THE STATE *of* ALASKA

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May 12, 2016

Honorable Senator MacKinnon
Alaska State Legislature
State Capitol, Room 516
Juneau, AK 99801-1182

Re: CSSB 128 – the proposed revenue limit and an accompanying savings rule

Dear Senator MacKinnon:

Thank you for incorporating a revenue limit in the committee substitute (CS) for the Alaska Permanent Fund Protection Act (APFPA).[1] By reducing the draw when other revenues are high, the revenue limit allows a 5.25% draw in low revenue years; without the limit, a draw this high would likely degrade the real value of the fund over time. The limit will also help smooth unrestricted general fund (UGF) expenditures through a mid-range of oil prices. In doing so, it will help us avoid repeating the state's historic cycle of growing and cutting government and the resulting damage to the economy. Finally, in preserving the value of the fund, the revenue limit also protects the dividend. In short, the revenue limit is a critical addition to the bill.

But, the revenue limit is meaningful only if we find the right balance. Following up on conversations with legislators, we wanted to offer the results of further analysis and the administration's perspective on a few points, including:

1. The level of the revenue limit threshold;
2. Holding that threshold steady over time; and
3. A savings rule to accompany the revenue limit.

The approach taken on each of these points can affect the long-term success of the plan.

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[1] For purposes of this letter, our comments are based on CSSB 128 (FIN) Ver. S.

I. The revenue limit threshold should be set at $1.0 billion.

As initially conceived, the revenue limit would reduce the amount drawn from the permanent fund to support UGF expenditures by one dollar for every dollar that production taxes and unrestricted mineral royalties exceed $1.0 billion. With a $1.0 billion threshold, the revenue limit is meaningful within a reasonable range of oil prices ($65 to $100 per barrel in FY17[2]). Also, because the Department of Revenue (DOR) forecasts that production taxes and 80 percent of unrestricted royalties will total only about $520 million in FY17, a $1.0 billion threshold still leaves room for some additional capital spending or other budgetary growth as oil prices recover.

In conversations with legislative finance, we agreed that increasing this threshold to $1.2 billion made sense because the allocation of 20 percent of unrestricted royalties to the dividend affected expectations for the amount available for other UGF expenditures. But, in the current CS, all funds allocated to the dividend are disassociated from the revenue limit calculation. Therefore, the administration believes the threshold should be restored to $1.0 billion.

A $1.0 billion revenue limit threshold reflects a somewhat optimistic baseline expectation of about $3.0 billion in annual revenue from investment earnings, production taxes, and unrestricted non-dividend royalties.[3] DOR's probabilistic modeling forecasts an average of about $2.85 billion each year from these same three revenues over the next 24 years – through a full range of oil prices. Increasing the threshold for the revenue limit to $1.2 billion will not increase the amount of revenue we actually collect, or can reasonably expect over time. But, because the higher revenue limit will have less of an effect less often, it will only place greater pressure on the permanent fund and fail to capture savings when revenues do increase.

II. The revenue limit threshold should not increase with inflation.

We offered the revenue limit with an inflationary growth factor applied to the threshold; however, additional analysis in response to questions from Representatives Gara and Kawasaki revealed that this adjustment is problematic. By 2027, if production declines as predicted by DOR a $1.0 billion flat threshold would not be triggered until oil is $95 per barrel; the POMV draw would not be completely offset until well over $140 per barrel. If the threshold is also increased by inflation, an even higher price will be required to begin offsetting the POMV draw. The revenue limit would become meaningless over time and provide for more spending just as

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[2] Oil prices are expected to eventually even out around $65 per barrel. Setting the initial revenue limit threshold at that price means that the limit will offset the POMV draw only in "upside" years (when production taxes and royalties are higher than usual).

[3] This $3 billion baseline expectation includes (1) 80% of the POMV draw (about $1.92 billion in FY17, increasing as the fund grows) and (2) the $1.0 billion threshold level of production taxes and unrestricted non-dividend royalties (only expected to total about $520 million in FY17). It does not include other existing UGF revenues (ranging between $600 and $800 million), any new revenues, draws from the CBR or other savings accounts, or production taxes and UGF royalties that exceed the amount needed to fully offset the POMV draw.

our production and revenues are declining. In order to prevent permanent fund draws to the general fund as being a source of budgetary growth, we think the inflation adjustment of starting revenue limit threshold should be removed.

Some have voiced concerns that, without increasing the threshold by inflation, there would be no budgetary growth over time to keep pace with inflation. But, the POMV draw does provide for growth regardless of the revenue limit because the amount of the draw increases as the fund grows (at least in pace with inflation). DOR's modeling shows that unlike the $1.2 billion inflated threshold, the lower threshold results in an expected outcome of some growth in the permanent fund over the rate of inflation – this means higher dividends and more support for the general fund when production declines and the state becomes more reliant on fund earnings. Since the POMV draw is already calculated to grow with inflation, putting an inflation adjustment in the revenue limit creates an unnecessary distortion.

III. A savings rule for peak revenue years would balance the framework.

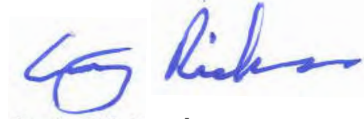
While the revenue limit would smooth UGF revenues through a mid-range of oil prices, the initial APFPA proposal would smooth UGF revenues through a full range of oil prices, from low to high. Capturing revenue from high oil price years in the fund offers significantly greater potential for fund growth while allowing for even higher draws in very low revenue years. This dynamic was well illustrated in the historic counterfactual analysis provided in our April 28 letter responding to Senator Micciche's question. If the initial APFPA framework had been put into place in 2005, we would have saved $24 billion more in the permanent fund compared to actual savings and $19 billion more than under the CS framework. These greater savings would have also produced higher dividends than the CS – dividends which would continue to grow with the fund. Of course, a larger fund can also sustain larger payouts to the general fund.

Partnered with the revenue limit, a rule to save at least some peak revenues could capture some of the advantages offered by the initial APFPA framework. For example, the bill could include a trigger for increasing the percentage of royalties deposited in the permanent fund principal (after the revenue limit completely offsets the POMV draw). This would create more opportunities for fund growth, produce higher dividends, and compensate for years of reduced royalty contributions, while also improving the fund's capacity to protect against low revenue years. At the same time, peak production taxes would be available for capital projects, constitutional budget reserve (CBR) repayment, or any other legislative priority. Because the dedicated fund prohibition does not apply to royalty contributions to the permanent fund, a statutory trigger could operate automatically. We have attached a potential amendment to the CS that would place additional royalties into the permanent fund once the permanent fund POMV draw has been reduced to zero.

Thank you again for your efforts to develop the best solution for the state's fiscal challenge. We greatly appreciate your work on this important legislation and look forward to continuing this conversation with you and the finance committee members.

Sincerely,

Randall Hoffbeck
Commissioner of Revenue



Craig Richards
Attorney General

Cc: Members of the House and Senate Finance Committees

AM-# (savings rule)
05/12/16
3:53 pm

AMENDMENT

OFFERED IN THE SENATE FINANCE COMMITTEE BY ____________________

TO: CSSB 128(FIN) ver. S

1 Page 4, following line 8:
2 Insert
3 "(2) If the state receives revenues within the fiscal year sufficient to allow the
4 maximum reduction under AS 37.13.140(c) to the amount available for distribution under
5 AS 37.13.140(b), all mineral lease rentals, royalties, royalty sale proceeds, net profit
6 shares under AS 38.05.180(f) and (g), federal mineral revenue sharing payments, and
7 bonuses received by the state thereafter in the current fiscal year."