GOVERNOR KNOWLES' FY2003 EXECUTIVE BUDGET OVERVIEW

BUDGET AND FISCAL ISSUES

MAJOR ELEMENTS OF THE PROPOSED BUDGET AND RELATED LEGISLATION

OVERALL BUDGET

- The Governor's FY2003 budget is $7.3 billion from state general funds, federal funds, corporate receipts, fees, investment income and all other fund sources. This is a $188.9 million increase over FY2002.
- The general fund budget is $2.60 billion, a $179.9 million increase over the current fiscal year. Of this amount, $99.7 million is needed to maintain the current level of services.

OPERATING BUDGET

- The proposed general fund operating budget contains $57 million in non-discretionary general fund increases to maintain the same level of service as FY2002. An additional $43 million in general fund dollars is required to replace one time or short-term funding sources. These changes are explained in detail in the Governor's Initiatives section. http://www.gov.state.ak.us/omb/initiatives/InitiativesAll.PDF
- Additional investments are proposed in five areas, each of which is described in detail in the Governor's Initiatives section.
  - Smart Start / Strong Future for Alaska's Children addresses child safety, health and early education ($9.2 million general funds, $4.1 million tobacco settlement funds and $4.1 million in federal and other funds);
  - Quality Education incorporates the recommendations of the Education Funding Task Force ($32.7 million, of which $1.7 million is in the operating budget and the rest is tied to legislation);
  - Alcohol treatment and abuse prevention to reduce future costs stemming from alcohol and drug abuse ($4.7 million general funds and $300,000 mental health trust funds);
  - Oil Safety and Development addresses problems of aging infrastructure and increased demand for oil and gas exploration and development permits ($3.7 million in general funds and $1.1 from current fee structures); and
  - University of Alaska investments continue the revitalization of our state university ($17 million); and
  - Smaller amounts are proposed for avalanche safety, addressing the effects of environmental contaminants, implementing the Millennium Agreement on State-Tribal relationships and Tolerance Commission recommendations.

CAPITAL BUDGET

- The Governor's FY 2003 proposed capital budget is $925 million in total funds, which is $247 million less than FY 2002. The general fund capital dollars are $114 million, the same level as this year.
- Federal funding accounts for $681 million or three-fourths of the capital budget, most of which is directed to highway, airport, sewer, water and sanitation projects. The current year federal funding level is $923 million. As the federal funding picture becomes clearer and Congress finishes work on the FFY2002 budget, the amount of federal funds authorized for capital projects will undoubtedly increase.

BONDS AND OTHER LEGISLATIVE PROPOSALS WITH BUDGET IMPACTS

- To help erase large backlogs in needed infrastructure and take advantage of extremely favorable interest rates, several bond proposals are recommended. These projects are explained in detail at http://www.gov.state.ak.us/omb/03OMB/budget/BondOverview.PDF.
  - School construction and major maintenance –voter approved general obligation bonds for $200 million with $100 million of that amount to be appropriated in FY2003;
  - Deferred maintenance, replacement of facilities that can't be repaired cost-effectively, ADA compliance and limited expansion of a few state facilities – $135.6 million in certificates of participation;
  - Accelerated transportation bonds for highways and ferries – $425 million in GARVEE bonds to reduce general fund match requirements by $62 million over the 18 year life of the bonds;
  - Harbor upgrades and transfers to municipal ownership – revenue bonds for $39 million backed by existing marine motor fuel taxes; and,
  - Replacement seafood and food safety lab – $11.5 million in certificates of participation.
- Funding for improvements in K-12 education and veterans services will be in fiscal notes to legislation proposed by the Governor. These are:
  - Education Funding Task Force-recommended changes to increase the K-12 foundation formula funding and to improve student assessment and school performance at $30.2 million; and
  - Veterans' housing at the renamed Pioneers' and Veterans' Homes which will require $2.7 million general funds and generate $2.6 million in fees in FY2003. In addition, the Governor is proposing to expand veterans' housing with $4 million of the $135.6 million in certificates of participation mentioned above and $6 million federal funds. The type of housing will depend on a $250,000 study of veterans' housing needs in the capital budget. The capital budget also includes $125,000 to match private contributions for an endowment to maintain veterans' memorials around the state.

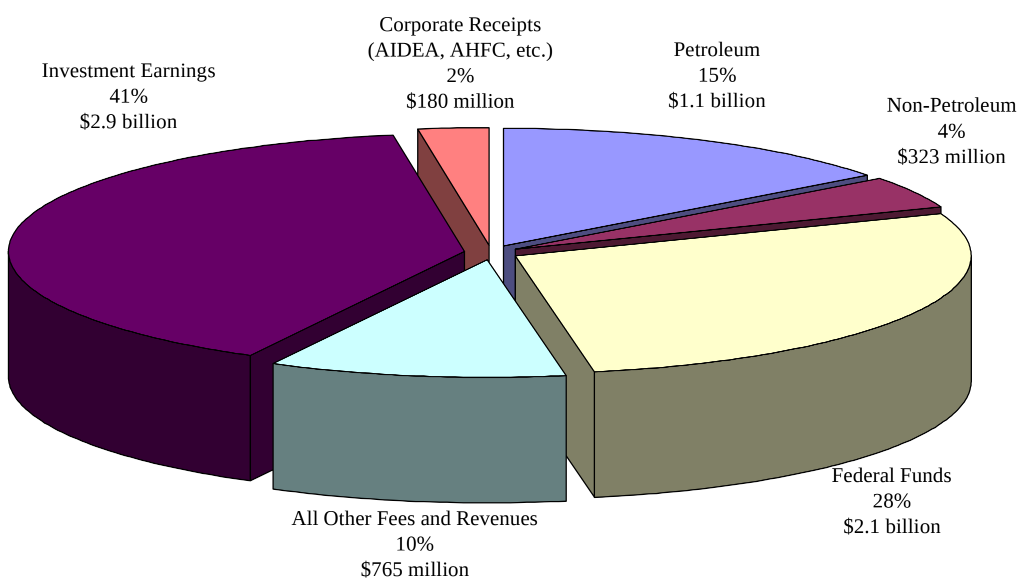
REVENUE ISSUES

OIL PRICE TRENDS

- If oil prices average $20.55 per barrel for State Fiscal Year 2002 (July 1, 2001 – June 30, 2002) as projected in the Department of Revenue *Fall Forecast*, the state will end the fiscal year with a general fund budget shortfall of approximately $900 million. However, most oil industry analysts believe oil prices won't remain at these levels indefinitely. As prices return to the historical average of $17-18, the fiscal gap is expected to increase over the next few years.
- The *Fall Revenue Forecast* projects the average price of oil for FY2003 at $18.81 per barrel. With this average price and the Governor's proposed budget, a Constitutional Budget Reserve (CBR) draw of $1.2 billion will be required to balance the FY2003 budget.
- While oil prices have a major year to year impact on petroleum revenues, they are becoming less significant over time in terms of the state's total revenues. Petroleum royalties and taxes now account for only 15% of total revenues. (Revenue Sources – Chart 1.)

Chart 1

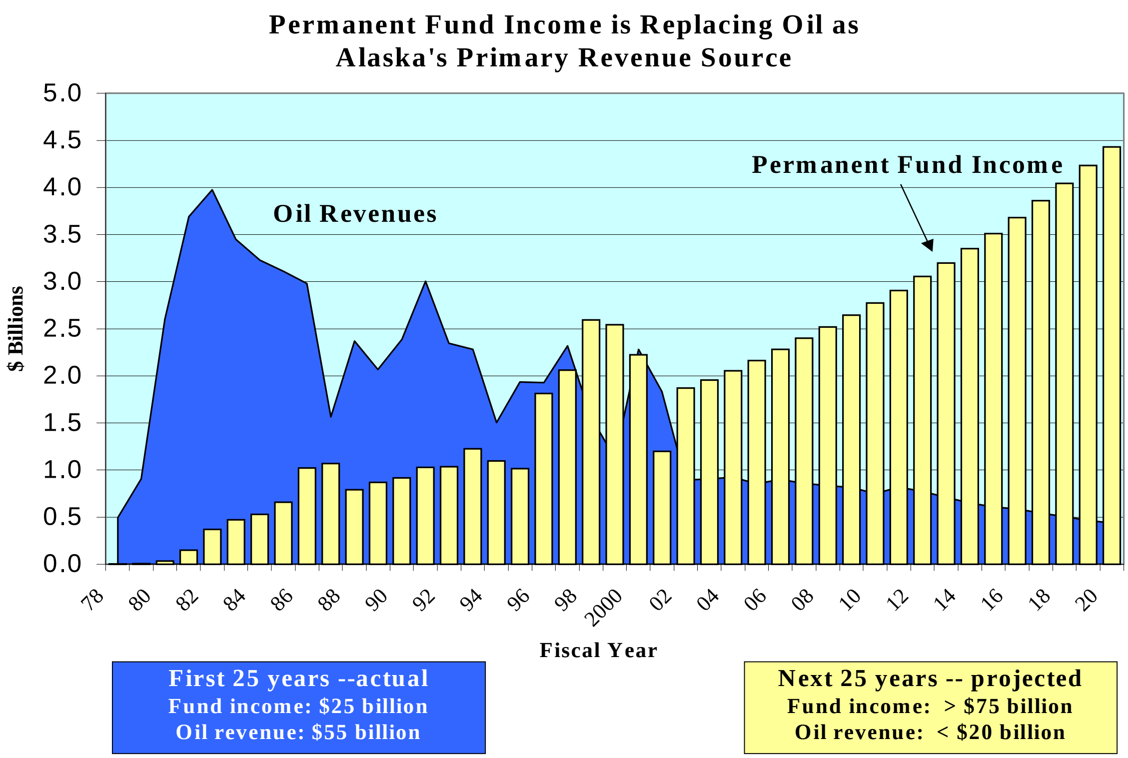
FY2003 Revenue Sources: $7.3 Billion Total Funds



INVESTMENT EARNINGS

- The most profound change in Alaska's fiscal picture in recent years was that Permanent Fund earnings overtook petroleum revenues as the largest and fastest growing source of state revenues. (Permanent Fund – Chart 2.)
- Note that the simultaneous oil price drop and market losses in FY2001 are exceptions to the longer-term trend that investment earnings predominate and tend to offset oil price volatility (i.e., financial markets tend to move higher when oil prices decline and vice versa).

Chart 2

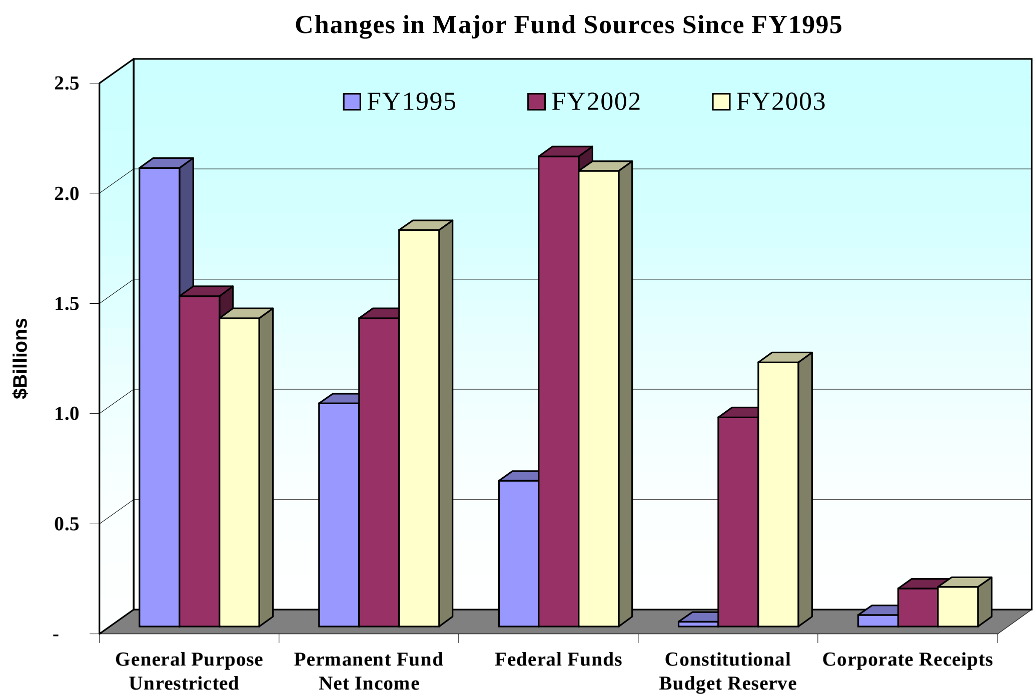


- During FY2001, the Permanent Fund had $1.2 billion in statutory net income. Net income is projected to be $1.35 billion in FY2002 and $1.8 billion in FY2003. Lower than expected returns in FY2001 and 02 will have multi-year economic consequences for the state due to the five-year averaging provision in the dividend calculation statute. Payouts for PFDs are currently projected to decline from $1.1 billion in FY2001 to $1 billion in FY2002 and $961 million in FY2003.
- The CBR is projected to generate $169 million in earnings this year but only $83 million next year because the year-end balance is projected to drop from $2.36 billion at the end of FY2002 to $1.35 billion in FY2003.
- Due to the state's dependence on petroleum revenues, the Department of Revenue believes a minimum balance of $1.5 billion in the CBR is needed to offset the effects of oil price volatility and to smooth out seasonal variations in the state's cash flow. A more diverse revenue base would permit a smaller CBR balance to cushion against the volatility of petroleum revenues.

FEDERAL REVENUE

- Federal funds for Federal Fiscal Year 2002 (October 1, 2001 – September 30, 2002), comprise more than a quarter of the state's total budget. The largest categories of federal funding are for construction of highways ($354 million) and airports ($119 million), and the Medicaid program ($583 million).
- For the most part, federal funds are restricted to specific uses. Most federally funded programs come with a state match requirement or involve restrictions such as maintenance of effort requirements that disallow or limit reductions in the level of state funding.
- As federal funds have increased in recent years, so have state match requirements. The state general fund match required in FY2003 will be $303 million to receive $2.1 billion in federal funds. Failure to meet federal standards in areas such as tobacco control and open container laws have cost the state federal funds in previous years and preliminary indications are that sanctions will be imposed again next year.
- The formula that determines the federal share of the Medicaid program was changed by Congress last year. While the state is expected to receive an additional $201 million in federal Medicaid funds for FY2003, the state match share will increase by $26.6 million in general funds and $68.8 million in other funds. Refinancing arrangements will be needed to keep the overall state general fund increase for caseload growth down to about $8 million.
- Chart 3 provides a snapshot of the growth in federal funds compared to changes in other major fund sources since 1995.

Chart 3



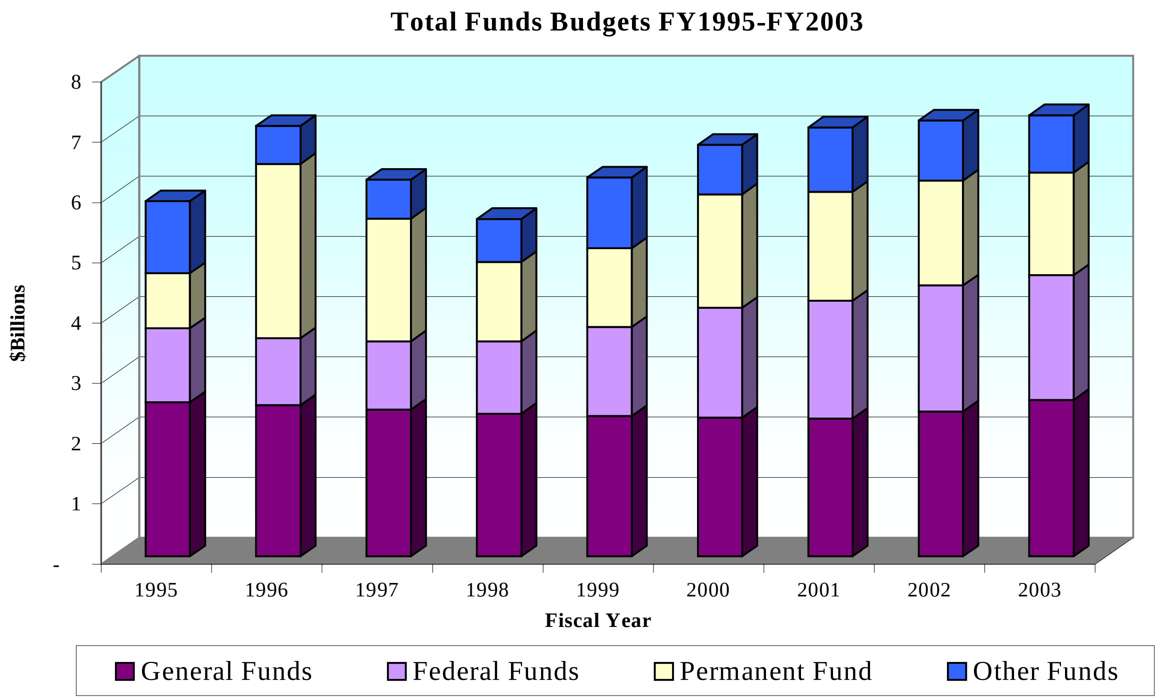
- The state is vulnerable to a potential reduction in federal funding in coming years with the likely return of federal deficits and increasing concerns about earmarking funds in the Congressional appropriation process.

EXPENDITURE ISSUES

TOTAL SPENDING

- Since FY1995, general fund spending has remained stable or trended downward while spending of Permanent Fund earnings, federal and other funds (such as receipts of the international airports and state corporations) has increased. Chart 4 shows this in nominal dollars, so the trends are even more pronounced when adjusted for inflation.

Chart 4



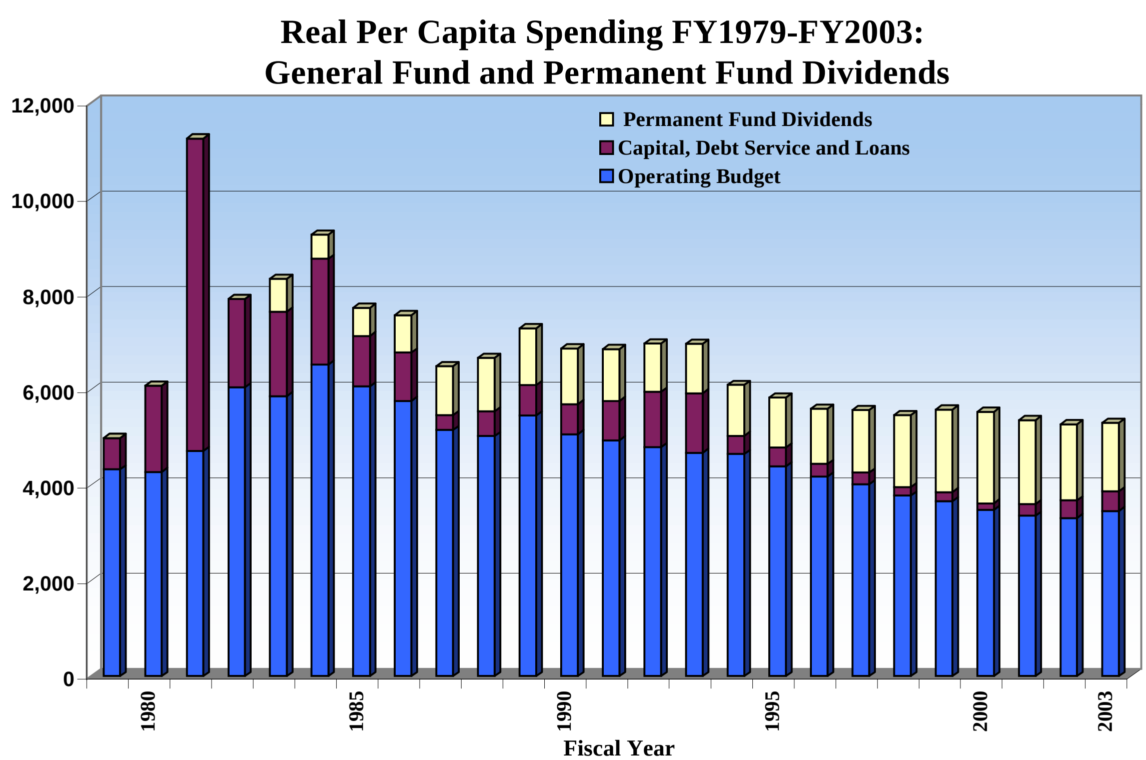
- The FY1996 and 1997 spikes in spending Permanent Fund earnings include special deposits made from the Permanent Fund Earnings Reserve Account to the Fund principal. Spending on dividends and inflation proofing steadily increased from $880 million in FY1995, peaking at $1.8 billion in FY2001. Lower earnings are expected to reduce spending for dividends and inflation proofing to $1.67 billion in FY2002 and $1.62 billion in FY2003.

- Population and inflation are the main drivers of public service costs. Certain portions of the population as well as certain types of inflation have a disproportionate impact on the state budget. The most expensive groups in terms of state spending are school age children, males 18-25 and seniors. Inflation of medical costs, higher education and energy costs have a proportionally larger effect on the state budget than they do on household incomes.

- The peak of the baby boom echo generation is currently passing through the middle grades of the public school system. Statewide K-12 enrollment has remained relatively flat for the past couple of years and is projected to increase only slightly (<1%) in FY2003 to 133,304 students. The average per year cost of educating a K-12 student is $8,070 ($5,368 state share). Overall enrollment has begun to decline in many of the larger urban school districts (which have lower costs per student due to economies of scale and less expensive supplies such as heating fuel), while it continues to increase in rural districts (which have higher per student costs).

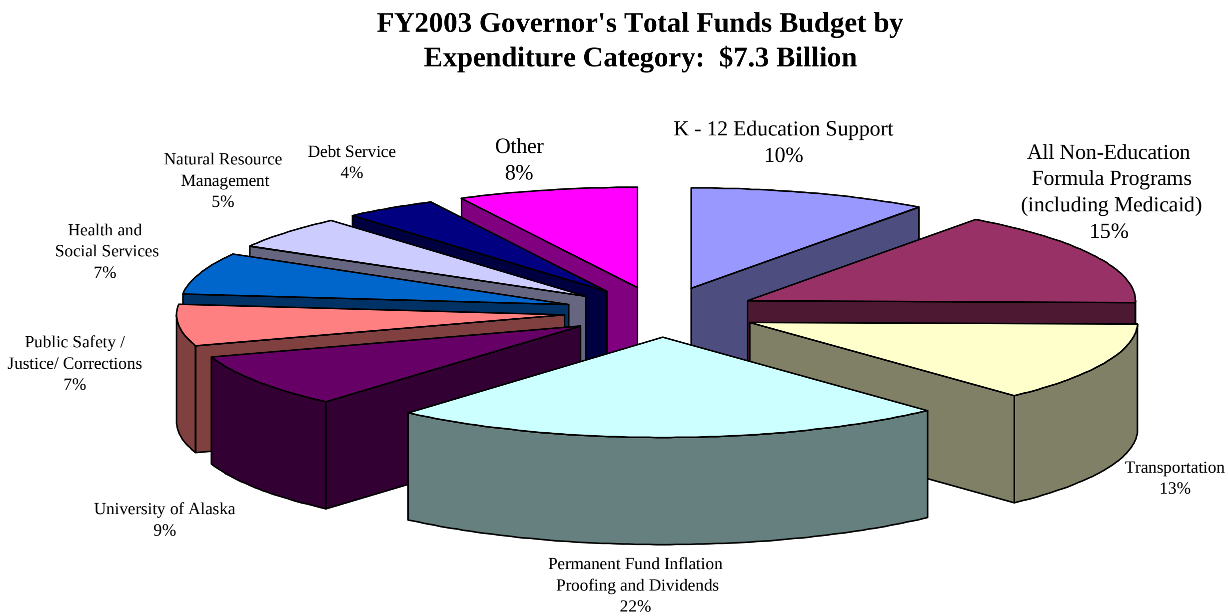
- Males age 18 – 25 account for the bulk of the cost of the criminal justice system. As the baby boom echo generation comes of age, we can expect their numbers to cause a commensurate increase in crime, which will drive up public safety, prison and court costs. The state cost of incarcerating an inmate averages about $41,000 per year.
- A rapidly aging overall population has profound implications for the next 25 years. Already we are experiencing a sustained increase in the number of seniors with more severe health problems who require care under Medicaid in state facilities. The average cost for a senior on Medicaid is $1,209 per month, while the average cost per month for a Pioneer Home resident is $5,973 (of which residents on average pay 38%). The growth in the total cost of Medicaid for Alaska's seniors has doubled from about $50 million if FY1997 to about $100 million in FY2003 and has averaged 12% each of the last three years.
- Specific types of inflation have budgetary impacts greater than those experienced by households. For example, the price of specialized goods and services purchased by universities nationwide (e.g., lab and research equipment, library materials) has risen much faster than the overall inflation rate. Likewise, energy prices are a small component of the overall consumer price index (CPI) but higher fuel prices have big impacts on the ferry system, 24-hour facilities like Pioneer Homes, and the Power Cost Equalization program.
- On a real (inflation-adjusted) per capita basis, the level of state general fund spending proposed for FY2003 is $1,100 lower than it was in FY1979, the first full year of oil flow through the pipeline (Chart 5). However, when Permanent Fund dividends are added in, spending per person in today's dollars is $320 higher than in FY1979.

Chart 5



- The broad program categories in the FY2003 Governor's total funds budget are shown in Chart 6. The dominant expenditure category is for Permanent Fund dividends and inflation proofing which dwarfs all other categories of the overall state budget.

Chart 6



- After the Permanent Fund appropriations, payments to school districts for K-12 education account for the largest single program expense at $741 million.
- State responsibilities for other basic public services – transportation, university, public safety, health, natural resource management and debt service – comprise 60% of the total budget. Many of these areas have required additional investments in the past years to keep up with increased public demand. All other functions, including Finance, Treasury, the Legislature, Governor's Office, Motor Vehicles, Occupational Licensing, etc., amount to only 8% of the total funds budget.

FEE-SUPPORTED SERVICES AND THE "OFF BUDGET" MYTH

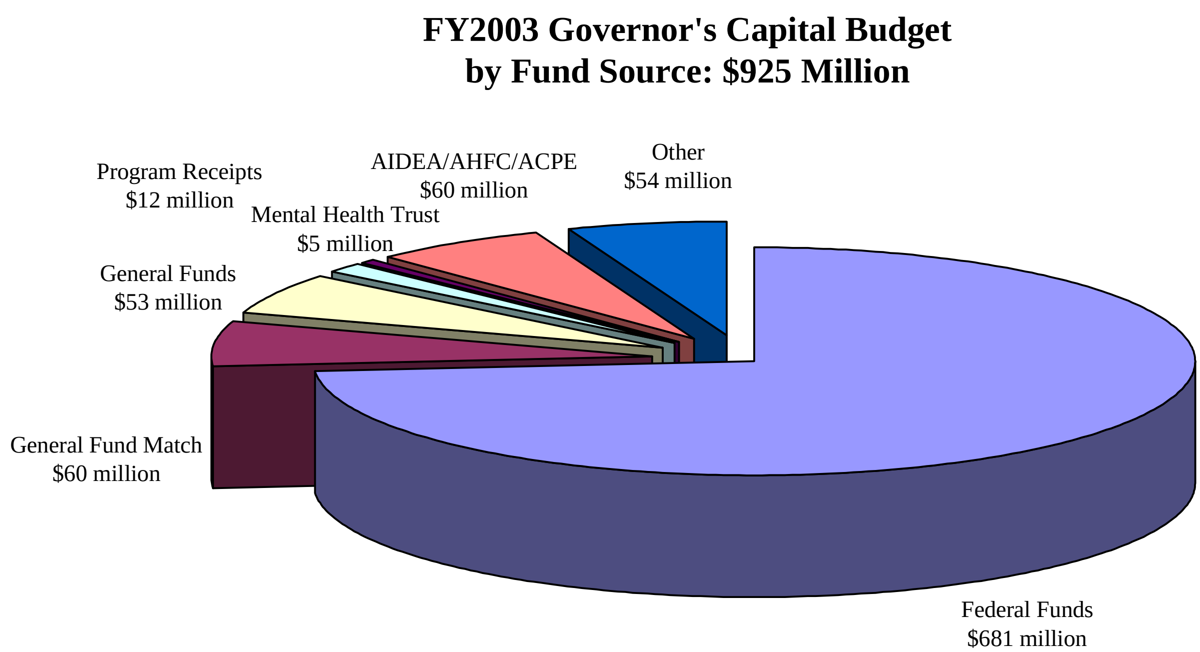
- One of the more persistent "myths" about the state budgeting process is that certain programs have been moved "off budget". In fact, all of these programs are still "on budget". They are included in the Governor's budget and appropriated by the Legislature each year as required by statute.
- What has actually occurred is a change in the categorization of revenues that are restricted for a particular purpose (e.g., fees from totally self-supporting programs and proceeds from the sale of Tobacco Settlement payments) from general funds to "other funds" since they are not considered available for shifting to other purposes.
- Fee-supported increases in the budget do not increase the budget gap or the draw on the Constitutional Budget Reserve because the cost increase is fully paid from fee receipts. Legislation in recent years that changed the categorization of fees acknowledged that these activities should not be viewed as competing for "all purpose" general fund revenues such as oil and gas taxes and royalties.

- Fee-supported programs (as well as all items in the "other funds" category) must still be appropriated just like programs funded with general funds. They are subject to the same scrutiny by the administration and legislature, and are not automatically approved.

CAPITAL PROJECTS

- The proposed revenue sources for the FY2003 capital budget are in Chart 7. Three-fourths will come from federal dollars, principally for transportation projects. General funds, including $60 million of general fund match required for federal projects, represent only 12% of the total capital budget.

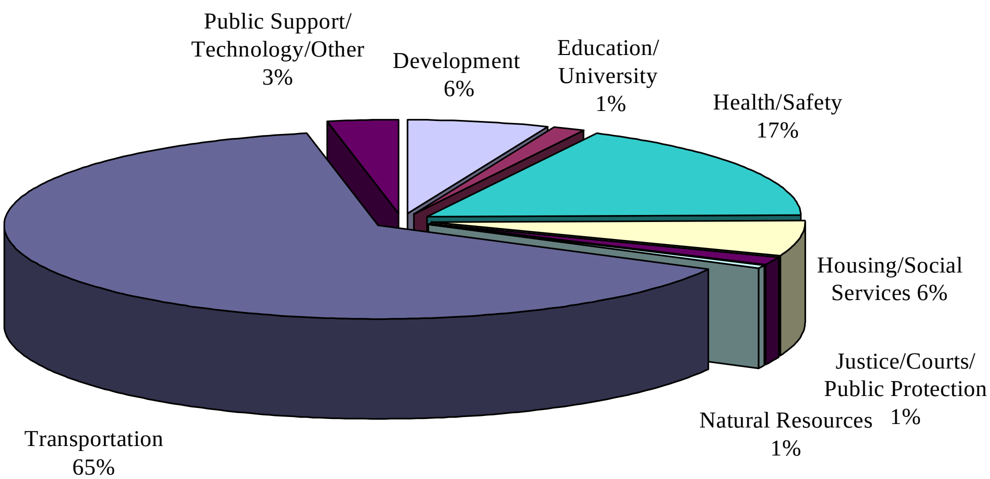
Chart 7



- The main difference between FY2002 and 03 is the $127 million reduction in international airport construction bond receipts since enough bonds were issued last year to fund the major capital construction needs. The international airport system is a self-sustaining entity funded via landing fees, rental charges and passenger facilities charges.
- Among the types of capital projects, transportation continues to be by far the largest category at $594 million or two-thirds of the overall capital budget. As shown on Chart 8, the next largest category is health and safety at 17%.

Chart 8

FY2003 Governor's Capital Budget by Expenditure Category: $925 million

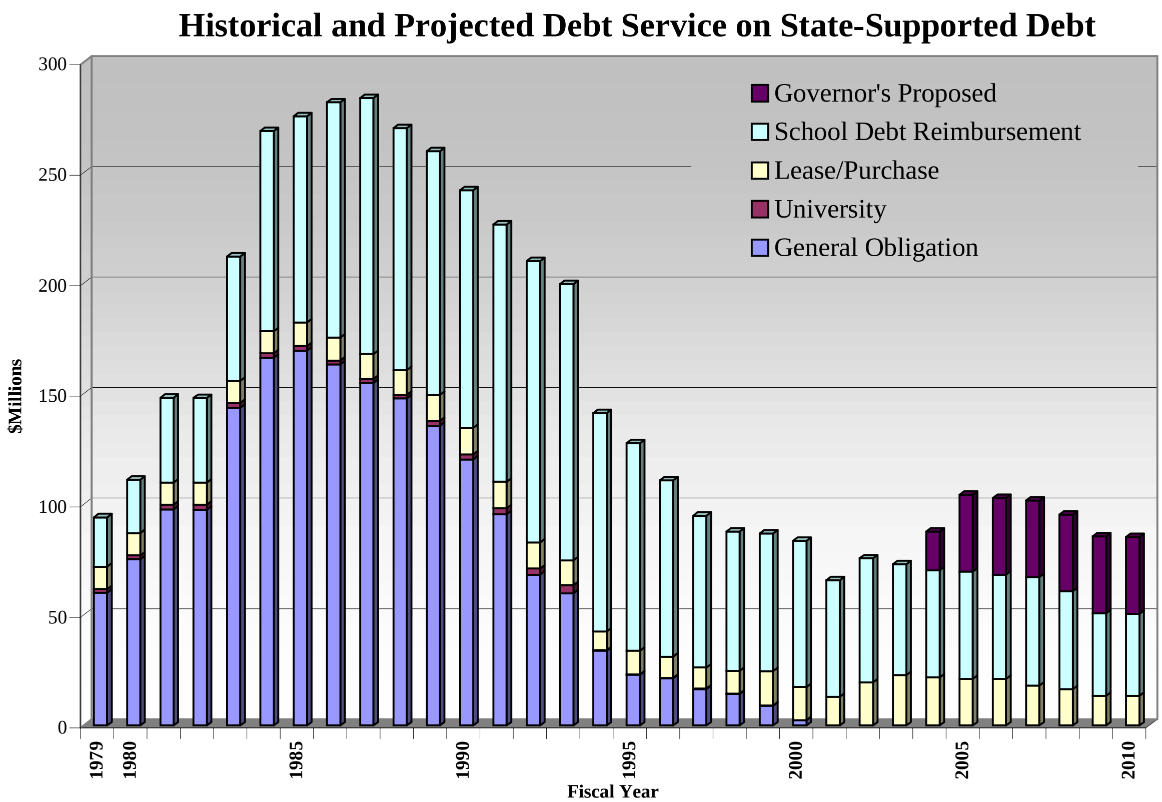


- Schools, harbors and deferred maintenance of state facilities are addressed in the Governor's bond proposals described in the Bonds section: http://www.gov.state.ak.us/omb/03OMB/budget/BondOverview.PDF.
- Bulk fuel storage facilities, health clinics and other very basic infrastructure projects in rural areas receive funding directly from the federally-funded Denali Commission with the state providing a share of the total cost. As with all federal funding, this money is restricted to specific uses and projects.

FINANCING STATE INFRASTRUCTURE

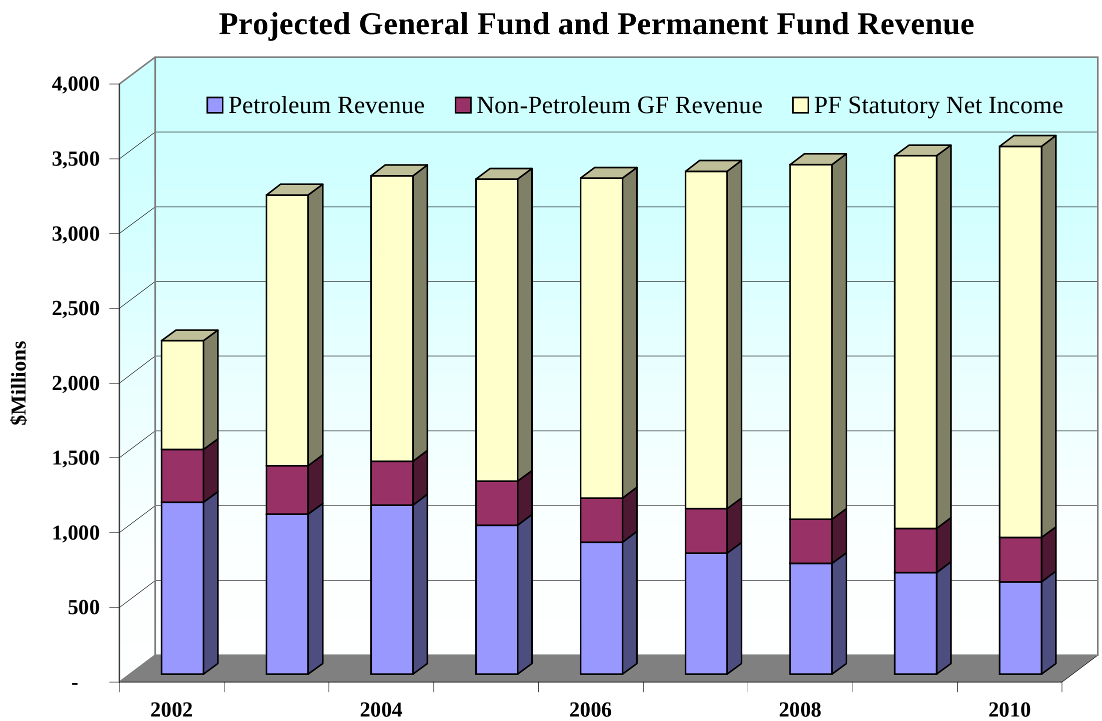
- The state made the final payment on its outstanding general obligation debt in October 1999. The most recent general obligation (GO) bonds, which require statewide voter approval, were authorized in FY1981: $289 million for various purposes including transportation, education, water and sewer projects.
- Since that time, the state has purchased or constructed various buildings using lease/purchase and certificate of participation (COP) financing. Examples are prisons, courthouses, and the Public Health Lab. Lease/purchase payments must be appropriated annually by the legislature and figure into the state's debt capacity.
- Debt payments on the Governor's bond and COP proposals would not begin until FY2004. As shown in Chart 9, even when they peak in FY2008, the total level of debt will be less than in FY1981 and one-third of the FY1987 peak.
- In the beginning of the oil era in FY1979, Alaska's debt capacity and debt service payment schedule were tied closely to the Prudhoe Curve of oil production and petroleum revenue. Total annual debt service payments peaked in FY1987 at $284 million during the highest years of North Slope oil production (see Chart 9). As petroleum revenues have become a smaller share of Alaska's total budget picture and investment earnings have become more important, state debt capacity is no longer determined by the Prudhoe Curve.

Chart 9



- Despite the decline in oil revenues, Alaska continues to enjoy very favorable rates on its bonds. From a Wall Street perspective, the decline in future petroleum revenue is more than offset by Permanent Fund statutory net income. Any new revenue sources added in the next several years to address the fiscal gap will increase revenues available to make debt service payments. As Chart 10 indicates, projected future revenues paint a much different picture than when the state's historical debt service capacity was tied to the Prudhoe Curve.

Chart 10



- Historically, Alaska's debt service capacity has been measured as a percentage of general fund revenue to reflect the state's dependence on petroleum revenue. However, with Permanent Fund earnings assuming an ever-larger share of available revenues, more traditional ratios of state credit analysis are appropriate. These include net tax supported debt per capita, and net tax supported debt as a percentage of personal income. Using these measures, Alaska is extremely well placed relative to other states in its capacity to issue additional debt. Only 10 states have lower per capita state supported debt than Alaska ($260). The rating agencies place Alaska's credit worthiness (Aa2 – Moody's; AA Standard and Poors and Fitch) in the top third of states in terms of debt as a percentage of personal income.

- In recent years, new revenue sources have been leveraged to finance construction of schools, university, harbor projects and other state facilities. Sources such as tobacco taxes, AHFC dividends and tobacco settlements have been used for debt service payments that would have otherwise come from general funds. However, with no new funding sources on the horizon, debt service payments for most types of future bond sales will be made with general funds.

- The current interest rate environment offers the best rates on bonds in many years, which provides a unique opportunity for a multi-year financing plan to meet the state's infrastructure needs and catch up on deferred maintenance. GO bonds proposed by the Governor would carry an interest rate of less than 5%. Rates for lease/purchase arrangements or certificates of participation and revenue bonds would be only slightly higher.

- The Governor's capital financing proposals include these traditional financing instruments plus, for the Accelerated Transportation Initiative, a newer financing method called GARVEE bonds. These leverage future federal highway funds to build projects much sooner than they would otherwise be funded. Because interest earnings on the bonds qualify as state matching funds, GARVEEs actually reduce the general funds needed to match federal transportation dollars.

- Careful consideration has been given to the effect the bond package will have on the statewide economy and the capacity of the in-state construction industry to handle the work. One reason for doing the projects now is to upgrade major portions of the state's physical infrastructure before mega-construction projects such as the gas pipeline or missile defense system get underway later in the decade. Doing a very large volume of state infrastructure and private sector projects simultaneously would likely result in an influx of workers and their families rather than relying on current state businesses and workers.
- The balance struck in the Governor's bond package spreads projects out over time, by type and geographically so as to not overtax the in-state construction industry. For example, highway construction (called horizontal construction) involves different companies than school construction (vertical construction). Likewise, deferred maintenance work on schools and state facilities is shorter-term and involves smaller contractors than those that would typically bid on large projects such as schools. Firms involved in harbor construction are fairly specialized. The table below projects cash flow into the statewide construction industry from existing and proposed bond projects given typical timelines.

Construction Cash Flow

Existing and Projected Cash Flow from Bond Projects in Addition to Regular Capital Budgets
($ millions)

State Funded Public Sector Projects	FY 02	FY 03	FY 04	FY 05	FY 06	FY 07	FY 08
Existing Projects							
School Projects Funded via AHFC/Tobacco Bonds	60.0	60.0	45.0	11.4			
Other Projects Funded via AHFC Bonds	25.0	30.0	30.0	25.0	5.1		
Alaska Gateway Project	50.2	11.6	0.8				
Projected Cash Flow from School Debt Reimbursement Projects	86.8	114.9	39.7	10.7			
Alaska Psychiatric Institute	1.5	8.7	24.4	6.9			
Governor's Proposed							
General Obligation School Bond Projects*		20.0	65.0	70.0	35.0	10.0	
Accelerated Transportation Initiative (GARVEE)		10.3	38.7	76.4	141.9	68.5	14.5
Harbor Bonds		2.0	9.4	9.4	9.4	7.2	
Deferred Maintenance COPs		48.0	48.0	48.0			
Seafood and Health Safety Lab	1.5	6.4	6.4				
Total Cash on the Street in Addition to Regular Capital Budgets	**225.0**	**311.9**	**307.4**	**257.8**	**191.4**	**85.7**	**14.5**

*Based on a typical phased payment schedule for school construction projects.

STATE WORK FORCE AND CONTRACT ISSUES

- Recruitment and retention issues have surfaced as serious problems in the state government work force. For example, the Department of Fish and Game is losing staff to the federal government which has a large new budget for subsistence management and can offer higher base salaries plus a 25% tax-free COLA for jobs in Alaska. The Department of Transportation and Public Facilities can't compete with private sector firms that pay more for engineers.
- Large private employers like Alyeska and major hospitals are having similar problems and are offering higher salaries to meet their recruitment goals. Even after the state increased salaries for nurses last year, the Departments of Health and Social Services and Corrections are still losing nurses to larger private and municipal hospitals.
- Over the next five years, the state is likely to lose over 25% of its total work force just to retirement. There is a dearth of 20-30 year old replacement workers in the statewide population due to net out-migration from the state in recent years. Job opportunities in the western states, from which Alaska has traditionally drawn workers, are also a major factor. In addition to lower salaries than in the federal and private sectors, reduced benefits for Tier II and Tier III state workers have made state jobs less competitive than in the past.
- The Division of Personnel has identified mission critical job classes which departments are having extreme difficulty filling. These include: engineers, biologists, health care professionals, accountants, financial administrators, public safety professionals, social workers, specialized education job classes, computer programmers and other technology professionals.
- Last session, the Legislature passed HB 242 (Chapter 57, SLA 01) that allows retired government employees and teachers in the PERS and TRS retirement systems to return to work without losing their accrued benefits. While they do not accrue additional retirement credits, they collect a regular salary in addition to their retirement pay. The intention was to retain valuable employees in their peak years of productivity who would otherwise be lost to retirement. It is too early to gauge the effectiveness of this program and whether it will have any significant effect on the current brain drain of state employees and teachers. Other ways of improving the recruitment and retention of state employees are being explored.
- Over the longer term, slowing economies in West Coast states as well as the potential for large projects in Alaska such as the gas pipeline or missile defense system could portend a new wave of migrants from the lower-48 states in search of high paying construction jobs. These projects would likely have the double effect of straining public services as well as luring away state employees who provide the services. This was certainly true during construction of the Trans-Alaska Pipeline.
- FY2003 is the third and final year of executive branch labor contracts. Costs for these contracts and equivalent increases for non-represented employees will be $14.1 million in FY2003. University, court system and legislative labor costs will add another $8.3 million.