

## **Will Reducing Oil Taxes Spur Production? The Critical Question in Alaska's FY 2014 Budget Process**

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### **Introduction**

The article describes the process leading to the Alaska FY 2014 budget plan. It covers the period from the most recent Alaska report (McBeath 2012) in December 2012 to December, 2013. The report begins with a discussion of the Alaska economy in 2012–13. It briefly treats the state's redistricting process, and the 2012 state elections for the legislature.

Next, the report discusses state issues with a federal connection tracked in Alaska reports of recent years. The report's focus is the FY 2014 budget process. It includes the governor's requested budget (operating, supplemental and capital), and legislative responses.

A special section examines the main fiscal issue in the first session of the 28th Alaska Legislature: Governor Parnell's proposed reform of the state oil taxation regime, which failed to gain support of the state Senate in 2012, but was enacted in April 2013. The report provides data on the final state budget: revenues, capital, and supplemental budgets, and the state's operating budget (all funds), and it concludes by summarizing the FY 2014 budget process and raises again the issue of Alaska's long-term fiscal sustainability.

### **The Alaska Economy in 2012 and 2013**

Alaska's economy has three pivots: the oil and gas industry, the Alaska Permanent Fund (PF), and everything else (including the last decade's very large federal receipts, now beginning to decline). The oil industry, through severance taxes, royalties, and corporate income and other business taxes (in FY 2013), supplied more than 90 percent of the state's general fund (GF) revenue. Since 1980 Alaska has had neither an income tax nor a state sales tax; earnings of the PF contribute little to state government revenues.

As reported in the last three years, Alaska's economic conditions have been good while those of some other western states have undergone contraction. Job growth has been good in most categories except for construction trades and the public sector. Because Alaska's economy expectedly is seasonal and there are limited job opportunities in most rural areas, the unemployment rate is usually higher by several points, but in the last four years it has been below the national rate (in February 2013, 6.5 percent while the national rate was 7.5 percent). State taxation of oil and gas development, largely occurring on state lands, explains the difference. Tax revenues depend on the highly volatile price of oil (and gas) and the amount of production, and we

consider these before discussing briefly other natural resource circumstances and the state's return on investments in 2013.

## **Oil Prices**

In the last dozen years, the low point for oil prices was at the start of the Murkowski administration (2002–03), with prices in the \$20/barrel range. In more recent years, prices have increased by five-fold and during this reporting period have stayed mostly above \$100/barrel. In December 2012, the state Department of Revenue (DOR) projected that the price of oil from 2014 until 2018 would range from \$109/barrel to \$118/ barrel (DOR, Revenue Sources Book, December 2012). The following December, DOR forecast an oil price of \$105.68/barrel for FY 2014 and \$105.06/barrel for FY 2015, a lower price than in recent years (DOR, Revenue Sources Book, December 2013).

## **Oil/Gas Production Prospects and Problems**

Production from the state's legacy fields of Prudhoe Bay and Kuparuk continues to decline, and oil is now more expensive to extract. North Slope oil production peaked at 2.1 million barrels/day in 1988. By 2012 production had declined to 579,100 barrels/day. Introducing the Revenue Sources Book for 2012, then-DOR Commissioner Bryan Butcher commented:

North Slope oil production continued to decline at a rate of 3.3% in FY 2012. If an average of the two years' decline is taken into account it follows the historic average trend, around 5.5% per year. While the forecast over the next two years anticipates decline rates of 4.5% and 2.6% respectively, without new discoveries or additional investment, the Department forecasts a steeper decline in the future (DOR press release, 12/4/12). This remained the position of the department through the legislative session, and of the Parnell Administration as it sought to reduce petroleum production taxes.

The three main North Slope oil producers—BP, ConocoPhillips, and ExxonMobil—produced healthy profits on their operations in 2012. ConocoPhillips reported \$2.3 billion in Alaska earnings under the existing tax structure. It paid the state \$3.7 billion in taxes in 2012 as compared to \$2 billion in 2011. Senator Wielechowski (D, Anchorage), a leading opponent of the governor's oil tax reform proposal, said ConocoPhillips made \$28/barrel in Alaska, as compared to \$11/barrel in its Lower-48 operations (*Anchorage Daily News* (ADN) 2/8/13).

According to DOR data, oil industry profits before federal taxes rose to \$6.7 billion in FY 2012, an increase of \$500 million from the previous year. Profit divided by total barrels produced was \$31.16/barrel, an increase of 12 percent from the \$28.16 posted the previous year (*Alaska Budget Report* (ABR) 1/31/13). As we note below, the majors emphasized that an oil tax overhaul definitely would lead to more investment (ADN 3/27/13; *Fairbanks Daily News-Miner* (FDNM) 3/31/13, 4/18/13; *Alaska Dispatch* (AD) 90/10/13.)

The independents operating in Alaska's oil fields were more aggressive (and optimistic) than the majors. A surprising contrast with the rest of America's oil patch was that the division of oil and gas of the Department of Natural Resources (DNR) did not include shale oil (or for that matter, heavy oil) in its production estimates, saying that at present this area was too "speculative" to warrant mention (FDNM 1/29/13).

## **Other Natural Resources**

Tourism and fisheries employ many thousand more workers than the oil industry, but have a far less significant impact than oil and gas on the state economy. In 2012–13 tourism revenues were good. Although the King Salmon harvest in 2012 was declared a disaster by the U.S. commerce department, the other salmon fisheries were productive (*Alaska Economic Report* (AER) 11/9/13).

In the last two years, rare earth minerals have attracted much attention globally, but the state has only vague estimates on their location and potential value. Hard rock mining operations remained profitable in 2012 and early 2013; however, the drop in the price of gold to \$1,340/ounce caused investors to back away from new prospects such as the planned Livengood gold mine (FDNM 7/14/13). The largest prospect—the Pebble gold/copper/molybdenum mine in the Bristol Bay—faced increased environmental opposition and permitting delays (FDNM 2/6/13, 4/27/13) during the year. Then, the largest backer, Anglo-American PLC withdrew from the project (FDNM 9/17/13) seeming to seal its fate. A huge open pit mine adjacent to the world class salmon fisheries of Bristol Bay seems unlikely in the near term.

## **Returns on Investments**

The state’s largest single asset remains the PF, which has regained most of the value lost during the recession. It was worth \$45.4 billion in March 26, 2013 rising in market value to \$48.5 billion by the end of 2013. Few of the earnings of the PF are used to support state government operations; the major value of the PF is to fund PF dividends. The PF dividend in October 2012 was relatively small—\$878, because the payout is based on a five-year rolling average of earnings, influenced strongly by economic downturns (ADN 9/9/12). In October 2013 the payout was \$900, which some commentators attributed to the end of the Great Recession and improvement of stock market values. Others pointed to a decline in applications as antifraud efforts intensified.

## **Redistricting and the 2012 State Elections**

The essential features of the Alaska population have not changed much since previous reports. The number revealed in the 2010 census (710,000 Alaskans) was the basis of the state redistricting process conducted by a five-member redistricting board with a strong Republican bias. A series of challenges to the board’s proposed major changes, most noticeable in the interior and western Alaska rural regions, almost interfered with the holding of primary elections in August, 2012. The final pre-election ruling of the Alaska Supreme Court required the board to meet state constitutional requirements (primarily concerning the compactness of districts) and then meet the terms of the federal Voting Rights Act. The board drew an “amended proclamation plan” to comply with the court order, and the plan was cleared by the Department of Justice (ADN 5/4/12) and used in the 2012 primary and general elections.

The board’s consistent objective was to create a Republican majority in the state Senate (and thereby remove the Bipartisan Working Group, which had been in power since 2006) and to increase the number of Republicans in the House. It did this through straightforward “cracking and packing”—gathering Democratic votes into a smaller number of districts while spreading Republican votes more widely. In the primary election, it pitted Democratic legislators against one another in Anchorage. In the general election, the plan paired two incumbent Republican senators

against two incumbent Democrats, with the former in more congenial precincts. In the House, the plan paired two incumbent Republicans against two incumbent Democrats.

The redistricting plan produced the outcomes its framers intended. In the House, the working majority of the Republicans increased. In the Senate, Republicans won a majority. While small numbers of Democrats (mostly from rural districts) joined Republican majorities, the legislature was clearly unified under Republican power. Shortly after the election, Democratic Representative Lindsey Holmes switched her partisan identification to Republican, and picked up a valued seat on the House Finance committee (ADN 1/13/13).

The business of redistricting did not finish with the 2012 election, however. Complaints about the failure to meet state constitutional requirements caused the Alaska Supreme Court to order the redistricting plan be redrawn for the 2014 elections (FDNM 12/19/12). The Alaska Supreme Court did not insist on exactness regarding districts' compactness, and the final plan did not need to be "drastically different" (ADN 4/30/13, 5/31/13). The redistricting board returned to work (FDNM 6/8/13).

In late June, the U.S. Supreme Court struck key provisions of the Voting Rights Act. The effect of the action was to remove Alaska from strict court scrutiny including the preclearance procedure (ADN 6/26/13). The redistricting board created three new rough draft maps and held hearings on them in the state's major population centers (FDNM 6/20; ADN 6/30/13, 7/1/13). The board's new election map reconnected two liberal communities (Ester, Goldstream), previously paired with remote western Alaska villages, to the Fairbanks borough and gave the city of Fairbanks its own Senate district (FDNM 7/9/13, 11/19/13).

The original plaintiffs again filed suit in superior court, alleging the latest plan was flawed in Fairbanks and Mat-Su, and continued to link disparate regions (ADN 7/20/13). Judge McConahy found the plan to meet state constitutional requirements, and the plaintiffs declined to appeal. For the next four state elections, it is very likely the plan will produce Republican majorities in the House and Senate.

## **State Issues with a Federal Connection**

We treat three issues that have some bearing on fiscal policy in Alaska: OCS drilling, natural gas, and federal government downsizing in Alaska (including sequestration).

### **OCS Drilling**

The Alaska press featured Royal Dutch Shell during 2012 and 2013 as the company, returning to Alaska after an absence of more than a decade, attempted to drill for oil in five leased near-shore areas of the Chukchi and Beaufort Seas. Native villages and environmentalists opposed the drilling, and challenged the primary permitting agencies (EPA and BOEM).

In the 2012 season, Shell began to drill "top holes" in the Chukchi Sea, but problems with the drilling ship brought an early close to its season. (Even a Shell tow vessel had fuel problems before the drill rig came to ground on Kulluk, a remote island: FDNM 5/23/13, 5/25/13.) The company planned no further drilling in 2013 (FDNM 2/28/13). The House Sustainable Energy and Environment Coalition began an investigation into Shell's drilling barge, raising questions about the long-term prospects for this type of OCS drilling (ADN 1/4/13); while referring to Shell's travails, ConocoPhillips blamed the "uncertain regulatory environment) for the lack of exploratory drilling (AD 4/10/13).

Shell continued work on its offshore drilling plans, while paying for pollution charges and equipment failures (ADN 9/6/13, 11/1/13). Meanwhile, the U.S. district court approved oil spill plans for drilling off the Alaska coast (FDNM 8/7/13).

## **Natural Gas**

While DNR Commissioner Dan Sullivan remained optimistic about plans to move some of Alaska's large North Slope natural gas deposits to markets through the proposed large-diameter line, little progress has been made. In Governor Parnell's State of the State address, he set a deadline of mid-February for agreement of the state, TransCanada, and the producers of details on the size of the projected gas pipeline and the gas treatment (liquefaction) plant on the North Slope (FDNM 1/17/13). The producers met this request with a two-page document, which answered few questions (FDNM 2/20/13). The only movement visible was agreement to develop the LNG site at Nikiski in south-central Alaska (ADN 10/8/13). It appears that the long-range plan developed under the Alaska Gasline Incentive Act (AGIA) in 2007 to move Alaska gas in a large-diameter pipeline to the U.S. Mid-West is now dead, only waiting for its obituary to appear in Alaska's media.

Two other proposals attracted more attention. Supporters of a proposal to build a small-diameter pipeline from the North Slope to areas south, for in-state use of gas, continued to complain that the large pipeline proposal stood in the way (FDNM 2/15/13). Supporters and opponents sparred over the cost (about \$7 billion), need and location. The city of Valdez opposed gas line construction and spent \$900,000 in a campaign against the legislative vehicle, HB4, championed by House Speaker Mike Chennault. By session's end, both houses had approved HB 4 (FDNM 3/29/13, 4/2/13, ADN 4/12/13). Then controversy shifted to the Regulatory Commission of Alaska (RCA), which considered competing pipeline applications at contentious gas utility hearings (ADN 9/18/13).

Impatient Fairbanksans who paid far higher fuel costs than residents of other large Alaska cities, supported the trucking of natural gas down the Dalton Highway to the Interior (FDNM 4/12/13). The governor agreed to state loans and grants to underwrite this project (FDNM 1/17/13, 1/27/13), and he signed the gas trucking bill into law in late May 2013 (FDNM 5/30/13). In this case too, competing applications from different organizations seemed likely to slow the trucking plan (FDNM 6/16/13).

## **Proposed Downsizing of Eielson AFB**

In early 2012, the U.S. Air Force proposed, as part of a national cost-savings effort, to move the squadron of F-16 fighter planes from Eielson Air Force Base (25 miles south of Fairbanks) to the Joint Base Elmendorf-Richardson in the Anchorage area. Eielson hosts more than 5,000 military and civilian employees of the defense department; its contribution to the borough's economy is estimated to be around 10 percent (FDNM 2/4/12).

The Alaska congressional delegation actively opposed the action, placing restrictions on the proposed move in the FY2013 military budget, and added amendments in both House and Senate military budgets (FDNM 12/11/12, 12/8/12, 12/22/12). Senator Lisa Murkowski even introduced an "America Needs Eielson Act of 2013," recalling the 2005 campaign to save Eielson from the BRAC process. The Air Force held public meetings to prepare for environmental analyses of the proposed transfer (ADN 1/18/13), and the scoping and other meetings attracted large crowds.

The draft EIS recommended transfer of the F-16s but only after further hearings (FDNM 6/4/13, 6/6/13).

In mid-July 2013 the air force held the hearing to nearly universal opposition. Critics, including Senator Murkowski, questioned transferring F-16s when Eielson was a top contender for a new squadron of F-35s. The Anchorage mayor said his city did not have sufficient housing for new military personnel (FDNM 7/17/13, 7/18/13, 7/24/13). Within two months the AF Commander said no Asia-Pacific bases would be closed, and by early October, the USAF abandoned its plans to move the 21-plane squadron.

The official explanation noted failure to find significant savings from a transfer, likely harm to the Interior's economy, and the need for a strong focus on the Asia-Pacific (FDNM 9/23/13, 10/3/13). Restructuring plans in the US Army also mentioned Alaska's two posts, with some proposals adding, and others reducing military personnel (FDNM 1/22/13, 4/21/13).

## **Sequestration**

In the first through the third quarters of 2013, sequestration had noticeable effects in urban areas of Alaska. Furloughs of federal civilian personnel began in February, reducing to four-days the workweeks of employees in several agencies (FDNM 2/21/13). Overall, projected cuts were \$78 million to army base operations and \$12 million to the air force. There were reductions of teachers and aides at the 10 schools serving military dependents (but no school closures). Clean water/air enforcement expenses were projected to decline by \$1.8 million.

Reductions in federal grants were more difficult to estimate and included \$2.1 million reduction in Fish & Wildlife protection grants, funding for infectious disease monitoring, substance abuse counseling, AIDS testing, law enforcement grants and child care expenditures (ADN 2/25/13). The military did cancel Northern Edge training exercises involving 9,000 reserves (ADN 4/6/13). The USAF cancelled Red Flag Alaska military exercises (FDNM 3/18/13) and grounded the F-16s for several months (FDNM 4/10/13). Furloughed employees took about 11 days of unpaid leave (FDNM 7/6/13). Not all of the other cuts materialized.

Effects of the partial federal government shutdown were newsworthy as well. Resource agencies such as BLM and the USFWS reduced hours of staff, and the Parks Service developed an Alaska version of the Washington Monument strategy. It put into effect restrictions on access to national refuges (including ANWR) and closure of some parks, prompting Governor Parnell to threaten to sue (FDNM 10/6/13, 10/16/13).

Compared to other states, Alaska is particularly vulnerable to sequestration because it ranks third in per capita number of federal employees, is second in the rate of military spending to GDP, has the highest percentage of veterans in its population, and 60 percent of its land is federally-owned (FDNM 2/19/13).

## **The FY 2014 Budget Process**

In 2013, Alaska had a conservative Republican governor, Sean Parnell, and both houses of the legislature were under Republican control. Before the governor revealed his budget in mid-December 2012, he announced he was adding more funding to his "choose respect" initiative (ADN 11/30/12). Shortly thereafter, he announced a \$355 million package of loans, tax credits, and grants to bring North Slope gas to the Interior and build a natural gas liquefaction plant on the North Slope (FDNM 12/18/12).

## **Governor's Request and Operating Budget**

The governor's FY 14 budget request was lean: it sought \$12.8 billion, a starting point almost \$1.1 billion lower than FY 2013's general fund spending. Most of the savings would come from the capital budget; at \$1.8 billion it was considerably lower than the \$2.9 billion capital budget Parnell approved in spring 2012. The governor's operating budget request held budget growth to about 2.5 percent over the adjusted base budget, with approximately \$159 million in new state general fund increases.

The governor's request was about \$508 million less than projected revenues for FY 2014, but lower than expected oil prices and production levels changed an expected surplus for FY 13 into a deficit. This meant that to balance the FY 13 budget required a withdrawal from savings. Had the legislature passed a budget maintaining the same level of spending as in fiscal year 2013, the FY14 deficit would be \$510 million.

### **Winners and Losers**

Table 1 compares spending under Governor Parnell's FY 14 budget request to the current year's level of spending. (Generally, the legislature adds items to the governor's budget request, but in FY 2014 this was not the case.)

### **Military & Veterans' Affairs**

This agency had the most budget growth in the governor's FY14 request, with about a 66 percent increase in state general funds. Most of the operating fund increases were for the Alaska Aerospace Corporation, and the supplement met "the operation and maintenance costs of the Kodiak Launch complex"(ABR 1/17/13, 9).

### **Law**

Increases in the department's budget included monies for ongoing oil, gas and mining legal services, including Pt. Thomson litigation, TAPS tariff and property tax issues, FERC issues and state gas pipeline matters. Typically, the legislature included such funding in the budget as a one-time appropriation.

### **Office of the Governor**

Most of this increase paid for the governor's initiative to prevent domestic violence and sexual assault. While directed to the governor's budget, most of the funding was transferred to other agencies.

### **Public Safety**

The nearly \$12 million increase paid for 15 new Village Public Safety Officers, and six new troopers (in Fairbanks, the Mat-Su borough and the Kenai peninsula).

**Table 1. Winners and Losers, FY 2014 Governor’s Request (in thousands)**

<b>Agency</b>	<b>FY13 adj. Base</b>	<b>FY 14 Gov Request</b>	<b>% Change</b>
Military and Veterans’ Affairs	\$13,627	\$22,603	65.9
Law	58,192	65,834	13.1
Governor	25,829	28,887	11.8
Public Safety	170,860	182,684	6.9
Natural Resources	101,666	106,842	5.1
Alaska Court System	107,735	111,892	3.9
Education & Early Development	1,266,482	1,309,492	3.4
Administration	107,097	110,047	2.8
Revenue	41,251	42,179	2.3
Fish & Game	86,982	88,903	2.2
Environmental Conservation	48,081	48,133	2.2
Transportation	352,415	359,391	2.0
Health & Social Services	1,295,862	1,319,000	1.8
Labor & Workforce Development	67,919	69,059	1.7
Corrections	305,103	309,256	1.4
University of Alaska	73,621	73,662	0.1
Legislature	73,621	73,662	0.1
Branch-wide (Fuel Costs)	36,000	36,000	0.0
Commerce, Community & Economic Development	180,791	139,780	-0.7
<b>Total</b>	<b>\$5,003,538</b>	<b>\$5,134,834</b>	<b>2.6%</b>

Source: Legislative Finance Division, “Overview of the Governor’s FY2014 Request, adapted from Alaska Budget Report, January 17, 2013.

### **Natural Resources**

Most of this new funding covered expenses for staff and consultants for the Alaska Gasline Inducement Act (AGIA). Other programs benefitting from increases were the guide concession area program and oil and gas arbitration expenses.

### **Alaska Court System**

New funding allowed the court system to expand bandwidth to relieve network congestion, replace funding for existing drunk driving courts and bring the system into compliance with ADA requirements.

### **Education & Early Development**

Although the governor did not support additional funding to increase the Base Student Allocation, he did request \$25 million of one-time funding for school districts facing high energy costs and rising expenditures related to other fixed costs (shipping, transportation).

## **Commerce, Community & Economic Development**

This department lost \$1 million in funding, due to a decline in spending required for the Power Cost Equalization (PCE) program. In 2011, the legislature deposited \$400 million into the PCE Endowment.

## **Health & Social Services**

Although the department's budget increased only 1.8 percent, it is the largest state agency and the amount translated into \$37 million. This included increased funding for Medicaid that was much less than Legislative Finance estimated would be needed in FY2014 (ABR 1/17/13, 10–11).

## **Supplemental Budget**

Governor Parnell submitted his supplemental appropriations bill in late January and asked for a \$2.9 million *decrease* in FY13 general fund spending. A proposed \$25 million cut in the state's contribution to the Medicaid program and \$6.0 million reduction in debt service made possible the reduction. However, this supplemental spending plan did not address the \$410 million budget deficit Legislative Finance projected for FY13. (No action was necessary to address the potential deficit, as the 2012 operating budget bill contained a clause specifying that any general fund deficits would be paid for by an automatic withdrawal from the state's statutory budget reserve.)

Areas of new spending in the supplemental included monies for wildfire suppression, affordable housing projects, Department of Law judgment and settlement costs, disaster relief, increases for state pioneer homes, youth centers and the like. (ABR 1/31/13).

## **Capital Budget**

The governor proposed a capital budget of \$1.8 billion, and legislative leaders initially said they planned to add only \$263 million (ADN 1/30/13). Governor Parnell remarked he expected legislators to propose their own projects; he hinted he would not object to as much as an additional \$500 million in projects. The Senate added \$160 million to the governor's total, and the House raised the amount another \$200 million for a \$2.2 total capital budget (ADN 4/7/13, 4/14/13).

Legislative Finance compiled a 10-year history of legislators' capital additions (after vetoes) showing that they added at least 15 percent to the governor's proposal. On average, legislators more than doubled the capital outlay (ABR 1/24/13, 7). In 2013 legislators in both houses amended the governor's capital budget request by just over 20 percent.

## **Legislative Responses**

Legislators were generally optimistic about the governor's budget planning. Clearly, after the Republican gains in the 2012 election, oil tax reform was the highest item on the agenda (discussed below), followed by a series of energy proposals—the natural gas pipeline, LNG trucking, and hydropower development among others (FDNM 1/18/13).

Democratic legislators in particular took exception to the governor's lack of interest in raising the Base Student Allocation for K-12 education. Conservative Republican legislators focused

on a proposed amendment to the state constitution that would allow public spending for private education and the development of a state voucher program (which did not pass in 2013).

Most work of legislators on the operating budget was not controversial. By mid-March, two thirds of the way through the 90-day session, the House of Representatives sent a \$9.8 billion operating budget to the Senate. The budget bill (HB 65) passed by a mostly party-line vote of 29-8. Republicans spoke of the need to rein in spending given declining oil production, while Democrats argued for increasing spending on education and behavioral health. (The governor's budget request reduced behavioral health and Medicaid, cuts that the legislature did not restore.) The House budget bill was \$100 million lower than the governor's request, but still a \$285 million increase over the adjusted base budget (ABR 3/15/13). Within two weeks the Senate had passed a slightly larger (\$9.9 billion) operating budget (ABR 3/29/13). The extra funding added for K-12 education applied only to improvements of school security.

### **Revision of Alaska's Clear and Equitable Share (ACES)**

In both sessions of the 27th Alaska Legislature, Governor Parnell introduced legislation to revise ACES, believing it essential to lower taxes on the industry in order to encourage oil companies to invest in exploration and production. The legislative vehicle then, HB110, sharply cut the "progressivity" feature of ACES. It capped the production tax at 50 percent (compared to the ACES rate of 75 percent) and established a tiered or bracketed system, starting at 25 percent for new field sites. In both the 2011 and 2012 sessions, the House (under Republican rule) supported the governor's proposal while the Bipartisan Working Group (with 10 Democrats and six Republicans) opposed it.

The dramatic change in the Alaska Senate after the 2012 election raised confidence among tax reform advocates that Parnell's third attempt would be successful. The new bill (SB 21 and its companion HB 72) was significantly different from HB 110. Instead of attempting to make progressivity more palatable to the industry, the administration simply eliminated it, replacing it with a flat 25 percent profits tax at all prices. The bill reduced company take at prices below about \$80/barrel, but greatly increased profits for producers above that mark. It eliminated capital credit provisions found in existing legislation. Overall, the bill was simpler than then-current ACES law or the old HB 110.

The new proposal continued to reflect Parnell Administration philosophy on what actually spurred investment and production increases in the oil industry. It contended that Alaska's oil tax was much too punitive to producers and thus discouraged them from investing in the state. Instead it chased them to other provinces/areas where friendlier tax regimes promised higher rates of return. Oil industry representatives said the proposed tax cut would lead to more investment (ADN 3/27/13); a BP executive remarked that Parnell's proposal was a "game changer" (FDNM 4/9/13).

Those in opposition to the governor's approach (including most Democrats in the legislature) believed it was more sensible for the state to take a higher tax return for Alaska, especially when oil prices were high, and then offer incentives in the form of credits and tax deductions to create incentives for investment. Senator Hollis French, previously in the Senate majority, said that the evidence of legacy fields showed that low tax rates (such as those for Kuparuk) did not result in increased production (ABR 1/24/13, 1-3). Former Senate Finance Co-chair (and Sitka Republican) Bert Stedman remarked that the cut was too large and would damage the state (ADN 4/3/13).

Estimates of the cost to the state of the governor's proposal were up to \$1.5 billion in the next fiscal year (ADN 1/17/13). The legislation received considerable testimony and attention in Senate Resources and was revised in Senate Finance on its way to the floor in late March 2013. The Senate raised the flat tax rate from 25 to 35 percent, but added a \$5/barrel credit to reduce the effective rate (ADN 4/15/13). Under the flat tax system, oil producers would make very large windfall profits at high oil prices, while the state's take would improve slightly.

The cost to the state treasury of the Senate revision would be between \$800 million and \$1 billion, a half-billion less than the governor's proposal (ABR 3/22/13). As FDNM commentator Dermot Cole noted, the ultimate cost of the overhaul would depend on the price of oil (quite volatile) and the amount produced (difficult to predict); FDNM 3/31/13.

The Senate revision passed out of the body with a slim majority of 11–9, and this was a victory for the governor. It faced a more hospitable audience in the House, where the question was whether any further revisions endangered the narrow base of support in the Senate (ADN 3/13/13, 3/15/13; FDNM 3/21/13; *Juneau Empire* (JE) 3/22/13). Yet Co-chair of Senate Resources Eric Feige feared the cuts to oil taxes were not deep enough (FDNM 4/6/13). The legislature adopted the tax change in mid-April by a largely partisan vote (ADN, ABR 4/15/13). Rallies of opponents gathered in Anchorage, Fairbanks and Juneau to protest (FDNM 4/15/13).

After passage, the oil industry rejoiced. ConocoPhillips said it would boost investment on North Slope fields and seek new drilling sites (ADN 4/18/13). BP planned to bring new drill rigs to the North Slope by 2016, part of a \$1 billion investment increase (FDNM 6/3/13). The president of BP Alaska said SB 21 made new projects and North Slope investment feasible, including construction of a large-diameter gas pipeline (ADN 10/3/13).

Within days of legislative passage of HB 21, opponents organized a referendum campaign to repeal the "tax cut for oil companies," using the slogan "Vote YES: Repeal the Giveaway" (ADN 4/20/13). By early September, they had collected 45,664 signatures, some 15,000 more than needed for a referendum (FDNM 9/6/13).

## **Final State Budget**

We discuss supplemental, operating and capital budgets after first considering Alaska's revenue stream.

### **Revenues**

Table 2 indicates all sources of revenue for state government, comparing estimated revenues for FY 2013 with those estimated for FY 2014.

Overall, state revenues are projected to decline through FY 2014, with the difference from the previous year projected to be nearly 15 percent lower. Total general funds are expected to decline by \$1.34 billion, the decline associated primarily with the projected reduction in oil production from legacy fields (Prudhoe Bay and Kuparuk) and lower than estimated oil prices. Other state funds are expected to increase somewhat, and federal funds flowing into Alaska are expected to remain essentially the same (not decline, as they did in previous years).

### **Capital Budget**

The capital budget is significantly smaller than that for FY 2013: about \$2.2 billion. This is some 15–20 percent larger than the amount the governor asked for, but during the 2013 session

**Table 2. Revenue Sources, FY 2013-2014 Budgets (millions)**

<b>Revenue source (excludes Permanent Fund earnings)</b>	<b>FY 2013</b>	<b>FY 2014</b>
Unrestricted General Funds (based on oil forecasts of the Department of Revenue)	7,580.7	6,162.7
Designated General Funds	893.0	970.6
Total General Funds	8,473.7	7,133.3
Other State Funds	527.0	564.6
Federal Receipts	2,927.4	2,966.9
<b>All Funds</b>	<b>11,928.1</b>	<b>10,664.8*</b>

\*Excludes PF earnings

Source: State of Alaska Fiscal Summary—FY 13 and FY 14, 7/24/13.

the branches (and legislative houses) did not spar over the size. The legislature denied or reduced many projects requested by the governor. Because capital appropriations extend over many years, it is difficult to gauge what is authorized and expended in any given year. As Legislative Finance Director David Teal noted in 2011: the funds are reserved when appropriated but are not tracked until money is spent (personal communication, 8/25/11). In the FY 2014 budget, federal funds comprised about 47 percent of the total capital spending; federal receipts were \$28 million greater than in 2012.

### **Supplemental Budget**

The final, official amount for the FY 12 supplemental was \$20 million in the operating budget and nothing in the capital budget. This amount was the smallest in recent memory. Supplemental budgets are designed to accommodate unanticipated needs during the year in which the legislature is adopting a budget for the next fiscal year. The state had such needs, for example increased expenditures on Medicaid, but the executive did not use the supplemental budget for this purpose in 2012.

### **Operating Budget**

Alaska's FY 2013 operating budget totaled \$9.9 billion, about 2.5 percent larger than the FY 2012 budget. Table 1 compares the FY 2013 and FY 2014 budgets in terms of "winners and losers." There were few changes to the governor's request budget during the legislative session.

Normally, Alaska governors make few if any vetoes in the operating budget, and Governor Parnell did not veto funding for any substantive policy area. He vetoed \$1.8 million from five different agencies because of calculation errors; and \$700,000 from the Fairbanks fish hatchery that was "no longer needed" (Office of Management & Budget 5/21/13). Although vetoes were few and small, the agencies argued that they did not get what they wanted.

Table 3 presents agency totals alone for all sources of funding.

**Table 3. Agency Summary—FY 2014 Operating Budget, all sources (millions)**

<b>Agency</b>	<b>UGF*</b>	<b>DGF*</b>	<b>Other</b>	<b>Federal</b>	<b>All Funds</b>
Administration	86.8	24.5	34.9	3.8	150.0
Commerce, Community & Econ. Dev.	47.1	92.8	11.9	21.6	173.4
Corrections	297.0	16.7	.3	5.3	319.3
Education & Early Development	1,282.6	24.3	15.1	233.9	1,555.9
Environmental Conservation	23.4	27.1	4.9	25.1	80.5
Fish and Game	81.4	8.8	35.7	63.8	189.7
Governor	29.5	0	0	.2	29.7
Health & Social Services	1,236.2	73.4	26.4	1,248.8	2,584.8
Labor & Workforce Development	35.0	1.5	99.3	101.0	236.8
Law	81.2	2.7	27.5	2.0	88.4
Military & Veterans Affairs	172.3	8.4	.3	10.8	191.8
Natural Resources	81.2	25.9	26.8	22.5	156.4
Public Safety	172.3	6.4	.3	10.8	189.8
Revenue	33.3	9.8	216.9	77.5	337.4
Transportation	283.0	68.5	85.3	3.8	440.6
University of Alaska	371.3	305.5	1.7	150.9	829.4
Alaska Court System	110.6	.5	.7	1.7	113.5
Legislature	74.4	.1	0	0	74.5
Branchwide unallocated appropriations	40.4	1.1	.5	1.7	43.7
<b>Total</b>	<b>4,368.9</b>	<b>721.5</b>	<b>466.3</b>	<b>1,998.0</b>	<b>7,785.6</b>

\*UGF=unrestricted general funds; DGF=designated general funds, including program receipts that are restricted to the program that generates the receipts and revenue that is statutorily designated for a specific purpose; #The total excludes statewide items such as debt service, fund capitalization and direct appropriations to retirement systems.

Source: 2013 Legislature-Operating Budget; Agency Summary, Numbers and Language Appropriations (non-duplicated funds), Legislative Finance Division, July 24, 2013 (adapted by authors).

Notwithstanding federal fiscal distress and the expiration of most stimulus funding, the federal share of the operating budget is roughly the same as the previous year. Three agencies are the primary beneficiaries of federal funding. In terms of absolute federal dollars, the Department of Health & Social Services has the largest take, some \$1.25 billion (about 48 percent of the agency's budget). Recipients of the second and third largest absolute amounts of federal funding are the Department of Education and Early Development and the University of Alaska. Their dependence on federal dollars is less (just 15 and 18 percent respectively) than that of DHSS. One other department is significantly dependent on federal funding: The Department of Labor & Workforce Development receives 43 percent of its budget authority from the U.S. These ratios are not greatly different from previous years.

Program receipts, such as user, license, and permit fees, as well as university tuition, are large parts of the budgets of several state agencies. For FY 14, they will comprise 64 percent of the budget of the Department of Revenue, 23 percent of the Department of Administration's funding, 42 percent of Labor & Workforce Development, and 19 percent of the Department of Fish & Game budget.

### **Reserve Funds and the FY 2013 Budget**

As in previous years, Alaska's enacted budget is a plan, with revenues from oil (and thus dependency on production rate and oil prices) setting budget parameters. If expected revenues do not materialize, there will be automatic draws from reserves. Table 4 presents information on Alaska's savings accounts, because they provide an essential cushion to the state given the volatility of its revenue stream.

In our 2012 report, we noted that reserves for FY 12 and FY 13 were \$21.6 and \$23.9 billion respectively. This year's projected reserves are smaller, at \$22 billion projected for FY 14 or nearly \$2 billion less. Thus begins the start of the draw on state reserves, as oil prices decline somewhat and oil production falls. The Permanent Fund earning reserve account is used to fund PFDs, and this will cost the state \$957 million in FY 14. The remainder provides a comfortable cushion for the state in troubled fiscal times nationally and internationally.

That this cushion is short term was the subject of critical commentary by the state's senior economist and long-term state budget analyst Scott Goldsmith. A month before the governor was to issue his FY 2015 budget request, Goldsmith urged the governor and legislature to cut spending by \$1.5 billion in order to avoid more drastic cuts in a decade, when savings accounts would be drained (ADN 11/13/13).

## **Conclusion**

Alaska once produced more oil than any other state. In 1988, some 2.1 million barrels daily entered the Trans-Alaska Pipeline System (TAPS). Now Alaska produces less crude (about 540,000 barrels/day) than Texas and North Dakota and soon may be overtaken by California. Still, between 90 and 92 percent of the state's general fund comes from oil production taxes, royalties, and corporate taxes. Exploitation of other natural resources of the state—fisheries, mining, wood products, its natural beauty (through tourism)—employs thousands of Alaskans but contributes only small amounts to state government expenses. High oil prices and large state surpluses protected state finance during the Great Recession, but continued production declines, the

**Table 4. Approximate Balances of Reserve Accounts, FY 13 and FY 14 (in millions)**

<b>Nature of Reserve</b>	<b>FY 13</b>	<b>FY 14</b>
<b>Undesignated Reserves</b>	19,725.6	19,482.9
Permanent Fund Earnings Reserve Account	2,610.1	2,951.1
Constitutional Budget Reserve Fund (cash)	11,529.1	11,972.0
Statutory Budget Reserve Fund	5,098.5	4,431.4
Alaska Housing Capital Corporation Fund	487.9	128.4
<b>Designated Reserves</b>	2,653.7	2,609.8
Alaska Capital Income Fund	77.3	2.3
Alaska Higher Education Investment Fund	406.1	406.3
Public Education Fund	1,201.4	1,202.6
Revenue Sharing Fund	180.0	180.0
Railbelt Energy Fund	(0.0)	(0.0)
Power Cost Equalization Endowment	788.9	818.6
<b>Total Reserves (excluding Permanent Fund Principal)</b>	<b>22,379.3</b>	<b>22,092.7</b>
Years of Reserves (Reserves/UGF Appropriations)	2.81	3.23

*Source:* State of Alaska Fiscal Summary—FY 13 and FY 14 (Part 2), Legislative Finance Division, August 7, 2013 (adapted by authors)

need to draw down surpluses to balance state accounts, and volatility in oil prices create an uncertain environment for state fiscal policy.

In the 27th Legislature (2010–12), Governor Parnell and other Republican leaders sought to reverse oil production declines by overhauling the state’s 2007 petroleum production tax. At high oil prices, this tax produced huge surpluses for the state, but the major oil firms operating in Alaska—ConocoPhillips, BP, and ExxonMobil—threatened an investment strike (and dragged their corporate feet on natural gas exploration/development) if the tax rates did not fall. The governor had support from the Republican-led House, but in the 27th legislature, as in the two previous legislatures, a bipartisan working group composed of 10 Democrats and 6 Republicans held power. Its leaders refused to submit to the governor on tax overhaul.

In 2012, the complexion of the Senate changed. A redistricting board dominated by Republicans packed Democratic voters into a smaller number of districts while spreading Republican voters widely, giving a competitive advantage to Republican candidates. The election increased the size of the House’s Republican majority and brought Republicans back to power in the Senate.

It was a foregone conclusion that the power shift in the legislature would give the oil industry what it sought. Still, new members in the Senate with undetermined views kept suspense alive until the end of the short, 90-day session. As to the operating, supplemental, and capital budgets, the governor got most of what he asked for. Legislators adopted a \$9.9 billion operating budget just 2.5 percent larger than the previous year. The supplemental was one of the tiniest on record.

The capital budget, at a tad over \$2 billion, was 50 percent smaller than FY 2013, and overall state spending declined from FY 2013.

Other issues with budget ramifications—moving North Slope gas south to reduce in-state energy costs, the Air Force’s proposal to transfer a 21-plane squadron of F-16s to the base near Anchorage, the federal agency sequestration and partial government shutdown—were sideshows to the oil tax overhaul. Once passed and signed into law, Democrats attacked the “giveaway” to oil companies and in a few months collected more than enough signatures so a referendum to repeal SB 21 would be on the August 2014 primary election ballot. That made the election season, when both Governor Parnell and U.S. Senator Mark Begich faced re-election campaigns along with all House and many Senate members, quite interesting.

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