Alaska Permanent Fund Protection Act

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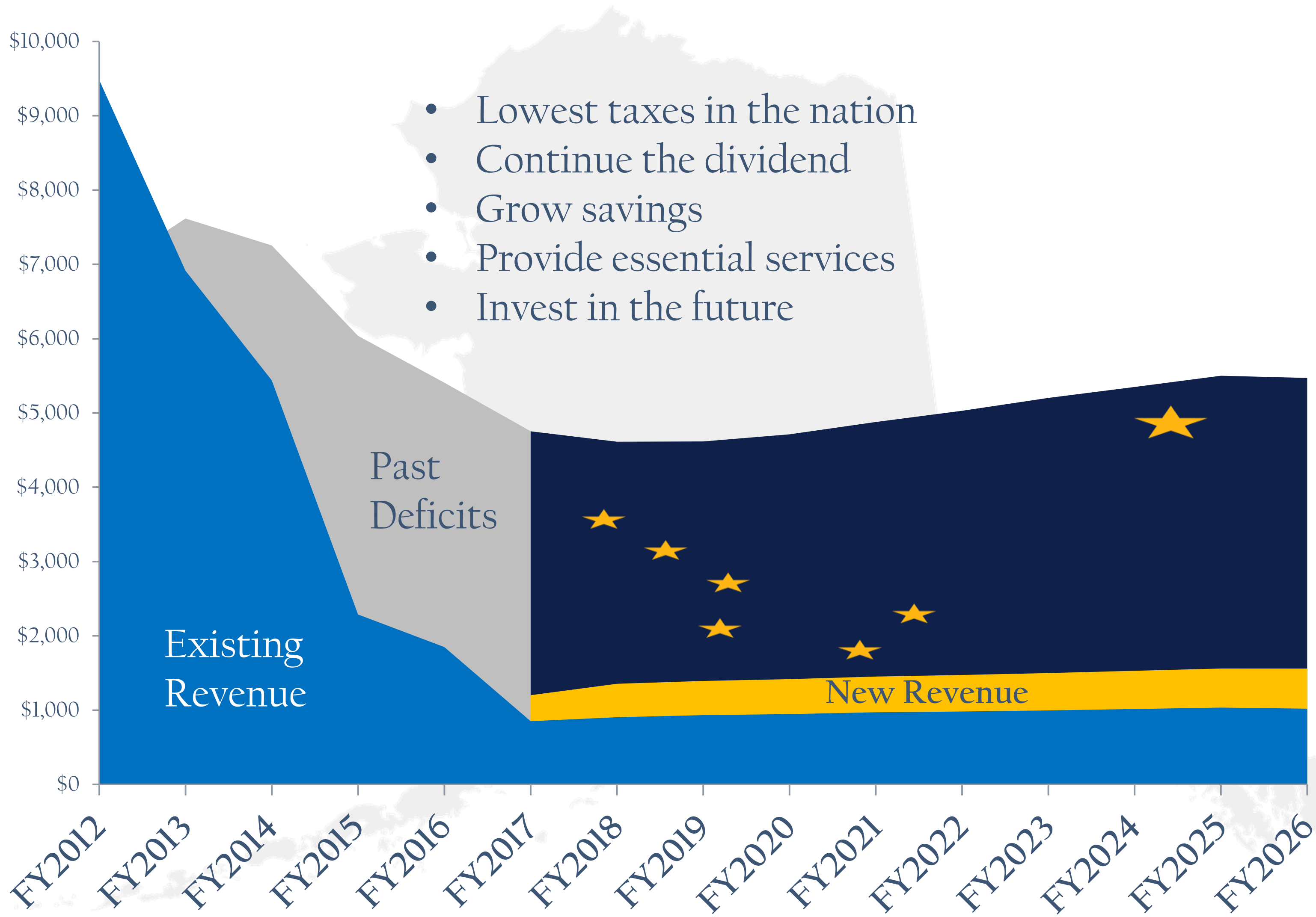
INTRODUCTION

THE NEW SUSTAINABLE ALASKA PLAN

FY16 Budget	**$5.2 billion**
Alaska Permanent Fund Protection Act	$3.3
Revenue from existing taxes and fees	$0.85
Earnings on savings	$0.135
	$4.285
Spending reductions (est.)	
Net cuts in FY17 (additional cuts of $0.1 through FY19)	($0.1)
Reform O&G Tax Credits	($0.4)
	($0.5)
New Revenue Components (est.)	
Mining	$0.006
Fishing	$0.018
Tourism	$0.015
Motor Fuel	$0.049
Alcohol	$0.040
Tobacco	$0.029
Oil and Gas	$0.1
Individual Alaskans (Income Tax)	$0.2
	$0.457

The New Sustainable Alaska Plan



Alaska Permanent Fund Protection Act

1. Sustainably draw from the Earnings Reserve
2. Minimize oil price volatility in the General Fund
3. Adjust the dividend

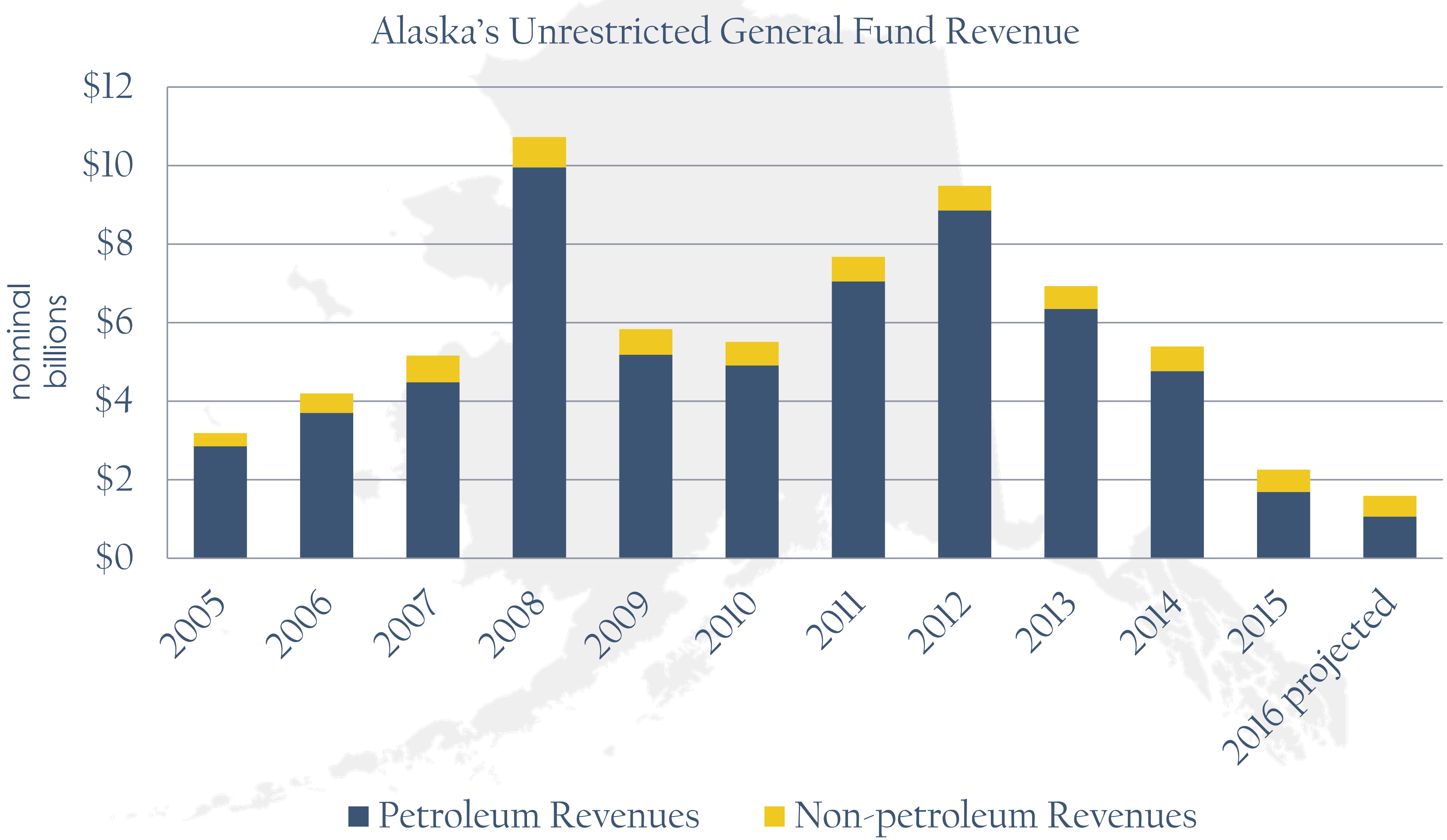
The Fiscal Challenge

Defining the Problem

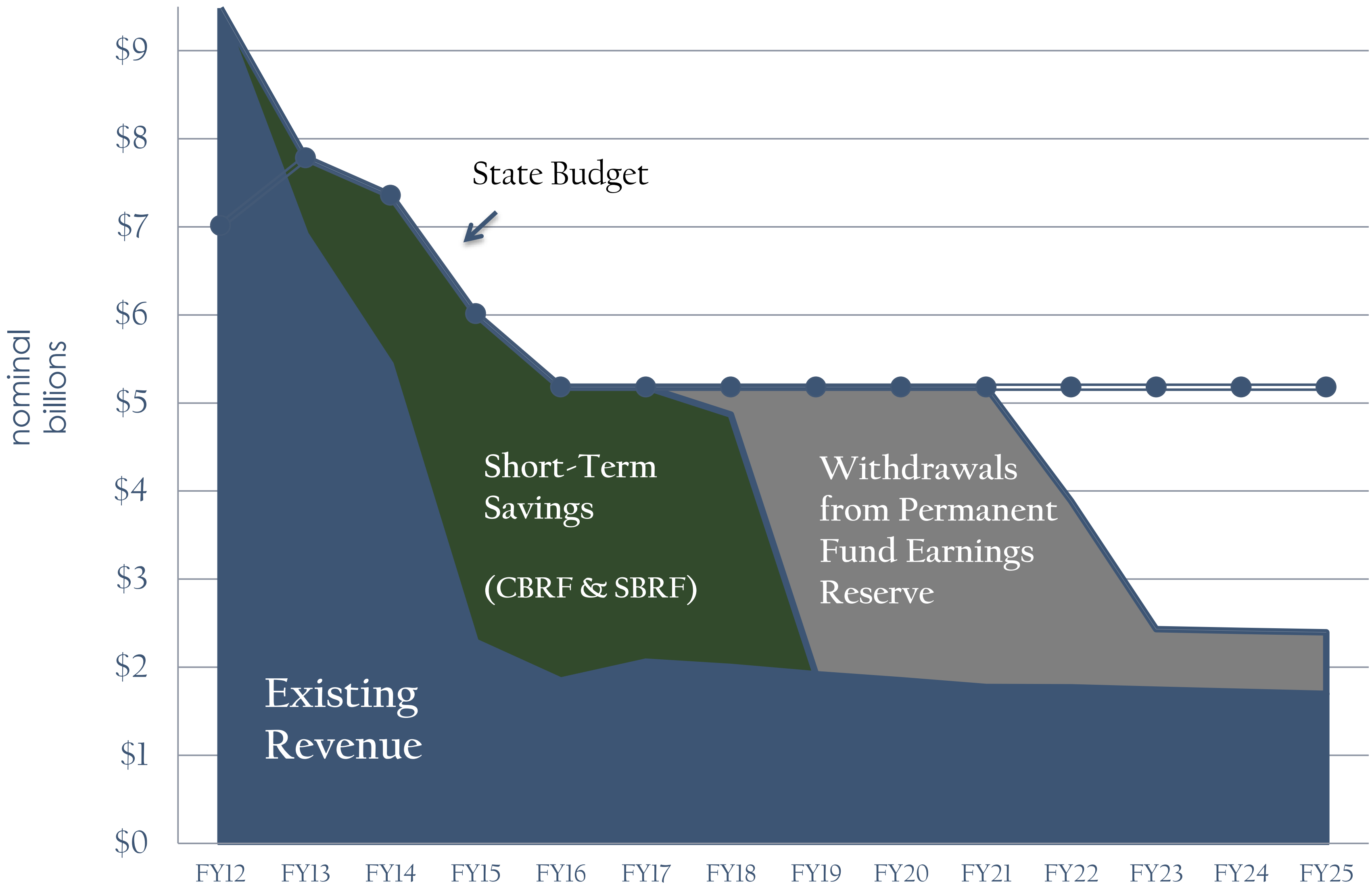
Defining the Problem

- Short-Term:
  - Drop in oil prices has resulted in large budget gaps
- Medium-Term:
  - State savings will be spent in about 4 years
  - Uncorrected, state budget hole will damage Alaska's economy
  - Dividend payments are unsustainable under the status quo
- Long-Term:
  - State's undiversified budget is highly dependent on petroleum revenues
  - There has been a declining trend in North Slope petroleum production
  - Cyclicality in petroleum prices creates an unstable state budget and economy

Short-Term Problem

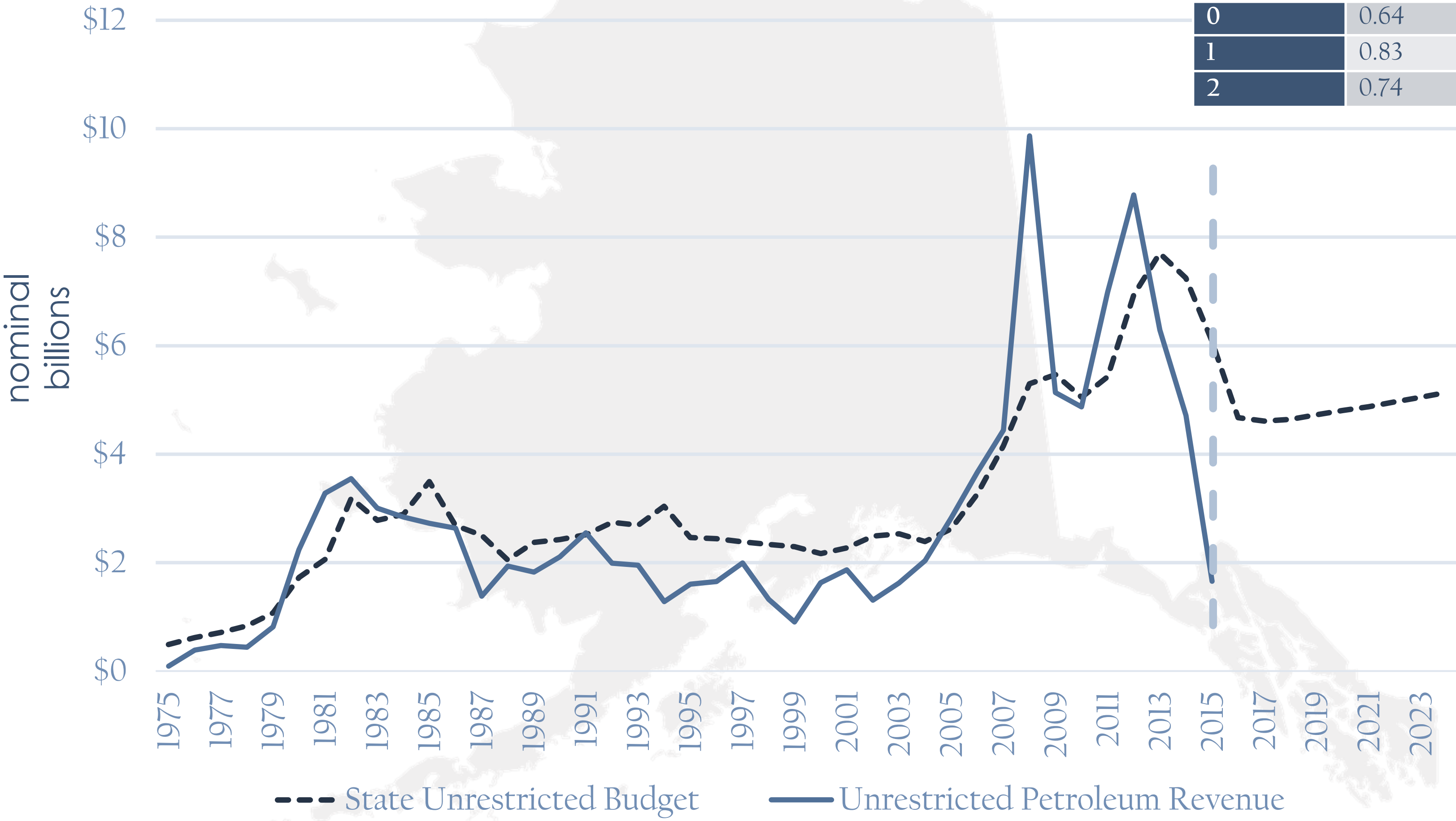


MEDIUM-TERM PROBLEM



Long-Term Problem

Year Lag	R-Square Value
0	0.64
1	0.83
2	0.74



A Solution: the Alaska Permanent Fund Protection Act

Bill Overview

Overview

1. **$3.3 billion endowment draw for the General Fund**
   - Rising by inflation starting in 2020
   - Sustainable

2. **100% of production taxes and royalties go into the Permanent Fund**
   - 25% of royalties always go the Corpus
   - Remainder allocated to maintain target balance

3. **Dividends** equal to 50% of prior year's royalties paid from Earnings Reserve

Alaska Permanent Fund Protection Act

1. Protect the corpus
2. Protect the dividend
3. Grow the fund
4. Stabilize the budget
5. Stabilize the economy

Fiscal Policy for Alaska

Analysis of Options

The Permanent Fund

"I wanted to transform

oil wells pumping oil for a finite period into

money wells pumping money for infinity."

~ Governor Hammond (1976)

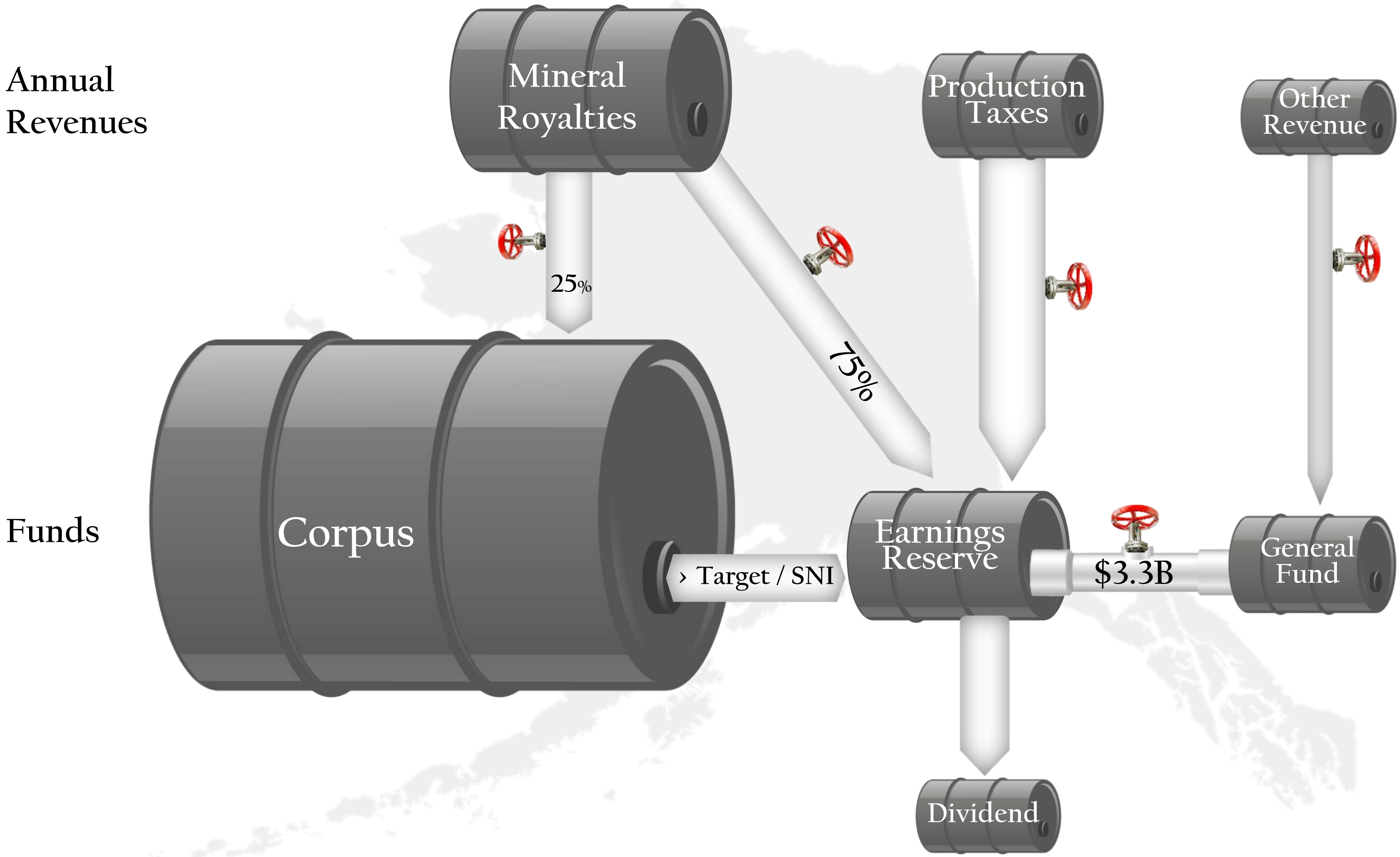
Rule-Based Fiscal Policy

- **Volatility Rule**
  - In the Permanent Fund
  - Some in the dividend
- **Spending Rule**
  - Draw: fixed $3.3 billion with periodic review
  - Dividend: 50% of annual mineral royalties to Alaskans
- **Savings Rule**
  - 25% of mineral royalties to corpus
  - Presumption of savings when revenues peak
  - Appealed royalties and production taxes continue to flow to CBR
- **Growth Rule**
  - Assets grow with inflation
  - Opportunities for additional growth assigned to the corpus and dividend
- **Protection Rule**
  - Preserve constitutional protection of the corpus
  - Transfers funds in excess of earnings reserve target balance to the corpus
  - Earnings reserve durability tested

DEFINING "SUSTAINABLE"

- Protect the Corpus
- Earnings Reserve Durability
- Inflation Proofing
  - Maintain the real value of the Permanent Fund
  - Transfers to the Corpus

APFPA Cash Flows



How to handle the draw

Status quo sustainable draw = $2.4 billion
Funds to the general fund = $2.4 billion – dividend payout ($1.4 billion in FY16)

POMV:

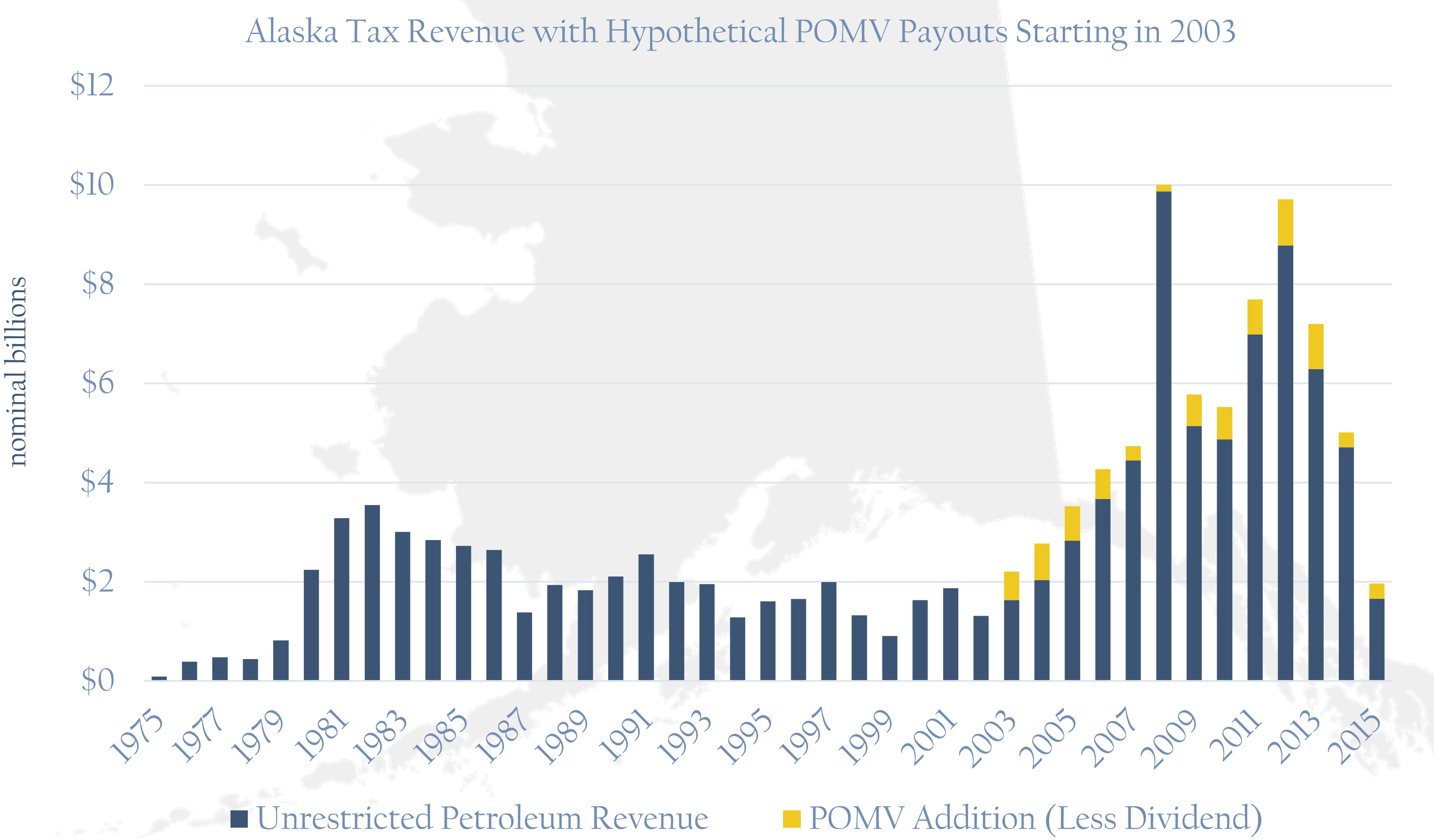
- Draw self-adjusts
  - Lower chance of depletion
  - Less fund growth potential
  - No periodic review
- Year-to-year budget volatility
- Rule incorporating petroleum revenue is complex
- Must be on net value of assets

Fixed:

- Draw does not self-adjust
  - Greater chance of depletion
  - Greater fund growth potential
  - Requires periodic review
- Stability for the budget
- Incorporating petroleum revenue not complex

How to handle the draw

A simple endowment draw adds revenue, but does not address volatility



Calculating the Draw

The Financial Model

- Probabilistic: provides range of potential outcomes
- Starting Assets = $55B
  - $45B in Corpus
  - $7B in Earnings Reserve
  - $3B from CBR
- Inflation = 2.25%
- Investment Returns
  - Total Return = 6.90%
  - Statistutory Net Income = 6.01%

Calculating the Draw

The Petroleum Model

- Oil price
  - Mean value from probabilistic distribution
  - Inputs – a range of prices for each year – from revenue forecasting session
  - Same underlying data used for the Revenue Sources Book, but the RSB uses only a single price (the median) from the forecasting session
- Production volumes and costs
  - Same forecast as Revenue Sources Book (Fall 2015)
  - Conservative
- Shortcut Model
  - Input the above oil price, production volume, and costs
  - Deterministic calculation of annual production tax and royalty revenues

Calculating the Draw

Annuity-Like Fixed Payment to the General Fund

Starting Balance = $55 billion

\+ **Inflows** =

Investment income
100% production taxes
100% royalties

\- **Outflows** =

Expenses
Dividend
Draw (inflation increase delayed until 2020)

= **End-of-Year Balance**

… **$3.3 billion** annuity from financial and petroleum wealth
(2040 Balance = 2016 Balance + Inflation)

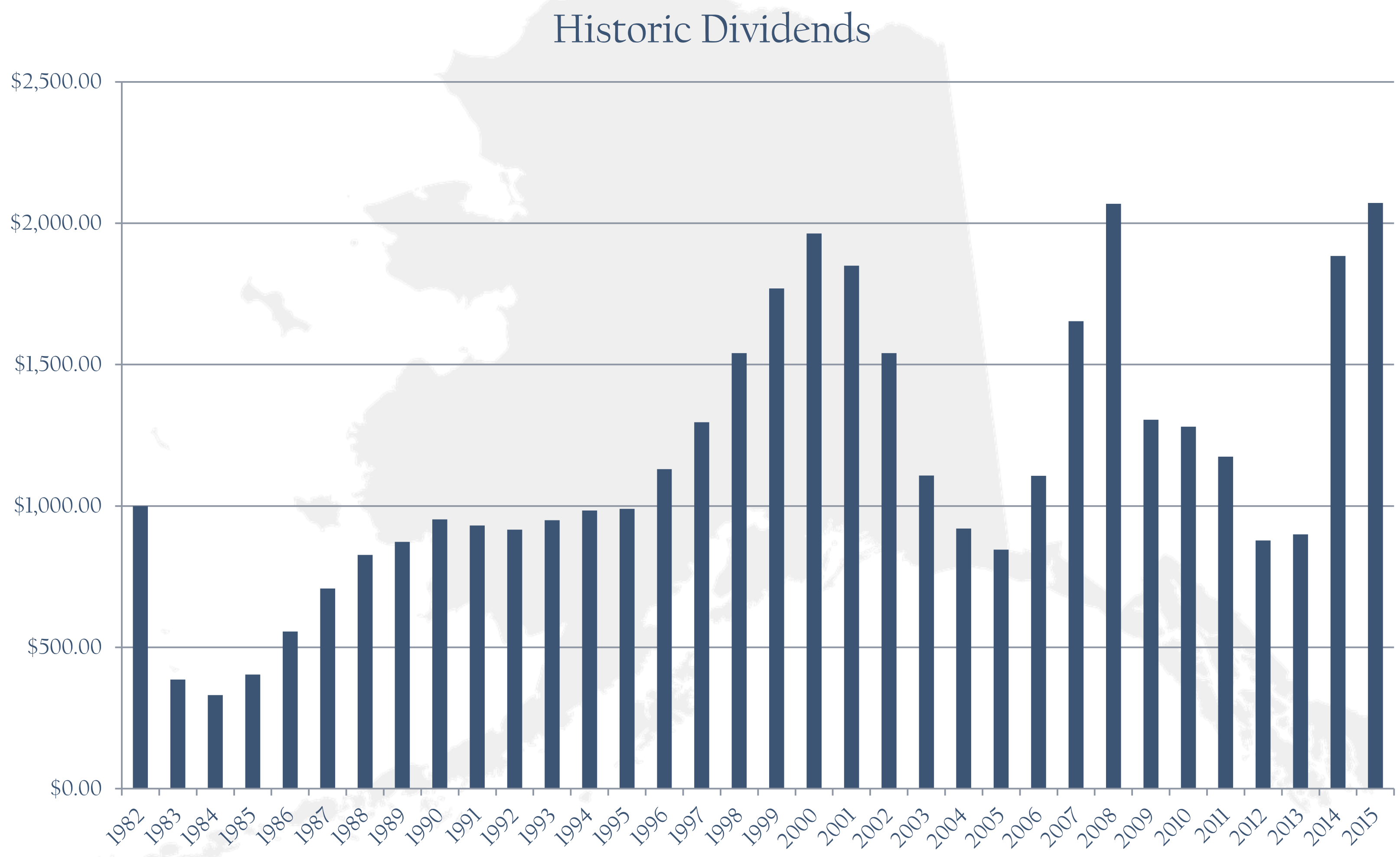
Earnings Reserve Durability

- Target balance: 4 times the prior year draw
  - If Earnings Reserve at target balance:
    - 100% of production taxes and 50% of royalties deposited in Corpus
    - 50% of royalties deposited in Earnings Reserve
  - If Earnings Reserve under target balance:
    - Up to 100% of taxes & 75% of royalties deposited in Earnings Reserve
    - Minimum of 25% of royalties deposited in Corpus
  - If Earnings Reserve over target balance:
    - Excess transferred to the Corpus
- **$3 billion transfer from the CBR**

Earnings Reserve Durability

- Robust Earning Reserve Cash Inflows
  - $3B transfer from the CBR
  - Statutory Net Income
  - Petroleum revenue
- Long-Lead Adjustment Opportunities
  - 4:1 coverage ratio
  - Periodic review
  - Robust modeling
  - Sufficient time to react

How to handle the dividend



How to handle the dividend

The current formula distributes 50% of realized gains

Annualized average of last 5 years of statutory net income ($13B x 0.21%)

Take half ($2.7B ÷ 2)

Transfer to Dividend Fund ($1.4B)

After adjustments, divide by number of recipients ($1.4B ÷ 644,511)

2015 individual check = $2,072

Use of Fund Income

Since inception (in billions)

46%	Paid out to Current Generations	23.5
54%	Saved for Future Generations	27.7

“the Board recognizes that … a POMV spending limit methodology … may necessitate changes to … the Permanent Fund Dividends”

APFC Board Resolution 03-05

How to handle the dividend

$1,000 Flat Dividend

- Costs about $650 million per year
- Compared to 50% royalty dividend, reduces the sustainable draw by about $200 million per year

Royalty Dividend

- 50% of Alaska's ownership share of oil revenue
- Reflects our success as a state and connects Alaskans to the economy
- Increases or decreases according to what we can afford

Periodic Review

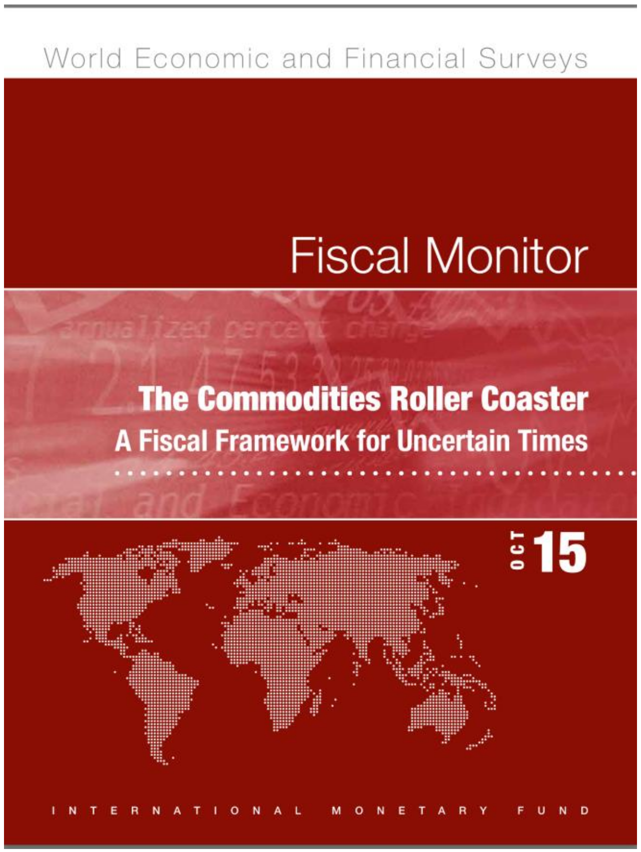
- Flexibility to adjust the draw downward
- Schedule: 2017, 2020, then every 4 years
- Consistent methodology
  - Variables
  - Sustainability metric
- Report, supporting data, and analysis publically available

Solving the Long-Term Challenge

Fiscal Policy for Oil Economies

Government Spending & the Economy

- *The Commodities Roller Coaster* –
  the International Monetary Fund studied 85 economies over 3 decades
- Government spending in commodity-based economies tends to move up and down with commodity revenue
- Pro-cyclical government spending stunts economic growth
- Stabilizing fiscal policy has the inverse effect, increasing GDP growth by 0.3% annually



Break-Even Oil Price

- A widely used rule-of-thumb measure of the oil price required to balance the government budget in any given year
- Options for petroleum states to bring down break-even oil prices are generally
  - Diversify revenues through other types of taxation
  - Use sovereign wealth assets
- Alaska: $109

Country	Break-Even Oil Price (2015)
Norway	$40
Kuwait	$54
Abu Dhabi	$55
Russia	$105
Saudi Arabia	$106
Nigeria	$122
Iran	$131
Algeria	$131
Venezuela	$160

Alaska: in the Middle

Alaska lacks

- Revenue diversity
- Fiscal rules to address pro-cyclical spending

But, like Norway, Kuwait, and Abu Dhabi, Alaska has

- A large sovereign wealth fund
- Proven experience with rule-based fiscal policy
- An independent investment authority

Alaska has a cash flow problem, not a wealth problem.

Solving the Problem this Year

The Cost of Delay

DELAY WILL . . .

- Risk the sustainability of an endowment plan
- Reduce the sustainable draw
- Risk a downgrade of Alaska's credit rating
- Damage Alaska's economy

Alaska Permanent Fund Protection Act

The Bill

Alaska Permanent Fund Protection Act

- Section 1: **Revenue to the Corpus**
- Section 2: ERA "target balance"
- Section 3: Conforming Amendment
- Section 4: **ERA transfer to Dividend Fund**
- Section 5: **ERA transfer to Corpus**
- Section 6: **Revenue to the ERA, Draw, and Periodic Review**
- Section 7: Conforming Amendment
- Section 8: Conforming Amendment
- Section 9: $1,000/person dividend in 2016
- Section 10: Effective July 1, 2016

Alaska Permanent Fund Protection Act

1. Volatile petroleum revenue to the Permanent Fund
2. Stable endowment draw to the General Fund
3. Continued dividend for Alaskans