The Alaska Permanent Fund Protection Act

For a Strong Alaskan Economy and an Enduring Permanent Fund

The centerpiece of the New Sustainable Alaska Plan, the Alaska Permanent Fund Protection Act (APFPA) establishes a new fiscal framework to address the bulk of this year's budget gap. This new framework replaces volatile petroleum revenues with a sustainable and consistent $3.3 billion endowment draw from the Permanent Fund's earnings reserve account (ERA) as the primary funding source for unrestricted General Fund expenditures. The APFPA also reforms the formula for calculating dividends to connect Alaskans with the state's economic health.

The main components of this new fiscal framework include:

(1) Depositing volatile petroleum royalty and production tax revenue into the Permanent Fund;

(2) Transferring a stable $3.3 billion endowment draw from the ERA to the General Fund for annual spending; and

(3) Distributing 50% of royalties in a dividend to Alaskans.

By directing the highly variable flow of petroleum revenue into a larger pool of assets and correctly calibrating annual withdrawals from that pool, the APFPA harnesses the state's financial wealth to provide long-term stability to the state budget while preserving the dividend program and the value of the Permanent Fund.

More than helping to resolve this year's fiscal challenge, the APFPA ends four decades of boom-and-bust budgeting and the damaging impact those cycles have on the broader state economy. Backed by rigorous financial modeling, this is the change that will correct the structural imbalance in our fiscal framework, regain the confidence of the credit rating agencies, and set Alaska on a course to greater economic prosperity.

Incoming Revenue Placement

The APFPA fiscal structure distributes annual revenue between the fund and dividends:

Mineral Royalties: 50% to the dividend; 49.5% to the Permanent Fund[1]

Production Taxes: 100% to the Permanent Fund

Investment Income: 100% to the Permanent Fund

Within the Permanent Fund, the incoming revenue is allocated between the corpus and the ERA according to two rules. First, the constitution requires that 25% of royalties go to the corpus. Second, the remaining revenue is allocated to maintain the ERA at a target balance of four times the prior year's draw. Investment income is the first revenue to maintain the ERA balance. All additional revenue – royalties, taxes, and investment income – beyond the amount required to maintain the target balance goes to the corpus where it is constitutionally protected.

Calibrating the Endowment Draw

To be sustainable over the long-term, the draw must be calibrated to ensure that it does not degrade the value of the financial assets and to allow opportunity for growth in the fund. Reasoned assumptions, paired with the best available data, underlie the probabilistic financial model used to determine the amount that may be sustainably withdrawn on an annual basis.

The probabilistic modeling of oil price and investment income is crucial. Unlike a deterministic calculation, which uses singular inputs for each variable and calculates a single anticipated future outcome, the probabilistic model uses a range of inputs and produces a range of potential future outcomes. Given the annual variability in both investment returns and petroleum revenues, the probabilistic model provides essential insight about the down-side risk and the up-side potential.

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[1] AS 37.14.150 directs one-half of one percent of mineral royalties to the Public School Trust Fund.

The significant modeling constraints, assumptions, and data inputs include:

- Sustainability Metrics: (1) maintain the real value of starting assets and (2) ensure the durability of the ERA to avoid pressure to spend from the corpus
- Starting Fund Value: $55 billion (APFC forecast for end of FY16 and a $3 billion transfer from the Constitutional Budget Reserve)
- Oil Price: modeled probabilistic using DOR Fall 2015 forecasting session data
- Oil Production: DOR Fall 2015 Revenue Sources Book (deterministic modeling)[2]
- Investment Returns: 6.90% total return, 6.01% statutory return (Callan Associates)
- Inflation: 2.25% (Callan Associates)

Using these assumptions, if the draw is not adjusted for inflation until 2020, the system can sustainably produce an annual draw of $3.3 billion.

Understanding that it is impossible to know future outcomes with certainty, the APFPA institutes a periodic review to ensure the draw remains sustainable and may be adjusted if necessary. Specifically, the APFPA requires that in 2017, 2020, and every four years thereafter the Commissioner of Revenue will issue a Sufficiency of Assets Report that includes:

1. An evaluation of the sufficiency of the ERA balance, given anticipated revenues;
2. An evaluation of the long-term sustainability of the draw amount; and
3. A determination that the draw amount (a) may be continued or (b) is unsustainable and recommend a reduced draw or another adjustment strategy.

To ensure the legislature and the public may review and critique the recommended draw, to ensure transparency, the APFPA requires publication of the underlying data and calculations in their native file format.

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[2] The model does not include production beyond the projects reflected in the official revenue forecast. Projects excluded from the analysis include many potential large projects, such as AKLNG. Generally, future projects would improve the durability of the system and increase the growth of both the Permanent Fund and dividends. The production forecast is one source of conservatism in the model.

Royalty Dividend

Under the current fiscal framework, the state does not have adequate financial resources to fund a dividend over a sustained period of low petroleum revenue without also imposing a heavy tax burden on Alaskans. The existing dividend distributes investment income from the ERA. But, the state is on course to begin funding the budget from the ERA in FY2018. Without a change, Alaskans will soon face a depleted ERA, no dividend payouts, and the prospect of spending down the corpus of the Permanent Fund.

The APFPA funds the dividend from 50% of resource royalties – the state's ownership share of natural resources. Based on the royalty forecast in the APFPA model, this formula produces dividends listed in Table 1. The forecast below does not include new resource development; so, dividends will increase beyond this forecast as new projects produce new royalty revenues.

Table 1: 50% Royalty Dividend Forecast[3]

	2017	**2018**	**2019**	**2020**	**2021**	**2022**	**2023**	**2024**	**2025**	**2026**
Un-risked	$850	$932	$1017	$1014	$1057	$1038	$999	$949	$928	$877
Risked	$850	$923	$977	$939	$951	$908	$849	$787	$755	$700

While changing the dividend formula is necessary for a sustainable fiscal framework, in the current oil price environment, the forecast does mark a substantial step down from the last dividend checks. To smooth the transition, the APFPA supplements the 2016 dividend so the checks total $1000 per person.

The royalty dividend equitably distributes Alaska's resource wealth across generations. This formula also allocates a specific and independent revenue stream to dividends to ensure the program continues even as the state makes the necessary changes to correct the current fiscal imbalance and provide a stable economic environment for positive private-sector growth in the state.

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[3] This forecast includes adjustments for population growth and program costs. The RSB publishes risked values –values that are discounted to account for the uncertainty of future events.