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How Might The Oil Price Plunge Affect U.S. States' Credit Quality?

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It's only natural to wonder how the recent dramatic decline in oil prices could affect U.S. states' credit quality. But as with most macroeconomic developments, the sector doesn't lend itself to sweeping conclusions. Most states have little oil production activity. In them, the effects are straightforward: Standard & Poor's Ratings Services expects declining fuel prices to benefit the consumer, leading to greater consumption activity, leading additional sales tax revenue.

The story is more complicated when it comes to the oil producing states. Some states with significant oil production industries have enough economic diversity that the effects of reduced capital spending and employment in the sector are muted. Other states' economic bases are more concentrated in natural resource extraction. The oil price decline came on fast and by most accounts state revenue forecasters didn't anticipate it. At first glance, the rapid descent in oil prices would spell trouble for states with economic concentration in oil production. But from a credit perspective, we have long been aware of the role that oil extraction plays in these states' economies and fiscal arrangements. We have found that the states with significant oil production industries have accumulated reserves or don't rely extensively on oil-related revenues to fund their operating budgets. As a result, despite headlines that might suggest otherwise, for these states the plunge in oil prices is a contingency that we have accounted for in our ratings.

That being said, credit quality for the oil producing states likely is not immune to a long-term secular slide in oil prices. Much will depend on the future direction of oil prices and—perhaps even more importantly—the fiscal management response of the states.

Two states with similarly sized oil producing industries could feel the effects of a contracting oil industry in vastly different ways depending on several variables:

- What oil price and production level did the state assume in its budget?
- How much does the state's operating budget rely on oil-related tax revenue?
- Did the state use prior period of high oil prices to accumulate reserves?

Finally, many states have substantial debt secured by gasoline tax and motor vehicle related fees. Falling oil prices will likely not affect bonds secured by these revenue sources, as gas taxes are typically levied on a per gallon basis. To the extent that lower gas prices promote more travel and purchase of motor vehicles, these highway user taxes should increase. Some states may even try to raise gas tax rates, taking into account the lower overall price of fuel, in order to fund new infrastructure projects.

Some Key Data For Major Oil-Producing States

	Fiscal 2015 oil price assumption ($)	Oil-related revenues as share of operating budget*	Reserves as % of expenditures (fiscal 2015)
Alaska	105.06	79%	233%†
Louisiana	95.8	15%	5.40%
Montana	78.35	6%	15.40%
New Mexico	86.5	17%	10.90%
North Dakota	80	4.40%	53.9%‡

Some Key Data For Major Oil-Producing States (cont.)			
Oklahoma	87	4.90%	7.50%
Texas	64.35	6.40%	33.10%
Wyoming	50.00¶	17%	57%‡

*Data for New Mexico, Louisiana, and Montana include gas. ¶Updated current mid-biennium state forecast. Original budget forecast for 2015 was $87. †Alaska also forecasts $3.6 billion in investment earnings in fiscal 2015 that could be utilized to fund operations by a vote of the legislature. ‡As a percent of two-year budgeted expenditures for the 2013-2015 (North Dakota), 2015-2016 (Wyoming) biennium. Estimated fiscal end 2015 balance will be 108% (North Dakota), 113% (Wyoming) of half of the two-year budgeted expenditures.

Alaska

GO rating: AAA/Stable

For fiscal 2015, the state assumed oil prices would average $105.06 per barrel, giving rise to about 495,900 barrels per day of production on the North Slope. Based on more recent price and production information, the state has revised its estimates to $76 per barrel and 509,500 barrels per day for fiscal 2015. The state's assumptions regarding oil prices and production are integral to its budget condition because oil-related revenues made up 88% of its estimated revenue for the 2014 fiscal year and 79% for fiscal 2015. At enactment, the state's budgeted general fund expenditures for fiscal 2015 exceeded its unrestricted revenues by $1.4 billion. Weaker oil prices and production resulted in an updated budget gap of $3.5 billion, equal to 57% of general fund expenditures.

Alaska projects that fiscal 2015 will end with total budget reserves of $9.6 billion, or 157% of expenditures. In addition, the state's permanent fund earnings reserve balance, which can be drawn upon with a majority vote of the legislature, is expected to have a balance of $4.66 billion at fiscal year end, bringing total reserves available for operations to 233% of expenditures. Finally, Alaska's practice of prefunding major expenditures serves as another type of fiscal reserve. For instance, the fiscal 2015 budget prefunds the $1.2 billion fiscal 2016 education budget.

The state's large reserve balances also generate considerable annual revenue. Although the revenue from investment earnings is considered restricted, it could be made available for appropriation. In fiscal 2014, the state's constitutional budget reserve (CBRF) returned approximately $1 billion in revenue that -- with a three-fourths vote of the legislature -- could be appropriated. Likewise, the state's permanent fund generated $7.9 billion in investment revenue that could be appropriated with a majority vote of the legislature. And because most of the revenue is saved rather than spent, the state's net asset position can increase even when there is a deficit of unrestricted revenue in the general fund. For example, the state's governmentwide net asset position increased to $82.1 billion in fiscal 2014, from $76 billion the prior year, despite a $1.9 billion unrestricted revenue shortfall relative to appropriations.

Projections for fiscal 2015 indicated reduced investment earnings of $270 million in the CBRF and $3.3 billion from the permanent fund. These amounts, if the legislature voted to make them available for appropriation, would approximately cover the revised budget gap estimate of $3.5 billion.

Louisiana

GO rating: AA/Stable

The governor authorized midyear budget adjustments after the state's revenue estimating conference (REC) revised fiscal 2015 revenue downward by $171 million in November 2014, or about 2% of budget, reflecting lower assumed $81.33 oil prices. We understand the REC is likely to produce revised forecasts in late January 2015 that could reduce these revenues further based on continued oil price declines. Total oil and gas related revenue--including severance, royalties, rentals, and bonuses--represents about 15% of the general fund budget, excluding statutory dedications. While prolonged declining oil prices could certainly impact the state's mineral-dependent employment base, the state has significant offshore drilling activity which is less sensitive to short-term drops in oil prices than that of shale plays. Additionally, falling energy prices could benefit Louisiana's petrochemical industry which helps to mitigate the negative effects of the oil price shock. Exploration programs at the relatively higher-cost Tuscaloosa Marine Shale in the state could face challenges.

Mississippi

GO rating: AA/Stable

Oil price declines are not likely to adversely affect Mississippi's budget given the oil severance tax revenue represents only 1.5% of general fund revenue. While there could be a slowdown in employment related to the development of the relatively higher-cost Tuscaloosa Marine Shale in the southwestern portion of the state, mining and logging overall represents a relatively small 0.8% share of state employment.

Montana

GO rating: AA/Stable

The state general fund relies primarily on individual income taxes (50%) and only derives 5% to 6% of its revenue from direct oil and gas related receipts, excluding other resources-based income from metal and coal mining. A portion of oil and gas revenue also flows to special funds as a component of state support to counties and school districts. Given the relatively small exposure to oil prices, current fiscal 2015 general fund revenue estimates reflect receipts are tracking higher than budget. Current forecasts by both the executive and legislative finance committee reflect continued revenue growth in the next biennium, although the level of projected growth differs based on oil price and interest rate assumptions. Legislative estimates assume an oil price of about $77.50 for fiscal 2015 and Montana oil prices track lower than the West Texas Intermediate prices. However, high paying jobs in the oil and gas industry still produce meaningful economic impact directly and indirectly. Indirectly, a very large price decline leading to sustained lower production could ultimately impact the economy and state corporate and individual income taxes that flow to the general and special funds.

New Mexico

GO rating: AA+/Negative

In December, the state revised its fiscal 2015 revenue forecast to incorporate a lower assumed $71 per barrel oil price, reflecting New Mexico oil prices which are well below West Texas Intermediate oil prices. The revenue estimate projects 2.3% year-over-year revenue growth in fiscal 2016 assuming a lower $66 price per barrel. Direct revenue to the general fund from oil and gas receipts represents about 16% of the state's general fund budget, which does not include severance taxes and certain other land trust income that does not flow directly to the general fund. New Mexico uses annual severance tax receipts for capital and severance bond debt service expenditures and deposits surplus severance tax revenue into the severance tax permanent fund. The state also deposits mineral production royalties, leases, and land sale proceeds 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%. Estimated distributions to the general fund from permanent fund interest earnings reflect a combined 11% of the state's fiscal 2015 general fund budget. New Mexico's structural budgetary balance positions the state well to confront depressed energy prices and slow economic growth in the near term, although a prolonged downturn could impact employment and ultimately other state revenue. According to estimates by the New Mexico Tax Research Institute, the indirect relationship of oil prices on state gross receipts taxes, incomes taxes and sales taxes from oil and gas production represent another 5.6% of the state's general fund budget.

North Dakota

ICR: AAA/Stable

Oil taxes have a limited direct impact on the state's general fund, as the amount that flows in is capped at $300 million per biennium, or about 4.4% of the fiscal 2013-2015 general fund budget, which has already been reached for the current biennium. However, excess oil taxes above that cap flow to state reserve funds and special funds or to local governments . Much of oil-funded state reserves are used for capital projects that are important given the economic growth concentrated in the western part of the state. Compounding potential revenue declines from reduced production, one of the state's two oil taxes is subject to price-based triggers that could reduce the rate of taxes, although we project that the $300 million general fund amount would still be reached for the 2015-2017 biennium. Oil activity also drives other taxes, such as sales and income taxes, and a decline in oil production would negatively impact those taxes. For November 2014, the latest available data, total revenues and transfers were 9.5% ahead of projections for the biennium. While sales taxes and individual income taxes were below projections for November alone, officials indicate that these declines were attributed to timing differences in revenue collections that were reversed in December.

The recommended 2015-2017 biennial budget used a November revenue forecast, before the steepest oil price declines, and the state plans to update the revenue forecast in March 2015 prior to budget passage; the budget was based on oil prices that ranged between $74 and $82 over the biennium. The current 2015-2017 revenue projection projects 4.8% (or $469 million) revenue growth from the current biennium forecast. Sales taxes are projected to grow by 19% and individual and corporate income taxes are projected to grow by 25%. These growth figures will likely be reduced in the next forecast, reflecting the oil price decline.

Oklahoma

GO rating: AA+/Stable

On Dec. 17, Oklahoma's Board of Equalization (BOE) updated its fiscal 2015 and 2016 revenue estimates, including the assumptions on natural gas and oil prices. Based on these estimates, the state expects revenues to exceed budget by $37.8 million at fiscal year-end 2015, and would deposit this amount to the rainy day fund. For the remaining seven months of fiscal 2015, the BOE is projecting $76.32 per barrel on oil, down from its previous estimate of $87. For 2016, the state is assuming oil prices of $59.97 per barrel. In our view, based on current prices, these estimates could turn out to be high. The state will update its estimates in February and then again in June. Although total gross production taxes make up 4,9% of general fund revenues, the portion attributable to oil is only 2.5% of the general fund revenues. In accordance with Section 23, Article X of the Oklahoma Constitution, amounts available for appropriation cannot exceed 95% of certified revenues, providing a 5% cushion against revenue fluctuations, and the state has broad powers to proportionately reduce appropriations or borrow from available funds to avoid deficit spending. In our view, although the impact of lower oil prices on gross production taxes might be limited, due to the significant presence of energy related companies in the state, the impact on the overall economy could be more profound, and affect other revenues over the longer term.

Texas

ICR: AAA/Stable

In our view, the volatility in the energy sector presents a potential downside risk to the state's economy and an extended contraction in oil prices could have a significant impact on employment and other areas of economic growth in the state. Texas remains the nation's largest producer of crude oil and natural gas, the largest consumer of energy, and home to many of the country's energy-related corporations. Consequently, we expect that oil and gas prices will continue to play an important role in the state's economic and fiscal future. However, we also believe that the growing diversity of Texas' economy will help to mitigate the impact of the current level of decline in energy prices, although additional declines from the current level would increase the negative economic impact.

While the current decline in oil prices will affect Texas' economy and revenues, both the state comptroller and the Federal Reserve Bank of Dallas (in a recent report) project that while job growth will slow in 2015, it will remain positive for the state overall. The Dallas Federal Reserve report projects that Texas job growth will be 2% to 2.5% in 2015, around the U.S. level. The Dallas Fed economist estimates that $50 bbl is below the breakeven point for the majority of shale drilling and that the gross state product (GSP) impact from slowing oil production will be greater than the job impact, as output per worker in mining is significantly higher than the average for the state. Mining is about 3% of Texas employment but about 14% of GSP.

The state's 2014-2015 biennial budget assumed that oil would be $80 per barrel, which is about 74% above the current price of West Texas Intermediate oil. However, oil production taxes comprise only 4.8% of general revenues in the fiscal 2014-2015 biennial budget, with natural gas production taxes comprising another 2.6%. In our view, given the funding formula for the state's economic stability fund (ESF) and state highway fund (SHF), in which 75% of the surplus of oil and natural gas tax collections that exceed 1987 collection levels are transferred into those funds, declines in oil and gas revenues will limit the increases in the ESF and SHF but have a more limited impact on general revenue spending.

The comptroller's fiscal 2016-2017 revenue forecast, released on Jan. 12, 2015, projects that GSP growth will slow but remain positive, dropping to 3.0% in 2015 and an annual average of 3.7% over the 2016-2017 biennium. The revenue forecast projects a 6.0% increase in total net revenue growth from the 2014-2015 biennium to 2016-2017, including an 8.9% increase in sales taxes. Oil production taxes are projected to decrease by 14.3%, or $948 million, with an additional $281 million decline in natural gas production taxes. The oil price projection in the forecast is an average of $64 in fiscal 2015, $65 in FY 2017 and $69 in 2017. Total production is projected to decrease slightly in FY 2015 and flatten in 2016 and 2017.

Wyoming

ICR: AAA/Stable

Severance tax and federal mineral royalties directly attributable to oil account for about 17% of combined general and budget reserve account revenues. The state estimates that every $5 dollar drop in the price of oil per barrel loses the state about $35 million: $17.2 million in general fund revenue and about $18 million in a separate school foundation account for K-12 education. Because fiscal 2015 is half over, the state expects a muted effect on the recent price drop for fiscal 2015. The state's most recent January 2015 consensus revenue forecast reduced expected 2015-2016 biennium revenues by $231 million from the enacted budget (or $218 worse than the most recent October 2014 forecast). The relatively small decrease in revenues on a $3.5 billion biennium budget is the result of windfall revenues received when oil prices were above its $85 per barrel budget assumption in the first part of calendar 2014, offset by oil prices now projected to be below the $87 per barrel assumed in the enacted budget for calendar 2015. The updated January forecast now assumes an oil price of $50 per barrel in 2015, offset by a minor increase in investment earnings from its $9.8 billion of combined permanent funds. The legislature is currently considering the governor's request for $156 million of additional mid-biennium spending; however, the legislature has had a history of making mid-biennium cuts to restore structural balance while holding reserve levels comparable to annual spending levels. The state is well-positioned to weather revenue fluctuations in the short term, with $2.0 billion in combined general fund, legislative stabilization account, and budget reserve fund balances that are greater than annual spending. The state's 2015-2016 biennium budget had assumed no change in reserve levels from the prior year, but reserves in December 2014 were already about $200 million higher than budgeted for fiscal end 2016.