

SENATE FINANCE COMMITTEE
January 27, 2011
9:03 a.m.

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CALL TO ORDER

Co-Chair Stedman called the Senate Finance Committee meeting to order at 9:03 a.m.

MEMBERS PRESENT

Senator Lyman Hoffman, Co-Chair
Senator Bert Stedman, Co-Chair
Senator Lesil McGuire, Vice-Chair
Senator Johnny Ellis
Senator Dennis Egan
Senator Donny Olson
Senator Joe Thomas

MEMBERS ABSENT

None

ALSO PRESENT

David Teal, Director, Legislative Finance Division

PRESENT VIA TELECONFERENCE

None

SUMMARY

^FY12 Budget Overview & Fiscal Summary

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DAVID TEAL, DIRECTOR, LEGISLATIVE FINANCE DIVISION, presented the PowerPoint presentation: "An Overview of Alaska's Fiscal Situation, Senate Finance Committee."

Co-Chair Stedman remarked that he advised Mr. Teal to highlight the basic aspects of the budget to help the public understand the process. He stated that there could be some redundant information for the committee members.

Mr. Teal presented 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 million 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.

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.

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.

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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.

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.

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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.

Co-Chair Stedman pointed out line 36, and asked for further explanation. Mr. Teal stated that line 36 displayed a cash flow deficit of \$26 million. He remarked that the governor would withdraw \$310 million from savings accounts, which would give a surplus of \$284 million for FY12. He referred back to FY11, and remarked on a deficit of \$14 million. He stated that the \$14 million deficit was inaccurate because it was only a projection. He stated that the management of spending was easier than spending, because revenue is uncontrollable.

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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.

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Co-Chair Stedman recalled conversation about the growth of agency operations. He referred to line 8 on slide 10, and wondered if there should be a concern beyond what the state controlled. Mr. Teal encouraged the committee to pay attention to all operations. He stated that the committee had the most control over the agency operations, but assured the committee that they had control over all the

other items, including retirement spending and statewide debt.

Co-Chair Stedman looked at the 5.2 of the total operations in slide 11, and wondered if a 3 percent expectation would be reasonable. He also queried the impact of various expectations based on the growth of the prior five years. Mr. Teal replied that some later slides might address the concerns.

Senator Thomas wondered if the FY11 surplus calculations incorporated the governor's capital budget vetoes. Mr. Teal replied that they did, but did not include the supplemental budget.

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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.

Co-Chair Stedman wondered if there was a projection for the end of FY12. Mr. Teal replied with 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.

Co-Chair Stedman remarked that most states have tight budget issues, so they strictly deal with budgetary issues on a month to month basis. He wondered if Mr. Teal was familiar with that practice. Mr. Teal replied that other states could not measure reserves in terms of years because they had substantially smaller reserves. He stated that the other states look at liquidity needs. He stated that if Alaska were to have no revenue whatsoever, Alaska could function for two years because of its substantial reserves.

He alleged that the recession proved the wisdom of reserves.

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Senator Thomas pointed out the forward funded education fund, and wondered if LFD classified it as reserves. Mr. Teal responded that the balance was always the same, year to year, because it is continually funded.

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.

Mr. Teal presented slide 16: "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.

In response to a question by Co-Chair Stedman, Mr. Teal stated that expenditures did not depend on the price of oil. The revenue curve was not flat, and it curves because there was a progressive tax scheme. He remarked that the graph did not include the pipeline shutdown.

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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.

Co-Chair Hoffman requested a chart with FY12 showing the parameters of the governor's new tax structure. Mr. Teal agreed to provide that information.

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.

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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.

Mr. Teal showed 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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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.

Co-Chair Stedman mentioned that there would be discussions in committee related to cash flow in the retirement funds.

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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.

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.

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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.

Mr. Teal referred back to slide 25. The chart showed a surplus until 2017, but there would be a distinct deficit in 2020.

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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 Stedman remarked that OMB projections were different than the LFD projections, and wondered if there had been any reconciliation. Mr. Teal replied that OMB was using the ten-year projections with a 3 percent growth rate, because the instructions were to increase the budget at 3 percent. He furthered that the 3 percent growth rate was in keeping with inflation.

Co-Chair Stedman expressed concern about the dialogue in the press related to growth rates, which gave the impression that the rate of change in the operating is not accurate. He pointed out that this was because the press was not including statewide operations. Mr. replied that LFD accounted the last five years, and chose to merely continue that trend in their projections.

Co-Chair Stedman requested a projection at 3 percent growth, and then apply the retirement related to Medicare issues. Mr. Teal replied that that LFD had a model to determine that growth, but anticipated that the model would not provide much more information.

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Co-Chair Hoffman felt the projection from 2013 to 2010 was too conservative in slide 25, based on historical projects.

Senator Olson referred to slide 22, and queried the significant decline in 2033 to 2040. Mr. Teal replied that projections state what it pays for a certain number of years. The drop is because of what is considered to be the last payment in 2029.

Senator Olson wondered what percentage of reliability could be assumed in slide 22. Mr. Teal replied that other factors were other considered like health care and mortality rates, but the main factor for the gap was due to investment drops. He alleged that the chart understates the severity of the financial situation.

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Co-Chair Stedman stated that he anticipated the 8.25 percent growth rate be adjusted downward.

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ADJOURNMENT

The meeting was adjourned at 10:12 AM.