

HOUSE FINANCE COMMITTEE
February 10, 2014
1:32 p.m.

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CALL TO ORDER

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

MEMBERS PRESENT

Representative Alan Austerman, Co-Chair
Representative Bill Stoltze, Co-Chair
Representative Mark Neuman, Vice-Chair
Representative Mia Costello
Representative Bryce Edgmon
Representative Les Gara
Representative David Guttenberg
Representative Lindsey Holmes
Representative Cathy Munoz
Representative Steve Thompson
Representative Tammie Wilson

MEMBERS ABSENT

None

ALSO PRESENT

Karen Rehfeld, Director, Office of Management and Budget, Office of the Governor; John Boucher, Senior Economist, Office of Management and Budget, Office of the Governor.

SUMMARY

^OVERVIEW: FY 15 10-YEAR PLAN

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KAREN REHFELD, DIRECTOR, OFFICE OF MANAGEMENT AND BUDGET, OFFICE OF THE GOVERNOR, presented the PowerPoint presentation: "FY 2015 Ten-Year Plan Overview" (copy on file). She described the ten year plan as a tool to utilize when crafting the annual budget and place in context of the

long term view. Adjustments would be necessary as conditions and circumstances change.

JOHN BOUCHER, SENIOR ECONOMIST, OFFICE OF MANAGEMENT AND BUDGET, OFFICE OF THE GOVERNOR, began with slide 2: "Brief History."

- Enacted in 2008 (HB 125)
- Initial statewide plan in winter 2008
- First agency plans in January 2009
- Fiscal planning module automated and part of the Alaska Budget System (ABS) 2010/2011
- First ABS generated plan in January 2012

Mr. Barnhill stated that the FY 15 plan represented the sixth year of the ten-year plan. The Office of Management and Budget strove to continually improve the plan's process and product.

Ms. Rehfeld discussed slide 3: "Purpose of the Plan."

A tool to keep a dialogue about Alaska's future in the forefront.

- Creates annual dialogue about the future fiscal health of Alaska
- Provides context for budget decisions within the overall revenue picture
- Informs decision making given a range of scenarios

Ms. Rehfeld related that over the next decade Alaska must transition from a predominantly oil revenue base to an oil and natural gas revenue base and develop other resource industries. Natural gas development would provide economic opportunity and a stable and clean energy source for Alaskans. She offered that the plan was produced annually and was based on Department of Revenue's (DOR) Fall Forecast. Alaska needed to enforce budget discipline in order to sustain itself through 2024. The state expected to slow the decline in oil production while natural gas production expanded into a larger role in the state's economy.

Ms. Rehfeld assumed that the combined balances of the state's two primary reserve accounts; the Statutory Budget Reserve (SBR) and the Constitutional Budget Reserve (CBR)

would remain positive over the next decade through conservative spending scenarios. The level of state spending played a critical role in the revenue versus expenditure equation. The plan was designed to "inform" through a range of scenarios. Reserve funds, spending reductions, and "other fiscal tools" would be employed to manage the budget over the next ten-year period.

Mr. Boucher continued with slide 4: "Plan Requirements."

Objectives of the 10-year plan

- AS 37.07.020 (b) (2) says the annual plan must:
 - o Balance the budget between sources and uses of funds
 - o Provide for essential state services
 - o Protect Alaska's economic stability

Mr. Boucher added that the plan must also project balances for the reserve accounts and describe the major assumptions of the plan. He indicated that the "foundation" of the plan was DOR's Fall Revenue Forecast. He listed other assumptions of the plan: a 2.5 percent inflation rate and population growth projected at slightly over 1 percent annually.

Mr. Boucher continued with slide 5: "Annual Plan Release Scheduled."

Executive Summary and Agency plans

- Statewide Executive Summary released in December
- Individual agency plans released in January
- Statewide and agency plans provide different levels of detail and information

Mr. Boucher explained that OMB granted the agencies leeway when developing its spending projections but also provided the following guidance from the instruction memo. He read:

"The process of making ten-year projections is not an opportunity to ask for every program or everything that every program has ever wanted rather the projections should be the result of a rational objective process within the department that would withstand the scrutiny of the governor, the legislature, and the public."

Mr. Boucher reported that each agency plan contained two types of projections. One projected the "current level of service;" the cost of providing the current level of service for 10 years. An important rule was not to assume that general funds (GF) could be used to backfill anticipated lost revenue from other fund sources. The other type of projections made in the plan was "initiatives." He explained that "the projection was designed to highlight projected costs associated with expanding or contracting a service capacity of the agency from its FY 14 level or if new GF would be required to replace non-GF fund sources." Agencies were required to produce spending projections for the operating, capital, and for formula programs. He noted that some budget items, i.e., wage and benefit increases, state assistance payments to employee retirement systems, annual debt service, and fund capitalizations were projected as statewide appropriations. The budget office was responsible for coordinating or producing the statewide projections.

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Ms. Rehfeld continued with slide 6: "Guiding Principles of the FY2015 Plan."

Foundation framework and strategies

- Develop Alaska's Natural Resources
- Restrain Spending
- Save for Future Generations

Mr. Boucher detailed slide 7: "Develop Alaska's Natural Resources."

Prosperity hinges on responsible development of abundant natural resources

- Strategy - Increase Oil Production
- Strategy - Gas for Alaskans and Markets Beyond
- Strategy - Strategic Minerals Development
- Strategy - Affordable Power

Mr. Boucher announced that 90 percent of the state's unrestricted general fund revenue was created from oil production. The administration's highest economic priority was the development of the state's natural resources. The

state's long-term plan included slowing the decline in oil production. The vast natural gas potential was an important piece of the long term health of Alaska's economy. He noted that Alaska had an important role in developing a domestic supply of strategic minerals. The state had an ambitious goal to generate 50 percent of the state's electricity through renewable resources by 2025 and continue to invest in energy conservation. Developing the state's other natural resources played a significant part in Alaskan's future.

Ms. Rehfeld continued with slide 8: "Restrain Spending."

Smaller, more efficient government delivering essential services

- Strategy - Spending Targets
- Strategy - Results Based Budgeting
- Strategy - Long-Term Investment Initiatives

Ms. Rehfeld noted that spending reductions had been achieved in the past two years years due to the significant effort by the governor and legislature to stay within defined spending targets. The administration also employed "performance based budgeting;" focused on the outcomes from agency mission and core services. The administration coordinated among the agencies in an effort to eliminate waste and duplication. She mentioned that the administration encouraged agencies to discover innovative ways to deliver services. She added that long-term investments included legacy projects, roads to resources, transportation infrastructure, and energy and were key to the long-term economic health of the state.

Mr. Boucher continued with slide 9: "Save for Future Generations."

Maintain Alaska's economic stability

- Strategy - Preserve and grow Alaska's Permanent Fund
- Strategy - Build Reserves/Prudent Use of Reserves
- Strategy - Forward Fund
- Strategy - Focus on essential services

Mr. Boucher announced that the savings portion of the plan was the foundation for "protecting" Alaska's economic stability. Savings extended Alaska's economic stability beyond the life of the revenue resource. He informed the committee that two critical elements grew the permanent fund; mineral royalty revenue and inflation-proofing appropriations. The December [2013] Permanent Fund Report showed that out of the \$44 billion balance over \$22 billion had been appropriated through the legislature. The state's dedicated oil revenue contributed \$14.5 billion to the fund. Inflation proofing and dedicated revenue were projected to contribute \$19.8 billion to the fund by 2024 when the balance could be \$78 billion.

Mr. Boucher communicated that the plan advised that any surplus GF should be set aside in reserve accounts. He noted that from the inception of the CBR through 2005 more than \$5.2 billion was borrowed from the fund to balance the budget. Surpluses beginning in FY 2007 replenished the CBR and the balance had grown to \$12 billion. The current balance of the SBR was \$4.7 billion. The plan predicted that draws on the reserve fund would be necessary to balance the budget in the near future. The plan employed the strategy of forward funding for endowing programs to provide fiscal stability.

Mr. Boucher listed the important funds that were endowed through forward funding; the public education fund, Community Revenue Sharing Fund, the Power Cost Equalization Fund (PCE), and the Alaska Higher Education Investment Fund. From a spending prospective, the plan prioritized spending according to essential services; resources and energy, education, public safety, transportation infrastructure, and Alaska's military.

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Ms. Rehfeld discussed slide 10: "Plan Scenarios."

Alternate scenarios provide reasons for optimism and caution

- Optimism
 - o Alaska's current financial outlook is positive
 - o Strong reserves
 - o Triple A bond rating
 - o Fiscal discipline

- Caution
- Oil price and production levels quickly change the fiscal outlook
- Conservative revenue picture tempers long term outlook

Ms. Rehfeld continued with slide 11: "Three Alternate Statewide Scenarios."

Revenue outlook requires reduced spending and use of reserves

- Lower oil price and production result in decreased revenue
- Require fiscal discipline and prudent use of reserve funds in the near term to provide essential services
- Focus on priorities and strategic investments to grow the economy

Mr. Boucher continued with slide 12: "Three Alternate Statewide Scenarios."

Illustrate possibilities given different price and production assumptions

Scenario 1 - Fall 2013 forecast with flat general fund spending beginning in FY2015

Scenario 2 - Fall 2013 forecast for price with enhanced production and flat general fund spending beginning in FY201

Scenario 3 - \$100 price per barrel with flat general fund spending beginning in FY2015

Mr. Boucher discussed slide 13: "Disclaimer."

Expect the plan to change

- The statewide scenarios are used as a planning tool
- Assumptions of revenue and expenditures are intended to inform and provide context to budget deliberations
- Revenue shortfalls will need to be managed through a combination of budget reductions and use of reserve funds in the near term.

- All three principles of the ten-year plan need to move in concert - develop our natural resources, restrain spending, and save for the future.
- The plan will change as conditions warrant.

Mr. Boucher continued with slide 14: "Fall 2013 forecast, General Fund spending capped at \$5.6 billion through FY2024." He detailed that the chart depicted the price and production forecast from the fall revenue forecast on the top two lines, the third line contained the expected GF revenue, the fourth line showed the GF expenses, the fifth line displayed revenue surplus or shortfalls. The blue line depicted the balance of the CBR and the green line disclosed the SBR balance. He explained that the model used to generate the information did not anticipate rational behavior. The order in which the reserves were drained in the plan was SBR, CBR main account, and the CBR sub accounts. Scenario 1 predicted budget deficits through 2024 and steady draws from the SBR and the CBR. The total reserve balance would be \$7.9 billion by the end of 2024.

Mr. Boucher continued with slide 15: "Mid-High Case oil Production, Fall 2013 price, \$5.6 Billion GF Spending." He explained that scenario 2 assumed that oil production fell half way between DOR's 2013 forecast and the "un-risked" technical assessment that was provided to the department. With the scenario, the state had a deficit of nearly \$2 billion in 2014 and a short term decline, due to a \$3 billion deposit in the retirement accounts, in the total reserves through 2015. As oil production and prices raised the reserve deficit was reversed by 2016. Annual draws were anticipated in order to balance the budget but the CBR balance would continue to increase to \$12 billion through 2023 when the budget deficits start to increase.

Mr. Boucher continued with slide 16: "Revenue at \$100 oil beginning FY 2015, \$5.6 Billion GF Spending through FY 2024." He relayed that in scenario 3 annual spending growth was held at \$5.6 billion. The scenario illustrated the potential deficits under lower than forecasted oil prices. He stated that if the scenario actually happened spending would most likely not be sustained at FY 15 levels but he wanted to demonstrate the length or the strength of Alaska's reserve position. Under the scenario budget deficits would grow to \$3 billion through 2014. The reserve balances would be exhausted by 2022.

Ms. Rehfeld concluded with slide 17: "Wrap Up."

The ten-year plan is a tool to guide budget development and decisions

Optimism

- Alaska's current financial outlook is positive
- Strong reserves
- Triple A bond rating
- Fiscal discipline

Caution

- Oil price and production levels quickly change the fiscal outlook
- Conservative revenue picture tempers long term outlook

Ms. Rehfeld cautioned that while the future pointed to "relative fiscal stability for the state if oil prices hold above \$100 per barrel," the state must take a cautious approach to its finances to ensure essential services in the future. The challenge was to find a balance between current and future Alaskans. She thought that due to the diligent budget work done by the administration and legislature, the state was in a position to be optimistic while exercising strength and caution.

Co-Chair Austerman understood that the ten-year plan was authorized in statute, but oil prices were highly unpredictable and production models were variable. He wondered whether the Ten-Year Plan provided value to the state.

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Ms. Rehfeld perceived that the exercise had value on two levels. One level was the global perspective the plan provided in the budget development. On a departmental level it allowed the agencies to examine how its mission or core services were delivered and what future challenges they were facing. She noted that the global perspective allowed OMB to identify where the department budget "pressures" were. The information was useful to identify the priorities and necessary reductions for the current and future fiscal years. She thought that the ten-year plan was not precise but the exercise provided value to the budget process.

Mr. Boucher added that the value was in the education and "self-examination" the process allowed. He provided an example about a previous year's budget based on higher oil prices which then dropped. The situation initiated discussions about the plan's model and how price fluctuations affect GF revenue in the current year. The department's managers understood how the price of oil influenced overall state revenue and the impact decisions made at the department level had on the budget. He stated that the ten-year plan was a tool available to the agencies to emphasize the state's dependence on oil revenue and fluctuations in price. The plan was also a valuable tool in employee contract negotiations.

Co-Chair Austerman identified that the GF expenses in the three models were held at \$5.6 billion each year. He added that the spending in Medicaid was predicted to increase to \$1.3 billion over the same time period, PERS and TRS would increase by \$500 million next year, the governor's increase for education in FY 15 was \$51 million, the Department of Environmental Conservation (DEC) was expected to have spending increases in the range of \$6 million to \$16 million. He wondered how the administration could project FY 15 budget figures with all of the impending expenses and how the governor planned to keep the budget at that spending level. He reiterated his doubt regarding the value of the ten-year plan.

Ms. Rehfeld replied that the executive summary in December designated \$5.6 billion as a target level for GF expenses. She noted much discussion regarding capping state spending at that level. The plan was not designed to consider all of the individual components that comprise GF expenditures. Difficult budget choices would be necessary in future budget deliberations. She thought that the value of the plan kept the "pressure on the overall spending number in our planning process."

Co-Chair Austerman stated that the projections for next year were available and the plan's projections were not accurate. He did not wish to release the plan's projections to the public with the knowledge that anticipated expenses were much higher.

Mr. Boucher acknowledged the plan's shortcoming. He stated that the LFD projection utilized similar numbers based on \$100 oil. He noted that it was challenging to decide what

the costs would look like in the next five years. He believed that the plan kept the budget discussions focused on spending.

Co-Chair Austerman declared that the state would never be able to cut its way to prosperity. A flat budget would not grow the state's economy enough to establish a sustainable tax base.

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Representative Thompson expressed the same concerns about flat funding. He stressed that aside from the increases that Co-Chair Austerman mentioned the largest portion of the budget was expended on personnel. The step increases and contractual obligations made the spending target unattainable. He thought that it was unrealistic to use the FY 15 level as a target unless entire programs were cut from the budget.

Ms. Rehfeld replied that the administration was actively involved in educating the agencies about the fiscal outlook, which tempered expectations. She stated that some negotiated contracts were lean. She knew that the state would not be able to conduct business as usual and meet the spending targets. The necessity to cut some positions and reevaluate current merit and step schedules would be warranted.

Representative Munoz cited slide 14, which depicted the FY 15 \$5.6 billion general fund expenses. She understood that the PERS and TRS actuarial payment of \$600 million was not included in the figure and was expected to be deducted from the CBR. The subsequent \$500 million PERS and TRS payments proposed by the governor were also not included in the model. She asked for clarification.

Ms. Rehfeld replied that the CBR main account balance showed the \$3 billion FY 15 draw into the trust fund. In the out years, the annual retirement payment would be capped at \$500 million and would have to be included in the \$5.6 billion cap.

Representative Munoz emphasized that her exact point was that it was not included in the FY 15 plan.

Ms. Rehfeld stated that current year's target was not established and the \$5.6 billion was a discussion point.

Representative Wilson asked whether priorities were established by agencies. She remarked that she had never seen priorities listed for the Department of Education and Early Development (DEED) or Department of Labor and Workforce Development (DOL). She understood the difference between governmental priorities and obligations. She expressed concern that the bills that contained additional GF expenses were governor's bills and he did not include the expenditures in the model. She asked how much of the budget expenses would be shifted to the municipalities if the state could not cover the bills. She believed that additional budget pressures would overwhelm the Interior.

Ms. Rehfeld answered that agencies were instructed to allocate its resources to statutorily driven core services. She offered that non-core services were a lower priority especially in low funding environments. The agencies budget should focus on statutorily driven core services in budget subcommittee. She added that cost shifting to municipal governments would happen through the decisions made in budget deliberations. She noted that the December budget preceded the governor's legislation and would be included in the amended fiscal summary due the thirtieth legislative day.

Representative Wilson wondered why the information was not utilized in the presentation.

Mr. Boucher stated that the numbers in the plan could be changed.

Representative Wilson revealed that a commissioner had told her he was unable to share a list of priorities. She reiterated that she had never seen a list of priorities based on agencies mission.

Representative Gara asked about slide 14. He asked whether the proposal was to flat fund agencies to the FY 15 level through FY 24.

Ms. Rehfeld responded in the affirmative. She stated that for the purposes of the executive summary, the model was designed to show the impacts of flat funding.

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Representative Gara asserted that the FY 15 budget was not really a \$5.6 billion budget because more PERS/TRS and capital expenses amounting to a \$6.7 billion were proposed by the governor. The CBR would have a budget deficient by 2024 with a \$6.7 billion budget. He wondered whether the governor wanted the legislature to cut \$1.5 billion between FY 15 and FY 16.

Ms. Rehfeld replied that the decision of what would ultimately be funded would be made during the legislative process.

Representative Gara asserted that in order attain the \$5.6 billion goal in FY 16 the legislature would need to cut \$1 billion.

Representative Gara referenced that the state adopted a new methodology to forecast oil production. He stated that he did not remember projections of 285,000 barrels per day by FY 24 under SB 21. He wanted proof from the administration that the figures were disclosed during SB 21 hearings.

Ms. Rehfeld stated she would follow up with Department of Revenue.

Representative Gara stated that the state could not continue to cut its way to prosperity. He discussed the proposed cuts of \$1 billion for the following fiscal year and more cuts in subsequent years to sustain a flat budget. He pointed to the Department of Health and Social Services (DHSS) and other agencies that could not identify any additional wasteful spending. He stressed that the administration needed to identify wasteful spending in order for the legislature to know how to develop a "proper budget." He wanted answers from the agencies.

Ms. Rehfeld did not disagree. She communicated that the governor's office had the exact discussions with departments on an annual basis. She stated that the "hard work" to locate inefficiencies would continue. She believed a conversation was necessary to determine a reasonable level of spending in the current environment.

Representative Guttenberg was concerned about the general fund expenses line on slide 14 regarding the "reality and lack of vision for the future." He concurred with the plan requirements and the importance of economic stability. He

anticipated major projects on the horizon listed on slide 7. He contended that the projects were expensive but could be planned and costs could be estimated. He wanted "the vision of the state built into a dialog" around the costs and benefits of the mega projects for the state and wanted the governor to take the lead. He wondered how the different initiatives would affect the next ten years. He emphasized that the costs were quantifiable now. He felt that the plan did not include any possibilities for growth through investments in the state and lack vision. The plan could be a place to begin the dialog but needed "help and guidance" from the administration.

Mr. Boucher replied that mega projects were an optimistic piece of Alaskans future. He thought that estimating costs at this point was premature because the dialog with the legislature needed to occur "at the appropriate time." The text of the plan acknowledges future competing priorities that will demand difficult conversations in the near future. He did not believe that the plan was meant to provide all of the answers.

Representative Guttenberg stated that the governor's anticipated work on the pipeline and anticipated future work on the Susitna Dam were known quantities. He wondered why the project costs were not included in the plan. He pointed out that OMB suppressed information to keep the budget flat in the various scenarios. He felt that the plan could be more "realistic" if not precise.

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Representative Edgmon appreciated the work involved in the projections. He understood that external circumstances were difficult to predict. He hoped that the scenarios worked out as described in the plan, but felt that internal cost drivers and external forces could dramatically change the budget. He appreciated that the scenarios were conservative and included "bare bones" numbers regarding oil revenue. He understood that it was impossible to control the general fund revenues and oil production. He wondered when the revenue curve would begin to rise again and where the state would be on the revenue curve in four to five years. He felt that the scenarios were not optimistic.

Ms. Rehfeld acknowledged that the scenarios were very conservative in terms of revenue.

Mr. Boucher felt that it was "important" to include a scenario with a "tempered" amount of increased production. He portrayed a mid-level scenario based on half of the anticipated increased oil production, which would increase revenues approximately \$4 billion. He deferred to DOR to ascertain "how conservative the estimate was."

Co-Chair Austerman opined that the budget process should continue with similar "reality based" conversations. He thanked OMB for the smaller budget that was \$30 million less than last year and felt that the approach was correct. He wanted to avoid drastic reductions that would cause the state's economy to crash. He appreciated the conversations with the administration over the previous summer.

Co-Chair Stoltze acknowledged the role of OMB in submitting a "more realistic" and smaller budget than the commissioners requested. He understood the difficulty involved in cutting the budget and appreciated the leadership. He warned against uncontrollable state spending. He communicated that his constituents had strong fiscal concerns about budget sustainability.

Co-Chair Stoltze discussed the Susitna Dam and the goal to produce 50 percent of the state's electricity through renewable resources. He did not see a "commitment for that from the administration." He believed that the governor displayed a commitment to gas for railbelt utilities. He averred that the public was misled about the state's commitment to renewable energy based on the "assumptions that were built into the gasline proposals." He thought that the price was "far too optimistic." He revealed that some of the contracts that were made with the Susitna hydroelectric project were being shifted to the gasline. He wished that "the state would stop pretending that the administration had a goal of 50 percent renewable energy." He stated that every message from the administration countered that goal. He proposed a "more candid and blunt discussion about what the real commitment" was. He acknowledged problems with management of the Susitna Dam project from "a bunch of exempt employees." He advised disciplinary action to get the project on track rather than abandoning the project.

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Co-Chair Stoltze spoke to board extensions. He stated that "larger, overriding issues" existed regarding funding the boards. He judged that there were "real big holes in the way that the Department of Commerce, Community and Economic Development (DCCED) was portioning the cost." He believed that the issue made it "difficult to pass out" board extension legislation without some resolution with DCCED.

Representative Costello stated that the department was concerned about some of the "erratic" board costs. She stated that Representative Olson introduced legislation to address some of the "longstanding problems" regarding licensure and the fees that Alaskans paid.

Co-Chair Stoltze related that he had not heard any contention about specific board extensions but spoke to the larger fiscal concerns related to boards.

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ADJOURNMENT

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The meeting was adjourned at 2:57 p.m.