

Uncharted Waters: Alaska's 2015 Budget Process

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Introduction

Fiscal year 2015 was an eventful one in Alaska contrary to expectations during the 2014 legislative session. In 2014, Republican Governor Sean Parnell proposed a conservative budget with few major changes from the previous year, and the legislature passed the governor's budget with only minor alterations. One possible major change did not materialize when, in an August referendum, voters failed to repeal the More Alaska Production Act (MAPA)—a reform of Alaska's oil tax laws passed by the state legislature in April 2013 that increased the marginal rate at which petroleum firms are taxed when oil prices are low and decreased marginal rates when prices are high.

In late August, Alaska's bland gubernatorial race was shaken up by the emergence of a "unity ticket" in which two opponents to Republican Sean Parnell—Independent Bill Walker and Democrat Byron Mallott—joined forces and the Walker/Mallott ticket ultimately defeated Parnell in the general election. Also in August, global prices for oil began a rapid decline with prices for Alaska North Slope Crude dropping about 50 percent by late December 2014. As revenues from oil make up more than 90 percent of the state government budget, this drop has substantial fiscal implications for Alaska. Going forward, the Walker Administration will likely propose significant cuts to operating budgets and eliminate funding for several large infrastructure projects in 2015.

This paper describes the process leading to the Alaska FY 2015 budget and important changes since the adoption of the 2015 budget in spring 2014. It covers the period from the most recent Alaska report (McBeath and Wright 2014) in December 2014. The report begins with a discussion of the Alaska economy in 2013 and discusses state issues with a federal connection tracked in Alaska reports of recent years. The next section of the report is an analysis of the FY 2014 budget process. It includes the governor's requested budget (operating, supplemental, and capital), winners and losers in the proposed operating budget, and legislative responses.

The report concludes with data on state revenues for FY 2015, estimated to be \$2 billion less than the previous year, and state reserves.

Background: Alaska's Economy in FY 2014

Alaska's economy has three pivots: the oil and gas industry, the Alaska Permanent Fund (PF), and everything else (including in the last decades very large federal receipts, now beginning to decline). The oil industry through severance taxes, royalties, and corporate income and other business taxes (in FY 2014) supplied about 92 percent of the state's general fund (GF) revenue. Alaska has not had an income tax since 1980; it has never had a state sales tax; and earnings of the PF contribute little to state government revenues.

During the Great Recession, Alaska's economic conditions were good while those of some other western states underwent contraction. Job growth has been good in most categories except the public sector. Because Alaska's economy is seasonal and there are limited job opportunities in most rural areas, the unemployment rate is usually higher than the national rate by several points, but since 2008 it has been below the national rate (in January 2014, 6.4 percent while the national rate was 6.6 percent; BLS current population survey). State taxation of oil and gas, 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. These are considered in the following section before discussing briefly other natural resource circumstances and the state's return on investments in 2014.

Oil Prices

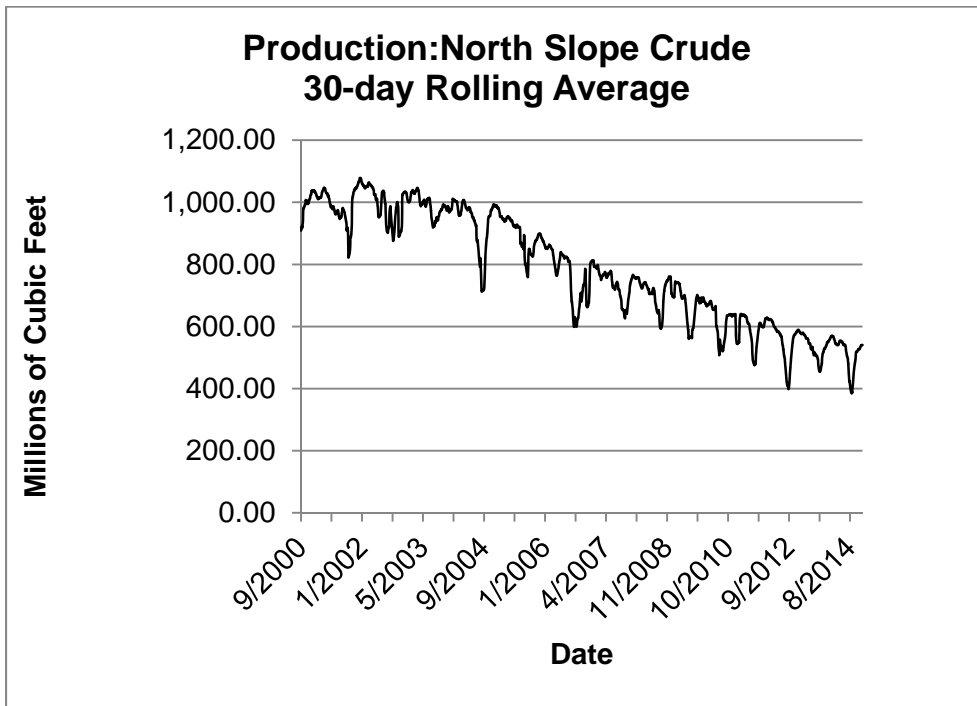
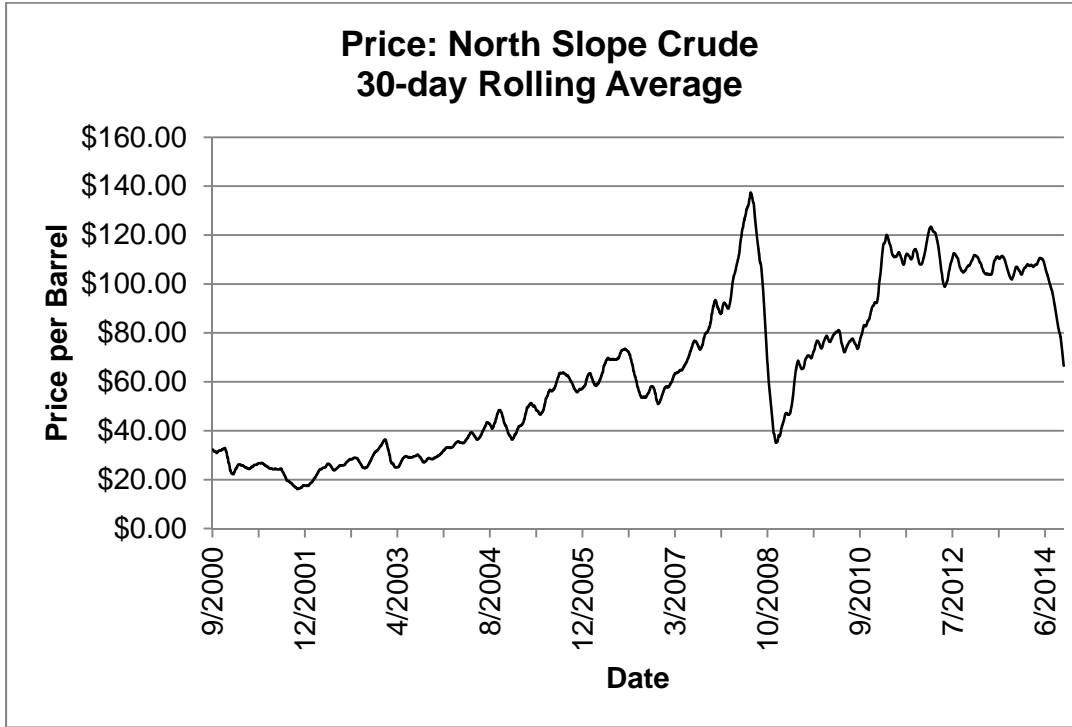
In the twenty-first century, the low point for oil prices was early in the Murkowski Administration (2002–06), with prices in the \$20/barrel range. In more recent years, prices have increased five-fold and during this reporting period have stayed mostly above \$100/barrel (in February 2014, ANS West Coast oil prices ranged from \$103.38 to \$109.57). In August 2014, global oil prices began a precipitous decline, with prices for Alaska North Slope crude dropping to around \$55/barrel by late December 2014. With more than 90 percent of Alaska's state government revenue coming from taxes on oil production, this drop has significant implications for Alaska's budget going forward. See Figure 1 for an illustration of these changes over time.

Oil/Gas Production Prospects and Problems

In addition to the 2014 decline in oil prices, production from the state's legacy fields of Prudhoe Bay and Kuparuk continues to decline, as has production overall (including new fields such as Alpine brought on line since the late 1980s). From the peak North Slope oil production of 2.1 million barrels/day in 1988, production had declined to 531.6 thousand barrels/day by late 2013. Oil production in FY2014 was somewhat better than forecast, at 531,074 barrels/day compared with the 508,000 barrels/day forecast (Alaska Department of Revenue 2014). Introducing the Revenue Sources Book for 2013, Department of Revenue (DOR) Commissioner Angela Rodell commented:

The State of Alaska received a total of \$15.8 billion in FY 2013 from all sources. Of this total, General Fund unrestricted state revenues totaled \$6.9 billion, with oil revenues accounting for approximately 92% of all unrestricted revenue. The Department of Revenue is now forecasting unrestricted revenue of \$4.9 billion and \$4.5 billion for FY 2014 and FY 2015, respectively. This is a significant revision to our unrestricted revenue from the previous forecast . . . Fundamentally, future growth in unrestricted state revenue will require higher oil prices and/or stable or increased

Figure 1. 30-Day Rolling Averages



Note: Until recently, the decline in Alaska's oil production has been masked by historically high prices. The recent drop in the price of oil, combined with long-term production declines, have significant negative implications for Alaska's fiscal outlook.

production. Fortunately, with the More Alaska Production Act (the revision to ACES)¹ we have a tax regime that can address the one factor we can influence—increased production. (Department of Revenue press release, 12/4/13).

This decline in revenue related to production owes more to production declines than to the revision to Alaska’s oil tax regime. During the legislative session, the more than \$2 billion decline in oil revenues to the state was the constant refrain of legislators in addressing budget issues.

The three main North Slope oil producers—BP, ConocoPhillips, and ExxonMobil—produced healthy profits on their operations in 2013. Their promises of increased spending led the Department of Revenue (DOR) to increase spending projections on the North Slope by \$10 billion over the next 10 years. In early 2014, BP and ConocoPhillips announced \$4.5 billion in new projects; about \$1.5 billion of this was investment in near-term projects that would produce 55,000 barrels/day in new production by 2018 (Alaska Legislative Digest (ALD) 1/8/14).

The independents operating in Alaska’s oil fields were more aggressive (and optimistic) than the major companies. 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 (*Fairbanks Daily News-Miner (FDNM)* 1/29/13).

Other Natural Resources

The short story on mining, tourism, fisheries, and other renewable and nonrenewable resources is that they do not rival the impact of oil and gas, either individually or collectively in terms of revenue; yet they employ more Alaskans than the oil/gas industry and need to be considered.

It was gold that brought Alaska global attention, and gold remains an Alaska metal of considerable interest. But mining prospects in Alaska extend to the most recent substance, rare earth minerals (the state has only vague estimates on their location and potential value). At the high point of gold mining, in 1916, some 8,500 miners were working in Alaska. In recent years, mining jobs hovered around the 1,500 level until a growth spurt began in 2005, pushing industry jobs past the 3,500 mark in July 2011 (Alaska Economic Trends, May 2013). The production of Alaska minerals climbed from a value of less than \$1 billion in 2001 to \$3.5 billion in 2011, resulting from an increase in number of new mines as well as expanded operations at existing mines. Mining operations remained profitable in 2013–14, with an increase of 500 workers predicted in early 2014 (Alaska Economic Trends, January 2014); but the largest prospect—the Pebble gold/copper/molybdenum mine in the Bristol Bay—faced increased environmental opposition and permitting delays (*FDNM* 2/6/13). The federal EPA opined in an environmental statement that Pebble might harm salmon-breeding streams. This conflict between mining and fisheries is likely to involve action at both state and federal levels (see *FDNM* 8/27/13; in general *Alaska Business Report (ABR)* 5/2.13; and *ADN* 1/12/14). In November 2014, Alaskan voters expressed strong opposition to the Pebble project by approving a ballot referendum which would require the legislature to approve any proposal for mining in the Bristol Bay watershed by a majority vote (Alaska State Division of Elections, 2014 General Election Results, 2014).

¹ “Alaska’s Clear and Equitable Share”—an act that sought to reform Alaska’s oil tax structure, passed under Sarah Palin in 2007.

The tourism industry was vibrant in 2013. The number of peak season jobs reached 46,500, and 1.96 million visitors came to the state. Visitors spent about \$1.8 billion, and the economic impact of the industry reached more than twice that amount, \$3.9 billion. However, taxes and revenues were only \$179 million (Department of Commerce, Community, and Economic Development March 2014).

Fisheries contributed to the Alaska economy in 2013 in different ways. Of the five Pacific salmon species that thrive in Alaskan waters, king salmon were hard hit. Weak returns caused state fisheries managers to close seasons and limit sport, commercial, and subsistence fishing (*Peninsula Clarion* 7/23/13). The good news, however, was that in 2013 there was a record pink salmon harvest, the second most valuable on record; sockeye salmon held onto its position as the most valuable salmon species harvested (ADFG, Division of Commercial Fisheries 10/10/13). Some coastal municipalities survive on raw fish taxes, but the state generates only very small revenues from permitting fees and taxes.

Wood/forest products remain depressed in Alaska and this has had adverse effects on communities, schools, and economies, particularly in the southeast. Just 307 people were employed directly in forestry and logging jobs in 2011, down from 4,600 in 1990, and the total payroll was just over \$20 million (Resource Development Council 2012).

Finally, estimates on construction spending in 2014 increased by 18 percent. Defense spending (much of which is construction-related) is expected to reach nearly \$400 million, up 89 percent (AER 2/9/14).

Return on Investments

The state's largest single asset remains the Alaska Permanent Fund (PF), which has regained most of the value lost during the recession. The Permanent Fund, a sovereign wealth fund seeded with oil revenue, now generates more revenue than the state's taxes on oil, though most fund earnings are spent on dividend checks for individual Alaskans, not on government services. The PF's market value in March 2014 was 50 billion. 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 2013 was relatively small, \$1,000, because the payout is based on a five-year rolling average of earnings influenced strongly by economic downturns (*ADN* 9/9/12).

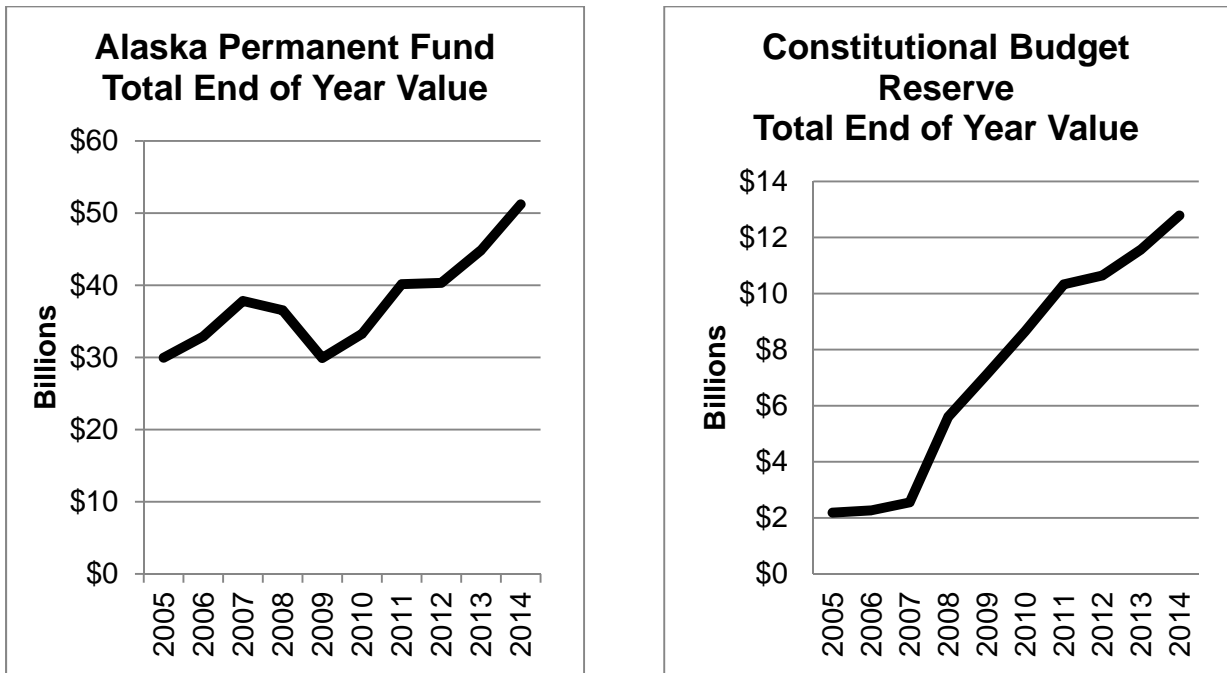
Alaska's other savings accounts continue to increase in size, with the Constitutional Budget Reserve increasing to about \$12.7 billion in 2014. See Figure 2 for an illustration of the value of these funds.

Alaska Demography

The estimated 2013 population of Alaska was 735,132, a 3.5 percent increase from the U.S. Census-identified population of 710,231 Alaskans in 2010. Alaska is the 47th largest state in population, with only Wyoming, Vermont, and North Dakota being more sparsely populated. Table 1 indicates the state's population distribution by race/ethnicity:

The essential demographics of the Alaska population—in race, ethnicity, age, and gender—have not changed much in the last decade. The state's Native population, estimated at 17 percent, is larger as a proportion of the overall state population than any other state (Alaska Economic Trends April 2013, "Alaska's Native population"). Because Table 1 data follows U.S. Census definitions, which allow individuals to respond as multicultural ("two or more races"), the Native

Figure 2. Alaska’s savings accounts



Alaska’s savings accounts—the Alaska Permanent Fund and Constitutional Budget Reserve—continued to increase in value from 2013 to 2014.

Table 1. Alaska’s Race/Ethnic Distribution, 2013

White, non-Hispanic	63.1 %
Alaska Native (and American Indian)	14.8 %
Hispanic/Latino	6.1 %
Asian	5.7 %
Black	3.7 %
2+ races, other	7.1 %
Total	100 %

Source: Alaska Quick Facts from the US Census Bureau <<http://quickfacts.census.gov/qfd/states/020000.html>>.

figure is understated. The Alaska Native population is indigenous and nearly a fifth of Alaskans. Native people are a majority in most rural regions of the state, and they are a young population overall.

Redistricting

The numbers revealed in the 2010 census were the basis of the state's decennial redistricting process. The process was conducted by a five-member redistricting board with a strong Republican bias (four of five were registered Republicans). 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 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 the terms of the federal Voting Rights Act. The board then drew an "amended proclamation plan" to comply with the court order. This 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 increase the number of Republicans in the House. It did this through straightforward "cracking and packing"—collecting 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 to 26 seats (of 40). In the Senate, Republicans won a majority of seats (13 of 20). While small numbers of Democrats (mostly from rural districts) joined Republican majorities, the legislature was 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*).

Complaints about the failure to meet state constitutional requirements caused the Alaska Supreme Court to order that the state redistricting plan be redrawn for the 2014 elections (*FDNM 12/19/12*). This redrafting may have slightly benefitted Alaska's Democratic Party, which did somewhat better in fall 2014 than in 2012, but did not shift the partisan balance of the state legislature, where Republicans maintained control of both chambers (Alaska State Division of Elections, 2014 General Election Results 2014).

State Issues with a Federal Connection

Three issues have some bearing on fiscal policy in Alaska: outer continental shelf (OCS) drilling, natural gas development, and federal government downsizing (including sequestration).

OCS Drilling

In 2013, Royal Dutch Shell returned to Alaska after an absence of more than a decade, attempting 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) though exploration went forward.

In the 2012 season, Shell began to drill "top holes" in the Chukchi Sea, but problems with its drilling ship brought an early close to its season. The company planned no further drilling in

2013 (*FDNM* 2/28/13). Meanwhile, 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 due to high economic and environmental costs (*ADN* 1/4/13).

Shell's plans for 2014 drilling involved a 29-vessel support fleet, including an upgraded drillship to work in the Chukchi Sea, a semisubmersible Polar Explorer, oil spill response vessels, and helicopter support. Prompting Shell's work schedule (and plans for drilling in the Beaufort Sea as well) is the upcoming expiration in 2016 of five of its leases (Alaska Economic Report (AER) 12/29/13).

A Ninth Circuit Court of Appeals ruling took exception to a key part of the environmental impact study for the 2008 Chukchi Sea Outer Continental Shelf lease sale, and Shell put off its 2014 drilling plans (AER, 2/9/14).

Natural Gas

In Governor Parnell's 2013 State of the State address, he set a deadline of mid-February for agreement of the state, TransCanada, and producers on details of 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 that answered few questions (*FDNM* 2/20/13). However, by the start of 2014, Governor Parnell announced an agreement among the three big firms leasing most of the North Slope gas, TransCanada, and his administration, which was the basis for a high priority bill on a large-diameter line from Prudhoe Bay to Southcentral, where the gas would be liquefied at a plant in Nikiski, and shipped to Asia.

Major elements of the plan included:

- The state would take its royalty (approximately 12.5 percent, to be determined by the legislature, in kind, in the form of gas);
- TransCanada would invest in/own a share of the gas treatment plant and pipeline, and the state would have the option to acquire part or all of this;
- The state would directly invest in and own part of the liquefied natural gas (LNG) at Nikiski;
- Because the state lacks an LNG marketing unit, the major producing partners would assist the state in selling its share of LNG (*ALD* 1/20/14).

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 due to the Alaska Gasline Inducement Act (AGIA) (*FDNM* 2/15/13). The agreement struck by the Parnell Administration with producers and TransCanada would terminate the AGIA license the state has had with TransCanada since 2009, and this will no longer be an obstacle to the small pipeline (*Alaska Journal of Commerce* 1/29/14). Meanwhile, Fairbanksians, who paid far higher fuel costs than residents of other Alaska cities, supported trucking natural gas down the Dalton Highway to the interior. The governor agreed to state loans and grants to underwrite this project in the 2013 session (*FDNM* 1/17/13; 1/27/13), though the trucking project has not yet materialized.

Federal Government Downsizing

In 2013 Alaska averted the hollowing out of its large air force base, Eielson, as the air force withdrew its proposal to move a squadron of F-16s to Joint Base Richardson-Elmendorf (near Anchorage). During the remainder of 2013 and into 2014, Eielson became a top candidate for a

squadron of F-35s, which would enlarge the base. Restructuring plans in the US Army have not yet significantly affected Alaska's two posts, but may in the future.

Sequestration associated with federal deficits may affect civilian more than military employees. Compared to the 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 2015 Budget Process

In 2014, 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, he announced he was adding more funding to his "choose respect" initiative, a campaign intended to reduce domestic violence (*ADN* 11/30/12).

Governor's Request. The governor's FY 15 budget request was lean, proposing \$1.3 billion less in general fund spending than the current year and 150 fewer positions (some gimmickry was involved in these calculations; see *ABR* 3/14/14). This small budget request resulted from lower tax receipts, primarily due to low oil production. The budget request totaled \$5.6 billion in state general funds and \$12.4 billion when the Permanent Fund, federal and other funds are included. The reduction in general funding for FY 2015 as compared to FY 2014 amounted to 18.4 percent. Governor Parnell did not miss an opportunity to criticize the federal government:

Our budget proposal does something the federal government seems incapable of. It significantly reduces spending and addresses the biggest cost driver—our state's unfunded pension liability payments. My administration is focused on living within our means, meeting our constitutional priorities, fixing what we have, and finishing what we've started. I will continue to work with legislators to hit a lower fiscal target (Office of the Governor, press release 12/12/13).

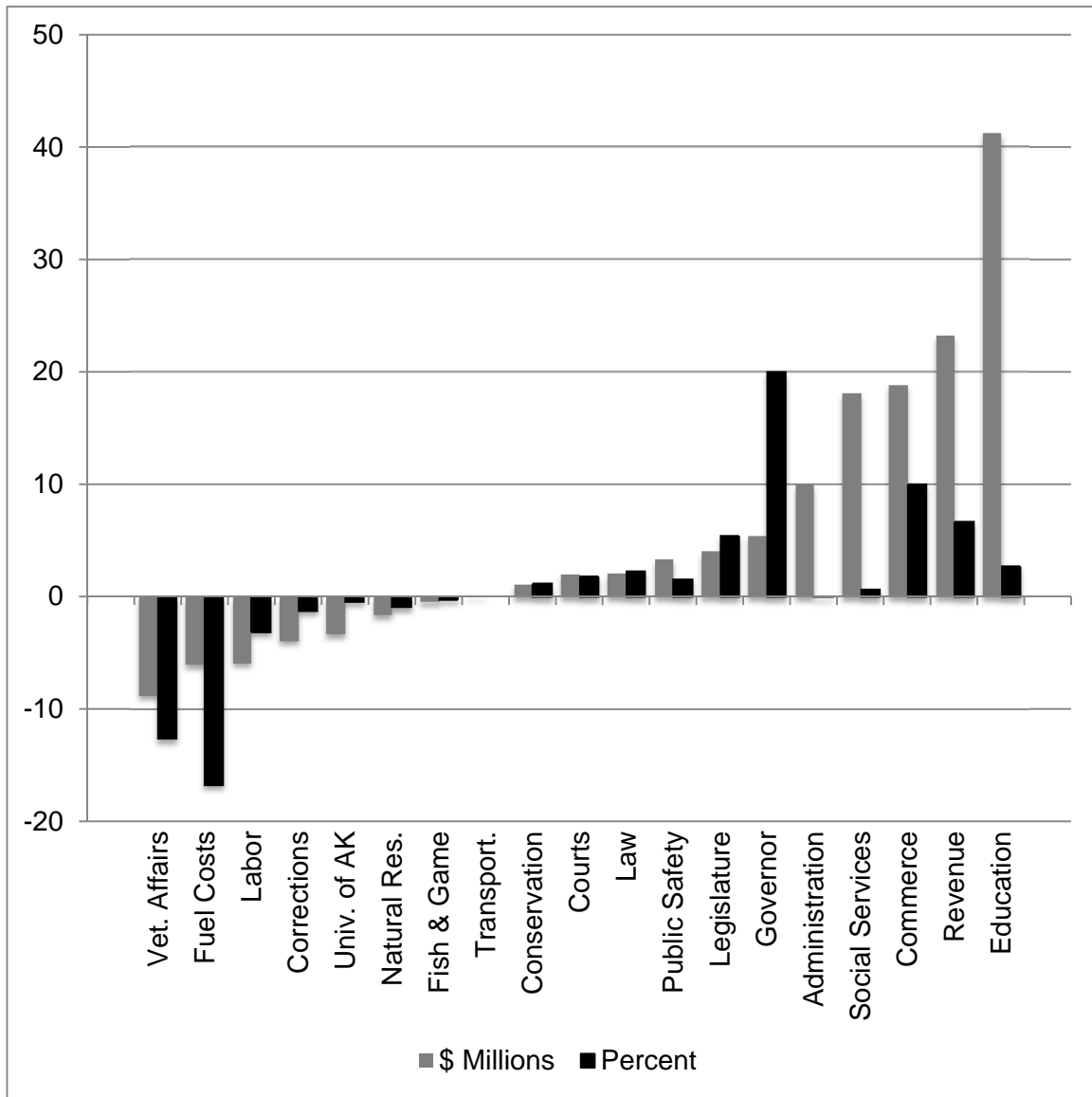
The largest single proposal the governor made concerned the state's unfunded pension liability, estimated to be some \$12 billion. Governor Parnell proposed that \$3 billion be transferred from the state's Constitutional Budget Reserve (CBR) into the state's retirement trust funds, which would reduce the liability while reducing the amount of fixed annual payments in the future.

The governor also proposed a modest increase in the Base Student Allowance (BSA), which determines how much money schools receive per pupil. The BSA had not been increased in the previous three years. Governor Parnell linked this proposal to significant reforms in charter school legislation and to a proposed constitutional amendment to allow public funding of private and sectarian school education.

Winners and Losers

Figure 3 compares spending under Governor Parnell's FY 15 budget request to the current year's level of spending. We discuss additions or reductions in six areas that exceed five percent: the departments of commerce, military and veterans affairs, revenue, the governor's office, legislature, and unallocated appropriations (see *ABR* 2/28/14 and 3/21/14). Most were routine, house-keeping changes.

Figure 3. Winners and Losers in the Governor’s Operating Budget Request



Difference between FY 2015 governor’s budget request and FY 2014 adjusted base. Gray bars represent the absolute change in millions of dollars and black bars represent percentage change over previous year.

Source: Legislative Finance Division, 2014 Legislature-Operating Budget, Agency Summary, 2/25/14.

Commerce, Community and Economic Development

Much of the increase in this agency’s budget was to increase support for the Alaska Gasline Development Corporation, alternative energy, and other economic development activities. The

agency was also to provide grants to organizations across the state, including the Bering Sea Fishermen's Association.

Governor's Office

About half of the increase in funding the governor's office was to support his Choose Respect campaign, an effort to reduce violence toward women and domestic violence generally.

Military and Veterans Affairs

For several years, the state has extensively subsidized the Alaska Aerospace Corporation, housed in this department. In 2013, the legislature decided to reduce the subsidy by \$2 million in FY 2015 and subsequent years. Federal funds for this project also were reduced. In addition, the governor's office planned reductions to the Alaska Military Youth Academy and the Alaska Guard Facilities Maintenance.

Department of Revenue

Most of the increase to the DOR's budget was to support the Alaska Permanent Fund Corporation's custody and management fee office.

Legislature

Increases in funding for the legislature were to defray additional expenses of the legislative audit function and to pay for increased costs in rental of legislative facilities.

Unallocated Appropriation

The OMB anticipated a statewide reduction in fuel costs for the upcoming fiscal year.

Supplemental Budget

Governor Parnell submitted his supplemental appropriations bill in early February and asked for \$53 million. Areas of new spending in the supplemental included monies for wildfire suppression, Department of Law judgment and settlement costs, and disaster relief. The governor's supplemental budget was adopted by the legislature with relatively minor changes, one important exception being the addition of \$50 million to the University of Alaska's capital budget appropriations for the University of Alaska Fairbanks' power and heat plant (described in greater detail below).

Capital Budget

The governor proposed a capital budget of \$1.7 billion, the smallest in recent years. In his transmittal letters to the Speaker of the House and President of the Senate Governor Parnell indicated:

The capital budget for FY 2015 focuses on fixing what we have through deferred maintenance and finishing what we have started. It provides matching funds to leverage federal and local dol-

lars. The budget contains ongoing investments in energy development, roads to resources, water and sewer projects, and school construction (Office of the Governor, transmittal letters, 1/17/14).

As in past years, the Department of Transportation and Public Facilities would receive the lion's share of capital funding, some \$1.2 billion. Roughly 60 percent of overall capital funding would come from the federal government.

Legislative Responses

David Teal, director of the Legislative Finance Division since 1998, spoke before both House and Senate finance committees early in the second session with gloomy messages about the fiscal catastrophe awaiting Alaska if spending habits did not change. "We are spending about \$7 billion and our (general fund) revenue is only \$5 billion. We're overspending by 45 percent." He expected deficits of about \$2 billion through FY 2024, when the statutory budget reserve and CBR would be exhausted. To avoid disaster, Teal urged legislators to begin making politically painful cuts this year.

The capital budget was now less flexible than previously and could not be used easily to reduce deficits. The operating budget lacked flexibility because three items—the state-federal Medicaid program, education aid paid following a statutory formula, and contributions to the state's underfunded retirement systems—composed more than half the operating budget. This left only agency operations, and Teal affirmed that such cuts, if significant (at least two percent) and continuing would make the budget more sustainable (*ABR* 1/31/14). No important actor proposed increases in taxes through the legislative process to fill the fiscal gap.

Responses to Governor Parnell's education proposals were more heated than other areas of the budget. The Parnell Administration had not increased the BSA since 2010 (*ALD* 1/29/14), and proposed an increase of \$201 over three years. The predictable coalition of NEA officers/members (the state's largest union), school board members, school administrators, and PTA members descended on Juneau to lobby for an increase at least twice that large. Hearings on amendments to charter school law drew much interest and discussion. The revisions would expand the state's charter school programs by allowing the education commissioner to override a school board's rejection of charter school applications and require districts to provide transportation for charter school students (*ABR* 3/14/14). A final measure of education reform was the repeal of the state's High School Graduation Qualifying Exam, and its replacement, at state expense, by student scores on the ACT, SAT, or a career readiness exam (*ALD* 3/2/14).

Other controversial measures included yet another attempt to eliminate Medicaid payment for all voluntary abortion procedures, the only exceptions being rape, incest, and those very narrowly defined as medically necessary (possible death or serious physical impairment to a woman; *ALD* 3/10/14). A second highly controversial proposal would rescind the University of Alaska Regents' policy prohibiting guns on campuses.

The Completed Operating Budget

Most of the work by 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 an \$8.3 billion operating budget to the Senate. The budget bill (HB 266) passed by a mostly party-line vote. Republicans spoke of the need to rein in spending given declining oil production, while Democrats argued for increasing spending on education among other areas.

The House budget bill was \$50 million lower than the FY 2014 budget and a \$28 million decrease from the governor's request (*ABR 3/14/14*). Though neither the House's operating budget nor subcommittee work in the Senate included the governor's proposal to transfer \$3 billion from state reserves to reduce the liability in the state's pension systems (*ABR 3/21/14*), the pension fund reimbursement was included in the final version of the budget, passed shortly before the end of the legislative session.

The Senate operating budget, passed in mid-April, made few major changes to the House's budget bill. At the end of the day, only two areas saw substantial changes from the governor's budget request; these were the Department of Education and the Department of Natural Resources.

Department of Education

Late in the legislative process, the Senate finance committee negotiated a funding increase for the Department of Education largely consisting of a \$100 million increase to be shared with local school districts. This increase, controversially, was a one-time increase and did not result from a change to Alaska's Base Student Allocation formula for per-student school district transfers—no change to the BSA was made. This \$100 million was the bulk of a 7.7 percent increase in education spending over the previous year, but left unresolved the question of how Alaska's per-student funding formula will be structured in the future (Gutierrez 2014).

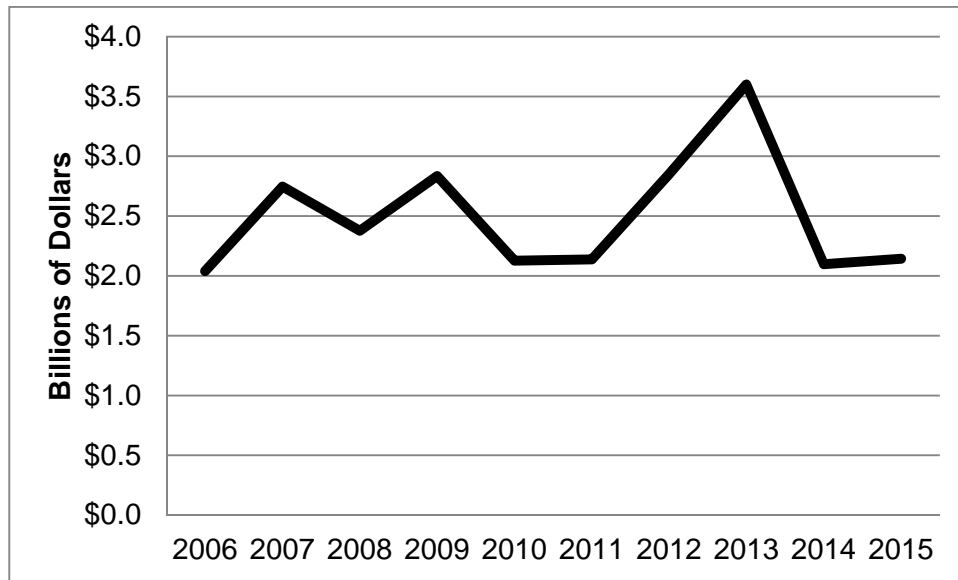
A second emerging controversy has to do with local government contributions to education. State law currently requires local school districts to commit a certain portion of local property tax revenues to local schools. In 2014, the Ketchikan Borough sued the state, arguing that these requirements constituted a tax earmarked for a particular purpose; such taxes are unconstitutional in Alaska. In December 2014, a superior court judge ruled in favor of Ketchikan, potentially putting the state on the hook for \$222 million in 2014 and requiring a change of the funding formula for local schools in the future (Morrow 2014).

Department of Natural Resources

Late in the legislative session, the legislature passed SB 138, the latest in a long line of attempts to advance the export of Alaska's substantial North Slope natural gas deposits. While North Slope oil deposits have been exploited for decades, substantial subsoil deposits of natural gas remain trapped alongside Alaska's North Slope oil. Alaskans have pushed for the export of these natural gas deposits to international markets for decades, but no attempt to commercialize North Slope gas has yet been successful, in part because of the expense of building infrastructure in Alaska's unforgiving northern climate and the historically low value of natural gas relative to crude oil.

SB 138 made a number of changes to Alaska's statutes that may make natural gas export more likely, in part by making Alaska an approximately 25 percent share owner of the construction of natural gas liquefaction and pipeline infrastructure (Forgey 2014). Advocates suggested that the bill was the next logical step to advance commercialization of Alaska's North Slope gas (Feige 2014), while critics derided the proposal as "yet another study" (Walker 2014) and charged that the bill exposed the state of Alaska to too great a financial risk if pipeline proposals

Figure 4. Total Capital Budget Expenditures, by Year



Source: Legislative Finance Division, 2014 Legislature-Capital Budget, Agency Summary, 1/6/15.

don't pan out (Stedman 2014). The cost of the proposal was about \$9 million dollars, which accounts for essentially all of the legislature's 5.1 percent increase in funding to the Department of Natural Resources.

The Final Capital Budget

The legislature made few major changes to the governor's capital budget, and enacted a capital budget only slightly larger than that passed for FY 2014, at just over \$2.1 billion dollars, and lower than the capital budgets for FY 2012 and 2013. Figure 4 shows how the enacted capital budget has varied over the last several years.

A few projects funded in the FY 2015 Capital Budget were controversial. Among these were funding for bridge and rail connections to the Point Mackenzie area north of Anchorage, road construction to Juneau and Ambler, maintenance work at the Alaska Aerospace Corporation's Kodiak rocket launch facility, and construction of a large dam on the Susitna river near the town of Talkeetna.

Point Mackenzie Projects

For decades, business leaders in Anchorage have advocated the development of the sparsely populated region across the Knik Arm of Cook inlet from downtown Anchorage. This area, called Point Mackenzie, is tantalizingly close to downtown Anchorage—around 1.5 miles at the narrowest point of Knik Arm. Currently, the small amount of economic activity that takes place

in Point Mackenzie is mostly related to agriculture and the state correctional system; there are two prisons located in the area.

Boosters advocate two projects intended to promote economic development in Point Mackenzie, Anchorage, and the nearby Matanuska-Susitna borough. The first of these is a rail link to deep-water port facilities on Knik arm. Advocates of this project argue it will improve the competitiveness of Alaska's mining industry by providing a more easily accessible port facility for mineral resources and fossil fuels in the Alaska railbelt (Moosey 2012), while opponents note potential negative impact on fisheries and argue that the economic benefits will be minimal, in part due to the difficulty in docking vessels at the port facility, which is exposed to strong tidal and river currents and winter ice (Whedbee, 2012).

The legislature added \$8 million dollars to the rail link project for FY 2015, supplementing the governor's \$5 million budget request. However, this was a much smaller appropriation than the \$60 million the Matanuska-Susitna borough had requested, and a tiny piece of the total funding needed to complete the project, estimated at \$275 million (Caldwell 2013).

A second project proposed for this area is the Knik arm bridge, which would link downtown Anchorage and Point Mackenzie. The bridge has been derided as a "bridge to nowhere," but supporters see it as a way to open up developable land near Anchorage and reduce transport costs in South-Central Alaska. In 2014 the legislature approved the governor's \$5 million request for the project; much of the remainder (including \$50 million in FY 2015) will be paid for by federal grants and low interest loans. The total cost of the project is estimated at \$900 million (Mauer 2014).

Road Projects

The capital budget provides funding for a number of road construction projects, some of them controversial. First, the governor's budget request included \$6 million dollars for a road to improve access to the rural village of Tanana, currently off the road system. The request was funded by the legislature, and road construction has begun. This will be the state's first attempt to connect a rural community to the road system in over a decade (Friedman 2014).

The legislature also chose to fund the governor's \$35 million dollar budget request for the controversial Juneau Access project, which seeks to improve access to the state capital—which is also unconnected to the road system—by extending a road nearly 100 miles north of Juneau and constructing a ferry terminal that will carry vehicles and passengers to the nearby communities of Haines and Skagway (both located on the road system, although travel to other parts of Alaska will still require several hours of driving through Canada).

Kodiak Launch Complex

The Alaska Aerospace Corporation was created in 1998 as a quasi-public corporation that would build an aerospace industry in Alaska. Alaska Aerospace operates the Kodiak Launch complex, a rocket launching facility located at Narrow Cape, on Kodiak Island. The launch complex has never been profitable and has been heavily subsidized by both the state and federal government. For FY 2015, the legislature included a small amount of funding for the Kodiak Launch Complex--\$2.5 million—in the capital budget, on top of \$6 million in the operating budget (Cole 2014).

The UA System

The legislature approved projects that benefit the University of Alaska system including replacement for the University of Fairbanks' aging power and heat plant (\$182 million, about \$157 million will be raised through a bond issue), and a new engineering building at the University of Alaska, Anchorage (\$46.6 million, to complete a project that will cost \$132.2 million over several years) ("Building Anchorage: UAA Engineering and Industry Building" 2013; Edge 2015; McCoy 2014). Some funding was provided to enclose an engineering building under construction in Fairbanks (\$10 million) that was included in the governor's initial budget request.

The Susitna-Watana Dam

The final controversial project is a large hydroelectric facility located near the confluence of the Watana and Susitna rivers, near the town of Talkeetna. The legislature appropriated \$20 million to the project, currently in its initial stages. The project, projected to cost around \$9 billion, is derided by critics for its environmental costs—including significant and negative impacts on salmon fisheries—but is seen by proponents as a reliable source of inexpensive energy for railbelt Alaska (Manning 2014).

Reserve Funds and the FYI 2015 Budget

Our 2012 report (McBeath 2013, in Table 5) indicated that in FY 2013 the state would have \$21 billion in undesignated savings (from the Permanent Fund earnings reserve account, the constitutional budget reserve fund, the statutory budget reserve, and the Alaska Housing capital corporation fund). In addition, designated savings would amount to \$2.7 billion, including monies from special funds (for example, the public education fund, railbelt energy fund, and Power Cost Equalization (PCE) endowment). Overall reserves of the state of Alaska that could be used relatively easily to balance budgets totaled nearly \$24 billion. An even more positive recent study by Commonwealth North entitled "Alaska's 2013 Assets Review" reported that the state's net assets at the end of FY 2013 were \$76 billion, larger by \$5.9 billion than the previous year (*ABR* 1/31/14).

With a deficit of \$1.5 to two billion in FY 2015, there is sufficient reserve funding for the next few years. The problems likely will begin 4–5 years in the future. Ending this report on a positive note, at present, the state's fiscal condition is excellent. A study published in early January 2014 by the Mercatus Center of George Mason University concluded that Alaska ranked first among the states in budget health. The rankings were based on five factors: liquidity, budgetary balance, avoidance of debt in financing current and long-term spending, and ability to pay for essential services (*ABR* 1/31/14). In addition, the state has at least \$1 to \$1.5 billion in remaining debt capacity (*ALD* 2/16/14).

Conclusion

In 2013, Governor Parnell and other Republican leaders succeeded in altering the state's oil tax structure, passing the "More production declines by reducing the progressivity of the existing tax structure—effectively lowering taxes when oil prices are high. Voters failed to repeal MAPA

by referendum in August of 2014, and elected a pro-oil Republican legislature in November. In the same election, however, voters selected, by a narrow margin, an independent governor with little political record but a history of combativeness with the oil and gas industry. Alaskan voters also chose to raise the minimum wage, legalize marijuana, and oppose the proposed Pebble mining project in the Bristol Bay watershed.

The political uncertainty of 2014 was matched by a great deal of economic uncertainty. Alaska remains a state heavily dependent on tax revenues from oil production, even as oil production and prices fall. If the 2014 drop in oil prices is sustained—oil fell below \$50/bbl in January 2015, down from over \$110/bbl in 2013—the state may find itself facing an untenable fiscal situation. On the other hand, oil prices are unpredictable and may soon rise again.

In 2015, under an untested executive, the state will make difficult choices about where best to cut expenditures. Further changes to the state's revenue structure are unlikely as obvious changes—new sales or income taxes or use of the state's Permanent Fund—are deeply unpopular. In short, the state is likely to face an uncomfortable year.

At the same time, Alaska has planned well for the immediate future, accumulating large reserves of cash that may be used to fund state government expenditures. In addition to Alaska's Permanent Fund, currently valued at over \$51 billion, the state has several smaller reserve accounts, including smaller constitutional and statutory budget reserves that are relatively easy to tap. Though substantial budget reductions are likely, the state has enough savings to weather several years of low oil prices.

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