

ALASKA STATE LEGISLATURE
HOUSE SPECIAL COMMITTEE ON WAYS AND MEANS

March 27, 2006

8:59 a.m.

MEMBERS PRESENT

Representative Bruce Weyhrauch, Chair
Representative Ralph Samuels
Representative Paul Seaton
Representative Peggy Wilson
Representative Max Gruenberg
Representative Carl Moses

MEMBERS ABSENT

Representative Norman Rokeberg

COMMITTEE CALENDAR

HOUSE BILL NO. 418

"An Act relating to a mining production tax; relating to the mining license tax; relating to production royalties on minerals; relating to exploration incentive credits; and providing for an effective date."

- HEARD AND HELD

HOUSE BILL NO. 492

"An Act relating to the transfer of the state's interest in certain gas to the Alaska Retirement Management Board for the purpose of satisfying the unfunded accrued actuarial liability of the state and employers of teachers in the state to state retirement systems; and providing for an effective date."

- HEARD AND HELD

PREVIOUS COMMITTEE ACTION

BILL: HB 418

SHORT TITLE: MINING PROD. & LICENSE TAXES/ROYALTIES

SPONSOR(S): REPRESENTATIVE(S) SEATON

02/01/06	(H)	READ THE FIRST TIME - REFERRALS
02/01/06	(H)	W&M, RES, FIN
02/22/06	(H)	W&M AT 9:00 AM CAPITOL 106
02/22/06	(H)	Heard & Held

02/22/06 (H) MINUTE(W&M)
02/24/06 (H) W&M AT 9:00 AM CAPITOL 106
02/24/06 (H) Heard & Held
02/24/06 (H) MINUTE(W&M)
02/27/06 (H) W&M AT 9:00 AM CAPITOL 106
02/27/06 (H) Heard & Held
02/27/06 (H) MINUTE(W&M)
03/01/06 (H) W&M AT 9:00 AM CAPITOL 106
03/01/06 (H) Heard & Held
03/01/06 (H) MINUTE(W&M)
03/06/06 (H) W&M AT 9:00 AM CAPITOL 106
03/06/06 (H) <Bill Hearing Canceled>
03/22/06 (H) W&M AT 9:00 AM CAPITOL 106
03/22/06 (H) Heard & Held
03/22/06 (H) MINUTE(W&M)
03/27/06 (H) W&M AT 9:00 AM CAPITOL 106

BILL: HB 492

SHORT TITLE: NATURAL GAS ROYALTIES TO FUND PERS/TRS
SPONSOR(S): FINANCE BY REQUEST

03/15/06 (H) READ THE FIRST TIME - REFERRALS
03/15/06 (H) W&M, FIN
03/20/06 (H) W&M AT 9:00 AM CAPITOL 106
03/20/06 (H) Heard & Held
03/20/06 (H) MINUTE(W&M)
03/22/06 (H) W&M AT 9:00 AM CAPITOL 106
03/22/06 (H) Scheduled But Not Heard
03/27/06 (H) W&M AT 9:00 AM CAPITOL 106

WITNESS REGISTER

IAN LAING, Staff
to Representative Paul Seaton
Alaska State Legislature
Juneau, Alaska

POSITION STATEMENT: Explained the differences between the existing Mining License Tax and the proposed committee substitute (CS), Version S.

DICK MYLIUS, Acting Director
Division of Mining, Land and Water
Department of Natural Resources (DNR)
Anchorage, Alaska

POSITION STATEMENT: During the hearing of HB 418, answered questions.

NELS TOMLINSON, Economist
Tax Division
Department of Revenue (DOR)
Juneau, Alaska

POSITION STATEMENT: During the hearing of HB 418, answered questions.

JOHANNA BALES, Excise Audit Manager
Tax Division
Department of Revenue (DOR)
Anchorage, Alaska

POSITION STATEMENT: During the hearing of HB 418, answered questions.

REPRESENTATIVE MIKE KELLY
Alaska State Legislature
Juneau, Alaska

POSITION STATEMENT: Presented information and questions on HB 492, on behalf of the House Finance Committee, sponsor by request, of which he is a member.

BRIAN ROGERS, Chair
Planning and Development Committee
Board of Regents
University of Alaska
Fairbanks, Alaska

POSITION STATEMENT: During the hearing of HB 492, provided information.

BOB SHEFCHIK, Chief of Staff
Mayor's Office
Fairbanks North Star Borough
Fairbanks, Alaska

POSITION STATEMENT: During the hearing of HB 492, provided information.

MIKE BARNHILL, Assistant Attorney General
Labor and State Affairs Section
Department of Law (DOL)
Juneau, Alaska

POSITION STATEMENT: During the hearing of HB 492, answered questions regarding the possible legal implications.

ACTION NARRATIVE

CHAIR BRUCE WEYHRAUCH called the House Special Committee on Ways and Means meeting to order at [8:59:28 AM](#). Representatives

Weyhrauch, Moses, and Seaton were present at the call to order. Representatives Gruenberg, Samuels, and Wilson arrived as the meeting was in progress.

HB 418-MINING PROD. & LICENSE TAXES/ROYALTIES

8:59:44 AM

CHAIR WEYHRAUCH announced that the first order of business would be HOUSE BILL NO. 418, "An Act relating to a mining production tax; relating to the mining license tax; relating to production royalties on minerals; relating to exploration incentive credits; and providing for an effective date." [Before the committee was the proposed committee substitute (CS) for HB 418, Version 24-LS1456\S, Chenoweth/Bullock, 3/22/06, which had been adopted as the work draft on 3/22/06].

9:00:01 AM

IAN LAING, staff to Representative Paul Seaton, Alaska State Legislature, on behalf of Representative Seaton, sponsor of HB 418, provided a brief summary of the bill's intent which is to determine whether a better return on investment, for the exploitation of the resources in the mining industry, can be expected without harming [future] investment by the industry. He informed the committee that the mining industry currently pays federal, municipal, and state taxes. He listed the major taxes on the state level that are primarily affected by the bill: the Mining License Tax; royalties for mineral and coal; and claim rentals on state land. He then directed the committee's attention to the revised table in the committee packet [labeled "State Revenue Collected through Major Taxes and Fees on Mining - FY 98-03"] and explained that it now includes figures through fiscal year 2004 (FY 04).

MR. LAING then highlighted some of the key differences between the existing Mining License Tax and Version S. One of major differences, he said, is that of changing the current "percent depletion" method of the Mining License Tax to a "cost depletion" one. A mining company would no longer be allowed to annually deduct a percentage of gross even after its costs have been recouped, he clarified, because by using a cost depletion method, only a percent of a mining company's development expenses, equal to the percent of the total ore body that is mined, would be an allowable deduction. He noted that this change will [largely] tend to apply to the larger mines that have a general idea of what the ore body is. However, he

remarked that the bill does allow some flexibility for smaller operations with insufficient resources to determine the consistency of the ore body. He went on to explain that the current Mining License Tax, after deductions are applied, is calculated as a percentage of net income. Yet in Version S, he highlighted that these percentages have all been raised by 2 percent of net income with an additional tax bracket of 11 percent for income over \$500,000. Additionally, he said, Version S would eliminate the deduction of indirect expenses which again would apply to much larger mining operations.

MR. LAING informed the committee that the most substantial change proposed in Version S is made to mineral royalties. He noted that every other rights holder in the state - from Native corporations to the university and Mental Health Trust lands - charges a mining royalty. This royalty, he explained, is quite different than the current 3 percent of net income the state calculates and charges under the [Mining License Tax]. Version S would implement a new royalty that charges 3 percent of "net smelter return" (NSR) which changes the royalty from a profits tax to one based on the actual mineral value. He listed some of the allowable deductions with the NSR tax: return from the smelter, transportation expenses, smelting fees and penalties. In response to Chair Weyhrauch, he explained that a "non-smeltable" is any "mineral that occurs in its native state." He deferred to Department of Natural Resources (DNR) for a more thorough definition, explaining that he is unaware of any mineral mined in Alaska that would be considered non-smeltable.

MR. LAING then turned the discussion to coal royalties and informed the committee that Version S proposes that the 5 percent adjusted gross value, currently in regulation, not only be put into statute but also adopted as the minimum royalty. Furthermore, he noted that the rate allows for the deduction of transportation costs from the point at which the coal is weighed and loaded, to its point of sale. He opined that this would be of no substantial difference to the industry because it only adopts what's currently established in regulation.

[9:11:05 AM](#)

CHAIR WEYHRAUCH asked how "the point at which it is weighed" differs from "mine mouth."

MR. LAING said that "mine mouth" is somewhat of a misnomer and has no specific definition. He explained that not until the coal is extracted, transported to a crusher, crushed, and loaded

for transport is its value assessed and an adjusted gross value assigned. Then directing the committee's attention to rents for coal and minerals, he highlighted that Version S proposes the same rates currently in regulation - \$3.00 for coal and \$3.30 for minerals - be adopted as the minimum, with ties to the Anchorage Consumer Index, and adjusted as needed every 10 years.

[9:13:22 AM](#)

REPRESENTATIVE SEATON further clarified what is meant by "depletion." He said that currently depletion can be done one of two ways: by cost or by a [percent] of gross value of the minerals. He explained that Version S focuses on the cost method which allows for costs to be depleted, however, subtracting the amount for mined minerals is not.

[9:14:18 AM](#)

REPRESENTATIVE WILSON, referring to the Mr. Laing's mention of coal rental rates being tied to the Anchorage Consumer Index, inquired as to whether this is currently done or a proposed change.

MR. LAING stated his understanding that it's the minerals rent that's currently tied to the Anchorage Consumer Index; Version S applies this to coal rent as well.

[9:14:54 AM](#)

REPRESENTATIVE SEATON indicated that the proposed rates, though tied to the "Consumer Price Index," would only be adjusted every ten years. He clarified that it's not meant to be an annual increase in the rents.

[9:15:22 AM](#)

MR. LAING added that if the Anchorage Consumer Price Index were applied to the coal value at the time it was adopted, it would total \$5.25 and does account for inflation.

[9:16:31 AM](#)

DICK MYLIUS, Acting Director, Division of Mining, Land and Water, Department of Natural Resources (DNR), in response to Chair Weyhrauch, explained that he has heard general concern from the industry as to what the possible impacts might be on future development should the current taxing structure change.

He said, however, that he has not received any specific feedback on [Version S]. In further response to Chair Weyhrauch, he opined that it was beyond his division's capability to analyze how the changes to the current tax structure would change the economics to the industry.

[9:18:10 AM](#)

REPRESENTATIVE SEATON inquired as to whether Mr. Mylius perceives the additions [to the rents] on coal are "basically just putting in statute the minimums of what [is currently done] in regulations, except for changing the ... reassessment period from 20 years to 10 years."

MR. MYLIUS stated his agreement in as far as it pertained to coal fees currently in regulation. In further response to Representative Seaton, he agreed that the cost method of depletion is one of two methods currently used; however, his division has not yet evaluated the effects of changing to this method alone.

[9:19:40 AM](#)

REPRESENTATIVE WILSON requested Representative Seaton provide further explanation on the possible depletion methods.

REPRESENTATIVE SEATON explained that currently, the [mining industries] can either deplete based on costs put into a project or can subtract from taxes a percent of the minerals no longer in the field. He stated his understanding that many of the larger mining operations deduct a "huge part" of taxes because they "used up more of the minerals [which] are no longer there to take." The proposed tax change in Version S, he clarified, allows the depletion of costs as a deduction, however, not the depletion of minerals removed from the ground.

[9:21:06 AM](#)

CHAIR WEYHRAUCH inquired as to whether there is a depletion allowance for oil in federal law.

REPRESENTATIVE SEATON expressed his belief that there is no oil depletion allowance at the state level.

[9:22:12 AM](#)

NELS TOMLINSON, Economist, Tax Division, Department of Revenue (DOR), summarized those questions asked by the committee at a previous hearing on HB 418, and then answered by Dan Stickel and Johanna Bales from the DOR Tax Division, in a memo dated March 3, 2006. In regard to the possible impact of the bill on tax revenues should the Pogo and Kensington mines be excluded from the analysis, he directed the committee's attention to the charts on page two of the memo that summarize the effect. He relayed that revenue increases [from the proposed tax change] would be approximately \$1 to \$4 million smaller per year than what was previously determined in the department's original fiscal note. As for "an estimate of the deductions taken from gross revenue to arrive at a taxable income," he listed the 2004 totals for the industry as a whole: the depletion allowance amounted to 18 percent of gross income; the direct mining expenses were approximately 52 percent of gross income; and indirect mining expenses amounted to 6 percent of gross income.

[9:25:07 AM](#)

The committee took an at-ease from 9:25 a.m. to 9:28 a.m.

[9:28:00 AM](#)

CHAIR WEYHRAUCH inquired as to whether the "Schedule A" Mr. Tomlinson referred to is based on the aggregate of the tax returns from the companies.

MR. TOMLINSON said this is correct.

[9:28:31 AM](#)

REPRESENTATIVE SEATON inquired as to whether the memo before the committee is based on the original bill and not Version S.

MR. TOMLINSON said this is correct.

CHAIR WEYHRAUCH asked Representative Seaton how Version S would affect the analysis provided in the memo.

REPRESENTATIVE SEATON expressed his belief that it would be a considerable change. He explained that upon hearing industry concerns regarding a tax based on gross as proposed in the original bill, Version S was drafted to return to the original structure of the mining tax, eliminating some of the problems of indirect costs. These changes would affect the percentages shown on the charts in the memo by reducing the amounts of

revenue, he said. Should Version S move from this committee, he remarked, a new fiscal note would be prepared prior to the bill hearing in the House Resources Standing Committee.

[9:29:42 AM](#)

REPRESENTATIVE WILSON asked Mr. Tomlinson whether DOR could provide the committee with [a revised fiscal note] in response to changes proposed in Version S.

MR. TOMLINSON expressed that this would be possible.

[9:30:05 AM](#)

CHAIR WEYHRAUCH requested that the possible impacts to the mining industry be addressed.

[9:30:18 AM](#)

JOHANNA BALES, Excise Audit Manager, Tax Division, Department of Revenue (DOR), confirmed that the information in the memo "really doesn't apply anymore to [Version S]." She informed the committee that she applied the changes [proposed in the Version S] to the income in 2004 and estimated, by denying the use of percentage depletion, that there would be a \$7 million increase in the Mining License Tax. By applying the new tax rate shown on page 9 of Version S, she explained that the current tax rate is adjusted up by 2 percent, with a new tax rate of 11 percent added and the use of a graduated tax rate denied. Based on these changes, she relayed that there would be an increase of an additional \$7 million a year with an overall impact on revenue estimated at \$14 million per year.

[9:32:10 AM](#)

REPRESENTATIVE SEATON noted that in the original bill, revenues were "graduated in under the gross tax" to where revenues for 2011 or 2012 were projected to be approximately \$30 to \$45 million. However, he explained that in Version S, the increase would be approximately \$15 million "because it doesn't grade in." He summarized that although this amount is not nearly as much as those generated in the original bill, it would still be an increase to the current tax revenues of approximately \$8 million.

[9:33:28 AM](#)

MR. TOMLINSON directed the committee's attention to the third question addressed in the March memo which read:

Has any economic analysis been performed that might indicate at what point the tax burden on the mining industry becomes onerous?

MR. TOMLINSON explained that DOR has not yet done such an analysis and is unable to tell the exact impact on the industry at this time. He relayed that the department does "know that increasing the tax is going to ... slightly decrease the profitability [to the mining industry]" and perhaps cause mines to leave a little more ore in the ground. Additionally, he said that although a company on the verge of profitability might be swayed by changes to the tax structure, DOR is not aware of any company in the state at this particular stage of investment. He then addressed the final question in the memo as to what the mining industry pays the state in corporate income taxes. He highlighted that the approximate tax liabilities of \$133,000 in FY 04 and \$120,000 in FY 05 are actually far lower than can be expected now that the mineral prices are much higher.

CHAIR WEYHRAUCH inquired as to whether the increase on mineral prices from this year to last could be quantified.

MR. TOMLINSON directed the committee's attention to the projections [derived from the tax changes proposed in the original bill] on page 2 of DOR's fiscal note which show the Mining License Tax revenues for FY 08 at approximately \$20 million and for FY 09 at \$18 million. Should mineral prices return to their long-term average, he explained that tax revenues of \$5 million a year are projected from approximately FY 08 to FY 11.

[9:36:39 AM](#)

REPRESENTATIVE WILSON requested clarification of the wording in the March memo which reads, "[DOR] may receive zero or more than one tax return from a company in a given fiscal year."

MR. TOMLINSON explained that this is a matter of timing and that it's possible to receive two tax returns from one company within the same fiscal year: one year's return submitted just after the June 30 cutoff and the following year's return submitted prior to its June 30 cutoff.

REPRESENTATIVE SEATON returned to Mr. Tomlinson's earlier explanation of the projected changes in tax revenues for FY 08 and FY 09 given the possible fluctuations in mineral prices. He inquired as to whether Mr. Tomlinson might have misinterpreted Chair Weyhrauch's request for information on "corporate income taxes" by instead provided the figures for "Mining License Tax" revenues.

MR. TOMLINSON confirmed that he had mistakenly quoted figures for the Mining License Tax, not those for corporate income tax. Although he said that he does not have with him a set of projections for corporate income for the mining industry, he opined that it would be reasonable to take those Mining License Tax numbers as surrogates for the increase [in mineral prices]"

[9:39:18 AM](#)

MS. BALES interjected to note that one difference between the Mining License Tax and corporate income taxes is that the former is based on the mining activity in the state as opposed to the latter tax that uses a "waters-edge" basis. She explained that everything a corporation does is dictated by its activity in the United States. She opined that it's difficult to predict that significant increases in the Mining License Tax will actually result in matching increases in corporate taxes because there are many more variables involved. She further clarified that a single [corporate] taxpayer could report different industries and activities. As per the request of Chair Weyhrauch, she defined "waters edge" as meaning activity "within the United States" [versus worldwide]. Unlike the oil and gas corporations, she explained that all other industry corporations "look at all their activity that's conducted in the United States, ... take a percentage of their activity in Alaska, and they allocate all of their income from activities in the United States."

[9:41:10 AM](#)

REPRESENTATIVE SAMUELS inquired as to how many mines in Alaska paid corporate income taxes and asked whether these taxes came solely from the Red Dog Mine.

MS. BALES highlighted that there are approximately 180 mining taxpayers, however, she estimated that less than a quarter of those are organized as C Corporations filing corporate tax returns. She said that the remainder file either as individual

royalty owners, S Corporations, or partnerships. In further response to Representative Samuels as to whether the corporate income taxes paid are equally distributed, she relayed that only a few pay the corporate income tax based on the activity that they have. "The larger mines are held by corporations and there are just a few of those," she said.

REPRESENTATIVE SAMUELS asked whether one could assume this trend [to incorporate] would continue over the next couple of years [or], whether the currently incorporated mines would [just] expect to pay a little more.

MS. BALES said the [latter] would be a correct assumption.

[9:43:41 AM](#)

CHAIR WEYHRAUCH, having determined there was no further testimony, announced that the bill would be held over.

HB 492-NATURAL GAS ROYALTIES TO FUND PERS/TRS

[9:44:10 AM](#)

CHAIR WEYHRAUCH announced that the final order of business would be HOUSE BILL NO. 492, "An Act relating to the transfer of the state's interest in certain gas to the Alaska Retirement Management Board for the purpose of satisfying the unfunded accrued actuarial liability of the state and employers of teachers in the state to state retirement systems; and providing for an effective date."

[9:45:35 AM](#)

REPRESENTATIVE MIKE KELLY, Alaska State Legislature, presented HB 492 as a member of the House Finance Committee, sponsor by request. He referred to the discussion of the challenges to HB 492 at the recent meeting with the Alaska Retirement Management Board (ARMB). He summarized some of the main challenges as being the valuation of the gas interest - particularly in advance of a gas pipeline being built - and the risk as to whether the asset could easily meet some of the early payout requirements.

[9:47:27 AM](#)

BRIAN ROGERS, Chair, Planning and Development Committee, Board of Regents, University of Alaska, informed the committee that

the regents advanced this concept of the transfer of a major asset [proposed in HB 492], to balance the systems' liabilities in an effort to address the unfunded liability in the Public Employees' Retirement System (PERS) and Teachers' Retirement System (TRS). He relayed that one of the few assets the state has of sufficient value, and which could produce income in roughly the same timeframe as the needs of the system, is the natural gas assets in Prudhoe Bay. He noted that [using this asset] would free up current funds to meet other state needs while attempting to match the cash flows. He remarked that currently there is no model of these cash flows and opined one is needed to ensure that the pay out is roughly in line with the cash needs of the system. At the recent meeting with the ARMB, he said it became clear that the valuation is the most substantial challenge to this particular asset. The regents recommendation, he highlighted, is that the state attempt to have the Department of Natural Resources (DNR) transfer assets roughly approximating the \$5 billion set out in the bill, and that the ARMB obtain an independent, third party valuation to meet its fiduciary responsibility in seeing that asset and liabilities are balanced. He said he is aware that some believe there are constitutional problems to the bill due to a possible dedication of funds. The regents have expressed their belief that this involves "a transfer of assets and not a dedication of the revenues from those assets." He suggested some additional legal analysis would be useful to the committee.

[9:50:45 AM](#)

REPRESENTATIVE SEATON asked for further clarification on Mr. Roger's comment regarding "freeing up current funds to meet other needs."

MR. ROGERS explained:

In the FY 07 budget, approximately \$125 million will be the aggregate cost to state government, local government, school districts, and the university for the 5 percent increase in the PERS and TRS rates. So, if we freeze rates at current levels, as the bill calls for during the valuation process, that \$125 million can either ... represent a reduction to the spending or can represent funds available for other purposes. If we look at the projections as they were prior to Friday, once rates hit their top point, the annual cost to state, local, school district, and university is just over \$400 million per year that

would be deposited into the funds over the next 30 years to the extent that the passage of an asset transfer allows the freezing of the rates, or even a roll back of the rates to the normal cost rates, that \$400 million is available for other purposes.

REPRESENTATIVE SEATON referred to the information provided in the March 22, 2006 memo from Susan Taylor of DOR's Treasury Division, to Tom Boutin, DOR's Deputy Commissioner in which it's explained that the cost of assets [such as mineral rights] shall be capitalized as incurred. Additionally, Representative Seaton said the memo specifies that according to the Governmental Accounting Standards Board (GASB), the cost of the recorded asset would be zero. He asked Mr. Rogers whether the effect of these two points wouldn't "be the same as just saying 'we're not going to reduce the unfunded liability and make any payments into it'."

MR. ROGERS relayed that this is correct for purposes of the "booked value" of the assets being transferred: it will be booked at a zero value because the acquisition cost is zero. However, for purposes of calculating the unfunded liability, he explained that it's the "market value of assets" being considered rather than the historical value. Furthermore, he continued, it's the market value of the gas assets that the actuaries would need to determine when they address the remaining unfunded liability. He said that it is this determination which [the regents] believe requires an independent appraisal.

[9:54:25 AM](#)

CHAIR WEYHRAUCH, in noting that the resource [identified in HB 492] is limited to gas, inquired as to why other assets are not considered: coal, rental-producing residential properties, or those state lands being developed, leased, and payments made to the ARMB.

MR. ROGERS explained that it is challenging to find other assets that equate to the same kind of value. He relayed that any oil resources of value are already being produced and "spoken for in the state budget." He said that those oil reserves not yet producing might be considered, however, these are included in the budget process as well. Given the interest in gas and the movement toward a gas pipeline, he opined that "we're finally at a point where the gas assets are approaching a real value that can be determined as opposed to a much more speculative value."

[9:56:57 AM](#)

REPRESENTATIVE KELLY requested clarification from Mr. Rogers on his approach to assigning some value to the gas asset regardless of no pipe in sight [as opposed to] the GASB approach which assigns a zero value until the gas is actually rushing through the pipe.

MR. ROGERS relayed that those oil and gas properties commonly bought and sold in the industry are not sold at book value but rather at an amount a buyer is willing to pay to a willing seller. The gas on the North Slope, even if currently stranded, does have value, he opined, and one to which an appraiser could assign a market value. He stated his belief that whereas GASB does require entries to be kept at cost, the state's actuaries would consider market values when determining funding ratios for the unfunded liability. He remarked that "on a book basis, the state would continue to show a deficit, but on a computed actuarial basis of the funding ratio, [the state] would be moving it up toward the 100 percent level."

REPRESENTATIVE KELLY opined that the method Mr. Roger's suggested - that of the state transferring a rough estimate of the reserves from DNR into the ARMB and then assigning an appraised value - is somewhat of a "trust us" approach. He inquired as to whether the state could "get a handle on the value" prior to the asset being transferred.

MR. ROGERS suggested that the legislature could obtain an independent appraisal of the value and that this alternate approach might result in a closer approximation [in value] than one DNR might assign. He expressed his belief that [the unfunded liability] is a long-term problem requiring a long-term fix and should not be rushed.

[10:01:09 AM](#)

REPRESENTATIVE SAMUELS opined that with reserves taxes, expansion lease revokes, and different political factions "trying to scuttle any deal that might come forward," it would be difficult to [assign] a net present value to the gas pipeline scenario "until things play out a little bit [more]." He remarked that an additional consideration might be that of lawsuits resulting from passed legislation on either the gas pipeline or a reserves tax. He highlighted that even at the point the Federal Energy Regulatory Commission (FERC) has

"project sanction," when booking the value of a resource for company shareholders is allowed, isn't "enough for GASB." Furthermore, should a gas deal be ratified by the legislature and signed by the governor, it would still be five or more years of design and permitting work before the project is sanctioned.

MR. ROGERS stated his agreement that the issue of timeline is important and opined that following the correct solution at the right time with any legislation, such as HB 492, involves a major fiscal action. As to the issue of project sanction, he expressed his belief that a value can still be assigned to an asset, regardless of whether one has been assigned by GASB or the industry. "While that value may not be able to appear on your books, it can be part of your long-term plan," he said. He relayed that knowing there is a project "that is moving to sanction and has a likelihood of development, would allow an appraiser to apply that probability of success to a reasonable value." He noted that there are other assets to PERS and TRS with similar valuation challenges, particularly as they move into private equities, and opined that there are multiple ways to address this.

[10:07:42 AM](#)

REPRESENTATIVE SEATON highlighted that 75 percent of the payouts to the PERS and TRS systems are anticipated to be from interest earned on deposited money for assets that are earning interest in the fund. Then considering the book reserves of a gas asset that is as yet not interest-bearing and would not be generating income until it comes online, he asked Mr. Rogers how not to deplete those assets that are interest-bearing and currently used to pay off the past PERS and TRS service costs.

MR. ROGERS informed the committee that the concern regarding the funding ratio could be offset by two effects. The first, he clarified, is that the proposed legislation provides for a freeze at the current rates with annual payments directed toward paying the past service liability. Additionally, he said, there would be some cash coming in every year from employers for the past service liability. Secondly, he explained that to the extent that the valuation of the gas resource is transferred, a discounted cash flow method is used with an appropriate discount rate applied. He highlighted that every year closer to the gas flowing, its value would appreciate; it would not be cash income. Given that it will be at least 10 years until the income flows, the actual asset in nominal dollars that is likely to be transferred, will be significantly in excess of the \$5

billion laid out in [HB 492], he said, and would increase in value over time.

[10:12:03 AM](#)

REPRESENTATIVE SEATON asked if he were correct in understanding that Mr. Rogers is not referring to \$5 billion worth of gas assets, but rather to the transfer of what's anticipated to be \$10 billion worth of gas assets should it come on line in nine years.

MR. ROGERS said that this is correct and added that with some of the income being earned beyond that time, the total value would likely be somewhat higher than that.

[10:12:53 AM](#)

REPRESENTATIVE KELLY noted two criticisms of the bill: the asset placement being such that it would be difficult to receive the federal government's portion of benefit costs on projects; and that some interpret the proposed solution as a way to postpone debt payment and therefore requiring that future generations pay the debt.

MR. ROGERS said that although there may eventually be a future solution to this, he did not know of a method whereby the state can avoid picking up a portion of the federal share. From the university's standpoint, he relayed that it has been losing its competitiveness for federal funding because the benefit rate it can [afford to] offer does not compare with that offered by the competition. He explained that one effect this has is that the university is not able to acquire some of the grants and contracts that would hypothetically pay some of this liability. Secondly, he said the federal government's ability to pay is self-limiting for major portions of the university because of having to reduce the level of staffing within a fixed grant or contract. Either challenge, he opined, is minor compared to the significant challenge that school districts, municipalities, the university, and state face in addressing the "relentless increase in the rates." As for the criticism that suggests the bill postpones payment of the debt, he expressed his belief that it does match "current assets with current liabilities."

[10:17:26 AM](#)

BOB SHEFCHIK, Chief of Staff, Mayor's Office, Fairbanks North Star Borough, referred to discussions on HB 492 at previous

committee meetings and at the recent ARMB meeting. He informed the committee that he would characterize the reception toward this proposed legislation as being positive regarding its creative approach to solving a sizeable problem, to one that is skeptical toward the details of how or even if it will work. He said he identified two threshold hurdles: requests for more thorough analysis of possible constitutional challenges, and requests to pencil out the cash flows "to really show that bills will be paid without eating into the corpus of the funds that are already there."

REPRESENTATIVE WILSON noted the possibility that some other energy source might be discovered causing gas prices to drop and leaving future generations with an unfunded liability with no way to pay for it.

MR. SHEFCHIK said he agreed with the possibilities of gas prices being volatile and depressed for a period of time. He commented that in doing the cash analysis for either the retirement funds or the state budget, one would want to look at a high, medium, and low range of net prices on gas. In answer to questions regarding whether [this legislature] may result in future generations having to pay the debt, he pointed out that the proposed legislation provides [merely] a different mechanism for paying the debt over the same 25-year period at which it is currently amortized. He expressed his belief that the intent to pay off the debt is unchanged.

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REPRESENTATIVE KELLY expressed his hope that Mr. Shefchik would address the "fed funding question, problem, opportunity" in addition to the "burden on the payroll of ... over 50 percent now and in the other case, approaching 40 percent of wages."

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REPRESENTATIVE SEATON, in noting that all the gas income would initially be routed to the general fund [anyway], questioned whether the bill is simply another way whereby the state would "pick up the entire expense [of the \$15.6 billion future liability]," transferring funds to the PERS/TRS accounts, and keeping the employers at their same rate.

MR. SHEFCHIK clarified that the intent of the bill is not to maintain or pare back [employer] rates. He said that assuming there is an approximated match between assets and past service

liability, the ARMB would instead determine rates that gravitate to the normal cost rate of approximately 13.5 percent. He explained that this setting of rates by the ARMB would only occur during the "transition year" after which time the board would continue with its fiduciary responsibility of ensuring that assets and revenues [sufficiently] meet liabilities. He stated that he would somewhat agree with the possibility of the generated gas revenues becoming general fund revenues, to then be transferred by the state to the ARMB, but this would only be part of the picture and not a total absolution of how bills will be paid.

REPRESENTATIVE SEATON relayed that there is some question as to whether the bill will actually fix the current rates and that it does not recognize that the PERS system is not currently paying the normal cost. He said that he does not quite understand how, under the scenario proposed in the bill, the employers would be paying any portion of the past service cost given that the ARMB can't book a value [for the gas asset]. Furthermore, he questioned whether the rates could change until a value is actually booked or unless the "legislature comes in and says ... 'we are going to set the rates at below the actuarially computed costs assuming that we'll have value in this asset in the future'."

MR. SHEFCHIK said that this is not [the intent of the legislation], that he understands the question posed by Representative Seaton, and will address it in the written explanations he is preparing.

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REPRESENTATIVE KELLY opined that if the valuation has been accurately determined, it is important not to think that the present value of either cash or gas interest be treated any differently from one another. To this point, he added that whether the state adds \$7 billion in cash to the fund or \$7 billion in gas interest to the fund, it is still a matter of working with the present value that will hopefully grow over time. He said the hope would be that the gas asset would grow a greater amount than cash, would be valued conservatively, and match cash investments. He then highlighted that within only a year, the liability has grown from \$5.7 billion to approximately \$7 billion - a growth that completely consumes any excess in this year's revenue. "It completely chewed it up," he said. He opined that some are opposed to simply having the state write checks to pay off the debt but expressed his hope that the

[legislature] continues to grapple with alternate ways to address the liability, "because it is massive."

10:30:57 AM

MR. SHEFCHIK, in response to Chair Weyhrauch, informed the committee that he would provide them with a written analysis of the issue at hand.

10:31:45 AM

MIKE BARNHILL, Assistant Attorney General, Labor and State Affairs Section, Department of Law (DOL), expressed his belief that the main purpose of the bill is to relieve employers of liability for past service costs. In noting that it's the ARMB's charge to examine all possible ideas to solve the debt problem, he opined that the route proposed by the bill is not the sole solution. He informed that committee, however, that the most serious issue with the legislation is one related to dedicated funds. He provided the committee with background information on this issue:

In 1975, our office issued an opinion that interpreted the Alaska constitution's prohibition on dedicated funds and it said, "It's our conclusion that the dedication of any source of public revenue - tax, license, rental, sale, bonus royalty, royalty, or whatever - is limited by the state constitution to those existing when the constitution was ratified or required for participation in federal programs."

MR. BARNHILL highlighted that it is the source of the revenue that is at issue and not necessarily the revenue itself. He cited an example of a recent Alaska Supreme Court ruling involving the securitization of the tobacco settlement where it was determined that funds were not dedicated because the state has never relied on tobacco lawsuit settlements in the past as a "traditional" source of revenue. In noting that the state has relied almost entirely on oil and gas royalties and taxes since 1977, he opined that this is "obviously" a traditional source of revenue. Regardless of whether a distinction can be made that [the gas asset] is "a future gas interest reduced to present value," he expressed his uncertainty as to how the court would rule [on HB 492]. If the legislature attempts to pass this bill, "we would try our hardest to defend it because that's what we do," he said.

CHAIR WEYHRAUCH interjected to ask whether [DOL] could first recommend to the governor that he sign the legislation because it is constitutional.

MR. BARNHILL said he would not recommend it because it appears to be more like a "traditional source of revenue" than a tobacco lawsuit settlement and because the state has "extensively relied on oil and gas revenues." If the legislation is passed this year and it goes into litigation, it could take three to four years for the Alaska Supreme Court to issue a decision - a delay that might cost [the state] as much as \$1.6 billion. He repeated that should the state pass this legislation, DOL would defend it, but opined that "it's a particularly risky strategy."

REPRESENTATIVE SEATON sought confirmation of his understanding that the problem is the "source of the revenue," not the dedication of money. He asked whether money that is appropriated and then put into an account would fall under the same criteria.

MR. BARNHILL confirmed that the legislature can certainly appropriate money from the general fund to the pension funds on an annual basis.

CHAIR WEYHRAUCH remarked that to say any source of revenue, that is a non-traditional source, shall be transferred to the ARMB for payment of past service liabilities would be an interesting policy question.

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MR. BARNHILL said that under the tobacco securitization case, the route Chair Weyhrauch suggested could certainly be explored.

[10:38:44 AM](#)

REPRESENTATIVE KELLY inquired as to whether the annual appropriation of funds to the unfunded liability would result in making the monetization, and use of that as a security instrument in the fund, worth less in value.

MR. BARNHILL remarked that perhaps two different issues are being addressed: valuing an asset on a net present value basis and securitizing or monetizing the asset on a net present value basis. He opined that there isn't any constitutional problem with putting all of a securitized or monetized asset into the general fund to be appropriated on an annual basis by the

legislature if a way can be found to securitize it consistent with the Alaska Statehood Act.

[10:41:15 AM](#)

REPRESENTATIVE SAMUELS expressed his belief that just as with the timber industry, Alaska has never relied on gas. He said that at some point in the future, not only would a gas pipeline be built, but Alaska would be extremely dependent on gas revenues. He asked Mr. Barnhill if he differentiated between the hydrocarbons.

MR. BARNHILL highlighted that whereas Alaska has received Cook Inlet gas royalties since 1959 or earlier, it has received no significant amount of North Slope gas royalties to date. As to whether the courts would make any geographical distinctions, he said that although he is uncertain, he would bet they would likely not do so.

[10:42:46 AM](#)

MR. ROGERS, in response to Chair Weyhrauch, said he would work with Mr. Shefchik to prepare written responses to some of the issues raised.

REPRESENTATIVE KELLY reminded Chair Weyhrauch that an amendment was drafted to include the municipalities in the bill and asked whether it be put on hold.

CHAIR WEYHRAUCH requested Representative Kelly distribute the amendment to the committee members to be discussed at a future point in time.

REPRESENTATIVE SAMUELS returned to his earlier mention of the potential conflict between the long-term interests of the ARMB and the state, and requested that Mr. Rogers and Mr. Shefchik address this issue as well. In response to Chair Weyhrauch, he further clarified that the DNR commissioner could be "in-between a rock and a hard place" with the possibility of the governor and the ARMB having conflicting agendas.

[HB 492 was held over.]

[10:44:49 AM](#)

ADJOURNMENT

There being no further business before the committee, the House Special Committee on Ways and Means meeting was adjourned at 10:44 a.m.