

Executive Summary

Bridging the Revenue Gap from Today to First Gas

Looking ahead at the next 10 years, Alaska must move to diversify its revenue base. The main emphasis of the 10-year plan is to facilitate Alaska's transition from a predominantly oil revenue base to an oil and natural gas revenue base. Construction of a pipeline to monetize Alaska's natural gas resources is a key element in providing for the future fiscal and economic stability of the state. Revenue generated from a natural gas pipeline will help diversify Alaska's revenue sources by providing a substantial source of revenue to offset declining oil revenue. In addition, the gas pipeline will provide economic opportunity through the provision of a stable, clean source of energy to fuel Alaskan businesses and homes.

Based on the Alaska Department of Revenue's Fall 2008 forecast and the assumed expenditure projections, Alaska can use spending discipline combined with prudent use of the state's reserve accounts to sustain itself through fiscal year 2019. This plan would achieve the goal of transitioning the state from FY2010 to first gas, which is currently estimated to occur in the 2018 to 2020 time period. Under these assumptions, the balance of state's primary reserve account, the Constitutional Budget Reserve, would remain above \$4.0 billion for the next ten years. By the end of the period, an anticipated rise in oil production and prices would reduce the pressure to draw on the CBR, and the onset of gas revenue would position the state to rebuild its reserve accounts. ***The 10 year forecast shows that budget shortfalls over the 10-year period could be filled primarily through the use of reserve funds, however, other fiscal tools including spending reductions could be used in addition to, or in lieu of, reserve funds.***

The plan assumes modest spending growth of 3.0% annually, and anticipates no major change to the revenue structure in place as of the beginning of FY2009. This growth rate assumption will be challenging to meet, and implies that the delivery of state services will become more efficient over the 10-year period. Inflation is assumed at 2.75% and population growth will be slightly above 1.0% annually. That implies that state spending on a per capita basis will decline over the next ten years in real terms.

While overall spending is projected at an average annual growth rate of 3.0%, it is anticipated that portions of the budget will grow faster, and that will require other areas to grow at a slower rate or decline to meet the projected rate of growth. One particularly challenging example of this issue in the operations portion of the budget is the state's projected Medicaid spending. In FY09 the state's portion of the federal Medicaid program was \$465 million, over the next 10 years that figure is projected to increase at an annual rate of over 7.0% and by FY2019 is projected to require a \$1.03 billion contribution from the state's general fund.

Among the other challenges that must be considered in the planning horizon are: financing investment expenses associated with the gas line project; dealing with the high cost of energy for Alaskans; shoring up an aging transportation infrastructure; handling

the effects of growing elderly and prison populations; and tackling the adverse affects of climate change. All of these issues must be considered while continuing to provide an acceptable level of government services to Alaskans.

Low Oil Prices and the Plan

At this writing, the possibility of oil prices falling below the Fall 2008 forecast must be considered. In that scenario, current projections for spending and use of the state’s reserve accounts must be reevaluated. More conservative spending plans would be necessary and the ability of the combination of the state’s reserve accounts to facilitate the transition from today to a gas pipeline become questionable. Reduced spending, additional use of Alaska’s reserve accounts, and other revenue enhancement measures could potentially be considered.

The Plan’s Imperative

The overarching objectives of the 10-year fiscal plan are guided by the newly added statutory language that requires the Executive branch to produce a 10-year plan on an annual basis. Alaska Statute 37.07.020 (b) (2): says that the fiscal plan

“must balance sources and uses of funds held while providing for essential state services and protecting economic stability of the state.”

Essentially, there are three requirements that the Executive’s plan must meet:

- Balance the budget between sources and uses of finds,
- Provide for essential state services, and
- Protect Alaska’s economic stability.

The Plan’s Guiding Principles and Supporting Strategies

The 10-year plan meets the statutory objectives through the application of several foundational principles. The principles outlined below provide the guidance for spending and savings strategies represented in the plan.

Principle: Responsibly Develop Alaska’s Natural Resources

The State of Alaska’s fiscal future hinges on the prudent development of its abundant natural resources. In 1959, when Alaska became a state, 99.8 percent of the land was owned by the federal government. The Alaska Statehood Act gave the State the right to select and acquire approximately 104 million of the nearly 365 million acres of federal lands in Alaska. It was envisioned that the management of this land base and the associated resources would provide the State with a viable economic foundation. That stable economic base would then enable the State to provide governmental services to the people of Alaska, and reduce the likelihood that Alaska would be a drain on the federal treasury.

To date, the strategy of building Alaska's economy on natural resources has been effective. The State takes in significant revenues from companies that lease State-owned lands for extraction of oil, natural gas and coal, gold, zinc and other minerals and shares with the federal government revenues from oil, natural gas and other assets extracted from federal lands leased by private companies. Currently, nearly 90% of the State's unrestricted General Fund revenue is generated from petroleum production activities. For the foreseeable future, the health of Alaska's fiscal system will be linked to the wealth generated from the monetization of Alaska's natural resource base.

Strategy: Facilitate Gas Line Development- The Administration's highest priority is the development of the State's natural resources. The State's long-term planning is based in part on efforts to develop natural gas resources before oil resources are depleted. Currently, natural gas produced in conjunction with oil production on the North Slope is stranded from the market, and development of this critical resource has been limited because a pipeline to transport recovered natural gas to market outside Alaska has not been constructed. To spur commercialization of Alaska natural gas, the Administration developed and the Legislature enacted the Alaska Gasline Inducement Act ("AGIA") in 2007; and in August 2008, authorized the State to award an AGIA license to TransCanada Alaska, a wholly-owned subsidiary of the TransCanada Corporation ("TransCanada"). Along with the license, the state committed to a cost-sharing agreement with TransCanada that provided a \$500 million state commitment to assist in underwriting the costs of the project. In addition to the TransCanada project, two of the three major North Slope producers, ConocoPhillips and BP, are pursuing their own gas pipeline project, called Denali. While the State's economic past and present is tied to oil, the state's future is dependent upon the development its abundant natural gas resources. During the next several years the Administration will be actively pursuing a project to monetize Alaska's gas.

Strategy: Facilitate Other Oil & Gas Development- In addition to the promotion of activities to spur bringing Alaska's natural gas to market, the State implemented a taxation structure called Alaska's Clear and Equitable Share (ACES) that is intended to encourage additional exploration and development of Alaska's oil resources. While increasing the rate of taxation, the ACES system authorizes a company to reduce its tax liability to the extent that it invests in equipment, projects or other items that are deemed to be capital expenditures. Additionally, a limited credit is granted to companies that qualify as small producers. Also, under certain conditions the state will assist in underwriting a portion of qualifying oil and gas development investment expenditures by providing nonproducing companies with cash rebates. These are intended to spur additional investment in Alaska's oil patch that will result in increased oil production in the future.

Strategy: Facilitate Other Natural Resource Development- While oil and gas resources are the largest potential revenue sources for the state, other resource development efforts will also help diversify the state's revenue base. While they

currently play smaller roles than oil and gas in terms of generating revenue to the state, mineral mining activity, fisheries and tourism also are critical contributing industries to the State's revenue stream and economic diversity.

Principle: Live Within Our Means

The plan keeps recurring expenditures in line with what the State can reasonably expect its funding sources to be for the current year as well as for the immediate future. The guiding principle in the plan is to fund state services through the state's annual ongoing revenue stream in combination with the judicious use of reserve accounts. In addition, the plan calls for spending to be held at a rate that is sustainable given the amount of revenue and reserves that are projected to be available between today and the onset of natural gas revenue.

Principle: Control the Growth of Government

In contrast to revenue, the part of the fiscal equation that Alaska's policy makers can have the greatest impact on is the size of the State budget. Given current expectations of future revenue and reserve availability, the base spending scenario in the 10 year plan contemplates growth over the period averaging 3.0% annually. This spending rate is not intended to indicate a commitment to spend at that level, and will be adjusted as circumstances dictate. The Administration is committed to promoting more efficient ways of providing and delivering government services, and in the 3.0% growth scenario will have to implement multiple strategies in order to restrain growth. Substantial reductions in state spending would require reductions in important public services and less investment in Alaska natural resources and infrastructure. Cost growth in areas such as Medicaid, K-12 education and retirement system costs also make it difficult to reduce total state spending over time.

Principle: Save for Future Generations of Alaskans

Along with resource development, the savings element of the plan meets a basic challenge facing Alaska- turning the non-recurring revenue stream produced from Alaska's resources in to a long term recurring revenue source that can help maintain Alaska's economic stability beyond the life of the resource. The primary vehicle for this effort is Alaska's Permanent Fund, and a primary objective of the plan is to continue growing the Permanent Fund. In addition to growing the Permanent Fund, when an opportunity presents itself, such as was experienced during the run up of oil prices in 2007 and early 2008, the plan contemplates depositing unspent unrestricted revenue in reserve accounts such as the Constitutional Budget Reserve. The prudent use of Alaska's reserve accounts can provide the State with a means to stabilize a revenue stream that is subject to the dramatic swings of oil prices. The availability of these reserves underpin the state government's ability to provide the services that are considered its responsibility

without having to draw upon other means of revenue generation such as broad-based taxes or use of the Permanent Fund.

Strategy: Preserve and Grow The Permanent Fund - The primary vehicle for this effort is Alaska's Permanent Fund, which receives ongoing deposits of mineral royalty revenue as well as annual appropriations to inflation proof the fund. Currently, the main contribution of Alaska's Permanent Fund to the state's residents is the annual Permanent Fund dividend payment. In 2008, the dividend amounted to \$1.26 billion distributed to about 611,000 dividend eligible citizens. This distribution was more than the equivalent of a 13th month of wage and salary payroll to the state's economy.

Strategy: Build Reserves When Possible, Use Them Judiciously When Necessary - Beyond continuing to grow the Permanent Fund, the plan contemplates that in times of surplus unrestricted general fund revenue that a portion of that revenue be used to build reserve accounts. To date, the primary reserve account drawn upon to fund ongoing operations of state government has been the Constitutional Budget Reserve fund (CBRF). Since its inception more than \$5.2 billion has been borrowed from that fund to pay for state funded services. Recent general fund revenue surpluses have allowed the CBRF to be replenished with \$4.0 billion and its balance has grown to approximately \$6.2 billion as of December 2008. Additionally, in FY2008, the Legislature appropriated an additional \$1.0 billion of the surplus revenue to another savings account called the Statutory Budget Reserve.

Strategy: Forward Fund When Appropriate - Another method the plan contemplates to provide fiscal stability is forward funding programs. Examples where the state has built reserves to fund programs in future years include:

- Public Education Fund: More than \$1 billion has been set aside to fund the state's projected contribution to funding K-12 education one year in advance. This has helped stabilize the funding stream for Alaska's K-12 education sector.
- Community Revenue Sharing Fund- \$180 million was set aside in FY08 in an attempt to stabilize annual funding to local communities for provision of local government services.
- Alaska Capital Fund: More than \$300 million was set aside fund future capital projects.

Strategy: Focus Investment The plan prioritizes spending according to the Administration's investment priorities of:

- Resource development,
- Infrastructure development.
- Education,
- Public safety, health and welfare.

Fall 2008 Revenue Forecast, FY10 Governor's budget

with 3% annual budget growth beginning in FY11

Oil Price & Production

	FY09	FY10	FY11	FY12	FY13	FY14	FY15	FY16	FY17	FY18	FY19
Fall 2008 Forecast ANS West Coast (\$/bbl)	\$77.66	\$74.42	\$71.65	\$72.57	\$73.55	\$74.24	\$73.82	\$78.51	\$80.74	\$83.03	\$85.31
Fall 2008 Forecast production (mbbl./day)	0.683	0.659	0.640	0.641	0.641	0.658	0.633	0.614	0.605	0.584	0.643

Revenue vs. Spending (\$ Millions)

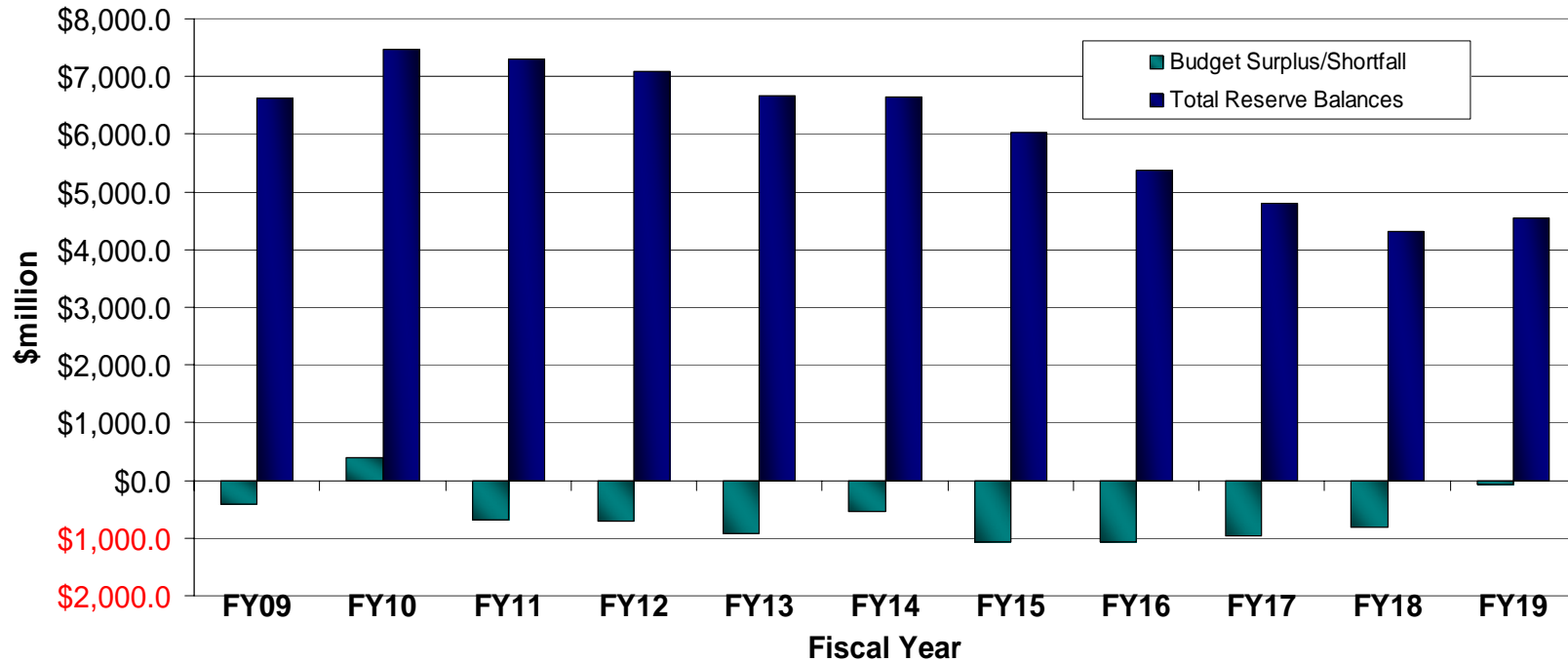
General Fund Unrestricted Revenue	\$6,765.4	\$5,275.4	\$4,356.6	\$4,482.3	\$4,417.9	\$4,964.1	\$4,596.3	\$4,758.8	\$5,052.2	\$5,383.2	\$6,294.6
General Fund Expenses	\$7,167.6	\$4,886.7	\$5,033.3	\$5,184.3	\$5,339.8	\$5,500.0	\$5,665.0	\$5,835.0	\$6,010.0	\$6,190.3	\$6,376.0
Budget Surplus/Shortfall	\$402.2	\$388.7	\$676.7	\$702.0	\$921.9	\$535.9	\$1,068.7	\$1,076.1	\$957.9	\$807.2	\$81.5
Reserve Balances											
CBRF Total	\$5,985.6	\$6,806.5	\$7,301.0	\$7,097.9	\$6,673.1	\$6,636.0	\$6,035.0	\$5,378.9	\$4,791.9	\$4,308.6	\$4,551.8
Statutory Budget Reserve Balance	\$638.5	\$664.5	\$0.0	\$0.0	\$0.0	\$0.0	\$0.0	\$0.0	\$0.0	\$0.0	\$0.0
Total Reserve Balances	\$6,624.1	\$7,470.9	\$7,301.0	\$7,097.9	\$6,673.1	\$6,636.0	\$6,035.0	\$5,378.9	\$4,791.9	\$4,308.6	\$4,551.8

Appropriations projections in the plan do not represent a commitment by the Administration to propose spending at a particular level in FY2010 or any future year.

The 10 year forecast shows that based on current revenue and expenditure assumptions, budget shortfalls over the 10-year period could be filled through prudent use of reserve funds. However, other fiscal tools including spending reductions could be used in addition to, or in lieu of, reserve funds.

The plan will be revisited as conditions warrant.

Budget Surplus/Shortfall and Total Reserve Balance Through FY2019



Appropriations projections in the plan do not represent a commitment by the Administration to propose spending at a particular level in FY2010 or any future year.

The 10 year forecast shows that based on current revenue and expenditure assumptions, budget shortfalls over the 10-year period could be filled through prudent use of reserve funds. However, other fiscal tools including spending reductions could be used in addition to, or in lieu of, reserve funds.

The plan will be revisited as conditions warrant.