ALASKA STATE LEGISLATURE
JOINT MEETING
HOUSE FINANCE COMMITTEE
SENATE FINANCE COMMITTEE
March 19, 2013
9:05 a.m.

9:05:17 AM

CALL TO ORDER

Co-Chair Kelly called the Senate Finance Committee meeting to order at 9:05 a.m.

SENATE FINANCE COMMITTEE MEMBERS PRESENT

Senator Pete Kelly, Co-Chair
Senator Kevin Meyer, Co-Chair
Senator Anna Fairclough, Vice-Chair
Senator Click Bishop
Senator Mike Dunleavy
Senator Lyman Hoffman
Senator Donny Olson

SENATE FINANCE COMMITTEE MEMBERS ABSENT

Senator Lyman Hoffman

HOUSE FINANCE COMMITTEE 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 Lindsey Holmes
Representative Scott Kawasaki, Alternate
Representative Cathy Munoz
Representative Steve Thompson
Representative Tammie Wilson

HOUSE FINANCE COMMITTEE MEMBERS ABSENT

Representative David Guttenberg

ALSO PRESENT

Dr. Scott Goldsmith, Professor Emeritus, Institute of Social and Economic Research, University of Alaska Anchorage; Representative Lora Reinbold.

SUMMARY

PRESENTATION: MAXIMUM SUSTAINABLE YIELD: A FISCAL ROAD MAP FOR ALASKA

9:07:50 AM

Co-Chair Kelly presented a YouTube presentation that was produced on AlaskaBudget.com.

Vice-Chair Fairclough restated that the video was located on AlaskaBudget.com.

Co-Chair Kelly shared that Dr. Goldsmith had developed a fiscal plan for the Alaska.

9:11:42 AM

^PRESENTATION: MAXIMUM SUSTAINABLE YIELD: A FISCAL ROAD MAP FOR ALASKA

DR. SCOTT GOLDSMITH, PROFESSOR EMERITUS, INSTITUTE OF SOCIAL AND ECONOMIC RESEARCH, UNIVERSITY OF ALASKA ANCHORAGE (UA), presented the PowerPoint, "Maximum Sustainable Yield: A Fiscal Road Map for Alaska" (copy on file). He remarked that there were positive and negative aspects to the fiscal issues for Alaska. He stated that his presentation was based on his research and analysis, and was not in conjunction with UA. He remarked that Alaska had a unique fiscal challenge, because of the heavy dependence on oil production. The general fund (GF) revenue was more than 90 percent directly dependent on oil. He estimated that the indirect benefit to the GF was more than 95 percent. He stressed that it was difficult to base most of the revenue on oil, because oil production had been in decline for the previous 20 years.

Dr. Goldsmith looked at slide 2, "10 Year Fiscal Plan: Hints at the Problem." He stated that the Alaska Office of Management and Budget (OMB) had a ten-year fiscal plan. The plan hinted at the problem that Alaska faced. He stated that the slide showed a ten-year projection. The GF

expenditures, represented as bars on the graph, were growing with population, inflation, and increased needs. The green line represented GF revenues. He stressed that the bars and the lines were moving in opposite directions, showing the gap between revenues and expenditures getting larger year by year. He stated that the graph showed a difference of approximately $4 billion in FY 23. He declared that Alaska had savings that would cover the annual deficits for a number of years. He felt that the ten-year plan did not get to the crux of the fiscal problem.

Dr. Goldsmith presented slide 3, "Looking Beyond 10 Years." He looked at the top graph, and explained that the green portion represented GF revenues; and the red portion was the withdrawal from cash accounts to fund the growing GF. The graph was a ten-year projection and showed that growing GF needs could be met for ten years, under certain reasonable assumptions. He moved on to the bottom graph, and explained that it represented what would happen beyond the ten year horizon. After ten years, the red portion disappeared and a large gap opened up between growing expenditures and available revenues to fund the expenditures. He explained that the green area represented current oil revenues; the tan area represented new oil revenues from unconventional sources; and the purple area represented an estimate of revenues from a gas pipeline. The fiscal gap continued to grow over time, and remarked that the structural change would continue. He pointed out that revenue remained relatively flat. He stressed that expenditure demand would continue to grow with population and inflation increases. He stated that the Alaska state budget was a large portion of the state's economy, so if the budget needed to decrease, Alaska's economy would suffer.

Dr. Goldsmith looked at slide 4, "Non-Petroleum Strategies for the Future?"

-Natural Resource Development
-Value Added Processing
-Economic Diversification
-Infrastructure Investments in Power and Transportation
-Footloose Industry
-Renewable Energy

9:19:34 AM

Dr. Goldsmith displayed slide 5, "Non-Petroleum GF Revenues." He remarked that the various economic strategies had not contributed to Alaska's ability to finance government. He explained that the graph showed that GF revenues from non-petroleum sources was approximately $1,000 per capita, and remarked that the graph reflected the lack of ability to generate GF revenues from non-petroleum sources as the economy grew.

Dr. Goldsmith highlighted slide 6, "How can We Sustain a Healthy Level of Public Services in the Future?"

> MAXIMUM SUSTAINABLE YIELD Management of our biggest asset—Petroleum.
>
> 1)How Big is Our Nest Egg
> 2)How Should We Manage It
> 3)How Should We Spend it

Dr. Goldsmith looked at slide 7, "Petroleum Wealth in our Infrastructure." He explained that Alaska had collected approximately $180 billion in petroleum revenues since statehood. He explained that investments were made in physical capital: dams, roads, and other types of infrastructure; and human capital: education, health care, etc. He stressed that those forms of capital had contributed to the strength and health of the economy. He furthered that approximately 20 to 25 percent of the revenue had been put into savings accounts like the permanent fund and general fund.

Dr. Goldsmith discussed slide 8, "Petroleum Wealth in the Bank (Billion $)." He stated that the large financial accounts totaled approximately $60 billion, factoring the stock market and other factors.

9:23:26 AM

Dr. Goldsmith looked at slide 9, "Petroleum Wealth in the Ground." He shared that there was petroleum revenues that had not been collected. These were revenues that were hoped to derive from future oil and gas production. He stated that the potential for additional production was profound. He stated that the slide represented his projections based on an assumption of reserves that were economically

recoverable at current prices. He stated that the total was between 28 to 38.5 billion barrels of oil, independent of gas. The slide divided up the projection between known conventional, known unconventional, and yet to be discovered oil.

Dr. Goldsmith highlighted slide 10, "Revenue Potential Constrained." He stressed that the oil in the ground would not likely generate the kind of income that Alaska was accustomed. He stated that the chart gave the sense of what types of taxes and royalties, under current law, Alaska would collect from production of the various categories of oil. He pointed out that conventional oil on state land paid a production tax royalty, state income tax, and property tax. Marginal oil and unconventional oil, in theory, generated the same types of taxes and oils; but in reality the return was unlikely to be as large as conventional production on state land. He pointed out that the state would only share in half the royalties that the federal government would collect on that unproduced oil.

9:28:21 AM

Dr. Goldsmith looked at slide 11, "Future Petroleum Revenue: Value Today (Billion $)." He stated that the graphic attempted to summarize what the current value might be of the state's share of in-the-ground oil and gas. He remarked that he had created a projection of future revenues year-by-year from potential production and development from various types of oil. He remarked that the graph reflected the flow of future revenues year-by-year out through 2039. He pointed out that the $67 billion area was based on the DOR projection, which was based on known conventional oil on state lands. He stated that his graph pushed the projection beyond the ten-year period, and included other potential sources of revenue. He stated that the cumulative nominal return would result in $536 billion dollars, according to his analysis. He stated that his research used a net present value analysis.

Dr. Goldsmith highlighted slide 12, "Petroleum Wealth of the 'Owner State'."

TOTAL: $149 Billion
In the Bank: $60 Billion
In the Ground: $89 Billion
Known Conventional Oil: $67 Billion

Other Oil and Gas: $22 Billion

$200,000 for each current resident.

Dr. Goldsmith looked at slide 13, "How should we Manage the Nest Egg (Asset, Endowment)?" He remarked that the asset was in the form of infrastructure, so it was time to determine the nest egg based on money in the bank and resources in the ground.

Dr. Goldsmith displayed slide 14, "How Much of the Nest Egg Should We Spend?"

DRAW each year at a rate that will conserve the value of the Nest Egg for future generations of Alaskans—the Maximum Sustainable Yield.

9:36:10 AM

Dr. Goldsmith highlighted slide 15, "Maximum Sustainable Yield: Calculation." He stated that the draw-rate needed to be determined based on assumption that the population of Alaska had been growing at approximately 1 percent per year. He stressed that 1 percent of income needed to return to GF to offset the increase in population. He determined that the maximum sustainable yield draw-rate would be 4 percent, resulting in $6 billion in maximum sustainable yield to maintain the value of the nest egg.

Dr. Goldsmith discussed slide 16, "Maximum Sustainable Yield: Mechanics." He explained that the nest egg currently earned $7.3 billion based from oil and gas revenue; and $4.5 billion in financial earnings. The total nest egg cash flow was $11.8 billion. He stated that 4 percent would allow a draw of $6 billion in maximum sustainable yield, and the remaining $5.8 percent could be returned to savings and reinvestment.

Dr. Goldsmith looked at slide 17, "Maximum Sustainable Yield: Disposition." He explained that the total maximum sustainable yield of $6 billion would be used for the permanent fund dividend (PFD): $1 billion; $5 billion for the general fund; and $5 million in GF non-petroleum revenues. The result would be $5.5 billion in GF maximum sustainable yield.

9:42:05 AM

Dr. Goldsmith highlighted slide 18, "Maximum Sustainable Yield Nest Egg Growth." He stated that the value of the oil in the ground was decreasing, so the share of the nest egg held as oil in the ground would decrease. He furthered that money would be returned to the nest egg as financial savings, so the savings share would grow to offset the decline in oil value in the ground. He stressed that the total value of the nest egg would grow over time, at 1 percent a year in real dollars.

Dr. Goldsmith discussed slide 19, "Maximum Sustainable Yield: General Fund Growth." He explained that the GF would, over time, receive less revenue from current petroleum revenues; and more of its revenue from financial earnings. He remarked that the GF expenditures could grow based on non-petroleum revenues, and would grow at the rate of inflation and population. He stressed that the graph was based on the maximum sustainable yield calculation for the nest egg. He explained that non-petroleum revenues could affect the projection, if they experienced growth.

Dr. Goldsmith looked at slide 20, "FY 2013 General Fund Spending (Billion $)." He explained that the current GF actual spending was at $7.6 billion; the GF maximum sustainable yield draw was $5.5 billion; so the GF was over spent by $2.1 billion. He stressed that the GF was experiencing a fiscal burden and asset erosion. He pointed out that this calculation was after subtracting endowment spending on the PFD and adding in non-petroleum revenues; and it was imperative to maintain the maximum sustainable yield and save all revenues above that amount.

9:47:18 AM

Dr. Goldsmith highlighted slide 21, "Maximum Sustainable Yield: Implementation."

-Gradual transition to GF Maximum Sustainable Yield level
-Protection of financial assets
-Active participation in management of petroleum in the ground thru alignment
-Establish monitoring system to track Nest Egg value, set MSY target for each budget, and track progress towards sustainability

Dr. Goldsmith looked at slide 22, "Maximum Sustainable Yield: Challenges to Implementation."

"It can't work"
-Confusion about the concept
-Uncertainty about portfolio size, rate of return, population growth, risk aversion
-Institutional constraints
-Political challenge of constraining current spending level
-Fragility of social contract (trust)
-Suppression of individual positive discount rate
-Speculative/Opportunistic migrants

"It shouldn't be tried"
-Aversion to Public Savings Accounts
-Negative effects of “Rentier Society” or “Trust Fund Babies”
-Indifference to future generations of Alaskans
-Past good luck will continue
-Life was better before petroleum
-Future generations' preferences unknowable
-Money in the bank is not working for Alaska economy

9:52:25 AM

Dr. Goldsmith highlighted slide 23, "MSY Sensitivity to Assumptions." He stated that his calculation was his own, and remarked that everyone would come up with a different number. He stressed that the number would change over time, because of the changing conditions in the oil market and technology. He pointed out that the targets for saving, investing, or spending needed to adjust to take account of those changes. He stated that the last two slides represented the sensitivity of his nest egg calculation. He stated that the far left bar on the graph was a measure of the current estimated nest egg size. He explained that he had divided the nest egg into three components: blue, financial analysis; red, known conventional oil; and black, other oil and gas. He stated that the blue portion was pretty stable as it represented money in the bank. The red portion was also fairly stable, although price varied over time. He stressed that the black portion could provide substantial income, benefit, and revenue for Alaska. He added that there was much uncertainty, and did not know the fiscal terms. He remarked that his determination of the

nest egg reflected a conservative forecast for other oil and gas revenues.

Dr. Goldsmith looked at slide 24, "Future Petroleum Revenues have Lower Current Value." He explained that the graph displayed how the oil and gas that would not be produced in the near future, and how it would only have a modest impact on the size of the nest egg, because of the net present value calculation.

Dr. Goldsmith highlighted slide 25, "Better than the Current Fiscal Strategy?" The graphic on the slide said, "Please God, give us another oil boom, we promise not to @#&%! it away this time."

Co-Chair Kelly stressed that Dr. Goldsmith was available for information, not debate. He observed that there were large numbers available for budgets, but the presentation was not a recommendation.

10:02:13 AM

Co-Chair Stoltze recalled a presentation from 2011, and remembered graphic figures of up to $3 billion. He recalled that the presentation explained that Alaska should receive $4,000 per ounce for gold; a $20 tax on each salmon; and a $2,000 tourist tax. He also recalled a presentation the following year that showed a $7.5 billion gap with $10,000 per ounce for gold; a $50 tax on each salmon; and a $7,500 tourist tax. He remarked that the current presentation centered on oil revenues, and stressed that those previous presented taxes were so miniscule compared to oil revenues. Dr. Goldsmith replied that he wanted to focus on strategy and target. He agreed that the non-petroleum revenues were approximately $500 million for a decade, and showed very little expansion. He stressed that the profitability of the industries did not have the capability to generate the kind of revenue from petroleum. He specifically pointed out that the average tourist in Alaska was not spending ten times as much as they did in 2000. He asserted that he felt that all the industries were contributing a fair share, but their share could not replace the declining revenue in oil and gas.

Co-Chair Stoltze remarked that the unrestricted general fund (UGF) had approximately $36 million from commercial fishing and approximately $65 million from mining. He

furthered that cigarettes and insurance premiums paid more tax than the commercial fishing industry. He understood that the focus should be on the oil revenue, because it was the significant portion of Alaska's revenue.

10:07:17 AM

Representative Thompson looked at the maximum sustainable yield, and noticed that the nest egg was at $149 billion, of which $89 billion was still in the ground with a 5 percent return. He wondered if that assumption was like depending on 5 percent from the bank that had not yet been invested. Dr. Goldsmith responded that he did expect a 5 percent increase in the value of what was in the ground, because the entire value of the nest egg was increasing at almost 5 percent.

Senator Dunleavy inquired if the $20 billion combined debt was considered in Dr. Goldsmith's calculations. Dr. Goldsmith responded that the GF debt was part of the GF appropriations, so any debt for general obligation (GO) bonds would come under the 5.5 percent maximum sustainable yield for GF.

Representative Gara looked at slide 11, and surmised that the red portion of the chart was a revenue assumption from a large natural gas pipeline. Dr. Goldsmith agreed.

Representative Gara furthered that the last page implied that it was "dumb luck" that Alaska was in its current state. He stressed that Alaska had raised an extra $15 billion by passing the last oil tax reform in 2007. Dr. Goldsmith argued that the cost of oil had increased, therefore allowing an opportunity to change the oil tax structure.

Representative Costello wondered if the discount factor included inflation or the forgone present consumption. Dr. Goldsmith replied that he conducted his analyses independent of inflation, and then apply inflation in the end. He conducted his research in this manner because people like to see nominal dollars rather than "real" dollars. He explained that the discount factor in real terms was 5 percent, which was consistent with the permanent fund goal under a real long-term basis according to a rate of return. He explained that some economists felt that 5 percent was too high, but stated that the 5 percent

was based on the last 20 years. He noted that the rate of return on the nest egg decreased, if that 5 percent were lower.

10:12:17 AM

Representative Holmes looked at slide 5, and wondered why there was a spike and sudden decrease in the 1970s. Dr. Goldsmith responded that the impact was mostly based on the elimination of the individual income tax and other tax changes.

Co-Chair Kelly wondered if that impact was based on the corporate income tax decrease following the oil boom in the 1970s. Dr. Goldsmith reiterated that it was primarily a result of the elimination of the personal income tax.

Representative Wilson wondered if a certain percentage of the oil revenue should be automatically into a savings account. Dr. Goldsmith responded that the focus should not be on savings, but rather on what the state could afford to spend. He remarked that the $5.5 billion was in the budget, and anything above that should be put into savings. He pointed out that that amount varied from year to year, so there was no formula to determine the exact amount that should be saved each year.

Representative Wilson felt that the strategy was not unlike a retirement account. Dr. Goldsmith agreed and furthered that there will come a day when the oil revenue is no longer available.

Representative Wilson felt that that perspective should have been in place to begin with.

10:17:29 AM

Co-Chair Kelly stated that he heard a presentation from Dr. Goldsmith in 1996. Dr. Goldsmith responded that Alaska had done pretty well, in terms of the permanent fund. He noted that Alaska had taken in $180 billion, with 20 to 25 percent in savings.

Co-Chair Kelly stressed that the challenge was to focus on decreased spending in order to implement the plan. He felt that the current growth of 6.4 percent was unsustainable. He stressed that it was not effective to merely "cut the

budget." He pointed out that there should be a plan to keep the government from growing.

Representative Kawasaki looked at slide 20. He wondered if there would be a consideration to support a bill that would take billions of dollars of revenue and asset erosion.

Co-Chair Kelly felt that Representative Kawasaki's question was an attempt to start a debate on oil taxes.

Dr. Goldsmith replied to Representative Kawasaki's question, and stated that the $5.5 billion calculation was contingent upon the current assumptions from DOR for petroleum revenues for the next ten years. He furthered that he had added assumptions to augment those calculations.

Representative Gara remarked that ConocoPhilips had recently released a statement that declared that they could reduce their production decline to 3 percent. He wondered if the analysis was based on the 6 percent decline from DOR or the 3 percent decline from ConocoPhilips. Dr. Goldsmith responded that he used the DOR Fall Revenue Forecast that was contingent on the 6 percent decline.

Co-Chair Kelly remarked that ConocoPhilips was only one company in the oil industry, so a model could not be made based on their declarations.

10:22:17 AM

Vice-Chair Fairclough wondered where the 3 percent production decline could be found. She wondered if it was a distorted fiscal analysis. She wondered if that was based on a newspaper article or an actual report. Co-Chair Kelly stated that a response could be saved for a later date.

Dr. Goldsmith stated that his analysis was based on many assumptions, and felt that there were many different uncertainties. He stressed that his numbers should not be considered the best an only numbers, but that the approach and way of thinking about Alaska's fiscal future. He felt that his presentation should spark a discussion on how to reduce spending, and a general discussion of what the overall strategy should be when planning for future generations.

Dr. Goldsmith stressed that his approach focused on the petroleum nest egg, and how much could be spent from that nest egg. He pointed out that spending and maintaining maximum sustainable yield could be achieved, if other tax sources could contribute.

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ADJOURNMENT

10:27:04 AM

The meeting was adjourned at 10:27 a.m.