Presentation to the New Mexico Revenue Stabilization and Tax Policy Committee:

General Fund Consensus Revenue Estimates — August 30, 2012

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Summary

The preparation of a consensus revenue forecast by the Revenue Estimating Group — composed of the professional economists at the Department of Finance and Administration (DFA), the Department of Transportation (DOT), the Legislative Finance Committee (LFC) and the Taxation and Revenue Department (TRD) — is a long-established basis for estimation of the state's General Fund Revenues. The new forecast prepared this month generally reflects the wide-spread weakness and uncertainty that exists in the economy today. From the state's perspective there is a singular "bright spot" in this forecast that relates to the strength of the oil production sector.

Table 1 provides a summary of the revisions to previously estimated revenues contained in the most recent consensus forecast.

Table 1
August 2012 Consensus General Find Revenue Estimate
(Million Dollars)

	FY12	FY13	FY14	FY15	FY16
Recurring revenue:					
December 2011 Estimates	5,532.8	5,688.2	5,841.8	6,036.8	6,153.9
2012 Legislation	(4.0)	(18.4)	(40.0)	(53.8)	(69.1)
August 2012 forecast revisions	217.5	17.6	120.3	198.8	322.5
August 2012 Estimates	**5,746.3**	**5,687.5**	**5,922.1**	**6,181.7**	**6,407.3**
Annual percent change	6.3%	-1.0%	4.1%	4.4%	3.6%
Non-recurring revenue:	18.3	(3.3)	(0.9)	—	—
Total revenue	**5,764.6**	**5,684.2**	**5,921.2**	**6,181.7**	**6,407.3**

The uncertainty in both domestic and international arenas has created an economic environment where weak growth is forecast, with significant risk sensitivities and volatility in many sectors. Recent national forecasts reflect lowered expectations for the balance of FY13, and only limited rebound thereafter. Table 2 summarizes the major sector changes from the December 2011 revenue estimates.

Table 2
August 2012 Major Forecast Revisions by Revenue
(Comparison to December 2011 Forecast, Million Dollars)

	FY12	FY13	FY14	FY15	FY16
Gross Receipts Tax	70.00	47.70	38.90	26.60	51.60
Compensating Tax	(7.50)	(8.10)	(14.40)	(13.20)	(11.40)
Insurance Taxes	0.70	(9.70)	(2.90)	16.10	18.80
Personal Income Tax	30.00	40.20	55.30	67.30	80.30
Corporate Income Tax	(27.00)	(73.30)	(53.60)	(38.90)	(13.90)
Severance Taxes	35.60	(3.80)	31.40	46.50	51.00
Rents & Royalties	120.30	32.40	71.40	87.30	99.30
Other	(4.66)	(7.73)	(5.85)	7.06	46.71
Total Recurring Revenue	**217.50**	**17.60**	**120.30**	**198.80**	**322.50**

For a moment setting aside the contributions of the extractive sector, strong GRT revenues in FY12 drive the revision in the state's tax receipts. This strength was largely exhibited in the first part of the calendar year 2012. The forecast continues with stronger GRT revenue performance throughout the forecast period, exhibiting generally declining adjustments that reflect less robust growth expectations in "out" years.

The dominant role of GRT in the forecasted FY13 General Fund revenues is illustrated in the attached pie chart.

Importantly, the growth in taxable gross receipts is also fueled by the oil and gas industry. In FY12 taxable gross receipts have increased by approximately $2.5 billion, and approximately $900 million of that increase is directly tied to the oil and gas industry. The strength in Manufacturing, with taxable gross receipts increasing about $400 million is driven by approximately $300 million in petroleum refining taxable gross receipts.

In contrast, the large Retail Trade component of taxable gross receipts which constitutes nearly 25% of taxable gross receipts, experience anemic growth of only slightly greater than 1%

in FY12. Likewise, weakness in construction, which constitutes nearly 11% of the gross receipts tax base, reflected a continuing decline in FY12 with a nearly 2% loss in reported taxable gross receipts.

Compensating tax is one of the most difficult of the tax revenue streams to forecast, and the revisions from the prior forecast reflect generally weakening estimates of economic activities moderated by the stability of oil prices.

The revisions for insurance tax premiums are impacted to a limited extent by the implementation of the Patient Protection Affordable Care Act provisions that are *now* included in New Mexico law. There are *additional* significant changes that may be anticipated to these revenue streams if the state chooses to adopt the Medicaid eligibility expansion (and other provisions of the federal program), assuming such provisions remain intact after this Fall's election.

Personal Income Tax revenues are forecasted slight stronger than in the prior forecast. This may be attributed to the increase in oil and gas withholding provisions enacted by the Legislature in 2011, and the higher base will continue into the future.

Generally weaker corporate profits than were previously anticipated drive a significant decline in the Corporate Income Tax revenue collections in FY12, with this trend is magnified looking forward into FY13 and FY14. It is also notable that although New Mexico Film Credits were less than $10 million in FY12, more than 90% of those credits decrease CIT liabilities.

The stronger Severance Tax forecast largely relates to much higher oil production volumes, which appears to provide a sustainable base-level of production through the forecast period. Oil prices, and revenues from natural gas production, are generally somewhat lower than had previously been expected. However, the real strength of the oil and gas sector is demonstrated in the bonuses paid for leases and mineral revenues from Federal lands. These substantial revisions to the December 2011 forecast are a primary driver of the relatively optimistic outlook provided by the consensus forecast revisions.

Looking Forward

The forecast faces numerous risks, and significant uncertainty that will only partially be resolved with the national elections this Fall. The greatest risks to an across-the-board strengthening of the economy — which is likely facing a long, slow climb to recovery — are the potential for a worsening of the Eurozone fiscal woes, and further tempering of the growth in the far-east powerhouses of China and India.

Distant as these economies may be from New Mexico, recent reports of strengthening of New Mexico's exports may be short lived if the dollar strengthens internationally and these major trading partners' economies show further signs of weakness.

Closer to home, resolution of the impasses facing Congress and their inability to reach budget compromises will continue to cloud the future until resolved.

On the upside, there is a great deal of optimism with respect to the benefits New Mexico oil producers may realize with the development of horizontal drilling and production technologies. Although there is a forecast of an approximate 3% per year increase in oil production, one major producer has expressed its expectation that its dramatic successes in increasing recoverable reserves will also provide *much strong* year-over-year growth in output. There is general belief that during the next several years' *oil prices* for New Mexico's production will remain relatively stable, and that the emergence of significant new ***domestic*** production and pipelines to market centers will create a greater insulation from world oil price fluctuations.

Gross Receipts Taxes

Increasing income levels, measured by variables such as wages and salaries, are among the most important drivers of the gross receipts revenues in New Mexico. The strength of GRT revenues may also be coupled (generally) to the health of the oil and gas industry and construction industries. With the exception of the oil sector, the previously noted weak recovery in these other economic measures partially explain the poor performance of GRT revenues in the current forecast.

It must also be acknowledged that the impacts of the High Wage Jobs Tax Credits significantly weaken the GRT forecast. The phased implementation of the anti-pyramiding manufacturing deductions has increasing impacts in the forecasts beyond FY13 — that is, implementation of these deduction begins at the start of 2013.

<u>Corporate Income Taxes</u>

Corporate income tax revenues are received largely from the largest corporations that do business in New Mexico, with the great majority of these firms having significant out-of-state operations. Generally, these are firms with greater than $1 million in taxable income (after adjustment for operating losses and other deductions allowed by New Mexico's statutes) — and, thus, forecasts of national corporate income taxes and corporate profits are relied on to estimate these revenues.

The Congressional Budget Office and IHS-Global Insight (the state's macro-economic forecasting service) are providing very weak estimates of these two key economic indicators. In the future, the anti-pyramiding initiatives may have some impact on the profits earned by business entities with presence in New Mexico, but these incentives may have greater significance in creating a more favorable environment for businesses to locate in New Mexico — contributing to a greater corporate tax base.

<u>Natural Resource Extractive Sectors</u>

The old adage ". . . as goes oil and gas, so goes New Mexico" is a long standing refrain of these consensus revenue estimates. Revenue boom and bust cycles for New Mexico are easily traced to conditions in oil and natural gas markets. Clearly, the health of oil production can be given much credit for the relatively favorable revenue news from FY12 and looking forward.

Recently, oil prices have been sustained (for a number of years) at levels that allow introduction and implementation of new production technologies. This stable economic environment has allowed increasing domestic oil production — including dramatically expanded New Mexico production — to be substituted for imports.

The completion of the Gulf Coast Project oil pipeline from Cushing, Oklahoma to the Gulf Coast will open new market opportunities, and should be operating before the end of 2013. This project, and the potential development of the Keystone XL pipeline project, will help to further stabilize market opportunities for New Mexico oil production and may help moderate domestic price volatility by greater insulation from world markets.

This shift to greater market stability appears sustainable in oil.

In contrast, the domestic natural gas industry is suffering from its own success. Excess supplies have driven “real” natural gas prices — after adjusting for inflation — to their lowest levels since implementation of price deregulation under the Natural Gas Policy Act of 1978.

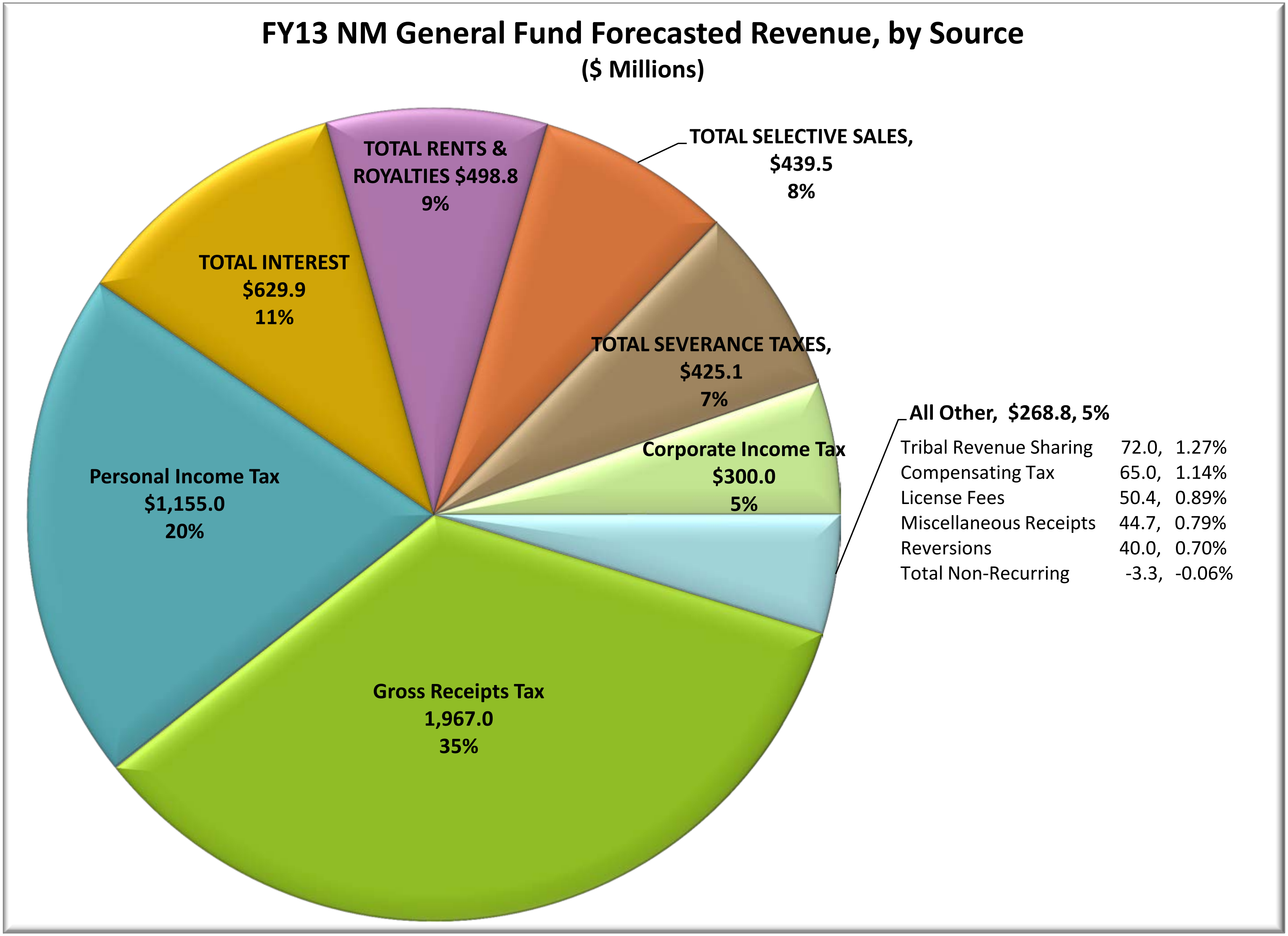
Excess supplies resulting from successful, new production techniques, and cost savings from greater efficiencies throughout the industry allow more and more gas to flood the market. In New Mexico, much of the economic benefit of production is found in natural gas liquids — products such as propane, butane, ethane and natural gasoline — that are produced with natural gas.

But, as did the “gas bubble” of the late 1980s, this current supply surplus will moderate.

These economic realities have a strong relation to the recent, high bonus bids for leases, and these property acquisitions bode well for New Mexico’s extractive industry.

Production from other mineral resources is expanding — and in FY12 we even have a commercial gold mine paying taxes for the first time in several years.

We have reason to be optimistic about economic development and New Mexico’s extractive industries.


FY13 NM General Fund Forecasted Revenue, by Source
($ Millions)
TOTAL RENTS & ROYALTIES $498.8 9%
TOTAL SELECTIVE SALES, $439.5 8%
TOTAL INTEREST $629.9 11%
TOTAL SEVERANCE TAXES, $425.1 7%
All Other, $268.8, 5%
Tribal Revenue Sharing 72.0, 1.27%
Compensating Tax 65.0, 1.14%
License Fees 50.4, 0.89%
Miscellaneous Receipts 44.7, 0.79%
Reversions 40.0, 0.70%
Total Non-Recurring -3.3, -0.06%
Corporate Income Tax $300.0 5%
Personal Income Tax $1,155.0 20%
Gross Receipts Tax 1,967.0 35%