text.

Sources: State of New Mexico; Moody's Investors Service

This publication does not announce a credit rating action. For any credit ratings referenced in this publication, please see the ratings tab on the issuer/entity page on www.moody's.com for the most updated credit rating action information and rating history.

Recent Developments

Recent developments are incorporated in the Detailed Rating Considerations.

Detailed Rating Considerations

Tax Base and Nature of Pledge

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. 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. These taxes are separate from the "severance" taxes and mineral production royalties deposited in the state's General Fund.

New Mexico is the sixth-largest producer of crude oil in the nation, after Texas, North Dakota, California, Alaska, and Oklahoma. The majority of the state's oil is produced in the Permian Basin in the southeastern portion of the state. The volume of oil production increased rapidly after fiscal 2009, reaching a record level in fiscal 2015. Oil prices and the taxable value of oil produced peaked in fiscal 2014. The state is the seventh largest producer of natural gas in the nation, with the majority of the state's production in the San Juan Basin in the northwestern corner of the state. The volume of gas production has been in gradual decline since fiscal 2005. Gas prices and the taxable value of gas produced peaked in fiscal 2008.

Severance tax 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 oil and gas reserves. The historic volatility of severance tax revenues was demonstrated by a dramatic 32.2% decline in fiscal 2010 and an 11.7% decline in fiscal 2013. Past large decreases have generally been followed by large increases. The recent decline in oil and gas prices has resulted in particularly large declines in pledged revenues--a drop of 7.7% in fiscal 2015 and a projected drop of 36.8% in 2016. These losses are unlikely to be recovered in near term.

Debt Service Coverage and Revenue Metrics

As a result of the decline in severance tax revenues, current coverage has fallen from recent levels. Fiscal 2015 actual revenues provided 3.64 and 3.30 times coverage of 2015 debt service on the senior and subordinate bonds, respectively. Fiscal 2016 projected revenues are expected to provide 2.22 and 2.02 times coverage of 2016 debt service on the senior and subordinate bonds, respectively. Projected 2016 revenues provide 2.16 times coverage of peak debt service on the senior lien bonds and 1.91 coverage of peak debt service on the senior and subordinate lien bonds combined, both following the issuance of the 2016 bonds.

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 Covenant

DEBT STRUCTURE

Following the issuance of the 2016 bonds, the state will have an estimated \$862.8 million senior lien bonds and \$112.5 million subordinate lien bonds, all fixed-rate.

The volatility of the pledged revenue stream is 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 steadily from fiscal 2017 through final maturity in 2026. As a result of this structure, severance taxes could fall significantly for multiple years without any shortfall in the amounts required for debt service.

Severance taxes are deposited upon receipt in the Bonding Fund. There is no debt service reserve for the bonds. However, state statutes require 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.

The state recently enacted legislation enhancing the additional bonds tests for the severance tax bonds. Most significantly, base revenues for the tests was changed from the prior year actual to the lesser of prior year actual and current year projected. This limits the issuance of additional bonds in periods of significant revenue decline, such as fiscal 2016. In addition, the coverage requirement for

senior lien bonds will increase gradually from 2.0 times to 2.10 in 2019, while the coverage requirement for senior and subordinate lien bonds combined will increase gradually from 1.60 times to 1.66.

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.

PENSIONS AND OPEB

The state's pensions are primarily provided through the multi-employer Public Employees Retirement Association (PERA). Moody's adjusted net pension liability (ANPL) for the state for fiscal 2014 is \$6.4 billion. Its three-year average ANPL through 2014 equaled 52% of governmental revenues, slightly below the 53% 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 many best governance practices including a consensus revenue forecasting process, multi-year revenue projections, and timely budget adoption, its financial reporting has had 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 been released on a timely basis. Prior to fiscal 2007, CAFRs were issued on average 19 months after the end of the fiscal year.

The state has made significant progress in improving its financial reporting. The fiscal year 2013 and 2014 CAFRs were audited, but these audits contained numerous findings related to cash reconciliations and consolidations. The state is committed to a number of initiatives to eliminate the findings and improve the timeliness of its CAFRs. Officials expect that the 2015 CAFR will be released in June 2016, 12 months after the end of the fiscal year. They also expect the number of audit findings to be reduced. The fiscal 2015 statutory General Fund audit reflected sufficient progress on cash reconciliation to allow the state to release the \$100 million special reserve it had established to cover any adjustments necessary to resolve the cash discrepancies and to receive an unqualified audit opinion. 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 credit challenge.

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 2016A and Taxable Series 2016C bonds will fund general government capital projects. Proceeds of the Series 2016B bonds will be used to refund outstanding senior lien bonds for debt service savings.

Obligor Profile

New Mexico is the 36th-largest state by population, at 2.1 million. Its state gross domestic product, \$92.2 billion, is the 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.

Methodology

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

Ratings

Exhibit 3

New Mexico (State of)

Issue	Rating
Severance Tax Bonds, Series 2016A	Aa2
Rating Type	Underlying LT
Sale Amount	\$141,220,000
Expected Sale Date	05/17/2016
Rating Description	Special Tax: Non-Sales/ Non-Transportation
Severance Tax Bonds, Refunding Series 2016B	Aa2
Rating Type	Underlying LT
Sale Amount	\$196,405,000
Expected Sale Date	05/17/2016
Rating Description	Special Tax: Non-Sales/ Non-Transportation
Taxable Severance Tax Bonds, Series 2016C	Aa2
Rating Type	Underlying LT
Sale Amount	\$75,000,000
Expected Sale Date	05/17/2016
Rating Description	Special Tax: Non-Sales/ Non-Transportation

Source: Moody's Investors Service

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