

RatingsDirect®

Summary:

New Mexico; Miscellaneous Tax

Primary Credit Analyst:

Oscar Padilla, Farmers Branch (1) 214-871-1405; oscar.padilla@spglobal.com

Secondary Contact:

David G Hitchcock, NEW YORK (1) 212-438-2022; david.hitchcock@spglobal.com

Table Of Contents

Rating Action

Negative Outlook

Credit Opinion

Related Research

Summary:

New Mexico; Miscellaneous Tax

Credit Profile

US\$125.0 mil severance tax bonds ser 2020A due 07/01/2039

<i>Long Term Rating</i>	AA-/Stable	New
-------------------------	------------	-----

New Mexico severance tax

<i>Long Term Rating</i>	AA-/Stable	Affirmed
-------------------------	------------	----------

New Mexico supplemental severance tax

<i>Long Term Rating</i>	A+/Stable	Affirmed
-------------------------	-----------	----------

Rating Action

S&P Global Ratings assigned its 'AA-' rating to the State of New Mexico's \$125 million severance tax bonds, series 2020A, and affirmed its 'AA-' rating on the state's parity senior-lien severance tax bonds. At the same time, S&P Global Ratings affirmed its 'A+' rating on New Mexico's subordinate supplemental severance tax bonds outstanding. The outlook on all ratings is stable.

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, secure 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 2020A bond proceeds will fund various capital improvement projects in the state.

We rate the bonds under our "Priority-Lien Tax Revenue Debt" criteria (published Oct. 22, 2018), which factors in both the strength and stability of the pledged revenues as well as the general credit quality of the entity where pledged revenues are distributed and/or collected (the obligor's creditworthiness [OC]). The priority lien rating for the severance tax bonds is tied to the OC for the State of New Mexico.

Credit overview

Approaching the end of the year, the dual economic shock of a pandemic-induced recession and an oil price rout has disproportionately weighed on New Mexico's economic and budgetary outlook. Despite the shocks, the state's total severance tax receipts (excluding other income) ended fiscal year 2020 up nearly 3% for the year. This is largely attributable to the timing of collections, which we understand lags three months. Since averaging 114 rigs in March 2020, in the work week ending Oct. 16, 2020, rigs totaled 45 in the state, according to Baker Hughes. The impact of the slide in production and price on pledged receipts is captured in the state's projection for the current fiscal year (2021), with receipts forecast to decline nearly 32% from the previous year to \$465.84 million (excluding other income). State projections reflect a subsequent bounce of 14% to \$532.59 million—roughly three-fourths of 2020 levels. While the sector remains pressured, in a sign of somewhat improved conditions, S&P Global Ratings recently revised its oil and natural gas assumptions up for the remainder of the year. Our revised price deck raised Brent and West Texas Intermediate price assumptions by \$10/a barrel (bbl) to \$40/bbl and \$35/bbl, respectively, in 2020, and to \$50/bbl

and \$45/bbl in 2021. Henry Hub and AECO Hub prices per million British thermal units (\$/mmBTU) were revised up to \$2.75/mmBTU from \$2/mmBTU, and to \$2/mmBTU from \$1.25/mmBTU, respectively. (For additional information, see "S&P Global Ratings Revises Oil and Natural Gas Price Assumptions," published Sept. 16, 2020.) Typically, New Mexico oil sells about 10% below benchmark Texas crude oil due to higher transportation costs, while its natural gas sells somewhat above benchmarks due to usable liquids typically contained within the state's natural gas. The state's price forecast of \$38/bbl for oil and \$2.35 per thousand cubic feet (mcf; approximately equivalent to mmBTU) in 2021 aligns roughly with our price assumptions within the short-term. Present headwinds notwithstanding, we anticipate that as the global and national economic recovery begins to gain a stronger footing, pledged receipts will again revert back to growth, albeit likely not at the rate they did in the years prior to the pandemic.

The ratings reflect our view of New Mexico's:

- Very strong 3.4x projected coverage of senior-lien maximum annual debt service (MADS), using fiscal year 2021 forecasted severance taxes, and combined senior- and subordinate-lien MADS by forecasted severance taxes is very strong at 2.96x;
- Declining debt service schedule after fiscal year 2021 and rapid debt amortization, with all principal to be retired by 2031 on the senior-lien and in 2026 on the subordinate-lien;
- Additional bonds tests (ABT) for both senior- and subordinate-lien bonds that is supportive of stable credit quality. State statute requires effectively a senior-lien coverage ABT of 2.10x MADS and 1.66x MADS for combined senior and subordinate bonds, using the lesser of the current or previous year's pledged receipts; and
- High volatility associated with mineral prices and production levels as evidenced by swings in severance tax collections ranging from a decline 38% in 2016 to increasing 46% in 2019.

The stable outlook reflects our view that despite a projected decline in pledged receipts in fiscal year 2021 will remain supportive of very strong debt service coverage (DSC) on senior-lien bonds and supplemental bonds. The stable outlook reflects our expectation that DSC will remain very strong on senior-lien debt and at least strong on subordinate-lien debt our outlook horizon as oil and gas prices 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 good ABTs.

Environmental, social, and governance factors

Absent the implications of COVID-19, we consider New Mexico to have higher environmental and social risks compared with other states. Environmental risks stem from the state's high concentration in the oil and gas industry and potential for increasing regulatory challenges or costs as some sectors of the global economy transition to alternative forms of energy. We also view social risks as slightly higher than those of other states due to New Mexico's below-average population growth and an age dependency ratio that is substantially above the national average. We view its governance risks as being in line with the sector and it has historically maintained a strong management and policy framework to respond to developing risks. For more information on the state's general credit characteristics, see our full analysis, published May 19, 2020.

Negative Outlook

Downside scenario

Should MADS coverage fall materially below the ABTs, a negative rating action or outlook revision is possible.

Upside scenario

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 we could raise the ratings.

Credit Opinion

Revenue volatility: High

New Mexico levies severance taxes on a variety of minerals. Oil (78% of state-estimated fiscal 2021 severance taxes), natural gas (21%), and coal and other minerals (1%) are the major severance tax revenue generators. Total receipts include investment earnings and other income, which have averaged \$18 million since 2016. These other revenues, collectively, are forecast by the state to total \$12 million per year through 2025.

Severance taxes have exhibited marked volatility over time. Following a 28% increase in severance tax revenue in fiscal 2014, severance taxes declined 8% in fiscal 2015, and declined another 38% in fiscal 2016 in a similar price rout, before increasing 12% in fiscal 2017. Subsequently, severance tax receipts grew 35% and 46% in fiscal years 2018 and 2019, respectively. Fiscal year 2020's growth of 3% is forecast to be followed by a 32% decline in 2021. While not anticipated to rebound back to 2020 levels, fiscal year 2022 is forecast to have a healthy bump to 14%. We believe historical fluctuations in severance tax highlight the inherent volatility of commodity prices and mining production, with an outlook that remains susceptible to evolving global economic conditions.

Coverage and liquidity: Very strong (senior-lien); Strong (subordinate supplemental lien)

We calculate fiscal 2021 severance taxes produce very strong, in our view, 3.4x coverage of new senior-lien pro forma MADS that occurs in fiscal 2021 after this sale, not including interest earnings or other financing revenues. We calculate fiscal 2021 severance tax revenues cover new combined senior- and subordinate-lien MADS by 2.96x. Our calculation for MADS coverage excludes the investment earnings and other income. Including these other financing sources, we calculate senior-lien MADS coverage by total forecast pledged revenue rising slightly to 3.49x, and combined senior and subordinate MADS coverage rising to 2.96x. Reflecting the overall strength of the pledged receipts, fiscal 2021 total receipts would have to decline by slightly more than 80% before coverage equaled senior-lien debt service and slightly over 77% for combined coverage.

The estimated 14% severance tax growth in fiscal 2022 provides for senior-lien MADS coverage of 3.96x (excluding other sources), and combined senior- and subordinate-lien MADS coverage to 3.71x. Actual coverage (including realized other financing sources) of senior-lien bonds produced 4.75x with combined coverage of 4.16x.

The ABTs for the severance tax bonds restrict the state's ability to issue parity long-term 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. State statute also limits debt issuance to an effective

coverage test of 2.10x MADS beginning in fiscal 2019 and thereafter for senior debt, and 1.66x MADS for combined senior and subordinate bonds, using the lesser of the current or previous year's pledged receipts. Bond counsel has previously opined that these statutory ABTs cannot be reduced without an impairment of bond covenant. We believe the current ABT substantially constrains issuance of additional new money parity senior-lien debt without an upturn in available pledged tax revenue, although the state expects issuance in future years, which would still be possible in view of the current declining debt service schedule. Senior-lien amortization is front-loaded with 83% of principal retirement in five year and all by 2031. All subordinate-lien supplemental bonds are retired in five years. In our view, the difference in the effective ABTs on the senior-lien and subordinate-lien supplemental bonds is what distinguishes our assessment of overall coverage and liquidity.

New Mexico can also issue temporary short-term supplemental severance tax notes with a lower coverage test. The state typically issues short-term severance tax-secured notes with a one-day maturity to the state treasurer to make funds available for capital projects that would otherwise flow to the state's permanent fund, 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 1.07x. Based on statute, 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 phased up to 1.16x by fiscal 2022.

Pledged severance tax revenues are collected monthly. There is no debt service reserve, however, to release excess funds on the day before semiannual debt service is due, there must be a balance in the bond fund equal to the next two semiannual debt service payments.

Economic fundamentals: Strong

We view the large statewide economic base of nearly 2.1 million people that generates pledged state-derived tax revenues as strong, despite a somewhat above-average reliance on federal employment, due to federal laboratories and military bases, and on oil and gas production. Increased federal defense spending and, until recently, a rebound in oil and gas production due to fracking activity in the Permian Basin, helped boost the state economy in recent years after a previous period of weakness.

Since the Great Recession, the state has experienced slower population growth than the nation, after having faster growth in the previous decade. The state population grew only 0.20% in 2019 and 0.05% in 2018, and had slight declines in both 2014 and 2015, resulting in a 2019 state population of 2.1 million. From 2009-2019, the state population increased overall 2.9%, compared with 7.0% for the U.S. New Mexico's age-dependency ratio (which measures nonworking-age population to working-age population) was 68.1% in 2018, a large 5.6 percentage points above that of the U.S., reflecting a growing retiree population attracted to the state's moderate climate and low cost of living.

The state's relatively large federal employment sector due to the presence of federal laboratories and military bases provides economic stability. The state ranks first in the nation in terms of federal spending per dollar of tax paid, indicating the importance of federal dollars. Federal employment is concentrated in New Mexico's three air force bases, as well as the White Sands Missile Range, and the Los Alamos and Sandia national laboratories. Other industries

include high-technology manufacturing attracted by state tax breaks and the proximity to federal labs, tourism, and call-center businesses, which are partially enticed by New Mexico's low business costs. Governmental sector employment was higher than the national average at 22% of state employment in 2019 compared with 15% nationally; governmental employment does not include additional military employment at the state's military bases.

IHS Markit forecasts the state's gross state product (GSP) will contract 3.8% by the end of 2020, marginally better than the U.S.'s 4.0% contraction, and subsequently rebound with growth of 1.9% and 2.7% in 2021 and 2022, respectively. Long term, we believe the state--like the nation as a whole--will have to contend with certain structural factors: evolving productivity developments, lower labor-force participation, and shifting trade dynamics, and now the potential lasting negative imprint of the pandemic.

Linkage to state general creditworthiness

Given that the state collects the pledged revenues, we view the rating on the severance tax bonds as linked to New Mexico's creditworthiness. For this reason, under our priority-lien criteria, we consider the linkage between the priority-lien pledge and the State of New Mexico close.

Related Research

Through The ESG Lens 2.0: A Deeper Dive Into U.S. Public Finance Credit Factors, April 28, 2020

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. Complete ratings information is available to subscribers of RatingsDirect at www.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column.

Copyright © 2020 by Standard & Poor's Financial Services LLC. All rights reserved.

No content (including ratings, credit-related analyses and data, valuations, model, software or other application or output therefrom) or any part thereof (Content) may be modified, reverse engineered, reproduced or distributed in any form by any means, or stored in a database or retrieval system, without the prior written permission of Standard & Poor's Financial Services LLC or its affiliates (collectively, S&P). The Content shall not be used for any unlawful or unauthorized purposes. S&P and any third-party providers, as well as their directors, officers, shareholders, employees or agents (collectively S&P Parties) do not guarantee the accuracy, completeness, timeliness or availability of the Content. S&P Parties are not responsible for any errors or omissions (negligent or otherwise), regardless of the cause, for the results obtained from the use of the Content, or for the security or maintenance of any data input by the user. The Content is provided on an "as is" basis. S&P PARTIES DISCLAIM ANY AND ALL EXPRESS OR IMPLIED WARRANTIES, INCLUDING, BUT NOT LIMITED TO, ANY WARRANTIES OF MERCHANTABILITY OR FITNESS FOR A PARTICULAR PURPOSE OR USE, FREEDOM FROM BUGS, SOFTWARE ERRORS OR DEFECTS, THAT THE CONTENT'S FUNCTIONING WILL BE UNINTERRUPTED OR THAT THE CONTENT WILL OPERATE WITH ANY SOFTWARE OR HARDWARE CONFIGURATION. In no event shall S&P Parties be liable to any party for any direct, indirect, incidental, exemplary, compensatory, punitive, special or consequential damages, costs, expenses, legal fees, or losses (including, without limitation, lost income or lost profits and opportunity costs or losses caused by negligence) in connection with any use of the Content even if advised of the possibility of such damages.

Credit-related and other analyses, including ratings, and statements in the Content are statements of opinion as of the date they are expressed and not statements of fact. S&P's opinions, analyses and rating acknowledgment decisions (described below) are not recommendations to purchase, hold, or sell any securities or to make any investment decisions, and do not address the suitability of any security. S&P assumes no obligation to update the Content following publication in any form or format. The Content should not be relied on and is not a substitute for the skill, judgment and experience of the user, its management, employees, advisors and/or clients when making investment and other business decisions. S&P does not act as a fiduciary or an investment advisor except where registered as such. While S&P has obtained information from sources it believes to be reliable, S&P does not perform an audit and undertakes no duty of due diligence or independent verification of any information it receives. Rating-related publications may be published for a variety of reasons that are not necessarily dependent on action by rating committees, including, but not limited to, the publication of a periodic update on a credit rating and related analyses.

To the extent that regulatory authorities allow a rating agency to acknowledge in one jurisdiction a rating issued in another jurisdiction for certain regulatory purposes, S&P reserves the right to assign, withdraw or suspend such acknowledgment at any time and in its sole discretion. S&P Parties disclaim any duty whatsoever arising out of the assignment, withdrawal or suspension of an acknowledgment as well as any liability for any damage alleged to have been suffered on account thereof.

S&P keeps certain activities of its business units separate from each other in order to preserve the independence and objectivity of their respective activities. As a result, certain business units of S&P may have information that is not available to other S&P business units. S&P has established policies and procedures to maintain the confidentiality of certain non-public information received in connection with each analytical process.

S&P may receive compensation for its ratings and certain analyses, normally from issuers or underwriters of securities or from obligors. S&P reserves the right to disseminate its opinions and analyses. S&P's public ratings and analyses are made available on its Web sites, www.standardandpoors.com (free of charge), and www.ratingsdirect.com (subscription), and may be distributed through other means, including via S&P publications and third-party redistributors. Additional information about our ratings fees is available at www.standardandpoors.com/usratingsfees.

STANDARD & POOR'S, S&P and RATINGSDIRECT are registered trademarks of Standard & Poor's Financial Services LLC.