

SENATE FINANCE COMMITTEE
January 28, 2010
9:06 a.m.

[9:06:36 AM](#)

CALL TO ORDER

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

MEMBERS PRESENT

Senator Bert Stedman, Co-Chair
Senator Johnny Ellis
Senator Dennis Egan
Senator Donny Olson
Senator Joe Thomas

MEMBERS ABSENT

Senator Lyman Hoffman, Co-Chair
Senator Charlie Huggins, Vice-Chair

ALSO PRESENT

Senator John Coghill
David Teal, Director, Legislative Finance Division

PRESENT VIA TELECONFERENCE

None

SUMMARY

^FY 2011 BUDGET OVERVIEW & FISCAL SUMMARY
PRESENTATION: LEGISLATIVE FINANCE DIVISION

[9:07:03 AM](#)

DAVID TEAL, DIRECTOR, LEGISLATIVE FINANCE DIVISION, referred to a previous budget presentation by the Office of Budget and Management (OMB) regarding the governor's FY 11 request. He clarified that Legislative Finance Division's (LFD) role as a nonpartisan legislative agency was to add context to the budget to facilitate good budget decisions.

He related that he would also bring perspectives from the Department of Revenue (DOR).

[9:11:21 AM](#)

Mr. Teal stated that the legislative fiscal analyst's overview of the governor's FY 11 request, as depicted in the fiscal summary on page 2 of the document entitled, "FY 2011 Budget Overview", is in the "recast of general funds format". The December 15 fiscal summary released by the Office of the Governor used the old fund categorizations. Since the LFD overview uses a new format, it does not agree with the governor's version and comparisons cannot be made. In the LFD general fund column, there is an extra \$750 million showing. The focus is on the general fund column because that is how the fiscal gap is determined - the surplus or deficit. He suggested not focusing on the differences in the fiscal summaries from OMB and DOR. He reported that OMB has now revised their summary to match LFD's recast version.

Co-Chair Stedman commented that it was thought that a recast version would be launched during the last session, but it was too complex. It was finished over the interim. A goal for the next interim would be to recast several previous years' budgets for comparison purposes. He related the potential to share budget information in a standardized format. He called it a work in progress.

[9:13:59 AM](#)

Mr. Teal offered to answer questions about the fiscal summary.

Mr. Teal focused on line 10 of the summary, which shows an increase in agency operating budgets of about 3.7 percent. Co-Chair Stedman clarified that it was "non-formula in agencies", a subcomponent of the agency operations. Mr. Teal related that the governor has talked about holding growth in the general fund budget down to under 3 percent. The fiscal summary shows that it is over 3 percent, which is a function of the recast. It's larger than OMB showed; however, OMB now agrees with LFD's numbers. The important point is to realize that 3.7 percent is smaller than it has been in the past couple of years.

Mr. Teal emphasized that the smaller increase in general fund is due to the omission of several items from the budget, including labor negotiations. When a labor agreement is reached, amendments will be put forth that will increase this number, depending on what happens with the extension of the Medicaid matching rate. If that rate reduction is not extended, the state could be looking at a \$100 million increase in FY 11 just for that. He expected the 3.7 percent to increase as the session progresses.

[9:16:19 AM](#)

Co-Chair Stedman pointed out that more data and amendments would be available next week. He suggested discussing the initial budget and updating it as more information is forthcoming.

Senator Thomas asked if Co-Chair Stedman was referring to supplemental amendments. Co-Chair Stedman replied that he was talking about amendments from the administration for the FY 10 budget. Senator Thomas wondered if the supplemental budget would include non-formula items. Co-Chair Stedman did not know. He reiterated that the numbers could increase soon.

Mr. Teal agreed that the fiscal summary was a starting point and would change as the supplemental budget and amendments were offered. For example, there is a \$35 million fire suppression supplemental that would increase the FY 10 numbers, which reduces the difference between FY 10 and FY 11. He stated his goal was to look at the big picture.

Co-Chair Stedman cautioned to keep in mind that adjustments made to FY 10 changes the comparison to FY 11. It is important to look back at previous budgets.

[9:19:19 AM](#)

Mr. Teal noted both an advantage and a disadvantage to looking at graphs - a \$35 million supplemental will not show. The fiscal summary shows only the big items and trends.

Mr. Teal turned to slide 3 - the fiscal sensitivity chart. He explained that one axis is the price of oil and the other is billions of dollars, which measures the height of

two curves on the chart. The two curves are expenditures in revenue. The expenditure is a flat line because \$4.1 billion is the current FY 10 budget, no matter the price of oil. At any price of oil, it is still \$4.1 billion. The revenue curve does change depending on the price of oil. He gave examples: at \$40 per barrel approximately \$3.5 billion is generated; as oil increases to \$90, about \$9 billion in revenue is generated. It is a curve because of progressive tax rates. The higher the price of oil, the higher the tax rate, which makes it non-linear. He pointed out that the breakeven point would be at \$64 per barrel and \$5.13 billion in revenue.

Mr. Teal noted that the budget of \$4.1 billion passed last year does not include forward funding of education at approximately \$1.1 billion. If that was funded, the expenditure curve would shift up to \$5.1 billion reaching a breakeven point. He showed the results of oil at higher and lower than \$63 per barrel.

Mr. Teal summarized the "take away" points of the chart. As expenditures increase, the expenditure line shifts upward causing the breakeven point to increase. With an increase from \$4.1 billion to \$5.1 billion, the breakeven price went up \$10. Every dollar change in the price of oil equals a change of \$100 in revenue. As the price of oil changes, "you walk along the revenue curve rather than shifting that revenue curve".

[9:23:55 AM](#)

Mr. Teal reported the good news that the breakeven price is about \$64 and the DOR projection for the price of oil is \$67, which puts the state into a surplus category of about \$450 million. Even better news is that the current price of oil is up in the low \$70's, which would lead to a surplus of \$2.2 billion. If education is to be forward funded, the surplus falls to \$1.1 billion.

Co-Chair Stedman asked what it would be at \$80. Mr. Teal calculated the surplus to be \$2.5 billion after education is forward funded. Co-Chair Stedman concluded that oil prices need to be tracked in order to accurately deal with the FY 10 budget.

[9:26:02 AM](#)

Mr. Teal spoke of the fiscal sensitivity of general fund revenue in FY 11 - slide 4. He pointed out significant differences between FY 10 and FY 11. The number for expenditures went up to \$5.6 billion from \$5.1 billion because total spending is up by \$550 million, or 10.7 percent. He noted that revenue in FY 11 is different than in FY 10; at \$40 it is about \$2.5 billion, instead of just over \$3 billion. At \$90, instead of being \$9 billion, it's a little less than \$8 billion. The breakeven point is now \$74.

Co-Chair Stedman pointed out that the industry is having parallel concerns because of declining production.

[9:28:32 AM](#)

Senator Thomas asked if the decline in oil is the primary component affecting the state. Co-Chair Stedman stated that price and volume are the main components; however the state is much more sensitive to price than to volume changes. As volumes decline, cost factors per barrel rise. He suggested that the state keep in line with the industry regarding the breakeven point. Mr. Teal offered to provide more information about that.

Mr. Teal shared the good and the bad news about the FY 11 budget. The breakeven point has gone up to \$74 per barrel; the price forecast is above \$74. It is \$76.35 which would be a surplus situation. The governor shows a savings, in addition to expenditures. The scholarship fund would affect the expenditure line because it is money "removed from the table", even though it does not leave the treasury.

[9:31:32 AM](#)

Mr. Teal highlighted key points in the sensitivity charts - slide 5. A \$1 change in oil price produces a \$100 million change in revenue - movement along a revenue curve. Declining oil production is a double whammy - it shifts the revenue curve downward and results in less oil and less profit. Even if costs stay the same, as the number of barrels falls there are fewer barrels to spread the costs over. The average cost per barrel increases. As the cost per barrel increases (OPEX and CAPEX), it reduces the per-barrel profit and shifts the revenue curve downward.

Co-Chair Stedman noted that other presenters call it "profit oil".

Mr. Teal stated that it is difficult to see on the sensitivity charts that the revenue curve shifted downward. Slide 6, a simplified chart depicting FY 10 and FY 11, shows the point at which the budget and revenue curves cross at \$64. He described what would happen if the price of oil shifts downward. He described the resulting breakeven point. Expenditures also shift upward in FY 11. He provided various scenarios.

[9:38:05 AM](#)

Mr. Teal noted implications for the future. First, is that the revenue curve will continue to shift downward as production falls. Second, as expenditures increase, the curve will shift up. Both make the breakeven price of oil higher. The breakeven point will continue to increase. The Department of Revenue predicts that production will fall by about 4 percent. That impact translates to about \$200 billion, which means the revenue curve will shift down each year by about \$200 million. The breakeven point is useful for about a two-year analysis.

[9:39:45 AM](#)

Mr. Teal turned to a 10-year revenue and spending graph provided by DOR. The purpose of looking forward is to add context to the FY 11 budget. The graph shows that the surplus continues to grow from FY 09 to FY 14 and then tapers off to breakeven in FY 19. The reserve in 2020 will be about \$24 million under the DOR assumptions.

Mr. Teal stated that Legislative Finance revised the chart in order to show why the fiscal surplus began to taper off. He pointed out that the legislature's role is to make appropriations and to control long-term revenues.

Mr. Teal explained slide 8, which shows the same data from a different perspective over a greater period of time - FY 05 to FY 19. He pointed out large surpluses in FY 08. He maintained that there is more to be seen than what is depicted on the previous chart. Revenue tapers off and is part of the problem. The price of oil, as projected by DOR, continues to increase. In spite of that increase, the revenue curve is turning downward. By 2014, the decline in

production has finally caught up. The downward shift in the revenue curve is increasing faster than the price increase of oil. The concern is that, in spite of increasing oil prices, revenue is declining.

[9:44:00 AM](#)

Mr. Teal focused on the expenditure side of the chart. Commissioner Galvin's chart was based on a 3 percent growth in expenditures, which has also been incorporated into the Legislative Finance chart. He called it an extremely conservative view. He questioned what would happen if the 3 percent number is off.

Mr. Teal explained that slide 9 helps to answer that question. It depicts growth in agency operating budgets for FY 06 - FY 11. In FY 06 \$3.1 billion was spent, which increased to \$4.2 billion by FY 11. The next column shows the change in expenditures. He described each column - annual growth rate, share of growth, and cumulative share of growth - and showed the difficulties of maintaining a 3.3 percent growth rate. He questioned if funding should be dependent on a targeted growth rate.

[9:48:50 AM](#)

Co-Chair Stedman speculated what would happen with Military & Veterans Affairs under that scenario.

[9:50:06 AM](#)

AT-EASE

[9:51:01 AM](#)

RECONVENED

Mr. Teal plugged a 6.6 percent growth rate - the historical growth rate - into the chart to demonstrate how problems would result in 2016. He concluded that the scenario would be worse than that of today, where there is a healthy fiscal situation. He stressed the importance of surplus and deficit under different scenarios.

Co-Chair Stedman questioned if this year's growth rate is 10.7 percent. Mr. Teal demonstrated the results of a 10.7 percent growth rate. Once the operating budget is increased, it is difficult to move it back down. Decisions made in the FY 11 budget process impact the amount of money in the future.

Co-Chair Stedman commented on adding a \$300 million capital budget into the mix. Mr. Teal saw the merits and consequences of both growth rates. He opined that compound growth rates are bad in the long run. An attempt to avoid compound rates was the use of one-time increases. He stressed the importance of revisiting one-time items every year. He spoke of the importance of considering the impacts of growth rates.

Mr. Teal wondered how much faith should be put into revenue forecasts.

10:00:06 AM

AT-EASE

10:01:11 AM

RECONVENED

Mr. Teal continued to elaborate on the question as to how much faith the legislature should put in revenue forecasts. He turned to slide 10 - monthly oil revenue volatility. In a given month the revenue can change drastically, by as much as \$1 billion. The forecast (July - June) from DOR predicted \$3.2 billion in oil revenue. The DOA forecast (June - May) predicted \$4.2 billion in oil revenue. The issue is oil revenue volatility from month to month. Oil revenue can vary from \$1.2 billion to \$46 million a month. The point is that oil revenue is unpredictable.

Co-Chair Stedman noted that PPT and ACES were calculated using four scenarios; however, a \$100 change in oil price was never expected.

Senator Thomas did not understand how there could be such a variety of revenue prices. Co-Chair Stedman explained that progressivity kicks in and distorts the curve, particularly at prices of \$80 and higher. Senator Thomas remembered that chart. Co-Chair Stedman suggested looking at PPT in FY 09 to see how the tax kicked in at various prices. Progressivity is intended to "capture the spikes".

10:06:35 AM

Senator Ellis requested charts to show the budget with and without PPT. Co-Chair Stedman said that could happen appropriate to ELF, as well as PPT and ACES. Senator Ellis shuddered to think where the state would be if it had not changed its oil taxes. Co-Chair Stedman mentioned that the production sharing arrangement is used globally now. He announced that a consultant, David Wood, would be

addressing that issue shortly. He thought standard deductions, excluded expenditures, base tax, and progressivity, would be included in the presentation.

Senator Ellis asked if it was possible to find out how much was paid out in production credits last year and what is projected for this year. Co-Chair Stedman said it was possible to obtain that information. He also wished to see where the 20 percent credit went. He thought there would be confidentiality issues, but the issue of credits should be examined.

Senator Ellis asked for that information before the committee considers the governor's request for more credits. Co-Chair Stedman agreed. He wanted to do the analysis first on ACES, before individual proposals would be looked at. He informed the committee that the consultant has been hired and the model has been built. The industry, legislature, and DNR are all working on testing the model.

[10:13:30 AM](#)

Mr. Teal commented that tax credits shift the revenue curve downward. He questioned if the credits produce enough production in the future to shift the revenue curve upward, offsetting the short-term downward curve. He emphasized the importance of considering their affect on the curve. To ascertain that information, industry projections have to be relied upon. He discussed the relationship of the forecast to the process. He stressed that timing is important when the oil revenue is counted, as oil price is very volatile. He concluded by emphasizing that budget decisions need to include a long-term look.

[10:17:47 AM](#)

Co-Chair Stedman highlighted a communication problem when providing budget information to the public. He thought the solution would be to synchronize numbers between the various entities; DOR, OMB, and the legislature. He suggested that everyone needs to work together to present consistent information to the public.

Senator Ellis discussed a concern about the negative tone related to formula programs. He termed the need for them a "natural progression". He suggested being mindful of that

when attempting to control spending. Co-Chair Stedman added that education also falls into that category.

Mr. Teal commented that the formula programs are increasing and will continue to increase; therefore, there will be less money available. He was not suggesting that the formula programs needed to be reduced, but rather that they made budget decisions more difficult.

#

ADJOURNMENT

The meeting was adjourned at 10:20 AM.