

**ALASKA STATE LEGISLATURE
HOUSE SPECIAL COMMITTEE ON WAYS AND MEANS**

February 5, 2007

3:31 p.m.

MEMBERS PRESENT

Representative Mike Hawker, Chair
Representative Anna Fairclough, Vice Chair
Representative Bob Roses
Representative Paul Seaton
Representative Peggy Wilson
Representative Max Gruenberg

MEMBERS ABSENT

Representative Sharon Cissna

COMMITTEE CALENDAR

PRESENTATION BY OFFICE OF MANAGEMENT & BUDGET

PREVIOUS COMMITTEE ACTION

No previous action to record

WITNESS REGISTER

JOHN BOUCHER, Senior Economist
Office of Management & Budget
Office of the Governor
Juneau, Alaska

POSITION STATEMENT: Presented an overview of future state revenue and budget trends and answered questions.

MELANIE MILLHORN, Deputy Commissioner
Department of Administration
Juneau, Alaska

POSITION STATEMENT: Presented an overview of future state spending on retirement and benefit funds and answered questions.

CHARLENE MORRISON, Chief Financial Officer
Division of Retirement and Benefits
Department of Administration
Juneau, Alaska

POSITION STATEMENT: Explained an accounting matter related to budget projections.

JANET CLARKE, Assistant Commissioner
Department of Health and Social Services
Juneau, Alaska

POSITION STATEMENT: Presented an overview of future state spending for the state Medicaid program.

ACTION NARRATIVE

CHAIR MIKE HAWKER called the House Special Committee on Ways and Means to order at [3:31:04 PM](#). Representatives Roses, Seaton, Fairclough, and Wilson were present at the call to order. Representative Gruenberg arrived as the meeting was in progress.

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Presentation by Office of Management & Budget

CHAIR HAWKER noted that one of the committee's tasks is to consider how to reconcile future expenditures with future revenues. This task requires setting the stage and making judgment calls to help determine future fiscal policy. The information presented today may provide a background for future policy discussions, he said.

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JOHN BOUCHER, Senior Economist, Office of Management & Budget (OMB), Office of the Governor, paraphrased from the following written testimony [original punctuation provided]:

First of all I want to say that the Governor supports the efforts of this committee to address the structural budget issues that face the State of Alaska. These meetings are important in framing the discussion about what options the state has moving forward. The administration looks forward to continuing this conversation that is critical to the future of Alaskans.

In attempting to address the Committee's question "Where did the fiscal gap go?" The answer might be summarized best by saying that the fiscal gap has not "gone" anywhere- It is an issue that needs to be addressed. While timeframes and revenue pictures may have changed, the fundamental issues surrounding the fiscal gap have not.

Most of the fiscal plans crafted in the last 20 years have emphasized a combination of controlling government spending, setting aside Alaska's surplus revenues for use during times when revenue is scarce, and examining options for diversifying Alaska's revenue base to help offset the impact that the declining Prudhoe Bay production curve has on state revenue

Governor Palin's FY08 budget proposal represents a move toward meeting two of the objectives mentioned - controlling the growth of spending and putting away a portion of the projected surplus for use at a future date. While the details of the FY08 plan are yet to be determined, the Administration looks forward to having the conversations necessary to help achieve the desired results of controlling government spending and setting surplus revenue aside for use in the future while providing the level of services that Alaskans deem appropriate.

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CHAIR HAWKER reminded the committee and the public that today's presentation will be more of a macro overview of budget issues and noted that he had requested that OMB address the issues of the Public Employees' Retirement System (PERS), the Teachers' Retirement System (TRS), and the Alaska Medicaid State Plan (Medicaid). The decision to emphasize these areas of spending should not be characterized as a policy call; however, he noted that these issues are important ones that the legislature must address.

MR. BOUCHER referred to an OMB PowerPoint presentation that was provided to the committee. He directed the committee's attention to a graph titled, "Total Appropriations by Revenue Source," which shows four main categories of revenue. Mr. Boucher explained the categories as follows [paraphrasing from written testimony; original punctuation provided]:

The top or dark blue bar is revenues appropriated from the Alaska Permanent Fund.

Permanent Fund appropriations include the monies made available for the annual dividend as well as inflation proofing the fund. Operational costs for

administering the fund and the hold harmless provision are accounted for here. (Amerada Hess is excluded)

The lighter colored bar that is 2nd from the top represents federal funds in the state budget. For federal funds, it is critical to understand that the number presented represents the amount that state programs are authorized to use in federal funds during the budget cycle. Actual federal receipts spent during a fiscal year often come in at a significantly different level depending on a number of factors such as the number of eligible participants in programs that are partially paid for by federal funds.

The red colored bar is other state funds. The other funds portion includes revenue that is statutorily restricted for use by a particular program. For example tuition receipts from the University is one example of this type of funds. This is also where appropriations of proceeds from the sale of general obligation or Tobacco bonds would be counted.

The bottom, or light blue bar represents the General Fund,

It is important to understand that when most people are talking about Alaska's fiscal gap - they are talking about the light blue bar in the picture-

The "fiscal gap" is most often defined as the relationship between the amount of general funds appropriated in any one fiscal year and the amount of unrestricted general fund revenue accrued in any one fiscal year.

REPRESENTATIVE GRUENBERG referenced the graph titled, "Total Appropriations by Revenue Source," and asked if federal funding is increasing at a rate greater than inflation.

MR. BOUCHER replied that it appears that Alaska received more in fiscal year (FY) 2007 than in FY00. He did note that as past chair of the U.S. Senate Committee on Appropriations, Alaska Senator Ted Stevens was able to secure federal funding for Alaska. However, the "future may not look quite so bright," cautioned Mr. Boucher.

CHAIR HAWKER expanded on the issue of available federal funding by noting that previous legislatures did not spend a lot of federal funds available to the state. Therefore, the House Finance Committee refinanced some program changes, in Medicaid for example, to take advantage of available federal funding.

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REPRESENTATIVE GRUENBERG suggested he would like to review in the future the concept of taking full advantage of federal funding opportunities as one way to raise revenue for the state.

CHAIR HAWKER stated he endorsed this type of future discussion, for in the future there may very likely be a decrease in federal funds for Alaska.

MR. BOUCHER concurred with Chair Hawker's observation that future federal funding may not continue at the same level as in the past.

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REPRESENTATIVE GRUENBERG noted that the committee needs to carefully examine federal funding because there may be ways for the state to continue to receive federal funding without having to accept some of the restrictions the federal government places on those funds. He referenced a recent House State Affairs Standing Committee hearing on driving while under the influence issues in which it became clear that if the state did not do some things it did not want to do anyway, it would still receive the same amount of federal funding, but with less restrictions, said Representative Gruenberg.

REPRESENTATIVE ROSES confirmed this and noted the federal funding referred to by Representative Gruenberg was put into a different spending category, but "we didn't lose it."

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CHAIR HAWKER pointed out that the FY07 appropriations shown in the graph titled, "Total Appropriations by Revenue Source," reflects appropriations of \$500 million into the Education Fund, \$183 million into the Power Cost Equalization Fund (PCE), and \$300 million into the Capital Savings Account. In general, in order to save money, the legislature has to appropriate it,

noted Chair Hawker, which is part of the reason why the spending for FY07 looks high on the graph.

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MR. BOUCHER drew the committee's attention to the graph titled, "General Fund Revenue versus Appropriations." He explained that until oil price increases began in FY04, it was routine for general fund appropriations to exceed general fund revenues. Indeed, draws from the Constitutional Budget Reserve Fund (CBR) were taken eight times between 1994-2004 to cover spending. This resulted in an accumulated draw from the CBR of \$5.2 billion, he said.

CHAIR HAWKER observed that oil prices were "in single digits" during a couple of those years.

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MR. BOUCHER explained that the FY08 appropriations shown on the graph titled, "General Fund Revenue versus Appropriations," are interim numbers because the governor is in the process of developing an amended FY08 proposal. The graph shows that if spending is held level for the next 8 years, there will have to be a draw from the CBR in FY10; by FY15 the draw from the CBR would be near \$1 billion annually.

MR. BOUCHER then drew the committee's attention to the chart prepared by the Legislative Finance Division titled, "General Fund Budget." In reference to some abbreviations shown on the chart, Mr. Boucher explained that PEF is the Public Education Fund, ADRF is the Alaska Debt Retirement Fund, PCE is the Power Cost Equalization Program, and AHFC is the Alaska Housing Finance Corporation. Mr. Boucher noted that the budget projections shown assume a 4 percent annual rate of growth and a capital budget of \$200 million annually. He said that under this scenario, draws on the CBR will reach \$1 billion around 2010, or about five years earlier than predicted in the scenario presented in the graph titled, "General Fund Revenue versus Appropriations." He pointed out that neither scenario is necessarily better than the other; the scenarios just reflect different outcomes depending on budget decisions and revenue sources.

MR. BOUCHER suggested to the committee that a better way to represent the effect of spending choices is presented in the matrix titled, "Constitutional Budget Reserve Runout Matrix."

This matrix predicts how long the CBR will last depending on the state's spending level and the price of oil. He emphasized that the critical assumptions in this scenario are that all surplus revenue will go into the CBR, and all revenue shortfall will come out of the CBR. Mr. Boucher agreed with Chair Hawker's observation that this approach simplifies future predictions by only specifying one savings account.

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MR. BOUCHER responded to Representative Seaton by noting that the OMB projections for future oil prices and production volumes were taken from the Department of Revenue's Fall 2006 Revenue Sources Book.

CHAIR HAWKER noted that the Department of Revenue (DOR) forecasts include both oil price and production variables, and asked if the figures on the matrix take both those variables into account.

MR. BOUCHER assured Chair Hawker that the OMB summary did incorporate the DOR variables of oil price and production. He continued by advising that it is possible to maintain the CBR until FY 2020 if the current oil forecast price holds and if spending can be kept somewhere between \$3.7-\$4 billion annually. The governor's initial FY 2008 budget falls in that range, but Mr. Boucher acknowledged that keeping spending flat would be a challenging task and require some significant changes in state spending patterns.

MR. BOUCHER emphasized that although there are many factors that exert pressure on state spending, today's hearing would only address two specific forces: increased Medicaid costs and the PERS/TRS unfunded liability. Mr. Boucher stressed that in the proposed FY08 budget, PERS/TRS payments are estimated at one-third of total state spending. This one-third figure is understated because it excludes PERS/TRS increases prior to FY08. For example, legislative increases to the student base funding allocation are not included in the pie chart titled, "The PERS/TRS/Medicaid challenges."

CHAIR HAWKER observed that over the last four years the student base allocation has increased by 33 percent, or about \$250 million per year, with a very large portion of that going into these retirement funds.

REPRESENTATIVE WILSON advised that if PERS/TRS was included in the education foundation formula, it would increase funding by \$1,005 per student.

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MELANIE MILLHORN, Deputy Commissioner, Department of Administration, directed the committee to the chart titled, "PERS Projected Contribution Amounts to FY 2015." Ms. Millhorn advised the committee that the predictions made on this chart were based on data from June 30, 2005, which is the most recent information available to the Department of Administration (DOA). Based on that data, there is a \$6.9 billion shortfall in PERS contribution rates. However, in October 2006, the Alaska Retirement Management Board (ARM Board) commissioned an "experience" study of the PERS contribution history. This study compared the actual experience of the system to the assumptions used. Based on this study, the projected unfunded liability for PERS/TRS rose to \$8.6 billion, said Ms. Millhorn. She cautioned the committee that because the state did not fund "at the actuarial calculated rate" for FY05-07, there was a funding shortfall of about \$750 million. As a result, warned Ms. Millhouse, the actual costs for FY09 will be higher than is shown on the chart.

MS. MILLHORN referred to the now-repealed 2 AAC 35.900, which limited PERS employer contributions from increasing more than 5 percentage points in any one given year. The effect of this now-repealed regulation can be seen on the previously mentioned chart as employer contribution amounts only went up by 5 percent annually. The ARM Board has now adopted the actuarial calculated rate using a level dollar amortization schedule, Ms. Millhorn informed the committee.

CHAIR HAWKER observed that this change explains the large increase in PERS contributions predicted for FY08, and the more level spending predicted for FY08-15.

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REPRESENTATIVE FAIRCLOUGH asked whether there was any similar chart for 1994 forward, and whether it used the same escalation factor of about 5 percent.

MS. MILLHORN stated the DOA does have that information and can provide it to the committee. Beginning with the valuation in 2001, the PERS system was 100.9 percent funded, so the

contribution rate was a minimal 6.77 percent, which was below the normal cost rate.

REPRESENTATIVE FAIRCLOUGH, in trying to ascertain the cost escalation of the benefit portion of PERS/TRS, asked if there was some history showing past increases.

MS. Millhorn answered that the DOA's comprehensive annual financial reports show the trend of the benefit increases. She explained that approximately 2,000 members retire each year under PERS/TRS, so "yes, that amount goes up each year."

REPRESENTATIVE FAIRCLOUGH, in reference to the flat spending projections shown from FY08-15, questioned whether the projections calculate front loading the program and paying the actual costs "so that there is not a delta" in between the \$8 billion shortfall.

MS. MILLHORN responded that since the plan is now closed it has been amortized over a 25-year period and each year's valuation will establish the contribution rate that must be made to liquidate the past service cost. Ms. Millhorn explained that there will be increased medical costs which will differ from plan assumptions, but calculations are done each year to determine how much needs to be paid to payoff the unfunded liability.

CHAIR HAWKER said that the actuaries who determine the future amortization rates for the PERS/TRS liability do include a medical cost escalation factor when projecting future program costs. This escalation factor, which Ms. Millhorn believes to be 9.5 percent, is factored in and discounted back to achieve level funding to pay off the future liability. If the state was able to reduce the inflation factor to 1 percent, for example, there would be an experience differential that would be incorporated into each subsequent valuation, resulting in a lower future cost estimate, he explained.

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REPRESENTATIVE FAIRCLOUGH stated she found it hard to believe that future contribution rates for PERS/TRS could be fairly flat. The trend for FY04-07 was an upward trend that would seem to be what we may experience in the future, she opined.

REPRESENTATIVE SEATON volunteered that past legislatures were informed that the eventual anticipated payout for PERS/TRS would

be about \$15.6 billion more than was funded. Therefore this chart shows the unfunded liability amortized by equal payments until the under-funded amount is paid off.

REPRESENTATIVE FAIRCLOUGH acknowledged the calculations and complexities, but maintained interest in any information that illustrates a track record of level payments as are shown on the chart titled, "PERS Projected Contribution Amounts to 2015."

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CHAIR HAWKER noted that in past years the retirement liability was not fully funded, but that policy changed, which explains the jump in spending between FY07 to FY08.

REPRESENTATIVE FAIRCLOUGH asked Ms. Millhorn if there is any track history of level payments, or whether that was affected by the prior 5 percent contribution rate increase cap.

MS. MILLHORN explained that there was a percent of pay contribution being made to Tiers 1-3; what has changed is the amortization schedule now that Tiers 1-3 have closed. This stops the addition of new members to the plans; however, medical costs remain the primary driver contributing to the unfunded liability. The new tiers do not have the volatility of prior systems, which eliminates the unfunded liability component of new tiers coming in, she said.

REPRESENTATIVE FAIRCLOUGH asked why the shortfall was being estimated at \$2 billion more than was estimated in 2006, for a total shortfall of \$10 billion.

MS. MILLHORN replied that there will be many adjustments based on the findings of the "experience study" and these adjustments will be calculated into a determination of what the liabilities will be as of June 30, 2006. The assumption now is that the liability will be closer to \$10 billion, Ms. Millhorn concluded.

MS. MILLHORN agreed with Chair Hawker's observation that changes to the system are slow to come because of the budget process and pointed out that the June 30, 2005, valuation sets the FY08 rate.

REPRESENTATIVE FAIRCLOUGH asked what happens if the state does not pay the retirement liability at the calculated rate.

MS. MILLHORN answered that if payment is not made at the calculated rate,

"You essentially have not begun the process to pay this off for that 25-year period, which is what has happened to PERS/TRS. So, it's really important that you hit that calculated rate and you begin the process to liquidate the unfunded liability."

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REPRESENTATIVE FAIRCLOUGH pointed out that a payment-style approach would result in a total greater payment amount due to interest costs.

MS. MILLHORN agreed and added that Buck Consultants projected that payment of \$500 million into the PERS/TRS system would result in a \$680 million savings over the course of the amortized schedule.

MS. MILLHORN referred to the graph titled, "PERS/TRS Projected Contribution Amounts to FY 2015," which shows a dramatic jump in the state's contribution amount from \$174 million in FY04 to \$905 million in FY08. She told Chair Hawker that the actuarial valuation reports project out until the year 2036, at which point the unfunded liability will be paid off. Once the unfunded liability is paid off, the employer resumes payment at the normal cost rate for the defined benefit members, which she estimated to be about 14.48 percent. In comparison, in FY08 PERS will be paid at 39.76 percent and TRS at 54.03 percent.

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CHARLENE MORRISON, Chief Financial Officer, Division of Retirement and Benefits, Department of Administration, clarified that the Division of Retirement and Benefits uses a 25-year amortization schedule, but it also asks the actuary to prepare a 30-year projection.

MS. MILLHORN added that the ARM Board is authorized to adopt the amortization schedule, and has adopted a 25-year amortization schedule. She noted that generally accepted accounting principles do not allow amortization beyond the 25-year period; however the ARM Board did look at the effect of payment of the unfunded liability over a 30-year period. To extend payment from 25 to 30 years increases the total amount paid by almost \$2.4 billion, she said.

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REPRESENTATIVE FAIRCLOUGH raised the issue of whether there has been any consideration of what will happen to remaining plan assets if there are no more beneficiaries entitled to plan benefits, but there are still assets in the plan. She referenced a situation in which a plan with no remaining beneficiaries had millions of dollars in plan assets left. The result was litigation to determine what to do with the plan assets, a result that could have been avoided with some forethought, she noted.

MS. MILLHORN said she is not aware whether the aforementioned scenario described has been considered. Ms. Millhorn explained that retirees who return to work have to pay past service associated with that member's return to state employment. A returning retiree is no longer able to use their retiree medical plan, they must use the active plan, she said.

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JANET CLARKE, Assistant Commissioner, Department of Health and Social Services, said that Medicaid costs present a long-term challenge for the state budget. She reminded the committee that Medicaid is the state-federal partnership program that provides health care coverage for low-income individuals: children, adults, and the elderly. Ms. Clarke referred to a study prepared by The Lewin Group for the Alaska Department of Health and Social Services titled, "Long Term Forecast of Medicaid Enrollment and Spending in Alaska: 2005-2025" ("Lewin forecast"). She noted that many of the program trends she will present to the committee today were identified by the Lewin forecast. Ms. Clarke presented her testimony with a PowerPoint presentation provided to the committee titled "Department of Health and Social Services Presentation to the House Ways and Means Committee, February 5, 2007."

MS. CLARKE told the committee that past Medicaid spending was primarily on children up to age 19, but future predictions show that Medicaid spending on those over age 35 will increase in the next 20 years. This trend is depicted on the chart sub-titled, "Alaska's population growth will be driven by the elderly." From 2006 to 2026, the elderly population of Alaska is predicted to increase from 6 percent to over 16 percent of the state's population. The elderly population uses long-term care, which is one of the most expensive parts of the Medicaid program, so

the increase in the elderly population greatly increases the state's Medicaid costs, said Ms. Clarke.

MS. CLARKE reminded the committee that Medicaid is a state-federal partnership and currently the state receives federal funding at almost 58 percent, so for every dollar Alaska spends, almost 58 cents of that is federal money. Alaska's Medicaid spending is projected to grow 7.9 percent, from 2006 to 2026. Without calculating for inflation, this results in an increase in spending from \$1 billion in 2006 to \$4.86 billion in 2026, she concluded.

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CHAIR HAWKER noted the care that went into the Lewin forecast which resulted in an accurate projection of the state's current program. He warned that the federal contribution amount may be lowered to around 53 percent due to federal statutory changes.

MS. CLARKE informed the committee that the federal money is not inflation proofed and Alaska's contribution rate will drop to 52.48 percent in October 2007 unless there is a change in federal law. The Division of Retirement and Benefits is working with other states to find ways to avoid a reduction in federal spending, she said.

MS. CLARKE referenced the graph titled, "Spending on the Elderly will Surpass Spending on Working-Age Adults and Children by 2019." Increased costs for the elderly reflect a fundamental and expensive shift in the program, which has typically concentrated on children, Ms. Clarke said. She emphasized that state general fund spending on Medicaid will increase at an average annual rate of 8.6 percent, rising from \$363.1 million in 2006 to \$205 billion in 2026.

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REPRESENTATIVE SEATON asked whether the program had to offer everything, such as long-term care, to beneficiaries.

MS. CLARKE replied that the legislature has a lot of influence on the policy choices of what services will be covered by Medicaid. The federal government lists some services and

coverage as mandatory, others are optional. Some long-term care coverage is mandatory, but choices can be made on the number of nursing home beds, she noted. The legislature does have quite a bit of choice with regard to the path of this program, she stated.

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REPRESENTATIVE WILSON questioned whether federal funding will increase as shown on the graph titled, "Projected Total Spending on Medicaid by Fund Source."

MS. CLARKE replied that the graph referred to by Representative Wilson is based on current federal policy.

MS. CLARKE compared the 2005-2025 Medicaid forecast to the 2006-2026 forecast and noted that overall state spending for 2025 is predicted to be 8.8 percent lower than was predicted in the 2005-2025 forecast. This may be due in part to some regulatory changes in the personal care attendant program developed by the DOA in conjunction with the legislature. This policy change is one of many factors that have contributed to some flattening out of Medicaid spending, she said. Ms. Clarke concluded by reminding the committee that legislative policy choices can make a difference in the long-term forecast.

ADJOURNMENT

There being no further business before the committee, the House Special Committee on Ways and Means meeting was adjourned at [5:04:40 PM](#).