Municipal Market Comments

Ascent Investment Partners

January 16, 2015

from Montage Investments

Oil Price Drop Will Have Varying Impacts on Municipals; Local Governments Appear Most at Risk

The domestic oil industry has experienced a dramatic resurgence in production since 2011 and is nearing the historic peak production level of 1970. Low interest rates and technology developments have driven production growth to annual rates of greater than 14% each year since 2011, according to data from the U.S. Energy Information Agency (EIA). Even with the steep drop in oil prices over the second half of the year, 2014 production is expected to post 16% growth. This incredible growth has been a boon to the economies of the states and communities in which this production is occurring. In these oil-heavy states, the pace of economic recovery from the recession has far outstripped the national rate.

With oil prices down more than 50% from June 2014 levels, the impacts on exploration and production (E&P) companies and related firms are reasonably apparent to most market observers. Consequently, we have seen spreads on the bonds of oil sector companies move significantly wider over the past six months, particularly in the high-yield segment of the market. What is less clear-cut, though, are the potential credit and market impacts on the municipal bonds of issuers most exposed to the fallout from a sustained period of sub-$60 oil.

Investors may have a hard time determining the extent to which their individual municipal bond holdings or bond mutual fund positions may be exposed to oil market. Offerings of municipal bonds secured by "oil patch" issuers have been increasing over the past three months. Investors need to undertake thorough fundamental analysis of each bond's credit characteristics in order to determine if these are truly distressed credits that should be avoided, or opportunities to buy solid securities being sold out of fear.

Ascent believes that the states are generally well positioned to weather the storm of oil price volatility. Even with a sustained period of low oil prices, few states are overly dependent on the industry to the extent that we expect their bonds' ratings or pricing to suffer relative to the general market. Those that we believe are at greater risk of credit deterioration include Alaska, North Dakota and New Mexico. While we expect Texas' economy to slow markedly, at this point we expect the state will be able to maintain its strong credit position.

In contrast, we view local issuers as being at much greater risk for significant credit impacts and pricing declines. Even so, we do not expect widespread rating downgrades or bond defaults in local issuers in oil boom regions. While the diversity of local issuers makes it very hard to generalize about municipal bonds, those in Texas, New Mexico and North Dakota have most benefited from the oil boom and so appear to be most exposed to a potential bust. We expect that the worst credit effects are likely to be felt in small cities and school districts in Texas, as well as a scattering of municipalities with concentrated local economies and tax bases.

The EIA currently projects that oil production in 2015 will continue to increase despite lower prices. At the same time, capital spending on new wells is shrinking rapidly and oil sector employment has begun to come under some pressure. Should low prices persist into 2016 and beyond, we would expect to see significant declines in production and development. The effects of falling oil prices on municipal issuers will be extremely varied. It is impossible to generalize about the extent of rating or market impacts due to the diversity of issuers, not only between states but even within states. Municipalities can generate economic benefits from a variety of direct and indirect sources related to oil production, and any individual issuer's reliance on a particular revenue flow can only be determined through detailed analysis. In our analysis of municipal bonds, we carefully examine revenue sources that could be impacted by oil market volatility, including:

- **Severance taxes levied by states that directly tax production.** These vary by state, however, and they can be based on market price, volume produced, or some combination of the two. The revenue impacts of declines in prices and production can vary widely, depending on each state's tax structure and the extent to which price and production fluctuates in 2015 and beyond. Volumetric taxes are likely to increase in 2015 in most states, while value-based fees are already in sharp decline and creating revenue shortfalls in oil-producing states that levy them, most notably Alaska. To the extent that states redistribute significant portions of their severance tax revenues to localities (local sharing of these revenues varies state-to-state), the impacts may also be felt on the local level.
- **Property taxes levied by states and local governments.** Property taxes are the primary revenue source for a wide range of local governments in the U.S. including cities, counties, towns, school districts and a variety of other local taxing bodies. Some states also levy property taxes at the state level. These taxes are levied on both real property and on personal property, which generally includes things like drilling rigs and related production equipment. Local governments could be at great risk of tax base loss should the value of natural resources and oil industry real estate and equipment fall significantly, though these impacts likely won't show up in local tax rolls until the 2016 tax year or later.
- **Sales and use taxes levied by states and local governments.** Sales and use taxes represent a significant revenue source for many state and local governments. In some states, sales taxes represent the largest source of local general revenues for cities and towns, far outweighing the revenues generated by local property taxes. A slowdown in drilling activity will have significant impacts on the economies of those areas. To the extent that service companies and other secondary and tertiary support businesses (restaurants, hotels, etc.) lose business flow, revenues to the local government will fall. These effects may begin to be felt in the very near term.

- **Personal and corporate income taxes.** States depend on personal and corporate income taxes for a substantial portion of their general revenues. As oil sector firms report results from the fourth quarter of 2014 and in 2015, we expect corporate income tax revenues in oil states to reflect weakened earnings in the industry. Should low prices persist and oil sector employment begin to significantly drop in 2015 and beyond, we would expect the personal income effects to begin to be felt in states' fiscal 2016 budgets.

States' Oil Production and Reliance on Oil Tax Revenue

State	Oil Production, Sept. 2014[1]	FY2014 General Fund Revenues[2]	FY2014 Oil Price Forecast[3]	FY2015 Oil Price Forecast[3]
Texas	3,511	8%	$ 82.18	$ 80.33
North Dakota	1,185	6%	$ 75.00	$ 80.00
California	559	<1%	NA	NA
Alaska	478	89%	$106.61	$105.06
Oklahoma	349	4%	NA	NA
New Mexico	322	19%	$ 95.75	$ 92.00

[1] Thousand barrels per day.

[2] Percentage of general fund revenues generated by taxes on oil production.

[3] Forecast average price for the fiscal year (ended June 30).

Sources: U.S. Energy Information Administration; *"U.S. Public Finance: Low Oil Prices Will Pressure States Reliant on Extraction Taxes,"* Moody's, Oct. 27, 2014.

States

The table above shows the six states that produce more than 300,000 barrels per day and which collectively account for more than 70% of domestic oil production, along with their relative dependence on oil revenues to fund general governmental budget spending. Most of the commentary on municipal impacts from lower oil prices has focused on the state level. From this perspective, analysts focus heavily on Texas (G.O. bond ratings Aaa/AAA/AAA) and North Dakota (Aa1/AAA), the two states that are the largest producers of oil and that have also seen the most dramatic production growth since 2011. While oil production in each of these states has tripled since 2009, they are not overly dependent on oil sector revenues in their budget structure.

Alaska (Aaa/AAA/AAA) is also considered a higher risk state, with Moody's revising its rating outlook to negative in December over concerns about the state's revenue flows in the current fiscal year. Unlike the oil boom states, however, Alaska's production has been in steady decline since its peak in 1988, with 2013 production down fully 75% from the late 1980s highs. Alaska established and funded a significant rainy-day fund during times when oil prices have been high, giving the state a substantial cushion should low prices persist. In the intermediate term, however, the state's credit ratings will likely suffer if prices remain near or below current levels.

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Local Governments

If oil prices remain low for an extended period of time, counties, towns and cities that have been at the center of the oil boom in the U.S. in recent years will face the prospect of a significant downturn in economic activity and in their taxable property bases. It is impossible to generalize the highest risk municipal bond issuers because of the diversity of municipal bond issuers and the structural details of their bond issues. Proper risk/reward analysis cannot be done without diving into the credit specifics of each issue.

It is possible, however, to identify regions that will likely face the highest degree of economic pressure should oil exploration and production drop off significantly. Based on 2013 figures produced by oil consulting firm Drilling Info, the top 20 oil producing counties in the U.S. accounted for 52% of all domestic production (see table below). It is important to note that of the 20, three are areas located offshore in the Gulf of Mexico. Furthermore, Beechey Point and Harrison Bay in Alaska are U.S. Geological Survey quadrangles located in North Slope Borough and represent essentially all of the oil production in that state. We are left with a list of 15 counties in five states that we would expect to contain local issuers at relatively higher risk of oil market impacts.

Top Oil Producing Counties – 2013

Rank	County	State	Avg. Daily Production (Mbbl/day)[1]
1	Green Canyon[2]	Gulf of Mexico	408
2	Beechey Point[3]	Alaska	395
3	Kern	California	386
4	Mississippi Canyon[2]	Gulf of Mexico	350
5	McKenzie	North Dakota	237
6	Mountrall	North Dakota	216
7	Karnes	Texas	214
8	Eddy	New Mexico	141
9	LaSalle	Texas	141
10	Dunn	North Dakota	138
11	Weld	Colorado	138
12	Williams	North Dakota	134
13	Dewitt	Texas	133
14	Dimmit	Texas	117
15	Gonzales	Texas	116
16	Lea	New Mexico	116
17	Andrews	Texas	100
18	Harrison Bay[3]	Alaska	91
19	McMullen	Texas	88
20	Alaminos Canyon[3]	Gulf of Mexico	85

[1] Production in thousands of barrels per day.

[2] Bureau of Ocean Energy Management, Regulation and Enforcement (BOEMRE) defined protraction area located offshore.

[3] U.S. Geological Survey quadrangle falling within North Slope Borough, AK.

Sources: *"Half of US Oil Production Comes from Theses 20 Counties,"* Drilling Info, April 3, 2014.

From this starting point, investors can identify issuers that might be located in or near these counties and begin examining the underlying oil sector exposure. At Ascent, we utilize fundamental credit analysis on each bond we place in an account, being sure to understand the underlying credit characteristics. By analyzing sector exposure and revenue composition before purchasing any bond, we are able to make better-educated valuation decisions on the bonds we position for our clients.

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