January 23, 2012

Senator Timothy Jennings
Senator John Arthur Smith
Senator Stuart Ingle
Speaker Ben Lujan
Representative Henry “Kiki” Saavedra
Representative Thomas Taylor

Gentlemen,

This letter is to notify you of the conclusions of the consensus revenue estimating group, which met last week to determine whether any revision is appropriate in the General Fund revenue forecast they prepared in December 2011. The consensus group is comprised of career economists from the Legislative Finance Committee, Department of Finance and Administration, Taxation and Revenue Department and Department of Transportation.

In their deliberations, the consensus group took into account the following new information collected since the preparation of their December forecast:

- A revised forecast of the national economy by the IHS/Global Insight forecasting service. The service has not significantly revised its outlook for the U.S. economy since the December 2011 consensus forecast was prepared.
- Two additional months of revenue collections. For most taxes, this information covers economic activity in the months of October and November. For the oil and gas taxes this information covers activity in September and October. For Federal Mineral Leasing payments the information covers activity through December.
- Monthly New Mexico employment reports from the Department of Workforce Solutions.
- Monthly reports on economic activity from the U.S. government.
- Monthly reports on income tax collections of the U.S. government.
- Updated information from a variety of sources on energy prices.

Following a detailed review of each major General Fund revenue the consensus group concluded that no change in the General Fund forecast is warranted at this time. The group found small variances from forecast of some individual revenues, but, since some revenues are over forecast while others are under forecast, the net of these effects is insignificant relative to the normal forecast uncertainty.
In recent weeks, there has been extensive discussion of natural gas prices, and some have argued that the state’s revenue outlook should be revised downward in response to relatively low levels of spot market natural gas prices. On my own behalf, not that of the consensus group, I offer the following reasons why the Legislature and the Executive should respect the conclusions of the group not to revise their forecast:

- Although natural gas prices have fallen somewhat, oil prices have risen. Oil now comprises 40 percent of total General Fund revenue from oil and gas production. In addition, rising oil prices also raise prices for natural gas liquids. Natural gas liquids now comprise over one-third of the value of natural gas products contributing revenue to the General Fund. Thus, the level of oil prices is now more important to General Fund revenue than is the level of “dry” natural gas prices.

- Natural gas prices are now low enough that they will bring about an increase in demand, which will itself help to bring up prices. In addition, nationwide drilling for natural gas has fallen to a level 50 percent below its peak in 2008, to a level first seen in 2000. Reduced drilling means less future supplies, which will in turn lead to higher prices. It is because of these kinds of market fundamentals that energy future traders are currently trading natural gas contracts for delivery next spring at prices $1.00 higher than today’s price.

- Natural gas prices are not so low that they will necessarily lead to large-scale shut-ins. A recent analysis by Barclay’s Capital found that only minimal amounts of gas were shut in during the last period when dry gas prices fell below $3.00 in 2009. Producers are sometimes reluctant to shut in wells because of contractual obligations to their customers, to their investors and to their royalty owners. In addition, it is sometimes difficult to bring production back to its previous rate after a shut in. Finally, producers are now earning a substantial return from natural gas liquids production — in both of New Mexico’s producing basins — so they continue to have strong incentives to produce notwithstanding low prices for dry gas.

- Direct revenues from oil and gas comprise roughly 16 percent of total recurring General Fund revenue. The current forecast expects growth of less than 1 percent in these revenues in FY13. The forecast of total revenue growth is 2.4 percent in FY12 and 2.8 percent in FY13. These growth rates are well below the long-term average of almost 4.5 percent. Thus, the consensus group has already adjusted their outlook to a significant extent to take into account the uncertain economic times.

- The consensus process is one that New Mexico has used for many years to great benefit. Members of the group are not politically appointed, so their decisions are not influenced by political considerations. Relying on professionals and keeping politics out of the revenue forecast is a best practice that the state should adhere to.

- In the past, the consensus group has sometimes over-estimated revenue and sometimes under-estimated revenue. They do not have perfect foresight, but there does not appear to be any systematic bias in their forecasts.
• The best way to manage uncertainty about our revenue outlook is not by political influence of the revenue forecast but by prudent management of the state’s reserves. The state ended FY11 with General Fund reserves at 9.6 percent of appropriations. This is much higher than reserves have been in the last 3 years, and, given the relatively low rate of growth in the revenue forecast, is more than sufficient to accommodate the uncertainty in the economic outlook.

In conclusion, I want to thank the staff members of the consensus revenue estimating group for their conscientious work on this difficult task, and I look forward to working with the Legislative leadership to implement prudent budget policies now and in the future.

Sincerely,

Thomas E. Clifford, PhD
Cabinet Secretary Designate

CC  Keith Gardner, Chief of Staff
    Demesia Padilla, Cabinet Secretary, NM Taxation and Revenue Department
    David Abbey, Director, NM Legislative Finance Committee