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MEMORANDUM

To: Rick May, DFA Secretary

From: Stephanie Schardin Clarke, Interim Director

Date: August 8, 2011

Re: Severance Tax Permanent Fund Contributions

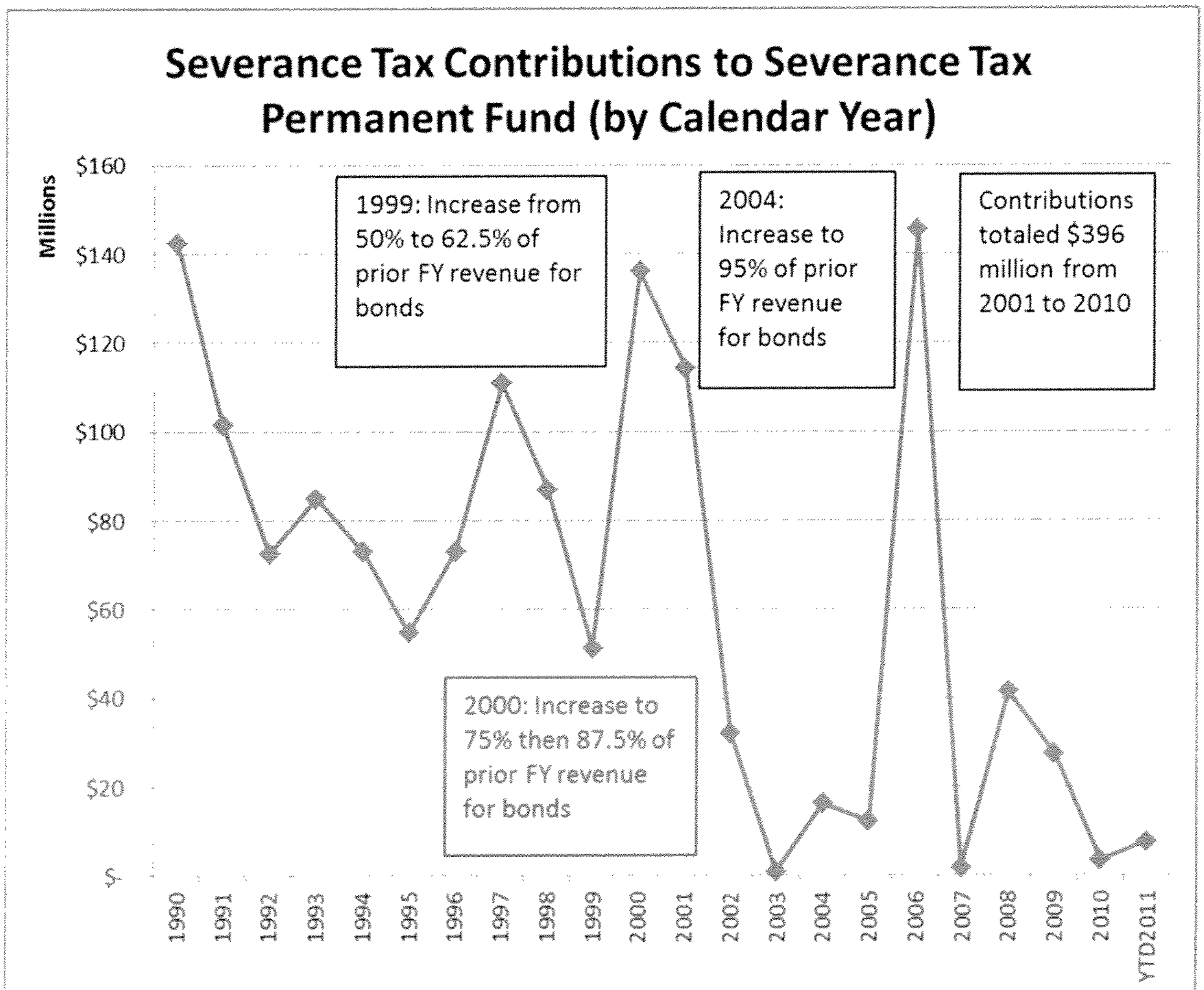
In recent months a policy question posed in various venues has been whether a greater share of severance tax revenues should be transferred to the Severance Tax Permanent Fund (the "Permanent Fund") rather than the current utilization in the Severance Tax Bond (STB) program for capital projects. Below is a brief history and additional data that I hope will be helpful in informing this dialogue.

History

Since 1937, severance taxes have been collected on the severance of natural gas, oil and a handful of other minerals from the ground in New Mexico. Since 1959, certain severance tax receipts have been deposited into the Severance Tax Bonding Fund (the "Bonding Fund") and used to service bonds issued to fund a variety of capital improvements in the State. When the severance tax bonding program was created in 1959, severance tax bonds were only issued to fund capital projects authorized by the Legislature. At that time, statute restricted capacity to issue new bonds such that debt service on outstanding bonds could be serviced with 50% of the prior fiscal year's Bonding Fund revenue. Assuming flat revenue collections from one year to the next, that meant that about half of severance taxes would be used for bonding purposes, and about half would be transferred to the Permanent Fund (however, this would vary year to year based on whether Bonding Fund revenues were rising or falling).

In 1999-2000, as a result of the Zuni lawsuit, which successfully challenged the constitutionality of New Mexico's educational financing and required the State to establish and implement a uniform system of funding future public school capital improvements, supplemental severance tax bonds were created to provide a dedicated funding stream for public school capital improvements. The statutory capacity to issue senior and supplemental severance tax bonds was increased above the long standing 50% level: capacity for bonds was increased from 50% to 62.5 percent in 1999, increased further to 75% and then 87.5 percent in 2000, and finally to the current level of 95% in 2004.

Money in the Bonding Fund has been pledged for payment of principal and interest on senior and supplemental severance tax bonds and notes. Each June 30 and December 31, excess money in the Bonding Fund over the amount necessary to meet all principal and interest payments on all outstanding STBs is transferred to the Permanent Fund, where it is invested by the State Investment Council. The chart below demonstrates that contributions to the Permanent Fund have declined since statutory capacity began to be increased in 1999. However, due to years of significant revenue growth–such as CY2006 when natural gas prices soared following hurricanes Katrina and Rita—contributions have continued to be strong with nearly $400 million transferred to the Permanent Fund from 2001 to 2010.

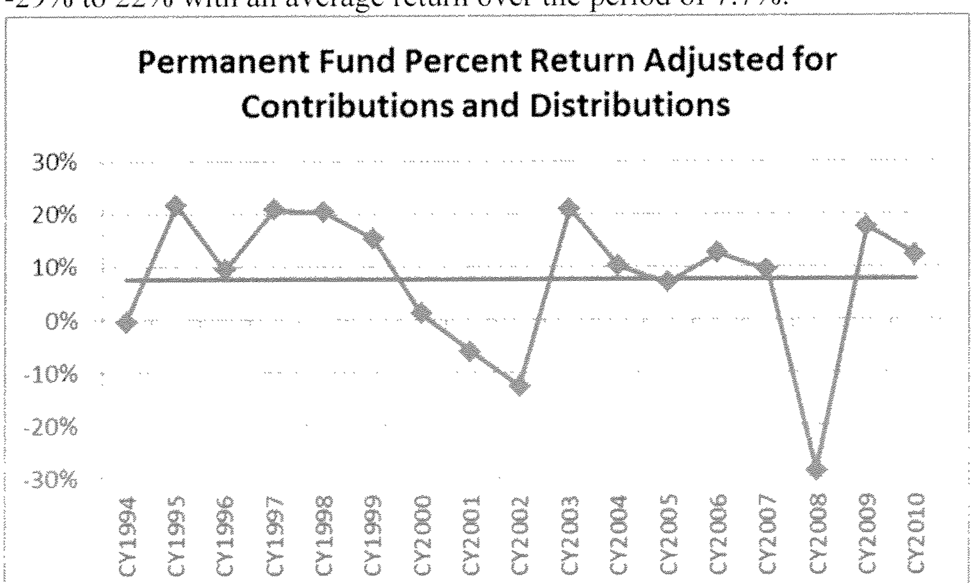


Since the supplemental STB program was initiated in FY2000, a total of $254 million in long-term bonds and $1.812 billion in short-term notes have been issued to fund public school capital improvements, an average of $172.2 million per year. In the same period, $1.1 billion of senior long-term bonds and $1.16 billion in senior short-term notes have been issued to fund statewide capital projects and water projects, an average of $184.6 million per year.

Policy Considerations

It has been suggested by some that statute setting STB capacity should be amended to reduce the capacity for STBs and allow for greater contributions to the Permanent Fund. The following policy considerations should be considered when thinking about that approach:

- If there is concern that using severance taxes for the STB program denies future generations of New Mexicans an investment in their future through the Permanent Fund, it should be considered that STBs are used to finance capital assets, not operations, and as such capital projects financed with STBs are also an investment in the future of New Mexico. This point drives home the importance of the State using STB capacity strategically to ensure the State's investment in capital assets yields a high return.
- Capital projects financed through the STB program stimulate the New Mexico economy by creating construction employment, and also reward the State through the generation of gross receipts taxes on that construction activity. Conversely, with a few exceptions, the Permanent Fund is invested out-of-state and as such does not stimulate the State economy.
- Investing severance tax revenues in the Permanent Fund is not without risk and thus does not guarantee preservation of those funds for future generations of New Mexicans. As shown in the chart below, from 1994 to present, after adjusting for contributions and distributions, annual return on the Permanent Fund has fluctuated from -29% to 22% with an average return over the period of 7.7%.



- There may be some misconception that failure to contribute to the Permanent Fund on an ongoing basis diminishes the corpus of the fund. Distributions from the Permanent Fund to the General Fund each year equal 4.7% of the five-year average market value. That means as long as return on the Permanent Fund less costs of carrying out the investments exceeds 4.7 percent, the corpus will still gain value absent any contributions.