

HOUSE FINANCE COMMITTEE
January 23, 2007
1:35 p.m.

CALL TO ORDER

Co-Chair Meyer called the House Finance Committee meeting to order at [1:35:07 PM](#).

MEMBERS PRESENT

Representative Mike Chenault, Co-Chair
Representative Kevin Meyer, Co-Chair
Representative Bill Stoltze, Vice-Chair
Representative Harry Crawford
Representative Richard Foster
Representative Les Gara
Representative Mike Hawker
Representative Reggie Joule
Representative Mike Kelly
Representative Mary Nelson
Representative Bill Thomas, Jr.

MEMBERS ABSENT

None

ALSO PRESENT

Patrick Galvin, Acting Commissioner, Department of Revenue; Dr. Michael Williams, Chief Petroleum Economist, Department of Revenue; Jerry Burnett, Director, Administrative Services, Department of Revenue; Gary Bader, Chief Investment Officer, Department of Revenue; Cheri Nienhuis, Petroleum Economist, Department of Revenue; Representative Anna Fairclough

PRESENT VIA TELECONFERENCE

None

GENERAL SUBJECT(S):

OVERVIEW: DEPARTMENT OF REVENUE BUDGET

The following overview was taken in log note format. Handouts will be on file with the House Finance Committee through the 25th Legislative Session, contact 465-6814. After the 25th Legislative Session they will be available through the Legislative Library at 465-3808.

TIME	SPEAKER	DISCUSSION
1:35:16 PM	Co-Chair Meyer	Introduced members of the House Finance Committee.
1:37:22 PM	PATRICK GALVIN, ACTING COMMISSIONER, DEPARTMENT OF REVENUE	Summarized the responsibilities of the Department of Revenue: the Tax Division, Child Support Services Division, the Permanent Fund Dividend Division, and the Treasury.
1:39:24 PM	Commissioner Galvin	Introduced members of his management team: Brian Andrews, Deputy Commissioner working on Treasury issues; Marcia Davis, Deputy Commissioner, responsible for gas line and tax issues; Jerry Burnett, Legislative Liaison for the Department; Gary Bader, Chief Investment Officer; John Iverson, Director, Tax Division; Dr. Michael Williams, Chief Economist
1:42:44 PM	Commissioner Galvin	Noted that the discussion would focus on projected crude oil prices and future projections, Petroleum Profits Tax (PPT) status, revenue milestones, and the investment situation.
1:44:35 PM	DR. MICHAEL WILLIAMS, CHIEF ECONOMIST, DEPARTMENT OF REVENUE	<p>Introduced the topic of Crude Oil Prices:</p> <ul style="list-style-type: none"> • The Department's official crude oil price forecast for FY 2007 as contained in the <i>Revenue Sources Book</i> or RSB [page 97]. • The actual prices for FY 2007 for the months for which we have data. • The volatility of crude oil as reflected in daily prices. • The topics or drivers that are causing volatility <p>Dr. Williams referred to a handout entitled "Crude Oil Prices, State Revenue & the PPT" (copy on file).</p>
1:46:46 PM	Dr. Williams	Read from a prepared statement: "Let's begin with the Department's official price forecast for Alaska North Slope crude oil or ANS. The chart presents prices in dollars per barrel and the vertical axis goes from \$40 to \$75. The horizontal axis contains monthly average prices beginning in June 2006 and running through May 2007. The reason the data begin in June is because oil prices and production in June are the basis for royalty and

		<p>production tax payments in July - the first month of Alaska's fiscal year." "The green bars represent our forecast prices and the dark blue line represents actual prices. When we prepared the forecast we had actual prices for June, July and August - that is the reason they match. Our crude oil price forecast for FY 2007 is \$59.15 per barrel - which is the average of the 12 months you see in the chart. You will note we correctly predicted prices declining; however, we missed the exact trajectory.</p> <p>Moving on to volatility, this chart contains the daily price of ANS beginning with June 1, 2006 and running through January 18, 2007. You will note there are some dramatic changes. Prices increase almost 13% between June 13 and July 14, and then decline more than 29% or \$22 per barrel between July 14 and October 30. Thereafter, prices increase 12% by December 15 before declining another 20% by January 18. What is causing these dramatic swings? Will they continue?</p> <p>To help you understand the causes of these price changes, I am going to discuss some key topics or drivers as I call them. One must keep in mind that the price of an item - any item - is determined by the relative supply and demand for the item in the market place. Crude oil is a commodity that is traded on electronic exchanges worldwide."</p>
<p>1:47:48 PM</p>	<p>Dr. Williams</p>	<p>"So what are the drivers? We will begin with the demand for refined petroleum products - things like gasoline, jet fuel, diesel and heating oil. Demand is one of the pillars that determines price. In general, greater demand for a good provides support for higher prices. In the United States, according to the American Petroleum Institute, "... petroleum deliveries, a measure of demand, fell by roughly 1% to 20.6 million barrels per day [mbd],</p>

		<p>down from 20.8 mbd in 2005, which was below the 2004 level"¹. The International Energy Agency estimated that world oil demand in the industrial countries - countries like the US, Japan and Germany - declined by 0.6% in 2006. However, global demand increased due to the increases in Asia and the Middle East. According to a Citigroup analyst "We've entered that era on a worldwide basis where demand is growing more slowly."² The recent declines come at a time where there has been warm weather, so the demand for heating fuel has been reduced by weather.</p> <p>Next, we look at another pillar that helps determine price - the supply side. In general, greater supplies of a good [relative to demand] have a depressing effect on price. Here we see events that have offsetting effects. The Organization of Petroleum Exporting Countries or OPEC has attempted to stem the price decline by reducing their production. They consciously reduced output in December, October and September. They have publicly stated that they might convene a special meeting to discuss further production cuts. You should also note that Angola became a member of OPEC on January 1, 2007.</p> <p>Crude oil production in non-OPEC nations has been increasing as has the inventories of crude oil. With slowing demand, the increase in non-OPEC production has offset the declines by OPEC. The result has been an increase in inventories. According to the IEA, crude oil stocks for the industrial countries reached their highest level in 20 years in May 2006 and continued to increase for four of the next six months."</p>
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¹ *Anchorage Daily News*, "Demand for Petroleum Drops Second Year", January 20, 2007.

² *Ibid.*

		<p>"Taken together we see a picture of decreasing demand, increasing supplies and increasing inventories. What is causing demand to slow and non-OPEC supplies to increase? A major factor is high crude oil prices. High crude oil prices translate to high prices for refined petroleum products. These high prices have an impact on consumption. It has taken time for the impact to be seen, but the recent consumption statistics reflect the price effect. On the supply side, the high prices have led to large oil company profits, which have in turn led to a drilling and exploration bonanza world wide. Companies are exploring and developing resources around the world.</p> <p>Geopolitical events also contribute to price volatility. When Venezuela and Bolivia talk nationalization, there is an impact on the crude markets with a perception of reduced supply and higher prices. The fighting in Iraq, Russian policy changes with regard to energy development and other events all influence crude oil prices."</p>
<p>1:52:48 PM</p>	<p>Dr. Williams</p>	<p>"Please bear with me as I attempt to tie much of this together to help you understand the functioning of the market. A key ingredient in all of this is what people think the future holds - their perceptions. If a refinery operator believes demand is strong and supplies are not forthcoming [here you should think of 2004 global oil demand growth of 3.4% followed by supply disruptions caused by Hurricane Katrina in 2005], that operator is likely to purchase additional supplies [remember, after 2004 there is limited world wide spare crude oil production capacity]. Now, multiply this by all the refinery operators, airlines, petrochemical plants and one sees strong demand for crude oil, with the different market segments bidding up the price. Now throw in the financial sector. Institutional investors see an opportunity - they too believe demand is increasing with limited supplies -</p>

		<p>and they purchase derivatives - further bidding up the price. This is basically what happened in 2004 and 2005.</p> <p>The year 2006 opened with people believing [1] there was no price effect that would dampen oil demand and [2] there would be a nasty hurricane season in 2006 that would reduce oil supplies. With continued unrest in Iraq and problems in the Russian oil sector, this led to the steady increase of prices that peaked in July. Thereafter it became clear that the price effect was working as demand for oil was declining, and there were no supply disruptions due to hurricanes. In addition, warm weather reduced winter heating oil demand. The IEA lowered its demand estimate in September, October, November and January [it was unchanged in December].</p> <p>On a very different but related topic, the demand for corn has risen as the demand for ethanol has increased and corn prices are at 10 year highs. While crude oil prices are declining, financial investors still want to earn a profit in commodities, so they may move money to commodities other than oil - such as corn. The recent freeze in California has damaged the citrus crop, so orange juice prices are likely to increase. Perceptions: it may be easier to make more money in orange juice and corn than oil. Thus, we could see additional money exit oil and enter these other commodities. This could amplify the downward trend in oil prices.</p> <p>In summary, when people's perceptions change, they change their behavior. The advent of computers and the internet speed information worldwide and a change in perception can very rapidly translate to a change in action and prices. It is people's perception of future prices that causes them to take action - they get their</p>
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		<p>information from television or the internet and make their decisions - whether hedging jet fuel purchases for an airline, purchasing commodities for an institutional investor, or betting on price declines at a hedge fund.</p> <p>With regard to prices, we did forecast the price decline. Further, I believe prices will remain volatile. Again, I do not think the financial sector causes the trends; I believe they amplify the trends. In the short term, there is possible price support from the recent cold weather that could stimulate the demand for heating oil. Also, if OPEC does decide to further reduce output, it can impact the markets. The two key ingredients: the supply-demand balance and people's perceptions of the markets."</p>
<p>1:55:46 PM</p>	<p>Dr. Williams</p>	<p>"Next, I want to turn to our fall forecast revenue projections. These can be found in the <i>Revenue Sources Book</i>. I will review our projections, highlight the importance of oil revenues to Alaska, and describe some basic analysis to give you an idea of where we are today.</p> <p>Our official forecast of General Fund Unrestricted Revenue for FY 2007 is \$4.9 billion. Of the total, \$4.3 billion or 88% comes from oil. I would like to review the categories. The first is Royalty revenue - this does not include the 25% that goes to the Permanent Fund or PF. You see we project about \$1.5 billion and this is based on price, volume and the royalty rate [about 12.5%]. Next is the production tax - which is the new Petroleum Profits Tax or PPT that Commissioner Galvin will discuss shortly. Our estimate is that it will generate about \$2 billion. The key aspects here are production volumes, price, costs and credits. Next on the list is Income Tax which we project at about \$657 million. The drivers for income tax include prices, production and some factors our accountants refer</p>

		to as apportionment factors. It is pretty complicated and I will not get into the details now. We project about \$52 million from property taxes and this is based on assessed value. Monies from bonus, rents, etc. are projected at about \$51 million and the recent lease sale in the Beaufort Sea in October is the main reason for this high number. Our projection for non-oil revenue is about \$580 million. This includes many other categories such as alcohol and tobacco taxes, fines and forfeitures, licenses and permits, investment income and other."
1:57:00 PM	Dr. Williams	<p>"As you can tell, oil revenue dominates the Alaska revenue picture and crude oil prices and crude oil production volumes are the key factors in estimating oil revenue. To see our status on these two factors, I compare our forecast with actual prices and volumes for the fiscal year-to-date.</p> <p>In this chart the vertical axis is percent change. Our ANS crude oil price forecast for FY 2007 that is published in the RSB is \$59.15 per barrel. ANS crude oil prices through January 18 average \$61.81 which is \$2.66 or 4.3% above the forecast. Regarding ANS crude oil production, our volume forecast for FY 2007 in the RSB is 739,618 barrels per day [b/d]. Through January 17 ANS crude oil production averaged 722,845 b/d which is 16,773 b/d or 2.3% below our forecast. Since oil production in Alaska is higher during the cooler months, I expect our production volume estimate will get closer to the forecast as time goes on.</p> <p>These conclude my remarks on crude oil prices and the revenue forecast published in the <i>Revenue Sources Book</i>. I would now like to turn the floor over to Commissioner Galvin who will discuss the PPT."</p>
1:59:16 PM	Co-Chair Chenault	Asked if \$580 million in the non-oil revenue stream is an increase or decrease in revenue sources for the

		state from the previous year.
1:59:52 PM	Dr. Williams	Responded that it is an increase of less than 1 percent. He referred to page 9 of the "Revenue Sources Book" (Copy on File).
2:00:59 PM	Dr. Williams	Clarified that it is an increase of 2 percent because investment income has doubled.
2:01:29 PM	Commissioner Galvin	Pointed to page 9 and stated that with regard to the actual revenue sources, the amount is relatively flat between FY 06 and what is projected for FY 07 and FY 08. What changes is investment income, thus resulting in a higher number.
2:02:22 PM	Co-Chair Meyer	Noted that the price of oil can't be controlled, but production can. He questioned what is being done to curb production decline. He inquired about a production spike in 2012, as shown on the graph on page 13 of the Fall 2006 Revenue Sources Book. He wondered about current exploration and incentives.
2:03:33 PM	Commissioner Galvin	Replied that exploration has been heavier this year compared to recent years. He referred to incentive credits given for exploration and an increase in exploration, both on the North Slope and in Cook Inlet. He said he expects several new off-shore fields to be added to the projection forecast.
2:05:11 PM	Co-Chair Meyer	Concluded that in 2012 some additional fields would come on line.
2:05:24 PM	Commissioner Galvin	Explained that development now in those fields would lead to production in five years.
2:05:42 PM	Dr. Williams	Referred to page 103 of the Fall 2006 Revenue Sources Book, where Liberty field comes on line in 2012. Commissioner Galvin described the make-up of Liberty and the projection that it could be on line in 2012. Co-Chair Meyer asked about Shell's holdings in the Chukchi Sea area. Commissioner Galvin said there were currently no leases in that area, but there were a number of Shell leases in the Beaufort Sea area. Co-Chair Meyer noted that the gas pipeline will also help production.
2:07:54 PM	Representative Gara	Asked for an estimate of how much more revenue there would be absent the

		pipeline shut down.
2:08:07 PM	Dr. Williams	Replied that estimates are not up to date because some of the production is still being shut in. Commissioner Galvin added that the estimates are on-going.
2:09:11 PM	Representative Gara	Asked how Point Thompson might affect the production volume picture. Commissioner Galvin replied that it may take 10 to 13 years to go from exploration to production. Dr. Williams said Point Thompson could occur without a gas pipeline and, in this forecast, is scheduled to come on line in 2017. The prediction is far enough in the future as to not impact near-term supplies. As a gas cycling project it is feasible.
2:10:59 PM	Commissioner Galvin	Referred to page 6 of the handout entitled "Crude Oil Prices, State Revenue & the PPT". He addressed the PPT True-Up Payment. Companies were allowed to continue to make payments under the previous tax program until April 1, 2007, when they will have to make the payment they should have made during that time, less what they actually did make under the previous tax program. Based on forecasts, payments should be a little under \$1 billion and will be an indication as to how well PPT is working.
2:13:16 PM	Commissioner Galvin	Noted that there would have to be some adjustments made to PPT regulations, which have not been finalized. Companies are basing payments on what those regulations may be. There are two regulation adjustment packages set up. The first one created draft regulations and raised the issues of the transfer of exploration credits, clarification of lease expenditures, overhead rates, ring fencing losses, information reporting requirements, and penalty provisions.
2:17:41 PM	Commissioner Galvin	Explained that the second process requires final reviews by the Department of Revenue's Director and Commissioner, as well as by the Department of Law and the Lieutenant Governor's Office.
2:18:34 PM	Co-Chair Meyer	Asked about the status of PPT and what the estimate of the surplus for 2007

		might be given that production has stabilized and prices are fluctuating. Commissioner Galvin replied that the process that generates the Revenue Sources Book bi-annually would determine that answer. He noted that it would be premature to make an estimate now. A better estimate will be available in a couple months. Dr. Williams said he expected it to be available in April.
2:20:11 PM	Co-Chair Meyer	Noted that there is a lot of heavy oil up on the North Slope. He wondered if PPT and the 20 percent credit would provide incentive to go after that oil. Commissioner Galvin thought it was too early to tell. That was one of the primary objectives of the credit. Co-Chair Meyer said the companies wanted a 40 percent credit. Commissioner Galvin explained how it would be determined if the credit is effective.
2:21:35 PM	Dr. Williams	Referred to page 85 where alternatives are presented in the form of three tables of potential revenues to the state under different scenarios.
2:22:08 PM	Vice-Chair Stoltz	Asked if the regulations revert to the effective date of April 1, 2006. Commissioner Galvin replied that they do.
2:22:35 PM	Representative Hawker	Noted the intent to put together the best possible information to get to a projection. He asked if April 1 is the date for that. Dr. Williams said that is when the new Revenue Sources Book will be published. Commissioner Galvin related the steps that go into determining the forecasts and the timeline for determining the final number.
2:24:06 PM	Representative Hawker	Asked if that process will fit into a 90-day session scenario. He predicted that it would provide the information to the legislature at the end of that timeframe. Commissioner Galvin said the information would be distributed as it comes in, but the estimate would be determined at the end of the time period and still would be only a projection.
2:26:07 PM	Representative Hawker	Pointed out that the true-up payment, from April 1, 2006, to the end of September 2006, - three calendar

		quarters - is estimated to be close to \$1 billion more than under ELF. Commission Galvin agreed. Co-Chair Meyer said that with more production that number would be even larger. Commissioner Galvin added that if the price or production goes up, that number goes up.
2:27:53 PM	Representative Hawker	Wondered about the percent of increase over ELF. Dr. Williams, referring to the slide on Oil Dependency, thought it would be doubled. He requested Cheri Nienhuis to address that question.
2:29:27 PM	CHERI NIENHUIS, PETROLEUM ECONOMIST, DEPARTMENT OF REVENUE	Stated that the increase in FY 07 over the ELF for a full fiscal year would be \$1.2 billion. That includes the April and May payments, as well. It would double in about 5 quarters. Co-Chair Meyer asked when the fiscal year started. Ms. Nienhuis said it starts with production on June 1, which would mean a payment on July 1.
2:30:46 PM	Representative Kelly	Asked what part of the 100 percent increase relates to the progressivity piece. Ms. Nienhuis thought about 10 percent.
2:31:20 PM	Representative Gara	Thought that the oil companies' deductions would be seen at the end of March. He wondered if the deductions would be taken at the first tax reporting period. Commissioner Galvin said he would find out and get back to Representative Gara. Representative Gara wondered what the take would be if the tax was based on a world average. Commissioner offered to provide that information.
2:33:04 PM	Co-Chair Meyer	Questioned the definition of world average. Representative Gara responded with a definition based on last year's presentations. He pointed out that it is up to the Department of Revenue to determine that figure.
2:33:50 PM	JERRY BURNETT, DIRECTOR, ADMINISTRATIVE SERVICES, DEPARTMENT OF REVENUE	In response to a question from Co-Chair Meyer, said that the Department of Revenue has been working with the cruise ship industry regarding head tax regulations. The expected gross revenue from the tax is \$50 million. He explained how the tax would be split between the Department of Environmental Conservation for the Ocean Ranger Program, and local communities. Co-

		Chair Meyer asked if the money could be used for municipal revenue sharing. Mr. Burnett said he could not answer that question. Mr. Burnett explained that the other two parts of the cruise ship initiative that are important are the tax on gambling and the corporate income tax. The first returns will be from 2007.
2:36:42 PM	Co-Chair Meyer	Noted that several people were added to the department to deal with the cruise ship initiative, so the \$50 million figure would be a gross number. Mr. Burnett agreed. He clarified that \$4 million goes to the Department of Environmental Conservation for the Ocean Ranger program.
2:37:00 PM	Representative Hawker	Pointed out that the initiative may have conflicts with federal statutes such as taxation of gaming, which may pose the risk of authorizing Indian gaming. Commissioner Galvin agreed that it is a legitimate concern and it is being looked into.
2:38:26 PM	Representative Hawker	Referred to corporate income taxes and an international treaty argument regarding taxing foreign registered vessels at sea. Commissioner Galvin responded that the department is working with the Department of Law on that issue. Representative Hawker referred to Section 3, the conflict with Marine Transportation Security Act of 2002, which argues that the designation of funds under the initiative is in conflict with federal law. He maintained that the initiative is setting the industry up for a class action lawsuit. Commissioner Galvin emphasized the intent to avoid such conflict of interest and lawsuit. He reiterated that he is requesting legal advice on the matter.
2:40:42 PM	Representative Hawker	Asked what criteria will be used to evaluate this issue. Commissioner Galvin said the individual merits of the case should be looked at. The likelihood of success and available alternatives that would avoid the exposure, yet fulfill the intent of the initiative, will be evaluated. The analysis of the issue should be advanced so that the department can

		present the information to the legislature and assessments can be made.
2:42:15 PM	Representative Hawker	Asked if the legal analysis would be available for use within a 90-day session limit. Commissioner Galvin affirmed that the material would be available.
2:43:08 PM	GARY BADER, CHIEF INVESTMENT OFFICER, DEPARTMENT OF REVENUE	Provided members with backup material: "Department of Revenue, Treasury, Investment Function" (copy on file.) He reviewed page 2 and noted that the treasury: oversees \$24.9 billion, manages the cash need of the state and Alaska Retirement Management Board (ARMB), manages the ARMB domestic fixed income assets, manages the ARMB real estate investment trust assets, and manages three fixed income investment options for the Alaska Student Loan Corporation.
2:45:38 PM	Mr. Bader	Reviewed page 3, "Internally Managed Portfolio Returns". He noted that the Treasury manages several accounts including: short-term fixed income, intermediate term fixed income, broad market fixed income, and ARMB fixed income. He observed that the Treasury has exceeded its target rates.
2:48:50 PM	Mr. Bader	Explained page 4, "Non-Retirement Investment Returns - Annualized As of September 30, 2006". He emphasized that the Treasury does not manage accounts for the PFD except to invest the dividend amount for a short period before distribution. There is a sub-account in the Constitutional Budget Reserve Fund (CBRF), which provides authorization for a 5-year investment horizon. This allows for a more aggressive investment than with the main account.
2:51:01 PM	Representative Hawker	Referred to the CBRF sub-account and noted that discussions had occurred for allowing investments of the entire CBR in the same manner (managed for a 5-year payout period.) He requested an opinion from Mr. Bader on giving greater investment authority.
2:52:02 PM	Mr. Bader	Could not answer the question at this time.
2:52:47 PM	Mr. Bader	Reviewed page 6, "One Year Cumulative Attribution Effects", a

		characterization of the investment pension funds and asset classes that the pension funds invest in. He noted that the retirement fund returns were 11.46 percent and benefited by diversity. The manager effect and asset allocation were positive.
2:54:57 PM	Mr. Bader	Reviewed page 7, "CAI Public Fund Sponsor Database" which shows the range of returns of public pension funds. He noted that Alaska was near the top 8 percent of public pension funds ending September 30, 2006. The state was in the 67 th percentile in the last 7 years.
2:56:28 PM	Mr. Bader	Spoke to page 8, "Pension Funds - Cumulative Returns Actual vs. Target". He observed that the TRS fund tends to do a little better than PERS. Over time, the gross returns have exceeded actuarial returns. Returns over a 15-year period were 9.01 percent; after expenses they were 8.7 percent.
2:58:40 PM	Co-Chair Meyer	Provided an overview of the anticipated House Finance Committee schedule, points of order for running the Committee smoothly and teleconferencing.
3:04:42 PM	Representative Hawker	Mentioned the cell phone rules. Discussion followed regarding conflict of interest disclosure.
3:07:53 PM	Co-Chair Chenault	Spoke to the possibility of a 90-day session and how it could be accomplished.
3:08:33 PM	LOUANNE CHRISTIAN, FINANCE COMMITTEE AID	Introduced staff members and informed the members of protocols of the Committee.
3:14:45 PM	Representative Thomas	Asked how to communicate with staff members. Ms. Christian explained that notes could be distributed through the Finance Committee staff.
3:15:40 PM	Co-Chair Meyer	Added that meetings are also televised. Ms. Christian stated that the boxes are removed from the table for the subcommittee meetings.
3:17:14 PM	Co-Chair Meyer	<u>ADJOURNMENT</u> The meeting was adjourned at 3:16 PM.