Severance Tax Bonding Overview

Department of Finance and Administration
State Board of Finance

Revenue Stabilization & Tax Policy Committee

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History of Severance Tax Bonding Program

Severance taxes have been collected by New Mexico since 1937.

Since 1959, certain severance tax receipts have been deposited into the Bonding Fund and used to service Severance Tax Bonds (STBs) to fund capital improvements.

The modern Severance Tax Bonding Program dates to 1973, when the Severance Tax Permanent Fund (STPF) was created. At the time, statute restricted capacity to issue new STBs such that debt service could be paid with 50 percent of prior fiscal year Bonding Fund revenue.

In 1976, the Permanent Fund reached constitutional status.

Various legislation throughout the years has amended how capacity has been estimated and how STB proceeds are used to fund capital.

- Beginning in 1999, as a result of the Zuni lawsuit, the State was required to establish and implement a uniform system of funding future public school capital improvements. The STB program was expanded so that additional revenue could be used to pay debt service on Supplemental Severance Tax Bonds (SSTBs), which are used to fund public school capital improvements.

- In years when oil and gas revenues have declined, legislation has allowed the BOF to “sweep” the Bonding Fund to fund capital projects.

Overview of STB Program: General Mechanics

Severance Taxes are paid by mineral extraction industries on the value of resources severed from the ground (Severance Tax)

Tax revenues are held within the Severance Tax Bonding Fund (STBF) and are only available to pay debt service, limited costs of administering the STB program, or for transfers to the Severance Tax Permanent Fund (STPF).

- The remaining balance in the STBF, minus the next two debt service payments, is statutorily mandated to be transferred to the STPF 2x/year (December and June).

Debt service payments (on long-term bonds) are paid in January (interest only) and July (principal & interest)

The State issues both Senior and Supplemental Bonds and Notes.

Overview of STB Program: Bonds & Notes

Severance Tax Bonds & Notes:

- Long-term Senior and Supplemental Severance Tax Bonds and short-term Senior and Supplemental Severance Tax Notes are issued by the BOF.
- **Senior** Severance Tax Bonds and Notes fund capital projects appropriated by the legislature
- **Supplemental** STBs (bonds and notes) are issued to fund public school capital projects, as certified and managed by PSCOC.
- **All STBs** are secured and paid by severance tax revenues.

	SENIOR	SUPPLEMENTAL
Long-Term Bonds	Funds capital projects as authorized by the Legislature Tax-Exempt Sold 1x/year, competitively 10-year maturity	Funds public school capital projects as certified by PSCOC Tax-exempt Sold infrequently, competitively 10-year maturity
Short-Term "Sponge" Notes	Funds capital projects as authorized by the Legislature Taxable 1-2-day maturity ("pay as you go") Sold 1-2x/year (Dec/June)	Funds public school capital projects as certified by PSCOC Taxable 1-2-day maturity ("pay as you go") Sold 1-2x/year (Dec/June)

Overview of STB Program: Key Differences

Key Differences

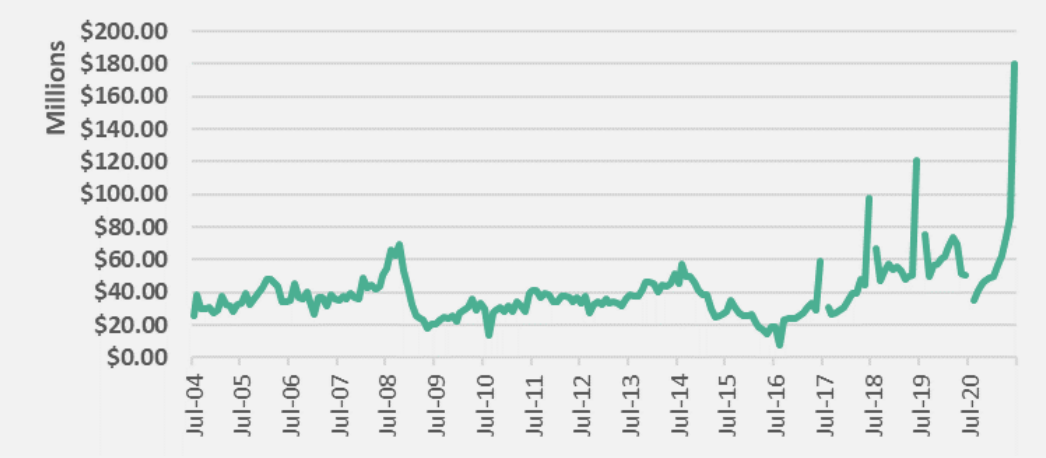
- **Notes** are sold to the State Treasurer's Office to "sponge" up extra cash in the Severance Tax Bonding Fund before balances are transferred to the Severance Tax Permanent Fund.
- **Taxable projects,** as determined through the review process, are typically included in the Notes, allowing for projects that may conflict with IRS requirements for tax-exempt issuances.
- **Earmark Projects** (Water Trust Board, Colonias Infrastructure Board, and Tribal Infrastructure Board) are typically included in the June Senior Severance Tax Note.
  - Receive a statutorily mandated percentage of the Senior Severance Tax Bonding Capacity (9.0% for WTB and 4.5% for each of CIB and TIB).
- **Bond ratings** are received for any long-term debt issued. Ratings are received from Moody's and Standard & Poors.
  - Senior STBs have a senior or first priority lien in the event of default. As a result, Supplemental STBs are rated one notch lower than Senior STBs.

Overview of STB Program: Recent Trends

Recent Trend in Revenues & Issuances

Increases in oil and gas prices and volumes, accelerating in 2019, have significantly increased Severance Tax revenues, resulting in higher bonding capacity.

Monthly Revenues to the Bonding Fund, FY05–FY21

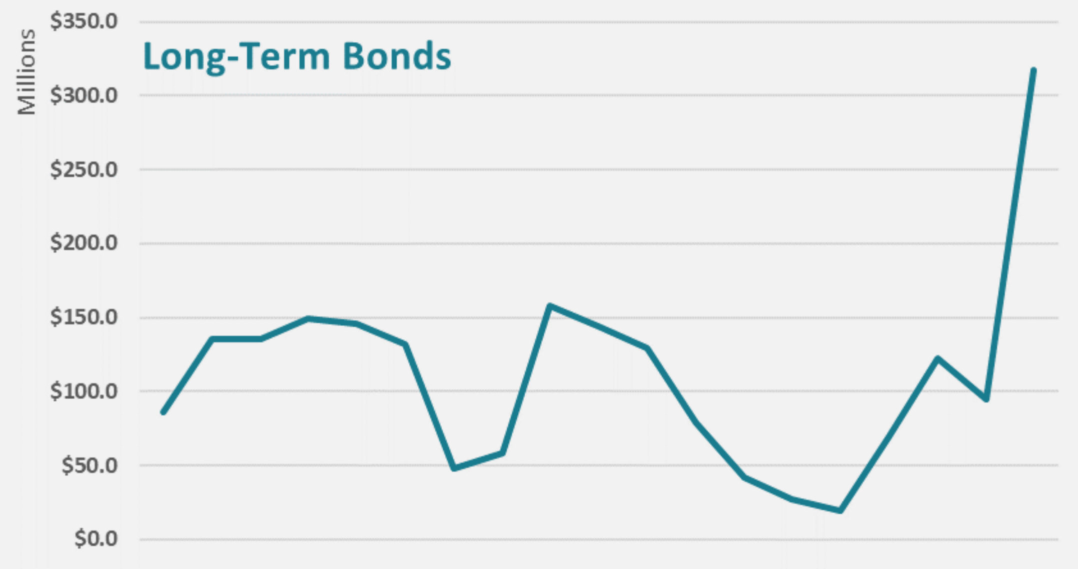


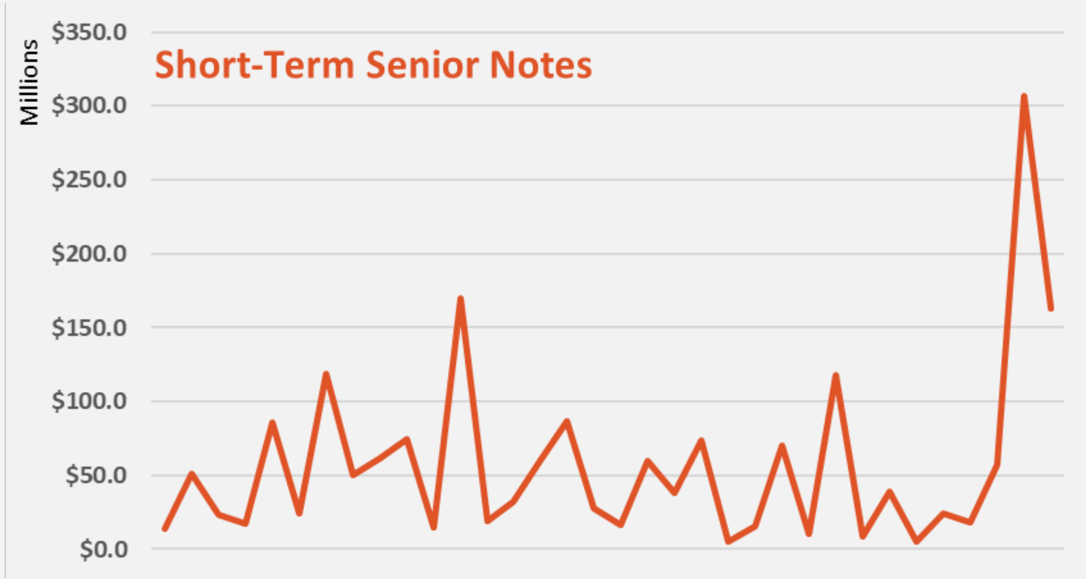
New Mexico's current outstanding STB debt totals:

$994,171,666 (Senior)

$37,318,250 (Supplemental)

Bond & Note Issuances, FY05–FY21





Bonding Capacity: General Information

Revenues

FY21 Revenues

98.1% Oil and Gas Severance Tax Revenues

1.29% Investment Income **0.61%** Coal and Other Mineral Revenues

Estimated Revenues

CREG 5-year estimates (oil and gas prices and volumes) and DFA out-year estimates (years 6–10)

DFA 10-year estimates for all other revenues

Debt Service

FY21 Actual Annual Debt Service

$157.5 million

Projected Annual Debt Service Payments

Based on projected Senior long-term debt

Bonding Capacity: Key Factors

Bonding capacity is an estimate of the amount of debt the State can incur, taking into account several key factors, including:

- **Statutory Limits on Debt**
  - STB: *<u>Senior</u>* annual debt service cannot exceed 47.6 percent of the lesser of the prior year's actual severance tax revenues and the current year's estimated revenues.
  - *<u>Senior and Supplemental</u>* annual debt service cannot exceed 87.8 percent of the lesser of the prior year's actual revenues and current year's estimated revenues.
- **Projected Future Severance Tax Revenues (primarily oil and gas)**
  - The BOF uses 10-year severance tax revenue projections produced by the DFA Chief Economist and the Consensus Revenue Estimating Group (CREG).
- **Outstanding and future projected long-term debt service**
  - Long-term debt service is spread across a 10-year period, because the State issues its long-term bonds with a maturity of 10 years.
  - Short-term debt service (notes) hits within one fiscal year, as notes are sold to the State Treasurer overnight to "sponge" up cash in the severance tax bonding fund.

Bonding Capacity: Timing

Bonding capacity estimates are used to guide the legislature when it makes capital project appropriations during the Legislative session.

- SBOF staff, with the State's financial adviser, prepare preliminary capacity estimates each August, upon release of new tax revenue projections from the Consensus Revenue Estimating Group (CREG) and the DFA chief economist.
- The SBOF updates capacity estimates in December for release to the legislature prior to session start in January.
- If major changes occur that will impact revenue projections during the year, SBOF staff will update the capacity estimates to reflect the most recent revenue outlook.

Bonding Capacity Estimates: Use

The Legislature:

- Uses capacity estimates to appropriate funding to capital outlay projects that will be funded with bond proceeds.
- Makes STB appropriations every year (typically).
- The Senior Severance Tax bonding capacity available for new appropriations equals the total capacity net:
  - Any past capital project appropriations not yet funded (known as "Authorized but Unissued" projects)
  - Earmark projects, including water, colonias, and tribal set asides.
  - Water project funding is managed by the Water Trust Board, which receives 9 percent of annual senior severance tax bonding capacity.
  - Tribal project funding is managed by the Tribal Infrastructure Board, and Colonias project funding is managed by the Colonias Infrastructure Board. Each receive 4.5 percent of annual senior severance tax bonding capacity.

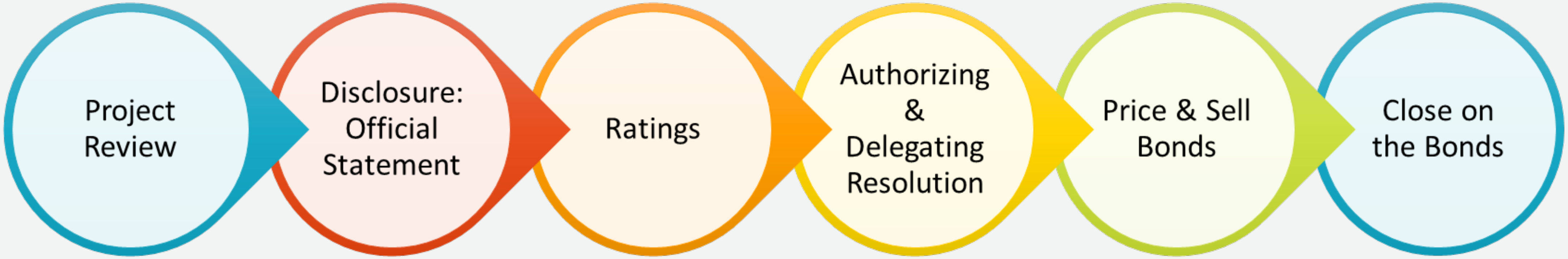
Bonding Capacity: Revenue Scenarios

- Since STBF revenues are derived from the production of oil, natural gas, and other minerals, they are naturally volatile.
- Statutory capacity works to control this by tying capacity to the lesser of two years of revenue.
- The amount of bonds issued is the lesser of statutory capacity **or** cash available.^^
  - Scenario 1: If revenues in the current year are lower than the previous year, then the State issues based on the revenues.
  - Scenario 2: If revenues in the current year are higher than the previous year, then the State issues based on the capacity.
- This ultimately impacts the transfer to the Severance Tax Permanent Fund
  - If the issuance is constrained by cash (Scenario 1), less (or even no) cash will go to the STPF**
  - If the issuance is constrained by capacity (Scenario 2), more cash will go to the STPF

^^Revenue estimates are used in sizing mid-year issuances, most commonly notes

**Legislation in 2019 requires the State to transfer a minimum of $23.69 million to the STPF every December, as long as funds are available after setting aside the next two debt service payments. $31.87 million was transferred in December 2019 and $29.27 million was transferred in December 2020.

The Bond Sale Process: Timeline



The bond sale process is very involved and typically takes around 3 months in total.

Participants in the process are broad and include several other State departments, bond counsel, tax counsel, disclosure counsel, Board of Finance counsel, and the State's financial adviser.

The Bond Sale Process

Project Review

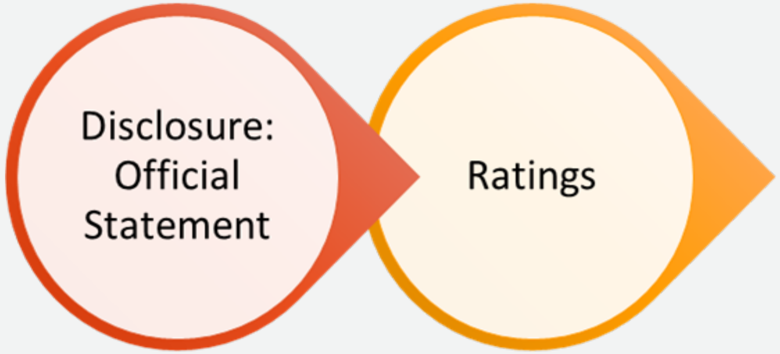
Project Review: The Questionnaire Process

- BOF staff and legal counsel send project questionnaires to the local entities that will be receiving proceeds.
- BOF staff and legal counsel review all projects to identify if any do not meet requirements of state and federal law (tax issues, anti-donation issues, project readiness).
- Projects that are determined to comply with state and federal law and are “ready” to be included in the issuance will be included in the sale.

What typically causes a delay in disbursing project funds?

- Recipient will not be able to encumber 5 percent of the funds within 6 months of bond issuance or expend 85 percent of the funds within 3 years of bond issuance (tax-exempt requirement).
- Funding is not sufficient to complete the project or a well-defined phase of the project.
- The project has Constitutional anti-donation issues.
- Project will be operated by a private or non-profit entity but fair market rent or services in lieu of cash rent has not been established through a lease.
- The public body receiving the appropriation does not own the site.
- The project recipient is not compliant with the State Audit Act and Executive Order 2013-006.

The Bond Sale Process



Drafting of Preliminary & Official Statement

- Requirements for disclosure are outlined by the Federal Securities and Exchange Commission (SEC)
- Extremely important document used to "disclose" any "material" matter related to the state that a reasonable bondholder might consider to impact his/her/its purchase of the bonds.
  - The general financial well-being of the state: financial problems, lawsuits, unfunded liabilities, statutory changes (i.e., is there anything that could negatively impact the state's ability to meet its debt obligation?)
  - Gets published prior to the sales as an informational document to potential bond buyers.

Ratings

- Several DFA divisions participate in presenting to the ratings agencies on the state's economy, budget, fiscal health, and new initiatives.
- Ratings will impact the interest rate at which the bonds are sold.

The Bond Sale Process

Board of Finance adopts an authorizing and delegating resolution approving the sale of the bonds.

- The final project list is produced, following completion of the questionnaire process.

Bonds are priced and sold in a competitive bid process

- The offeror providing the lowest interest rate will be awarded the sale.
- Typically anywhere from five to seven offerors

Agencies provide certifications for proceeds

- Agencies must certify that at least 5 percent of proceeds will be expended or encumbered within 6 months and 85 percent will be expended within 3 years.
- Agencies request and instruct the Board to issue and sell the bonds.
- Agencies certify all conditions, contingencies, and limitations imposed by the act have been satisfied.

Bond Ratings

Bond ratings are critical in saving the State money when issuing debt.

- Higher bond ratings result in a lower cost of issuance to the state as interest rates offered by competitive bidders is lower.

Key Factors for New Mexico

- “Positives” for the ratings agencies:
  - Declining debt service and rapid debt amortization (10-year maturity)
  - Strong existing and statutory debt service coverage and continued conservative debt practices for leveraging volatile revenues (conservative issuance of debt)
  - 25%+ reserves
  - Strong economic fundamentals (strong budgeting practices and debt management, even in economic hardship or challenges)
- Focus areas for potential future upgrades:
  - Economic diversity for less concentration in energy and government employment.
  - Reductions in direct and indirect pension liabilities (although recent legislative action related to PERA and ERB has been viewed as positive steps by ratings agencies)