THE STATE of ALASKA
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April 13, 2016

Honorable Representative Steve Thompson
Alaska State House of Representatives
State Capitol, Room 515
Juneau, AK 99801

Re: Permanent Fund Proposal

Dear Representative Thompson:

Thank you for the opportunity to review and comment on the committee substitute for House Bill No. 245(FIN). This letter addresses the Administration's view on the committee substitute.

As an initial matter, the Administration appreciates that the Senate, House, and Administration are considering plans to use Permanent Fund earnings, and adjust the method of paying dividends, that are increasingly similar. There are several aspects of the committee substitute that are similar or different from the original version of the Alaska Permanent Fund Protection Act (APFPA) that the Administration can support, including:

- A sustainability target of maintaining the real value of the Permanent Fund based upon an assumption of 6.9 percent Permanent Fund total returns and an inflation rate of 2.25 percent;

- A percent of market value (POMV) draw from the Earnings Reserve Account (ERA), as opposed to a fixed draw, that is based on a five or six multiyear average of the Permanent Fund value;

- A yearly dividend to Alaskans calculated as an average of 20 percent of royalties going to the General Fund and 20 percent of the POMV payout, also to be paid from the General Fund. This provides for an approximately $1,000 dividend with upside if oil prices or production rise;

- A fixed initial dividend of $1,000. The Administration is concerned that a fixed dividend for more than one year risks diluting the connection to the new dividend payout formula, so would prefer a fixed $1,000 dividend for just the first year, but will not oppose a longer fixed dividend period;

- Repeal of the "Amerada Hess" provisions in current AS 37.13.145(c) and (d); and

- Statutory changes that result in managing the Constitutional Budget Reserve for higher returns.

However, there are parts of the committee substitute that the Administration believes can be enhanced. Those include:

- Ensuring a POMV draw that does not exceed what is sustainable under the above definition. The Department of Revenue (DOR) calculates a POMV draw of approximately 4.9 percent is the maximum sustainable amount under the committee substitute where additional revenues are not directed to the Permanent Fund (e.g., as originally provided in the APFPA), assuming the POMV is calculated based on the average of the first five of the last six years. The Administration is flexible in considering the sustainability conclusion based on non-DOR models, so long as such models are subject to peer review and accurately constructed;

- Having a mechanism to grow the corpus of the Permanent Fund with inflation. The committee substitute as drafted removes the inflation proofing transfer rule under current AS 37.13.145(c). As with the original version of APFPA, the need to maintain a robust ERA that can support increased draws to the general fund warrants revisiting the existing inflation proofing rule. However, leaving all realized gains in the ERA does not adequately grow the corpus. The APFPA as originally drafted provided that amounts in the ERA in excess of four times the current year draw would be transferred to the corpus. The Administration felt that was a reasonable balance between ensuring a durable ERA and the laudable goal of growing the corpus so it retains its relative value across generations. The Administration believes some version of a similar rule to transfer funds from the ERA to the corpus is appropriate; and

- Meaningfully addressing the impact of oil price volatility on the State budget and the private sector economy. As you are aware, the APFPA originally placed all royalties and production taxes into the ERA and drew out a fixed amount. The Governor has also indicated a willingness to have those revenues placed in the ERA, with an increased POMV draw percentage. Alternatively, if the Legislature does not wish to place additional petroleum revenues into the Permanent Fund, a system should be adopted that reduces the POMV draw to reflect rising oil revenues. The revenue limit proposal adopted by Senate State Affairs to reduce the POMV draw for each dollar royalties plus production taxes to the General Fund exceed $1 billion is a sound approach. The attached memorandum addresses these two options in more detail.

Thank you again for the opportunity to comment on the committee substitute and your willingness to work collaboratively to arrive at a balanced, long-term fiscal plan for the State. If we can answer any additional questions, please do not hesitate to let us know.

Sincerely,

Randall Hoffbeck
Commissioner of Revenue

Craig Richards
Attorney General

Protecting the Permanent Fund under a POMV Plan: OPTIONS FOR REVENUE LIMTS

By Department of Revenue and Department of Law (April 13, 2016)

The current low oil price environment, in conjunction with declining oil production, has necessitated the transition to using permanent fund earnings to support the State budget. But Alaska still has ample resources to develop, and oil prices are unpredictable. A plan that would continue to draw from the permanent fund even after oil prices (and petroleum revenues directed to the general fund) recover would be equivalent to drawing from a retirement fund after returning to full-time employment.

We have examined two frameworks that address the uncertainty of oil price and investment revenues: an endowment framework paired with a revenue limit and the sovereign wealth framework. Both of these frameworks may be paired with a percent of market value (POMV) formula to calculate the annual draw.

Option 1: Reducing ERA Draw When Oil and Gas Revenues are High

The revenue limit proposed by the Senate State Affairs committee addresses the variability of oil price with a traditional endowment approach. It reduces the POMV draw from the fund by $1 for every $1 over $1 billion of production taxes and royalties deposited in the general fund. Compared to a simple POMV draw, this approach would improve the sustainability of payouts from the permanent fund, reduce the risk of increasing spending expectations in years of high petroleum revenues, and reduce the variability of UGF expenditures.

SSTA Revenue Limit (all values in billions$)		
UGF Petroleum Revenue	POMV Draw	Total[1]
$0.5	$2.5	$3.0
$1.0	$2.5	$3.5
$2.0	$1.5	$3.5
$3.0	$0.5	$3.5
$3.5	$0	$3.5
$4.0	$0	$4.0
$5.0	$0	$5.0

The table illustrates this revenue limit with various levels of production tax and royalty receipts and a hypothetical POMV draw of $2.5 billion. In addition to improving the sustainability of a POMV draw, this approach ensures that in earnings from the permanent fund are not used to grow government spending in periods of high petroleum revenues. The revenue limit has three phases:

- As oil price and UGF production taxes and royalties increase, between current revenue expectations and $1 billion, this framework provides flexibility for the legislature to undertake additional priority expenditures.

- Between approximately $1 billion and $3.5 billion of UGF production taxes and royalties, the framework smooths UGF revenue volatility and ensures our financial savings in the permanent fund are not spent when they are not necessary to support a sustainable budget.

- When production tax and royalty revenues exceed approximately $3.5 billion the framework avoids spending from our financial savings at all while making all of UGF petroleum revenues available for expenditure. This allows flexibility for appropriations to other various priorities, such as capital projects or replenishing the CBR. Essentially, when petroleum revenues are sufficient, the state's finances revert to the current system.

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1 This total does not include approximately $850 million of stable, existing general fund revenues of that are unaffected by the proposed fiscal plan.

Option 2: Including Oil and Gas Revenue in POMV Draw

Alternatively, to account for the variability in revenues, the committee substitute could be amended to (1) place all annual production taxes and royalties in the ERA and (2) increase the POMV draw to 6.5% to reflect the higher sustainable draw permitted by increased revenue inflows to the ERA. Draft language that may accomplish this approach is included in the attachment.

The greater stability provided by this option has several advantages and is the favored approach of the administration. A revenue limit paired with a POMV draw, as described above, is a middle ground that handles a good share of oil price volatility and prevents the permanent fund from being spent when petroleum revenues are large enough to support a sustainable budget.

Proposed Language for a POMV Draw Paired with a Revenue Limit

* **Sec.4.** AS 37.13.140 is amended by adding new subsections to read:

(c) In the event that the sum of oil and gas production taxes under AS 43.55.011 - 43.55.180, mineral lease bonuses, rentals, royalties, royalty sale proceeds, net profit shares under AS 38.05.180(f) and (g), and federal mineral revenue sharing payments received by the state and deposited into the general fund in the current fiscal year exceeds $1,000,000,000, the amount available for distribution under (b) of this section shall be reduced by one dollar for each dollar in excess of $1,000,000,000.

Proposed Language for a POMV Draw with Variable Petroleum Revenues Deposited in the Permanent Fund

* **Sec.4.** AS 37.13.140 is amended by adding new subsections to read:

(b) The corporation shall determine the amount available for distribution on July 1 of each year. The amount available for distribution equals six and one-half percent of the average market value of the fund, including the earnings reserve account established in AS 37.13.145, for the first five of the preceding six fiscal years, including the fiscal year just ended, computed annually for each fiscal year in accordance with generally accepted accounting principles but may not exceed the year-end balance of the earnings reserve account for the fiscal year just ended.

* **Sec. 5.** AS 37.13.145 is amended by adding new subsections to read:

(f) Except as otherwise provided under art. IX, sec. 17, Constitution of the State of Alaska, 100 percent of the money collected by the Department of Revenue, within the fiscal year, under the oil and gas production tax, AS 43.55.011 - 43.55.180, may be appropriated to the earnings reserve account.

(g) 54.5 percent of all mineral lease bonuses, rentals, royalties, royalty sale proceeds, net profit shares under AS 38.05.180(f) and (g), and federal mineral revenue sharing payments received by the state may be appropriated to the earnings reserve account.