Alaska Permanent Fund Protection Act

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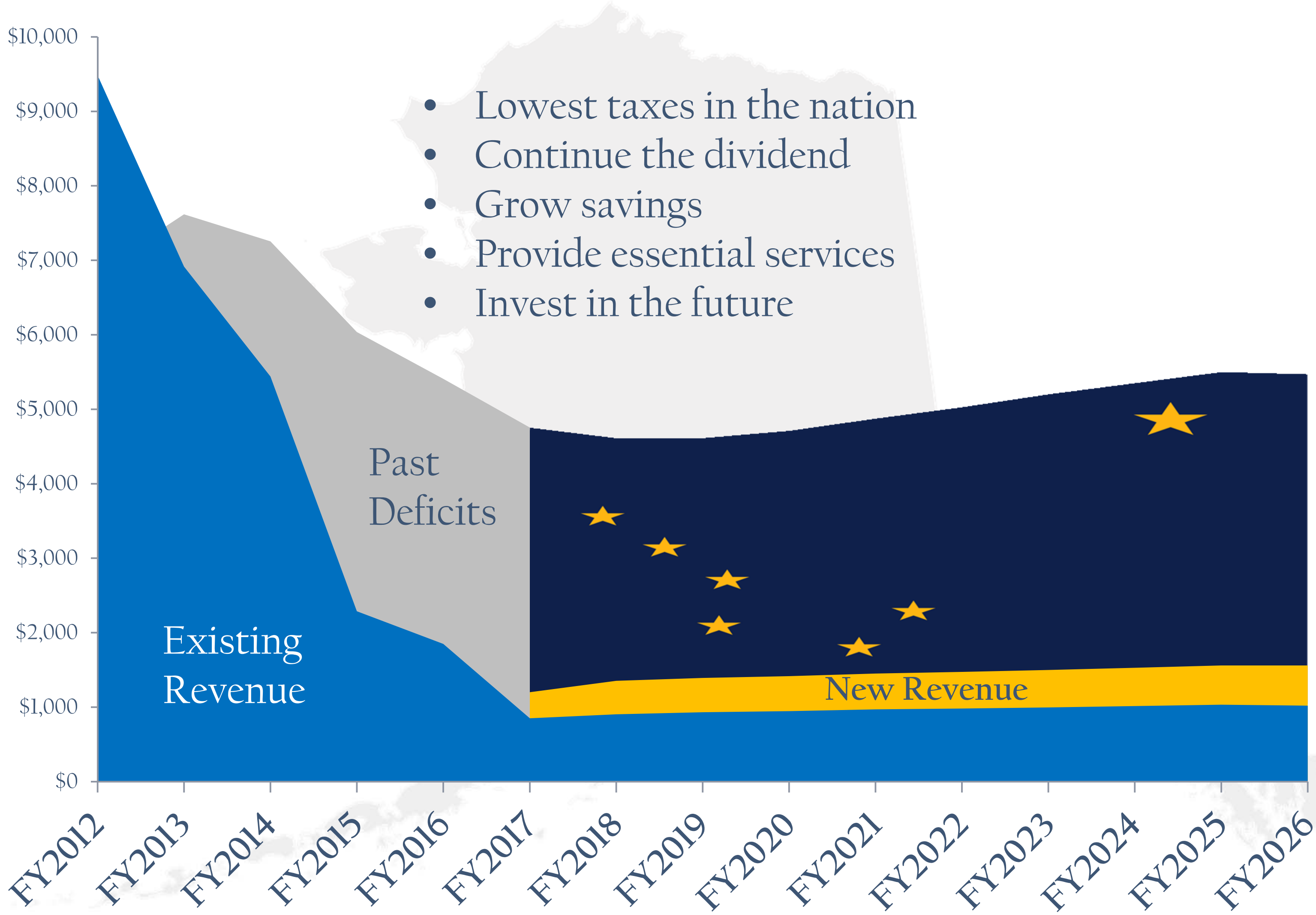
INTRODUCTION

THE NEW SUSTAINABLE ALASKA PLAN

FY16 Budget	**$5.2 billion**
Alaska Permanent Fund Protection Act	$3.3
Revenue from existing taxes and fees	$0.85
Earnings on savings	$0.135
	$4.285
Spending reductions (est.)	
Net cuts in FY17 (additional cuts of $0.1 through FY19)	($0.1)
Reform O&G Tax Credits	($0.4)
	($0.5)
New Revenue Components (est.)	
Mining	$0.006
Fishing	$0.018
Tourism	$0.015
Motor Fuel	$0.049
Alcohol	$0.040
Tobacco	$0.029
Oil and Gas	$0.1
Individual Alaskans (Income Tax)	$0.2
	$0.457

THE NEW SUSTAINABLE ALASKA PLAN



Alaska Permanent Fund Protection Act

1. Sustainably draw from the Earnings Reserve
2. Minimize oil price volatility on the General Fund
3. Adjust the dividend

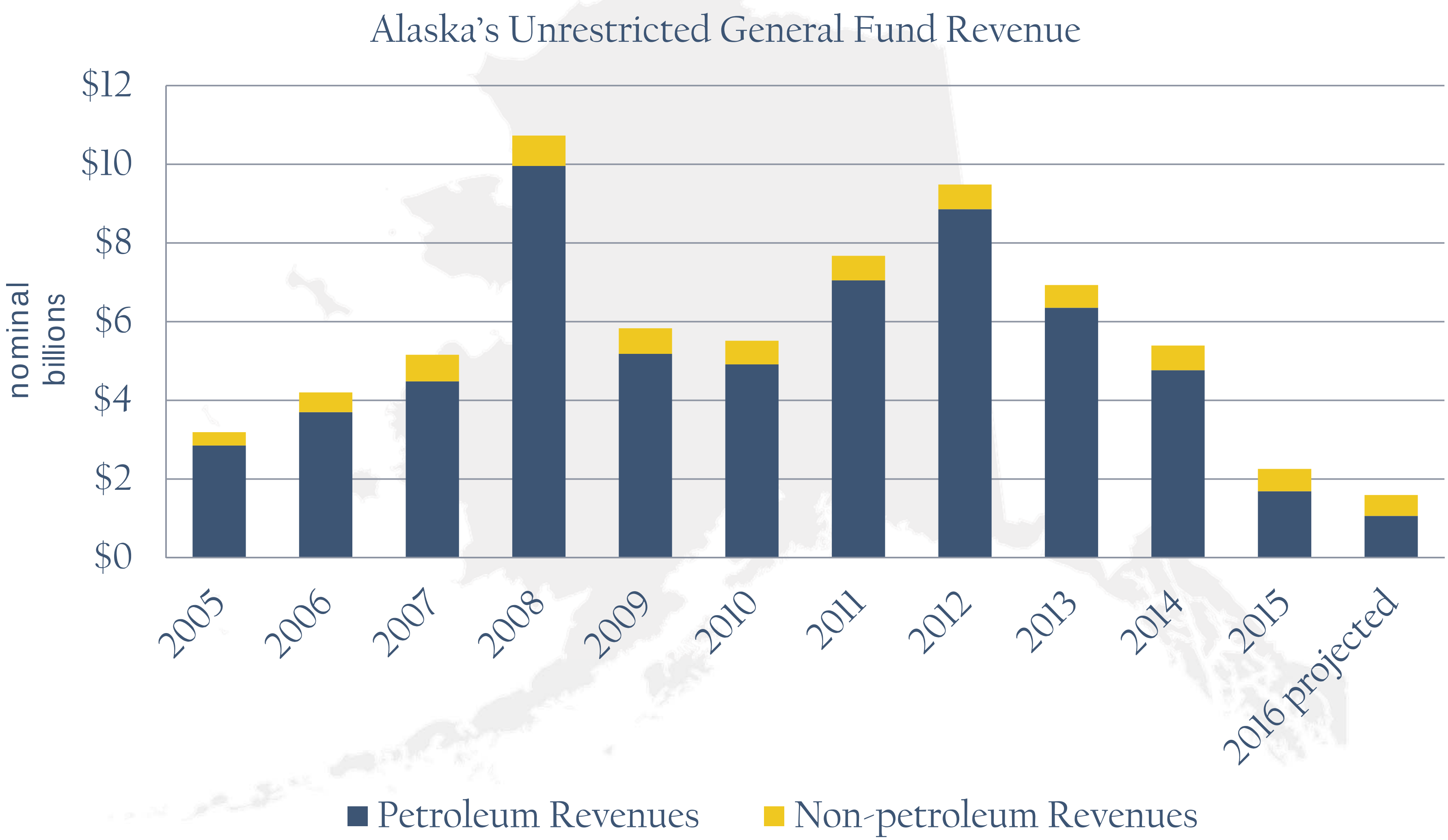
The Fiscal Challenge

Defining the Problem

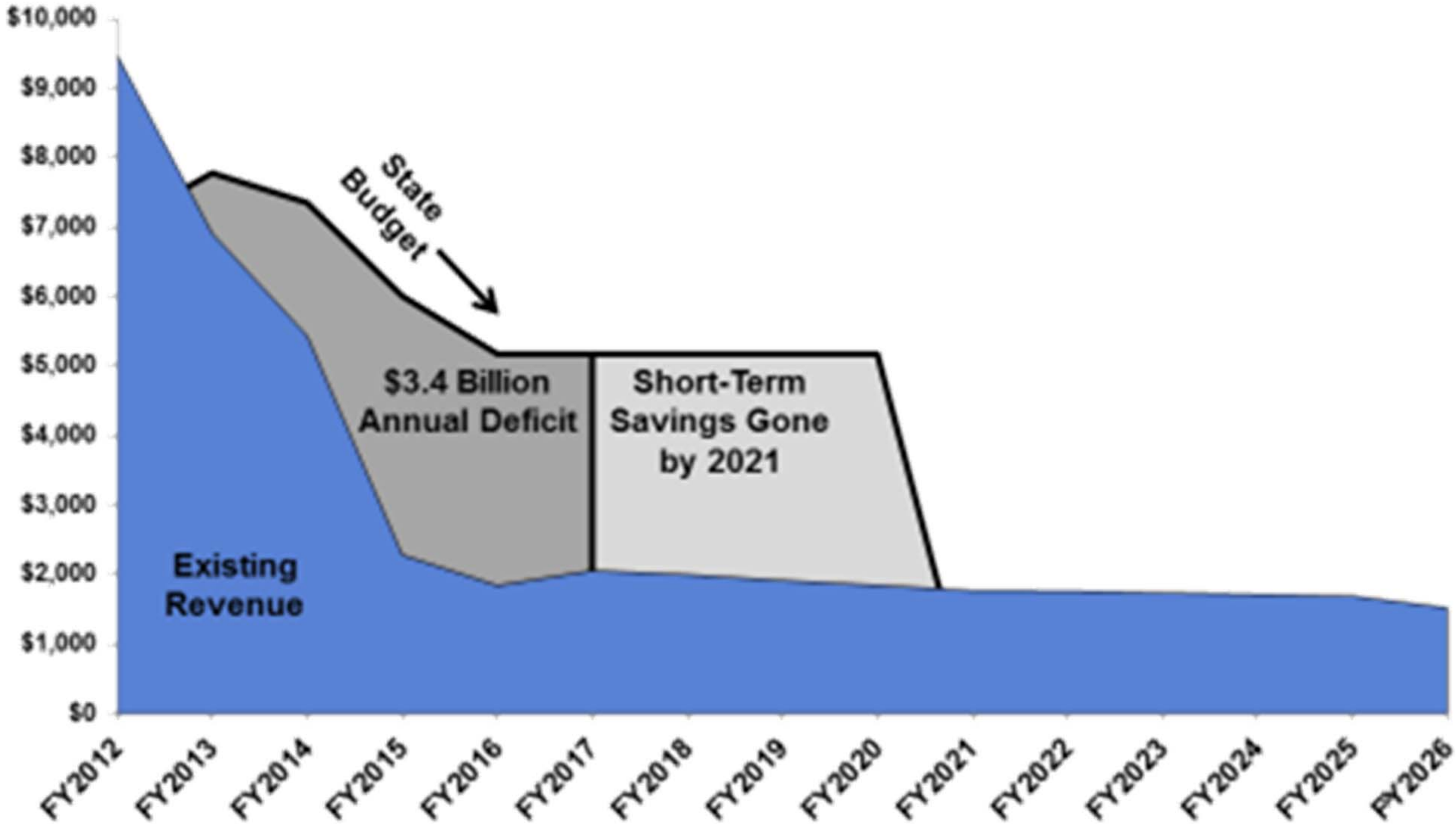
Defining the Problem

- Short-Term:
  - Drop in oil prices has resulted in large budget gaps
- Medium-Term:
  - State savings will be spent in about 4 years
  - Uncorrected, state budget hole will damage Alaska's economy
  - Dividend payments are unsustainable under the status quo
- Long-Term:
  - State's undiversified budget is highly dependent on petroleum revenues
  - There has been a declining trend in North Slope petroleum production
  - Cyclicality in petroleum prices creates an unstable state budget and economy

SHORT-TERM PROBLEM

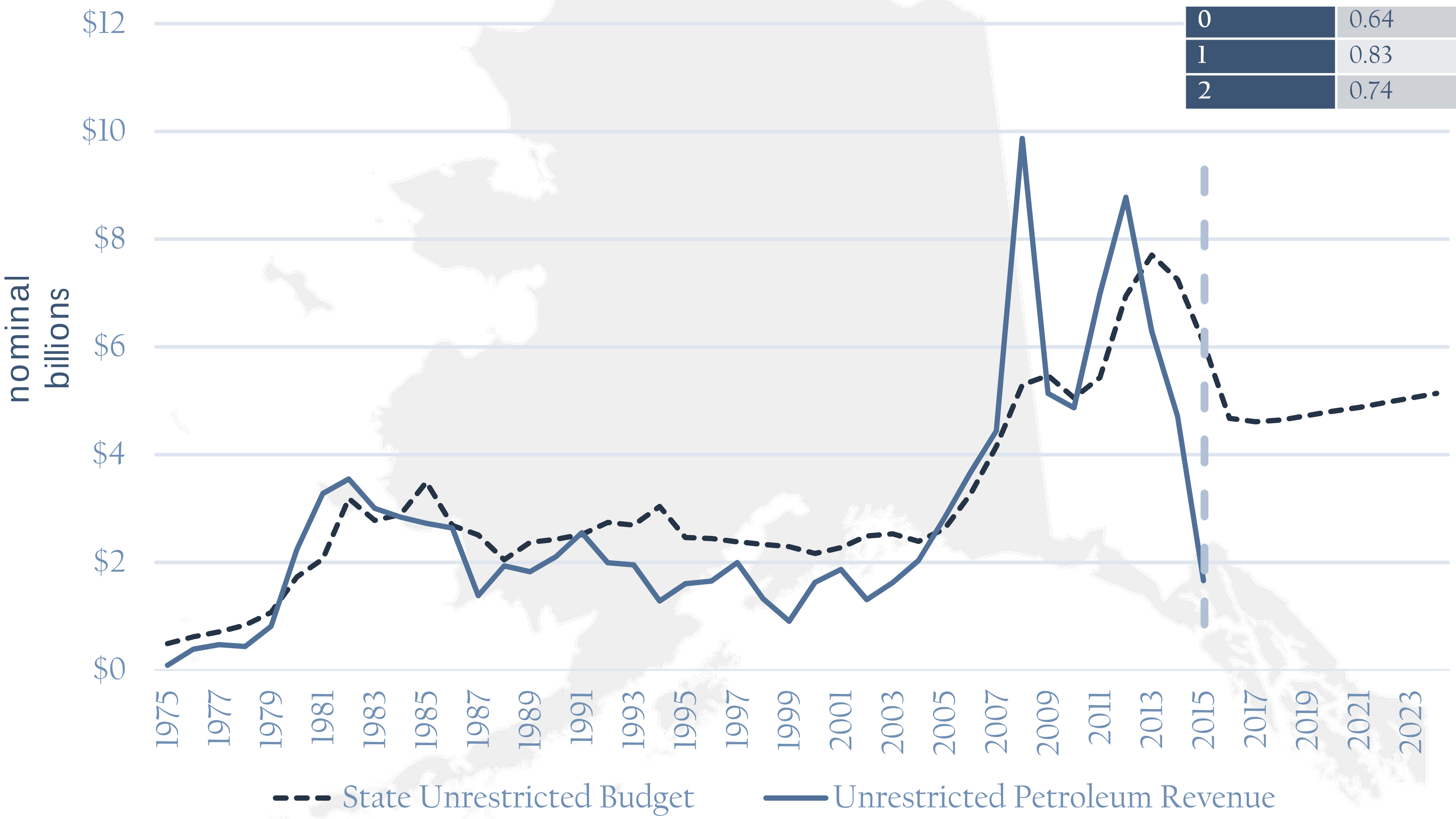


Medium-Term Problem



Long-Term Problem

Year Lag	R-Square Value
0	0.64
1	0.83
2	0.74



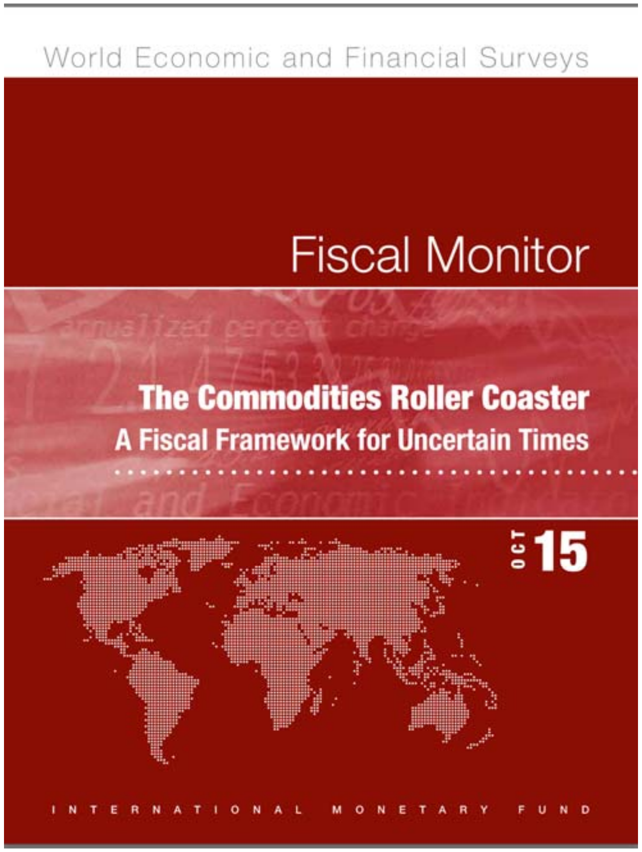
Solving the Long-Term Challenge

Fiscal Policy for Oil Economies

THE COMMODITIES ROLLER COASTER

For better or worse, state spending impacts the broader economy

- Study of 85 economies over 3 decades
- Government spending in commodity-based economies tends to move up and down with commodity revenue
- Pro-cyclical government spending stunts economic growth
- Stabilizing fiscal policy has the inverse effect, increasing GDP growth by 0.3% annually



Break-Even Oil Price

- A widely used rule-of-thumb measure of the oil price required to balance the government budget in any given year
- Options for petroleum states to bring down break-even oil prices are generally
  - Diversify revenues through other types of taxation
  - Use sovereign wealth assets
- Alaska: $109

Country	Break-Even Oil Price (2015)
Norway	$40
Kuwait	$54
Abu Dhabi	$55
Russia	$105
Saudi Arabia	$106
Nigeria	$122
Iran	$131
Algeria	$131
Venezuela	$160

Alaska: in the Middle

Alaska lacks

- Revenue diversity
- Fiscal rules to address pro-cyclical spending

But, like Norway, Kuwait, and Abu Dhabi, Alaska has

- A large sovereign wealth fund
- Proven experience with rule-based fiscal policy
- An independent investment authority

Alaska has a cash flow problem, not a wealth problem.

Analysis of Options

The Permanent Fund

"I wanted to transform

oil wells pumping oil for a finite period into

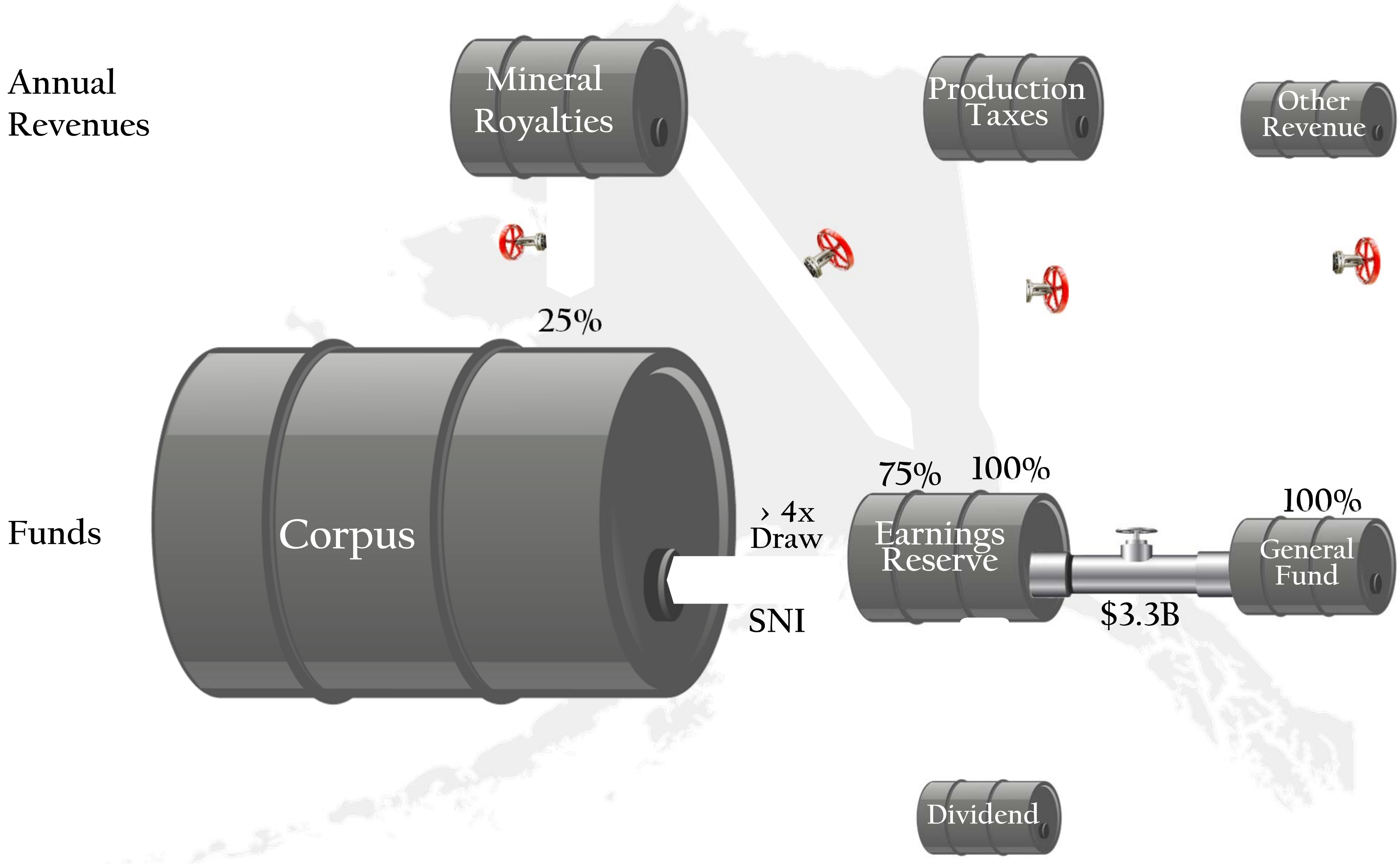
money wells pumping money for infinity."

~ Governor Hammond (1976)

DEFINING "SUSTAINABLE"

- Protect the Corpus
- Earnings Reserve Durability
- Inflation Proofing
  - Maintain the real value of the Permanent Fund
  - Transfers to the Corpus

APFPA Cash Flows



How to handle the draw

Status quo sustainable draw = $2.4 billion
Funds to the general fund = $2.4 billion – dividend payout ($1.4 billion in FY16)

POMV:

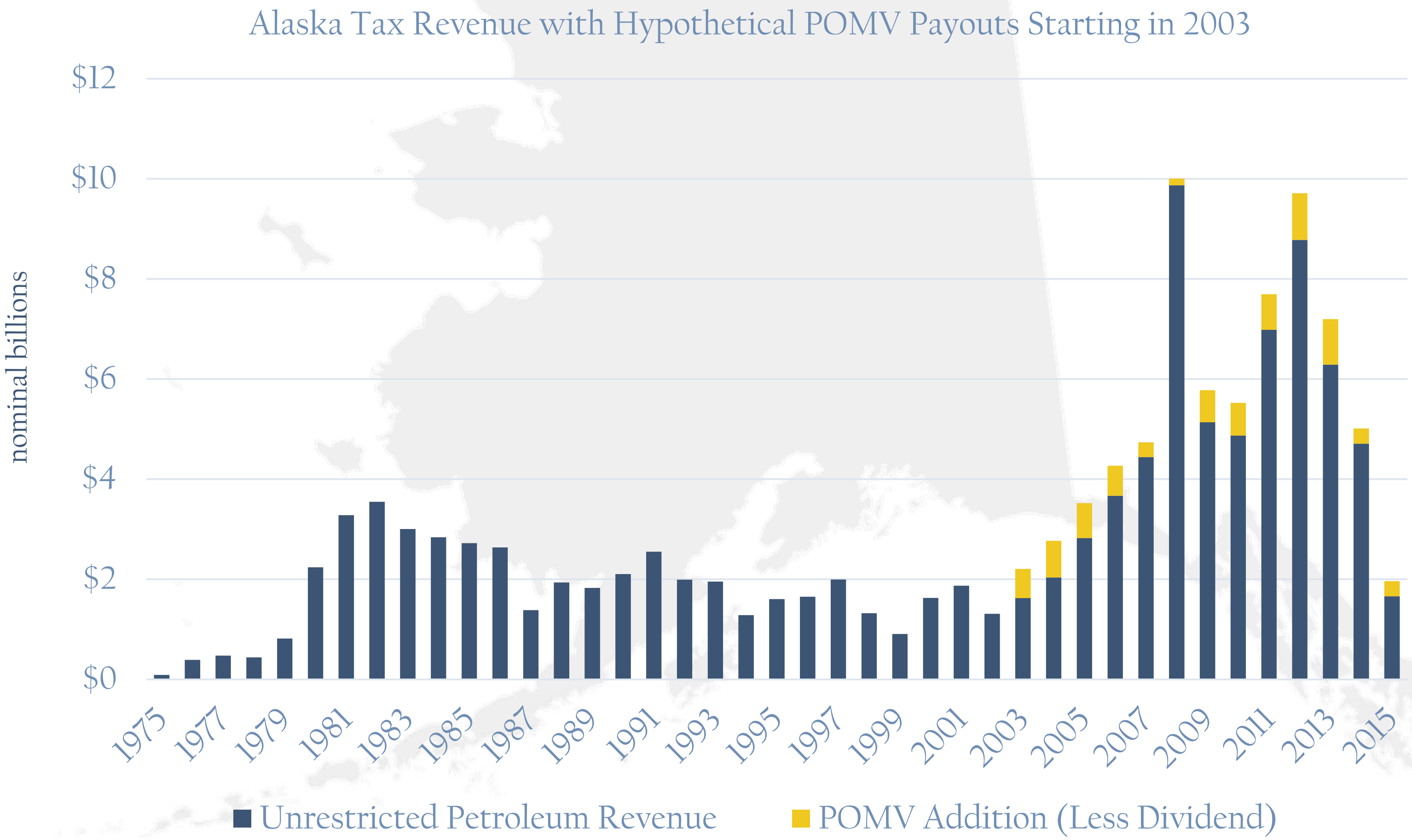
- Draw self-adjusts
  - Lower chance of depletion
  - Less fund growth potential
  - No periodic review
- Year-to-year budget volatility
- Rule incorporating petroleum revenue is complex
- Must be on net value of assets

Fixed:

- Draw does not self-adjust
  - Greater chance of depletion
  - Greater fund growth potential
  - Requires periodic review
- Stability for the budget
- Incorporating petroleum revenue not complex

How to handle the draw

A simple POMV endowment draw adds revenue, but does not address volatility



Calculating the Draw

The Financial Model

- Probabilistic: provides range of potential outcomes
- Starting Assets = $55B
  - $45B in Corpus
  - $7B in Earnings Reserve
  - $3B from CBR
- Inflation = 2.25%
- Investment Returns
  - Total Return = 6.90%
  - Statutory Net Income = 6.01%

Calculating the Draw

The Petroleum Model

- Oil price
  - Mean value from probabilistic distribution (2017 = $56.23)
  - Inputs – a range of prices for each year – from revenue forecasting session
  - Same underlying data used for the Revenue Sources Book, but the RSB uses only a single price (the median) from the forecasting session
- Production volumes and costs
  - Same forecast as Revenue Sources Book (Fall 2015)
  - Conservative
- Shortcut Model
  - Input the above oil price, production volume, and costs
  - Deterministic calculation of annual production tax and royalty revenues

CALCULATING THE DRAW

Annuity-Like Fixed Payment to the General Fund

Starting Balance = $55 billion

+ **Inflows** =

Investment income from financial model
100% production taxes from petroleum model
100% royalties from petroleum model

- **Outflows** =

Expenses

Dividend

Draw (inflation increase delayed until 2020)

= **End-of-Year Balance**

… **$3.3 billion** annuity from financial and petroleum wealth
(2040 Balance = 2016 Balance + Inflation)

EARNINGS RESERVE DURABILITY

- Target balance: 4 times the prior year draw
  - If Earnings Reserve at target balance:
    - 100% of production taxes and 50% of royalties deposited in Corpus
    - 50% of royalties deposited in Earnings Reserve
  - If Earnings Reserve under target balance:
    - Up to 100% of taxes & 75% of royalties deposited in Earnings Reserve
    - Minimum of 25% of royalties deposited in Corpus
  - If Earnings Reserve over target balance:
    - Excess transferred to the Corpus
- **$3 billion transfer from the CBR** for a starting balance of $11.6 billion (including anticipated FY16 income)

Earnings Reserve Durability

- Robust Earning Reserve Cash Inflows
  - $3B transfer from the CBR
  - Statutory Net Income
  - Petroleum revenue
- Long-Lead Adjustment Opportunities
  - 4:1 coverage ratio
  - Periodic review
  - Robust modeling
  - Sufficient time to react

How to handle the dividend

The current formula distributes 50% of realized gains

Annualized average of last 5 years of statutory net income ($13B x 0.21%)

Take half ($2.7B ÷ 2)

Transfer to Dividend Fund ($1.4B)

After adjustments, divide by number of recipients ($1.4B ÷ 644,511)

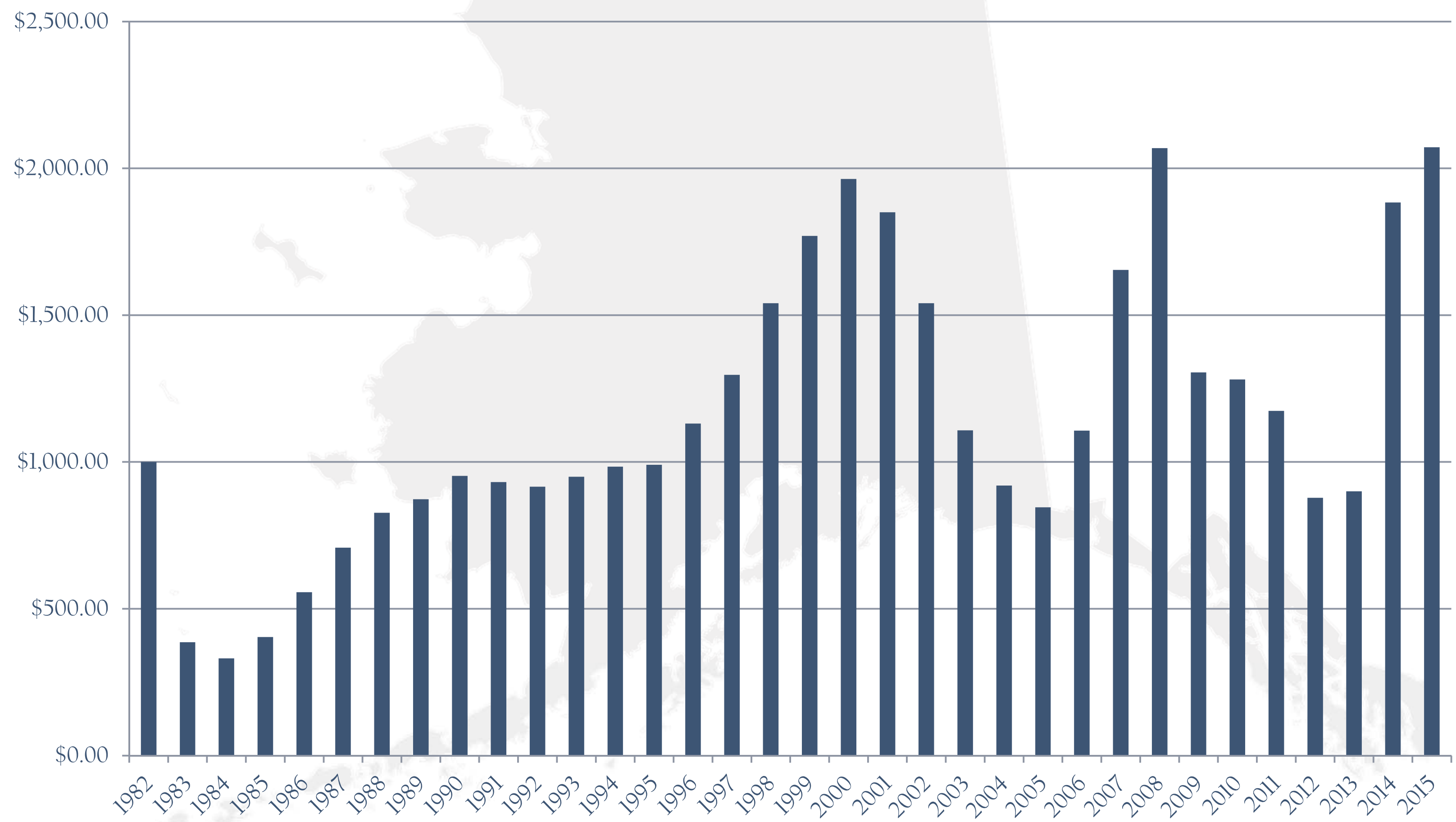
2015 individual check = $2,072

Use of Fund Income

Since inception (in billions)

46%	Paid out to Current Generations	23.5
54%	Saved for Future Generations	27.7

How to handle the dividend



How to handle the dividend

$1,000 Flat Dividend

- Costs about $650 million per year
- Compared to 50% royalty dividend, reduces the sustainable draw by about $200 million per year

Royalty Dividend

- 50% of Alaska's ownership share of oil revenue
- Reflects our success as a state and connects Alaskans to the economy
- Increases or decreases according to what we can afford

"*the Board recognizes that … a POMV spending limit methodology … may necessitate changes to … the Permanent Fund Dividends*"

APFC Board Resolution 03-05

Periodic Review

- Flexibility to adjust the draw downward
- Schedule: 2017, 2020, then every 4 years
- Consistent methodology
  - Variables
  - Sustainability metric
- Report, supporting data, and analysis publically available

Alaska Permanent Fund Protection Act

The Bill

OVERVIEW

1. **$3.3 billion endowment draw for the General Fund**
   - Rising by inflation starting in 2020
   - Sustainable

2. **100% of production taxes and royalties go into the Permanent Fund**
   - 25% of royalties always go the Corpus
   - Remainder allocated to maintain target balance

3. **Dividends** equal to 50% of prior year's royalties paid from Earnings Reserve

Alaska Permanent Fund Protection Act

- Section 1: **Revenue to the Corpus**
- Section 2: ERA "target balance"
- Section 3: Conforming Amendment
- Section 4: **ERA transfer to Dividend Fund**
- Section 5: **ERA transfer to Corpus**
- Section 6: **Revenue to the ERA, Draw, and Periodic Review**
- Section 7: Conforming Amendment
- Section 8: Conforming Amendment
- Section 9: $1,000/person dividend in 2016
- Section 10: Effective July 1, 2016

Section 1 – Revenues to the Corpus

- Amends AS 37.13.010(a)
- **Production Taxes** (100%) directed to the corpus
  - Currently, goes to the General Fund
  - Increases funds available to the corpus
  - Requires an appropriation
- **Mineral Royalties** (49.5%) directed to the corpus
  - Constitutionally mandated 25% (no change)
  - An additional 24.5% (an increase from 5%)
- **Redirection Mechanism**: taxes and 24.5% of royalties (but, not the constitutional 25% of royalties) are subject to a redirection mechanism.

Section 1 – Revenues to the Corpus

- **Redirection Mechanism**: if needed to maintain the target balance, some petroleum revenue may be redirected to the ERA
  - Funds subject to redirection: 24.5% of the royalties and 100% of production taxes.
  - Helps ensure the ERA is not depleted if there are several consecutive years of low petroleum revenue and low investment income.
  - Protects the corpus. Depleting the ERA would put the corpus at risk as the state searches for additional funds to pay for government.
- **Presumption of savings**
  - Allows for redirection to the ERA when needed, but there is a presumption that funds go to the constitutionally protected corpus whenever possible
  - Intergenerational equity
- **Removes distinction between old and new leases**

SECTION 2 – ERA "TARGET BALANCE"

- Adds subsection (d) to AS 37.13.010
- Defines "**target balance**" by cross-reference to section 7, AS 37.13.145(l):

"target balance" is equal to **four times the prior year's sustainable draw** from the earnings reserve account

- Synched with timing of the Periodic Review
- Balances two objectives:
  - ERA durability (to protect the corpus)
  - A mechanism to transfer funds to the constitutionally protected corpus

SECTION 3 – NET INCOME OF THE FUND

- Conforming amendment to AS 37.13.140
- **Retains net income definition** excluding unrealized gains or losses
  - Unrealized gains or losses are allocated pro rata between the corpus and the ERA. Once the gains or losses are realized they are allocated entirely to the ERA.
  - Often unrealized gains are associated with illiquid, long-term, and higher earning investments. Leaving the distinction in place helps protect against premature spending that may reduce overall investment returns.
- **Repeals calculation of "income available for distribution"**
  - Repeals language limiting available funds to the 5 year rolling average of net income
  - Repealed because
    - Part of current dividend calculation, which changes
    - Other income, production taxes and royalties, may also be available in ERA

Section 4 – ERA Transfer to Dividend Fund

- Amends AS 37.13.145(b)
- **Changes amount transferred from ERA to Dividend Fund**
  - APFPA: 50% of prior year royalties
  - Previously: half of the 5 year rolling average of annual net income or ERA balance
- **Changes timing of the transfer**
  - APFPA: beginning of the fiscal year
  - Previously: end of the fiscal year
- **Royalties gather in ERA before going to the dividend**
  - Retains the dividend's connection with the Permanent Fund and the protection afforded the corpus.
  - Helps with cash flow, particularly in first few years.
  - Executes the rule-based system in the first year the same way it will operate in future years. Consistency is important to developing the custom that will protect the corpus.
  - Clear that the dividend and are UGF sharing available revenue.

SECTION 5 – ERA TRANSFER TO CORPUS

- Amends AS 37.13.145(c)

- **Changes amount transferred**
  - APFPA: funds in ERA exceeding the "target balance" go to the corpus
  - Previously: funds necessary to inflation proof the corpus

- **Changes timing of the transfer**
  - APFPA: when excess funds available
  - Previously: every year, unless ERA exhausted

- **Flexible transfers to the corpus**
  - Improves durability of the ERA, thereby protecting the corpus
  - Nearly $1 billion would be required for inflation proofing this year
  - Funds necessary for full inflation proofing of the fund may stay in ERA for a period

- **Presumption of savings**
  - Transfers funds over the target balance even if it exceeds inflation proofing
  - Excess funds become constitutionally protected and invested to earn into the future

Section 6 – Revenues to the Earnings Reserve

- Adds subsections (e) to (l) to AS 37.13.145

- **Redirection Mechanism** – (e) and (f) mirror the redirection provisions in section 1 – if needed to maintain the target balance, up to 100% of production taxes and 24.5% of royalties that are otherwise deposited in the corpus may be redirected to the ERA

- **Dividend Royalties** – (g) – the 50% of royalties allocated to the dividend gather in the ERA until they are transferred to the Dividend Fund under section 4

SECTION 6 – SUSTAINABLE DRAW

- Subsections (h) and (i)
- **Annual endowment transfer** from the ERA to the General Fund
- **$3.3 billion fixed-draw**
  - Ceiling, except
  - Inflation adjustments beginning in FY20
- **Timing**
  - "each fiscal year"
  - Intended to be flexible
  - Treasury and APFC have room to work out a practical and efficient system
- **Appropriation**
  - Framework relies on legislature partnering with the executive
  - The Alaska legislature has a long history of following a rule-based policy for the ERA

Section 6 – Periodic Review of Draw

- Subsections (j) and (k)
- **Sufficiency of assets review** conducted by Revenue allows draw to be adjusted to ensure the fund value is not degraded
- **Scheduled**: 2017, 2020, then every 4 years
- **Formulaic**: uses the same approach and variables used to calculate the initial draw
- **Protects the ERA** while providing consistency and stability for the General Fund
- **Transparency**
  - Review provided to the legislature
  - All supporting information and analysis also provided

SECTIONS 7 - 10 – $1,000 DIVIDEND & MISCELLANEOUS

- Section 7 – **conforming amendment** to AS 37.13.300(c) isolating net income of the mental health trust fund from net income available for draw to the General Fund

- Section 8 – **conforming amendment** to AS 43.55.080 directing production taxes to the Permanent Fund

- Section 9 – amends uncodified law and specifies **2016 checks will be $1,000/person** – hitting reset for the dividend and easing transition to the new system.

- Section 10 – **July 1, 2016 effective date**

Alaska Permanent Fund Protection Act

1. Protect the corpus

2. Protect the dividend

3. Grow the fund

4. Stabilize the budget

5. Stabilize the economy