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F I S C A L   I M P A C T   R E P O R T

SPONSOR M.J. Garcia **ORIGINAL DATE** 02/08/10 **LAST UPDATED** **HB**

SHORT TITLE Oil & Gas Tax Changes for Emergency Fund **SB** 208

ANALYST White

APPROPRIATION (dollars in thousands)

Appropriation			Recurring or Non-Rec	Fund Affected
FY10	FY11	FY12		
$0.0	($45,600.0)	($36,200.0)	Recurring	Severance Tax Bonding Capacity
$0.0	($42,500.0)	($32,500.0)	Recurring	Supplemental Severance Tax Bonding Capacity

(Parenthesis ( ) Indicate Expenditure Decreases)

REVENUE (dollars in thousands)

Estimated Revenue			Recurring or Non-Rec	Fund Affected
FY10	FY11	FY12		
$0.0	($72,329.2)	($95,844.3)	Recurring	Severance Tax Bonding Fund
$0.0	$95,562.7	$96,482.6	Recurring	Public School Fund

(Parenthesis ( ) Indicate Revenue Decreases)

ESTIMATED ADDITIONAL OPERATING BUDGET IMPACT (dollars in thousands)

	FY10	FY11	FY12	3 Year Total Cost	Recurring or Non-Rec	Fund Affected
Total	$0.0	$0.1	$0.1	$0.1	Recurring	TRD Operating Fund

(Parenthesis ( ) Indicate Expenditure Decreases)

Duplicates and Conflicts with SB 255
Conflicts with HB 268, SB 185, and SB 192

SOURCES OF INFORMATION
LFC Files

Responses Received From
Taxation and Revenue Department (TRD)
Energy Minerals and Natural Resources Department (EMNRD)

Public School Finance Authority (PSFA)
Department of Finance and Administration (DFA)

SUMMARY

Synopsis of Bill

Senate Bill 208 would temporarily decrease severance tax rates and increase oil and gas emergency school tax rates by one percent in order to provide additional revenue to the public school fund (PSF) while simultaneously ensuring that the combined total tax burden between the two revenue sources remains constant. The proposed rate adjustments would take effect July 1, 2010 and expire June 30, 2013.

Senate Bill 208 would also allow for distributions to be made to the severance tax bonding fund (STBF) from oil and gas emergency school tax revenues while the rate adjustments are in effect, if BOF can certify that such a distribution is necessary to meet debt service obligations on outstanding severance tax bonds (STB) and or supplemental severance tax bonds (SSTB).

FISCAL IMPLICATIONS

Senate Bill 208 carries with it a variety of fiscal implications on the general fund (GF) and STB capacity. Table 1 shows that during FY11-FY14, $290.2 million in revenues would be diverted from the STBF to the PSF.

Table 1:

STBF/GF Revenue Impacts (millions)

	FY2011	FY2012	FY2013	FY2014	Total
STB Revenue - SB208 Scenario	$ 327.04	$ 308.60	$ 313.59	$ 391.68	$ 1,340.91
STB Revenue - January Estimate	$ 399.37	$ 404.45	$ 411.13	$ 416.20	$ 1,631.15
SB 208 STB Revenue Loss	$ (72.33)	$ (95.84)	$ (97.55)	$ (24.52)	$ (290.24)
Public School Fund Revenue Gain	$ 95.56	$ 96.48	$ 98.19	$ -	$ 290.24

Cumulatively over the life of the bill the amount of revenue transferred from one tax program to the other equals out, however during individual fiscal years this is not the case. The disparities within individual fiscal years are the result of different accrual procedures for each of the funds in question. These procedures are discussed in more detail in the significant issues section below.

Table 2:

Capital Outlay Impacts of SB 208

	FY11 Current	FY11 SB208	FY11 Loss	FY12 Current	FY12 SB208	FY12 Loss
Senior Long-Term Issuance	149.5	149.5		149.5	149.5	
Senior Sponge Issuance	70.4	24.8		71.7	35.5	
Senior STB Capacity	**219.9**	**174.3**	**(45.6)**	**221.2**	**185.0**	**(36.2)**
Water Project Fund	*(22.0)*	*(17.4)*		*(22.1)*	*(18.5)*	
Net Senior STB CAPACITY	**197.9**	**156.9**	**(41.0)**	**199.1**	**166.5**	**(32.6)**
Supplemental Long-Term Issuance	-	-		-	-	
Supplemental Sponge Issuance	140.5	98.0		151.8	119.3	
Supplemental STB CAPACITY	**140.5**	**98.0**	**(42.5)**	**151.8**	**119.3**	**(32.5)**

The proposed reductions in STBF revenue would have a significant negative impact on senior

STB and supplemental STB capacity in FY11-FY14. Table 2 details these impacts in FY11 and FY12. Senate Bill 208 would decrease net senior STB capacity, which determines the amount of capital outlay available for annual appropriation from the legislature, by a combined $73.6 million in FY11 and FY12. The proposed legislation would also decrease supplemental STB capacity, which is appropriated to the Public School Capital Outlay Council for public school infrastructure projects, by a combined $75 million in FY11 and FY12. Senate Bill 208 would also decrease senior and supplemental STB capacities in FY13 and FY14. However the consensus STB capacity estimate does not typically forecast that far into the future, and therefore the exact capacity impacts in those years is decidedly negative but indeterminate.

SIGNIFICANT ISSUES

Accrual Processes: Although the effects of the proposed rate adjustments will cumulatively net out with respect to each tax program, disparities will exist between the two funds on an individual fiscal year basis due to differences in accrual procedures. Senate Bill 208 would make the proposed rate changes effective July 1, 2010, and therefore all taxable items under both severance taxes and oil and gas emergency school taxes sold in July would be subject to the new rates. However, the revenues from these sales are accrued to the different accounts in different months. Figure 1 shows the process in which oil and gas taxes are paid and eventually deposited in their respective funds. Once oil and gas products are sold, producers must pay taxes on those products within 55 days to the Taxation and Revenue Department (TRD), in this case by September 25th. After these taxes are received by TRD, processing of the receipts occurs after which cash is deposited into each tax program's respective beneficiary account the following month, in this case October.

Figure 1:

Oil and Gas Tax Payment Example

July	August	September	October
Product Sold		Tax Paid to TRD	Cash Transferred from TRD to PSF/STBF

Day 0 -->Day 55---------------->Day 90

PSF Revenues Accrue to Sales Month	STBF Revenues Accrue to Cash Month

The PSF is an account within the GF used to fund public schools. As part of the GF the revenues which flow into the PSF, oil and gas emergency school taxes, are accounted for on a 60 day modified accrual basis as per the Financial Control Division (FCD). Therefore, using the example above, oil and gas emergency school taxes received by TRD within 60 days of a July sale will be accrued and credited as GF revenue in the month of July even though the cash was not actually transferred to the PSF until October.

The payment and deposit process shown in Figure 1 holds true for severance taxes as well, however due to the mechanics of the STB program the accrual process differs. When sizing STB issuances, particularly over-night sponge notes, the BOF must anticipate how much cash will be in the STBF at the time of sale. Because the bonds can only be issued against actual cash that has been deposited in the STBF, and not on revenues that are expected to accrue to the fund within 90 days, revenue to the fund reflects a different set of sales months than oil and gas emergency school taxes. FY11 revenues to the PSF for example, will reflect taxes on products sold between July 1, 2010 and June 30, 2011. FY11 STBF revenues on the other hand will reflect taxes on products sold between April 1, 2010 and March 31, 2011, as the taxes received on products sold in April are actually deposited into the STBF in July.

The proposed legislation has the potential to create serious concerns with respect to investor confidence in the program. Investors will most likely become concerned that such a drastic temporary change in the scope of the program can be implemented on such short notice with relatively little warning. Once this precedent is set, investors may wonder if the state will in future take steps to further weaken the security of the program every time it experiences short-term fiscal difficulties. A one-time change could also result in a ratings downgrade for the program which, coupled with reduced investor confidence, could severely increase future debt service levels ultimately resulting in an even greater decrease in STB capacity.

State Board of Finance (BOF):

> "Any action to change the tax rate applied to the benefit of the Severance Tax Bonding Fund would likely have repercussions on the credit perception of severance tax bonds. Bondholders would assess the projected impacts on STBF collections under a variety of market circumstances, particularly in light of the recent volatility seen in pricing over the past several years. Furthermore, the redirection of revenues from the STBF to operating fund will raise red flags for bond rating agencies and institutional investors who will see the action as an encroachment on the STBF resources and become concerned with the fundamental nature of the severance tax bonds as a stable, limited tax credit going forward.
>
> The State must also remain cognizant of the covenant by the State Board of Finance that the State will maintain tax rates at levels necessary to assure that the STBF revenues will produce 2.00x debt service coverage in each year. Accordingly, any action should be taken with careful consideration for the range of potential revenue impacts on the STBF, and to the commitments made by the State to its bondholders. (In other words, it should be stress tested under different pricing scenarios)."

Based on consensus STBF revenue estimates, the proposed decreases in tax rates provided in Senate Bill 208 would decrease the debt service coverage ratios on these bonds dangerously close to 2.0. If oil and gas prices were to decrease, even by a modest amount, while the rate adjustments are in place this coverage ratio could fall below 2.0 in violation of state bond covenants.

CONFLICT, DUPLICATION,

Senate Bill 208 duplicates Senate Bill 255, however the degree to which the proposed rates change in the two pieces of legislation conflict.

Senate Bill 208 conflicts with House Bill 268, Senate Bill 185, and Senate Bill 192 which all make appropriations from senior and or supplemental STB proceeds for state operations and or reserves. If Senate Bill 208 were to pass there would be insufficient capacity to accomplish such appropriations in their entirety.

TECHNICAL ISSUES

Taxation and Revenue Department (TRD):

Current system code related to advance payment calculations is controlled by tax rates and related tax payments in effect for a 12-month period ending each March 31. For example, the advance payment calculation to be completed in June 2010 recognizes the tax payments related to the 12-month period ending March 31, 2010. Those taxes are based upon current tax rates. The advance payment cannot be determined based upon a tax rate established with an effective date of July 2010 sales.

Recommendation:

- Change Section 8 A. (1) to read as follows: the average tax pursuant to those sections for the twelve months ending March 31, 2011 shall be determined recognizing tax rates in effect for that 12 month period.
- Change Section 8 A (2) to read as follows: the average tax pursuant to those sections for the 12 months ending March 31, 2014 shall be determined shall be determined recognizing tax rates in effect for that 12 month period.

OTHER SUBSTANTIVE ISSUES

Public Schools Facility Authority (PSFA):

In the 1999 Zuni lawsuit, Judge Joseph Rich ordered the state to establish a uniform and dedicated funding system for school capital improvements. Redirecting this funding stream could immediately put the state out of compliance with the Zuni lawsuit court agreement which specified the supplemental severance tax bond proceeds as a dedicated funding stream.

This bill only delays the inevitable fiscal restructuring needed. Inadequate school facilities will not support educational programs. Many school districts are completing project planning, have passed local bond elections and will not be able to move forward and risk arbitrage and public confidence issues.

DMW/mt