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Summary:

Alaska; Appropriations; General Obligation; Moral Obligation

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Alaska		
Alaska Mun Bnd Bank GO		
Unenhanced Rating	AA(SPUR)/Negative	Downgraded

Rationale

Standard & Poor's Ratings Services lowered its rating to 'AA+' from 'AAA' on Alaska's general obligation (GO) debt, and its ratings to 'AA' from 'AA+' on the state's appropriation-backed debt. We also lowered our rating to 'A+' from 'AA' on some bonds that were issued by the Alaska Energy Authority and are backed by a moral obligation pledge from the state. The outlook on all debt ratings is negative.

The rating actions reflect our view of the state's credit quality as oil prices have continued to slide, falling below forecasts from earlier this year, causing an already large structural gulf between unrestricted general fund revenues and expenditures to widen further. The negative outlook continues to reflect our opinion that if lawmakers do not enact significant fiscal reforms to reduce the state's fiscal imbalance during its 2016 legislative session, Alaska's downward rating transition will likely persist. Furthermore, it's possible that the downward rating migration could accelerate if lawmakers continue to fail to act as the state's budget reserves (not including the permanent fund) approach depletion. On the other hand, the state's large reservoir of financial assets provides it with options that we believe have the potential to stabilize its credit quality. Governor Bill Walker's fiscal 2017 budget proposal illustrates one approach to potentially reducing the effect of oil price volatility on state finances. However, the politics of enacting what amounts to an austerity-based overhaul of state finances render its prospects uncertain. And even this would leave the state with a structural gap, estimated at $427 million, or almost 9% of proposed appropriations in fiscal 2017 (although the shortfall would shrink to just $28.2 million in fiscal 2018 under the governor's plan). But until its budgetary trajectory is brought closer to alignment, the state's credit quality is under negative pressure, in our view. The state's credit quality nevertheless continues to benefit from several strong features:

- Budget reserves that, despite not representing a permanent solution to the state's unrestricted general fund deficit problem, remain large, equal to 312% of annual appropriations (as of Aug. 31, 2015);
- Potential to resolve much of the general fund gap by overhauling the flow and customary treatment of various legally unrestricted state revenues; and
- Moderate debt burden and closed defined-benefit retirement system that should benefit actuarially from a recent

large asset infusion.

Much about Alaska's recent economic and fiscal experience is summed up by collapsing oil prices on the global markets and declining production on Alaska's North Slope. Reflecting its linkage to the commodity markets, Alaska's economy has begun to contract and is out of step with the U.S. economy, which continues to expand. For much of the past 40 years, taxes and royalties on oil production have been sufficient to pay for a majority of the state's general fund expenses. For instance, in fiscal 2012 when Alaska North Slope (ANS) west coast spot prices averaged $112.65 per barrel, the state brought in nearly $9.5 billion in total unrestricted revenue. But by the spring of 2015, the state's ANS oil price forecast -- $66.03 per barrel in fiscal 2016 -- was projected to produce just $2.2 billion in unrestricted general fund revenue. Consequently, despite having cut spending by 16% relative to the prior year, the state's fiscal 2016 budgeted appropriations still exceeded anticipated revenues by $2.7 billion, a shortfall equal to 54% of budgeted expenditures. Lawmakers covered the gap in the budget by authorizing a transfer from the state's Constitutional Budget Reserve (CBR), albeit only after first getting hung up in the negotiating process.

Even this would prove optimistic, however, and as the year progressed, the slump in oil prices persisted. In its fall revenue forecast update, the state revised its fiscal 2016 ANS average spot price forecast lower, to $49.58 per barrel, translating to a downward revenue adjustment of about $600 million. With just $1.6 billion in unrestricted revenue for the year, the state's updated fiscal gap has ballooned to an estimated $3.55 billion. More recent spot price trends have fallen even further, to below $40 per barrel as of mid-December, implying an even larger fiscal gap.

Alaska's still sizable budget reserves enable it to endure large operating deficits for several years, but ultimately the fiscal trajectory sketched out above is unsustainable. Apart from the effect of falling commodity prices, declining oil production is putting a strain on state finances. ANS oil production peaked in 1988 at 2 million barrels per day, but has been in gradual decline since. The state anticipates 504,900 barrels of production in fiscal 2017, falling to less than 400,000 barrels per day by 2022. Following a months-long campaign to highlight these facts, Governor Bill Walker put forward a plan to overhaul, or "re-plumb," state finances as part of his fiscal 2017 budget proposal.

Governor's proposal to reform state finances

The main thrust of the governor's financial reform proposal involves Alaska's transitioning away from relying on volatile oil revenues to fund state government. Under the governor's plan, Alaska would instead finance most of its general fund expenditures from investment earnings on its asset holdings, in a variant of what state officials refer to as the sovereign wealth fund model. The state estimates that, in order to sustainably support both general fund and the permanent fund dividend program at present levels, roughly $100 billion in total assets is necessary. However, the value of Alaska's combined assets -- prodigious as they are -- fall short of this, at about $56 billion. The governor's proposal represents, therefore, a partial sovereign wealth fund model, supplemented by several other more conventional fiscal reforms that result in additional revenue and lower spending.

In our view, the governor's various reform proposals fall into one of the following three categories:

- 1. Adopt a partial sovereign wealth fund model highlighted by two fundamental changes to the design of Alaska's finances:
- --a. Redirect all oil production tax revenue and 50% of oil royalty revenue away from the general fund to the state's permanent fund earnings reserve. The oil-related revenues make up $946 million of $1.8 billion in total projected

unrestricted revenue for fiscal 2017. The remaining $851 million in nonpetroleum related unrestricted revenues would continue flowing into the general fund as it does now;

- --b. Establish an annual draw from the permanent fund earnings reserve (PFER) to the general fund, used to pay for a majority of governmental operations. The draw amount (proposed at $3.2 billion for fiscal 2017) would be set according to formula and designed to preserve the real value of Alaska's invested assets.
- 2. Implement an additional $114 million (2.8%) in cuts to state agency operations following $400 million in reductions in fiscal 2016. Additional future spending reductions would come from the governor's proposal to transform its oil and gas tax credit program into a loan program intended to spur development activity while lowering expenses.
- 3. Generate additional tax revenue from a new personal income tax as well as increases to the state's mining, fishing, motor vehicle, alcohol, and tobacco taxes. New revenue from these changes would sum to a projected $350 million in fiscal 2017 but up to $460 million in future fiscal years once annualized.

Governor's proposal would link permanent fund dividends to Alaska's natural resources

Central to the governor's reform proposal is the capacity of the state's financial assets to sustainably support an annual transfer of investment earnings to the state's general fund. Traditionally the state has used half of the investment earnings from the Alaska permanent fund to pay an annual dividend to state residents. As part of repurposing these revenues, the governor has recommended changing the method for funding the annual dividend program, tying it to the state's receipt of oil royalties rather than to investment returns. This adjustment -- which is integral to the sovereign wealth fund model -- would reduce the cost of the dividend program to about $700 million in fiscal 2017 from $1.4 billion in fiscal 2016. While there is a philosophical consistency to the governor's approach in that the dividend program was meant to recognize Alaskans as resident-owners of its natural resources more than beneficiaries of its investment gains, the bottom-line result is a smaller dividend check.

Assessing the financial reform proposal from a credit perspective

The governor's proposal illustrates how it's possible that Alaska's fiscal flexibility could extend well beyond that which is provided by its traditional definition of unrestricted general fund revenue. By redirecting oil-related revenue to its PFER, future windfall-like revenues from oil price spikes would be retained in the permanent fund, allowing the state's asset base to grow. Conversely, when oil prices fall to low levels, the resulting decline in oil-related revenue would be absorbed by the state's permanent fund rather than its general fund. Insofar as the sovereign wealth fund model would transfer the volatility of the oil-related revenue away from the general fund to the state's permanent fund, it could have a stabilizing effect on the state's budget performance. It could help lawmakers be less inclined to engage in yo-yo budgeting. We have observed that lawmakers in Alaska have a history of allowing appropriations to swell during years when oil prices are high, only to be forced to make steep cutbacks when they fall.

Stabilizing the state budget in the manner proposed by the governor involves a wholesale redesign of the state's financial architecture, however. Not surprisingly, some of the individual components of the proposal have already been met with resistance by some members of the legislature and other stakeholders. And if the politics of enacting a fiscal overhaul prove too politically difficult, resulting in inaction this year, the state's options will narrow. On a combined basis, Alaska's various budget reserves currently total about $15.7 billion (PFER, CBR, and statutory budget reserve). While reserves at that level remain comparatively strong, it's unlikely they can be sustained, considering the state is operating with a $3.5 billion structural deficit this year.

Even assuming no budget reform and an unrestricted general fund structural deficit of about $3 billion, the projected date-to-depletion of the state's reserves is unclear. That's because a significant share of permanent fund investment earnings are retained and allowed to accumulate in the PFER. In fiscal 2017, for example, the state forecasts investment earnings of $3.4 billion, approximately $1.4 billion of which would be spent on dividends under the existing methodology. The remaining $2 billion in investment earnings would bolster and extend the life of the state's budget reserves even if they were simultaneously being drawn upon to fund the budget gap.

Nevertheless, Alaska's lawmakers confront a relatively urgent situation if they hope to move the state away from its budgetary dependence on the volatile oil-related revenues. In order for the annual draw from state savings to be sustainable, officials estimate that Alaska's invested assets need to generate a 6.5% average annual rate of return. According to the governor's proposal, the state's asset base currently could sustainably support a $3.2 billion transfer to the general fund. But if lawmakers defer taking action, allowing PFER balances to be drawn down, the assets would support only a smaller annual transfer.

In our view, Alaska has sufficient financial resources to stabilize general fund operations if it can assemble the necessary political will to adopt the necessary changes. We expect this will require asking residents to accept reduced state spending, higher taxes, and, if it is to use investment earnings, a reconstituted -- and lower -- dividend payment. Although from a constitutional and statutory standpoint, the investment earnings are unrestricted revenues, using them to fund general fund expenses represents a politically difficult tradeoff. Given that lawmakers have yet to coalesce around either the governor's proposal or some alternative, we therefore continue to evaluate the state's creditworthiness largely according to its existing budgetary framework. Through this lens, and in light of the unrelenting oil price declines, the state's fiscal structure is deeply misaligned and its reserves, while still significant, are declining at a fast rate.

The stakes are high for the state to enact a package of fiscal reforms that would help stabilize the state's credit quality at a high rating level. Part of the administration's medium term fiscal strategy involves using pension obligation bonds in an effort to drive down the budgetary cost of funding actuarially sound annual contributions. On the economic development front over the longer term, we understand the state is interested in seeing its estimated 30 trillion cubic feet in natural gas reserves get developed. And lacking a mechanism for delivering the gas to market, state officials are contemplating partially debt-financing a natural gas pipeline. Both propositions make less economic sense, however, in a scenario where the state's credit rating is significantly lower and its cost of capital materially higher.

Based on the analytic factors we evaluate for states, on a four-point scale in which '1' is the strongest, Standard & Poor's has revised its composite score to '1.8' from '1.7.' (The changed composite score is the result of the state's fiscal imbalance, which caused us to revise to '1.7' from '1.3' the state's budgetary performance score. In addition, we revised the state's economic score to '1.5' from '1.4.')

Composite scores ranging from 1.6 to 1.8 correspond with a 'AA+' rating under our criteria. Although previously we have employed a one-notch upward adjustment as allowed under our criteria to account for what we viewed as uncommonly high budget reserve levels, we view the current trajectory of the reserves and fiscal condition as no longer warranting this adjustment.

Outlook

The negative outlook reflects the large structural budget deficit in Alaska's unrestricted general fund. Currently, the state is able to finance its operating deficits by withdrawing funds from its budgetary reserves. Alaska had built up large budget reserves that thus far have shielded the state's credit quality from the degradation that the large deficits would inflict on most states' credit quality. But the magnitude of the fiscal deficits makes the arrangement unsustainable and, unless corrected, inconsistent with the current rating. Therefore, we will likely again lower the state's rating -- possibly by more than one notch -- if state lawmakers do not enact measures to begin correcting the state's fiscal imbalance during its 2016 legislative session.

The typical lag that exists between the enactment of fiscal policy adjustments and when they yield results implies the need for lawmakers to act soon. Therefore, even with its reserve balances at still-strong levels, we would likely lower the state's rating even within the next year if lawmakers defer enacting corrective fiscal policy adjustments.

In the event policymakers continued to take no action, the current initial rating change most likely represents the first step in a downward migration that would likely accelerate as the state's reserve balances approached depletion. If lawmakers succeed in putting the state on what we view as a glide path to a sustainable fiscal structure, with its strong reserve balances still intact, we could revise the outlook to stable.

Related Criteria And Research

Related Criteria

- USPF Criteria: State Ratings Methodology, Jan. 3, 2011
- USPF Criteria: Financial Management Assessment, June 27, 2006
- USPF Criteria: Debt Statement Analysis, Aug. 22, 2006
- USPF Criteria: Appropriation-Backed Obligations, June 13, 2007
- USPF Criteria: U.S. Public Finance Long-Term Municipal Pools, March 19, 2012
- USPF Criteria: Methodology: Definitions And Related Analytic Practices For Covenant And Payment Provisions In U.S. Public Finance Revenue Obligations, Nov. 29, 2011
- USPF Criteria: Methodology: Rating Approach To Obligations With Multiple Revenue Streams, Nov. 29, 2011
- USPF Criteria: Assigning Issue Credit Ratings Of Operating Entities, May 20, 2015
- Criteria: Use of CreditWatch And Outlooks, Sept. 14, 2009

Ratings Detail (As Of January 5, 2016)		
Alaska GO		
Long Term Rating	AA+/Negative	Downgraded
Alaska APPROP		
Long Term Rating	AA/Negative	Downgraded
Alaska GO		
Long Term Rating	AA+/Negative	Downgraded
Alaska Energy Auth, Alaska		
Alaska		

Ratings Detail (As Of January 5, 2016) (cont.)		
Alaska Energy Auth (Alaska) pwr rev (Bradley Lake Hydroelectric Proj)		
Long Term Rating	A+/Negative	Downgraded
Alaska Mun Bnd Bank, Alaska		
Alaska		
Alaska Mun Bnd Bank (Alaska) GO		
Long Term Rating	AA/Negative	Downgraded
Alaska Mun Bnd Bank (Alaska) GO and rfdg bnds (Alaska) ser 2015 THREE due 10/01/2044		
Long Term Rating	AA/Negative	Downgraded
Alaska Mun Bnd Bank (Alaska) GO moral oblig (MBIA) (National)		
Unenhanced Rating	AA(SPUR)/Negative	Downgraded
Alaska Mun Bnd Bank (Alaska) GO (AMBAC)		
Unenhanced Rating	AA(SPUR)/Negative	Downgraded
Alaska Mun Bnd Bank (Alaska) GO (Moral Ob)		
Long Term Rating	AA/Negative	Downgraded
Alaska Mun Bnd Bank (Alaska) Moral Ob 2015A-B TWO		
Long Term Rating	AA/Negative	Downgraded
Alaska Mun Bnd Bank (Alaska) MORALOBLIG		
Long Term Rating	AA/Negative	Downgraded
Alaska Mun Bnd Bank (Alaska) MORALOBLIG		
Long Term Rating	AA/Negative	Downgraded
Alaska Mun Bnd Bank (Alaska) MORALOBLIG		
Long Term Rating	AA/Negative	Downgraded
Alaska Mun Bnd Bank (Alaska) MORALOBLIG		
Long Term Rating	AA/Negative	Downgraded
Alaska Mun Bnd Bank (Alaska) MORALOBLIG		
Long Term Rating	AA/Negative	Downgraded
Alaska Mun Bnd Bank GO		
Unenhanced Rating	AA(SPUR)/Negative	Downgraded
Alaska Mun Bnd Bank (Alaska) GO		
Unenhanced Rating	AA(SPUR)/Negative	Downgraded
Matanuska-Susitna Boro, Alaska		
Alaska		
Matanuska-Susitna Boro (Alaska) lse rev rfdg bnds (Alaska) (Goose Creek Correctional Ctr Proj)		
Long Term Rating	AA/Negative	Downgraded
	NR(prelim)	
Matanuska-Susitna Boro (Alaska) lse rev (Goose Creek Correctional Facs) (ASSURED GTY)		
Unenhanced Rating	AA(SPUR)/Negative	Downgraded

Many issues are enhanced by bond insurance.

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