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

SPONSOR Garcia, M.J. **ORIGINAL DATE** 02/17/11 **LAST UPDATED** **HB**

SHORT TITLE Decrease Oil & Gas Severance Tax Rates **SB** 100

ANALYST Burrows

APPROPRIATION (dollars in thousands)

Appropriation			Recurring or Non-Rec	Fund Affected
FY11	**FY12**	**FY13**		
	($45,800.0)	($50,200.0)	Recurring	Senior Severance Tax Bonding Capacity
	($41,200.0)	($45,100.0)	Recurring	Supplemental Severance Tax Bonding Capacity

(Parenthesis ( ) Indicate Expenditure Decreases)

REVENUE (dollars in thousands)

Estimated Revenue			Recurring or Non-Rec	Fund Affected
FY11	**FY12**	**FY13**		
	($75,200.0)	($104,300.0)	Recurring	Severance tax bonding fund
	$100,300.0	$105,600.0	Recurring	General Fund - Public School Fund

(Parenthesis ( ) Indicate Revenue Decreases)

Relates to HB222

SOURCES OF INFORMATION
LFC Files

Responses Received From
Taxation and Revenue Department (TRD)
State Investment Office (SIC)
Public School Facilities Authority (PSFA)
Public Education Department (PED)

SUMMARY

Synopsis of Bill

Senate Bill 100 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 while simultaneously ensuring that the combined total tax burden between the two revenue sources remains constant. The proposed rate adjustments would take effect from FY12 through FY14.

Senate Bill 100 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 the State Board of Finance (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).

The bill also allows the Secretary of the Taxation and Revenue Department to adjust the oil and gas school and severance tax rates in the event the price of gas or oil falls below a certain threshold as outlined in current law.

The effective date of the provisions of this bill is July 1, 2011.

FISCAL IMPLICATIONS

Fiscal impacts are based on the consensus revenue estimating group forecast of oil and gas prices and volumes. Revenue accrual procedures are different for the general fund and the bonding fund. Revenues to the general fund accrue in the sales month of the products. Revenues in the bonding fund are accrued when cash is received, typically 3 months after the sales month. For this reason, an additional revenue loss to the STBF in FY15 of $26.7 million would occur to compensate for the imbalance between the STBF loss and the general fund gain in FY12. Revenue changes are shown as "Recurring" despite the sunset provisions because the two taxes are considered part of the recurring revenue base of the two funds.

Senate Bill 100 provides that bonding capacity for FY12 would be determined by reducing FY11 oil and gas severance tax revenue by 1 percent, and the capacity for FY15 would be determined by increasing FY14 oil and gas severance tax revenue – as calculated by the lower rate assumed in this bill – by 1 percent. In this way, the effect of the 1 percent shift would impact the bonding capacity in the same fiscal years that oil and gas school tax revenue was affected.

The figure below illustrates the impact of Senate Bill 100 on the STB capacity.

Impact of SB100 on STB Capacity

	FY12			FY13		
	Current	**SB100**	**Difference**	**Current**	**SB100**	**Difference**
Senior Long-Term Issuance	$180.6	$180.6		$180.6	$180.6	
Senior Sponge Issuance	$67.3	$21.5	($45.8)	$63.1	$13.0	($50.2)
Senior STB Capacity	**$247.9**	**$202.2**	**($45.8)**	**$243.8**	**$193.6**	**($50.2)**
Authorized Unissued	*$0.0*	*$0.0*		*$0.0*	*$0.0*	
Water Project Fund	*$24.8*	*$20.2*	*($4.6)*	*$24.4*	*$19.4*	*($5.0)*
Tribal Infrastructure Fund	*$12.4*	*$10.1*	*($2.3)*	*$12.2*	*$9.7*	*($2.5)*
Colonias Infrastructure Project	*$12.4*	*$10.1*	*($2.3)*	*$12.2*	*$9.7*	*($2.5)*
Net Senior STB Capacity	**$198.4**	**$161.7**	**($36.6)**	**$195.0**	**$154.9**	**($40.1)**
Supplemental Long-Term Issuance	$0.0	$0.0		$0.0	$0.0	
Supplemental Sponge Issuance	$144.8	$103.6	($41.2)	$168.0	$122.8	($45.1)
Supplemental STB Capacity	**$144.8**	**$103.6**	**($41.2)**	**$168.0**	**$122.8**	**($45.1)**
Total STB Capacity	**$343.2**	**$265.4**	**($77.8)**	**$363.0**	**$277.7**	**($85.3)**

Senate Bill 100 would decrease net senior STB capacity, which determines the amount of capital outlay available for annual appropriation from the legislature, by a combined $76.7 million in FY12 and FY13. 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 $86.3 million in FY12 and FY13. The bill would decrease total STB capacity by $91.8 million in FY14 after appropriations for earmarked projects.

SIGNIFICANT ISSUES

The Severance Tax Bonding Act includes several covenants to provide security to bondholders, including the requirement that deposits into the STBF are sufficient to produce amounts necessary to meet debt service charges, a statutory issuance test limiting debt service on new and outstanding issuance to no more than 50 percent of revenues for STB and 45 percent of revenues for SSTB. Moreover, the state is required to use its “best efforts” to deposit in the fund amounts that will equal 200 percent of the amount of debt service scheduled to be due in each fiscal year (a 2.0x coverage ratio). Any funds remaining in the STBF at the end of the fiscal year are transferred to the Severance Tax Permanent Fund (STPF).

PED reports the State Equalization Guarantee (SEG) is the allocation school districts and charter schools receive through the public school funding formula. The SEG accounts for 94 percent of the public school fund, and is the primary source of funding for school districts’ and charter schools’ operational budgets. Recent reductions to the SEG appropriation are being offset by the American Recovery and Reinvestment Act (ARRA) appropriations, which are not anticipated to be awarded in FY12.

The bill includes certain provisions to protect bondholders, including the requirements that severance tax bonds should not be issued with the expectation that a distribution of oil and gas school tax receipts will be used to satisfy any portion of the debt service, and the oil and gas school tax receipts should not be used in the determination of STB capacity. However, the bill does not ensure the state will fulfill its covenant to maintain a 2.0x coverage ratio. Because the bill reduces the level of bonds that can be issued in the future, which will thus lower the annual debt service, the bill does not appear to impair the state's ability to meet its obligations to existing bondholders.

The precedent set by such a proposal, however, could have a much greater impact on the state than the one-time issuance. TRD notes, Senate Bill 100 might cause investors to question the state's long-term commitment to the bonding program.

The PSFA expresses concern that bond ratings agencies may consider the proposed tax shift a material weakness in the fiscal affairs of the state, and assess a rating change to New Mexico's bonds for the perceived increase in risk.

RELATIONSHIP

House Bill 222 proposes to increase the oil and gas school tax on oil from 3.15 percent to 4 percent.

TECHNICAL ISSUES

TRD notes that Section 4, page 4 authorizes the Secretary of the Taxation and Revenue Department to adjust tax rates in the event that oil and gas prices fall below a certain threshold set by current law. However, TRD feels this language is unnecessary, since the lower rates that are triggered by the lower prices are already included in these statutes. If, on the other hand, this provision is meant to shift liabilities from the oil and gas severance to the oil and gas school tax with the price trigger, the language needs to be clarified.

TRD also reports the use of the term "reserve fund" in Section 2, page 2 of the bill is unclear because it does not conform to the way the state board of finance (BOF) manages the severance tax bonding program. The Bonding Act does not allow more than the next two debt service payments to remain in the fund. The language seems to provide the BOF discretion to establish a reserve fund of unspecified magnitude, which could prevent the goals of the statute from being achieved.

Moreover, according to TRD, tax distributions are currently programmed based on distribution months not sales months. For this reason, TRD suggests the bill be amended to include the following language, which will prevent costly and time-consuming changes to the oil and gas tax database: "The distribution pursuant to Section 3 of this act applies to receipts from the oil and gas emergency school tax that are attributable to receipts received on or after July 1, 2011 and prior to July 1, 2014."

OTHER SUBSTANTIVE ISSUES

According to the Public School Facility Authority (PSFA), average investment of public school facilities required by the state to keep current facilities conditions from worsening is about $125 million. Current unfunded needs for public school facilities total about $4.05 billion. Any additional funding burden imposed on the Public School Capital Outlay Fund, which is funded through the proceeds from SSTB, could accelerate the worsening of school facilities conditions.

The SIC notes that the Severance Tax Permanent Fund (STPF) has been generally declining over the past decade, primarily due to the mechanism that allows the state board of finance (BOF) to issue supplemental severance tax bonds in addition to senior severance tax bonds. According to the SIC, contributions to the STPF have averaged $43 million annually since FY2000 with large fluctuations across years, while distributions from the STPF to the general fund have remained more consistent at an average of $177 million annually. Since June 30, 2000 the fund has decreased nearly $750 million in valuation. This does not take into account real dollar value losses due to inflation.

The SIC states that strong investment returns are needed to offset this loss of revenue, and thereby maintain or grow the corpus of the fund. However, 10-year returns as of the quarter ending 12/31/10 stood at only 3.3 percent. A return of 8 percent has historically been considered the investment standard, though nationally some funds have set long-term target rates at 7 percent or lower. While past investment performance is not indicative of future potential for returns, when taking into account the effects of annual compounding of returns, the impact of removing additional contributions to the STPF by decreasing severance tax revenues will be significant.

WHAT WILL BE THE CONSEQUENCES OF NOT ENACTING THIS BILL

The oil and gas school and severance tax rates will remain as in current law.

LKB/bym