

A Comparison of Plans to Re-Plumb Alaska's Cash Flow

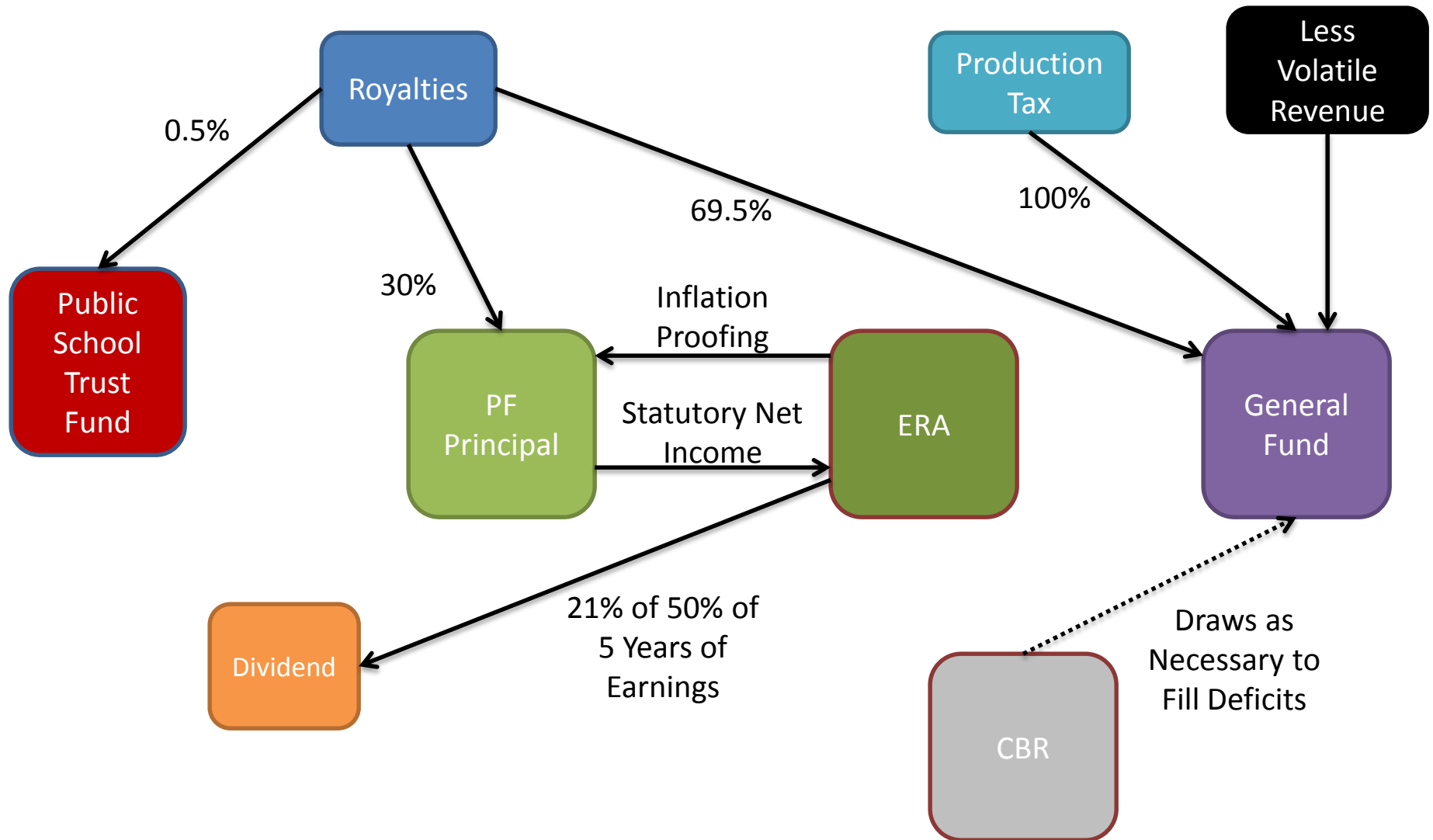
- Cash Flow Diagrams
- Models

Senate Finance Committee—March 23, 2016

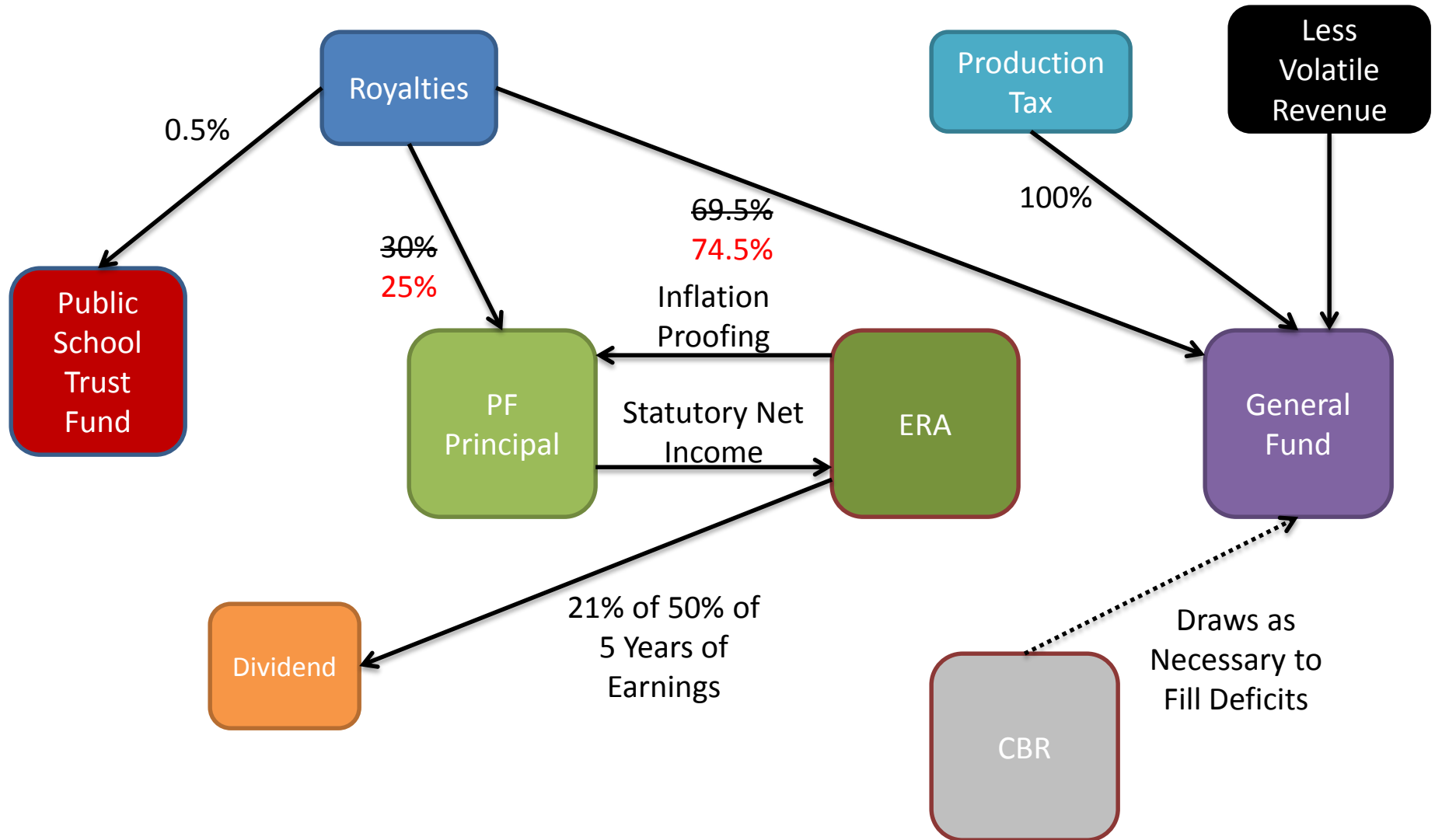
David Teal, Director

Legislative Finance Division

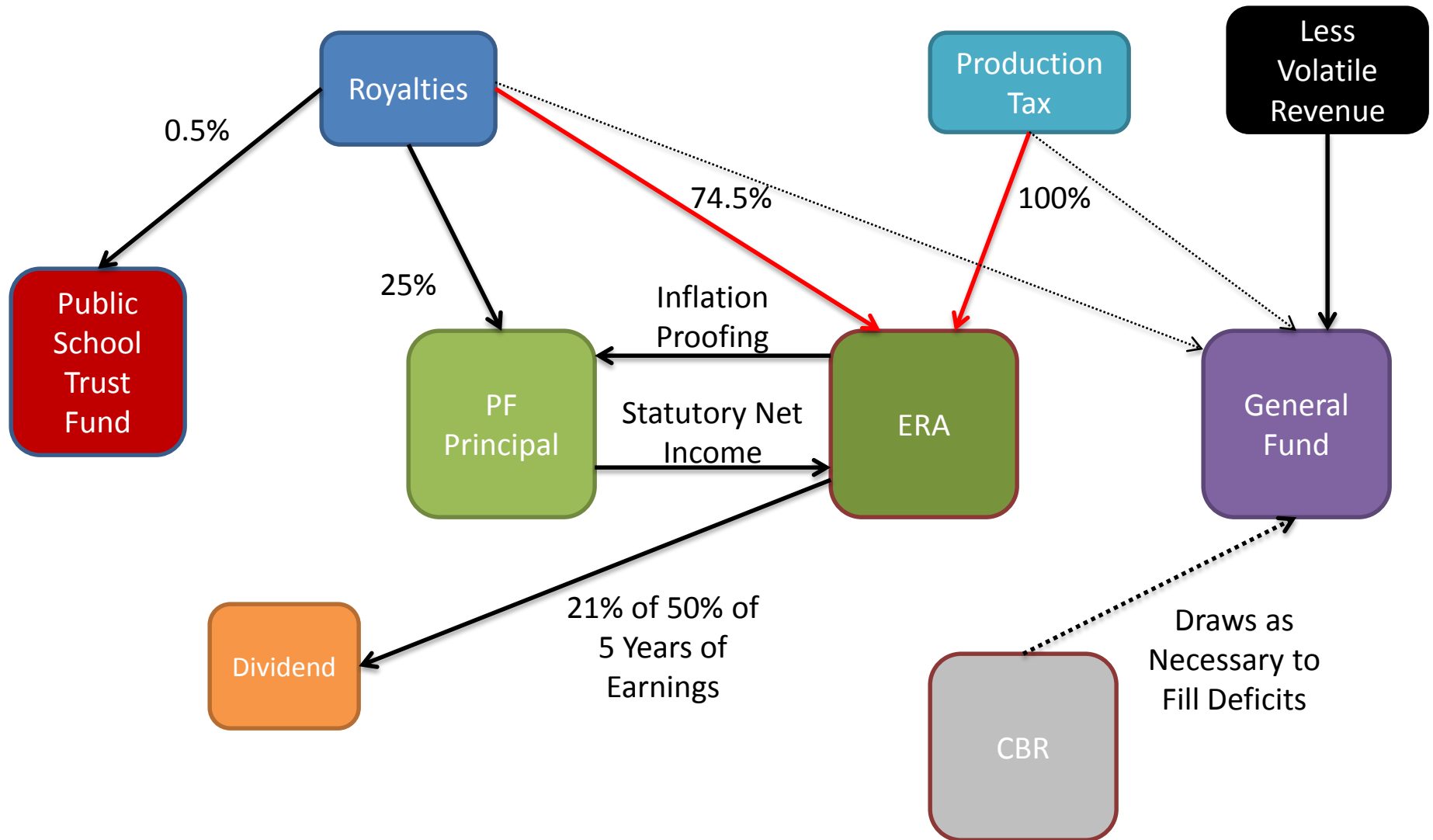
Current Cash Flow



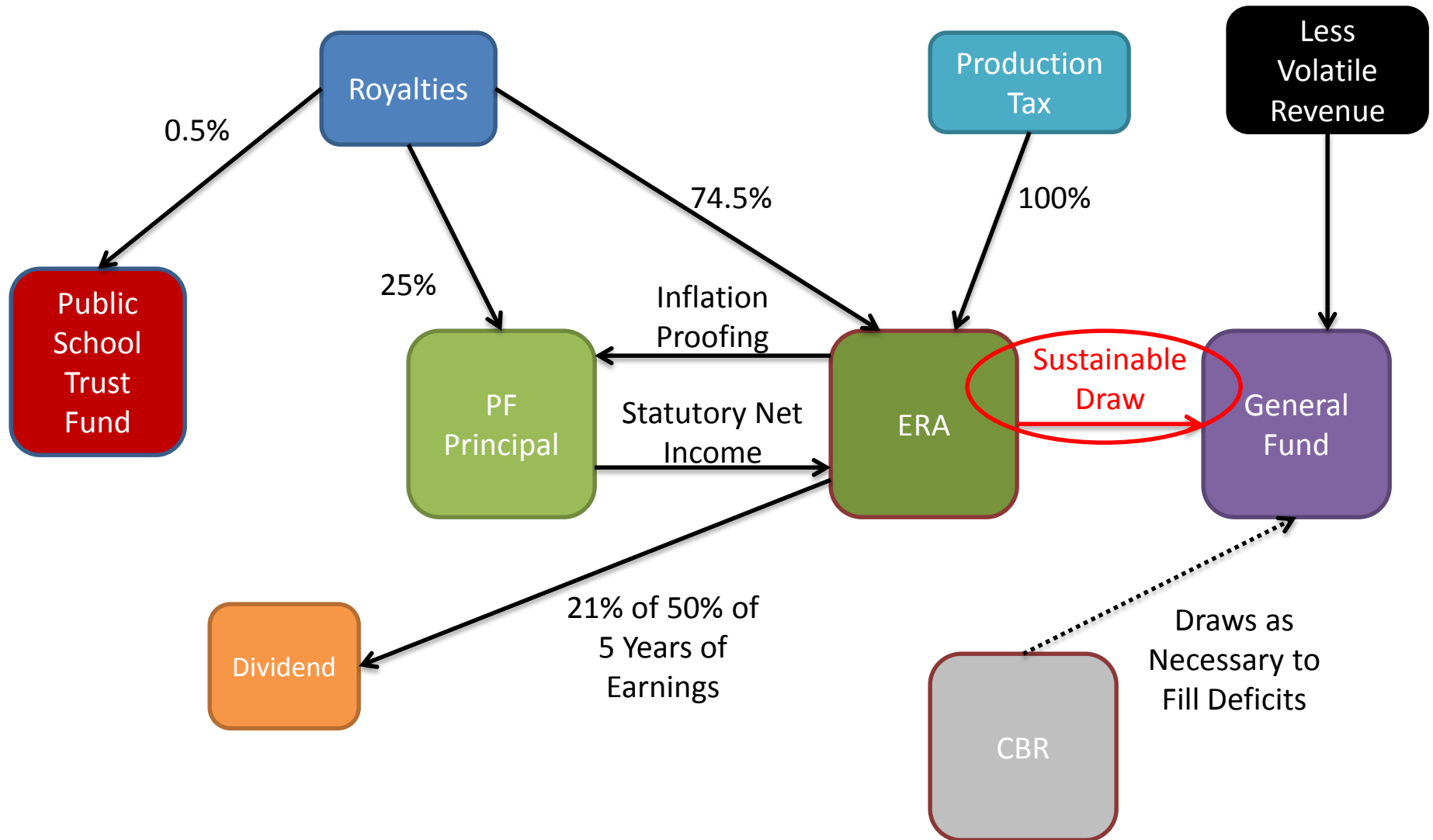
1. Change Royalty Percentage (PFPA)



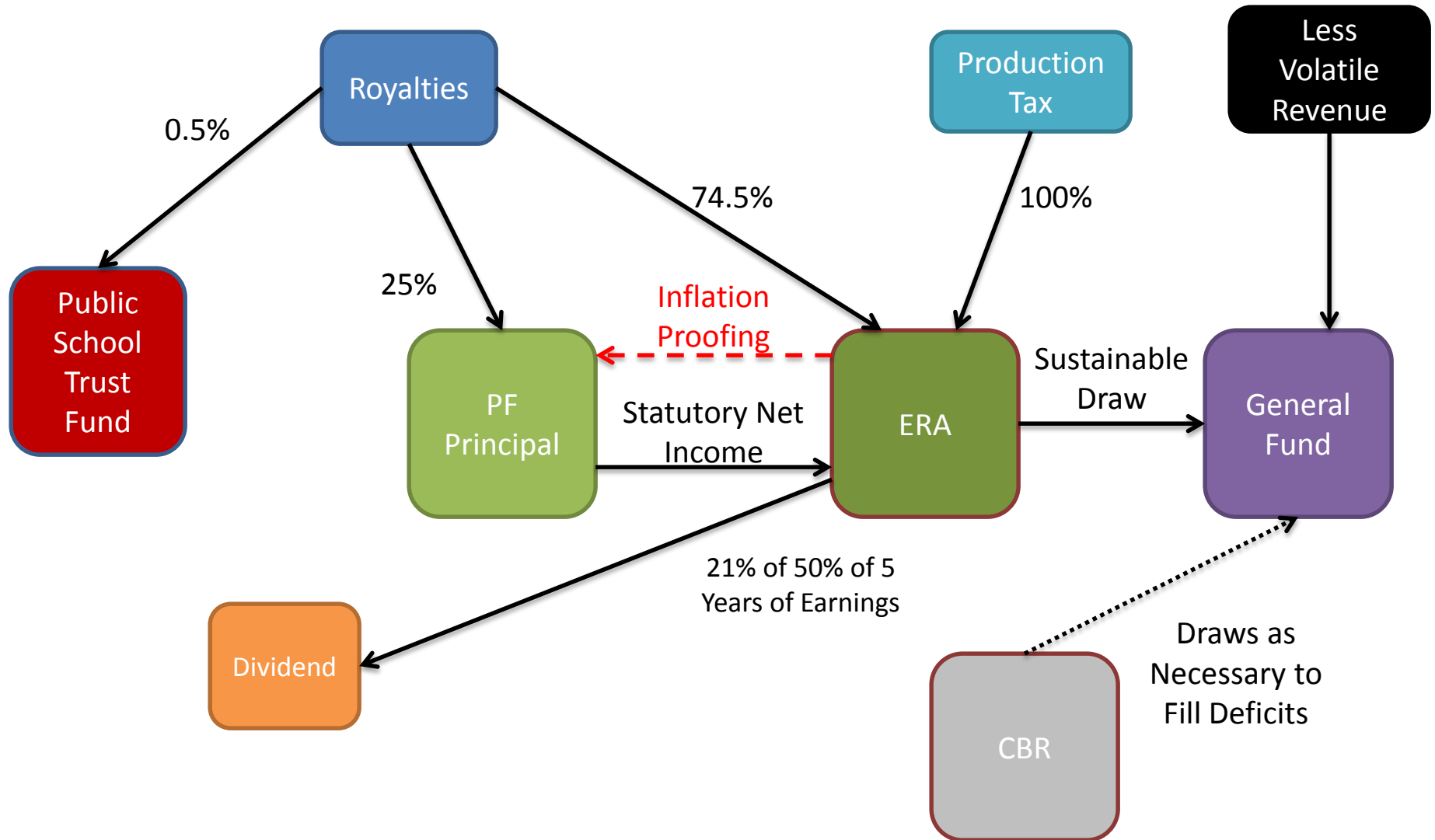
2. Re-Route Taxes and Royalties to ERA (PFPA)



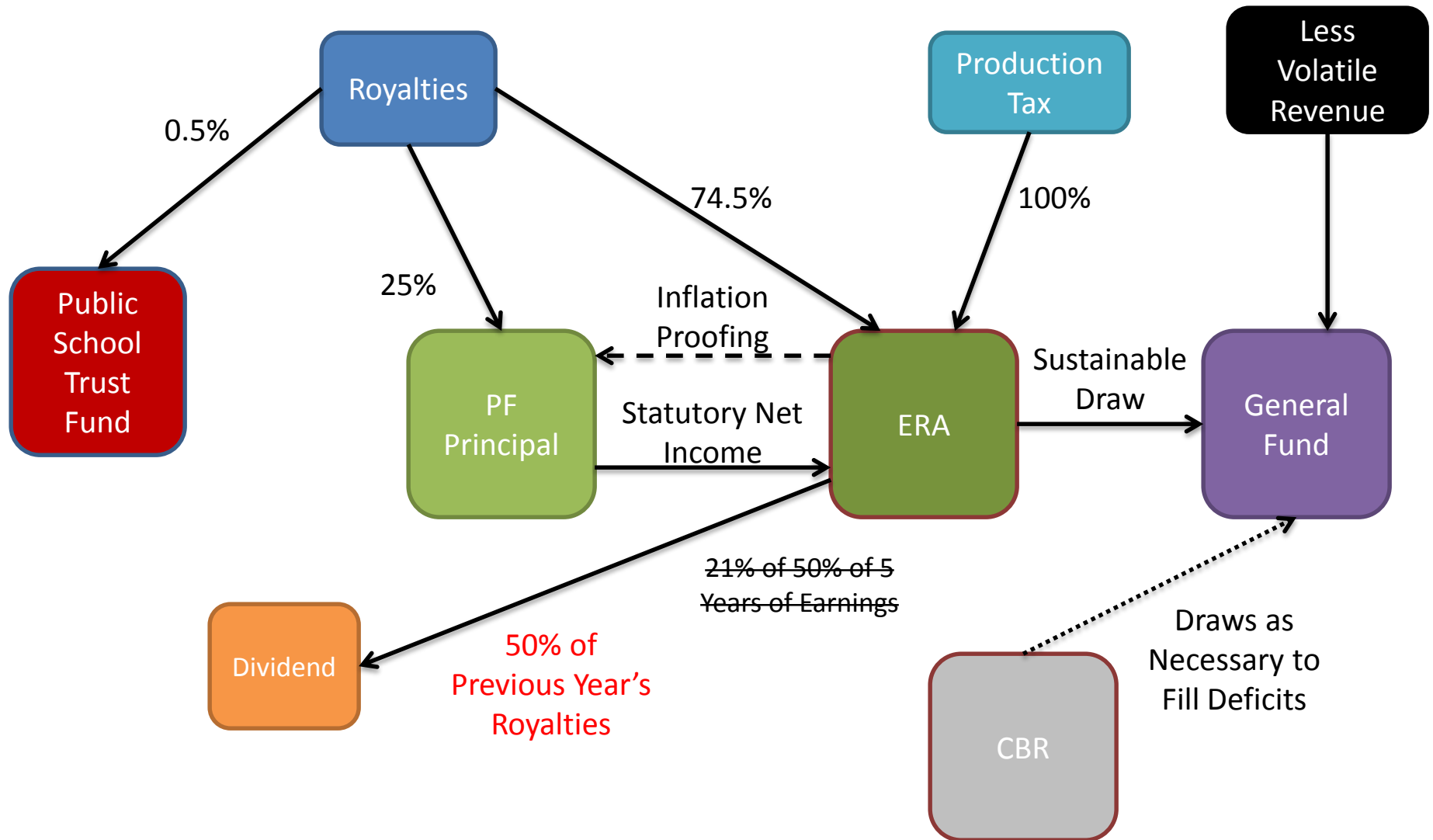
3. Add Sustainable Draw from ERA (PFPA)



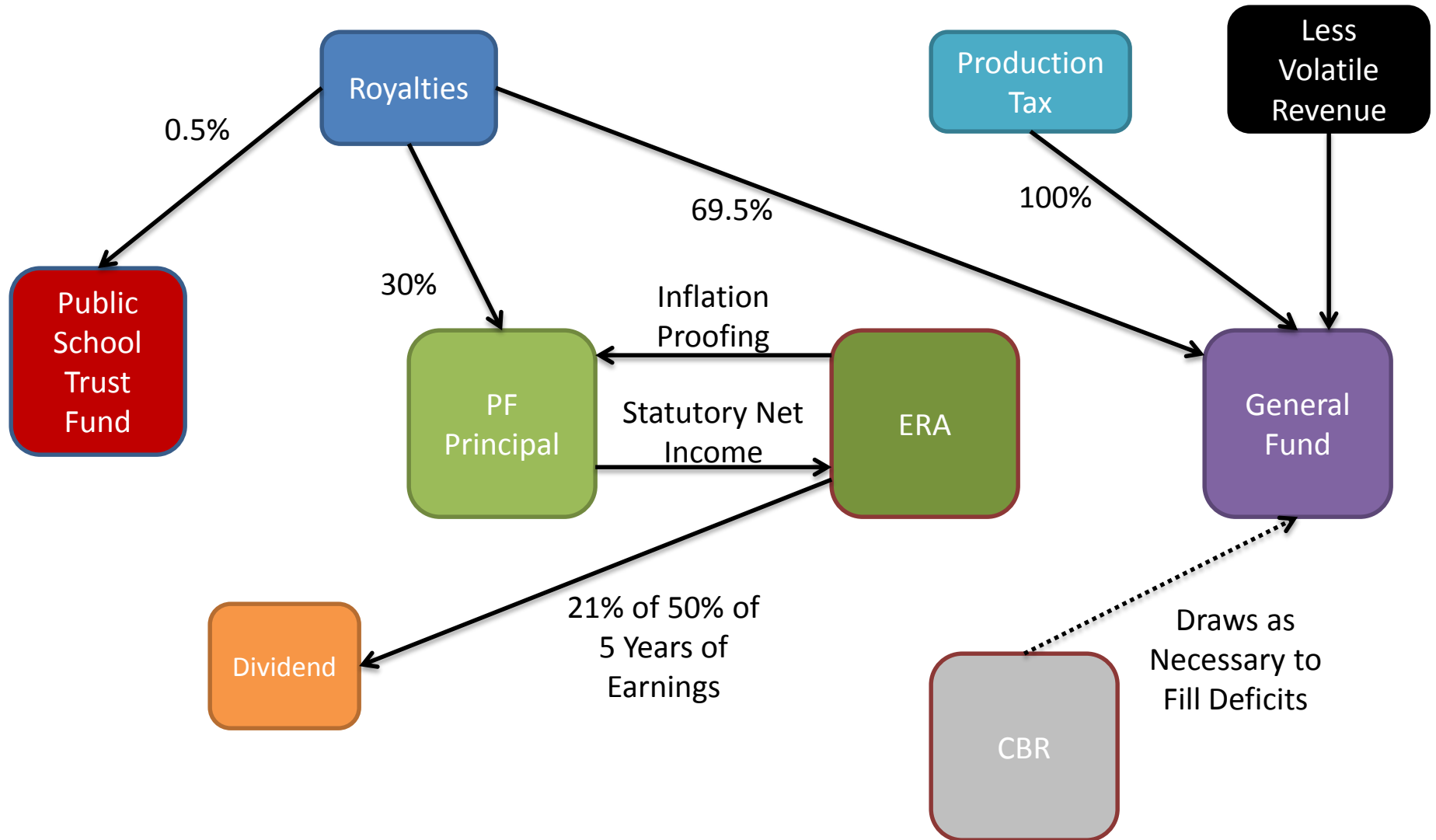
4. Change Inflation Proofing to an “Overflow” Mechanism (PFPA)



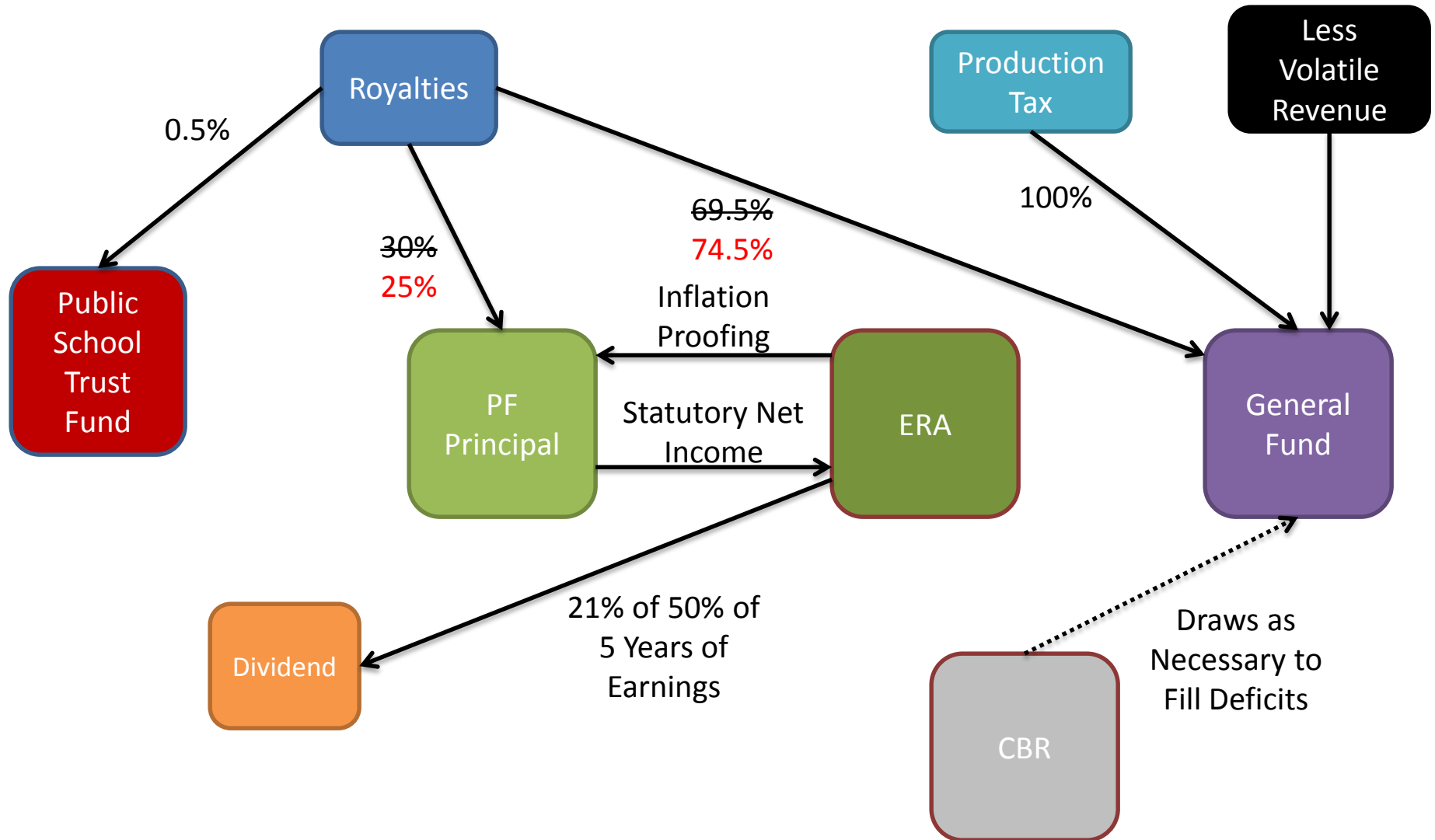
5. Change Dividend Source and Calculation (PFPA)



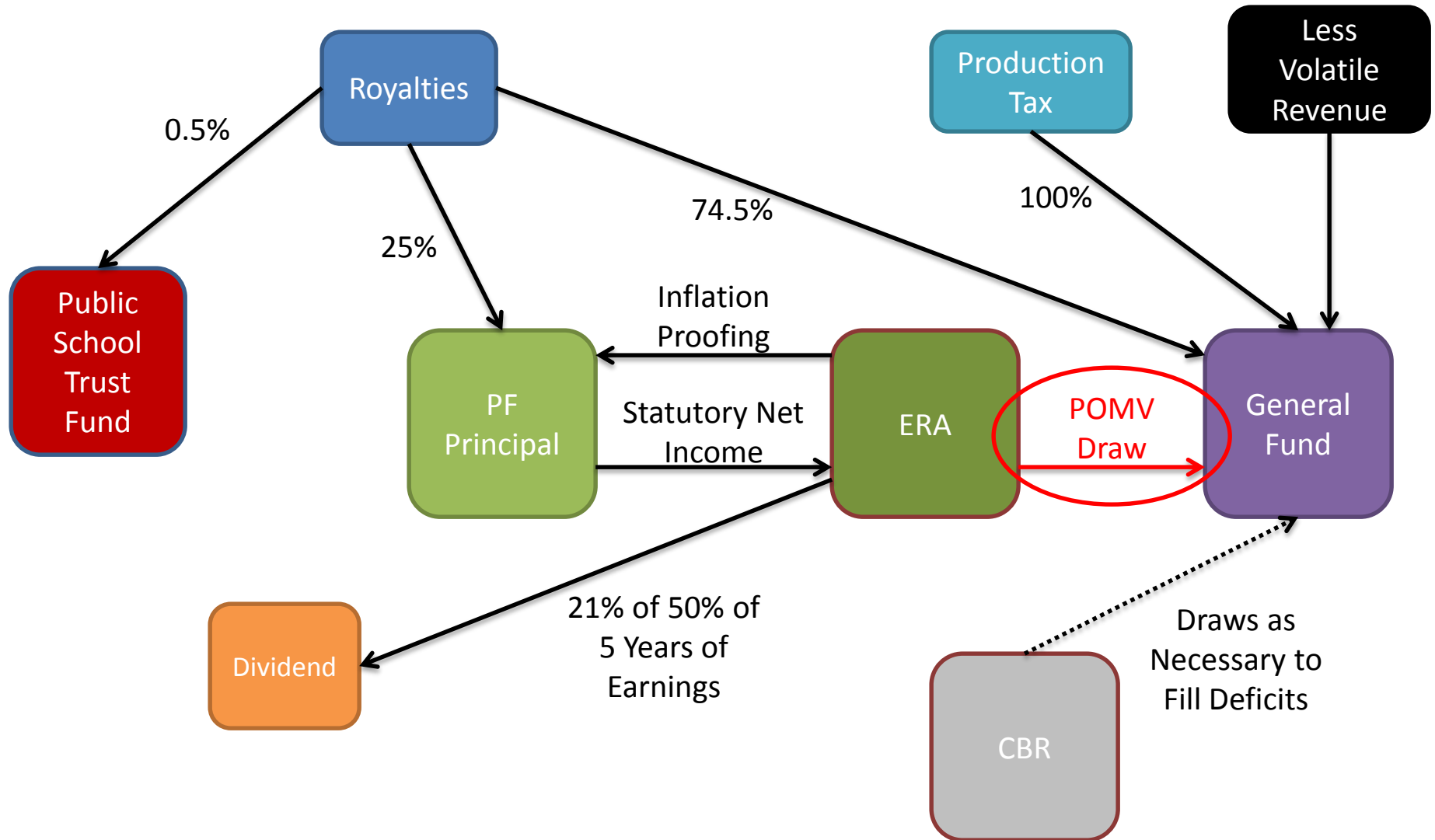
Current Cash Flow



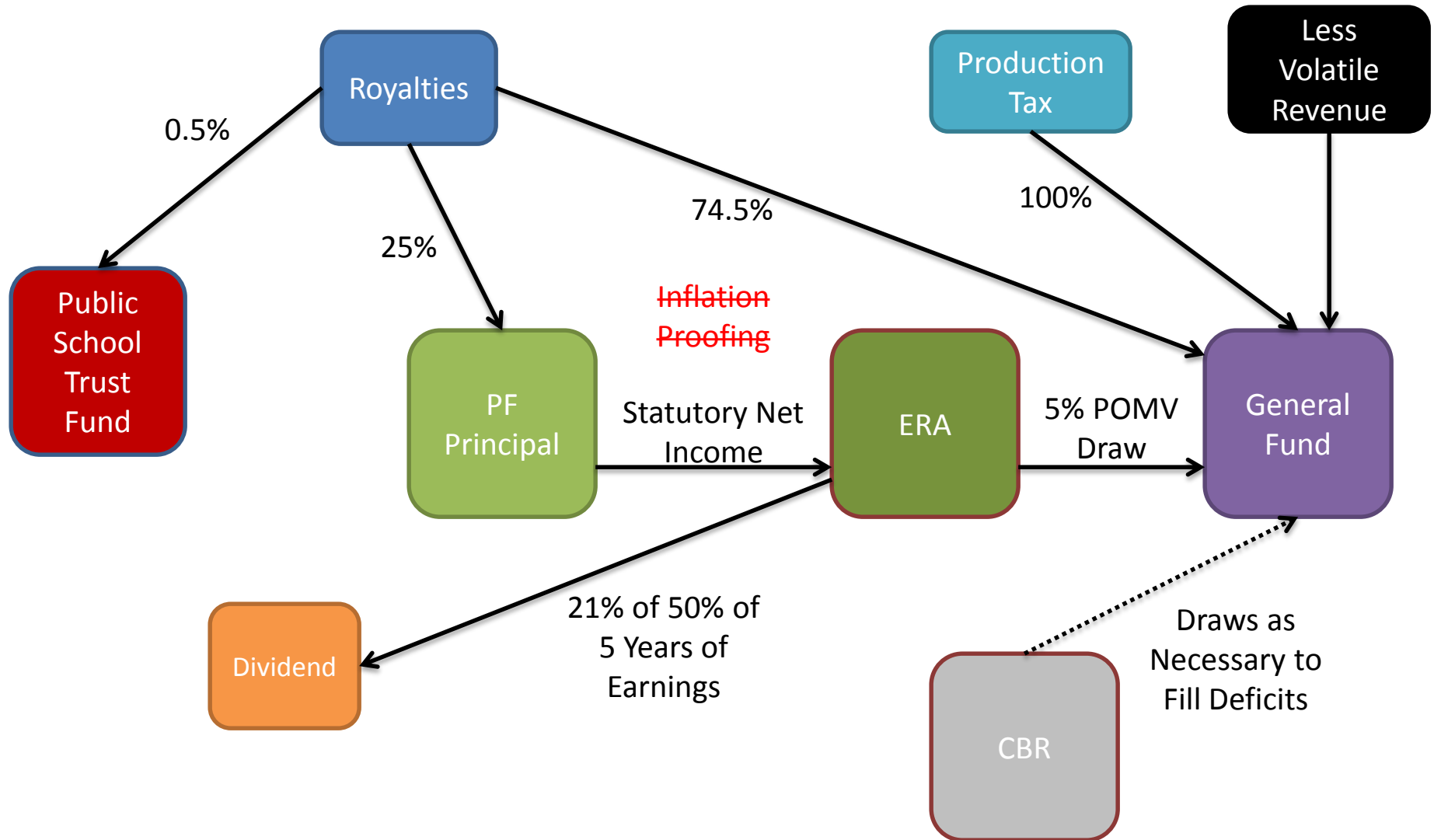
1. Change Royalty Percentage (SB114 / HB303)



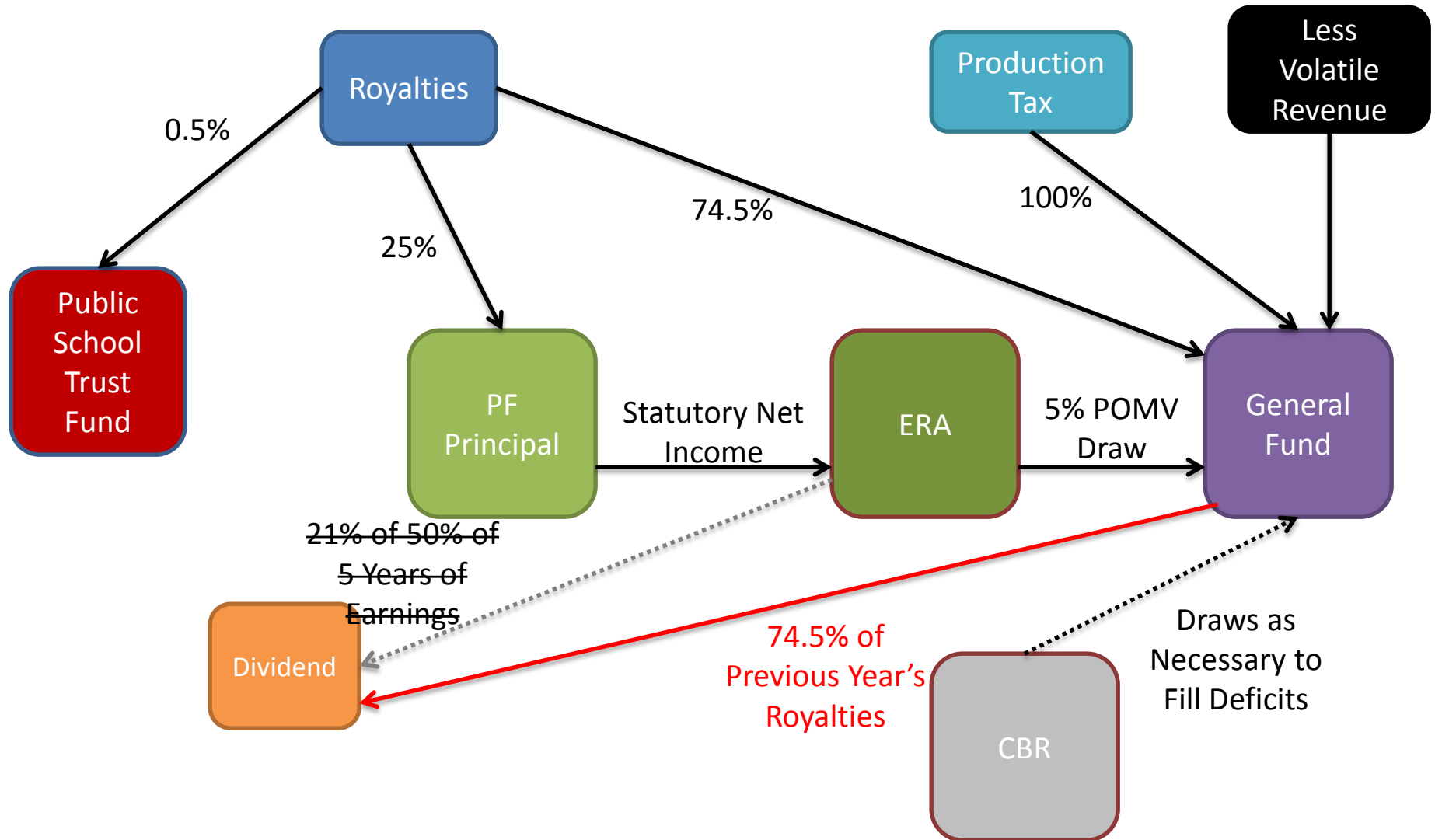
2. Add POMV Payout (SB114 / HB303)



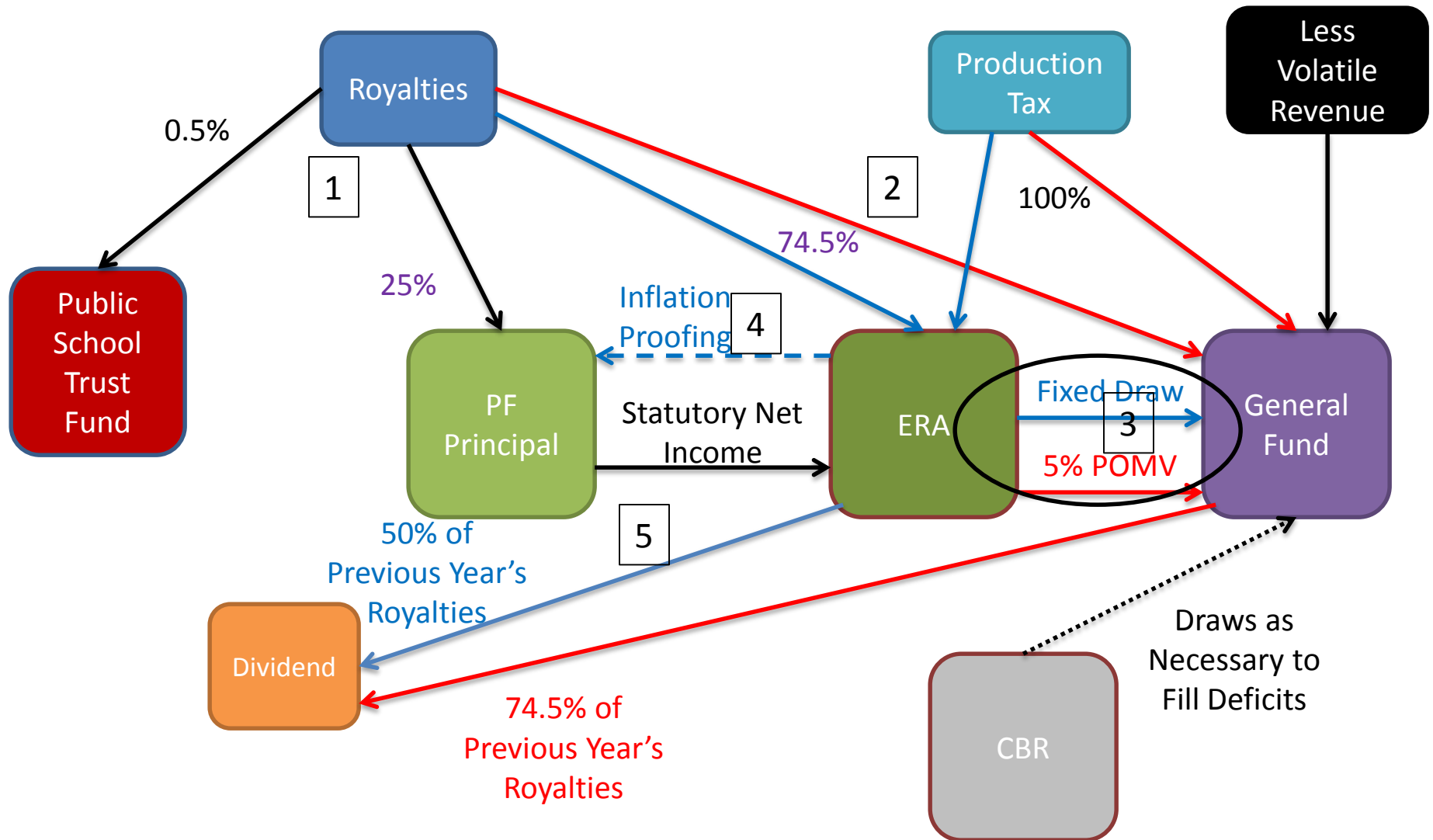
3. Remove Inflation Proofing (SB114 / HB303)



4. Change Dividend Source and Calculation (SB114 / HB303)



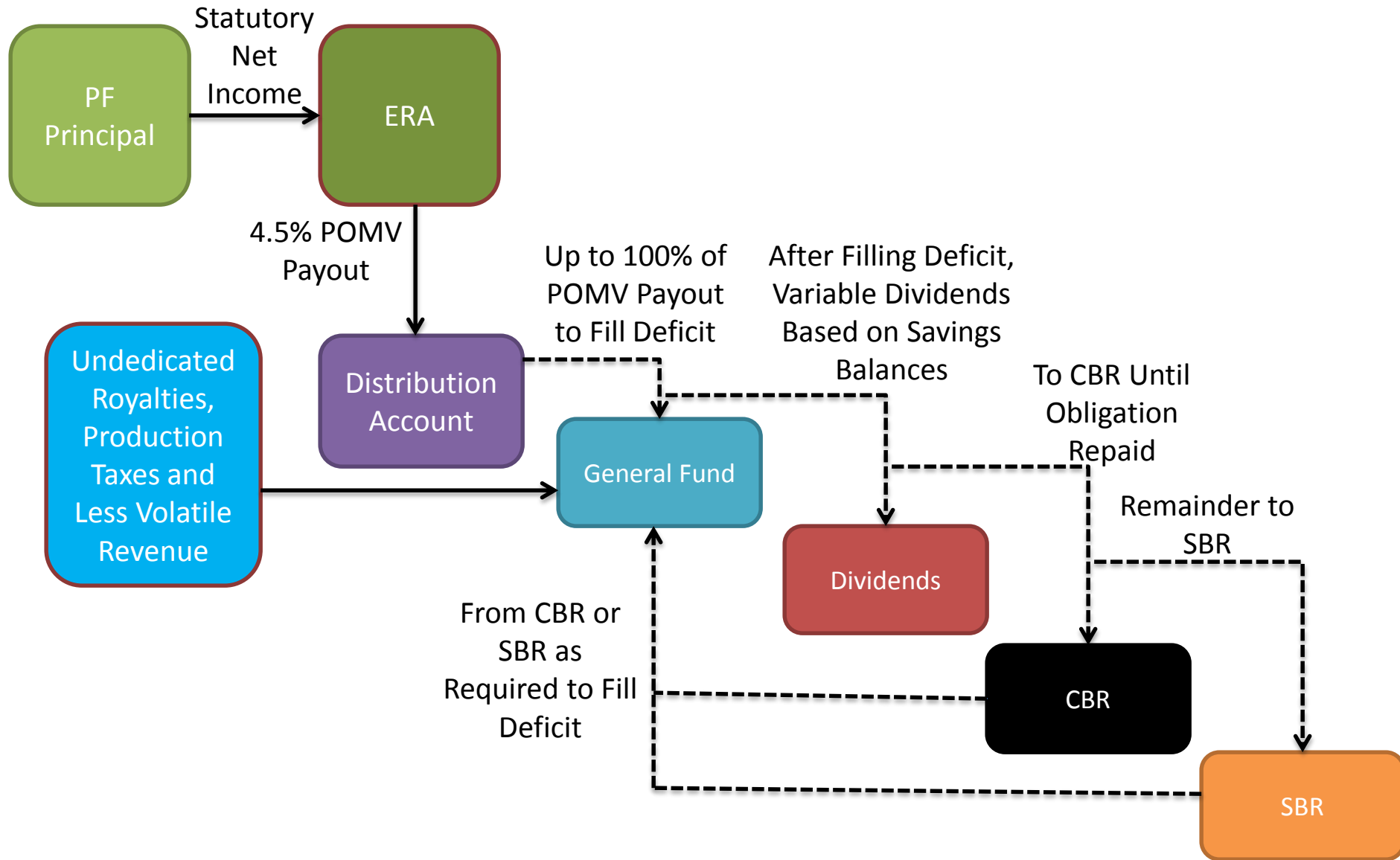
PFPA vs. SB114 / HB303



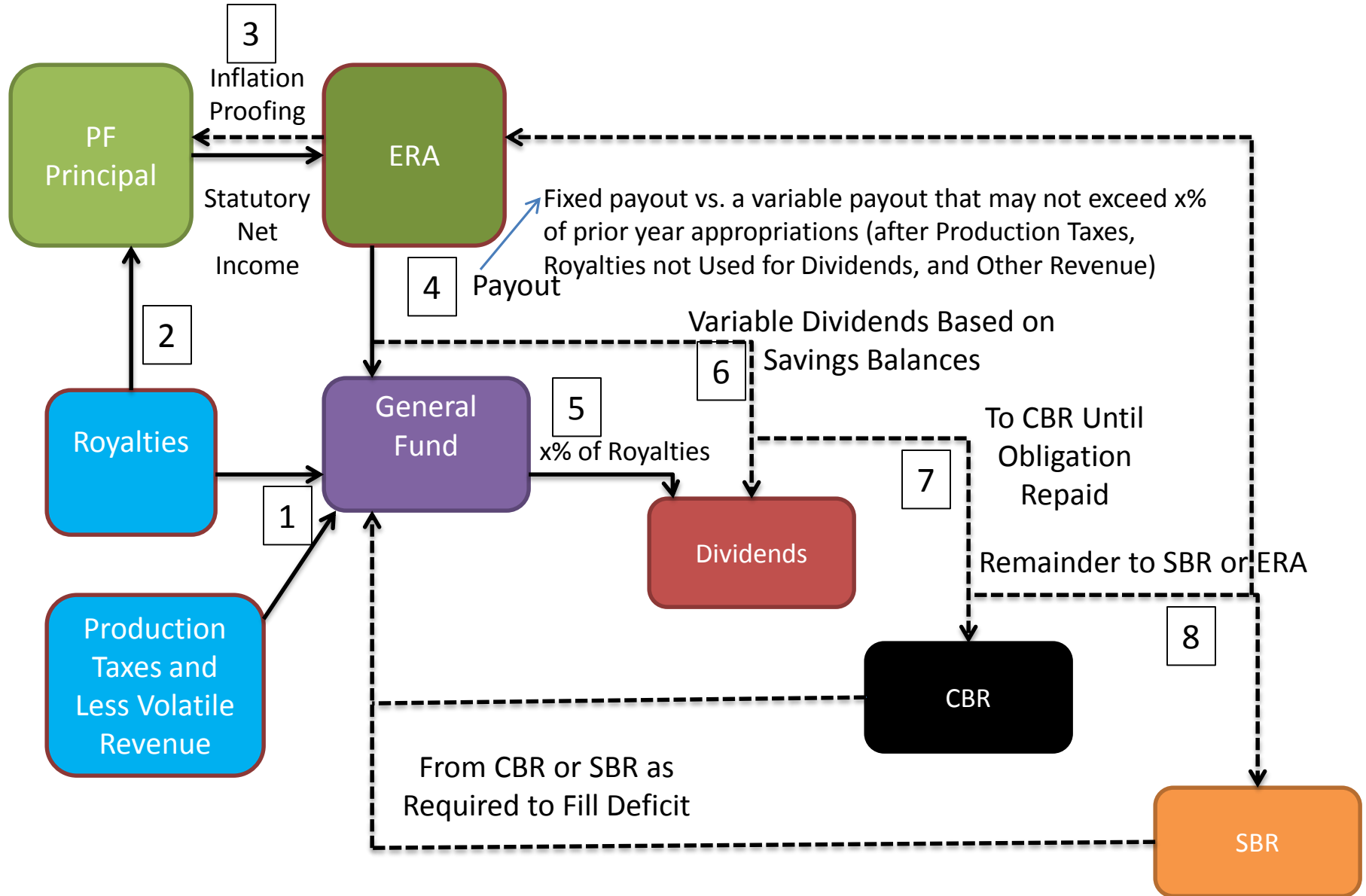
PFPA vs. POMV: Which is Better?

1. A fixed draw is highly dependent on actually attaining the projected rates of return and projected oil revenue.
2. Those projections look forward 20 years--hence the need for review of sustainability of the draw.
3. We are not very good at projecting rates of return, and even worse at projecting oil revenue.
4. POMV looks backwards 5 years and the payout is based on actual events rather than on projections.
5. Ask yourself this question: Is your hindsight better than your foresight?
6. Lest that question appears to be one-sided, note that POMV fails the stability test—if royalties and production tax revenue jump \$4b and fill the deficit without the need for a payout, the payout still occurs and there would be a tendency, or at least a possibility, of spending the windfall.
7. Is there a hybrid that offers the comfort of hindsight offered by POMV and the stability of PFPA?

HB 224 Cash Flow



Decision Points



Decision Points

1. Do you direct volatile revenue to the GF or the ERA? Trade-off: fixed draw vs. “good enough” stability. This choice is made once you decide on #4.
2. Reduce dedication to 25%? Do you save while harvesting? Not a critical decision—it affects 10s of millions vs. 100s of millions under decision #3.
3. Inflation Proofing--Do you want greater protection of the PF if it increases the risk of failing to have the cash needed for a payout? Once money is in the PF, it can never be spent, while money in the ERA can be spent any time.
4. The payout is your first critical decision. Trade-off: do you favor a forward-looking, manual adjusting fixed draw that promises greater stability, or a backward-looking, self-adjusting draw that offers less stability? Spending restraint under high oil prices is a key element of PFPA. But POMV’s weakness in that area can be overcome by limiting the payout to prior year appropriations (plus some room for growth, if desired). The POMV payout can be turned into a spending limit.

If you chose a variable draw, what payout rate will you choose? Trade-off: a lower rate means less money now, but it increases growth of the ERA and other reserves so could mean larger payouts in the future. 4.5% of \$70b is greater than 5% of \$60b.

But a lower payout rate means larger deficits in the short-term—do you want to reduce spending or increase taxes to fill the gap, or do you have sufficient reserves to fill deficits? The longer you wait to act, the lower your reserves and the higher the risk of failure.

5. Second critical choice is the amount and source of dividends. This applies to #5 and #6. Recall that IP can never be spent, but it spins off spendable earnings in the future. Once money is spent on dividends, it can never be recovered. **Trade-off:** higher dividends mean lower reserves and greater risk of unfillable deficits (or higher taxes or reduced spending on things other than dividends). This trade-off exists regardless of the source of dividends. **Another trade-off: dividends and the economy.**
6. The source of money for dividends may not be a critical choice in terms of maintaining healthy reserves, but it is a decision you will need to debate. Dividends now reflect the health of financial markets rather than the fiscal health of the state. Basing dividends on royalties (PFPA and SB114) would bring in short-term fiscal health, while basing dividends on reserve balances (HB224) would bring in long-term fiscal health. Why not do all three? That would provide a stable, guaranteed dividend with a kicker.
7. And 8. Deciding what to do with money that remains after the deficit is filled and dividends are paid is hardly worth talking about. You can set up rules or leave that decision to future legislatures.