Reducing the Deficit: Investing Alaska's Vast Cash Reserves

Senate Bill 114

Senator Lesil McGuire

Senate State Affairs

2/9/16

The Permanent Fund and the Dividend

November 1976- Voter Approved Constitutional Amendment Creating the Permanent Fund

2/21/1977- 9th Legislature
Created Permanent Fund thru CS to SS to HJR 39

-to convert a part of the depleting petroleum asset into a permanent and sustainable financial asset- (Goldsmith, 2002)

Zobel v. Williams (Argued: 10/7/1981, Decided: 6/14/1982) US Supreme Court
HELD: The Alaska Dividend distribution plan violates the guarantees of the Equal Protection Clause of the 14th Amendment

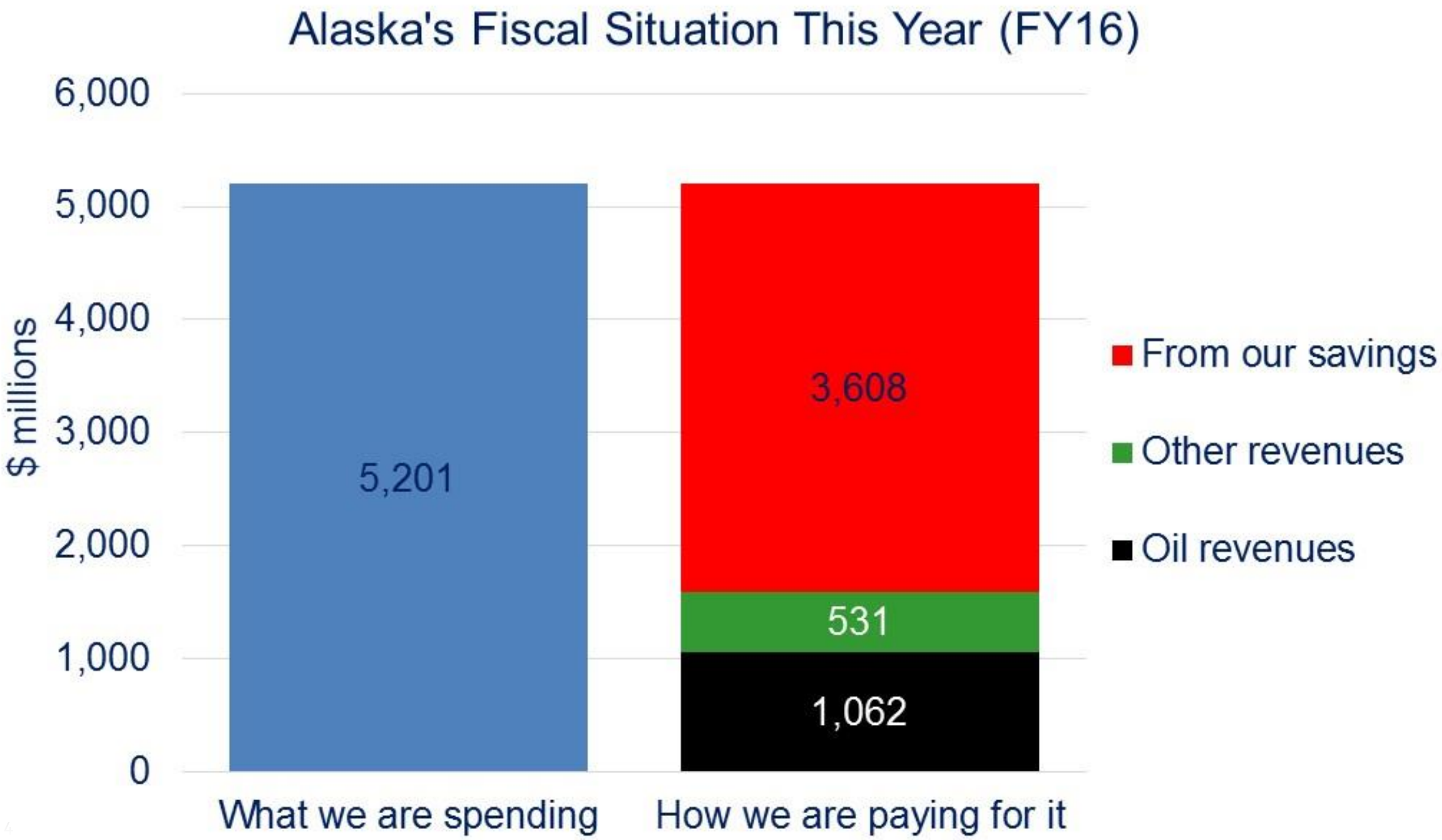
1982 The first Permanent Fund Dividend
Created by a statutory overlay on the constitution (signed into law 4/16/1980)

Is there a Problem?

A $3.5-4Billion Deficit

- The legislature has enacted heavy spending cuts over the last 2 years
- The state has several savings accounts, but

  Revenue models show that if oil prices do not rebound, those savings will be gone in about 2 years
- We cannot wait and hope for high oil prices
- The price of inaction now could be disastrous for the state's future



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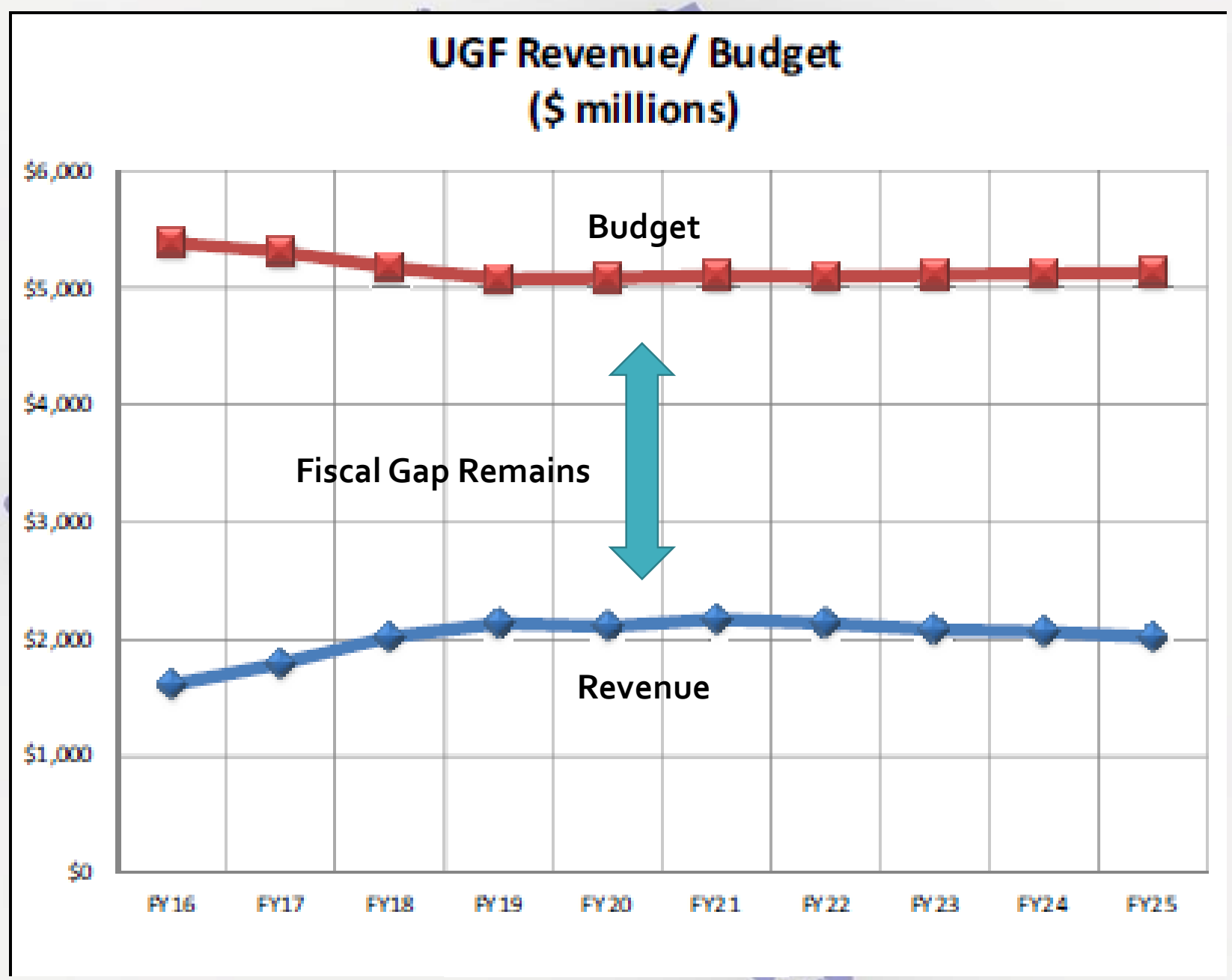
The Five Stages of Grief

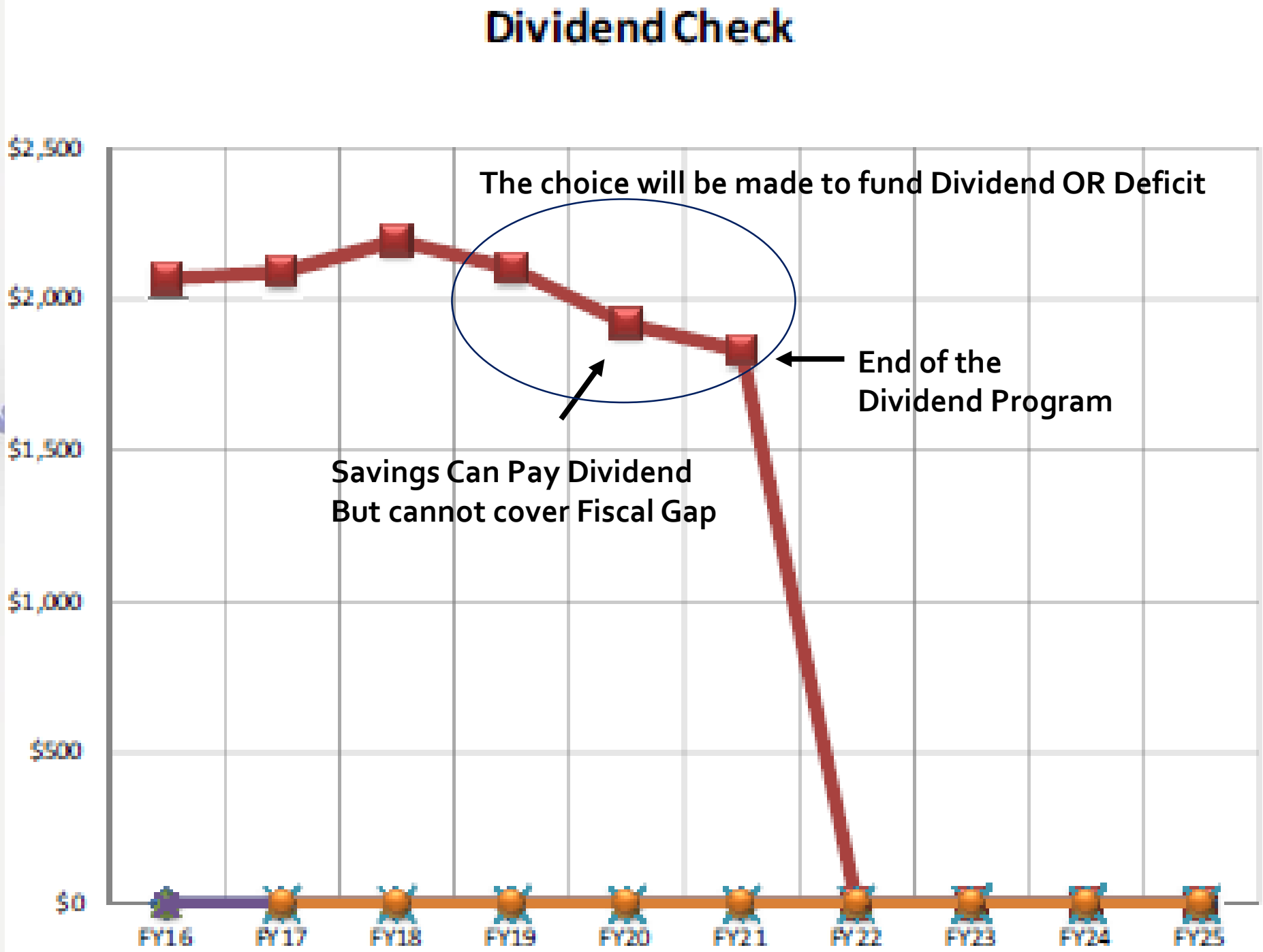
- Denial
- Anger
- Bargaining
- Depression
- Acceptance

What is the cost of doing nothing?

Status Quo


UGF Revenue/ Budget
($ millions)
$6,000
$5,000
$4,000
$3,000
$2,000
$1,000
$0
Budget
Fiscal Gap Remains
Revenue
FY16
FY17
FY18
FY19
FY20
FY21
FY22
FY23
FY24
FY25

Status Quo

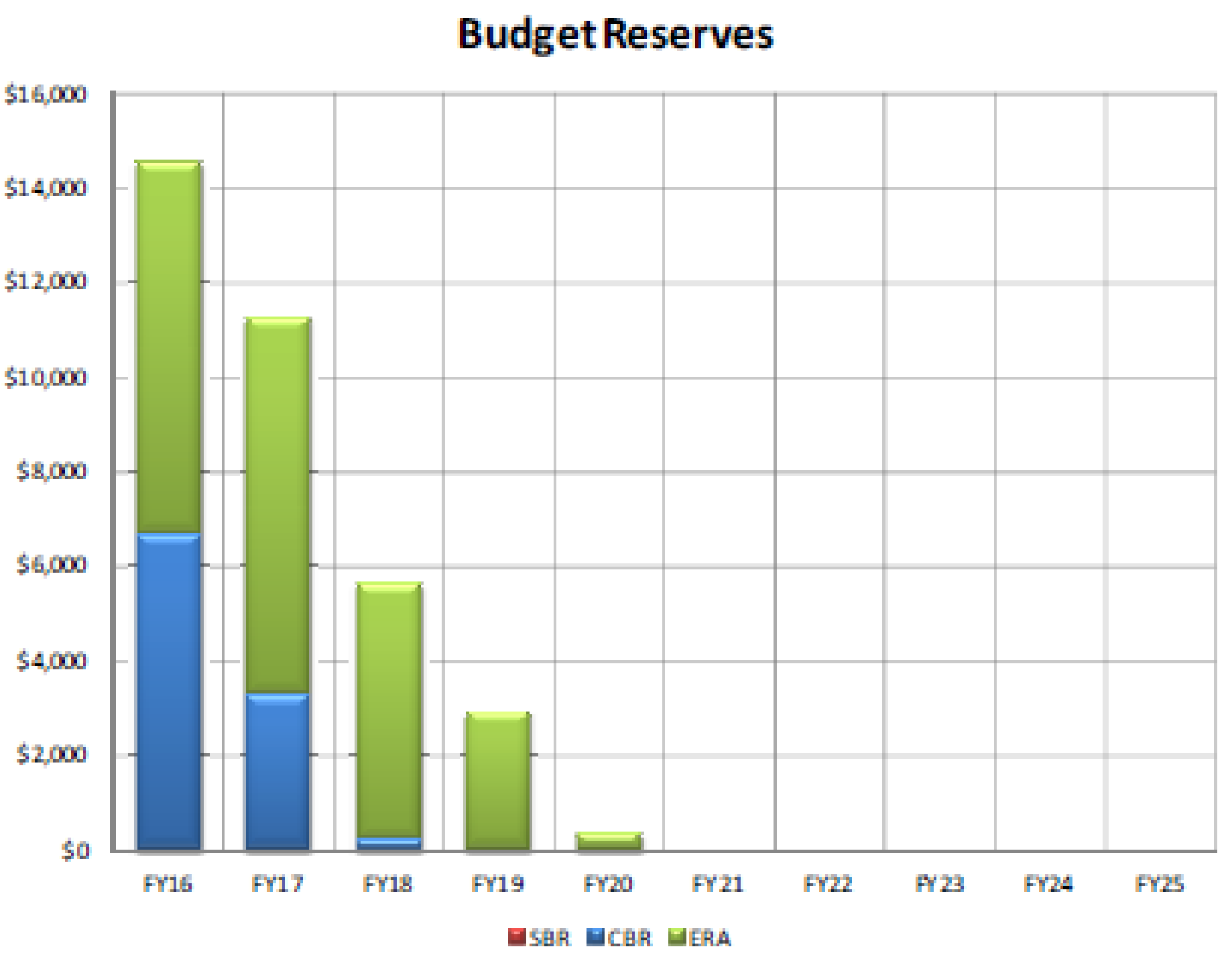

Dividend Check
$2,500
$2,000
$1,500
$1,000
$500
$0
FY16
FY17
FY18
FY19
FY20
FY21
FY22
FY23
FY24
FY25
The choice will be made to fund Dividend OR Deficit
End of the
Dividend Program
Savings Can Pay Dividend
But cannot cover Fiscal Gap

Status Quo

When the CBR is gone
The ERA will be required

When the ERA is gone….

What do we draw from then?



A Path Forward

> "If I had one hour to solve a problem, I would spend 55 minutes thinking about the problem and 5 minutes thinking about the solution."
> - *Albert Einstein*

We need a plan to address the problem

In crafting SB114 I had these principles in mind:

The solution needed to:

1) Retain a dividend
2) Reduce the volatility in the state budget
3) To clearly expose the size and cost of government
   - so that downward pressure would ensure that Alaskans could begin an honest assessment of needs vs. wants
4) Be enduring to allow maximum use of our wealth over generations so that benefits and burdens are shared
5) Be <u>Simple and Easy</u> to implement

What SB 114 IS NOT

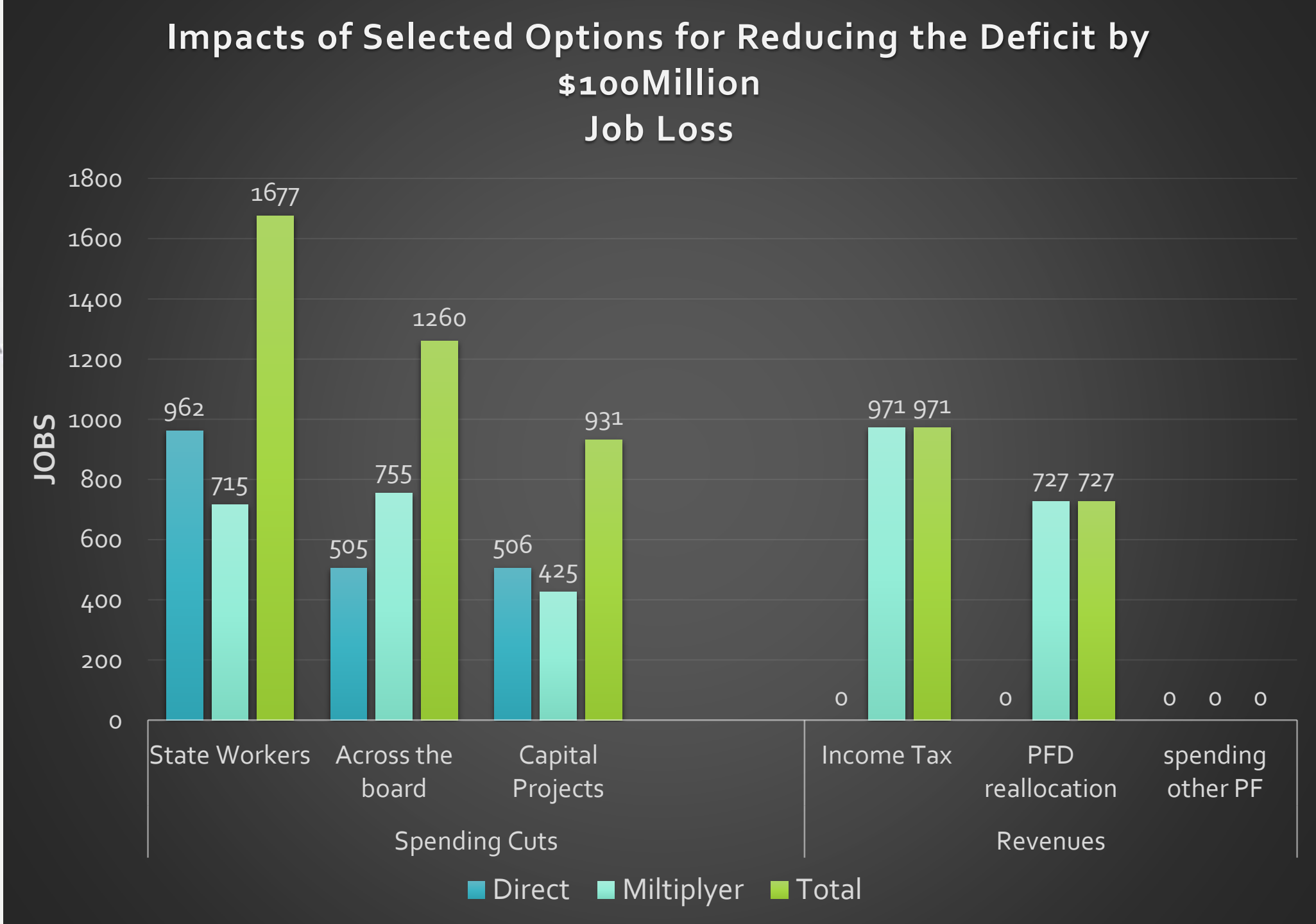
It is <u>NOT</u>

- **A Raid on the Permanent Fund**
  - **The Permanent Fund cannot be touched without a constitutional amendment**
  - **SB114 would only draw funds from the Earnings Reserve Account**
- **A way for Government to increase the Budget**
- **A Dividend Killer**

What SB 114 IS

It IS

- **A way to connect Alaskans directly to their share of the <u>Natural Resources</u>**
- **A way to <u>protect your dividend</u> into the future**
  - **Without a structural change, the dividend will go away in a few short years**
- **A way to ensure that <u>services you enjoy continue to be provided</u>**
  - **Police (public Safety)**
  - **Firefighters**
  - **Roads**
  - **Education**
  - **Health and Human Services**
  - **The Marine Highway**
  - **Parks and Recreation**
  - **Fish and Game management**



Source:
Mouhcine Guettabi And Gunnar Knapp
Alaska Business Monthly 2016

SB114 Spending Limitations?
Volatility in Commodity Prices

- **Without Oil Tax Revenue flowing through the ERA**
  - **Available General Funds will continue to swing with commodity price**
  - **Some volatility will remain**

Unless limitations are put in place

There are many options

SB114 Spending Limitations? Volatility in Commodity Prices

- The Legislature *could* consider some of the following to reduce volatility:
  - Language that says "FY(x) appropriation cannot exceed 110% or 120% of previous years draw" – can pick a number.
  - POMV could be a range of% depending on returns, oil tax revenue, cash flow needs, capital project outlays, etc…
    - i.e.—POMV could equal 2%-8% to fill the budget deficit, "whichever is less"
  - Can create an overall spending cap

A $3.5-4Billion Deficit- volatility in Commodity Prices

We have seen this before

For decades

Oil Price x Volume = State Budget

This has been Volatile and Unstable

<u>We have been saved in the past by rebounding oil prices</u>

What is different today is:

We no longer have the volume

(oil would need to be over $108bbl to balance the budget)

Einstein said "We cannot solve our problems with the same level of thinking that created them."

A $3.5-4Billion Deficit

Some things we *Must* ask ourselves:

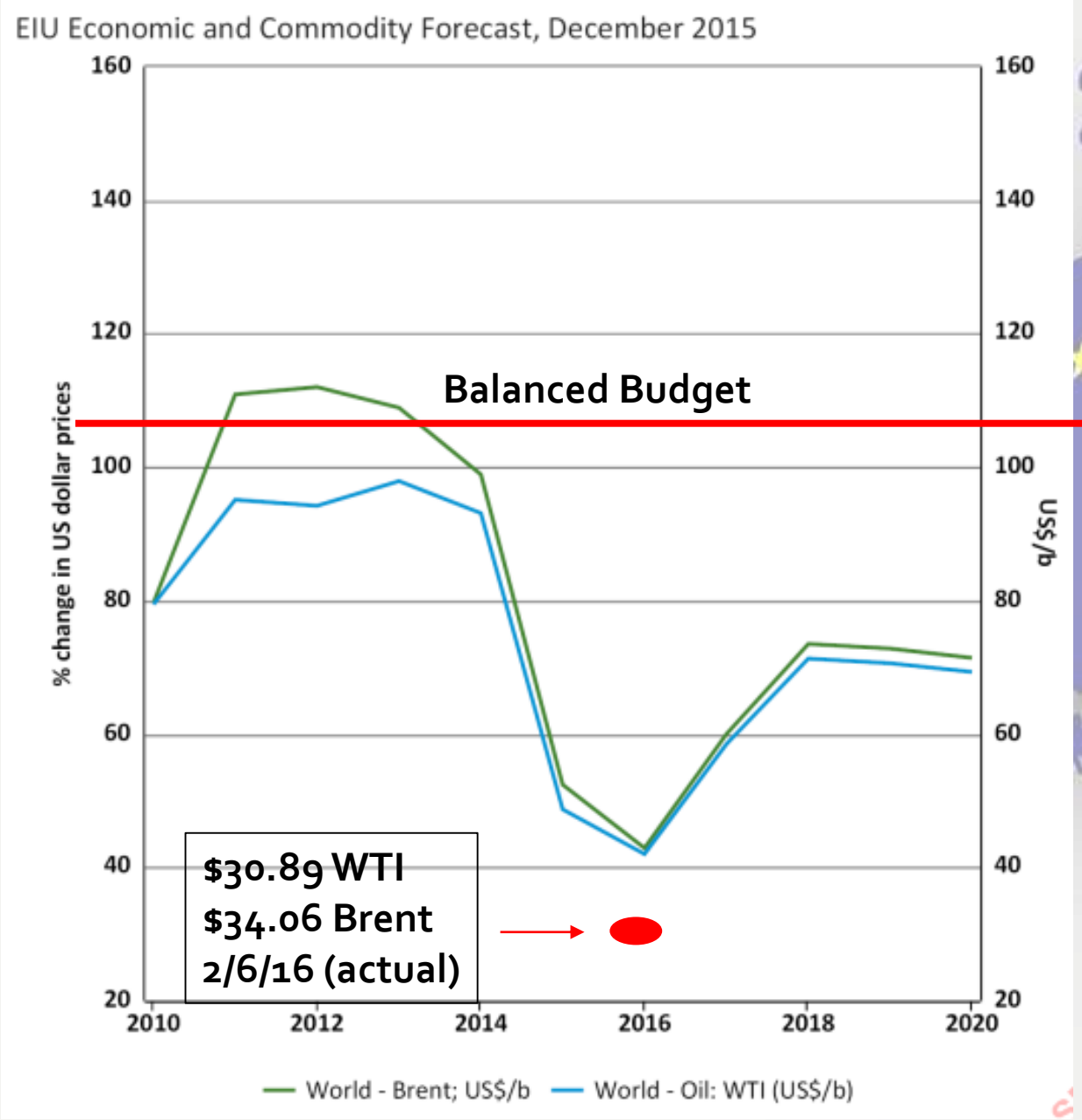
(oil would need to be over $108bbl to balance the budget)

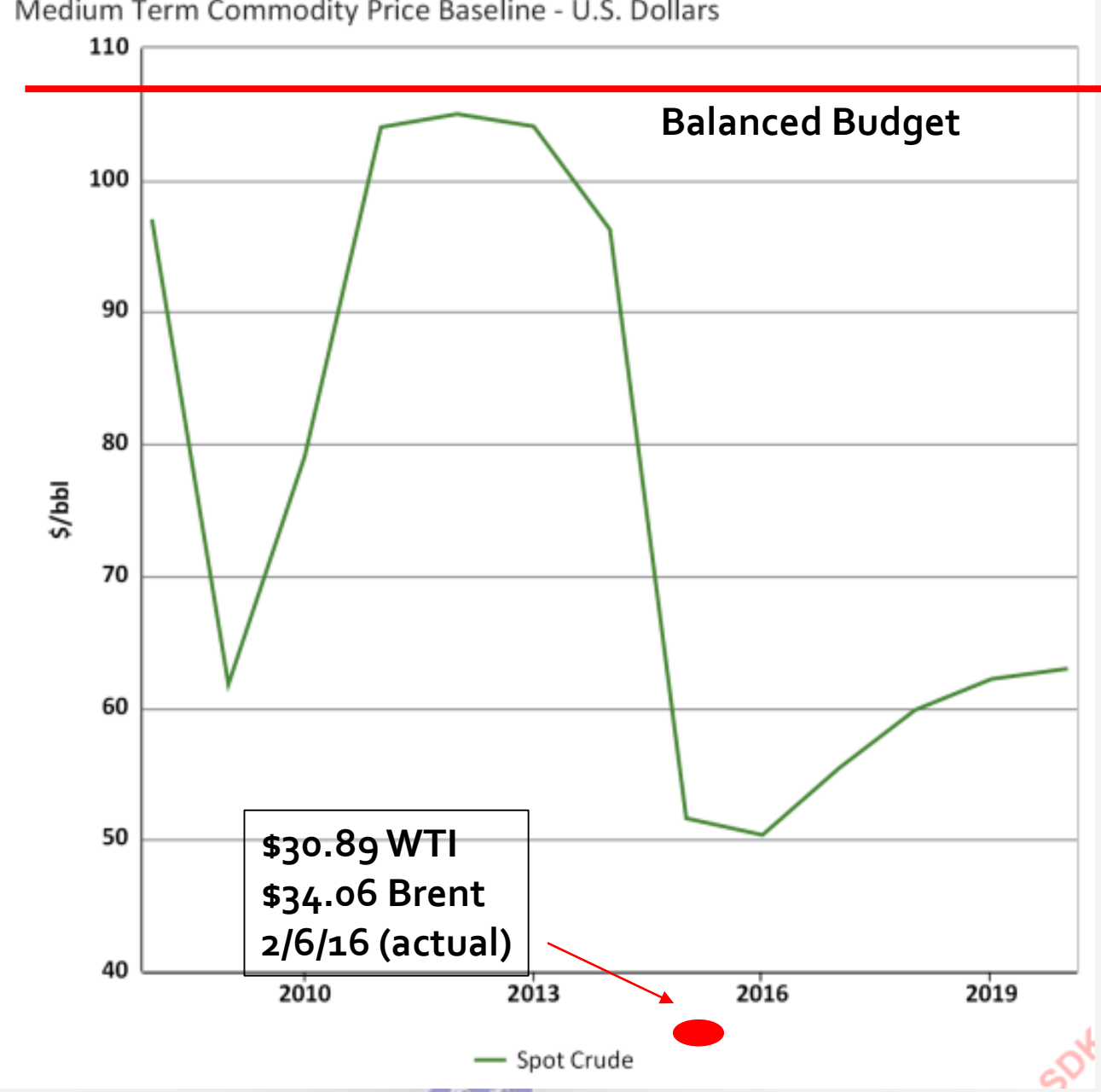
Will Oil Prices Rebound?

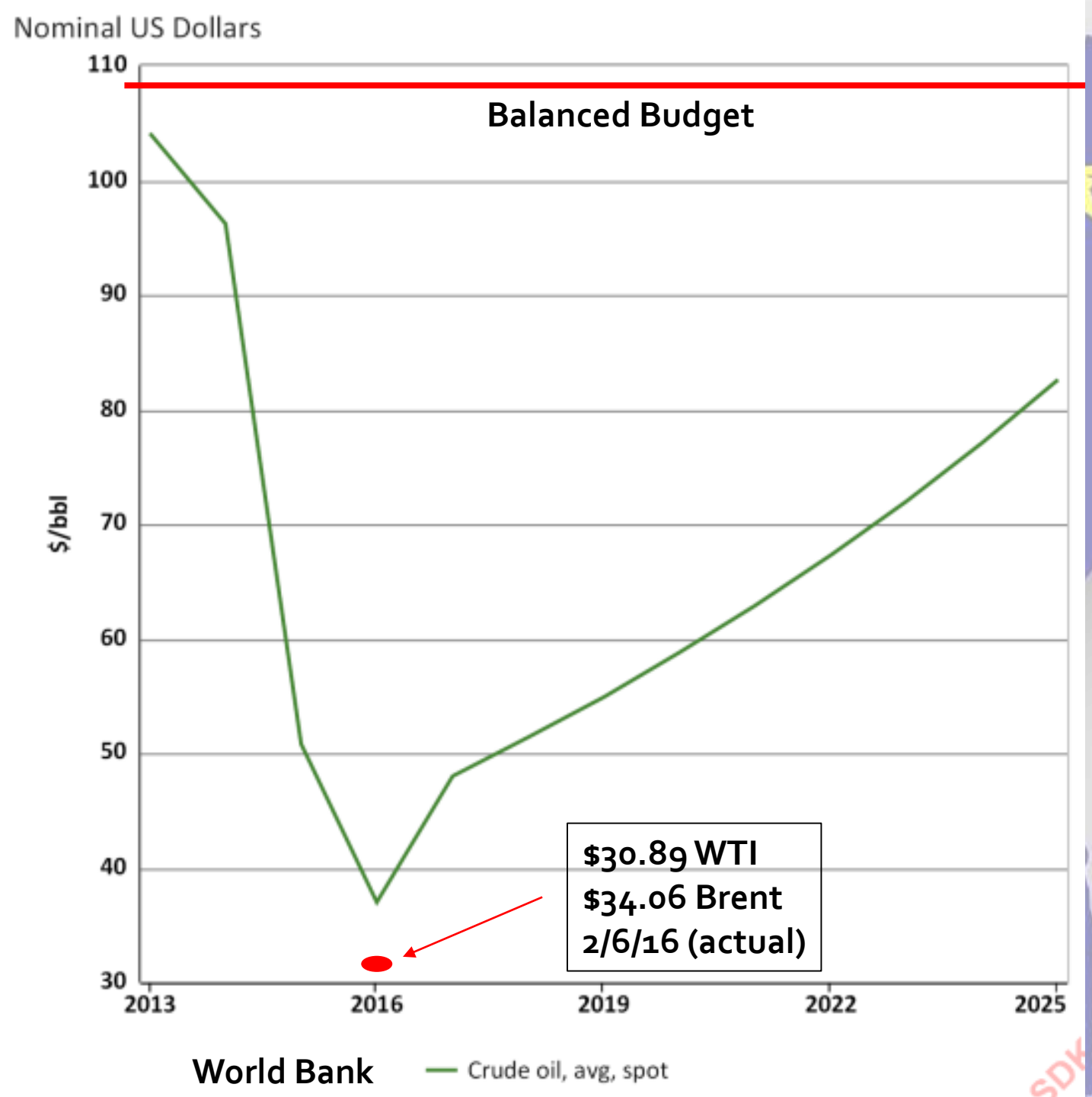
How high?

When?

Einstein said "We cannot solve our problems with the same level of thinking that created them."


EIU Economic and Commodity Forecast, December 2015
% change in US dollar prices
US$/b
Balanced Budget
$30.89 WTI
$34.06 Brent
2/6/16 (actual)
World - Brent; US$/b
World - Oil: WTI (US$/b)

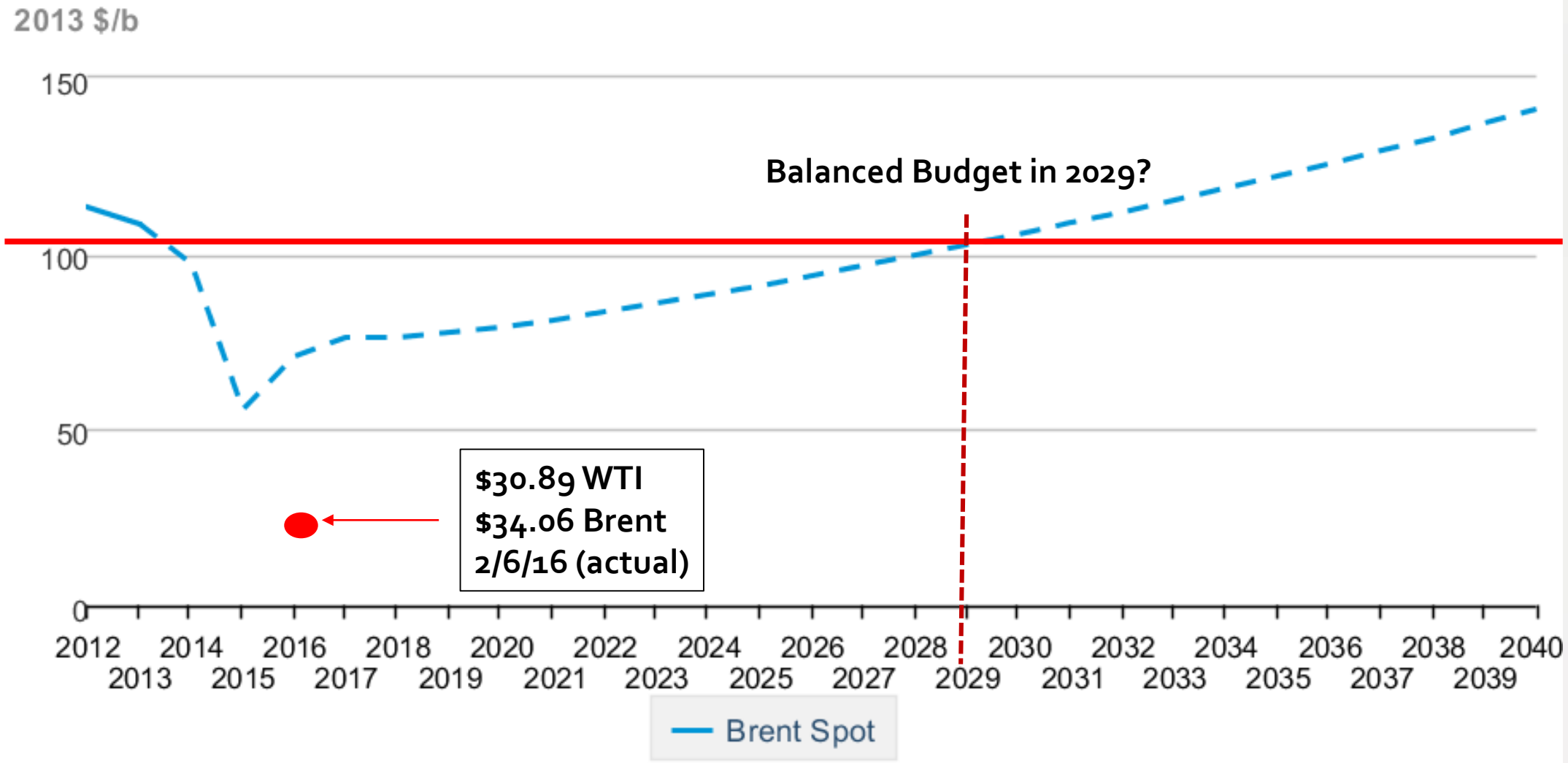

Medium Term Commodity Price Baseline - U.S. Dollars
$/bbl
Balanced Budget
$30.89 WTI
$34.06 Brent
2/6/16 (actual)
Spot Crude


Nominal US Dollars
110
100
90
80
70
60
50
40
30
$/bbl
2013
2016
2019
2022
2025
Balanced Budget
$30.89 WTI
$34.06 Brent
2/6/16 (actual)
Crude oil, avg, spot

World Bank

Real Petroleum Prices: Crude Oil

Case: Reference case



Source: U.S. Energy Information Administration

A $3.5-4Billion Deficit

- **Oil Price Projections have been inaccurate**

- **Is the International Oil Market fundamentally different now?**
  - **Perhaps**

- ***Should we bet* on oil prices to save us in the future?**
  - **A better question:**

Should we bet our future on oil prices?

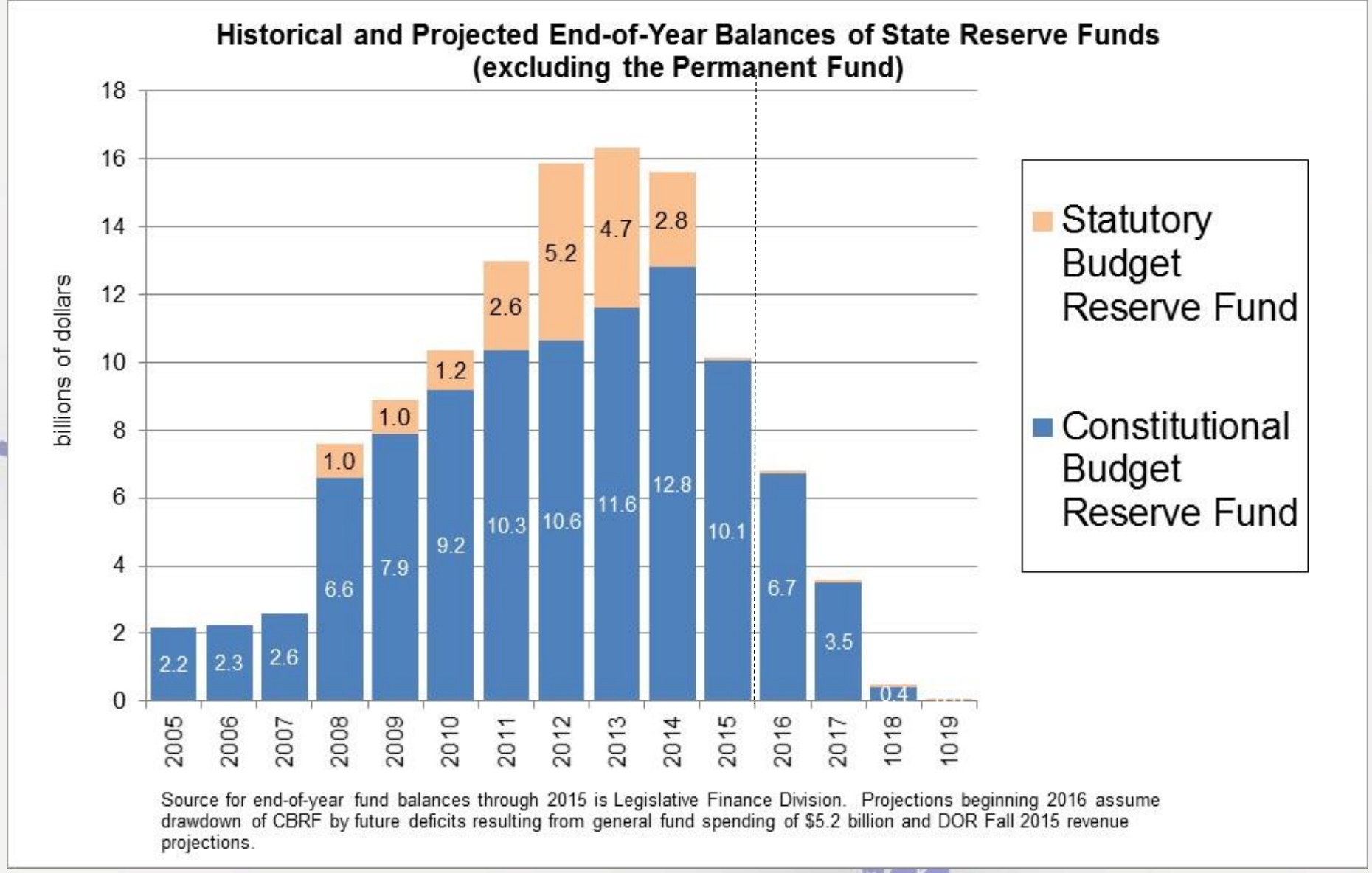
A $3.5-4Billion Deficit

- What has been done with savings at high oil prices?
- Snapshot of the Present
- Looking forward

The Legislature did a GREAT job saving during high oil Prices

But

Savings have Been depleted

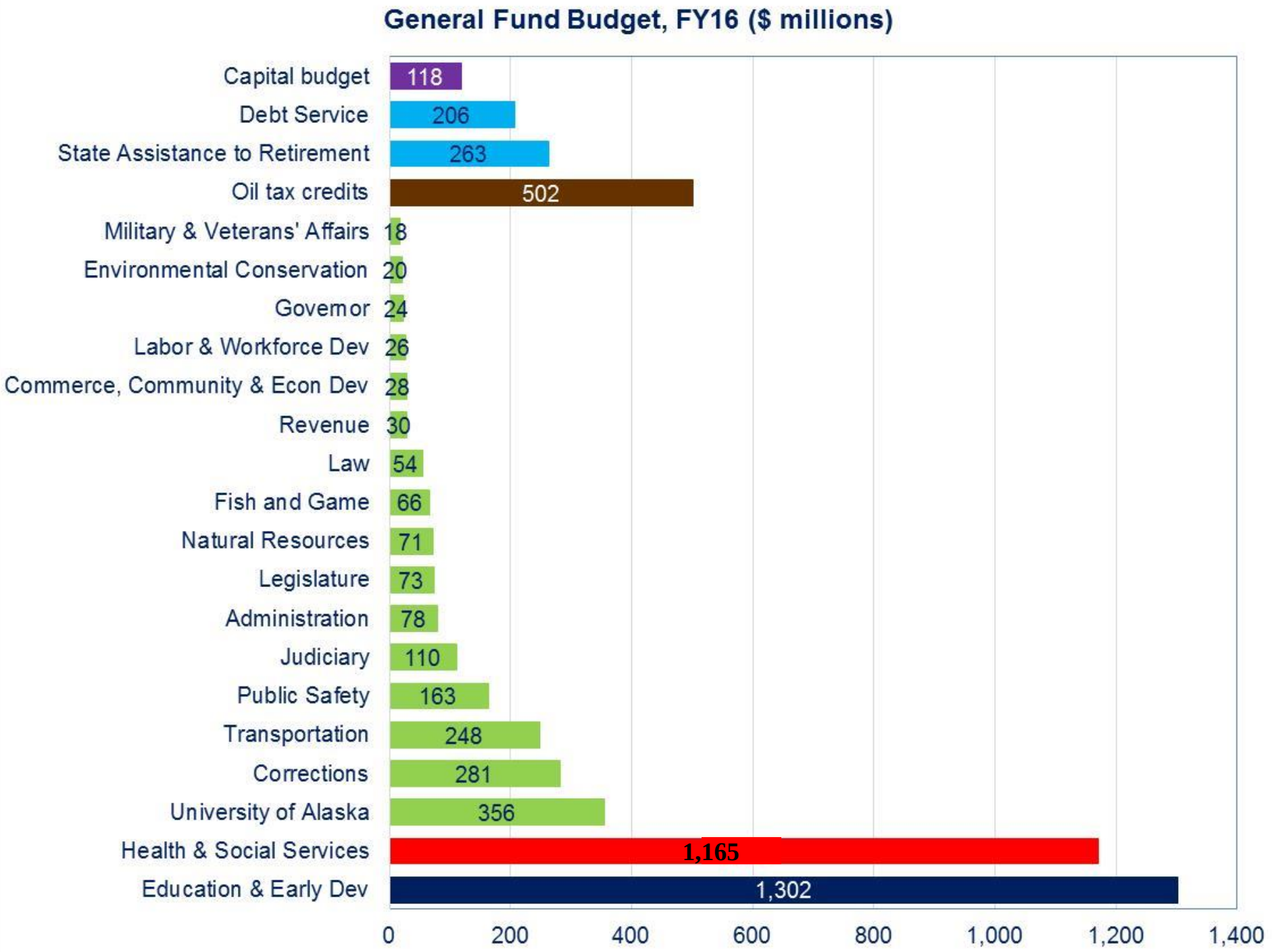


- 2008-09: Record high oil prices under ACES
- 2013: Low price and low volume- began draw down of SBR
- 2018: We cannot pay our bills with savings

Gunnar Knapp- ISER

- How we are spending $5.2 billion in FY16

- There are still cuts we can make
- But the low-hanging fruit may be gone
- These outlays do not capture program receipts or federal matches
  - Which would be vulnerable with deep cuts

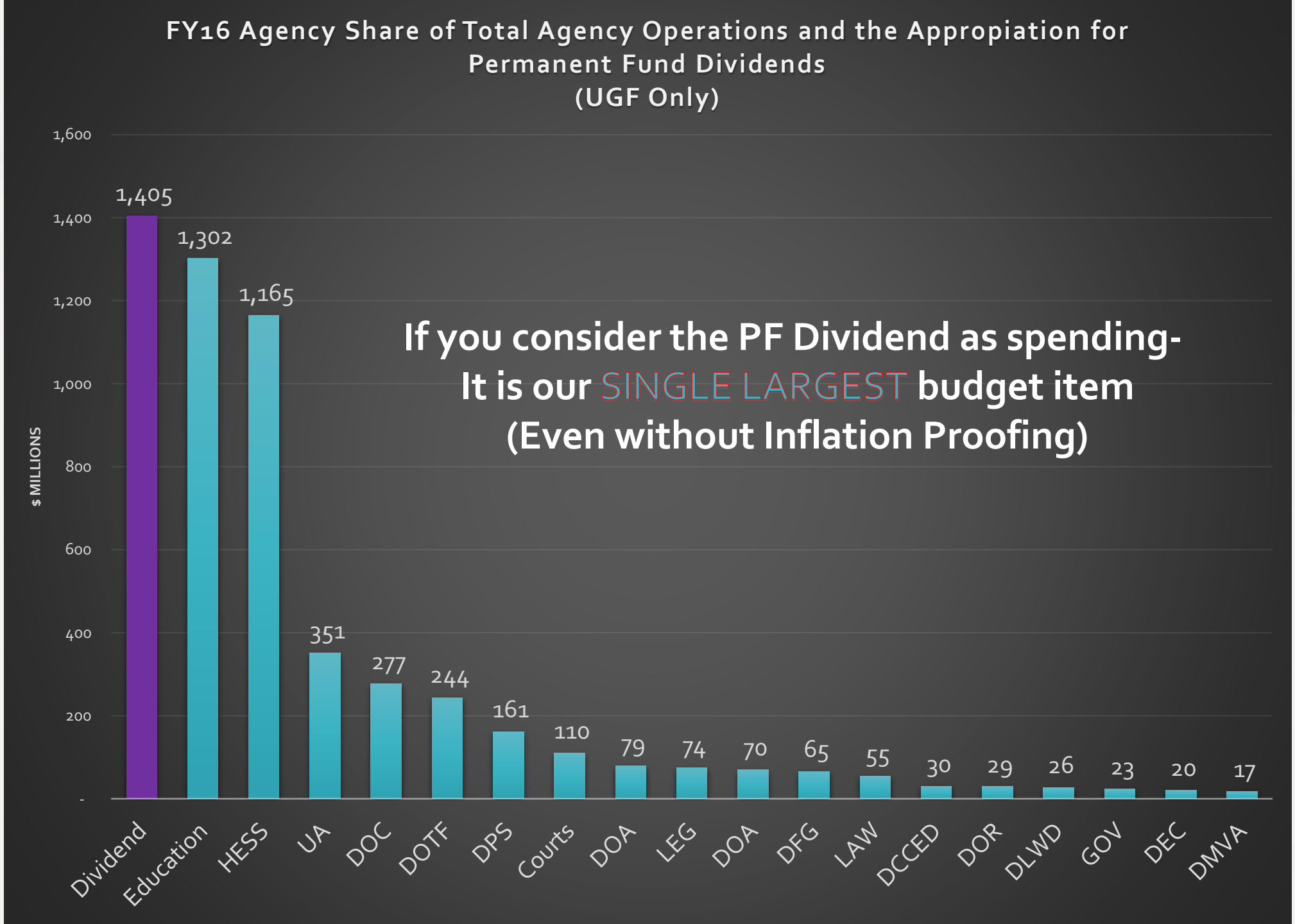


Potential New Revenue From Sustainable Alaska Plan

There are several new revenue options
But even together they do not close the gap

We cannot close the gap with <u>cuts</u> or new <u>broad-based revenue</u> ALONE

A sound fiscal solution will necessarily involve using the Permanent Fund


FY16 Agency Share of Total Agency Operations and the Appropiation for Permanent Fund Dividends
(UGF Only)
$ MILLIONS
1,600
1,400
1,200
1,000
800
600
400
200
-
1,405
1,302
1,165
351
277
244
161
110
79
74
70
65
55
30
29
26
23
20
17
Dividend
Education
HESS
UA
DOC
DOTF
DPS
Courts
DOA
LEG
DOA
DFG
LAW
DCCED
DOR
DLWD
GOV
DEC
DMVA
If you consider the PF Dividend as spending-
It is our SINGLE LARGEST budget item
(Even without Inflation Proofing)

SB 128 (APFPA) vs SB 114

Key Elements

- *Royalties go to Dividend under both plans*
  - *PFPA = 50% of Royalties (~$1,000 dividend and falling)*
  - *SB 114= 74.5% of Royalties (nearly 50% Higher Dividend)*
    - *$1,000 minimum*
- *PFPA plan moves CBR and Oil tax revenue into Earnings Reserve Account*
  - *There are possible legal issues regarding the CBR sweep*

- *PFPA plan is NOT a POMV*
  - *Targets a set number ($3.3B) for withdrawal and spending*
    - *This is telling the legislature you have "x" amount to spend every year*
  - *Does not adjust to market returns and actual earning of the ERA*

- *SB 114 does not change oil tax revenue (still straight to GF)*

- *AFPA is designed as an annuity- looks 25years into the future: Foresight*
- *POMV is based on actual values- Looks 5 years into the past: Hindsight*

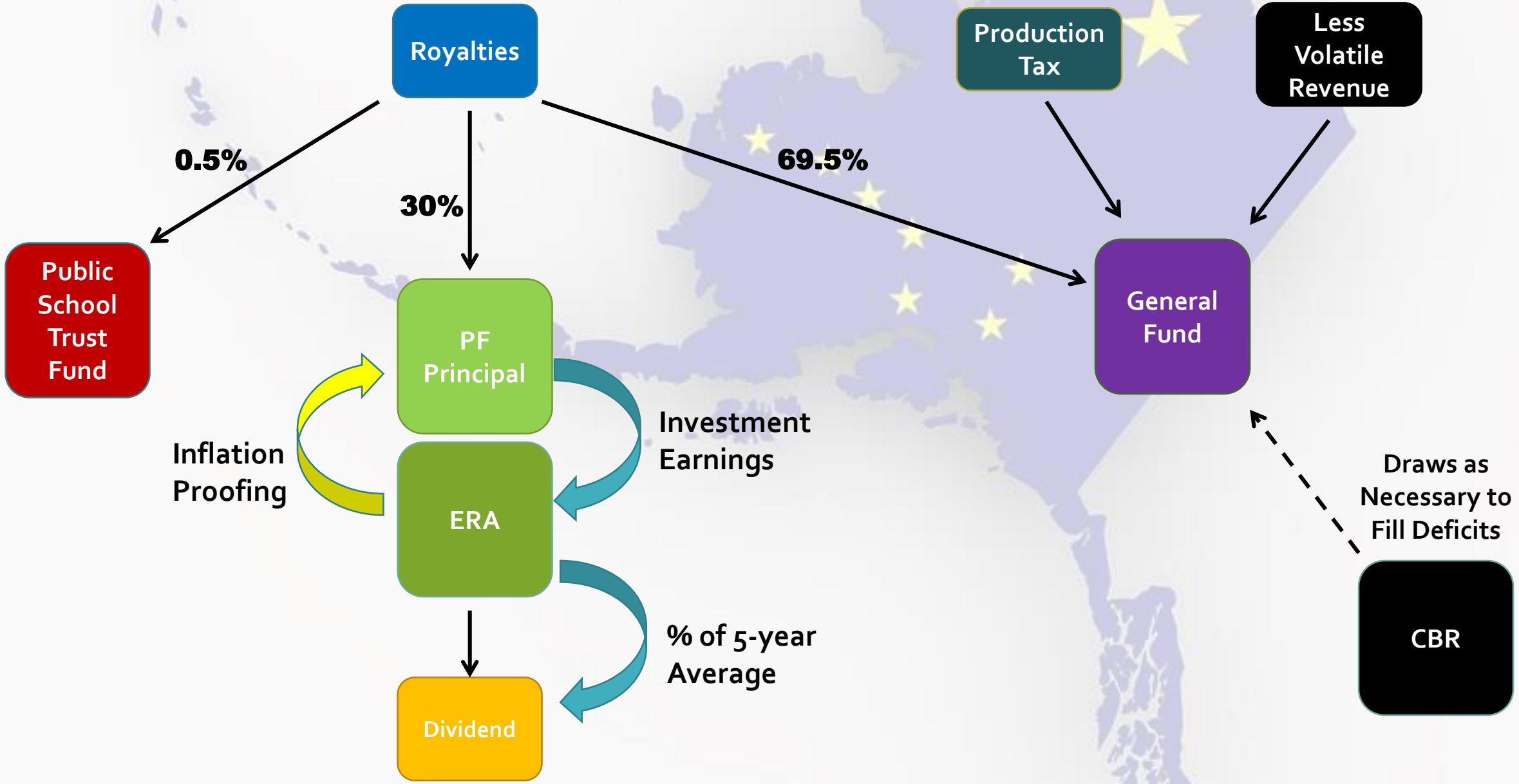
SB 114

Key Elements

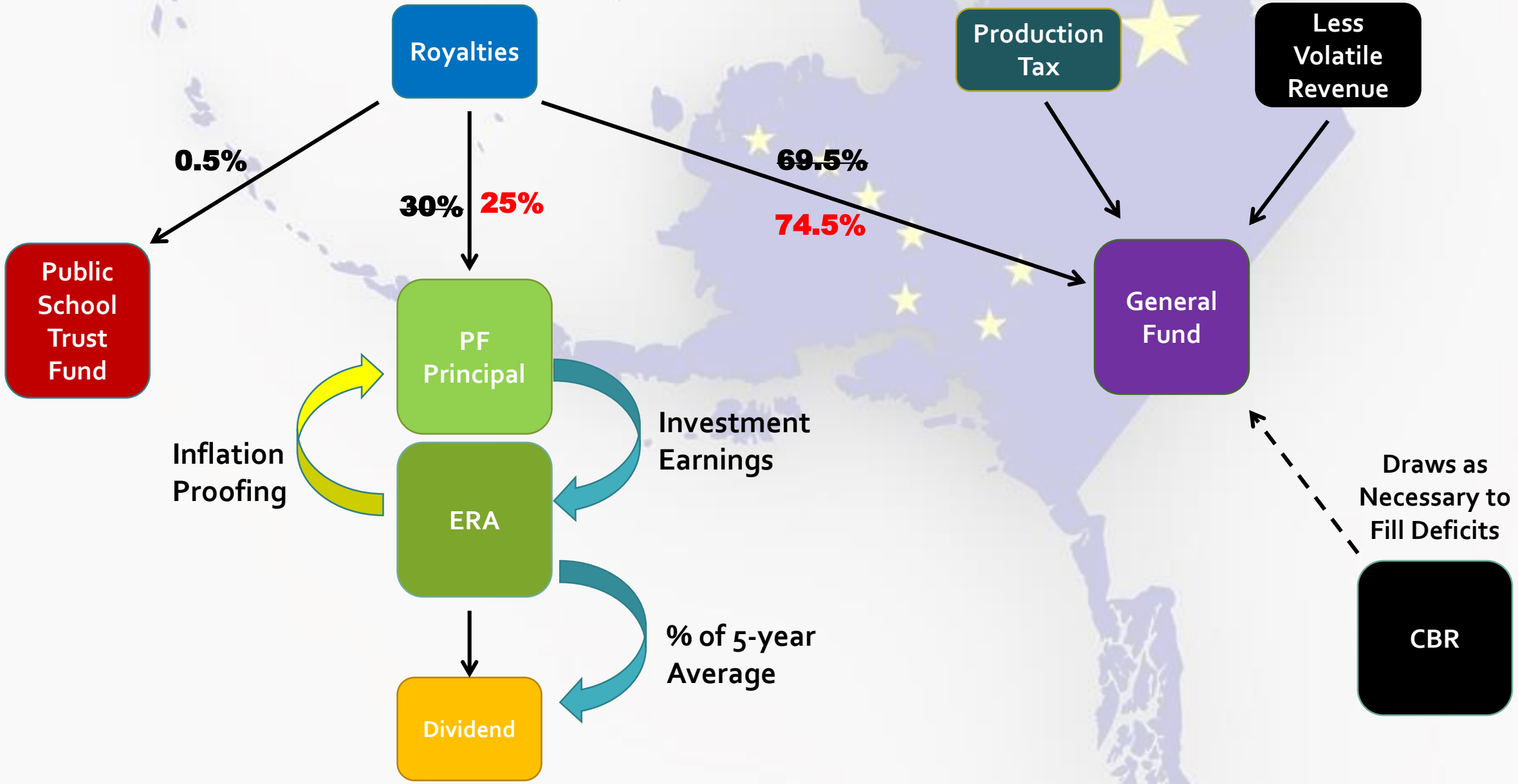
The Plumbing

4 basic Changes

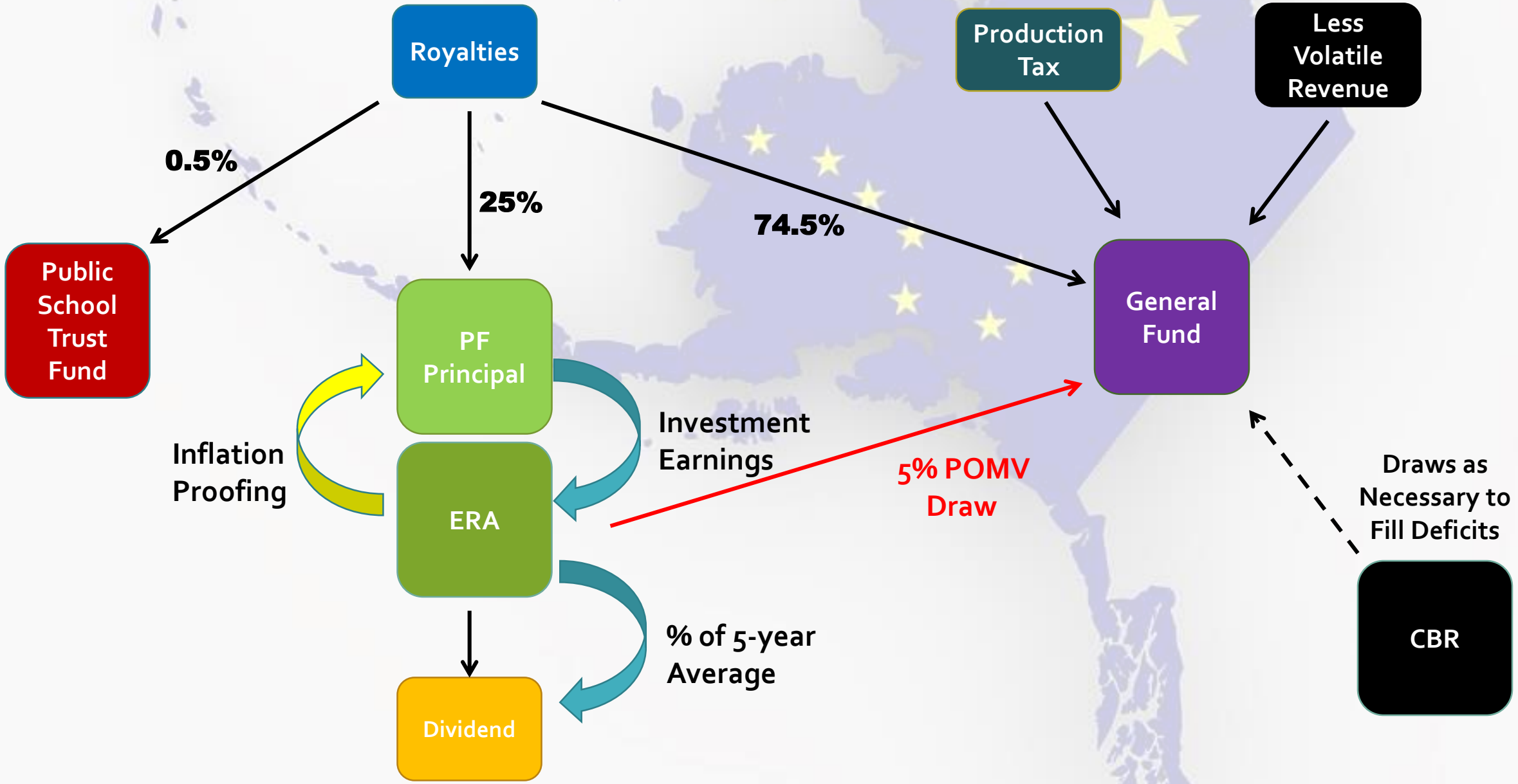
Current Cash Flow



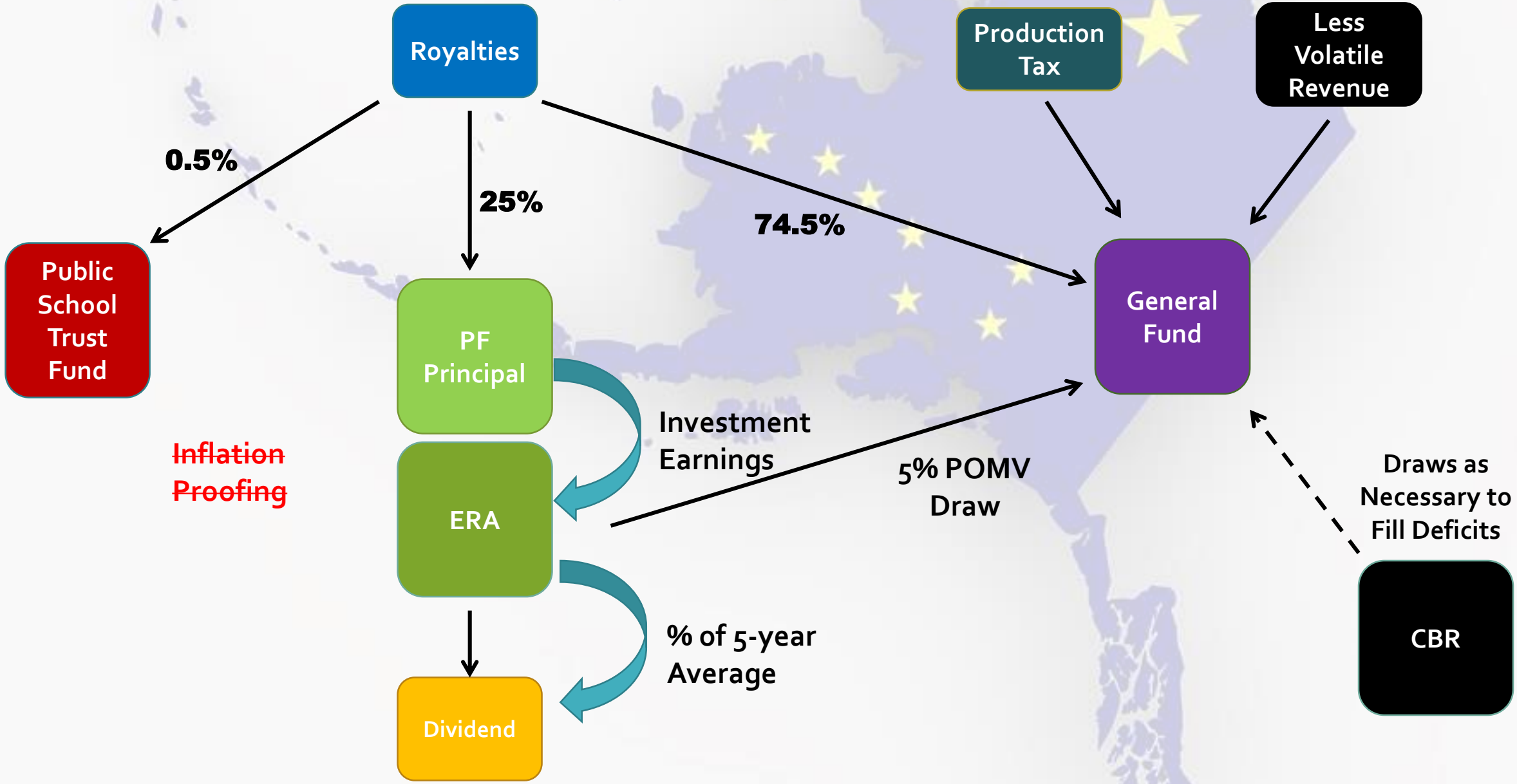
SB 114 Change 1. Royalty Percentage



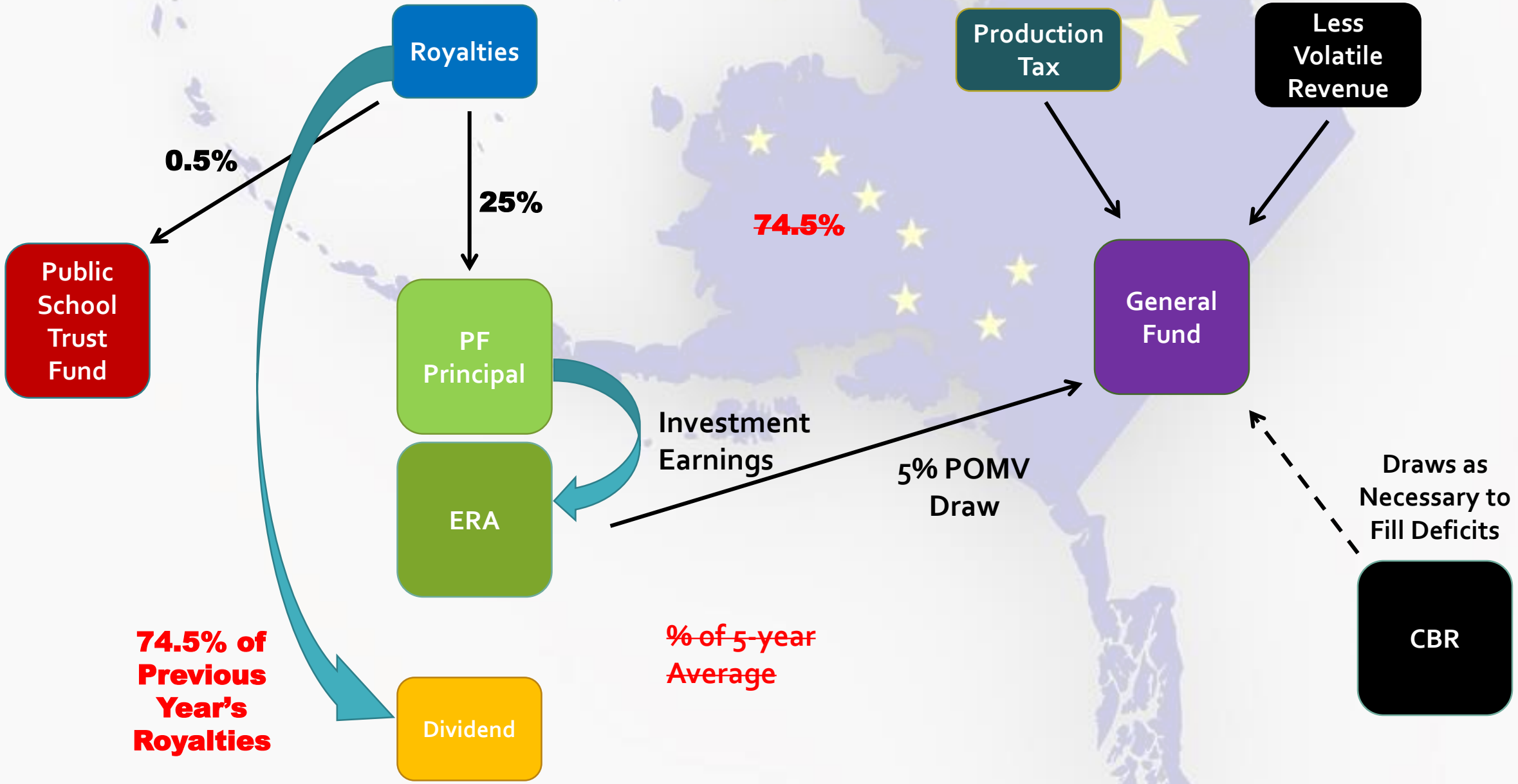
SB 114 Change 2. Add POMV Payout



SB 114 Change 3. Remove Inflation Proofing



SB 114 Change 4. Dividend Source and Calculation



SB 114: The SWAP- Rents and Royalties

- <u>Currently</u>,
  - 30% of all Royalties and Rents from
    - Oil, Gas and Federal Mining revenue
      - Deposited into the Permanent Fund corpus
  - 0.5% to School Trust Fund
  - 69.5% deposited to General Fund

SB 114: Rents and Royalties to Dividend

- 74.5% of all R&R would be deposited into the Dividend Fund
- No Permanent Fund Earnings would be used for Dividend
- SB 114: puts a floor (guarantee) of $1,000 Dividends

SB 114: PF Reserve Earnings Account and the General Fund

- The exchange for R&R to Dividend Fund:
  - 5% of the total value of the Permanent Fund (Corpus + ERA)
    Withdrawn from ERA
    Deposited into General Fund

    - This is often called a Percent of Market Value (POMV) concept
    - Returns on PF investments average more than 5%
      - Thus you inflation proof the PF plus the 25% R&R deposit
        The PF continues to grow

SB 114: PF Reserve Earnings Account and the General Fund Inflation Proofing?

Callan's Est. Return on Permanent Fund Investments = 6.9%

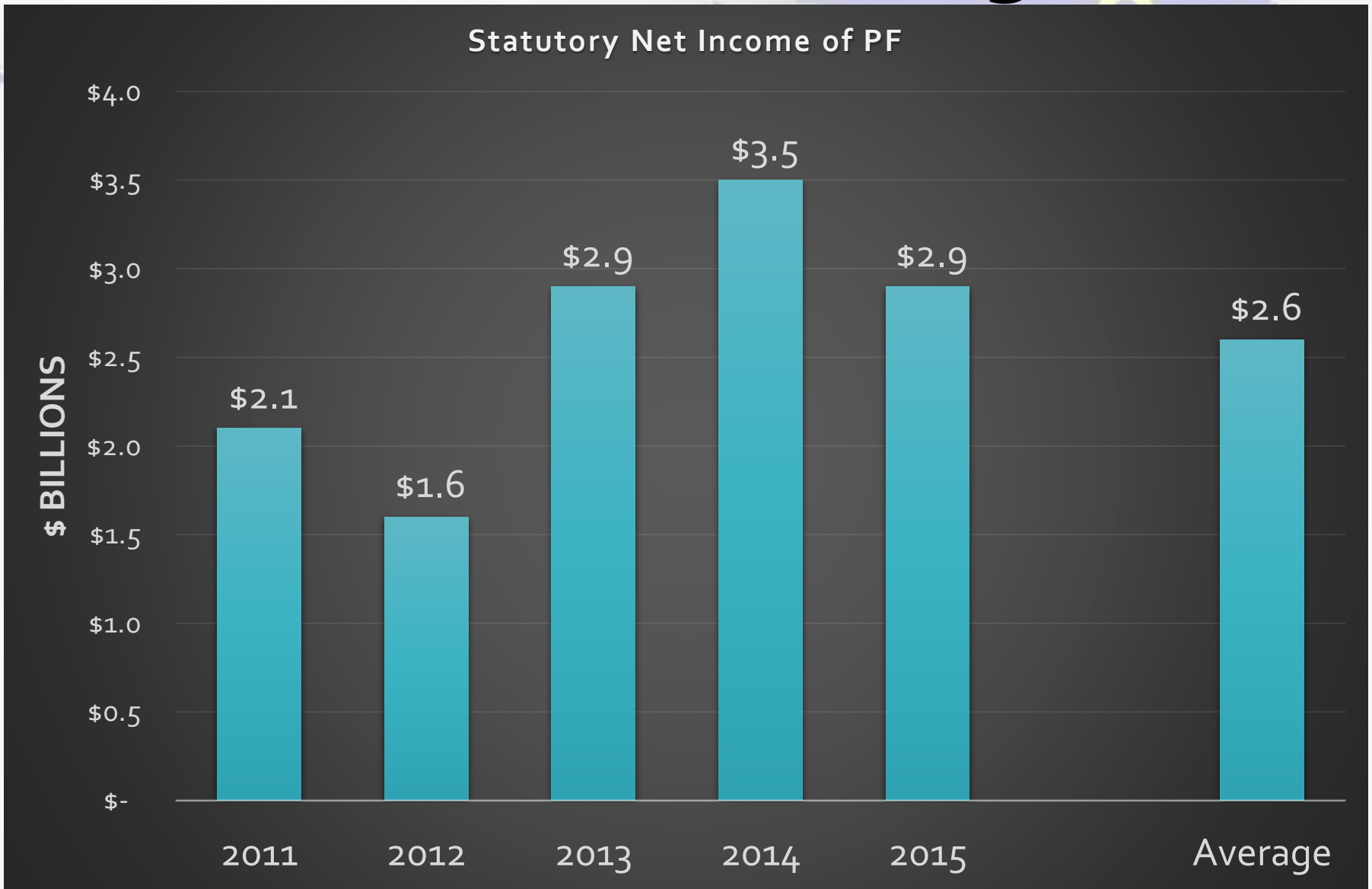
POMV Draw = 5%

To the Earnings Reserve Account = 1.9%

To the Corpus of the Permanent Fund = 25% of Royalties

Total Royalties $961M * 25%= $240M

SB 114: PF Reserve Earnings Account and Inflation Proofing?



SB 114: The Dividend

Two Scenarios

Currently the SS for SB 114 holds the 2016 Dividend harmless (status Quo)

This effects the amount of the POMV draw to the general fund

SB 114: The Dividend

Scenario 1

- **<u>2016 Dividend is Held Harmless (Status Quo)</u>**

- Dividend= More than **<u>$2,000</u>** (total payout $1,405 Billion)
- POMV= **<u>$1,269.3</u>** Billion net increase to General Fund

- This cuts the Deficit by **<u>1/3</u>**

SB 114: The Dividend

Scenario 2

- **<u>2016 The Royalties Swap Occurs</u>**

- Dividend= **<u>$1,023.74</u>** (total payout $715.9 Billion)
- POMV= **<u>$1,958.4</u>** Billion net increase to General Fund

- **<u>This Cuts the Deficit in half</u>**

SB 114Dividend and GF Scenarios

Scenario 1

- **Oct 2016 Dividend at Status Quo**
- Dividend= **$2,000**
- POMV= **$1,269.3 Billion**
- **This Cuts the Deficit by 1/3**

Scenario 2

- **2016 The Royalties Swap Occurs**
- Dividend= **$1,023.74**
- POMV= **$1,958.4 Billion**
- **This Cuts the Deficit in half**

Difference: $700Million

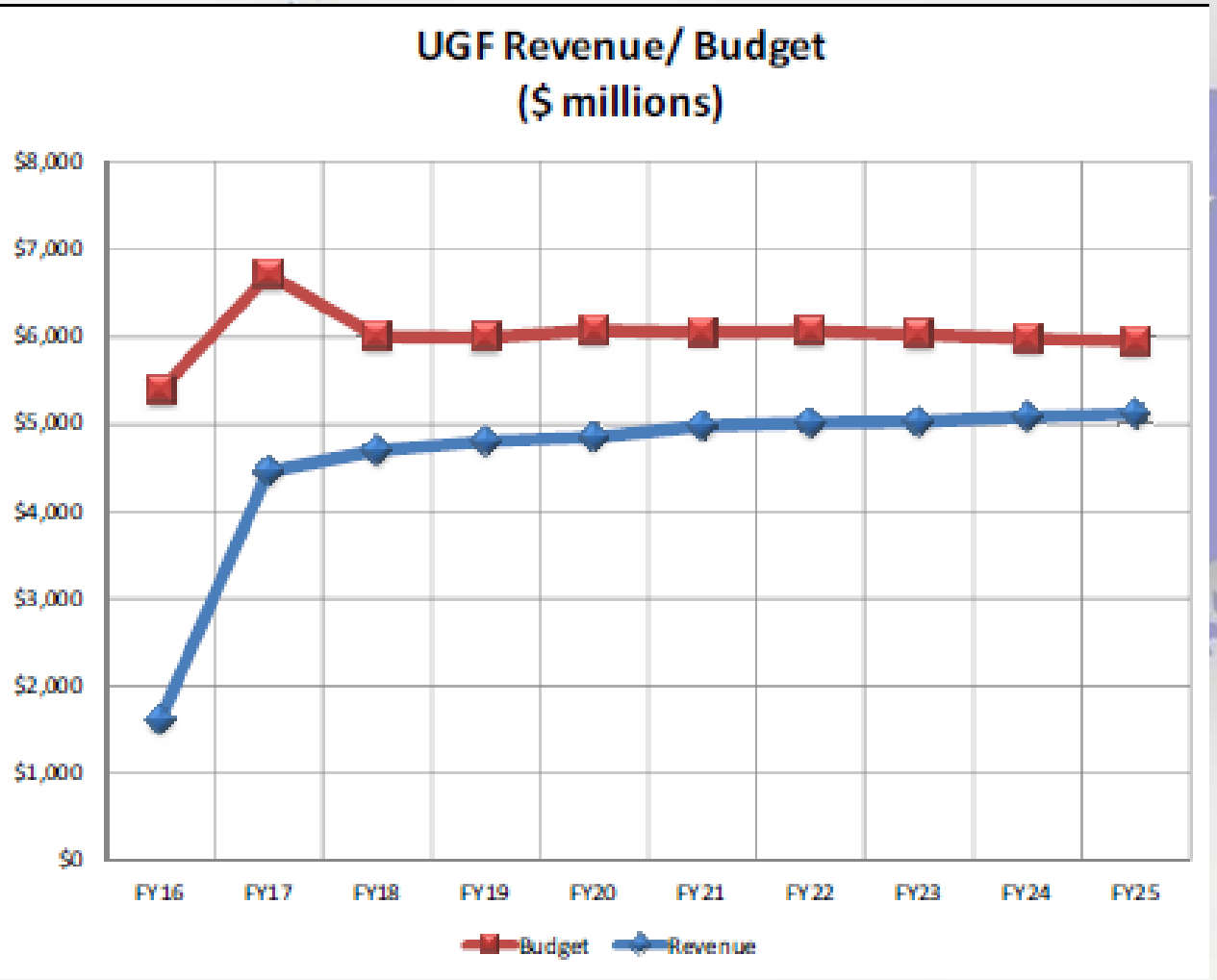
SB 114: Modeling

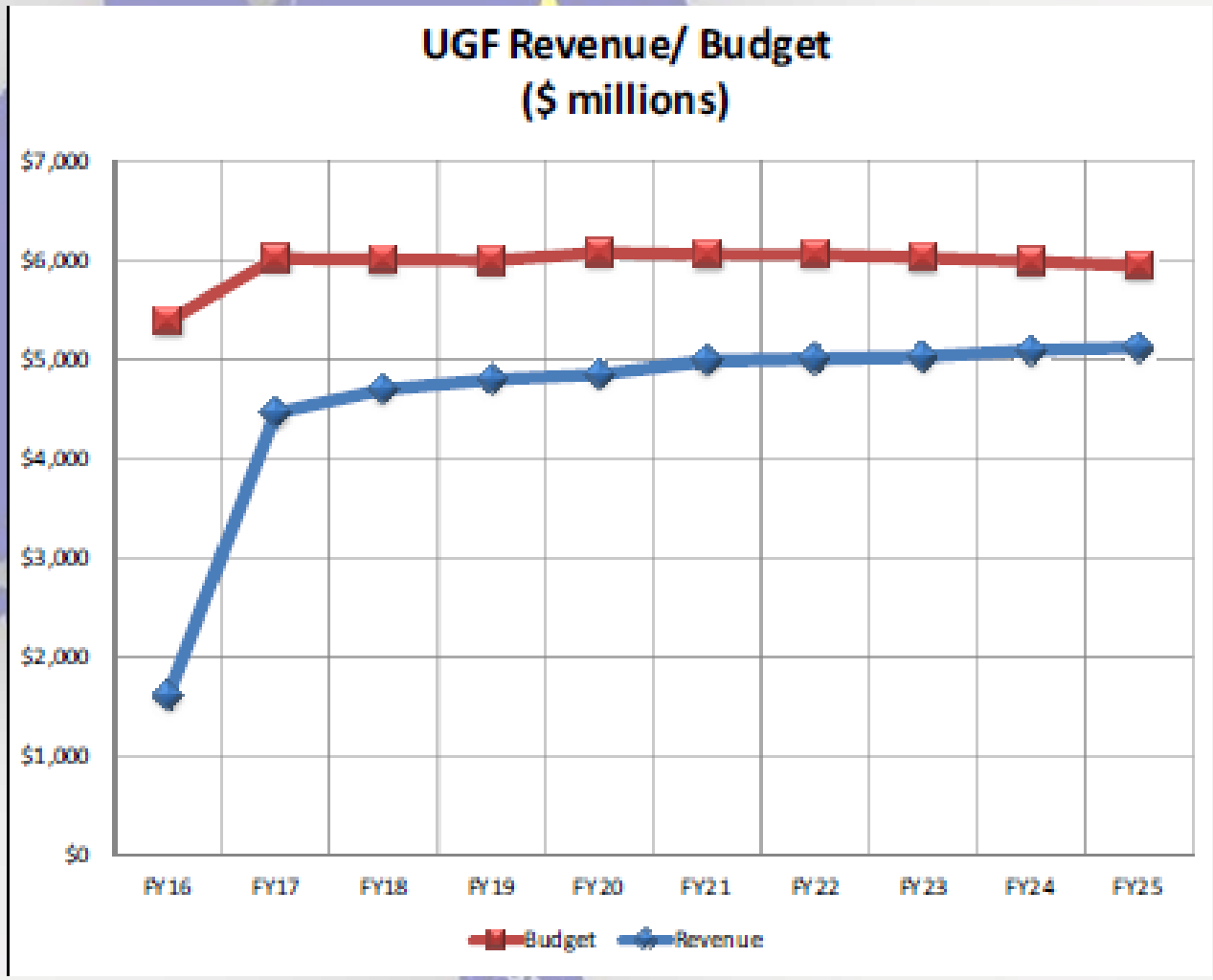
Scenario 1 **(Dividend held harmless in 2016)**

VS

Scenario 2 **(Swap occurs in 2016)**

SB 114: Modeling

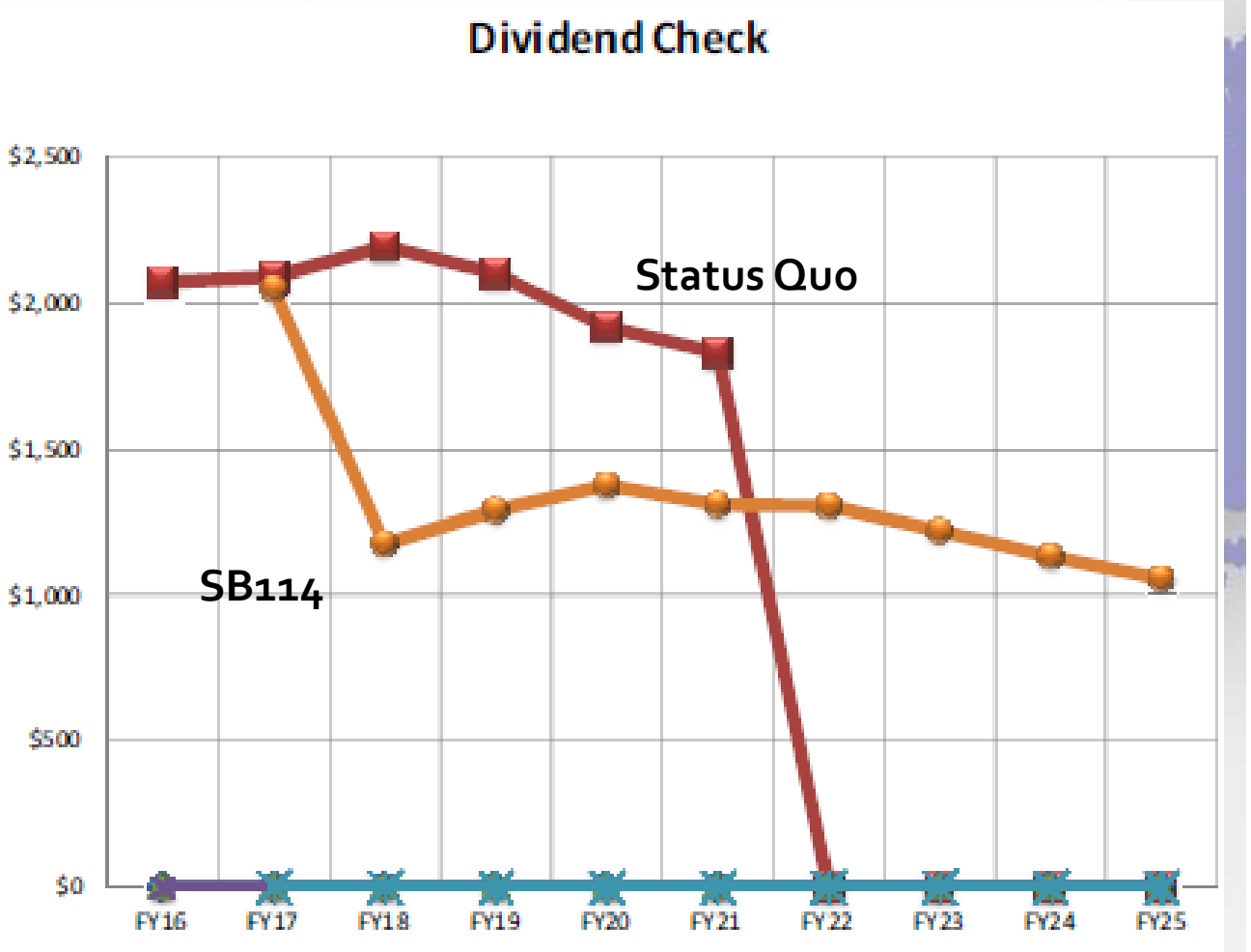




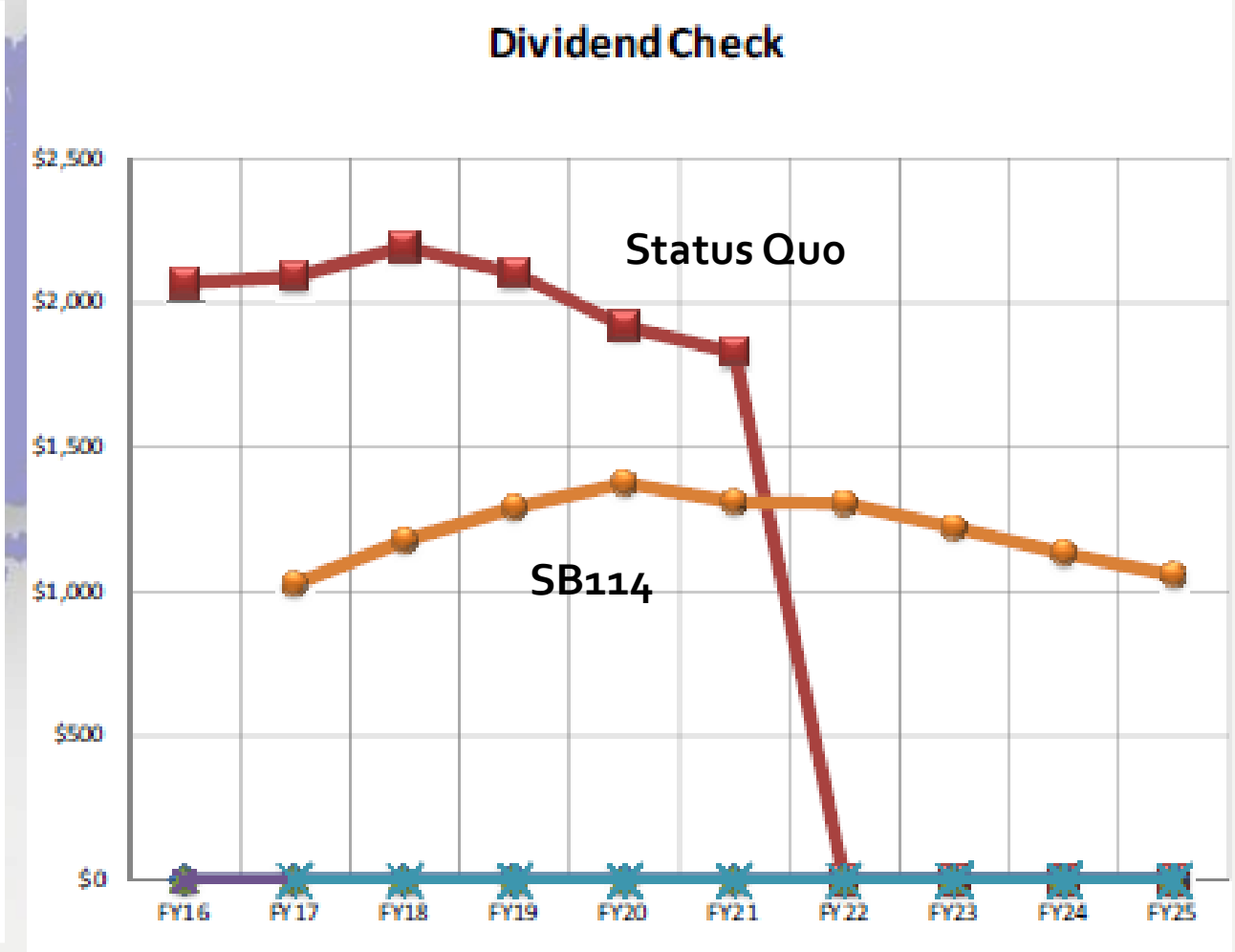
Scenario 1
Dividend held harmless

Scenario 2
Swap occurs in 2016

SB 114: Modeling

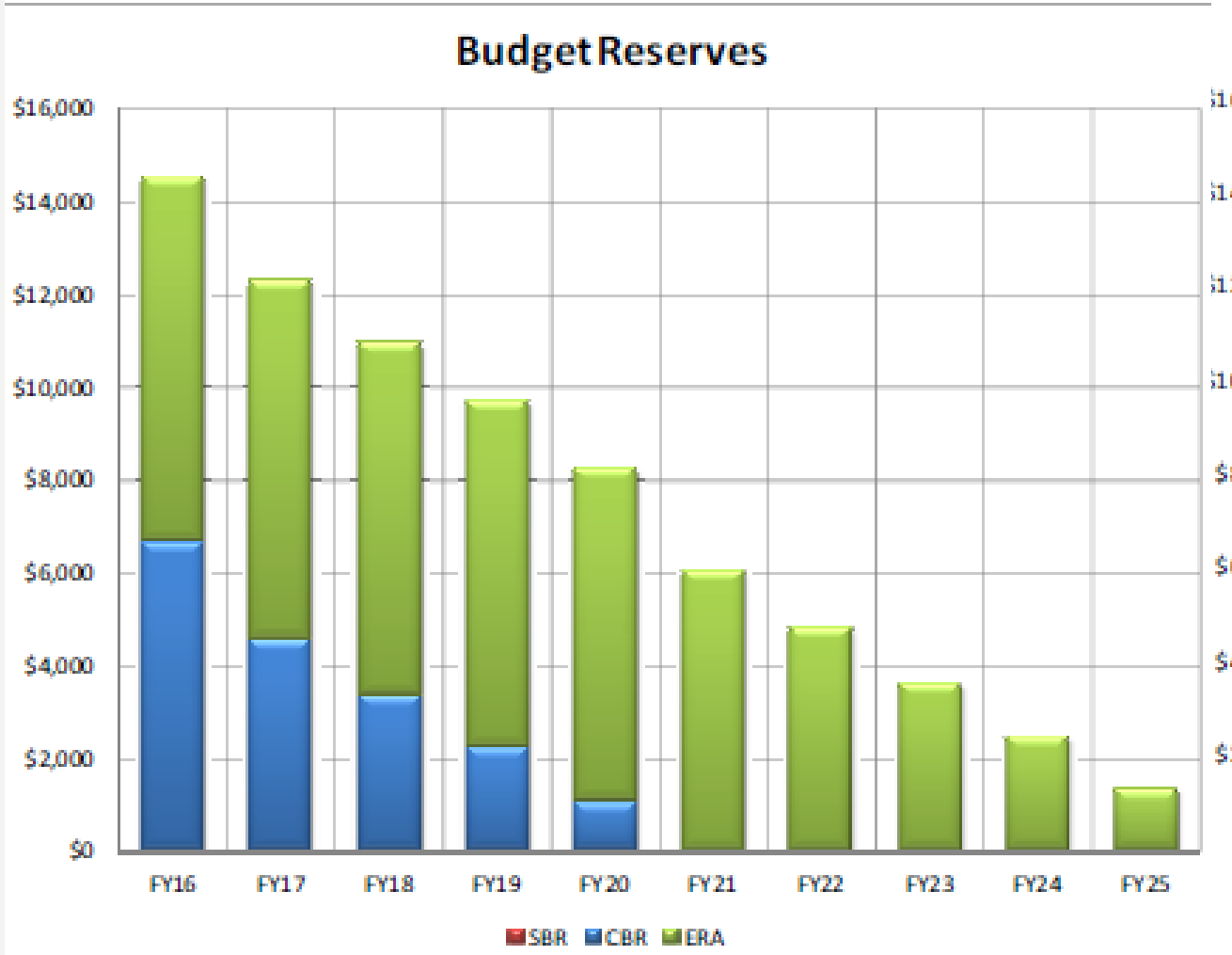


Scenario 1
Dividend held harmless

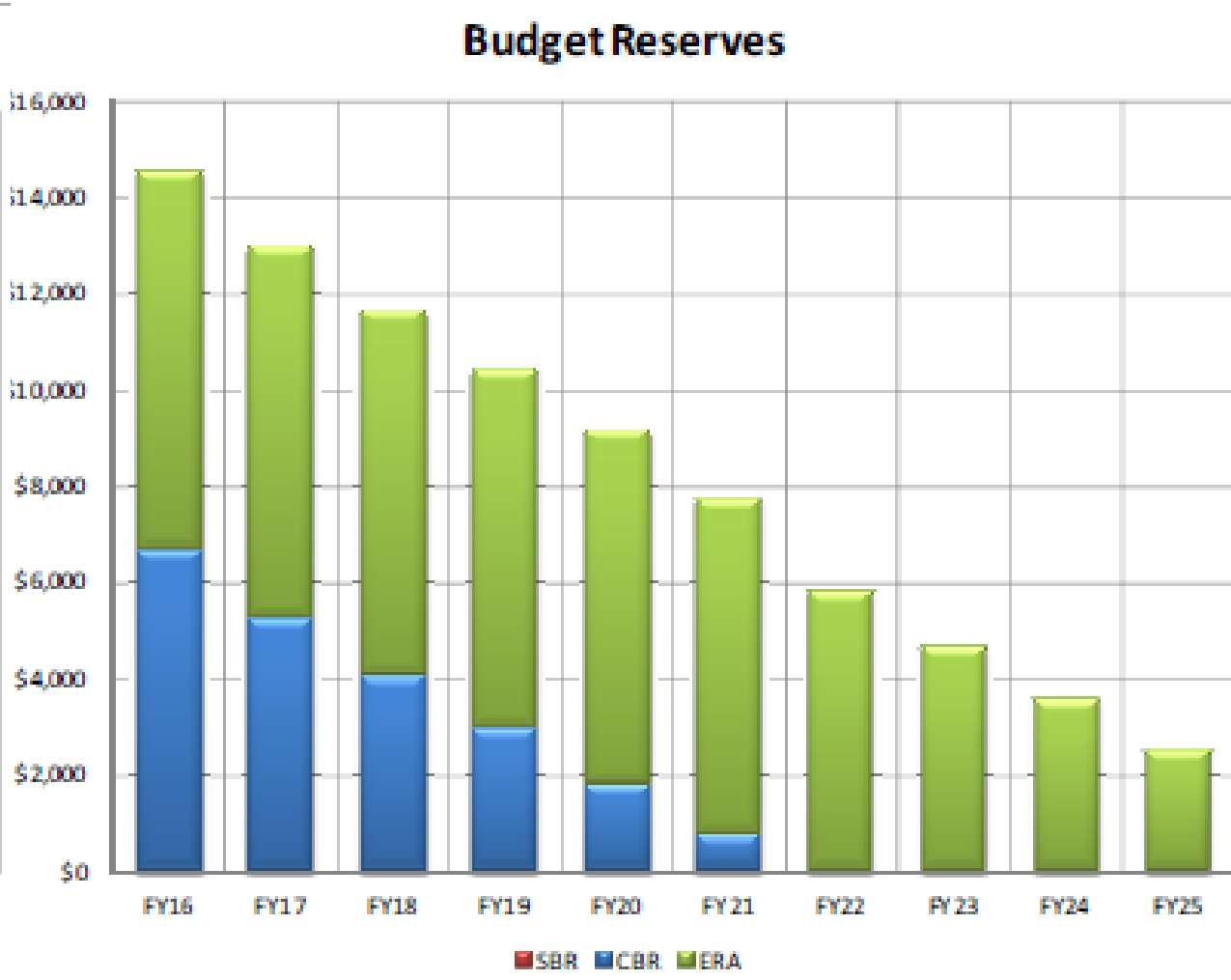


Scenario 2
Swap occurs in 2016

SB 114: Modeling



Scenario 1
Dividend held harmless

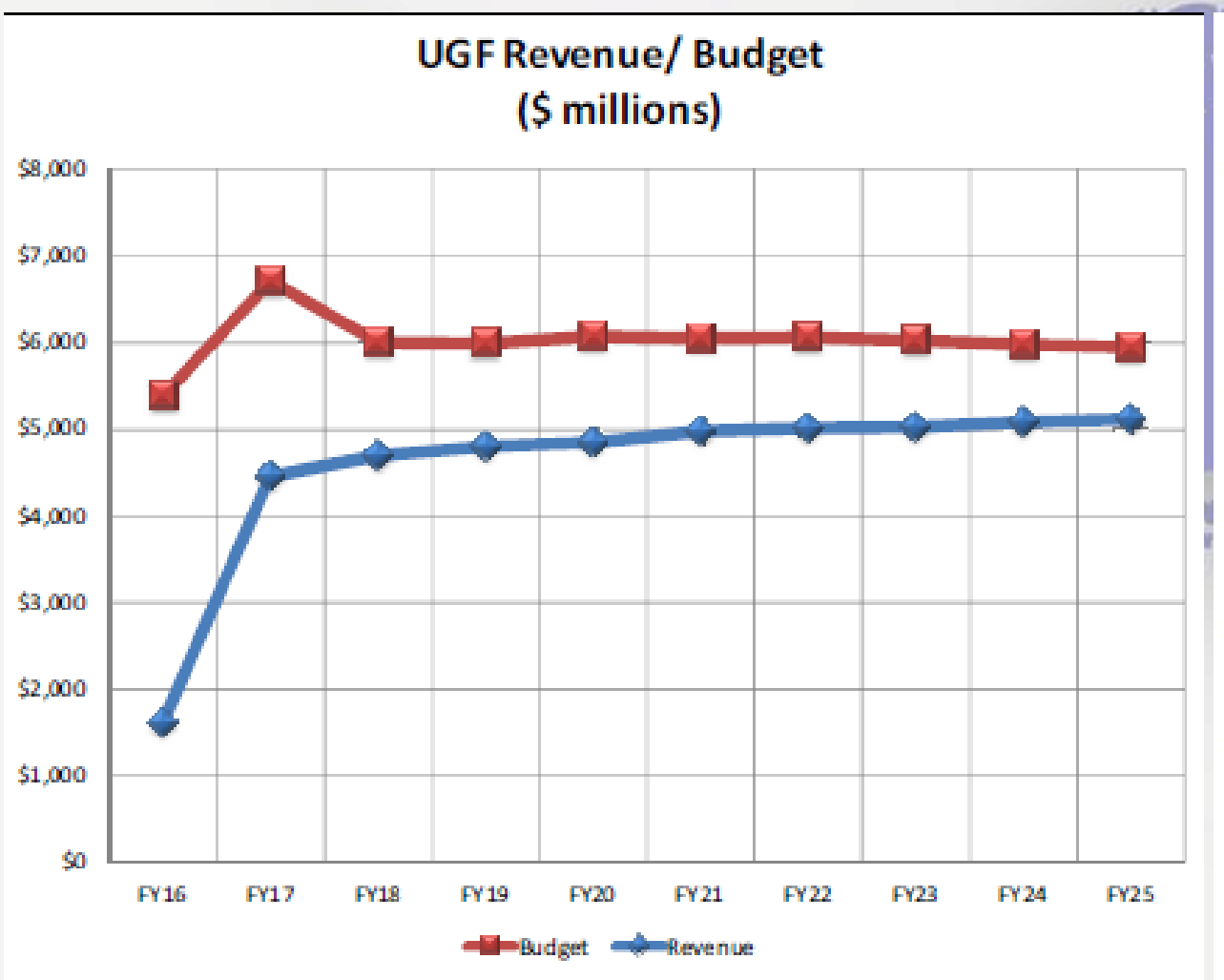


Scenario 2
Swap occurs in 2016

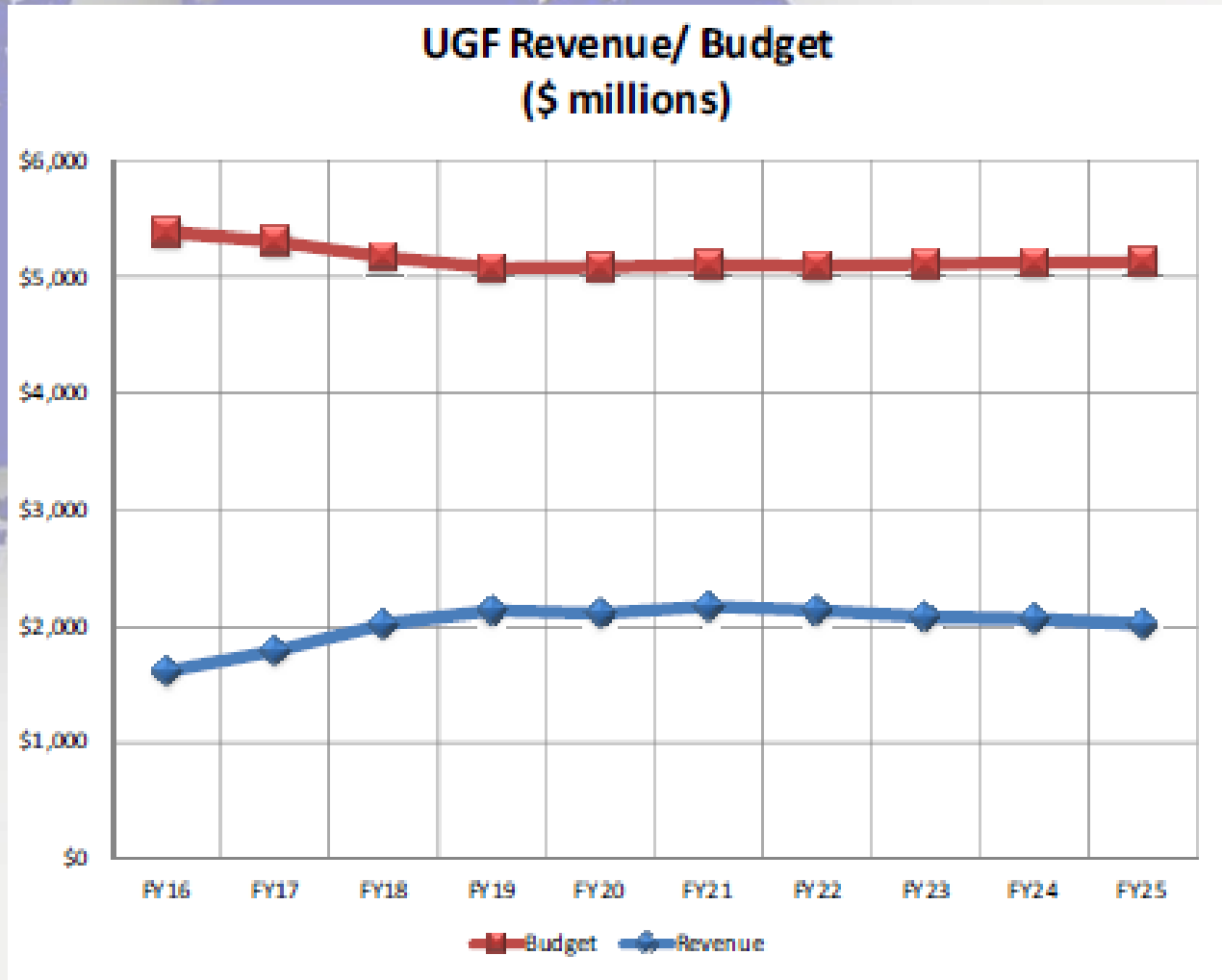
SB 114: Modeling Scenario 1 Vs Status Quo

(Dividend held harmless in 2016)

SB 114: Modeling Scenario 1

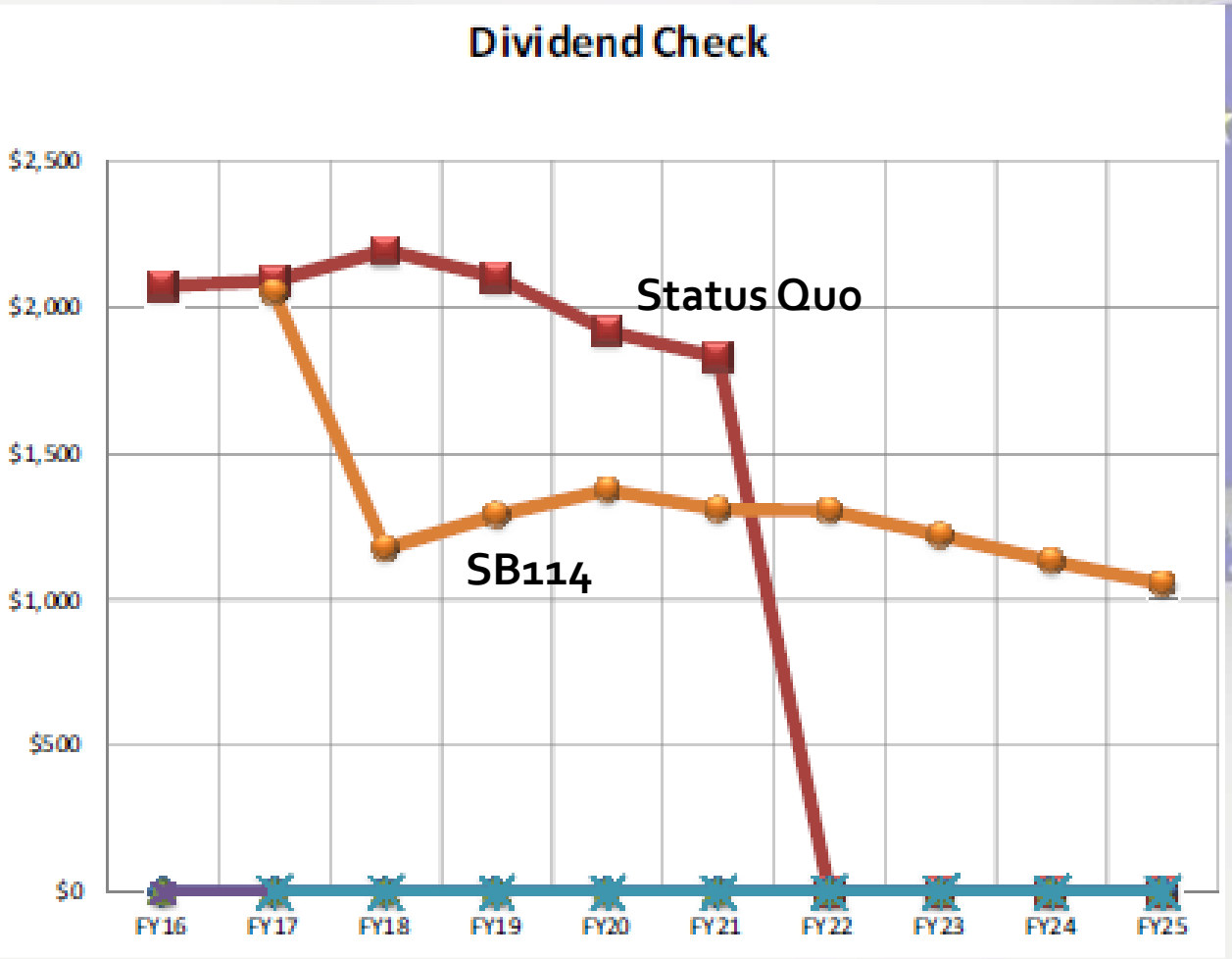


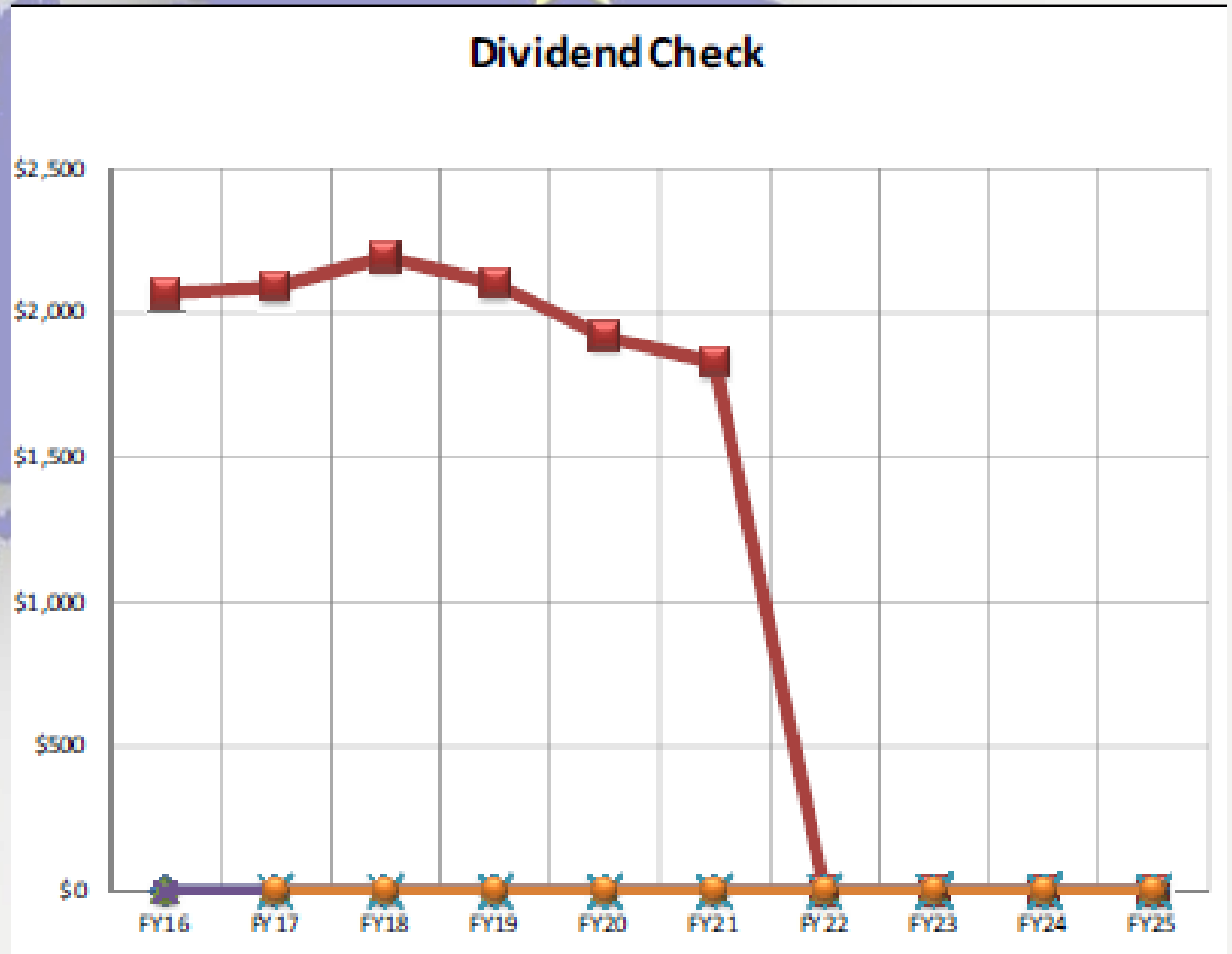
SB114



Status Quo

SB 114: Modeling Scenario 1

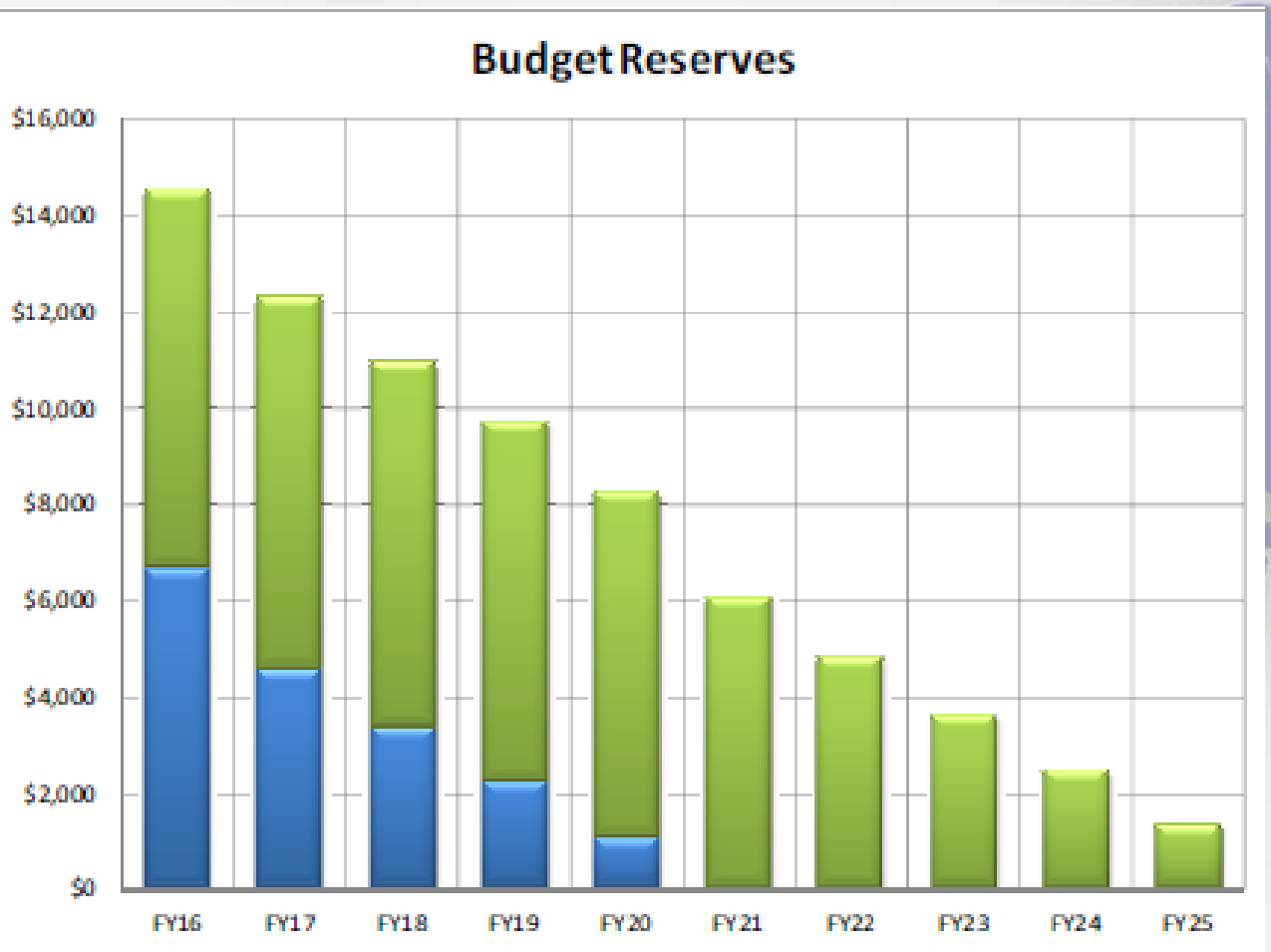


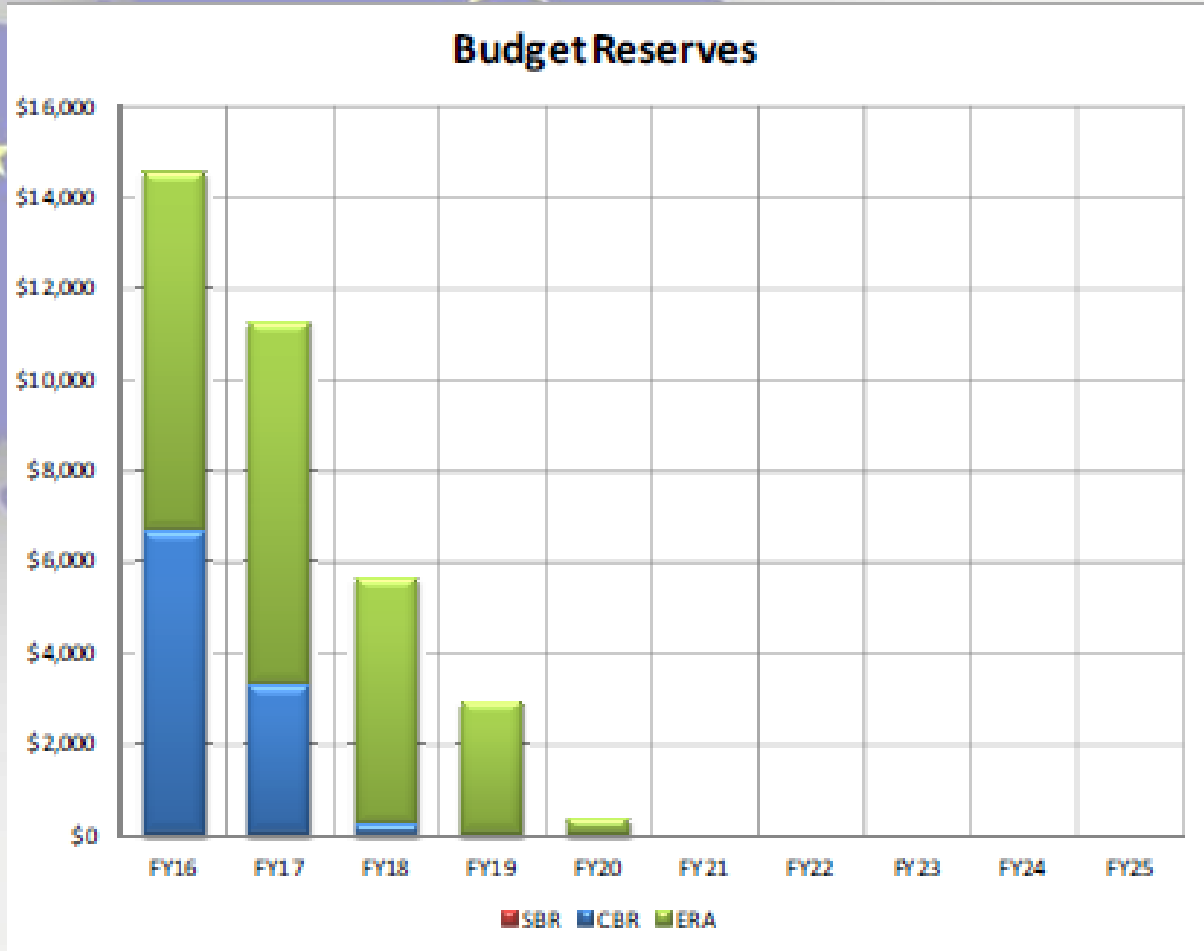


SB114

Status Quo

SB 114: Modeling Scenario 1



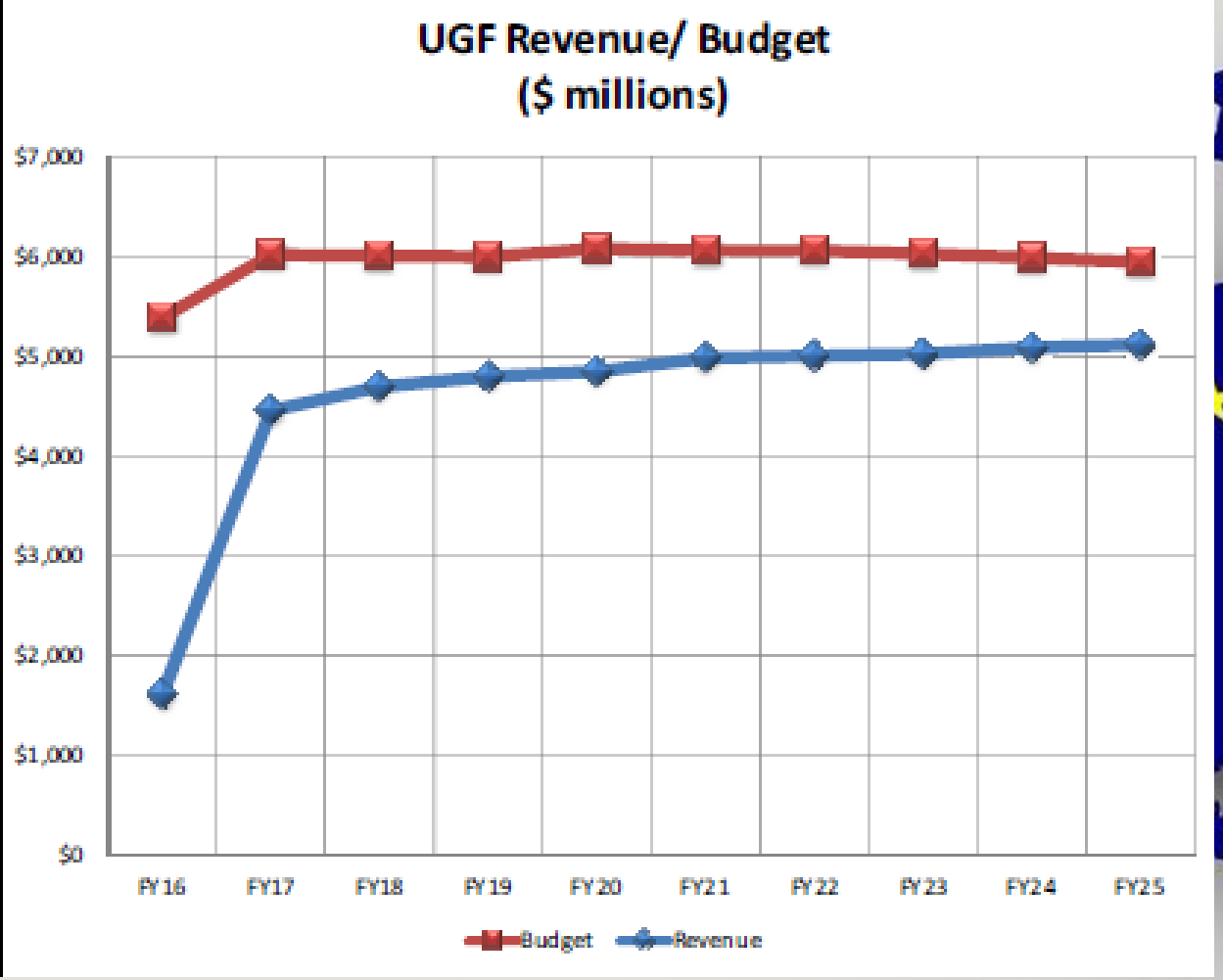


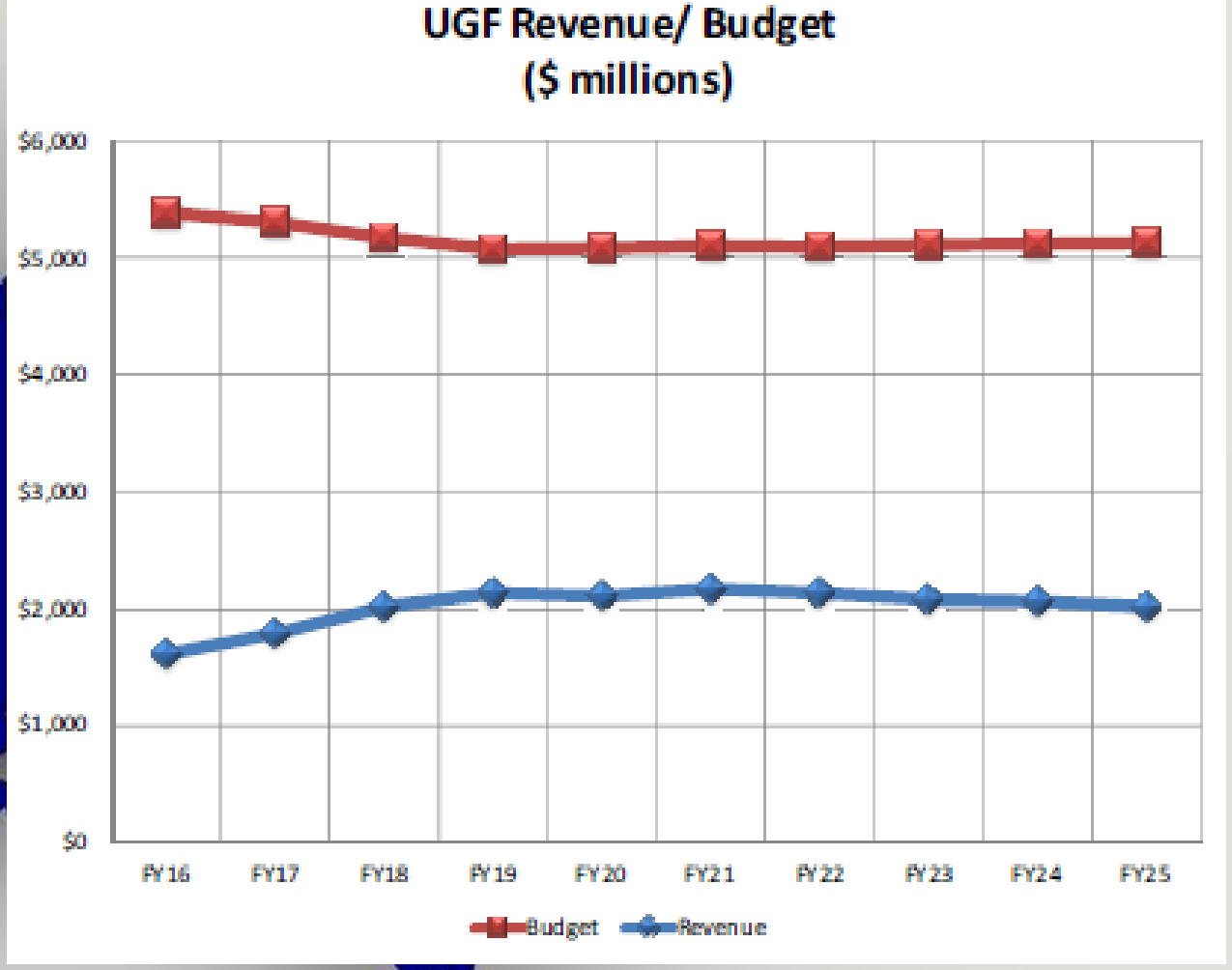
SB114

Status Quo

SB 114: Modeling Scenario 2 VS Status Quo

Dividend Swap in 2016

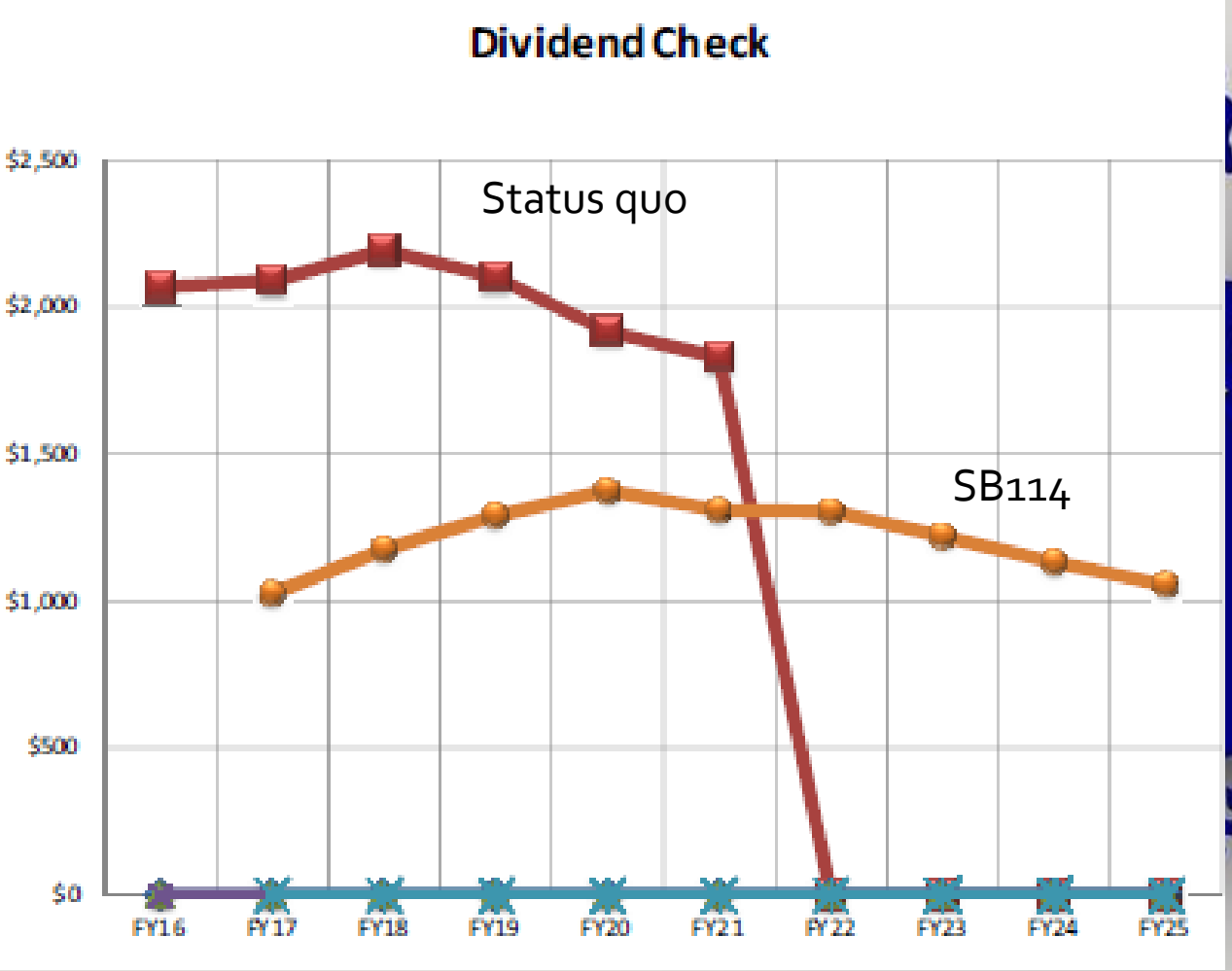


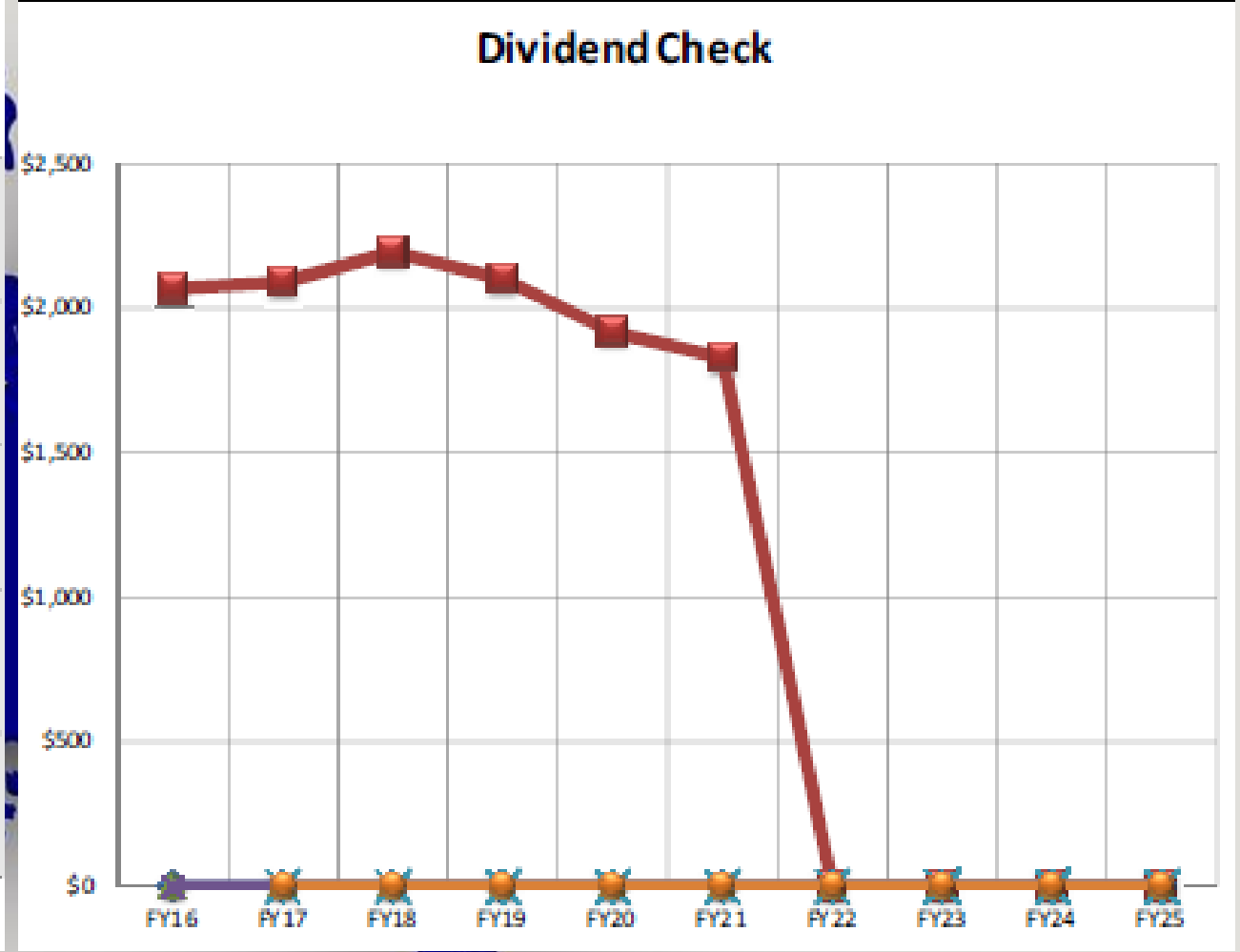


SB114

Status Quo

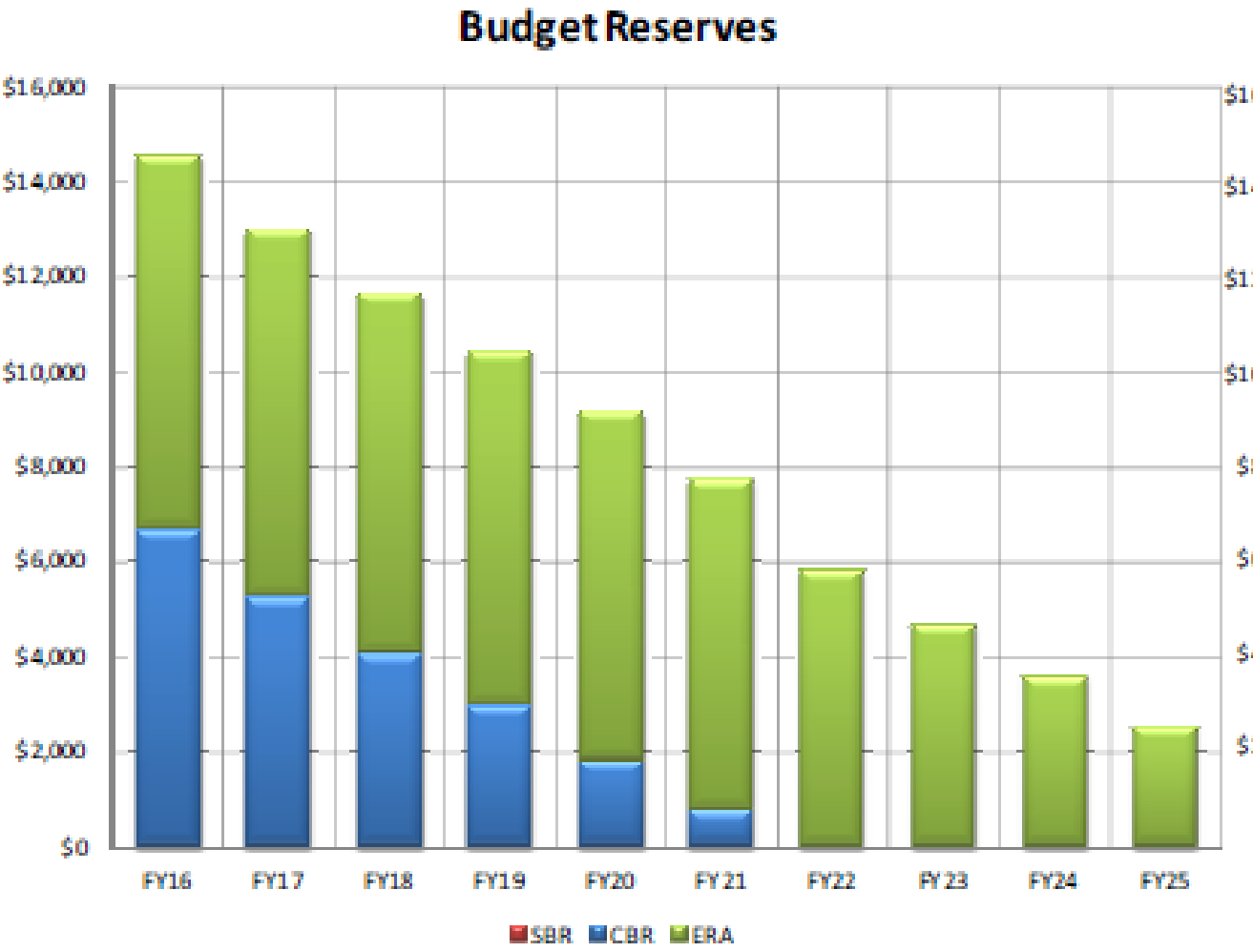
53

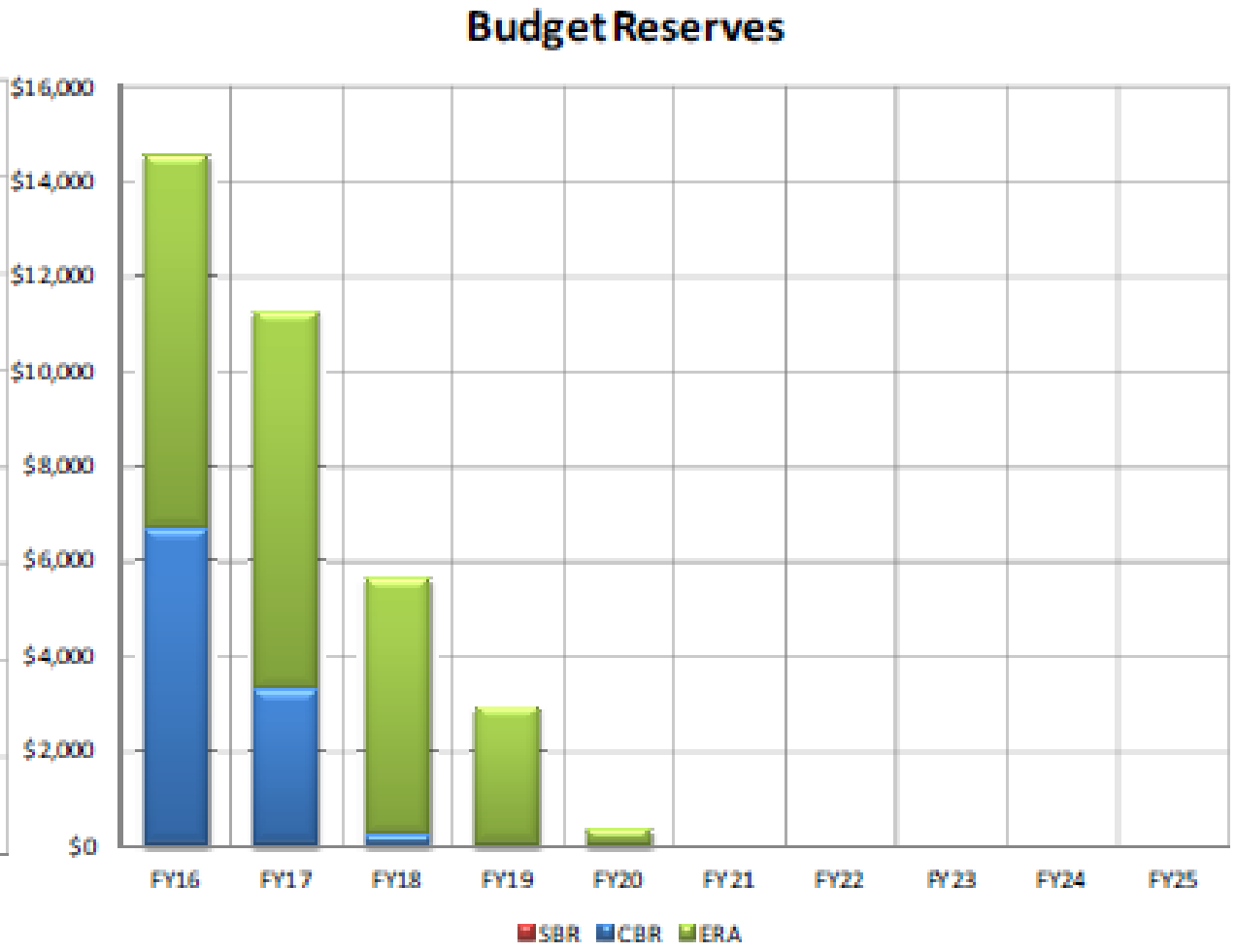




SB114

Status Quo





SB114

Status Quo

SB 114: The overall effect

- **Ties the Dividend directly to Oil & Gas and Mineral production**
  - **Currently structured to pay a dividend with a floor of $1,000**
  - **Protects the Dividend for future generations**
- **Reduces the CBR draw to cover deficit**
  - **This will extend the life of the CBR several years**
- **Gives the legislature "Glide Path" (breathing room) to consider**
  - **Additional budget cuts**
  - **New sources of revenue**
- **Reduces the deficit between 1/3 and ½ depending on final formula (scenario 1 vs scenario 2)**

SB 114: The overall effect

- **Maintains downward pressure on the operating budget- by not closing the gap**
- **Provides for constitutional and statutory underpinnings of the PF**
- **Reduces the volatility in the budget process**
  - **Stability**
- **A POMV is a proven model and considered "Best Practice" by many fund managers**

SB 114: Final Thoughts

- **Alaska has always been a "Boom and Bust" state (now due to commodity volatility)**
  - **BUT, <u>we don't have to be</u>**

- **We are in Chapter 38 of ALASKA**
  - **How do we want the next chapters to read?**

SB 114: Our Glide Path

59