NEW MEXICO LEGISLATIVE FINANCE COMMITTEE

Capital Outlay Issues and Potential Initiatives

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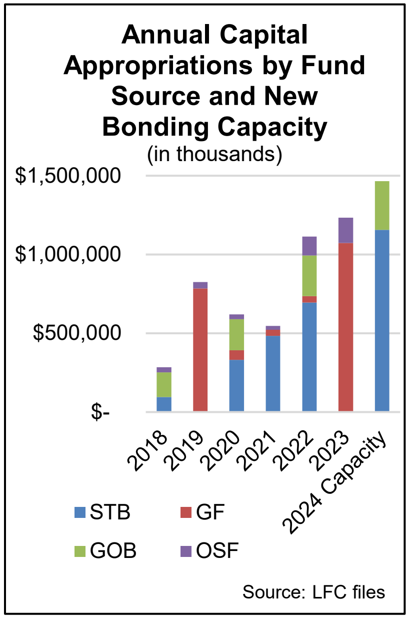
The current capital conundrum: big opportunity and big challenges.

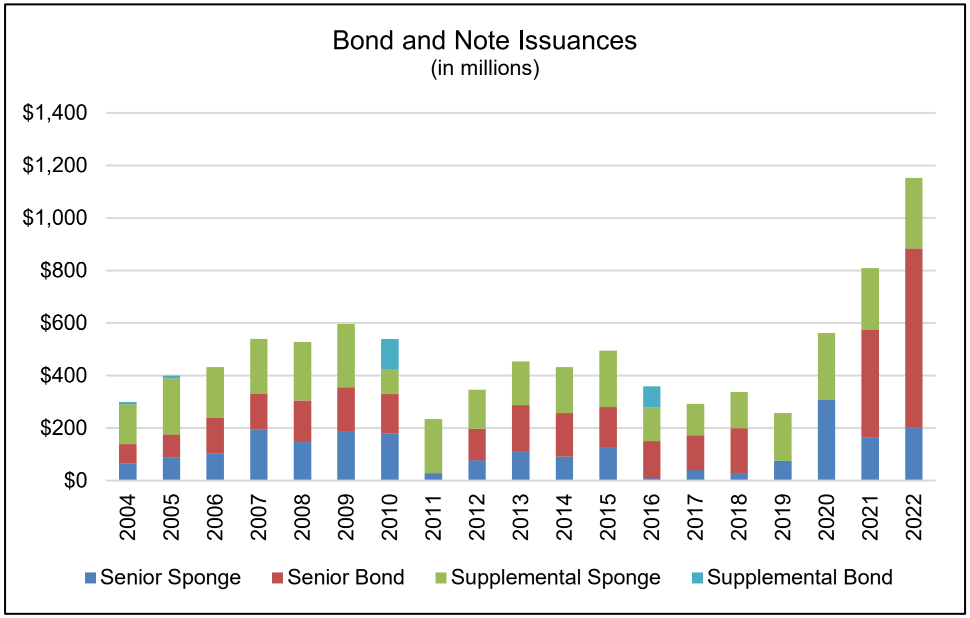
- Surging state revenues and time-limited federal dollars present a historic opportunity to meet New Mexico's infrastructure needs.

- ***But*** **…** realizing this opportunity will be challenging due to:
  - Systemic issues unique to New Mexico's capital outlay process, particularly for local projects;
  - Rising construction costs; and
  - Public and private sector capacity limitations.

- Recent increases in revenue dedicated to capital projects are likely to be temporary and the state has no plan for a replacement source.

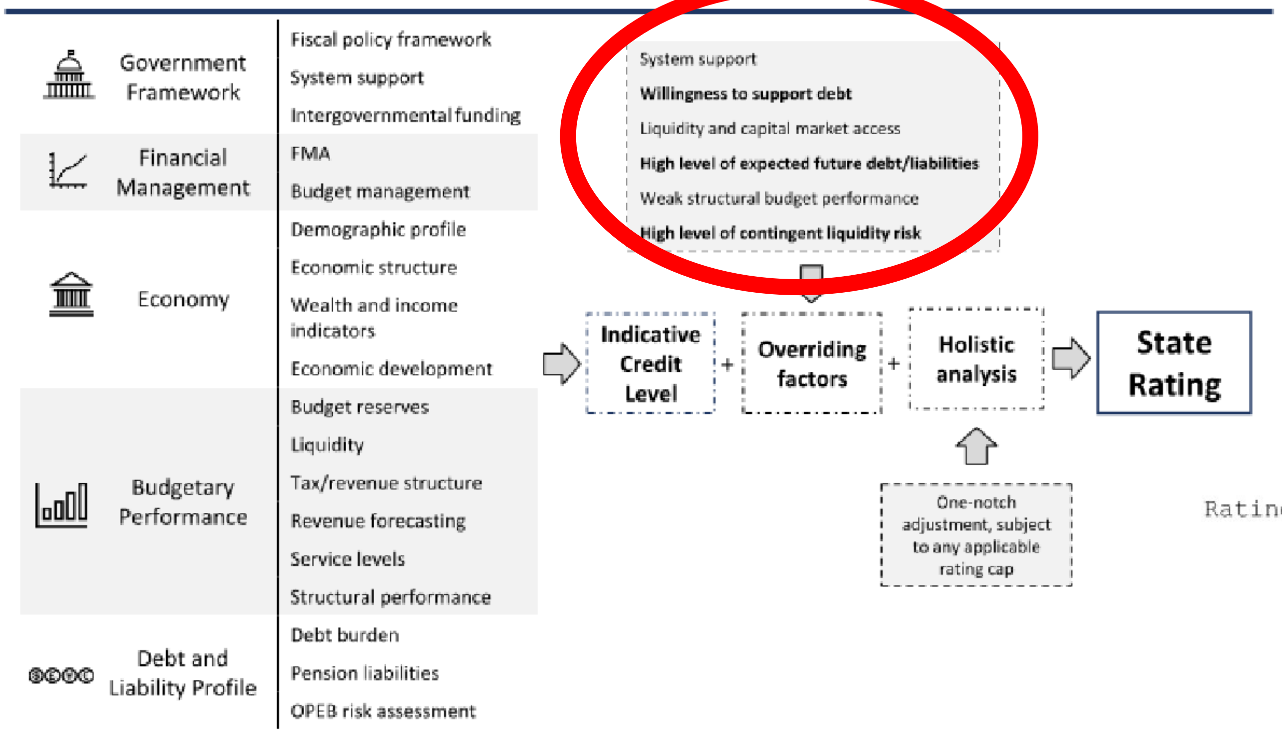
Capital outlay is the state's most reliant program on oil and gas revenues.





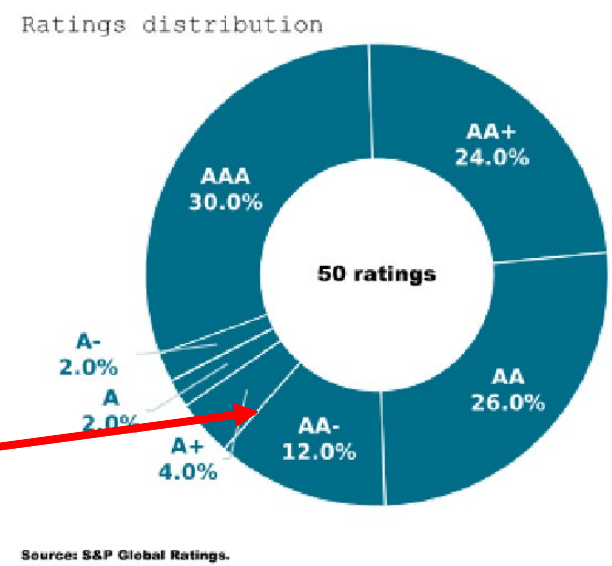
- Severance tax bonds are issued against severance tax revenue from oil, gas, and other natural resources which flows into the severance tax bonding fund.
- Capacity is based on estimates for oil and gas which are difficult to predict.
- Only twice has general fund been used as the primary funding source for capital outlay, usually when cash is available, and debt is more expensive.

The state's bond ratings are in the bottom 20%, nationally.



Source: S&P Global Ratings, U.S. State Methodology, November 16, 2023

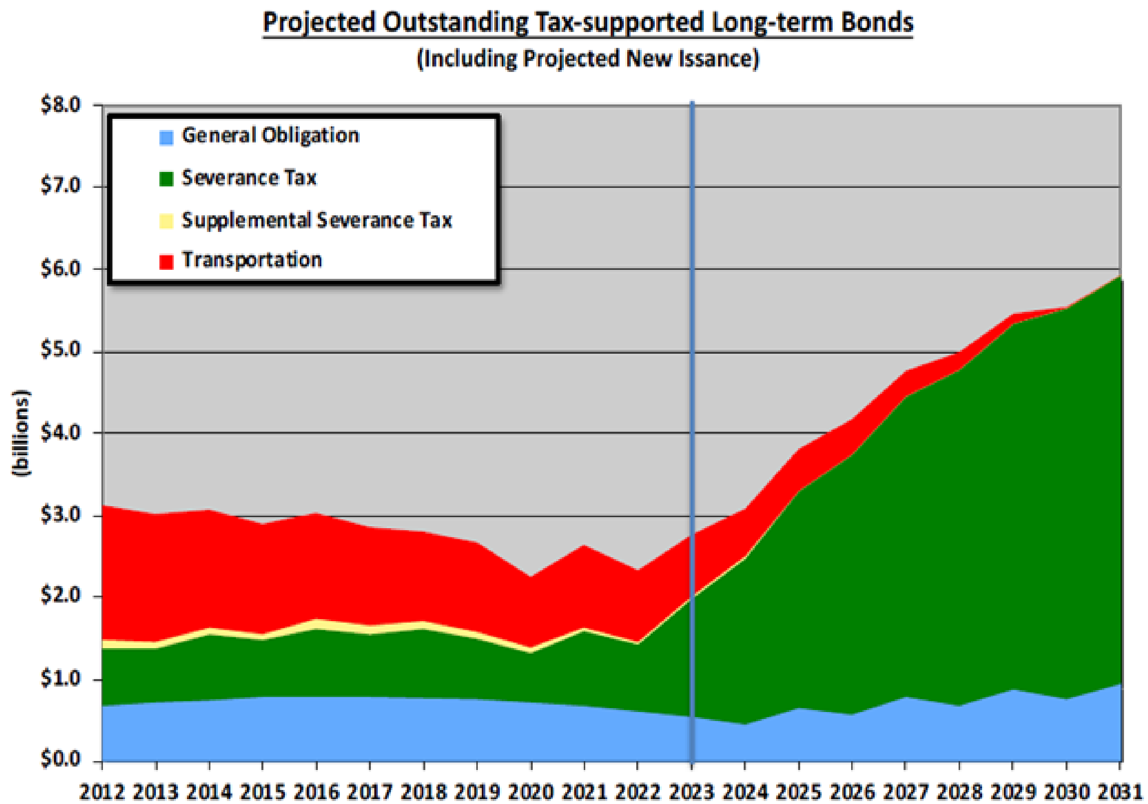
- Bond rating agencies are flagging for:
  - high levels of debt,
  - high levels of revenue volatility,
  - weak structural performance, and
  - high levels of liquidity risk.



New Mexico has AA- and A+ bond ratings for the severance tax program.

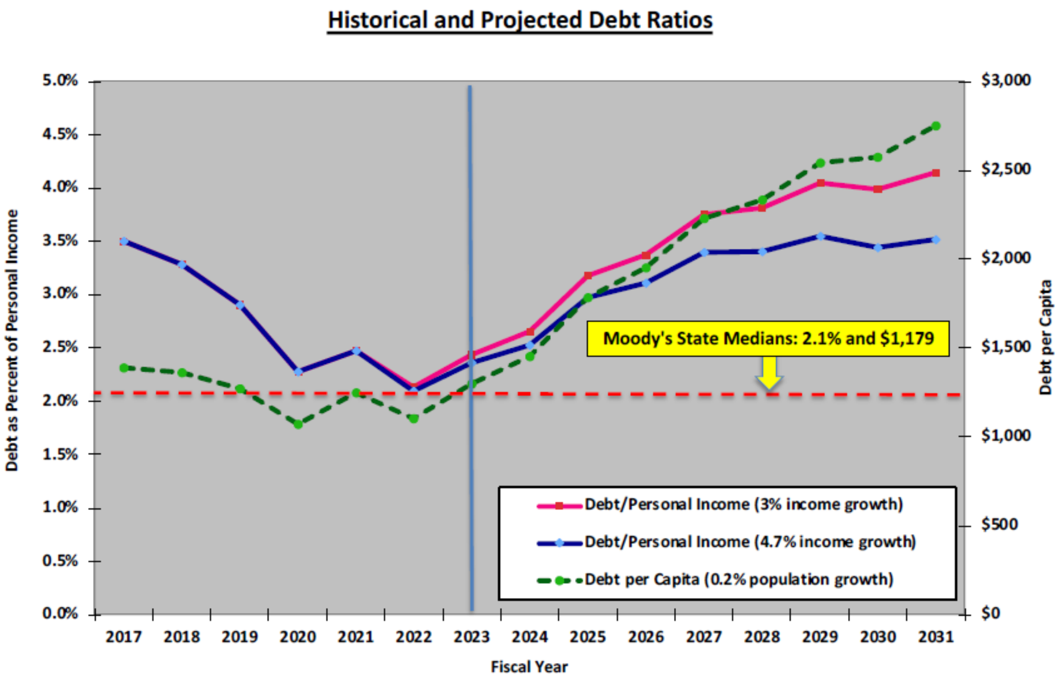
Dramatic increases in bonding capacity, if fully utilized, could jeopardize the state's bond ratings.

- Increases in oil and gas production are driving up capacity for severance tax bonds.
- Because of the complete dependence on oil and gas revenues, capacity is highly volatile and dependent on forecasts.



Source: Board of Finance Debt Affordability Study

Measures of state debt levels could spike with current uses.



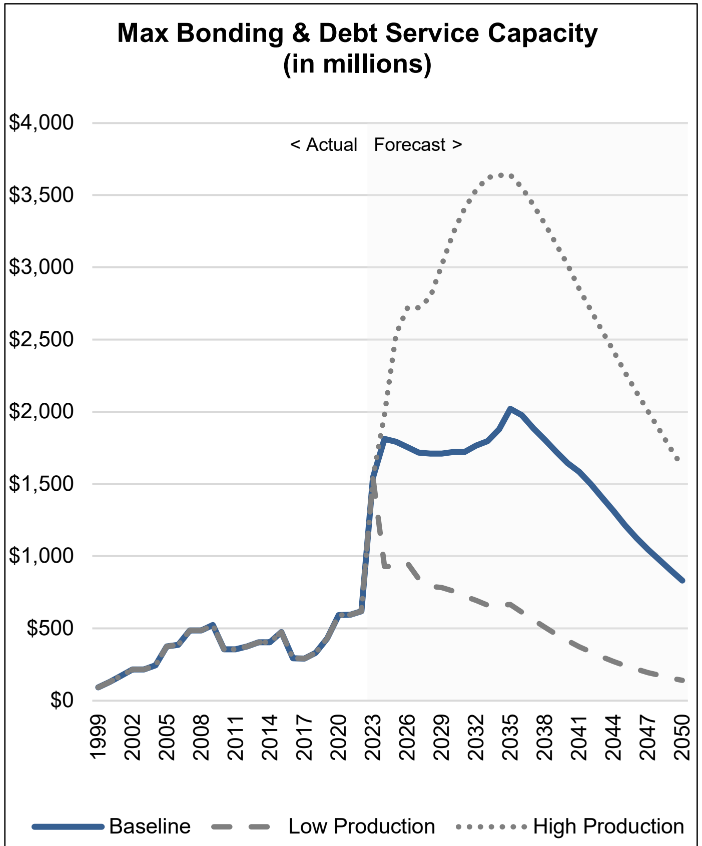
Source: Board of Finance Debt Affordability Study

- Measures of NM's debt burden are watched by bond rating agencies.
- High debt burdens would likely be unsustainable for NM's population in the event of an oil decline.

The state has no long-term back-up plan for funding capital projects as severance tax revenues decline.

- Declining severance tax revenues are likely to make it difficult for the state to both finance new capital projects and to maintain the investments it is making today.

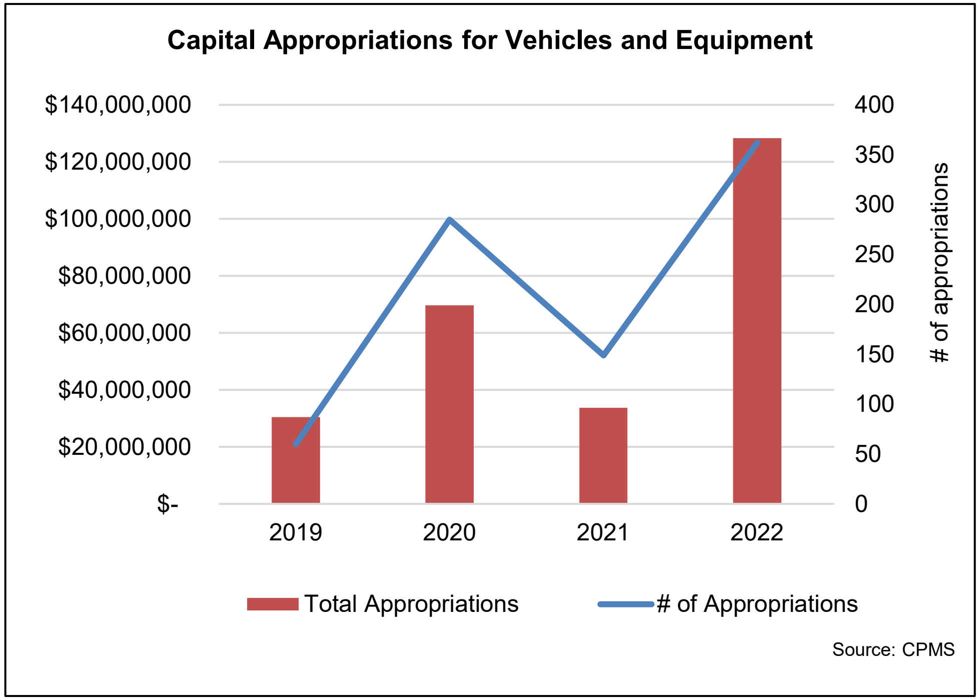
- The general fund will come under pressure to be a replacement source for capital at a time when it faces its own headwinds from declining oil and gas production.



Note: Low and high production estimates are based on CREG oil and gas scenarios.

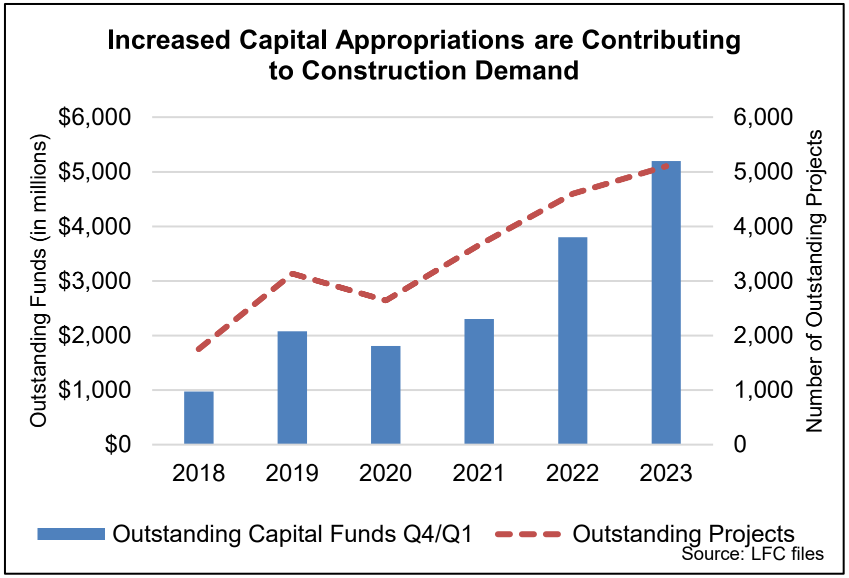
Source: LFC Forecast, July 2023

New Mexico is an outlier in using long-term debt to finance small projects and equipment.



Outstanding capital funds totaled an estimated $5 billion in the first quarter of FY24.

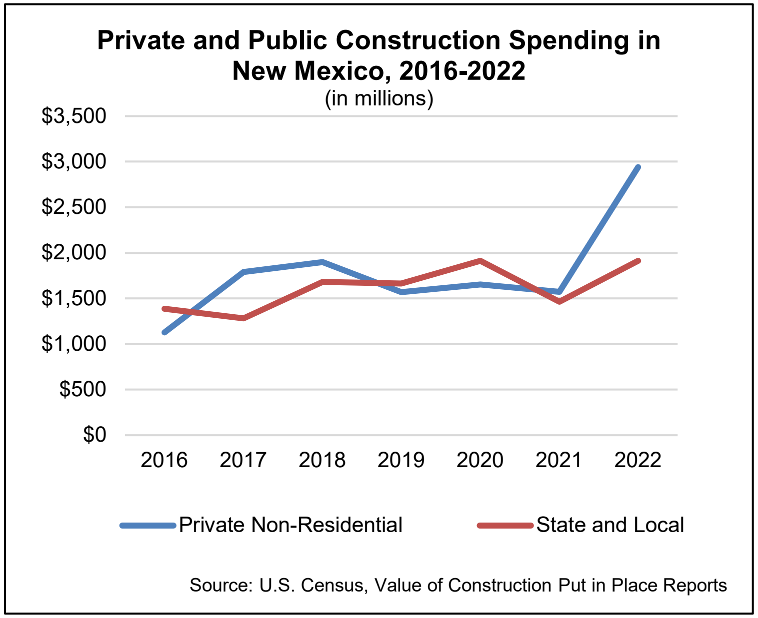
- The unspent funds include:
  - **$2.8 billion** in projects authorized by the Legislature;
  - **$472.7 million** in severance tax bond earmark programs;
  - **$1.2 billion** in supplemental STBs for public schools; and
  - **$514.2 million** in special appropriations to capital projects from 2021/2022 special and regular sessions.



Barriers to project success include current market conditions and systemic issues.

- Cost increases no longer appear to be driven primarily by spikes in material costs or supply chain disruptions.

- Instead, an extraordinarily busy construction market, a limited labor pool to meet demand, and other sources of uncertainty for contractors appear to be more significant factors.



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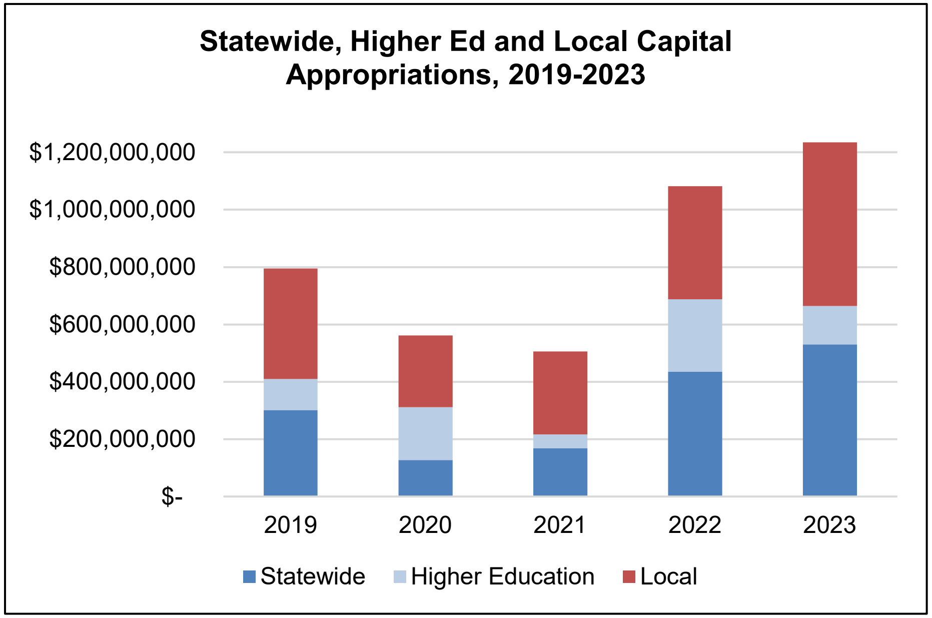
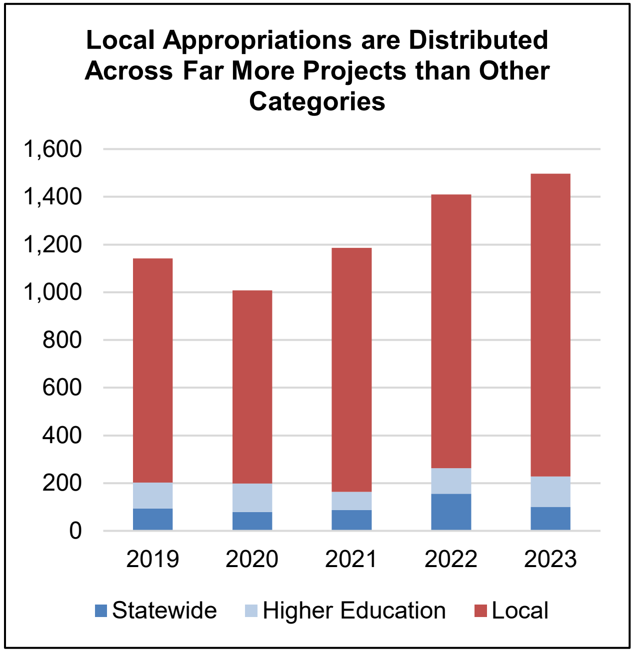


- Local projects face the most barriers to completion, including:
  - Piecemeal funding
  - Limited local capacity to secure full funding, manage grants, and complete projects
  - Lack of planning prior to funding requests
  - Inconsistent prioritization of projects based on need and benefits
  - Ineffective use of capital outlay to leverage other funding sources
  - Reluctance to utilize debt to finance projects

The impact of local capital outlay on the state is diluted by the volume of funded projects.



- Under the current system, it is difficult for the Legislature to prioritize key areas of investment and high-impact local or regional projects and provide funding to such projects at higher levels.

- As a result, the impact of even billion-dollar capital bills is muted because the dollars are spread thin across thousands of projects that do not necessarily represent the state's most urgent needs.

Solutions: Earlier Request Deadline + Project Vetting

- Set an earlier deadline for local capital outlay requests.
- Use any increase in legislative staffing to help legislators collect key information about projects requesting funding.
- A basic vetting system <u>need not</u> infringe on legislative discretion over capital appropriations but could support more strategic decision making and increase the likelihood capital dollars translate into efficiently completed projects that improve communities.
- Such a change could allow the Legislature to separate funding for planning and design from funding for construction and support any number of targeted future initiatives the Legislature might want to pursue.

Solutions: Create a Dedicated Infrastructure Division within DFA

- The division would:
  - Provide funding navigation assistance and improve coordination of funding sources
  - Streamline state administration of capital appropriations
  - Provide or coordinate grant and project management support for communities that require it
  - Be tasked with supporting project completion in addition to oversight of spending

Solutions: Reduce Debt Capacity and Redirect Savings

- The Legislature could set annual bonding capacity at a lower level than currently allowed in statute with several goals:
  - To extend the overall life of the bonding program with projected severance tax revenues
  - To protect the state's bond ratings
  - To generate savings that could be directed to a new capital reserve – a savings and spending account that would grow over time and provide an annual distribution for appropriation to capital projects

Solutions: Reduce Debt Capacity and Redirect Savings

- The capital reserve could support:
  - Emergency debt coverage, if ever needed
  - Cash financing for capital priorities determined by the Legislature and specified in statute.
    - Example: The fund could support appropriations for planning, design, and small projects, helping the state transition to a more "normal" bonding program, where cash supports project development and small investments and long-term debt covers major projects that are ready for construction.

QUESTIONS?

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