

MEMORANDUM

TO: Stephanie Schardin Clarke, Interim Director
State Board of Finance

FROM: Sutin, Thayer & Browne
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DATE: August 16, 2011

SUBJECT: Severance Tax Bonding Memorandum

Pursuant to your request, this memorandum describes the legislative history of the Severance Tax Bonding Act and the Severance Tax Permanent Fund for the purpose of providing this information to others.

I. Summary

As the historical description indicates, severance taxes were first used in New Mexico as a current funding source for the general fund. In 1959, the legislature authorized the use of severance taxes to back bonds issued by the State for capital projects, with any severance taxes not needed to pay interest and principal on the bonds to be deposited in the general fund. In 1973, the legislature created statutorily the Severance Tax Permanent Fund (“Permanent Fund”) and directed that severance taxes not needed for debt service be deposited in the Permanent Fund rather than the general fund. The legislature created this new Permanent Fund to serve as an endowment fund for capital projects, as all income from the Permanent Fund was to be deposited into the capital program fund. In 1976, the Permanent Fund was given constitutional status by the electorate, and the electorate authorized the legislature to invade the corpus (with a 3/4th vote in each house) of the fund for operating expenses and to use the income from the Permanent Fund for operating purposes, thus changing the Permanent Fund from an endowment for capital projects to a rainy day fund for operating purposes. In 1982, the electorate amended this constitutional provision to eliminate the possibility that the legislature would invade the corpus, thus making the Permanent Fund an endowment to produce income for operating purposes. In 1996, another constitutional amendment was adopted that forced distributions of moneys from the Permanent Fund based solely on a fixed percentage of the fund’s market value, which in a declining market scenario could force distributions from the corpus even where the fund had net losses.

Until 1999, the bonding program was designed by statute to operate more or less on the assumption that half of the severance taxes were to be used to support the bonds and half to be deposited in the Permanent Fund. The mechanism to get this result is the statutory issuance test. As a result of court imposed pressure to increase dramatically state funding for public school capital outlay, the legislature began to authorize greater portions of severance tax revenues to be used for bonding rather than for deposit in the Permanent Fund with such greater portions to be exclusively used for capital projects for education. Currently, up to 95% of deposits into the

Bonding Fund, as measured by the statutory issuance test, may be used to service some type of debt for capital outlay.

II. The Severance Tax Bonding Act

A. General Purpose

New Mexico has levied taxes on the severance of various natural resources within the State since 1937, at which time all severance taxes were paid into the general fund. See Laws 1937, ch. 103, § 4. Severance taxes continued to be deposited into the State's general fund until 1959, when the legislature enacted the Severance Tax Bonding Act and created the Severance Tax Bonding Fund. Laws 1959, ch. 323, § 3. In 1961, the legislature repealed a significant portion of the 1959 law and replaced it with a substantially similar Severance Tax Bonding Act ("Act"). At that time, all severance taxes were deposited into the severance tax bonding fund to pay debt service on severance tax bonds issued to fund capital improvements authorized by the legislature, and any funds in the Bonding Fund above the amount necessary to pay debt service in the ensuing year were directed to the general fund. See Laws 1961, ch. 5, §§ 3, 4, 6. Section 27 articulated the purpose and intent of the Act:

The purpose of the severance tax bonding act is to establish the authority who shall issue and sell all severance tax bonds for financing specific projects authorized by the legislature and to guarantee redemption of such bonds by revenue derived from the receipts from taxes levied upon natural resource products severed and saved from the soil, and such other monies as the legislature may from time to time determine. It is intended that projects to be financed from the fund shall include but not be limited to the construction of buildings for state institutions and water resource projects; and it is further intended that the income from water resource projects in excess of the amount required for operation and maintenance of the project shall be used to repay the severance tax bonding fund.

Laws 1961, ch. 5, § 27. The current version of the statute includes substantially the same provision, adding public school buildings to the list of projects to be financed and designating the use of certain bond proceeds for various specific purposes. See NMSA 1978, § 7-27-27.

B. Severance Tax Bonding Fund

To achieve its purpose, the Act created the severance tax bonding fund ("Bonding Fund") and authorized the State Board of Finance to issue and sell severance tax bonds. Laws 1961, ch. 5, §§ 3, 8.

From its inception, the statutory scheme has permitted only the pledge of severance taxes to pay debt service on the bonds. Laws 1961, ch. 5, § 4. A 1991 Attorney General opinion offered the following reason that no other tax may service the bonds: "Severance tax bonds authorized by the legislature are not the kind of debt contemplated by Article IX, sections 8 and 9 because they are not dependent on the general taxing power of the state for their retirement.

They are payable exclusively from a special fund created by the Severance Tax Bonding Act, NMSA 1978, Sections 7-27-1 through 7-27-48.” 1991 Op. Att’y Gen. No. 91-01. Given that no other revenue stream may be pledged, the State’s bonding capacity varies from year to year based solely on a percentage of the prior year’s deposits into the Bonding Fund, as discussed more fully in Section D below. See NMSA 1978, § 7-27-14(B).

C. Severance Tax Permanent Fund

Prior to 1973, any excess funds in the Bonding Fund over the amount required to pay principal and interest on bonds were transferred to the general fund. See Laws 1961, ch. 5, § 6. In 1973, however, the legislature established the severance tax permanent fund in the state treasury to receive the residual revenues from the Bonding Fund that were not reserved for payment of severance tax bonds. Earnings from the investment of the Permanent Fund were to be appropriated to the capital program fund for capital outlay projects.¹ In this way, the Permanent Fund was originally intended to serve as an endowment for future capital projects. See Laws 1973, ch. 294, § 4.

In 1976, the electorate approved a constitutional amendment giving the Permanent Fund constitutional status. See N.M. Const. art. VIII, sec. 10. This amendment permitted the legislature in its discretion to appropriate funds from the corpus of the Permanent Fund. H.J.R. 5 (Laws 1975). The amendment also allowed the legislature to appropriate the income from investments for operating expenses. Id. In 1982, the electorate approved a second constitutional amendment that removed the legislature’s discretionary power to appropriate funds from the corpus, but still authorized the legislature to appropriate the income from investments. H.J.R. 12 (Laws 1981). The 1996 constitutional amendment, which remains in effect today, provided that the legislature could appropriate limited distributions from the Permanent Fund in the same manner as other general operating revenue. S.J.R. 2 (Laws 1996); N.M. Const. art. VII, sec. 10(C). The annual distributions are calculated as 4.7% of the average of the year-end market values of the Permanent Fund for the immediately preceding five calendar years. Id. The 1996 amendment also required all earnings from investment of the Permanent Fund to be credited to the corpus of the fund. S.J.R. 2 (Laws 1996); see also, NMSA 1978, § 7-27-5 (noting that purpose of investing the Permanent Fund is to provide income to that fund).

Article VIII, section 10(A) of the New Mexico Constitution provides that that part of the severance tax revenue that is in excess of “that amount that has been or shall be reserved by statute for the payment of principal and interest on outstanding bonds to which severance tax revenue has been or shall be pledged” shall be deposited into the Permanent Fund. To this end, the state treasurer is required to transfer to the Permanent Fund on December 31 and June 30 of each year “all money in the severance tax bonding fund except the amount necessary to meet all principal and interest payments on bonds payable from the severance tax bonding fund on the next two ensuing semiannual payment dates.” NMSA 1978, § 7-27-8. Given that deposits to the Bonding Fund vary each year, as do debt service payments, the amount transferred to the Permanent Fund also varies from year-to-year.

¹ Laws 1973, ch. 294, § 2 created both the severance tax permanent fund and the severance tax income fund. In 1996, the legislature abolished the severance tax income fund and transferred the proceeds in that fund to the severance tax permanent fund. Laws 1996, ch. 3, § 2.

D. Statutory Issuance Test

Severance tax bonds are issued to finance capital projects throughout the State. In 1999, following the Zuni lawsuit, the legislature created supplemental severance tax bonds to provide a dedicated funding revenue stream for public school capital improvements. NMSA 1978, § 7-27-12.2. Capacity to issue both types of bonds in a given year is determined by a statutory issuance test.

The statutory issuance test is based on the prior year's deposits into the Bonding Fund. Senior long-term severance tax bonds may be issued so long as the debt service on all outstanding and new senior bonds in any future year is 50% (or less) of the total amount deposited into the Bonding Fund in the previous year. NMSA 1978, § 7-27-14(B). Supplemental long-term severance tax bonds may be issued so long as the debt service on all outstanding bonds – senior and supplemental – is 62.5% (or less) of the total amount deposited into the Bonding Fund in the previous year. NMSA 1978, § 7-27-14(C).²

The Board of Finance may also issue short-term severance tax and supplemental severance tax notes (sometimes referred to as “sponge notes”) to borrow against available cash in the Bonding Fund in order to fully utilize allowable capacity for capital projects. NMSA 1978, § 7-27-14(D). Senior sponge notes can be issued subject to the same statutory issuance test applicable to senior long-term bonds. Supplemental severance tax notes may be issued if total debt service for all outstanding and new severance tax bonds and notes does not exceed 95% of the total deposited in the Bonding Fund for the prior year. NMSA 1978, § 7-27-14(D).³

As noted above, because deposits into the Bonding Fund vary from year to year, the deposits to the Permanent Fund from the Bonding Fund necessarily change each year. In general, upward trending deposits into the Bonding Fund result in larger transfers to the Permanent Fund (because the cash in the Bonding Fund exceeds bonding capacity as measured by the statutory issuance test), while downward trending annual deposits result in less money being transferred to the Permanent Fund. We note that at least once in recent years, recognizing that a large amount of cash was available in the Bonding Fund in excess of statutory bonding capacity, the legislature authorized the Board of Finance to issue sponge notes (both senior and supplemental) in excess of the 95% statutory issuance test.

² This percentage for long-term supplemental severance tax bonds represents an increase from the 50% statutory cap originally imposed on all severance tax bonds. Laws 1961, ch. 5, § 11.

³ The legislature has increased the limit to issue supplemental sponge notes several times: the amount was originally capped at 75% of the deposits into the Bonding Fund during the preceding fiscal year (Laws 2000 (1st S.S.), ch. 6, § 7); then raised to 87.5% (Laws 2000 (2nd S.S.), ch. 11, § 2); and raised again to 95% (Laws 2004, ch. 125, § 2).