

SENATE FINANCE COMMITTEE
January 23, 2014
9:10 am

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CALL TO ORDER

Co-Chair Kelly called the Senate Finance Committee meeting to order at 9:10 a.m.

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

MEMBERS ABSENT

Senator Donny Olson

ALSO PRESENT

Angela Rodell, Commissioner, Department of Revenue; Senator Charlie Huggins; Karen Rehfeld, Director, Office of Management and Budget (OMB), Office of the Governor; John Boucher, Senior Economist, Office of Management and Budget, Office of the Governor.

SUMMARY

SB 119 BUDGET: CAPITAL

SB 119 was HEARD and HELD in committee for further consideration.

SB 120 APPROP: OPERATING BUDGET/LOANS/FUNDS

SB 120 was HEARD and HELD in committee for further consideration.

SB 121 APPROP: MENTAL HEALTH BUDGET

SB 121 was HEARD and HELD in committee for further consideration.

FY15 REVENUE FORECAST: DEPARTMENT OF REVENUE

FY15 BUDGET OVERVIEW: OFFICE OF MANAGEMENT and BUDGET

#sb119

#sb120

#sb121

SENATE BILL NO. 119

"An Act making appropriations, including capital appropriations and other appropriations; making appropriations to capitalize funds."

SENATE BILL NO. 120

"An Act making appropriations for the operating and loan program expenses of state government and for certain programs, capitalizing funds, and making reappropriations; making appropriations under art. IX, sec. 17(c), Constitution of the State of Alaska, from the constitutional budget reserve fund."

SENATE BILL NO. 121

"An Act making appropriations for the operating and capital expenses of the state's integrated comprehensive mental health program."

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^FY15 REVENUE FORECAST: DEPARTMENT OF REVENUE

ANGELA RODELL, COMMISSIONER, DEPARTMENT OF REVENUE, (DOR) displayed the PowerPoint presentation, "Fall 2013 Revenue Forecast" (copy on file).

Commissioner Rodell looked at slide 3, "Unrestricted Revenue Forecast 2012-2022." She explained that the slide was intended to give a sense of FY 12 and FY 13 compared to the forecast. She noted that oil prices had trended downward over the two most recent fiscal years. She remarked that oil production had declined from 579,000 barrels in FY 12 to 531,000 in FY 13. She stated that the

forecast production was 508,000 for FY 14. She shared that lease expenditures in FY 12 and FY13 were approximately \$4.4 billion and \$4.9 billion, so there was a slight increase from FY 12 to FY 13. She stressed that there was a significant increase in lease expenditures for FY 14 and FY 15. She remarked that unrestricted general fund (UGF) revenues had declined. She explained that FY 12 had UGF revenues of \$9.4 billion, and dropped to \$6.9 billion in FY 13. She explained that FY 14 UGF revenue was forecasted at \$4.9 billion, and was forecasted to remain \$4.9 billion over ten years. She stated that in FY 12 there was a production tax value of \$79.33, declined in FY 13 to \$67.76, and declined even further in FY 14 to \$54.57.

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Senator Hoffman recalled a meeting in the previous year when DOR had remarked that their predictions were too optimistic. He liked that the department had overestimated their numbers, because the predictions were historically over-inflated. He felt that the current predictions beyond 2022 were too optimistic, because the U.S. was becoming energy independent. He wondered if the optimistic numbers were achievable. Commissioner Rodell replied that she had the most confidence in the predictions through 2017. She was focused on those numbers, because there were global and internal analyses that looked at the near-term price forecast. She remarked that inflation was a consideration, and the chart reflected the up-trend due to inflation. She understood that the estimate may be overly optimistic, but felt that the near-term numbers were the most accurate.

Senator Hoffman understood that it was difficult to determine the forecast, because the oil companies were making the investment. He wondered when that production would stabilize. Commissioner Rodell responded that stabilization could occur in 2017 or 2018, because there was a "ramp up" in activity. She remarked that DOR had changed its methodology for production forecast, because the recent forecast had been overly optimistic. She explained that DOR made significant effort to decrease the error rate of the forecasts. She stressed that the current estimates were more conservative than in the past. She stated that she had some slides in the presentation that reflected that change.

Co-Chair Kelly asked Commissioner Rodell to present those on-topic slides.

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Commissioner Rodell moved to slide 12, "Production History and Forecast." She explained that, historically, Prudhoe Bay was always the center of oil production for the state. She looked at 2001; new fields came online and began producing oil. During that time there was a leveling out of production that came in on a daily basis. She felt that same effect would occur in the future. She remarked that there was additional production currently occurring outside of Prudhoe Bay. She stated that the slide included forecasts for non-Prudhoe Bay field production. She felt that projecting activity outside of Prudhoe Bay was of great value to Alaska.

Commissioner Rodell looked at slide 13, "ANS Oil Production Forecast." She noted that 2005 showed a FY13 projection of more than 800,000 barrels per day. This projection was overly optimistic, because the current production was approximately 500,000 barrels per day. She felt that the forecast did not provide the most accurate information, even as recently as fall 2011. She remarked that the fall 2011 forecast was significantly overstating the amount of production versus what was actually true in FY13.

Commissioner Rodell discussed slide 14, "ANS Oil Production Forecast."

Currently Producing:

-Oil from wells that are in production and following typical reservoir engineering optimization without major investment.

Under Development (UD):

-Oil from projects that will add incremental oil to existing fields or will bring new fields into production.

-Project must have senior management approval and be allocated funds in the company's budget.

Under Evaluation (UE):

-Oil from projects that are likely to occur in the future, but have not met the requirements of the previous category.

-Requires that oil reserves are known and recovery is technically possible with current technology.

Under Development + Under Evaluation = "New Oil"

Commissioner Rodell highlighted slide 15, "ANS Oil Production Forecast."

"Currently Producing" oil was not risked

-Engineering assessment based on actual production data

The "New Oil" portion of the Forecast was adjusted for risks

-Accounts for uncertainty in subsurface conditions and risk of delay

The "Under Evaluation" portion of the Forecast was risked at a greater rate than "Under Development"

-Accounts for greater uncertainty in subsurface conditions and higher risk of delay

Commissioner Rodell looked at slide 16, "ANS Oil Production - Actuals and Forecast." She remarked that the barrels would be added into the production forecast, once there was greater confidence that they would actually be produced.

Commissioner Rodell discussed slide 17, "ANS Oil Production - Actuals and Forecast." In order to establish the new methodology, DOR examined its own recent practices. She explained that the slide reflected the decline rates that occurred annually starting in 2006. She stated that the department looked over the past seven years, and continued the pattern reflected in the black dotted line. She explained that the black dotted line was used as a starting point for determining the forecast. She pointed out that the bottom grey dotted line was a projection if there was no new oil. The top dotted line was based on old

methodology. She explained that using the new methodology, with risk factoring, was reflected in the solid black line.

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Commissioner Rodell highlighted slide 18, "North Slope Production Forecast." The slide showed what was currently producing, and how it would decline. It showed what new oil was from the legacy fields, and would not be eligible for the Alaska Production Act tax credits. She remarked that a significant portion of new oil would continue to come from the legacy fields. She pointed out that the brown area represented what DOR forecasted to be eligible for the tax credit. The green area was upside potential, which was seen as production that would occur if everything happened exactly as forecasted.

Senator Hoffman remarked that there was still a gradual decline, and wondered why there was no stabilization in the forecast. He specifically wondered when there would be an increase in revenue. Commissioner Rodell replied that DOR did not look 10 years into the future, so she did not know if or when there would be an increase in production revenue.

Senator Hoffman wondered if that increase in revenue and production would ever occur. Commissioner Rodell replied that she did not know.

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Commissioner Rodell highlighted slide 5, "Fall 2013 Highlights."

Oil price and production levels have been reduced relative to the 2013 Spring Forecast.

Correspondingly, unrestricted revenues have been revised down from the Spring 2013 Forecast.

Revenue impacts largely due to changes in oil price, production, lease expenditures, and tariffs.

Substantial (~\$10 billion) increase in spending on the North Slope over the next 10 years.

Oil companies project increased North Slope production following the increased activity.

-DOR continues to prudently assess future production and the forecast is not intended as a comprehensive assessment of all the potential activity or projects under evaluation.

State investment earnings are strong.

Commissioner Rodell looked at slide 6, "General Fund Unrestricted Oil Revenues." She explained that there were four components of petroleum revenue that DOR forecasts. She noted that royalty, corporate income tax, and property tax were all relatively stable. She stressed that production tax had the most significant decline. She explained that the lease expenditures would continue to have an effect in the near-term on the production tax forecast, because of the net tax system.

Commissioner Rodell discussed slide 7, "General Fund Unrestricted Other Revenues." She explained there other revenue tax types that were important to the Alaska General Fund (GF). She stressed that the revenues on the slide were not as important as the petroleum revenue, but contributed significant amounts of revenue to the state. She remarked that the forecast of \$86 million was roughly up 15 percent for FY 14. She reported that the estimate would be closer to \$100 million with three months of additional earnings from when the forecast was set in October.

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Commissioner Rodell highlighted slide 8, "Total Revenue Forecast - FY 13, 14, and 15." She remarked that the total state revenue from FY 13 actuals was \$15.8 billion. The forecasted revenue for FY 14 was \$12.8 billion, and the forecasted revenue for FY 15 was \$12.3 billion.

Commissioner Rodell discussed slide 9, "General Fund Unrestricted Revenue Price Sensitivity FY 2014-2016." She

understood that the price sensitivity of the forecast was always of interest to the committee. She explained that the slide showed much less volatility in revenues due to changes in price. She expressed that she would like to work with the committee to examine how changes in production affect the Unrestricted General Fund (UGF). She felt that DOR had stabilized the forecast: at \$100 per barrel there would be \$4 billion in UGF revenue. Alaska would receive an additional approximately \$1 billion of the cost per barrel increased by \$10. Alaska would still continue to generate significant revenue, even if the cost per barrel decreased. This was because there was not much effect on volatility as the price declines.

Commissioner Rodell looked at slide 10, "Fall 2013 Total Revenue Forecast." She stated that the graphic displayed a picture of what had occurred over the ten year history and the ten year forecast. She noted that 2004 showed an actual production of roughly 974,000 barrels per day, and production had decreased to 531,000 barrels per day in the current day. The forecast showed that the decline would stabilize, and she believed that there would be approximately \$500,000 for the next two fiscal years.

Commissioner Rodell looked at slide 20, "Alaska North Slope Crude West Coast Price." She remarked that there were many activities that affected the global oil market. She pointed out a few of the activities that affected the price of oil in FY 12 and FY 13: supply disruptions in Yemen, Syria, and South Sudan; Syria used chemical weapons; and the threat of regional warfare in the Middle East in response to the use of chemical weapons from Syria.

Commissioner Rodell highlighted slide 21, "Key Oil Price Drivers."

Supply and Demand

There are two main factors to monitor.

- Global spare capacity, since it is both a reflection of supply and demand. In other words, the Organization of Petroleum Exporting Countries (OPEC) spare capacity (flipping a switch) is key.

- Cost of developing new oil supply.

Department is developing a probability and statistical model incorporating spare capacity and cost of developing new supply to help forecast ANS prices in the future.

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Senator Hoffman wondered how the efforts of the United States to become energy independent and the transportation costs of importing oil affected ANS pricing. Commissioner Rodell responded that the price of oil would stay relatively low compared to recent years. She furthered that Oil Producing and Exporting Countries (OPEC) was hoping to keep the price of oil around \$100 per barrel.

Commissioner Rodell discussed slide 22, "Price Forecast Methodology."

Price Forecasting Session

Held a day long oil price forecasting session on October 1, 2013.

Speakers provided insight into oil markets, probability and analysis, modeling, and financial aspects of commodity markets.

39 participants from state government, academia and the private sector.

-DOR, DNR, DOL, OMB, University, Legislative Finance and outside participants.

Participants were asked to forecast real ANS prices for the West Coast.

-Real prices were converted to nominal using a 2.5 percent inflation assumption.

Median price path was chosen for each time period.

Commissioner Rodell highlighted slide 23, "Historical ANS West Coast FY Oil Price Bands, Annual Average and Official FY 2013 Forecast." The slide showed the actual average

price that was used and converted into revenue. She pointed out 2009, when there was global unrest the average price was \$68.34 per barrel. She remarked that over the course of the entire year in 2009, the price ranged from under \$40 per barrel to as high as \$130 per barrel. She remarked that the price range narrowed as the global economy was steadying. She looked at 2013, and noted that there was very little price volatility.

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Commissioner Rodell looked at slide 26, "Contributors of Changes in FY 2014 Revenue Forecast." She explained that the average production tax value per barrel was reduced by \$9.23. She furthered the slide displayed a simplified calculation, and did not represent any actual company value, and assumed a 12.5 percent royalty.

Commissioner Rodell highlighted slide 27, "Contributors of Changes in FY 2015 Revenue Forecast." She noted that the average production tax value per barrel in this slide was reduced by \$14.90. She explained that it was a simplified calculation, and did not represent any actual company value. It also assumed 12.5 percent royalty.

Senator Dunleavy queried the reasoning for the increase in lease expenditures. Commissioner Rodell responded with slide 28, "North Slope Lease Expenditure Forecast Change, CAPEX." She stated that there was an expected increase in activity and drilling in capital expenditure forecasts. She remarked that FY 14 had an increase and FY 15 had an even greater increase in deductible lease expenditures of \$1 billion.

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Co-Chair Kelly surmised that the increase in capital expenses was not reflected in the current revenue forecasts. Commissioner Rodell replied that some of it was included, but not all of it.

Co-Chair Kelly wondered if he could receive forecasts with all of the capital expenses included. Commissioner Rodell agreed to provide that information.

Commissioner Rodell looked at slide 29, "North Slope Lease Expenditure Forecast Change, OPEX." She stated that the

slide showed a significant increase in operating expenses versus the capital expenditures in 2014. She explained that the companies were building staff, which is why there was low capital expenditures in 2014 but there was increased in 2015.

Co-Chair Kelly introduced the staff of the Senate Finance Committee.

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Co-Chair Meyer recalled the governor stating that \$105 per barrel was the crossover price between ACES and the More Production Act. He understood that the price of oil was low, as more oil was produced. He felt that Alaska was more attractive to investors as oil prices continue to decrease. He remarked that the increase in expenditures was accurate, because the oil companies were announcing new projects. He stressed that the intent of the passage of the More Production Act was get more production. He wondered if Commissioner Rodell agreed that the \$105 per barrel was the crossover point to the More Production Act. Commissioner Rodell replied that she believed that it was still the crossover point. She stated that she had no further information, but shared that DOR was continually evaluating the projection.

Co-Chair Meyer felt that there had been historically accurate production forecasts, which included potential offshore development. Commissioner Rodell understood that there were many opportunities for companies to develop in Alaska, which DOR did not include in the production forecasts.

Co-Chair Meyer remarked that companies were still experimenting with the potential for heavy oil. He stressed that there was potential for exploration in Alaska, but understood that DOR could not include that potential in the forecasts. Commissioner Rodell agreed, and stressed that DOR must provide the best estimate of revenue based on current knowledge. She stressed that Alaska was AAA-rated for investors, because the revenue forecast was taken very seriously. She did not want to give the misperception that Alaska was misleading, or creating an environment in the near-term that was unrealistic. She stressed that 90 percent of Alaska's revenue depended on the oil production

tax, it was important to be conservative and forthright with the revenue forecast.

Co-Chair Meyer remarked that some oil companies are reluctant to explore for oil, because they feel that they may discover gas instead of oil.

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Commissioner Rodell discussed the presentation, "State of Alaska, An Update on the State's Savings Accounts" (copy on file). She stated that the presentation was intended to provide a sense of the performance of the state's savings accounts. She shared that the equity markets had been very good to everyone who had investments in the equity markets in calendar year 2013. She stated that the Dow Jones Industrial was up over 25 percent over the year, so the state realized the benefit of that through its equity investments.

Commissioner Rodell displayed slide 3, "General Fund and other non-segregated investments (GeFONSI)." She stressed that she hoped to work with the committee to examine information from the Federal Reserve related to quantitative easing. She shared that there were DOR staff that were examining the state's asset allocations and its exposure to the bond market. As interest rates increase, the bond prices decrease, to the mark to market value of the investments would also decrease. She stressed that there needed to be an examination of the time horizons of the reserve draws, and what can be done to mediate that issue. She explained that GeFONSI provided the day-to-day cash for the operations of the state. She stated that it had a moderate risk profile, with a short to intermediate investment horizon, because of the liquidity requirements of the state. She explained that on December 21, 2012 there was a balance of \$11.8 billion, and on December 21, 2013 there was a balance \$5.76 billion. She explained that the statutory budget reserve (SBR) was removed from the GF, and created its own asset allocation. The SBR was now invested independently from the GF.

Senator Hoffman queried the justification of moving the SBR. Commissioner Rodell replied that DOR felt that given the size of the balances in the GF, the SBR needed to be allowed to invest in a slightly longer time horizon.

Senator Hoffman remarked that SBR was still considered GF to be spent by the legislature, and felt that excluding the SBR did not give a true picture of the GF balance. Commissioner Rodell remarked that the SBR was still at the discretion of the legislature, but had its own page.

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Commissioner Rodell highlighted slide 4, "Constitutional Budget Reserve Fund (main and sub)." She explained the slide divided the CBR between the main fund and the sub fund. She stated that the sub fund was determined to have a longer time horizon, and take a higher risk profile. She stressed that the sub fund would receive the true benefit of the equity investments that the CBR sub fund made. She remarked that the state increased the value of the sub fund by almost \$700 million. She furthered that the majority of the main fund was in treasury bills and bonds.

Commissioner Rodell looked at slide 5, "Power Cost Equalization Fund." She explained that statute required the Power Cost Equalization (FCE) to target a 7 percent return rate, therefore there was an 80 percent allocation to equities. She stressed that the allocation was of great benefit over the year prior, because the fund increased from \$787.5 million to \$937.3 million at the end of December 2013.

Co-Chair Meyer looked at slide 4, and noted that the governor had suggested withdrawing \$3 billion from the CBR for a cash infusion into the unfunded liability. He wondered if the \$3 billion would come from the main fund or sub fund. Commissioner Rodell responded that the trust funds had an asset allocation that was different than the sub fund. She remarked that the sub fund did not perform as well as PERS and TRS by comparison. She explained that there would be an examination of the investments in both the main and sub funds; examine the asset allocation for PERS and TRS; and move it from either fund. This would result in rebalance between the sub and main funds.

Co-Chair Meyer looked at the PCE fund, and felt that it had done substantially better than some of the other funds. Commissioner Rodell agreed, and explained that statute required the PCE to achieve 7 percent.

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Co-Chair Meyer wondered if the PCE was too large. He remarked that PCE was working as intended Commissioner Rodell responded that it was one of the first years that did not require a GF contribution to the PCE.

Senator Hoffman recalled that the previous year's market was considerably different than current markets. He remarked that the previous year's presentation showed a loss in the PCE fund, because of the higher required return of 7 percent. He stressed that the state was fortunate to have a robust market in 2013.

Co-Chair Meyer quipped that he was merely looking for more money for the capital budget.

Vice-Chair Fairclough stressed that the market was constantly readjusting, and Alaska was "riding on top of the budget" to Alaska's benefit. She stressed that there should be less risk to the state. She felt that the fund should lower the rate of return, so the investors were not forced to invest in more risky proposals.

Commissioner Rodell highlighted slide 6, "Public School Trust Fund (Principal and Income accounts)." She stated that the Public School Trust Fund had an allocation of 58 percent to the broad market, 27 percent domestic equity, and 15 percent international equity. She explained that the fund had a lower allocation to the equity markets, and the fund increased from just under \$500 million to \$536.7 million by the end of December 2013. The fund had an actual rate in FY 13 of 8.19 percent. She felt that the slide was a good illustration between the PCE with an 80 percent allocation to equity; versus the Public School Trust with an allocation of approximately 40 percent to equities.

Commissioner Rodell looked at slide 7, "PERS and TRS." She remarked that PERS and TERS was allowed to have a much broader asset allocation and touch on more markets than the CBR. She remarked that domestic equity was approximately 26 percent and global equity was approximately 25 percent. She added that PERS and TRS was able to put money into real assets like timber land and farm land.

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Commissioner Rodell highlighted slide 8, "APFC." She stated that PERS and TRS did slightly better than Alaska Permanent Fund Corporation (APFC). She explained that it was due to different long term investment goals, and the need to achieve different rates. The APFC's goal was achieve a real rate of return of 5 percent, and it had exceeded that goal.

Commissioner Rodell discussed slide 10, "FY 2014 Investment Revenue Forecast." She remarked that the forecast showed an increase in investment income of over \$100 million in UGF. She stated that the restricted funds in GF saw an increase of \$7.7 million. She announced that the CBR saw an increase of \$823 million. With the addition of the other funds and APFC, the total restricted amount was \$4.8 billion. She stressed that the market had been very good to the state over the previous year.

Co-Chair Meyer surmised that the PERS and TRS fund relied on an 8 percent return over a 30 year period, but noticed that the PCE fund had an "unrealistic" expectation of 8 percent. He queried the difference. Commissioner Rodell responded that PCE had a statutory requirement to achieve 7 percent without regard to inflation. She remarked that it was a very aggressive rate of return. She stated that PERS and TRS had a different time horizon. It assumed 8 percent, including an inflation factor, so a real return should be slightly less than 8 percent for achievement. She stressed that the actuary used that outline to value the fund, to determine the available benefits over thirty years.

Co-Chair Meyer wondered if the annual \$500 million request for the unfunded liability would increase, if the re rate of return on the PERS and TRS was not met. Commissioner Rodell responded in the affirmative, and furthered that the goal of the \$500 million annual request was to keep that number the same annually. She stressed that the liability would adjust based on investment returns. She remarked that there could be years where the liability increases or decreases. She felt that intention with the governor's proposal was to create some budget certainty.

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^FY15 BUDGET OVERVIEW: OFFICE OF MANAGEMENT and BUDGET

KAREN REHFELD, DIRECTOR, OFFICE OF MANAGEMENT AND BUDGET (OMB), OFFICE OF THE GOVERNOR, discussed the PowerPoint presentation, "FY 2015 Budget Overview, Senate Finance Committee" (copy on file). She stated that there were three budget bills for the operating, capital, and mental health budgets.

Ms. Rehfeld highlighted slide 2, "Budget Vision." She stated that Governor Parnell was very optimistic about Alaska's future. She remarked that Alaska's economy was growing, and provided many opportunities for Alaskans. She felt that the effort of the legislature had worked to put Alaska's finances in order. She felt that Alaska had solid a solid financial footing, strong bond ratings, and felt that the branches of Alaska's government were working well together to sustain the financial energy.

Ms. Rehfeld discussed slide 3, "Budget Principles."

Four principles to guide FY2015 budget

- Live within our means
- Focus on constitutional priorities
- Fix what we have
- Finish what we started

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Ms. Rehfeld looked at slide 4, "FY2014/FY2015 Budgets: Big Picture." She remarked that the governor and the legislature had worked very closely the previous year to set a spending target. She pointed out that the previous year's budget was over \$1 billion less than the previous fiscal year. She stated that the current budget request had reduced the pressure on the GF by over \$1 billion. She stressed that less revenue meant less spending. She stated that OMB had asked the departments to carefully evaluate their core services, and only request funds that would not require additions to the budget. She stressed that OMB was looking at different ways to decrease overhead, be more efficient, and focus on Alaska's priorities. She pointed out that the savings account would need to be accessed in the current and following fiscal years in order balance the

need to provide essential services and the short-term revenue picture. She felt that the state would see a turnaround in resource production in the near future.

Ms. Rehfeld highlighted slide 5, "Alaska's Reserve Accounts." The purpose of the slide was to show how the savings accounts had grown over a period of time, from FY 02 to FY 15. She pointed out that the reserve accounts had grown from approximately \$2 billion to \$16 billion. She remarked that higher oil prices made it possible to put more money into the savings accounts. Maintaining and managing the reserves were keys to the long range annual fiscal plan. She felt that the reserves could be used wisely to address the short term budget dilemmas. She added that the reserves could also be used to invest differently to cover the cost of the pension unfunded liability.

Senator Hoffman wondered if the \$11.3 billion FY 15 projection reflected the three areas the governor discussed as priorities. He asked specifically if the \$3 billion unfunded liability was taken from the savings account. He also wondered if there was a budget for the state's spending on the proposed gas line. He further asked if the proposal included the governor's education funding intentions. If those items were not included, he queried the funding number that would include all of those priorities. Ms. Rehfeld responded that the projection reflected the transfer of \$3 billion from the CBR into the retirement trust funds. She stated that the governor spoke about two separate pieces which included the gas line and the potential for the education funding package, but were not incorporated in the December numbers. She stressed that bills regarding those issues had not been introduced with accompanying fiscal notes. She furthered that there would be adjustments to the overall budget, depending on where the spending lined up at the end of the legislative session. She explained that the chart showed the governor's December 15 budget as proposed and the impact on the reserves. She felt that \$11.3 billion was a strong reserve account for the end of FY 15.

Vice-Chair Fairclough looked at the issue of transferring \$3 billion to the Arm Board, and its current rate of return, which was better than past years. She noted that the 8 percent rate of return required a historical examination over 30 years, to determine how the real numbers would be affected. She felt that moving \$3 billion

over to a management tool, based on only one year's rate of return was not historically high. Ms. Rehfeld stated that Vice-Chair Fairclough made a good point regarding the Arm Board's historic rates of return.

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Ms. Rehfeld discussed slide 6, "FY2015 Budget by Fund Source." She stated that the next few slides were designed to provide some context into the total budget with all three budget bills combined. She announced that the total request for all funds for FY 15 was \$12.4 billion. She reported that the chart showed that the UGF budget of \$5.64 billion was just slightly over 50 percent of the total budget. She explained that the \$3.11 billion of federal funds was 23 percent of the budget. She announced that the \$2.15 billion in the permanent fund component for dividends and inflation proofing was 15 percent of the budget. Designated GF of \$868.4 million was 7 percent of the total budget. She announced that \$600.6 million of other state funds was approximately 4 percent of the total budget. She pointed out that other state funds included a transfer of \$3 billion from the CBR to the Retirement Trust Funds was a component of the other state funds line item. She stressed that the item was outlining the removal of money from one fund and moving it to another fund. She stressed that the fiscal summary included a net-out, but restated that moving the funds was reflected in that particular component.

Ms. Rehfeld addressed slide 7, "FY2015 Budget by Category." She remarked that the total budget request was \$12.4 billion, and the chart outlined the categories of the proposed funding. She looked at the left-hand side of the pie chart. She explained that the red and pink portions were the areas of the budget that were considered non-discretionary. She stated that the blue portions of the pie chart were more discretionary funds, so the reductions in governor spending would be focused on those blue areas. She looked at the dark red portion, which was the K-12 Formula, which included the school funding formula. She explained that the school funding formula was based on the current statutory student allocation of \$5,680 per student. She furthered that the formula also included transportation expenditures. She stressed that the budget fully funded the current statutory entitlement, and forward funded education in the budget. She remarked that the budget also included the \$25 million that was technically outside the school

funding formula for utility and energy related costs. She looked at the darkest pink area of the chart that represented other formula programs with \$2.02 billion, which was for Medicaid, public assistance, and power cost equalization. She looked at the statewide appropriations portion of the chart which contained \$3.88 billion that was direct payment for the unfunded liability. She furthered that the statewide appropriations also included the \$450 million tax credit, which included debt service payments and community revenue sharing. She restated that the permanent fund budget of \$2.15 billion would be used for inflation proofing and dividends. She remarked that the state agency operations budget related to the 14 state departments, UA, the legislative branch, and the judicial branch. She noted that the portions of the chart titled "Agency Nonformula and other funds" and "Agency Nonformula Unrestricted GF" totaled \$4.3 billion. She stressed that \$2.26 billion in Agency Nonformula funds was UGF, and remarked that much of the legislative attention was on that portion of the budget.

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Ms. Rehfeld looked at slide 8, "FY2015 UGF Spend: \$5.6 Billion." She stressed that the governor and the legislature had worked together very well on fiscal issues and fiscal discipline. The chart showed that the previous year's spending target reduced the GF spending by over \$1 billion. She added that the FY 15 proposal included an additional reduction of \$1.3 billion. She recognized that there would be a downward pressure on GF spending, and reducing the state operating budget. She felt very optimistic about the potential shift in resource production, because of recent changes in the tax structure. She remarked that there would be some difficult decisions in the next couple of years, but felt that the current budget was very responsible as it related to the current revenue picture. She remarked that over the years there had been very healthy capital budgets, with remaining funds from previous appropriated projects that would be available to continue work on those efforts.

Co-Chair Kelly wondered if there was a number on the capital budget dollars that had yet to be spent. Ms. Rehfeld responded that the current numbers needed to be updated, but she stated that the recent prepared numbers reflected \$6 billion that had yet to be spent with various

projects yet to come online. She stated that there was anticipated federal authorization for some projects.

Co-Chair Kelly surmised that \$6 billion was previously appropriated funds that needed to be spent. Ms. Rehfeld replied that \$6 billion was the amount in spring 2014, and stressed that the recent updates had not yet been released.

Co-Chair Meyer surmised that there were some bonds that had not yet been sold. Ms. Rehfeld responded that there were some bond-funded projects that had not moved forward for various reasons.

Co-Chair Meyer understood that there was a 5-year window for use of capital funds.

JOHN BOUCHER, SENIOR ECONOMIST, OFFICE OF MANAGEMENT AND BUDGET, OFFICE OF THE GOVERNOR, responded that he was not certain about the timeframe, but remarked that there could be tax consequences because of the earnings. He stressed that the department was carefully managing how they were rolling out the most recent bond issues based upon some of the discussed issues.

Ms. Rehfeld furthered that once the bonds were sold, there were some time horizons that required use of the funds. She announced that DOR would know more about that issue.

[11:05:17 AM](#)

Senator Hoffman noted that the unfunded liability was included in the draw-down of the reserve accounts. He felt that the spending chart did not show the \$3 billion as expenditure. He felt that the UGF spending would be more in the neighborhood of \$8.6 billion with the unfunded liability inclusion. He furthered that there were large issues, including education and the gas line. He expressed concern related to the use of the savings account, and stressed that the energy costs should be addressed for all Alaskans. Ms. Rehfeld clarified that the proposal for the unfunded liability was moving \$3 billion from the CBR. Slide 8 only referred to UGF, so the transfer on the fiscal summary would be considered "other funds." She agreed that OMB was concerned about the use of the savings accounts, and OMB was annually preparing its ten-year plan released on December 12, 2013. She noted scenarios where OMB had built in some potential midrange production numbers, and

OMB had also examined some different price indicators. The legislature needed to impose fiscal discipline on the annual UGF spending for maximizing deliverance of public service and minimizing the draw on reserves, as OMB prepared the state's projected use of the savings accounts.

Ms. Rehfeld displayed slide 9, "FY2015 General Fund Budget by Category." She remarked that the slide was similar to slide 8, but focused solely on the GF budget. She felt it was important to understand the categories of the \$5.64 billion in UGF funding. She remarked that the red colored areas of the pie related to non-discretionary funds; and the blue colored areas related to discretionary funds.

Co-Chair Kelly handed the gavel to Co-Chair Meyer.

11:10:30 AM

Ms. Rehfeld highlighted slide 10, "State Assistance payments." She stressed that the retirement unfunded liability was a very serious issue. She announced that it was the single largest cost-driver in the operating budget. She stressed that if it was not addressed, it would have a negative impact for future generations. She shared that the legislature, governor, and Arm Board had worked very diligently on this issue. Over the previous seven years, the state had paid over \$3.3 billion in direct assistance payments to help address the unfunded liability. She stressed that the payments had been a relief to municipalities and school districts. She stressed that there was an almost \$12 billion unfunded liability. She explained that the black bars on the chart showed the escalating cost of the assistance payments, based on the current methodology of level percent of pay. Over a period of time to 2032, the stated will have spent \$15.2 billion. The governor had proposal was highlighted by the blue bars. She noted that there was a \$3 billion for the current fiscal year, and then the annual payment would be capped at \$500 million. The result would be extending three years beyond the current methodology, but would cost the state \$2 billion less than the current level percent of pay. She stressed that the goals of OMB were the same as the legislature: to be able to manage the annual cost of the program; meet the obligations to the retirees; preserve the health of the trust funds; and to not leave this problem to the next generation.

11:14:27 AM

Co-Chair Meyer felt that the \$3 billion would be considered spending. Ms. Rehfeld responded that the transfer was leverage the use of the existing savings, to maximize the benefit of the funds that were already in the savings account. She remarked that the result would take the pressure off the annual recurring revenue from the UGF.

Co-Chair Meyer stressed that if CBR money was considered UGF money, and could be used toward roads, schools, etc., it should be considered spending. He wondered why the funds needed to be deposited in the trust, rather than set aside in a reserve or escrow account. He agreed that the issue should not be held off for the next generation, but did not want to spend too much and deny that generation possible education funding. Ms. Rehfeld agreed, and stated that a three quarter vote of the legislature allowed the use of the CBR for any item the legislature might choose. She explained that the governor proposed a single item, but did not request the funding for any other purpose.

Co-Chair Meyer handed the gavel to Co-Chair Kelly.

Co-Chair Meyer wondered if the fund was unhealthy. Ms. Rehfeld replied that the fund had and AAA rating.

Co-Chair Meyer remarked that Alaska was one of four states that had accounted for medical unfunded liability, so it looked much worse than other states. Ms. Rehfeld agreed and furthered that it was how the unfunded liability was calculated.

11:19:32 AM

Vice-Chair Fairclough remarked that there was already a payment method to pay off the unfunded liability, and as long as the payments were met, Alaska would be viewed in good standing. She wondered if a subaccount were to flatten the payments to draw interest, the rating agencies would still apply a remarkable rating. Ms. Rehfeld agreed and furthered that it was one of several approaches that had been considered.

Co-Chair Kelly felt that the issue was important, and pointed out that it was probably the largest issue facing the legislature in the operating budget.

Vice-Chair Fairclough stressed that one of the measurement tools that she will be examining was what was left in the fund. She remarked that the Arm Board was responsible for the health of the people that were promised benefits. She stressed that her votes would be in line with that responsibility.

Senator Hoffman agreed that there should be further examination of the unfunded liability issue. He remarked that there had been various proposals about creating a reserve account. The Arm Board had opposed that proposal; because it did not reflect what they felt was the true liability. He remarked that the proposal would be considered a loan, so the state would get the funds returned.

Vice-Chair Fairclough stressed that she was concerned about what would be leftover in the fund after a \$3 billion investment. She understood that the Arm Board needed to be sure that there was cash flow to make their annual payments to beneficiaries' health needs. She wanted to know what the cash flow would look like after the \$3 billion infusion.

[11:24:01 AM](#)

Co-Chair Kelly stressed that there had been conversations regarding the unfunded liability, and hoped that Ms. Rehfeld would communicate to the governor that the legislature supported a healthy retirement system.

Senator Bishop stressed that lowering the cost of energy in rural Alaska was another important issue in maintaining a healthy cash fund.

Ms. Rehfeld discussed slide 11, "Spending Controls."

Maximize efficiency/Rein, in operating spending

- Improve/Streamline Business Processes
- Regulations Review- AO 266
- Enhance technology
- Lower cost of purchasing
- Reduce footprint/cost of office space
- Deleted 150 vacant positions

Ms. Rehfeld looked at slide 12, "Budget Priorities."

Focus on Administration's strategic investment priorities

Education
Resources and Energy
Public Safety
Transportation/Infrastructure
Military Support

Ms. Rehfeld displayed slide 13, "FY2015 Budget- Another Perspective." She remarked that the chart reflected that 60 percent of Alaska's budget benefitted communities and organizations through grants, direct payments, and capital project funding.

[11:29:49 AM](#)

Co-Chair Kelly thanked Ms. Rehfeld for her work at OMB. He stated that it was rare for the governor to present a budget that contained a reduction. He understood that the reduction was difficult, because there were over a billion requests that OMB needed to filter in order to draft a budget. He felt that Alaskans would want to reduce the government agencies even more than the current budget request. Ms. Rehfeld agreed that OMB had worked hard to develop the proposed budget. She remarked that, historically, there were far more state department requests that what was included in the budget. She stated that there were not an overwhelming number of requests that were considered for the current budget, because OMB encouraged the departments to limit the requests to significant areas of problem or concern in their individual budgets. She pointed out that there was an actual reduction in the agency operations portion of the budget. She understood that the statewide portion of the budget that included the unfunded liability payment or shifts in the tax credits were big picture inclusions. She restated that the agency budget was a reduction. She asserted that the following year's budget would include more reductions than the current year.

Co-Chair Kelly commented that the previous year's budget halted a default expansion of government. He felt that there needed to be a reduction of funding for state agencies.

Co-Chair Kelly handed the gavel to Vice-Chair Fairclough.

Senator Hoffman asked for a report on the revenue sharing program. Ms. Rehfeld indicated that she would provide that information.

SB 119 was HEARD and HELD in committee for further consideration

SB 120 was HEARD and HELD in committee for further consideration.

SB 121 was HEARD and HELD in committee for further consideration.

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ADJOURNMENT

[11:35:36 AM](#)

The meeting was adjourned at 11:35 a.m.