

HOUSE FINANCE COMMITTEE
January 20, 2017
1:32 p.m.

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CALL TO ORDER

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

MEMBERS PRESENT

Representative Neal Foster, Co-Chair
Representative Paul Seaton, Co-Chair
Representative Les Gara, Vice-Chair
Representative Jason Grenn
Representative David Guttenberg
Representative Scott Kawasaki
Representative Dan Ortiz
Representative Steve Thompson
Representative Cathy Tilton
Representative Tammie Wilson

MEMBERS ABSENT

Representative Lance Pruitt

ALSO PRESENT

David Teal, Director, Legislative Finance Division; Pat Pitney, Director, Office of Management and Budget, Office of the Governor.

SUMMARY

FY 18 GOVERNOR'S FY 18 BUDGET OVERVIEW: OFFICE OF MANAGEMENT AND BUDGET

FY 18 GOVERNOR'S BUDGET AND FISCAL SUMMARY: LEGISLATIVE FINANCE DIVISION

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Co-Chair Seaton discussed the meeting agenda.

^FY 18 GOVERNOR'S BUDGET AND FISCAL SUMMARY: LEGISLATIVE
FINANCE DIVISION

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DAVID TEAL, DIRECTOR, LEGISLATIVE FINANCE DIVISION, provided a PowerPoint presentation titled "Overview of the Governor's FY18 Budget Request" dated January 20, 2017 (copy on file). He intended to point out what he believed was the most important issue in the budget; he could not say why it had been done, but he could explain what happened. He encouraged questions throughout the presentation.

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Mr. Teal believed that looking only at the fiscal summary did not provide a perspective on where the numbers came from and how they compared to the past. He spoke to a chart (Figure 1) on slide 2 showing total agency operating budgets, statewide items and capital budget (unrestricted general funds (UGF) only). The black line represented revenue and the bars showed expenditures. He noted that expenditures had trended up from 2007 through 2014 and had fallen rapidly through 2017. He highlighted that FY 18 was indistinguishably close to FY 17. The current budget was not significantly different than the prior year budget. He addressed that the current year represented the sixth consecutive year of deficits, where expenditures exceeded revenue. The deficits were not the small-type that appeared if revenue came in under projections and the state was a bit light on its ability to fully fund the budget. As with the past five budget cycles, there was a very large structural deficit. He did not intend to address fiscal plans or look beyond FY 18 in the current overview.

Vice-Chair Gara pointed to slide 2 and observed FY 17 and the governor's proposed FY 18 budget was flat. He remarked it was much lower than the budget the legislature had passed the prior year. He detailed that the legislature had passed a budget the previous year and the governor had engaged in substantial vetoes because the legislature had passed no fiscal plan. He mentioned the budget related to education, pupil transportation, and foster care. He asked about the difference between the budget passed by the legislature and the governor's vetoes.

Mr. Teal estimated the vetoes added up to over \$1 billion. He detailed that a large portion was due to Permanent Fund Dividend cut of \$700 million. Oil taxes were vetoed down to the statutory minimum of \$30 million. He agreed that if the vetoes were restored to the FY 17 budget the chart would show a larger decline between FY 17 and FY 18.

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Mr. Teal relayed the state continued to struggle with deficits despite the spending reductions. He pointed to peak spending of \$9.4 billion, which had dropped to \$5 billion in FY 17 and FY 18. Many people were thinking the budget was \$4.3 billion; the current chart used a \$5 billion budget because it included the governor's \$700 million request for dividends.

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Mr. Teal stated that most Alaskans knew oil prices had fallen and were aware of the revenue decline. However, some people remembered when oil prices had been \$9 per barrel - those individuals reasoned that if the state had made it under such low oil prices that it should be able to make it under the current prices. When individuals heard about large deficits, it was understandable why people may think the deficits were due to constantly increasing expenditures. Even though people heard about General Fund expenditures dropping, they believed total expenditures must still be going up and they did not really understand the difference. He moved to a chart on slide 4 titled "Figure 2: Total Operating and Capital Budgets," in response to the notion that total spending had increased even as UGF went down. The blue portion of the bars reflected UGF. Designated general funds (DGF), other state funds, and federal funds were shown stacked on top of the UGF portion of the bars, which had been a pretty constant \$600 million. He continued that adding \$600 million to the bars resulted in the same pattern - increasing expenditures and then reducing. He pointed to an oddity in FY 15 due to a \$3 billion expenditure from the Constitutional Budget Reserve (CBR) for the [unfunded] retirement liability.

Mr. Teal continued that there had been a question in the Senate about much of the cost of government going to pay for positions.

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Mr. Teal moved to slide 5 and addressed total budgeted positions. He detailed that budgeted positions had fallen from about 25,000 to 22,000 (a reduction of 2,400 positions and approximately 10 percent). He returned to Figure 1 on slide 2 and pointed out that at the same time expenditures fell by about \$5.1 billion. He believed the easiest explanation of how the present differed from the past was that if the state had a \$5 billion budget back in the days of higher revenue (2007 through 2013), on average there would have been a \$3 billion surplus. Whereas, at present there was a \$3 billion deficit in FY 17 and \$2.7 billion in FY 18. The revenue decline was the component that had really hit the state hard. He did not believe "crisis" was too strong a word to use when describing the situation. He addressed that the state had built massive reserves during years of revenue surpluses. As long as the state had reserves to fill deficits, there really was not a problem. He continued that even the second year of low oil prices, arguably someone may say using reserves would be fine. Slide 6 showed what six consecutive years of deficits had done to the state's reserve balances. The CBR and Statutory Budget Reserve (SBR) had been up to over \$16 billion [in FY 13]; deficits had chipped away at the savings rapidly - they would only have about \$2 billion left at the end of FY 18, which was insufficient to get through FY 19 if business as usual continued. He elaborated that business as usual meant sticking to existing revenue sources, maintaining expenditures at the same level, and using the CBR to plug the deficits.

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Mr. Teal noted that spending in Figure 1 (slide 2) included spending from the [Permanent Fund] Earnings Reserve Account (ERA) for inflation proofing and dividends. He stated that the detail was handled differently in a presentation the committee would receive by the Office of Management and Budget (OMB). He continued that most of the charts in the OMB presentation excluded dividends. He continued that it was a way to make the proposed budget comparable to historic budgets. The Legislative Finance Division (LFD)

opted to include the dividend because it was an overview of what the governor did; LFD included dividends and inflation proofing in all historic budgets as well. He explained that there had been a major reclassification of expenditures due to the way the governor presented the budget. He pointed to a black dashed line representing total revenue, which showed that under the governor's proposed budget there was a payout from the ERA based on percent of market value (POMV). He detailed that the amount coming into the General Fund from the ERA was the POMV payout; the amount was roughly \$2.5 billion per year. When \$700 million was subtracted for dividends there was a net of \$1.8 billion - the pre-POMV revenue had moved up to match the post-POMV on the slide. He pointed to the solid black line (UGF revenue) below the dashed line (total revenue) and explained that the fiscal gap that had been \$2.7 billion was reduced to under \$1 billion after the transfer from the ERA. He considered the transfer to be the issue in the budget. He did not disagree with any of OMB's fiscal summary numbers. He concluded that the differences between the LFD and OMB presentations of the governor's proposed budget was insignificant.

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Mr. Teal continued to address the chart on slide 2. He noted that the FY 17 and FY 18 budgets were very close in terms of money spent. The significant point was that the ERA transfer was classified as UGF. To illustrate his point, he addressed how ERA appropriations had been treated in the past (slide 7). The slide showed a portion of the FY 16 fiscal summary, which showed that DGF (including dividends) totaled \$941 million. Below the sum, dividends were listed as \$1.4 billion. He stated that it should be obvious that the \$1.4 billion was not included in the DFG total of \$941 million; it was not included in any roll up because since the inception of the Permanent Fund, the ERA had been effectively "off-budget." He elaborated that expenditures and revenue from the ERA had not been counted. He stated it was a major switch in policy or in the way things were classified - it had a very significant impact on the way people may view dividends. He continued that the ERA was now classified as UGF, dividends were UGF payments, which was a more technical way of indicating that under the governor's proposed budget, dividends would compete with K-12 and all other UGF expenditures. Dividends were no longer "off-budget."

Mr. Teal returned to Figure 1 on slide 2, which included dividends as general funds. The chart included \$2.5 billion

flowing in, less the \$700 million flowing out for dividends; dividends were included in the bars and in revenue on the chart. He explained that FY 17 looked much the same because the governor's operating budget included a supplemental FY 17 appropriation from the ERA to the General Fund for the POMV payout. He remarked that it was not obvious in the bill that the appropriation was a supplemental request. The governor could request anything he wanted, but it did not necessarily mean the legislature had to fund it. The Legislative Finance Division was presenting the budget as submitted by the governor.

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Mr. Teal continued to address slide 2. He explained that the ERA off-budget status had been a reporting problem since the inception of the Permanent Fund. The courts had clearly stated that the ERA was available for appropriation for any purpose at any time, which would normally make the funds UGF. He emphasized he was referring to the full balance of the ERA, which could be spent at any time. The discussion was about how to get the distortion out of the reporting. He referred to FY 18 and its \$2.7 billion deficit. He detailed that if the desire was to report the ERA balance as spendable UGF, it would mean \$10 billion could be added to the state's revenue - suddenly the state would go from having a deficit to having revenue exceeding \$10 billion and expenditures of \$5 billion, which would mean a budget surplus in FY 18. He reasoned that thinking the state had a surplus could impact attitudes in the building about spending. On the contrary, being in a deficit situation probably made people think more about expenditures because there was not an available surplus. He explained the format predated his time with the Legislative Finance Division. The significant implication was the reclassification to UGF should have been done a long time ago. The ERA had designated spending purposes in statute, which allowed the fund to be classified as designated. The statutory designations were for inflation and dividends. He relayed that the proposed budget included no inflation proofing and the appropriation for dividends came from the General Fund. Therefore, neither of the designated purposes of the ERA were being met; in fact, the only purpose of the ERA was to transfer money to the UGF. Given that fact, he asked how the money could be classified as anything other than UGF.

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Mr. Teal turned to the fiscal summary on slide 9. He reviewed the four fund classifications in reduced amount of discretion. He specified that UGF could be spent by the legislature for any purpose, while DGF had a stated statutory purpose (using the funds for that purpose was not required - the funding was not dedicated, it was only designated). Other funds were often dedicated by the Alaska Constitution or by federal rules (e.g. Fish and Game funds with limited purposes). Federal funds often had strict limitations. Expenditure categories included agency appropriations, statewide appropriations, capital appropriations, and the ERA appropriations.

Mr. Teal pointed to agency operations in the second to the last column, third row down - the proposed FY 18 budget reduced FY 17 agency operations by \$121.5 million. He turned to slide 10 and addressed Figure 6: Partial View of the Fiscal Summary. He believed OMB would provide detail on the differences between the FY 17 and FY 18 budget. He intended to address the management plan budget, which was the budget the Executive Branch had started FY 17 with. He explained that LFD had removed some items from its FY 18 budget explanation as directed by the legislature. He furthered that the State of Alaska budget was not like some states or governments that used pure incremental budgeting where once something was in the budget it remained in the base. One-time items had been added to Alaska's budget - things that caused increments to be removed from the budget the following year. In that vein, the governor started FY 18 with an easy removal of \$63 million. Similarly, there were other temporary increments (e.g. three to five-year increments), which were small and not enough to worry about.

Mr. Teal continued that the \$12.4 million maintenance increments had been put in the language during special session the previous year as part of the negotiations to secure the supermajority vote to gain access to the CBR the previous session. The proposed budget included some salary increases; it did not really mean contractual salaries as much as it had in the past - contractual salary increases were near zero because of the renegotiated contracts. The increment pertained primarily to health cost increases. There was also funding related to language and carry forwards that was minimal.

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Mr. Teal addressed the FY 18 adjusted base on slide 10. The governor had begun FY 18 with an automatic \$30 million reduction given by the legislature; therefore, the budget started at about \$3.8 billion. In addition to the built-in reductions, the governor had submitted decrements of \$38 million. Decrements were offset with \$31 million of increments. The largest adjustment pertained to fund changes [\$83.9 million]. He detailed that most of the fund change increment was \$70 million for motor fuel - many people believed it was not fair because motor fuel had been UGF revenue and expenditures in the past. The governor had moved the funds from UGF to DGF. He elaborated that because the change decreased DGF spending, it was possible for someone to say that the governor's distorted UGF spending by \$70 million. He continued that it was not a significant problem - the motor fuel taxes could have and perhaps should have been designated the entire time. The statutes specified the taxes were to be used for highway maintenance at present. He elaborated that new law was not needed to move the funds - it was merely something that had been missed when making UGF and DGF classifications. He explained that moving the funds did not really cost any money; the entire proceeds of the motor fuel tax was spent, and it helped the deficit because there was \$35 million in additional revenue. He continued that it did not really matter whether the item was UGF or DGF. Some fund source changes were more advantageous.

Mr. Teal pointed out that the Other spending category had increased (slide 10). Much of the increase related to the Department of Fish and Game. He reminded committee members that [the cost of] hunting and fishing licenses had been increased by the legislature, meaning that more money went into the Fish and Game Fund (an "Other" dedicated fund). As Fish and Game Fund expenditures increased, UGF could decrease. There was another reduction of \$30 [million] from the base, resulting in the same \$121 million shown in the fiscal summary pertaining to agency operations. He relayed it was defined as the day-to-day operations of government. The fiscal summary did not show that pupil transportation was not fully funded. He detailed that there was no change from FY 17 to FY 18 because the governor vetoed \$6.3 million from pupil transportation the previous year and did

not restore or replace the money in the proposed FY 18 budget.

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Vice-Chair Gara looked at slide 10. He spoke to the prior year's UGF spending that was artificially lower because the legislature had used substantial DGF to fund normal things - things that would have normally been funded with UGF. The situation meant it was much harder to cut the previous year's UGF budget because it was artificially low. He asked about the kinds of DGF spent the previous year that made UGF spend look lower. He believed the items included Power Cost Equalization (PCE) and higher education.

Mr. Teal suspected the governor would agree it was hard to cut from general funds given the circumstances of using DGF the previous year; however, the governor continued to use some of those DGF sources in the proposed budget. He noted that it had not occurred as much in agency operations as it had in other areas. He turned to Figure 7 on slide 11. He highlighted that debt service had a \$27 million increase. He noted that the increase in the debt service may be recognized if one recalled the governor's veto of school debt reimbursement the previous year. The proposed FY 18 budget would fully fund school debt reimbursement. Community assistance had zero funding in FY 17 because Figure 7 only included UGF. He explained that community assistance had been funded the previous year with DGF (the PCE Fund). Theoretically, PCE investments were supposed to fund community assistance in the current year as well (assuming there were earnings in excess of PCE's needs). He noted the program subsidized rural energy. The hope was that the approximately \$950 million PCE Fund would spin off enough earnings to fund the PCE program and community assistance. He elaborated that PCE consumed \$35 million to \$40 million in the current year. The state had hoped for earnings in excess of that, but the earnings had been about \$9 million, which was not sufficient to fund even the PCE needs. There was no money in the FY 18 budget for community assistance. He explained the \$30 million flowing out of the program annually would flow out in FY 18, but unless the \$30 million was replaced in FY 18, the fund balance would drop and the payout in FY 19 would drop. Instead of \$30 million, the amount would be reduced to \$20 million in FY 19 to be spread amongst communities (unless community assistance was funded).

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Mr. Teal spoke to FY 17 oil and gas production tax credits of \$30 million UGF on slide 11. There had been a large governor's veto the previous year down to the minimum statutorily required funding. With higher oil prices, the minimum statutory requirement was \$74 million in FY 18. The governor was stuck with a \$44 million increase in that area. He continued that because the governor vetoed municipal debt service there had also been a reduction in the Regional Educational Attendance Area (REAA) school fund because the two programs were tied together. With the full funding of municipal debt reimbursement, the REAA fund was also fully funded (a \$9 million change in UGF). Other fund capitalizations represented a smaller increment.

Mr. Teal spoke to retirement costs and referred to Vice-Chair Gara's comment that the Higher Education School Fund had been used; \$90 million had been a big use of higher education funds in FY 17. The numbers from the previous year showed that in FY 18 the state's requirement for paying assistance to school districts, municipalities, and the state itself, would fall by \$90 million. The idea had been to take advantage of the opportunity by using a one-time funding source, meaning that the \$90 million would not have to be replaced in FY 18. The scenario had not played out as desired; rates had fallen by \$30 million instead of \$90 million - there was still \$60 million of higher education money being used for retirement assistance. Higher education money continued to be used in other programs as well - he did not believe the number exceeded \$12 million to \$15 million. The money was still used in agency operations, primarily for programs in the Department of Education and Early Development (e.g. Washington, Wyoming, Alaska, Montana, and Idaho (WWAMI), museums, mentoring, and other). Judgements and claims were down from the previous year - the Moore Settlement related to education funding. Capital spending was up by \$19 million, which was no surprise.

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Representative Grenn asked about the investment strategy of the PCE Fund. He wondered why the balance had been so low in the past year and how it compared to years past.

Mr. Teal responded that the issue was not about investment strategy. He detailed that the at one time the funds had been invested to make a 7 percent payout (a fairly high return) and the returns had been achieved. The returns were based on FY 16 - the calculation lagged one year to know how much money the fund had instead of trying to make predictions. He continued that retirement funds lost around 0.04 percent the in FY 16. He continued that PCE had been slightly better, but a \$9 million return on a \$900-plus million fund was not very much. He did not believe the issue was as much about investment strategy as it was about a bad financial that had impacted the Permanent Fund, retirement funds, and the PCE Fund; all had done relatively poorly compared to most years.

Representative Grenn asked for verification he was referring to 2016. Mr. Teal responded in the affirmative.

Representative Wilson referred to the motor fuel tax that was supposed to be designated for highway maintenance. She remarked that the funds also went to public safety, which was not related to highway maintenance. She asked if it did not make the point that the funds could be used for anything, although maybe within legislation "it might emphasize going somewhere."

Mr. Teal replied it did make that point. His office had spoken with the Department of Public Safety (DPS) about the issue. The department contended it was a fine use of the funds because, for example, the department responded to accidents on the Glenn Highway. He countered that LFD did not buy the argument. He reasoned the service was not classified as highway maintenance in most people's view. However, it emphasized the fact that designated funds, regardless of their designated purpose, could be spent by the legislature for any purpose. There was an LFD report his office could run that showed all non-designated uses of designated funds.

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Representative Wilson referred to the governor's desire to put a significant part of the ERA into the General Fund (including the dividend). She asked about the benefit of all the different funds, when they could be used for whatever the legislature wanted. She surmised it would be clearer for investors if the money was all located in one

area to have visibility of the total savings. She remarked that expenditures on PCE, higher education, highways were all appropriated within the General Fund. She wondered about the benefit of having separate funds.

Mr. Teal believed the framers of the [Alaska] Constitution would agree completely - they had tried to avoid the situation by prohibiting dedicated revenue. The state had veered very far from that original intent, while remaining within the constitutional requirements. He underscored that funds were designated, not dedicated. If the designations were followed, there was not a large difference between a designation and a dedication, except legal. The designated funds could all be used for whatever purpose the legislature chose. He questioned why the money was not counted as available to pay any state obligation, which was what investors had said. He noted that the revenue forecast included discussion on the point - Wall Street indicated Alaska did not have as big a problem as it indicated because it had much more revenue available than it was reporting. For that reason, the ERA had been moved to UGF. The issue could be taken another step by saying that all the designated funds were simply fooling the public, while others would say they really did want cigarette tax used for health services or alcohol tax used for alcohol rehabilitation. It was simply one legislature specifying that a particular revenue source should be used for a specific purpose; however, one legislature could not bind the hands of future legislatures.

Representative Wilson surmised that the various revenue sources were all invested differently than if they were all commingled where a portion could be invested more aggressively. She thought it would be helpful to know about all the different funds and their amounts to get a better understanding of how well the state's money was working - prior to consider taking money from the people. She wanted the ability to compare the funds' returns to the ERA, CBR, and SBR.

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Co-Chair Seaton believed the report was available on the LFD website.

Representative Wilson responded that the report did not disclose how the funds were invested. She stated that some

of the funds were invested more aggressively than others. She believed it had been pointed out with PCE that required an aggressive investment strategy to hit its 7 percent return target. She did not believe the detail was on the website.

Mr. Teal agreed. He detailed that page 2 of the LFD fiscal summary included a number of the large reserve funds; however, the Department of Revenue's (DOR) website showed individual funds with balances and returns. He did not know how many were available, but the information would come from DOR. Additionally, the Permanent Fund published monthly projections. Information about the PCE Fund and others should be on the DOR site.

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Vice-Chair Gara agreed with Representative Wilson. He spoke to the prior session, which he believed was extreme related to people trying to make UGF expenditures look smaller by spending a substantial amount of money from DGF. He stated that many legislators would be judged by what they had done to the UGF budget compared to the previous year; however, the previous year's UGF budget looked much smaller than it would have if there had been lower DGF spending. He believed it was a fake comparison. He wondered if there should be a category showing the use of DGF to pay for UGF spending. He asked if there should be a category of combined DGF and UGF spending. He reasoned it reflected state spending. The public wanted to know about state spending and did not care about how it was named.

Mr. Teal answered that the fiscal summary on slide 9 showed the information. The slide did not provide a comparison, but the math could be done if desired. He elucidated that DGF, other, and federal funds were fairly consistent from year-to-year. It was not the classification of those funds that was inconsistent; the inconsistency was the use of the funds. He continued that it was as Vice-Chair Gara had specified - if the designated funds (i.e. Higher Education Fund) were drained by using \$100 million to \$150 million UGF for non-designated purposes, the fund would not have the ability to pay for its intended purpose. He elaborated that if the Higher Education Fund was used beyond the current year [for other items], it would not pay grants and scholarships. One of the problems was that people compare spending levels, which he did not believe should be done.

He specified that spending levels were easily distorted, and it was much better to look at the deficit. He moved to Figure 7 on slide 11. It was much easier to look at the deficit. For example, the spending level could be cut by \$700 million or \$800 million at present - all the legislature had to do was pass a law that incoming royalties were put into the Public Education Fund and were to be used for education. He explained that the outcome would be reduced UGF spending by \$700 million to \$800 million; the use would be classified as designated. The action would also reduce the revenue stream by \$700 million; therefore, the deficit would not have changed. He encouraged the legislature to focus on the deficit and not on the spending level.

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Mr. Teal moved to Figure 8 on slide 12. The capital budget was up \$19 million, which was no surprise because a number of one-time fund sources had been used the previous year. The proposed capital budget was the bare minimum required to get available federal match - there was not much in the budget that was just pure state projects. The total budget authorization shown on the slide was \$4.3 billion. He reminded committee members that in Figure 1 he had talked about the \$5 billion budget. In the old way of doing business, expenditures would have been specified as \$4.3 billion and the deficit was \$2.7 billion; however, the current budget added the ERA.

Mr. Teal turned to slide 13 to illustrate his point with Figure 9. The figure compared the previous way of doing things (base) [with the governor's request]. He detailed that the base method excluded the POMV payout (\$2.5 billion) from revenue and the additional royalties under the Permanent Fund Protection Act (PFPA). He elaborated that it referred to changing the flow of royalty oil [revenue] to the Permanent Fund from the constitutional 25 percent plus the existing statute's 25 percent of new production. The PFPA would repeal the extra 25 percent from the fields, meaning it would go to the General Fund instead of the Permanent Fund. He continued to address the base method. Spending would be the governor's proposed budget, with dividends classified as DGF. There were no revisions to what was considered traditional revenue sources - base revenue (primarily from oil). The total authorization was

\$4.292 billion. He pointed to the \$2.7 billion deficit shown at the bottom of Figure 9.

Mr. Teal continued to review Figure 9 and addressed the governor's request [in comparison to the base method discussed above]. Revenue was slightly higher - the Capital Income Fund was added because it was a part of the ERA and was considered UGF revenue under the governor's request. He pointed to the POMV payout and extra revenue coming from royalties (\$55 million) that would be diverted from the Permanent Fund to the General Fund. Revised revenue was approximately \$4.2 billion. The spending level was the same, but dividends were counted as UGF. The Capital Income Fund moved from other classifications to UGF. The governor's request showed a \$5.1 billion authorization and an \$874 million deficit. The method used in the governor's proposed budget was a different way of looking at the budget. He underscored that it was not possible to use the different methods in FY 17 and FY 18 with an expectation there could be a comparison. Even though the governor's budget included the dividend as part of general funds, to make things comparable OMB had presented the information by subtracting dividends from the various expenditures. He believed OMB would address the method during its presentation to the committee. He hoped OMB would explain why it had used the particular method.

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Mr. Teal turned to Figure 10 on slide 14. He addressed the types of holes in the budget. The deficit was \$870 million to \$900 million in FY 18. He explained that if the motor fuel taxes were not reclassified, UGF expenditures would increase by \$70 million. He underscored that the money was being spent at present, but as DGF. He stated that if the legislature wanted to fund community assistance it may find other fund sources or may decide to pay with UGF. The legislature may decide it did not want to use higher education funds to pay for retirement assistance (UGF was used as well). The proposed budget included no school construction or major maintenance; there was no \$10 million or \$25 million for University deferred maintenance. Oil tax credits were currently \$74 million - the legislature could choose to fund them at \$974 million. The legislature was not necessarily looking at holes, because they did not have to be filled, but they were issues that needed to be addressed. If the legislature chose to address the issues,

it was looking at a deficit of roughly \$1 billion. He did not want to get into how the legislature may fill the deficit; it pertained to a fiscal plan.

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^FY 18 GOVERNOR'S FY 18 BUDGET OVERVIEW

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PAT PITNEY, DIRECTOR, OFFICE OF MANAGEMENT AND BUDGET, OFFICE OF THE GOVERNOR, introduced herself and provided a PowerPoint presentation titled "FY2018 Budget Overview: House Finance Committee" dated January 20, 2017 (copy on file). She agreed it had been helpful to have Mr. Teal provide the LFD overview first. She agreed with the construct of including UGF in total to reduce confusion. She turned to slide 2 titled "Alaska's Budget in Household Terms." She reasoned it was challenging to get people to understand the large numbers and the presentation attempted to boil the information down to common household terms. She reviewed the slide:

Income has dropped more than 80%

- Your annual income dropped from \$80,000 to \$16,000

Spending has been reduced 44%

- You have been able to reduce your rent or mortgage, heat, food, every day travel, and vacations. You stopped building your cabin, stopped remodeling, and you'll keep your old car.

Expenses have been cut from \$80,000 to \$45,000

Savings has one year remaining

- You had \$130,000 in the bank, but now only \$25,000

Investment accounts have been growing steadily

- You have \$500,000 in an IRA and you need to decide whether to use it and how much you can prudently use

An income/spending gap remains

Ms. Pitney elaborated that the state's investment account had to last in perpetuity.

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Ms. Pitney turned to slide 3: "Governor Walker's FY2018 Fiscal Plan":

To foster safer communities, resource development, and economic security requires sustainable and balanced budgets long term, and to that end the Governor's

FY2018 budget is comprised of three necessary elements:

1. Continue to reduce state spending
2. Draw from Permanent Fund earnings to support vital state services and protect the dividend
3. Generate more revenue

Ms. Pitney expounded that the Permanent Fund Protection Act (PFPA) had three protections: 1) it protected the fund's value, growing with inflation; 2) the Earnings Reserve Account (ERA) was protected to ensure available funding; and 3) the dividend payout of approximately \$1,000 per person was protected. She spoke generating more revenue and relayed the administration was comfortable working with the legislature on additional broad-based tax to fill the budget gap. The administration believed that over time oil would increase to \$60 per barrel on average; therefore, the necessary additional tax would be between \$600 million and \$700 million (beyond what the governor's budget proposed).

Ms. Pitney relayed that the pie chart on slide 4 titled "FY2018 Budget by All Fund Sources" provided an illustration of all funds that came through the state. One-third of the state budget came from federal funds (shown in blue). The administration had looked for ways to maximize the federal funds. She listed Medicaid expansion and ensuring the state met matches for the Department of Transportation and Public Facilities (DOT) and water and sewer projects as examples. Federal funds were equally split - one-third came from DOT highway funds, one-third came from Medicaid, and one-third was classified as "all other" (the University comprised a large portion of the last segment). She reiterated the importance of federal funds and expressed the administration's hope that the funds increased. She explained the concept was the same as trying to keep the military in the state. Additionally, the

budget included 7 percent Other funds, 10 percent designated general funds (DGF), 7 percent Permanent Fund Dividend, and 42 percent or \$4.3 billion in unrestricted general funds (UGF). Including the dividend, the UGF portion of the budget was \$5 billion.

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Ms. Pitney continued to slide 5 titled "FY2018 Unrestricted General Fund Spending Without Dividends: \$4.3 Billion." She relayed that she preferred Mr. Teal's slide showing all funds over time (adjusted). She addressed major spending categories in FY 13, FY 15, and FY 18. Categories included agencies without K-12, K-12, retirement contribution and debt, capital, oil and gas tax credits, and dividends. She referred to the retirement contribution and debt and explained that if the legislature had not deposited \$3 billion into the retirement account, the retirement and debt expenditure would remain near the FY 13 level. The \$3 billion had dramatically reduced the ongoing retirement liability and had helped significantly. She noted that capital spending had been reduced dramatically from close to \$2 billion in FY 13 to just over \$100 million in the proposed FY 18 budget. Tax credits were down to \$74 million and the dividend was \$695 million. She pointed to the green bars that represented FY 18 UGF spending and explained that the various categories represented options where reductions or increases could be made to increase or decrease savings.

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Ms. Pitney moved to slide 7: "FY2018 Unrestricted General Fund Operating Spending Without Dividends: \$4.2 Billion." She reported that UGF spending had decreased from a peak \$6 billion to \$4.215 billion; it represented a small decrease from FY 17. She turned to slide 8 that provided a historical perspective of the UGF agency operating budgets. Agency operating budgets totaled approximately \$3.7 billion at present; it was nominally the same level it had been in FY 11 (a rollback of seven years). When only factoring in inflation, the budget was equivalent to FY 08 levels. When adjusting for inflation and population the budget was back to FY 02 levels.

[2:48:03 PM](#)

Co-Chair Seaton asked whether the UGF agency operations on slide 8 included DGF. He was interested in the total agency expenditures. Ms. Pitney answered that slide 8 only included UGF for agency operations. She believed she also had the graph for DGF. Co-Chair Seaton asked Ms. Pitney to send the information. Ms. Pitney agreed.

Ms. Pitney turned to slide 9 titled "Budget Guidance to Agencies." The slide included questions OMB had asked commissioners when it began developing its agency operating budget. She was pleased the questions were similar to the ones asked in the legislature's subcommittee process. She shared that OMB had looked through an analysis of constitutional and statutorily required programs and 96 percent of the budgetary components had a statutory requirement. She clarified it did not mean every dollar within the components was statutorily required. She explained it meant that making further reductions, similar to what had been done with justice reform and Medicaid reform, in many cases it would require statutory changes.

Ms. Pitney addressed slide 10 titled "All Agencies are Making Reductions." The graph showed reductions in UGF with two adjustments. The right side of the graph showed the percent reduction for each agency and the left showed the dollar amount. She specified that the Department of Commerce, Community and Economic Development (DCCED) and DOT each had an adjustment. The adjustment for DCCED was the removal of the tourism budget at the beginning and the end to normalize for the tourism budget that had been moved to the capital budget; DCCED had the largest reduction at 54 percent. She elaborated that DOT had been reduced by 22 percent to adjust for the motor fuel tax fund change.

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Vice-Chair Gara referred to the fund change in the motor fuel tax. He knew the governor had proposed a motor fuel tax increase. He asked for details about the change in categorizing motor fuel tax revenue.

Ms. Pitney answered that a motor fuel tax bill had been submitted by the governor. The designation was for infrastructure (i.e. highways, airports, marine, infrastructure, and safety). Because the classification was DGF, she was comfortable in the concepts discussed that things coming from General Fund could be classified as UGF

(e.g. alcohol tax, motor fuel tax, Power Cost Equalization, Higher Education Fund, and other). She believed things the legislature was paying directly for should remain DGF (e.g. tuition for a student, ferry fares, business licenses). She explained it would be a weird public policy to use tuition fees for something like public safety. She used ferry fares and business licenses as another example and believed the fees were appropriately DGF. She agreed it would make the future look more transparent. She added that OMB took its lead on the designations from LFD with the exception of the proposal on motor fuels.

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Vice-Chair Gara asked if the budget included the presumption the legislature was passing the governor's motor fuel tax. He believed that was unique and did not fall in the normal process.

Ms. Pitney replied that typically the state was not in the current budget situation. The previous year the administration had proposed the Permanent Fund Protection Act (PFPA) and nine revenue bills, it had presumed they would all pass. The same question had been asked at that time, but with much more consternation. She continued that it was a proposal; a bill had been submitted for the motor fuels tax and the PFPA. She conceded it was not traditional, but a sixth year of deficits was unacceptable.

Co-Chair Seaton remarked that the DOT budget showed a [UGF] reduction of 22 percent [on slide 10]. He asked if the reduction included revenue from the motor fuel tax. He wondered if the reduction was much greater than 22 percent because projected revenue was included.

Ms. Pitney answered if the slide only looked at the UGF and the reduction from FY 15 to the FY 18 proposal, it would be closer to 45 percent. She explained that the \$70 million that had been reclassified had been normalized. The true reduction was 22 percent; DOT's operating reduction had been reduced by 22 percent.

Co-Chair Seaton surmised it was through FY 18 including the designated revenue from the tax. Ms. Pitney agreed.

[2:57:26 PM](#)

Representative Ortiz referenced the cycle of consistent reductions to agencies. He furthered that Ms. Pitney had talked about having to determine whether services were constitutionally required or mandated in some way. He asked if agencies had been given an opportunity to tell the administration how well they were able to fulfil their mission, based on the reductions that had occurred. He wondered if agencies had been able to say how their ability to do their job was being hurt.

Ms. Pitney replied there had been numerous discussions. She stated it was very difficult for the reductions to occur; it was very hard for the agencies to continue levels of service with significant reductions. She relayed it had been a big part of the ongoing discussion. She continued that then it was a reality check to determine if they really wanted to "do this."

Representative Ortiz asked if the discussions included the potential overall impact to the economy and other.

Ms. Pitney answered that the office was conscious and aware there were choices; they were trying to make the best choices, while maintaining as much of the economy as possible. One of its main choices was to ensure the state continued to meet its federal matches. She relayed that losing more federal funds had a tenfold impact on the state's economy. The administration had also considered ways to shift funding - much of the Medicaid expansion efforts had been to use federal funding for things that had previously used state funds.

[3:00:21 PM](#)

Representative Wilson pointed to the Department of Health and Social Services (DHSS) and remarked that slide 10 only pertained to UGF. She referred to a bill sponsored by Senator Pete Kelly that had passed, which aimed at using waivers and federal funding. She noted that some of the UGF that had been removed from DHSS had been replaced by federal funds and programs were still in operation.

Ms. Pitney agreed.

Representative Wilson asked if there was a graph depicting items that would have been funded by UGF if it were not for federal funds or motor fuel tax funds. She remarked the

chart made it look like a bigger drop in services, whereas, it was more of a transfer of funds to DGF or federal funds.

Ms. Pitney answered she could provide the total funds over the timeframe.

Co-Chair Seaton would provide the information to committee members.

Ms. Pitney continued that one of OMB's primary goals was to capture the federal funds around Medicaid expansion (\$300-plus million into the state's economy) at a time when substantial funding was taking place through other cuts.

[3:02:07 PM](#)

Ms. Pitney addressed a pie chart showing UGF agency operating budget priorities on slide 11. She explained that the chart helped reflect the priorities and where money was pulled from. She specified that UGF funding for education, the University, and the Alaska Vocational Technical Center (AVTEC) was down 9 percent and accounted for 43 percent of the state's budget. She furthered that UGF funds for health, life, safety, and justice (the Department of Corrections, the Department of Public Safety, DHSS, the Office of Public Advocacy, the Public Defender Agency, and the Court System) was down 13 percent and accounted for 44 percent of the state's budget. She relayed that UGF funding for all other executive agencies (Alaska State Legislature, Office of the Governor, Department of Administration, Department of Labor and Workforce Development, Department of Revenue, and other) was down 41 percent and accounted for just over 10 percent of the state's budget.

Co-Chair Seaton asked if the agency operating budgets [on slide 11] reflected grants.

Ms. Pitney answered that the slide included grants. She elaborated that 46 percent of the operating budget represented money directly out the door to an organization, community, and other. Only 44 percent remained in government. The 46 percent included all funds - including Medicaid.

[3:04:39 PM](#)

Ms. Pitney turned to slide 12 and addressed ongoing cost containment efforts to continue reducing spending:

- 2500 fewer state employees since FY2015
- State employee savings through eliminated pay increases, furloughs, and healthcare cost passed to employees
- Executive branch travel reductions
- Reduced and consolidated leases

Ms. Pitney elaborated that the governor had introduced pay freeze legislation in the current year - prior to the current year, cost of living allowances (COLA) had been eliminated and all union contracts had been negotiated during the current administration. Healthcare cost had been passed on to employees to limit how much the state had to cover in the employee health insurance plans. Executive branch travel was expected to be down by 41 percent by the end of the year. Additionally, 100,000 square feet had been reduced in lease facilities, which amounted to \$3 million.

Vice-Chair Gara stated that the Alaska Court System had pitched something that was working successfully in terms of cost savings. He discussed that the state used to have what he considered "crazy" early retirement programs that had always been controversial. The Court System had proposed to employees who were at least three years into being eligible to retire that they could retire early with three months' severance pay. The negative side was losing knowledge, but the benefit was people who were high-step employees with high salaries would be replaced with younger workers at a great savings. The Court System relayed that the option had saved a substantial amount of money. He asked if other agencies had considered the option voluntarily.

Ms. Pitney answered that many people had already elected to retire, which was part of the 2,500 fewer paychecks (listed on slide 12); very few of the positions were being replaced at present. The idea of a retirement incentive program often involved an employee that would require hiring three people to replace them. She furthered that the option was a consideration and would have to be done in a smart way and would involve the unions. She stated it would also be across the board instead of targeted as the courts had done.

Vice-Chair Gara noted the positive side meant replacing tenured employees with people looking for new job opportunities entering the workforce at a cost savings.

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Ms. Pitney returned to slide 10. She pointed out that Judiciary had received the lowest reductions; Fridays had been reduced to half-day, which was a pay reduction to every employee and represented about two-thirds of the reduction. The department was "people dependent," but it was facing a very different budget environment than the other departments (e.g. DLWD, DCCED, DOR, or the Office of the Governor). Very different actions were required at a 6 percent reduction versus a 25 percent reduction.

Vice-Chair Gara understood.

Representative Thompson asked how many of the 2,500 fewer state employees had received a pink slip and had been laid off versus old positions being eliminated.

Ms. Pitney answered the 2,500 fewer state employees were actual employees no longer working. She detailed that in the executive branch at the end of FY 15 there had been 37 layoffs. At the end of FY 16 another 40 employees had been laid off. She viewed it as the fourth layoff notice. She shared that in the coming September and October, OMB was working with agencies on "heads up" meetings where they would provide budget targets and so forth. The agencies were making their budget decisions and were beginning to talk to their divisions about what their budget reduction recommendations to the administration would be. At that time the agencies would give notice to their employees if funds for their positions would be eliminated at the end of the year. The governor's office submitted a list of PCNs [position control numbers] for reduction on December 15; any person in one of those PCNs would be looking for a job. The legislature then added to program reductions often with specific PCNs. The commissioners would tell the employees that would be affected what was coming. She elaborated that the administration did not issue a union-required layoff until 30 days prior to the end of the fiscal year. She was proud of the state for having so few, relative to the reduction in employees over the timeframe. She stated it was a last ditch unfortunate event, at which point the impacted individuals were on unemployment insurance.

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Ms. Pitney turned to slide 14 showing position reductions since FY 15. The current state employee level was equivalent to the FY 02 level. She reported that 2,259 positions had been deleted. She noted that Mr. Teal had reported 2,402 - the difference was that slide 14 began with FY 15 and Mr. Teal had begun with FY 14. She stated that positions were a number and a classification on a list; just because a department had a position did not mean it was budgeted. For example, the Department of Public Safety (DPS) had positions in particular locations - if there was a higher need in one location versus another, the department could choose to fill the position in that location when an employee resigns. She elaborated that for DPS to meet its budget, it had to have 42 empty positions every day of the year. Over the past year, DPS had a low of 29 vacant positions to a high of 60 vacant. She explained it was a number with a classification of an employee and characteristics that administratively meant it was necessary to have equal pay and many things; however, in a sense it was unbudgeted. There were PCNs that were unfilled and unbudgeted.

Co-Chair Seaton surmised the vacancy factor would depend on which agency they were discussing. For example, a department with 800 employees and a 10 percent vacancy factor meant that 80 positions would not be funded in the budget.

Ms. Pitney replied in the affirmative.

Ms. Pitney moved to slide 15 and addressed ongoing cost containment efforts and complex state policy considerations. The items on the list were the "big rocks," the complex, difficult state policy considerations that could have cost implications either direction. The justice reform effort in the past year was an excellent piece of legislation; it was not without issues and required tweaks over time. She detailed that the justice reform brought cost-savings in prison beds, but cost increases in pretrial services, substance abuse, and recidivism programs. Over time, the investment would contain the costs of prisons in the future. The biggest fear was continuing business as usual would require opening another prison. A prison was roughly 300 people, which cost an average of over \$100,000

per person including benefits - a cost of \$300 million (excluding costs to build the facility). She emphasized the importance of keeping the prison population low, while keeping society safe.

Ms. Pitney addressed healthcare and relayed there had been several beneficial healthcare changes that had allowed the state to contain costs; however, healthcare continued to be the major cost driver. Medicaid expansion had allowed the state to bring in federal funds and had saved state dollars. The Medicaid reform bill allowed the state to try out some things and incentivized reform efforts; there were 19 different groups currently in Medicaid reform. She addressed redesigning healthcare employee and retiree plans and finding providers. The healthcare authority may provide a roadmap for all the items. Additionally, there was the private health insurance market. All the items were driven by the underlying cost of the state's healthcare system. She stressed that the costs could not be maintained at the current level without addressing the system. The administration was working on each item individually, but was beginning to include them under one broad umbrella. The administration looked forward to working with the legislature on how to address reducing costs within the overall healthcare system. She underscored that everyone wanted quality, affordable, and accessible healthcare. She highlighted the importance of proceeding forward with all involved stakeholders. She concluded that failing to address the system meant it would "continue to move out."

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Vice-Chair Gara spoke to the high cost of medical care. He noted the best chart had always been the increase in Medicaid cost. The increase was not due to providing more services, but to additional people and a higher cost of healthcare. He had been asked if he would lead the effort to stop the rise in medical costs to get to a more rational medical cost system in Alaska. He did not have the expertise. He asked if the administration was going to undertake the lead on the issue and whether it would happen. He remarked that the problem was daunting.

Ms. Pitney agreed that the issue was daunting. Fortunately, there were individual departments working on each of the healthcare items (listed on slide 15). She had been given the task of corralling the issue and coming up with the

next step. She underscored it was not possible to come up with the next step "unless we're all in." She looked forward to working with the legislature on the issue. The administration would be leading education efforts by bringing stakeholders in and bringing each of the items forward during the current session. The administration believed the session would be an education opportunity to determine the right way to address the issues. She added that each of the items was currently being actively addressed. She agreed that the administration would take the issue on in earnest and hoped the legislature would participate.

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Representative Guttenberg noted the Healthcare Taskforce would sunset the following year. He detailed that the taskforce had published five years of reports on ways to improve and drive down costs. He stated that the legislature had addressed one of many recommendations. He surmised the legislature had basically ignored the recommendations. He had testified on the 80-percentile rule on out-of-network healthcare costs. He had asked Commissioner Valerie Davidson [of the Department of Health and Social Services] to help provide any changes she wanted to see. He explained that it had not been functioning for the past two years because the legislature would not fund it. He believed it was critical for establishing a roadmap. The legislature had not seriously addressed the recommendations from over the years. He believed it was necessary to start looking at work that had been done. He was concerned that a new federal administration would prevent everyone from having a clear view until they lay out a plan in the future. Many of the recommendations were very good, but they had never been addressed. It was clearly one of the most expensive employee related costs for the state and private sector. He stressed the enormity of the work that had already been done by the taskforce. He believed feedback from Commissioner Davidson would be helpful. He concluded that the taskforce had done significant work and the legislature had not yet taken the issue up.

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Ms. Pitney addressed education and the system reform process on slide 15. The administration did not anticipate

a decrease in the cost of education, but the quality of education could increase. There had always been criticism of the K-12 outcomes in Alaska. The administration was looking for ongoing cost containment and increased quality. She elaborated that Department of Education and Early Development Commissioner Michael Johnson had set out five goals and was establishing a process and taskforce to move through broad systemic reform for review the following legislative session. She noted that the taskforces would include legislators as well. The items on slide 15 represented the largest budgetary cost increase drivers. She emphasized the importance of tackling the issue to keep the cost of government from rising dramatically in the future. She noted that inflation was anticipated and with reforms the state could anticipate long-term cost containment.

Ms. Pitney turned to reorganization efforts on slide 17 including shared services, information technology consolidation, and optimizing DOT project delivery. The items on the slide did not impact the mission, but impacted how well the mission was accomplished with the available money. She detailed that Shared Services involved consolidating backroom administrative functions in the Department of Administration (DOA) and changing the process to reduce costs. She elaborated that funding remained in the agencies and agencies would pay DOA on a service-level agreement. Agencies would pay a set amount for DOA to handle accounts payable, travel and expense reporting, and other. The administration anticipated a 10 percent savings in the first year, a 30 percent savings in the second year, and at maturity reductions in cost (of performing the service) could reach 40 to 50 percent. The proposed budget would transfer 70 PCNs from other departments into DOA for Shared Services. She relayed that Information Technology (IT) consolidation was a similar approach; 68 positions would be transferred from other departments into DOA under the proposed budget. The increase in positions for DOA shown in the proposed budget was due to consolidation efforts. The last major reorganization effort the administration was working on was for the optimization of project delivery in DOT.

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Ms. Pitney continued to address DOT project delivery. She explained that the state had a fixed amount of federal

highway matching funds; the goal was to complete the most highway, airport, and port projects as possible with the money. She detailed that 76 positions associated with the reorganization effort had been reduced within the proposed budget. She addressed slide 18 related to statewide obligations. She characterized the cuts as daunting and explained they had all been taken in nonformula agency operating budgets and had been largely offset by statewide obligation increases. The oil and gas statutory increase was \$44 million, bringing the total to \$74 million. School debt reimbursement and Regional Educational Attendance Area (REAA) funding had added \$40 million in UGF spending. There was not an increase in UGF for retirement payments, but she agreed with Mr. Teal that it was the last year the state could use the Higher Education Fund for anything other than funding the scholarship program it was designed for.

Ms. Pitney remarked that Mr. Teal had addressed community assistance. The last item was the private insurance market. She explained that the \$55 million had come on the previous year and continued into FY 18; it was a piece of one of the major budgetary cost drivers. She elaborated it was a subsidization of the private insurance market. She explained that it kept the rates lower for the 25,000 people who did not receive insurance through Medicaid or their employer. She noted there were some federal implications and significant uncertainty on the federal side. The long-term nature of the issue would be an active discussion during session.

[3:31:19 PM](#)

Ms. Pitney moved to slide 19 and addressed examples of direct state funding. She referred to her earlier statement that 46 percent of the operating budget funding went directly to communities. The items on slide 19 all reflected General Fund payments to communities. The chart provided a table showing what portion of the \$4.2 billion operating budget went to payments to communities. For example, Anchorage received a direct payment of \$470 million, Mat-Su received \$228 million, Kenai received \$100 million, and Fairbanks received \$162 million. The money directly went directly to communities for operation and was not state employee related. The administration had largely tried to maintain community support areas. She reasoned that continued reductions would get pushed into communities.

Representative Guttenberg knew there had been a significant push in the past to get school districts to increase pupil transportation efficiency. He noted some districts had been successful and others had not. He asked if the administration had looked at pupil transportation. He remarked it was easy to be inefficient when picking up students. He wondered if the administration had revisited the issue to determine if there was room to drive costs down.

Ms. Pitney answered that the topic would be considered by Commissioner Johnson as part of an overall education reform. The question was about determining the right incentives for everyone to focus on quality for the individual student. There had been a veto of \$6.3 million in the last year's budget to pupil transportation, which had been maintained in the current budget.

Ms. Pitney briefly highlighted slide 20, which included revenue measures that would have their own legislation. She moved to slide 21, which showed a bar chart of ERA draws. The chart included UGF and DGF totals from FY 15 to FY 18. There had been no Permanent Fund draw in FY 16 and there had been a draw in FY 17. The governor was proposing a draw in FY 18 as well. The chart also showed an increase in federal and other revenue sources.

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Co-Chair Seaton asked any information provided by the administration to be sent to his office directly. He would disseminate the information to committee members.

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ADJOURNMENT

[3:36:26 PM](#)

The meeting was adjourned at 3:36 p.m.