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Contacts

John Lombardi 212-553-2829
Associate Analyst
john.lombardi@moodys.com

Ted Hampton 212-553-2741
VP-Sr Credit Officer
ted.hampton@moodys.com

Emily Raimes 212-553-7203
VP-Sr Credit Officer
emily.raimes@moodys.com

Nicholas Samuels 212-553-7121
VP-Sr Credit Officer
nicholas.samuels@moodys.com

Timothy Blake 212-553-4524
MD-Public Finance
timothy.blake@moodys.com

Jack Dorer 212-553-1332
MD-Public Finance
jack.dorer@moodys.com

State of Alaska

Bold Proposal Shifts Oil Price Volatility Away from Budget

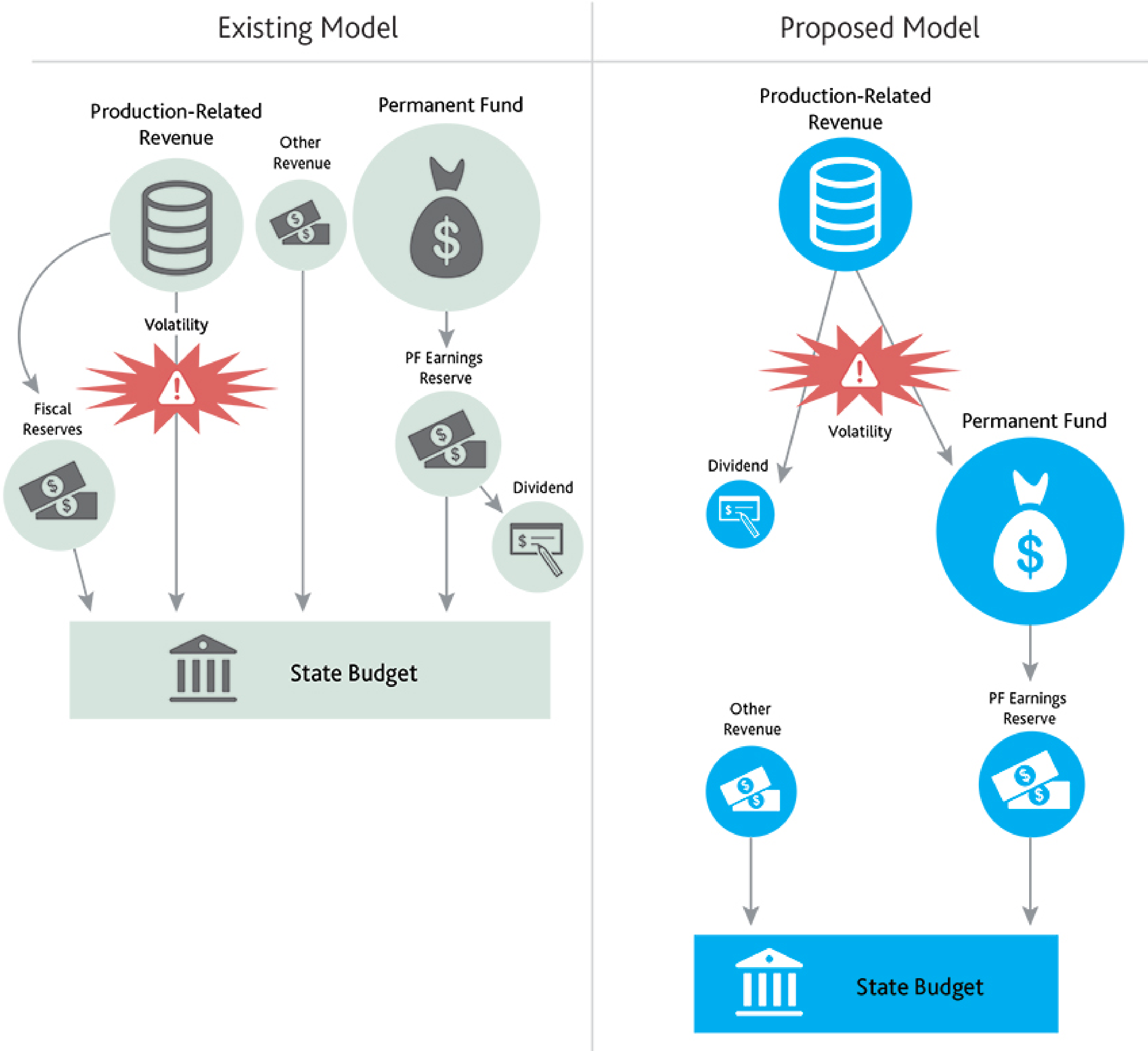
On December 9, Governor Bill Walker of Alaska (Aaa negative) released a $4.8 billion fiscal 2017 budget proposal that would redirect the flow of petroleum-related tax revenue, restructure the distribution of earnings from the state's $47 billion Permanent Fund, and levy an individual income tax for the first time in 35 years. The proposal represents a bold effort to address the state's enormous budget imbalance caused by sharply lower oil prices and to shift the future funding of government operations away from direct oil sector volatility.

Oil and gas production-related taxes provided nearly 90% of the state's fiscal 2014 general fund revenues, but these revenue sources declined by more than 60% over the subsequent two fiscal years. To close the resulting budget gaps, the state tapped its substantial fiscal reserves, drawing down $2.8 billion in fiscal 2015 and an estimated $3.4 billion in fiscal 2016, even after cutting $1.1 billion of operating and capital spending from the 2016 budget. The expected reserve draw this year covers a very large 68% of estimated expenditures, while the projected gap between unrestricted revenues and expenditures for fiscal 2017 is about 63%.

The centerpiece of the governor's plan is a proposed increase in the amount of Permanent Fund investment earnings (calculated on a smoothed return basis) transferred to the state's general fund each year. To accomplish this the plan would replace the annual dividend paid to Alaska residents from the Permanent Fund's earnings with a smaller dividend paid from half of annual production-related revenues. The remainder of the production-related revenue would be transferred to the Permanent Fund (see Exhibit 1). The estimated annual transfer to support the general budget is $3.2 billion, compared to production revenue and reserve draws of $4.4 billion in fiscal 2016. The goal of this new approach is to shield the state's operating budget from volatility in the global commodity markets while still allowing Permanent Fund principal to grow over time.

The proposed income tax would generate approximately $200 million in annual revenue, while adjustments to other taxes would yield another $260 million. The budget proposal also cuts $100 million from agency budgets in fiscal 2017 following significant reductions that started in fiscal 2013. Since then, spending has been cut from $8 billion to $5 billion, a 35% reduction. The state would also modify the oil and gas tax credit system, although it would honor existing claims. To provide economic development assistance, the plan establishes a low interest revolving loan program as a substitute for tax credits, with interest rates tied to job production for Alaskans. These actions are estimated to produce $500 million in yearly benefit to the state's budget.

Exhibit 1
Existing and Proposed Models of Government Funding



Source: State of Alaska; Moody's Investors Service

The governor also proposes a capital budget plan for fiscal 2017 using general obligation bond financing instead of pay-as-you-go funding for transportation projects and other capital investments. The plan is to take advantage of current market conditions while state investments are yielding a greater return than the cost to borrow. Additionally, under a 2008 legislative authorization, the state can issue up to $5 billion in pension obligation bonds (POBs) and may borrow $2.5 billion, or half the authorization, in the next six months. Proceeds of the POBs, structured as annual appropriation bonds rather than general obligations, would be used to pay down unfunded liabilities and not replace the state's annual pension funding in fiscal 2017 or beyond. The governor will seek the legislature's concurrence before issuing the POBs.

The governor's overall plan will be politically difficult to implement given the call for an income tax and the smaller size and shift in funding of the resident dividend program. The income tax was chosen for its progressive nature and to capture revenue from out-of-state workers. Alaskans received a record dividend payout last year of $2,072 per person and the new proposal, based on current forecasts, would sustain a dividend of about $1,000 annually for the near future. Nonetheless, there will be opposition by many Alaskans, whose wallets' would take a hit from both a new income tax and a reduced dividend.

Alaska's large financial reserves have allowed the state to manage in this new low oil price environment. Between the Constitutional Budget Reserve Fund (CBRF) and the Permanent Fund Earnings Reserve (PFER), the state's available reserves total about $16.1 billion, or nearly five-times the current deficit. However, based on the current level of state spending, the reserves are being spent at the rate of approximately $65 million per week. At current and projected oil prices, the $10 billion CBRF, which is tapped first to fill gaps, will be depleted by the end of fiscal 2018, or another 2.5 years.

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