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Collapsing Oil Prices Seep Into State Credit Profiles

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In its recent state sector outlook, Standard & Poor's Ratings Services identified 11 states as coming under negative fiscal pressure at the start of 2016. Low and declining oil prices explain much of the pressure in at least five of these states. Not all states with significant oil producing sectors are faced with fiscal pressure to the same degree, however. There are several variables that explain why some oil producing states are more immediately affected in their budgets by falling oil prices than others. These include:

- What oil price did the state assume in its budget?
- How much does the state's operating budget rely on oil-related tax revenue?
- Did the state accumulate reserves while oil prices were high?

In short, the more aggressive a state was with regard to its assumptions and use of oil-related revenues during the oil boom, the more acute its fiscal pressure now, in the oil price bust. For states with greater budgetary reliance on oil-related revenue, the unrelenting decline in prices places a larger burden on state lawmakers to identify and enact corrective fiscal measures. Short of something not easily forecasted, such as a supply shock stemming from turmoil in the Middle East, it's unlikely that state policymakers will be bailed out by a sharp rebound in oil prices. On the contrary, as of early 2016, and with sanctions on Iran being lifted, oil prices have continued to fall and are now well below what the states had forecasted. At this point, all of the states in our survey still have a higher price forecast for 2016 than does Standard & Poor's ($40 per barrel). For fiscal 2017, only one state (North Dakota) forecasts a price range in line with our forecast price ($45 per barrel); the other states still have a more bullish outlook. This suggests that as they head into budget season, fiscal pressures in these states could be more intense than what their official forecasts currently anticipate. (See "S&P Lowers Its Hydrocarbon Price Deck Assumptions On Market Oversupply; Recovery Price Deck Assumptions Also Lowered," published Jan. 12, 2016 on RatingsDirect.)

Some oil producing states have partially mitigated the effect of commodity market volatility on their budgets by segregating the oil-related revenue, putting most of it in reserves or special funds. But with producers reining in their operations, economic losses are not confined to just the energy sectors in these states. Overall job growth from among the oil producing states in our survey is now materially lower than for the nation as a whole. According to the Bureau of Labor Statistics, whereas total nonfarm payroll jobs increased 1.9% during the 12-month period through November 2015, the eight states in our survey saw job growth of just 0.9%. Not surprisingly, lower than expected job and economic growth is showing up in the recent revenue data reported by Texas, North Dakota, Louisiana, and Oklahoma, where collections have fallen short of the budget forecast. There are also signs of expenditure side pressure where job losses translate to higher demand for social services. For example, public assistance expenditures in Texas are running ahead of budget in fiscal 2016 while tax collections are lagging fiscal 2015 receipts through the same date. This environment contributes to our belief there is potential for an uptick in rating volatility in the state sector during 2016.

Alaska (AA+/Negative)

Much about Alaska's recent economic and fiscal experience is summed up by collapsing oil prices on the global markets and declining production on Alaska's North Slope. Reflecting its linkage to the commodity markets, Alaska's economy has begun to contract and is out of step with the U.S. economy, which continues to expand. For much of the past 40 years, taxes and royalties on oil production have been sufficient to pay for a majority of the state's general fund expenses. Plummeting oil prices have changed this and now the state has come to rely on transfers from its budget reserves to bridge a large structural gap between revenues and expenditures. However, despite comparatively large reserves, we do not view the arrangement as sustainable considering that the state's unrestricted general fund faces a budget deficit equal to roughly two-thirds of baseline expenditures. Absent a course correction, we believe the state's present fiscal trajectory points to potentially weaker credit quality.

In response to the situation, Governor Bill Walker has put forward a plan to redesign the state's financial architecture. According to the governor's proposal, Alaska would transition to a sovereign wealth fund model and move away from relying on oil-related revenues to finance its annual unrestricted general fund budget. Here, oil-related revenues would bypass the state's general fund and flow directly into its permanent fund. The state would then pay for most of its general fund expenditures from a consistent draw on the its permanent fund earnings reserve (PFER), essentially repurposing its investment earnings. Currently, a significant share of the investment earnings are used to finance the state's permanent fund dividend program, paid to state residents. The governor's proposal—or something like it—could potentially stabilize the state's budget performance. But the policy tradeoffs, which involve a reduced dividend payment (tied to oil royalties, not investment earnings), new and higher taxes, and spending cuts, are likely to be difficult politically. And even these changes wouldn't immediately eliminate the structural deficit. Assuming the legislature approved the governor's fiscal reform package in its entirety, there would still be a $427 million gap equal to almost 9% of expenditures in fiscal 2017 according to budget documents.

Nevertheless, despite its recent downgrade and negative outlook, Alaska's credit quality at this time remains very strong, in our view. The state is unique in that it typically supplements its budget reserves even as it draws upon them for operations. It does this by retaining a significant share of permanent fund investment earnings (the portion not used for the dividend payments) in its PFER, from which lawmakers can appropriate with a majority vote. In fiscal 2017, for example, the state forecasts investment earnings of $3.4 billion, approximately $1.4 billion of which would be spent on dividends under the existing dividend payment methodology. The remaining $2 billion in investment earnings—retained in the PFER—slows the rate at which the budget deficit depletes the state's reserves, although they remain in decline. Therefore, we view the state's reliance on its budgetary reserves for funding its operating expenditures as unsustainable.

Louisiana (AA/Negative)

In November 2015, Louisiana's revenue estimating conference (REC) revised its official forecast for fiscal 2016 state general fund revenue downward by $370 million, or 4% compared to August 2015 forecasts, reflecting the lower oil prices and revenues as well as weaker corporate and general sales tax collections. The REC also reduced fiscal 2017

forecasted general fund revenue by $324 million, which is 3.5% lower than the August 2015 estimate. Total oil and gas related revenue--including severance, royalties, rentals, and bonuses--represents 8% of the state's forecasted general fund revenue, excluding statutory dedications, down from 12% in fiscal 2015. The REC forecasts for the longer term, for fiscal 2018 to fiscal 2020, assume oil prices will gradually increase. While oil and gas price declines are likely to have caused some indirect dampening of other state general revenue, the timing of recent changes in tax deductions and credits implemented by the last legislature is also playing a part in tax collection variations. The state has significant offshore drilling activity which is less sensitive to short-term drops in oil prices than that of shale plays, but prolonged declining oil prices are likely to impact the state's mineral-dependent employment base. Additionally, falling energy prices could benefit Louisiana's petrochemical industry which somewhat helps to mitigate the negative effects of the oil price shock. Still, falling oil prices and revenue in conjunction with continued structural budgetary imbalances exacerbate the state's ongoing fiscal challenges. Since the REC's official forecast, the incoming administration has preliminarily estimated an additional $700 million to $750 million shortfall in fiscal 2016 and $1.9 billion in fiscal 2017 due to lower revenue and higher than expected health costs. However, we anticipate these estimates could continue to change based on further official REC forecasts and Medicaid expansion in the state. The governor is due to release his proposed budget for fiscal 2017 in February 2016.

Montana (AA/Stable)

Montana's general fund receives only about 3% of its revenue directly from oil and gas-related receipts (excluding other resources-based income from metal and coal mining). The state's general fund operations, therefore, are somewhat insulated from fluctuations in direct oil and gas revenue. With revised oil price assumptions, state officials estimate roughly $12 million to $13 million less in general fund revenue from mineral production in each of fiscal 2016 and 2017, which represents a relatively minimal direct 0.6% impact to the biennium general fund budget. While the mining and logging sector represents only 2% of state employment, this exceeds the national average and ancillary economic activity associated with supporting oil production multiplies the impact these high-paying jobs have for the state's economy and employment. The state's unemployment rate currently remains low at 4% and below the national 5% average, but we believe very large price declines leading to sustained lower production in the long-term could ultimately dampen economic growth and indirectly affect state corporate and individual income taxes that flow to the general and special funds. Currently, individual income tax collections have increased and held with budgeted estimates. Estimated year-to-date general fund revenue through the end of November 2015 was tracking 1.4% above the same period in the prior year; however, trends are currently slightly lower than the budgeted 2.9% growth due primarily to some weakness in year-to-date corporate income tax and property tax revenue. We believe the state's currently strong general fund reserves at 21% of expenditures at the end of fiscal 2015, and projected at 15% of expenditures at the end of the biennium, provide the state with ample flexibility to manage through any slight revenue fluctuations.

New Mexico (AA+/Negative)

Energy related revenues have a moderate, although declining impact on New Mexico's general fund, in our view. The

state currently projects a 0.1% decline in total general fund revenue in fiscal 2016, in part due to declines in energy related revenue. According to the governor's executive budget proposal, this would still leave the state with a general fund budgetary basis balance at fiscal end 2016 of 8.1% of recurring appropriations, a level we view as good, although down from 10.0% the year before.

In December 2015, the state revised its revenue forecast to incorporate a lower assumed $44 per barrel oil price in fiscal 2016, $7.50 less than it projected in August. The December forecast projects general fund energy related revenues, consisting of severance taxes, rents, and royalties, will decline by $221 million in fiscal 2016, to $791 million, or 13% of total general fund revenue, down from 16% of revenue in 2015. The state forecasts New Mexico oil prices will rebound to $49 in fiscal 2017, and $56 in 2018. The state projects that the rebound in prices and volume increases will raise recurring energy related general fund revenue to $808 million in fiscal 2017, although due to a forecasted increase in other general fund revenue, the percent of energy related revenue in the general fund would decline slightly to 12% of overall recurring general fund revenue. Oil production in New Mexico has been increasing, despite recent price drops, which has somewhat cushioned revenue losses. New Mexico's price of oil declined to $61 per barrel in fiscal 2015, from $95 the year before; however, oil production increased to 141 million barrels in fiscal 2015, from 114 million in 2014. The state projects oil production volume to continue to increase. The state forecasts volume to rise 6.1%, to 150 million barrels in fiscal 2016, and rise further to 155 million barrels in 2017. The state also projects a decline in natural gas prices in fiscal 2016 and a small rise in 2017, while production would remain essentially stable in fiscal 2016 and a decline slightly in 2017. If there were a decline in production volume, in could also affect other state gross receipts taxes. General fund energy related revenue does not include certain severance taxes and land trust income that does not flow directly to the general fund, but which is used for capital and severance bond debt service expenditures, with surplus severance tax revenue deposited into the severance tax permanent fund. Certain mineral production royalties, leases, and land sale proceeds are also deposited into the land grant management permanent fund. Distributions from each of the permanent funds to the general fund are constitutionally limited to between 4.7% and 5.5%.

North Dakota (AAA/Stable ICR)

In our view, North Dakota's limited direct reliance on oil taxes coupled with a very strong reserve position and flexibility to cut expenditures support the rating despite volatility in oil prices. Oil taxes have a limited direct impact on the state's general fund, as the amount that flows directly into the general fund is capped at $300 million per biennium, or about 5% of the fiscal 2015-2017 general fund budget. However, a large part of the state's economy can be traced to the development of shale oil fields, and extended oil price declines have affected sales tax and other revenues. For the first five months of the 2015-2017 biennium, general fund tax revenue was $152 million, or 8.9% below budget, with a 26.5% decline in sales tax revenues as the largest driver of lower revenues. The state is currently waiting on a new forecast that will be available in January before taking budgetary action, but it will likely cut agency appropriations by 2.5% across the board, or about $105 million. If revenue shortfalls exceed the 2.5%, the state may tap its $572 million budget stabilization fund. Based on the enacted budget, state officials project total reserves in the budget stabilization fund, foundation aid stabilization fund, strategic investment and improvements fund, and general fund ending balance to be $2.2 billion as of June 30, 2017, or 91% of annualized ongoing expenses in the 2015-2017 biennium. The state

will update its reserve projections after the new forecast is released.

Oklahoma (AA+/Stable)

Oklahoma's general operating budget is structured to mitigate oil price declines, although indirect economic effects have been of sufficient magnitude to pressure the fiscal 2016 budget, particularly sales and income tax revenues. The state is constitutionally required to budget only 95% of estimated revenues, and no oil gross production taxes are recorded in the general revenue fund until they exceed $150 million. Originally, the state had anticipated oil revenues would flow into the general fund in November, but most recent projections estimate just 2% of originally budgeted revenues for the whole fiscal year. Total general fund revenue collections for the first five months of fiscal 2016 were 4.6% below official estimates; within the its budget the state's built in a 5% cushion. However, November general fund collections and updated projections indicate that revenue shortfalls may surpass the 5% threshold, which would trigger mandatory appropriation reductions across the board to cover the dollar amount of shortfall projected for the remainder of the fiscal year. Oklahoma's most recent forecast projects fiscal 2016 collections will fall 7.7% below initial estimates and that fiscal 2017 collections will fall 12.9% short. For fiscal 2016, the state has enacted across the board cuts at an annualized rate of 3% beginning in January 2016, which amount to 6% of monthly allocations for the remaining six months of the fiscal year. It reduced general fund allocations by $176.9 million to cover an expected $157 million shortfall. The legislation has yet to approve a fiscal 2017 budget, and it is unclear at this time whether the state will draw down reserves.

Texas (AAA/Stable ICR)

Texas's limited direct reliance on oil production and natural gas production taxes on general operations and the state's strong reserve levels have positioned the state well through this downturn in oil prices. Oil production taxes comprise only 4% of general revenues in the fiscal 2016-2017 biennial revenue estimate, with natural gas production taxes comprising another 2%. In our view, declines in oil and gas revenues will limit the increases in the economic stabilization fund (ESF)--also known as the rainy-day fund--and state highway fund (SHF), but have a more limited impact on general revenue spending, given the funding formula for the state's ESF and SHF. Under the formulas, 75% of the oil and natural gas tax collections that exceed 1987 collection levels are transferred into those funds, therefore reducing the amount available for general revenue spending. However, there has been a softening of other tax revenues due to the oil price declines, in particular in the state's sales tax revenues, which account for 56% of total net general revenues. As well, there may be a link with expenditure pressures as public assistance has grown by 6.3% in the first four months of the fiscal year compared to the prior year. That said, in our view, the state's reserve position will allow it to manage through these budget pressures during the current biennium. Despite the projected declines in oil and gas collections, the rainy-day fund is projected to increase to $10.4 billion (or approximately 20% of fiscal 2017 general fund expenditures) by the end of the biennium. Furthermore, if we assumed no growth in the ESF, the state still has liquidity in the rainy day fund commensurate with a 'AAA' rating. The state should be releasing an updated revenue forecast for the current biennium later this month.

Wyoming (AAA/Stable ICR)

Wyoming has significantly downsized its revenue forecast due to declining oil, natural gas, and coal prices. However, revenues could possibly come in lower than the state's official forecast for the upcoming 2017-2018 biennium, released on Jan. 14, 2016. The state's consensus revenue forecast notes that it used oil price data gathered as of Jan. 5, but by the time of its release, oil prices had declined another 18%. The state officially forecasts an oil price of $39 per barrel in fiscal 2016, and $40 for the calendar year 2016. It projects oil prices to rise to $50 in calendar 2017 and $55 in calendar 2018. However, while still noting that oil has a significant effect on revenue, the state is projecting little change in reserves at the end of the 2015-2016 biennium, in part due to earlier high prices. State revenues are more dependent on coal mining than oil extraction. Coal comprises 41% of state severance taxes, compared to 26% for oil, and 29% for natural gas. The state also has very sizeable operating reserves, approaching its level of annual expenditures, not including constitutionally protected permanent funds. The state projects it will end the 2016 biennium with combined general fund, budget reserve account, legislative stabilization reserve account, and school foundation account reserves of $1.99 billion, or 91% of half of the 2015-2016 two year biennium expenditures for the combined general fund and school foundation program appropriations. The state estimates that oil production derived revenues alone constitute approximately 12% of general fund total revenues for fiscal years 2016 and 2017. While the state does not release a public breakout of direct oil revenues derived from both severance tax and federal mineral royalties for its combined general fund, budget reserve account, and school foundation program operating funds, the state's recent consensus forecast projects that combined severance tax and federal mineral royalties (including revenue from coal, oil, natural gas, and trona) will be 38% of 2015-2016 biennium general fund and budget reserve account revenues, a figure that will rise to 40% in the 2017-2018 biennium, which we have used for our accompanying table. The governor, in his 2017-2018 executive budget proposal, proposes spending down some of the state's substantial reserves on one-time capital expenses and replacing part of the draw down by diverting some severance tax revenue currently flowing into permanent funds back into the budget reserve account.

Key Data For Major Oil-Producing States

	Fiscal 2016				Fiscal 2017		
	Price assumption at budget enactment ($/barrel)	**Price assumption (revised) ($/barrel)**	**Oil-related revs as % of operating revs**	**Reserves as % of expenditures**	**Price assumption ($/barrel)**	**Oil-related revs as % of operating revs**	**Reserves as % of expenditures**
Alaska†	67.49	49.58	79.0	312.0	56.24	67.0	245.0
Louisiana*	61.77	48.02	8.0	5.0	54.09	8.0	N/A
Montana*‡	59	41.00	2.6	15.0	51.00	2.9	15.2
New Mexico*‡	66.00	44.00	13.0	8.1	49.00	12.0	8.0
North Dakota‡	42.00-53.00	*	5.0	91.0	42.00-53.00	5.0	91.0
Oklahoma**	57.55	42.83	0.0	5.4	53.57	0.1	5.4
Texas‡	64.35	49.48	6.4	25.0	56.52	6.0	28.0
Wyoming‡	55.00	39.00¶	37.5¶¶	91.2	50.0¶	40.0¶¶	64.1

Key Data For Major Oil-Producing States (cont.)

*Data for New Mexico, Louisiana, and Montana include gas. **Oklahoma's original fiscal 2016 budget anticipated oil-related revenues would equal 4% of operating revenue. †Alaska lawmakers are considering proposals to adjust what are considered operating revenues to include a greater share of the state's investment earnings. ‡Montana, North Dakota, Texas, and Wyoming budget on a biennial basis. Reserve percentages are presented on an annualized basis for comparability. For North Dakota, Texas, and Wyoming, the annualized reserve percentages are presented as adjusted by S&P. New Mexico 2017 reserve estimate based on governor's executive budget proposal. Wyoming's original price assumption of $55 was for calendar 2016; the updated 2016 price assumption of $39 is for the June 30 fiscal year (the updated calendar 2016 assumption is 42). ¶Wyoming forecast for 2016 is for the June 30, 2016 fiscal year; its calendar year 2016 forecast is $42; the 2017 forecast is for the calendar year. ¶¶Wyoming percentage of revenue is for severance taxes (including oil, natural gas, coal, and trona) and federal mineral royalties as a percent of biennium forecasted combined general fund and budget reserve account revenue only.

Related Criteria And Research

Related Research

U.S. States Have Strong Credit Quality Though Low Oil Prices And Budget Management Will Test Some, Jan. 11, 2016

We have determined, based solely on the developments described herein, that no rating actions are currently warranted. Only a rating committee may determine a rating action and, as these developments were not viewed as material to the ratings, neither they nor this report were reviewed by a rating committee.

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