Permanent Fund Protection Act

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Basic Elements of the Bill

The Permanent Fund Protection Act proposes:

1. A framework for sustainable withdrawals from the earnings reserve account (ERA) and

2. A sustainable dividend formula.

Presentation Overview

Part I: The Problem

Part II: The Permanent Fund

Part III: The Permanent Fund's Role in a Solution

Part IV: The Bill

Part V: Conclusion & Sectional

Part I

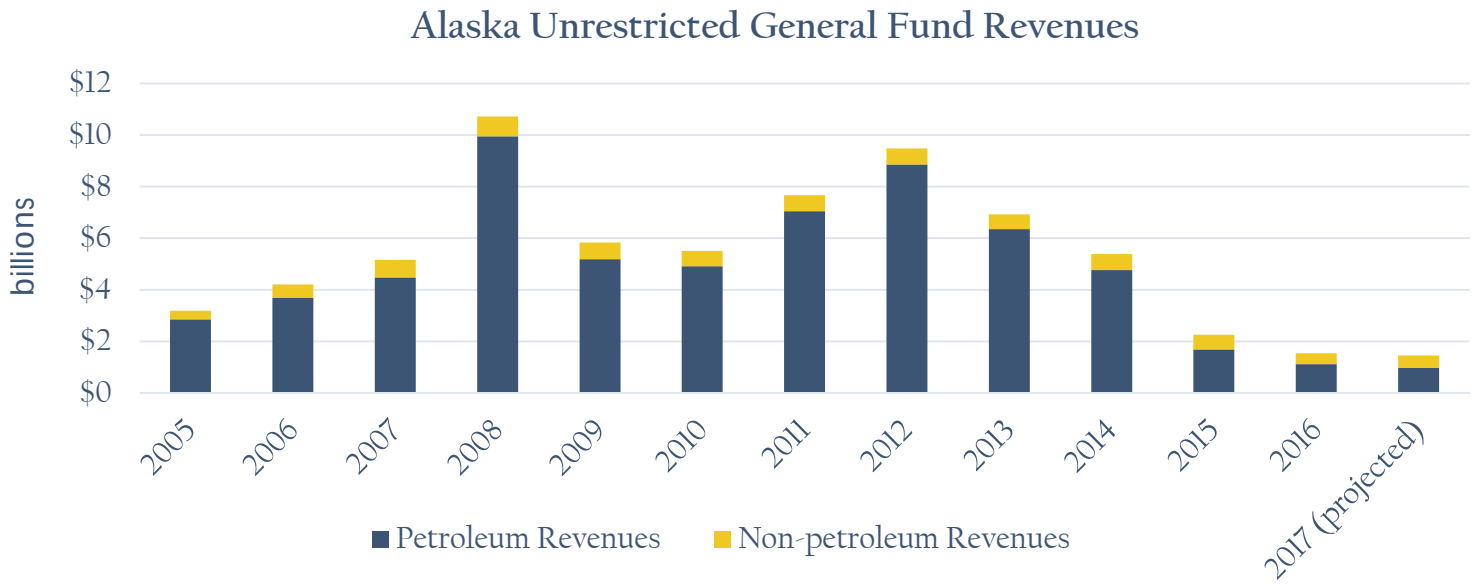
Defining the Problem

The Problem

1. Low oil revenues
2. Persistent deficit
3. Diminished budget reserves

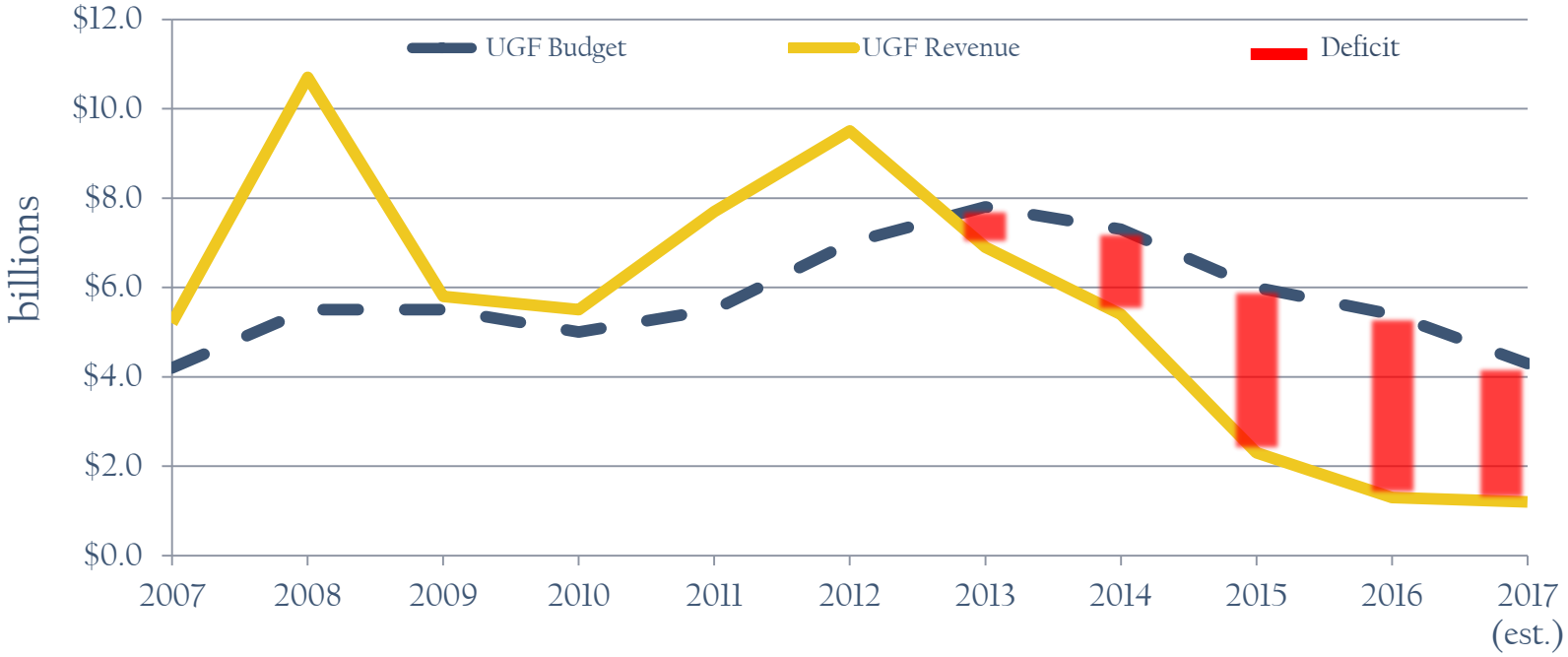
Low Oil Revenue

- From 2005 to 2014, over 90% of UGF revenues came from petroleum.
- Between 2012 and 2015, oil revenue fell by $7.8 billion – a 88% drop.

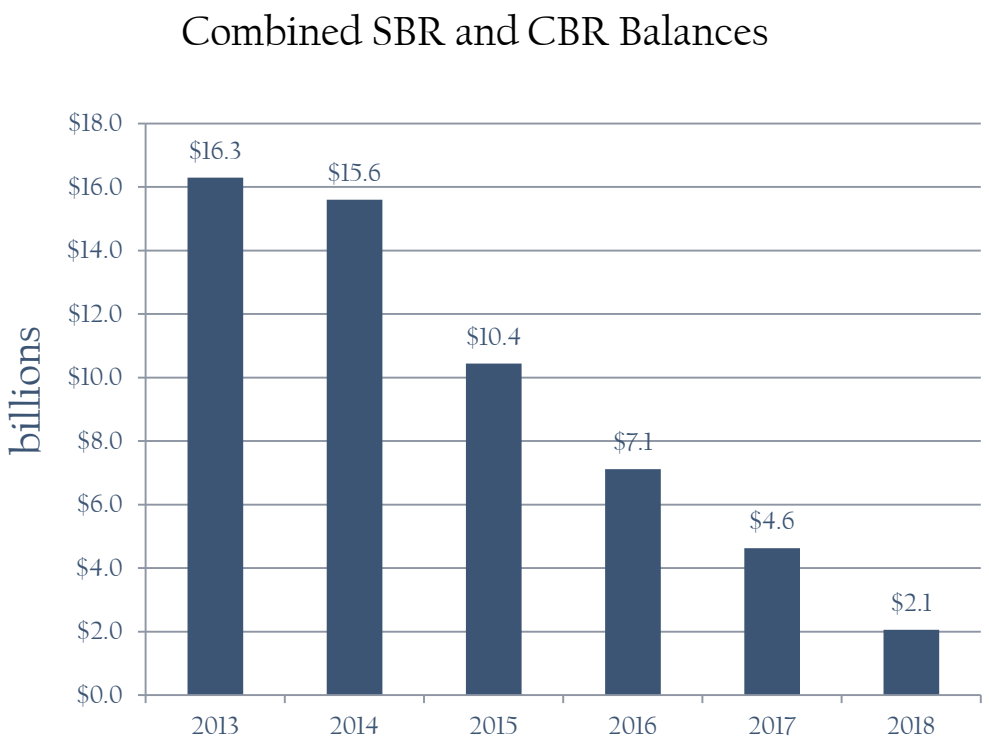


"Deficit" Spending

- Although the UGF budget has been cut by 44% since 2013, the deficit remains.



Diminished Budget Reserves



- Since 2013, the state has relied upon its reserves to balance the budget.
- Totaling $16.3 billion in 2013, the budget reserve funds will hold less than $5 billion by the end of FY17.
- Without new revenue options, the remaining budget reserves will be gone early in FY19.

The Problem

Once the budget reserves are depleted,

the only place to turn is the permanent fund.

Part II

The Permanent Fund

The Permanent Fund: Structure

1. **Principal**: $44.2 billion
   ($39.4 billion non-spendable and $4.7 billion of unrealized gains)

   "Alaska Permanent Fund - At least twenty-five per cent of all [mineral royalties] received by the State shall be placed in a permanent fund, the principal of which shall be used only for those income-producing investments specifically designated by law as eligible for permanent fund investments. All income from the permanent fund shall be deposited in the general fund unless otherwise provided by law." Alaska Const., Art. 9 Sec. 15

2. **Earnings Reserve Account**: $8.6 billion

   "The earnings reserve account is established as a separate account in the [permanent] fund. Income from the fund shall be deposited by the corporation into the account as soon as it is received. Money in the account shall be invested in investments authorized under AS 37.13.120." AS 37.13.145(a)

* Balances as of the end of fiscal year 2016 as listed in APFC "history and projections" report (Nov. 2016).

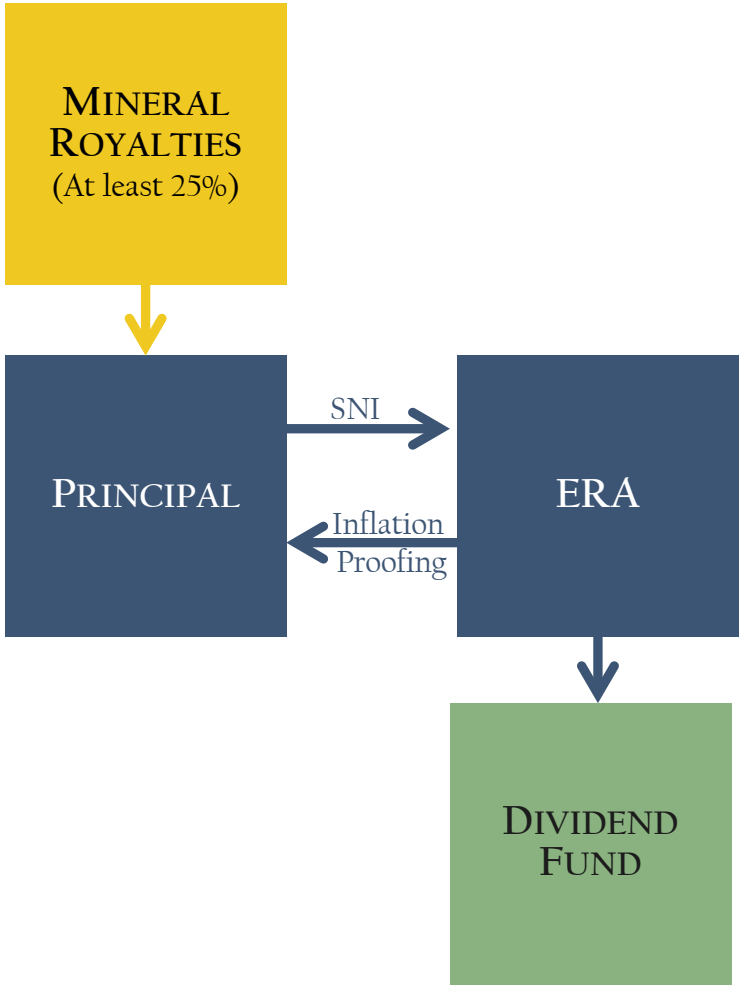
The Permanent Fund: How it Works

Principal (corpus)

- Money In:
  - Mineral Royalties (currently ~30%)
  - Inflation Proofing
- Money Out:
  - Prohibited

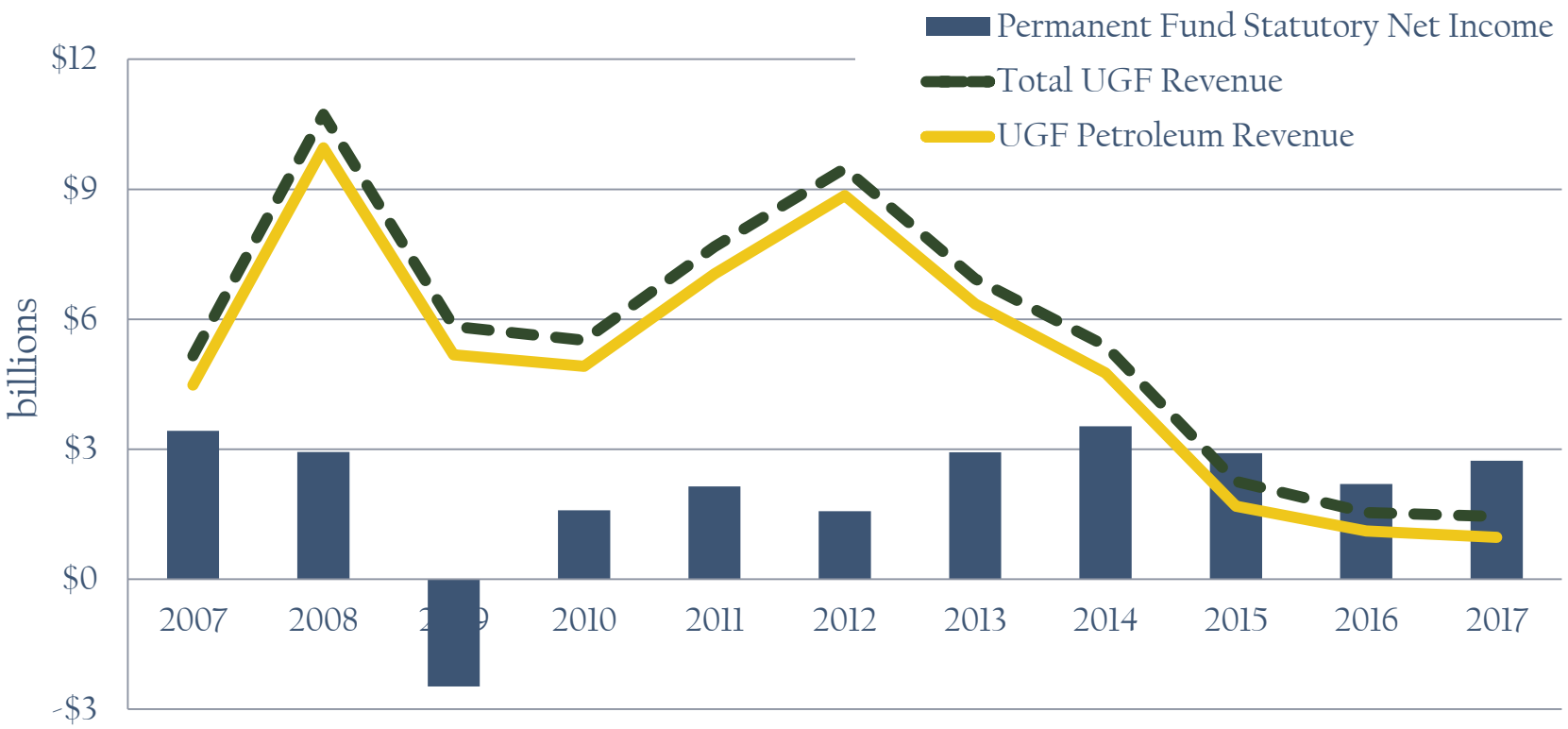
Earnings Reserve Account

- Money In:
  - Investment Income
- Money Out:
  - Inflation proofing
  - Dividends (approx. 50% SNI)

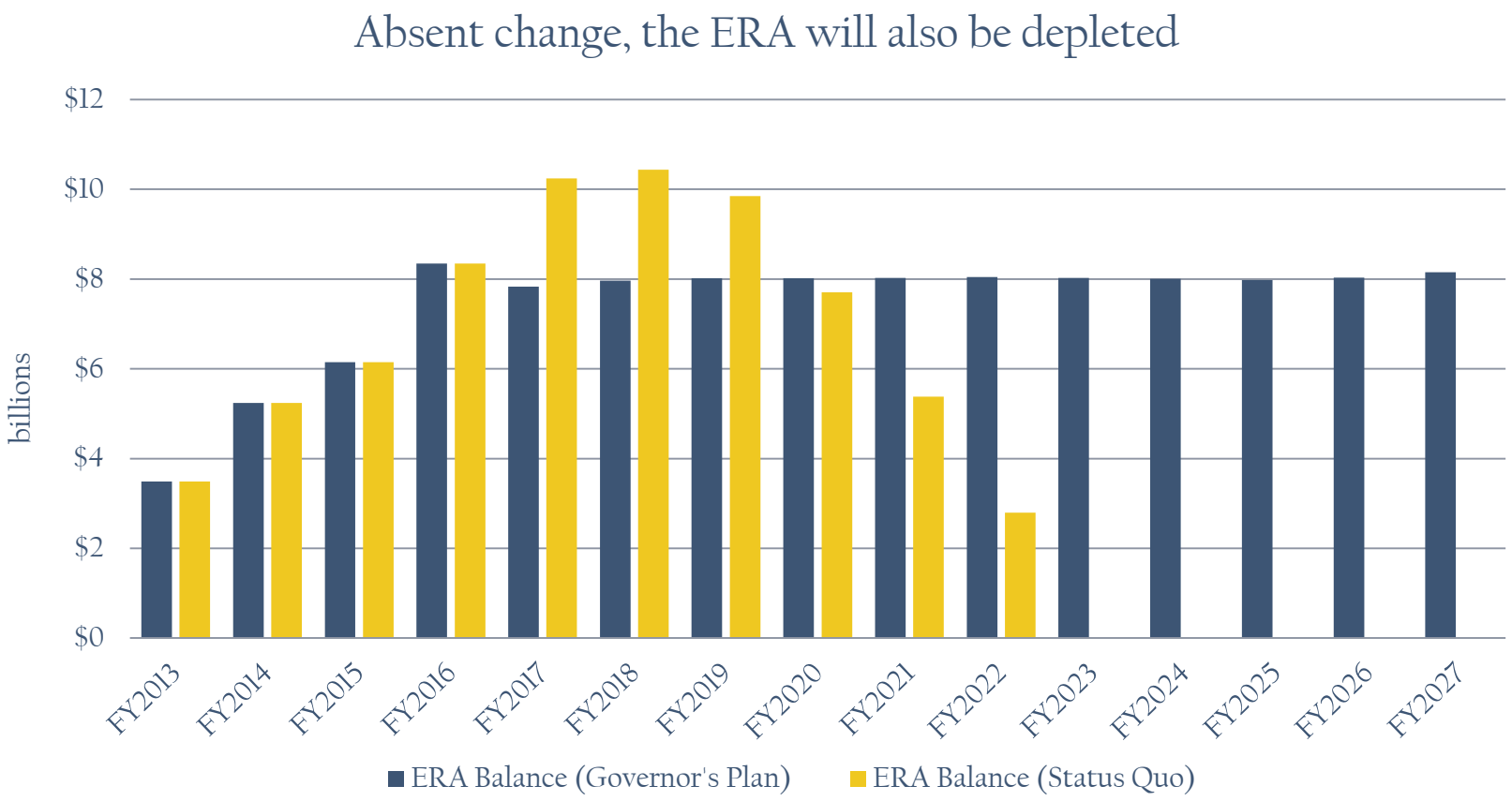


The Permanent Fund: Earnings

The fund is now big enough that annual earnings can exceed all UGF revenues.



The Problem


Absent change, the ERA will also be depleted
billions
$12
$10
$8
$6
$4
$2
$0
FY2013
FY2014
FY2015
FY2016
FY2017
FY2018
FY2019
FY2020
FY2021
FY2022
FY2023
FY2024
FY2025
FY2026
FY2027
ERA Balance (Governor's Plan)
ERA Balance (Status Quo)

Part III

The Permanent Fund's Role in a Solution

Why use Permanent Fund Earnings?

FY18 Budget	**$4.2 billion**
FY18 Budget Gap	**$2.8 billion**
Potential Tools to Close the Gap	
Motor Fuels Tax Increase	$0.1
Other Broad Based Tax	$0.6
Corporate Income Tax	$0.1
Oil Tax Credit Reform	$0.1
Max. Cuts Proposed (over 3 years)	$0.75
Permanent Fund Protection Act (net dividend)	$1.9
Others?	

How should we use the Permanent Fund?

"This proposal, if approved, would amend the Constitution of the State of Alaska by … establish[ing] a constitutional permanent fund into which at least 25 percent of all [mineral royalties] received by the State would be paid. The principal of the fund would be used only for income-producing investments permitted by law and the **income from the fund would be deposited in the general fund of the State and be available to be appropriated for expenditure by the State** unless otherwise provided by law."

Ballot Proposition No. 2
Permanent Fund from Non-Renewable Resource Revenue
Constitutional Amendment

How should we use the Permanent Fund?

A plan to use the fund should be …

1. **Long-term**

   - The fund is meant to provide for all generations of Alaskans.
   - As North Slope production declines, the fund's earnings will be increasingly important to sustaining public services.
   - Unlike petroleum, our financial reserves can be a renewable resource.
   - Like petroleum, investment earnings can be highly variable.

How should we use the Permanent Fund?

A plan to use the fund should be …

2. **Sustainable**

   - Maintain or grow the real (inflation-adjusted) value of the permanent fund
   - Provide for a dividend
   - Ensure the ERA holds enough to bridge years of low earnings ("ERA durability")

How should we use the Permanent Fund?

A plan to use the fund should be …

3. **Rule-Based** (Saving, Spending, Dividend)
   - Withdrawals occur under a set of statutory rules
   - Designed to protect the fund and guard against unsustainable uses
   - International best practice

How should we use the Permanent Fund?

Examples of rule-based frameworks used for other sovereign wealth funds:

GIC

- Singapore developed a proprietary model that projects 20-year returns
- The government may spend 50% of the annualized 20-year expected returns

- Kazakhstan uses a fixed annual draw of $8 billion, which may be adjusted by 15%
- The draw is reduced if the fund balance is less than 20% of the GDP

NORGES BANK
INVESTMENT MANAGEMENT

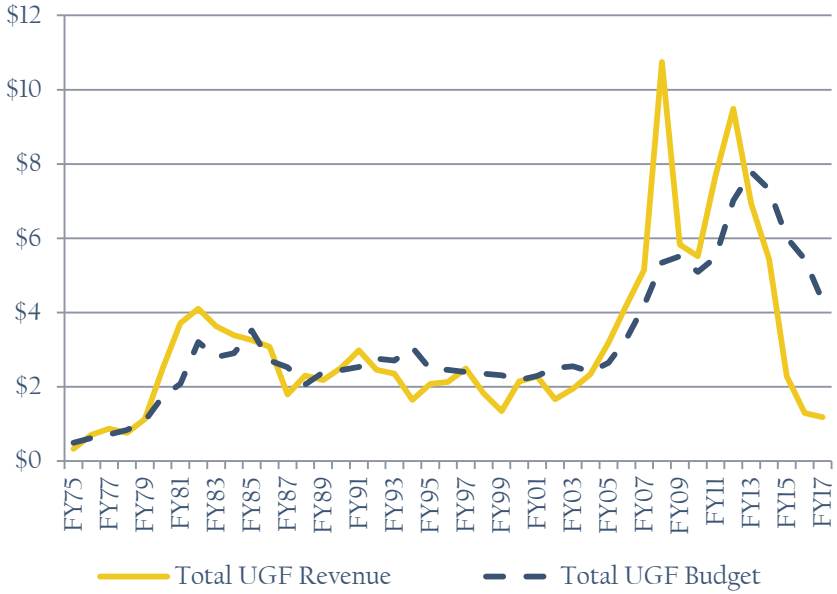
- Norway limits withdrawals to 4%, funding the budget largely from other revenues
- Withdrawals over 4% are allowed in limited circumstances, but require a parliamentary resolution

How should we use the Permanent Fund?

A plan to use the fund should be …

4. **Stabilizing:**

   - Over the long term, economies that experience repeated ups and downs grow slower than stable economies.
   - Because commodity prices are volatile, economies dominated by a single commodity industry experience more (and more pronounced) cycles.
   - Government spending that follows the same cycle amplifies the damaging effect.



How should we use the Permanent Fund?

A plan to use the fund should …

5. **Maximize the use of the permanent fund earnings:**

   - Other proposed new revenues and cuts could reduce the deficit by millions, the fund can *sustainably* contribute billions
   - Withdrawing too much is unsustainable and risks damaging the fund
   - Withdrawing too little limits future options for full fiscal solutions

Part IV

The Permanent Fund Protection Act

Bill Summary

HB61 is a slimmed down version of the bill that passed the Senate last year

Last year, the 29th Legislature held 39 hearings on the Alaska Permanent Fund Protection Act (SB128, HB245, and SB5001):

- SSTA: 10 hearings, including 2 days of public testimony
- SFIN: 10 hearings, including 1 days of public testimony
- HFIN: 19 hearings, including 4 days of public testimony

Other bills addressing the use of permanent fund earnings were also considered:

- SB114 (Sen. McGuire): 7 hearings in SSTA, 9 hearings in SFIN
- HB303 (Rep. Millet): 4 hearings in HFIN
- HB224 (Rep. Hawker): 4 hearings in HFIN

HB61 is the same as the CS for SB128, but without provisions re.:

- CBR management
- APFC procurement
- Secondary savings rule

Bill Summary

The PFPA outlines a long-term plan with 3 formulas:

1. **Sustainable draw formula**
   - 5.25% POMV
   - Draw limit

2. **Sustainable dividend formula**
   - 20% of UGF royalties
   - 20% of POMV draw

3. **Adjust deposits to corpus**
   - Reduce royalty deposits to 25%
   - Change inflation proofing transfers

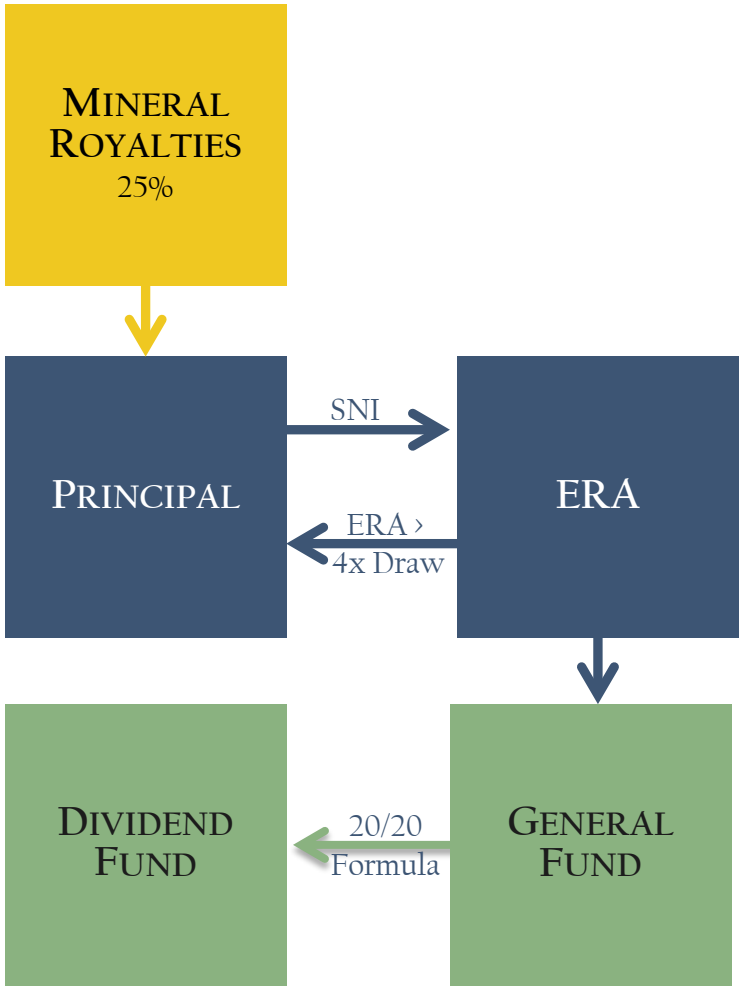
Bill Summary

Principal (corpus)

- Money In:
  - Mineral Royalties (25%)
  - Inflation Proofing (4 times rule)
- Money Out:
  - Prohibited

Earnings Reserve Account

- Money In:
  - Investment Income
- Money Out:
  - Inflation proofing (4 times rule)
  - Withdrawals for UGF & dividend (POMV – draw limit)



POMV Draw

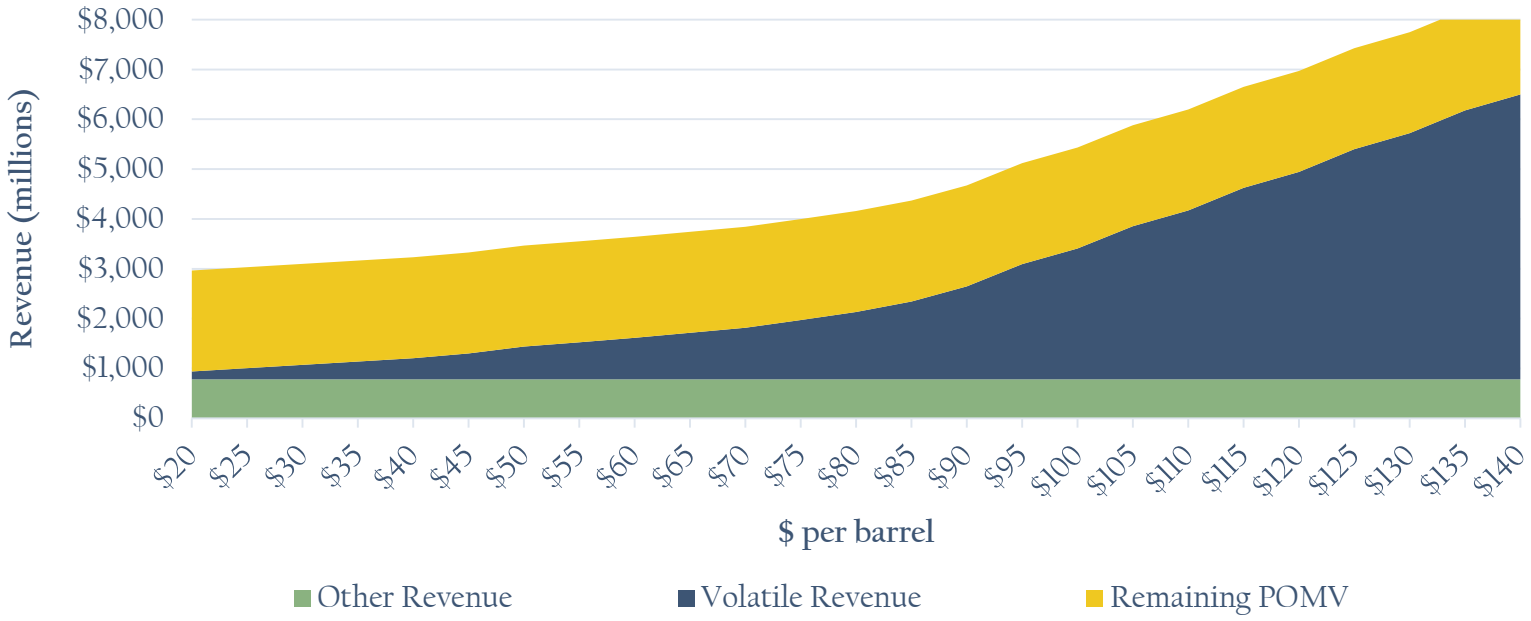
- **5.25%** of the average fund value in the first 5 of the last 6 years
- Example: draw calculation for fiscal year 2018

End of FY	Fund Value (billions$, excludes Am.Hess.)	
2012	$39.9	Average = **$48.1**
2013	$44.4	
2014	$50.8	
2015	$52.4	
2016	$53.1	
2017	$53.6	
2018	…	

- Average fund value in the first 5 of the last 6 years = **$48.1** billion
- 5.25% of $48.1 = **$2.5** billion
- Effective POMV: = **4.7%** of 2017 value

- Aggressive, but sustainable … *if* the draw limit is applied

UGF Revenue & Oil Price
(with POMV only)



By itself, a 5.25 % POMV draw formula:

- Does not stabilize UGF revenue (revenue continues to vary with oil price)
- Based on current forecasts, may not be sustainable (long-term, the inflation-adjusted value of the fund may decline).

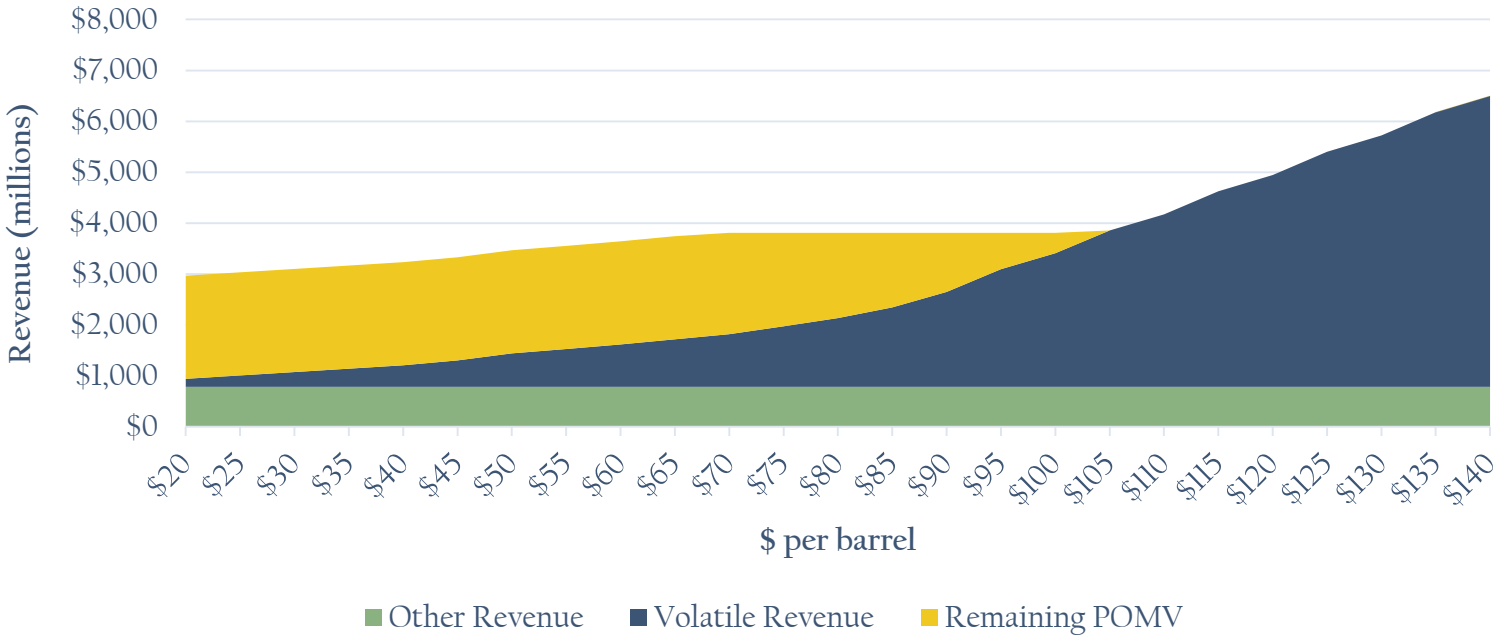
Draw Limit

- Reduces the POMV draw by $1 for every $1 that UGF production taxes and royalties exceed $1.2 billion.

- Does not apply to the portion of the POMV going to dividends.

UGF Revenue & Oil Price

(with POMV & Draw Limit)



A formula that includes a draw limit:

- Gradually reduces the amount drawn from the ERA as oil revenues increase
- Stabilizes UGF revenue through a range of oil prices
- Grows the fund more, producing larger draws and dividends in the future

Sustainable Dividend Formula

- $1,000 per person for the first 2 years, then
- 20% of UGF royalties (15% of all royalties), plus
  20% of the 5.25% POMV draw (about 1% POMV)
  (expected to be about $1,000 per person into the future)

Inflation Proofing Transfers

- AS 37.13.145(c) currently provides for annual inflation proofing transfers from the ERA to corpus
- The ERA needs a sufficient balance to be able to meet the draw each year ("ERA durability" concern)
- Bill provides that the ERA balance over 4 times the maximum 5.25% draw (after current year draw) is transferred to corpus instead

Timing Matters

- Review framework in three years
- Immediate effective date (potentially in FY17)
- Timing of transfers:
  - In the past, appropriations from the ERA occurred in the FY prior to using the money, *i.e.*, the dividend was forward-funded. For example, money for the October 2015 dividend (paid during FY16) was appropriated on June 30, 2015 – the last day of FY15.
  - To accommodate the UGF use, the appropriation from the ERA will now occur in the same FY. In other words, instead of the FY18 ERA appropriation being used in FY19, it will be used for FY18.

Permanent Fund Protection Act

Conclusion

Permanent Fund Protection Act

- Sustainably provides billions to the general fund (when needed)
- Preserves the dividend program
- Stabilizes the budget to give investors confidence in our future

PFPA Sectional

- Section 1: Review framework in 3 years
- Section 2: Royalties to the principal
- Section 3: Conforming Amendment (CA)
- Section 4: POMV and draw limit formulas
- Section 5: CA
- Section 6: Appropriations from ERA to general fund and principal
- Section 7: Dividend appropriation (20/20 formula)
- Section 8: CA
- Section 9: CA
- Section 10: $1,000 dividend per person in October 2017 and October 2018
- Section 11: CA
- Section 12: CA
- Section 13: CA and repeal language re. CBR investment
- Section 14: CA
- Section 15: Immediate effective date