

HOUSE FINANCE COMMITTEE
February 8, 2012
1:36 p.m.

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CALL TO ORDER

Representative Bill Thomas Jr., Co-Chair 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 David Guttenberg
Representative Reggie Joule
Representative Les Gara
Representative Mark Neuman
Representative Tammie Wilson

MEMBERS ABSENT

None

ALSO PRESENT

Bryan Butcher, Commissioner, Department Of Revenue; Bruce Tangeman, Deputy Commissioner, Tax Division, Department of Revenue.

PRESENT VIA TELECONFERENCE

Victoria Ferguson, Petroleum Economist, Tax Division, Department of Revenue; Lennie Dees, Audit Master, Tax Division, Department of Revenue.

SUMMARY

PRESENTATION: DEPARTMENT OF REVENUE
FY 13 Revenue Forecast
State Savings Account & Budget Reserves

^DEPARTMENT OF REVENUE FY 13 REVENUE FORECAST

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BRYAN BUTCHER, COMMISSIONER, DEPARTMENT OF REVENUE, provided members with a PowerPoint presentation: Overview of Fall 2011, Revenue Forecast (copy on file). The largest segment of state revenue came from oil. The state also had significant income from federal receipts and investment revenue.

Commissioner Butcher spoke to unrestricted general fund revenue as reflected in slide 5. He explained that a little over 60 percent of the state's expected revenue in FY 12 came from production tax. Remaining revenue came from: royalties - 23.9 percent; corporate income tax - 7.4 percent; property tax - 1 percent; and non-oil revenue - 8 percent.

Commissioner Butcher concluded that oil revenue accounted for 92 percent of the state's unrestricted general fund income and non-oil revenue accounted for 8 percent.

Commissioner Butcher broke down the state's non-oil revenue income. Corporate tax was the largest share at 21 percent. Other non-oil revenue included: mining tax, insurance premiums, tobacco tax, and motor fuel tax.

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Commissioner Butcher observed comments and frustrations expressed by legislators in the previous session that the department had been overly optimistic.

Commissioner Butcher split out the three categories of forecasted production:

1. Currently Producing

Currently producing production included base production and enhanced recovery production from investment in rate enhancing activities (perforations, stimulations, well work overs, and gas and water injection support). This was the easiest category to forecast since forecasts were based on current production.

2. Currently under Development

The Liberty Alaska project was an example of a project that was currently funded or awaiting project sanction in the near future. The "green light" was given to move forward, but the project was not yet to the point of production. This category was less certain than the previous but more certain than the next category.

3. Currently Under Evaluation

Currently under evaluation production included technically viable projects in the stage where engineering, cost, risk and reward were being actively evaluated. These projects were unfunded but were considered to have a high chance of being brought to fruition. Port Thomson would be in this category. There was an expectation for future production and projects were technically viable enough to include in out-years' forecast, but a lot of things had to happen for production to occur.

Commissioner Butcher observed that shale oil was not in the forecast due to a lack of data. He anticipated exploration wells by Great Bear Petroleum that could provide additional information in the coming years.

Commissioner Butcher added that the department would forecast any businesses that were doing business in the state for tax credit purposes. Estimates for participation in the tax credit program were made regardless of where a company was in production.

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Commissioner Butcher spoke to factors that affect production forecasting: geology, development plan, commercial (oil price and market conditions), permitting, production profile, and timing. He referred to the Liberty project that had been delayed by British Petroleum (BP). The project was moved out of the forecast due to unanticipated factors, which had delayed the project.

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Commissioner Butcher reviewed the graph on page 12, which depicted projects under evaluation, under development, and

currently producing. The department had been most accurate at predicting currently producing projects; projects under evaluation were the most speculative and reliant on permitting, taxation, market and other issues.

Representative Doogan questioned how the department separated projects under development from projects under evaluation. Commissioner Butcher explained that projects under development were not being produced but were being funded; projects under evaluation had not received funding or a "green light."

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Commissioner Butcher, in response to a question by Representative Doogan, clarified that shale oil and heavy oil were not included in the forecast due to insufficient data relating to when they would be economic. There was no "realistic idea of when it may come on line."

Representative Doogan asked for a list of projects that were not far enough along to put into any of the categories.

BRUCE TANGEMAN, DEPUTY COMMISSIONER, TAX DIVISION, DEPARTMENT OF REVENUE, responded that heavy oil and shale oil would constitute the list.

Representative Doogan summarized that the level of speculation was being measured. The line between under evaluation and nothing was not clear. Mr. Tangeman referred Representative Doogan to page 37 of the Department of Revenue's, Revenue Source Book, Section 4, Crude Oil Production for an explanation.

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Mr. Tangeman reviewed slide 13, ANS (Alaska North Slope oil) Production Forecast and Decline Rates, FY 12 - FY 21. He explained that the chart stacked up the three categories previously discussed to a total ANS production forecast with a final percentage change from prior year. The department added a percent change from the prior year column for currently producing. He emphasized that the currently producing category was the most solid. All three categories required significant capital and operating expenses to be realized. The 2009 forecast, predicted that

the Kuparuk [oil field] production in 2011 to within 39 barrels a day; Kuparuk would be under currently producing.

Mr. Tangeman observed that the Department of Revenue had been criticized as being overly optimistic in the final percentage change from prior year for all three categories. The addition of the added percent change from the prior year column for currently producing provided more certainty.

Co-Chair Thomas ascertained that forecast assumed no change to the tax code.

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Representative Guttenberg observed that Great Bear Petroleum anticipated future production; and if it were included in the projection.

Commissioner Butcher emphasized that the department worked closely with the Department of Natural Resources and the Alaska Oil and Gas Conservation Commission (AOGCC) on the forecast. He observed that Great Bear Petroleum had not drilled into the shale rock to determine potential or looked at economics. Shale oil development would require additional infrastructure. He felt that shale oil development was too speculative for an estimate in the current year. Subsequent years might be included.

Mr. Tangeman added that the state was exposure to Great Bear Petroleum for the first time. He did not doubt the resource. He pointed out a lack of roads in Alaska compared to other states. North Slope shale oil development economics had not been determined. He stressed the state's responsibility to put out the best number and the lack of data for shale oil production forecasts.

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Representative Guttenberg expressed appreciation for the department's forecast but emphasized the need for legislators to look at the gray areas in order to determine where to go.

Vice-chair Fairclough referred to the Department of Revenue's, Revenue Source Book, pages 37 through 41. She

felt the book was helpful and appreciated the department's conservative but hopeful forecast.

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Mr. Tangeman discussed improvements in methodology. The department created a standardized reporting form for production and reserve forecasting information. He maintained the form would be beneficial to the department and producers. Petroleum engineer and petroleum economists compiled the forecast information instead of reinterpreting data previously received. The department previously received production forecast information in various forms without standardization. The department also received down time estimates, which was an example of new information used by the production forecast. The department followed up and met a second time with industry to confirm the department's assumptions and ensure forecast results were reasonable with the companies' projections. He stressed that the state was not a producer and was reliant on industry information. Production forecasting required consideration of each project's geology, development plans, commerciality, production profiles, decline curves and timing. The department used extensive well and field specific data acquired from producers, AOGCC, and DNR. He emphasized that AOGCC and DNR played a large role as the experts in the field. New field development was very important in mitigating decline rates.

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Mr. Tangeman concluded that production forecasting required consideration of each project's geology, development plans, commerciality, production profiles, decline curves and timing. The department relied on other departments and experts to assist them in putting together the forecast. New field development would be most important to mitigating the decline rate.

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Representative Doogan asked if "new field development" referred to the development of new fields or new development in fields.

VICTORIA FERGUSON, PETROLEUM ECONOMIST, TAX DIVISION, DEPARTMENT OF REVENUE (via teleconference), explained that

field development referred to both: there could be additional development in an existing field, and there could be new development in a new field.

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Commissioner Butcher spoke to price forecast methodology. An oil price forecasting session was held on October 3, 2011, and included 26 participants from the Department of Revenue, Department of Natural Resources, Department of Labor and Workforce Development, Office of Management and Budget, University of Alaska, Legislative Finance Division, and outside participants. Forecasting session presentations included supply, demand, geopolitics, financial markets, and outside expert forecasts. The forecasts of these experts were averaged and blended equally with the New York Mercantile Exchange (NYMEX), and the federal U.S. Energy Information Administration (EIA), to derive a price forecast for FY 11 through FY 16. Beyond FY 16, the department took the constant real price increased by 2.5 percent for inflation.

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Commissioner Butcher discussed the change from Alaska North Slope (ANS) to West Texas Intermediate (WTI) oil. The WTI differential had been between one and two dollars premium to ANS. He discussed the methodology due to the widening differential. Previously, the department had adjusted the WTI forecast by a dollar or two. In the last year, ANS rose as high as \$28 above WTI. The price dipped to within \$5 and was around \$16 to \$18 higher at the time of the meeting. Experts agreed that there was a glut of oil being produced from North Dakota and the southern states that was limited in the number of pipelines. Experts also noted that the lack of export and refinery capacity. He concluded that ANS would come back in line with WTI over the next years. He suggested that WTI would come up in price rather than ANS dropping.

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Vice-chair Fairclough questioned if Commissioner Butcher referred to the "global" supply. She asked the production timeline for other jurisdictions that had received heavy capital investments out-side of the U.S. She observed that the U.S. imported 70 to 80 percent of its crude oil.

Commissioner Butcher acknowledged that a majority of U.S. crude oil was imported; the majority came from Canada. He affirmed that the forecast looked at global supply and demand. He observed that new technologies were affecting project economics. Demand had been affected by the worldwide recession. The department needed to determine what the price would look like as the recession recovered.

Vice-chair Fairclough questioned if American energy consumption was flat. Commissioner Butcher could not respond but observed that there was an expectation that consumption would be affected by the milder winter in the lower 48.

Vice-chair Fairclough wondered when competitor's production would come on line: would competitive production occur in two years, five years, or ten years out?

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Mr. Tangeman observed that there had been discussion around the ANS - WTI issue in other states. He noted there were a variety of projects that could affect production that would also affect the ANS - WTI ratio. The North American market understood quick fixes were possible.

Vice-chair Fairclough expressed concern that the budget was based on \$94 per barrel of oil that was at risk of decline.

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Representative Neuman questioned if the department's price forecast utilized outside participants. Commissioner Butcher explained that the department used many of the same experts as the oil companies, but they tried to rotate experts. Representative Neuman acknowledged the value of utilizing industry experts. Commissioner Butcher noted that industry's view of the future would be more proprietary.

Representative Wilson asked if the price of royalty oil had to be tied to ANS or could WTI be used. Commissioner Butcher observed that the Department of Natural Resources would need to answer the question.

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Commissioner Butcher reviewed the ANS - WTI oil price differential contained on slide 18. He observed that the differential shot up in the middle of 2011. The department expected the differential to continue for another year or so. He felt the market would correct itself.

Commissioner Butcher compared ANS, WTI and Brent [Crude]: ANS was a dollar below Brent; and WTI was below both ANS and Brent. The differential was expected to narrow over time. The average differential was \$18.41 for FY 12. The department's FY 12 estimate was \$18.22.

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Representative Doogan observed the expectation that Brent would close the gap. Commissioner Butcher clarified that the expectation was that Brent and ANS would stay the same and WTI would come up due to an increased in pipelines and refineries or retrofitting that would alleviate the glut.

Commissioner Butcher reviewed slide 20, Price Forecasts as of October 2011. He observed that the graph depicted FY 11 to FY 16 forecasts by the NYMEX, EIA, the Department of Revenue, the price session and expert analysts. The department's forecast fell in the middle to conservative range. One of the points made by Standard and Poor's in assessing the state's credit rating was its historic conservatism on oil price. In all but one year the price of oil exceeded the state's forecast over seven years.

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Commissioner Butcher reviewed slide 21: Fall 2011 DOR Oil Price Forecast. He noted the chart showed real and nominal dollars and was \$109.33 per barrel of oil (p/b) for FY 13. He anticipated the price would remain around \$100 p/b but not go much over \$109 p/b.

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Commissioner Butcher, in response to a question by Representative Doogan, explained that the FY 12 projection referred to the fall projection, which updated the spring projection. The spring forecast, final look at FY 12, would come in April 2012 based on company true up.

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Mr. Tangeman reviewed lease expenditure forecast methodology. He noted the department requested capital and operating lease expenditure projections from North Slope unit operators in the fall and the spring of each year for the next five years from the current year. The department would meet with and request spending projections from companies that were not currently producing but had announced drilling and/or development plans. He noted new interest and explorers that had not entered into the production side of their potential; the expected expenditures for capital were taken into account. The department also reviewed and coordinated with production forecast regarding anticipated developments outside the five-year time horizon received from operators and updated long-term capital and operating expenditure projections based on new information. The department saw an increase in the forecast from new explorers without a tax liability.

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Mr. Tangeman discussed slides 24, which looked back at FY 12 to FY 16. He pointed out that the Alaska's Clear and Equitable Share Act (ACES) was signed in December 2007, but capital programs for explorers and producers were already in place for FY 08 and into FY 09. He explained that FY 09 was the first time the [ACES] tax change would have been incorporated. There was a bump in FY 10; but there was a decrease in FY 11 actual numbers.

Mr. Tangeman noted that the price in 2012 was notably lower than in 2011 (slide 26). The price of oil in 2012 had been consistently higher than 2011. There was a dip from FY 10 to FY 11 in capital expenditures (CAPEX); the trend continued in FY 12. There was a decrease in capital expenditure of 13 percent under 2011. There was an increase in operating expenses (OPEX) of over 19 percent from the prior year. He observed that the cost of substances other than oil in production was driving up the OPEX.

Co-Chair Thomas asked who had the actual facts related to the number of drills and permits. Commissioner Butcher replied that AOGCC kept an accurate drill count and the Department of Natural Resources kept count on permits.

Mr. Tangeman pointed out that during Petroleum Production Tax (PPT) and ACES debates it was not possible to look at

the five years previous; forecasts were all based on modeling. The state was now in the position to look back at actuals. He believed it would be an important part of the conversation going forward and stressed that the constant was the oil price, which had been incredibly high for a long time.

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Representative Doogan referred to slides 24 and 25 and asked how they related to operating expenses and projected capital expenditures. He wondered whether the numbers were an accurate portrayal.

Mr. Tangeman explained that increases were projected. Explorers added a new level of speculation. Tax credits had a direct impact on capital spending. He anticipated increased capital expenditures.

Commissioner Butcher emphasized the department's ability to look at historical information for future predictions. He observed the department sometimes was overly optimistic on the amount of expenditures and production.

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Mr. Tangeman stressed the possible versus the probable. The resource was tremendous providing a lot of possibilities. Actual information from a historical point of view was beneficial for basing discussions [for future forecasts].

Representative Neuman observed that the combined CAPEX and OPEX continued to increase.

Mr. Tangeman noted that the cost to produce a barrel of oil had increased; capital uplift was needed to offset the production decline of 10 to 12 percent.

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Mr. Tangeman, in response to a question by Representative Guttenberg, explained that CAPEX would be affected by allowing and receiving tax credits. There was an increase in the capital expenditure projections along with increased tax credits.

Representative Neuman asked if production credits were applied against the net tax owed to the state. The gross value of the oil minus standardized deductions of capital and operating to get to a net; the tax rate on the net provides the value of revenue. Production tax credits were applied against the net, deducted from taxes owed the state.

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Mr. Tangeman agreed with Representative Neuman's assessment of the state's tax process was contained in the income statements on pages 102 - 104 of the Resource Sources Book. He stressed the complexity of the state's tax system, which he maintained was the most complicated system in North America and perhaps the world. He observed that there were dozens of ways that the tax system could be adjusted and each would affect another. Income statements represented a snap shot with the different variables used.

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LENNIE DEES, AUDIT MASTER, TAX DIVISION, DEPARTMENT OF REVENUE (via teleconference), provided an update on production tax credit. He referred to slide 28. By FY 13, the accumulation of production tax credit given over a six year period since inception was estimated to be over \$5.1 billion. Slide 29 depicted the amount of credits that would have been earned via the tax credit certificate (blue bar, series 1); and the credits that would have been applied against production tax liabilities (red bar, series 2). Mr. Tangeman interjected that slides 28 and 29 were summary rollup slides, and a high level look at the tax credit program.

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Co-Chair Thomas asked the total income to the state in relationship to the \$5 billion the state gave up in tax credits. Mr. Tangeman offered to provide the information.

Commissioner Butcher pointed out that tax credits for new exploration would not show revenue until years into the future. The average time from exploration to development in Alaska was 10 years.

Co-Chair Thomas concluded that the state took in \$8 billion and gave up \$1 billion.

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Representative Doogan asked for more information regarding years prior to 2009. Mr. Tangeman agreed to provide the information.

Representative Guttenberg asked the difference between series 1 and 2. Commissioner Butcher explained that series 1 were certificated without tax liability series 2 were certificated with tax liability

Representative Neuman asked if it were possible to look at how production credits affected the amount of throughput in Trans-Alaska Pipeline System (TAPS).

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Commissioner Butcher thought it would be difficult to make a direct correlation between credits and production. An attempt had been made to look at the past five year's tax credits and their affect. Representative Neuman acknowledged the difficulty since the tax structure had changed and there was no baseline.

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Mr. Dees reviewed slide 30, which provided detail of transferrable tax credit certificates claimed by fiscal year and broken down by credit type of actual received applications for companies or explorers. Future projections were difficult since the credits were unknown.

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Mr. Dees observed that slide 31 broke down transferable tax credits that were issued and applied to production tax credit liability for the outstanding balance of tax credit certificates at the end of FY 11. A total of \$42 million transferable tax credit remained that could be transferred or applied to production tax liabilities.

Mr. Tangeman, in response to a question by Representative Guttenberg, clarified that the 2006 audit was completed and the department was currently auditing 2007. A desk audit

would be done on tax credits. Another trued-up would be done by the companies on March 31, for the previous calendar year. There were severe penalties (11 percent) for under-reporting. The numbers would be trued-up, but he expected them to be close.

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Vice-chair Fairclough asked the dollar value of outstanding tax credits that could potentially be refunded by the state of Alaska. Mr. Dees noted there were \$42 million outstanding as of December 2011.

Vice-chair Fairclough referred to slide 30, and asked the 2010 - 2011 difference. She observed that there was a drop off in the Exploration - .025 line. Mr. Dees noted that there was no exploration activity in the state after oil prices decreased at the end of 2008. Only a few applications were received after the winter of 2010. There was a lag between when activity occurred and the state received the credit application. Credit applications must be submitted within six months of the activity. He estimated the state received \$99 million in the fall of 2009, which would have corresponded to the end of drilling activity in the first half of 2009.

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Vice-chair Fairclough observed that there was an influx of credits available from 2008, 2009 to 2010, which were held flat in 2011. She wondered if Alaska was seen as a place to invest or if tax credits on the books were being spent.

Mr. Dees reviewed slide 32: "Credits Applied Against Production Tax Liability, by Fiscal Year." The credit was listed by credit type. He observed that FY 12 and FY 13 were projections; FY 11 was awaiting the final true-up and had not been finalized.

Mr. Dees explained that data also existed for years prior to 2009.

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Representative Costello asked how a company without a tax liability could apply for production tax credits and the difference between series 1 and 2. Mr. Tangeman explained

that production tax credits were tax credits available for oil and gas. Series 1 (blue) were tax credit certificates or cash payments out; and the series 2 (red) was the amount taken against tax liability. The same tax credits were available to explorers and producers, although it would be simpler for a producer to net the credit against their tax liability.

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Representative Doogan observed that the total was roughly the same for producer or explorer tax credits. Commissioner Butcher was not sure if there was a connection. Mr. Dees pointed out that the credits applied against the date the expenditure occurred. He suggested that there was a coincidence. In 2010, the law regarding the ability of companies to convert tax credit certificates to cash was changed. Previously, reinvestment had to occur within 24 months to get the credit in cash. Now companies were able to get their refund as soon as their application was received. He suggested that the new policy might have sped up the level of activity. Representative Doogan acknowledged that it could be an anomaly.

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^DEPARTMENT OF REVENUE STATE SAVINGS ACCOUNT & BUDGET RESERVES

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BRYAN BUTCHER, COMMISSIONER, DEPARTMENT OF REVENUE, provided members with PowerPoint Presentation: State of Alaska, An Update on the State's Savings Accounts (copy on file). He pointed out that short term investments earned low interest rates, which were expected to continue. Markets did well in FY 11 in longer-term investments (21 to 22 percent). The market declined significantly at the end of the fiscal year: 9 percent in the first quarter of FY 12, which rebounded to half.

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Commissioner Butcher referred to slide 3: General Fund Other Non-Segregated Investments (GeFONSI), which were in short-term investments liquidity purposes to run state

government. These investments made just under two percent in FY 11. Fiscal year 13 was a little under one percent.

Commissioner Butcher reviewed slide 4, Constitutional Budget Reserve (CBR). The main fund was invested for short-term return (2.64 percent in FY 11, and 3.73 in FY 12 to date); and the sub-fund was invested for long-term return (21 percent in FY 11, and down by 4 percent in FY 12 to date). There was a significant difference between short and long term investments. He observed that FY 12 had not been as good as FY 11.

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Representative Doogan recalled that there was approximately \$3 billion in funds available that were not in the Constitutional Budget Reserve Account and questioned how they were invested. Commissioner Butcher explained that the funds were included in the GeFONSI section in short-term returns.

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Commissioner Butcher looked at the Power Cost Equalization (PCE) Fund on slide 5. The fund was invested for a seven percent return. The return in FY 11 was a little under 22 percent. The fund was down at a little under a four percent loss for FY 12. He concluded that the rate of return averaged over 18 months was healthy.

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Commissioner Butcher reviewed the Public School Trust Fund. The principle was invested for a six percent return and was at seventeen percent for FY 11 and flat for FY 12. The income being paid out was funded short term and only made a fraction.

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Commissioner Butcher discussed the Public Employees' Retirement System (PERS) and Teachers' Retirement System (TRS) funds. He observed that the PERS Fund earned 21 percent; the TRS Fund earned 21.23 percent. They were invested the same; the different rates of return resulted from timing issues.

Commissioner Butcher noted that the unfunded liability was not reduced due to changes by the Alaska Retirement Board (ARM) and was down 8.25 to 8.0 percent.

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Representative Guttenberg clarified that all percentages were the same and asked if they were invested in the same manner. Commissioner Butcher affirmed.

Representative Guttenberg asked if they could be separated if there were a change of investment policy. Commissioner Butcher affirmed.

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Commissioner Butcher reviewed the Alaska Permanent Fund Corporation (APFC), which earned a little over 20 percent. He observed that APFC utilized similar investment strategies as PERS, TRS and the CBR sub-fund.

Representative Wilson asked if Alaska helped other state's infrastructure projects. Commissioner Butcher did not recall any Alaskan investments in other state's infrastructure. Mr. Tangeman interjected that there might be a project in Chicago.

Representative Wilson questioned why investment was not made in Alaskan infrastructure.

Commissioner Butcher clarified that APFC would be willing to look at any project that fell under the prudent investor rule. He observed that the Alaska Permanent Fund Corporation staff could provide more detail. Representative Wilson asked for a list of APFC real estate and infrastructure investments and a definition of what qualified a project.

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Co-Chair Stoltze acknowledged but pointed to past failures of the Alaska Housing Finance Corporation and the Alaska Industrial Development and Export Authority (AIDEA).

Vice-chair Fairclough commented that Mike Burns, Executive Director, Alaska Permanent Fund Corporation, Department of Revenue indicated to her that APFC was looking at big

projects. The intent was to find long-term projects with long years of stable investments.

Vice-chair Fairclough asked if there were an ebb and flow to the market and if there were a difference by quarter. Commissioner Butcher noted that there did not seem to be a particular trend.

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Representative Doogan observed a \$71 million fish plant in his district that was not processing fish and resulted in a state loss. He recalled substantial legislative debate in 1979 and 1980 about how the Permanent Fund (PF) should be invested. The development bank would have put all the money into the state.

Commissioner Butcher recalled that Dave Roses presented detail in his memoir relating to the pros and cons of investing in the state. He observed that Mr. Roses posited that a deep state recession would be magnified if the PF were invested in-state. The state would not want to be forced into a political decision in order to protect PF investments that could go sideways.

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Commissioner Butcher observed that the total of investments brought in revenue of a little over \$8 billion in FY 11: \$6.8 of the billion was in the Alaska Permanent Fund. The FY 12 actuals were not as high due to volatility in the market.

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Commissioner Butcher concluded that there was good and bad news in the projections for FY 12.

#

ADJOURNMENT

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The meeting was adjourned at 3:31 PM.