

HOUSE FINANCE COMMITTEE
January 22, 2015
1:31 p.m.

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CALL TO ORDER

Co-Chair Neuman called the House Finance Committee meeting to order at 1:31 p.m.

MEMBERS PRESENT

Representative Mark Neuman, Co-Chair
Representative Steve Thompson, Co-Chair
Representative Dan Saddler, Vice-Chair
Representative Bryce Edgmon
Representative Les Gara
Representative Lynn Gattis
Representative Scott Kawasaki
Representative Cathy Munoz
Representative Lance Pruitt
Representative Tammie Wilson

MEMBERS ABSENT

Representative David Guttenberg

ALSO PRESENT

Helen Phillips, House Finance Committee Assistant, Legislative Finance Division; David Teal, Director, Legislative Finance Division; Representative Cathy Tilton; Former Representative Mary Sattler.

SUMMARY

OVERVIEW OF ALASKA'S FISCAL SITUATION: LEGISLATIVE FINANCE DIVISION

Co-Chair Neuman relayed that committee meetings would begin on time. He introduced committee members. He introduced the legislative finance committee staff.

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HELEN PHILLIPS, HOUSE FINANCE COMMITTEE ASSISTANT, LEGISLATIVE FINANCE DIVISION, introduced staff. She discussed items related to staff including hours and committee coverage. She pointed out committee file locations for members. She referred to microphones on the committee table and pointed out reference materials in the room.

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Ms. Phillips continued to discuss items pertaining to the committee room and decorum. She relayed that she looked forward to working with members during the session.

Co-Chair Neuman pointed to various logistics pertaining to the committee including quorum and other. He communicated that electronic devices were not allowed at the committee table during meetings. He introduced his staff.

Co-Chair Thompson introduced his staff.

Co-Chair Neuman communicated that the governor's supplemental budget was due on February 3, 2015; the governor's operating budget amendments were due by February 18, 2015. He relayed that a budget subcommittee schedule was forthcoming. He pointed to subcommittee closeout deadlines; the target deadline was February 27, 2015. He shared that currently the Office of the Governor was working off of a draft operating budget; as updates were made available, the committee would receive them from the Office of Management and Budget or through the departments.

^OVERVIEW OF ALASKA'S FISCAL SITUATION: LEGISLATIVE FINANCE DIVISION

DAVID TEAL, DIRECTOR, LEGISLATIVE FINANCE DIVISION, asked his staff to introduce themselves.

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Mr. Teal provided a PowerPoint presentation titled "An Overview of Alaska's Fiscal Situation" dated January 22, 2015 (copy on file). He referred to a Legislative Finance Division (LFD) document that had been provided to committee members titled "The Fiscal Year 2016 Budget: Legislative Fiscal Analyst's Overview of the Governor's Request" (copy

on file). He highlighted that low oil prices had caused low revenue and corresponding deficits in Alaska.

Co-Chair Neuman communicated that committee members could ask questions during the presentation.

Mr. Teal provided information about his presentation; the handouts did not necessarily match the order in which he would present the slides. He addressed slide 2 titled "Figure 1. Unrestricted General Fund Revenue and Budget History." He detailed that the chart depicted pertinent data pertaining to Alaska's revenue and expenditures for the past 39 years. He shared that much of the presentation would convey the numbers on slide 2 in a way that was easier to understand. He pointed out that revenue was volatile due to oil price volatility. He noted that oil production was fairly constantly declining, but it was fairly predictable and was nowhere near as volatile as price and revenue. He discussed the difficulty in maintaining a stable budget with a volatile revenue stream. He stressed that oil revenue equated to 90 percent of the state's revenue stream. He discussed that during a period of volatile revenue, building financial reserves during high revenue periods, aided in budget stabilization. He pointed to Figure 1 and noted that the state had been fairly successful in employing the strategy over time.

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Mr. Teal moved to Figure 2a on slide 4 titled "Alaska Unrestricted General Fund Revenue (Left Axis) and Average ANS Price/bbl (Right Axis)." He reiterated that the state had done a relatively good job of saving money when revenue was high. He referred back to slide 2 and pointed to savings that were shown in pink and titled "net fund transfers." Figure 2a on slide 4 included both revenue and price information. He noted the declining trend in revenue from the peak of production at 2 million barrels per day in 1982 to about 500 thousand barrels per day at present. He explained that price and production had impacted the revenue decline. Price alone had driven the revenue increase between approximately 2002 and 2006 under PPT [Petroleum Production Tax]. He relayed that following 2006 it was less clear where revenue stemmed from due to the impact of price production and the tax mechanism. He planned to only address revenue. He noted there were high prices and revenue in 2008, which continued to rise before

falling to an average of \$76 in the current year and \$66 in the upcoming year. He pointed to a dotted line on the chart that was meant to distinguish between the past and the future revenue forecast. He noted that members may question the forecast given that the current price of oil was approximately \$50/bbl. Future prices did not represent a healthy rebound; prices were headed where they had never been in the past. He cautioned members to avoid being misled by the spot price of oil; the average 2015 price to date was \$85/bbl.

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Mr. Teal stated that if the average price remained at its current price, the average price for the year would be around \$75 or so. He reiterated that members may question the forecast if they did not believe the price and revenue forecast were overly optimistic. He noted that LFD relied on the Department of Revenue (DOR) for forecast data. He returned to Figure 1 on slide 2 and relayed that without expenditure reductions or revenue enhancements the state could experience deficits of \$1 billion on an annual basis, which included the price recovery incorporated in the DOR forecast. He detailed that the growth in price that began in approximately 2005 was not sustainable; expenditures had gone from roughly \$3 billion up to \$6 billion in ten years' time.

Mr. Teal pointed out that many people in the legislature had known for years that the expenditure growth and expenditure levels were not sustainable. He communicated that if the growth was sustainable, the state would have somewhere around \$10 billion in revenue and expenditures, which represented approximately twice the amount of current revenue. He remarked that recognizing the situation had not been enough to avoid it. He noted that despite reduced expenditures subsequent to 2013, the state was still facing deficits of \$3.5 billion in both FY 15 and FY 16. He stated that on the positive side the state had built huge reserves during periods of high prices; however, it was burning through the reserves rapidly. He pointed to the red bars below the axis on Figure 1 (slide 2), which represented withdrawals from savings; red bars above the axis represented deposits into savings.

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Mr. Teal relayed that several slides broke the expenditure chart into pieces in an effort to make it easier to identify the problem and potential solutions. He moved to slide 5 titled "Figure 3. Unrestricted General Fund Revenue and Budget History Agency Operations." He detailed that the chart could be thought of as the cost of running programs and included formula programs (e.g. K-12 and Medicaid) and non-formula programs (e.g. day-to-day operations). He pointed out that spending had been fairly flat from the mid-1980s to 2005. He relayed that operating costs had increased with the dramatic increase in revenues beginning in 2005; costs had nearly doubled since 2004. He compared it to a trend that had occurred in the early 1980s; when revenue had first begun to flow, the budget had increased from \$1 billion to \$2 billion in a short period of time (as shown on the chart).

Co-Chair Neuman referred to the 1983 and 1985 bars on slide 5. He commented on the growing population in Alaska in relation to growth in operating costs. He asked if population growth was included in the data. Mr. Teal replied that he would address population in a subsequent chart.

Co-Chair Neuman recognized former Representative Mary Sattler in the audience.

Representative Gara observed that the 1983 and 1985 expenditures shown in Figure 3 were roughly the same. He asked if the figures represented actual or inflation adjusted dollars. Mr. Teal replied that the figures represented nominal (actual) dollars.

Representative Gara asked for verification that spending per resident had decreased during the [1983 and 1985] timeframe especially in inflation adjusted dollars. He remarked that some catchup had occurred to deal with the decrease when the state's revenue began to increase.

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Mr. Teal agreed and noted that the information was shown in the slide that included the population adjustment.

Mr. Teal continued to address Figure 3 on slide 5. He disputed the notion that the driver of the increase had resulted from formula programs. He detailed that non-

formula spending was growing at the same pace as formula spending. He turned to a cost driver pie chart labeled Figure 4 on slide 6. He relayed that the agency operations increase from FY 06 to FY 15 was approximately \$1.9 billion. He pointed to K-12 that was currently a \$1.3 billion program, which accounted for \$485 million of the \$1.9 billion growth (26 percent). He elaborated that the growth rate of education was approximately 57 percent over the period, which represented slower growth than that of non-formula programs and far slower than Medicaid growth. He communicated that K-12 accounted for 33 percent of the budget in 2006 and currently accounted for approximately 30 percent. He stressed that K-12 was a driver due to its large size, but not because it was growing quickly. Medicaid accounted for \$415 million of the \$1.9 billion growth. Together, K-12 and Medicaid accounted for close to half of the operating budget growth. However, Medicaid's share of the budget had increased from 11 percent in FY 06 to 15 percent in FY 15, which represented faster than average growth (149 percent over the specified timeframe).

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Mr. Teal continued to address Medicaid growth. He stated that when a large program like Medicaid grew quickly it became a cost driver. The third driver of the \$1.9 billion increase was salaries and benefits, which totaled \$350 million. He broke the component into three pieces. First, negotiated salaries accounted for \$150 million in general funds (the total was double the amount when factoring in all funds). Second, monthly health insurance costs had increased from \$800 per person in FY 06 to over \$1,300 in FY 15 (an annual increase of \$6,500 per employee). He added that the number of state employees had also increased by 2,000 during the time period; therefore, healthcare insurance premiums had increased by approximately \$75 million. Third, the state's contribution to retirement costs (the amount paid to employees in payroll checks) had increased from 11 percent to a cap of 22 percent, which amounted to approximately \$130 million from FY 06 to FY 15. He summarized that K-12, Medicaid, and salaries accounted for roughly two-thirds of the undesignated general fund growth between FY 06 and FY 15. The remainder of the growth was a result of various expenditures such as Village Public Safety Officer positions, prisons, the Office of the Governor, the legislature, oil and gas permitting, and

other (all items that fell into the nonformula category that were associated with agency operations).

Representative Gara asked for verification that during the ten-year period K-12 expenditures had risen by an average of 2.6 percent per year for a total of 22.6 percent. Mr. Teal replied that growth of 2 percent per year was not sufficient to reach the 22.6 percent total over a ten-year period.

Representative Gara remarked that during the ten-year period the legislature had corrected what some people had thought was a discriminatory education funding mechanism. As a result the state had begun spending significantly more on rural schools to correct the issue. He noted that the increase also represented a catchup period due to relatively flat education funding that occurred in the preceding 15 years. He did not believe the statements were controversial.

Mr. Teal agreed. He returned to Figure 3 and noted that it may be pertinent to question how funding had remained flat for 20 years. He believed the cost drivers provided some answers to the question. The K-12 budget began at less than \$500 million in 1984 and was still less than \$700 million in 2004 (roughly 50 percent growth over a 20-year period).

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Representative Wilson wondered if there was a way to determine how much federal requirements to programs in various departments (e.g. the Department of Transportation and Public Facilities and the Department of Environmental Conservation) had contributed to agency operations growth in the past ten years.

Mr. Teal agreed that there were federal mandates. He added that many people referred to the requirements as unfunded federal mandates. He acknowledged that the mandates were driving state spending more in the future than in the past. He noted that it did shed light on why the growth had occurred; he planned to elaborate on the issue later in the presentation. He addressed how funding could stay flat. He shared that Medicaid had doubled during the 1990s from \$64 million to \$136 million; Medicaid was currently at \$700 million. He stressed that the rate of increase for healthcare costs had accelerated rapidly. He addressed

salaries as another driver of the cost increase; there had been no negotiated salary increases in 11 of the 20 years prior to FY 06. Additionally, there had been no retirement cost increases in the past; the cost had been 11 percent for many years. He communicated that there had been no unfunded liability in the state retirement system until 2005. He noted that the time period on the chart was a time of slow to negative growth due to the inflation and population changes. He believed no one would argue that there had not been unmet needs during the flat funded period; for a period beginning in 2005 there had been revenue to address some of the unmet needs.

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Mr. Teal addressed statewide operations, which included operating costs that were not attributable to any single agency (Figure 5, slide 7). He spoke to items including debt service, which was essentially the entire amount of statewide operating costs in years shown on the slide. He detailed that the state had issued general obligation bonds on a schedule referred to as the Prudhoe Bay curve that were set to be paid off by 2000. While statewide costs had been made up almost completely of debt service, it had been small during the period [late 1990s]. Debt service had begun growing because the state had issued general obligation bonds.

Mr. Teal highlighted a breakdown of the costs in Figure 6, slide 8. The bottom portion of the bars on the chart represented state debt service (shown in black). He relayed that the state currently spent \$230 million in general funds on debt service (the cost had doubled since FY 00); the figure had been \$0.00 in FY 00 and roughly \$100 thousand in FY 06. However, the growth had been slow in comparison to the increase in state assistance to retirement. Retirement costs skyrocketed when the state had lost substantial funds in the stock market in the early 2000s and again in 2008 and 2009. The unfunded liability would have driven rates to levels that municipalities could not afford; therefore rates for municipalities had been capped at 22 percent (the state paid the costs above 22 percent). He noted that there was also a cap for the Teachers' Retirement System (TRS) at a different rate. He detailed that the unfunded liability had been \$18 million in 2006. The state had expected the cost to climb to approximately \$75 million, and to begin declining. Instead,

rates had continued to climb to a peak of \$634 million per year in 2014; the liability would have been over \$700 million in 2015 or over \$1 billion if the state had followed the recommendations of the Alaska Retirement Management Board. However, \$3 billion from the CBR had been used to pay down some of the debt in 2014. He noted that without the deposit the unfunded liability would have continued to increase towards \$1.2 billion per year.

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Co-Chair Neuman asked about expectations if the chart was extended to represent future years.

Mr. Teal replied that if the legislature had not passed legislation the prior year (HB 385) the trend would have continued upward to approximately \$1.2 billion. With the deposit the cost had declined to \$260 million in FY 16. Without the adoption of HB 385 the FY 16 deficit would be \$750 million to \$1 billion higher; the state would be facing a deficit of \$4.3 billion or more instead of a \$3.6 billion deficit. He relayed that there was a tremendous payoff for contributing substantial funds to the unfunded liability; the state was saving \$750 million or more annually for a deposit of approximately \$2.3 billion.

Mr. Teal addressed the fund capitalizations category shown in green in Figure 6; the capitalizations had been \$0.00 in FY 06 and FY 07. He detailed that it was not until FY 08 and FY 09 that the amounts had grown tremendously. Oil and gas tax credits (shown in red) reached \$625 million in FY 15 and were projected to be approximately \$700 in FY 16.

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Mr. Teal highlighted capital budget spending on slide 9, Figure 7. He pointed out that the spending followed the revenue curve; capital budgets tended to be higher when revenue was higher. Likewise, when revenue disappeared so did the capital budget. He reasoned that looking at where growth had occurred in the past may help the legislature to unwind some of the growth. Additionally, he focused on the past partly because some individuals blamed the legislature for the current fiscal situation. He returned to cost drivers (shown on slide 6). He noted that the legislature was not responsible for negotiating salaries. He looked at \$75 million in healthcare costs, plus Medicaid growth of

\$415 million and stressed that the costs were not unique to Alaska. He relayed that every state struggled with healthcare costs and with determining how to deal with the increasing costs of Medicaid. He referred to annual retirement costs of \$130 million built into the payroll in addition to the \$260 million in state assistance and emphasized that the legislature did not control the stock market. The state was paying \$400 million per year to make up for stock market losses. He noted that total cost of the items he had just covered was over \$1.5 billion.

Representative Munoz addressed Figure 6 and asked if the \$700 million FY 16 [oil and gas] tax credit reflected any credits paid off under Alaska's Clear and Equitable Share (ACES).

Mr. Teal replied that the chart may reflect the data; however, LFD did not receive enough detail from DOR to know whether the credits were carry forward or where they were going. He communicated that there were two types of tax credits. First, there were credits that large producers could take that was deducted from the revenue owed by producers. He likened the credit to deductions taken by individual tax payers on their personal income tax paid to the federal government. However, the credit referenced on slide 8 was a purchasable credit for small producers or others who lacked the revenue stream to take a tax credit. The parties were issued a certificate of credit that could be sold to another party (typically a major producer) for sale to the state. He explained that the two credits were very different; the large producer credits reduced revenue whereas the small purchasable credits did not. He elaborated that the small credits took an appropriation to purchase the credits, which had increased to \$700 million.

Mr. Teal noted that the amount of credits purchased by the state exceeded the production tax revenue by roughly \$100 million in FY 15 and \$300 million in FY 16 (projected). He did not know if the credits would be on an annual basis. He elaborated that if the state issued a credit for something like \$50 million, a company could turn it in during the current year, the upcoming year, or the year after. He detailed that there was no way to earn interest on a credit until it was turned in and purchased. He questioned why a company would hold on to a credit when it could turn it in and invest the money. He reiterated that LFD did not receive enough detail from DOR to know precisely who the

credits were issued to, what they were for, and where they were for. He explained that many of the credits were Cook Inlet credits as opposed to North Slope credits. He deferred the question to DOR for further detail.

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Co-Chair Neuman noted that DOR and Department of Natural Resources would be present the following week to address the committee. He remarked that the committee could potentially have additional meetings pertaining to tax credits if necessary.

Representative Munoz believed \$350 million in credits had been paid off under ACES when the state had transitioned to the current tax regime under SB 21 in 2013. She thought it would be helpful to know where the credits were reflected currently and in future years.

Mr. Teal relayed that the projection for future credits was not a continuation of \$700 million per year; the DOR Revenue Sources Book showed the figure dropping to \$250 million per year after FY 17. The figures were high, but he did not know the precise reason. He turned to Figure 8 on slide 10 that showed per capita unrestricted general fund revenue and budget history adjusted for inflation. He remarked that population had grown and inflation increases had occurred. He pointed to a clear downtrend from 1983 to 1999. The state's current real per capita expenditures was less than the state spent in the 1980s; it was more than the state had spent in the 1990s. He reminded the committee that the chart included the \$1.5 billion in retirement costs and salary increases (things that had not occurred in the flat midsection of the chart). He added that the downward trend would have continued if the \$1.5 billion was subtracted.

Co-Chair Neuman referred to the agency operations portion of the bars in the chart on slide 10 (shown in blue). He remarked that the component included state personnel costs. He observed that if the state were to eliminate all of its employees it would impact the budget deficit by \$1.4 billion. He remarked that the state agency operations had become fairly efficient. He pointed to costs of around \$9,200 per state employee in the early to mid-1980s; the cost was currently \$7,200, which represented a downward trend in agency operation costs.

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Representative Gara noted that the bulk of the Medicaid expenditure increases were due to people moving into Alaska and an increased number of individuals on Medicaid. He asked for an explanation of net fund transfers shown on the chart (Figure 8) especially related to 2008.

Mr. Teal explained that the net fund transfer (shown in red) represented a deposit to savings. He pointed out that when the state spent more than it had the net transfer was shown in red below the \$0.00 axis. He highlighted the \$2 billion to \$3.5 billion deficits [in 2015 through 2017]. He relayed that the \$1.5 billion in "hard to avoid costs" was half of the \$3 billion increase that had occurred since 2005. He referred to looking at the capital budget as another potential area for cost reduction and noted that some individuals may believe some of the past capital budget spending may have been wasteful. He pointed out that approximately \$4 billion of the \$10 billion in general funds appropriated to the capital budget during the 10-year period had not yet been spent. He stated that as the projects rolled out they would supplement the smaller capital budgets in the future. He elaborated that a very low capital budget in the current year would not stop the capital budget spending due to the \$4 billion backlog.

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Mr. Teal believed the critical question was not about who was to blame for the debt, but focused on what the state could or should do about the fiscal gap. He communicated that there had not been much the legislature could do about many of the expenditures that had occurred. The pertinent question was whether it was possible to cut the state's way out of debt.

Mr. Teal addressed slide 11, Figure 9 titled "UGF Revenue/Budget (Oil at \$60/bbl)(No Growth Scenario)." He stated that quick action was necessary if the legislature believed that oil prices would remain low. Under the scenario on slide 11 the fiscal gap remained at \$3 billion to \$3.5 billion per year. He stressed that reserves would vanish rapidly at \$60 per barrel oil; the legislature would have no choice but to balance the budget. He addressed the possibility of a rebound in oil prices on slide 12 titled

"UGF Revenue/Budget (DOR Forecast)(No Expenditure Growth Scenario)." He relayed that reserves would last substantially longer, but the problem would not really be solved; there would still be an annual deficit of \$1 billion per year. He questioned whether it was possible to cut the state's way out of deficit, how much needed to be cut, and where the cuts could be taken. He addressed potential cuts to the capital budget and relayed that the governor's proposed capital budget was about as lean as it had ever been. He noted that of the \$106 million capital budget, almost everything was leveraged money (including federal matching funds). He communicated that there was not much of anything that people would consider to be "cuttable" without losing money in addition to the general funds.

Mr. Teal addressed "Hard to Cut" items in the operating budget in Figure 11 (slide 13). The figure listed debt service, retirement assistance, production tax credits, K-12 formula, and Medicaid for a total of \$3.2 billion. He reminded the committee that current revenue was \$2.2 billion. He elaborated that [to cut the state's way out of deficit] the legislature would have to cut \$1 billion from the hard to cut items and eliminate everything else. He stressed that there was no payroll associated with the items on slide 13. He reiterated that the items included retirement assistance, debt service, payments to businesses, grants to individuals, and payments to bond holders and trust accounts. He stated that if the items were cut, the legislature would also need to cut all state employees funded with general funds in addition to cutting the \$1 billion from the items on slide 13. He stated that mathematically it was not feasible to cut the state's way out of the deficit. He noted that it did not mean that no reductions were possible and that none should be attempted. He concluded that balancing the budget was not an easy feat.

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Mr. Teal relayed that beginning in 2008 LFD had been preparing for the day that expenditures would be more critically examined than they had been in the preceding 10 years. The division had worked with the legislature on several fronts and the legislature had taken the lead on several items. Items included a 2008 fund reclassification project, 10-year look-back graphs, and models (e.g. oil price forecasts and the reserve burn). More recent items

included an indirect expenditure report and legislation passed in recent years (HB 30) required audits of agencies to determine places to cut. He relayed that there had been consideration of breaking the capital budget down into pieces to show detail such as which items required federal match, which were job producers, which were grants to municipalities and nonprofits, and other in order to make it easier to focus on reductions. He stated that the reclassification and redesign of the fiscal summary provided consistent data. He believed there had been a time when legislators and others could not understand the spending (e.g. general fund spending, receipts, and other); he believed the problem had been rectified. He communicated that the legislature could rely on the fiscal summary to help determine what kind of money and how much was being spent. He elaborated that the model could be of great assistance in the development of a logical, defensible, and long-term spending plan; it could be used by the legislature to set annual targets for operating budget reductions. The goal would be to set some level of reserves and to determine upfront that reserves would be maintained, for example, at \$6 billion out by 2022. With the goal in mind, it would be possible to determine what cuts needed to be made and what revenue enhancements were necessary to meet the desired level of reserves.

Mr. Teal referred back to slide 12, Figure 10. He believed that unfortunately, balancing the budget on the expenditure side would mean cutting \$3.6 billion from the governor's budget. He noted that it would be an understatement to say that cuts at that magnitude would be difficult; he believed they would be unachievable. He relayed that only \$1.3 billion would be saved even if all state employees were terminated. He opined that given the reality, it was prudent to consider revenue enhancements. He reasoned that the state could hope for oil prices to recover, but Figure 2a that showed the DOR forecast with \$1 billion deficits was optimistic (slide 4). He returned to slide 12, Figure 10a, which illustrated that even with the forecast, the state could expect deficits of \$1 billion or more (without expenditure reductions or revenue enhancements). He communicated that the longer the large deficits persisted, the lower the reserve balances would become, and the level of necessary changes become more drastic.

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Mr. Teal relayed that he did not intend to discuss additional revenue options during the presentation. He highlighted income tax; sales tax; property tax; oil taxes and credits; Permanent Fund Dividend caps, reductions, or triggers; financial strategies such as collateralization or borrowing; healthcare provider taxes, motor fuel taxes; and other. He noted that there was no shortage of options on the revenue producing side. He discussed that the governor had stated that he did not intend to consider revenue enhancements until expenditures had been reduced. He knew many legislators agreed with the strategy. He understood the sentiment, but contended that much of the spending had been unavoidable. He did not believe the state had overspent, but that the problem pertained to revenue, which was too sensitive to prices. He reasoned that if oil prices remained at current levels, savings would be eliminated. He hoped he was wrong, but in the current environment it was necessary to hope for the best, but to plan for the worst.

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Co-Chair Neuman discussed a realistic timeframe within which to address the \$3.5 billion deficit. He noted that it was impossible to know what the deficit could be in the upcoming year. He stated that potentially under the best circumstances the deficit could be reduced in five years, which equated to a 20 percent reduction per year (\$750 million in the current year). He did not believe it was possible to make \$750 million in reductions in operating expenditures alone. He mentioned other potential methods of saving including basic agency reductions, efficiencies, and new revenues. He noted that the new revenues could include items such as park fees, licenses, and other. He hoped there would be increased revenues coming from expanded economic opportunities, royalties, corporate and production tax, economic development expansion, and other. He had asked the departments to help the legislature develop a three to five year vision for each department. He relayed that the departments were committed to working with the legislature on the effort. He believed everyone had a good understanding of the current fiscal situation. He opined that the committee would have the ability to address the issues impacting all regions of the state.

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Co-Chair Thompson referred to an LFD Indirect Spending Report provided to committee members earlier in the week. He elaborated that the report was a result of legislation passed the prior session (HB 306). An in-depth report had been done through DOR related to the state's tax credits and reduced fees. He added that the report included recommendations on existing tax credits (e.g. whether a credit had outlived its usefulness, had not met legislative intent, how much a credit cost, and other). He noted that the credits equated to millions of dollars in reduced fees and tax credits. Credits were offered for taxes on fish, education, small businesses, and other. He stressed that small increments added together equated to large increments. He asked members to review the document.

Representative Wilson noted that if the state was a private business it would not be able to wait to address reductions. She reasoned that a budget represented a maximum amount provided to agencies and not necessarily an amount they had to spend. She believed it would be beneficial to look at the current budget to prevent some of the cuts in the future from being as major.

Mr. Teal replied that the state was currently in the middle of the fiscal year [FY 15], which would make it difficult for agencies to respond and achieve any real savings by the end of the current fiscal year. He noted that it would be possible to reduce positions in the supplemental budget if those positions would be eliminated in the FY 16 budget.

Representative Wilson understood a plan was needed and that it would not be possible to reduce the deficit in one large chunk. She referred to Mr. Teal's examples highlighting how long reserves would last under two scenarios (slides 11 and 12). She wondered if the state should plan for the worst-case scenario to prevent it from getting into a situation where there would be no savings left to use.

Mr. Teal answered that the legislature had to balance the issue. He referenced charts in the presentation that would help them to weigh the decision. He stated that the legislature could wait to address any revenue enhancements; however, he believed taking two years to look at expenditure reductions with the knowledge that the budget could not be reduced sufficiently to fill the gap was a waste of time. He stressed that it took significant time to implement changes such as an income tax. He stated that it

may be necessary to wait until FY 17 to begin an income tax, which would mean revenue from the tax would not be received until FY 18.

Co-Chair Neuman stated that he and Co-Chair Thompson intended to take a conservative approach related to the price of oil. He remarked that if the price of oil increased there were savings that would need to be replenished.

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Vice-Chair Saddler pointed to Figure 1 and noted that there had been times in the past when there had been less revenue available than forecasts had projected. He observed that the state had dealt with the issue somehow. He asked how the state had handled the issue historically and how things were different at present.

Mr. Teal responded that the Constitutional Budget Reserve (CBR) had been created in 1981. He believed the establishment of the reserve had represented wisdom and foresight. He detailed that the fund had allowed the years where it had been possible to spend more than the state had; reserves had been built up when possible and had been spent in times of declining revenue. He observed that it was not as simple as letting numerous employees go and shutting down programs in one year and then hiring them back and restarting programs if revenue rebounded the next year. He stated that government was a very "slow to respond beast." He communicated that the state's reliance on oil as its primary revenue generator and the volatility of oil prices made it impossible for the state to respond. He remarked on the difficulty of budgeting with such volatile revenue and relayed that having reserves was the solution.

Vice-Chair Saddler asked whether there was an objective measure for the amount of reserves maintained in the CBR or other reserve fund.

Mr. Teal answered that no rule had been established; Alaska was in unchartered territory in comparison to other states. He elaborated that when other states had recessions their revenue dropped by 5 to 10 percent, which threw their entire state government into chaos; their responses to declining revenue included furloughs and reductions to items like K-12 funding. The other states had to respond

immediately due to a lack of reserves. He stated that the prudent level of reserves depended on volatility. He remarked that if a state had a very steady source of revenue it was possible to function with a small reserve; however, reserves needed to be high when the revenue stream was volatile. He relayed that at one time Alaska had approximately half of all of the reserve balances of all 50 states. He communicated that the National Conference of State Legislatures (NCSL) had removed the state from reserve charts because it distorted the numbers. He shared that some states did not maintain a surplus of revenue due to the belief that a surplus was not what state government was about. For example, some states refunded income tax in the event of a surplus. He discussed that the state prepared a budget every year based on the needs of Alaskans; revenue was secondary. He stressed that the reserves needed to be large, but he did not have a figure.

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Vice-Chair Saddler spoke to the accuracy of the DOR forecasting method. He wondered if recent changes had made the forecast more reliable.

Co-Chair Neuman replied that DOR could address the issue during its presentation to the committee the following week.

Mr. Teal elaborated on his prior statement that previously the state had considered the revenue forecast, but had not responded to it. He stated that it had become necessary to strongly consider the forecast. He disputed that state budgeted with such a large and optimistic forecast; the state budgeted based on need. He noted that a "band" was created to address what would happen if revenue failed to come in. He pointed to sensitivity charts on slide 12 that showed what would occur if oil prices did not live up to projections. He elaborated that in FY 15 the charts had used oil prices as low as \$90/bbl. He believed there was not a forecaster in the world who would have foreseen the decline in price. He advised the committee that a forecast could not be anything more than an educated guess.

Representative Pruitt referred to items the presentation classified as hard to cut (slide 13). He observed that three of the items had end dates sometime in the future. He

wondered how much debt service was outstanding and the timeframe it would take to pay it off.

Mr. Teal answered that most all of the debt issued was subsequent to 2005 (i.e. 2010, 2013, and 2015); most of the issuances were for 20 years. The debt service would decline, but the state was looking at debt into the 2030s.

Co-Chair Thompson recalled that the legislature had infused the unfunded retirement liability with \$3 billion the prior year. He pointed to projections the prior year that future annual payments would be \$400 million. He referred to an increment of \$260 million for FY 16. He wondered if the lower figure was a result of the 18 percent interest the retirement fund had made in the last year.

Mr. Teal replied that with retirement assistance, it was not possible to know "where it was going." He elaborated that in addition to depositing funds, HB 385 [legislation that increased funding of the retirement liability in 2014] had removed time lags, changed the amortization method, and other. He relayed that LFD had predicted the annual payment would be approximately \$350 million; however, there had been good returns in the past year. He detailed that the former methodology had been that the rate determination was always three years behind. Additionally, there was a five-year smoothing calculation.

Mr. Teal explained that there had been many attempts in the formula to make retirement contributions steady. He noted that it made sense when dealing with employers who did not want a payment rate to go up and down. The determination that municipalities were responsible for paying 22 percent was "rock steady" and would be for years to come. He communicated that the state did not really care about the volatility so the stabilizers had been removed to respond better to market earnings. He agreed that returns in the prior year had been positive, which had reduced the anticipated payment from \$350 million to \$260 million. However, poor returns would create additional or new debt, but the formula would pay off the debt over a 25-year period. He relayed that a loss of \$1 billion would have an impact, but it would not be massive. He did not expect the payment to jump around by \$100 million. He believed there would be a slow increase in the payment rather than a slow decline.

Co-Chair Neuman discussed the schedule for the following day.

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ADJOURNMENT

2:58:24 PM

The meeting was adjourned at 2:58 p.m.