GOVERNOR KNOWLES'
FY2002 EXECUTIVE BUDGET
MAJOR FISCAL ISSUES

Revenue Issues

OIL PRICE TRENDS

- If oil prices average $30.17 for State Fiscal Year 2001 (July 1, 2000 – June 30, 2001) as projected in the Fall Forecast, the state will end the fiscal year with a general fund budget surplus of approximately $120 million. However, most oil industry analysts believe that oil prices won't remain at these levels indefinitely.
- The Fall Department of Revenue state revenue forecast projects the average price of oil for FY2002 at $24.28 per barrel. With this average price and the Governor's proposed budget, a Constitutional Budget Reserve (CBR) draw of $527 million would be required to balance the FY2002 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. (See FY2002 Revenue Sources – Chart 1.)

INVESTMENT EARNINGS

- The most profound change in Alaska's fiscal picture in recent years has been that Permanent Fund earnings have overtaken petroleum revenues as the largest and fastest growing source of state revenues. (See Permanent Fund – Chart 2.) Note that the oil price spike in FY2001 is an exception to the longer-term trend.
- The CBR is projected to generate $162 million in earnings in FY2001 and $170 million in FY2002. The balance in the CBR at the end of FY2001 is projected to be $3.113 billion and $2.8 billion in FY2002.

FEDERAL REVENUE

- Federal funds for Federal Fiscal Year 2001 (October 1, 2000 – September 30, 2001), comprise more than a quarter of the state's total budget. The largest categories of federal funding are highways ($322 million), airports ($111 million), and Medicaid ($472 million).
- For the most part, federal funds are restricted to specific uses and most federally funded programs come with a state match requirement or involve restrictions such as

Chart 1

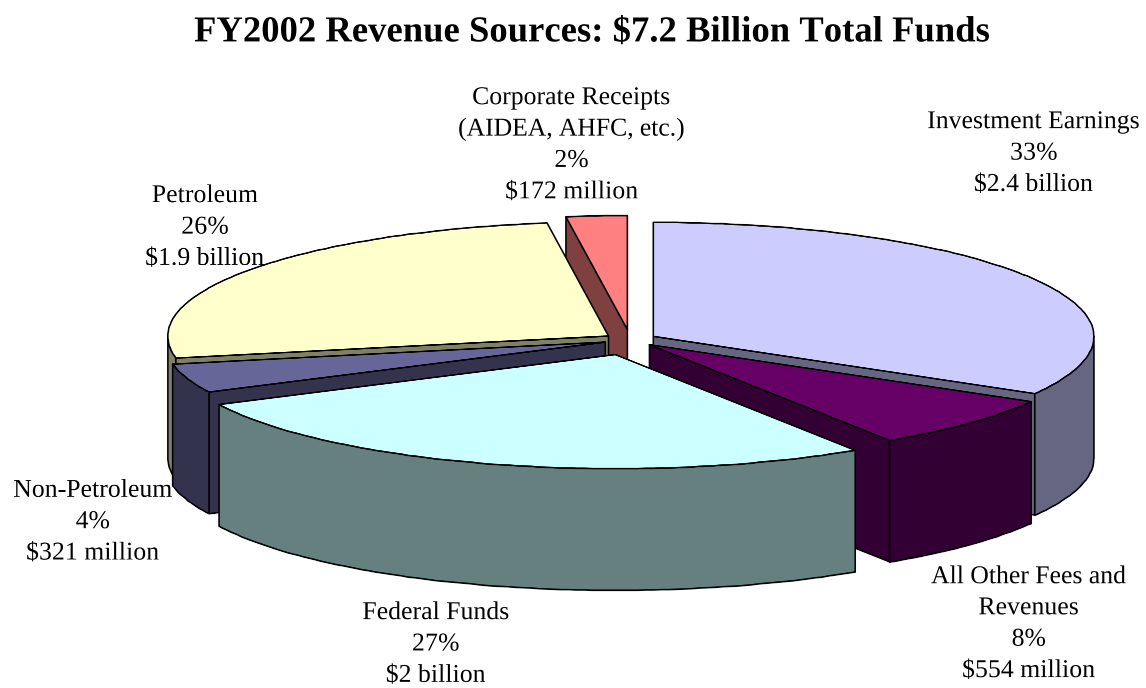
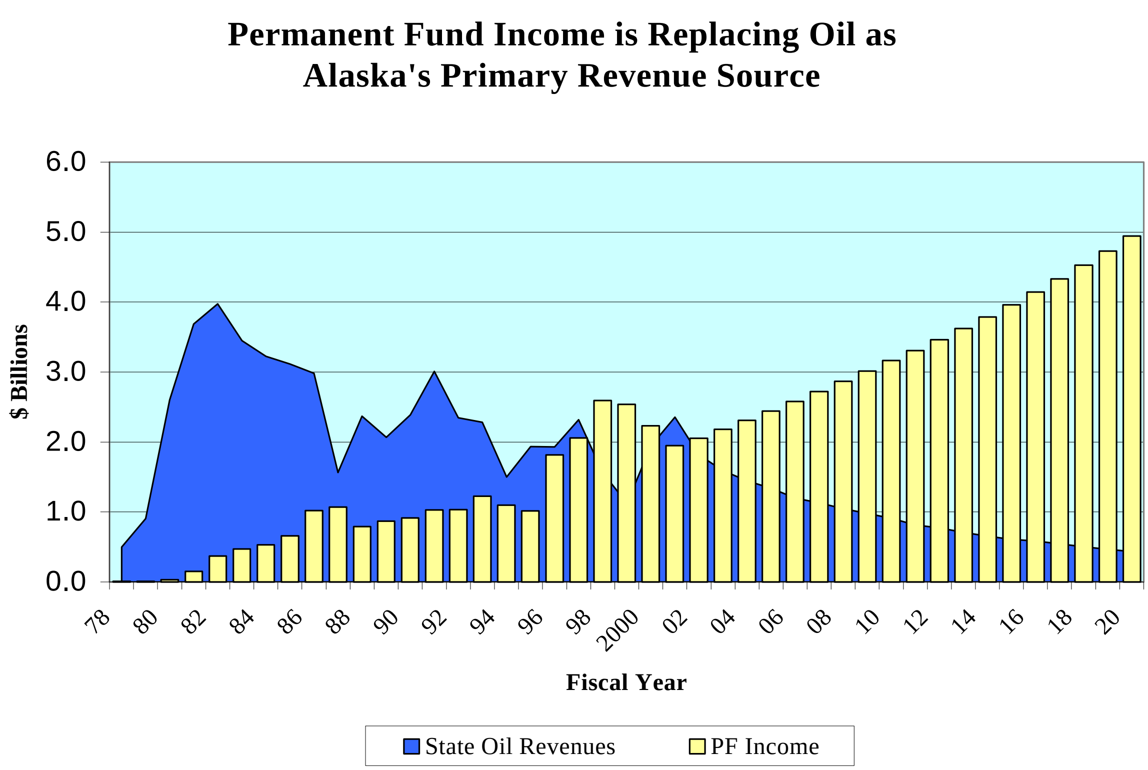


Chart 2



maintenance of effort requirements, i.e., requirements which disallow or limit reductions in the level of state funding.

- State match requirements have increased, while non-attainment of federal standards in certain service areas (e.g., tobacco control and open container laws) have cost the state federal funds. The state general fund match required for receiving $2 billion in federal funds for FY2002 is $254 million.
- As of the release of the Governor's proposed FY2002 budget, parts of the federal fiscal year 2001 budget are still not complete. The most uncertain areas of federal revenues are: Medicaid, education, health and social services, and child development.
- The formula that determines the federal share of the Medicaid program is up for reauthorization in Congress next year. Changes to the formula are contained in the Balanced Budget Refinement Act of 2000 currently under negotiation between Congress and the White House. Unless congressional action modifies the existing schedule of formula changes, an increase of approximately $31 million in state funding for the Medicaid program will be required.
- The Major Changes in Total Fund Sources Since FY1995 - Chart 3, provides a snapshot of the growth in federal funds compared to changes in other fund sources since 1995.
- The state is vulnerable to a potential reduction in federal funding in coming years as leadership positions held by Alaska's congressional delegation change. One strategy for mitigating this risk is to incorporate federal funds for Alaska programs into ongoing federal programs, rather than as special funding earmarked for Alaska.

Expenditure Issues

TOTAL SPENDING

- The Total Funds Budgets FY1995 – FY2002 - Chart 4 shows total funds spending since FY1995. During that time, general fund spending has trended downward while spending of Permanent Fund earnings, federal and other funds (such as receipts of the international airports and state corporations) has increased.
- The largest spikes in spending Permanent Fund earnings correspond to years in which special deposits were made from the earnings reserve to the Permanent Fund principal. However during the entire period, spending on dividends and inflation proofing steadily increased from $880 million in FY1995 to $1.908 billion anticipated in FY2002.
- A number of significant factors underlie these trends in state spending. For instance, the peak of the baby boom echo generation is passing through the public school system with the fastest growing populations of school age children in the villages of rural Alaska. Also, an aging population means that more seniors with more severe health problems are being cared for under Medicaid and in state facilities.

Chart 3

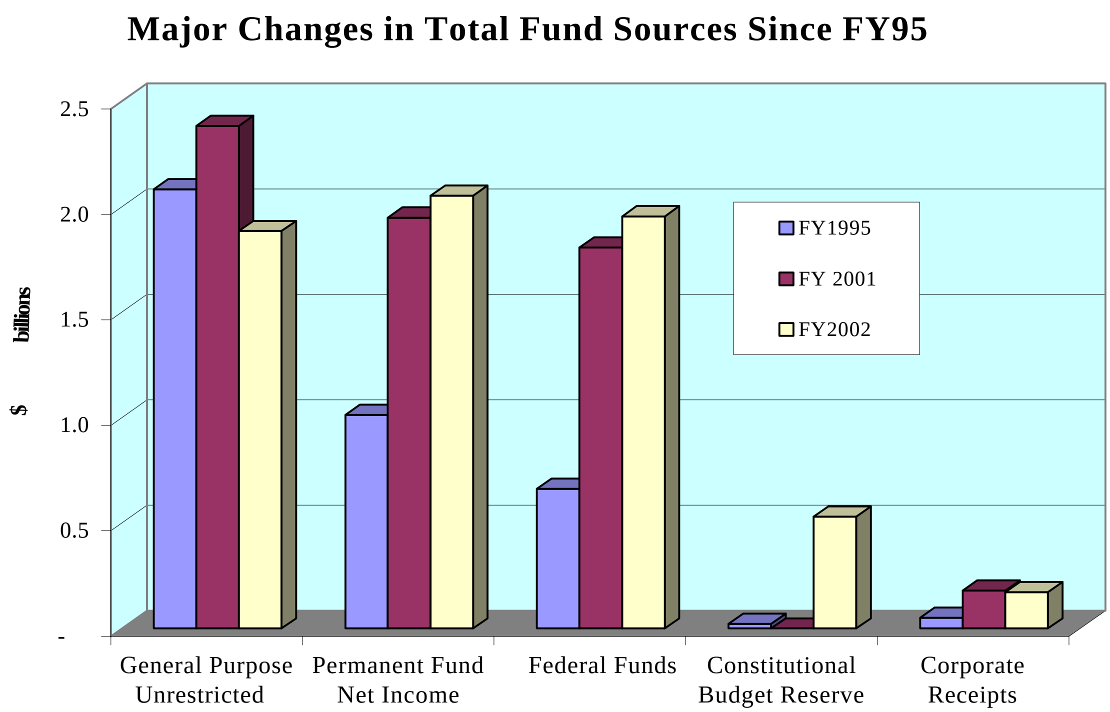


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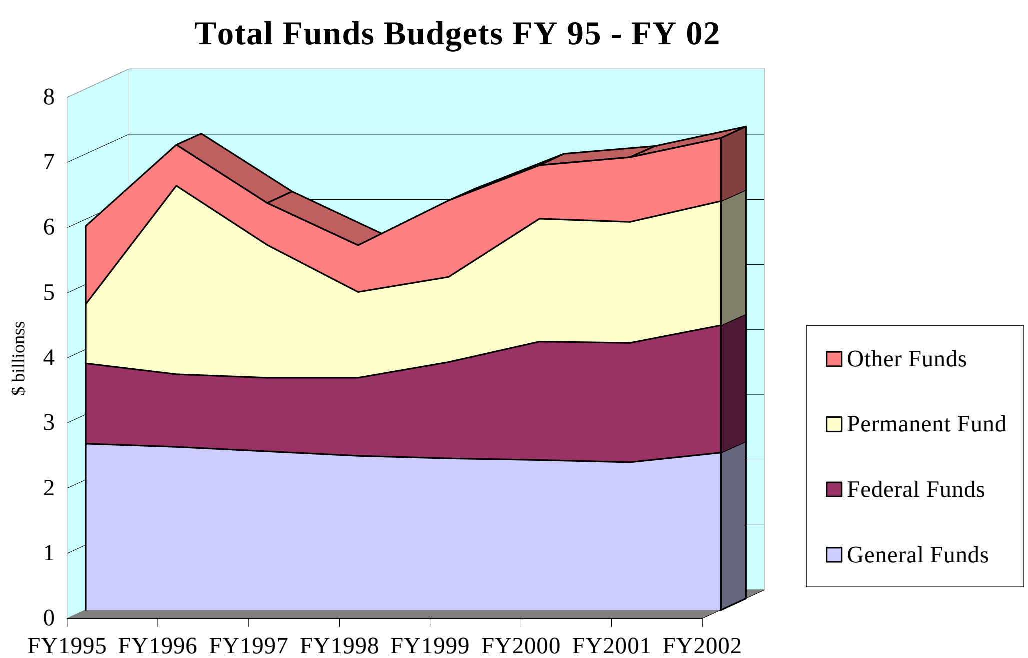
Chart 4



- For the most part, inflation has been absorbed in departmental budgets. Higher oil prices in FY2001-2002 especially affect the cost of operating ferries, trooper and Fish & Game vessels and aircraft, Power Cost Equalization, and heating for schools and other public facilities.
- Even as state match requirements have increased in concert with federal revenues, Alaska is the only state to have actually reduced general fund spending during the past several years.
- General Fund Budget Cuts vs. Increases for K-12 Education and Dividends FY1995-FY2002 – Chart 5, is a snapshot of the most significant changes in state spending since FY1995 in the Governor's proposed FY2002 Budget.
- One-time monies used in the operating budget and non-general fund sources used to pay debt service have shielded the state's general fund exposure in the recent past but will need to be replaced or supplemented with general funds in the FY2002 budget. (See The Governor's Proposed FY2002 Budget by Expenditure Category- Chart 6).

Chart 5

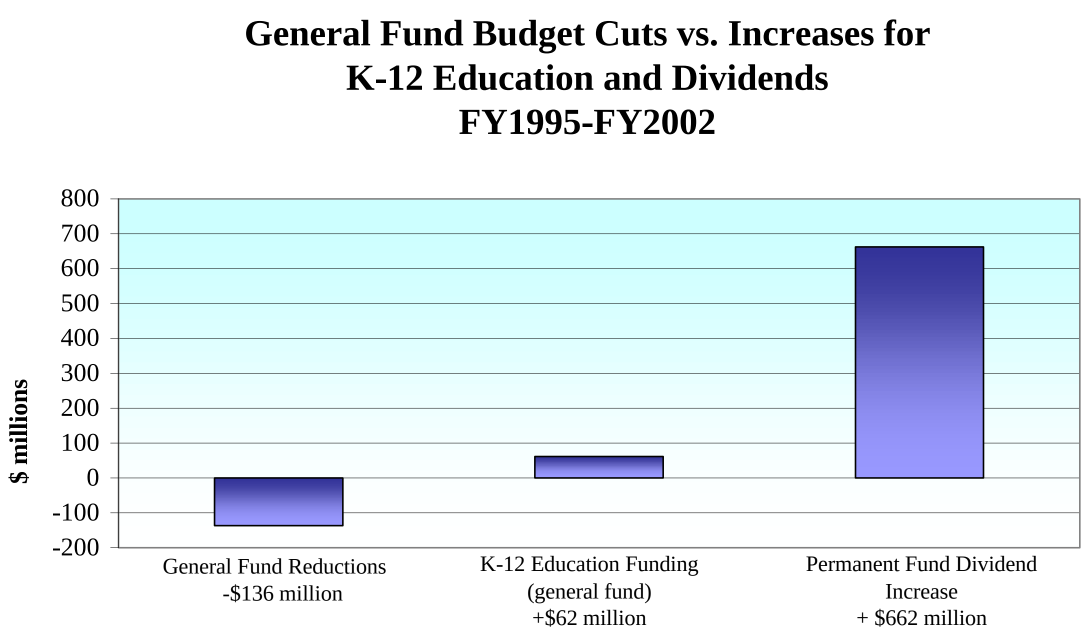
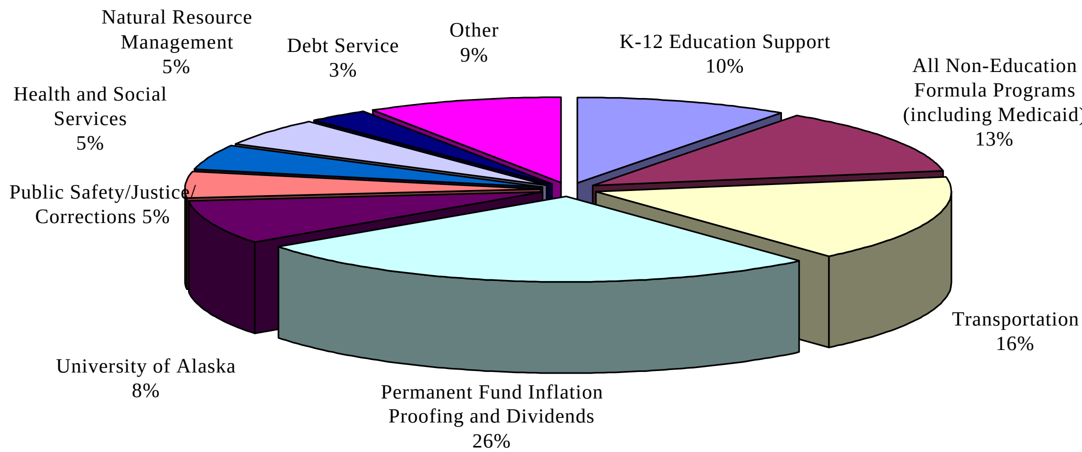


Chart- 6

FY2002 Governor's Proposed Total Funds Budget by Expenditure Category: $7.2 billion



FEE SUPPORTED SERVICES

- A statute passed last session (HB 418; Chapter 101, SLA 00), changed the way fee supported services are classified from general fund to "other funds". This continued a two year joint effort by the administration and legislature to clarify which budget increases and cuts actually affect the fiscal gap.
- Fee-supported increases in the budget do not increase the draw on the Constitutional Budget Reserve because they are fully supported with fee receipts. Legislation changing how fees are treated acknowledged that these activities aren't competing for general purpose revenues such as oil and gas taxes and royalties.
- However, fee-supported programs must be appropriated just like programs funded via general funds and are subject to the same scrutiny by the administration and legislature.
- Fees and expenses will not match exactly in any given year. Therefore, to ensure that fees take into account any variations from the previous year, agencies must be able to carry the revenues generated from fee supported services forward from one year to the next to allow for setting multi-year fees (e.g., for licensing of various professions) or to smooth out year to year fluctuations in receipts to maintain minimum service levels.

STATE DEBT ISSUES

- The state made the final payment on its outstanding general obligation debt in October 1999. General Obligation (GO) bonds require statewide voter approval. The last approval of GO bonds was in FY1981: $289 million for various purposes including transportation, education and water and sewer projects.
- Since that time, the state has made numerous purchases of buildings and other facilities using lease/purchase financing where the individual projects were not large enough to warrant going to the voters. Lease/purchase payments must be appropriated annually by the legislature and count against the state's debt capacity (FY 2002 Governor's Budget Debt obligations and Revenue Sources – Table 1).

Table 1

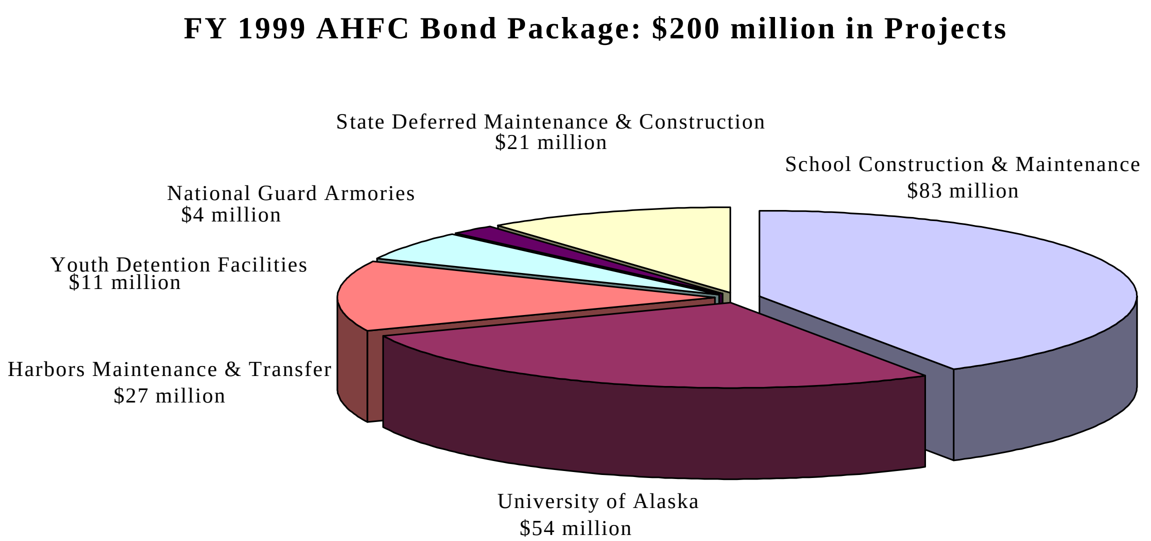
FY2002 Governor's Budget
Debt Obligations and Revenue Sources
($ thousands)

Debt	**FY2001**	**FY2002**	**Inc/(Dec)**
School Debt Reimbursement (estimated maximum)	52,818.9	57,020.5	4,201.6
Lease Finance (FY2001 $12,857.8 and FY2002 $12,430.0)			
Palmer Airport Fire Facility	767.7	766.8	(0.9)
Spring Creek Correctional Facility	4,035.4	4,021.6	(13.8)
Palmer Courthouse	414.4	415.8	1.3
Kenai Courthouse	562.8	563.0	0.3
Court Plaza Building	445.3	0.0	(445.3)
Anchorage Times Building	790.3	789.7	(0.6)
Soldotna DOT Maintenance Facility	631.9	637.3	5.4
Anchorage Health Lab	2,235.5	2,261.3	25.8
Fairbanks Courthouse	2,890.5	2,894.5	4.0
Trustee Fees	84.0	80.0	(4.0)
Anchorage Jail	0.0	3,555.7	3,555.7
Atwood Building	3,541.4	3,535.2	(6.2)
AHFC Debt (Pre HB281)	34,992.5	37,988.0	2,995.5
AHFC Debt (HB281 - UofA, AHFC, …etc.)	0.0	6,012.0	6,012.0
Tobacco Settlement Bonds (schools)	0.0	10,512.5	10,512.5
Total Debt	104,210.6	131,053.9	26,843.3
Fund Sources			
Cigarette Tax (schools)	29,337.3	29,049.1	(288.2)
AHFC Dividend (debt)	50,000.0	50,000.0	0.0
Debt Retirement Fund Balance	7,100.8	0.0	(7,100.8)
Appropriation to Bond Committee	2,450.0		(2,450.0)
K-12 Lapse	400.0		(400.0)
Tobacco Settlement Bonds (schools)		10,512.5	10,512.5
Known and anticipated reduction to debt and/or increased revenue	1,991.9		(1,991.9)
General Funds Required	**12,930.6**	**41,492.3**	**28,561.7**
Total Fund Sources	104,210.6	131,053.9	26,843.3

Note: In addition to the items listed above, the Alaska International Airport System and State corporations such as AHFC and AIDEA also issue and pay for debt for corporate purposes. Also, the Alaska Clean Water Fund and Alaska Drinking Water Fund are capitalized in part from debt that is paid from their respective fund earnings.

- During the past three years, the legislature has authorized $859 million in debt financed projects (categories shown in FY 1999 AHFC Bond Package – Chart 7 and FY2001 Bond Package – Chart 8). Under pressure to reduce general fund spending, policy makers have looked to sources outside the general fund to finance needed capital construction and maintenance projects.

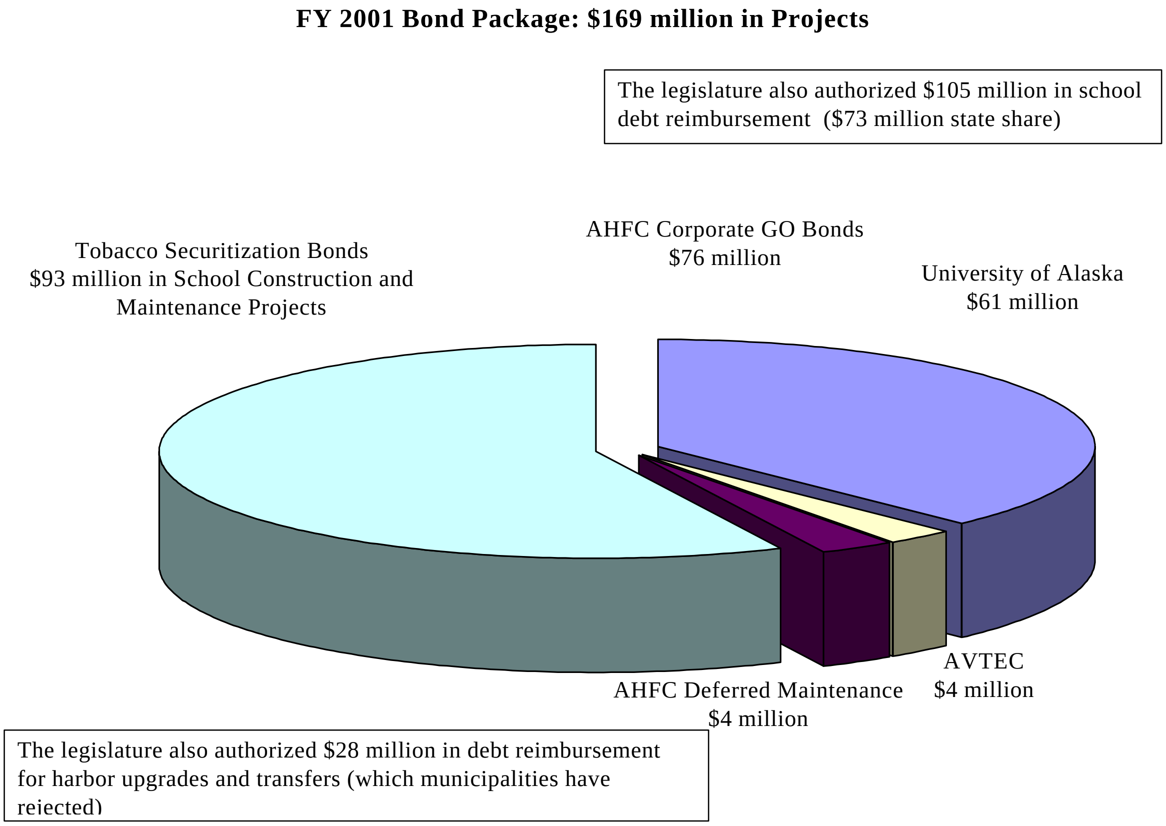
Chart 7



The legislation also authorized $357 million in school debt reimbursement to municipalities ($250 million state share)

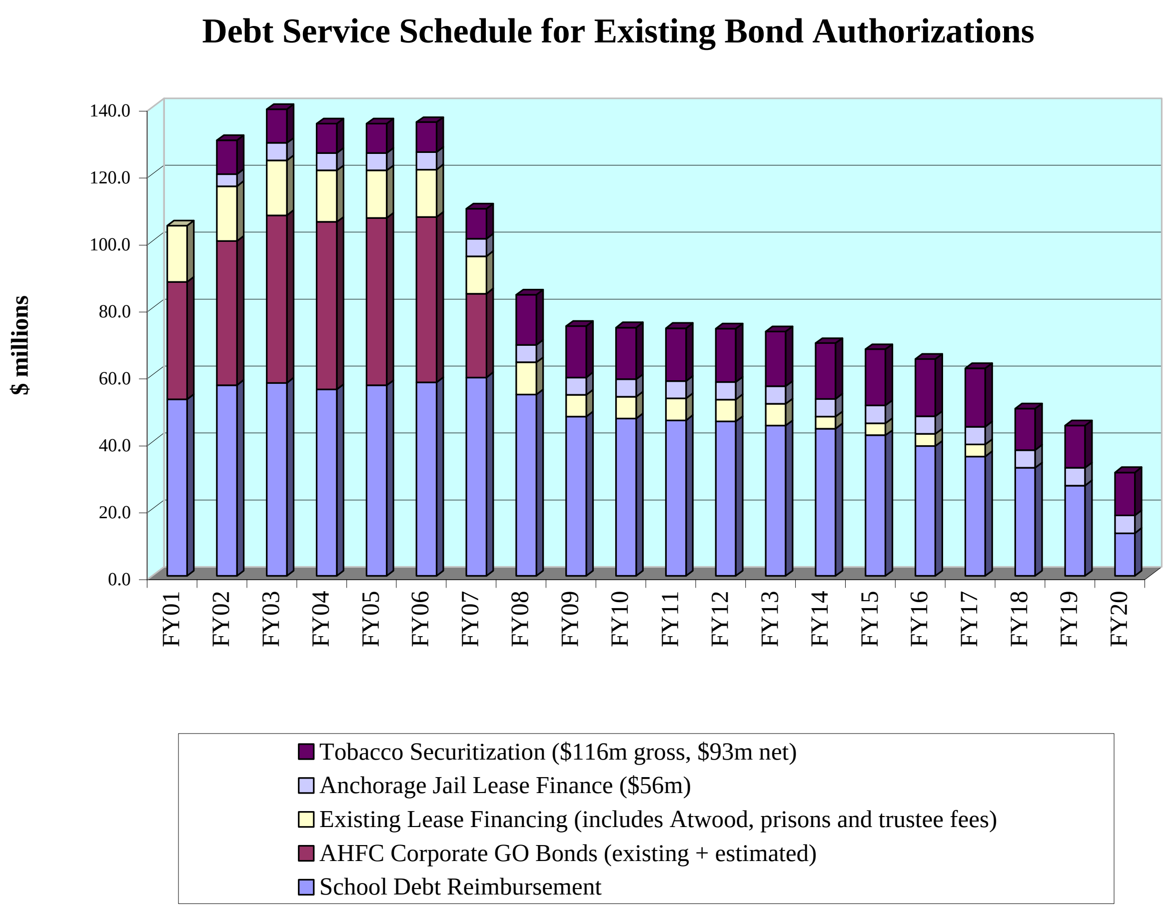
- Since the first payment for a bond issue usually isn't made until the year after the debt is authorized, a long-term commitment to pay debt service for a capital project can be made without counting as a general fund expense in the current year's budget.
- Funding sources for debt have included the corporate general obligation capacity of Alaska Housing Finance Corporation (AHFC) at $300 million over 7 years, cigarette tax revenues which are dedicated to the school fund (and may only be spent for education) at $30million per year, and tobacco settlement payments at an average of about $23 million per year.
- As of FY 2001, all of the corporate general obligation debt capacity of AHFC has been used to fund university, harbor and school construction and maintenance projects. All of the tobacco tax revenue stream has been devoted to school debt reimbursement and 40% of the tobacco settlement revenue stream (after $1.4 million for tobacco control) has been pledged to pay debt service on $113 million of school construction bonds which yielded $93 million in projects.

Chart 8



- For the past few years general fund payments for debt service have been reduced by carry forward amounts in the debt retirement fund (DRF), delays in municipal bond sales that caused payments for school debt reimbursement to be less than anticipated, and the remainder of the AHFC annual cash dividend left over after paying corporate GO debt service.
- These sources of carry forward balance in the DRF have been exhausted. The last use of the DRF balance was $4.1 million to fund employee contracts in the FY2001 budget.
- All of these factors contribute to a $28.5 million increase in the FY 2002 general fund budget to pay for existing debt service.
- See Debt Service Schedule on Existing Bond Authorizations - Chart 9.

Chart 9



STATE WORK FORCE 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 due to its 25% COLA for jobs in Alaska, and 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.
- The state is likely to lose over 25% of its total work force just to retirement over the next five years. 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. Likewise reduced benefits for Tier II and III state workers have made state jobs less competitive than in the past.
- The Division of Personnel has identified mission critical job classes that departments are having extreme difficulty in filling. These include: engineers, biologists, health care workers, accountants and financial administrators, public safety professionals, social

workers, specialized education job classes and especially computer programmers and other technology professionals.

- A Task Group drawn from state agencies is working on short and long-term recommendations for dealing with these recruitment and retention issues.

EMPLOYEE CONTRACTS

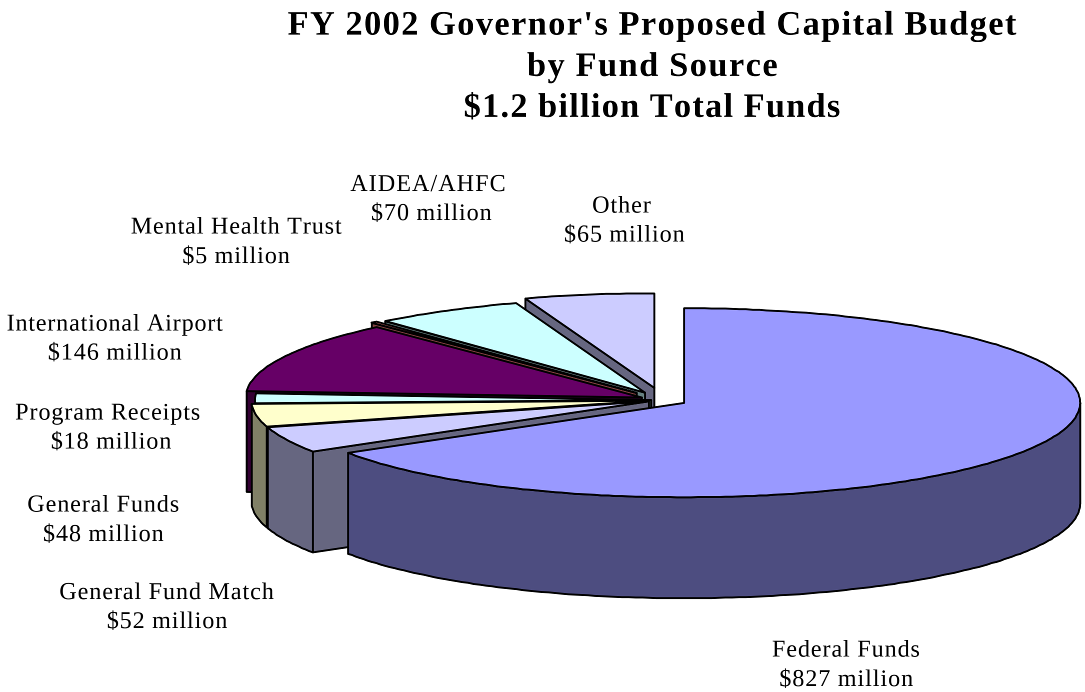
- The first year of executive branch labor contract increases, FY 2001, cost $10.4 million in general funds and $22.9 million in total funds, primarily for lump sum payments ($1,200 for most employees) and health insurance increases.
- For the second year of the employee contracts there is expected to be an estimated net cost of $4.1 million in total funds. Various rate reductions for retirement and other employer costs will be offsetting a 2% COLA increase and increased health insurance costs. Health insurance premiums for employees in most bargaining units are scheduled to increase to $575 per month (current rates vary among bargaining units but a majority are $515/mo.) for FY2002.
- For a summary of new positions in the Governor's FY2002 budget, go to: http://www.gov.state.ak.us/omb//2002Site/Budget/positionChg.PDF in the Office of Management and Budget website.

CAPITAL BUDGET

- The Governor's FY 2002 proposed capital budget is just under $1.2 billion in total funds, similar in size to FY 2001. Federal funding accounts for two-thirds of the capital budget, with the bulk directed to highway, airport, sewer and water and sanitation projects. Additionally, the Denali Commission has become a separate but complementary avenue of federal funding primarily for bulk fuel storage facilities and other infrastructure projects in rural areas.
- FY2002 Governor's Proposed Capital Budget by Fund Source – Chart 10 and FY2002 Governor's Proposed Capital Budget by Expenditure Category – Chart 11 show the Governor's proposed Capital Budget by fund source and expenditure category respectively.
- International airport revenues ($19 million) and airport construction bond receipts ($127 million) together comprise about 12 % of the capital budget. The international airport system is a self-sustaining entity funded via landing fees, rental charges and passenger facilities charges.
- The next largest category of capital project funding is the state general fund match (4%) required to secure federal funds, primarily for highway and water and sewer projects.
- Altogether only about 10% of the entire capital budget - general funds (4%) and other funds such as Alaska Housing Finance Corporation (AHFC), Alaska Commission on Postsecondary Education (ACPE), and Alaska Industrial Development and Export Authority (AIDEA) dividends (6%) – can be considered somewhat discretionary spending. However, even within this amount, most of the projects would not be

considered optional – for instance, roof repairs and replacement of outdated computer systems.

Chart 10



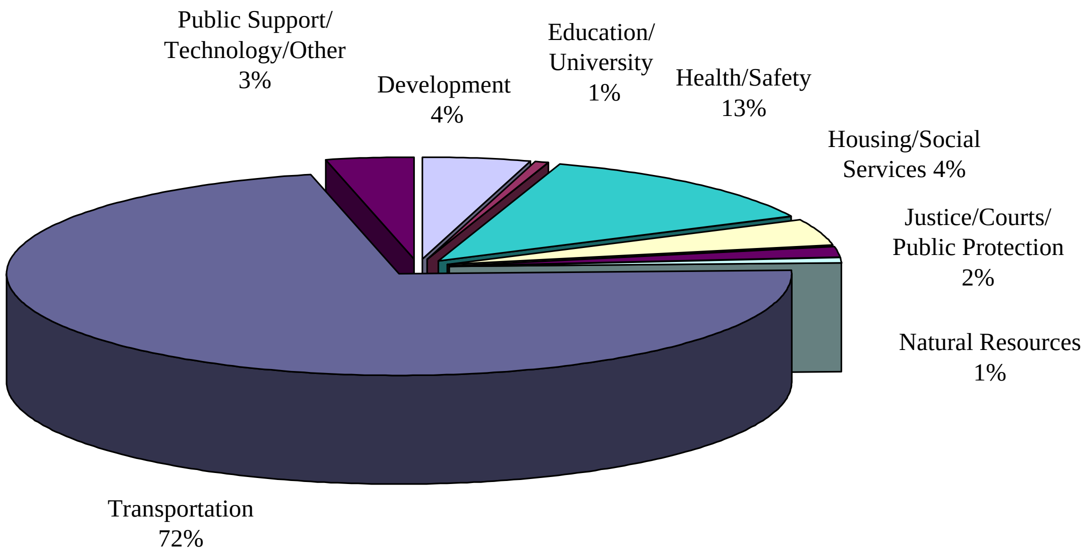
- A new challenge in the FY 2002 capital budget will be to fund the first major installment of a multi-year federal mandate to replace emergency communications equipment requiring local, state and federal compatibility. The FY2002 project total is $17.1 million, of which $14.9 million is federal funds and $2.2 million general fund match. A detailed joint federal/state state analysis being conducted by Motorola Corporation will provide more detailed cost estimates in the Spring of 2001.
- The Governor will be offering separate legislation to fund school construction and major maintenance early in the legislative session.

DEFERRED MAINTENANCE

- Deferred maintenance continues to be a growing problem for most state-owned buildings. Budget cuts to building operation and maintenance budgets since the mid-1980's, combined with inadequate capital funding for major maintenance and renovation projects, have led to increased deterioration of state buildings. While the University of Alaska has received substantial funding to address deferred maintenance needs in the last several years, most other state agencies have received very little.

Chart 11

FY2002 Governor's Proposed Capital Budget by Expenditure Category $1.2 billion Total Funds



- The state's long-term fiscal situation has made it difficult to provide general funds for deferred maintenance or to restore operation and maintenance funding to adequate levels. The facilities rent program, which was begun in FY 2001 and covers eight of the state's major office buildings, is successfully funding some critical maintenance needs in these buildings. However, this program will not be able to address all of the accumulated deferred maintenance needs in these eight buildings, or in other state-owned buildings outside the fund.
- Some state buildings have deteriorated to the point that the safety and health of employees and the public has been endangered. For example, in the State Office Building in Juneau, areas of the lobby have been roped off because concrete pieces of the roof have been falling to the floor. In addition, deteriorated plumbing has made drinking fountain water undrinkable in some parts of the building.
- The statewide deferred maintenance situation has deteriorated to the point that the state has little choice in the near future but to commit a substantial amount of money to repairing state-owned buildings to keep them safe and usable by employees and the public.

AMERICANS WITH DISABILITIES ACT FUNDING

- Approximately $45 million is still needed for Americans with Disabilities Act (ADA) compliance projects in state-owned buildings. While the state has been able to meet ADA accessibility requirements by making program accommodations for disabled Alaskans, it is also important to remove physical accessibility barriers in state buildings.
- All of the ADA funds appropriated to date will have been spent by September 2001.