

HOUSE FINANCE COMMITTEE  
February 18, 2011  
1:36 p.m.

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CALL TO ORDER

Co-Chair Thomas called the House Finance Committee meeting to order at 1:36 p.m.

MEMBERS PRESENT

Representative Bill Stoltze, Co-Chair  
Representative Bill Thomas Jr., Co-Chair  
Representative Anna Fairclough, Vice-Chair  
Representative Mia Costello  
Representative Mike Doogan  
Representative Bryce Edgmon  
Representative Les Gara  
Representative David Guttenberg  
Representative Reggie Joule  
Representative Mark Neuman  
Representative Tammie Wilson

MEMBERS ABSENT

None

ALSO PRESENT

Bryan Butcher, Commissioner, Department of Revenue; Jerry Burnett, Deputy Commissioner, Treasury Division, Department of Revenue; Bruce Tangeman, Deputy Commissioner, Tax Division, Department of Revenue; Representative John Coghill.

PRESENT VIA TELECONFERENCE

Cheryl Nienhuis, Petroleum Economist, Tax Division, Department of Revenue; Frank Molli, Petroleum Engineer and President, Molli Computer Services, Inc.

SUMMARY

Revenue Forecast and Savings Accounts

^REVENUE FORECAST AND SAVINGS ACCOUNTS

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BRYAN BUTCHER, COMMISSIONER, DEPARTMENT OF REVENUE (DOR), introduced department staff and provided an outline of the presentation topics. He began on slide 4 ("Revenue Classification Changes") of a PowerPoint presentation titled "Overview of Fall 2010 Revenue Forecast." He discussed that previously there had been two categories of revenue: unrestricted and restricted. Changes had been made to increase the number of revenue categories to four, which included unrestricted general fund, designated general fund, other restricted, and federal revenue (the latter three categories previously fell within the restricted group). He explained that the change was reflected in the department's Revenue Source Book. He delineated that in addition to historical data and forecast information, each year the source book had a special focus; the 2010 focus was on tax credits.

Commissioner Butcher pointed to estimates of total revenue on slide 5: "FY 11 and FY 12 Total Revenue." He discussed the "unrestricted general fund" category: the oil revenue estimate was \$4.6 billion for FY 11 and slightly over \$5 billion for FY 12; other sources were slightly under \$500 million for FY 11 and FY 12; investment revenue was estimated at approximately \$200 million and above for FY 11 and FY 12. "Designated general funds" were estimated at \$281 million for FY 11 and \$282 million for FY 12. Under the category of "other restricted revenue," oil revenue was slightly under \$700 million for FY 11 and \$755 million for FY 12. He noted that federal receipts were slightly over \$3 billion for FY 11 and approximately \$100 million less in FY 12; these funds were the most restricted because the state was required to use them for specific purposes.

Representative Wilson had heard multiple times that oil revenue would drop; she wondered why projections showed that it would continue to increase.

Commissioner Butcher responded that oil production had been on the decline; however, the price of oil had been increasing. The department expected a slight growth in revenue due to the increase in oil price.

Representative Wilson asked whether DOR anticipated that the price of oil would increase by at least 6 percent in the upcoming year. Commissioner Butcher responded in the affirmative. He added that there was additional price and production forecast detail later in the presentation.

Representative Gara asked for a definition of restricted oil revenue. He pointed to the restricted revenue in the amount of \$669 million for FY 11 and \$755 million for FY 12 and wondered whether funds were classified as restricted because they were related to capital credits that the state owed.

Commissioner Butcher responded that restricted category included revenue that went into the Alaska Permanent Fund and the Constitutional Budget Reserve (CBR).

Representative Gara wondered whether capital credits fell into the restricted category because they related to money the state owed to others. Commissioner Butcher answered that capital credits were classified as money going out; whereas, the current slide pertained to revenue that was coming in (slide 5).

Representative Guttenberg asked whether the FY 11 restricted oil revenue in the amount of \$19.5 million represented 10 percent of the 90 percent/10 percent split. He referred to the commissioner's comment that the funds were the most restricted because the federal government required the state to use them for specific items.

Commissioner Butcher replied that the funding was coming in from National Petroleum Reserve-Alaska (NPRA).

Representative Guttenberg wondered why the funds were restricted. Commissioner Butcher clarified that his comment about the most restrictive revenue had been related specifically to federal receipts.

Commissioner Butcher discussed a breakdown of unrestricted revenue on slide 6: "FY 11 and FY 12 General Fund Unrestricted Revenue." The department expected that

approximately 50 percent of the unrestricted revenue would come from the oil production tax or ACES [Alaska's Clear and Equitable Share]. He explained that slightly over 25 percent came from royalty revenue, slightly under 10 percent came from corporate income tax, and less than 2 percent was generated from property tax. Non-oil revenue totaled slightly under \$700 million.

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Representative Doogan asked for details regarding the \$3.3 billion FY 11 investment revenue listed on slide 5. Commissioner Butcher answered that the majority of the investment revenue was from the Alaska Permanent Fund Corporation (APFC).

Representative Doogan wondered whether the term "majority" meant 80 percent or other in the specific case.

JERRY BURNETT, DEPUTY COMMISSIONER, TREASURY DIVISION, DEPARTMENT OF REVENUE, answered that the APFC portion was approximately \$2.5 billion; the remaining \$842 million came from the CBR. He noted that to-date both areas had earned significantly more than the figures listed in the presentation.

Commissioner Butcher directed attention to slide 7: "FY 11 and FY 12 Unrestricted Non-Oil Revenue Detail." The slide included the top five largest taxes including: (1) corporate income tax of approximately \$80 million; (2) mining tax of slightly under \$50 million; (3) insurance premiums at slightly over \$50 million; (4) tobacco tax of \$44 million; and, (5) motor fuel tax of slightly under \$40 million. He explained that "investments" and "other" (charges for services, fines, forfeitures, licenses, permit, rents, ect.) totaled approximately \$159 million.

Representative Gara asked for verification that a corporation was only required to pay non-oil corporate income tax if it was registered as a C corporation. Commissioner Butcher responded in the affirmative.

Representative Gara queried the logic behind the requirement. Mr. Burnett answered that the individual owners of an S corporation were taxed on their individual income and were not taxed on corporate income at the federal level. The State of Alaska did not have an

individual income tax or a business tax; therefore, the statute would have to be modified in order to include S Corporations.

Representative Gara believed the issue reflected a loophole in state law. He surmised that a savvy company could register as an S Corporation to avoid corporate tax and unlike other states, Alaska did not have an income tax; therefore, the companies would avoid income tax as well.

Mr. Burnett responded that currently LLCs, partnerships, and S Corporations did not pay corporate income tax in Alaska.

Representative Gara asked whether the corporations would be exempt from the corporate income tax regardless of the level of profits they brought in.

Mr. Burnett responded in the affirmative and likened it to the state's absence of individual income tax.

Commissioner Butcher addressed slide 9 titled "10-Year Revenue and Spending," that combined general fund expenses with oil income and other for the next 10 years. He detailed that a 3 percent budget escalation had been factored into the data. He noted that the slide had been submitted to DOR by the Office of Management and Budget (OMB); therefore, departmental input on future spending was not included. The chart forecasted that the total amount of reserves could potentially increase up to \$27 billion through FY 20, given an annual 3 percent budget escalation.

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Co-Chair Thomas asked whether the chart on slide 9 reflected the current ACES tax system. Commissioner Butcher responded in the affirmative.

Representative Gara wondered how confident he should feel about the projections of budget surpluses in future years. He believed there were a couple of problems with the chart on slide 9. He detailed that the governor's FY 12 budget showed a deficit of approximately \$150 million (not including the possibility of a change to Medicaid that would result in higher cost to the state); however, the chart indicated it was in a surplus.

Commissioner Butcher responded that he would need to follow up on the question. He opined that OMB had intended the chart to provide a snapshot for the future based on relatively constant spending (including an annual 3 percent inflation) combined with the production and oil price estimates.

Representative Gara remarked that the legislature had been told there was a FY 12 budget deficit of \$150 million. He believed there would be an additional \$1.2 billion cost to the state if the governor's oil tax bill [HB 110] passed. He was concerned that the combination of the two would mean a potential \$1.4 billion deficit for the state in FY 12.

Commissioner Butcher responded that the governor's oil tax legislation would not take effect until 2013 if it passed and would not impact FY 12.

Representative Doogan believed that beginning in 2013 the total givebacks from the governor's oil tax bill would be closer to \$1.5 billion or \$1.6 billion. He wondered why the chart on slide 9 did not include capital expenses. Commissioner Butcher thought that OMB had grouped capital expenses in with the revenue and spending figures; however, OMB could provide more detail.

Representative Doogan replied that he would follow up with OMB, given that the chart did not appear to have capital expenses included.

Representative Wilson wondered whether the commissioner could recall a time when the budget had only grown by 3 percent from one year to the next. Commissioner Butcher believed there were some years in the late 1990s and early 2000s when the budget grew by 3 percent. He remembered that the 3 percent growth had occurred, but he did not remember an exact time period.

Representative Wilson requested that OMB update slide 9 with a revised budget growth figure. She added that the chart reflected a ten-year period and believed the committee should not have to go back more than ten years to find an occurrence of the 3 percent growth that OMB had used.

Representative Edgmon believed that slide 9 conveyed the wrong picture if the purpose was to provide a projected snapshot of state revenue and spending.

Commissioner Butcher understood but could not speak specifically to the intent behind the slide. He added that the use of a 6 percent to 7 percent annual budget increase would look different; however, the chart would still show a substantial projected surplus in later years based on the price of oil.

Representative Edgmon emphasized that the 3 percent annual increase did not mirror current growth, which was closer to 10 percent per year.

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Representative Gara wondered what would make the budget surplus grow in future years. He remarked that he would love to see the surplus grow; however, he did not understand how a potential deficit in FY 12 of \$150 million combined with a decrease in oil production and a slight increase in oil price would make that possible. Additionally, he asked whether there was an assumption that Congress would modify the Medicaid law, which it had not done.

Commissioner Butcher replied that the question should be directed to John Boucher at OMB.

Representative Doogan communicated that the slide had been presented to the committee by DOR and was misleading. He only wanted to see the slide again in the future if there was support for the information that it contained.

Co-Chair Thomas noted that he was interested in the projections that had been used for the price of oil in slide 9. He thought that OMB could potentially have more current numbers that reflected an increase in oil prices and would modify the FY 12 budget.

Commissioner Butcher replied that there would be a discussion about FY 11, FY 12, and FY 13 later in the presentation. He added that the DOR Revenue Sources Book provided more detail as well.

Commissioner Butcher moved on to slide 11: "FY 10 Production Tax Calculation." He explained that the average cost per barrel of oil in FY 10 was \$74.90, which was multiplied by 643,515 barrels to equal the value per day. The number of total taxable barrels was calculated by subtracting the 31,067,340 royalty and federal barrels from the annual North Slope production of 234,883,705, which equaled the total taxable barrels of 203.8 million. The downstream transportation costs of approximately \$6.00 per barrel, the deductible operating lease expenditures of approximately \$10.64 per barrel, and the deductible capital lease expenditures of \$8.55 per barrel were then subtracted from the total value per barrel and equaled \$49.69. The total transportation costs and total lease expenditures were each multiplied by the 203.8 million barrels per year and subtracted from the total value, which equaled a production tax value (PTV) of just under \$4 billion. The PTV of \$49.69 was multiplied by the 203.8 million barrels and equaled \$10,128,100 billion, which represented the total taxed by the state. It was necessary to multiply the tax base of 25 percent by the PTV and to add it to the progressive tax rate (which began at \$30 per barrel and had a 0.4 percent increase for every dollar up to \$49.69) of 7.9 percent to reach the total tax due before credits of \$3.329 billion. The total tax due and the credits of \$350 million were then subtracted and equaled the total FY 10 production tax of \$2,979,800. He added that the calculation had been simplified somewhat for the presentation and would not match the Revenue Source Book precisely.

Commissioner Butcher pointed to slide 12: "FY 11 Production Tax Projected." He highlighted that the price per barrel was projected to be approximately \$3.00 higher per barrel than in FY 10. The production was approximately 30,000 barrels less than in FY 10. The total production revenue was projected to be down almost \$400 million from FY 10. He added that the calculations were based on the department's fall 2010 forecast in the Revenue Sources Book; there would be an updated spring forecast issued in late March 2011 that would provide a more accurate view to date, an estimate of the end of FY 11, and updated FY 12 numbers.

Representative Wilson wondered whether the total would be \$79.39 per barrel in FY 11 if there was a gain of 6 percent that had been discussed on slide 9. Commissioner Butcher replied that the department could provide a very specific breakdown.

Representative Wilson thought that there had been earlier testimony that a 6 percent gain was needed to counter the 6 percent drop in production. She noted that slides 11 and 12 did not reflect a gain of 6 percent.

Commissioner Butcher answered that the total taxes that would come in during FY 11 were not limited to the production tax, which represented slightly below 50 percent of what the state brought in.

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Commissioner Butcher directed attention to slide 13: "FY 12 Production Tax Projected." He reiterated that the figures on the slide came from the DOR fall 2010 forecast. The price per barrel of \$82.67 was almost \$5 more than the price in FY 11. The number of barrels was projected at a slight increase of 7,000 barrels over FY 11; however, the fall forecast had assumed that the Liberty oil field would begin operation in FY 12, which was not the case; therefore, the numbers would be revised in the spring forecast.

Representative Gara pointed to \$450 million in credits applied against taxes that were listed at the bottom of slide 13. He wondered whether an additional \$400 million in credits that the state reimbursed to companies who did not pay taxes was included in the calculation.

CHERYL NIENHUIS, PETROLEUM ECONOMIST, TAX DIVISION, DEPARTMENT OF REVENUE (via teleconference), responded that the tax credits, which would be refunded for FY 12, were not reflected in slide 13. She explained that the credits paid through refunds were appropriated by the legislature; therefore, they were not included in the incoming revenue tax calculation.

Representative Gara asked whether the total tax after credits on the bottom line of slide 13 should be closer to \$2.3 billion instead of \$2.754 billion.

Ms. Nienhuis answered that the state would take in the total production tax revenue listed on slide 13, but the appropriation for the credits would be a different amount. She believed the number was close to \$400 million for FY 12.

Representative Gara asked whether the total FY 12 tax after credits would be less than \$2.7 billion, given that slide 13 reflected \$450 million in credits funded to companies that paid tax, but did not reflect \$400 million in credits paid to companies that did not pay tax.

Ms. Nienhuis replied that the state would see revenues of approximately \$2.7 billion, but there would be an appropriation made by the legislature for the refundable credits.

BRUCE TANGEMAN, DEPUTY COMMISSIONER, TAX DIVISION, DEPARTMENT OF REVENUE, added that the actual credit calculation applied against the tax liability would appear under the deductible operating and capital expenditures. He explained that the appropriation would be to cover the \$450 million in credits. He detailed that there were two different types of credits: (1) credits that were applied against the tax liability, which would appear under the operating and capital expenditure reduction; and, (2) capital credits that were paid out to those without a tax liability, which were the \$450 shown on slide 13.

Representative Gara asked for clarification that the additional credits were included under the lease expenditures category; therefore, the \$2.7 billion figure was accurate on slide 13.

Mr. Tangeman responded in the affirmative.

Commissioner Butcher discussed that the components of the production tax calculation included production, price, lease expenditures, and tax credits (slide 14).

Representative Edgmon wondered why the marine transportation costs had decreased in FY 10 through FY 12, but the TAPS Tariff had steadily increased during the same period (slide 13).

Commissioner Butcher replied that as oil production declined the tariff increased because there were fewer barrels traveling through the pipeline.

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Commissioner Butcher addressed slides 16 through 17 titled "Three Categories of Forecasted Production:" (1) Currently Producing fields included base production and enhanced recovery production from investment that was currently occurring. He noted that numbers in the category provided more certainty in a forecast, given that they reflected currently producing wells; (2) Currently Under Development fields included new projects that were currently funded or were awaiting project sanction in the near future (e.g. Nakiachuk, which had been under development and had begun producing a couple of weeks earlier). He relayed that there was less certainty with the numbers, but the department felt comfortable with them; and, (3) the Currently Under Evaluation category was the most speculative of the three and included technically viable projects under active evaluation for engineering, cost, and risk and reward. The projects were currently unfunded but were under serious consideration by producers. The numbers were provided to give the state an idea of what the out-years would look like.

Commissioner Butcher highlighted the "Factors that Affect Production Forecasting" on slide 18:

1. Geology
  - Rock type and formation characteristics
  - Depth, thickness, pressure
  - Oil and gas characteristics (oil gravity, viscosity, water content, etc.)
2. Development Plan
  - Well density and development rate
  - Well bore size and completion technique
  - Artificial lift and enhanced oil recovery
  - Facilities and surface operations
3. Commercial
  - Project economics
  - Oil price and market conditions
  - Government Policy: access, regulation, taxation
4. Production Profile
  - History, stage of depletion
  - Use production profile to extrapolate trends

## 5. Timing

Commissioner Butcher elaborated that the Liberty oil field provided a good example of timing (factor 5). The process involved discussions with producers to determine when the field would come online and the understanding that items may arise that could alter how the department looked at its next forecast.

Commissioner Butcher pointed to slide 19: "North Slope Production Decline." The production peak had occurred in FY 88 with slightly over 2 million barrels per day. Production had dropped approximately 68 percent since its peak and was at 644,000 barrels per day in FY 10. The decline had been an average of 5 percent per year since FY 88. He relayed that over the prior 10 years the production decline rate had been approximately 4.2 percent per year. The department expected the decline to flatten out at about 3.2 percent per year through FY 30.

Vice-chair Fairclough asked for detail regarding the 7 percent decline between FY 09 and FY 10 that was shown in the DOR forecast book.

Commissioner Butcher replied that the numbers in the presentation represented an average decline by year. He thought that production forecaster Frank Molli would be able to provide information regarding the difference between the forecast versus the actual decline from FY 09 to FY 10.

FRANK MOLLI, PETROLEUM ENGINEER AND PRESIDENT, MOLLI COMPUTER SERVICES, INC. (via teleconference), answered that new development such as Oooguruk, was the largest contributor to the decreasing of the decline. Continued development on the Alpine, Kuparuk, and Prudhoe oil fields had also contributed to the reduction in the decline.

Vice-chair Fairclough noted that the revenue forecast also included a 1 percent production increase; however, it had been determined that the number was not accurate. She believed the revenue production forecast was more optimistic than it should have been. She wondered whether the forecasted decline would be 4.3 percent or closer to 6 percent, given that Liberty had not come online.

Mr. Molli replied that he did not know what the exact decline rate would be. The startup of Liberty would need to be pushed further out into the future, which would reduce the forecast for FY 11 and FY 12. He noted that the spring forecast would be calculated soon.

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Representative Costello referenced a DOR graph that showed the forecast from 2001 to 2010. She wondered whether DOR had reassessed how it determined the production forecast, given that the numbers seemed to be overly optimistic over the ten-year period.

Commissioner Butcher agreed. He had communicated to the department his goal towards objectivity and accuracy. He believed the forecast had become more aligned when Mr. Molli became the forecaster two years earlier. He explained that actual production tended to be lower than projections for a couple of reasons: (1) unscheduled pipeline shutdowns could not be factored into the projection. He referenced two unexpected pipeline shutdowns that had occurred the prior month; and, (2) projects were never completed earlier than expected; they either began on time or later than anticipated.

Representative Costello asked whether the committee should assume a less optimistic outcome based on the ten-year track record.

Commissioner Butcher replied that the department developed its estimates based on information that came from producers. He believed that she was right to be slightly pessimistic about the forecast; however, the department tried to develop a good estimate without being overly optimistic about the operation start dates of future projects.

Vice-chair Fairclough conveyed that she would like to see the same conservative approach in the department's ten-year operating budget growth projections. She believed the 3 percent budget growth used on slide 9 was not helpful in relaying to Alaskans how important it was to keep budget growth down, given that actual growth was between 7 percent and 10 percent or more.

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Representative Joule recalled that the production decline had been predominately at 6 percent for a number of years. He asked for verification that the department looked at historical data to determine what the actual decline had been. Commissioner Butcher responded in the affirmative.

Representative Joule wondered whether the decline had been close to 6 percent. He assumed the meters were correct, given that they were used to tax people to generate revenue. He felt that the average decline over the past ten years of 4.2 percent (shown on slide 19) was 2 percent lower than what Alaskans had been led to believe.

Commissioner Butcher answered that he was limited to the current information. He explained that the information was based on historical data and on the fall 2010 revenue book. He hoped to be as specific as possible going forward and referenced upcoming slides that would show the historical decline and the three categories of production (from least to most speculative).

Representative Doogan observed that over the past 30 or so years the revenue projections had always matched the budget plan of the governor at the time. He hoped the trend could be broken, but understood that there were political considerations. He had learned approximately 30 years earlier to not give much credence to the projections as they never seemed to turn out they way they were portrayed. He hoped that the commissioner would try to cure his skepticism.

Commissioner Butcher responded that he shared some of the same concerns. He would provide more detail on things that had been done in the past several years to effect change, such as involving the legislature and others. The process in the past had not been open for participation, which had changed in recent years.

Vice-chair Fairclough wondered whether there were storage tanks available on the North Slope. She asked whether oil could have been diverted into storage tanks during a shutdown and routed through the pipeline once it was fixed. She thought that with storage tanks there would be less production lost when a line was shut down, given that the use of tanks would enable production to continue to flow.

Commissioner Butcher replied that there was a limited storage capacity. He would determine the amount that had been stored during the January shutdown and would get back to the committee.

Vice-chair Fairclough referred to recent headlines indicating that revenue had been lost during the shutdown. She found it hard to believe that a producer would stop production if they had storage capacity to pump the oil into, which could prevent the state from losing revenue.

Commissioner Butcher replied that it had been unknown how long the shutdown would last and that production was curbed or stopped completely. He thought that the shutdown would have lasted longer, but because it had occurred during the cold winter, the pipeline needed to be restarted as quickly as possible.

Representative Wilson wondered whether the department could provide an average decline for each year over the past 20 years.

Commissioner Butcher answered in the affirmative. He relayed that the department would provide the graph if the information did not appear in the source book.

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Representative Wilson remarked that there were years within the past ten-year period where production had increased, which may have caused the average decline to appear lower than it had been in more recent years.

Commissioner Butcher replied that he would get the information to the committee. He did not recall whether the decline had shifted from 6 percent to 5 percent and what the cause had been.

Mr. Tangeman communicated that page 98 of the Revenue Source Book showed a history by field for the past ten years and page 99 showed the forecast for the next ten years.

Representative Edgmon asked whether the factors affecting production forecasting on slide 18 were listed statutorily.

Commissioner Butcher responded that the factors had been compiled by Mr. Molli and represented a general view of items that were weighed during the development of the production forecast.

Representative Joule wondered how long it took DOR to decipher the geology information (slide 18) once it had been received from the oil industry. He remembered that the information had required translation in the past.

Commissioner Butcher confirmed that the geology information did come from producers. He asked Mr. Molli to elaborate.

Mr. Molli replied that the geology information was accessible to the public and was generally used to determine the original oil that was in place prior to production. He did not know how far in advance the information was made public. He added that the department did rely on the information from operators and the Alaska Oil and Gas Conservation Commission (AOGCC).

Representative Guttenberg discussed how important it was for the legislature, DOR, and the Department of Natural Resources (DNR) to understand the factors that affected production forecasting (slide 18). He referenced the various decline rates on slide 19. He wondered whether the department had reevaluated prior forecasts with known factors that affected production forecasting to determine whether the original timeline was accurate.

Commissioner Butcher would find out whether there was time and the ability to uncover the details that had gone into prior forecasts to determine whether there was a flaw in previous work. He explained that because Mr. Molli had only done the forecasts for the past couple of years, he did not have complete transparency regarding factors used in earlier calculations.

Co-Chair Thomas referred back to slide 9 that OMB had added to the DOR presentation. He was concerned that the public would look at the 3 percent projected budget growth on the slide and would then blame the legislature if the growth ended up much higher. He hoped people would realize that the number was not firm and would shift as supplemental increases or budget amendments from the governor were added. He believed the current budget increase had started at 4.8 percent before any other additions were made.

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Commissioner Butcher surmised that OMB had used an inflation factor to estimate a percentage it could use over a 10 to 20 year period instead of trying to estimate where the budget would be growing in 5 to 10 years.

Commissioner Butcher relayed that slide 20 titled "ANS Production History and Forecast," showed the historical view of the Alaska North Slope (ANS) production curve from its peak in 1988 through two significant declines and out at a more gradual rate of decline through 2019. The chart also included a breakdown by oil field to show how each field had factored into the overall decline. He highlighted that Prudhoe had been the largest contributor and that Kuparuk's impact had been much smaller, but was more substantial than the other fields. He detailed that the forecast did not include the Outer Continental Shelf (OCS), NPRA outside of Moose's Tooth, or heavy oil that was currently under development at Ugnu.

Commissioner Butcher detailed that slide 21 titled "Forecasted ANS Production FY 2010 - 2020," provided historical data and a forecast of fields that were currently producing, under development, and under evaluation. The chart illustrated the three types of fields: (1) currently producing fields and their forecast curve for over the next 10 years; (2) fields under development, which reduced the decline curve in the near-term; and, (3) fields under evaluation, which were more speculative and shown in the later years.

Representative Gara asked for an example of major fields that were currently under development and the level of production expected.

Mr. Molli responded that projects anticipated in the under development category were Liberty with peak production of 38,000 barrels, Nakiachuk with a peak production of approximately 26,000 barrels, and continued development within the Alpine, Prudhoe, and Kuparuk fields.

Vice-chair Fairclough queried whether the inclusion of Prudhoe Bay was based on investment in viscous or heavy crude production. Mr. Molli answered that the items had not been included for Prudhoe Bay; however, there was some

viscous oil production in areas such as Schrader Bluff that had been included; heavy oil had not been included.

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Representative Gara had heard about substantial stores of heavy oil at Kaparuk and Prudhoe Bay and believed there had been heavy oil production at Schrader Bluff. He wondered what made the production of heavy oil possible at some smaller fields, but not at larger fields.

Mr. Molli replied that oil production at Schrader Bluff was considered viscous and was slightly lighter than heavy oil. There was currently no significant production of heavy oil, which was primarily the Ugnu formation, but there were tests underway to determine the best way to produce it.

Representative Gara had heard from a BP representative that the company planned to move forward with the production of heavy oil. He wondered when that would take place and about the quantity that would be produced.

Mr. Molli had spoken with BP representatives, but did not know the answer to the specific question. He added that he would consider the information if it was brought to DOR.

Representative Doogan believed that his former assumption that there was a statutory basis for how revenue forecasts were developed was incorrect. He wondered whether it would be possible to direct how the forecasts were made in statute. He thought that an increasingly thorough projection, which detailed what and when production would occur, would be necessary in the future when fields under development and under evaluation would be more and more necessary to keep production numbers up. He wondered how the information could be perfected to provide a more accurate projection.

Commissioner Butcher responded that DOR would be happy to discuss the idea, but he thought it would be difficult to put into statute, given that the process involved bringing in a large amount of information from operators. He explained that the forecasting process was subjective by nature. Information that sometimes seemed optimistic was derived from the producers; for example, when producers provided estimates on production per day, the department

was not able to make changes to the data. He noted that Mr. Molli could provide more detail.

Representative Doogan remarked that he didn't need to know build the car; he just wanted to know that it was running okay. He discussed that based on the history of the projections there was no reason to believe that they were accurate. He acknowledged the importance of the projections and explained that he wanted to be proactive if there was something that could be done to advance the process. He stressed the need for improvement, which would inspire more confidence in the accuracy of the projections, given that the data impacted decisions he would make on different areas of the budget.

Commissioner Butcher answered that they could bring Mr. Molli in to discuss the issue and that at the beginning of each legislative session DOR could present the details behind the forecast calculations. He added that the purpose of the spring forecast was to provide an update on factors that had changed the production forecast presented at the beginning of each fiscal year. He relayed that price forecasting had improved considerably in recent years.

Representative Costello queried whether all of the factors that affected production forecasting (slide 18) were weighted equally in the forecast development. Mr. Molli responded in the negative. He elaborated that the heaviest weight was given to the past performance of the wells and fields.

Representative Costello wondered about the role of project economics in the forecast development. She thought that the geology, development plan, and production profile could all look good, but that project economics could be a deal breaker.

Mr. Molli agreed. The department anticipated that the operators ran extensive economics and would not sanction a project until they were happy with the numbers they had run.

Representative Costello asked whether the department examined the success of efforts that were made to increase production or whether it relied solely on the industry and historical data.

Mr. Molli replied that he would assign the method to the production forecast if it had been successful in the past; the method would not be utilized if it had not produced any significant change in production.

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Representative Gara asked whether it was plausible that BP had currently stalled investment due to the impact the oil spill in the Gulf of Mexico had had on the company's worldwide financial situation.

Commissioner Butcher did not believe there was enough information to speculate on the answer.

Commissioner Butcher directed attention to slide 22 "Conclusion on Production," that discussed what was used in the production forecasting. The department used extensive well and field specific data that was received from producers, AOGCC, and DNR. He relayed the importance of new field development in mitigating decline rates.

Representative Guttenberg wondered whether Pt. Thompson had been included in new prospects. Commissioner Butcher believed that the fall 2010 forecast had estimated that Pt. Thompson would come online in FY 15.

Mr. Molli clarified that limited production was scheduled to occur at Pt. Thompson in FY 15. The gasline was scheduled for completion in 2021 and major production would not happen until that time.

Representative Edgmon wondered whether the committee would receive detail that would show how the tax rate adjustment proposed in the governor's oil tax legislation [HB 110] would impact factors in the production profile if the bill came to the committee.

Commissioner Butcher answered that DOR would present estimates on the amount reinvestment would create and scenarios about the future. The governor had vocalized his preference for the industry to provide the committee with its idea on how the tax rate would impact production.

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Vice-chair Fairclough recalled that in a past production tax discussion a spreadsheet had been utilized to provide multiple scenarios for committee members. She thought that it would be helpful to develop a similar spreadsheet that showed one barrel of oil as a fixed point on one axis and price on another axis, with the ability to generate multiple scenarios using different credits.

Mr. Burnett believed that the referenced chart was accessible.

Vice-chair Fairclough thought the tool would help communicate data and scenarios from the governor to the legislature and on to the public. The spreadsheet would also provide a tool to examine how amendments would impact the numbers.

Co-Chair Thomas asked whether oil price projections were all calculated in-house or if some were contracted out or compared to others. Commissioner Butcher replied that the next several slides provided detail on oil price calculations.

Commissioner Butcher moved to slide 24: "Price Forecast Methodology," which described how the price forecast methodology had been compiled over the past several years. There was a price forecasting session that had included 27 participants from the Departments of Revenue, Natural Resources, Labor, and OMB, the University of Alaska, Legislative Finance Division, and other. Presentations had been generated that looked at supply, demand, politics, financial markets, and outside expert forecasts. He expounded that the forecasting session used the New York Mercantile Exchange (NYMEX), Energy Information Agency (EIA) (the official federal forecasting agency), and other sources to develop the most accurate price forecast. For projections beyond FY 15 an inflation of 2.75 percent was added to a constant price.

Commissioner Butcher explained that the chart on slide 25: "Price Forecasts as of October 2010," showed price session, analyst data, DOR forecast, and the forecast curve for the EIA and NYMEX. The items were closely aligned through FY 12, but began to skew in later years, given that forecasters tended to vary as they moved further away from the current date and historical data. The trend fell in line with most federal and other expert projections.

Co-Chair Thomas asked whether DOR predictions were ever compared to those of oil analysts outside of Alaska.

Commissioner Butcher responded that professional analysts outside the state were depicted by the purple line shown on the chart (slide 25). He reiterated that the chart included data from the NYMEX, EIA, and other. He added that the department would follow up with a chart that included the different predictions and more detail on what had occurred.

Co-Chair Thomas remarked that the department's numbers appeared relatively aligned with the analyst data (slide 25).

Commissioner Butcher highlighted that the price forecasting was currently much more public than it had been in the past; therefore, it would be possible to identify and look into DOR numbers if they appeared to be misaligned with other data.

Representative Edgmon felt that price calculations were a product of a thorough and rigorous methodology, but that production projections appeared to be much more speculative and included discretion that varied dependent on the administration.

Vice-chair Fairclough asked for a historical look at how close past price and production projections had been to what had actually occurred. She wondered whether DOR had looked at the risk management model that was utilized by APFC. She thought the corporation's risk model had offered an interesting look at the risk involved in price and production forecasting and could be useful in providing a different way to display projection data.

Commissioner Butcher responded that he would participate in his first APFC Board meeting the following week and would determine whether the board thought the model would be helpful for DOR projections at that time.

Mr. Burnett communicated that the DOR Treasury Division had a similar risk model that the department would look at as well.

Vice-chair Fairclough appreciated the security and risk management models that were utilized at APFC and understood that DOR had a similar approach.

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Representative Costello asked whether DOR could develop a plan that would provide increased production forecasting accountability. She agreed that there was quality assurance in the price forecasting; however, the production forecast seemed to lack the same level of accountability.

Commissioner Butcher replied that he would be happy to look into ways to improve production forecasting. He explained that price forecasting was easier given that there were analysts and experts worldwide who worked to determine oil price projections; however, production forecasting involved a tremendous amount of work that involved discussions with operators regarding field locations, when fields would come online, etc.

Representative Doogan wondered whether it was true that there were not any price forecasting outliers as shown on the "Price Forecasts as of October 2010" chart (slide 25). Commissioner Butcher would get back to the committee with an answer.

Commissioner Butcher concluded with slide 26 titled "Fall 2010 DOR Oil Price Forecast." The slide showed the FY 10 actual versus nominal prices for West Texas International (WTI) compared to ANS as well as annual 2.75 percent inflation factored projected prices for FY 11 through FY 15. The FY 10 ANS nominal price of \$74.90 was projected to increase to \$77.96 in FY 11, \$82.67 in FY 12, and \$87.86 in FY 13. He discussed the expectation for a slow and steady oil price increase over the next five years.

Representative Doogan referenced his earlier question about forecasting outliers and did not believe the information on slide 26 was likely. He did not disagree with the analysis as shown over time; however he wanted a more realistic price forecast on a year-to-year basis. He thought that the identification of outliers would help to determine downside risk, which would work to inform decisions about how to utilize a budget surplus.

Commissioner Butcher agreed and would get the information to the committee. He recognized the possibility that FY 13 could have been \$105 or could just as easily have been \$60 and that the prediction could have made.

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Mr. Burnett provided a PowerPoint presentation titled "State of Alaska: An Update on the State's Savings Accounts." He discussed slide 3: "General Fund and Other Non-Segregated Investments." He explained that year-end market values for 2008 through 2010 were shown for each of the funds. Returns shown on the slide were year to date (2010 calendar year), fiscal year to date (July 1, 2010 to December 31, 2010), three year actuals, and five year actuals. The General Fund and other non-segregated investments held approximately \$6.5 billion at the end of 2010, which were comprised of 98 funds and accounts, including the general fund, forward funding for education, the Alaska Housing Finance Corporation capital and capital income accounts, and the Statutory Budget Reserve Fund (SBR). He noted that a couple of additional accounts would be added to the group. Major funds included the General Fund and the SBR, which had a balance of \$1,197,500. There had been a \$190 million surplus at the end of FY 10, which had been transferred into the SBR in February 2011. Forward funding for education was currently close to \$1.6 billion; each fiscal year slightly over \$2 billion was designated for education and approximately \$1 billion of the funds was spent each year. He relayed that a substantial amount of cash flowed through the account, including the capital and operating budgets; therefore, a large portion was fixed income and short-term.

Mr. Burnett explained that the returns on fixed income investments for the current fiscal year were much lower than they were historically because the Federal Reserve had set short-term interest rates artificially very low; the practice was good for businesses and bad for fixed income investments. He elaborated that there would be a period in which fixed income investments would not have favorable returns, given that short-term interest rates could not go down. He furthered that the fund would lose a little money when the short-term interest rate began to increase, but it would subsequently begin to earn money again.

Mr. Burnett moved to slide 4 titled "Constitutional Budget Reserve Fund (Main \$ Sub)." The CBR was divided into two funds: the main fund and the sub fund. Both funds contained approximately \$5 billion at the end of 2010. As of the close of business on February 17, 2011 the funds totaled \$10.133 billion and had increased slightly given that equity markets were currently up. The main fund had increased significantly over the past five years largely due to legislative deposits and settlement money. Sub fund returns over the past five years had averaged 4.21 percent and were directly related to investment. He communicated that the main account had performed better during the past five years; however, he expected that it would not be doing as well over the next year. The sub fund had a chance of doing much better if the upswing in the equity markets continued.

Mr. Burnett pointed to retirement accounts on slide 5 titled "PERS & TRS." The Public Employees' Retirement System (PERS) and the Teachers' Retirement System (TRS) accounts had the fiduciary oversight of the Alaska Retirement Management Board. The accounts were made up of pooled investments and had the same asset allocations; however, the funds' returns were slightly different due to different cash flows. Together the funds contained slightly over \$15 billion. There were a couple of other retirement funds, including the Judicial Retirement Fund and the National Guard and Naval Militia Retirement System, which had similar characteristics to PERS and TRS. The slide did not include the PCE [Power Cost Equalization] endowment or the Public School Trust Fund, which were invested similarly and had similar return characteristics to the CBR sub account. He noted that he would provide the committee with the account totals at a later time.

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Representative Gara asked what what percent of the expected liability was represented by the \$15 billion in the PERS/TRS funds.

Mr. Burnett answered that the total liability was estimated to be in the \$25 billion range; therefore, the funds would equal approximately 60 percent of the total liability. He detailed that the total was different for PERS and TRS and pensions and health care. Pensions and health care were typically separated, but had been factored together on

slide 5 for the sake of simplicity. The numbers on the slide did not include numbers for the newer defined contribution system.

Vice-chair Fairclough had read an article that classified pension funds into four different zones (safe, etc.). She wondered whether the state pension fund was rated by the zones.

Mr. Burnett replied that he had not seen the ratings. He thought that Alaska's ratings were very good compared to other states. Some other states showed much higher funding levels; however, the majority did not include funding for health care and other non-pension liabilities in their funds. Many states funded retiree health care items as they arose; whereas, Alaska had always pre-funded the items.

Vice-chair Fairclough wondered whether the state would back out the specific liability to achieve a better standing for rating purposes.

Mr. Burnett replied that the state disclosed all information to ratings agencies. He noted that the state had been upgraded to a AAA rating during the current year.

Commissioner Butcher added that the rating agencies had just begun to take into consideration what the State of Alaska had been doing for quite some time. He communicated that other states were not happy with the shift as it made their retirement systems look far worse than they had previously. Alaska was one of four states that had included the information; therefore, it was in much better shape than other states. The information would be extracted from the data if the goal was an apples-to-apples comparison between states. He noted that the state was in the upper portion of states in terms of liability.

Vice-chair Fairclough had reviewed pension liability information provided by a labor organization to its members. The organization was much higher funded and she believed the number looked out of whack. She wondered whether the inclusion of health care considerations was potentially a new method going forward.

Mr. Burnett responded that a non-governmental pension would be evaluated differently.

Representative Edgmon queried the number of active and retired participants. He thought the number may have been around 80,000. Mr. Burnett noted that 80,000 was not an unreasonable estimate. He would follow up with the exact number at a later time. He noted that the number was also available on the Division of Retirement and Benefits website.

Representative Doogan surmised that the 60 percent figure represented the amount that would be paid towards the total liability if the funds were cashed out immediately.

Mr. Burnett explained that there were currently 60 percent of the necessary funds to pay retirement benefits if no more payments were made to the funds, state employees stopped working immediately, employees eligible for retirement retired, and assuming that the projected actuarial rate of return was achieved on average during the entire period of time. He elaborated that because the system was continuous it would not work exactly as presented in the hypothetical scenario.

Representative Edgmon thought that health insurance rates, mortality rates, and other factors would need to be accounted for as well.

Mr. Burnett communicated that the additional factors including an insurance rate increase, longevity, and other were built into the actuarial projections.

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Representative Wilson deduced that the 60 percent figure did not necessarily mean that all Alaskan communities were 60 percent invested.

Mr. Burnett answered that local governments throughout Alaska participated in the state's retirement funds and paid 22 percent into PERS and approximately 12 percent into TRS. Under the current system the local governments had no other liability for their employees. He explained that the state paid the additional amount above the local government portion up to the actuarial required rate that would amortize the unfunded liability for the next 21 years.

Mr. Burnett moved on to slide 6 titled "APFC." He relayed that at the end of 2010 the fund balance had been \$38

billion, which had grown from \$28 billion at the end of 2008. The increase had been a combination of cash flows into and out of the fund (e.g. annual permanent fund dividend distribution) and investment returns. The fund had earned 4.14 percent over the past five years. The portion of the fund invested with equity exposure had done very well in the past year and the overall fund had earned 14.45 percent in the first half of the last year (fiscal year to date).

Representative Edgmon queried whether the APFC portfolio was less liquid and more focused on long-term growth than the prior two funds that had been discussed.

Mr. Burnett replied in the affirmative. He expounded that the APFC fund was very similar to the PERS and TRS funds, but it did not have the same cash flow. He noted that there was minimal difference between the five year actuals for PERS, TRS, and the APFC fund, which were 4.04 percent, 4.01 percent, and 4.14 percent respectively. The sub-account of the CBR fund was slightly higher and did not require rebalancing for cash flows. He noted that it was not possible to make an apples-to-apples comparison between the different funds.

Mr. Burnett concluded with slide 8: "FY 2011 Investment Revenue Forecast." The slide showed how each fund had performed in the first part of the fiscal year and projections for the remainder of the fiscal year. He was not surprised that unrestricted income was down from the prior year, given the low interest rates. He was not confident that the slightly higher projections would come to fruition in the second half of the fiscal year. He relayed that the unrestricted income did not represent a large portion of the revenue forecast; however, it was a significant amount of money invested that was currently not earning very much. He explained that the trend would continue until short-term interest rates improved.

Mr. Burnett discussed restricted investments on slide 8. He informed the committee that the CBR had earned \$700 million in the first half of the fiscal year and the forecast through June 30, 2011 was \$271 million. To date the fund had earned approximately \$200 million in the second half, but it was possible that the market could flatten out or change before the end of the period. The Alaska Permanent Fund had already earned more in the first half of the

fiscal year than was projected for the entire FY 11. He furthered that the fund was invested for the long-term and there had been good absolute performance to date. He noted that it was unclear how long the equity market upturn would last.

Commissioner Butcher added that the permanent fund was almost as high as it had been prior to 2008.

Representative Doogan observed that he should have been more concerned about investment income than oil revenue. Mr. Burnett remarked that things were leaning that direction. He communicated that since 2004, excluding the money in the retirement funds, the money invested by DOR had increased from approximately \$5 billion to approximately \$18 billion.

Co-Chair Thomas thanked Commissioner Butcher and DOR staff for their presentations.

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ADJOURNMENT

The meeting was adjourned at 3:29 PM.