# FISCAL IMPACT REPORT

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| | | **LAST UPDATED** | 2/7/24 |
| **SPONSOR** | Lente/Small | **ORIGINAL DATE** | 1/27/24 |
| **SHORT TITLE** | Capital Outlay Changes | **BILL NUMBER** | House Bill 253/aHAFC |
| | | **ANALYST** | Carswell/Torres, Ismael |

**APPROPRIATION***
**(dollars in thousands)**

| FY24 | FY25 | Recurring or Nonrecurring | Fund Affected |
|---|---|---|---|
| | ($31,000.0) | Recurring | Senior Severance Tax Bond Proceeds |

Parentheses ( ) indicate expenditure decreases.
*Amounts reflect most recent analysis of this legislation.

| Type | FY24 | FY25 | FY26 | FY27 | Recurring or Nonrecurring | Fund Affected |
|---|---|---|---|---|---|---|
| Senior Severance Tax Bond/Note Proceeds | | $31,000.0 | $62,000.0 | $93,000.0 | Recurring | Capital Development & Reserve Fund |
| Senior Severance Tax Bond/Note Proceeds | $0.0 to $500,000.0 | | | | | Capital Development & Reserve Fund |
| Investment Distribution | | | $1,600.0 | $4,800.0 | Recurring | Capital Development Program Fund |
| Severance Tax Bond Capacity Available for Appropriation | | ($257,000.0) | ($257,000.0) | ($257,000.0) | Nonrecurring | Senior Severance Tax Bond Capacity Available for Appropriation |

Relates to Senate Bill 217

### Sources of Information

LFC Files
Board of Finance Analysis

Agency Analysis Received From
Board of Finance (BOF)

## SUMMARY

### Synopsis of HAFC Amendment to House Bill 253

The House Appropriations and Finance Committee amendment to House Bill 253 authorizes the Board of Finance to convert any excess cash available in the severance tax bonding fund at the end of FY24, up to $500 million, into a one-time distribution to the capital development and reserve fund created by HB253. The distribution would occur with the proceeds of taxable severance tax notes, with the exact amount to be determined only after the Board of Finance made all other authorized issuances, including any authorizations made by the 2024 Legislature. The funds reflect one-time savings from using general fund instead of bonding for capital projects during the 2024 legislative session.

The amendment also makes several technical changes suggested by the Board of Finance to provide a mechanism for unexpended distributions from the new reserve fund to flow to the severance tax permanent fund.

### Synopsis of Original House Bill 253

House Bill 253 amends the Severance Tax Bonding Act to, under certain circumstances, reduce maximum long-term debt capacity from the severance tax bonding program and distribute any cash savings to a new capital development and reserve fund. HB253 requires the State Board of Finance to estimate the amount of long-term bonding capacity available to the Legislature based on the lesser of the current method and a new method that ties long-term bonding capacity to median state debt ratios.

HB253 creates the capital development and reserve fund as a nonreverting fund managed by the State Investment Council and requires the Board of Finance to make an annual allocation to the reserve consisting of the savings generated by limiting long-term bond issuances to the median state debt ratios, when such savings exist.

HB253 also creates the capital development program fund as a nonreverting fund in the state treasury. On July 1 of each year, a distribution shall be made from the capital development reserve fund to the program fund in an amount equal to 5 percent of the average year-end value of the reserve fund over the previous three years. Money in the program fund shall be available to the Legislature for appropriation to capital projects with a total cost of less than $5 million dollars and for planning and design of capital projects with higher total costs.

Expenditures from the capital development and reserve fund and capital development program fund shall only be for purposes specified in the bill. Unlike the severance tax permanent fund, which receives distributions from cash left in the severance tax bonding fund at the end of each year and is invested for the benefit of the general fund, the newly created capital development and reserve fund is seeded only from the proceeds of short-term debt issuances and can only be used for capital purposes, including as a reserve for coverage of existing debt in the event of insufficient revenues.

This bill does not contain an effective date and, as a result, would go into effect 90 days after the Legislature adjourns, or May 15, 2024, if enacted. However, because the bill changes the estimation process reported on January 15, the impacts of HB253 are not until FY25.

## FISCAL IMPLICATIONS

The fiscal impacts to the bill relate to (1) severance tax bonding capacity available for appropriation, (2) funding of a newly established capital development and reserve fund, and (3) appropriations available from a newly established capital development program fund.

The bill constrains the capacity available for appropriation in years in which capacity for appropriation, established using statutory debt limitations and state Board of Finance (BOF) policy, exceeds the capacity for appropriation that maintains stable debt ratios over time.

According to the Board of Finance:

> Given current revenue estimates and U.S. median debt ratios for all states as published by Moody's (debt per capita, $1,179, and debt as a percentage of personal income, 2.1 percent), capacity available for appropriation, while maintaining stable debt ratios over time, would be approximately $846 million in FY25, including a reduced long-term severance tax bonding capacity of $400 million from $657 million. (This assumes an issuance of $350 million in long-term senior severance tax bonds in FY24.) This reflects a reduced capacity available for appropriation of approximately $257 million in FY25. It's important to note that the reduced capacity available for appropriation of $846 million is still significantly higher than historic levels, which were nearly always below $300 million annually. The reduction in capacity for appropriation would fluctuate beyond FY25 based on numerous factors, including oil and gas severance tax revenues, growth in outstanding debt across the state's bonding programs (severance tax, general obligation, and transportation), population growth, and income growth.
>
> Given the above estimates and an issuance maturity term of 10 years, the Board would issue approximately $31 million in taxable short-term senior severance tax notes at the end of FY25 and transfer that amount to the newly established Capital Development and Reserve Fund, beginning July 1, 2025 (FY26). The transfer would occur annually for a total of 10 years (FY26 through FY35), as long as revenues remain sufficiently high to include such an amount in taxable short-term senior severance tax note issuances.
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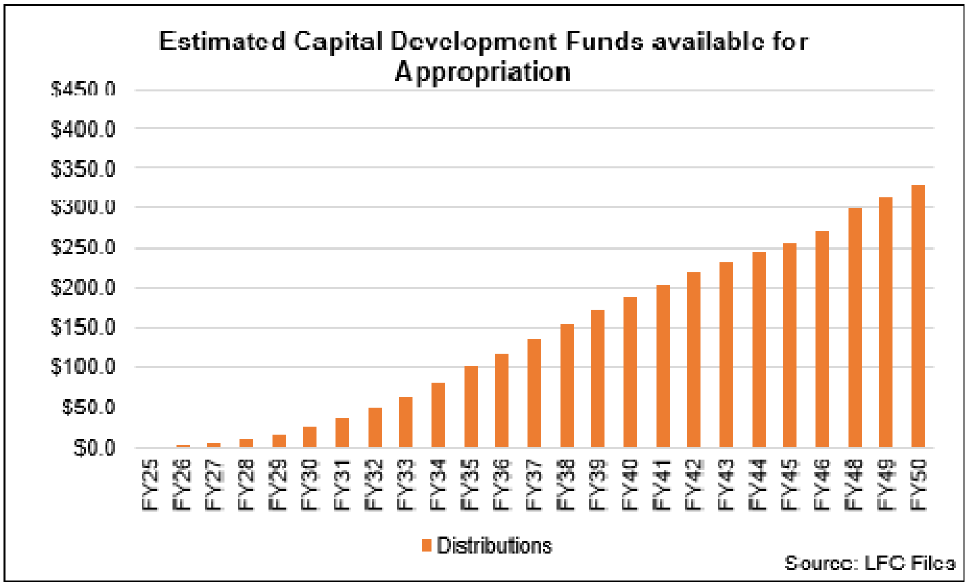
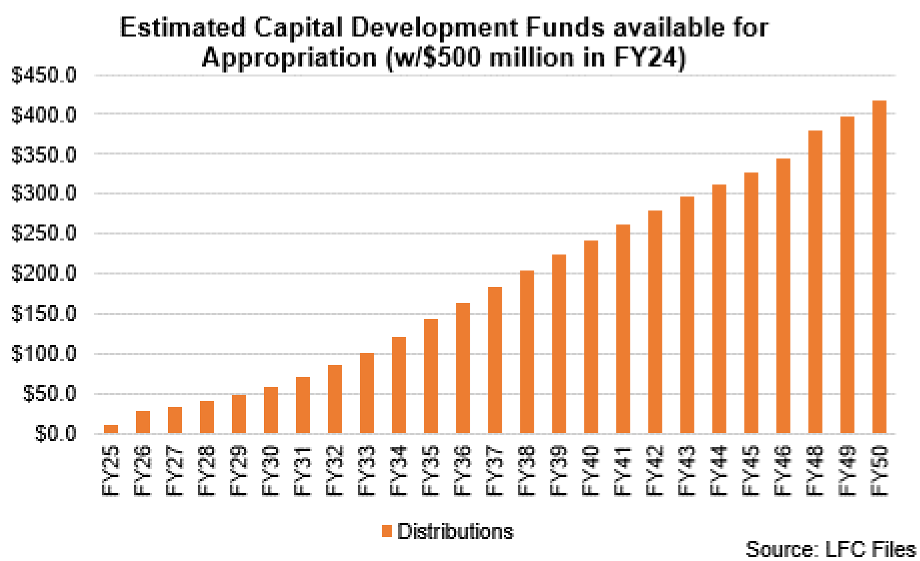
> If revenues fall, the transfer to the Capital Development and Reserve Fund could drop to zero in any given year. Projecting severance tax revenues is inherently challenging given the volatility of the source of revenues. ... If issuance of long-term severance tax bonds is constrained to $400 million annually for that period to ensure stabilized debt ratios, the compounded revenues to be transferred to the capital development and reserve fund would total close to $1.7 billion for the FY26 to FY35 period.

Given the annual distributions into and out of the newly created capital development and reserve fund, LFC analysis assumed an asset allocation and return target similar to the land grant permanent fund of 7 percent annual returns. The resulting funds estimated available for appropriation each year are reflected below.

Furthermore, because the above estimates assume issuance of long-term debt in FY24, the actual impacts to bonding capacity in FY25 are likely to be smaller than shown here if no long-term debt is issued in FY24. Similarly, the savings from the above estimates are likely to be greater than shown here if no long-term bonds are issued in FY24.




The growth of the reserve fund could be significantly boosted by the one-time distribution authorized by the HAFC amendment to HB253, if such a distribution occurred. The amount available for such a distribution could range from $0 to $500 million, depending on revenues into the bonding fund through the end of the fiscal year and any action by the Legislature to authorize those funds for other purposes. The chart below illustrates the impact of a $500 million one-time distribution in FY24.




While the reserve fund is growing and distributions are still modest, the impact to overall revenues available for capital appropriations could be mitigated by funding capital outlay with a mix of severance tax bond proceeds and general fund. Such a mixed funding model could support capital appropriations packages at a similar scale to the last several years.

## SIGNIFICANT ISSUES

HB253 seeks to address distinct but related risks to the state's capital outlay system. Capital outlay is the state's most reliant program on oil and gas revenues, with the proceeds from severance tax bonds being one of the only dedicated revenue sources for capital improvements to state facilities, public schools, and higher education institutions. The severance tax bonding program also supports state investments in local and tribal infrastructure through the water project fund, colonias infrastructure fund, tribal infrastructure fund, housing trust fund, and through appropriations to local projects sponsored by House and Senate members and the governor.

Severance tax bonds are a form of debt repaid with revenues from severance taxes on oil, gas, and other minerals deposited into the severance tax bonding fund. Though the Legislature has taken several steps to insulate the general fund from future declines in oil and gas revenues, no such measures have been adopted for the capital program. In the long-term, these revenues are expected to stagnate and then decline, with a steep decline forecasted by the late 2030s under both baseline and high production scenarios. A future decline in severance taxes will weigh on the general fund as it becomes a replacement source for capital at a time when general fund revenues will already face headwinds from declining oil and gas production, which could make it difficult for the state to finance new capital projects and maintain its existing assets. Long-term planning is needed to avoid this future fiscal strain.

Heavy reliance on volatile revenues already compromises the state's ability to make consistent and needed investments in physical infrastructure. The state's debt capacity has increased significantly over several years because of the oil boom, but as recently as 2017, revenues were insufficient to support any new capital appropriations.

Additionally, while increased debt capacity presents opportunity, it carries significant risk. By law, total debt through the state's bonding program is limited to 86.2 percent of the lesser of current-year or prior-year bonding fund revenue; capacity for long-term debt is based on estimates for 10 years of revenue, interest rates, and other factors. Current capacity levels, if fully utilized, present a risk to the state's bond ratings due to the potential impact to debt ratios, with long-term estimates showing the state's debt ratios potentially soaring. The Legislature's decision to finance new 2023 capital projects with general fund instead of debt mitigated this risk. Continued general fund surpluses present the Legislature with the same option in 2024. However, going forward, if the state assumes the high levels of debt that are expected to be available under current statutory limits, the state's bond ratings could be downgraded, which could raise the cost of debt and erode the buying power of current revenues.

HB253 addresses the risk high debt levels pose to the state's credit ratings by tying annual long-term debt capacity to median state debt ratios published by national municipal bond rating agencies. By adhering to debt ratios in line with the national average, a state demonstrates prudent fiscal management, instills investor confidence, and reduces the risk of default from an excess of debt repayment per person. For New Mexico, adhering to these ratios could also extend the life of the bonding program with projected revenues – meaning a more stable level of funding would be available for a longer period of time than if no action is taken.

HB253 also redirects savings generated from the new approach to an interest-bearing trust fund dedicated to capital projects. While the new fund would have to grow substantially to become a full replacement source for severance tax revenues, it represents an important first step toward building a capital program with longevity. Distributions from the new fund would begin immediately and grow over time and would be available to the Legislature for appropriation to capital projects.

## PERFORMANCE IMPLICATIONS

The state Board of Finance submitted the following analysis related to HB253's impact on stabilizing the state's debt ratios and addressing the capital program's long-term revenue issues and overall performance:

> In its 2023 Debt Affordability Study, the state Board of Finance (BOF) recommended debt levels that would stabilize debt ratios over time, including debt per capita and debt as a percentage of personal income. ... (T)hese ratios, along with the level of financial reserves and trends in state revenues and other financial resources, directly impact the state bond ratings, and the state bond ratings, in turn, directly impact the state's cost of capital. Understanding the position of the state relative to its peers allows stakeholders across the state to monitor its financial and debt positions and provides a framework for benchmarking with respect to debt issuance levels, debt capacity, and levels of new investment. Due in large measure to the conservative debt management practices of the state, the key debt ratios have historically allowed for regular issuances of new bonds without any adverse impact on debt metrics. Increases in new debt indicated by the State's long-standing debt capacity policies and the state's historic revenue levels could change that. Restraining long-term severance tax debt to levels to keep state debt ratios in line with median levels across the county would ensure the state is not over-burdening its population with outstanding debt relative to the practices among peer states. It would also reduce the risk to the state of availability of funds for capital purposes in the future, should severance tax revenues decline, by reducing the long-term debt service costs related to current issuance. Finally, it would signal to the bond ratings agencies that the state remains committed to prudent fiscal management of the state's debt programs and financial resources.
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> The development of the capital development and reserve fund, with balances growing as the state continues to see high revenues, could address concerns with funding capital projects in the event severance tax revenues decline significantly in the future. Severance tax revenues have historically been the main source of funding capital in the state. A major decline in revenues has happened in the past and could in the future jeopardize the state's ability to fund capital. The bill ensures that the capital development and reserve fund could be tapped in future years when severance tax revenues do not support capital investments.
>
> The development of the capital development program fund creates a recurring revenue source that supports not just the funding of smaller capital projects but also the funding of planning efforts related to larger capital projects. A critical factor for the state's capital outlay process is to ensure that capital appropriations are expended timely and for the purpose originally envisioned. This requires sufficient and thoughtful planning of projects prior to receipt of appropriations. Recurring revenues that support better planning prior to appropriations for construction can strengthen the pipeline of capital appropriations, ensure more timely expenditures, and ensure development of capital projects that are priorities identified by local public entities throughout the state.
>
> Additionally, it is best practice to prioritize the use of long-term tax-exempt municipal debt for large capital projects. New Mexico is the only state that funds small dollar

amount capital with tax-exempt municipal debt. the establishment of the capital development program fund, in combination with the capital development and reserve fund, could move the state towards the best practice of reserving long-term debt for major capital initiatives.

## CONFLICT, DUPLICATION, COMPANIONSHIP, RELATIONSHIP

HB253 relates to SB217, which would transfer the savings from avoided debt service in 2024 from the severance tax bonding fund to the severance tax permanent fund. Those savings could instead be used to seed the capital development and reserve fund created by HB253, if the bill is enacted.

## OTHER SUBSTANTIVE ISSUES

The Board of Finance notes the New Mexico Constitution requires severance tax revenues exceeding the amount reserved by statute for payment of debt service to be transferred to the severance tax permanent fund and that HB253 could create a parallel fund which permits distributions not specified in the constitution. The Board of Finance indicates an option to address this concern could be to provide a mechanism for periodic transfers from the reserve fund to the permanent fund.

However, transfers to the reserve fund would be made with the proceeds from severance tax notes, a form of short-term debt already frequently used in the bonding program, and therefore would not represent an excess in the fund required to be transferred to the permanent fund. This is a similar mechanism by which the severance tax bonding fund allocates money to the public school capital outlay fund, though allocations to the reserve would likely be made with the proceeds of taxable notes, which do not carry the same restrictions imposed by tax-exempt notes. Additionally, expenditures from the new fund would only be for capital purposes in compliance with the severance tax bonding act.

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**Flowchart of Changes:**