

July 5, 2007 Tax-exempt severance tax bond proceeds for water projects under the Water Project Finance Act

David Abbey, Director
New Mexico Legislative Finance Committee
325 Don Gaspar, Suite 101
Santa Fe, New Mexico 87501

Dear Mr. Abbey:

You have requested an Attorney General's opinion on a series of seven questions relating to use of tax-exempt severance tax bond proceeds for water projects, particularly water rights adjudications, under the Water Project Finance Act.¹ Based on our examination of the relevant New Mexico constitutional, statutory and case law authorities, and on the information available to us at this time, we conclude that federal law and regulations governing tax-exempt financings are not relevant to proceeds from senior taxable short-term, or sponge, severance tax notes ("senior sponge notes"), the type of financing that has traditionally been used to fund water projects, and that the current state of the law ensures adequate capacity to continue to provide taxable severance tax note proceeds for water projects—and particularly for water rights adjudications--into the foreseeable future.

Water projects, including water adjudications, are funded from severance tax financings pursuant to legislative directives. See NMSA 1978, §§ 7-27-10.1 (2003) and 72-4A-9 (2005). In section 7-27-10.1, the legislature authorizes the annual issuance of severance tax bonds in the amount of ten percent of the estimated bonding capacity for that year for the use of the water trust board to fund water projects statewide. Upon the water trust board's certification of need, the state board of finance ("Board") issues bonds for that purpose, and the proceeds of those bonds are appropriated to the water project fund (the "Fund"). The Fund is created by section 72-4A-9, and includes monies appropriated for the purpose of supporting water projects. Pursuant to section 72-4A-9, ten percent of all monies in the Fund are dedicated to the State Engineer for water rights adjudications, which monies are nonreverting.² This office has previously upheld the use of proceeds from severance tax financings to fund water adjudications and court costs related to them consistent with section 72-4A-9, including the application of that section's ten percent set-aside to any such proceeds. See N.M. Att'y. Gen. Op. No. 05-04 (2005). We direct your attention to that opinion if you have any concerns related to use of proceeds for those purposes generally.

All of your questions relate to federal law and regulation governing issuance of tax-exempt bonds. Historically, the proceeds that have been used to fund the appropriation made to the Fund in section 7-27-10.1 for water rights adjudications (and other water projects) have come from senior sponge notes sold to the State Treasurer. Therefore, federal tax limitations on the use of proceeds from tax-exempt financings are not applicable to those proceeds.³

We recognize, however, that you also raise a question concerning what would happen in a year in which there is not enough short-term (“sponge”) bonding capacity to issue short-term taxable severance tax notes or sufficient general fund revenues in the Fund to cover section 72-4A-9’s dedication of ten percent of all monies in the Fund for water rights adjudications, and whether such a situation would trigger the need to issue tax-exempt bonds and thus create potential issues under federal requirements governing proceeds from tax-exempt financings. In the first instance, since section 72-4A-9 only dedicates ten percent of the actual monies in the Fund, the funding requirement is by definition limited to what is in the Fund: it is ten percent of any amount in the Fund. If for whatever reason there are no available, unreserved monies in the Fund in any particular year, the statutory dedication demands nothing more.

Moreover, and more significantly, still assuming the absence of other revenues in the Fund to satisfy the ten percent pledge of monies in that fund for water rights adjudications, concern that in any given year there will not be sufficient senior sponge note capacity is unwarranted, given current law. Subsection (A) of section 7-27-10.1 requires the board of finance division of the department of finance and administration to estimate each year the amount of bonding capacity available for severance tax financings to be authorized by the legislature, and then authorizes the Board to issue bonds in the amount of ten percent of that capacity figure for water projects statewide. It is from that ten percent that the ten percent dedicated to water rights adjudications is funded, which results in one percent of capacity being dedicated for those adjudications. See NMSA 1978, § 72-4A-9 (2005).

As a practical matter, the circumstances that would lead to there being no senior sponge capacity are limited. In order for there to be no senior sponge capacity, the current fiscal year cashflow into the bonding fund would need to be not materially greater than the amount necessary to meet the long-term debt service and set aside requirements imposed by law⁴ for that fiscal year, or fifty percent of the preceding fiscal year’s revenues would have to be not materially greater than current fiscal year senior bond debt service (notwithstanding the amount of current fiscal year revenues).⁵ See NMSA 1978, §§ 7-27-14(A) and (B) (2004). If either of these conditions is found, then there will be no senior sponge capacity in the current fiscal year. In such a circumstance, one percent of the projected bonding capacity would be one percent of the long-term debt capacity (since there would be no senior sponge capacity). We have been advised by the Board’s director and its financial advisor that under this scenario, a reasonable strategy to fund water rights adjudications (which may not meet the requirements of the laws and regulations governing the issuance of tax-exempt bonds), would be to structure and sell one percent of the long-term capacity amount as a one-month (for example) taxable note to the State Treasurer, in much the same manner as the senior sponge bonds are done now. Under the Board’s current financing plan, where the Board projects \$135 million of long-term bond capacity on an annual basis, this strategy would result in the sale of a one-month taxable note in the amount of \$1.35 million, with total interest for the month of \$5,000.

Thus, even in the absence of other monies in the Fund, the legislature's dedication of one percent of bonding capacity for water rights adjudications, as suggested above, can be accommodated within the bonding program without recourse to proceeds from tax-exempt bonds.

Finally, we note that two of your questions also concern a specific proposed use of these proceeds by the State Engineer: to function as the state match for the U. S. Army Corps of Engineers project for terrain mapping. One question is whether it is permissible under federal and state law to use these proceeds for operational expenses as opposed to creating a capital asset. Again, as discussed above, any limitation imposed by federal law or regulation is not applicable here. Further, this office has determined that the legislature has expressly authorized the use of ten percent of the proceeds of severance tax bond/note issuances for water adjudications (including the court's costs associated with such adjudications).

The other question as to this proposed use is whether terrain mapping constitutes a water adjudication expense authorized by section 72-4A-9. We note this question arose in the context of a budget adjustment request ("BAR") to use money in the water project fund for this specific purpose, and that the Department of Finance and Administration ("DFA") in approving the BAR, determined the use of these funds for this purpose was appropriate. We requested and were provided the BAR documents, including the Legislative Finance Committee's objections to the BAR and the State Engineer's and DFA's September 26, 2006 letter responding to those objections, along with a number of other documents explaining the relationship between terrain mapping and water rights adjudications. In a November, 2004 presentation to the LFC, the need to develop adjudication technologies and capabilities was discussed, including utilization of Geographic Information System (GIS), Global Positioning Systems (GPS), and aerial photography. Similarly, the Office of the State Engineer Interstate Stream Commission's 2004-2005 Annual Report contains a description of the first stage of the adjudication process--the completion of a hydrographic survey. That Report explains that such a survey includes acquisition and analysis of current and historical aerial imagery. All such surveys are now based on GIS and computer mapping technologies and high-resolution digital imagery. As described in the Scope of Work appendix to the State Engineer's contract with the Corps, the Corps will provide digital elevation models of New Mexico. Finally, as described in the September 26, 2006 letter, this project "provides visual documentation that is used by the State Engineer as evidence of water use and water rights" and "will provide current digital aerial imagery that will become part of the technical evidence used" in water rights adjudications.⁶ Based on this information and these representations, we believe use of proceeds which have been appropriated to the water project fund pursuant to section 72-4A-9 may be used to provide the state match for the Corps terrain mapping project.

If we may be of further assistance, please let us know. Your request was for an Attorney General's Opinion on the matters discussed above. Such an opinion would be a public document available to the general public. Although we are providing you our legal advice in the form of a letter instead of an Attorney General's Opinion, we believe this

letter is also a public document, not subject to the attorney-client privilege. Therefore, we may provide copies of this letter to the public.

Sincerely,

Martha A. Daly
Assistant Attorney General

Cc: Albert Lama, Chief Deputy Attorney General
Stephen R. Farris, Director, Water, Environment & Utilities Division

[1] We understand that your opinion request dated February 12, 2007 supercedes that dated September 21, 2006.

[2] In addition, the legislature allocated twenty percent of that ten percent to the Administrative Office of the Courts for courts' costs associated with those adjudications.

[3] Our research discloses that the first severance tax bond financing for water project funding occurred on June 29, 2004, in the form of a taxable note sold to the State Treasurer. See Transcript of Severance Tax Note Series 2004SA, which includes a Resolution, Notification and Certification by the Water Trust Board dated April 7, 2004, certifying the need for \$12,553,200 for that purpose, and bond counsel's opinion dated June 29, 2004 opining that interest on the note was not exempt from federal income tax. Similarly, in 2005, water projects were funded out of Severance Tax Note Series 2005S-A, dated June 29, 2005, and in 2006, water projects were funded from the proceeds of Severance Tax Note Series 2006S-A, dated June 29, 2006. As was the case in 2004, the transcripts for the 2005 and 2006 notes issues contain opinions of bond counsel reflecting the taxable nature of those notes. Each of these notes matured one day later.

[4] The set aside requirements are those found in NMSA 1978, § 7-27-8 (1973), which requires that on December 31 and June 30 of each year, money in the severance tax bonding fund be transferred to the severance tax permanent fund except for the amount necessary to meet all principal and interest payments on bonds payable from the fund on the next two semiannual payment dates.

[5] For purposes of illustration, current debt service requirements are projected at \$135 million, while revenue for fiscal year 2006 was \$532,386,000. Fifty percent of that revenue is \$266,193,000, almost double projected debt service requirements.

[6] Based on these descriptions, it does not appear that the intended use of the proceeds is for personnel services and benefits or to fund the operating costs of the Office of the State Engineer, and thus is not contrary to the State Engineer's March 8, 2006 letter to the Finance Authority, in which he advised that the

severance tax note proceeds
here under discussion would not be used for those purposes.