

New Mexico; Miscellaneous Tax

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Credit Profile

US\$223.19 mil severance tax bnds, rfdg ser 2016B due 07/01/2024		
<i>Long Term Rating</i>	AA-/Stable	New
US\$170.2 mil severance tax bnds ser 2016A due 07/01/2026		
<i>Long Term Rating</i>	AA-/Stable	New
US\$75.0 mil taxable severance tax bnds ser 2016C due 07/01/2022		
<i>Long Term Rating</i>	AA-/Stable	New
New Mexico severance tax		
<i>Long Term Rating</i>	AA-/Stable	Downgraded
New Mexico severance tax		
<i>Long Term Rating</i>	AA-/Stable	Downgraded
New Mexico supplemental severance tax		
<i>Long Term Rating</i>	A+/Stable	Downgraded

Rationale

S&P Global Ratings lowered its rating on the State of New Mexico's \$717.8 million parity senior-lien severance tax bonds to 'AA-' from 'AA', and lowered its rating on the state's \$122.5 million New Mexico subordinate supplemental severance tax bonds to 'A+' from 'AA-'.

The downgrades follow what we believe are a significant drop in New Mexico oil and gas prices that we expect will lead to a material decline in severance tax debt service coverage (DSC) by pledged revenue for the foreseeable future. The outlook on all bonds is stable, reflecting our belief that DSC will remain good, if reduced, following expected declines in severance taxes this year.

At the same time, S&P Global Ratings assigned its 'AA-' long-term rating and stable outlook to New Mexico's series 2016A severance tax bonds, series 2016B severance tax refunding bonds, and series 2016C taxable severance tax bonds.

A lien on money deposited into the severance tax bonding fund, including net tax receipts generated from natural gas, 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 debt service.

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

- Significant recent declines in pledged revenue, including an 8% decline in pledged severance tax revenue in fiscal 2015, and an estimate by the state of what we consider a large 38% decline for the fiscal year ending June 30, 2016, based on the state's January 2016 forecast. The declines are attributable to falling oil and gas prices and production. We believe that prices could remain depressed for some time;
- Still strong 2.00x coverage of pro forma senior-lien maximum annual debt service (MADS) after this sale, using the

state's estimate of fiscal 2016 severance tax revenue, although this coverage is down from 3.39x in 2015, the time of our last review when we used previous lower MADS and 2015 revenue. The state calculates debt service using additional interest earnings and financing sources, which we calculate would produce new senior-lien MADS coverage based on fiscal 2016 revenue estimates at a slightly higher level of 2.10x;

- Good 1.78x coverage of combined senior- and subordinate-lien MADS by severance tax revenue alone, although down from 2.99x coverage (from our 2015 rating review) using previous MADS;
- Strong senior-lien additional bonds test (ABT) requiring at least 2.0x DSC to issue additional parity senior-lien bonds, and a good subordinate-lien ABT requiring 1.6x DSC. Based on recently enacted legislation, the coverage tests will increase gradually in the next three years from 1.66x MADS to 2.10x MADS by fiscal 2019, and will use the lesser of the current or previous year receipts; and
- Declining debt service schedule after 2017 and rapid debt amortization, with all principal to be retired by 2026.

Additional rating factors include what we consider:

- The inherent instability associated with natural gas and oil prices and production levels, which account for the bulk of pledged revenues. Previously, severance tax receipts declined 32% in fiscal 2010 and increased 21% and 28% in 2012 and 2014, respectively; and
- State geographic limitations in serving natural gas markets that might be distant from New Mexico, particularly as shale gas production picks up near eastern markets.

We understand that the proceeds of the series 2016A and 2016C bonds will be used to fund various state capital improvements, and the series 2016B bonds will be used to advance-refund certain maturities of the state's series 2011A-1, 2013A, and 2014A severance tax bonds. Most of the refunding savings will be taken in the first four years, although no year will have present value dissavings because of the refunding.

New Mexico levies severance taxes on a variety of minerals. Oil (67% of projected fiscal 2016 severance taxes), natural gas (29%), and coal (3%) are the major severance tax revenue generators. Carbon dioxide, copper, potash, and other minerals account for the balance. We calculate fiscal 2015 severance taxes produced strong 3.23x coverage of new senior-lien pro forma MADS after this sale, not including interest earnings or other financing revenues, with MADS expected in fiscal 2017. We calculate fiscal 2015 severance tax revenues cover new combined senior- and subordinate-lien MADS by 2.86x. In addition, the state realized \$5 million of investment earnings in its bond fund in fiscal 2015 and \$8.4 million from other financing sources. Including interest earnings and other financing sources, we calculate senior-lien MADS coverage by 2015 severance taxes rises slightly to 3.32x, and combined senior and subordinate MADS coverage rises to 2.94x.

However, the state estimates severance taxes will decline 38% in fiscal 2016, based on New Mexico's Jan. 15, 2016, forecast. This follows a previous 8% decline in 2015. We calculate this would produce what we view as a significant decline in MADS coverage, to a still-strong 2.00x in fiscal 2016, and good coverage of 1.78x on combined senior and subordinate MADS. The state forecasts an 11% increase in severance taxes in fiscal 2017. We believe that the state's oil price forecast of \$42 per barrel in fiscal 2017 and \$3.20 per thousand cubic feet (/mcf) is in line with S&P Global Ratings' forecast (see "S&P Lowers Its Hydrocarbon Price Desk Assumptions On Market Oversupply," published Jan. 12, 2016, on RatingsDirect). Typically, New Mexico oil sells about 10% below benchmark Texas crude oil due to higher transportation costs, while New Mexico natural gas sells somewhat above benchmarks due to useable liquids typically contained within the state's natural gas.

In our opinion, forecasted revenue declines further illustrate the volatile and cyclical nature of severance taxes, which we believe has been offset from a credit perspective by high DSC, a declining debt service schedule, and strong ABTs. While previous declines may have had primarily a cyclical element, we believe current price declines are partially the result of new drilling technology and may persist for some time. In fiscal 2010, pledged severance tax revenue declined 32%, followed by a 6% increase in fiscal 2011. In fiscal 2012, tax revenues rose 21%, followed by another 12% decline in 2013. In 2014, tax revenue increased 28% as oil production rose to a peak and there was a slight uptick in natural gas production. However, we believe that increasing recent oil and gas production because of "fracking" and horizontal drilling, particularly in eastern shale fields located closer to population centers, have reduced demand for New Mexico natural gas. The state's severance taxes fell 8% in fiscal 2015. Last July, New Mexico projected increased lower prices would reduce state severance taxes by a further 21% in 2016. However, its updated January 2016 forecast now projects a 38% drop in severance taxes in 2016, and we believe the reduction could be greater as the result of recent oil and gas volatility. New Mexico projects that severance taxes will increase 11% in fiscal 2017 and 7% in 2018 as oil prices recover.

The ABTs for the severance tax bonds limits the state's ability to issue parity debt. These tests and a "best efforts" pledge to maintain annual deposits in the bonding fund equal to 2.0x senior DSC and 1.6x supplemental DSC are positive credit factors, in S&P Global Ratings' opinion. New Mexico typically issues short-term notes with a one-day maturity to the state treasurer to make funds available for capital projects, although, based on statute, notes can be issued for longer periods as long as they mature within the fiscal year. New Mexico can spend severance tax revenue for capital projects through the issuance of these notes if pledged deposits cover total combined annual debt service of senior, subordinate supplemental, and short-term bonds by at least 1.05x. Based on enacted legislation, the state could spend severance taxes for capital projects midyear if the lesser of previous-year or current-year receipts covers all annual debt service by 1.06x in fiscal 2016 phased to 1.16x by fiscal 2022. 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. The state currently plans to sell additional severance tax debt of about \$166 million-\$170 million per year over 10 years, to the extent permitted by the ABTs.

Outlook

The stable outlook reflects our expectation that DSC will remain strong on senior-lien debt and good on subordinate-lien debt during our two-year outlook horizon as oil and gas prices and production stabilize, or recover, and a declining debt service schedule props up MADS coverage. We expect that, as debt rolls off, New Mexico will continue to issue additional debt, which will keep DSC near the ABT. However, we see DSC as protected from significant additional bonding due to what we view as the good ABTs. We also expect natural gas and oil reserves will continue to be replenished to maintain sufficient production over the bonds' relatively short 10-year life, despite depressed oil and gas prices and the potential for future cyclicity in severance tax revenues. Should MADS coverage fall materially below the ABTs, a further downward adjustment of the rating or outlook is possible. If we believe the long-term outlook for prices, production, and additional bonding would support future DSC levels that would remain substantially above the ABTs, which we don't believe will occur in the near term, we could potentially raise the ratings.

Bond Provisions

The bonds are a special obligation of New Mexico, secured by monthly 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 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.

The legislature has revised state statutes to reduce the severance tax bonding capacity in order to provide additional funds flowing to the severance tax permanent fund. The statutes currently prohibit 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 the lesser of the severance tax bond deposits in the previous year or current year cover certain threshold tests each year. Beginning in fiscal 2016, senior severance tax bonds outstanding must be serviced with no more than 49.4% of the annual deposit into the severance tax bonding fund, and total senior and long-term supplemental severance tax bonds by no more than 61.9% of the annual deposit--this is equivalent to a 2.02x ABT on the senior-lien bonds and a 1.62x ABT on the combined senior- and junior-lien bonds. The capacity is reduced each year for the next few years until fiscal 2019 when senior bonds can be serviced with no more than 47.10% of annual deposits and senior and supplemental long-term bonds require no more than 60.1% of deposits, or effective ABTs of 2.12x and 1.66x, respectively. 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. In fiscal 2016, state officials can also issue short-term supplemental tax notes maturing within the fiscal year if New Mexico can service total combined bonds outstanding with no more than 94.4% of the lesser of the previous or current-year annual deposit into the severance tax bonding fund (or 1.06x effective ABT); the test drops each year until fiscal 2022 when it reaches 86.2% (or 1.16x effective ABT). Aside from the change to bonding capacity mentioned above, the state reports that there have been no other recent significant legislative changes in the severance tax distributions, the tax base, or to severance tax rates.

Mineral Production And Reserves

New Mexico oil production has previously benefited from increased production in the Permian Basin, shared with Texas, while natural gas largely comes from the separate San Juan basin, which has seen rising pipeline transportation rates. Increased oil and gas production due to "fracking" and horizontal drilling has led to significant price declines, and consequent decrease in severance tax. Oil production accounted for about 66% of severance taxes in fiscal 2015, and natural gas accounted for 32%.

Oil price declines have affected oil severance taxes. Average oil sales prices in New Mexico peaked in fiscal 2014 at \$95.13/barrel, before declining to \$60.67/barrel in 2015. The state forecasts an average price of \$40.50/barrel in fiscal 2016, \$42.00/barrel in 2017, and \$45.00/barrel in 2018. State oil sales volume hit a peak in fiscal 2015 of 141.4 billion barrels. The state forecasts sales of 150 billion barrels in fiscal 2016, 155 billion barrels in 2017, and 158 billion barrels in 2018. New oil well completions in the state have fallen from a peak of 1,592 in 2011 to 813 in 2015. New Mexico projects that oil severance tax revenue will fall to \$201.8 million in 2016 from \$283.7 million in fiscal 2015.

Oil severance tax rates are 3.75% of value, with reduced rate exceptions for certain categories of production. The state also 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.

Declining natural gas prices have also affected gas severance tax revenue. The gross average natural gas sales price in the state peaked in fiscal 2014 at \$5.13/mcf, before falling to \$3.78/mcf in fiscal 2015. The state's January 2016 forecast projects average natural gas sales prices of \$2.60/mcf in fiscal 2016, \$3.20/mcf in 2017, and \$3.40/mcf in 2018. At the same time, production has been relatively flat, with peak sales volume of 1,186 billion cubic feet (bcf) in fiscal 2014, which fell to 1,185 bcf in 2015. The state forecasts sales of 1,180 bcf in 2016. However, prices have taken a toll on new natural gas drilling activity, with natural gas well completions declining each calendar year from 1,759 bcf in 2006, to 99 bcf in 2015. The state projects natural gas severance tax will fall to \$87.6 million in fiscal 2016 from \$122.0 million in fiscal 2015.

Natural gas severance tax rates are 3.75% of the wellhead value of production less deductions for the expense of processing and transporting to the first point of sale, with greater reductions for certain categories of production. Deductions have ranged from 17.0% of gross value in fiscal 2006 to 26.0% in fiscal 2015 and have been forecast at 23.9% through 2020, which incorporates the higher pipeline transportation costs in the San Juan Basin.

Coal severance taxes were a minimal 2% of fiscal 2015 severance tax revenue. After a number of years of stable revenues, net coal severance tax declined 41.2% in fiscal 2011, 18.0% in 2014, and 27.0% in 2015. The state attributes this to the renegotiation of several long-term mine-mouth contracts, and a gradual switch of electric generators from coal to other power sources. New Mexico has exempted new coal contracts from a coal surtax, reducing the overall effective tax rate per ton of coal to 1.11% of value in 2015 from 1.77% in 2011. As a result of decreasing production and the lower effective tax rate, net coal severance tax fell by more than 50% from fiscal years 2011 to 2015 to a net \$5.9 million after intergovernmental tax credits. The state's forecast projects coal severance tax receipts will remain stable at \$10 million through fiscal 2020.

Other severance tax sources comprise a minor portion of overall tax revenue.

New Mexico Severance Tax Bond Coverage

Fiscal year	Current historical and projected total severance taxes (\$)	Y-O-Y change (%)	Senior-lien MADS (\$)	Senior-lien MADS coverage (x)	Annual senior-lien debt service (DS)	Coverage of annual senior-lien DS (x)	Combined senior and subordinate MADS (\$)	Coverage of combined senior and subordinate MADS (x)
2011	366,727	0.0	150,681	2.4	103,867	3.53	169,707	2.2

New Mexico Severance Tax Bond Coverage (cont.)

Fiscal year	Current historical and projected total severance taxes (\$)	Y-O-Y change (%)	Senior-lien MADS (\$)	Senior-lien MADS coverage (x)	Annual senior-lien debt service (DS)	Coverage of annual senior-lien DS (x)	Combined senior and subordinate MADS (\$)	Coverage of combined senior and subordinate MADS (x)
2012	462,831	26.2	150,681	3.1	121,367	3.81	169,707	2.7
2013	414,375	(10.5)	150,681	2.8	127,951	3.24	169,707	2.4
2014	530,668	28.1	150,681	3.5	126,397	4.20	169,707	3.1
2015	486,039	(8.4)	150,681	3.2	137,412	3.54	169,707	2.9
2016p	301,595	(37.9)	150,681	2.0	142,085	2.12	169,707	1.8
2017p	335,339	11.2	150,681	2.2	150,681	2.23	169,707	2.0
2018p	359,041	7.1	150,681	2.4	144,492	2.48	169,707	2.1
2019p	377,637	5.2	150,681	2.5	134,573	2.81	169,707	2.2
2020p	389,531	3.1	150,681	2.6	123,217	3.16	169,707	2.3

YOY--Year-over-year. p--State's projections. MADS--Maximum annual debt service.

Related Criteria And Research

Related Criteria

- USPF Criteria: Special Tax Bonds, June 13, 2007
- Criteria: Use of CreditWatch And Outlooks, Sept. 14, 2009

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