

MINUTES
SENATE FINANCE COMMITTEE
January 22, 2007
9:01 a.m.

CALL TO ORDER

Co-Chair Lyman Hoffman convened the meeting at approximately [9:01:14 AM](#).

PRESENT

Senator Lyman Hoffman, Co-Chair
Senator Bert Stedman, Co-Chair
Senator Charlie Huggins, Vice Chair
Senator Kim Elton
Senator Joe Thomas
Senator Fred Dyson

Also Attending: SENATOR LYDA GREEN; DR. MICHAEL WILLIAMS, Chief Economist, Department of Revenue; GARY BADER, Chief Investment Officer, Treasury, Department of Revenue; JERRY BURNETT, Administrative Services Director, Legislative Liaison, Department of Revenue; BRIAN ANDREWS, Deputy Commissioner, Treasury, Department of Revenue; CHERIE NIENHUIS, Petroleum Economist, Department of Revenue; DAVID TEAL, Legislative Fiscal Analyst, Legislative Finance Division, Legislative Agencies & Offices; MINDY ROWLAND, Senate Finance Committee Secretary

Attending via Teleconference: From an Offnet Location: PATRICK GALVIN, Commissioner, Department of Revenue

SUMMARY INFORMATION

Revenue Update Presentation
by the Department of Revenue

The Committee heard a fiscal overview from the Department of Revenue. No committee action was taken.

[9:01:43 AM](#)

Co-Chair Hoffman welcomed Committee members, staff, and the audience to the first meeting of the Senate Finance Committee of

the Twenty-Fifth Alaska State Legislature. The Senate majority this Session is comprised of a "bipartisan organization" which was "something new for the State" in recent years.

Co-Chair Hoffman spoke as follows.

An effort would be made to put partisanship aside and try to work as a bipartisan organization so that we can address the needs and the issues of the State of Alaska that the people that have elected us to office to do... I think that the people of Alaska expect. So this is a new day in Alaskan government. We have a great deal of work before us crafting the operating and the capital budgets. There will be many different issues coming before this Committee and I'm eager, as well as my Co-Chairman, to work with each and every one of you to get what's the best for the State of Alaska.

We are very fortunate this year to have a \$1.3 billion surplus that we anticipate at the end of this current year, but that doesn't mean that we, as a State of Alaska, are in good shape because we still don't have a long term fiscal plan. We depend heavily upon oil for our revenues, and, as everyone is well aware, the price of oil goes up and comes down. And this last year, we've seen something unforeseen and that's the slowing down and even the closure of the gasline. So, things are quite volatile and we need to keep that point in mind.

[9:04:15 AM](#)

Later on this week I will be completing the assignments for the operating budget subcommittees. We've directed our staff to work with each member of the Finance Committee to coordinate all of our efforts.

[9:04:27 AM](#)

Committee introductions ensued.

[9:05:08 AM](#)

Senator Elton, representing Senate District B, noted that this was his ninth year representing the citizens of Juneau in this

capacity. Previous to that he served four years as a State Representative. Jesse Kiehl would be his Finance Committee aide.

[9:06:07 AM](#)

Senator Thomas, a lifelong Alaskan, appreciated the opportunity to represent the Fairbanks area in Senate District D where he grew up and looked forward to serving on this Committee. He would be assisted by staffers Catherine Reardon and Joe Hardenbrook.

[9:07:07 AM](#)

Senator Dyson, Senate District I, stated that Elmendorf and Fort Richardson military bases, Eagle River, and a portion of Chugiak were included in his district of 35,000 people. The significant numbers of active and retired military personnel in his district skewed its demographics to the high side. His constituents are mature and thoughtful. It has been a privilege to represent them in the legislature for ten years and for six years prior to that on the local assembly. His efforts on the Finance Committee would be supported by staff person Lucky Schultz.

[9:08:22 AM](#)

Senator Huggins, Senate District H, characterized his constituents in the Chugiak and Talkeetna area as "able-bodied" and "diverse". His district is "demanding" in part due to "the huge growth spurt" the area has experienced and its subsequent impact on infrastructure and schools. Other issues of importance to the district are the proposed Knik Arm Bridge crossing and the railroad network. An issue of statewide importance is the proposed Alaska gas pipeline. Deborah Grundmann is serving as his Finance Committee aide.

[9:09:40 AM](#)

Co-Chair Hoffman noted that Committee member, Senator Donny Olson, who was absent today, represented Senate District T which includes the North Slope Borough and the Northwest Arctic Borough. Senator Olson is a doctor, a pilot, and held a law degree. Co-Chair Hoffman indicated Denise Liccioli, Finance Committee aide, and Ginny Austerman, Legislative aide, would assist Senator Olson.

Co-Chair Hoffman, Senate District S, is a lifelong Alaska, representing the Yukon-Kuskokwim delta, the Alaska Peninsula, the Aleutians, and the Pribilof Islands. He introduced his Finance Committee staffers Tim Grussendorf and Tom Maher.

[9:10:53 AM](#)

Co-Chair Stedman, Senate District A, noted that his district encompassed the southern portion of Southeast Alaska including Ketchikan, Sitka, Petersburg, Wrangell and numerous smaller communities. The dynamics of Southeast Alaska differed from other areas of the State in that the area's economy was "stagnant"; and while the economy of Southeast Alaska appeared to be flat, it would, in reality, reflect a decline were the City and Borough of Juneau removed from the equation.

Co-Chair Stedman shared that District A was continuing to absorb the economic aftermath of the closure of two pulp mills. A decline in school enrollment has been experienced, skilled workers are migrating north to find employment, and surface transportation issues abound. While the proposed gas pipeline project could provide energy to other regions of the State, hydro power would continue to be furthered in Southeast Alaska.

Co-Chair Stedman recognized Miles Baker and Steve Porter as his Finance Committee staff.

Co-Chair Stedman assumed chair of the meeting.

[9:15:31 AM](#)

MINDY ROWLAND, Senate Finance Committee Secretary, introduced Assistant Secretaries Robin Paul and Rose Foley.

Co-Chair Stedman advised Committee members to direct questions about bill files and the flow of Committee material to the Finance Committee Secretarial staff.

Co-Chair Stedman next addressed Committee protocol. The intent of the Chairmen "is to run a fairly formal committee". The issues addressed by the Committee are of such "a serious matter that I prefer that all of the seated Senators have the ability to hear and listen to all of the information presented". Elected officials and other presenters should speak clearly into the microphones so that the minutes could be recorded accurately and

so listeners could hear the testimony. Acronyms should be avoided and "straight forward English" should be used.

Co-Chair Stedman, anticipating that a multitude of documentation would be addressed during Committee proceedings, advised against shuffling paper and other materials as the recording microphones were quite sensitive and the noise would be amplified. This could negatively affect the ability of listeners to hear the testimony.

Co-Chair Stedman also asked that cell-phones and other electronic devices be turned off during the meetings as they disrupt the process.

[9:19:00 AM](#)

Co-Chair Stedman urged Members to be prompt to meetings as they would begin on time and conclude prior to scheduled Senate floor sessions. Daily meetings would be expected as the Session progressed.

Co-Chair Stedman communicated his desire that, in consideration of time, presenters' testimony be provided uninterrupted. The desire was to provide ample time for questions, response, and follow-up. Members should direct their questions through the Chair.

Co-Chair Stedman also specified that topics generating substantial discussion would be set aside in order to allow Members to further address the issue with the concerned entity. The issue would then be brought back before the Committee. The same approach would be taken when an unanticipated issue arose, in the effort to keep the Committee process moving.

Co-Chair Stedman also asked Members to alert a department of any particular issue of concern prior to the hearing. This would promote better dialogue by allowing the departments to more adequately respond to an issue.

Co-Chair Stedman stated that while the goal was to conduct a formal hearing process, the tone should be relaxed.

[9:22:57 AM](#)

Co-Chair Stedman noted that, as a matter of routine, Members would receive a packet pertinent to each topic on the daily agenda. For instance, today's packet includes copies of the material that would be addressed by the Department of Revenue.

Co-Chair Stedman pointed out that, in an effort to improve the public's ability to observe Committee proceedings, a new projector screen had been installed in the Committee room for easier viewing of power point presentations and the like.

^Revenue Update, Department of Revenue

[9:24:14 AM](#)

Revenue Update
Department of Revenue

[9:24:42 AM](#)

PATRICK GALVIN, Commissioner, Department of Revenue, testified via teleconference from an offnet location and apologized that concurrent gas pipeline meetings prohibited him from attending in person. Department of Revenue staff in attendance would provide the bulk of the presentation.

[9:25:28 AM](#)

Commissioner Galvin specified that the Department is the primary agency involved in collecting State revenue. The Tax Division is responsible for the majority of that revenue, including the revenue generated by corporate income taxes and the Petroleum Profits Tax (PPT) tax on oil and gas production.

The Department also monitors taxes the State levies on fuel, fish, cigarettes and other commodities.

Commissioner Galvin stated that, in addition to monitoring taxes levied on fuel, fish, cigarette, and other commodities, the Department also houses the Child Support Services Division which is responsible for collecting child support payments, the Permanent Fund Dividend (PFD) Division which collects PFD applications and distributes the funds, and the Treasury Division, which serves in a variety of money management

functions except for those associated with the Alaska Permanent Fund. Gary Bader would be discussing some of the funds managed by the Treasury Division later in this hearing.

Commissioner Galvin also noted that the Treasury Division is responsible for managing the State's debt in respect to the Municipal Bond Bank and "other public financing portions of the State". The Division employs a Cash Manager "who is tasked with making sure the State has cash in hand to make our payments and to manage" the State's cash to achieve the best possible return and a Comptroller who is charged with ensuring that the State "is properly reporting and controlling the different aspects of the Treasury and the Department".

Commissioner Galvin stated that the Department's management team consists of Brian Andrews, Deputy Commissioner for Treasury; Jerry Burnett, Director, Administrative Services Division and Legislative Liaison; Marcia Davis, Deputy Commissioner for Tax and Gasline Issues; and John Iverson, Director, Tax Division/Anchorage.

[9:32:34 AM](#)

In consideration of time, Co-Chair Stedman asked Members to hold questions until the end of each presentation.

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State of Alaska Department of Revenue
Crude Oil Prices, State Revenue & the PPT
January 22, 2007

DR. MICHAEL D. WILLIAMS, Chief Economist, Department of Revenue, utilized a handout titled "Crude Oil Prices, State Revenue & the PPT" handout [copy on file] and testified as follows.

Good morning ladies and gentlemen, my name is Michael D. Williams and I am the Chief Economist for the Alaska Department of Revenue. Thank you for the introduction Commissioner Galvin. I would like to discuss two topics with you - crude oil prices and the Department of Revenue forecast. After I have reviewed these topics I will be happy to attempt to answer your questions.

[9:33:28 AM](#)

Page 1B

Agenda

- Crude Oil Prices
- State Revenue
- Petroleum Profits Tax

Page 2A

Crude Oil Prices

- Fall 2006 RSB Forecast
- Actual Prices
- Volatility
- Drivers
- Conclusions

Mr. Williams:

Let's begin with crude oil prices. Under this heading there are several topics I would like to cover and they include the following: The Department's official crude oil price forecast for FY 2007 as contained in the *Revenue Sources Book* 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; and, finally, I will close with some conclusions.

[9:33:52 AM](#)

Page 2B

ANS Crude Oil Prices
FY 2007 Forecast, Dollars per Barrel

[Chart comparing the forecasted prices to the actual price experienced per barrel of oil for the months of June 2006 through January 2007. The Department's forecast for February is \$55 per barrel and \$50 per barrel for March through May 2007.]

Dr. Williams:

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 begins in June is because oil prices and production in June are the basis for royalty and 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.

[9:34:53 AM](#)

Page 3A

Daily Crude Oil Prices

ANS, Dollars per Barrel, June 1, 2006 through January 18, 2007

[Line chart depicting an upward trend in daily crude oil prices in June, July, and August 2006, and a downward trend from August 2006 through January 2007.]

Dr. Williams:

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?

[9:35:37 AM](#)

Drivers

- Demand
- Supply
- Prices
- Geopolitical Events
- Financial Sector

Dr. Williams:

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. 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], down from 20.8 mbd in 2005, which was below the 2004 level". 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." The recent declines come at a time where there has been warm weather, so the demand for heating fuel has been reduced by weather.

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.

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 International Energy Agency (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.

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 higher 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.

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.

Another sector I want to discuss is the financial sector. When I speak of the financial sector I am talking about several different groups who participate in buying and selling crude oil derivatives. Producers and consumers: these folks use oil in their business, think of oil companies, petrochemical plants, refineries and airlines. They use hedging techniques to control their costs and revenue. Pure Financial Players: these folks do not use oil

in their business. Think of four categories of players: one: financial institutions; two: commodity trading advisors; three: the 530 hedge funds; and four: institutional investors. The institutional investors are the most recent entrants and they view commodities as an asset class. Investor products such as commodity indices provide an opportunity to diversify.

The various pure financial players have different goals and different impacts on the crude oil market. Most likely the financial sector does not determine the trend, but they amplify the trend - and they may be part of the reason prices rose so quickly, and recently declined sharply. I am not an expert in all the financial derivatives, but I am aware of the fact that the amount of money in the financial sector dwarf's that of the oil markets. So if the financial sector chooses to move into or out of crude oil, it can have dramatic impacts on prices.

[9:44:05 AM](#)

Conclusions

- Forecast Price Decline
- Prices Remain Volatile
 - Financial Sector Amplifies Trends
- Possible Price Support:
 - Cold Weather & OPEC

Dr. Williams:

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 percent 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, and they purchase derivatives, further bidding up the price. This is basically what happened in 2004 and 2005.

The year 2006 opened with people believing one: there was no price effect that would dampen oil demand and two: 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.

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.

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 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.

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.

[9:44:24 AM](#)

Page 4B

Revenue Projections

- Fall 2006 RSB
- Oil Revenues Dominate
- Variance Analysis

Dr. Williams:

Next, I want to turn to our fall forecast revenue projections. These can be found in the *Revenue Sources Book*. 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.

Dr. Williams noted that a copy of the Department's Fall Revenue Forecast Book [copy on file] was included in Members' packets.

[9:44:41 AM](#)

Page 5A

Oil Dependency

Fy2007 General Fund Unrestricted Revenue, Millions

Royalty-Net PF	1,503.9	30.6%
Production Tax	2,067.2	40.1%
Income Tax	657.2	13.4%
Property	51.7	1.1%
Bonus, Rent, etc	51.4	1.0%
<u>TOTAL OIL</u>	<u>4,331.5</u>	<u>88.2%</u>
Non-Oil	580.8	11.8%

TOT BUDGET 4,912.3 100.0%

Dr. Williams:

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 percent. 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 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.

[9:46:28 AM](#)

Page 5B

Variance in Key Factors

For FY 2007, Year-to-Date Changes From Fall Forecast

[Chart depicting an increase of approximately four percent in the price of Alaska North Slope (ANS) oil and a decrease of approximately two percent in production volume.]

Dr. Williams:

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.

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 percent 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 percent 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.

[9:47:35 AM](#)

Dr. Williams concluded speaking to the portion of the presentation pertaining to crude oil prices and State revenues.

[9:47:44 AM](#)

Page 6A

Petroleum Profits Tax

- "True-Up" Payment
- Regulations Status

Commissioner Galvin stated that his remarks would concentrate on updating the Committee on the status of the PPT regulations and the revenue the "true-up" payment would provide the State in a few months.

[9:48:24 AM](#)

Page 6B

PPT True-Up Payment

- Due End of March
- Estimate = \$0.95 billion
 - April, May = \$0.29 billion
 - June - December = \$0.66 billion

Commissioner Galvin addressed the PPT's "true-up" payment provision. While the PPT tax went into effect on April 1, 2006, the first PPT payment would not be due until April 1, 2007. The determination was that this timeframe would provide companies time to understand how the State would implement the PPT provisions, allow them to update internal systems, and estimate their payments under the PPT. Until then, companies would continue their monthly tax payments based upon the former severance tax structure referred to as the Economic Limit Factor (ELF). On April 1, 2007, companies would be required to true-up the difference between the tax paid under ELF and that required under the provisions of the PPT.

Commissioner Galvin clarified, however, that the PPT regulations would not be in place until after April 1, 2007. Thus, companies would be basing their true-up payment on "communications that's been going on in the development of the regulations to clarify some of the areas under the law that needed clarification and they can kind of get a sense of where we're going with it. They're going to do the best they can to see where the State expects them to go on the interpretation of aspects of it, and then they'll proceed with their returns and their payments. But, there'll subsequently be additional clarifications and additional adjustments that will be necessary as our regulations are finalized and the companies will have to respond to that".

[9:50:27 AM](#)

Commissioner Galvin anticipated that on April 1, 2007, the State would receive approximately 0.95 billion dollars of additional revenue based on companies' estimates of the PPT payments in excess of the ELF payments made to date.

[9:51:23 AM](#)

Page 7A

PPT Regulations Status

- Publicly Noticed Workshops Oct - Nov
- Draft Regulations Created
- Public Comments & Hearing: Dec. 13 - Jan. 17
- Issues Raised:
 - o Transfer of Exploration Credits

- o Clarification of Lease Expenditures
- o Overhead Rates (Too high - Too low)
- o Ring Fencing Losses
- o Information Reporting Requirements
- o Inclusion of Penalty Provisions

Page 7B

PPT Regulations Status

- Estimated Revision Time: Mid February
- Final Review
 - o DOR Director & Commissioner
 - o Department of Law
 - o Lieutenant Governor's Office
- Expected Implementation - April
- Second Regulation Project - Spring '07
(To include: Clarifying allowable lease expenditures and use of operating agreements)

Commissioner Galvin reiterated that the PPT regulation process would not be completed before April 1, 2007. The first regulations being addressed pertained to how companies would submit tax returns and other [unspecified] large PPT issues.

Commissioner Galvin stated that a second group of regulations would address specific details about allowable expenditures and how certain costs and operating agreements would be treated under the new tax system.

[9:52:15 AM](#)

Commissioner Galvin advised that the first set of regulations under consideration were being "developed with extensive work within the Department" as well as with the industry and other interested parties.

[9:52:42 AM](#)

Commissioner Galvin noted that the effort to date included discussion-based workshops. Draft regulations were issued in December and public hearings were held in December and January. A comment period deadline recently concluded.

[9:53:15 AM](#)

Commissioner Galvin noted that the Department would further evaluate the issues raised by the industry and Legislators, as depicted on page 7A.

Commissioner Galvin announced that the regulations would be reviewed by the Department of Law before being transmitted to the Lieutenant Governor's office.

9:55:15 AM

Commissioner Galvin anticipated the first set of regulations to be completed no earlier than late March. However, this was not considered "a realistic timeframe" as it would not allow sufficient time for them to be accommodated in industry returns. Efforts should be made to get "the regulations right the first time".

Commissioner Galvin noted that work on the second set of regulations is also being conducted. Those should be finalized by this spring.

9:56:30 AM

Co-Chair Stedman reminded the Committee of the extensive analyses that was conducted during the PPT deliberations when the tax was shifted from gross value to net value. He suggested that the Committee revisit the issue to ensure the analyses was correct; specifically as he recalled that the fiscal note at the time was estimated to be approximately \$400 million, not the currently stated \$290 million.

9:57:19 AM

Co-Chair Stedman requested information be provided which would allow for a comparison between the fiscal note and the "reality" of the collections for the months of April and May.

9:57:38 AM

Commissioner Galvin indicated the information would be provided as soon as it was available.

9:57:51 AM

Co-Chair Stedman also asked that the numbers reflect the aggregate impact of credits and deductions as he was interested in determining whether the 20 percent credit had the intended effect of encouraging investment. This consideration should be continually monitored.

Co-Chair Stedman suggested that the Committee further examine the Constitutional Budget Reserve (CBR) projections, the "net-back issue" relating to the Trans Alaska Pipeline System (TAPS), and changes in tariffs and forward projections reflected in the Revenue Sources Book.

[9:59:26 AM](#)

Co-Chair Stedman specified that the Committee would request additional detail on the analysis of the price and production modeling.

[10:00:04 AM](#)

Co-Chair Stedman was also interested in the spread of the West Texas Intermediate (WTI) oil price in comparison to the Alaska North Slope (ANS) price, taking into account market conditions that might affect those price differences.

[10:00:34 AM](#)

Co-Chair Stedman further noted that gas prices should be addressed, specifically the oil-to-gas price ratio, as he understood that ratio to be in flux.

[10:01:34 AM](#)

Co-Chair Stedman allowed that some of the detail requested may be delivered to the Senate Resources Committee, rather than the Senate Finance Committee.

[10:01:49 AM](#)

Senator Elton referred to the "Crude Oil Prices, State Revenue & the PPT" chart depicted on page 5B and surmised that oil revenues were dependent on both ANS price and production volume. He asked Dr. Williams if an analysis had been conducted to determine the monetary loss the State experienced due to the temporary cessation of production on the North Slope at a time

of extremely high oil prices, and if there was a way to recover the lost funds.

[10:03:03 AM](#)

Dr. Williams replied that an analysis had been conducted in October or November to determine the change in revenues resulting from the shut-down; however, no updates have been conducted since then. He considered the production volume "deferred" rather than lost, as the oil was still in the ground for later extraction.

[10:03:53 AM](#)

Senator Elton deduced from the revenue price projections that the price received for the deferred production would be less than it would have been at the time of the pipeline shut-down.

[10:04:17 AM](#)

Dr. Williams responded that he could not predict the price as the time of the production was an unknown element.

[10:04:36 AM](#)

Commissioner Galvin stated that the Department was currently examining the losses associated with the shut-down of the pipeline; however, providing an estimate of losses at this time would be "premature". The Department of Law is investigating avenues for recovering lost revenues. He added that the geological and engineering impacts of the shut-down have yet to be addressed.

[10:05:43 AM](#)

Co-Chair Stedman considered Senator Elton's question to pertain to the PPT tax collection. That issue would be further addressed at a later time.

[10:06:15 AM](#)

Co-Chair Hoffman pointed out that the Senate Finance Committee had been unaware that pipeline tariff increases were being considered, but now understood the increases would be approximately \$1.50 per barrel. He asked whether further

increases in the pipeline tariff are anticipated as a result of declining production.

[10:07:09 AM](#)

Commissioner Galvin was also concerned about the proposed increases. The tariff settlement agreement entered into by the State in the past is being reopened for discussion with the pipeline owners. He was "hopeful" that the deliberations would result in a more favorable tariff than in years past. However, it was premature to speculate on the rates.

[10:08:11 AM](#)

Co-Chair Stedman commented that the oil and gas tariff issue would be revisited with regards to the impact on both the industry and the State.

[10:08:21 AM](#)

Senator Thomas asked if the tax year and the fiscal year were the same.

[10:08:39 AM](#)

Dr. Williams affirmed, noting the time period was July 1 to June 30, but specified that June prices are used to project July revenues.

[10:08:58 AM](#)

Senator Thomas asked whether the costs associated with the corrosion removal and repair of the pipeline would be tax deductible.

[10:09:34 AM](#)

Commissioner Galvin replied that the companies were proceeding with the understanding that those costs would be deductible; however, there had been no definite resolution of the issue yet.

[10:10:16 AM](#)

Co-Chair Stedman clarified that the corrosion issue would be addressed later, as the Administration had the information and would present it to the Committee.

[10:10:43 AM](#)

Senator Huggins referred to the price projection of \$55 on page 2B, and asked when Dr. Williams anticipated prices to increase as a result of increased demand.

[10:11:24 AM](#)

Dr. Williams did not expect a recession and assumed that the strong global economy would produce more demand. He did not know exactly how high the price of oil would climb, but aligned himself with the Department's forecast.

[10:12:25 AM](#)

Senator Huggins, referencing Dr. Williams' comment regarding the California citrus crop, understood that the crop was valued in the "single digit" billions of dollars.

[10:12:49 AM](#)

Dr. Williams explained that the citrus crop example was offered as an illustration of a multi-commodity market. Investors choose to invest their funds in profitable markets. Orange juice funds were provided as an example of market changes and forces that might cause investors to modify their portfolios.

[10:14:01 AM](#)

In response to a question from Senator Huggins, Dr. Williams identified \$59.15 as the State revenue forecast's "break-even" price.

[10:14:22 AM](#)

Senator Dyson asked if that figure accounted for the income generated by the PPT tax.

[10:14:37 AM](#)

Dr. Williams affirmed.

[10:14:47 AM](#)

Commissioner Galvin clarified that the Department utilized the \$59.15 figure to estimate revenue for the fiscal year. A surplus would be experienced at this price.

[10:15:31 AM](#)

Co-Chair Stedman specified that that information was depicted on page 3 of the Revenue Sources Book.

[10:15:55 AM](#)

Senator Huggins stressed the importance of knowing the "break-even" price. He recalled that the previous year's figure had been slightly more than \$47. He assumed that the amount was higher in the current fiscal year.

[10:16:21 AM](#)

Co-Chair Stedman informed that the Committee would utilize the FY 07 break-even price volume until a FY 08 figure was determined.

[10:17:40 AM](#)

GARY BADER, Chief Investment Officer, Treasury, Department of Revenue, utilized a handout titled "Department of Revenue, Treasury, Investment Function" dated January 22, 2006 [copy on file], to overview the treasury investment function within the Department of Revenue.

[10:18:07 AM](#)

Page 2

Investments

- Treasury oversees \$24.9 billion.
 - Retirement (ARMB) funds (~\$15 billion).
 - Defined contribution funds (~\$2.5 billion).
 - Other state funds (~\$7.4 billion).
- Treasury manages the cash needs of the State and ARMB.

- Treasury manages the ARMB domestic fixed income assets (~\$2.7 billion).
- Treasury manages the ARMB real estate investment trust assets (~\$125 million).
- Treasury also manages three fixed income investment options for the Alaska Student Loan Corporation (~\$95 million).
 - Two intermediate bond portfolios.
 - One managed against the Lehman Aggregate Index, less BBB securities.

Mr. Bader overviewed the information, defining ARMB as the Alaska Retirement Management Board.

[10:20:07 AM](#)

Page 3

Internally Managed Portfolio Returns

[Table listing the following:

Fund: AY70

Fund Name: Short-Term Fixed Income - 91 day T-bill

Market Value: \$2,582,831,472.06

1 Year: 4.95

(4.50)

2 Year: 3.91

(3.56)

3 Year: 3.04

(2.73)

5 Year: 2.57

(2.30)

Fund: AY72

Fund Name: Intermediate Term Fixed Income ML 1-5 YR Gov

Market Value: \$3,194,628,112.17

1 Year: 4.09

(3.70)

2 Year: 2.82

(2.29)

3 Year: 2.53

(2.00)
5 Year: 3.43
(3.18)

Fund: AY73
Fund Name: Broad Mkt Fixed Income LB Aggregate
Market Value: \$1,077,207,815.11
1 Year: 4.13
(3.67)
2 Year: 3.70
(3.23)
3 Year: 3.89
(3.38)
5 Year: 5.08
(4.81)

Fund: AY77
Fund Name: ARM Board Fixed Income LB Aggregate
Market Value: \$2,682,706,242.20
1 Year: 4.28
(3.67)
2 Year: 3.84
(3.23)
3 Year: 3.93
(3.38)
5 Year: 5.08
(4.81)

Fund: AYT1
Fund Name: Origination Fee LB Aggregate A+
Market Value: \$20,906,018.33
1 Year: 3.91
(3.70)
2 Year: 3.51
(3.25)

Fund: AYT2
Fund Name: Surplus ML 1-5 Yr Gov
Market Value: \$75,153,975.56
1 Year: 3.70
(3.70)
2 Year: 2.44
(2.29)

Fund: AYT3

Fund Name: Borrower Benefits ML 1-5 Yr Gov
Market Value: \$2,716,898.60
1 Year: 3.80
 (3.70)
2 Year: 2.52
 (2.29)

Source: State Street]

Mr. Bader told that the first numbers listed for each year of a Fund represent the fund's actual returns. The second set of numbers, which are in parentheses, represent the benchmark for each fund. The comparison of the two indicates the success of the investments. Mr. Bader noted that all of the funds listed "outperformed" the bench marks. According to Callan Associates International (CAI), the AY77 ARMB fund ranked in the top 14 percent of public pension funds for the year ending September 30. This was a "vast improvement" over the FY 01 ranking which was in the top 65 percent.

[10:22:44 AM](#)

Page 4

Non-Retirement Investment Returns - Annualized
As of September 30, 2006

[Table listing the funds managed by the division, their market value, and rates of return for 1 year, 3 years and 5 years. The following funds are highlighted:

Fund Name: General Investment Fund
Market Value: \$3,044,124,592
1 Year: 4.48%
3 Years: 2.85%
5 Years: 3.09%

Fund Name: Constitutional Budget Reserve
Market Value: \$1,898,870,859
1 Year: 4.51%
3 Years: 2.98%
5 Years: 3.80%

Fund Name: Permanent Fund Div Hldg
Market Value: \$702,604,132

1 Year: 4.94%
3 Years: 2.97%

Fund Name: CBRF Subaccount
Market Value: \$512,371,173
1 Year: 9.26%
3 Years: 10.46%
5 Years: 8.02%]

Mr. Bader noted that the Alaska Permanent Fund transfers money to the Division of Treasury after determining the earnings available for distribution. Those funds are invested until they are distributed through the Permanent Fund Dividend in October.

[10:23:47 AM](#)

Mr. Bader noted that the Constitutional Budget Reserve Fund (CBRF) Subaccount was developed for long-term investments of five years or more. The larger rate of return to this account is due to the investment horizon and the ability to invest more aggressively.

[10:24:41 AM](#)

Page 5

Retirement Fund Returns

[10:24:47 AM](#)

Page 6

September 30, 2006
One Year Cumulative Attribution Effects

[Table listing the following:

Asset Class: Domestic Equity
Effective Weight: 38%
Avg Trgt Weight: 36%
Actual Return: 9.71%
Target Return: 10.74%
Manager Effect: (0.39%)
Asset Allocation: (0.00%)

Asset Class: Domestic Fixed-Income
Effective Weight: 21%
Avg Trgt Weight: 23%
Actual Return: 4.31%
Target Return: 3.67%
Manager Effect: 0.14%
Asset Allocation: 0.19%

Asset Class: High Yield
Effective Weight: 2%
Avg Trgt Weight: 2%
Actual Return: 7.02%
Target Return: 7.90%
Manager Effect: (0.02%)
Asset Allocation: 0.01%

Asset Class: Real Estate
Effective Weight: 10%
Avg Trgt Weight: 9%
Actual Return: 18.31%
Target Return: 18.46%
Manager Effect: (0.01%)
Asset Allocation: 0.05%

Asset Class: International Equity
Effective Weight: 17%
Avg Trgt Weight: 15%
Actual Return: 20.75%
Target Return: 19.32%
Manager Effect: 0.26%
Asset Allocation: 0.24%

Asset Class: Int'l Fixed-Income
Effective Weight: 3%
Avg Trgt Weight: 2%
Actual Return: 1.62%
Target Return: 2.02%
Manager Effect: (0.02%)
Asset Allocation: (0.12%)

Asset Class: Private Equity
Effective Weight: 5%
Avg Trgt Weight: 6%
Actual Return: 18.44%
Target Return: 13.36%

Manager Effect: 0.26%
Asset Allocation: (0.02%)

Asset Class: Absolute Return
Effective Weight: 3%
Avg Trgt Weight: 3%
Actual Return: 7.65%
Target Return: 8.91%
Manager Effect: (0.03%)
Asset Allocation: 0.03%

Asset Class: Other
Effective Weight: 1%
Avg Trgt Weight: 3%
Actual Return: 12.30%
Target Return: 6.75%
Manager Effect: 0.04%
Asset Allocation: 0.13%

Total: 11.46% = 10.71% + 0.22% + 0.51%

A notation reads as follows: Current Quarter Target = 30.0% S&P 500, 20.0% L/B Agg, 14.0% MSCI EAFE Index, 9.0% NCREIF Total Index, 6.0% Russell 2000, 2.0% ML Hi Yld Cash Pay Index, 2.0% Citi Non-US Gvt Bd Idx 2.0% MSCI Emer Markets and 1.0% NAREIT Equity Index.]

Mr. Bader summarized the table and noted that the fund earned 11.46 percent for the year ending September 30, 2006 as the result of a positive manager and positive asset allocation effect.

[10:26:28 AM](#)

Page 7

September 30, 2006
CAI Public Sponsor Database

[Bar graph depicting return percentages of Last Year, Last 2 Years, Last 3 Years, Last 5 Years and Last 7 Years of the CIA Public Fund Sponsor Database and the Total Fund.]

Mr. Bader commented that the Division's fund was in the top eight percent of public pension funds during the "Last Year"

investment period. He noted "significant improvement" over the past seven years, when the fund was in the 67th percentile.

[10:27:34 AM](#)

Page 8

Pension Funds

Cumulative Returns Actual vs Target.

[Line graph depicting the Cumulative Returns for the Total Fund, the Total Fund Target, and the Actuarial Expected Return for the years of 1991 to 2006.]

Mr. Bader informed that the Total Fund relates to the Public Employee's Retirement System (PERS) and the Teachers' Retirement System (TRS). While the two retirement funds are managed the same, they have slightly different rates of returns due to differing contributions. For the past 15 years, the funds have had an average return of 9.01 percent, outperforming the actuarial assumption.

[10:29:00 AM](#)

Co-Chair Stedman anticipated the Committee would spend a substantial amount of time examining the State's retirement systems.

Co-Chair Stedman warned Committee members to discern whether numerical references were referring to gross or net amounts. He would ask the Treasury to provide additional clarifying information about their rates of return.

Co-Chair Stedman alleged that different liability charts "don't match up," as he had identified a discrepancy of \$8 to \$10 billion.

[10:30:37 AM](#)

Senator Elton, referencing the investment overview on page 2 of the Treasury handout, asked which category included the State's Supplemental Benefits System (SBS) funds.

[10:31:05 AM](#)

Mr. Bader replied that SBS was included in the "Defined contribution" category. It currently amounts to approximately two billion dollars.

[10:31:20 AM](#)

Senator Elton inquired as to who sets the benchmarks.

[10:31:32 AM](#)

Mr. Bader responded that the benchmarks are set by the Commissioner of the Department of Revenue each year before July first and are typically based on other commonly accepted financial benchmarks.

[10:32:21 AM](#)

Co-Chair Stedman interjected to note that the Committee would further address the retirement system's administration and function. The retirement board is managed somewhat differently than other fields under the Division of Treasury.

[10:33:03 AM](#)

Senator Elton continued, asking if the benchmarks on page 3 of the handout were "industry standard" for similar portfolios.

[10:33:27 AM](#)

Mr. Bader affirmed, noting that the State of Alaska is slightly different than a money market fund in that the State allows one additional month for investment than a money market fund.

[10:34:10 AM](#)

Co-Chair Stedman commented that the Permanent Fund Board, the ARMB, and the Treasury Division would discuss the establishment and function of benchmarks in more detail at a later date.

[10:34:32 AM](#)

Senator Huggins asked the function of the public school trust fund.

[10:34:46 AM](#)

Mr. Bader informed that the account was established many years ago and is used as a revenue source for the foundation funding formula for public schools.

[10:35:09 AM](#)

Co-Chair Stedman added that the fund is "fed" every year. Additional information, including a "tax book", was available to Members for review in conjunction with the Revenue Source Book.

[10:35:40 AM](#)

Senator Thomas assumed diversification and revenue anticipation would be reviewed in a subsequent Committee meeting.

[10:36:07 AM](#)

Co-Chair Stedman affirmed.

[10:36:39 AM](#)

Co-Chair Hoffman noted that the Power Cost Equalization (PCE) endowment fund was listed at \$180 million and asked when the appropriation made to the fund the previous year would be reflected in the fund balance.

[10:37:07 AM](#)

Mr. Bader was unsure, but would research the question.

[10:37:29 AM](#)

Co-Chair Stedman asked that Mr. Bader provide an estimate on the "payout rate" of the trust and explain the management of those assets.

#

ADJOURNMENT

Co-Chair Bert Stedman adjourned the meeting at [10:39:01 AM](#).