Fiscal impact reports (FIRs) are prepared by the Legislative Finance Committee (LFC) for standing finance committees of the Legislature. LFC does not assume responsibility for the accuracy of these reports if they are used for other purposes.

FISCAL IMPACT REPORT

		LAST UPDATED	2/16/23
SPONSOR	Gonzales	**ORIGINAL DATE**	1/23/23
SHORT TITLE	Excess Oil & Gas Funds to Severance Tax Fund	**BILL NUMBER**	Senate Bill 26/aSFC
		ANALYST	Torres, I.

REVENUE* **(dollars in thousands)**

Estimated Revenue					Recurring or Nonrecurring	Fund Affected
FY23	**FY24**	**FY25**	**FY26**	**FY27**		
		($587,600)	($1,204,000)	($1,681,700)	Recurring	General Fund
		$587,600	$1,204,000	$1,681,700	Recurring	Severance Tax Permanent Fund
No fiscal impact – the bill does not affect the current distributions to the early childhood trust fund.					Recurring	Early Childhood Trust Fund
		Positive – Increased distributions from STPF, see fiscal implications			Recurring	General Fund – Interest Earnings from Severance Tax Permanent Fund

Parenthesis ( ) indicate revenue decreases
*Amounts reflect most recent analysis of this legislation.

Sources of Information

LFC Files

Responses Received From
Department of Finance and Administration (DFA)
Taxation and Revenue Department (TRD)
State Investment Council (SIC)
Early Childhood Education and Care Department (ECECD)

SUMMARY

Synopsis of SFC Amendments to Senate Bill 26

The Senate Finance Committee amendments to senate bill 26 are technical changes as suggested by the Department of Finance and Administration to clarify the transfers as drafted. The amendments have no impact on the substance of the bill.

Synopsis of Original Senate Bill 26

Senate Bill 26 transfers excess oil and gas revenue generated through the oil and gas emergency school tax and royalties for production on federal land (Federal Mineral Leasing payments) to the severance tax permanent fund (STPF) beginning in FY25.

Sections 1 and 2 of the bill send any revenue above the amount the general fund received in FY24 from the oil and gas emergency school tax to the existing excess extraction taxes suspense fund.

At the end of the fiscal year, the Department of Finance and Administration determines whether and how much of the revenue in the suspense fund is to be distributed to either the early childhood education and care fund (i.e., the “early childhood trust fund” or ECTF), tax stabilization reserve fund (TSR), or the severance tax permanent fund.

Consistent with current law, if total revenue from the school tax in a given fiscal year exceeds the five-year average of total school tax revenue, the excess above the five-year average would continue to be distributed to the ECTF or TSR.

If there is still an amount remaining in the suspense fund after those distributions to the ECTF, TSR, or both are made (i.e., an amount above FY24 levels but below the excess of the five-year average), then the residual excess amount would be invested in the severance tax permanent fund. If school tax revenues do not exceed FY24 levels, no transfers to the suspense fund (and thus to the ECTF, TSR, or STPF) would be made.

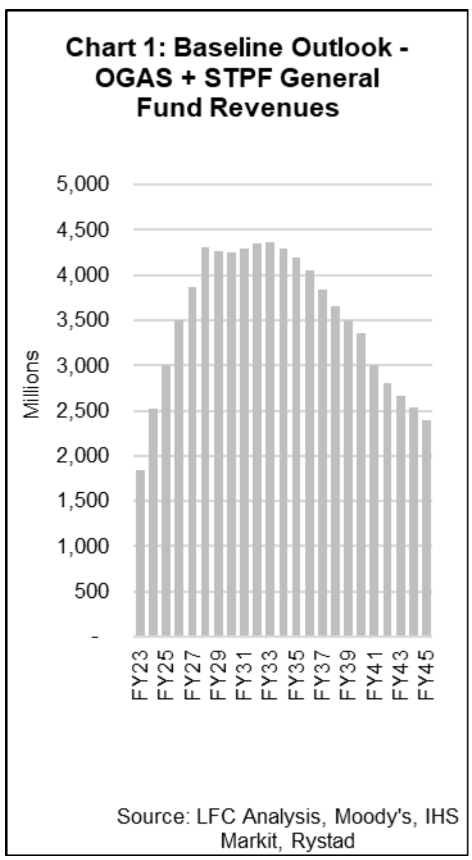
Section 3 provides a similar mechanism for federal mineral leasing (FML) payments. Consistent with current law, the excess of the five-year average of total FML payments to the state would continue to be distributed to the ECTF. If, after the distributions to the ECTF, the remaining amount that would otherwise be deposited into the general fund exceeds the amount the general fund received in FY24, then the amount above FY24 levels would be invested in the STPF.

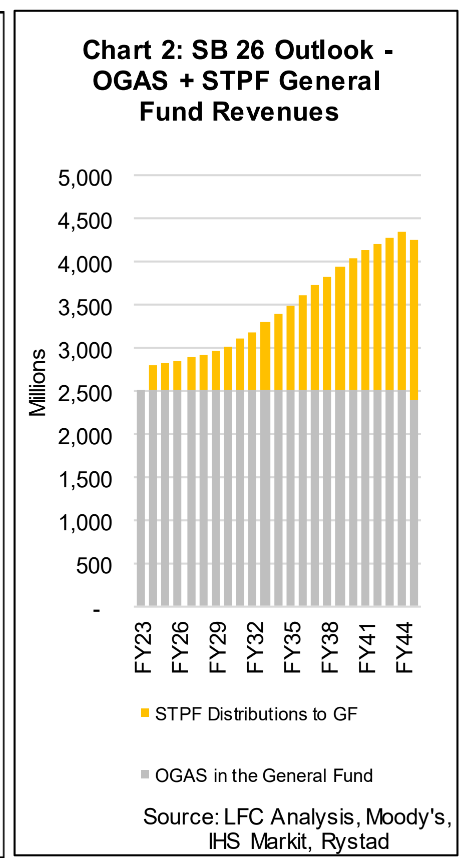
The effective date of this bill would be July 1, 2024.

FISCAL IMPLICATIONS

The fiscal impacts were determined using the December 2022 Consensus Revenue Estimating Group (CREG) forecast to calculate the impact of the proposed new distributions.

In effect, Senate Bill 26 limits the amount of oil and gas emergency school tax and federal royalty payments the general fund can receive to the amount it received in FY24. Excesses above the five-year averages for these two oil and gas revenue sources would continue to be distributed to the ECTF, TSR, or both consistent with current law. Those oil and gas revenues above FY24 levels but below the five-year average



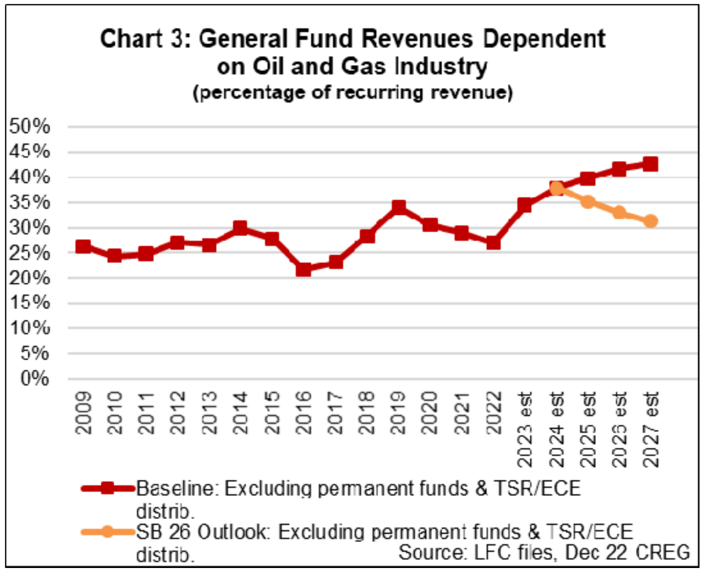


would be invested in the STPF.

In the long run, SB26 is estimated to offset the losses to the general fund from decreasing oil and gas revenues in the future as severance tax permanent fund distributions from investment earnings grow faster than declines in oil and gas revenue.
In June and October 2022, the Legislative Finance Committee (LFC) and the Revenue Stabilization and Tax Policy Committee requested analysis of a scenario proposed by SB26. LFC and consensus revenue estimating group (CREG) analysis of oil and gas revenues determined the state may receive a peak in oil and gas revenues by FY28 with a subsequent plateau and decline in those revenues by FY32. Status quo oil and gas revenues plus distributions from the severance tax permanent fund are illustrated in Chart 1.

LFC and SIC estimate the proposed distributions in SB26 would result in long-term revenue growth as shown in Chart 2.

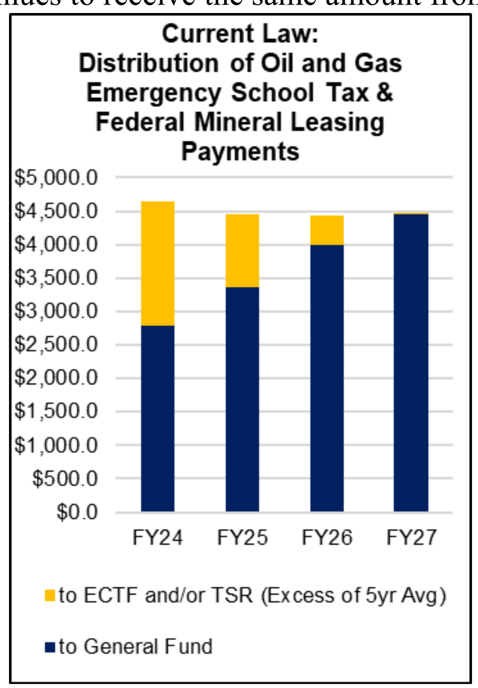
Furthermore, the new transfers would significantly decrease the volatility of the general fund and would decrease budgetary reliance on the oil and gas industry. LFC analysis indicates the general fund will be 11.4 percent less reliant on the oil and gas industry by FY27 under SB26. The decreasing reliance under SB26 is shown in Chart 3 versus the current outlook.

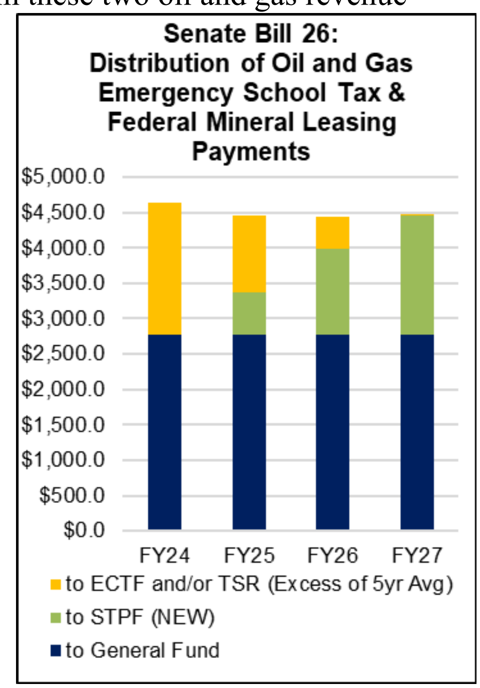


The following analysis is provided from the State Investment Council:

New Distributions to the STPF Under SB26. Under both current law and SB26, the ECTF, TSR, or both would continue to receive the same distributions. Starting in FY25, the bill would ensure the general fund continues to receive the same amount from these two oil and gas revenue sources as it received in FY24 ($2.78 billion as estimated in the December 2022 consensus revenue estimate). The STPF would receive the difference between the FY24 level and the excess of the five-year average, which for FY25 would be $587.5 million under the current consensus revenue estimate.

The charts illustrate the effects of the SB26:





Additional STPF Inflows to Generate Future Large Additional Distributions to General Fund. To analyze the effects Senate Bill 26 would have on long-term contributions to the STPF and long-term distributions from the STPF to the general fund, SIC staff used data on estimated oil and gas school tax and federal mineral leasing payments from the December 2022 consensus revenue estimate as well as data provided by LFC staff on estimates for these two revenue sources through 2050.

The following reflects additional key assumptions SIC staff used to perform this analysis:

- For calendar years 2023-2032, we assume an expected annual compound return on STPF investments of 5.7 percent, consistent with our April 2022 asset allocation study that considers our general consultant RVK's capital market assumptions and return expectations for the various asset classes in which the STPF is invested. Notably, this return assumption is below the SIC's long-term target return of 6.75 percent, reflecting the Council's expectation that the next decade may be one of both volatility and depressed investment returns. However, for calendar years 2033 and beyond, the analysis assumes the targeted rate of return of 6.75 percent.
- Contributions of severance tax revenue to the STPF under current law are assumed to be equal to the Board of Finance's estimates from December 2022, which provide inflow projections through 2032. Longer-term inflows into the fund are estimated using internal oil and gas price and production projections and applying the statutory limits for use of those revenues for bonding capacity.
- Distributions from the STPF to the general fund of 4.7 percent of the five-year average market value of the STPF, consistent with current law.

While not immediate, the additional inflows into the severance tax permanent fund under SB26 would result in large increases in the STPF's distributions to the general fund. As shown in the tables below, in less than 20 years the STPF would distribute over $1 billion in additional annual revenue to the general fund every year. Within 25 years, the total distribution from the STPF to the general fund could exceed $2 billion per year.

In October 2022, SIC staff were asked to present along with LFC staff to the interim Revenue Stabilization and Tax Policy (RSTP) committee on the long-term impact of additional contributions to the STPF. One of the scenarios requested by the committee was the concept currently envisioned in Senate Bill 26 – investing future oil and gas school tax and federal mineral leasing revenue above FY24 levels that would otherwise flow into the general fund.

As part of that analysis, LFC staff demonstrated that 1) long-term general fund revenues from the oil and gas school tax and FML payments are expected to peak within the next 10 years and consistently decline thereafter, and 2) investing oil and gas revenues above FY24 levels into the STPF could help offset projected future declines in general fund oil- and gas-related payments.

Additionally, despite the principal source of income into the STPF coming from volatile oil and gas revenues, a 2019 LFC volatility analysis found that distributions from the permanent funds are the state's most stable (i.e. least volatile) source of general fund revenue. This is because the distributions from the permanent fund are based on five-year averages of the fund's ending balance, which reduces annual volatility in the STPF caused by market swings and variance in oil and gas inflows. For example, in 2008 the value of the STPF fell nearly 32 percent during the Global Financial Crisis; however, general fund distributions from the STPF *grew* by 3.6 percent in FY08 and by 8 percent in FY09.

Thus, by investing the excess oil and gas revenues above FY24 levels that would otherwise flow into the general fund, SB26 would allow the STPF to ultimately deliver a more gradual and sustainable source of general fund revenue to support state budgets.

Calendar Year	Current Estimated STPF Ending Balance	New Estimated STPF Ending Balance under SB26
2020	$5,849.5	**$5,849.5**
2021	$6,733.8	**$6,733.8**
2022	$7,640.0	**$7,640.0**
2023	$7,838.8	**$7,838.8**
2024	$8,227.3	**$8,227.3**
2025	$8,618.9	**$9,206.4**
2026	$9,050.4	**$10,872.7**
2027	$9,468.4	**$13,063.1**
2028	$9,866.6	**$15,151.9**
2029	$10,296.3	**$17,296.9**
2030	$10,678.0	**$19,417.9**
2031	$11,061.2	**$21,620.3**
2032	$11,447.6	**$23,899.3**
2033	$11,958.7	**$26,221.6**
2034	$12,480.1	**$28,511.7**
2035	$13,010.5	**$30,725.7**
2036	$13,548.5	**$32,806.3**
2037	$14,091.1	**$34,688.2**
2038	$14,638.4	**$36,388.6**
2039	$15,190.3	**$37,925.0**
2040	$15,747.5	**$39,316.1**
2041	$16,310.1	**$40,345.5**
2042	$16,879.2	**$41,162.6**
2043	$17,455.2	**$41,921.6**
2044	$18,038.6	**$42,663.7**
2045	$18,629.4	**$43,395.6**
2046	$19,228.4	**$44,123.6**
2047	$19,836.3	**$44,852.2**
2048	$20,453.9	**$45,583.7**
2049	$21,080.6	**$46,317.9**
2050	$21,717.2	**$47,055.6**

Fiscal Year	Current Estimated STPF Distribution to General Fund	New STPF Distribution to General Fund under SB26	Additional General Fund Distribution from STPF under SB26
FY20	$225.3	**$225.3**	
FY21	$234.0	**$234.0**	
FY22	$246.4	**$246.4**	
FY23	$265.8	**$265.8**	**-**
FY24	$289.6	**$289.6**	**-**
FY25	$316.7	**$316.7**	**-**
FY26	$341.1	**$341.1**	**-**
FY27	$367.2	**$372.7**	**$5.5**
FY28	$388.9	**$411.6**	**$22.7**
FY29	$406.1	**$462.6**	**$56.4**
FY30	$425.2	**$531.3**	**$106.1**
FY31	$444.6	**$616.6**	**$171.9**
FY32	$464.0	**$712.5**	**$248.6**
FY33	$482.9	**$813.6**	**$330.7**
FY34	$501.5	**$915.4**	**$413.9**
FY35	$521.2	**$1,019.5**	**$498.3**
FY36	$541.7	**$1,124.9**	**$583.2**
FY37	$563.6	**$1,231.2**	**$667.6**
FY38	$587.0	**$1,336.3**	**$749.4**
FY39	$611.8	**$1,437.8**	**$825.9**
FY40	$637.0	**$1,533.3**	**$896.3**
FY41	$662.5	**$1,621.8**	**$959.3**
FY42	$688.2	**$1,702.6**	**$1,014.3**
FY43	$714.2	**$1,773.4**	**$1,059.2**
FY44	$740.4	**$1,834.3**	**$1,093.9**
FY45	$766.9	**$1,886.3**	**$1,119.4**
FY46	$793.6	**$1,930.9**	**$1,137.2**
FY47	$820.7	**$1,969.2**	**$1,148.5**
FY48	$848.2	**$2,004.7**	**$1,156.5**
FY49	$876.0	**$2,039.4**	**$1,163.4**
FY50	$904.2	**$2,073.8**	**$1,169.7**
Cumulative Additional General Fund Distribution under SB26			**$16,598.2**

SIGNIFICANT ISSUES

The following was noted by TRD:

> This bill appears to offer a stabilizing mechanism for the general fund distributions of oil and gas revenue from the Oil and Gas Emergency School Tax and federal mineral leasing. The current CREG December 2022 forecast calculates that under the current 5-year average mechanism, by FY2027, no transfers or very little transfer will occur to the reserve funds or ECECF. At that point, the state general fund would again be exposed to direct energy market shocks. These revenues are extremely volatile given their

dependence on the world supply and demand of oil. These changes to the distributions would further insulate the general fund from downturns in the near term until the point where revenue could drop below the threshold amounts. On the other hand, the general fund would see no increase in revenues if the oil and gas market saw growth in the near or far term.

Putting more volatile revenue into long-term investment funds will grow fund values and provide a stable return of interest income for the general fund. The complexity of these mechanisms though to move revenues between various funds is masking the transparency of public funds.

SIC adds:

The STPF has seen major challenges over the past two decades. Before the 90s, the STPF was able to grow, due to both strong investment returns and significant inflows delivered annually from the Severance Tax Bonding Fund, with approximately 50 percent of the state's severance taxes being used for bonding, and the other half being saved for the STPF.

Starting in the late 90s however, the percentages the state saved to the STPF changed due to multiple legislative actions, ultimately resulting in a baseline of only 5 percent of the state's severance taxes being saved to the STPF, with 95 percent being spent on bonding for capital projects.

Concerns over the dramatic restructuring of these funding streams and the associated impact on the long-term viability of the STPF, led lawmakers to take action in 2015, passing HB236, which adjusted the spend/save percentage of severance tax revenues from the 95/5 ratio, to a gradual implementation of a new formula that targets saving almost 14 percent (86.2 percent/13.8 percent) of the state's severance tax collections to the STPF by fiscal year 2022.

While there is an expectation that this change will eventually help put the STPF on stronger footing long-term, the Council's fiduciary consultant RVK grades each permanent fund on its long-term outlook and has noted ongoing concerns about the long-term viability of the STPF, given its historically volatile funding stream. RVK indicates that volatility, and without changes to the contribution/distribution structure, there is a higher probability that New Mexicans today are receiving an oversize share of STPF benefits, compared to what citizens will be able to experience in the future.

While the STPF received two very large contributions totaling over $1.9 billion in CY22 due to a significant rise in oil and gas prices during the year, it is likely an anomaly. In the 20 years from 2002-2021, the STPF received an average annual inflow from the severance tax bonding fund of less than $55 million, with contributions in some of those years totaling less than $1 million. The additional contributions to the STPF from Senate Bill 26 would help ensure the fund's inflows keep up with inflation and better enable the STPF to help meet the ever-growing demands on our general fund.

PERFORMANCE IMPLICATIONS

Below is investment performance data for the STPF, as of 6/30/22:

	1 year	3 years	5 years	7 years	10 years
STPF Returns (net of fees)	-4.39%	5.16%	5.85%	5.99%	7.21%

While the 10-year return metric surpasses the SIC's targeted rate of return for the STPF (6.75 percent), the Council anticipates the next decade may be one of both volatility and depressed investment returns. Longer-term returns, which include one or both of the major global investment crises experienced this century, are still struggling to achieve the SIC's long-term target of 6.75 percent. Like many institutional investors, the SIC has reduced its return expectations in the past few years, and have emphasized our expectation of potentially muted returns, given that current stock and bond valuations are extremely high on a historic basis.

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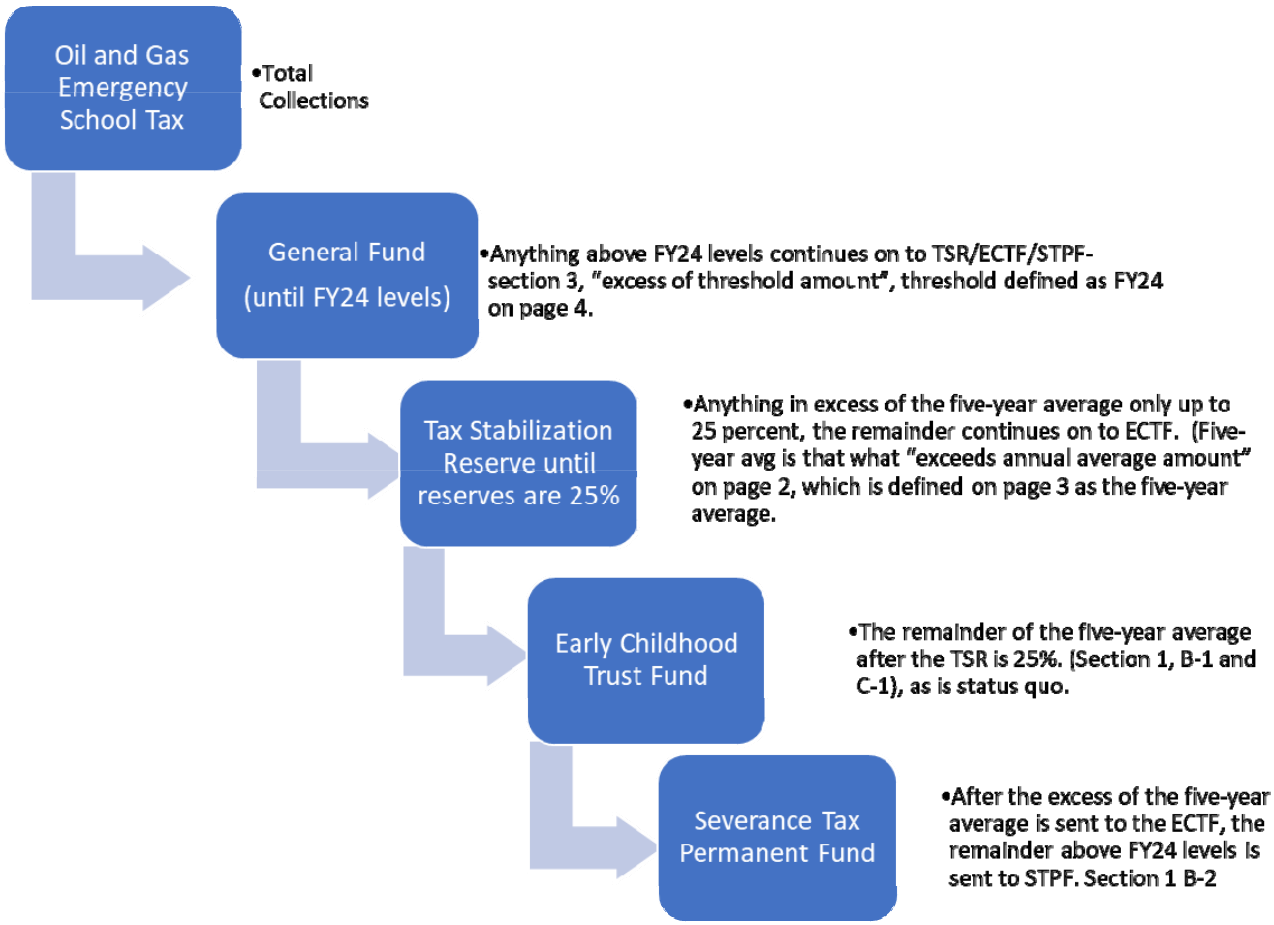
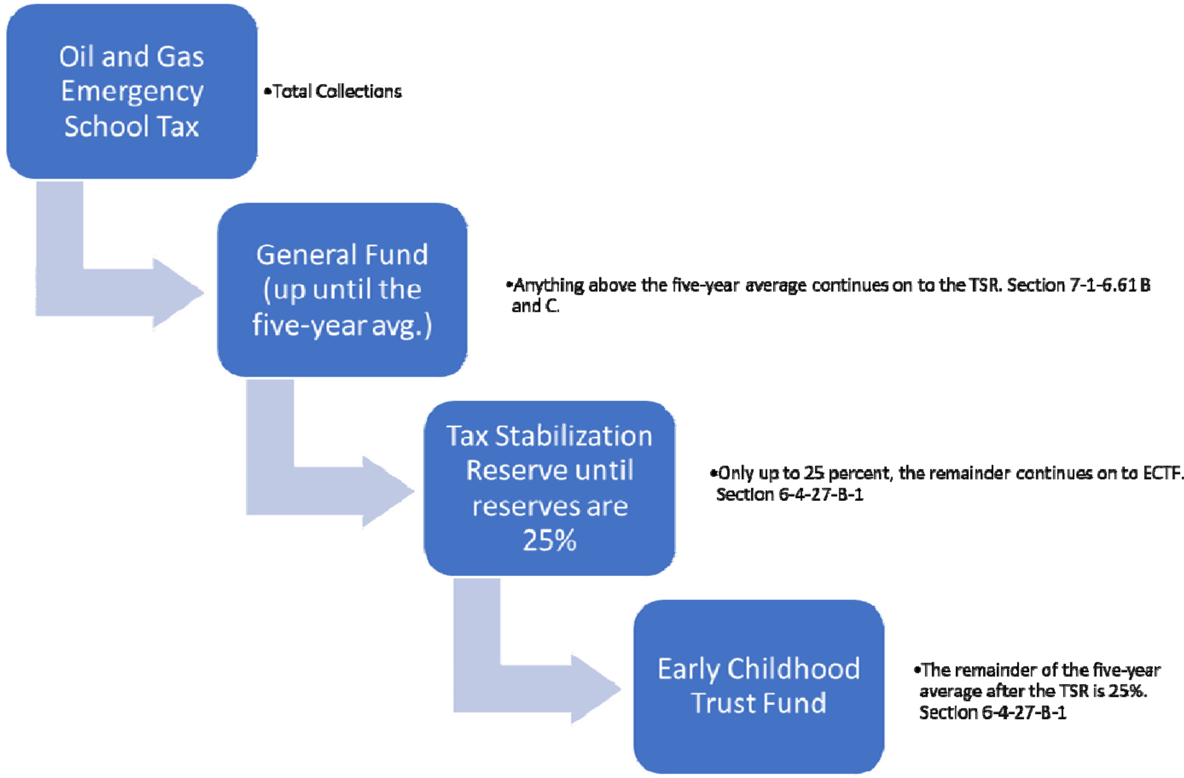
Appendix A- SB 26 Flow Chart



Appendix B – Current Oil and Gas Revenues Flow Chart



Appendix C- Table of Current Law vs Proposed SB 26 Distributions

Distributions of School Tax & FML Revenue - Current Law vs SB26 ($MM)					
Federal Mineral Leasing	**FY23**	**FY24**	**FY25**	**FY26**	**FY27**
Total FML Revenue	$3,036.4	$2,727.2	$2,542.7	$2,495.8	$2,517.2
Distribution of FML Revenue - Current Law					
FML to General Fund (5-Yr Avg)	$1,119.3	$1,613.7	$1,929.8	$2,274.9	$2,517.2
Excess Above 5-Yr Avg (to ECTF)	$1,917.1	$1,113.5	$612.9	$220.9	$0.0
Distribution of FML Revenue - SB26					
FML to General Fund (FY24 Level*)	$1,119.3	$1,613.7	$1,613.7	$1,613.7	$1,613.7
NEW - Excess Above GF FY24 to STPF	n/a	n/a	$316.1	$661.2	$903.5
Excess Above 5-Yr Avg (to ECTF)	$1,917.1	$1,113.5	$612.9	$220.9	$0.0
Oil & Gas Emergency School Tax	**FY23**	**FY24**	**FY25**	**FY26**	**FY27**
Total School Tax Revenue	$2,091.2	$1,913.0	$1,911.4	$1,939.9	$1,961.6
Distribution of School Tax Revenue - Current Law					
School Tax to General Fund (5-Yr Avg)	$838.0	$1,166.1	$1,437.5	$1,708.9	$1,944.3
Excess Above 5-Yr Avg (to ECTF or TSR)	$1,253.2	$746.9	$473.9	$231.0	$17.3
Distribution of School Tax Revenue - SB26					
School Tax to General Fund (FY24 Level*)	$838.0	$1,166.1	$1,166.1	$1,166.1	$1,166.1
NEW - Excess Above GF FY24 to STPF	n/a	n/a	$271.4	$542.8	$778.2
Excess Above 5-Yr Avg (to ECTF or TSR)	$1,253.2	$746.9	$473.9	$231.0	$17.3
School Tax & FML Distribution Summary	**FY23**	**FY24**	**FY25**	**FY26**	**FY27**
Total Distributions Under Current Law					
Total to General Fund	$1,957.3	$2,779.8	$3,367.3	$3,983.8	$4,461.5
Total to ECTF and/or TSR	$3,170.3	$1,860.4	$1,086.8	$451.9	$17.3
Total Distributions Under SB26					
Total to General Fund	$1,957.3	$2,779.8	$2,779.8	$2,779.8	$2,779.8
NEW - Total to STPF	n/a	n/a	$587.5	$1,204.0	$1,681.7
Total to ECTF and/or TSR	$3,170.3	$1,860.4	$1,086.8	$451.9	$17.3
Source: December 2022 Consensus Revenue Estimate					