

# **PRESENTATION ON ALABAMA'S FINANCIAL CONDITION**

## **FEBRUARY 8, 2011**

- I. Introduction
  - A. Welcome
  - B. You can see on the screen some of the resources that are available to you on the LFO website
    - 1. I went over some of them in depth at Legislative Orientation in December so I will not do that today
    - 2. A copy of this outline and exhibits will be available on the website this afternoon
- II. Budget Process
  - A. I talked a bit about the budget process at legislative orientation in December; this week the Permanent Joint Legislative Committee on Finances and Budgets will perform its statutory duty to hold hearings before the Regular Session and will report its findings and recommendations to the Legislature by the 7<sup>th</sup> legislative day of the Regular Session
  - B. The Governor is required by the Constitution to present his budget recommendations to the Legislature by the 2<sup>nd</sup> legislative day of the Regular Session
  - C. At that point, the Education Trust Fund budget and the State General Fund budget are treated as other bills and go through the committee process in both houses of the Legislature and are passed in both chambers
  - D. Amendment 448 of the Alabama Constitution provides that it is the paramount duty of the Legislature to pass appropriation bills and no other bill shall be signed and

transmitted to the other chamber until the basic appropriation bills are presented to the Governor

1. Unless the Chamber, by a vote of 3/5 of a quorum present, adopts a Budget Isolation Resolution (BIR) exempting a particular bill from the provisions of the Amendment
- E. Like other bills, if the House and Senate pass differing versions of appropriation bills, those budget bills go to a Conference Committee to address the differences
- F. When the appropriation bills go to the Governor, he can
1. Sign them
  2. Veto them
  3. Send them back to the Legislature with an executive amendment-these 3 options are available to the Governor for all bills
  4. The Governor has an option to line-item veto certain items in an appropriation bill and send only those items back to the Legislature for action without jeopardizing the remainder of the appropriation bill

### III. Revenue and Appropriation Structure of the State

- A. Alabama, unlike most states, has two major state appropriation bills
1. The General appropriation bill (referred to as the State General Fund) and
  2. The Education Trust Fund
  3. Both of which contain appropriations of other earmarked state funds and federal funds (referred to as middle column appropriations)

- B. Alabama earmarks more of its state revenue than other states
  - 1. according to the latest National Conference of State Legislatures' study
    - a. Alabama earmarked 84% of its receipts
    - b. the national average for earmarking was 24%
    - c. the highest state for earmarking next to Alabama was Michigan at 63%
  - 2. earmarking can be general or specific
    - a. sales taxes are earmarked for educational purposes
    - b. gasoline taxes are earmarked for construction and maintenance of roads and bridges and traffic safety
  - 3. earmarking can be statutory or constitutional
    - a. sales taxes are earmarked by statute
    - b. income, ad valorem and gasoline taxes are earmarked by the state Constitution
- C. Exhibit 1 shows the appropriation of all state funds for FY 2011 as of the end of December, 2010
  - 1. the General Fund accounted for \$1.6 billion
  - 2. the Education Trust Fund (ETF) accounted for \$5.5 billion
  - 3. all other state funds accounted for \$2.9 billion
  - 4. for a total of over \$10 billion in state funds (this amount varies, for FY 2008 there was a total of \$11.6 billion)
  - 5. I will not talk about many of the numbers on this chart, you can review that data at your convenience

6. But I do want to point out a couple of issues involving certain agencies
  - a. Medicaid is the largest consumer of General Fund dollars at \$345 million and FY 2011 is lower than usual because of federal stimulus funds that I will talk about in more detail later
    - i. If you follow the chart for Medicaid, you can see that the agency is also appropriated a large number of other state funds (this number includes provider taxes and other departmental receipts) for a total of over \$1 billion in total state funds that are used to match federal dollars (not included in this number are intergovernmental transfers from other agencies totaling an additional \$330 million)
    - ii. In a non-stimulus year, every state dollar brings in over \$2 in federal funds- in FY 2011 every state dollar is drawing down more than \$3 in federal dollars
    - iii. Medicaid provides healthcare for Medicaid recipients in the state and is a large economic engine in your local communities providing payments to doctors, pharmacists, hospitals and nursing home providers throughout Alabama

- b. The Department of Corrections is the second largest consumer of General Fund appropriations
  - c. Corrections and Medicaid together account for 42% of the General Fund (in a non-stimulus year an even greater percentage)
    - i. If a person qualifies for Medicaid services, the state has to provide mandated services as long as the state participates in the Medicaid program
    - ii. The Department of Corrections is obligated to provide a bed and medical services for every convicted felon sentenced to state prison
- D. Sources of Revenue to the General Fund
- 1. Exhibit 2 is a pie chart showing the major sources of revenue to the General Fund for FY 2010
    - a. the largest single source was insurance premium tax receipts at 15.9%
    - b. the second largest source was one-time receipts at 11.3% (this includes the \$161.6 million from the Rainy Day Account that I will discuss further)-it creates a problem for future years when one-time revenues are used for continuing expenses
    - c. interest income accounted for only 6.1% whereas in some years it is the major revenue source to the General Fund (averaging 13% of receipts annually for FY 2006 through FY 2009)

- i. the General Fund receives interest income from regular state deposits and from interest earned on Alabama Trust Fund assets (which is composed of lease payments and royalties from offshore oil and gas wells)
      - ii. interest rates have been at historic lows and the balances available to be invested have been significantly reduced
    - d. You can see the other major sources of revenue and their percentages
- E. Sources of Revenue to the Education Trust Fund (ETF)
  - 1. Exhibit 3 shows the sources of revenue to the ETF in FY 2010
    - a. the largest revenue source was individual and corporate income taxes which accounted for 55.6%
    - b. sales taxes accounted for 29.8%
    - c. utility taxes accounted for 8.1%
    - d. use taxes accounted for 4.6% (use taxes are sales taxes paid on goods bought out-of-state and brought into Alabama)
    - e. other revenue sources accounted for 1.9%
    - f. you can readily see that there are far fewer tax sources in the ETF than in the General Fund; but the taxes that respond more rapidly to changes in the economy are earmarked for the ETF – that is good for the ETF in good economic times but not during recessions

#### IV. State of the Economy

- A. In December, 2007, the nation began the longest and most severe economic downturn since the Great Depression
- B. National unemployment reached its
  - 1. Highest level in October, 2009 at 10.1%
  - 2. January, 2011 rate was 9%
- C. Alabama's unemployment reached its
  - 1. Highest level in January and February of 2010 at 11.1%
  - 2. December, 2010 rate was 9.1%
- D. The next 2 exhibits illustrate the effect of the Great Recession on state income and sales taxes in FY 2009
  - 1. Exhibit 4 shows the annual percentage change in gross income tax receipts since 1971
    - a. In FY 2009, gross income tax receipts declined by 7.9%
    - b. There has been negative growth only 4 times since 1971 including FY 2009 and FY 2010
    - c. The largest decline before FY 2009 was a negative 1.8% in 1982
  - 2. Exhibit 5 shows the annual percentage change in gross sales tax receipts since 1965
    - a. In FY 2009, gross sales tax receipts declined by 9.9%
    - b. Sales tax receipts have shown negative growth only 4 times since its inception in 1937

- c. Other than the FY 2009 decline, since 1965 gross sales tax receipts declined only once (in 2001) with a negative growth rate of 1.1%
  - 3. The questions that LFO faced as we revised estimates for FY 2011 and made estimates for FY 2012 were
    - a. Are we at the bottom of the recession and
    - b. How quickly and to what extent will the economy recover?
- V. Condition of the Education Trust Fund for FY 2008, FY 2009 and FY 2010
  - A. In order to give you an overview of where we are with the current budgets, I need to show you what has happened with the budgets over the last several years
  - B. Exhibit 6 shows the actual condition of the Education Trust Fund (ETF) for FY 2008, FY 2009 and FY 2010
  - C. We began to see early signs of the recession even before the start of FY 2008
  - D. This table shows a beginning balance of \$280 million but that was less than projected to be available for FY 2008
  - E. The ETF received almost \$6 billion in regular revenue in FY 2008- this was the largest amount of regular receipts to the ETF in history
  - F. However, appropriations for FY 2008 were \$6.7 billion
  - G. The Legislature had saved \$439 million over the previous 3 years of growth-this was accomplished by 2 methods
    - 1. The Legislature included language in the budgets that 75% of any unanticipated and unappropriated



beginning balance would automatically be transferred to the Statutory Proration Prevention Account and

2. The Legislature appropriated a total of \$34 million over two years directly into the Account
  - a. Members of the Legislature had hoped that the \$439 million would be a hedge for several years against proration when the inevitable downturn occurred
  - b. As it happened, the entire amount was needed to avoid proration in FY 2008
  - c. However, it did allow educational entities one year to prepare for budget reductions
- H. The Statutory Proration Prevention Account allowed the ETF to avoid proration of more than 7% in FY 2008
- I. For FY 2009, the Legislature reduced appropriations at the beginning of the budget cycle but it was not nearly enough
- J. There was a reduction in receipts of over \$730 million
- K. The voters ratified a Constitutional Amendment that reserved within the Alabama Trust Fund (the state's offshore oil and gas account) 6.5% of the previous year's appropriations from the ETF to be used to offset proration
- L. That amount was \$437.5 million and it was accessed in FY 2009 to mitigate the effects of proration
- M. This money is required by the Constitution to be repaid within 6 years (none of which has been repaid as of yet); however, there is a provision in the current budget that if there is a balance at the end of the fiscal year,

37.5% would go toward the repayment of the Rainy Day Account and 37.5% would be transferred into the Statutory Proration Prevention Account

- N. In spite of the availability of the Rainy Day Account, the ETF appropriations were still prorated 11% (without the \$437.5 million, proration would have been 18%)
- O. Receipts continued to decline in FY 2010 more than expected
- P. LFO missed our projections for FY 2010 by \$156.5 million (all attributed to lower than estimated income tax receipts)
- Q. Appropriations were prorated by 9.5% for FY 2010
- R. Expenditures from the ETF from FY 2008 through FY 2010 declined by almost \$1.5 billion

**VI. LFO Projections for the ETF for FY 2011 and FY 2012**

- A. Exhibit 7 shows the projected condition of the ETF for FY 2011 (current year) and LFO projections for FY 2012 (the budget you will be working on in the 2011 Regular Session)
- B. LFO has revised our estimates for FY 2011 to \$5.3 billion (this represents a growth rate of 1.5% over FY 2010 receipts)
- C. In addition, we expect to receive a food stamp sales tax reversion of \$18.6 million from the Department of Human Resources (the Department cannot expend any sales tax received from food stamps except for the purpose of administering the food stamp program)
- D. Kimberly Clark v. Department of Revenue is a corporate income tax case dealing with the 1997 sale of Kimberly Clark's Coosa property

1. In February 2010, the Alabama Supreme Court ruled in favor of the Department that the income from the sale should be classified as nonbusiness income and allocated to Alabama for income tax purposes
  2. The ruling means the state would be able to collect an estimated \$34 million in taxes, penalties and interest from the company
  3. This \$34 million was included in the total revenue available for appropriation in the FY 2011 Education Trust Fund budget
  4. The company filed a motion for rehearing which was denied by the Supreme Court in September 2010 but the company has filed a motion to have the case returned to the Administrative Law Division
  5. Currently, we still expect to receive this payment in FY 2011
- E. The Legislature authorized the Alabama Public School and College Authority (PSCA) to issue bonds to cover school bus fleet renewal funds for FY 2010 and FY 2011
1. There was an appropriation of \$32.3 million from the ETF that was being expended for school buses in FY 2010
  2. The bond authorization was for \$66.5 million
  3. This amount would allow the PSCA to repay the ETF for fleet renewal expenditures in FY 2010 and actually fund fleet renewal for FY 2011 from bond proceeds

4. This means that in FY 2012 the ETF will not receive \$32 million in revenue and the ETF budget will need to resume the appropriation for fleet renewal (basically a \$66 million shortfall for FY 2012)
- F. In March, 2002 the PSCA entered into a series of agreements with JPMorgan Chase Bank known as Swap Options
1. Under the terms of the agreement, the State received approximately \$12.6 million upfront and JPMorgan was granted an option to require the PSCA to enter into fixed interest rate swaps
  2. In 2008, JPMorgan gave notice of its intent to exercise those options
  3. The PSCA filed a declaratory judgment action in federal district court requesting the Court to determine the rights and obligations of the parties
  4. JPMorgan filed a counterclaim seeking \$122 million plus interest and attorney fees
  5. The PSCA and JPMorgan reached a settlement agreement in December, 2010 in which the Authority agreed to pay \$19 million from the ETF to settle the litigation and terminate the SWAP agreements
  6. LFO has adjusted its sales tax estimates downward by \$19 million to reflect payment of this settlement
- G. Total available for expenditure is estimated by the LFO to be \$5.4 billion for FY 2011

- H. ETF receipts will be \$126 million short of funding current appropriations based on LFO projections
- I. That would necessitate proration of 2.3% in the current fiscal year
- J. Revenue would need to grow 5.8% in order to fully fund FY 2011 appropriations
- K. Are we at the bottom of the Great Recession?
  - 1. A good sign-we have seen 11 consecutive months of growth in gross sales tax receipts (low growth but nevertheless growth)
  - 2. A bad sign-gross income tax receipts (which make up more than 50% of the ETF) are still negative-although we have seen growth in individual gross income tax receipts for the past 2 months
- L. LFO projections for FY 2012 are almost \$5.5 billion
- M. This represents a growth rate of 3.5% over LFO projections for FY 2011

**VII.** Effect of Federal Stimulus Funds in the Education Trust Fund

- A. Congress passed the American Recovery and Reinvestment Act (ARRA) in February, 2009 that provided stimulus funds to states in a variety of ways
  - 1. I want you to think about ARRA funds in two ways
    - a. First, Alabama is expected to receive a total of \$3.9 billion, much of which is for the expansion of existing programs such as clean water, highways, energy programs, etc.



3. The Governor must make those funds available to the local school systems in the 2010-2011 school year but schools have until September 30, 2012 to expend those funds
4. The funds must be used for compensation, benefits and other necessary expenses to retain existing employees, to rehire former employees or to hire new employees
5. School systems will receive \$3,079 for each FY 2011 state-funded teacher unit

**VIII.** Funding Shortfall in the Education Trust Fund for FY 2012

- A. Exhibit 10 shows the projected shortfall in the ETF for FY 2012
- B. LFO estimates for FY 2012 are \$36.4 million less than pending appropriations for FY 2011
- C. In addition, the ETF will lose federal stimulus funds totaling \$501.7 million
- D. The loss of federal JOBS funds (if local systems spend all of their JOBS funds in FY 2011) will be \$149.5 million
- E. Just those 3 things account for a shortfall of \$687.6 million
- F. Other issues to consider for FY 2012 include
  1. Repayment of the Rainy Day Account- \$437.5 million owed with 4 years left to repay
  2. Replacement of \$33 million in fleet renewal funds being paid from bond proceeds for FY 2011

**IX.** Condition of the General Fund for FY 2008, FY 2009 and FY 2010

- A. As I did with the ETF, I want to show you several years history of the General Fund
- B. Exhibit 11 shows the actual condition of the General Fund in FY 2008, FY 2009 and FY 2010
- C. All three years started the year with a beginning balance, however, a great portion of those balances were made up of one-time receipts or were the result of some of the actions taken to reduce expenditures
- D. Congress enacted the American Recovery and Reinvestment Act and we began seeing its effect in FY 2009
- E. The Governor and Legislature recognized that, with receipt of federal stimulus funds, the State General Fund would be facing a funding cliff in the near future but several things occurred to postpone this problem
  - 1. In FY 2009, the Governor asked agencies to save 10% of their appropriations; instituted a hiring freeze; and froze merit raises for state employees
  - 2. The Legislature added language in the State General Fund and ETF budgets allowing any funds reverted at the end of the fiscal year to be reappropriated to each agency in order for agency directors to develop a multi-year budget plan
- F. The Legislature passed a bill to reduce General Fund appropriations to Medicaid and other state agencies that provide Medicaid services by a total of \$225.4 million for FY 2009 as the result of the enhanced federal Medicaid match provided for in the federal act
  - 1. Basically, this meant that for a period of time states would have to put up less state funds in



order to draw down the same amount of federal funds

2. For example, before ARRA, Alabama received approximately \$2.13 in federal funds for every \$1 in state funds
  3. After the original ARRA, Alabama received approximately \$3.47 for every \$1 in state funds
  4. The original enhanced federal match began retroactively to October 1, 2008 and was scheduled to expire on December 31, 2010
  5. Congress extended the time frame for the enhanced match to June 30, 2011, albeit at a reduced match for the final two quarters
- G. You can see that expenditures from the General Fund in FY 2009 declined by \$118 million from FY 2008 and the ending balance was less than half of the ending balance in FY 2008
- H. In FY 2010, General Fund receipts continued to decline
- I. The Governor declared proration of 12% which he increased to 20% at the end of the fiscal year
- J. The same Constitutional Amendment that revised the ETF Rainy Day Account created a General Fund Rainy Day Account
1. This Amendment allows the Governor to access 10% of the previous year's General Fund appropriations in the event of proration, and the amount accessed must be repaid within 10 years
  2. For FY 2010, the Governor withdrew \$161.6 million from the Account to reduce proration from 20% to 10%

- K. FY 2010 receipts to the General Fund came in \$76 million less than LFO estimates
  - 1. From FY 2008 to FY 2010, total available receipts to the General Fund declined by \$520 million (25.3%)
  - 2. Expenditures from the General Fund decreased by \$361 million over that same period
- X. Condition of the General Fund for FY 2011 and LFO Projections for FY 2012
  - A. Exhibit 12 shows the projected condition of the General Fund in FY 2011 and LFO revenue projections for FY 2012
  - B. There are two Attorney General opinions that will affect the General Fund in FY 2011 and/or FY 2012
    - 1. At the request of the Alabama Trust Fund Board, the State Treasurer asked for an Attorney General opinion in February, 2010 seeking clarification and guidance regarding the calculation of realized capital gains
    - 2. Since the ratification of the Constitutional Amendment allowing distribution of capital gains, the Treasurer's office had been calculating capital gains in accordance with generally accepted accounting principles; however, a literal reading of the Amendment contains a different definition
      - a. Under generally accepted accounting principles, a realized capital gain is the difference between the selling price of an asset and the purchase price of that asset

- b. Under the Amendment, the amount of realized capital gain is the difference between the selling price of the asset and the fair market value of that asset as of the end of the immediately preceding fiscal year
- 3. The Attorney General opinion dealing with realized capital gains confirmed that the previous calculations were not in accordance with the Amendment and that the Board should transfer the difference as soon as possible
- 4. The Board then questioned whether the calculations of unrealized capital gains in the previous years were also incorrect
  - a. The issue was whether annual royalty payments should be excluded from the calculation of unrealized capital gains since the language in the Amendment did not specifically exclude those payments
  - b. A second Attorney General opinion was requested which was released in January, 2011 and stated that calculations for unrealized capital gains should not exclude royalty payments
- 5. Based on preliminary estimates prepared by the Treasurer's office, recalculating both realized and unrealized capital gains for FY 2003 through FY 2007 in accordance with the two AG opinions will result in an additional \$375.8 million in distributions from the Alabama Trust Fund, of

which \$263 million will be distributed to the General Fund

6. The Examiners of Public Accounts are currently reviewing the calculations
  7. That distribution is not reflected on Exhibit 12 because it has not yet been authenticated by the Examiners nor approved by the Alabama Trust Fund Board
  8. However, the capital gains of \$56 million recognized by the Trust Fund Board for FY 2011 is reflected in the Exhibit under the one-time revenues line
- C. The FY 2011 General Fund budget was based on General Fund revenue that was \$130 million higher than LFO original estimates but FY 2010 receipts came in even lower than LFO estimates
- D. The FY 2011 General Fund budget was also based on the expectation of the federal enhanced match being extended in full through June 30, 2011 (an additional \$197 million) which did not happen
1. Alabama will receive \$133 million of that amount
- E. Congress provided bonus payments for states that simplified their Medicaid and Children's Health Insurance programs in order to successfully enroll eligible children for Medicaid
1. 15 states received \$206 million for FY 2010 enrollments
  2. Alabama received the largest award of \$55 million and it is in a separate account awaiting appropriation

3. These funds cannot be used by Medicaid to match federal funds
  4. That amount is also not reflected on Exhibit 12 because a decision has not been made as to the appropriation of those funds nor the fiscal year in which the appropriation will be expended
  5. Alabama also received a bonus of \$39 million last year, which was appropriated to the Department of Corrections in the current year's budget
- F. Therefore, based on LFO revised estimates for FY 2011, the General Fund will be \$131.8 million short of funding current appropriations not including the possible \$263 million from retroactive unrealized capital gains or the \$55 million in the Medicaid bonus award (both of which are nonrecurring revenue sources)
- G. This \$131.8 million shortfall would dictate proration of 9% (assuming the Judicial Branch is protected in the same manner as in FY 2010) and assuming the retroactive capital gains and Medicaid bonus award are not utilized in FY 2011
1. The level of proration will change significantly if decisions are made to protect certain agencies such as Medicaid and Corrections
- H. LFO projections for receipts to the General Fund for FY 2012 are \$1.3 billion
1. This amount is \$511 million less than expenditures from the General Fund in FY 2008
- I. In summary, most agencies funded from the General Fund were cut 10% in FY 2009; another 10% in FY

2010; and are looking at more cuts in FY 2011 and FY 2012

1. It is important to remember that these cuts do not affect all state agencies in the same way
2. Some agencies (Department of Conservation, Department of Insurance, Department of Transportation, etc.) are funded with earmarked revenue which may not see the same levels of cuts
3. Other agencies are funded by administrative fees (Retirement Systems as a part of the employer's rate; Personnel Department as a per employee fee; or Department of Revenue as an amount off the top of tax collections)

**XI. Effect of Federal Stimulus on the General Fund**

- A. I have talked about the fiscal stabilization funds and how some of those funds were used to supplant ETF appropriations-there were also fiscal stabilization funds and federal stimulus funds available for non-educational appropriations
- B. Exhibit 13 shows the effect of the federal stimulus funds on General Fund appropriations over a three-year period
- C. Alabama's share of the fiscal stabilization funds was \$133 million
  1. The Legislature appropriated those funds for FY 2010
  2. The Department of Corrections received \$118.6 million and

3. The Departmental Emergency Fund received the remaining \$14.1 million
- D. I have explained the enhanced federal match for Medicaid
1. Exhibit 13 also shows how federal stimulus funds and the state fiscal stabilization funds offset General Fund appropriations by fiscal year
  2. There were no stimulus funds in FY 2008 when General Fund appropriations were \$1.8 billion
  3. In FY 2009, General Fund appropriations were reduced to \$1.7 billion but Alabama had the infusion of \$354 million in enhanced federal matching funds to bring total spending to \$2.1 billion
  4. In FY 2010, General Fund appropriations were reduced further to \$1.5 billion but total federal stimulus funds of \$527.6 million brought appropriations back up to \$2 billion
  5. In FY 2011, Congress extended the enhanced Federal match from December 31, 2010 (when it was scheduled to expire) to June 30, 2011, but at a reduced match for the last 2 quarters
    - a. However, the General Fund budget for FY 2011 is based on receiving the full enhanced match through June
    - b. That means that although Alabama will receive \$235 million in the enhanced match for FY 2011, Medicaid will be \$65 million short in state funds because that federal match is lower than anticipated and total spending will be down \$123.5 million

(including the State General Fund and stimulus funds) even if State General Fund revenues were to come in enough to fund current appropriations

**XII.** LFO Projected Funding Shortfall for the General Fund for FY 2012

- A. LFO projections for FY 2012 are \$1.3 billion
- B. This is \$747 million less than expenditures in FY 2009 counting federal stimulus funds used to supplement General Fund expenditures
- C. Even if General Fund revenues come in sufficient to fund current appropriations, the funding shortfall for FY 2012 is still dire
- D. Exhibit 14 shows the projected shortfall
  - 1. LFO estimates for FY 2012 are \$319.3 million less than pending appropriations for FY 2011
  - 2. Alabama will lose \$234.9 million in federal enhanced Medicaid match unless extended by Congress
  - 3. For a shortfall of \$554.2 million just accounting for those two items
- E. That would necessitate a growth rate of 29.4% for FY 2012 over LFO estimates for total receipts for the General Fund for FY 2011
  - 1. The General Fund has a structural deficit that growth cannot overcome
- F. Obviously, the projected numbers for FY 2011 and FY 2012 will be impacted by the decisions made concerning the \$263 million retroactive capital gains



distribution by the Alabama Trust Fund Board and the \$55 million in the Medicaid bonus payment

### **XIII. General Fiscal Issues**

#### **A. Alabama Trust Fund**

1. As I mentioned earlier in the discussions about the Rainy Day Accounts and the capital gains issue, the Alabama Trust Fund (ATF) was created as a depository for offshore oil and gas leases and royalty payments
2. The assets in the ATF had grown to \$3.2 billion as of September 2008
3. However, those assets were only \$2.5 billion as of September 2010 (not including the ETF and General Fund Rainy Day account receivables)
4. The assets of the ATF are held in perpetual trust and cannot be appropriated, expended, or disbursed except as provided by constitutional amendments, such as those that created the Alabama Capital Improvement Trust Fund (ACITF) and Rainy Day Accounts for the ETF and General Fund

#### **B. Alabama Capital Improvement Trust Fund**

1. The Alabama Capital Improvement Trust Fund (ACITF) was established by Amendment 666 to the Alabama Constitution, ratified in November 2000, and is funded with 28% of the royalties deposited into the Alabama Trust Fund in the previous fiscal year
2. \$702.3 million has been deposited into the ACITF since its inception

3. The amendment created a Bond Commission with authority to issue up to \$350 million in economic development bonds
  - a. A constitutional amendment was ratified in June 2007 to increase that bonding authority to \$750 million
    - i. \$720 million in bonds have been issued
    - ii. The remaining bonding authority is approximately \$30 million
  - b. Royalties are used to pay off these bonds
  - c. The remaining royalties in the ACITF may be used for other debt of the state or for economic development purposes
4. Exhibit 15 shows the status of the ACITF
  - a. The beginning balance in the ACITF for FY 2010 was \$19.8 million
  - b. The 28% of the royalties deposited into the ACITF in FY 2010 amounted to \$49.3 million
  - c. Expenditures from the ACITF for FY 2010 were \$63.8 million
  - d. The ending balance in the ACITF for FY 2010 was \$5.3 million
  - e. The royalties for FY 2011 are only \$34.4 million, which was lower than expected
  - f. There will be an ending balance in the ACITF for FY 2011 of \$4.1 million
5. Of the amount appropriated from the ACITF to-date:
  - a. \$108.6 million has been appropriated for new economic development projects

- b. \$273 million has been appropriated to pay debt service on bonds authorized by Amendment 666 and
  - c. \$316.6 million has been appropriated to pay existing debt service payments
- C. Public Road and Bridge Fund
  - 1. Exhibit 16 shows receipts to the Public Road and Bridge Fund since FY 2000
    - a. The fund is made up of gasoline taxes, motor fuel taxes and related fees, and inspection fees
    - b. You can see that the fund showed an actual decrease in FY 2007 through FY 2009; FY 2010 was about even with FY 2009
      - i. Alabama's gasoline and diesel fuel taxes are based on volume rather than price, so they are influenced by consumption and not by price at the pump
      - ii. The Department of Transportation has traditionally used state funds in the Public Road and Bridge Fund to match federal transportation funds available to Alabama and the remainder of state funds are used for maintenance of state roads
    - c. A component of the Federal Economic Stimulus Package was "shovel-ready" infrastructure projects, including roads and bridges. Alabama received a total allocation

of \$560.2 million from the American Recovery and Reinvestment Act

- i. \$513.7 million for roads and bridges;  
and
  - ii. \$46.5 million for public transit
  - iii. No state match was required for the stimulus funds
- d. Currently, the Department has allocated all federal stimulus funds and has spent \$353 million to begin work on 252 highway projects
- e. The Department has reported that 34,930 jobs have been created or sustained with stimulus funds

#### D. Tobacco Revenues

1. In 1998, Alabama, along with most other states, entered into a Master Settlement Agreement (MSA) with major tobacco manufacturers to settle claims that those manufacturers' did not disclose the harmful nature of smoking
2. Through FY 2010, Alabama has received a total of \$1.2 billion under this agreement
3. A key provision in the agreement provided 3 conditions under which the participating manufacturers could reduce the amount of their payments to states
  - a. The first condition was that the market share of the participating manufacturers falls more than 2%
  - b. Secondly, that the settlement agreement was a significant factor in the market share loss

- c. Third, a finding that a state or states did not “diligently enforce” statutes that require non-participating manufacturers to create escrow accounts to cover losses in any future litigation that might involve them
  - 4. In 2006 an independent economic consulting firm determined that the first 2 conditions had been met but also determined that all states were presumed to have diligently enforced their statutes
  - 5. Participating manufacturers disagreed and asked for a \$1.2 billion reduction in their April 2006 payment to states
  - 6. In Alabama, the Alabama Supreme Court held that the Master Settlement Agreement required arbitration and that arbitration should be national in scope
  - 7. In 2010, a Memorandum of Understanding was drafted by the participating manufacturers and submitted to the Attorneys General of the states to resolve all past disputes
    - a. That Memorandum was not agreed to and the issue is in arbitration
  - 8. Exhibit 17 shows the appropriations for FY 2011 of projected tobacco settlement revenues of a total of \$105.5 million
    - a. This estimate assumes that the participating manufacturers that have been paying and not escrowing their payments will continue to do so in April of this year
- E. Gulf of Mexico Energy Security Act (GOMESA) of 2006

1. Congress passed an Act that opened over 8 million acres of deepwater areas in the Gulf of Mexico for energy production and sent 37.5% of federal royalties from the new energy explorations to the four Gulf States of Alabama, Louisiana, Mississippi, and Texas
2. The 37.5% will be allocated among the 4 states based on each state's proximity to the center of the leased tract
3. 20% of each state's share will be paid directly to the coastal political subdivisions
4. The states receive funds in 3 ways
  - a. the bonus bid, which is the up-front amount the winning bidder pays for the lease
  - b. annual rent payments that the lessee must pay until production begins
  - c. the royalties, once production begins
5. Beginning in 2017, the four Gulf States will receive 37.5% of royalties from all Gulf leases entered into beginning in 1982
6. And in 2022, the states will share in all lease revenue from all blocks in the Gulf
7. Revenues from GOMESA are distributed to states and coastal political subdivisions (Baldwin and Mobile Counties in Alabama) in the fiscal year following receipt
8. In October, 2010, the Bureau announced that \$866,000 in FY 2010 revenues were being distributed

- a. Alabama's share of these revenues is \$206,000 and
  - b. Baldwin and Mobile counties will split an additional \$51,000
- F. Coastal Impact Assistance Program Fund (CIAP)
  - 1. The Energy Policy Act of 2005 passed by Congress authorized funds to be distributed to Outer Continental Shelf oil and gas producing states and coastal political subdivisions to mitigate the impacts of oil and gas activities
  - 2. The legislation authorized the appropriation of \$250 million annually for the program for each of the fiscal years 2007 through 2010
    - a. The distribution to each state is determined by the percentage of revenues generated from leases off its coast compared to the total amount of revenue from all leases
  - 3. The total allocation for Alabama for FY 2007 and FY 2008 was \$51.1 million split evenly between the years
    - a. Of which \$17.9 million was allocated to Baldwin and Mobile counties
  - 4. The allocation for FY 2009 and FY 2010 was \$39.4 million split evenly between the two years
    - a. Of which \$13.8 million was allocated to Baldwin and Mobile counties
  - 5. Alabama's funds are administered by the Department of Conservation's Land Division

#### **XIV. Conclusion**

- A. I know that I have given you a lot of information to absorb
- B. This presentation outline and the exhibits will be posted on the LFO website today
- C. I again (as I did in Tuscaloosa) encourage each of you to meet with me and other staff members of the LFO at your convenience individually or in groups for more in-depth discussions of the budgets and fiscal outlook for Alabama and
- D. I thank you for your time and attention
- E. Questions