

SENATE FINANCE COMMITTEE
April 22, 2015
1:36 p.m.

[1:36:02 PM](#)

CALL TO ORDER

Co-Chair Kelly called the Senate Finance Committee meeting to order at 1:36 p.m.

MEMBERS PRESENT

Senator Anna MacKinnon, Co-Chair
Senator Pete Kelly, Co-Chair
Senator Peter Micciche, Vice-Chair
Senator Click Bishop
Senator Mike Dunleavy
Senator Lyman Hoffman
Senator Donny Olson

MEMBERS ABSENT

None

ALSO PRESENT

Senator Kevin Meyer, Senator John Coghill, Senator Cathy Giessel, Representative Sam Kito; Representative Andy Josephson; Representative Cathy Giessel; Representative Tammie Wilson, Representative Les Gara David Teal, Director, Legislative Finance Division; Jerry Burnett, Deputy Commissioner, Treasury Division, Department of Revenue; Rob Carpenter, Budget Analyst, Legislative Finance Division;

SUMMARY

^PRESENTATION: ALASKA'S FISCAL CRISIS

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DAVID TEAL, DIRECTOR, LEGISLATIVE FINANCE DIVISION, explained that he would be discussing Alaska's fiscal crisis. He referred to the first graph on page 1, which showed a line graph; the blue line represented unrestricted

general funds, the red line represented expenditures. He said that the bar graph below showed the reserves balance into 2025. He stated that the model was currently set at the fall forecast, and at the Senate budget. He related that the graphs did not illustrate an unmanageable fiscal crisis. He pointed out to the committee that the billion dollar gaps in the budget had been closed due to the budget recently passed by the Senate. He relayed that the figures were roughly \$1 million below the governor's December 15th budget.

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Mr. Teal presented Slide 2, "Figure 1, Forecast of Total UGF Revenue - Fall 2014 vs. March 2015. He noted that the blue line indicated the fall forecast and the red line represented the spring forecast. In March the revised forecast dropped approximately \$400 million in FY 15, stayed the same for FY 16, and then the gap closed in FY 20.

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Mr. Teal turned to Slide 3, which illustrated that at the trajectory on Slide 2, the reserves were forecasted to be used up by 2022. He clarified that he was speaking of the constitutional budget reserve fund (CBR) and the statutory budget reserve fund (SBR).

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Co-Chair Kelly asked what had changed from Slide 1 to Slide 3.

Mr. Teal explained that the fall forecast had been replaced with the spring forecast on Slide 3.

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Co-Chair MacKinnon asked for the current price per barrel of oil. She queried the price points per barrel of Alaska North Slope (ANS) as projected past 2019.

Mr. Teal moved to Slide 4, "Figure 2. Alaska Unrestricted General Fund Reserve (Left Axis) and Average ANS Price\bbl (Right Axis)". He stated that the projected price was in the mid-60's, rising to \$130 by 2023. He said that the

problem was that the spring forecast, despite its downward revision, remained optimistic. He relayed that the new forecast listed prices never before seen. He opined that not only did the slide illustrate a rapid recovery in price, it went up beyond the highest average price the state had experienced.

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Vice-Chair Micciche asked for explanation on how the price ranges were determined.

Mr. Teal explained that Department of Revenue (DOR) produced the forecast, and that many sat in on the forecasting, including Legislative Finance Division. He said that everyone involved turned in their best guess and then left it to DOR to adjust the numbers as necessary before releasing the forecast. He stated that the forecast was DOR's best guess at oil price and oil production.

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Vice-Chair Micciche wondered why, historically, the state had been above industry estimates for oil prices.

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JERRY BURNETT, DEPUTY COMMISSIONER, TREASURY DIVISION, DEPARTMENT OF REVENUE, confirmed that Department of Administration used a variety of models and sources to formulate the forecast. He continued that the estimates were derived by the department's economic research group with input from the commissioner and tax director, and were similar to estimates from a number of outside sources. He contended that the department's estimates generally reflected industry estimates for oil prices.

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Co-Chair MacKinnon whether it was easier to project more accurate numbers closer to real time rather than far into the future.

Mr. Burnett replied that the department was much better at predicting the numbers for the short run instead of the long run. He said that sort range projections tended to be consistent with the NYMEX strip and other market forces,

whereas the future projections were based on an economic forecast over which no one had control.

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Vice-Chair Micciche stated that it seemed that there was a level of conservatism lacking from the forecasts.

Mr. Burnett commented that over the last several years there was additional conservatism built into the production forecast. He reiterated the difficulty in projecting far into the future. He directed committee attention to Slide 4, which he believed was a good linear interpolation of where the prices were, compared to what was forecasted.

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Co-Chair MacKinnon asked whether the state had shifted to a different type of forecasting prior to 1999.

Mr. Burnett said he could not speak to any change that had been made. He shared that the department engaged in a range of forecasts and probability levels resulting in a point price forecast for the Revenue Sources Book.

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Co-Chair Kelly commented that the department had done a fine job at forecasting a volatile commodity. He countered that the recent projections were too optimistic, given the current state of the market.

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Senator Dunleavy reiterated Co-Chair Kelly's comments about the overly optimistic oil prices used in the budget projections.

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Co-Chair Kelly thought as a product of the current meeting, the committee would further understand the forecast model and how different prices and different production levels would affect the money available for state operating expenditures.

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Mr. Teal referred back to Slide 4. He said that the difference between the revenue line and the price line was not an error; it illustrated that price and revenue correlated. He relayed that when the price was low, but production was high, the state still generated significant revenue. He asserted that it would not matter what the price was if there were little production. He said that, taking the DOR projection as a given variable, determining the most attractive price was impossible. He felt that the advantage of the forecast model was that the overly optimistic revenue forecast could be changed to reflect a more conservative price.

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Mr. Teal referred back to Slide 3, and adjusted the graph based on a hypothetical scenario of a \$70 price per barrel of oil. He pointed out that the fiscal crisis would be solved under the budget that the Senate passed depending whatever price you chose for the projection.

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Co-Chair MacKinnon asked what the forecast would look like using the current price of \$65 p/bbl.

Mr. Teal input the number and pointed out that the graph did not register a great deal of change.

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Mr. Teal referred to a Fiscal Sensitivity Chart (copy not on file). He explained that the revenue did not respond significantly until prices reached above \$80 p/bbl.

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Senator Bishop queried the number of barrels of oil produced daily in the state.

Mr. Teal responded that production was at approximately 500 p/bbl.

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Senator Meyer stated that he had heard rumors concerning increased levels of production. He thought that it would be

interesting to see what would happen when production increased. He held high hopes that production would increase before the price increased.

Mr. Teal said that he had no ability to predict the future; DOR crafted the production forecast based on field by field analysis, the Legislative Finance Division (LFD) did not have any data that would allow for the questioning of the production forecast. He asserted that price was really anybody's guess; but if the price remained where it was, even if production were to be substantially increased, there was not much per barrel at the current price. He reiterated that at current prices the state was not making much revenue.

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Senator Meyer reflected that the current problem mirrored financial issues from the late 1980's, except back then production was over a million barrels per day. He asserted that production mattered a lot.

Mr. Teal said that the rule of thumb in the 1980's was that for every \$1 change in the price of oil, the change in revenue was approximately \$150 million. He said that now for every \$1 change in the price of oil, the state saw roughly \$20 million. He contended that the difference was significant.

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Vice-Chair Micciche referred back to the sensitivity chart. He asked why the incline increased so dramatically at \$80 p/bbl.

Mr. Teal responded that that was how the production tax was designed. He added that the chart reflected the revenue at various prices.

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Mr. Teal referred back to Slide 3, and the hypothetical scenario of oil priced at \$70 per barrel. He said that were the price to be at \$70, there should be concern about a fiscal crisis because the fiscal gap would burn reserves rapidly. He stated that things could be done to ease the fiscal gap; the revenue curve could be increased, or the

expenditure curve could be decreased - if they coincided the budget would balance. He understood that some might label the current climate and Expenditure Crisis".

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Senator Hoffman understood that at \$70 per barrel, reserves would be depleted by FY 18. He asked by how much the state would be short in FY 18 to meeting a balance budget.

Mr. Teal stated the state would be short approximately \$3 billion dollars.

Mr. Teal explained that at \$70 p/bbl, after the budget that the Senate passed in FY 16, the fiscal climate would be flat; no growth, no decline. He said that the state could not operate at the deficit projected using those numbers. He said that there would be \$6 billion in reserves that would be accessible, but they would only last for 2 years.

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Mr. Teal summarized that the legislature needed to decide whether the expenditures line decreased or the revenue side increased.

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Mr. Teal presented Slide 5, "Figure 3. Per Capita Unrestricted General Fund Revenue and Budget History Adjusted for Inflation". He said that the slide reflected real per capita spending. In FY 16 the state spent roughly \$5000 per person, which was lower than almost any time in the past 40 years. He asserted that the legislature had not "spent their way into the problem".

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Senator Bishop asked whether part of the reason that departmental budgets had grown was because of deferred maintenance.

Mr. Teal stated that deferred maintenance was expensive to avoid, and that funding could be put into the capital and the operating budgets. He said that budget growth was due to deferred maintenance and unmet needs in the operating budget.

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Vice-Chair Micciche asked for a comparison of the fiscal crisis in the 1980's versus the current climate.

Mr. Teal surmised that without savings, there is no choice but to cut expenditures. He said that in 1991, the CBR was established to act as a shock absorber for budget reductions. He relayed that some would argue that the reserve had not acted as was intended because court cases and various interpretations had made it difficult to access.

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AT EASE

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RECONVENED

Mr. Teal discussed slide 6, "Figure 4. Cost Drivers--Agency Operations Contribution to Budget Increases FY06 to FY15 (\$ millions) \$1.9 Billion Total UGF Increase". He related that a common question was what had caused the growth in state expenditures. He noted that the chart illustrated the 4 primary budget drivers; K-12 Education, Medicaid, Salaries and Benefits, and Other Program Expansion.

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Co-Chair MacKinnon asked how much debt service was inside of the 34 percent for Other Program Expansion.

Mr. Teal explained that the slide was simply agency operations and did not include debt service. He added that debt service was classified statewide and was approximately \$230 million per year; while debt service had grown over the years it was still too small a driver to be considered. He concluded that some of the driver depended on the size of the program, as well as the rate of growth in the program.

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Co-Chair MacKinnon mentioned that debt service had been a huge issue in the past.

Mr. Teal clarified that Co-Chair MacKinnon was referring to state assistance for retirement as opposed to general

obligation debt service. He said that the actions that the legislature had taken in the previous year by paying \$3 billion into the retirement trust and refinancing the debt, reduced the state assistance to retirement from what would have been \$1 billion, to \$250 million. He furthered that, because of those actions, retirement assistance was no longer a cost driver. He suggested that the \$250 million could grow, but would most likely decline because healthcare costs were less than the retirement actuarial model showed them to be.

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Senator Dunleavy expressed concern about the lack of control over the fluctuating price of oil and the historically optimistic budgeting practices. He said that on July 5, 2008, the price of oil hit \$153 p/bbl; six months later the price was \$40 p/bbl. He shared some historical figures regarding the fluctuating price of oil. He reiterated the importance of applying conservative numbers to future budget projections.

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Mr. Teal referred to Slide 7, "Agency Operations, Percentage of Agency Operations budget (UGF Only)". He noted the roughly 30 percent of agency operations money went toward education, approximately 30 percent went to health and social services - much of that was Medicaid. He explained that between those two items was 6 percent of the budget, and then things dropped off to under 10 percent. He related that no much had changed from FY 15 to FY 16.

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Mr. Teal referred to Slide 8, "Agency Operations; Nominal \$". He said that the slide reflected the Senate's operating budget and that the highlighted cells noted the most comparable year. He said that the Senate had unwound 4 years of growth in a single year, which was a large accomplishment. He relayed that the level of reduction was deep and affected every agency.

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Mr. Teal looked at Slide 9, which illustrated the same numbers as slide 8, with the addition of FY 09. He did not

believe that many more cuts could have been made in the current operating budget.

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Co-Chair MacKinnon asked whether the spreadsheet would reflect differently if a federal overlay were applied, or other receipts. She inquired whether departments were responding by partnering with other sources, either through increasing their own receipt authority, or through federal government receipts.

Mr. Teal stated that federal receipts had been fairly steady, and after 2008 they had stopped increasing. He continued that other receipts had been relatively constant, but fees had not been raised in a number of years. He offered to calculate the total funds including the federal receipts.

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Co-Chair MacKinnon appreciated that the information would be provided at a later date.

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Vice-Chair Micciche pointed out the two biggest cost drivers on the slide were 2010 and 2012. He asked what the state should use as a metric for an acceptable level of spending per capita.

Mr. Teal stated that the per capita spending comparisons were available, but they were difficult to compare to Alaska due to great differences in the level of county and city involvement. He guessed that the state was likely on the high side of per capita spending.

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Co-Chair Kelly agreed that it would be difficult to compare Alaska with other states.

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Mr. Teal referred to a slide not in the packet "Figure 11.'Hard to Cut' Items in the Operating Budget". He stressed that cuts to the budget were difficult. He

asserted that for long-term sustainability, the gap between expenditures and revenue needed to be smaller.

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AT EASE

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Co-Chair MacKinnon commented that the legislature had been exploring the cost drivers for some time; for example, SB 64 had highlighted debt service pertaining to school construction. She asked what the legislature could do to drive down the total debt service number.

Mr. Teal said that the debt service was roughly \$230 million (UGF), the debt service reimbursement was general fund dollars and was included in the \$230 million. He stated that if school debt reimbursement were to be modified, debt service would fall. He believed that DOR did an excellent job at refinancing and refunding debt, and keeping the debt service as low as it could be given the level of debt outstanding.

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Co-Chair MacKinnon asked whether the school bond debt reimbursement was \$118 million.

Mr. Teal stated he did not have that number with him.

ROB CARPENTER, BUDGET ANALYST, LEGISLATIVE FINANCE DIVISION, confirmed that it was approximately \$118 million. [Mr. Carpenter gave this information from the staff table behind Co-Chair MacKinnon]

Co-Chair MacKinnon concluded that half of the debt service that the state was carrying was on school construction.

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Co-Chair MacKinnon asked if Mr. Teal had any recommendation on the remaining \$260 million in retirement benefits to be paid into the system by the state.

Mr. Teal said that the number for the retirement system would have been slightly over \$750 million in 2014. He

stated that the cost of retirement assistance would be \$257 million for 2015. He relayed that without the action taken by the legislature in 2014, the retirement assistance would have gone over \$1 billion in state assistance. He noted the \$500 million in savings would be a reoccurring savings. He explained that the state was currently looking toward a payment stream that would be between \$250 million and \$300 million over the next several years. He related that in looking at the reduction of retirement assistance, the state was picking up the cost for PERS and TRS employers, there were many options.

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Co-Chair Kelly asked if Mr. Teal could quantify recurring future cuts.

Mr. Teal referred to the \$500 million cut from the capital budget from the previous year, leaving only \$100 million. He argued that it would be difficult to cut another \$500 million from a \$100 million dollar budget, which meant that future cuts from the operating budget would be the only way to reduce expenditures in the future. He warned that a capital budget below \$100 million would mean that the state would not be making use of federal matching funds, and would not pay for deferred maintenance or emergencies.

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Mr. Teal spoke to the cuts to the operating budget. He discussed the cuts made to all four of the cost drivers, and referred back to Slide 3, explaining that even if the committee were to cut each category 10 percent each year through to 2024, budget reserves would still be exhausted by 2019.

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Senator Meyer asked for the current level of reduction.

Mr. Teal stated it was approximately 9 percent.

Senator Meyer asked about the oil tax credits, and whether they would they would sunset in the near future.

Mr. Teal stated that the tax credits for the current year totaled approximately \$750 million and were expected to be

\$250 million within the next few years. He said that the model included the reduction to \$250 million per year tax credit after 2017.

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Co-Chair Kelly asked whether the cuts that the Senate had made to the budget had been considered in the model reflected in the current presentation.

Mr. Teal answered in the affirmative, and referred to Slide 9. He continued that if 10 percent were to be cut from the K-12 budget each year, K-12 would drop to under \$500 million, Medicaid would drop from \$650 million to \$250 million. He thought that reaching those levels of expenditure would be difficult.

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Mr. Teal believed that the revenue measures should be looked at during the interim and carefully considered. He said that the cuts that the senate had made were deeper than he had imagined that they could be, he did not think that they were repeatable.

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Co-Chair Kelly asked Mr. Teal to compare the budget from the previous year to the budget that recently had been passed by the senate.

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Mr. Teal referred to Slide 3, and illustrated the scenario on the graph. He further adjusted the graph to depict the gap between revenue and expenditures to reflect having not made cuts the current senate version. He said that there was not a large difference in term of reserve burn even with the senate cuts, the reserves would still be up by 2018. He relayed that the difference could be seen in the long run; the \$4 billion gap became a \$3 billion gap.

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Co-Chair Kelly understood that in 2016, when the legislature returned to craft the FY 17 budget, the reserves would be depleted.

Mr. Teal replied no. He explained that the reserves would last through 2017. He warned that at that point expenditures would need to be drastically reduced, or revenue would need to be enhanced through taxes, or found in the earnings reserve, or other ways of using permanent fund earnings.

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Co-Chair MacKinnon understood that there would be some reserves left in 2017.

Mr. Teal agreed that the reserves would be end of year reserves and would not carry the state through 2018.

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Vice-Chair Micciche asked Mr. Teal to project the model with price sensitivity; what would the model look like at \$80 p/bbl.

Mr. Teal adjusted slide 3 to reflect \$80, \$90 and \$100 p/bbl. He said that things looked positive at \$110 p/bbl.

Vice-Chair Micciche queried the current methodology for the state's budget projections.

Mr. Teal responded that the state budgeted on the mean, and was unsure why the department had moved away from the high, medium, low forecast. He thought it was because the mean was used more often in budgeting causing people to lose interest in the high and the low numbers.

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Vice-Chair Micciche asserted that cuts needed to be made but other options should be explored. He felt that the problem was understanding how the state could operate efficiently while still delivering quality essential services.

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Co-Chair MacKinnon shared that the committee had examined the many difference cost drivers, addressing one component at a time.

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Vice-Chair Micciche queried for the logic behind the three quarters vote required to use the CBR.

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Senator Hoffman interjected that when the constitutional amendment was drafted, he was chairman of the House Finance Committee. He related that at the time the legislature had wanted a higher level of agreement, and it had been the position of the majority that it should be a two-thirds vote. He furthered that the republican minority had not wanted the number to be so low, so in order to get the votes the three-quarter number was instituted.

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Mr. Teal added that the framers of the amendment had intended it be to a "shock absorber" of sorts; the legislature could access the CBR with a simple majority vote, as long as no more money was spent than had been spent in the prior year. He said that in FY 17, the legislature should, without a supermajority, be able to draw as much as was needed from the CBR as long it does not exceed the FY 16 budget. He related that the courts involvement and subsequent ruling had led to a confusing interpretation and had led to the need for the supermajority vote because they counted the earnings reserve balance as available to spend.

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Senator Olson referred to Slide 6, and asked how much health insurance contributed to the cost of benefits.

Mr. Teal specified that approximately \$150 million of the figure on Slide 6 was health insurance.

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Senator Olson asked about the rate of inflation from 2006 to 2015.

Mr. Teal thought health costs had increased more rapidly, much more so than inflation. He said that there were periods of time that healthcare had risen by double digits,

while inflation was only 3 percent. He stated that healthcare costs had risen tremendously; the state currently spent \$1200 per employee, per month, on healthcare costs. He noted the \$350 million increase in roughly 10 years.

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ADJOURNMENT

3:02:49 PM

The meeting was adjourned at 3:02 p.m.