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October 15, 2013

Jane C. Driskell
State Budget Director
Office of the State Budget Director
Room 284, Capitol Annex
Frankfort, Kentucky 40601

Dear Ms. Driskell:

In accordance with KRS 48.120 and 48.115, the Consensus Forecasting Group (CFG) assembled on October 11, 2013 to consider preliminary revisions to the official revenue estimates for FY 2014 and to develop preliminary revenue estimates for FY 2015 and FY 2016. The preliminary estimates adopted by the CFG during the October 2013 meeting are contained in the table below.

<u>Fiscal Year</u>	<u>General Fund</u>	<u>Road Fund</u>
2014	\$9,578,900,000	\$1,581,300,000
2015	\$9,808,400,000	\$1,549,300,000
2016	\$10,029,400,000	\$1,554,400,000

The FY 2014 General Fund estimate adopted by the CFG is \$55 million more than the FY 2014 official enacted estimate. The FY 2014 Road Fund estimate adopted by the CFG is \$13.1 million more than the FY 2014 official enacted estimate. The FY 2014 General Fund and Road Fund estimates adopted by the CFG in October are preliminary and do not represent an official revision to the FY 2014 revenue estimates.

In addition to providing estimates for the General Fund and the Road Fund, the Consensus Forecasting Group provides estimates of the receipts the Commonwealth may receive from the Phase I Tobacco Master Settlement Agreement (MSA). The figures below represent the MSA revenue estimates adopted by the CFG at the October meeting and are not included in the General Fund totals. The FY 2014 MSA estimate has been increased by \$3.8 million when compared to the FY 2014 MSA estimate that was adopted by the CFG in December 2011.

<u>Fiscal Year</u>	<u>MSA Revenue</u>
2014	\$94,600,000
2015	\$92,500,000
2016	\$85,100,000

Risks to the Forecast noted by the CFG

In considering the revenue and economic forecast, the CFG cited three sources of uncertainty that could affect revenues. First, the CFG noted that a major component driving the forecasted economic growth over the upcoming biennium was an improvement in new home construction in the US. The economic forecast also suggested an increase in interest rates and saving rates over the upcoming biennium. With increasing interest rates and improvements in household savings over the biennium, there was some uncertainty expressed regarding whether the higher new home construction estimates could be attained, and whether growth in new home construction in Kentucky would follow the US pattern.

Second, CFG members noted the 20.1% decline in coal severance tax receipts in FY 2013, and the continued weakness in these receipts in the first quarter of FY 2014. The revenue forecast suggested coal severance tax receipts would decline by 11.3% in FY 2014—when compared to FY 2013 receipts—and would then stabilize around the \$200 million level in FY 2015 and FY 2016. CFG members discussed the significant changes in the energy market over the past 3-5 years and suggested that changes may continue to take place over time as more electric generating capacity moves away from coal. The CFG noted the risk in adopting the coal severance revenue forecast was that the market might continue to decline over the upcoming biennium.

Finally, since FY 2004 OSBD staff have provided information regarding the potential reduction in MSA receipts in the event that an initial ruling by the arbitration panel of “non-diligent enforcement” for the Commonwealth survives the appeal process. The provision of the MSA that allows for a reduction in payments is often referred to as the NPM adjustment provision.

At the October 2013 meeting, OSBD staff informed the CFG members that in September 2013 an arbitration panel of three former federal judges found that Kentucky, along with five other states, did not diligently enforce the escrow provisions of the MSA. OSBD staff indicated the Commonwealth is reviewing the arbitration ruling and will weigh all available options to avoid a reduction in the April 2014 MSA payment to the Commonwealth. Given the uncertainty of the timing and magnitude of any potential reduction in the MSA payments, the CFG did not change the MSA estimates, but noted once there is a final resolution of the 2003 NPM adjustment there could be a significant reduction in the annual MSA payment to Kentucky. If a reduction in the MSA payment does occur, it is unclear in which year the reduction will take place.

In summary, the General Fund, Road Fund and MSA revenue estimates adopted by the Consensus Forecasting Group represent an agreement as to the most likely outcome for

revenues for the next fiscal year and the upcoming biennium, given the information available on October 11, 2013. In the coming months, the CFG will have an opportunity to revisit the General Fund, Road Fund and MSA estimates, and will provide the official revenue estimates on or before the fifteenth legislative day of the 2014 Regular Session of the General Assembly as stipulated by KRS 48.120.

Sincerely,

A handwritten signature in blue ink that reads "Frank O'Connor". The signature is written in a cursive style with a large initial "F" and "O".

Frank O'Connor
Chairman, Consensus Forecasting Group
Professor of Economics
Eastern Kentucky University