

ALASKA PERMANENT FUND PROTECTION ACT

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OVERVIEW

- Defining the Problem
- Fiscal Policy for Oil Economies
- Analysis of Options
 - APFPA Summary
 - Defining “Sustainable”
 - How to Handle the Draw
 - How to Handle the Volatility
 - How to Handle the Dividend
- APFPA Sectional Analysis

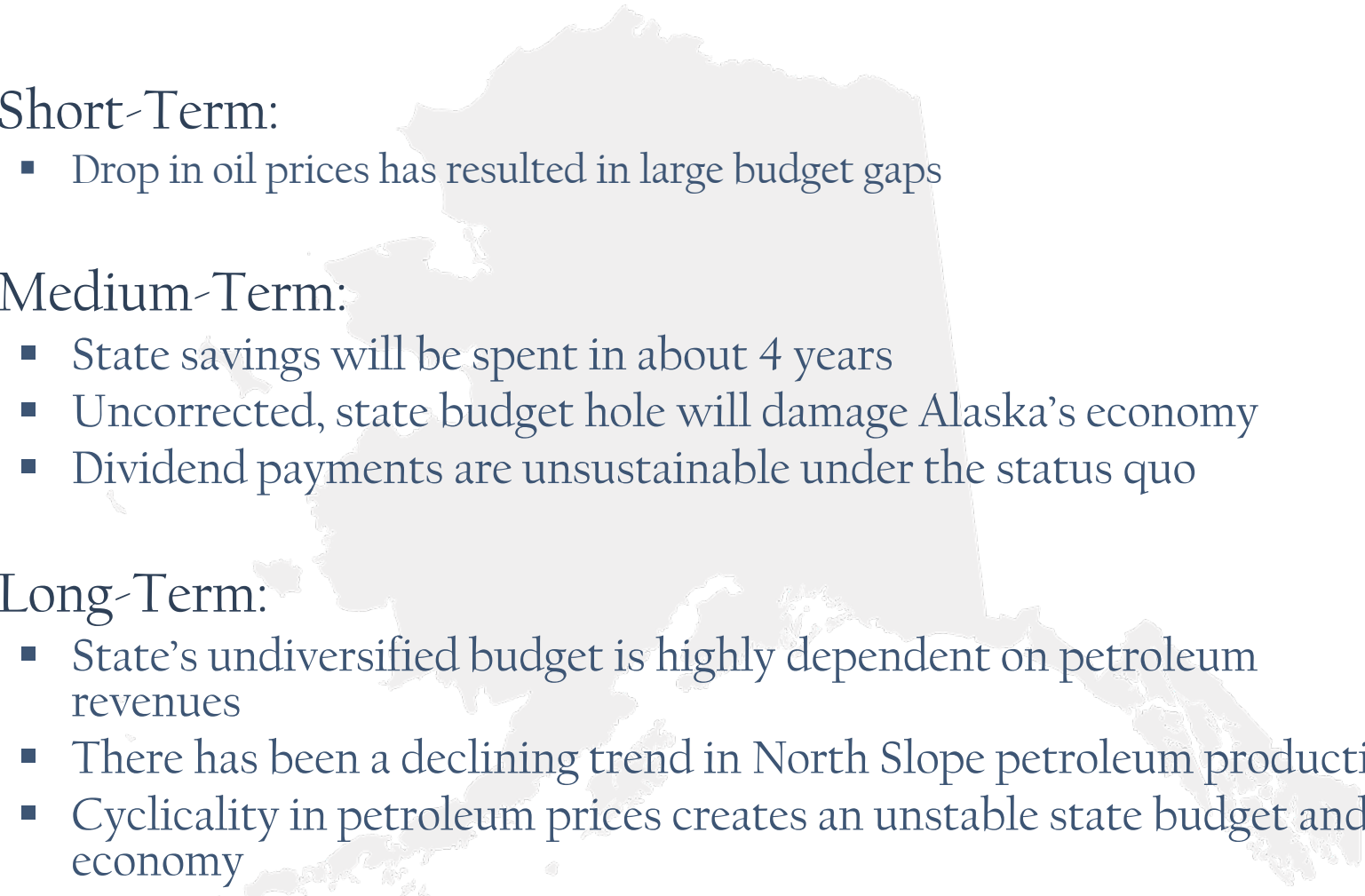




The Fiscal Challenge

DEFINING THE PROBLEM

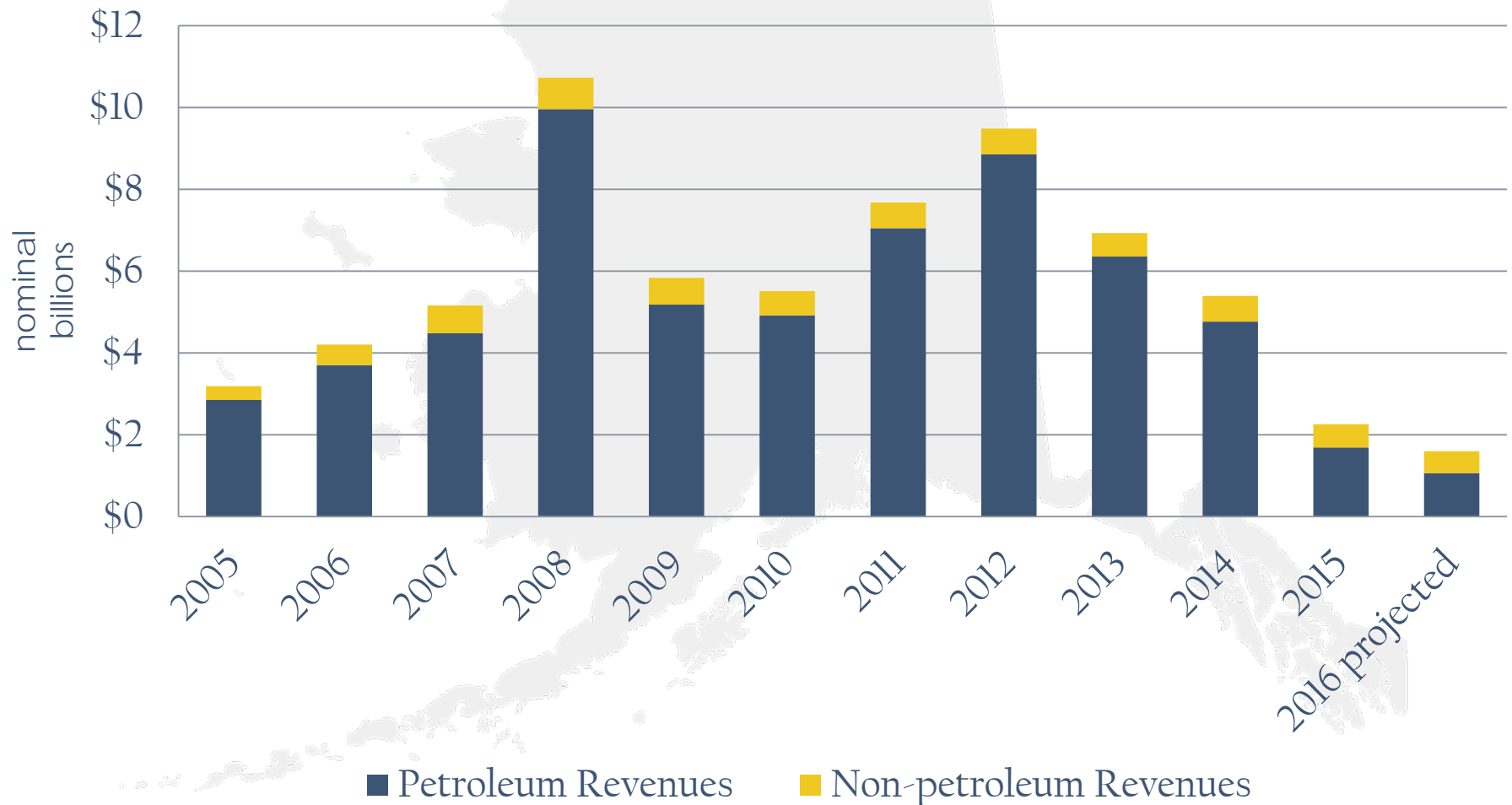
DEFINING THE PROBLEM

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- 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
 - Cyclicity in petroleum prices creates an unstable state budget and economy

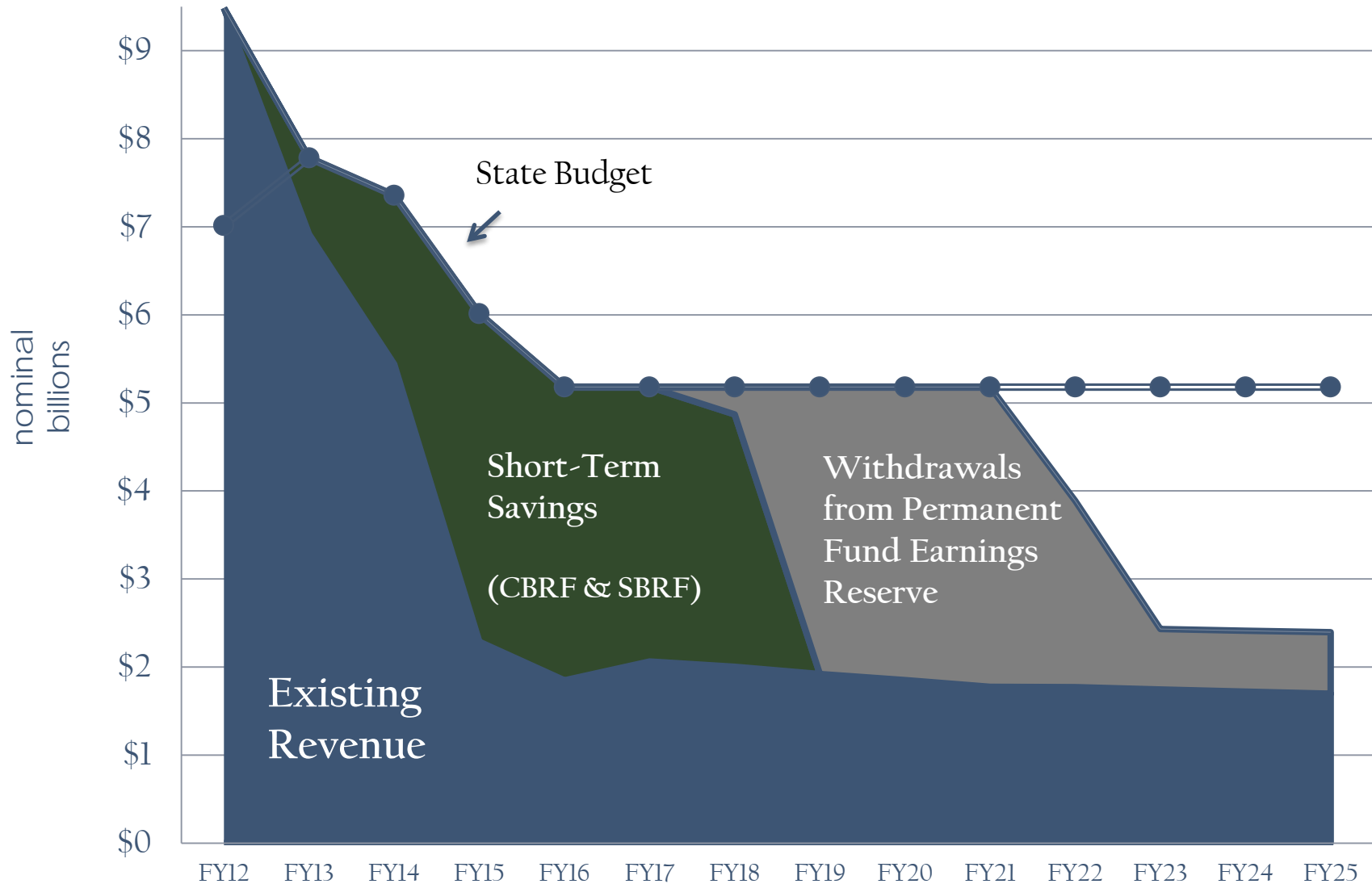


SHORT-TERM PROBLEM

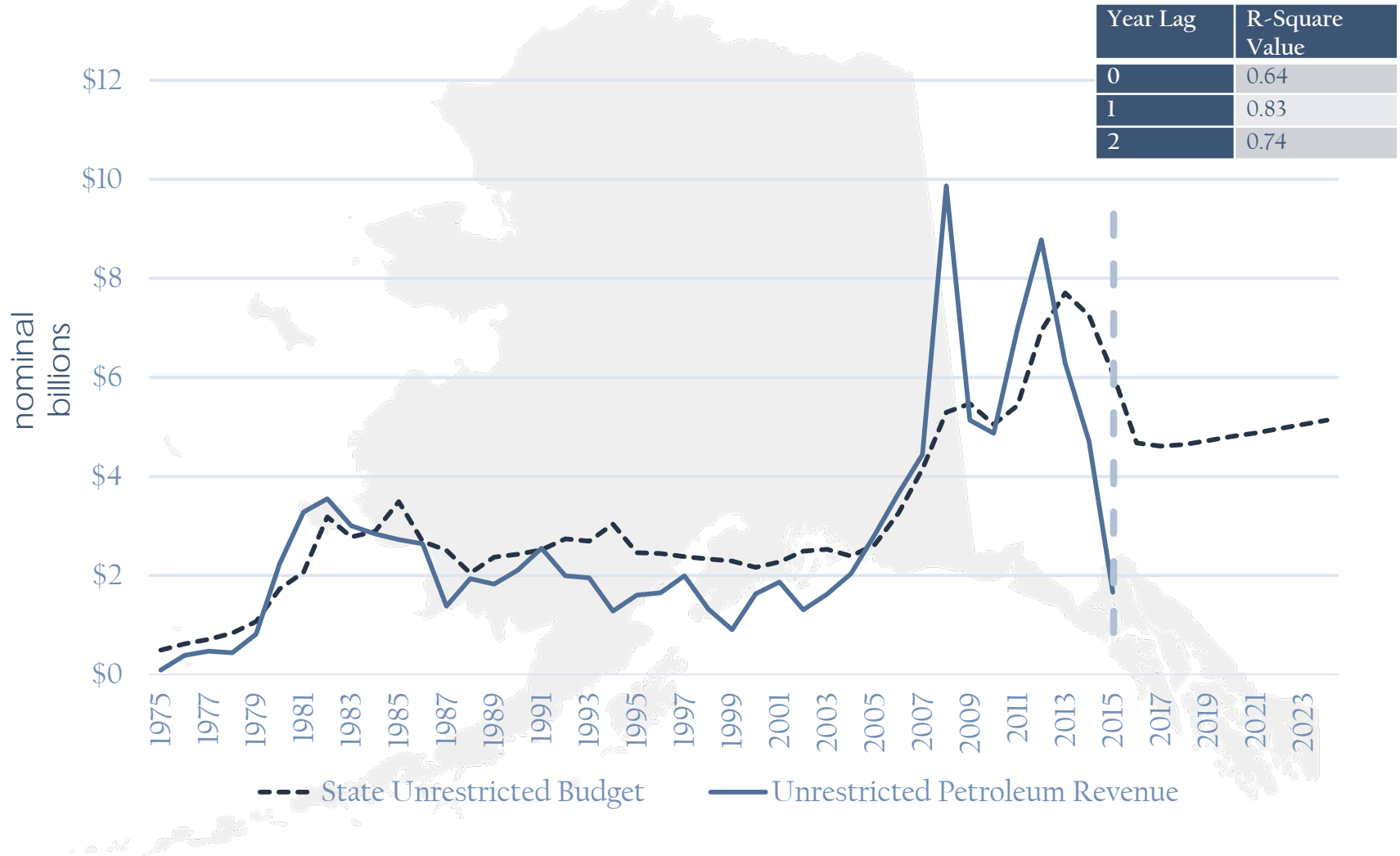
Alaska's Unrestricted General Fund Revenue



MEDIUM-TERM PROBLEM



LONG-TERM PROBLEM



WHY THE PERMANENT FUND?

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- Other pieces of the plan provide millions, the Fund can *sustainably* contribute billions
 - Placing petroleum revenues in the Permanent Fund is the cleanest way to address oil price volatility
 - There is no solution without Permanent Fund earnings and adjusting the dividend



WHY THE PERMANENT FUND?

“Of all the fiscal options for closing the deficit, only saving less of Permanent Fund earnings . . . would have no short-run economic impacts.”

Economic Impacts of Alaska Fiscal Options: Draft Report
Gunnar Knapp, Mouhcine Guettabi, and Matthew Berman
Institute of Social and Economic Research (March 2016).



DELAY WILL . . .

- Reduce the sustainable draw
- Risks a downgrade of Alaska's credit rating
- Damage the economy



LOWER SUSTAINABLE DRAW

- Every year of inaction, we spend around **\$2 billion** more than called for in the New Sustainable Alaska Plan
 - That money could be invested and produce income indefinitely
 - But, once it's spent, it's gone
- Overspending reduces the sustainable draw every year, *forever*
- Reduction must be made up in future cuts or taxes

Reduced Sustainable Draw (millions\$)				
Excess Spending	Years of Delay			
	1	2	3	4
\$500	\$75	\$150	\$200	\$250
\$1,000	\$100	\$250	\$300	\$400
\$1,500	\$125	\$275	\$350	\$450
\$2,000	\$150	\$325	\$400	\$500



COST OF A DOWNGRADE

“The state sold \$135 million of general obligation bonds yesterday [03/09/16], its first sale in almost a year. Tax-exempt securities maturing in August of 2035 sold at a top yield of 2.9 percent, about 0.35 percentage point higher than the benchmark securities due in 20 years. That gap is four times wider than what the state paid when it last sold debt in March of 2015.”

Bloomberg News



DAMAGE TO ALASKA'S ECONOMY

- Lower sustainable draw from financial assets requires
 - More taxes
 - Less government spending (services and jobs)
- Degraded confidence and less private sector investment
- Direct impacts on Alaskans
 - Job Market
 - Home Values



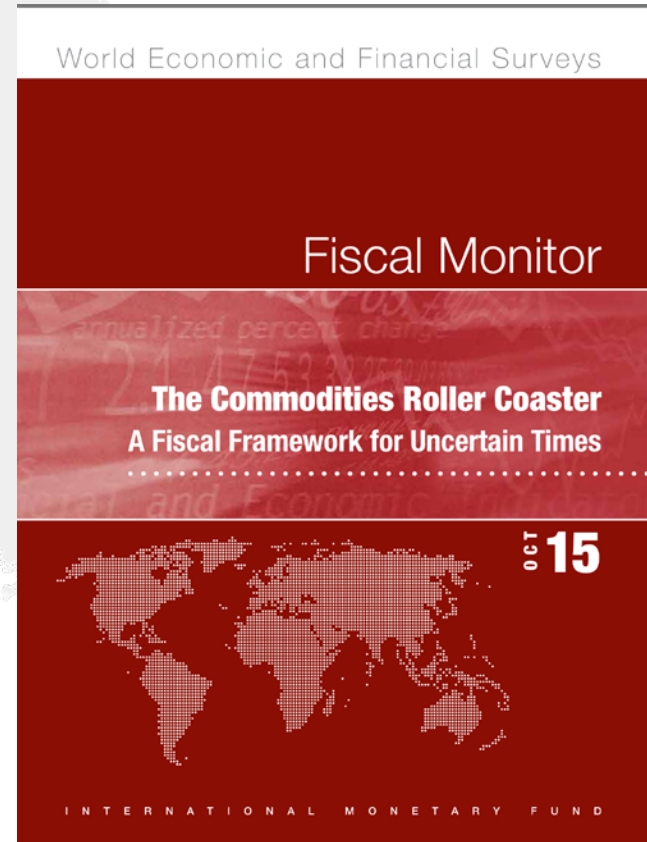


Solving the Long-Term Challenge

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



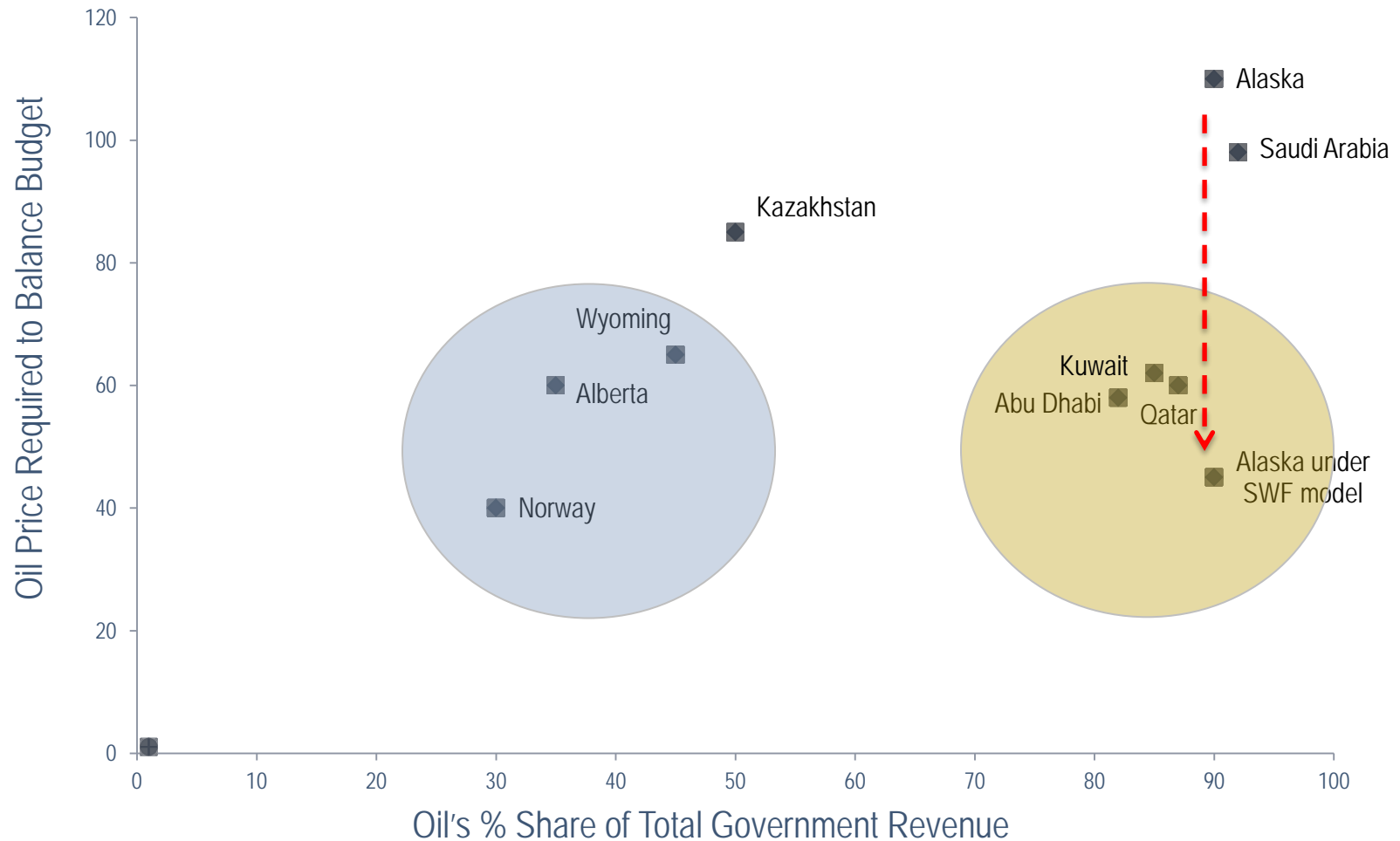
BREAK-EVEN OIL PRICE

- 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



OIL: BREAK-EVEN PRICE & SHARE OF REVENUE

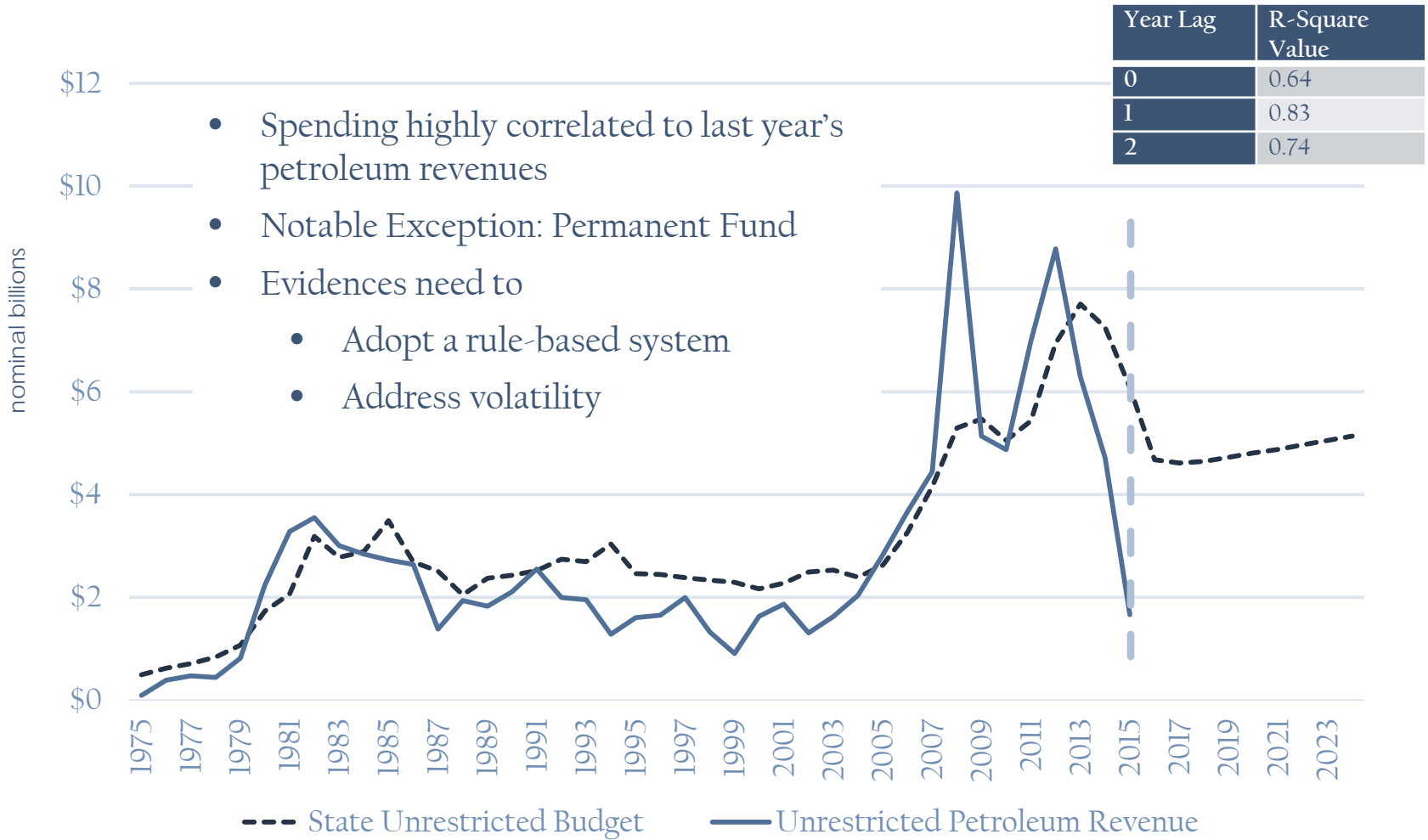




Fiscal Policy for Alaska

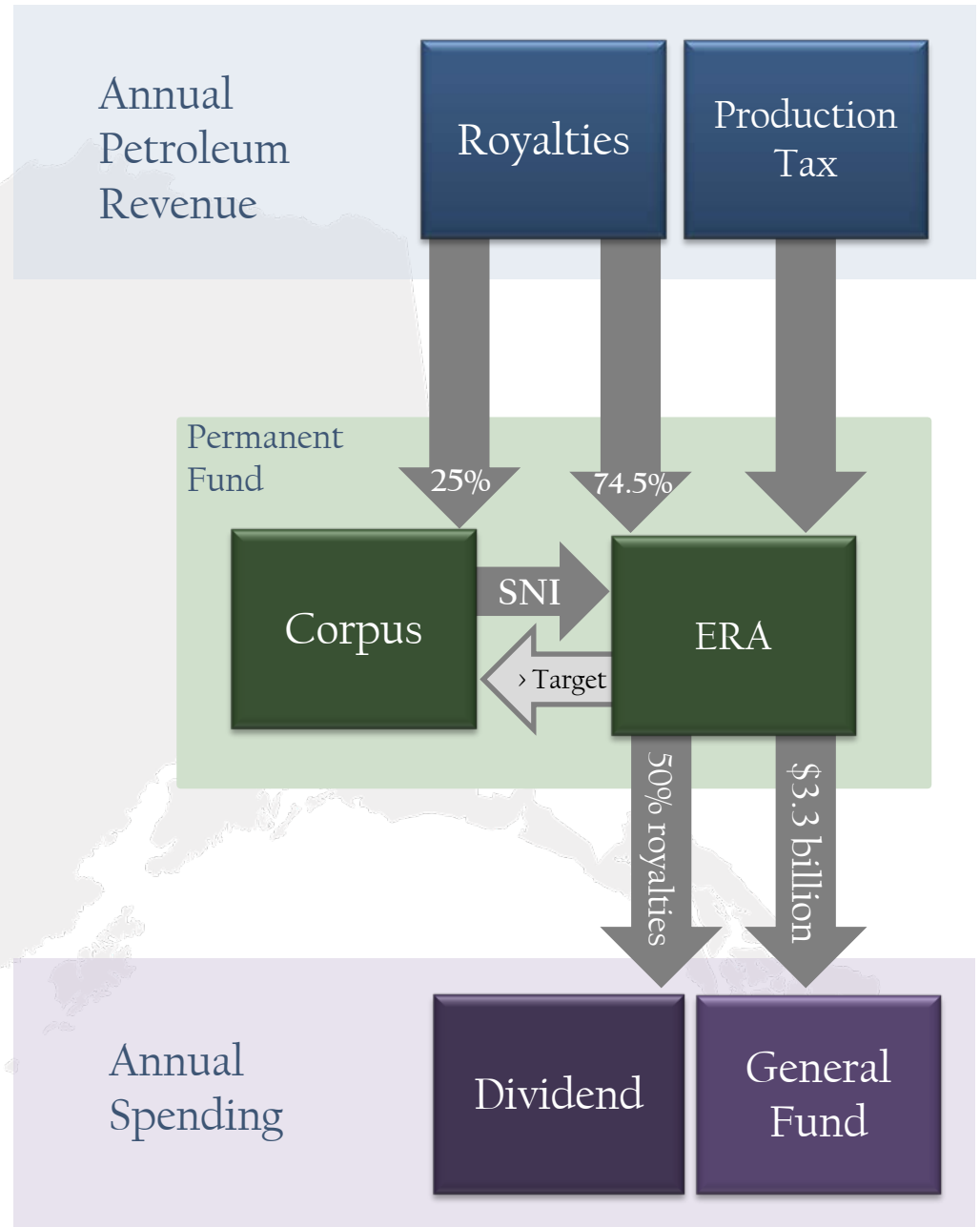
ANALYSIS OF OPTIONS

RULE-BASED FRAMEWORK



APFPA

1. Volatile petroleum revenues to the Permanent Fund
2. \$3.3 billion draw to the General Fund
3. Dividends
50% royalties



DEFINING “SUSTAINABLE”

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



HOW TO HANDLE THE DRAW

There are tradeoffs between different types of draw formulas

- Status quo framework
 - Sustainable draw \approx \$2.4 billion
 - Funds to the general fund = \$2.4 billion – dividend (\$1.4 billion in FY16)
- APFPA framework
 - Sustainable draw = \$3.3 billion or 6% POMV
 - Separate cash flow allocated to the dividend

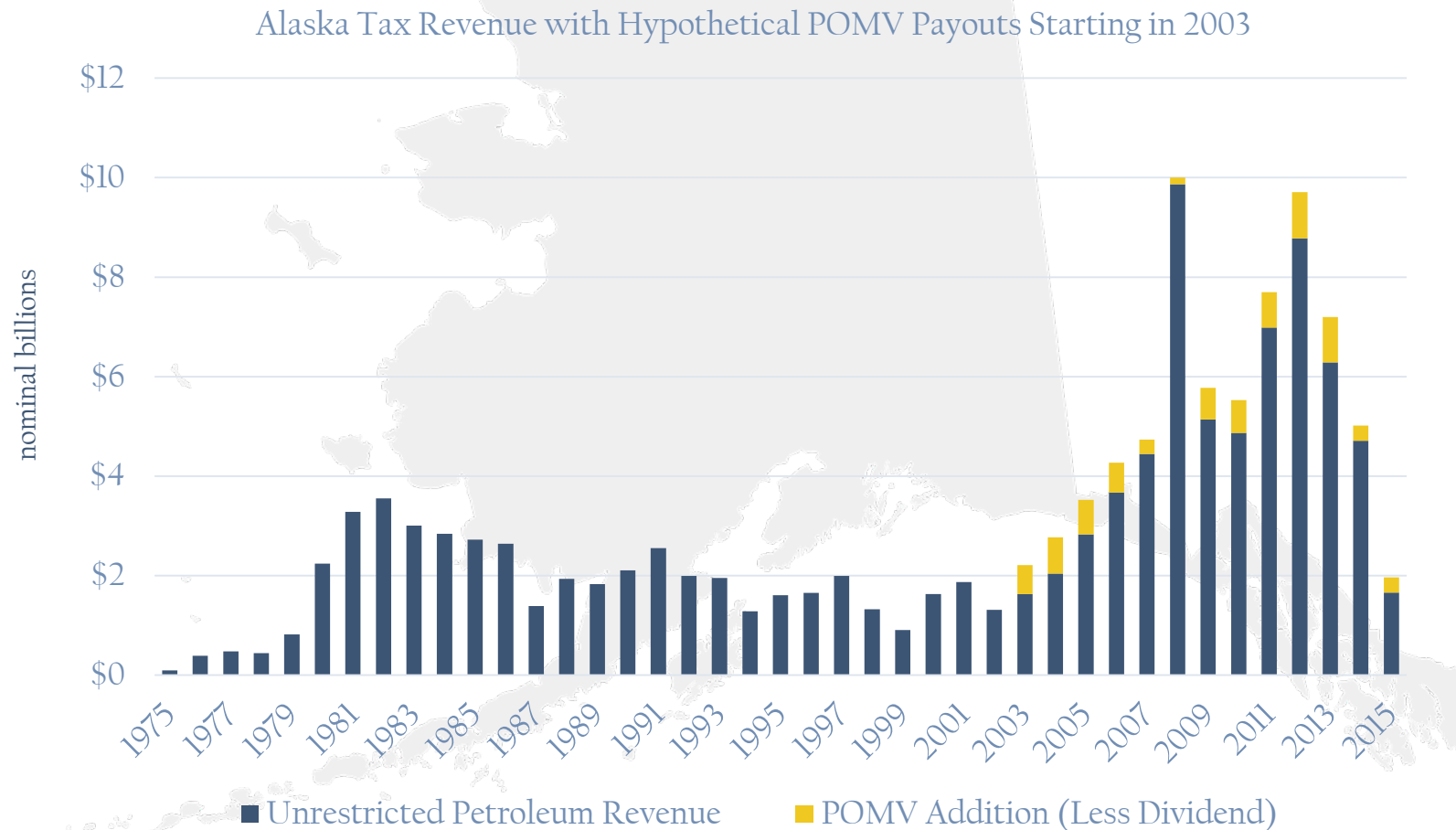
POMV	Fixed
<ul style="list-style-type: none">• Draw self-adjusts<ul style="list-style-type: none">Lower chance of depletionLess fund growth potential• Year-to-year budget volatility*	<ul style="list-style-type: none">• Draw does not self-adjust<ul style="list-style-type: none">Greater chance of depletionGreater fund growth potential• Stable Budget

*Volatility may be reduced, but not eliminated, with use of smoothing rule such as 5- year averaging



HOW TO HANDLE THE DRAW

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



HOW TO HANDLE VOLATILITY

STATUTORY NET INCOME (SNI) VOLATILITY

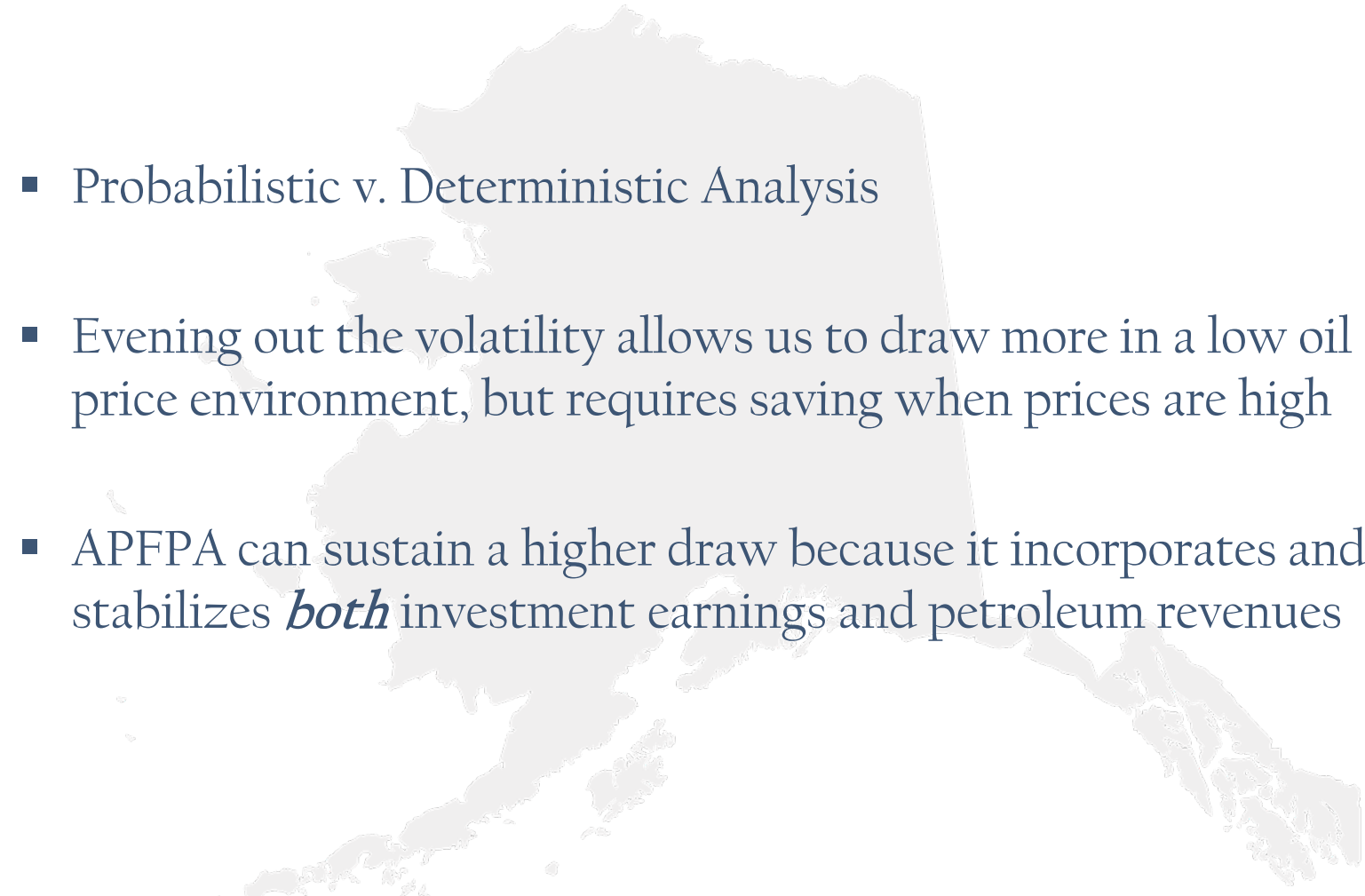
- Option 1:
 - SNI placed in earnings reserve
 - Formulaic draw (e.g., fixed draw or POMV)
- Option 2: constitutional amendment allowing pure POMV

PETROLEUM REVENUE VOLATILITY

- Option 1:
 - Royalties and production taxes placed in earnings reserve
 - Formulaic draw (e.g., fixed draw or POMV)
- Option 2:
 - Revenue limit
 - Reduce POMV draw as petroleum revenues in general fund go up
- Option 3:
 - Spending or appropriation limit not linked to earnings
 - Difficult to have a dependable rule



CALCULATING THE DRAW

- 
- Probabilistic v. Deterministic Analysis
 - Evening out the volatility allows us to draw more in a low oil price environment, but requires saving when prices are high
 - APFPA can sustain a higher draw because it incorporates and stabilizes *both* investment earnings and petroleum revenues



CALCULATING THE DRAW

Annuity Payment to the General Fund

Starting Balance = \$55 billion (\$45B in corpus; \$7B in earnings reserve account; \$3B from CBR)

+ 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)

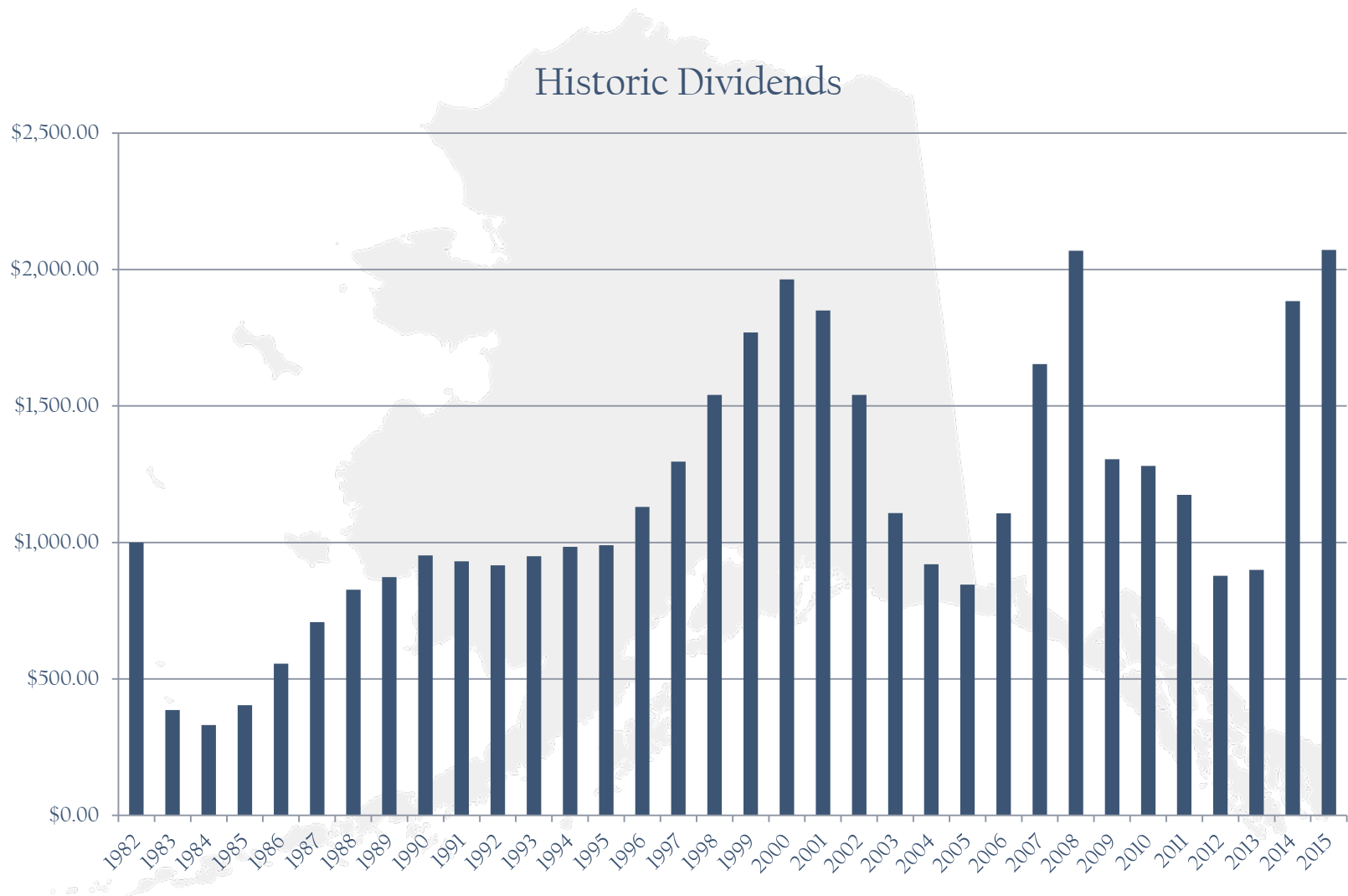


EARNINGS RESERVE DURABILITY

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- 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

- Earnings Dividend (current formula): half of statutory net income (SNI)
- Royalties Dividend: connects Alaskans to the economy
- POMV Dividend: based on Fund market value, not SNI
- CBR Dividend: based on CBR balance; rewards Alaskans for Legislature maximizing stabilization account
- \$1,000 Flat: ~ \$650 million, reduces the sustainable draw
- Mixed Formula: combination of different ideas



HOW TO HANDLE THE DIVIDEND

- Dividend formula should connect Alaskans to the economy and the fund
- Certain draw and dividend combinations do not work well
 - POMV draw & earnings dividend
 - Volatile dividend formula (*i.e.* royalty dividend) and floor
- Dividend formula tied to the balance of stabilization funds (*i.e.*, CBR) runs risk of politicizing rule-based dividend payout formula





Alaska Permanent Fund Protection Act

THE BILL

ALASKA PERMANENT FUND PROTECTION ACT

- 
- Section 1: Revenue to the Corpus
 - Section 2: Defines “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



RULE-BASED FISCAL POLICY

- **Savings Rule**
 - Permanent Fund SNI to earnings reserve
 - 25% of mineral royalties to corpus
 - 24.5% of royalties and 100% production taxes to earnings reserve
- **Growth Rule**
 - Assets grow with inflation
 - Opportunities for additional growth assigned to the corpus and dividend
- **Protection Rule**
 - Constitutional protection of the corpus
 - Transfers funds in excess of earnings reserve target balance to the corpus
 - Earnings reserve durability tested
- **Spending Rule**
 - Draw: fixed \$3.3 billion with periodic review
 - Dividend: 50% of annual mineral royalties to Alaskans
- **Volatility Rule**
 - Permanent Fund: SNI, 49.5% royalties 100% production tax volatility in the Permanent Fund
 - Dividend: 50% royalty volatility in dividend
 - General Fund: No SNI, royalty or production tax volatility in general fund



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

