

HOUSE FINANCE COMMITTEE
January 19, 2012
1:35 p.m.

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CALL TO ORDER

Co-Chair Stoltze called the House Finance Committee meeting to order at 1:35 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 Reggie Joule
Representative Mark Neuman
Representative Tammie Wilson

MEMBERS ABSENT

None

ALSO PRESENT

David Teal, Director, Legislative Finance Division;
Representative Alan Austerman.

SUMMARY

OVERVIEW OF THE GOVERNOR'S FY 2013 BUDGET:
Legislative Finance Division

Co-Chair Thomas introduced constituents from Skagway and welcomed them to the committee room.

^OVERVIEW OF THE GOVERNOR'S FY 2013 BUDGET: LEGISLATIVE FINANCE DIVISION

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DAVID TEAL, DIRECTOR, LEGISLATIVE FINANCE DIVISION (LFD), agreed with comments made by Office of Management and Budget (OMB) Director Karen Rehfeld who had discussed the governor's FY 13 operating budget the prior day. He explained that LFD agreed with the governor's presentation of the budget; the OMB fiscal summaries matched on a fund group and dollar basis.

Mr. Teal began a PowerPoint presentation titled "Legislative Fiscal Analyst's Overview of the Governor's FY 13 Budget" and relayed his intent to look at the budget in the context of Alaska's future. He informed the committee that the LFD Legislative Fiscal Analyst's Overview of the Governor's Request for the FY 13 budget was available on the LFD website (copy on file). The book included capital and operating budget fiscal summaries and agency operating budget details.

Mr. Teal believed the LFD report contained a significant amount of good news. There was a \$3.7 billion surplus that consisted of \$1.9 billion from FY 12 and \$1.8 billion from FY 13. He relayed that the current surplus was "huge" compared to budget surpluses in past years. He elaborated that in the prior year the total FY 11/FY 12 surplus had initially been \$25 million. The FY 12 surplus had grown above \$400 million and high oil prices had increased it to \$1.9 billion. He expounded that the available \$3.7 billion surplus was over 25 percent of the \$14 billion that had been set aside beginning in 2005.

Mr. Teal shared that it was good news that the governor's operating budget growth rate was 3.2 percent and not the 7.8 percent rate that had been in place since 2005.

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Mr. Teal pointed to slide 1 titled "Unrestricted General Fund Revenue/Budget." The chart illustrated what would happen if agency operating budgets continued to grow at 7.8 percent, capital budgets were \$882 million beginning in FY 13, and costs stayed flat statewide (with the exception of retirement). He discussed that under the scenario, deficits would occur beginning in 2015 and would ultimately reach approximately \$3 billion; financial reserves would be exhausted by 2025. He communicated that the 3.2 percent growth rate would result in a substantial drop in reserve

declines and would come close to balancing the budget. He explained that the capital budget would not remain at \$882 million during a deficit. He provided a hypothetical scenario in which the capital budget was reduced to \$500 million, which would have helped to balance the budget.

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Mr. Teal continued on slide 2: "Projected Reserve Balances." The chart illustrated how reserve balances would be impacted by a growth rate of 7.8 percent versus a growth rate of 3.2 percent. With a 7.8 percent growth rate, reserves were rapidly depleted and would be gone by 2025; however, with a growth rate of 3.2 percent, reserves remained at approximately \$20 billion. He stressed that a growth rate of 7.8 percent was not sustainable. He communicated that the governor's budget made a strong effort to reign in the operating growth.

Mr. Teal addressed slide 3 titled "Projected Direct State Contributions to PERS and TRS," and relayed that retirement contributions also had an impact on the future budget. He referred to the state's decision to cap the Teachers' Public Retirement System (TRS) and the Public Employees' Retirement System (PERS) at 12.56 percent and 22 percent respectively. He discussed that the state had initially believed the costs would be approximately \$200 million, that they would decline rapidly, and that it would be out of the business of state assistance by 2020 or so; however, poor investment returns beginning in 2008 had resulted in lost revenue. The losses led to revised future earnings and actuarial assumptions and an increased unfunded retirement liability of \$450 million or more in FY 12 and over \$600 million in FY 13. He elaborated that the liability would reach approximately \$800 million by FY 16 and would grow to approximately \$1.2 billion per year in subsequent years. He emphasized the large size of the numbers and noted that current K-12 education funding was approximately \$1.2 million.

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Mr. Teal informed the committee that there was some good news related state retirement costs. He explained that Alaska's system had unique characteristics that made the standard actuarial analysis obsolete. He furthered that Buck Consultants, the state's actuary, had modeled an

alternative concept showing that a single \$2 billion contribution to PERS would be sufficient to fund all future benefits without additional state contributions. He communicated that the \$2 billion payment to PERS would result in a savings of approximately \$400 million per year. The state would see its \$2 billion investment returned in five years and by 2025 the savings would be above \$4.8 billion. He stressed that the total operating budget reduction would be over \$7 billion by the time the unfunded PERS liability had been paid off. Under the Buck scenario, the state would spend \$2 billion upfront, but it would have more reserves in 2025 than it would if it continued to make annual contributions.

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Vice-chair Fairclough wondered whether "frontloading" the PERS/TRS obligations would improve the state's credit rating.

Mr. Teal did not know whether the state would be rewarded with an improved credit rating if it paid the liability off; however, he did not believe the payment would hurt its current AAA rating. He relayed that credit agencies factored multiple items into ratings including future revenue streams; the \$2 billion payment would make an impact, but it would not be as sizable as one may hope. He opined that credit based on a retirement system should be rated equally, but that was not the case. He expounded that unlike most states, Alaska currently funded its health care liabilities and stated its liability more honestly; however, states were all ranked the same.

Representative Gara asked whether the \$2 billion payment would sufficiently fund the current and future unfunded retirement liability.

Mr. Teal responded that the actuarial model required a one-time payment of \$2 billion, which would eliminate the need for future contributions. The municipalities and the state would continue to pay their 22 percent portion on payroll. He clarified that the current annual payments of \$300 million to \$466 million (above the 22 percent rate) would stop.

Representative Gara asked when the retirement liability would be paid down if the state made the \$2 billion payment

combined with the annual 22 percent contributions. Mr. Teal asked for clarification on the question. Representative Gara wondered what would occur in the last year projected on slide 3 [FY 33].

Mr. Teal replied that the state would save approximately \$5 billion in what would have been annual contributions to the retirement fund. Without the \$2 billion payment the liability would not be fully funded in the future. He explained that money would be transferred from a reserve account to make the benefit payments if necessary. The retirement model did not completely eliminate the unfunded liability by 2029, but it did eliminate the need for additional payments above the 22 percent.

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Representative Doogan asked whether the model funded the liability for both PERS and TRS.

Mr. Teal replied in the negative. The TRS system was significantly worse off and had a separate model; a payment of \$4 billion would be required to fix the system. He elaborated that the \$4 billion would save approximately the same amount that would have been saved in the PERS system. The state would initially be down \$6 billion in reserves, but reserves would continue to grow and would take time to recover.

Co-Chair Thomas informed the committee that there would be a more in-depth discussion on the issue at a later time.

Co-Chair Stoltze remarked that there was a much broader concern about the system that was not reflected in the government point of view. He referenced constituent concerns related to dependence on a declining industry.

Mr. Teal agreed that there was an expenditure side and revenue side of a budget problem. The revenue side required a discussion about oil production taxes, which was almost independent from the expenditure side of the budget. He acknowledged that the revenue side was equally as important, but he was focused on the expenditure aspects. He emphasized that the unfunded retirement liability was a large driver of the budget and would become a significant problem in the future; however, he believed there was a solution.

Mr. Teal discussed reasons LFD analysts were pessimistic about the future on slide 4 titled "FY 12/13 General Fund - Fiscal Sensitivity Overlay." He explained that the revenue curve was dependent on price of oil; however, each year as production declined the revenue curve shifted downward. The curve was approximately \$900 million less in FY 13 than it had been in FY 12 under any given price of oil; with oil at \$95 per barrel revenue was approximately \$7 billion in FY 12, but it was under \$6 billion in FY 13. Production decline would lead profit loss due to lower tax revenue combined with higher capital and operating costs. The revenue curve would shift downward and the breakeven price of oil would continue to increase; the breakeven rate had been \$94 per barrel in FY 12 and would be approximately \$100 per barrel in FY 13. He added that the revenue curve shown on slide 1 took the declining production into account. The decline was partially offset by the increased price of oil.

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Mr. Teal relayed that the second issue was related to the governor's proposed 3.2 percent agency operations growth rate, which would be difficult to achieve. He expressed skepticism about the plausibility of the proposed \$882 million capital budget. He believed it would be hard to stay at the proposed level because there were several items missing from the budget. Education funding for K-12 was flat from the prior year's budget and typically every \$100 increase in the Base Student Allocation (BSA) cost \$25 million; school boards had discussed a \$300 increase in BSA, which equated to approximately \$75 million. The Alaska Gasline Inducement Act (AGIA) had been short funded by approximately \$100 million. He communicated that the fuel trigger was at the same level as the prior year and stopped at \$100; however, the projected price of oil was \$109 per barrel. Extending the fuel trigger up to the projected price of oil would cost approximately \$9 million. Additionally, the proposed budget did not include \$3.5 million in actuarially required Judicial Retirement System (JRS) contributions.

Mr. Teal discussed that a number of funds spent more than they brought in including, fish and game, oil and hazardous, worker's safety, Alaska Marine Highway System, the Department of Natural Resources land disposal, and

others. He discussed that agencies typically had to request additional general funds when their normal fund source was depleted. A solution to the structural problem could take up to \$20 million for a one-time fix and significantly more for a longer term solution. Unlike other states, Alaska did not have sales and income taxes to fix the bulk of its revenue problems. Alaska currently depended on oil revenue; however, the resource-generated revenue only lasted as long as the resource itself. He communicated that without additional oil production the state would be forced into watching its revenue decline. He compared the state to an individual near retirement who would have to rely on savings.

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Mr. Teal emphasized that increased current savings improved the likelihood that the state could avoid income and sales taxes and losing the Permanent Fund Dividend in the future. He did not believe the FY 13 budget process would involve dissecting the governor's increments because there were not many increments on a department-by-department level. He thought the budget process would focus on the decision to spend versus the decision to build reserves. He believed that the combined importance of the revenue and expenditure decisions made the FY 13 budget cycle critical to Alaska's future.

Representative Gara pointed to the chart on slide 4. He referenced discussion that the breakeven point would be \$97 per barrel in the FY 13 budget. He believed there was an \$80 million difference between the FY 12 and FY 13 budgets and wondered whether the breakeven point would be \$103 per barrel if the legislature added \$80 million to the FY 13 budget.

Mr. Teal responded that point A on slide 4 reflected the FY 12 revenue curve and level of spending. He relayed that the governor's FY 13 budget was \$385 million lower than the FY 12 budget; although, the governor had reported it was \$800 million less. He explained that the budget was \$800 million less if money was not put into savings, but he believed that it was necessary to look at what was spent and not at the savings or transfers. At the FY 12 revenue curve the breakeven point was \$90 per barrel, but point C reflected the amount under the proposed FY 13 budget. He explained that point D showed what would happen if the FY 13 budget

was increased to the FY 12 level; the level would move beyond point D if the FY 13 budget was increased above FY 12 spending. He added that the breakeven point would be \$103 per barrel if an additional \$100 million was added to the budget.

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Representative Gara asked whether the chart on slide 4 showed an \$800 million or a \$300 million difference between FY 12 and FY 13. Mr. Teal answered that the FY 13 curve was \$385 million less than the FY 12 curve.

Representative Gara wondered whether the breakeven point would be approximately \$103 per barrel if an additional \$385 million were added to the budget.

Mr. Teal explained that the lower line on the chart (slide 4) was \$385 million less than the \$7 billion level in FY 12. He clarified that the level would be at point D on the chart if the budget was equal to the FY 12 level. The point would reach \$103 per barrel if an additional \$385 million was added to the FY 13 budget.

Representative Doogan asked why the governor's budget was \$385 million less than the prior year.

Mr. Teal referred to page 8 of the FY 13 LFD budget book. The operating costs were \$253 million more than the prior year; however, capital expenditures were \$638 million lower. The agency operating budgets had been increased between \$150 million to \$160 million; a significant portion was due to non-formula increases. Medicaid was up approximately \$45 million, but K-12 education would require approximately \$17 million less in FY 13 due to falling enrollment numbers.

Representative Doogan deduced that the actual budget was higher; however, the capital budget level included by the governor was less than it had been for the past couple of years. Mr. Teal responded in the affirmative.

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Representative Doogan asked whether the LFD analysis included assumptions for necessary additional spending that had been excluded from the governor's budget.

Mr. Teal replied that additional expenditures had not been built in to the analysis. He believed that the items "missing" from the budget made it difficult for the legislature to achieve the governor's proposed 3.2 percent budget growth. He did not know which additional expenditures the legislature would include. He provided an example and explained the legislature may or may not decide to increase the fuel trigger because the increase had not been requested by the governor. He did not know why items such as \$3.5 million for JRS had not been included; the legislature could decide to pay off the \$50 million unfunded JRS liability. There was a wide range of additional money that could be spent, which totaled approximately \$200 million to \$250 million; however, he surmised that the amount was much less than \$3.7 billion.

Representative Doogan asked whether the governor had not included sufficient funds in the FY 13 budget.

Mr. Teal replied that the question was difficult to answer. He believed the governor had done an excellent job reigning in agency operating money. He noted that items such as AGIA may have received "low-ball" funding; however, it was possible that the governor had a supplemental funding request plan. Traditional low-balling that sometimes happened on items such as Medicaid had not occurred, and an FY 13 supplemental request for the item was not expected. Items that had been left out of the budget were optional fixes for the legislature.

Co-Chair Thomas noted that the governor had an opportunity to amend the budget and could include items that had been left out.

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Representative Costello pointed to a loss of 280 positions reflected in the governor's budget in addition to an increase of \$66 million for salaries and benefits. She had learned that departments had carried unfilled positions in order to fund other positions and wondered whether the items were related.

Mr. Teal replied that many of the governor's deleted positions had been vacant. The purpose of the deletions was to get rid of long-term, unfunded, vacant positions. The

division had worked on the issue with OMB in the past, but vacancy factors were complicated. He did not believe it made sense to leave a vacant position in an agency budget to fund another position; however, it was currently set up that way. Additional positions had been included for the operation of the Goose Creek Correctional Center, but he did not know the net change in the positions. He explained that the \$66 million in salary increases was primarily due to contractual increases and the 3 percent cost of living allowance that were not of the agencies' choosing. There had also been a substantial increase in health benefits. He opined that \$66 million was an accurate number.

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Representative Costello asked whether the \$66 million would have been in the budget if the positions had not been deleted. Mr. Teal responded in the affirmative. He explained that the deleted positions had no impact on the \$66 million that had been included.

Representative Gara surmised that agencies had spent money designated for vacant positions on other items and without the vacant positions they would be unable to continue to fund the items.

Mr. Teal responded that the scenario represented one result that could occur. He pointed to detail about positions and vacancies in the LFD budget analysis. He detailed that when the legislature removed unfunded vacant positions and also deleted funding, agencies did not have enough money to continue funding other items or positions.

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Representative Gara surmised that agencies may have to lay off other employees if unfilled positions and funding were deleted. Mr. Teal responded in the negative. He communicated that the items had been factored into the FY 13 budget.

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ADJOURNMENT

The meeting was adjourned at 2:20 PM.