

CREDIT OPINION

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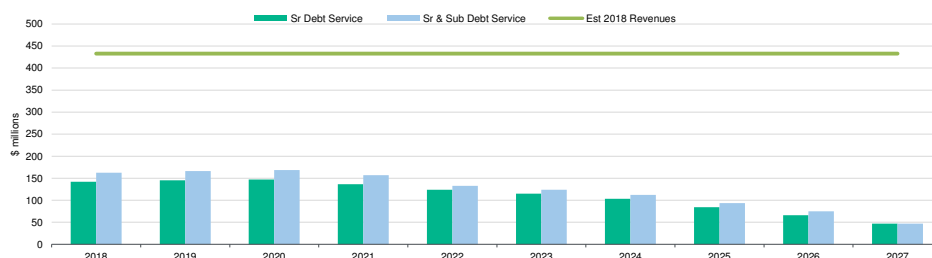
Update to credit analysis--New Mexico severance tax bonds

Summary

The credit quality of New Mexico's severance tax bonds (senior lien Aa2 stable, subordinate lien Aa3 stable) incorporates the inherent volatility of the pledged revenue stream, which consists primarily of taxes on the production of natural gas and oil in the state. This volatility is evidenced by sharp declines in fiscal 2015 and 2016, followed by recovery in 2017 and 2018. At the same time the bonds benefit from: a conservative debt structure that features rapid payout of outstanding bonds; requirements to maintain 12 months' debt service on deposit in the Bonding Fund, the fund in which pledged severance tax receipts are held; and 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

Bonds retire rapidly, debt service declines annually



Source: Official Statements.

Credit strengths

- » Pledged severance tax revenues have recovered following significant declines in fiscal 2015 and 2016.
- » Payout is rapid; bonds are issued with a maximum 10-year maturity, and annual debt service declines steadily from fiscal year 2019 to final maturity in 2027.
- » Statutory provisions offset the absence of a reserve fund--the state must maintain 12 months of debt service in the Bonding Fund before excess revenues can be released.

- » The state enhanced the additional bonds tests, in 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, via the issuance of short-term notes, used for capital spending.

Credit challenges

- » Coverage levels are relatively 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 stable outlook reflects the expectation that pledged revenues will not experience additional declines of the magnitude experienced in fiscal 2015 and 2016 in the near future, and that the state will maintain its conservative practices for leveraging this volatile revenue stream.

Factors that could lead to an upgrade

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

Factors that could lead to a downgrade

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

Key indicators

Exhibit 2

New Mexico Severance Tax Bonds	FY 2013	FY 2014	FY 2015	FY 2016	FY 2017
Current Coverage, Senior Lien Bonds (x)	3.31x	4.28x	3.64x	2.18x	2.52x
Current Coverage, Senior & Sub Lien Bonds (x)	2.84x	3.81x	3.30x	1.99x	2.22x
Nominal Pledged Revenue (Mil.)	\$424	\$541	\$500	\$310	\$355
Pledged Revenue Annual Change (%)	-11.7%	27.7%	-7.7%	-38.0%	14.5%
Senior Lien Additional Bonds Test (x)	2.00x	2.00x	2.00x	2.00x	2.05x
Subordinate Lien Additional Bonds Test (x)	1.60x	1.60x	1.60x	1.60x	1.63x

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

Source: Official Statements.

Profile

New Mexico is the 36th-largest state by population, at 2.1 million. Its state gross domestic product, \$97.1 billion, is the 37th-largest. The state's wealth levels are below average, with per capita personal income equal to 77.4% of the US level and a poverty rate among the highest for US states.

Detailed credit 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.

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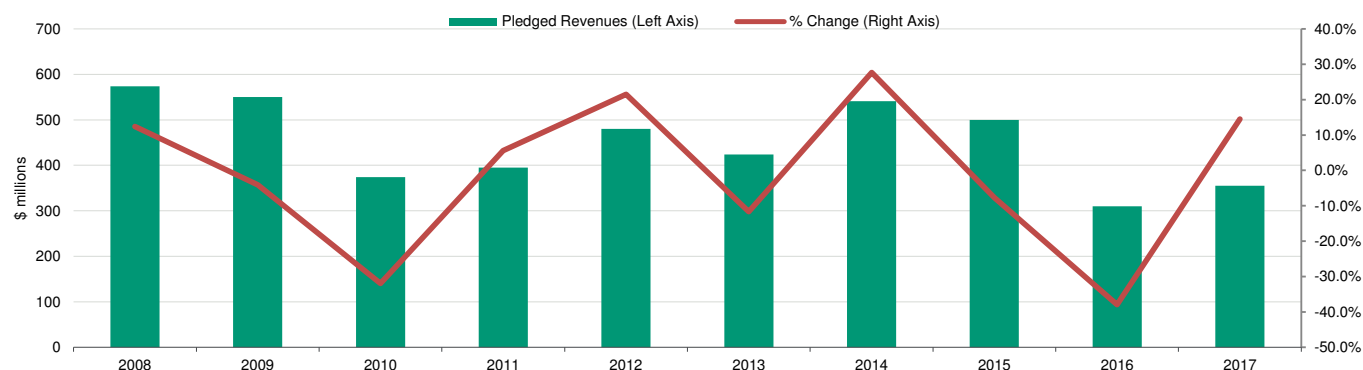
In fiscal 2017, severance taxes on oil and natural gas accounted for 97.5% of total severance tax revenues. These taxes are separate from the "severance" taxes and mineral production royalties deposited in the state's General Fund.

[New Mexico](#) (general obligation Aa1 negative) is the sixth-largest producer of crude oil in the nation. 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 of 153 million barrels in fiscal 2017. 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 declined after fiscal 2005, but has been relatively stable in recent years. 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 10.5% decline in fiscal 2013. Past large decreases have generally been followed by large increases. Falling oil and gas prices drove particularly large consecutive declines in severance tax revenues in fiscal years 2015 and 2016, 8.4% and 38.4%, respectively. Higher oil and gas prices and increased production has resulted in a recovery in severance tax revenues--these revenues grew by 12.2% in fiscal 2017 and the state currently projects an increase of 24.8% for fiscal 2018.

Exhibit 3

Pledged revenues have been highly volatile



Source: Official Statements.

Debt Service Coverage and Revenue Metrics

As a result of the decline in severance tax revenues in fiscal years 2015 and 2016, current debt service coverage fell significantly. Fiscal 2014 pledged revenues provided 4.28 and 3.81 times coverage of 2014 debt service on the senior and subordinate bonds, respectively. Coverage fell to 2.18 and 1.99 times in fiscal 2016. The recovery in severance tax revenues has resulted in an improvement in coverage. Fiscal 2018 estimated revenues provide current coverage of 3.04 and 2.66 times for the senior and subordinate bonds, respectively, and peak debt service coverage of 2.94 and 2.57 times.

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

DEBT STRUCTURE

Following the planned issuance of the Series 2018A bonds, the state will have \$855 million of senior lien bonds and \$94 million of subordinate lien bonds outstanding, 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 2020 through final maturity in 2027. 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.

In 2016 the state 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, because it only reduces the amount of money that would otherwise be transferred to the Permanent Fund.

DEBT-RELATED DERIVATIVES

New Mexico has no derivatives related to its general obligation bonds or its severance tax bonds. The New Mexico Department of Transportation is in the process of terminating \$420 million in interest-rate swaps related to its variable rate transportation revenue bonds issued through the New Mexico Finance Authority.

PENSIONS AND OPEB

The state's pensions are primarily provided through the multiemployer Public Employees Retirement Association (PERA). Moody's [adjusted net pension liability](#) (ANPL) for the state for fiscal 2016 is \$6.6 billion. Its three-year average ANPL through 2016 equaled 78% of total governmental own-source revenues, equal to the 78% median for all US states. The state also reports a UAAL for other post-employment benefits (OPEB) of approximately \$3.8 billion. The state's fixed costs—including debt service, Moody's calculated "tread water" pension cost, and OPEB contribution—equal 6.7% of revenues, below the median of 8.5%. Pensions and OPEB are not major factors in the special tax methodology.

Management and Governance

The state has many governance best practices including a consensus revenue forecasting process, multi-year revenue projections, and timely budget adoption. In addition, in conjunction with the fiscal 2018 budget, the state has established a Rainy Day Fund to capture future growth in oil- and gas-related general fund revenues. While it will likely take some time before the fund builds up any sizable balance, the mechanism should enhance budget discipline in periods of increasing revenue.

At the same time, the state's financial reporting has had numerous weaknesses. Prior to fiscal 2013, 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 were not 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. The audited 2015 CAFR was released in early July 2016, 12 months after the end of the fiscal year, and the number of audit findings was substantially reduced. The 2015 audit reflected enough 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. The audited 2016 CAFR was released in early July 2017 and the audited 2017

CAFR is expected to be released in mid-June 2018. 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.

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