

SENATE FINANCE COMMITTEE
January 27, 2020
9:01 a.m.

9:01:29 AM

CALL TO ORDER

Co-Chair Stedman called the Senate Finance Committee meeting to order at 9:01 a.m.

MEMBERS PRESENT

Senator Natasha von Imhof, Co-Chair
Senator Bert Stedman, Co-Chair
Senator Click Bishop
Senator Lyman Hoffman
Senator Donny Olson
Senator Bill Wielechowski
Senator David Wilson

MEMBERS ABSENT

None

ALSO PRESENT

Senator Cathy Giessel, Mike Barnhill, Acting Commissioner, Department of Revenue; Pam Leary, Director, Treasury Division, Department of Revenue.

SUMMARY

PRESENTATION: SAVINGS ACCOUNTS, BUDGET RESERVES, and CASH DEFICIENCY

Co-Chair Stedman stated that the committee would discuss the state's savings positions and cash flow. The following day the committee would consider a presentation on the governor's budget by the Office of Management and Budget (OMB). The day after the Legislative Finance Division (LFD) would present its view on the governor's proposed budget. He thought the week started a more robust discussion on the state's operating and capital budgets.

^PRESENTATION: SAVINGS ACCOUNTS, BUDGET RESERVES, and CASH DEFICIENCY

9:03:21 AM

MIKE BARNHILL, ACTING COMMISSIONER, DEPARTMENT OF REVENUE, stated that his colleague would handle most of the slide presentation, but he would converse on the topic of volatility. He anticipated that some topics would serve as an introduction of volatility management concepts. He was happy to return to delve further into the topics.

Mr. Barnhill expressed that there were two types of volatility associated with the discussion of rainy-day funds and state cash flows. He thought the concepts could be confused because the same tool was used to address both. He discussed structural revenue volatility, whereby the revenue structure assumed a certain amount of revenue would come in any particular year and then did not. He used the example of declining sales tax and oil taxes because of oil price or production differentials. The state used various techniques to absorb that volatility, and historically used the Constitutional Budget Reserve (CBR).

Mr. Barnhill discussed a second type of volatility - in-year cash flow volatility; whereby cash inflows were not evenly matched with cash outflows. He reiterated that the state had used the CBR to manage the in-year cash flow volatility; and had done so through a memorandum of understanding with respect to cash deficiency.

Mr. Barnhill stated there were other ways to manage in-year cash flow volatility, but the state had primarily used the CBR. He reiterated that there were multiple techniques to manage the volatility. He stated that there were many slides in the presentation with granular information regarding topics regarding state funds, returns, balances, and asset allocation. He queried the chair as to the will of the committee regarding hearing the detailed information.

Co-Chair Stedman pointed out that it was important to identify the slide numbers during the discussion. He thought the committee might want the granular discussion. He emphasized the importance of cash flow.

Mr. Barnhill stated that the presentation would proceed with discussion of rainy-day funds and other funds.

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PAM LEARY, DIRECTOR, TREASURY DIVISION, DEPARTMENT OF REVENUE, stated she had been with the state since 2007. She first worked with the Alaska Permanent Fund Corporation (APFC) and with the Department of Revenue (DOR) in the Treasury as comptroller. She had been a partner in Price Waterhouse Coopers in 2001.

Ms. Leary spoke to the presentation, "Update on the State's Rainy Day Funds and Discussion of State Cash Flows" (copy on file). She stated that the goal of the presentation was to give a high-level overview of the state's rainy-day funds and cash flows. She showed slide 2, "Update on Rainy Day and Other Funds."

Ms. Leary spoke to slide 3, "FY21 Days that Alaska could run on Total Balances (Rainy Day and Other Funds)," which showed a table depicting the total estimated balances of Alaska's Funds at the start of FY 21, and how many days each fund could pay for the operating budget of \$4.5 billion absent all revenues. She noted that the slide did not show the Permanent Fund Dividend (PFD) amount as an expense. She considered the CBR and estimated that there would be a beginning balance of \$1.9 billion, or six months of coverage of the \$4.5 billion operating budget. She explained that states differed in using revenue-based or expense-based statistic to determine how large a rainy-day fund should be. She explained that each state had a different set of circumstances, and Alaska experienced more volatility and required greater amounts in reserves.

Ms. Leary pointed out other funds listed on the table which could be appropriated if deemed necessary, such as the Power Cost Equalization (PCE) Fund and the Alaska Higher Education Investment fund. If the funds were added there would be about \$3.8 billion, for coverage of about 9 months of operating budget expense. She furthered that the Earnings Reserve Account (ERA) had an uncommitted balance of approximately \$10.2 billion, which would add 800 or so days to the coverage calculation. With the ERA, the coverage would total approximately 3 years.

Co-Chair Stedman asked if the amount excluded PFD payments.

Ms. Leary answered in the affirmative.

Ms. Leary commented that the slide provided context in terms of state assets and budget coverage but not necessarily how the assets should be used.

[9:11:08 AM](#)

Co-Chair von Imhof looked at the slide as an academic experience. She noted that Ms. Leary had alluded to the fact that there were consequences with each decision in choosing to liquidate any of the funds wholly or partially. She referenced use of the Higher Education Fund, liquidation of which would be detrimental to the Washington, Wyoming, Alaska, Montana, and Idaho (WWAMI) Program and scholarship programs. She asserted that liquidation of the ERA would create a loss of approximately half a billion dollars and would be detrimental to the growth of the Permanent Fund over time. She mentioned the percent of market value (POMV) draw. She reiterated that there were consequences to each decision.

Mr. Barnhill thought Co-Chair von Imhof made an excellent point. He suggested that there was more than an academic quality to the chart. He thought the slide begged the question of whether the state was using the traditional rainy-day fund like other states did. He thought the state was using its rainy-day fund as recurring revenue, which something more similar to a countdown clock rather than an economic cushion. He pointed out that five years previously the CBR had a balance of higher than \$12 billion. He thought there were ways to slow or arrest the progression of the fund balance countdown. He asserted that if the state continued to spend without making structural changes to the fiscal system, one could see where the end was.

Senator Hoffman asked for Mr. Barnhill to discuss the difference in the earnings of the CBR and the ERA.

Mr. Barnhill explained that the ERA of the Permanent Fund was invested more aggressively and had higher exposure. The CBR was invested with a lower exposure to equities and a much lower expected return than the Permanent Fund. He pointed out that the previous year was a banner year for fixed income. He expected the calendar year returns for the CBR would be very healthy but was dubious whether it would persist through the end of the fiscal year.

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Ms. Leary referenced slide 4, "Days Each State Could Run on Total Balances in FY 2018," which showed a map of the United States. She noted that part of the impetus for the information on slide 3 had been a study by the Pew Charitable Trusts. She pointed out that that even with the large draws it had taken, Alaska was second only to the State of Wyoming for total number of days of expenses in the funds. The median for all 50 states was about 40 days of coverage. The information on the slide looked at total balances, and the prior slide showed that Alaska was still in a healthy position.

Co-Chair Stedman asked if the total for Alaska funds included the \$14 billion total that included the ERA.

Mr. Barnhill stated that for purposes of the chart on slide 3 and in order to provide a comparison to other states, the total had included the balance of the ERA as of December 2019. He acknowledged that no one planned to use the ERA, but it could potentially be used. He pointed out that on slide 4, the chart had not included the ERA. He commented that the Pew Charitable Trusts reports ran on a lagging basis and the state had not been in the practice of appropriating from the ERA for purposes of spending. He shared that the Pew Charitable Trusts had a number of substantive informational reports. Alaska was featured in most reports as having high revenue volatility. A future slide would address the computation of the volatility.

Mr. Barnhill continued to address Co-Chair Stedman's question and slide 4. He described that when Alaska had over 80 percent of its Unrestricted General Fund revenue coming from petroleum, the volatility of revenue was quite high. Now that SB 26 had been enacted [legislation passed in 2018 that established a new statutory structure for expenditure of Permanent Fund income], and there was a different mix of revenue, the composition of the state's volatility was changing. He thought consideration of the "right" level for the CBR would require looking at the composition volatility. He thought five years previously the savings cushion would have rightly been high since the volatility was high. Moving forward with a new mix of volatility that was part oil and part investment earnings, the volatility would come down and the cushion could come down. He thought the state was not there yet since it had a

structural problem with revenues and was using its rainy-day fund as recurring revenue.

[9:19:02 AM](#)

Ms. Leary stated that the next series of slides were snapshots of the information on slide 3.

Ms. Leary turned to slide 5, "Constitutional Budget Reserve Fund":

- In 1990, voters of Alaska adopted an amendment to the constitution creating the CBRF. The fund was established as a savings fund to enhance budget stability. Consists of deposits resulting from resolutions of disputes about the amount of mineral lease bonuses, royalties or taxes.
- Legislature may appropriate from the CBRF to fund operations under certain conditions:
- Simple majority vote if available funds from other sources are less than amount appropriated to fund state government for the previous fiscal year.
- Otherwise 3/4s vote.
- Borrowings are allowed to fund temporary cash deficiencies and budget shortfalls as appropriated by the legislature.
- Borrowings must be repaid to the CBRF when there is a surplus in the general fund at the end of the year.
- As of FY10, the CBRF was repaid and no borrowing occurred FY 11-FY14.
- A Sub-fund of the CBRF was established in 2000. In 2008, \$4.1 B was deposited
- (1.5 CBRF Main + \$2.6B from GF). Sub Fund was liquidated in 2015 as required by statute as funds were deemed to be needed with 5 years.

Ms. Leary considered slide 6, "Constitutional Budget Reserve Fund Historical Invested Assets (in billions)," which showed a graph depicting historical balances of the CBR. She pointed out that the blue portion of the chart showed what was considered the "main" part of the CBR, while the yellow part of the chart depicted the sub-fund of the CBR which was created in 2000. In 2008, \$4 billion was

deposited into the fund, so that some portion of the CBR could be managed at a higher target of return.

Co-Chair Stedman asked Ms. Leary to discuss the internal structure of the management of the fund. He wondered if there were regular meetings and if minutes were taken. He asked about any paper trail the commissioner had to show the legislature and the public why a particular decision was or was not made. He recounted that several years previously when the large deposit had been moved into the subfund of the CBR, and the Senate Finance Committee co-chairs had objected to the decision. The decision lay solely in the hands of the DOR commissioner and had turned out abysmally. There had been concern that there was a lack of internal structure in the governance of the fund, and there was no paper trail showing the basis for the decision. He asked if there was a structure in place.

[9:23:38 AM](#)

Mr. Barnhill thought every commissioner of DOR had to answer for the actions taken in 2008. He recalled that the CBR was established in 1990, and the purpose of the fund was to deposit settlements from royalty and petroleum tax disputes. Over time the balance of the CBR had grown and the legislature had authorized a sub account that could be invested more aggressively. He continued that DOR, up until 2008, did not have a policy dictating when it would move funds from the main account into the sub account. In 2008, a decision was made to move a large chunk of money from the main account to be more aggressively invested in sub-accounts.

Mr. Barnhill recalled that in September 2008, the market crashed and there was a significant loss to the fund. He thought the first lesson learned was that when moving a large amount of money there should be a dollar-cost average and a different practice to avoid some of the draw-down. He continued that the beginning of 2009 had shown the beginning of a bull market with some ups and downs but that had persisted to the present time and was at an all time high.

Mr. Barnhill shared that there was a statute governing the CBR that established a 5-year horizon. The state had withdrawn all the sub-account money in 2015 because the chief investment officer at the time had believed the state

had crossed the time horizon. None of the money was exposed to aggressive management techniques and had not been since that time. He thought the chart on slide 3 illustrated that the state was well within a five-year horizon for spending the CBR.

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Co-Chair Stedman thought the unfortunate money shift in 2008 could be chalked up to inexperience. He was concerned that roughly 15 years previously there was an internal practice of having discussions and quarterly meetings. He considered that with the awesome authority of the DOR commissioner, he or she had to have practices in place to show the decision process. He emphasized that there should be a process and discussion that was shown.

Mr. Barnhill thought Co-Chair Stedman's point went to governance. He recalled that there was an annual discussion and paper trail that documented the conversation concerning all funds which the commissioner had under its investment authority - ranging from the General Fund to the PCE Fund and others. He asserted that there was a paper trail and different asset allocations for each. He thought there was quarterly reporting.

Co-Chair Stedman opined that there should be meetings more frequently than once per year. He advised that quarterly meetings and a paper trail had ceased to exist since a commissioner under former Governor Frank Murkowski.

Mr. Barnhill stated that there were boards and governing structures for large funds such as the Permanent Fund and the Public Employees' Retirement System (PERS). He thought the benefit of a board was the encouragement of regular discussion and transparency to the public. He hastened to add that he did not believe that the funds under the investment authority since 2009 had suffered from the lack of such governance.

Co-Chair Stedman wanted to move on from the topic but reiterated that there was a fundamental governance question.

Mr. Barnhill thought that Co-Chair Stedman had raised excellent questions. He stated he would love to return and share further thoughts. He was starting to consider side-

by-side performance of management, returns, and expenses; which had been included for budget subcommittees to see. He thought it was possible to see there were very different forms of governance, but ultimately returns were probably similar.

Co-Chair Stedman asserted that the commissioner should do the paperwork.

[9:31:58 AM](#)

Ms. Leary displayed slide 7, "Constitutional Budget Reserve Fund Fiduciary oversight: Commissioner of Revenue," which showed a data table including a pie chart that depicted an investment snapshot of the CBR. She noted the target asset allocation and the fact that there was moderate risk and an intermediate investment horizon. She pointed out that the balance as of December 31, 2019 was \$2.1 billion. She qualified that the slides showing cash and investment balances were a snapshot in time and may have information that differed from other sources. Future slides would address cash versus accrual. The one-year return for the period ending December 31 was 5.48 percent, which beat its benchmark.

Ms. Leary highlighted slide 8, "Power Cost Equalization":

- o The purpose of the PCE Endowment fund is to provide for a long-term stable financing source that provides affordable levels of electric utility costs in otherwise high-cost service areas of the state.
- o 5% of the monthly average market value of the fund for the previous 3 fiscal years may be appropriated. If prior years earnings exceed this amount, 70% (not to exceed \$55M) of the difference can be spent on related identified programs. Commerce is the agency that oversees the spending of the fund. SB196, effective 6/30/2016, changed the spending target from 7% to 5%.

Fund History:

- o 2000-Power Cost Equalization Endowment Fund established from Constitutional Budget Reserve Appropriation of \$100 million
- o 2002-PCE receives \$89.6 million from proceeds of the sale of the four dam pool hydroelectric project.
- o 2007-Additional appropriation of \$182.7 million
- o 2012-Additional appropriation of \$400 million

Ms. Leary looked at slide 9, "Power Cost Equalization - Historical Invested Assets (in millions)," which showed a line graph showing the balance of the PCE Fund over time.

Ms. Leary addressed slide 10, "Power Cost Equalization Fund - Fiduciary oversight: Commissioner of Revenue," which showed a data table containing a pie chart. She made note of the target asset allocation as well as the balance of \$1.1 billion as on December 31, 2019. The target asset allocation had a general mix of about 70 percent equity and 30 percent fixed income. The one-year actual returns were 21.66 percent as of December 31.

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Ms. Leary advanced to slide 11, "Alaska Higher Education Investment Fund":

- On September 1, 2012, the Alaska Higher Education Investment Fund was capitalized with a \$400 million deposit from receipts of the Alaska Housing Capital Corporation.
- On January 28, 2013 the Alaska Higher Education Investment Fund was moved out of the General Fund into a segregated fund, and an asset allocation was approved to generate earnings sufficient to meet the seven percent annual appropriation amount as required by AS 37.14.750.(c).
- Two-thirds of each year's appropriation is allocated for Alaska Performance Scholarship Awards and one-third of the appropriation be allocated for AlaskAdvantage Education Grants.
- In FY2019, \$11.75 million was allocated for Alaska Performance Scholarship Awards, and \$5.875 million was allocated for AlaskAdvantage Education Grants.
- In FY2020, \$11.75 million was allocated for Alaska Performance Scholarship Awards, and \$5.842 million was allocated for AlaskAdvantage Education Grants.

Ms. Leary looked at slide 12, "Alaska Higher Education Investment Fund - Historical Invested Assets (in millions)," which showed a line graph depicting the balance over the life of the fund, from \$400 million down to its current balance of \$359,000 as of December 31, 2019.

Ms. Leary showed slide 13, "Alaska Higher Education Investment Fund Fiduciary oversight: Commissioner of Revenue which showed a data table and a pie chart with target asset allocations, market values, and returns of the fund.

Co-Chair von Imhof discussed the PCE Fund and the Higher Education Investment Fund, which were swept the previous year. She questioned what would happen in the current year with the funds and if they would be swept again.

Mr. Barnhill stated that the sweeping of the PCE Fund had been a product of an opinion from the Department of Law (LAW). He stated that historically the state had almost always enacted an immediate reverse-sweep and the funds did not actually move. He mentioned the three-quarters vote required to secure the reverse sweep, which he thought was unusual. He thought having a three-quarters access vote required to access a rainy-day fund was unusual amongst the states. He thought that unless LAW came up with a different opinion, the process from the previous year would be repeated.

Co-Chair von Imhof asked if the funds were swept the previous year for a period of time before the vote could take place, and what kind of accounting quagmire was created.

Mr. Barnhill did not know what had happened in the interim.

Ms. Leary did not know what happened. She stated that from an investment perspective, the funds had stayed intact.

Co-Chair Stedman thought the department could get back to the committee with further explanation of the mechanics of the accounting. He recalled that there had been a delay in the sweep mechanism.

Co-Chair Stedman added to Co-Chair von Imhof's question and queried the position of the administration on the reverse sweep.

Mr. Barnhill did not mean to suggest the administration's perspective. He stated that from an investment management perspective, having a delay and possibly having the funds lapse into the CBR and being reversed some months later was disruptive.

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Co-Chair Stedman wanted clarity for the committee regarding the position of the administration regarding the reverse sweep. The committee had concerns about financial havoc when the legislature was not prepared for a reverse sweep not to take place. He recognized that the required vote was a hurdle, and he reiterated that he wanted the position of the administration to be clear.

Mr. Barnhill did not know how to answer for the administration's position. He knew that if there was not a reverse sweep that the state would have to move funds that were invested in equities into a fund that was 4 percent in equities, which would be challenging.

Co-Chair Stedman stated that the committee would address the question directly with the director of OMB. He understood that the administration had no interest in not having a reverse sweep.

Senator Hoffman had a vested interest in the PCE Fund and prior to the current administration, the fund had never been deemed a sweepable fund. He thought there had been strong legal opinions from the Legislative Legal Department indicated why the fund should not be part of the sweep. He thought there were two options, including to challenge the administration in court and assert that the attorney general's opinion did not have strong legal grounds. He thought there were organizations and individuals that wanted to challenge the administration in court. He thought the governor had stated publicly that he strongly supported the PCE Program and wanted to come up with legal language to ensure that future governors would not sweep the fund and work with the legislature to make the fund a non-sweepable item. He thought both paths should be pursued. He was working with the administration to come up with language to ensure the fund was not sweepable.

Senator Hoffman continued to address the topic of the PCE Fund. He would provide further information to members of the committee and the legislature on the strong arguments as to why the PCE Fund should not be sweepable.

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Co-Chair von Imhof wanted to clarify that if the reverse sweep did not happen, it would be difficult to fund programs that the funds provided revenue for. She thought it was important to determine the administration's interpretation of the constitution and how it may or may not continue in the next two or three months.

Mr. Barnhill appreciated the information and would relay the information to OMB.

Co-Chair Stedman asked for members and testifiers to abstain from using acronyms. He referenced a one-page report created by committee staff (copy on file) that showed balances and a look-back for the General Fund and Other Non-Segregated Investments (GeFONSI). He thought the report could serve to remind members of historical balances and returns. The report would be updated monthly by DOR.

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Ms. Leary referenced slide 14, "GeFONSI I and II":

- GeFONSI includes the General Fund and Other Non-segregated funds invested in a pooled environment (GF proper= \$400 million).
- Department of Administration separately accounts for each fund within State Accounting system.
- Department of Revenue is responsible for investing the GeFONSI and calculating and allocating daily investment earnings to each fund.
- 185 funds, assigned as Types 1, 2, or 3. Type 1 funds receive their earnings, the others do not.
- GeFONSI II was created in 2018 to target a higher risk return profile and includes funds that are type 2 or 3.

Ms. Leary estimated that there were 185 smaller funds in the GeFONSI that had particular purposes and were accounted for separately but had similar investment make-ups and were invested together. She explained that GeFONSI II funds may get its earnings if decided by the legislature.

Ms. Leary turned to slide 15, "General Fund and other non-segregated investments Historical Invested Assets (in billions)*," which showed a chart of historical balances of invested assets. She informed that the Statutory Budget

Reserve Fund (SBR) was part of the GeFONSI before and after being managed as a separate fund. There had been sufficient funds in the SBR that allowed it to be managed at a higher target return before lack of funding caused it to be rejoined to part of the GeFONSI.

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Co-Chair Stedman looked at the account balance reflected during 1994 to 2004 relative to the current balance and considered inflation and population change. He thought it appeared as if the state was in a better cash position currently. He asked for comment on the change from 2004 to 2019.

Ms. Leary thought historically the way the General Fund was used was for funding all different types of programs. A practice was created by which smaller funds were created to target specific programs. She qualified that when the department discussed cash, it generally spoke of the General Fund proper. There was a minimum balance in a working capital account from which the cash was used. She thought previously that with smaller budgets and cash flows, the amounts were smaller. She stated that a forthcoming slide would address cash balances specifically. The size of the funds had grown but the cash portion had remained relatively stable.

Co-Chair Stedman observed a \$2.3 billion increase since 2004.

Mr. Barnhill noted that in the 1990's the price of oil was averaging \$20/bbl, and bottomed in 1998 around \$8/bbl. Then there was a huge bull market after which oil prices had steadily climbed, had peaked in 2009, and then had started to decline again. He commented that state revenues had gone up dramatically with the price of oil in the 2000's and the budget had risen commensurately. The current budget had reset at a much higher level than the 1990's because the price of oil had gone up, and now the state struggled with the structural gap between revenues and expenditures.

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Co-Chair Stedman looked at 2004 and 2005 and thought there had been roughly about a \$2.3 billion increase in balance. He asked if Mr. Barnhill suggested that the state should

try and keep a balance of \$3.5 billion in cash, and the state could not operate under the cash balances reflected in 2004.

Mr. Barnhill thought ultimately there was a structural imbalance in the state. There were statutory structures that called for certain payments and did not have the funds to cover all of them. He thought there was a difficult choice for the administration and the legislature. He pondered whether the state would change the revenues, change the statutory commitments, or change the PFD formula; all of which the governor had stated were on the table for consideration. The governor had also pondered a spending cap and consideration of the PFD payment.

Co-Chair Stedman mentioned the minimum cash position of the state. He was interested in the recommendation of the administration on the minimum balance of the CBR.

Senator Bishop added that there were also constitutional payments to the CBR.

Mr. Barnhill assumed that Senator Bishop was referencing the repayment obligation. He referenced Co-Chair Stedman's mention of the minimum balance of the CBR. He thought as long as the state was using rainy-day funds as current revenue, it made the question of the size of cushion moot.

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Co-Chair von Imhof thought it might be helpful to do an inflation-adjusted comparison of 2004 to 2019 as mentioned by Co-Chair Stedman. She pondered the real value of the dollars over time. She asked how much of the funds were tied up in designated funds.

Co-Chair Stedman asked for the information to account for population changes and inflation. He affirmed that no one was asserting there was not a structural imbalance.

Mr. Barnhill thought the data points were important, and particularly relevant to the governor's proposed spending cap.

Co-Chair Stedman asked to move on.

Mr. Barnhill stated that the cap was adjusted by population and inflation.

Ms. Leary considered slide 16, "General Fund and other non-segregated investments (GeFONSI I & II) Fiduciary oversight: Commissioner of Revenue," which showed a data table that contained two pie charts showing the target asset allocation of the investments. She informed that the total of the combined funds was \$2.6 billion. She addressed the general operating account, which the department viewed as a floor minimum of about \$400 million. The one-year returns from 2019 for the GeFONSI I account was 2.9 percent, and GeFONSI II was 6.38 percent. She reminded that the additional returns from the fund went to the General Fund.

Ms. Leary displayed slide 17, "Revenue Volatility Management."

Mr. Barnhill stated that the point of the next slides would reintroduce management concepts that the state had not discussed in 20 years.

Mr. Barnhill highlighted slide 18, "Alaska has the highest Tax Revenue Volatility," which showed a bar graph. The graph showed that Alaska had the highest level of revenue volatility of any state. He thought the point of the report on rainy-day funds from the Pew Charitable Trusts was that the cushion correspond to the level of revenue volatility. He thought facts would suggest the state should have the largest cushion since it had the greatest amount of revenue volatility.

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Mr. Barnhill looked at slide 19, "Revenue Volatility Now Comes From":

- Commodity Volatility
 - Petroleum revenues are 28% of FY21 projected unrestricted general fund revenues
 - Uncertainty exists "in-year" for FY21
 - Will always have in-year uncertainty because we base budget on in-year oil collections

- Investment Return Volatility
 - Investment earnings are 62% of FY21 projected unrestricted general fund revenues
 - Certainty exists today for FY21 (lagging POMV formula)
 - Uncertainty today for FY22 and beyond

Mr. Barnhill asserted that the state reduced its volatility in the time since the passage of SB 26 and after bringing on investment earnings. He expected over time that the level of the state's rainy-day cushion would come down. He thought the chart on the previous slide would show that Alaska's revenue volatility was starting to tighten up. He pointed out that investment revenue could be volatile as well. He discussed the concept of standard deviation, through which one could see volatility for both commodities and investment return.

Mr. Barnhill relayed that for Alaska North Slope Crude over the previous ten years, the mean had been \$71/bbl and the standard deviation had been plus or minus \$25/bbl. He reiterated that past returns were not predictive of the future. He pondered a worst-case scenario in which the price of oil was \$30/bbl and considered the consequence of \$700 million less in revenue for FY 21. He suggested that \$700 million was a reasonable cushion to have in a rainy-day fund to accommodate the commodity volatility with a rainy day fund.

Mr. Barnhill discussed investment return volatility due to fluctuations in the stock market and Permanent Fund returns. He offered to work with legislative staff on a variety of models. He thought it was reasonable to say that expected Permanent Fund earnings for the following ten years could vary up or down by as much as a few hundred to several hundred million dollars per year based on changes to investment revenue. The analysis could be used to determine the appropriate size of the state's rainy-day cushion.

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Mr. Barnhill continued to address slide 19. He thought the state should model a range of scenarios and come up with a 50th percentile in a Monte Carlo analysis for commodity and investment return volatility, which he thought would

produce a reasonable number for a cushion. He reminded that DOR had advised the committee the previous year that \$2 billion was an appropriate number for a rainy-day cushion. He reiterated that the state was using its rainy-day funds as recurring revenue, and thought the state needed to deal with the issue.

Co-Chair Stedman stated that the discussion would be revisited after having the administration's proposed operating budget for consideration.

Mr. Barnhill addressed slide 20, "Volatility Management Techniques":

- Rainy Day and Other Funds (CBR and other fund balances)
- Oil Price Hedging
- Lagging PF Distribution Formula
- Distribution Formula Alternatives (Harvard/Yale/Tobin)

Mr. Barnhill qualified that the slide showed various techniques for addressing structural revenue volatility. He thought the technique used by the state for the past 20 years was to use the CBR as the rainy-day fund. He described the "backstop provision" in which the state utilized monies from the CBR if funds did not come in as expected. He mentioned oil price hedging, and recalled the state had last used the tool in 2001. He noted that there was a section in the Revenue Sources Book that discussed oil price hedging. Ultimately DOR believed as long as the state had a cushion, the cheapest way to absorb oil price volatility was through the CBR.

Mr. Barnhill continued to discuss slide 20. He noted that Mexico used oil price hedging and bought insurance every year on a particular price of oil. The practice was called "buying a put" and was the most expensive method of oil price hedging.

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Co-Chair Stedman asked for Mr. Barnhill to discuss the lagging formula for distribution from the Permanent Fund.

Mr. Barnhill stated that through the mechanism of SB 26, the state calculated an average of the earnings coming from

the Permanent Fund that could be accessed by taking five percent of the lagging five-year market average. Using the five-year average smoothed out the investment volatility somewhat. He qualified that even using the lagging five-year distribution formula, there could still be highs and lows in the earnings the formula produced.

Senator Wielechowski asked what Mr. Barnhill believed to be the minimum cushion the state should maintain the CBR.

Mr. Barnhill stated that there was no hard number for a minimum balance since the state was using the CBR for recurring revenues.

Co-Chair Stedman stated that the topic would be a major point of discussion after the budget was on the table and had heard from OMB and LFD.

Mr. Barnhill reminded that the methodology discussed on the previous slide would apply to how the state would arrive at an answer for a minimum cushion.

Co-Chair Stedman thought Senator Wielechowski's question was on point and thought there needed to be further refinement. He wanted the administration to have time to consider the question.

Ms. Leary advanced to slide 21, "Discussion of State Cash Flows."

Ms. Leary looked at slide 22, "SOA Treasury Cash Flow":

State of Alaska Division of Treasury Cash Management

Cash Inflows

- Tax Revenues
- Oil & Gas, Excise, Other
- Federal Dollars
- Grants, Medicaid, FHWA, Education, Other
- Earnings Reserve Funds
- Agency Receipts
- Fees, Licenses, Permits, Fines, Other

Cash Outflows

- School Education Payments

- Payroll & Pension Payments
- Vendor Payments
- Medicaid Payments
- External Program Grant Payments
- Debt Service Payments

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Ms. Leary spoke to slide 23, "Cash Management Objectives":

- Maintain adequate liquidity (\$400 million)
- Optimize cash resources.
- Safeguard State assets.
- Record financial activity affecting cash.

Co-Chair Stedman asked about the first bullet on slide 23.

Ms. Leary stated that the department wanted to make sure there was sufficient cash in the treasury to pay whatever bills came in. The treasury had targeted a balance of \$400 million as a base minimum, which would cover about two days of what she considered "perfect storm" expenses such as payroll and pension payments that occurred on the same day. The money would be replenished, and additional slides would address the mechanics by which cash calls were determined.

Co-Chair Stedman asked if the slide was an answer to Senator Wielechowski's question.

Mr. Barnhill reiterated that there were two types of structural volatilities: structural revenue volatility and in-year cash flow volatility. He noted that the slide addressed in-year cash flow volatility. The CBR was used to solve for both issues.

Co-Chair Stedman summarized that the slide addressed the amount of cash that was needed monthly to make bi-weekly payroll.

Ms. Leary answered in the affirmative. She qualified that the funds were different from reserves.

Ms. Leary referenced slide 24, "Cash vs. Accrual balances":

- Cash balance is what you have in the bank at a given point in time.

- Accrual balance takes into account what you have earned and when a liability is incurred at a particular point in time. It is what you should have at a particular point in time after all expected receipts and expenditures come in and out.
- Simple example: Your bank balance shows you have \$1,000 in cash at July 31. However, you know that you wrote checks for utilities on July 25 for \$400 that are for July utilities that have not yet cleared. You may have also earned a pay check of \$1,200 for work performed in July. Your accrual balance at July 31 would be \$1,800.

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Ms. Leary turned to slide 25, "Cash Flow Deficiencies":

- Prior to 1985, most unrestricted revenues flowed into and stayed in the General Fund for expenditure.
- Over time, the legislature has established many subfunds to segregate cash for budgeting purposes, resulting in less cash available to pay day-to-day operating costs.
- Expenditures can occur prior to receipt of revenue, resulting in a cash flow deficit:
 - Federal programs require expenditures before reimbursement.
 - i.e. Medicaid, Transportation, etc..
 - Beginning of year appropriation transfers do not match incoming revenue.

Ms. Leary explained that the treasury looked into the future to determine a cash flow deficiency.

Ms. Leary considered slide 26, "Cash Flow Deficiencies":

- Borrowing from budget reserve funds has been the solution of both cash shortages (cash flow deficits) and revenue shortfalls (budget deficits).
- During FY93-FY05, the legislature included language in the appropriation act permitting borrowings from budget reserve funds.
- The CBRF was fully repaid by FY10.
- Borrowing from the CBRF recommenced in FY14

- Per FY18 CAFR \$9.9B is owed to CBR

Senator Bishop asked if the \$3 billion transfer to PERS and the Teacher's Retirement System was included in the total owed to the CBR as reflected on the slide.

Mr. Barnhill believed the \$3 billion was included as it was from the CBR and subject to payback.

Senator Bishop thought the funds were still invested.

Co-Chair Stedman thought that the amount contributed was closer to \$2 billion. He stated that the committee would revisit the subject when the committee was discussing the state retirement system.

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Ms. Leary displayed slide 27, "Cash Deficiency Memorandum of Understanding":

- Original MOU signed 1994 by DOR, DOA, OMB & LAW.
- Updated December 1, 2017.
- Targets \$400m dollar minimum threshold.
- Outlines procedures for addressing cash deficiencies:
 - Develop monthly cash projections.
 - Monitor daily general fund cash balances.
 - Transfer from SBR, CBR & ERA as appropriated.
 - Perform temporary interfund borrowing.
 - Borrow from general fund sub funds, if temporary
 - If all appropriations/borrowing are exhausted:
 - Seek legislative action through the Governor to access additional funds through appropriation from other Rainy Day Funds discussed above.
 - Prioritize disbursements, restrict expenditures.

Ms. Leary commented that historically there was a time when the treasury encountered a cap on the amount that could be borrowed from the CBR and the treasury had to come to the legislature for additional funds to pay bills.

Co-Chair Stedman thought that there should be discussion on the subject. He was concerned about the easy access to the ERA. He did not recall borrowing from the ERA but was concerned it was easy to access the account with a simple majority vote.

Mr. Barnhill clarified that the borrowing discussed in the MOU was intended to manage the state's in-year cash-flow and must be paid back. The borrowing did not require an appropriation, but there was a danger of not being able to repay the funds because of a structural revenue issue. He thought Co-Chair Stedman's point was well put.

Co-Chair Stedman saw the phrase "as appropriated" and wanted to have further discussion at a later time. He was not personally comfortable with borrowing from the ERA after seeing what had happened with the CBR.

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Senator Olson considered the MOU and asked about the frequency of borrowing from the funds, specifically in the previous four years.

Mr. Barnhill stated that there would be a forthcoming slide that showed the CBR borrowing.

Ms. Leary stated that generally quarterly there was borrowing, depending upon what was seen in the forecast.

Ms. Leary showed slide 28, "CASH FLOWS IN THE GEFONSI OPERATING ACCOUNT."

Ms. Leary looked at slide 29, "Historic Actual Cash Inflows and Outflows FY 2017 - 2019*," which showed a bar graph depicting total cash inflows and total cash outflows. She commented that often there would be money in the treasury that stopped on its way to where it was going in the GF, which would be an inflow. The same funds could go to another fund for program expenditures and would be considered an outflow; and the graph might make it appear as if a lot more money was coming in and going out than in reality. She pointed out that the next cash amount in 2017 and 2018 had more cash outflows than inflows. The CBR borrowing, shown by the yellow bar, offset the situation fairly well. She pointed out that in 2019 there was a blue

bar representing the ERA appropriation that was taken for FY 19 and almost offset the outflow.

Co-Chair Stedman asked if the appropriation was the POMV draw of 5.25 percent.

Ms. Leary answered in the affirmative.

Co-Chair von Imhof looked at 2019, and asked if the green bar included federal money, mineral revenue, and all cash coming in. She pondered if the federal dollars were taken out, the blue bar became a bigger portion of the General Fund. She thought the point was that the blue bar was very small when you considered the total; however the amount was 65 percent of what was available to allocate.

Ms. Leary stated that Co-Chair von Imhof was correct. The blue line looked too small and was a portion of the cash supporting operations.

Co-Chair Stedman asked if the department could get back to the committee with regard to the relationship of the total less the federal funds.

Ms. Leary addressed slide 30, "Seasonal Cash Flow Fluctuations":

- June - Annual oil & gas property tax revenue.
- July - Debt service payments.
- Re-appropriation (July & August):
 - Finishing prior FY expenditures + current FY expenditures.
 - Allocating funds in or out of GF per new legislation.
- Summer - Peak season for construction projects and seasonal workers.

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Ms. Leary showed slide 31, "CASH IN THE GENERAL FUND PROPER."

Ms. Leary advanced to slide 32, "Daily General Fund Sufficiency Balance Calculation," which showed a graphical flow chart. She reminded that the treasury looked at the daily cash balance, subtracted obligations and cash

receipts in suspense, in order to determine the sufficiency of the cash balance.

Ms. Leary turned to slide 33, "FY2020 GENERAL FUND FORECAST."

Ms. Leary noted that slides 34 and 35 showed a graph that could be found on the treasury website that was updated every day. The "A" chart was for the beginning of any fiscal year, and the "B" chart was for the end. The graph was a visualization of what the model was showing for cash balance needs into the future. She highlighted larger transactions that impacted cash availability.

Ms. Leary considered slide 34, "General Fund Sufficiency July 1, 2019 - December 31, 2019," which showed a line graph showing the first six months of the fiscal year. She pointed out large transfers in the Public Education Fund and pension contribution transfer for about \$650 million at the start of the year. Just after, there was a replenishment of \$500 from the ERA to the General Fund. She made note of other smaller transfers, after which additional funds from the ERA were needed, particularly for the PFD disbursement. She noted that the items were tracked closely, and the division relied heavily on the previous year's net cash flow imprint to base modelling on.

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Ms. Leary reviewed slide 35, "General Fund Sufficiency January 1, 2020 - June 30, 2020," which showed a line graph addressing what was anticipated for the subsequent six months from the previous slide. She noted one significant change for the second half of the year was to implement monthly Public Education Fund transfers rather than quarterly, which was creating a smoothing effect in dealing with some of the state's cash flow needs. She addressed Senator Olson's question and noted that the quarterly receipt from the earnings was generally timed for the historical public education transfer and additional funds were requested if needed. The goal was to maintain above a \$400 million balance threshold.

Senator Olson asked if the intra-fund amounts borrowed had increased, decreased, or stayed the same.

Mr. Barnhill explained that not all the transfers were borrowed; the money being transferred from the ERA was an appropriation. When money coming from the CBR was coming via the operating language backstop, it was also an appropriation after having passed the three-quarter vote threshold. The funds did have to be repaid eventually. He thought the term "borrowing" could mean multiple things and was confusing.

Co-Chair Stedman articulated that the technically when funds were taken from the CBR, the monies had to be paid back at no interest. Any surplus in a given year automatically flowed back to the CBR if there was a debt. There was currently an approximately \$10 billion debt to the CBR. He thought if there was a surplus of recurring revenue it would automatically go back to the CBR.

Mr. Barnhill stated that the point of the chart was to illustrate what the overall cash position was on any given day. In order to meet the policy of maintaining a \$400 million daily cash balance, the flows were timed.

Co-Chair Stedman reminded that he would run the meeting.

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Co-Chair von Imhof understood that any surplus funds would get transferred back to the CBR. She asked if there was a trigger or upper limit.

Ms. Leary stated there was no upper limit, and the treasury tried to manage the money as closely as possible to what was needed. The trigger was when it was thought that the balance would dip below \$400 million for five consecutive days. The treasury set a schedule at the beginning of the year based on forecasts, which sometimes needed to be adjusted as quarterly revenues came in higher or lower than expected. She continued that the treasury tended to ask for enough funds to use for two or three months and tried to maintain the smallest balance possible so that funds could be invested elsewhere at a higher targeted rate.

Co-Chair von Imhof was curious about the trigger for moving funds back to the CBR. She observed there was three instances where amounts were transferred from the General Fund to the CBR.

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Co-Chair Stedman explained that there had been a brief at ease to discuss the question of the upper range that triggered funds to flow back to the CBR.

Ms. Leary stated that the transfers back to the CBR were funds that were supposed to be in the CBR rather than the GF, such as royalties.

Co-Chair Stedman asked if the chart would look different if the transactions were not present.

Mr. Barnhill stated that the transfers were relatively small amounts and would not make the chart look much different. He was not aware of an upper limit trigger.

Ms. Leary spoke to slide 36, "FY2021 GENERAL FUND FORECAST (using FY19 actuals)."

Ms. Leary noted that slides 37 and 38 showed the best guess at the time for FY 21, divided into the first and second six months of the year.

Ms. Leary discussed slide 37, "General Fund Sufficiency July 1, 2020 - December 31, 2020," which showed what the treasury anticipated will be happening for the year. She noted that the division did not normally forecast more than six months in advance because there were significant changes. She continued that the slide was up on the division's website. It was possible to see general patterns of cash inflows and cash outflows. at the start of FY 21, she anticipated large needs for public education and pension contribution transfers. It was possible to see the schedule for the ERA transfer to the General Fund would occur as anticipated in July, September, and December.

10:39:00 AM

Ms. Leary addressed slide 38, "General Fund Sufficiency January 1, 2021 - June 30, 2021," which showed the same line graph from the previous slide updated for the next six months. She pointed out the remaining request for funds

would come from the CBR, since the currently anticipated ERA allocation of \$1.086 billion in the governor's budget would be exhausted. There would be a need for \$1.4 billion from the CBR for cash flow purposes.

Co-Chair Stedman asked about the balance of the CBR.

Ms. Leary stated that currently there was \$2.1 billion in the CBR.

Co-Chair Stedman asked if under the scenario there was an expected CBR balance of \$600 million in the next fiscal year.

Mr. Barnhill stated that the OMB fiscal summary had projected a \$542 billion residual balance in the CBR.

Ms. Leary affirmed that the graph on slide 38 contained an estimate of where the money was needed.

Co-Chair Stedman thought the committee would take a more detailed look at the subject as the budget was considered and would discuss how to fund the deficit. He commented that choices were limited.

Senator Hoffman looked at slide 38 and asked if it was accurate to say that on June 30, 2021, the amount available in the CBR would be \$500 million.

Mr. Barnhill answered in the affirmative.

Co-Chair von Imhof asked at what point did end-year borrowing become deficit borrowing.

Mr. Barnhill stated that the OMB fiscal summary showed the deficit as \$1.5 billion, so there was deficit borrowing. He reiterated that the state was using its rainy-day fund as recurring revenue, which was deficit spending and borrowing from the rainy-day fund.

Ms. Leary went back to slide 37 and noted that the first time there was borrowing from the CBR was in December 2020.

Co-Chair Stedman thought some people in the building advocated for structural deficits, which would eventually make the state go broke.

Mr. Barnhill agreed, and stated that the chart on page 3 functionally served as a countdown clock. He thought the point of the whole presentation was to show that there was a structural deficit that needed to be addressed. It occurred to him that there a chicken-and-egg that had emerged. He thought everyone would agree there was a structural deficit and pondered what changes the state would make to the fiscal structure. He continued that DOR could tell the legislature what the right cushion would be based on the changes. He thought that he had heard from the committee that it wanted to hear what the cushion was and then decide on structural changes. He thought as long as there was agreement on the assumption that there was as structural problem, the issue could be worked through.

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Senator Wielechowski requested the chart on slide 38 with a projection of July 1, 2021 through June 30, 2022.

Ms. Leary stated that the second half of the chart would be an estimate based on a model, and that cash flows were extrapolated even further from revenue forecasting. She stated that the department could do the estimate, but it might not be as useful as anticipated.

Co-Chair Stedman thought the department would return when the committee got further into the discussion of the account balances under different budget scenarios. He thought Senator Wielechowski had raised a legitimate question and concern. He thought a projection would be easier to do an estimate on a quarterly basis. He pondered how the budget would set up future years.

Ms. Leary reviewed slide 39, "Take Aways":

- Cash flow forecasting is always wrong.
- Even if the State budget is balanced, borrowing for cash flow deficits will occur.
- Budget deficit borrowing may occur if forecasted assumptions are wrong.
- How much is borrowed depends on the actual amounts and timing of revenues and expenses.
- Higher Revenue Volatility requires greater Rainy Day fund reserves.

- Volatility management techniques are available.

Co-Chair Stedman thought the commissioner would be back in committee several times, as well as staff as appropriate.

Co-Chair Stedman discussed the agenda the following day.

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ADJOURNMENT

10:47:46 AM

The meeting was adjourned at 10:47 a.m.