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FISCAL IMPACT REPORT

ORIGINAL DATE 02/13/13

SPONSOR Gonzales LAST UPDATED _____ HB 391

SHORT TITLE State Transportation Project Bonds SB _____

ANALYST Soderquist

ESTIMATED ADDITIONAL OPERATING BUDGET IMPACT (dollars in thousands)

	FY13	FY14	FY15	3 Year Total Cost	Recurring or Nonrecurring	Fund Affected
Total		\$500.0		\$500.0	Nonrecurring	State Road Fund

(Parenthesis () Indicate Expenditure Decreases)

SOURCES OF INFORMATION

LFC Files

Responses Received From

Department of Transportation (DOT)
New Mexico Finance Authority (NMFA)

SUMMARY

Synopsis of Bill

House Bill 391 (HB 391) amends Section 67-3-59 NMSA 1978 and provides for the State Transportation Commission (STC) to administer Department of Transportation (DOT) bonds, liquidity facilities, and lines-of-credit previously issued by the New Mexico Finance Authority (NMFA). It also allows the STC to replace the NMFA as the contracting party to enter into interest rate exchange agreements and swap contracts, insurance agreements, remarketing agreements, and other agreements necessary to timely and effective bond issuance. In current statute, the NMFA issues bonds on behalf of the STC with final approval by the State Board of Finance.

HB 391 requires the STC, prior to July 1, 2013, to deliver a transition plan for the aforementioned responsibilities to the State Board of Finance. The transition plan must include the following: 1) notice to bondholders and contractual counterparties of HB 391 and all amendments, if any, to indentures of trust, resolutions, and other documents in connection with the issuance of bonds; 2) a plan for transitioning audit and related financial statement functions related to bonds; and 3) evidence that the ratings associated with the outstanding bonds will not be adversely impacted due to the STC administering the bonds.

FISCAL IMPLICATIONS

Fiscal implications include the costs of transitioning existing outstanding bond issues from the NMFA to the STC/DOT. Costs would include rating agency fees, trustee fees, bond counsel fees, and any other fees that may be necessary to effectuate a transition. Exact costs are unclear but the responses from both the DOT and the NMFA suggest the costs would be roughly \$500.0 thousand and perhaps slightly more. These costs would be non-recurring and would impact the State Road Fund.

Pursuant to a Memorandum of Understanding (MOU) between the STC, the DOT, and the NMFA and consistent with existing statute, the DOT currently pays the NMFA an annual fee equal to .25 percent of the outstanding principal amount of the STC's bonds. Previous transfers of fees totaled approximately \$2.4 million per year.

If the proposed legislation is enacted and the STC/DOT are provided the authority to issue and manage the State Transportation Bond Program, the DOT estimates that the administrative costs associated with the daily management of the Bond Program will be approximately \$870.0 thousand. The assumptions are based on estimated amounts for Professional Service Contracts consisting of Bond Counsel, Financial Advisor, and any other services contracts (including but not limited to the NMFA). Currently unknown costs such as salaries/ benefits, publication fees, subscriptions, travel costs, and other operating costs are not included in that estimate. The assumed future costs to the department are all dependent on bond program activity and may vary from year to year. So while some of the fiscal implications of the proposed transfer cannot be determined at this time, it is fair to say administrative savings will accrue, especially as duplicative activities are no longer pursued by both the DOT and the NMFA.

SIGNIFICANT ISSUES

Having the STC/DOT issue future state transportation bonds would be consistent with the manner in which most states manage their transportation bonding programs. However, the NMFA response mentions some observations relating to the proposed transfer.

The State Transportation Bond Program has approximately \$1.5 billion in outstanding bonds and includes approximately \$420 million in variable rate bonds that are tied to SWAP agreements. The size and complexity of the State Transportation Bond Program indicate that the management of the State Transportation Bond Program requires specific expertise. The NMFA currently assigns two individuals to the oversight and management the State Transportation Bond Program and has significant knowledge of the relevant issues. The STC/DOT contracts with an outside Financial Advisor – Public Financial Management (PFM) – with significant expertise. PFM is the Financial Advisor for many state transportation departments on bond program matters around the country. Further, the STC/DOT already has a bond manager in place that has become increasingly knowledgeable in managing many aspects of the State Transportation Bond Program. According to the NMFA, changing the management of the State Transportation Bond Program to the STC/DOT would likely mean that the STC/DOT would need either to add an individual to manage the cash and investment aspects of the program or to sub-contract these services to the Finance Authority. Given current administrative fees being transferred from the DOT to the NMFA, this would likely be a cost neutral action.

The NMFA has more significant concerns related to changes required by the proposed legislation that converts the responsibility of the issuance of state transportation bonds from the NMFA to the STC/NMFA. The NMFA is not aware of other instances in which an existing issuer of bonds that are outstanding is replaced by another issuer for those outstanding bonds. One way to affect such a change would be to refund all outstanding series of state transportation bonds, though this would not be cost effective. The state would incur significant costs of issuance and not all series of bonds may be able to be refunded on a tax-exempt basis. Federal tax law does permit the refunding of tax-exempt bonds, but only if those bonds are currently callable, or if not, only if the bonds have never been advance refunded. Some of the bonds under the State Transportation Bond Program may not be capable of being refunded on a tax-exempt basis because they may (i) not be currently callable and (ii) have already been advance refunded.

Furthermore, because bonds may only be advance refunded once, advance refunding bonds now might preclude the opportunity to obtain additional interest cost savings in the future, when it might be desirable to refund the bonds for economic, rather than political, reasons. In addition, federal tax law provides that any refunding of tax-exempt bonds triggers the calculation and payment of any arbitrage rebate (i.e., money payable to the federal government based on the profit from buying bonds in one market and selling them in another). Such calculation and payment must be done within 60 days of the date of the refunding and could include a significant amount if such amount was not provided due to the early retirement of the bonds. The early retirement of the bonds means that they have a shorter term and the issuer of the bonds may not be able to take full advantage of the ability to blend the yield on the bonds and, therefore, the amount of rebate owed could increase.

If the outstanding State Transportation Bonds are not refunded, then the NMFA would need to be replaced by the STC/DOT as the issuer of the outstanding bonds. The Master Indenture of Trust dated May 1, 2004 (Master Indenture), under which the State Transportation Bonds are issued, at Section 1105, does provide that all covenants, stipulations, obligations, and agreements of the NMFA will be binding on a successor. However, the proposed change is not a simple matter of succession as the NMFA is actually co-signatory with the DOT and the STC on a number of documents. It is possible that significant amendments will need to be made to the documents to remove the NMFA, rather than merely having the STC/DOT succeed to its covenants and agreements.

At a minimum, the NMFA would recommend amending the Master Indenture and each related supplemental indenture for the 13 series of outstanding bonds. The Master Indenture may be amended with bondholder consent, which would be expensive and time consuming to obtain and bondholders are not required to consent, or without bondholder consent under certain, limited circumstances. An amendment to the Master Indenture without bondholder consent would likely be pursuant to Section 701(O), which would require the Trustee, at its option and in reliance on an opinion of counsel, to determine that the change would not prejudice the Trustee or the owners of the bonds. Because this is an unusual transaction, counsel would likely want to rely on rating agency confirmations and on the certification of a third party that there would be no change to the administration of the bonds that could affect bondholders, including a statement that the STC/NMFA has the capacity to manage the bonding program.

In addition to the indentures, the NMFA is party to credit enhancement agreements and other contracts related to the State Transportation Bond Program. Although the NMFA is currently in the process of reviewing all related bond documents, the NMFA expects that all contracts,

including swap documents, letters-of-credit (LOCs), and insurance contracts, will require specific amendment and consent of the counterparty, which the counterparty, similar to the bondholder, is not required to give. Having the bond issues become the bonds of the STC/NMFA while some of the liquidity facilities remain in the name of the NMFA could create complications for the administration of the program though the market has always understood that the credit risk is solely with the DOT and not with the NMFA.

Finally, the bonds currently outstanding under the State Transportation Bond Program were issued by the NMFA pursuant to Section 67-3-59.3 NMSA 1978. The NMFA is a frequent issuer in the municipal bond market and investors have become familiar with the Finance Authority. Due to that familiarity, investors may in the past have placed some reliance on the NMFA's ability to administer a debt program. Recent evidence suggests that rating agencies and investors would prefer a separation of the NMFA and the STC/NMFA for bond issuance and management purposes. Consideration should be given to the effect disclosure of this change of administration of the bond program could have in the market.

The response from the DOT references many of the same concerns mentioned by the NMFA. Both the DOT and the NMFA agree that the transfer would make the management of the State Transportation Bond portfolio more efficient and perhaps more effective. The dissolution of the MOU and the amendment of the statute have been discussed for several years, with agreement on the action coming between the DOT and the NMFA only recently. However, the fundamental mechanics of the proposed transfer are recognized by both entities as difficult, labor-intensive and time-consuming. Both the DOT and the NMFA state that the effective transfer date proposed in the legislation is overly ambitious and should be amended.

In the last year, the NMFA has confronted concerns related to its audit procedures. The NMFA has provided its 2011 audit to the Office of the State Auditor. The State Auditor is expected to release the audit during the week of February 11th. Both rating agencies have maintained their ratings for the Public Project Revolving Fund – AAA from Standard and Poor's and Aa1 from Moody's. Both rating agencies are awaiting the release of the 2011 audit before removing negative watch designations. Based on the various investigative reports and review of unaudited 2011 audit results just prior to submission to OSA, rating agencies are expecting the 2011 audit will reveal nothing new and the audit situation will become a non-issue provided that progress continues to be made on tightening internal reporting procedures and controls. Consequently, the NMFA will be selling bonds again in May 2013 after the 2012 audit is complete.

PERFORMANCE IMPLICATIONS

The responses from both the DOT and the NMFA indicate there are no significant performance implications involved in the proposed transfer. Although additional staff may be required by the STC/DOT to administer the bonds, the primary result of the proposed legislation would be a reduction in duplication, an increase in flexibility, and efficiencies in expertise.

As mentioned above, the NMFA employs approximately two full time equivalent (FTE) persons to work on the STC/DOT matters. These two FTE could be easily absorbed into the on-going NMFA workload outside of the DOT work so there would be no material budget impact on the NMFA in changing the existing bond portfolio management arrangements. Overall costs to the DOT would likely eventually decline once unnecessary duplication was taken out of the bond management process and once the STC/DOT staff become more familiar with the intricate issues

surrounding the State Transportation Bond Program. It is possible that the DOT would hire additional FTE to assist in the management of the portfolio.

According to the responses from both the NMFA and the DOT, enactment of this legislation should have a net overall benefit to both entities. Neither entity is opposed to the proposed legislation.

ADMINISTRATIVE IMPLICATIONS

HB 391 requires that the transition from the NMFA to the STC/DOT occur by July 1, 2013, and that all bonds and credit facilities are to be placed in the STC/DOT's name by that date. Given the extensiveness and complexity of the technical matters that must be addressed in connection with the transition, the responses from both the DOT and the NMFA question the capacity of the NMFA and the DOT to complete the transfer in that timeframe. Therefore, additional flexibility is requested in the Alternatives section below.

TECHNICAL ISSUES

Transition from bonds under the Finance Authority's name to bonds under the STC/DOT's name will require legal expertise and will be a time-consuming process. For the tax reasons discussed above, in order to maintain their tax-exempt status, transition of some bonds may need to wait until the next available call date, which might be years after passage of the bill. The proposed July 1, 2013 effective date is not feasible.

OTHER SUBSTANTIVE ISSUES

New Mexico is an unusual, and perhaps unique, state in not having its state transportation department issue its own bonds and undertake credit facilities related to bonds in its own name. Currently, both the STC and the NMFA Board have to approve actions taken to issue or modify bonds and to undertake liquidity and credit facilities in multiple the STC and the NMFA Board meetings. Double approvals do not add much oversight as the NMFA has relatively little control over actions directed by the STC. Double approvals do add to costs of issuing bonds and do reduce flexibility to act in a timely manner. All parties must pay separate legal and other fees, which can be material for bond issues and credit facilities, to protect their own interests.

Although the NMFA response states that some new duplication could arise as some functions performed by the NMFA for the DOT are not now capabilities possessed by the DOT, they also recognize that the proposed legislation would allow the STC/DOT to sub-contract with the NMFA for specific services should it make sense to do so. The DOT does employ outside Financial Advisors and the DOT is able to rely on the broad expertise of those Financial Advisors for assistance in managing the DOT bond portfolio. The NMFA could ultimately be one of those entities.

Further, the NMFA response states that there is no investor or rating upside of the DOT issuing bonds through the NMFA but there is a potential investor and ratings downside; hence, the preference of the market to tie management of the DOT bond program to the entity, the STC/DOT, with actual credit responsibility for repayment.

AMENDMENTS

The NMFA supports having the STC/DOT be the issuer of future State Transportation Bonds, thus removing existing duplication of efforts and matching the name on the bonds with the credit risk.

However, in considering HB 391, the both the NMFA and the DOT recommends considering the cost and time required for the following and, most significantly, whether the actions mentioned can be effectively achieved by July 1. Among the many things to consider are: 1) identifying all outstanding documents that would need to be amended; 2) receiving consent from required parties to the amendment of bond documents; 3) negotiating and finalizing the amendments to the relevant documents. Although the NMFA considers it unlikely that bondholder consent would be required (although a bondholder may disagree), Trustee consent would be. The NMFA would expect the Trustee, and perhaps other parties, to require opinions of counsel related to the amendment of the Master Indenture, and perhaps other documents; 4) insurance company consents, as well as the consent of swap counter parties, and LOC credit providers; 5) receiving rating agency confirmation that the bond ratings of outstanding bonds would not change; and 6) dealing with any concerns raised by bondholders and other parties about the switch.

A longer transition period not requiring existing outstanding bonds and credit instruments to be switched within months from the NMFA to the STC/DOT may be in the DOT's best interest. If the bill will include the change of issue, the NMFA recommends adding to the required transition plan that must be submitted to the State Board of Finance, statements that the transition will not create a default under any bond document and that all required consents have been obtained. The NMFA also believes that HB 391 must address what will happen if, for example, a counterparty does not consent to the switch. Finally, the transition cannot occur for bonds where a required consent, opinion or rating confirmation is not obtained.

ALTERNATIVES

The response from the NMFA requests that, in lieu of HB 391, a memorial be passed directing the NMFA and the STC/DOT to work together to develop a plan to transition all transportation financing to the STC/DOT and any required legislation for consideration in the 2014 legislative session.

Further, amend the bill to remove the July 1 deadline, permissively authorizing the STC/DOT to exercise any power or authority necessary or advisable to transfer all transportation bond authority to them and direct the NMFA to cooperate with the STC/DOT in accomplishing the transition. The amendment could specifically authorize the STC/DOT to issue its own bonds in the future, refund Finance Authority bonds, and terminate liquidity facilities and SWAPS when all such necessary financial and administrative components have been completed to the satisfaction of the State Board of Finance. This would allow the transition to be accomplished over time and give the NMFA and the STC/DOT the ability to constructively and effectively address the numerous questions and complexities that are inherent in the task.

Retire the currently outstanding bonds with new bonds issued by the STC/DOT over time as cost effective opportunities arise. New bond issues solely for the purpose of replacing the NMFA with the DOT/STC would require engagement of experts, underwriters and counsel and could be quite expensive. Tax implications discussed above in Significant Issues would also need to be addressed.

To the extent that the transportation bond portfolio is likely to be restructured over the next few years, the NMFA's bonds may be replaced by the STC bonds in the normal course of that restructuring. The market would likely view such a switch positively as State transportation departments issuing their own bonds is the norm in the financial markets.

The existing arrangement can continue though both the STC/DOT and the NMFA are not in favor of continuing the status quo.

The DOT response suggested that the completion date for the proposed transition be modified to July 31, 2013, *or later*. This would allow ample time for the transition and for the STC to gain authority to issue new bonds in the STC's name, obtain credit facilities, and refund outstanding bonds, swaps, etc. in the STC's name when economic conditions are more conducive.

WHAT WILL BE THE CONSEQUENCES OF NOT ENACTING THIS BILL

The consequences include an opportunity lost to reduce duplication and administrative burden and to put the STC/DOT bond issuance processes in line with national practice. However, the current arrangement – administrative fees required by statute to be paid to the NMFA as an example – also transfers funds from the State Road Fund that could be used to reconstruct and maintain state highways, roads, and bridges.

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