APPENDIX W

MEMORANDUM

STATE OF ALASKA
Department of Revenue

To: File

Date: April 6, 2000

From: Wilson L. Condon
Commissioner
Department of Revenue

Telephone: 465-2301

Subject: Reserves Policy
As Amended[1]

2000 Reserves Policy

A. Defining Reserves Policy

The Commissioner of Revenue is responsible for managing the assets held by the State Treasury to (1) meet the daily cash flow needs of the state and (2) meet the longer term reserve needs of the state. (See AS 37.10.070 in Appendix A of the Treasury Division's Policies and Procedures Manual). To fulfill these responsibilities, the Treasury Division has consulted with and worked jointly with other state agencies (principally the Office of Management and Budget in the Governor's Office and the Division of Finance in the Department of Administration) to develop two separate policies: a Cash Deficiency Contingency Plan and Reserves Policy. The Cash Deficiency Contingency Plan is designed to insure that the state will be able to meet its very short-term daily cash needs. That Plan is discussed in

[1] This memorandum is the latest in a series of similar memoranda dated September 26, 1997, July 15, 1998, and December 28, 1998, and August 13, 1999.

further detail in Section XVI of the Treasury Division's Policies and Procedures Manual. (Appendix DA is a copy of the Cash Deficiency Contingency Plan.) The Reserves Policy, on the other hand, reflects somewhat longer term financial planning. That policy determines the manner in which Treasury must invest money in various state funds - most particularly the general fund and the Constitutional Budget Reserve Fund (CBRF) to:

1. Cover the expenditures authorized by the Legislature over the course of the current fiscal year;
2. Cover unexpected declines in the state's recurring revenue stream; and
3. Cover future expenditure authorizations by the Legislature.

Before 1997, the state had no separately articulated Reserves Policy.

B. Evolution of the Need for a Reserves Policy

Prior to fiscal year 1991, the state's recurring revenues and recurring expenditures were essentially equal. State operating budgets were balanced solely with recurring general fund revenues. Beginning in fiscal year 1991, and in each subsequent year except fiscal year 1997, the Legislature has balanced the state budget by appropriating sufficient money from the CBRF to cover the shortfall between recurring revenues and expenditures.

In 1997, the Department of Revenue adopted a Reserves Policy under which the Constitutional Budget Reserve Fund was to:

1. Provide money to cover anticipated and unanticipated budget shortfalls over a two-year time horizon;

2. Provide money to cover projected budget shortfalls until the time the state's recurring revenue is sufficient to meet its yearly expenses; and

3. Provide a long-term budget reserve.

Using the Department's revenue forecasts of 1997 and early 1998, it appeared as though the CBRF contained sufficient funds to contribute to each of these policy goals. Consequently, the Department adopted investment policies to match these goals. Some of the CBRF was invested in relatively short-term fixed income assets to cover both anticipated and unanticipated short-term needs. The balance of the CBRF was invested in longer-term fixed income assets and equity securities to meet the longer-term objectives.

Very large unanticipated short-term needs required a series of changes in the scope of the state's reserve policy and to the CBRF investment policy over the 1997 to 1999 time period. The collapse of oil prices in late 1997 extending through 1998 and into 1999 substantially reduced the state's anticipated oil revenue in two different ways. The immediate effect of low prices on production tax, royalty and income tax revenue requires no elaboration. The low prices also had the effect of deferring a substantial amount of North Slope investment that otherwise would have been made during the 1997 to 1999 time period. This investment deferral led to a substantial reduction in expected production volume and consequent state revenue.

The large withdrawals from the CBRF needed to balance the state's budget for fiscal years 1998 and 1999 reduced the balance in the fund so that only enough remained to cover the state's two-year shortfall needs. The need to drastically shorten the investment horizon for the CBRF led to significant changes in both the state's reserve policy and the CBRF investment policy in July 1998, December 1998 and July - September 1999.

C. The Reserves Policy

Treasury's Reserves Policy requires the use of the general fund as the primary source for daily cash flow expenditures and the CBRF to cover those daily cash flow expenditures not covered by the general fund.

The exact amount the state will need to fulfill this Reserves Policy cannot be precisely known. Treasury has made its best estimate of the amounts required in order to appropriately invest available reserves. Based on current spending and revenue projections, Treasury estimates that $2,100,000,000 over the amount of net disposable general fund unrestricted revenue forecast by the Department of Revenue should be allocated to cover anticipated and unanticipated shortfalls over a two year time horizon. This reflects the state's current fiscal position and the possibility of sustained low oil prices.

Treasury also anticipates using approximately $300,000,000 to provide for cash flow needs of the state. These cash flow needs result from a systematic mismatch in the timing of budgeted expenditures and anticipated revenues as well as the need to maintain a minimum operating balance in the state's general fund. Treasury would invest any remaining amount of the CBRF based on the premise that it this amount would be used for a longer-term need. As of April 12, 2000, the balance in the CBRF exceeded the amount needed to meet the state's two-year shortfall reserve.

D. Derivation of the Two-Year Reserve Requirements

To derive the state's short-term reserve requirements, Treasury employed the same basic analysis to oil prices and oil price volatility that it uses to analyze investments in assets in the securities markets. In essence, Treasury employed statistical analysis to measure the volatility of oil prices and then calculate the probability that oil prices and the consequent oil revenue would be substantially below what the Department of Revenue has projected. Treasury used an average estimated or implied standard deviation of oil prices, $3.83/barrel, over the relevant period to estimate the amount of money needed to cover a 90th percentile oil price decline. This results in a 10% probability that the reserve would not be sufficient to meet anticipated expenditures. Treasury adds the amount set aside to cover unanticipated declines to the Department of Revenue's most recent estimate of the deficits for the next two years' budgets based on a long-term average price per barrel of oil of $18.50. Treasury calculated the amount necessary to meet this objective at $2,100,000,000. Treasury's estimate of money required reflects both the state's current fiscal position and the possibility of sustained low oil prices.

E. What Funds are Available to Fulfill the Reserves Policy?

<u>The General Fund</u>

The general fund is the primary source of money to meet the state's daily cash flow needs. It does not contribute to the Reserves Policy, as Treasury expects that all of the money in the general fund will be spent in the fiscal year in which it is received.

<u>The Constitutional Budget Reserve Fund</u>

Treasury believes that the Constitutional Budget Reserve Fund (CBRF) is the only resource practically available to form the backbone of the Reserves Policy. For almost a decade, it has historically been the fund the Legislature has used to make up shortfalls

between recurring revenues and recurring expenditures. Treasury will manage the CBRF (see Appendix X for the Commissioner's Decision and Justification for Managing the CBRF in Treasury rather than the Permanent Fund Corporation). Because of Treasury's broad investment responsibilities, the CBRF can be invested easily in one or more of the multiple investment pools that Treasury maintains to accommodate the Reserves Policy and fulfill the needs of other fund assets under management.

The Permanent Fund

Article IX, Section 15 of the State of Alaska's constitution requires that the principal of the Permanent Fund be used only for income-producing investments. Thus, the principal of the Permanent Fund cannot be spent, and cannot contribute to the Reserves Policy.

Although Alaska's constitution prohibits expenditure of the Permanent Fund's principal, it does permit expenditure of the Permanent Fund's income. AS 37.13.020 explains:

> *"the fund should be used as a savings device managed to allow the maximum use of disposable income from the fund for purposes designated by law."*

Under the applicable statutes and accounting rules, the Fund's income consists of only realized income, and excludes any unrealized gains or losses.

At the end of each fiscal year, the Permanent Fund Corporation (PFC) must calculate the amount of income available for distribution from an account called the Earnings Reserve Account in which all unappropriated Permanent Fund income has been deposited. AS 37.13.145 specifies how that money is distributed from this account (subject, of course, to legislative appropriation):

1. Fifty percent of a defined amount, the "income available for distribution," is paid to the Department of Revenue for Permanent Fund dividends;

2. An amount sufficient to offset the effect of the previous calendar year's rate of inflation on the value of the principal of the Fund at the end of the current fiscal year is transferred to the principal of the Permanent Fund; and

3. Any remaining money in the Earnings Reserve Account remains in the Earnings Reserve Account unless otherwise appropriated by the Legislature.

The Permanent Fund Earnings Reserve Account

The Earnings Reserve Account (ERA) was unfortunately named, as this account is neither managed as a "reserve" in the manner contemplated in the state's Reserves Policy nor truly managed as an "account." It is treated and invested as a part of the Permanent Fund. AS 37.13.145, states that, "Income from the Fund shall be deposited by the corporation into the account as soon as it is received. Money in the account shall be invested in investments authorized under AS 37.13.120." Thus, the ERA is separate from the Permanent Fund in name only. The assets of the ERA are not immediately available for meeting short-term expenditure needs. The ERA is invested as part of the assets of the Permanent Fund in accordance with the asset allocation policy of the Permanent Fund. This means that the ERA is invested in all the different asset classes held by the Permanent Fund - including domestic fixed income, non-dollar bonds, domestic and foreign equity and real estate.

If funds were appropriated out of the ERA on relatively short notice, the staff of the PFC would no doubt be required to (1) liquidate a portion of the portfolio (most likely a portion of the fixed income portfolio) and (2) consequently rebalance the assets of the portfolio to realign in accordance with the asset allocation adopted by the PFC Board of Trustees.

The Permanent Fund and the ERA are now invested with the expectation of a single lump-sum cash draw each year to pay Permanent Fund Dividends. The PFC now prepares for this single cash draw by scheduling the maturities on fixed income investments so that the needed cash will be available when the Permanent Fund Dividend payments are scheduled.

If the ERA was incorporated into the state's Reserves Policy and the PFC required to make frequent but irregular cash draws from the ERA to fulfill Reserves Policy, the management practices of the Permanent Fund would likely be altered.

In addition, using the ERA in this manner would almost certainly lead to a relatively expensive set of investment transactions. Investment transactions have three components to the cost. They are:

1. The commission that is paid to a brokerage firm to transact the trade;
2. The difference between the selling price and the purchase price of a security; and
3. The impact on the market price of a security when purchasing or selling large quantities of that security.

A major rebalancing required by the asset allocation of a large portfolio of securities will almost certainly cost a significant amount.

Therefore, Treasury does not believe, at the present time, that the ERA of the Permanent Fund should be included in the assets available to implement a Reserves Policy.

F. Conclusion

The Reserves Policy ought to be based on use of only the general fund and the CBRF. This allows the Commissioner to fulfill his fiduciary responsibilities to:

1. Meet daily cash flow needs of the state;
2. Meet the longer term reserve needs of the state; and
3. Fulfill his investment responsibilities.

This will allow appropriate returns on the CBRF and the general fund and allow the Permanent Fund Corporation to focus on its objectives without having to compromise its mandates in order to accommodate the state's operating budget reserve requirements. (See Appendix X of the Treasury Division's Policies and Procedures Manual for a discussion of the issue of whether the CBRF should be managed with the Permanent Fund.)