

HOUSE FINANCE COMMITTEE
January 20, 2011
1:32 p.m.

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CALL TO ORDER

Co-Chair Thomas called the House Finance Committee meeting to order at 1:32 p.m.

MEMBERS PRESENT

Representative Bill Stoltze, Co-Chair
Representative Bill Thomas Jr., Co-Chair
Representative Anna Fairclough, Vice-Chair
Representative Mia Costello
Representative Mike Doogan
Representative Bryce Edgmon
Representative Les Gara
Representative David Guttenberg
Representative Mark Neuman
Representative Tammie Wilson

MEMBERS ABSENT

Representative Reggie Joule

ALSO PRESENT

David Teal, Director Legislative Finance Division;
Representative Alan Austerman; Doug Gardner, Director,
Legislative Legal and Research Services.

PRESENT VIA TELECONFERENCE

None

SUMMARY

^Overview of the Governor's FY12 Proposed Budget

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DOUG GARDNER, DIRECTOR, LEGISLATIVE LEGAL and RESEARCH SERVICES introduced the legal document drafting staff.

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Co-Chair Thomas stated that the Legislative Finance Division staff would be a useful tool and resource for the House Finance Committee (HFC) members during the course of the legislative session.

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DAVID TEAL, DIRECTOR, LEGISLATIVE FINANCE DIVISION, introduced the Legislative Finance Division (LFD) Staff.

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Mr. Teal presented a PowerPoint: "FY12 Budget Overview" (copy on file). He began with slide 2: "Four Elements of Budgeting." He stated that revenue had been a part of the budget in years prior, but a deficit had persisted in the 1990s. Budget discussions during the time of the deficit primarily pertained to appropriations. The budget was so unbalanced at the time of the deficit, there was little discussion related to balancing the budget. In 2005, oil prices rose, so revenue began to have an influence on budget discussions. Reserves were met and some debts were paid, because of the impact of revenue. Revenue influence also brought increased capital spending. He stated that the purpose for the budget reserves was for future planning and spending. He stressed the importance of a discussion about maintaining the reserve funds.

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Mr. Teal discussed slide 3: "Revenue Sources." The pie chart displayed the Department of Revenue (DOR) fall forecast of 2010, showing projected earnings for FY12. He remarked that the chart was accurate, but the money displayed did not represent potential for appropriations. The total revenue shown was \$13.3 billion, but the governor's budget was only \$11 million. The \$3.5 billion represented in the pie chart under investment related mostly to investment revenue from the Permanent Fund (PF) and Constitutional Budget Reserve Fund (CBR). Approximately \$500 million of the \$3.5 billion in investments would be available for legislative appropriations. Oil revenue was 45 percent of the budget; non-oil revenue was 7 percent of the budget; and federal revenue was 22 percent of the budget.

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Mr. Teal presented slide 4: "Revenue and Appropriations." He stated that money was categorized based on the degree of legislative spending discretion; therefore revenue and appropriations were in the same categories: Unrestricted General Funds (UGF), Designated General Funds (DGF), other state funds, and federal receipts.

Mr. Teal explained slide 5: "Federal Receipts." The federal receipts typically had specific requirements pertaining to spending, so the legislature would have very little discretion in the appropriation process. Federal receipts frequently require state matching funds, and would be split fairly evenly into thirds: Capital Budget, formula programs, and agency operations.

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Mr. Teal discussed slide 6: "Other State Funds." The year prior, LFD presented a "Before Budget Clarification Project." In the project, "other state funds" represented approximately \$3 billion. Currently the other funds held about \$500 million. There would be limited discretion in how the other funds could be spent. The other funds included international airport revenue, state corporation receipts, trusts, and dedicated funds. Even though limited discretion would be required when appropriating the other state funds, the legislature could decide where and how the money would be appropriated within the specific "other fund" categories.

Representative Neuman wondered how the other state funds decreased to \$300 million from \$500 billion. Mr. Teal replied that the change was due to LFD simplifying definitions.

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Mr. Teal continued with slide 7: "Designated General Funds." The designated general funds included university receipts, Alaska Marine Highway (AMHS) receipts, and other service fees charged by agencies. The legislature typically follows statutory guidelines, because the law prohibited spending program receipts outside the program that generated the receipt.

Mr. Teal discussed slide 8: "Unrestricted General Funds." The UGF revenue was mostly derived from oil revenue (88 percent). The legislature has complete discretion in appropriating UGF. The UGF was typically referenced as the measure of state spending, and was used to calculate the fiscal surplus or deficit.

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Mr. Teal displayed slide 9: "Revenue Sources-Degree of Discretion." He stated that the PF is not included in the UGF, because PF earnings are excluded from revenue. The PF is excluded from appropriations, because it is excluded from revenue.

Mr. Teal discussed slides 10 and 11: "Part one of the State of Alaska Fiscal Summary-FY11 and FY12." He pointed out the categories of funding: unrestricted, designated, other, federal, and total. He also noted the four categories related to the fiscal summary: Revenue, operations, statewide operations, and capital. He remarked that revenue was about \$300 million more than FY11; however GF spending was up by about \$400 million. Agency operations held at about \$167 million, and he noted a 3.8 percent increase from FY11. The statewide operations were up \$122 million, which was an 11.5 percent increase from FY11. The capital had a \$112 million increase, or an 18.4 percent from FY11. He noted a cash-flow deficit of \$25 million. He stated that the governor had requested a transfer of a net of \$310 million out of savings, giving a surplus of \$284 million. He stated that the summary showed a deficit in FY11, but that the deficit could be inaccurate.

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Representative Doogan wondered why a cash-flow deficit of \$25 million would represent a higher actual deficit. Mr. Teal replied that on a cash flow basis, the revenue supports a budget equal to the amount of revenue. The governor submitted a budget that would spend \$25 million more than the expected FY12 revenue. However, withdrawing money from savings accounts results in a deficit.

Representative Doogan asked why the governor asked for \$25 million, rather than \$310 million. Mr. Teal responded that unspent money from the governor's budget was put into a reserve account. A surplus may seem larger than the cash

flow supports because there could be a consolidation of reserves.

Representative Doogan felt that the governor was moving around unnecessary money, creating a larger budget than was needed. Mr. Teal guessed that the governor's budget might be motivated by potential oil tax reform. He alleged that the governor may have made the state seem more affluent, because the governor hoped to reduce oil taxes. If the state seemed to be in a surplus, then the chance to lower taxes would be greater. He advised the committee to consider motives when examining budget requests.

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Representative Gara wondered whether there was actually a \$150 million deficit, based strictly on cash flow. Mr. Teal felt further discussion was required.

Representative Gara queried the specific definition of "deficit." Mr. Teal clarified the definition of cash flow. On a cash-flow basis, deficits and surpluses are calculated based strictly on revenue and appropriations.

In response to a comment from Representative Neuman, Mr. Teal stated that LFD would track the governor's amendments to the budget. The fiscal summary shown in slide 10 was the governor's current budget proposal.

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Vice-Chair Fairclough stated the importance of understanding the difference between deficit spending and a balanced budget.

Mr. Teal discussed slide 12: "Fiscal Summary Key Points." He stated the FY12 revenue would be \$328 million above FY11 revenue, but spending is \$400 million higher. Agency operations would be up \$167 million (3.8 percent), statewide spending would be up \$122 million (11.5 percent), and capital spending would be up \$112 million (18.4 percent). There would be a cash-flow deficit of \$25 million, but in fiscal terms the \$25 million would be a rounding error. The governor would remove a net of \$310 million from savings accounts, but the FY11 surplus would still remain uncertain. Typically, the Legislature withholds supplemental budget decisions until March.

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Mr. Teal presented slide 13: "Reserves—the Third Element of Budgeting." Alaska has reserves unlike any other state. Excluding the PF, which cannot be spent, Alaska had over \$14 billion in reserves. Some funds would be difficult to access due to extensive restrictions: the permanent fund, the employee retirement accounts (Public Employee Retirement System [PERS] and Teachers Retirement System [TRS]) and the CBR. There is no disagreement on accessible cash of about \$1.5 billion.

Mr. Teal discussed slide 14: "Part two of the State of Alaska Fiscal Summary-FY11 and FY12." He stated that the PF would be difficult to access for political reasons, and the CBR would require a three quarter majority vote to access. Some of the designated savings were lumped into the GF. Some of the designated savings would not be considered savings, because while they are continually spent every year, the funds are refilled each year to accommodate the spending.

Mr. Teal addressed slide 15: "The Value of Reserves." Reserves allow comfort and flexibility. There was language in the budget that withdraws money from the CBR to compensate for possible overspending.

Vice-Chair Fairclough wondered why the projected surplus money was not focused towards paying the unfunded liability pension. Mr. Teal acknowledged her concern, but stated that if the liability was paid off it would use most of the reserves to do so. The pension liability was long-term, based on future earnings and assumptions, such as death rate and health-insurance costs. The money is not currently owed, but it simply assumed to be owed. He called it a "soft liability."

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Co-Chair Thomas remarked that the unfunded liability pension was an important issue that warranted discussion. Co-Chair Stoltze felt the unfunded liability pension should not be referred to as a "soft liability," but rather an "unpredictable liability." He stated that there was uncertainty in the obligation.

Vice-Chair Fairclough wondered if it would be better to pay the liability sooner, in order to avoid escalating interest rates. Mr. Teal responded that paying off an interested liability debt from a fund that is accruing interest would force the state to lose the interest earnings from the CBR. He remarked that if the state paid off all of the debts in PERS the state would be paying off other employers' debts. The state could pay off the debt, but the question is whether or not the state should pay off the debt. He encouraged further discussion regarding debt payments.

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Representative Gara asked whether the PERS/TRS settlement with Mercer was reflected in FY11 revenue or FY12 revenue. Mr. Teal replied that the retirement system has a time lag. For example, the rates of FY12 were based on the June 2009 valuation; that valuation carried forward losses from 2008. Because of the lag, the Mercer settlement money was not reflected in FY12. The Mercer settlement would not count for two more years.

Representative Guttenberg reiterated the importance of further discussion regarding debt payment.

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Co-Chair Thomas furthered that a more extensive overview would eventually occur in the session. Co-Chair Stoltze agreed.

Mr. Teal presented slides 16 and 17: "FY2011 Unrestricted General Fund Revenue - Fiscal Sensitivity." The chart showed what happens to revenue when the price of oil changes. Expenditures would not waiver, because they were not based on the price of oil. The revenue was dependent on the price of oil, and it is an upward curve because it is a progressive tax. The breakeven point on the graph was the point where expenditures are equal to the price of oil. In FY11, the budget was \$3.5 billion and the breakeven point was 77 dollars per barrel. The forecast price for oil was 78 dollars per barrel, which would give the UGF a surplus of \$50 million before transfers.

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Co-Chair Stoltze queried the fiscal impact of the recent brief shutdown of the oil pipeline. Mr. Teal replied that

the graph presented in slide 16 was a simplified representation, and the margin of error was about \$100 million. The chart was based on an annual average price, but profitability was measured monthly. The state gets more revenue if oil was to sell at 60 dollars per barrel one month and the next month at 80 dollars per barrel than it would if oil were 70 dollars per barrel a month for two months. This is because there would be higher tax revenue at higher oil prices. There would be a deficit of about \$1.6 billion, if oil were to fall to 60 dollars per barrel.

Co-Chair Stoltze remarked that the state cannot anticipate oil price fluctuations.

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Mr. Teal continued with slide 17: "FY2012 Unrestricted General Fund Revenue-Fiscal Sensitivity." The chart displayed the upward shift in expenditures from FY11, by approximately \$400 million. He remarked that the \$27 million fiscal gap would disappear if the price of oil was 25 cents higher than was projected. The charts represented rough estimates and generalizations.

Mr. Teal displayed slide 18: "Key Points." A one-dollar change in oil prices would produce a \$100 million change in revenue. Declining oil production, additional tax credits and/or declining profitability shifts the revenue curve downward, so reserves could vanish very quickly.

Mr. Teal discussed slide 19: "FY11/12 General Fund - Fiscal Sensitivity Overlay," representing the FY11/12 revenue. A higher expenditure curve with a lower revenue curve makes for a higher breakeven cost: 83 dollars per barrel. The breakeven price in FY10 was about 64 dollars per barrel.

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Representative Neuman assumed the drop in production was about five percent. Mr. Teal responded with slide 20: "Why the Revenue Curve Shifts Downward Over Time." Typically, a revenue curve would shift downward because of a decline in production, but the forecast for FY12 was up one percent. The change from FY10 to FY11 was more than the change from FY11 to FY12. Even though the production forecast was up one percent, the curve still turns downward. The revenue curve shifts downward if the nontransferable tax credits

were increased. The downward revenue curve may also be because of lower profitability. Profitability was affected by higher production costs with less oil. Less profit per barrel would cause the revenue curve to shift downward, making the breakeven price of oil higher.

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In response to a question by Representative Doogan, Mr. Teal said that according to the chart on slide 19, the revenue curve would shift downward if tax rates were lower. At any given price of oil, there is less revenue to the state. The downward shift would move at a given level of expenditures from point B to point D. The combination of increasing expenditures and decreasing revenue moves the breakeven point from point A to point D.

Representative Doogan wondered what might happen if production increased. Mr. Teal replied that if the production increased, the curve would shift upward if production increased and downward if production decreased.

Representative Doogan queried the breakeven points on the chart from slide 19. Mr. Teal pointed out the increase in breakeven point from 64 dollars per barrel in FY10 to the breakeven point of 77 dollars per barrel in FY11, which had a 4 percent reduction in the production cost. Slide 19 showed an increase of only 6 dollars per barrel from FY11 to FY12.

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Co-Chair Stoltze remarked that revenue projections seemed to overlook functionality of the oil pipeline. He stressed the importance of holding discussions related to oil.

Representative Gara wondered whether the opening of the Nikiachuck oil field had an impact on the projections. Mr. Teal replied that DOR projected years of production increases, and remarked that his own comments on oil taxes were based on the effect of the tax on the revenue curve.

Vice-Chair Fairclough sited other oil fields listed in the Fall 2010 Revenue Sources Book, which were optimistic for production.

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Mr. Teal showed slide 21: "Why Expenditures Shift Upward Over Time." Formula programs like K-12 education and Medicaid increase every year, and seem to have an inexhaustible demand. Incremental budget processes and simply reviewing the increments ultimately increases the budget. Debt service and tax credits were consequences of past legislation, so therefore would have an impact on expenditures.

Mr. Teal discussed slide 22: "State Assistance to Retirement." The current payment toward PERS and TRS was less than \$400 million per year, with a projected growth of up to \$1.4 billion year in 2029. He pointed out that in 2030 there would be a substantial drop to just over \$600 million. He encouraged further discussion regarding retirement payments.

Mr. Teal displayed slide 23: "The Fourth Element of Budgeting—A Plan." The governor's FY12 budget was balanced, and reserves were sufficient to handle basic circumstances. The governor's budget seemed to encourage production. Mr. Teal encouraged the legislature to consider short term gains and decreases in revenue, and note that the tax structure does not guarantee steady cash-flow. There would be a guaranteed downward shift in revenue, and the legislature must decide if there could be sufficient reserve funds.

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Mr. Teal discussed slides 24 and 25: "Unrestricted General Fund Revenue/Budget History." Appropriations were fairly even from about 1993 to 2004 because there was little money. When revenue expanded, so did expenditures.

Mr. Teal showed slide 26: "Growth in Agency Operating Budgets." He stated that projections were based on a constant capital budget of \$500 million. He felt \$500 million was a reasonable expectation of capital spending. Statewide operating costs were currently about \$1.2 billion, with added retirement costs included. Agency operations were difficult to predict, but they were projected to increase at a rate of 7.6 percent each year. The agency operations predictions were based on the growth from FY06 to FY11. The Department of Health and Social Services and the Department of Education and Early Development accounted for 52 percent of the growth in the

operating budget. Restraining the growth of the Operating Budget is difficult, because more than half the growth was in Medicaid and K-12 education. The revenue curve would shift downward and the combination would require reserve spending, if oil production projections could not meet expectations, oil tax rates were not reduced, and expenditure growth was difficult to control.

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Mr. Teal displayed slide 27: "Wrap Up." The fiscal situation was expected to be strong for FY12, because of a balanced budget and solid reserves. After 2012, there would be inevitable downward shifts in the oil revenue curve, upward shifts in the oil expenditure curve, and the retirement system unfunded liability would require greater payments. This combination would deplete the reserves rapidly. He pointed out that the reserves had been built up since 2005.

Co-Chair Thomas stated that some in the media project \$150 per barrel for FY13.

Co-Chair Stoltze stated a responsibility was placed on the state to decide how oil revenue is spent.

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Vice-Chair Fairclough commented that she was familiar with the economic forecast, and that Alaska had a fairly stable economic situation compared to other states.

Representative Neuman expressed concern that Alaska's revenue was strictly relying on a single source of income: oil.

#

ADJOURNMENT

The meeting was adjourned at 3:02 PM

