

SENATE FINANCE COMMITTEE  
February 6, 2009  
9:06 a.m.

[9:06:09 AM](#)

CALL TO ORDER

Co-Chair Stedman called the Senate Finance Committee meeting to order at 9:06 a.m.

MEMBERS PRESENT

Senator Lyman Hoffman, Co-Chair  
Senator Bert Stedman, Co-Chair  
Senator Charlie Huggins, Vice-Chair  
Senator Johnny Ellis  
Senator Kim Elton  
Senator Donny Olson  
Senator Joe Thomas

MEMBERS ABSENT

None

ALSO PRESENT

Kim Garner, Director, Division of Finance, Department of Administration; Kevin Brooks, Deputy Commissioner, Department of Administration; David Teal, Director, Legislative Finance Division.

SUMMARY

^Presentation:

State Budget Reserves/Savings Accounts and Sweep Mechanics

[9:06:15 AM](#)

Co-Chair Stedman observed the importance of understanding how sweep mechanics work and how the state's account books are closed. He acknowledged the importance of the relationship between the state's general fund and the Constitutional Budget Reserve Account (CBR), which is the state's main fallback account to cover any shortfalls. A 3quarter vote is needed to access the CBR. He noted that the state's cash reserve would be reviewed over the next months.

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KIM GARNERO, DIRECTOR, DIVISION OF FINANCE, DEPARTMENT OF ADMINISTRATION, explained the sweep process. The sweep calculation requires substantial, quality time with annual auditors. She emphasized the need to understand the general fund from an accounting viewpoint. The fund structure of the state of Alaska is determined by generally accepted accounting principles, which is reflected in the audited financial statements contained in the Comprehensive Annual Financial Report.

Ms. Garnero explained that accountants identify the overall general fund as fund 11000 in AKSAS, the statewide accounting system. Fund 11000 is comprised of all the sub-funds, most of which were established by the legislature. Fund 11000 also includes the lower level, primary general fund designated as 11100 in the accounting system; primary general fund is still very large, and accounts for the majority of the financial activity of the state of Alaska. Most funding sources are revenue streams into this general fund, including federal funds, program receipts, and receipt supported services.

9:12:56 AM

Ms. Garnero defined the reverse sweep as an appropriated transfer that restores the balances of the sub-funds to repay amounts previously borrowed or drawn. The reverse sweep is an appropriated transfer that restores the balance of the sub-funds. The sweep is done as the last step in preparing the Comprehensive Annual Financial Report; the reverse sweep occurs in early December, but the available balance is calculated as of June 30 of the previous fiscal year.

Ms. Garnero informed that the sweep is required under the Alaska State Constitution to repay previous borrowing every year with the general fund available balance. Under the terms of the constitution, anything spent from the CBR must be repaid by the general fund. The reverse sweep, on the other hand, is a legislative appropriation from the CBR, and it adds to the repayment requirement.

Ms. Garnero clarified that the "available for appropriation" calculation is the key to the sweep. The first step of the sweep moves all available funds up to the overall general fund (fund 11000). Encumbered amounts and amounts for continuing and

specific appropriations of the subsequent year are set aside. One of two criteria is used to determine which sub-funds are excluded from the sweep requirement:

1. If it meets the definition of "available for appropriation" as determined by the Supreme Court of Alaska; or
2. If it is legally restricted to a specific purpose by an outside entity.

Ms. Garnero noted that if a sub-fund meets either of these criteria, the available balance is not swept. The balance in the primary general fund 11100 is available for sweep, and in years of reverse sweep appropriation language, this is the only amount retained in the subsequent fiscal year as repayment of CBR borrowing.

Ms. Garnero provided a brief review of the state's recent cash flow borrowing. She referred to a spreadsheet contained on the department's webpage, which starts with the available balance of the CBR at the beginning of the fiscal year. She observed that from FY02 to FY05, borrowing occurred during the fiscal year to address cash flow needs of the general fund. This borrowing was authorized by appropriation language and followed a process established in an interagency memorandum of understanding (MOU). In FY02 and FY03, there was net cash-flow borrowing at June 30th. In FY04 and FY05, the state was able to repay the cash flow borrowing by June 30th. The additional (deficit borrowing) or repayment was based on the available balance calculation in the primary general fund 11100. In FY02 to FY05, more borrowing was required to bring a negative available balance in the general fund up to zero.

Ms. Garnero explained that in FY06 the general fund available balance was appropriated to the Public Education Fund, and in FY07, it was appropriated to the Alaska Capital Income Fund, both of which are sub-funds of the general fund.

Ms. Garnero concluded that in FY08, the general fund had an available balance to repay previous CBR borrowing, and \$582 million was transferred for this purpose.

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Ms. Garnero elucidated that the designated fund balance is the oil and gas production tax revenues budgeted in the next year. There is an annual direct appropriation from the CBR to the Treasury Division to pay management fees.

Ms. Garnero summarized that the ending available balance of the CBR increased about \$5 billion during FY08. This was the result of \$3 billion appropriated to the CBR, \$1 billion net sweep and reverse sweep, \$582 million additional general fund repayment, and the operating income of \$416 million.

Ms. Garnero provided members with a description of each sub-fund of the general fund, indicating whether or not it is swept, and if so, how much was swept in FY08 (copy on file).

Ms. Garnero drew attention to sub-funds; the CBR itself is a sub-fund of the general fund. The CBR is not swept to repay itself. However, the Budget Reserve Fund established in statute is a sweepable sub-fund, as is the Alaska Capital Income Fund. She explained that any fund established with language that allows a specific appropriation is sweepable because if it can be appropriated for "X" it can be appropriated for anything.

Ms. Garnero explained that language that establishes the fund "as spendable without further appropriation" meets the Supreme Court definition to exclude from sweep. The Public Education Fund and Permanent Fund Dividend Fund are examples of funds that are excluded from the sweep.

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In response to a question by Senator Stedman, Ms. Garnero clarified that the reverse sweep has reduced the CBR by \$1,466,159. Another billion dollars was transferred to the CBR based on an appropriation from the legislature from the general fund. There has been a year to date current net loss in earnings of \$65 million. The current balance of the CBR is close to \$6.8 billion. Co-Chair Stedman concluded that market values need to be watched in discussions of appropriations from the CBR.

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Senator Olson asked if sweeps ever occur at other times. Ms. Garnero noted that transfers are not appropriated [by the legislature] or authorized under the constitution.

In response to a question by Senator Elton, Ms. Garnero explained that the reverse sweep reinstates the cash to the sub-funds on July 1<sup>st</sup>. She acknowledged that state revenues flow in more slowly at the beginning of the fiscal year than

expenditures because of large payments that are due in July and August. A lot of the cash flow borrowing occurs at the beginning of the fiscal year and repayment begins at the end [of the fiscal year].

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Co-Chair Stedman stated that the hearing is not an issue of solvency or liquidity of the state, but an attempt to look at the next five years.

DAVID TEAL, DIRECTOR, LEGISLATIVE FINANCE DIVISION, provided a model to demonstrate the sweep process [members reviewed a excel spreadsheet, which Mr. Teal manipulated via overhead projector]. He referred to investment returns and the "burn rate." He observed that oil prices are currently down, creating deficits instead of surpluses. Given the deficit, the question is: "How fast are we burning through our reserves?" He observed that the state is doing okay if the reserve balances grow, but that action may need to be taken if the reserve balances decline.

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Mr. Teal explained that the model uses a simple growth rate as demonstrated in the spreadsheet provided to members (copy on file). Oil prices are averaged over the year, which is not a good way to discern revenue. He emphasized that it is important to watch the trends.

Co-Chair Stedman observed that a growth rate of 3 percent was used, which could be higher or lower. The model draws from the CBR first and then from the Statutory Budget Reserve Fund. He stressed that these factors were used as a starting point and that there would be opportunity for further discussion [regarding the priority of funds].

Mr. Teal observed that the model reviews several funds: Constitutional Budget Reserve Fund, Statutory Budget Reserve Fund, Alaska Housing Finance Corporation (AHFC) Capital Savings Account, Public Education Fund, and Permanent Fund Earnings (realized only).

Senator Eton asked how the Permanent Fund Earnings were plotted. Mr. Teal explained that only realized earnings were used. He noted that there are substantial unrealized losses, but until the losses are realized the cash is still in the account. Additional losses could occur if money is pulled from the

account. He noted that the legislature has historically avoided withdrawing from this account.

[9:32:12 AM](#)

Mr. Teal explained that he began with a 3 percent growth rate and oil at \$75 per barrel since the budget breaks. He explained that \$75 per barrel oil is the approximate breakeven price where reserves are essentially flat. In his scenario, reserves are fairly flat. The revenue picture looks better if oil prices are higher. He observed that a 3 percent [rate of inflation] looks better "if you want to hold a flat budget."

Mr. Teal observed that the budget picture would improve if there were a five percent operating reduction, which may be possible but has not been successfully done by the legislature in the past.

Co-Chair Stedman observed that a little less than half of the operating budget is formula driven, which cannot be controlled. He stressed that it is a challenge to keep the operating budget flat and virtually impossible to decline it at 4 percent per year compounded. He felt that 3 percent growth is a realistic range. Mr. Teal concurred.

Mr. Teal looked at a model in which oil prices drop to \$65 per barrel. Reserve balances would fall and the CBR would be almost gone by 2014. By 2015, the CBR, Statutory Budget Reserve Account and the AHFC Savings Account would all be depleted. The only funds left would be the Public Education Fund and the Earnings Reserve Account. The CBR would be depleted by 2012 at \$55 per barrel oil. There would be no reserves by 2014 if oil were at \$55 per barrel.

[9:36:55 AM](#)

In response to a question by Co-Chair Stedman, Mr. Teal explained the difference between the use of January 2009 and FY09. He followed the sweep process from 2006, which began with a CBR balance of \$2.2 billion. He demonstrated that at the end of January 2009 the CBR balance was \$6.8 billion. At the end of FY09 [June 30, 2009] there would be a deficit of \$1.36 billion, which would end the year with \$5.4 billion in the CBR.

[9:40:04 AM](#)

Co-Chair Stedman asked Mr. Teal to review growth factors. Mr. Teal observed that the permanent fund and retirement funds use estimates of 8 percent for their earnings because they have a long time horizon. The division used a 4 percent estimate to reflect the shorter time horizon. As oil prices have fallen, the investment horizon is shortened, due to the need to access reserves. The numbers will change slightly depending on interest rate assumptions. He felt that 4 percent is a reasonable return on the CBR given the potential cash needs.

Co-Chair Stedman observed that the CBR could be exhausted in three to eight years.

Mr. Teal explained that the CBR is split in to two accounts: an aggressive portfolio and one that is not as aggressive. The division looks at the CBR as one account. Co-Chair Stedman noted that there would be further discussions on the investment of the CBR.

[9:44:10 AM](#)

Mr. Teal reviewed the Statutory Reserve Fund. The legislature appropriated money to the fund and has never withdrawn funds from the account; the interest earned is not kept in the account. A billion dollar deposit was made with no earnings; the earnings or losses are credited to the general fund. He observed that because there is no interest on the fund there can be no loss.

Co-Chair Stedman observed that there is a question of whether or not the fund could incur losses. Mr. Teal agreed that it was a question for the Department of Revenue or Department of Administration.

Mr. Teal noted that the AHFC Capital Fund was also a one-time deposit with no withdrawals until 2010. The governor's 2010 budget request appropriates the funds. He observed that Co-Chair Stedman asked that the funds be withdrawn from the model since they are general funds and the desire was to address the access to reserves. The assumption is that the governor's expenditures of \$238 million would not occur.

Mr. Teal observed that the Public Education Fund is more complicated because there is an inflow and outflow every year. The fund does not earn interest or sustain losses. The balance is \$1.1 billion. The model assumes that the Public Education Fund remains at this level until conditions require the use of

the reserves. Any increase in education funding is built into the 103 percent rate that goes to expenditures overall.

Co-Chair Hoffman asked if there were provisions for increases regarding intensive needs and area-cost differentials, which would affect the bottom line of the fund.

9:47:28 AM

Mr. Teal acknowledged that there were changes to the education formula that would increase costs. He explained that the 2010 increase to education was about \$50 million. The fund will receive the increase for another couple of years because of the increase in the base student allocation, intensive needs, and the geographical differential. The [FY] 2010 operating budget shows an increase of approximately 2.7 percent including the \$50 million dollars [to the Public Education Fund]. He noted a better model could be designed based on each agency's growth, but [for simplicity] the division based its model on a 3 percent [growth rate].

Co-Chair Stedman suggested that the Legislative Finance Division could add to the model.

Mr. Teal reviewed the Permanent Fund Earnings Reserve. The division relies on public statements for their information on this fund. The fund contained \$1.4 billion in FY06. Dividends and inflation proofing are paid out and earnings are paid into the fund. The fund gained earnings through FY08, with a total of \$5 billion in reserves. The December 2008 statement showed a loss of \$407 million dollars. He estimated that the reserve loss is greater, but much of the loss is unrealized.

9:50:26 AM

Co-Chair Hoffman noted that the losses in the CBR were reported through the first week of February at \$765 million. Mr. Teal calculated the losses at \$789 million but noted that they may be using different assumptions than the Department of Revenue.

Mr. Teal concluded with the fact that at \$40 per barrel, reserves would be gone by 2012.

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ADJOURNMENT

The meeting was adjourned at 9:52 AM.

