S&P Global Ratings

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Summary:

New Mexico; Miscellaneous Tax

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Credit Profile		
US$312.115 mil severance tax bnds ser 2021A due 07/01/2031		
Long Term Rating	AA-/Stable	New
New Mexico MISCTAX		
Long Term Rating	A+/Stable	Affirmed
New Mexico MISCTAX		
Long Term Rating	AA-/Stable	Affirmed

Rating Action

S&P Global Ratings assigned its 'AA-' rating to the State of New Mexico's approximately $312.12 million severance tax bonds, series 2021A, 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, 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 2021A 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, on RatingsDirect), which factor 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 New Mexico.

Credit overview

A little more than a year removed from the uncharacteristically volatile period spurred by a pandemic-induced recession and an oil price rout, the headwinds which disproportionately weighed on New Mexico's economic and budgetary outlook, have now abated and reversed course. 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 reflected in the timing of collections, which we understand lags three months. After falling to 41 active rigs in in the fall of 2020, rig counts have steadily increased back to 72 as of May 2021, although still off their most recent peak of 117 right before the onset of the pandemic in early March 2020, according to Baker Hughes. The effect of the slide in production and price on pledged receipts is captured in the state's projection for the current fiscal year (2021), although its most revised forecast reflected a considerable improvement. While receipts were originally forecast to decline nearly 32% from the previous year (2020) to $465.84 million (excluding other income), the current forecast projects receipts being 5.6% lower, at $642.36 million. State projections reflect a subsequent bounce of 8.8% to $698.6 million in fiscal year

2022--roughly 2.7% more than 2020 levels. Total forecasted receipts are projected to be $654.36 million and $710.63 million in fiscal years 2021 and 2022, respectively. In a sign of overall improved conditions, S&P Global Ratings revised its oil and natural gas assumptions upward for the remainder of 2021 and 2022. Our revised price deck raised Brent and West Texas Intermediate price assumptions by $10/a barrel (bbl) to $60/bbl and $55/bbl, respectively, for 2021 and 2022. (For additional information, see "S&P Global Ratings Revises Oil And AECO Natural Gas Price Assumptions And Introduces Dutch Title Transfer Facility Assumption," March. 8, 2021). The state's price forecast is $43.5/bbl for oil and $2.45 per thousand cubic feet (mcf; approximately equivalent to mmBTU) in 2021. 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 its natural gas. While the strong reversal in prices since bottoming in 2020 has been a welcome surprise to the state, in our view, a new risk that has emerged involves potential changes in federal policy that could curtail or materially alter production operations in the state even if indirectly. We have noted ongoing risk from increasing regulations of carbon emissions and an accelerating energy transition to renewable energy that will overtime exert negative pressure on operating environments for states that have a comparatively large energy production exposure. (For more information, see "U.S. Oil And Gas-Dependent States Are Out Of The Woods (For Now)," April 15, 2021.) Lingering uncertainty notwithstanding, we anticipate that as the global and national economic recovery continues to gain momentum, pledged receipts will again revert 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 4x projected coverage of senior-lien maximum annual debt service (MADS), using fiscal year 2021 total forecasted receipts ($654.36 million), and combined senior- and subordinate-lien MADS by forecasted severance taxes is very strong at 3.79x;
- Declining debt service schedule after fiscal year 2023 and rapid debt amortization, with all principal to be retired by 2032 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 effectively requires 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 of 38% in 2016 to a jump of 46% in 2019.

The stable outlook reflects our view that despite a projected decline in pledged receipts in fiscal year 2021, total pledged receipts will remain supportive of very strong debt service coverage (DSC) on senior-lien and supplemental bonds. The outlook also reflects our expectation that DSC will remain very strong on senior-lien debt and at least strong on subordinate-lien debt over 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

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 on New Mexico, published April 30, 2021.

Stable 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 (82% of state-estimated fiscal 2021 severance taxes), natural gas (17%), and coal and other minerals (1%) are the major severance tax revenue generators. Total receipts include investment earnings and other income, which have averaged slightly over $18.5 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, the taxes declined 8% in fiscal 2015, and fell 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 roughly 3% is forecast to be followed by a 5.6% decline in 2021. By fiscal year 2022, they are forecast to grow 8.8% relative to 2021. 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 domestic and global economic policies.

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

We calculate fiscal 2021 severance taxes produce very strong, in our view, 3.9x coverage of new senior-lien pro forma MADS that occurs in fiscal 2023 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 3.7x. 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 4x, and combined senior and subordinate MADS coverage rising to 3.79x. Reflecting the overall strength of the total pledged receipts, fiscal 2021 total receipts would have to decline by 75% before coverage equaled senior-lien MADS and roughly 74%

for combined coverage.

The forecasted 8.8% severance tax growth in fiscal 2022 provides for senior-lien MADS coverage of 4.8x (excluding other sources), and combined senior- and subordinate-lien MADS coverage to nearly 4.1x.

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 all debt being retired by 2032. 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- 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, but 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 slightly over 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 0.32% in 2020 and 0.28% in 2019, and had slight declines in both 2014 and 2015. From 2010-2020, it increased 2.0% in aggregate, compared with 7.0% for the U.S. New Mexico's age-dependency ratio (which measures nonworking-age to working-age population) was 68.4% in 2019, a large 5.3 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. New Mexico 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 the state'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 22.6% of state employment in 2020 compared with 15.8% nationally; governmental employment does not include additional military employment at the state's military bases.

IHS Markit forecasts a 4.6% rebound in calendar year 2021 real gross state product (GSP), followed by 5.8% growth in 2022, compared to a forecasted expansion for the nation of 6.2% in 2021 and 4.3% in 2022. While New Mexico is forecast to grow slightly more than the national level in 2022, in the outer years, we anticipate the state will likely revert back to lagging the nation but will nevertheless benefit from overall growth. 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