Gurtin Municipal Bond Management

Credit Research Flash

Are Oil Dependent States Running on Fumes?

February 2015

As oil prices plummeted to historic lows in recent weeks, headlines surrounding the consequential budgetary pressures that may arise among the most oil-rich states are mounting. Recently, the Wall Street Journal highlighted the growing budgetary concerns among the top oil-producing states. With Texas, Alaska and North Dakota topping the charts in terms of oil and gas related tax revenues, the alarmist headlines have primarily converged on the potential budgetary shortfalls of these states.

Oil Dependent

Reliance on severance taxes charged on extraction of oil and other natural resources in the 2013 fiscal year*

State	SEVERANCE TAXES	AS PERCENTAGE OF TOTAL TAXES
Texas	$4.65 billion	9.0%
Alaska	$4.02 billion	78%
North Dakota	$2.46 billion	46%
Oklahoma	$516.0 million	5.8%
California	$37.7 million	0.03%

*Fiscal year ends June 30.
Source: Nelson A. Rockefeller Institute of Government

The Wall Street Journal

What many of these articles fail to mention are the proactive measures many of these states have already taken to mitigate the extreme pricing volatility that has always posed a threat to their fiscal stability. These steps include building extremely large reserve funds that can be drawn on to close budget gaps and limiting the reliance of core operating funds on oil and gas taxes by

diverting them to long term funds that are not used to finance day to day operations or debt expenses of the state. These are credit strengths that we have long recognized and emphasized in our analysis. Near term concerns over the sudden and immediate shift in pricing trends further validates our philosophy regarding the importance of rainy day reserves as a means to weather unexpected revenue declines. These reserves buy all of these states the most valuable commodity during times of budgetary stress- time. These states can immediately use reserves to temper losses in the short-term while right-sizing budgets to more realistic revenue projections. For these states especially, whose budgetary expectations can radically shift in a matter of weeks, the availability of these reserves to provide immediate relief, is a critical component of how we view their credit strength. Those with conservative fiscal planning during strong revenue years, such as Texas, Alaska, and North Dakota can withstand even the current dramatic losses in severance taxes while continuing to meet financial obligations and making necessary budgetary adjustments.

While the economic and demographic profiles of these states could not be more different, their robust financial positions are quite similar, and all have cushions that provide them with time to adjust to lower oil prices. Texas, with its broad and diverse economic base, has built unassigned balances in its General Fund of $8 billion (approximately 20% of tax revenues) and is far more reliant on other revenue sources as oil and gas related taxes account for only 4.5% of its estimated total 2014-2015 revenues. In other words, the state could withstand approximately 20 months devoid of severance tax receipts before depleting reserves, if all else remains equal. Alaska closed fiscal 2014 with $15.7 billion in unassigned balances (an eye-popping 531% of tax revenues), a robust cushion against any revenue deterioration. Additionally, the state established a Permanent Fund which requires 25% of all oil and gas royalties to be deposited into a restricted account. As of January 29, 2015, the Fund's market value was approximately $52.7 billion. North Dakota, a more recent beneficiary of the oil boom, has built unassigned balances in 2014 of $1.4 billion, or 36% of annual revenues. Additionally, the state capped its General Fund's exposure to oil and gas taxes at a modest $300 million, roughly 5% of its forecasted current biennial revenues, diverting the majority of oil taxes to the Legacy Fund, which currently has a balance of $2.9 billion which is greater than the General Fund's total expenditures in 2014.

Finally, while we believe that these states are well protected against lower oil prices, we do have concerns about local governments in states where oil production is crucial to the economy. Similar to recent news surrounding Kern County, California where local governments in the county are forecasting gloomy budget outlooks due to expected lower property taxes from oil related taxpayers, we anticipate pockets of local governments in other oil-dependent states will face growing credit risk should oil prices remain low. We are diligently reviewing all obligors that we believe are exposed to deflated oil prices and will quickly exit positions that we believe do not meet our extremely high credit thresholds.

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