ALASKA PERMANENT FUND PROTECTION ACT

For a Strong Alaskan Economy and an Enduring Permanent Fund

The Alaska Permanent Fund Protection Act (APFPA)will be the centerpiece of the New Sustainable Alaska Plan. Although the technical details are still being deliberated, the intent is for the APFPA to address s $2.4 billion of the $3.4 billion gap from earnings on the Permanent Fund. This would be made possible by transferring additional state financial resources to the Permanent Fund, depositing additional oil and gas revenue in the Permanent Fund, and paying a dividend from Alaska's oil and gas resource development. The remaining $1 billion gap can be addressed through a combination spending reductions and new revenues.

The APFPA is designed to end the boom and bust budgeting cycles Alaska has experienced for the last four decades through three mechanisms:

(1) Deposit volatile resource revenue in the Permanent Fund;

(2) Funds the annual budget through a stable and sustainable draw from the Earnings Reserve Account; and

(3) Produce a dividend for Alaskans from natural resource royalties.

By directing the highly variable flow of petroleum revenue into a larger pool of assets and correctly calibrating annual withdrawals from that pool, the APFPA harnesses the state's financial wealth to provide long-term stability to the state budget while preserving the dividend program and the value of the Permanent Fund.

I. Calibrating the Draw

To be sustainable over the long-term, the draw must be calibrated to ensure that it does not degrade the value of the financial assets and to allow opportunity for growth in the fund. The Department of Revenue modeled a variety of scenarios to determine the amount that could be sustainably withdrawn on an annual basis.

Reasoned assumptions, paired with the best available data, underlie the probabilistic financial modeling.[1] The significant modeling constraints, assumptions, and data inputs include:

- **Sustainability Metrics**: maintain the real value of starting assets and ensure the durability of the Earnings Reserve Account to avoid pressure to spend from the principal.
- **Starting Fund Value**: $56 billion
- **Oil Price**: modeled probabilistic using a PERT distribution and DOR 2015 forecasting session data.
- **Oil Production**: preliminary values from the DOR production forecast to be published in the 2015 Fall Revenue Sources Book (deterministic modeling)
- **Investment Return**: 6.65%
- **Inflation**: 2.25%

Sustainability Metric
Maintaining the median real value of the starting assets over the modeling horizon (24 years) is the primary constraint of the fiancial modeling. The starting assets include the Permanent Fund principal ($47 billion), the Earnings Reserve Account ($6 billion), and a one-time transfer of $3 billion from the Constitutional Budget Reserve. This sustainability metric essentially assumes inflation proofing of the starting assets.

This is a departure from current practice. The existing fiscal framework inflation proofs the principal and the 30% of royalties deposited in the principal.[2] Realized investment returns maintain the value of the entire fund, but provide growth in only the Earnings Reserve Account and the dividend.

The sovereign wealth approach plans for maintaining value of what we have today while ensuring that opportunities for growth are directed to the principal rather than spending. This change is appropriate as we transition to reliance on the investment earnings of our financial assets.

Oil Price and Production

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1 The model does not include any large future projects, such as AKLNG. Generally, future projects would improve the durability of the system and increase the growth of the Permanent Fund and dividends.

2 The royalty deposits provide for real growth in the principal. Unrealized gains are included in the balance of the principal, but once realized that value is deposited into the Earnings Reserve. Typically, inflation proofing is the only transfer from the Earnings Reserve Account to the principal.

The model uses preliminary values from the 2015 Fall Revenue Sources Book for the oil and gas revenue inputs. While the modeling used only petroleum revenue, the plan would deposit all natural resource royalties into the Permanent Fund.

Investment Returns

The return assumption is a significant variable. To calibrate the annual draw, the APFPA uses the 10-year average historical return and the 10-year total return forecast adopted by the APFC board. For the initial proposal, lacking a board-approved return assumption, the APFPA relies on the 10-year forecast published by Callan after advice from APFC staff. For the calculations today, weighting the historic and forecasted returns equally results in a 6.65% return assumption for the initial draw calculation.

A blend of a historic and forecasted return captures some benefits of both options. The 10-year rolling average historical return is factual, immune to short-term policy preferences and subjective judgement calls inherent in a forecast, and relatively stable. In the current context, the 6.4% historic return also provides a measure of conservatism to the calculations. Using the forecasted return shifts the calculation based on current market conditions.

Inflation

Several elements of the modeling include inflation adjustments: the real value of the base sovereign wealth assets, the payout amount, and the price of oil after 2024. The model used 2.25%, the inflation forecast produced for APFC by Callan.

II. Draw Rule

Using the assumptions discussed above, if inflation adjustments to the payouts are delayed until 2020, the system can sustainably produce an annual draw of $3.2 billion.

The APFPA institutes a periodic review to ensure the draw remains sustainable and may be adjusted if necessary. Specifically, the APFPA requires that every four years the Commissioner of Revenue will review the draw and issue a Sufficiency of Assets Report that includes:

1. An evaluation of the sufficiency of the Earnings Reserve Account balance, given anticipated resource and investment revenue;

2. An evaluation of the long-term sustainability of the draw amount; and

3. A determination that the draw amount (a) may be continued or (b) is unsustainable and recommend a reduced draw or another adjustment strategy.

III. Incoming Revenue Placement

As illustrated in the attached flow charts, the sovereign wealth fiscal structure distributes annual revenue to the fund and to dividends:

Resource Royalties: 50% to Dividend; 49.5% to Permanent Fund
Resource Tax Revenue: 100% to Permanent Fund

Investment Revenue: 100% to Permanent Fund

Within the Permanent Fund, the incoming revenue maintains the Earnings Reserve Account (ERA) at a target balance. Investment income is the first revenue stream to maintain the ERA balance. All additional revenue – royalties, taxes, and investment income – go to the principal of the fund.

B. Resource Revenue

Incoming mineral royalties are divided between the fund and dividends.[3]

1. Royalty Dividend

The royalty dividend equitably distributes resource wealth across generations. The forecast for royalty dividend amounts below does not include new resource developments, so new developments would be expected to increase the dividend from this forecast.

The APFPA funds the dividend from 50% of resource royalties – the state's ownership share of natural resources. Based on the preliminary fall revenue forecast, the 50% royalty formula produces dividends around $1,000 for the next several years. This is in the range of the average dividend payment under the current system - $1,148 over the life of the program.

Under the current fiscal framework, the state does not have adequate financial resources to fund a dividend over a sustained period of low petroleum revenue without also imposing a heavy tax burden on Alaskans. The existing dividend distributes investment income from the Earnings Reserve Account. But, the state is on course to begin funding the budget from the ERA in FY2018. Without a change, Alaskans will soon face a depleted ERA, no dividend payouts, and the prospect of spending down the principal of the Permanent Fund.[4]

2. Permanent Fund

All oil and gas tax revenue and 49.5% (the rest goes to dividends) of royalty revenue go to the Permanent Fund. Funds deposited in the principal will be constitutionally protected. Depositing additional revenue in the Permanent Fund ensures that the fund benefits from opportunities for growth, from increases in price or production. Alaska will save rather than spend.

However, the Earnings Reserve Account must be large enough to sustain the fixed annual draw over periods of low investment returns. Thus, if the ERA falls below a target balance, petroleum revenue (other than the 25% of mineral royalties which constitutionally must be deposited in the principal) is temporarily redirected to the ERA. The APFPA sets the ERA target balance at four times the last annual draw. This creates a more durable ERA and preserves the presumption of savings.

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[3] AS 37.14.150 directs one-half of one percent of mineral royalties to the Public School Trust Fund.

[4] Spending from the principal would require a constitutional amendment.

C. Investment Income

Generally, the current practice of depositing realized investment returns, the statutory net income, in the ERA continue. This revenue helps maintain the level of available funds. However, when the ERA balance exceeds the target balance, the excess is transferred to the principal. This is consistent with the policy of maintaining the real value of the starting assets and directing opportunities for growth to the fund.