FISCAL IMPACT REPORT

SPONSOR	HTRC	**ORIGINAL DATE** / **LAST UPDATED**	01/17/14 / 02/13/14	**HB**	36/HTRCS/aHAFC
SHORT TITLE	Tech Research Investment & Administration			**SB**	
				ANALYST	Dorbecker

REVENUE (dollars in thousands)

Estimated Revenue					Recurring or Nonrecurring	Fund Affected
FY14	**FY15**	**FY16**	**FY17**	**FY18**		
	($1,000.0)	($1,000.0)	($1,000.0)	($1,000.0)	Recurring	Sev. Tax Perm. Fund
		($5.0)	($20.0)	($40.0)	Recurring	General Fund
See "Fiscal Implications" below						

(Parenthesis ( ) indicate revenue decreases

SOURCES OF INFORMATION

LFC Files

Responses Received From
Department of Finance and Administration (DFA)
Department of Information Technology (DOIT)
Economic Development Department (EDD)
Higher Education Department (HED)
New Mexico Institute of Mining and Technology (NMT)
New Mexico State University (NMSU)
State Investment Council (SIC)

SUMMARY

Synopsis of HAFC Amendment

The House Appropriations and Finance Committee amendment changes the makeup of the "board of the technology research collaborative":

- The board shall consist of "eleven" members instead of "nine";
- The board shall have "five", rather than "four" governor appointees who must possess additional expertise in "entrepreneurship or technology businesses";
- The board must include the secretary of the Economic Development Department who may vote only to break a tie; and

- The amendment also adds a conflict of interest provision, prohibiting board members from participating or influencing an investment decision in which that member has a conflict of interest, pecuniary interest or other disqualifying interest with respect to an enterprise considered by the board.

Synopsis of Original Bill

The House Taxation and Revenue Committee Substitute for House Bill 36 amends a section 7-27-5.15 NMSA 1978 of the Severance Tax Bonding Act to require the State Investment Council (SIC) to invest at least .25 percent (approximately $11 million) of the market value of the Severance Tax Permanent Fund (STPF) into private equity funds through New Mexico businesses approved by the Technology Research Collaborative (TRC). The bill also reduces the investment portion of SIC's total investment capital in a businesses from 51 percent to 49 percent.

Under current law, SIC is authorized to invest up to 9 percent of the STPF in New Mexican technology businesses based upon review and recommendation by the SIC's private equity investment advisory committee (PEIAC). The amendment maintains the 9 percent cap and the role of PEIAC.

The bill also repeals 21-11-8.6 NMSA 1978, the statutory foundation for the TRC under present law, and replaces it with a new statutory section. The new section transfers the fiscal administration of TRC from the New Mexico Institute of Mining and Technology (NMT) to the Economic Development Department (EDD). The new section also changes the composition of the TRC board and requires monthly, rather than quarterly meetings. The new composition omits the governor or governor's designee, and reduces from five to four the members-at-large appointed by the governor and approved by the senate. The at-large appointees are now also required to include persons with expertise in the law, investment banking and venture capital. The new section also exempts the meetings of the TRC board from the requirements of the Inspection of Public Records Act.

The bill includes reporting requirements. The State Investment Officer (SIO) is required to periodically audit SIC's records of the severance tax permanent fund to ensure the account's effective administration. SIC must also compile an annual report that includes the amounts invested in each New Mexico private equity fund and the returns on those investments, as well as information about the objectives of the funds, the companies in which each fund is invested and how each investment enhances the economic development objectives of the state.

There is no effective date of this bill. It is assumed that the new effective date is 90 days after this session ends.

FISCAL IMPLICATIONS

The fiscal impact on the STPF is likely to be negative, or at minimum, expensive in terms of expected risk-adjusted returns relative to opportunity cost. SIC notes the bill requires about $11 million to be invested in technology businesses in New Mexico, but the return on this investment cannot be reasonably estimated because the businesses that will be invested in have not been identified.

However, using SIC's past experience with various Economically Targeted Investments (ETIs) as a guide, investment returns will be significantly lower than would otherwise be expected for investments with a similar level of risk (early stage venture investments are among the riskiest available in terms of financial returns). Currently, the 10 percent of the STPF that is invested in ETIs is estimated to cost the STPF $40 million annually in forgone returns compared to market rate investments. Using this as a rough approximation of the likely opportunity costs, SIC estimates the loss from investing .25 percent as required by the bill would be roughly $1 million per year.

Considering the negative effect of the bill on investment returns, the proposal would have a negative effect on the STPF 5-year average balance which determines the amount distributed from the STPF to the general fund at 4.7 percent per year. Therefore, the bill would likely have a negative general fund revenue impact as well.

SIGNIFICANT ISSUES

The bill requires that .25 percent of the STPF (roughly $11 million) be invested in New Mexican businesses approved by TRC, but does not address what should happen if no suitable investments can be found, to the satisfaction of both the TRC board and SIC.

For this matter SIC notes: "Requiring SIC to make an investment may lead to money being spent on ventures that are not likely to provide adequate return for the risks taken. This potential pitfall is exacerbated by the bill's failure to provide an instructive time frame by which the investments must be reasonably made. The absence of a time frame makes it possible that the STPF will feel compelled to make an investment in order to be in compliance with the law, rather than because an investment is in the best fiduciary interests of the STPF."

Other concerns SIC points out related to new material in section 2 and to the overall bill are:

1. EDD would appear to be the new fiscal agent and administrator for the TRC. Under Governor Richardson, a similar program called "Invest New Mexico" was created to conduct business investments sourced by EDD into the New Mexico private equity program. With EDD essentially having power to "green light" investments, SIC chose not get involved at the time. After three unsuccessful investments vetted by SIC staff (Eclipse & TCI Medical), SIC restructured how these investments are made by hiring an external experienced investment manager to make all future New Mexico private equity commitments.

2. The bill exempts TRC meetings from the Inspection of Public Records Act but reports on the profitability of individual investments are still required. Giving such company specific detail may reveal proprietary trade information, which may result in loss of competitive data and company value. See page 7 lines 12-13.

3. SIO is tasked with providing an annual report detailing how each investment "enhances the economic development objectives of the state." Page 7 lines 10-12. As TRC would be under the supervision of EDD, it may be that EDD, rather than the SIO, would be in a better position to articulate these results, and apply economic impact multipliers which currently falls outside SIC's core mission and expertise.

PERFORMANCE IMPLICATIONS

According to SIC, general investment returns of ETIs to the STPF have historically underperformed by approximately 1 percent per year. Given current valuations of the Fund, a 1 percent underperformance costs the state approximately $40 million annually. Given the current distribution rate of the STPF of 4.7 percent of its 5-year value, the direct impact on the STPF's contributions to the General Fund translates into nearly $1.9 million per year less than had ETI investments been made in strategies strictly focused on investment return.

The LFC tax policy of accountability is met with the bill's requirement to report annually to an interim legislative committee regarding the data compiled from the reports from taxpayers taking the deduction and other information to determine whether the deduction is meeting its purpose.

ADMINISTRATIVE IMPLICATIONS

Currently, SIC and their Private Equity Advisory Investment Committee (PEAIC) employ private equity fund managers by making commitments to their fund through the New Mexico Private Equity Investment Program (NMPEIP). SIC and their staff, while responsible for closely monitoring investment decisions made by these New Mexico-based private equity managers, remains as a passive investor in the process. SIC then has to rely fully on the professional managers they have hired to make top quality investments. The manager is in-turn, financially incentivized to make the best investments possible.

According to SIC, the bill seems to remove the SIC's experts from the equation however, replacing them with the TRC, which may or may not prove to be a suitable exchange because SIC no longer makes "direct" investments in New Mexico companies. Instead, SIC invests only with private equity managers, relying on their abilities and expertise.

If the SIC would still be allowed to employ its private equity advisor in this capacity, suitable compensation and/or profit sharing would have to be arranged by the Council. Such payments and costs are not contemplated by the bill.

TECHNICAL ISSUES

SIC states the new language on line 16 would seem to indicate SIC could only make such commitments to TRC approved entities "if they are in a fund structure." SIC believes this language as drafted may prevent direct investment in technologies that seek to be commercialized from the National Labs and New Mexico's research universities, as well as hinder the original intent of those seeking this legislation. SIC suggests this perceived conflict be addressed or clarified.

ALTERNATIVES

As the legislature did when it created the Small Business Investment Corporation (SBIC) in 2000, the legislature has the authority to "carve out" the 0.25 percent STPF allocation without including the SIC as fiduciaries in this process, leaving the investments solely in the hands of TRC, as it did with the SBIC board.

According to SIC, the SBIC's legislation is the only statutory ETI language that – like HB 36 – explicitly requires investment through the use of the words "shall invest", versus all other ETI legislation which is permissive. This allows the SIC to make prudent investments only at its discretion. SIC adds the SBIC's efforts to invest in early stage venture capital investments have not proven successful, having made 10 equity investments totaling $29.3 million dollars, which as of the end of FY13 were valued at $15.6 million, for a loss of $13.6 million in STPF funds.

WHAT WILL BE THE CONSEQUENCES OF NOT ENACTING THIS BILL

Under current law, SIC has the authority to indirectly co-invest in promising New Mexican technology businesses. Accordingly, not enacting the law will not prevent SIC from continuing its efforts to invest STPF assets in such business.

Does the bill meet the Legislative Finance Committee tax policy principles?

1. **Adequacy**: Revenue should be adequate to fund needed government services.
2. **Efficiency**: Tax base should be as broad as possible and avoid excess reliance on one tax.
3. **Equity**: Different taxpayers should be treated fairly.
4. **Simplicity**: Collection should be simple and easily understood.
5. **Accountability**: Preferences should be easy to monitor and evaluate

HD/jl:ds