

ALASKA LEGISLATURE

2439

HOUSE and SENATE FINANCE COMMITTEE FILES, 2003-2004

C. Oil Price Forecast

Oil revenue will continue to provide close to 80% of forecast Unrestricted General Purpose Revenue through FY 2009. Two elements are critical to the oil forecast: price and volume.

The spot price of ANS is quoted by subtracting a market differential from the price of West Texas Intermediate (WTI) on the New York Mercantile Exchange (NYMEX). There is no price for Alaska oil on the NYMEX. All of Alaska's current oil production is delivered to refineries on the U.S. West Coast (including Alaska and Hawaii). Consequently, Alaska's royalty and severance tax revenue depends in large part on the market price of Alaska North Slope crude oil (ANS) at U.S. West Coast refining centers.

The table below reflects actual prices for FY 2002 and the Department of Revenue's forecast of oil prices for the 8-year period beginning with the current fiscal year, FY 2003, and continuing through FY 2010. The short-term oil price forecast (FY 2003-2004) is based on a subjective assessment of market dynamics and trend analysis by participants at a Department of Revenue price scenario summit. Our long-term forecast (FY 2005-2010) is based on the premise that prices will converge to \$22 per barrel, the low-end of OPEC's current price target range.

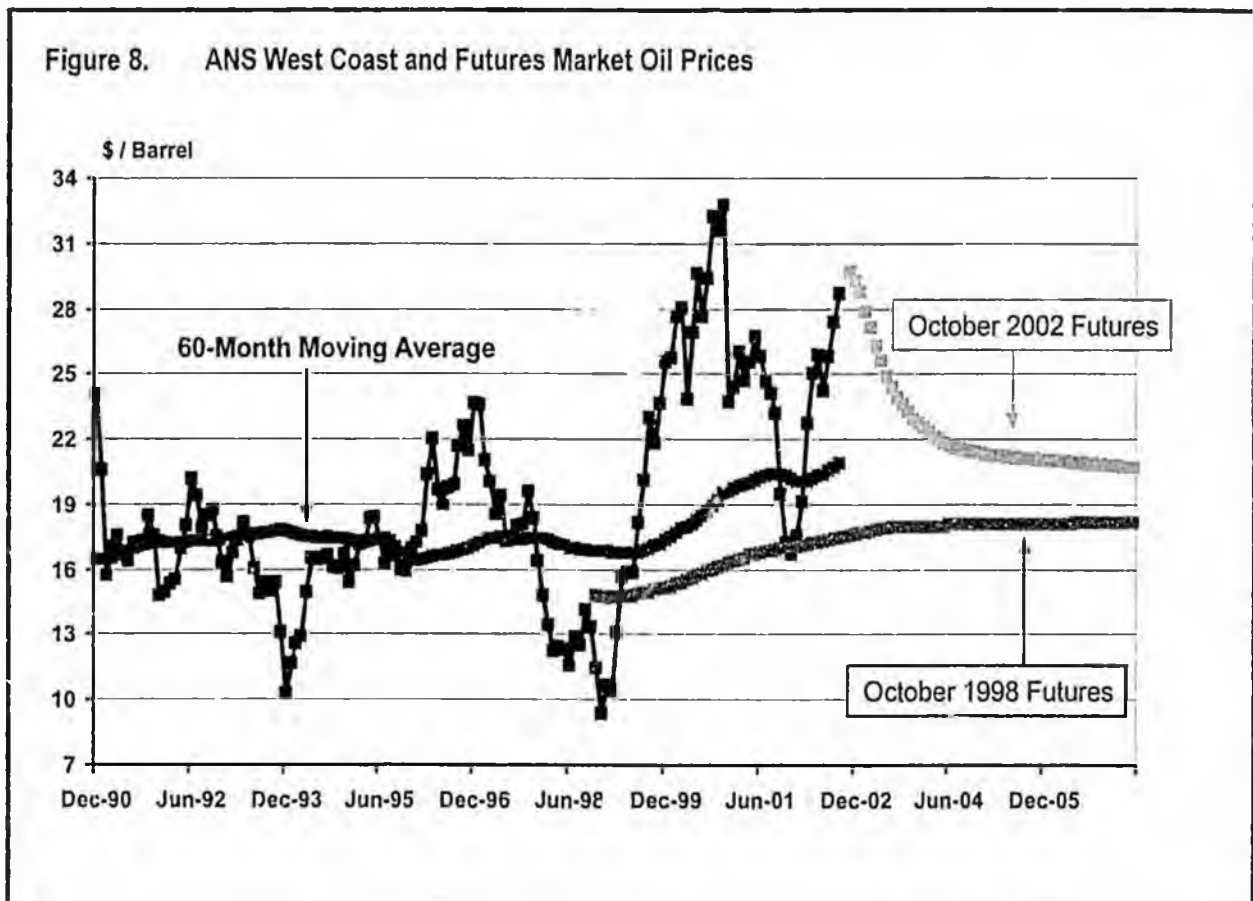
**Table 7. Delivered Price for ANS Crude Oil
Average West Texas Intermediate (WTI), ANS West Coast and ANS Wellhead
\$ per barrel**

<u>Fiscal Year</u>	<u>WTI</u>	<u>ANS West Coast</u>	<u>ANS Wellhead</u>
Actual 2002	23.80	21.78	16.80
2003	27.34	25.94	20.53
2004	24.90	23.25	17.88
2005	23.65	22.00	16.56
2006	23.65	22.00	16.41
2007	23.65	22.00	16.30
2008	23.65	22.00	16.26
2009	23.65	22.00	16.28
2010	23.65	22.00	16.17

The prices we are forecasting are higher than the average market prices experienced over the 16-year period since the 1986 oil price collapse but are consistent with prices since 1999. The figure on the next page depicts: (1) the monthly West Coast ANS market price from December 1990 through September 2002; (2) the 60-month moving average West Coast market price for the same period; and (3) a set of derived ANS futures prices for October 1998 and October 2002.⁽¹⁾

(1) The derived ANS futures price is based on the spot market differential between WTI and ANS applied to the WTI futures prices as reported on the New York Mercantile Exchange (NYMEX).

The figure below clearly illustrates the volatility of month-to-month crude oil prices. ANS West Coast prices during the pertinent time period ranged from just under \$10 per barrel to over \$32 per barrel. The average of the 60-month moving averages shown in the figure below is \$17.71 per barrel. The derived futures market prices reflected below illustrates that the current convergence price has increased by about \$3 per barrel since October 1998.

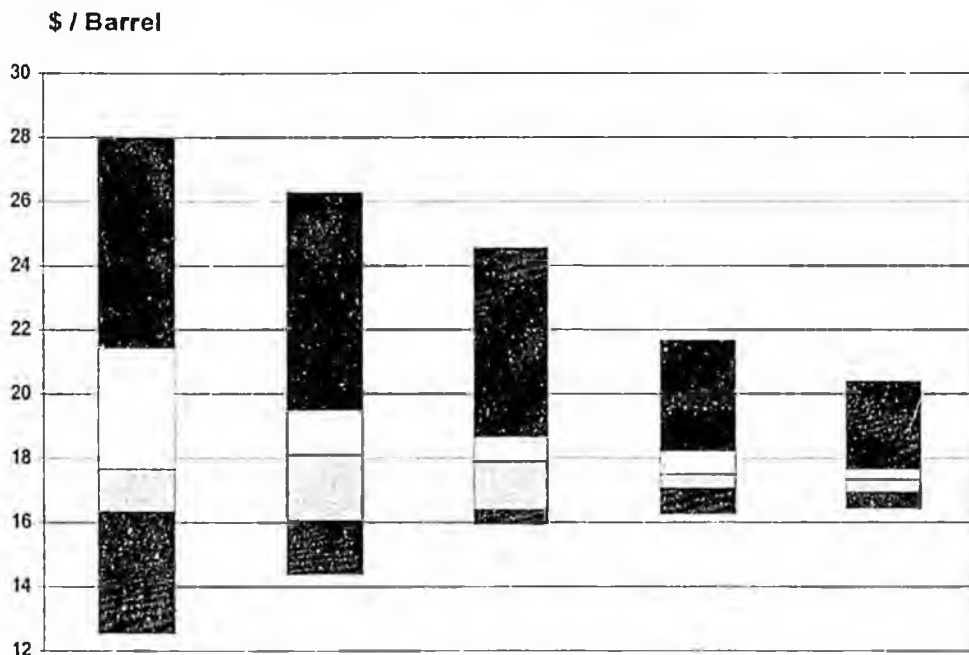


The figure on the next page reflects another analysis demonstrating both the short-term volatility and the longer-term stability of ANS West Coast market prices over the past 16 years. The left-hand bar depicts the variability of ANS West Coast oil prices for each of the rolling 12-month time periods (from December 1990 to September 2002). Ninety-five percent of those average prices fall between \$12.54 and \$28 per barrel; 50% of the time those prices fall between \$16.32 and \$21.47 per barrel, with a median price of \$17.64 per barrel.

The right-hand bar depicts the variability of the rolling 60-month time period. The 60-month average ANS West Coast market prices were obviously very consistent. Ninety-five percent of those averages fall between \$16.42 and \$20.40 per barrel; 50 percent of the time, between \$16.95 and \$17.68 per barrel; and the median of those 60-month average prices is \$17.35 per barrel. The middle three bars in the figure reflect the variability of the rolling 24-month, 36-month and 48-month time periods.

It is important to note that our base-case forecast through FY 2010 of \$22 per barrel reflects an assumption that OPEC will manage the market to a price above the long-term price suggested by the statistics illustrated below. OPEC has successfully managed its share of oil production for the past four years. The evidence is that ANS oil prices over the past 51 months have averaged \$22 per barrel.

Figure 9. Cumulative Average ANS Oil Price (December 1990-September 2002)
Moving Average and Confidence Intervals



Percentile Ranking	12-month	24-month	36-month	48-month	60-month
2.5%	28.00	26.28	24.53	21.65	20.40
25%	21.47	19.51	18	18.25	17.68
Median	17.64	18.11	17.91	17.51	17.35
75%	16.32	16.08	16.40	17.07	16.95
97.5%	12.54	14.37	15.93	16.26	16.42

The percentile ranking is the probability of exceeding the corresponding ANS oil price.

D. Oil Production Forecast

In 1988, ANS production peaked at 2.005 million barrels per day and has declined steadily since. The figure on the next page reflects the historical and projected rates for ANS oil production. FY 2001 was the first full year that ANS production averaged less than 1 million barrels per day — daily production averaged 0.991 million barrels per day. Thanks to the contribution of new fields, Northstar and Alpine, ANS production averaged 1.003 million barrel per day in FY 2002.

The future development of recent discoveries in the National Petroleum Reserve-Alaska (NPR-A) and the projected development of Nanuk, Fiord, Sourdough, Point Thomson and Liberty will increase production to slightly above the 1 million barrel per day level in FY 2008-2011.

A detailed field-by-field production forecast can be found in Appendix D.

Figure 10. ANS Historical Production
Million Barrels/ Day

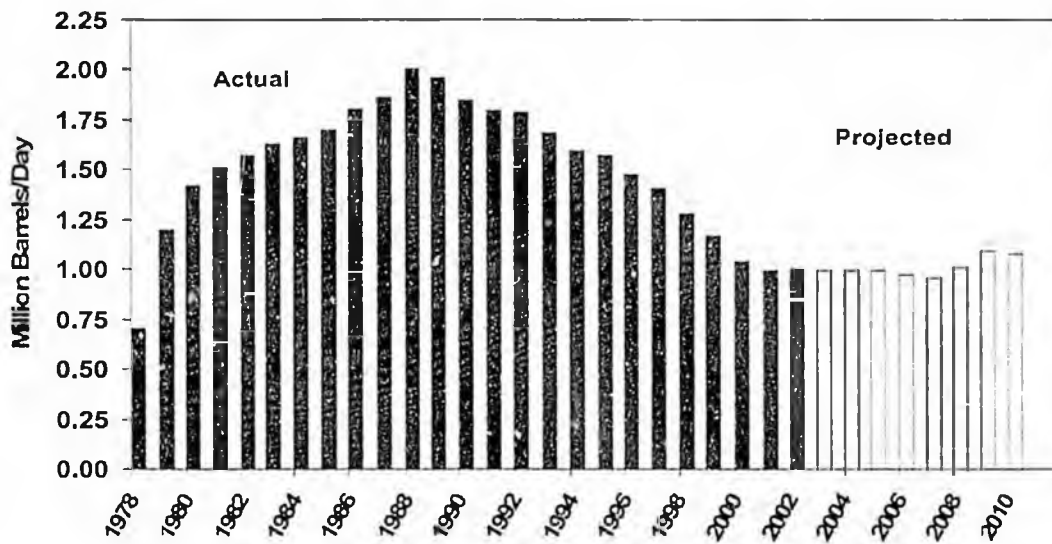


Table 8. ANS Oil and NGL Production
million barrels per day

<u>Fiscal Year</u>	<u>ANS Production</u>
Actual 2002	1.003
2003	0.994
2004	0.997
2005	0.992
2006	0.971
2007	0.956
2008	1.010
2009	1.091
2010	1.075

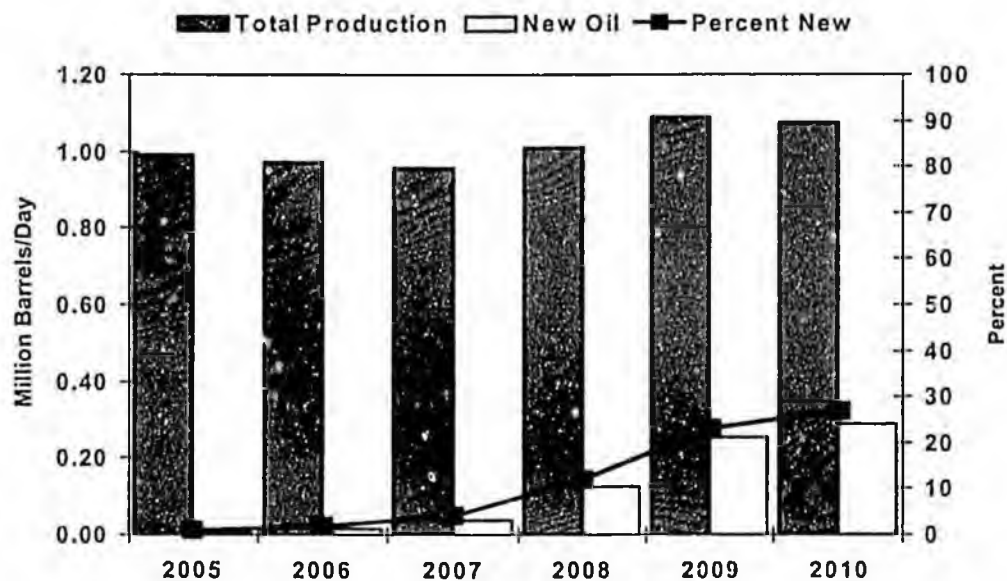
New Oil Development

As the volumes from the giant Prudhoe Bay and Kuparuk fields continue to decline, some of the decline in production will be offset by new oil development. In our forecast, new oil is defined as crude already discovered and likely to be developed. By FY 2009, as the table and figure below show, over one-quarter of our forecasted oil production will come from fields not currently producing oil.

Table 9. New Oil as a Percentage of Total Oil
million barrels per day

Fiscal Year	New Oil	Total Oil	New Oil as Percent of Total Oil
2005	0.005	0.992	0.5%
2006	0.015	0.971	1.5%
2007	0.038	0.956	3.9%
2008	0.125	1.010	12.4%
2009	0.254	1.091	23.3%
2010	0.289	1.075	26.9%

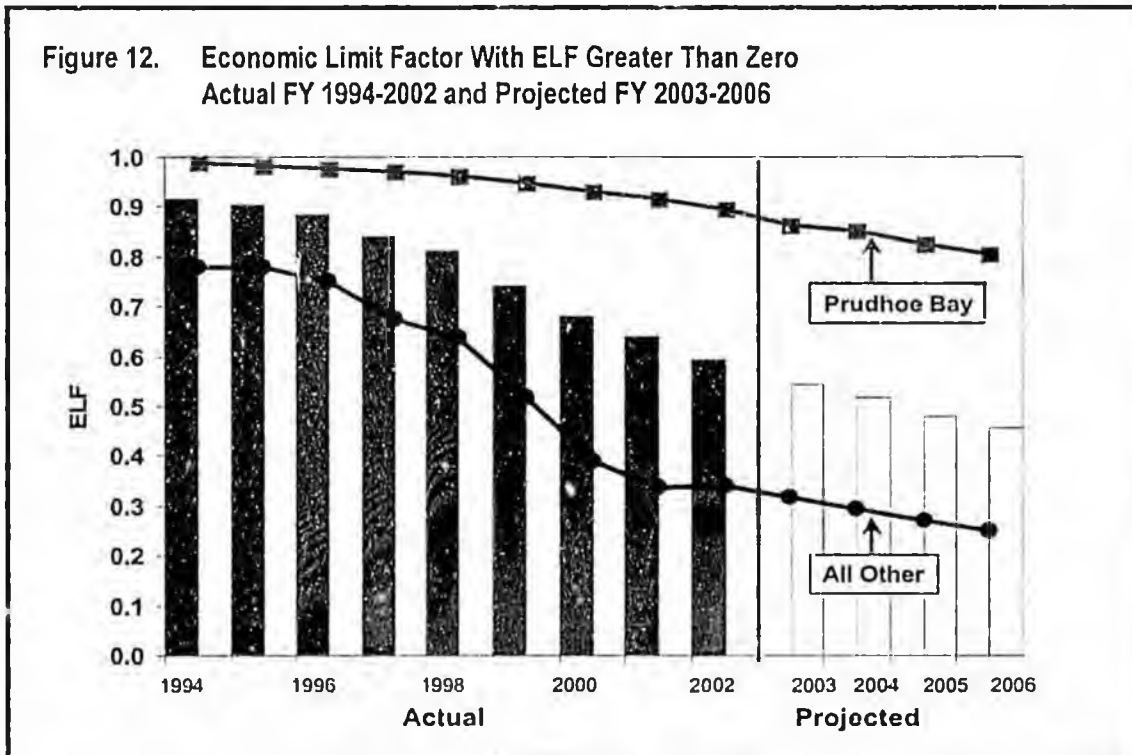
Figure 11. New Oil as a Percentage of Projected Oil



Economic Limit Factor

The average production tax rate on the North Slope has been falling as the result of the tax adjustment known as the Economic Limit Factor (ELF). The ELF is a factor that reduces the nominal production tax rate on a producing reservoir based on the average rate of production from the reservoir and the average productivity of the wells producing that reservoir. Since oil production rates and well productivity decline over time as an oil field is being produced, the average production tax rate will fall as well. Further, the ELF reduces the tax rate on smaller oil fields such that most fields producing less than 20,000 barrels per day will pay little or no production tax.

An ever smaller percentage of Alaska's current and projected North Slope oil production will continue to come from old, declining fields, while new production will come from small fields. Therefore, the average tax rate will continue to fall. The average oil production tax rate for North Slope production in FY 1994 was 13.5%; we project that for FY 2003 it will average 7.7%. The figure below illustrates the actual weighted average ELF for North Slope oil production since 1994 and our projections of that weighted average through FY 2006. The Prudhoe Bay ELF is also shown, as well as the average ELF for all of the other North Slope fields that have ELF's that are greater than zero.



E. Longer-Term Unrestricted Revenue Outlook

Using the price and volume components developed for this fall 2002 forecast, the table below summarizes the department's forecast of total Unrestricted General Purpose Revenue through FY 2010.

Fiscal Year	(Section V) Unrestricted Oil Revenue	(Section VI) Unrestricted Non-Oil Revenue	(Section VIII) Unrestricted Investment Revenue	Total Unrestricted Revenue	Percent from Oil
Preliminary 2002	1,320.1	290.7	43.1	1,653.9	80
2003	1,468.1	253.4	30.7	1,752.2	84
2004	1,326.7	260.1	16.7	1,603.5	83
2005	1,193.7	260.6	16.7	1,471.0	81
2006	1,152.1	261.1	16.7	1,429.8	80
2007	1,103.7	262.2	16.7	1,382.7	80
2008	1,088.4	263.4	16.7	1,368.5	79
2009	1,097.5	264.6	16.7	1,378.8	80
2010	1,020.7	265.8	16.7	1,303.2	78

F. Constitutional Budget Reserve

The table below reflects the amount needed to make up the difference between the Department of Revenue's forecast of Unrestricted General Purpose Revenue and the annual General Fund budget, shown here as a flat \$2.5 billion ⁽¹⁾.

Table 11. Difference Between Unrestricted General Purpose Revenue and General Fund Budget — "The Gap" ⁽¹⁾
\$ Million

Fiscal Year	Total	⁽¹⁾ General	Difference
	Unrestricted General Purpose Revenue	Fund Appropriation	
Preliminary 2002	1,653.9	2,503.9	(738.0) ⁽²⁾
2003	1,752.2	2,500.0	(747.8)
2004	1,603.5	2,500.0	(896.5)
2005	1,471.0	2,500.0	(1,029.0)
2006	1,129.8	2,500.0	(1,070.2)
2007	1,382.7	2,500.0	(1,117.3)
2008	1,368.5	2,500.0	(1,131.5)
2009	1,378.8	2,500.0	(1,121.2)
2010	1,303.2	2,500.0	(1,196.8)

(1) The projected Fiscal Year 2003-2010 budget of \$2.5 billion is simply a reference point for analysis. Any budget estimate used to determine "The Gap" will have its detractors — some will contend spending should be cut, while others will argue just as strongly that spending should be increased.

(2) The "Gap", or the draw on the CBRF for Fiscal 2002, is shown as actual cash spending which does not take into account Fiscal 2002 appropriations that will be spent in fiscal 2003.

As approved by voters in 1990, all of the money from oil and gas and mining tax and royalty settlements are deposited into the Constitutional Budget Reserve Fund (CBRF). Over the past nine years the state has deposited about \$5.6 billion into the reserve fund and has earned about \$1.5 billion on the money.

For all but two of those years, the state has relied on the CBRF to fill the difference between unrestricted revenue and the annual state budget.

Through November 20, 2002, approximately \$4.9 billion had been withdrawn from the CBRF to balance the budget, leaving a balance of \$2.075 billion.

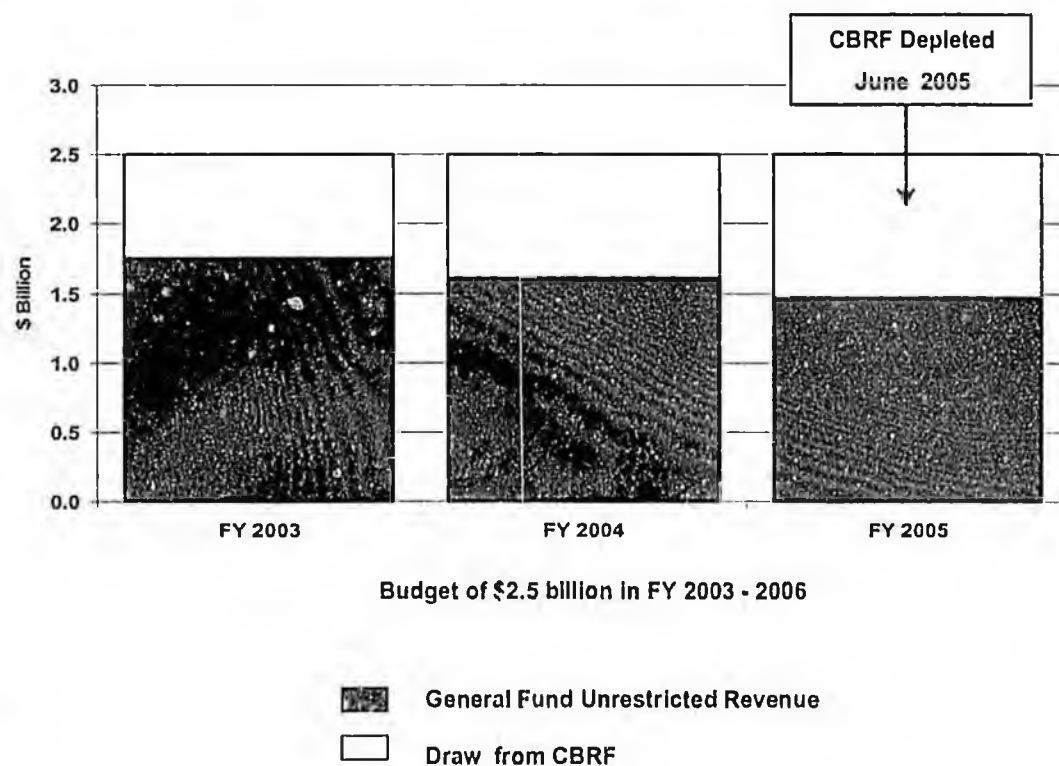
This table reflects the CBRF depletion matrix and the time period the fund could continue to make up the difference between Unrestricted General Purpose Revenue and the General Fund budget at various oil prices and budget levels. For example, assuming no change in the state's fiscal system, if we are correct in our oil price forecast and if we assume a flat General Fund budget of \$2.5 billion per year, the CBRF will be exhausted in June 2005.

Table 12. When Would the CBRF Be Gone?

State Spending and Oil Price Variables, Starting in FY 2003				
Annual State Budget	\$17.70/bbl	\$22.00/bbl	DOR Fall ⁽¹⁾	\$25.00/bbl
\$2.400 billion (no increases)	Oct-2004	Jun-2005	Nov-2005	May-2006
\$2.500 billion (no increases)	Jun-2004	Mar-2005	Jun-2005	Nov-2005
\$2.600 billion (+2%/yr growth)	Apr-2004	Nov-2004	Feb-2005	Apr-2005

(1) Based on Department of Revenue Fall 2002 oil price forecast: FY 2003 ANS, \$25.94; FY 2004 ANS \$23.25.
Sources: Department of Revenue Fall 2002 Forecast, Fiscal Driver Model of Oil Revenue and CBRF Performance.

Figure 13. Anticipated Life of the Constitutional Budget Reserve Fund



IV. ALASKA'S FISCAL OPTIONS

What Are the Options for Alaska's Fiscal Future?

We all hope that the road to a prosperous fiscal future is well marked and without detours. Alaskans are used to a few bumps in the road, we would just prefer not to break any axles along the way. But just as any Alaskan knows, we need to be prepared for roadside emergencies. A lack of enough money to pay for public services could be just such a problem.

The balance in the Constitutional Budget Reserve Fund is heading down, not up. This forecast book gives the Department of Revenue's best estimate of when the Budget Reserve Fund will hit empty, unless we take steps to close the fiscal gap. Any of several events could produce new revenues to reduce the gap. Among the long-term possibilities are unexpectedly high oil prices, large volumes of undiscovered oil flowing into the Trans-Alaska Oil Pipeline, or a natural gasline from the North Slope. (See Section II for a thorough review of the potential for increased North Slope oil development and a natural gas project for Alaska.)

This revenue forecast assumes none of the above in the next few years. Maybe later, but not now. We based our forecast on what we believe is a reasonable estimate of oil prices and known quantities of oil that can be produced before the end of the decade.

There also are no new or increased taxes in our revenue projections. And although some people have discussed the possibility of someday using some of the earnings from the Permanent Fund to help pay for public services, we did not include that in our state General Fund budget projections.

However, the future is uncertain, and any of the above possibilities could become reality in time. To help judge the possibilities and their economic value, we offer the following information in this section.

Could Higher Oil Prices Alone Fill the Fiscal Gap?

A quick study of the numbers shows it certainly is extremely unlikely. Alaska North Slope crude oil would have to fetch higher prices for a longer period than at any time in the pipeline's 25-year history. And not just a little higher for a short time, but a lot higher for a long time.

Although we believe North Slope oil production will hold just shy of 1 million barrels per day for the next few years, with a small increase later this decade, the state's declining production tax rate requires a higher price every year just to maintain the same revenues. North Slope oil would have to average more than \$37 a barrel in Fiscal 2003 to balance the budget. The number gets further out of reach each year. In Fiscal 2010, the price would need to be over \$43 a barrel.

To reach 2010 with something, anything, in the Budget Reserve Fund would require ANS oil averaging more than \$33 a barrel for the next seven years. Keep in mind that prices would have to hold fairly steady around that average — the state could not afford a couple of bad years along the way if we wanted to maintain the Budget Reserve Fund and pay our bills. For example, if North Slope oil dipped below \$15 for a year or more, as has happened three times since 1989, the Budget Reserve Fund would take such a deep hit that it would hit empty even if prices rebounded the next year.

Prices could rise above projections in the short term — maybe even enough to balance the budget for a short time. But it would take a major, sustained global shortage of oil to create the consistently high oil prices for the long term that could save the Budget Reserve Fund, and such a scenario is extremely unlikely. Oil is a market-traded commodity, with the forces of supply and demand determining the price. When supply exceeds the demand, prices fall. As oil gets cheaper, demand recovers, which, over time, leads to higher prices as demand builds to match supply. But when demand gets too high, squeezing the supply, prices rise and demand falls back down. Prices eventually come down, too. Because of how the market works, it is highly unlikely that oil prices could ever stay high enough long enough to solve Alaska's budget problem.

Higher - or Lower - Oil Production

Oil production could exceed our forecast, which includes only barrels from fields that are producing or have been discovered. For those that have been discovered, we included production only from those fields we expect to start pumping by 2010.

We forecast that "new oil," oil that has been discovered but is not yet flowing through TAPS, will constitute a substantial 12.4% of North Slope production by Fiscal 2008, growing quickly to 26.9% by Fiscal 2010. Clearly, Alaska is depending on a fair amount of this new oil just to meet our revenue forecast. Anything more than that would help close the fiscal gap, but North Slope oil production would need to more than double by 2010 to close the gap by itself.

It is possible that some of the discovered fields could start producing sooner than expected, meaning more production and more revenue to the state. We also expect new oil discoveries on the North Slope, but we do not believe those as-yet-undiscovered fields will begin producing before 2010. However, these undiscovered fields might also begin producing sooner.

On the other side of the fiscal coin, it is possible that some of the forecast production could be postponed past the expected start-up dates in this forecast. Also, the production rate for developed fields may decline at a faster rate than we project. For every upside, there is a downside. (See Section II, New Oil and Gas Production.)

Broad-Based Taxes

Though no one wants to pay taxes, it's always an option for the future if Alaska finds itself short of the money it needs to pay for public services. But just how much new revenue would taxes generate? And what are some of the options?

Personal Income Tax

Of the 50 states, 43 have a personal income tax. Joining Alaska on the list without a tax are Florida, Nevada, South Dakota, Texas, Washington and Wyoming. Of the 43 with a tax, New Hampshire and Tennessee collect taxes on dividends and interest income only.

There are three options for the tax base for calculating a personal income tax:

- **Adjusted gross income.** Because the tax base would be the highest of the three options, the tax rate would be the lowest. Adjusted gross income is Line 33 on the federal personal income tax Form 1040, which is an individual's gross income from all sources minus: IRA contributions, student loan interest, Medical Savings Account contributions, moving expenses, one-half of the self-employment tax paid by self-employed individuals, the self-employed health insurance deduction and alimony.
- **Federal taxable income.** This is Line 39 on Form 1040, which is adjusted gross income minus either the standard deduction or all of the itemized deductions allowed under federal law, plus the per-person exemptions allowed under the federal tax code. This requires the state to accept whatever tax deductions are allowed under federal law, although the state also could include its own deductions, credits or other conditions.
- **Federal tax liability.** This is what an individual pays the IRS. Because the tax base would be the lowest of the three options, the actual tax rate would be higher than if the rate were applied to gross income or taxable income. For example, a 1.87% tax on gross income, a 2.54% tax on taxable income, or a 12.66% tax on federal tax liability would all raise the same amount for the state — about \$250 million a year. Using Federal Tax Liability as the base would require the state to accept whatever deductions and credits are allowed under federal law. Federal tax liability is Line 40 on Form 1040 (before several credits under the IRS code), or Line 52 (after Education Tax Credits and Elderly and Disabled Care Credits and others), or Line 52 plus the Earned Income Credit and Additional Child Tax Credit.

These are approximate numbers for tax rates and how much revenue would be raised by a state personal income tax in Alaska. The table assumes a flat tax for the sake of simplicity in showing potential revenues.

Table 13. Income Tax Rates and Income Tax Projections (2000 IRS Data)

<u>\$ Million Revenue</u>	<u>% Adjusted Gross Income</u>	<u>% Federal Taxable Income</u>	<u>% Net Federal Tax Liability</u>
\$250	1.87	2.54	12.66
\$300	2.22	3.03	15.08
\$350	2.58	3.51	17.49
\$400	2.93	4.00	19.91

Alaska abolished its personal income tax in 1980. The tax raised \$210.4 million in Fiscal 1977, its highest collections ever. The tax was assessed as a percentage of federal taxable income, ranging from 3.5% for income up to \$8,000 per year to a high of 14.5% on income in excess of \$300,000. In the middle, taxpayers paid 10% of their federal taxable income over \$52,000. If the pre-1980 tax rates were in effect today, Alaskans would pay about \$750 million in state personal income taxes. If the tax brackets were adjusted for inflation, that number would be \$660 million.

An income tax certainly would collect money from non-residents working in Alaska, but there is no way to know exactly how much it would collect. The IRS reports income earned by taxpayers with an Alaska mailing address; it does not report income earned by non-residents working in Alaska. There are no exact numbers for non-resident wages in Alaska, but estimates range from 3% to 10% and the Department of Revenue believes the true number is probably in the middle. At 6% or 7%, an income tax that raised \$350 million would collect perhaps \$21 million to \$22 million a year from non-residents.

A state personal income tax would be deductible from federal income taxes for Alaskans who itemize. IRS statistics indicate about 25% of Alaska taxpayers itemize their deductions, though most higher-income Alaskans itemize on their federal returns. And since it would be the higher-income Alaskans who would provide most of the state's new income tax revenues, a substantial portion of that tax would be deducted from Alaskans' tax payments to the federal government.

Statewide Sales Tax

The only states in the nation without a statewide sales tax are Alaska, Delaware, Montana, New Hampshire and Oregon. The others collect taxes that range from a low of 2.9% in Colorado to 7% in Mississippi and Rhode Island. In most states, the cities, counties, transit districts and other taxing authorities add their sales tax onto the state tax rate, with the states handling collection and enforcement, then disbursing the funds to the municipal agencies. Because of the cumulative effect of adding local sales taxes to the state tax, many states set a maximum overall rate. The highest total rates approach 10%.

Most states exempt all or some food purchases from sales taxes, with a few states charging a lower tax rate on foods. All states exempt prescription medicines from sales tax. Of those states with a general statewide sales tax, the tax provides an average 32.3% of overall state general fund revenues.

Although there is no statewide sales tax in Alaska, about one-third of Alaskans live in a community — a city or a borough — with a municipal sales tax. The rates for those 200,000-plus Alaskans range from:

- A low of 1% in Tenakee and White Mountain.
- To a high of 7% in Wrangell and 6% in Petersburg, Cordova, Kodiak and Kotzebue.

The 100 cities and boroughs with a sales tax collected about \$125 million in Fiscal Year 2001, for an average of more than \$600 per capita. Each municipality has its own list of tax exemptions, limits and rules, such as a cap on the maximum amount of a single purchase subject to a sales tax (to ease the burden on purchasers of big-ticket items such as cars). There is no uniformity across the state.

If Alaska had a statewide sales tax, the Department of Revenue estimates the state would collect approximately:

- \$110 million a year for every 1% in a statewide sales tax on retail goods and services sold in Alaska, assuming no exemptions.
- \$75 million a year if foods and medical goods and services were exempted.

It's hard to say how much of the sales tax would be paid by visitors from out of state, although the Department of Revenue believes it would be in the range of 10% of total tax revenues for a tax in place for the entire year. Visitors spend heavily on gifts, food, lodging and tours, although federal law prohibits a state sales tax on air transportation.

Additional exemptions would reduce the tax burden on some residents and, consequently, reduce revenues to the state. Exemptions also could complicate administration of the tax. And, if the state exempted any goods or services already subject to municipal sales taxes, and then imposed its exemptions on municipalities, some cities and boroughs could see a drop in their tax revenues.

Sales taxes exemptions are a large issue nationwide. Businesses nationwide and other states are working hard to win nationwide adoption of a Streamlined Sales and Use Tax Agreement. Alaska is an "Observer State" and has monitored this project, which has as its goal:

"To simplify and modernize sales and use tax administration in the member states in order to substantially reduce the burden of tax compliance."

One of the major reasons for the push is to address the issue of lost state and municipal sales tax revenues to mail order and Internet commerce. The growth of mail order and Internet sales is costing states and municipalities billions of dollars a year in lost sales tax revenues. The retail industry has made it clear that it wants to see a set of uniform sales tax rules nationwide as a condition of working with the states to collect sales taxes on interstate commerce. Alaska would not be in compliance with the nationwide effort if it adopted a state sales tax without ordering the same exemptions and rules for municipal sales taxes statewide.

Permanent Fund Earnings

The Department of Revenue and the Alaska Permanent Fund Corporation believe the amount of "surplus" realized earnings available from the Permanent Fund over the next decade will average about \$250 million per year under the existing statutory framework for calculating earnings and Permanent Fund dividends. However, the actual amount available in any one year will vary enormously - ranging from \$0 to more than \$500 million, depending on the performance of the financial markets and the mechanics of how the surplus is determined.

Relying on the surplus under existing statute to help pay for public services could be risky. For example, if the surplus for Fiscal 2001 or Fiscal 2002 were determined on the basis of current-year realized earnings only, there would have been no surplus available.

The Department of Revenue strongly recommends calculating the amount available for distribution each year from the Permanent Fund using a moving average over a five-year period. More specifically, the department recommends the legislature adopt the Percent of Market Value (POMV) approach, rather than realized earnings, to determine the amount of funds available for distribution. Using such a moving average would reduce the wild swings in the amount that would be available each year vs. using only a single-year's earnings to determine the amount available for distribution.

Under the Percent of Market Value calculation as endorsed by the Permanent Fund Board of Trustees, 5% of the Permanent Fund's total market value, as averaged over the past five years, would be available for distribution each year. Assuming the fund's long-term earnings target is about 8% the payout limit at 5% would ensure that sufficient earnings remain in the Permanent Fund to protect it from inflation.

At a 5% payout, the Permanent Fund, in the median case, would generate more than \$1.3 billion a year, on average, between Fiscal 2003 and Fiscal 2008, according to the Permanent Fund Corporation. The earnings — and the dividends — would continue building over time. A \$1.3 billion payout could, for example, fund almost an \$1,100 dividend (assuming 600,000 eligible Alaskans) and still leave \$650 million for the General Fund to help pay for public services.

New Money vs. Old Money

Finally, any discussion of closing the state's fiscal gap should include a look at "new money" vs. "old (or recycled) money." The more new money can be brought into the state's economy to close the gap, the less damage to Alaska's economic health. Another way of characterizing this is saying if we can "export" our efforts to close the fiscal gap by "importing" new money, our economy will be better off.

Examples of new money are:

- State tax and royalty revenues from new oil and gas discoveries.
- Taxes generated by new or expanded economic activity.
- Surplus earnings of the Permanent Fund. This is money not currently circulating through the Alaska economy because it is mostly invested in stocks and bonds outside of the state.
- Taxes paid by non-residents.
- Federal tax savings from deducting a state personal income tax
- Cruise ship corporate taxes or passenger taxes.

Examples of old, or recycled money include:

- Increased excise taxes, such as alcohol and motor fuel taxes. However, some of the higher taxes would be paid by non-resident workers and tourists.
- Sales taxes.
- Personal income tax.
- Reduced Permanent Fund dividends (the loss to Alaska's economy would be reduced by the amount of dividend money that would have flowed out of state in savings or purchases).

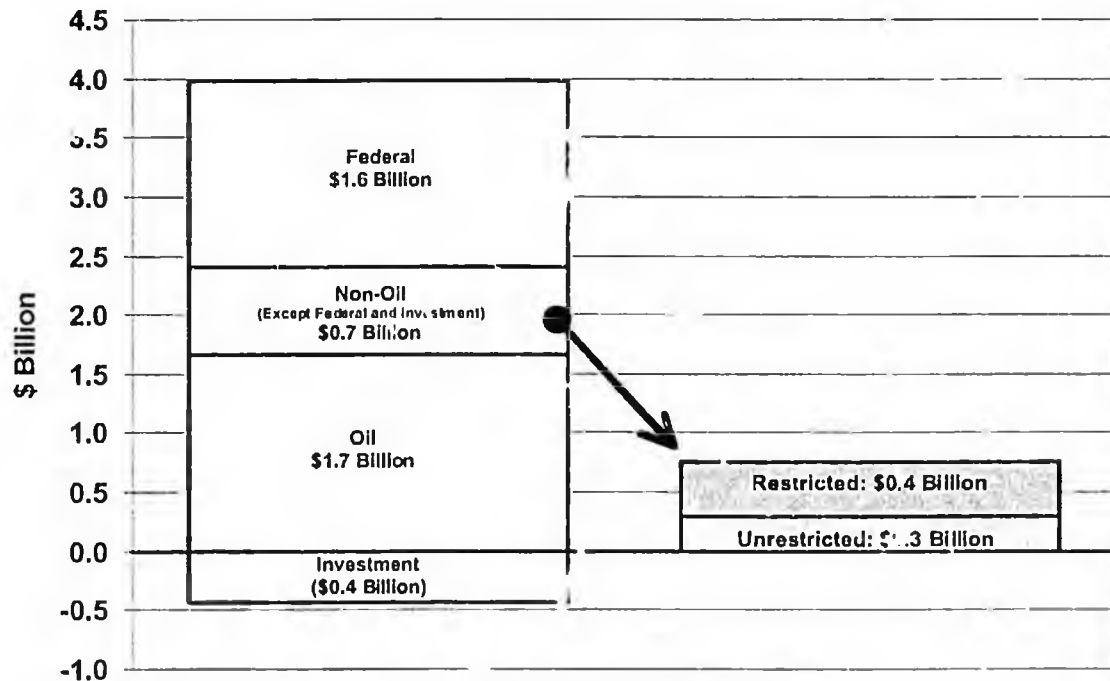
It's also worth considering in these discussions the reality of what has been called the "Alaska Disconnect." That is the disconnect between non-petroleum economic development and the state revenues needed to pay for the increased public services demanded by a growing population. Without a broad-based tax, non-petroleum economic development costs more in public services than it produces in revenues to the state. More jobs means more workers and more families and more children in school, more cars on the road, and more public expenses with no additional revenues to pay for those services.

V. OIL REVENUE

Table 14. Total Oil Revenue
Preliminary FY 2002 and Projected FY 2003-2004
\$ Million

	Preliminary FY 2002	FY 2003	FY 2004
Unrestricted			
Property Taxes	49.6	44.3	44.0
Corporate Income Taxes	178.4	160.0	200.0
Production Taxes	496.3	522.5	438.3
Royalties (including Bonuses and Interest)	<u>595.8</u>	<u>741.2</u>	<u>644.4</u>
Subtotal	1,320.1	1,468.1	1,326.7
Restricted			
Royalties to Permanent Fund & School Fund	264.2	327.2	295.6
Settlements to CBRF	90.2	30.0	20.0
NPRA Royalties, Rents and Bonuses	<u>1.7</u>	<u>34.8</u>	<u>2.9</u>
Subtotal	356.1	392.1	318.6
Total	1,676.2	1,860.1	1,645.3

Figure 14. FY 2002 Oil Revenue
\$1.7 Billion

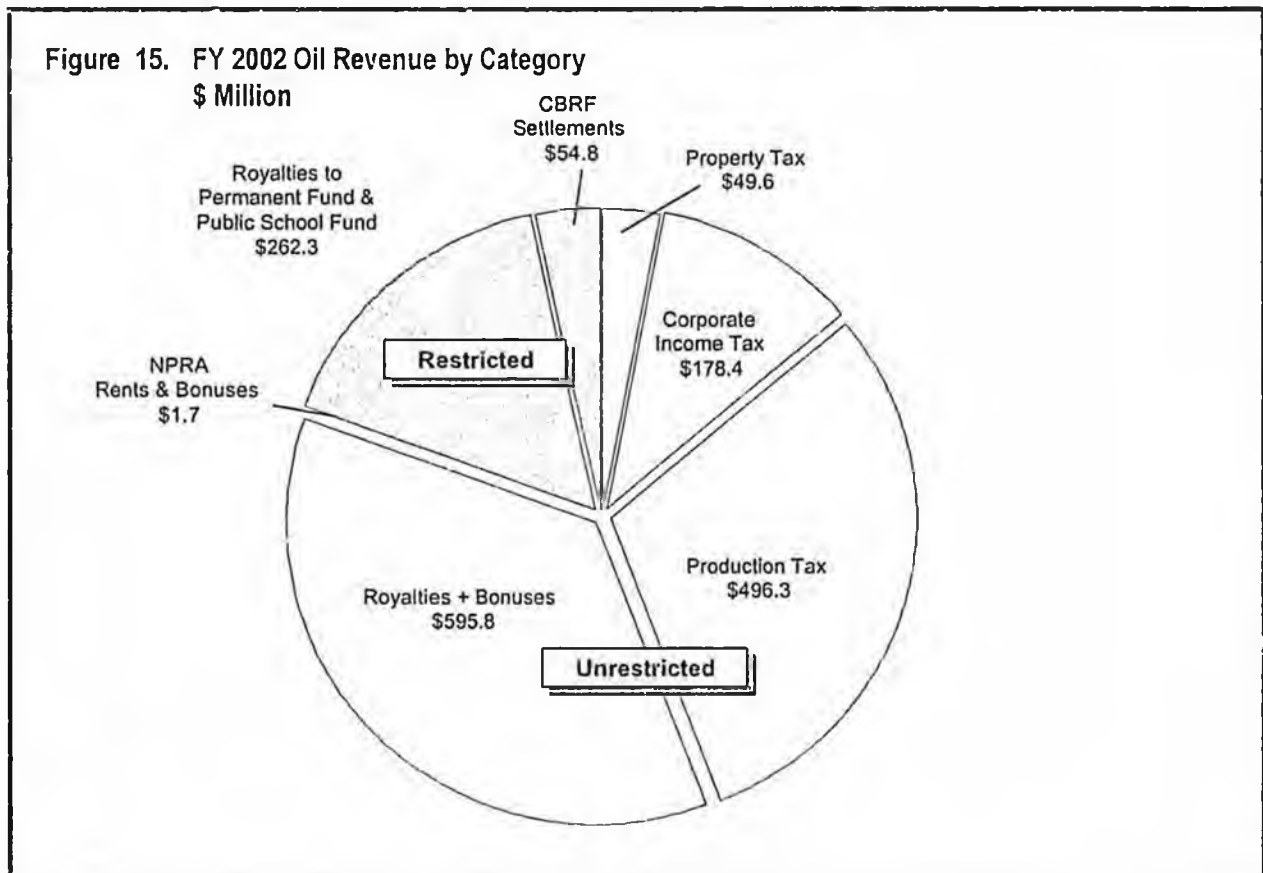


General Discussion

The state receives its oil and gas revenue from four sources: oil and gas production tax, property tax, royalties and corporate income tax. The bulk of the revenue received from taxes and royalties goes into the General Fund for general purpose spending. Slightly more than 30% of the royalty revenue goes into the principal of the Permanent Fund, and 0.5% goes into the Public School Trust Fund. Currently, the state's share of all lease bonuses from the National Petroleum Reserve-Alaska (NPR-A) goes into the NPR-A Fund.⁽¹⁾ Settlements of tax and royalty disputes between the State of Alaska and oil and gas producers go into the Constitutional Budget Reserve Fund (CBRF).

The figure below shows the actual amount of oil revenue from each source in Fiscal 2002.

As can be seen from the figure, royalties and severance taxes constitute the largest part of oil revenue — both restricted and unrestricted. This section begins with a discussion of these two revenue sources, both of which are driven by price and volume. We then review the price forecasting methodology that underlies our forecast, as well as explore how those market prices determine wellhead value. We also review our volume forecast, and close this section with a discussion of oil and gas property taxes, oil and gas corporate income taxes and the restricted portions of oil revenue.



(1) This fund implements a federal requirement that the state use its share of NPR-A oil revenue to satisfy the needs of local communities most affected by development in the NPR-A. For detailed information on this fund, see Section XII-P of Treasury's Investment Policies and Procedures Manual.

Unrestricted Oil Revenue

Table 15. Unrestricted Oil Revenue Projections
Preliminary FY 2002 and Projected FY 2003-2010
\$ Million

Fiscal Year	Property Taxes	Corporate Income Taxes	Production Taxes	Royalties including Bonuses & Interest	Total Oil
Preliminary 2002	49.6	178.4	496.3	595.8	1,320.1
2003	44.3	160.0	522.5	741.2	1,468.1
2004	44.0	200.0	438.3	644.4	1,326.7
2005	37.9	190.0	376.9	588.8	1,193.7
2006	35.7	180.0	359.6	576.8	1,152.1
2007	33.5	170.0	330.3	569.9	1,103.7
2008	31.2	160.0	318.7	578.5	1,088.4
2009	28.9	150.0	302.1	586.6	1,097.5
2010	26.5	140.0	297.2	557.0	1,020.7

Oil and Gas Production Taxes

All oil and gas production in Alaska except the federal and state royalty share is subject to the state's production taxes. The taxes consist of the oil and gas production tax and a hazardous release surcharge levied only on oil. All of these taxes are collected on a monthly basis.

Oil Production Tax

The tax rate for oil depends on the age of the field and the Economic Limit Factor (ELF). The ELF depends on the total daily oil production and the average daily per well oil production from each producing field.

The statutory production tax rate on oil is 12.25% of its value at the point of production for the first five years of field production and 15% thereafter. There is a minimum tax of 80 cents per taxable barrel.

The effective tax rate is calculated by multiplying the statutory tax rate, even if it is the minimum 80 cents per barrel, times the ELF. The ELF formula for oil production is:

$$ELF = \left[1 - \frac{(300 \times \text{wells})}{\text{volume}} \right]^{\left[\frac{(150,000)}{\text{volume}} \right]^{1.53333}}$$

"Wells" is the number of producing wells in the field and "volume" is the total daily production for the field.

The ELF formula results in lower effective tax rates for smaller, low-production fields and higher tax rates for larger, highly productive fields. There is a unique ELF for every combination of total daily field production and average daily per well production.

The taxable value of oil is determined by deducting allowable marine and pipeline transportation costs from the destination value of the oil at its disposition point. This point is defined as either a third-party sale or delivery to the producer's own refinery. The destination value for most dispositions is tied by regulation to the West Coast spot price of ANS crude oil.

Natural Gas Production Tax.

The statutory production tax rate on natural gas is 10% of its value at the point of production, regardless of the age of the field. There is a minimum tax of 6.4 cents per thousand cubic feet.

To calculate the effective tax rate, multiply the statutory tax rate, even if it is the minimum 6.4 cents per thousand cubic feet, by the ELF. The ELF formula for natural gas production is:

$$ELF = 1 - (3000/PPW)$$

PPW = average gas production per well per day in the field in thousand cubic feet

If the average daily per well gas production from a field is less than 3,000 cubic feet, the ELF is zero and no gas production taxes are assessed.

The taxable value of natural gas depends on the location of its disposition and its use. For Cook Inlet production, the value for gas sent to Japan as LNG is based on the sales price in Japan less marine, processing and pipeline costs; the value for sales to the Nikiski fertilizer plant is indexed to the current market price of anhydrous ammonia; the value for sales for local use is based on the average sales price for the contracts in effect each month. The small volume of taxable North Slope gas production is valued for tax purposes using the following formula linking it to the value for North Slope crude oil:

$$ANS \text{ Gas Taxable Value/mcf} = 0.10 \text{ (average ANS oil per barrel netback value)}$$

Hazardous Release Surcharge.

This tax was enacted following the 1989 grounding of the Exxon Valdez to provide an emergency fund to deal with hazardous substance spills.

The surcharge is comprised of two components: (1) a 3 cents per barrel charge on all oil production, except federal and state royalty barrels, and (2) an additional 2 cents per barrel charge on all oil production except federal and state royalty barrels whenever the balance in the state Oil and Hazardous Substance Release Prevention and Response Fund falls below \$50 million. The balance of the fund was \$50 million or greater for all of FY 2002, so the surcharge was 3 cents per barrel for the entire fiscal year.

Oil Royalties

Almost all Alaska oil and gas production occurs on lands leased by the state for exploration and development of oil and gas resources. As the land owner, the state earns revenue from leasing state-owned land as: (1) upfront bonuses, (2) annual rent charges, and (3) a retained royalty interest in oil and gas production.

Generally, the state issues leases based on a competitive bonus bid system. It has always retained a royalty interest of at least 12.5%. The vast majority of current production is from leases that carry that rate. Some currently producing leases carry rates as high as 20%.

State oil and gas leases provide that the state may take its oil royalty in barrels (in-kind) or as a percentage of the production value (in-value). Currently, the state takes approximately 60,000 barrels per day of Prudhoe Bay production in-kind and sells it to the Williams Alaska Petroleum Company, for its refinery in North Pole. The state's royalty share of Alaska North Slope production amounts to about 125,000 barrels per day.

The royalty oil taken in-value is valued according to a formula using a market basket of spot crude oil prices closely approximating the ANS West Coast spot price of oil less a transportation allowance back to the lease.

Oil Production Revenue Forecasting Methodology and Assumptions

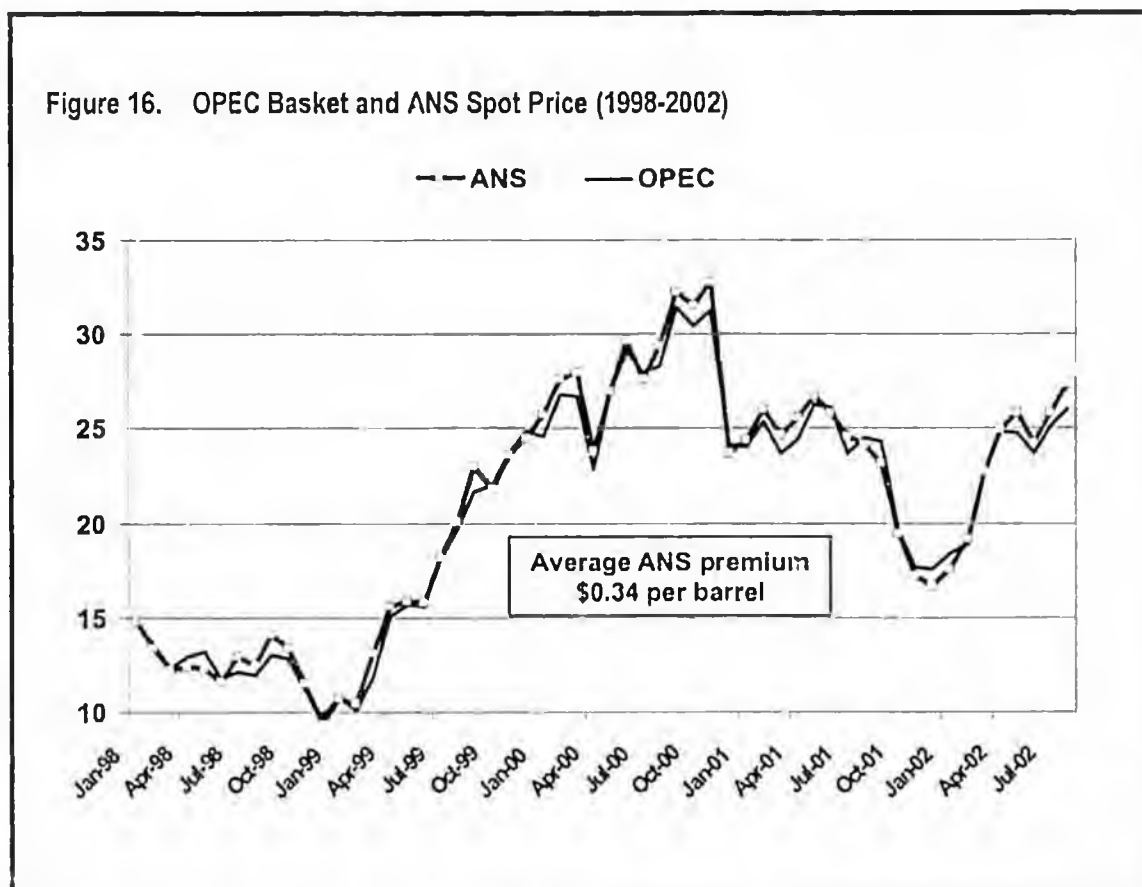
The forecasted value of the state's anticipated oil production is based on projections of the destination market price of oil and the cost of shipping oil by pipeline and tanker to market. The forecast is the product of a formal oil price scenario meeting that includes state economists and financial professionals from the Department of Revenue, Department of Natural Resources, Department of Labor, the Governor's Office of Management and Budget and the University of Alaska.

To develop a production volume forecast, the Department of Revenue uses an engineering consultant in conjunction with assistance from the Alaska Department of Natural Resources and the Alaska Oil and Gas Conservation Commission. This production volume forecast is developed from estimates of oil and gas production by field.

Oil Price Forecast

Our short-term price forecast (FY 2003-2005) is based on current supply-and-demand fundamentals and the uncertainty about a war with Iraq. For this three-year period, we are presenting two alternative cases: (1) no war with Iraq (our base case) and (2) war with Iraq.

Over the longer term, we present three alternative scenarios for a longer-term average price. Since 1999, the Organization of Petroleum Exporting Countries (OPEC) has endeavored to adjust its oil production quotas so that the current market price of the so-called OPEC basket falls within the range of \$22 to \$28 per barrel. The OPEC basket consists of seven different crude oils. ⁽²⁾ Over the past several years, the OPEC basket price and the West Coast delivered price for ANS have closely tracked one another with ANS selling at a modest premium to the OPEC basket. (See the figure below.)



(2) Saharan Blend, Minas, Bonny Light, Saudi Arab Light, Dubai, Tiajuana Light and Isthmus.

Because OPEC has been quite successful in managing the market and thereby keeping the price of the OPEC basket within its target range of \$22 to \$28 per barrel, we are changing our outlook for longer-term oil prices. For several years we have forecast that over the long term the delivered West Coast price for ANS would continue its post-1985 average of \$16.50 to \$17.50 per barrel. However, OPEC's success over the past three and a half years in maintaining the OPEC basket price within its target price band leads us to believe the most likely long-term delivered West Coast ANS price will be about \$22 per barrel (in nominal dollars) — the ANS price equivalent to the OPEC basket price at the bottom of the target range. That is our base case long-term oil price forecast.

As alternative cases, we present the results of using a \$17.70 delivered ANS price (the average delivered West Coast ANS price from January 1986 through October 2002), and using a \$25 price (the price equivalent to the mid-point in OPEC's target range and, coincidentally, roughly the ANS market price for November 2002).

Short-Term Scenarios.

Oil prices so far in FY 2003 are running \$5 higher than we forecast last spring. The uncertainty about a possible war with Iraq probably accounts for at least \$2 to \$3 of that increase.

The assumptions for our two alternative short-term price forecasts (FY2003 through FY2005) are:

- Worldwide economic growth sufficient to require a modest amount of new production from OPEC.
- Non-OPEC production will continue to grow because of high prices, and this production will satisfy most of the increase in demand created by economic growth.
- OPEC will continue to manage the volume of oil in the market so prices remain within its price target range.
- Inventories in key consuming countries will remain low.

In this forecast we present both a no-war scenario (our base case), and a war scenario in which hostilities occur in early 2003. In the war scenario we believe oil prices would spike to \$30.25 per barrel in the first quarter of 2003 and then decline to \$28.50 by summer. By 2005, we believe prices would be \$1.50 lower than in our base case because Iraq's production would likely increase following a war. A new regime and a need to rebuild the country after 10 years of U.N. sanctions would no doubt result in a surge in investments in new production.

**Table 16. Alternative General Fund Unrestricted Revenue, Short-Term Oil Price Scenarios
\$ Million**

No War Scenario — Our Base Case

FY	2003	2004	2005
ANS (\$/ Barrel)	\$25.94	\$23.25	\$22.00
General Fund Unrestricted Revenue (\$ Million)	1,752.2	1,603.5	1,471.0

War Scenario

FY	2003	2004	2005
ANS (\$/ Barrel)	\$27.94	\$23.19	\$20.50
General Fund Unrestricted Revenue (\$ Million)	1,885.7	1,599.6	1,377.4

Long-Term Scenarios.

**Table 17. Alternative General Fund Unrestricted Revenue, Long-Term Oil Price Scenarios
\$ Million**

Our Base Case Compared to \$17.70 and \$25.00/ Barrel

FY	2006	2007	2008	2009	2010
(\$/ Barrel)					
\$17.70	1,246.8	1,129.2	1,113.7	1,118.7	1,059.2
\$22.00 - Base Case	1,429.8	1,382.7	1,368.5	1,378.8	1,303.2
\$25.00	1,611.6	1,557.8	1,544.8	1,559.0	1,472.3

Current Oil Market Situation.

Alaska North Slope oil prices have been very strong so far in FY 2003, averaging \$26.50 per barrel so far this year. Signs of recovery in the U.S. economy, as well as lower production from Iraq and the prospect of another war in that region, have kept oil prices toward the upper limit of the OPEC \$22 to \$28 per barrel target range. Recent rebounds in crude inventories, along with continued increases in both OPEC and non-OPEC production as well as subtle moderation in war talk by the U.S., have seen prices falling back to around \$25 per barrel in late November.

Organization of Petroleum Exporting Countries.

OPEC has refrained from adjusting its production quotas from the levels established January 2002. They did, however, produce at 2.7 million barrels per day over quota in September. The members opted not to increase their quota to current actual levels at the September meeting, no doubt not wishing to institutionalize the higher current production levels in the event that softening oil prices would require adjusting quotas downward again.

The fundamental issue with respect to OPEC is that since April 2000 it has adjusted production quotas seven times; reducing production quotas in total by 5 million barrels per day since January 2001 and reducing actual production by 2.3 million barrels per day. The result has been a successful defense of the OPEC oil price target range of \$22 to \$28 per barrel.

This forecast assumes in the base case that OPEC is successful in continuing to manage the price band toward the bottom of its acceptable level.

Table 18. OPEC Production
Million Barrels Per Day

	September 2002	January 2002 Quota	over/(under) January 2002 Quota
Algeria	0.900	0.693	0.207
Indonesia	1.100	1.125	(0.025)
Iran	3.700	3.186	0.514
Kuwait	1.920	1.741	0.179
Libya	1.330	1.162	0.168
Nigeria	2.000	1.787	0.213
Qatar	0.660	0.562	0.098
Saudi Arabia	7.700	7.053	0.647
UAE	1.960	1.894	0.066
Venezuela	<u>3.100</u>	<u>2.497</u>	<u>0.603</u>
Subtotal (less Iraq)	24.370	21.700	2.670
Iraq	1.820		
Total OPEC	26.190	21.700	2.670

Source: Middle East Economic Review, October 28, 2002.

Alaska North Slope.

ANS prices closely track the price for the OPEC basket of internationally traded crude oils, the benchmark that OPEC uses to gauge the success of its production policy. ANS sells in direct competition with other waterborne crude oils sold at U.S. West Coast destinations. This includes a growing amount of crude oil from OPEC — primarily Saudi Arabia and Iraq.

ANS has a locational advantage over OPEC suppliers since it is the nearest waterborne source of crude oil for West Coast refiners. However, due to the seasonality of the West Coast market, ANS may trade at a premium or a discount relative to these competitive crude oils depending on the time of year and OPEC production policy. Currently, the West Coast crude oil market has strengthened at least in part due to Iraqi production cutbacks, with the result that ANS is now selling at a discount to WTI of \$1.55 per barrel, whereas in October 2001 the discount was \$2.84 per barrel. Last summer, differentials were even tighter due to seasonally lower ANS production and a tighter quality differential worldwide between high-sulfur crude oil like ANS and low-sulfur crude oil like WTI.

Other Transportation and Production Costs

Transportation Costs.

The forced replacement of vessels without double hulls with new, more expensive vessels, and the continued use of smaller qualified vessels to replace larger vessels retired by compliance with the Federal Pollution Act of 1990, will increase transportation costs in the future.

Trans-Alaska Pipeline System (TAPS) Tariffs.

The TAPS tariff is determined according to the TAPS Settlement Methodology, a rate-making method approved by the Federal Energy Regulatory Commission that allows the TAPS owners to recover their costs, including an allowance for profit. Under the agreement, future tariffs will be determined by operating cost trends, the production rate and inflation. Negotiations to revisit the TAPS Settlement Method will begin in January 2007.

TAPS tariffs are filed on a calendar year basis, with new tariffs taking effect January 1 each year. The expected tariff filing for calendar year 2003 is \$3.40 per barrel. The Fall 2002 Forecast Assumptions table on the next page contains projected tariffs for FY 2004-2010.

Feeder Pipeline Costs.

Certain additional transportation costs are also incurred to move the various crude oils that comprise ANS from North Slope production fields to Pump Station No. 1 of the Trans-Alaska Pipeline System. These include both feeder pipeline charges and other cost adjustments to account for the different qualities of oil entering the North Slope pipelines as well as market-location differentials for in-state sales. See Table 19.

Wellhead Price.

The combination of ANS wellhead value and production volume by field form the basis for both state production taxes and royalties. The wellhead value by field is calculated by subtracting the relevant marine transportation and pipeline tariff costs (as well as adjustments for North Slope feeder pipelines and pipeline quality bank) from the appropriate destination value. Table 19 on the next page reflects this calculation for FY 2003-2010.

**Table 19. Fall 2002 Forecast Assumptions
\$ per barrel**

Fiscal Year	ANS West Coast Price	ANS Marine Transportation	TAPS Tariff	Other ⁽¹⁾ Deductions & Adjustments	ANS Wellhead
Actual 2002	21.78	1.80	3.47	(0.29)	16.80
2003 ⁽²⁾	25.94	1.81	3.26	0.34	20.53
2004	23.25	1.86	3.34	0.18	17.88
2005	22.00	1.91	3.35	0.18	16.56
2006	22.00	1.96	3.45	0.19	16.41
2007	22.00	2.01	3.51	0.18	16.30
2008	22.00	2.06	3.45	0.26	16.25
2009	22.00	2.11	3.30	0.33	16.28
2010	22.00	2.16	3.32	0.37	16.17

(1) Other deductions include other pipeline tariffs, quality bank charges, location differentials and amended information.

(2) FY 2003 includes reported information through September.

Oil Production

Our short-term ANS oil production forecast has been reduced in anticipation of a slower than expected pace of heavy oil development, a slower pace of developing new Greater Kuparuk Area opportunities, delays in offshore Beaufort Sea developments, and uncertainty in facility expansion plans at the Colville River Unit. We have also incorporated recent unplanned production interruptions for the current fiscal year and have re-evaluated baseline reservoir performance at some of Alaska's mature fields. As a result, we expect to fall very slightly below the 1 million barrel per day level through FY 2007, at which point we anticipate new development will push production levels back over the 1 million per barrel level.

Production Highlights.

- FY 2003 production from Prudhoe Bay was reduced by about 9,000 barrels per day to reflect precautionary maintenance on over 130 wells.
- FY 2003 production from all North Slope fields was decreased an average 6,000 barrels per day due to repairing earthquake damage to the Trans-Alaska Pipeline vertical support system.
- The expected softening in the decline rate at the Prudhoe Bay field has been delayed. We now expect the rate of decline to slow in the next 2 to 3 years.
- Alpine's future peak production rate has been decreased to reflect current facility constraints. As a result, both the Fiord and Nanuq satellite fields have been delayed by one year due to uncertainty about the timing of required facility expansion.
- Kuparuk satellites were delayed one year to allow for continued evaluation.
- Both production rate and reserves in the Milne Point Kuparuk field have been significantly downgraded due to accelerated reservoir decline.
- Both the pace and production rate of development of heavy oil in the Schrader Bluff and West Sak fields have been reduced.
- Over the longer term, offshore developments for all Beaufort Sea development (primarily Liberty and Sandpiper) have been delayed by another year to account for potential environmental and permitting delays.

Table 20. Alaska Oil and NGL Production
Million Barrels per Day

	Actual FY 2002	FY 2003	FY 2004
Prudhoe Bay	0.4973	0.3952	0.3860
Midnight Sun	0.0062	0.0082	0.0066
Polaris	0.0014	0.0029	0.0043
Aurora	0.0051	0.0072	0.0077
Borealis	0.0133	0.0270	0.0293
Orion	0.0000	0.0007	0.0050
Kuparuk	0.1754	0.1580	0.1593
West Sak	0.0060	0.0074	0.0126
Tabasco	0.0028	0.0030	0.0027
Tarn	0.0273	0.0315	0.0255
Meltwater	0.0032	0.0096	0.0110
Milne Point	0.0397	0.0344	0.0367
Schrader Bluff	0.0117	0.0177	0.0225
Sag River	0.0007	0.0004	0.0004
Endicott/ Sag Delta	0.0296	0.0276	0.0283
Eider	0.0017	0.0011	0.0011
Badami	0.0017	0.0015	0.0013
Lisburne	0.0102	0.0095	0.0095
Point McIntyre	0.0454	0.0412	0.0365
Niakuk	0.0191	0.0142	0.0118
Alpine	0.0956	0.0972	0.0980
Northstar	<u>0.0200</u>	<u>0.0588</u>	<u>0.0620</u>
Total	1.0034	0.9936	0.9973
Cook Inlet	0.0293	0.0329	0.0409
Total Alaska	1.0327	1.0265	1.0382

Petroleum Property Tax

An annual tax is levied each year on the full and true value of property taxable under AS 43.56. The tax on oil and gas property is the only statewide property tax. The valuation procedure for three distinct classes of property — exploration, production and pipeline transportation — is described below.

Exploration Property:

Value is based on the estimated price that the property would bring in an open market under prevailing market conditions in a sale between a willing seller and a willing buyer, both conversant with the property and with prevailing general price levels.

The raw data for market value is gathered by the state appraiser by reviewing the details of equipment sales, attending auctions and reviewing trade journals. This data is then applied to the taxable property, taking into account age, capacity, physical and functional obsolescence.

Production Property:

Value is determined on the basis of replacement cost new less depreciation, based on the economic life of the proven reserves.

In the case of an offshore oil or gas platform or onshore facility, the number of years of useful life is determined by estimating when the facility would reach its economic limit, not on the basis of the projected physical life of the property. The time period until the estimated operating revenue would equal operating expenses plus the current age of the facility equals the total life. The depreciation factor for the facility equals the years of remaining life *divided* by the total life.

Pipeline Transportation Property:

The full and true value of taxable pipeline property is determined with due regard to the economic value of the property based on the estimated life of the proven reserves of gas or unrefined oil that will be transported by the pipeline. We rely upon several standard appraisal techniques to value Alaska pipelines. We primarily rely on the income method under which the value is the present worth of all future income streams of the pipeline. Over 95% of pipeline transportation property is accounted for by the Trans-Alaska Pipeline from Prudhoe Bay to Valdez.

The table on the next page illustrates the property tax distribution between local communities and the state for FY 2002. The property value is assessed by the state. A local tax is levied on the state's assessed value for oil and gas property within a city or borough, and is subject to the local property tax limitations established in AS 43.29.080 and .100. State law limits owners to paying 20 mills on their property — local governments get their share first, and the state receives whatever is left up to 20 mills.

Figure 17. FY 2002 Assessments by Property Type

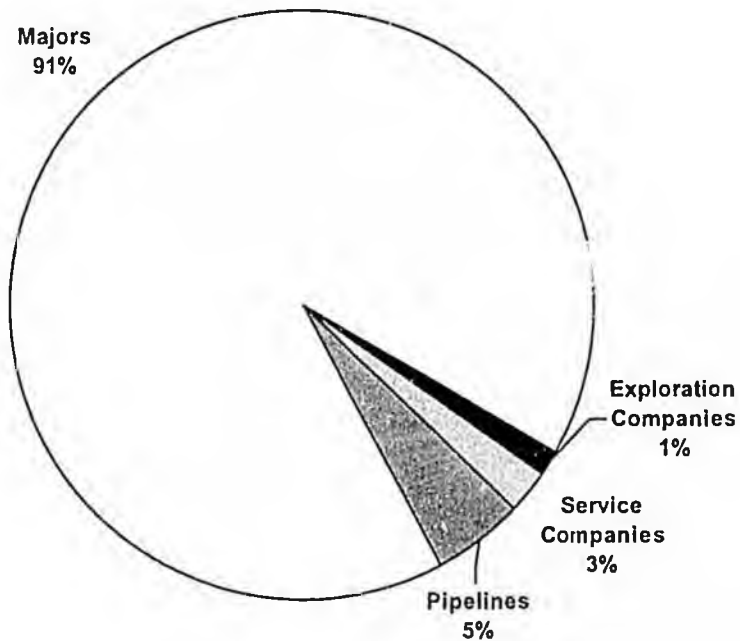


Table 21. FY 2002, Distribution of the Petroleum Property Tax
\$ Million

Municipalities	Gross Tax	Local Share	State Share
North Slope	210.5	194.7	15.8
Unorganized	27.3	0.0	27.3
Valdez	13.2	13.2	0.0
Kenai	13.2	7.9	5.3
Fairbanks	5.3	4.2	1.1
Anchorage	0.8	0.7	0.1
Other Municipalities ⁽¹⁾	0.2	0.1	0.1
Total	270.4	220.7	49.7

(1) Other municipalities include Matanuska-Susitna, Cordova and Whittier.

Petroleum Corporate Income Tax

A petroleum corporation's Alaska income tax depends on the relative size of its Alaska-vs.-worldwide activities and the corporation's total worldwide net earnings. The corporation's Alaska taxable income is derived by apportioning the corporation's worldwide taxable income to Alaska using the average of three factors: the proportion of the corporation's (1) tariffs and sales, (2) oil and gas production, and (3) oil and gas property in Alaska.

We begin our forecast by estimating the statistical relationship between historical collections of tax and the value of Alaska oil production. We then adjust the forecast for carryforwards and refunds. In FY 2003, the carryforward and refund adjustment is over \$70 million. This adjustment is a result of oil companies overpaying their income taxes. As a result of this adjustment, plus low marketing and refining margins, the FY 2003 petroleum corporation income tax projection is relatively low — in spite of projected high oil prices. As margins improve and refunds and carryforwards are used up, revenues should increase in FY 2004.

Restricted Oil Revenue

The table below reflects restricted oil and gas revenue.

A minimum of 25% of all mineral lease rentals, royalties, royalty sale proceeds, federal mineral revenue sharing payments and bonuses received by the state must be deposited into the Alaska Permanent Fund. For state oil and gas leases issued after 1980, state statute requires a 50% contribution to the fund. In addition, a state statute also requires a contribution of 0.5% of all royalties and bonuses to the Public School Fund Trust. As explained earlier, settlements with or judgments against the oil industry involving tax and royalty disputes must be deposited in the CBRF.

The state is entitled to 50% of all bonuses, rents and royalties from oil development activity in the federal NPR-A. All such revenue flows into the NPR-A Special Revenue Fund. All of the revenue in the fund each year is available for appropriation in the form of grants to municipalities that demonstrate present or future impact from NPR-A oil development. Of the revenue not appropriated to the municipalities, 25% goes to the Permanent Fund, 0.5% goes to the Public School Trust Fund, and the rest may be appropriated to the Power Cost Equalization and Rural Electric Capitalization Fund. Any remaining revenue after these appropriations lapses into the General Fund.

Table 22. Restricted Oil Revenue
\$ Million

	Preliminary FY 2002	FY 2003	FY 2004
Restricted Oil Revenue			
Royalties to Permanent Fund & Public School Fund			
Royalties to the Permanent Fund	260.2	321.9	291.0
Royalties to the Public School Fund	<u>4.0</u>	<u>5.3</u>	<u>4.7</u>
Subtotal	264.2	327.2	295.6
Settlements to the CBRF	90.2	30.0	20.0
NPR-A Royalties, Rents and Bonuses	<u>1.7</u>	<u>34.8</u>	<u>2.9</u>
Total	356.1	392.1	318.6

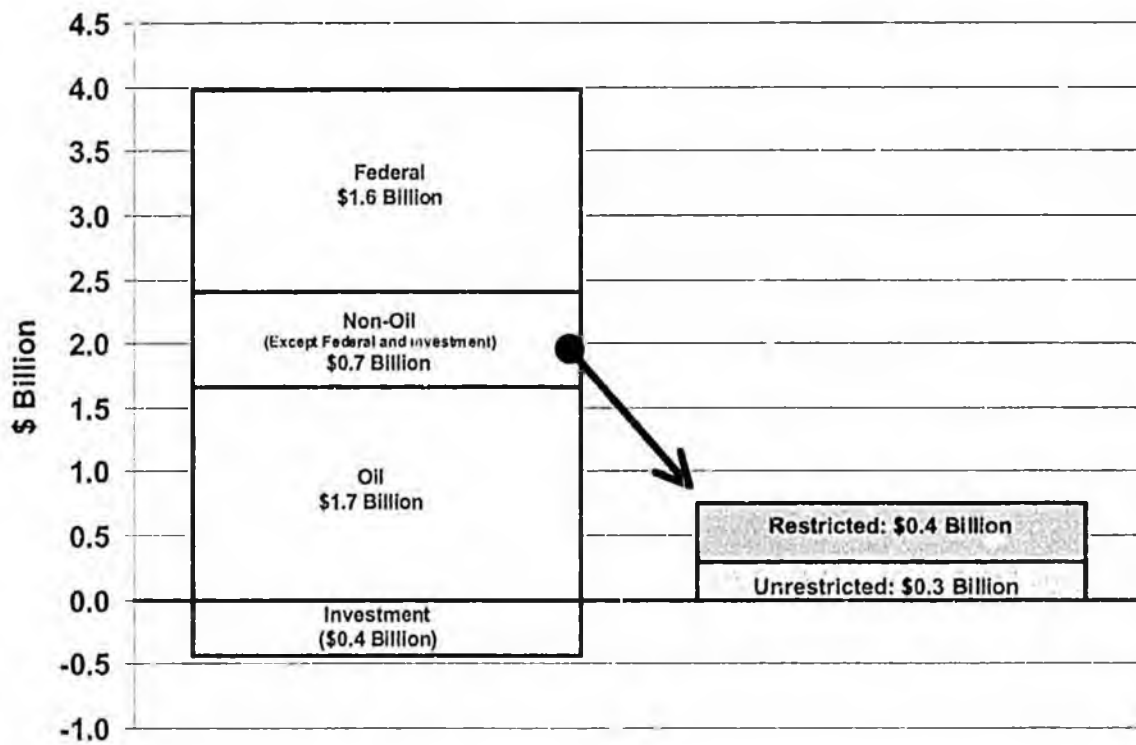
VI. NON-OIL REVENUE (EXCEPT FEDERAL AND INVESTMENT)

Income from sources other than oil and investments includes non-oil taxes, user fees and licenses. Many of these revenue sources are divided between unrestricted and restricted revenues; the amounts of each are reflected in the tables. Restricted revenue includes money deposited in funds other than the Unrestricted General Fund. For purposes of this forecast, restricted revenue also includes receipts that the legislature consistently appropriates or sets aside for a particular purpose or program, such as sharing of fish tax revenue with municipalities.

Table 23. Non-Oil Revenue (Except Federal and Investment)
Preliminary FY 2002 and Projected FY 2003-2004
\$ Million

	Preliminary FY 2002	FY 2003	FY 2004
<u>Unrestricted</u>			
Taxes	177.6	171.4	176.8
Charges for Services	20.2	12.7	12.7
Fines and Forfeitures	10.6	10.6	10.6
Licenses and Permits	42.2	32.5	33.2
Rents and Royalties	11.8	11.8	11.8
Other	<u>28.3</u>	<u>14.4</u>	<u>15.0</u>
Total Unrestricted	290.7	253.4	260.1
<u>Restricted</u>			
Taxes	57.7	62.8	67.8
Charges for Services	232.2	306.0	308.6
Fines and Forfeitures	24.9	24.7	21.5
Licenses and Permits	25.6	25.9	26.1
Rents and Royalties	0.0	0.0	0.0
Other	<u>125.1</u>	<u>129.0</u>	<u>82.3</u>
Total Restricted	465.5	548.4	506.3
Total	756.2	801.8	766.4

Figure 18. FY 2002 Non-Oil Revenue (Except Federal and Investment)
\$0.7 Billion



Non-Oil Tax

Alcohol Beverage Tax

Alcoholic beverage taxes are collected primarily from wholesalers and distributors for alcoholic beverages sold in Alaska. On October 1, 2002 per gallon tax rates on alcoholic beverages were increased from \$0.35 to \$1.07 for beer, \$0.85 to \$2.50 for wine and \$5.60 to \$12.80 for liquor. Also, starting October 1, 2002, 50% of the revenue is deposited in the "Alcohol and Other Drug Abuse Treatment and Prevention Fund." Because the legislature "may use the annual estimated balance in the fund to make appropriations to the Department of Health and Social Services," this revenue is reflected as restricted in the Revenue Sources Book.

Corporate Income Tax

Corporations that do business in Alaska pay the Corporate Net Income Tax unless they are organized under a special IRS rule (Subchapter S) that generally applies to small, closely held companies. A corporation that does business both inside and outside Alaska must apportion its income to determine how much income it earned here. Corporations other than oil and gas corporations apportion their income to Alaska by using a three-factor formula based on sales, property and payroll. Alaska taxable income is determined by applying the apportionment factor to the corporation's modified federal taxable income. Corporate tax rates are graduated from 1% to 9.4% in \$10,000 increments of Alaska taxable income. The maximum rate of 9.4% applies to income over \$90,000.

Electric Cooperative and Telephone Cooperative Taxes

The electric cooperative and telephone cooperative taxes dates back to 1959, when the first Alaska legislature enacted the Electric and Telephone Cooperative Act to promote cooperatives around the state. The electric cooperative tax is based on kilowatt-hours furnished by qualified electric cooperatives recognized under AS 10; the telephone cooperative tax is levied on gross revenue of qualified telephone cooperatives under AS 10. All revenue from the co-op taxes is deposited in the General Fund, but revenue from co-ops located in municipalities is treated as restricted revenue in this forecast because it is shared 100% with the municipalities.

Estate Tax

This tax is levied on the transfer of an estate upon death. The Alaska estate tax is tied to the federal tax: The amount of the state tax equals the maximum state credit allowed on the estate's federal return. As a result of changes to the federal estate tax, the Alaska estate tax will be phased out by FY 2006. All revenue derived from estate taxes is deposited in the General Fund.

Fisheries Business Tax

The fisheries business tax is the oldest tax in Alaska, dating from 1913. The tax is levied on businesses that process or export fisheries resources from Alaska. Although the tax usually is levied on the act of processing, the tax is often referred to as a "raw fish tax" because it is generally based on the value paid to commercial fishers for the raw fishery resource. Tax rates vary from 1% to 5%, depending on whether a fishery resource is classified as "established" or "developing," and whether it was processed by an on-shore or floating processor. All revenue from the fisheries business tax is deposited in the General Fund, but not all of it is considered unrestricted for the purposes of this forecast. Each year, the legislature appropriates half the revenue from the tax either to the municipality in which the resource was processed, or, when the resource was processed outside a municipality, to the Department of Community and Economic Development to share. Given that this sharing formula is in statute, and that the legislature consistently follows the statutory formula, this forecast considers the shared revenues to be restricted. Fisheries business tax revenues declined in FY 2003 (2002 fishing season), mostly as a result of lower salmon values.

Fishery Resource Landing Tax

The fishery resource landing tax was enacted in 1993. The tax is levied on processed fishery resources first landed in Alaska, and is based on the unprocessed statewide average value of the resource. Fishery resource landing taxes are collected primarily from factory trawlers and floating processors that process fishery resources outside of the state's 3-mile limit and bring their products into Alaska for transshipment. Fishery resource landing tax rates vary from 1% to 3%, based on whether the resource is classified as "established" or "developing." All revenue derived from the fishery resource landing tax is deposited in the General Fund, but, by statute, 50% is available for sharing with municipalities on the same lines as the fisheries business tax. The revenue to be shared is considered restricted.

Insurance Premium Tax

Insurance companies in Alaska do not pay corporate income tax or sales or other excise taxes. Instead, they pay an insurance premium tax. Receipts from this tax are deposited in the General Fund. However, receipts from the insurance premium tax that are accounted for in the "Workers Safety and Compensation Fund" are shown as restricted.

Mining License Tax

This tax is on the net income of mining property in the state, ranging from 0% to 7%, less exploration and other credits. Except for sand and gravel operations, new mining operations are exempt from the mining license tax for a period of 3½ years after production begins. The production value of minerals decreased from 2000 levels by 6.5% in 2001 to \$0.9 billion, mostly due to the decreased value of zinc. In 2001, zinc accounted for 70% of the production value for all metals mined in Alaska. Although the price of gold has improved by almost 10% over FY 2002, zinc prices remain low in FY 2003.

Motor Fuel Tax

The motor fuel tax dates back to 1945 when a tax of 1¢ per gallon was imposed on all motor fuel. The motor fuel tax is levied on motor fuel sold, transferred or used within Alaska. Motor fuel taxes are collected primarily from wholesalers and distributors licensed as qualified dealers. Current per gallon rates are 8¢ for highway use, 5¢ for marine use, 4.7¢ for aviation gasoline, 3.2¢ for jet fuel, and a variable rate of 8¢/2¢, depending on the season, for gasohol. Various uses of fuel are exempt from tax, including fuel used for heating or in flights to or from a foreign country. All revenue derived from motor fuel taxes is deposited in the General Fund, but 60% of taxes attributable to aviation fuel sales at municipal airports are shared with the respective municipalities, and hence considered restricted for purposes of this forecast.

Seafood Assessments and Taxes

The Department of Revenue administers several different programs that raise money through seafood assessments. The money raised is then set aside for the legislature to appropriate for the benefit of the seafood industry — either in marketing or in management/development of the industry. The four programs are the salmon marketing tax, seafood marketing assessment, salmon enhancement tax and dive fishery management assessment. The rates for many of these assessments are actually determined by a vote of the appropriate association within the seafood industry. Although all revenue received under these assessments is deposited in the General Fund, for purposes of this forecast it is treated as restricted revenue. With the exception of the salmon enhancement tax, all other seafood assessments are reflected under the Charges for Services section.

Tobacco Tax

The tobacco tax dates back to 1949, when a tax of 3 cents per pack of cigarettes and 2 cents per ounce of tobacco was enacted. The tobacco tax is levied on cigarettes and tobacco products sold, imported or transferred into Alaska. Tobacco taxes are collected primarily from licensed wholesalers and distributors. The tax rate on cigarettes is \$1 per pack of 20 cigarettes. The tax rate on other tobacco products — such as cigars and chewing tobacco — is 75% of the wholesale price. Seventy-six percent of cigarette tax revenue is deposited in the School Fund; 24% in the General Fund. All tobacco products tax revenue is deposited in the General Fund; all cigarette and tobacco products license fees are deposited in the School Fund. Revenue deposited in the School Fund is dedicated to the rehabilitation, construction, repair and insurance costs of state school facilities. The decrease in cigarette tax revenue is due to a decline in taxable cigarette sales. The increase in other tobacco products revenue is due to the growth in the wholesale value of other tobacco products.

Charitable Gaming

Under Alaska law, municipalities and qualified non-profit organizations may conduct certain charitable gaming activities. The purpose of these activities is to derive public benefit in the form of money for the charities and revenues for the state. The Department of Revenue collects permit and license fees, a 1% net proceeds fee, and a 3% pull-tab tax.

Table 24. Non-Oil Tax
Preliminary FY 2002 and Projected FY 2003-2004
\$ Million

	Preliminary		
	FY 2002	FY 2003	FY 2004
Unrestricted			
Sales and Use Tax			
Alcoholic Beverage	12.9	12.5	15.3
Cigarette	9.5	9.3	9.1
Other Tobacco Product	6.0	6.3	6.6
Insurance Premium	34.1	37.4	39.2
Electric and Telephone Cooperative	0.1	0.1	0.1
Motor Fuel	<u>40.2</u>	<u>36.1</u>	<u>37.5</u>
Subtotal	102.8	101.7	107.8
Corporation Income Tax	53.4	50.0	50.0
Fish Tax			
Fisheries Business	12.7	11.1	11.1
Fishery Resource Landing	<u>2.6</u>	<u>3.5</u>	<u>3.5</u>
Subtotal	15.3	14.6	14.6
Other			
Mining	0.5	0.5	0.5
Estate	3.1	2.1	1.4
Charitable Gaming	<u>2.5</u>	<u>2.5</u>	<u>2.5</u>
Subtotal	6.1	5.1	4.4
Total Unrestricted	177.6	171.4	176.8
Restricted			
Sales and Use Tax			
Alcoholic Beverage (Alcohol & Drug Treatment)	0.0	9.6	15.3
Insurance Premium (Workers Safety & Compensation)	3.2	3.0	3.0
Electric and Telephone Cooperative (Municipal Share)	3.1	3.1	3.1
Cigarette (School Fund)	30.3	29.3	28.6
Motor Fuel - Aviation (Municipal Share)	<u>0.2</u>	<u>0.2</u>	<u>0.2</u>
Subtotal	36.8	45.2	50.2
Fish Tax			
Fisheries Business (Municipal Share)	12.6	11.1	11.1
Fishery Resource Landing (Municipal Share)	4.6	4.1	4.1
Salmon Enhancement (Aquaculture Assoc. Share)	<u>3.7</u>	<u>2.4</u>	<u>2.4</u>
Subtotal	20.9	17.6	17.6
Total Restricted	57.7	62.8	67.8
Grand Total	235.3	234.2	244.6

Charges for Services

The charges for services reported in the next table do not include all charges for state services — it just reflects those that do not fit into other categories in this report. Most of these receipts are restricted revenue because they are returned to the program from which they came.

The only unrestricted revenue listed under charges for services in this report comes from fees and other program charges that do not have program receipt designations, or are not otherwise segregated and appropriated back to the program.

Marine Highway Fund

The revenue from certain transportation enterprises is reported here as a charge for state services. The Alaska Marine Highway Fund is in the General Fund and receives the revenue from operations of the state ferry system. The legislature has discretion over how the revenue is spent but, because it is customarily spent on Alaska Marine Highway operations, it is considered restricted.

Program Receipts

The definition of program receipts under AS 37.05.146 is "fees, charges, income earned on assets and other state money received by a state agency in connection with the performance of its functions." The statute then lists out all programs with program receipt authority. The statutory list includes many programs that are not included in Charges for Services because they are elsewhere in this forecast — such as federal receipts, trust funds and the Permanent Fund — or not state money, such as the public employee retirement funds. The table on the next page lists some of the larger individual programs and the receipts from those programs.

The largest of these is state airport revenue from landing and other fees, rents and the sale of aviation fuel. This is deposited in the International Airport Fund, which is an enterprise fund that the legislature traditionally appropriates only for air transportation purposes.

"Statutorily Designated" program receipts are those receipts from contracts, grants, gifts or bequests. The remaining program receipts are included under "Receipt Supported Services." Those not listed separately, or not described elsewhere in this forecast, are included in the catchall "Other."

Table 25. Charges for Services
Preliminary FY 2002 and Projected FY 2003-2004
\$ Million

	Preliminary FY 2002	FY 2003	FY 2004
Unrestricted			
General Government	17.0	10.0	10.0
Natural Resources	2.0	1.5	1.5
Other	<u>1.2</u>	<u>1.2</u>	<u>1.2</u>
Total Unrestricted	20.2	12.7	12.7
Restricted			
Marine Highway Receipts ⁽¹⁾	32.2	41.0	42.5
Statutorily Designated	55.5	98.7	98.7
Airport Receipts	72.6	74.0	74.0
Receipt Supported Services			
Pioneer Home Receipts	12.8	12.5	12.5
Banking and Securities	10.8	10.4	10.4
Occupational Licensing Receipts	6.4	7.9	8.2
Vehicle Registration Fees ⁽²⁾	*	6.5	6.5
Regulatory Commission of Alaska Receipts	5.9	5.5	5.5
DNR Recording Fees	5.3	5.1	4.9
Alaska Seafood Marketing	4.8	4.2	4.2
Insurance Licensing Fees and Permits	4.7	4.9	5.1
Commercial Fisheries Entry Commission Receipts	3.4	3.3	3.3
State's Child Support Enforcement Services ⁽²⁾	*	3.3	3.4
Oil and Gas Conservation	3.1	4.3	4.6
Vocational Tech Center and Teacher Certification	2.3	2.6	2.7
Test Fisheries Receipts	2.2	2.4	2.4
DOT Airport/ Navigation Fee ⁽²⁾	*	2.6	2.8
DOT Standards & Commercial Vehicles	1.7	1.7	1.9
DOT Whittier Toll	1.3	1.1	1.2
DEC Food Inspection ⁽²⁾	*	1.6	1.6
H&SS Vital Statistics	1.2	1.2	1.4
Corrections Community Residential Center	1.0	1.1	1.1
Other	<u>5.0</u>	<u>10.1</u>	<u>9.7</u>
Subtotal	71.9	92.3	93.4
Total Restricted	232.2	306.0	308.6
Grand Total	252.4	318.7	321.3

(1) In FY 2002, actual revenue was \$39.5 million. However, \$7.3 million was moved to prior year accrual in FY 2003 as a result of changes in accounting practices.

(2) In FY 2002, these receipt supported services were accounted for under unrestricted Licenses and Permits, Charges for Services and Other.

Fines and Forfeitures

This category includes civil and criminal fines and forfeitures, and money received by the state from the settlement of various civil lawsuits. The majority of the receipts under this category are from tobacco litigation and other settlements.

Tobacco Settlement

The tobacco settlement was signed by 46 states (including Alaska) in November 1998. The first payment from the settlement was made in FY 2000. In 2000 and 2001, the legislature authorized the sale of 80% of the future revenue stream from the tobacco settlement to a new public corporation, the Northern Tobacco Securitization Corporation, a subsidiary of the Alaska Housing Finance Corporation. The new corporation, in turn, sold bonds based on this revenue stream, and paid to the state the money raised by the bond sale, which the legislature appropriated for schools, the university and harbor projects. Starting in FY 2002, the remaining 20% of the settlement revenue each year will be deposited into the new Tobacco Use Education and Cessation Fund. We also show the 80% that goes directly to the Northern Tobacco Securitization Corporation for payment of the bonds.

Table 26. Fines and Forfeitures
Preliminary FY 2002 and Projected FY 2003-2004
\$ Million

	Preliminary		
	FY 2002	FY 2003	FY 2004
<u>Unrestricted</u>			
Other Settlements	5.0	5.0	5.0
Other Fines and Forfeitures	<u>5.6</u>	<u>5.6</u>	<u>5.6</u>
Total Unrestricted	10.6	10.6	10.6
<u>Restricted</u> ⁽¹⁾			
Tobacco Settlement (Northern Tobacco Securitization Corp.)	19.9	19.8	17.2
Tobacco Settlement (Tobacco Use Education & Cessation Fund)	<u>5.0</u>	<u>4.9</u>	<u>4.3</u>
Total Restricted	24.9	24.7	21.5
Grand Total	35.5	35.3	32.1

(1) Assumes that all four "Original Participating Manufacturers" pay their initial and annual payments in full. Brown and Williamson withheld payment in the past due to ongoing disputes with participating states.

Licenses and Permits

Licenses and permits represent another source of government revenue derived from charges for allowing people to participate in activities regulated by the state. The majority of the receipts under this category are from motor vehicle registration and fishing and hunting license fees.

Fishing and Hunting Licenses Fees

The majority of these fees are appropriated to a special revenue fund called the Fish and Game Fund. Money in the fund may only be spent for fish and game management purposes.

Motor Vehicle Registration Fees

Most motor vehicle registration fees are unrestricted license and permit revenue. However some registration fees are reflected under restricted receipt supported services.

Table 27. Licenses and Permits
Preliminary FY 2002 and Projected FY 2003-2004
\$ Million

	Preliminary FY 2002	FY 2003	FY 2004
<u>Unrestricted</u>			
Motor Vehicle	35.7	29.8	30.5
Other Fees	6.5	2.7	2.7
Total Unrestricted	42.2	32.5	33.2
<u>Restricted</u>			
Fishing and Hunting			
Hunting and Fishing Fees (Fish and Game Fund)	23.3	23.5	23.7
Sanctuary Fees (Fish and Game Fund)	0.1	0.1	0.1
Subtotal	23.4	23.6	23.8
Other Fees (Clean Air Protection Fund)	2.2	2.3	2.3
Total Restricted	25.6	25.9	26.1
Grand Total	67.8	58.4	59.3

Rents and Royalties

The majority of the unrestricted receipts under this category are from leasing, rental and sale of state land. Although certain restricted receipts go to the Permanent Fund, Mental Health Trust Fund and Public School Trust Fund, these are treated elsewhere.

Table 28. Rents and Royalties
Preliminary FY 2002 and Projected FY 2003-2004
\$ Million

	Preliminary FY 2002	FY 2003	FY 2004
<u>Unrestricted</u>			
Land Leasing, Rental and Sale	10.8	10.8	10.8
Coal Royalties	0.6	0.6	0.6
Timber Sales	0.2	0.2	0.2
Cabin Rentals	<u>0.2</u>	<u>0.2</u>	<u>0.2</u>
Total Unrestricted	11.8	11.8	11.8
 Grand Total	 11.8	 11.8	 11.8

Other

This category includes unrestricted contributions, unclaimed property and miscellaneous other receipts.

Public Corporation Dividends

The public corporations of the state listed in this section have been capitalized with state money, which the corporations use for purposes — usually loans — related to their mission. The dividend listed in the next table is treated as restricted revenue.

Unclaimed Property

Under the unclaimed property statutes, a person holding abandoned property belonging to someone else must turn the property over to the state, which holds the property in trust until claimed by its rightful owner. Most unclaimed property is in the form of cash (checking and savings accounts), stocks and bonds (including dividends) and safe-deposit box contents. Other property includes utility deposits, traveler checks and wages. Because not all unclaimed property owners are located, amounts received from holders exceed the refunds to owners. The Treasury Division maintains a minimum balance in the trust account and periodically transfers excess funds to the General Fund. Unclaimed property receipts for FY 2002 are far greater than in any other year because of a very large settlement of an unclaimed property dispute with Bank of America.

Table 29. Other Non-Oil Revenue
Preliminary FY 2002 and Projected FY 2003-2004
\$ Million

	Preliminary		
	FY 2002	FY 2003	FY 2004
<u>Unrestricted</u>			
Miscellaneous	13.3	10.4	11.0
Unclaimed Property	<u>15.0</u>	<u>4.0</u>	<u>4.0</u>
Total Unrestricted	28.3	14.4	15.0
<u>Restricted</u>			
Dividends from Public Corporations			
Alaska Housing Finance	103.0	103.0	75.7
Alaska Industrial Development & Export Authority	17.5	19.0	0.0
Alaska Student Loan Corporation	4.0	5.0	5.0
Alaska Municipal Bond Bank	<u>0.6</u>	<u>2.0</u>	<u>1.6</u>
Total Restricted	125.1	129.0	82.3
Grand Total	153.4	143.4	97.3

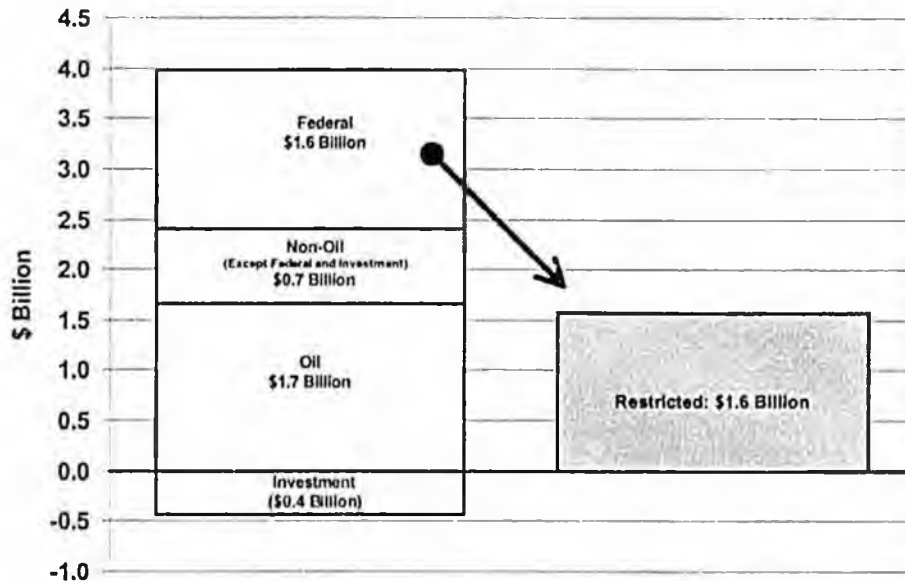
VII. FEDERAL REVENUE

Federal government spending has figured prominently in Alaska's history and is still a major force today, in spite of the maturing and diversification of Alaska's economy. In the latest fiscal year for which we have records, federal spending was \$6.4 billion. Part of that spending comes from the activities of the various agencies of the federal government, part is in the form of grants to state and local governments, and still another part is payments to individuals.

Table 30. Total Federal Revenue to the State
Preliminary FY 2002 and Projected FY 2003-2004
\$ Million

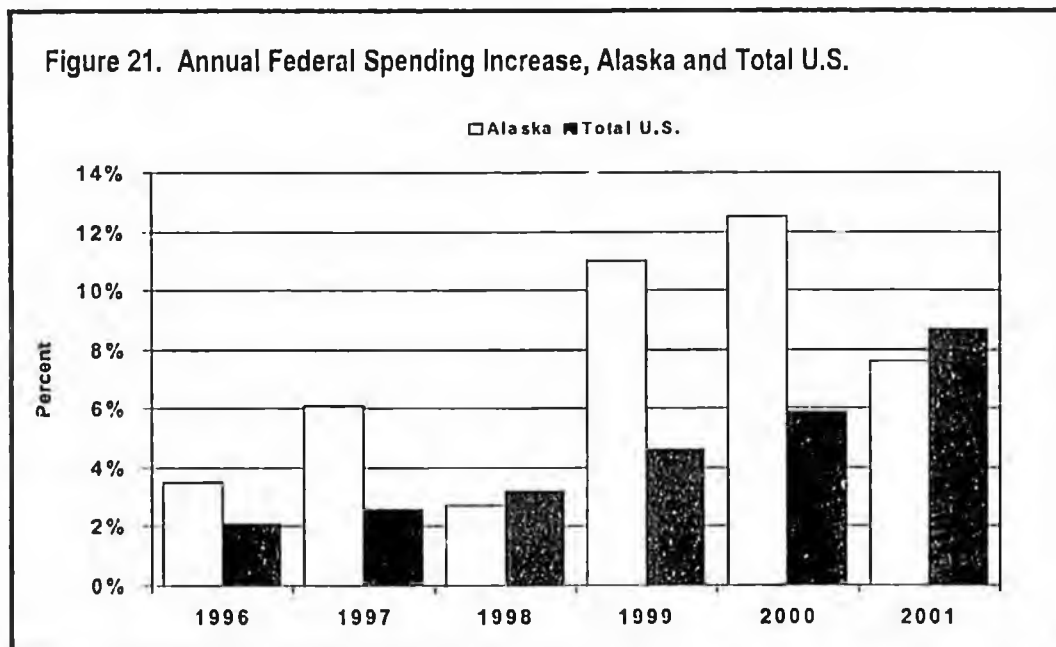
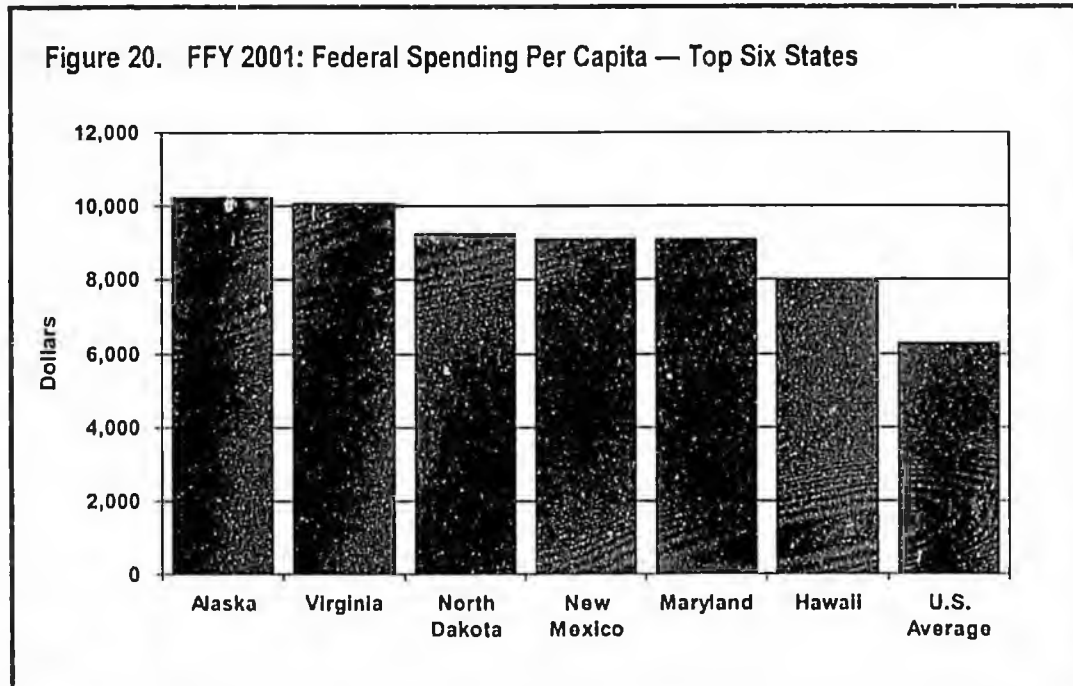
	Preliminary FY 2002	Budgeted	
		FY 2003	FY 2004
Restricted			
Federal Receipts			
Social Services	702.6		
Transportation	411.5		
Education	136.3		not appropriated yet
Natural Resources	107.2		
Public Protection	48.4		
Development	45.3		
Health	32.4		
Other	<u>88.4</u>		
Total Restricted	1,572.1	2,321.9	2,321.9

Figure 19. FY 2002 Federal Revenue
\$1.6 Billion



Total Federal Spending

The federal fiscal year (FFY) runs from October 1 through September 30. In FFY 2001, the federal government spent \$6.4 billion in Alaska.⁽¹⁾ Per capita, that's more money than any other state. It is also an increase over the year before, continuing a six-year trend of climbing federal spending. In fact, the federal government has increased its spending in Alaska at a faster rate than for the nation as a whole in four of the past six years.



(1) This and other federal funds figures in this section not otherwise attributed come from the Consolidated Federal Funds Report, U.S. Census Bureau, U.S. Department of Commerce, Washington, D.C. 20233.

About 39% of federal spending in Alaska is new money coming into the state — we received \$1.63 for every \$1.00 we paid in taxes.⁽¹⁾ Because the new money comes from outside the state, it contributes to an overall increase in the Alaska economy.

Among federal agencies, the Department of Defense spends the most in Alaska, followed by Health and Social Services. Together, they account for nearly half of all federal spending.

Not surprisingly, a large portion of federal money flows into Alaska through salaries of federal employees. However, more than a third of all federal spending is in the form of grants, mostly to state and local governments, but also to nonprofit organizations. Purchases of goods and services from Alaska businesses are also significant, as are direct payments to individuals for such things as retirement and disability.

Table 31. Total Federal Spending, FFY 2001
\$ Million

	By Agency		By Category	
	\$Million	Percent	\$Million	Percent
Defense	1,778	28	Grants	2,313 36
Health & Human Services	1,177	18	Salaries & Wages	1,414 22
Social Security	573	9	Procurement	1,130 18
Other Agencies	<u>2,875</u>	<u>45</u>	Retirement & Disability	936 15
			Other Direct Payments	<u>610</u> <u>10</u>
Total	6,403	100	6,403	100

Federal Funding in the State Budget

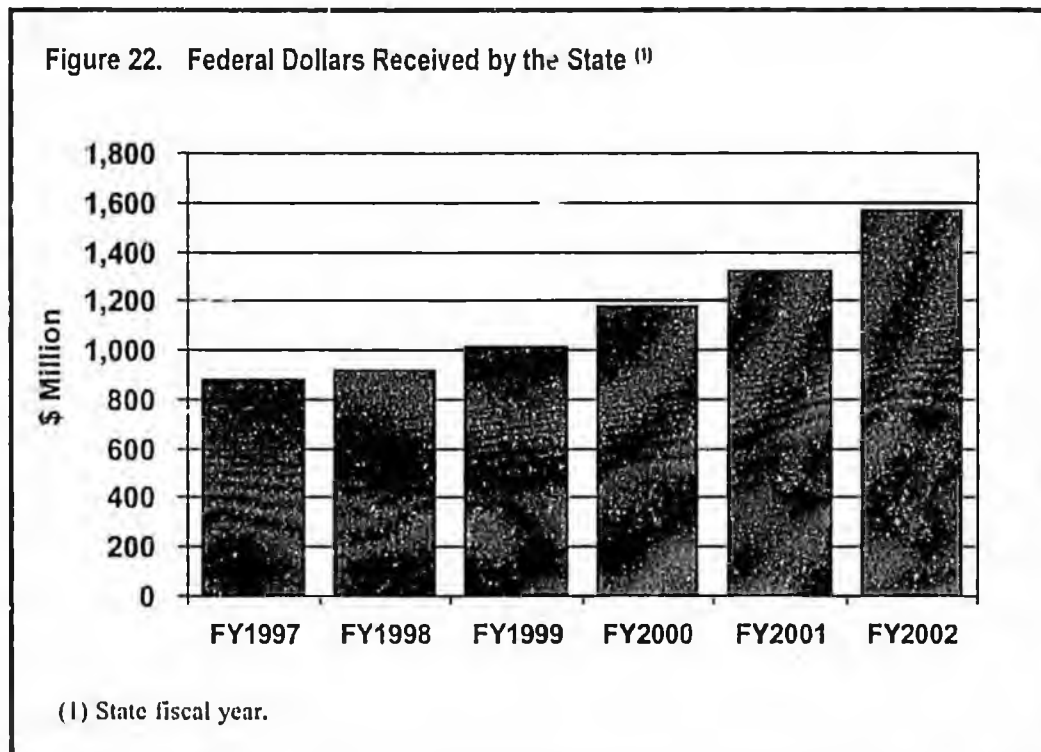
In FY 2002, the state received and spent approximately \$1.6 billion of federal funds. As with federal spending in Alaska generally, support to state and local governments has continued to increase.⁽²⁾

Federal funding in the state budget is restricted to specific uses, such as road improvements, Medicaid payments, and aid to schools. Approximately 45% of total federal money spent by the state is for capital projects.

(1) Special Report No. 116. J. Scott Moody, Tax Foundation. This report can be found at: <http://www.taxfoundation.org>.

(2) While we don't have figures for how much federal money went to local governments in FY2002, we can infer that the amount was roughly \$900 million to \$1 billion. In Federal Fiscal Year 2001, the last for which we have figures, Alaska state and local governments combined received \$2.4 billion.

Potential changes to federal law, differing federal and state fiscal years, and changing numbers of eligible Alaskans in certain programs make forecasting federal revenue difficult. For example, we can be pretty certain that the rising cost of medical care will drive up Medicaid costs, and that under current law federal revenues to the state will increase as a result. However, the number of Alaskans using the program could rise or fall as economic conditions change, and Congress could decide to alter the amount that states are reimbursed for Medicaid expenses. Similarly, we can fairly predict the rate at which we spend, and thus receive, federal transportation dollars already appropriated by Congress, but we cannot predict how much money Congress will appropriate. The estimates of federal revenues we present for state FY 2003 are, therefore, necessarily rough.



It is important to note that the state routinely budgets for more federal money than it actually receives. The legislature authorizes agencies to receive and spend the maximum that federally funded programs might need. Actual amounts normally turn out to be less. Also, some of the federal money appropriated for multi-year capital projects is received and spent in years following the one in which the money is appropriated.

For FY 2003, the state budgeted \$2.3 billion. Most federal funding requires state matching money. The budgeted state match in FY 2003 is \$287 million.

All federal funds, whether spent in the operating or capital budget, are restricted to specific uses. The largest categories of federal funding, as budgeted for FY 2003, are Medicaid (\$609 million), highways (\$514 million), education (\$179 million) and airports (\$159 million).

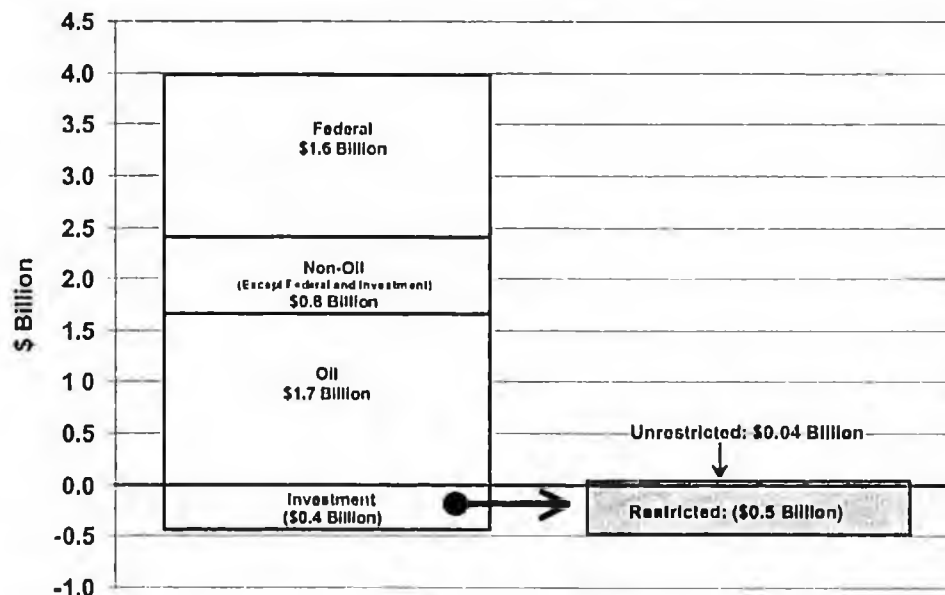
VIII. INVESTMENT REVENUE

Table 32. Total Investment Revenue
Preliminary FY 2002 and Projected FY 2003-2004
\$ Million

	Preliminary FY 2002	FY 2003	FY 2004
Unrestricted			
GeFONSI Pool Investments	35.4	25.6	11.6
Investment Loss Trust Fund	0.1	0.1	0.1
Interest Paid by Others	<u>7.6</u>	<u>5.0</u>	<u>5.0</u>
Subtotal	43.1	30.7	16.7
Restricted			
GeFONSI Pool Investments	10.6	7.2	3.4
Constitutional Budget Reserve Fund	122.3	83.7	48.5
Other Treasury Managed Funds	(0.8)	9.1	32.9
Alaska Permanent Fund (GASB) ⁽¹⁾	<u>(617.0)</u>	<u>129.0</u>	<u>1,815.8</u>
Subtotal	(484.9)	229.0	1,900.6
Total	(441.8)	259.7	1,917.3

(1) Governmental Accounting Standards Board (GASB) principles recognize changes in the value of investments as income or losses at the end of each trading day, whether or not the investment is actually sold.

Figure 23. FY 2002 Investment Revenue
(\$0.4 Billion)



Overview - Investment of State's Financial Assets

Revenue earned from investing the state's financial assets has become a major part of Alaska's revenue picture, exceeding all other state General Fund tax and royalty revenue in three of the five past years. The state's money is held in funds that fall into three categories: (1) revolving funds, (2) single-project funds, and (3) endowment funds.

(1) Revolving funds are funds that are continually expended and replenished. Examples of the state's many revolving funds include the General Fund and the International Airport Revenue Fund.

(2) Single-project funds are non-replenishing funds established with specific sums for specific projects or programs. Examples of this type of fund include the International Airport Construction Fund, as well as funds for capital grants to municipal governments, school districts, unincorporated communities and several funds for energy-related projects.

(3) The state's endowment funds are funds for which a principal balance is invested and the earnings go to support a public purpose. The state's endowment funds include the Alaska Permanent Fund, Mental Health Trust Fund, Alaska Science and Technology Fund, International Trade and Business Development Fund, Public School Trust, Alaska Children's Trust and Power Cost Equalization Endowment Fund.

Two different organizations manage the investment of most of the state's financial assets — the Treasury Division of the Alaska Department of Revenue and the Alaska Permanent Fund Corporation. The Treasury Division manages the many funds involved in the day-to-day operation of state government and also serves as the staff for the Alaska State Pension Investment Board in managing the several public employee retirement funds for which the state is responsible. In addition, it invests a portion of the University of Alaska Endowment and Exxon Valdez Oil Spill Trust Endowment. Finally, it manages state endowment funds not managed by the Permanent Fund, a portion of the Alaska Student Loan Fund and various state health and long-term care insurance funds.

The Alaska Permanent Fund Corporation has investment responsibility for the Alaska Permanent Fund, Mental Health Trust Fund, Alaska Science and Technology Endowment Fund and International Trade and Business Development Fund.

While we have included information about the Mental Health Trust Fund, Alaska Science and Technology Fund and International Trade and Business Endowment in this section of our forecast, we have not included projected investment revenue from these funds in our investment revenue totals. For financial reporting purposes, these entities are classified as component units of state government whose activities are accounted for separately from the activities of state government. ⁽¹⁾

The University of Alaska is the overall manager of its own endowment funds, and each of the state's independent public corporations except the Alaska Science and Technology Foundation manages its own cash assets.

The Treasury Division and the Alaska Permanent Fund employ similar processes when investing state assets. This involves selecting an asset allocation appropriate for the return objectives, risk tolerance, liquidity requirements and legal requirements for each individual fund. For example, where the state needs to spend the assets of a fund relatively soon — in other words, where the fund has a short-term investment horizon — the fund should be invested in assets such as short-term government securities whose value is unlikely to decline substantially in the near term. If the fund has a relatively long-term investment horizon, it is appropriate to invest a portion of the fund in riskier assets — such as stocks. Riskier assets are more likely to decline substantially in value in the near term but are also more likely to earn higher returns over the longer term.

The Treasury Division has established an array of investment pools with varying investment horizons and risk profiles. The funds are invested in these pools unless required by statute or bond indenture to be held separately. The investment pools maximize earning potential, provide economies-of-scale savings of time and dollars, and allow smaller funds to participate in investment opportunities that would otherwise be unavailable to them.

For a detailed discussion of the Treasury Division's investment process, together with the detailed investment policies of each of the funds managed by the Treasury Division, see the Division's Investment Policies and Procedures Manual at <http://www.revenue.state.ak.us/Treasury/policies/Manual.htm>.

For information on the investments managed by the Alaska Permanent Fund Corporation, see <http://www.apfc.org>.

(1) Component units are legally separate entities for which state government is financially accountable. The Mental Health Trust, Alaska Science and Technology Foundation and International Trade and Business Endowment are separately presented in the state's Comprehensive Annual Financial Report to emphasize they are legally separate from the state. The Alaska Permanent Fund Corporation is also classified as a component unit, but the report of its financial activity is blended into the primary state government report because its activities are, in substance, part of primary state government's operations.

Investment Forecast

To forecast investment revenue for the current fiscal year — FY 2003 — we combine each fund's actual performance through September 30 with a projection for the rest of the year. Normally, forecasts and estimated capital market median returns are based on information supplied by the state's investment consultant Callan Associates Inc. and its "Five-Year Capital Market Estimated Returns" (see the table below).

Table 33. Callan Associates Inc. 2002 Five-Year Capital Market Estimated Returns

Asset Class	Benchmark for Asset Class	%/ Year Median Expected Return	%/ Year Expected Risk
Equities			
U.S. Broad	Callan Associates Inc. (CAI) Broad Market	9.3	17.2
U.S. Large Cap	Standard and Poors (S&P) 500	9.0	16.0
U.S. Small Cap	CAI Small	10.6	25.0
International	Morgan Stanley Capital International EAFE	9.9	21.5
Fixed Income			
Domestic Broad Market	Lehman Brothers Aggregate	5.8	5.0
Domestic Short Term (cash equivalent)	Three-Month U.S. Treasury Bill	3.5	0.7
Domestic Intermediate Term	Merrill Lynch 1- to 5-Year Government	4.6	2.6
International	Salomon Brothers Non-U.S. Government	5.6	9.6
Other			
Real Estate		8.0	16.5
Economic Variables			
Inflation		2.9	1.8

The continued volatility in the world's financial markets makes focus on the expected risk columns in the table above particularly appropriate. The numbers in this column represent a statistical measure called standard deviation, which is the most commonly used measure of risk in the investment world. The standard deviation allows you to estimate a range in which you would expect results to fall two-thirds of the time. For example, Callan estimates an average annual return for the domestic broad market fixed-income asset class of 5.75% and an expected risk for that asset class of 5%. That means Callan is forecasting that two-thirds of the time the annual return for the domestic broad fixed-income asset class will fall between 0.75% (the median expected average annual return of 5.75% *minus* the expected risk of 5%) and 10.75% (the median expected return *plus* the expected risk).

The probability that a particular asset class or portfolio will have a negative return over a given period of time is another way to reflect the riskiness of that asset class or portfolio. The investment income summary tables in this section of the revenue forecast include an estimate of the probability of negative returns for each fund over a one-year period.

Given current market conditions, however, Callan Associates Inc. assumptions for projected fixed-income returns from last January are too optimistic. For the General Fund and Other Non-Segregated Investments (GeFONSI), the Constitutional Budget Reserve Fund (CBRF), International Airport and International Airport Construction Funds, we are substituting the current yields-to-maturity of the relevant asset classes. This lowers projected income from the income derived from Callans assumptions. (See comparison table below.)

We have continued to use Callan's Five-Year Market assumptions for the Public School Trust Fund, Alaska Children's Trust and the Power Cost Equalization Endowment.

Table 34. Callan Associates Inc. Capital Market Returns vs. Current Yield to Maturity

Asset Class	Benchmark for Asset Class	% per year Callan Associates Inc.	% per year Current Yield Expected to Maturity
Fixed Income			
Domestic Short Term (cash equivalent)	Three-Month U.S. Treasury Bill	3.5	1.19
Domestic Intermediate Term	Merrill Lynch 1- to 5-Year Government	4.6	1.99
Domestic Broad Market (Long Term)	Lehman Brothers Aggregate	5.8	4.31

(1) Yield as of November 12, 2002.

Unrestricted Investment Revenue

Table 35. Unrestricted Investment Revenue
Preliminary FY 2002 and Projected FY 2003-2004
\$ Million

<u>Unrestricted</u>	Preliminary FY 2002	FY 2003	FY 2004
GeFONSI Pool Investments	35.4	25.6	11.6
Investment Loss Trust Fund	0.1	0.1	0.1
Interest Paid by Others	<u>7.6</u>	<u>5.0</u>	<u>5.0</u>
Total	43.1	30.7	16.7

Unrestricted Investment Revenue from the GeFONSI Pool

A majority of the state's funds, including the General Fund, participate in an investment pool established by the Treasury Division called the General Fund and Other Nonsegregated Investments (GeFONSI) pool. Investment objectives for this pool are: (1) limited exposure to principal loss, (2) generate income without taking substantial risk, (3) minimal inflation protection, and (4) high liquidity. To achieve these objectives this pool is, in turn, invested in two fixed income pools established and managed by Treasury — Treasury's short-term, fixed-income pool and Treasury's intermediate-term, fixed-income pool. The GeFONSI pool has maintained an average balance of \$1 billion for the past eight years. The General Fund itself, with an average balance of \$300 million, is the largest participant in the GeFONSI pool. The balance of the GeFONSI pool consists of the cash assets of 120 other funds.

Of the funds participating in the GeFONSI pool, 61 are entitled to the actual income earned on their cash assets invested in the pool. The earnings from the cash assets of the other 60 funds are credited to the General Fund.

Table 36. GeFONSI Investment Revenue Summary
Preliminary FY 2002 and Projected FY 2003-2004

<u>Asset Allocation</u>		
<u>Treasury Pool</u>	<u>Percent Allocation</u>	<u>Performance Benchmark</u>
Short-term, Fixed-Income Pool	40%	Three-Month U.S. Treasury Bill
Intermediate-Term, Fixed-Income Pool	60%	Merill Lynch 1- to 5-Year Government Index
GeFONSI Pool Balance September 30, 2002		\$1,975.0 Million
Projected Annual Rate of Return		1.67 %
Probability of Negative Return Over 1 Year		15.72 %
Preliminary Actual Total Investment Income, FY 2002		\$ 46.0 Million
Projected Total Investment Income, FY 2003		\$ 32.8 Million
Projected Total Investment Income, FY 2004		\$ 15.0 Million

	\$ Million		
	Preliminary FY 2002	FY 2003	FY 2004
GeFONSI Pool Revenue into General Fund ⁽¹⁾	35.4	25.6	11.6
GeFONSI Pool Revenue Restricted	<u>10.6</u>	<u>7.2</u>	<u>3.4</u>
Total	46.0	32.8	15.0

(1) Includes subfunds of the General Fund.

For detailed information on the funds whose cash assets are invested in the GeFONSI pool and on the restricted and unrestricted investment revenue from the GeFONSI pool, see appendices P, Q and R of Treasury's Investment Policies and Procedures Manual.

Investment Loss Trust Fund (AS 37.14.300)

The trust fund was established for the benefit of participants in the state's Supplemental Benefits System annuity plan to insure against loss on investments in annuity contracts issued in the 1980s by Executive Life Insurance Company of California, which later became insolvent. The Department of Revenue is the custodian of the fund, which consists of money appropriated by the legislature. Money earned on the fund is retained in the fund but is available for appropriation by the legislature.

Table 37. Investment Loss Trust Fund Investment Revenue Summary
Preliminary FY 2002 and Projected FY 2003-2004

Asset Allocation

<u>Treasury Pool</u>	<u>Percent Allocation</u>	<u>Performance Benchmark</u>
Short-term, Fixed-Income Pool	100%	U.S. Treasury Bill

Investment Loss Trust Fund Balance September 30, 2002	\$ 7.4 Million
Projected Annual Rate of Return	3.5 %
Probability of Negative Return Over 1 Year	0.0 %

	<u>Total Return (\$ Million)</u>		
	<u>Preliminary FY 2002</u>	<u>FY 2003</u>	<u>FY 2004</u>
Investment Loss Trust Fund	0.1	0.1	0.1

Restricted Investment Revenue

Table 38. Restricted Investment Revenue
Preliminary FY 2002 and Projected FY 2003-2004
\$ Million

	<u>Preliminary FY 2002</u>	<u>FY 2003</u>	<u>FY 2004</u>
<u>Restricted</u>			
GeFONSI Pool Investments	10.6	7.2	3.4
Constitutional Budget Reserve Fund	122.3	83.7	48.5
Other Treasury Managed Funds	(0.8)	9.1	32.9
Alaska Permanent Fund (GASB) ⁽¹⁾	<u>(617.0)</u>	<u>129.0</u>	<u>1,815.8</u>
Total	(484.9)	229.0	1,900.6

(1) Governmental Accounting Standards Board (GASB) principles recognize changes in the value of investments as income or losses at the end of each trading day, whether or not the investment is actually sold.

Restricted Investment Revenue from the GeFONSI Pool

As presented in the table on the prior page, restricted investment revenue from funds whose cash assets are invested in the GeFONSI pool totaled \$10.6 million in FY 2002 and are projected to total \$7.2 in FY 2003 and \$3.4 million in FY 2004.

Constitutional Budget Reserve Fund (Alaska Constitution, Article IX, Section 17)

Voters approved a constitutional amendment in 1990 establishing the Constitutional Budget Reserve Fund (CBRF) and requiring the state to deposit all settlements from oil and gas and mining tax and royalty disputes into that fund. The money in the CBRF is invested by the Department of Revenue, and the CBRF retains its own investment earnings. Although, in theory, the legislature may appropriate money from the CBRF under certain conditions with a simple majority vote, in practice those conditions do not occur and it takes a three-fourths vote of the members of each chamber to appropriate money from the fund.

Since 1991 the legislature has appropriated money from the CBRF to balance the state's budget in every fiscal year except 1997 and 2001, when high oil prices resulted in small budget surpluses. The Alaska Constitution requires the General Fund to repay the money appropriated from the CBRF if the General Fund has a surplus at the end of any fiscal year, but the General Fund does not pay interest on the money it has "borrowed" from the CBRF. As of June 30, 2002, the General Fund had "borrowed" about \$4.6 billion from the CBRF.

On June 30, 2002, the CBRF cash balance was \$2.469 billion. The balance was down to \$2.075 billion on November 20, 2002. Based on our oil price and production projections, if the state maintains its budget at the level of the FY 2002 budget, but continues to draw on the CBRF to balance the budget, the CBRF will run out of money at the end of fiscal 2005 (see Section III).

Treasury's investment policies for the CBRF have changed over the years as the balance and the expected uses of the CBRF have changed. Before 1999 a portion of the CBRF was invested with a long-term horizon and some of the fund was invested in U.S. equities. The very low oil prices experienced in 1998 and 1999 led to a significant reduction in the amount in the fund. The reduced size of the fund significantly shortened its investment time horizon, meaning the state could no longer afford the risk of long-term stock investments because the CBRF would likely be drained over the next few years. Therefore, the fund's investments were moved out of equities and concentrated in relatively short-term, fixed-income securities. A significant change occurred again in 2000 when the legislature created a special subaccount in the CBRF in the amount of \$400 million. The legislature instructed the Department of Revenue to invest the \$400 million subaccount with a long-term horizon so that the money would be invested in stocks — not just bonds — in the hope of earning more investment revenue over time.

Table 39. CBRF Investment Revenue Summary
Preliminary FY 2002 and Projected, FY 2003-2004

Asset Allocation Regular Account

<u>Treasury Pool</u>	<u>Percent Allocation</u>	<u>Performance Benchmark</u>
Short-term, Fixed-Income Pool	10%	Three-Month U.S. Treasury Bill
Intermediate-term, Fixed-Income Pool	65%	Merrill Lynch 1- to 5-Year Government Index
Broad Market Fixed-Income Pool	25%	Lehman Brothers Aggregate Bond Index

Regular Account Balance September 30, 2002	\$1,934.8 Million
Projected Annual Rate of Return	2.49 %
Probability of Negative Return Over 1 Year	19.7 %

Asset Allocation Special Subaccount

<u>Treasury Pool</u>	<u>Percent Allocation</u>	<u>Performance Benchmark</u>
Broad Market Fixed-Income Pool	42%	Lehman Brothers Aggregate Bond Index
Domestic Equity Pool	41%	Russell 3000 Index
International Equity Pool	17%	MSCI EAFE Index

Special Subaccount Balance September 30, 2002	\$ 329.1 Million
Projected Annual Rate of Return	7.93 %
Probability of Negative Return Over 1 Year	23.36 %

	<u>Total Investment Income (\$Million)</u>		
	<u>Preliminary FY 2002</u>	<u>FY 2003</u>	<u>FY 2004</u>
Regular Account	143.4	89.4	19.8
Special Subaccount	<u>(21.1)</u>	<u>(5.7)</u>	<u>28.7</u>
Total	122.3	83.7	48.5

**Table 40 Constitutional Budget Reserve Fund Cash Flows
Preliminary FY 2002 and Projected FY 2003-2004
\$ Million**

	Preliminary FY 2002	FY 2003	FY 2004
Beginning Cash Balance CBRF	2,994.8	2,469.3	1,835.1
Beginning Main Account Balance	2,618.8	2,114.4	1,485.9
Transfer to Special Subaccount	0.0	0.0	0.0
Earnings on Main Account Balance ⁽¹⁾	143.4	89.4	19.8
Petroleum Tax, Royalty Settlements ⁽²⁾	90.2	30.0	20.0
Loan to GF (prior year)	0.0	0.0	0.0
Loan to GF (current year) ⁽³⁾	(738.0)	(747.8)	(896.5)
Payback of Cash Flow Draw	<u>0.0</u>	<u>0.0</u>	<u>0.0</u>
Ending Main Account Balance	2,114.4	1,485.9	629.3
Beginning Special Subaccount Balance	376.0	354.9	349.2
Earnings on Special Subaccount Balance ⁽¹⁾	(21.1)	(5.7)	28.7
Petroleum Tax, Royalty Settlements ⁽²⁾	0.0	0.0	0.0
Loan to GF from Special Subaccount	<u>0.0</u>	<u>0.0</u>	<u>0.0</u>
Ending Special Subaccount Balance	354.9	349.2	377.9
Total CBRF Balance	2,469.3	1,835.1	1,007.2

(1) The projected earnings rate for the balance of FY 2002, 2003 and 2004 is 2.49% for the undesignated subaccount and 7.93% for the special subaccount. These projections are based on Callan's capital market assumptions with the modifications reflected in the investment forecast explanation and Department of Revenue, Treasury Division's asset allocation.

(2) Settlement estimates are provided by the Department of Revenue and Department of Law.

(3) The FY 2002 draw is based on the audited cash balance in the CBRF as of June 30, 2002. FY 2003 CBRF draw projections do not represent final budget numbers.

International Airport Funds (AS 37.15.410 - .550)

In 1961 the Alaska Legislature established an enterprise fund, the International Airport Revenue Fund, to facilitate issuing revenue bonds for construction at the Anchorage and Fairbanks International Airports. Enterprise funds are self-supporting, revolving funds used to account for business-like state activities. They are financed through user charges and subject to legislative appropriation. Almost all the revenue and expenses of these two international airports flow through this Airport Revenue Fund, including the funding for most repair and maintenance projects. Consequently, the revenue fund is subject to large cash inflows and outflows.

The Airport Revenue Fund has maintained a significant balance (it has averaged \$85 million since 1996), and the investment earnings from the fund are a significant revenue source for the airport system. Most of the revenue to run the airports comes from landing and lease fees paid by the airlines, and the Department of Transportation and Public Facilities takes the fund's projected earnings into account in negotiating fees with airlines. Airport management and airline representatives have tried to keep fees as stable and low as practical. Relatively stable investment earnings assist the airport system and the airlines in meeting that goal.

**Table 41. International Airport Revenue Fund Investment Revenue Summary
Preliminary 2002 and Projected 2003-2004**

<u>Asset Allocation</u>		
<u>Treasury Pool</u>	<u>Percent Allocation</u>	<u>Performance Benchmark</u>
Short-term, Fixed-Income Pool	15%	Three-Month U.S. Treasury Bill
Intermediate-term, Fixed-Income Pool	85%	Merrill Lynch 1- to 5-Year Government Index

International Airport Revenue Fund Balance September 30, 2002	\$ 107.1 Million
Projected Annual Rate of Return	1.87 %
Probability of Negative Return Over 1 Year	20.21 %

	<u>Total Investment Income (\$ Million)</u>		
	<u>Preliminary FY 2002</u>	<u>FY 2003</u>	<u>FY 2004</u>
International Airport Revenue Fund	5.5	4.2	2.0

Major improvements in the International Airport system have generally been financed with revenue bonds. When issued, the proceeds of these airport revenue bonds are deposited into a separate International Airport Construction Fund. Unspent proceeds of four bond issues to finance major improvements at the International Airport system are currently invested in the Airport Construction Fund. The investment earnings from this fund are available to help pay for the construction project.

**Table 42. International Airport Construction Fund (1999 Issues) Investment Revenue Summary
Preliminary FY 2002 and Projected FY 2003-2004**

<u>Asset Allocation</u>		
<u>Treasury Pool</u>	<u>Percent Allocation</u>	<u>Performance Benchmark</u>
Short-term, Fixed-Income Pool	25%	Three-Month U.S. Treasury Bill
Intermediate-term, Fixed-Income Pool	75%	Merrill Lynch 1- to 5-Year Government Index
International Airport Construction Fund Balance September 30, 2002 \$ 117.2 Million		
Projected Annual Rate of Return		1.79 %
Probability of Negative Return Over 1 Year		18.61 %

	<u>Total Investment Income (\$ Million)</u>		
	<u>Preliminary FY 2002</u>	<u>FY 2003</u>	<u>FY 2004</u>
International Airport Construction Fund	7.2	4.3	1.2

**Table 43. International Airport Construction Fund (2002 Issues) Investment Revenue Summary
Preliminary FY 2002 and Projected FY 2003-2004**

<u>Asset Allocation</u>		
<u>Treasury Pool</u>	<u>Percent Allocation</u>	<u>Performance Benchmark</u>
Short-term, Fixed-Income Pool	50%	Three-Month U.S. Treasury Bill
Intermediate-term, Fixed-Income Pool	50%	Merrill Lynch 1- to 5-Year Government Index
International Airport Construction Fund Balance September 30, 2002 \$ 122.7 Million		
Projected Annual Rate of Return		1.59 %
Probability of Negative Return Over 1 Year		13.44 %

	<u>Total Investment Income (\$ Million)</u>		
	<u>Preliminary FY 2002</u>	<u>FY 2003</u>	<u>FY 2004</u>
International Airport Construction Fund	1.7	3.1	0.3

Public School Trust Fund (AS 37.14.110)

The net income of this Trust Fund may only be appropriated to support the state public school program. This trust fund was created from the Public School Permanent Fund on July 1, 1978, but its history goes back much further. The original source of funding consisted of income from the sale or lease of approximately 100,000 acres of land granted to the Territory of Alaska by an Act of Congress on March 15, 1915. The principal of the fund could not be appropriated by the legislature. The 1978 change abolished the land portion of the trust and, in its place, provided that one-half of 1% of the total receipts derived from the management of state land, including amounts paid to the state as proceeds of the sale or annual rent of surface rights, mineral lease rentals, royalties, royalty sale proceeds and federal mineral revenue-sharing payments or bonuses were to be deposited into the fund.

The money in the Trust Fund is invested and managed by the Department of Revenue, and the Commissioner of Revenue is the treasurer and fiduciary of the fund. The fund is managed to provide increasing net income over the long term for the fund's income beneficiaries. The principal of the fund and all capital gains or losses realized on the investment of the assets of the fund must be retained in the fund.

Currently, the fund each year distributes 4.75% of the last five years' average market value of the fund principal, as long as this amount does not exceed the accumulated interest and dividend income.

For a more detailed comparison of this fund with other state endowment funds, see Section IX of this forecast.

**Table 44. Public School Trust Investment Revenue Summary
Preliminary FY 2002 and Projected FY 2003-2004**

Asset Allocation

<u>Treasury Pool</u>	<u>Percent Allocation</u>	<u>Performance Benchmark</u>
Broad Market Fixed-Income Pool	55%	Lehman Brothers Aggregate Index
Domestic Equity Pool	45%	Russell 3000 Index

Public School Trust Fund Balance September 30, 2002	\$ 258.7 Million
Projected Annual Rate of Return	7.27 %
Probability of Negative Return Over 1 Year	20.48 %

	Total Investment Income and Distributable Income (\$ Million)		
	<u>Preliminary FY 2002</u>	<u>FY 2003</u>	<u>FY 2004</u>
Public School Trust Total Investment Income	(9.2)	2.6	17.5
Public School Trust Distributable Income	10.6	10.3	9.8

Alaska Children's Trust (AS 37.14.200)

Income from this endowment is used to provide grants to community-based programs for the prevention of child abuse and neglect. The trust provides individual grants of up to \$50,000 per year, matched by other sources.

The legislature established the trust in 1988. The Commissioner of Revenue is the fiduciary. The first significant funding of the trust occurred in 1996 when the legislature appropriated \$6 million to the trust. Appropriations, gifts, bequests and contributions of cash or other assets provide additional funds in the endowment.

Currently, the fund distributes 4.75% of the last five years' average beginning market value of the principal, as long as this amount does not exceed the accumulated interest and dividend income.

Legislation pending before the Alaska State Legislature would modify the laws governing this trust so that it would be administered in the same manner as a typical institutional endowment fund. The distinction between "principal" and "income" would be abolished and the fund would be managed to preserve its purchasing power over the long term. Five percent of the market value of the fund would be distributed to support grants to children's programs each year.

For a more detailed comparison of this fund with other state endowment funds, see Section IX of this forecast.

**Table 45. Alaska Children's Trust Investment Revenue Summary
Preliminary FY 2002 and Projected FY 2003-2004**

<u>Asset Allocation</u>		
<u>Treasury Pool</u>	<u>Percent Allocation</u>	<u>Performance Benchmark</u>
Broad Market Fixed-income Pool	55%	Lehman Brothers Aggregate Index
Domestic Equity Pool	45%	Russell 3000 Index
Alaska Children's Trust Balance September 30, 2002		\$ 8.3 Million
Projected Annual Rate of Return		7.27 %
Probability of Negative Return Over 1 Year		20.48 %

	<u>Total Investment Income and Distributable Income (\$ Million)</u>		
	<u>Preliminary FY 2002</u>	<u>FY 2003</u>	<u>FY 2004</u>
Alaska Children's Trust Total Investment Income	(0.3)	0.0	0.6
Alaska Children's Trust Distributable Income	0.4	0.3	0.3

Power Cost Equalization Endowment Fund (AS 42.15.070)

Two separate funds are involved in the Power Cost Equalization program: the Power Cost Equalization Endowment Fund, which supplies money to the program; and the Power Cost Equalization and Rural Electric Capitalization Fund, which distributes money for the Power Cost Equalization program.

The legislature in May 2000 established the Endowment Fund as a separate fund of the Alaska Energy Authority (AEA). The AEA is a public corporation of the Department of Community and Economic Development directed by the officers of the Alaska Industrial Development and Export Authority. The endowment consists of the following sources of revenue:

1. Legislative appropriations.
2. Accumulated earnings.
3. Gifts and bequests.
4. Federal money.
5. Payments received after June 30, 2001 from the sale of the state-owned Four-Dam Pool hydro-electric projects in Kodiak, Valdez, Ketchikan and Wrangell-Petersburg.

The Commissioner of Revenue is the fiduciary of the endowment. The Department of Revenue is to manage the endowment in a manner likely to achieve at least a 7% nominal return over time.

For the initial transition years (2002 through the first year after closing of the Four-Dam Pool sale), 7% of the market value on February 1 each year is designated to pay for the Power Cost Equalization program for the next fiscal year. After the transition years, on July 1 of each year, the commissioner must determine the monthly average market value of the endowment for the previous three fiscal years, excluding the transition years. Seven percent of this amount may be appropriated for the following fiscal year for three purposes:

1. Funding the Power Cost Equalization and Rural Electric Capitalization Fund (AS 42.45.100).
2. Reimbursement to the Department of Revenue for the costs of establishing and managing the endowment.
3. Reimbursement of other costs of administration of the endowment.

The Power Cost Equalization and Rural Electric Capitalization Fund is used to equalize power costs per kilowatt-hour statewide at a cost close to or equal to the average cost per kilowatt-hour in Anchorage, Fairbanks and Juneau by paying money to eligible electric utilities in the state.

The program fund has received direct legislative appropriations, appropriations from the Power Cost Endowment Fund, and money appropriated from the National Petroleum Reserve Alaska Special Revenue Fund. The program fund is managed by the Alaska Energy Authority.

For a more detailed comparison of this fund with other state endowment funds, see Section IX of this forecast.

**Table 46. Power Cost Equalization Endowment Investment Revenue Summary
Preliminary FY 2002 and Projected FY 2003-2004**

Asset Allocation

<u>Treasury Pool</u>	<u>Percent Allocation</u>	<u>Performance Benchmark</u>
Broad Market Fixed-Income Pool	42%	Lehman Brothers Aggregate Index
Domestic Equity Pool	41%	Russell 3000 Index
International Equity Pool	17%	MSCI EAFE Index

Power Cost Equalization Endowment Balance September 30, 2002 \$ 146.7 Million
 Projected Annual Rate of Return 7.93 %
 Probability of Negative Return Over 1 Year 23.36 %

	Total Return and Distributable Funds (\$ Million)		
	<u>Preliminary FY 2002</u>	<u>FY 2003</u>	<u>FY 2004</u>
Power Cost Equalization Endowment Total Return	(5.7)	(5.1)	11.3
Power Cost Equalization Endowment Distributable Funds	7.1	12.8	12.6

Alaska Permanent Fund Corporation - Four Endowment Funds

The four endowment funds managed by the Alaska Permanent Fund Corporation (APFC) — the Alaska Permanent Fund itself, Mental Health Trust, Alaska Science and Technology Endowment and International Trade and Business Endowment — share a common asset allocation. (See table below.) The APFC and the Mental Health Trust use an income measure called *statutory net income*. This measure is different from the income measure prescribed by the Governmental Accounting Standards Board (GASB) for public funds. Under GASB standards, public funds normally recognize changes in the value of investments as income, or losses, as they occur at the end of each trading day, regardless of whether the investment is actually sold. By Alaska law, however, to calculate income available for use from these two funds, gains or losses on individual stocks and bonds are not recognized until the stock or bond is sold. The portfolios of these funds usually include significant unrealized gains and/or losses. As those gains or losses are realized over time, they may cause the fund's statutory net income to differ significantly from the net income derived using GASB standards. Of these four endowments, only the revenue earned by the Permanent Fund is included in our summary.

Table 47. Four Endowment Trust Funds Managed by the Permanent Fund Corporation Revenue Summary

<u>Asset Allocation</u>	
<u>Asset Class</u>	<u>Percent Allocation</u>
Domestic Equities	37%
International Equities	16%
Domestic Fixed Income	35%
International Fixed Income	2%
Real Estate	10%
Projected Annual Rate of Return	7.95 %
Probability of Negative Return Over 1 Year	23.5 %

Alaska Permanent Fund.

In 1976, voters established the Alaska Permanent Fund by constitutional amendment. The amendment requires that at least 25% of the state's oil, gas and mining lease bonuses, rentals, royalties and federal mineral revenue-sharing payments be deposited into the fund. The legislature has, as described later, provided for use of some of the fund's income. The fund's principal, however, is protected by the constitution.

The legislature established the Alaska Permanent Fund Corporation (APFC) to manage and invest the fund's assets. The APFC is a public corporation managed by a board of trustees appointed by the governor.

The fund has grown significantly over the years, and as of October 31, 2002, had a market value of \$22.5 billion, of which \$22 billion is principal.

As fiduciaries for the fund, the trustees must have an investment objective that addresses the safety of the principal while maximizing total return. The board must also allow for maximum use of disposable income for purposes designated by law. To accomplish this, the board has adopted an investment policy that addresses risk, return, diversification and liquidity. Using this policy, the board adopted a strategic asset allocation by applying the basic process referenced earlier.

The table on the next page reflects the projected balances for the Permanent Fund, and projected income using both the statutory net income and GASB net income measures.

The Alaska Constitution requires the deposit of the income earned by the assets of the Permanent Fund "into the General Fund unless otherwise provided by law." The legislature has, by law, "provided otherwise" and all of the Permanent Fund's income is deposited into the Earnings Reserve Account within the Permanent Fund. This account was established by AS 37.13.145.

In turn, the income accumulated in the Earnings Reserve Account is statutorily applied to the Permanent Fund dividend program (AS 37.13.140 and AS 37.13.145(b)) and to inflation proofing the principal of the Permanent Fund (AS 37.13.145(c)). Realized Permanent Fund income in excess of the amount needed to satisfy the statutory dedication for annual dividends and inflation proofing — while legally available for other uses — has been left in the Permanent Fund Earnings Reserve Account. Because, as a matter of political custom, these excess earnings have been left in the Permanent Fund, this revenue forecast treats them as restricted revenue.

Table 48. Alaska Permanent Fund ⁽¹⁾
Preliminary FY 2002 and Projected FY 2003-2004
\$ Million

	Preliminary FY 2002	FY 2003	FY 2004
Principal			
Beginning Balance	21,047.6	21,884.2	22,552.7
Dedicated Petroleum Revenue	257.7	321.9	291.0
Inflation Proofing	602.3	346.4	662.8
Deposits to Principal (Settlement Earnings)	<u>(23.4)</u>	<u>0.2</u>	<u>12.6</u>
End-of-Year Balance	21,884.2	22,552.7	23,519.1
Earnings and Earnings Reserve Account (Statutory Income) ⁽²⁾			
Earning Reserve Account (ERA) Beginning Balance	2,383.7	1,135.7	752.8
Statutory Net Income and Settlement Earnings	261.3	693.7	1,338.6
Dividend Payout	(925.8)	(726.0)	(598.0)
Inflation Proofing	(602.3)	(346.4)	(662.8)
Deposits to Principal	23.4	(0.2)	(12.6)
Other Appropriations	<u>(4.5)</u>	<u>(4.0)</u>	<u>(4.0)</u>
ERA End-of-Year Balance (Statutory)	1,135.7	752.8	814.0
Earnings and Earnings Reserve Account (GASB Income) ⁽²⁾			
ERA Beginning Balance	3,767.3	1,641.0	693.4
GASB Net Income	(617.0)	129.0	1,815.8
Dividend Payout	(925.8)	(726.0)	(598.0)
Inflation Proofing	(602.3)	(346.4)	(662.8)
Deposits to Principal	23.4	(0.2)	(12.6)
Other Appropriations	<u>(4.5)</u>	<u>(4.0)</u>	<u>(4.0)</u>
ERA End-of-Year Balance (GASB)	1,641.0	693.4	1,231.8
Market Value			
Principal End-of-Year Balance	21,884.2	22,552.7	23,519.1
ERA End-of-Year Balance (Statutory Income)	1,135.7	752.8	814.0
End-of-Year Unrealized Earnings	503.3	(59.4)	417.8
Dividends Payable and Other Liabilities	<u>930.4</u>	<u>730.0</u>	<u>602.0</u>
End-of-Year Balance (Total Asset Market Value)	24,455.6	23,976.1	25,352.9
Reconciliation			
Dividends Payable and Other Liabilities	<u>(930.4)</u>	<u>(730.0)</u>	<u>(602.0)</u>
End-of-Year Balance (Net Asset Market Value)	23,525.2	23,246.1	24,750.9

(1) Source: Permanent Fund Corporation data using October 31, 2002, financial statements. Income projections are based on Callan Associates, Inc. 2002 capital market assumptions: 7.95% total return for FY 2004.

(2) Alternative measures of income. Under GASB principles, daily gains or losses in investment value are recognized. Under statutory net income, gains or losses in investment value are not recognized until the investment is sold.

Mental Health Trust Fund (AS 37.14.001).

The Mental Health Trust Fund is administered by the Alaska Mental Health Trust Authority. The trust was created in territorial days when Congress passed the Alaska Mental Health Enabling Act of 1956. To implement the trust, the state selected one million acres of land to provide revenues for the development of a comprehensive mental health program for the state's citizens.

The state eventually merged the Mental Health Trust lands with the state's general grant land and transferred some of these lands to private ownership, prompting litigation that resulted in an Alaska Supreme Court order to reconstitute the trust. In 1994, a final settlement reconstructed the trust with 500,000 acres of the original trust land, 500,000 acres of replacement land, and \$200 million in cash.

The trust's cash assets are held in the Mental Health Trust Fund and those assets are managed by the APFC. Trust lands are managed by the Trust Land Office in the Department of Natural Resources. The cash principal of the Mental Health Trust Fund must be retained in perpetuity in the fund for investment by the APFC and, as a result, may not be spent. The principal of the fund includes (1) the \$200 million referenced above, (2) a portion of the revenue from trust lands, and (3) fund earnings that the Trust Authority has transferred into the principal.

Earnings of the fund accumulate in an earnings account that is managed along with the fund's principal at the APFC. This earnings account, which is equivalent to the Permanent Fund's Earnings Reserve Account, is called the *Principal Reserve Account* by the Mental Health Trust Authority.

The operations of the trust, including management of the trust's lands and the Trust Fund and the trust's grant program, are paid for from yet another account called the *Mental Health Trust Settlement Income Account*. This account is managed by the Treasury Division, and is part of the GeFONSI pool described earlier in this report.

AS 37.14.031(c) requires the APFC to determine the annual net income of the Mental Health Trust Fund in the same manner it determines the annual net income of the Permanent Fund (on the basis of realized as opposed to GASB income). Further, AS 37.14.035(b) directs the APFC, at the end of each fiscal year, to transfer all of the Trust Fund's realized net income to the *Settlement Income Account* managed by the Treasury Division. A different practice has developed, however. The Trust Authority has the discretion under AS 37.14.039(b) to make arrangements to invest any money in the *Settlement Income Account* that exceeds the current and projected cash needs of the trust. The Trust Authority has concluded that these excess funds should be invested by the APFC along with the principal of the trust. Rather than transfer all of the annual earnings from the APFC to the *Settlement Income Account* at Treasury and then request the transfer of the excess amount back to the APFC, the Trust Authority has arranged for the APFC to transfer to the *Settlement Income Account* only the amount needed each year for the trust's operations and grant program.

While the operating budget of the Mental Health Trust is subject to legislative appropriation under the Executive Budget Act, the trust's grant program is not. When the trust awards grants to state agencies, those agencies must, of course, obtain legislative authorization to receive and expend those grants. No legislative approval or appropriation is required for the trust's grants to municipalities and/or nonprofit corporations.

The Mental Health Trust Fund spending policy is to distribute 3.5% of the year-end market value of the Trust Fund. The Mental Health Trust Authority has adopted this conservative distribution policy to build up a sufficient principal reserve and thus ensure the fund will be able to continue to support its program in years of poor returns in the financial markets. If income exceeds the 3.5% distribution, the excess remains with the Principal Reserve Account of the Trust Fund or is moved into the principal of the fund in accordance with the directions and policies adopted by the Trust Authority Board. Currently, the trust tries to maintain a balance in the Principal Reserve Account equal to four times the projected annual distribution. Eventually, the Trust Authority hopes to increase the annual distribution rate to 5% of the year-end market value.

Table 49. Mental Health Trust Fund ⁽¹⁾
Preliminary FY 2002 and Projected FY 2003-2004
\$ Million

	Preliminary FY 2002	FY 2003	FY 2004
Principal			
Beginning Balance	271.4	274.6	278.4
Deposits to Principal	3.2	3.8	4.4
End-of-Year Balance	274.6	278.4	282.8
Earnings and Principal Reserve Account (Statutory Income) ⁽²⁾			
Principal Reserve Account (PRA) Beginning Balance	53.2	50.5	56.3
Statutory Net Income	8.3	17.1	19.8
Distributions	(11.0)	(11.3)	(11.3)
PRA End-of-Year Balance (Statutory)	50.5	56.3	64.8
Earnings and Principal Reserve Account (GASB Income) ⁽²⁾			
PRA Beginning Balance	31.5	22.1	33.9
GASB Net Income	1.6	23.1	24.4
Distributions	(11.0)	(11.3)	(11.3)
PRA End-of-Year Balance (GASB)	22.1	33.9	47.0
Total Liabilities and Fund Balance			
Principal End-of-Year Balance	274.6	278.4	282.8
PRA End-of-Year Balance (Statutory Income)	50.5	56.3	64.8
End-of-Year Unrealized Earnings	(28.4)	(22.3)	(17.8)
Other Liabilities	0.0	0.0	0.0
End-of-Year Balance (Total Asset Market Value)	296.8	312.4	329.8
Reconciliation			
Other Liabilities	0.0	0.0	0.0
End-of-Year Balance (Net Asset Market Value)	296.8	312.4	329.8

(1) Source: Alaska Mental Health Trust Fund September 30, 2002, estimates using October 31, 2002, financial statements. Income projections are based on Callan Associates, Inc. 2002 capital market assumptions: 7.95% total return for FY 2004. Projected contributions and distributions are Alaska Mental Health Trust Fund estimates for current and future years.

(2) Alternative measures of income. Under GASB principles, daily gains or losses in investment value are recognized. Under statutory net income, gains or losses in investment value are not recognized until the investment is sold.

Alaska Science and Technology Foundation and Endowment (AS 37.17.010).

The Alaska Science and Technology Foundation was established in 1988 as a public corporation in the Department of Community and Economic Development to promote and enhance the development and commercialization of technology in the state.

The Alaska Science and Technology Endowment was established to support the foundation and was capitalized with \$100 million in legislative appropriations to benefit the foundation. The Alaska Permanent Fund Corporation (APFC) manages the endowment's investments.

The distribution of the endowment's income to the foundation is subject to the Executive Budget Act. The board has the discretion to divide the annual realized capital gains between principal and income of the fund. With one exception — totaling \$1.037 million in 1991 — the board has left the realized capital gains in the fund's income account.

Income from the endowment is used to fund grants through a competitive proposal process managed by the foundation's nine-member board of directors. The administrative expenses of the foundation are also paid from income, and the legislature also has appropriated income of the endowment to pay for the administrative expenses of the Alaska Aerospace Development Corporation and the University of Alaska agricultural and forestry experiment station research centers.

**Table 50. Alaska Science and Technology Endowment ⁽¹⁾
Preliminary FY 2002 and Projected FY 2003-2004
\$ Million**

	<u>Preliminary FY 2002</u>	<u>FY 2003</u>	<u>FY 2004</u>
<u>Market Value</u>			
Beginning-of-Year Balance (Market Value)	106.7	101.0	94.3
Transfers In	0.1	0.0	0.0
Transfers Out	(3.4)	(7.3)	(5.4)
Net Investment Gain/ (Loss)	<u>(2.3)</u>	<u>0.6</u>	<u>7.3</u>
End-of-Year Balance	101.0	94.3	96.2

(1) Source: Alaska Science and Technology Endowment estimates using October 31, 2002, financial statements. Income projections are based on Callan Associates, Inc. 2002 capital market assumptions: 7.95% total return for FY 2004. Projected contributions are actual year-to-date amounts for current year and zero for all future years. Transfers out are estimates provided by Alaska Science and Technology Endowment.

International Trade and Business Endowment.

In 1997, the legislature established the International Trade and Business Endowment and assigned the administration of the endowment to the Alaska Science and Technology Foundation. The legislature funded this endowment with an appropriation of \$4.95 million in FY 1997 to support programs for the development of international trade and business in the state. The Department of Community and Economic Development administers the programs supported by the income from this endowment.

**Table 51. International Trade and Business Endowment ⁽¹⁾
Preliminary FY 2002 and Projected FY 2003-2004
\$ Million**

	Preliminary FY 2002	FY 2003	FY 2004
<u>Market Value</u>			
Beginning-of-Year Balance (Market Value)	5.6	4.6	4.7
Transfers In	0.0	0.0	0.0
Transfers Out	(0.9)	0.0	(0.2)
Net Investment Gain/ (Loss)	<u>(0.1)</u>	<u>0.0</u>	<u>0.4</u>
End-of-Year Balance	4.6	4.7	4.8

(1) Source: Projected contributions and distributions are International Trade and Business Endowment estimates using October 31, 2002, financial statements. Income projections are based on Callan Associates, Inc. 2002 capital market assumptions: 7.95% total return for FY 2004. Projected contributions are actual year-to-date amounts for current year and zero for all future years. Transfers out are estimates provided by International Trade and Business Endowment.

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IX. STATE ENDOWMENT FUNDS

The State of Alaska has established several endowment funds to support specific public purposes. Proposals for additional endowment funds also have been introduced during recent legislative sessions. In 2000 the Power Cost Equalization Endowment Fund was established. In 2001, the legislature established an endowment for Alaska's participation in the Arctic Winter Games. In 2002, the legislature established an endowment to support veterans' memorials.

This section of the revenue forecast compares some important attributes of six existing endowment funds. The University of Alaska endowment is included in this comparison because it is one of the Alaska state public endowment funds that employs the annual distribution practices typical of the vast majority of endowments in the United States and Canada.⁽¹⁾

The fiduciary for each of these endowment funds has the responsibility for establishing an asset allocation policy for the fund. The table below compares the asset allocation policies for these endowments.

Today, under the standards adopted by the Governmental Accounting Standards Board (GASB), public funds complying with those standards determine and report their income by recognizing changes in the value of securities as income, or losses, as they occur at the end of each trading day, regardless of whether the securities are actually sold and the income taken, or realized. All six of these endowments report annual income on this basis. However, as reflected in the table, four of them — two of the funds administered by the Alaska Permanent Fund Corporation, the Public School Trust and the Alaska Children's Trust — use other measures of annual income for their distributions.

In determining the amount of income available for distribution each year for the two funds managed by the Alaska Permanent Fund Corporation, gains or losses on individual stocks and bonds are not recognized until the stock or bond is sold. For calculating distributable income for the Public School Trust and the Alaska Children's Trust, only interest earned and dividends paid are treated as income. Gains and losses in the value of individual stocks and bonds are never recognized as income. By law, those gains and losses remain with the principal of the fund.

Table 52. Target Asset Allocation - State Endowment Funds
percent

	Cash	U.S. Bonds	Foreign Bonds	U.S. Equities	Int'l Equities	Real Estate	Alternative Investments	Total
Alaska Permanent Fund	0	35	2	37	16	10	0	100
Mental Health Trust	0	35	2	37	16	10	0	100
Public School Trust	0	58	0	42	0	0	0	100
Alaska Children's Trust	0	58	0	42	0	0	0	100
Power Cost Equalization	0	42	0	41	17	0	0	100
University of Alaska Endowment	1	28	0	36	12	5	18	100

(1) The predominant practice, making annual distributions of 4% to 5% of the market value of the endowment, developed following a 1968 Ford Foundation study. See *The Ford Foundation Managing Educational Endowments* (New York, New York; 1968).

Table 53. Calculation of Annual Income - State Endowment Funds

	Financial Reporting of Income	Distributable Income
Alaska Permanent Fund	GASB (recognize gains and losses based on change in market value)	Interest earnings + dividends paid + gains and losses on securities actually sold
Mental Health Trust	GASB (recognize gains and losses based on change in market value)	Interest earnings + dividends paid + gains and losses on securities actually sold
Public School Trust	GASB (recognize gains and losses based on change in market value)	Interest earnings + dividends paid; gains and losses on value of securities are never income, they become part of principal
Alaska Children's Trust	GASB (recognize gains and losses based on change in market value)	Interest earnings + dividends paid; gains and losses on value of securities are never income, they become part of principal
Power Cost Equalization Endowment	GASB (recognize gains and losses based on change in market value)	GASB (recognize gains and losses based on change in market value)
University of Alaska Endowment	GASB (recognize gains and losses based on change in market value)	GASB (recognize gains and losses based on change in market value)

Several important considerations bear on the distribution policy established for an endowment fund.

What kind of distribution policy will minimize year-to-year volatility in distributions? Distributions based on the average of several years of fund earnings or several years of fund market value will be less volatile than distributions based on one year's earnings or one year's market value. Because the proportional variability in total market value from year-to-year will be smaller than the proportional variability in fund earnings, distributions based on fund market value will be less volatile than distributions based on fund earnings.

Where there is a prohibition on distributing fund principal, how can a fund best be managed to make it possible to continue distributions in a several-year bear market? To reduce the possibility of no distribution, a policy of retaining a large cushion in an earnings reserve account is essential. If all the fund's accumulated earnings are either distributed or moved to the fund principal when times are good, the fund may well be precluded from making distributions when times are bad.

What kind of distribution policy will provide maximum current distributions, yet protect the purchasing power of the fund and the fund distributions against inflation? The answer is: a policy that leads to the distribution, on average, of the long-run real return of the fund — that is the nominal average return of the fund minus the average inflation rate. If the long-run nominal return of the fund is 8% and the long-run inflation rate is 3%, then the fund can distribute 5% (8% minus 3%) of its value each year and still protect its purchasing power.

The following tables show how the legislature and the fund managers have addressed these questions.

Table 54. Distributable Income Determination - State Endowment Funds

Alaska Permanent Fund	The only regular distribution is for the annual Permanent Fund Dividend (PFD). That distribution, following the formula in AS 37.13.140-.150, equals 10.5% of the past five years' total realized income but not to exceed 50% of the balance in the Fund's Earning Reserve Account (ERA). The 50% limitation has never been triggered. Because the fund principal does not change with changes in investment market values, the market value volatility for the entire fund is absorbed by the ERA. Consequently, a large balance is needed in the ERA to ensure there are enough funds for the full annual dividend distribution according to the statutory formula. The annual PFD dividend distribution has been equal to about 4% of the market value of the fund.
Mental Health Trust	The Mental Health Trust Board adopted a policy to annually distribute 3.5% of the market value of the fund's total assets beginning in FY 2001. For FY 1996-1998 it was 3%; for FY 1999-2000 it was 3.25%. Because of recent declines in market value, the Trust Board is exploring a redefinition of "principal" so that losses in market value would be proportionally allocated to the principal account and the income account.
Public School Trust	The annual distribution is 4.75% of a five-year moving average of the fund principal's market value so long as that amount does not exceed the interest and dividend earnings available in the earnings account. The trust has accumulated a sizable income account balance so the fund is better able to retain its ability to distribute in a sustained bear market.
Alaska Children's Trust	The annual distribution is 4.75% of a five-year moving average of the fund principal's market value so long as that amount does not exceed the interest and dividend earnings available in the earnings account. The trust has accumulated a sizable income account balance so the fund is better able to retain its ability to distribute in a sustained bear market.
Power Cost Equalization Endowment	The annual distribution is 7% of the fund's market value. For the initial transition years, use the market value on February 1 for the subsequent fiscal year. Thereafter, use 7% of the monthly average value for a specified 36-month period.
University of Alaska Endowment	The annual distribution is 5% of a five-year moving average of the market value of the fund.

Table 55. Inflation-Proofing Procedures — State Endowment Funds

Alaska Permanent Fund	The legislature annually inflation proofs the principal of the Permanent Fund (but not the accumulated balance in the Earnings Reserve Account (ERA)) pursuant to AS 37.13.145. The legislature each year transfers from the ERA to the fund's principal an amount equal to the U.S. Consumer Price Index's effect on the value of the principal. The Alaska Permanent Fund Corporation's Trustees have proposed a constitutional amendment that would inflation proof the entire fund by limiting the annual distribution of earnings to 5% of the market value of the fund.
Mental Health Trust	The Mental Health Trust Authority has adopted two policies to inflation proof the fund. It limits distributions to 3.5% of the fund's market value. (The authority's ultimate distribution rate goal of 5% should still inflation proof the fund.) The authority also has adopted a policy transferring money from the reserve account to the principal whenever the reserve exceeds four times the annual income distribution.
Public School Trust	The asset allocation policy is such that, in combination with the requirement that the fund's capital gains and losses remain part of the principal of the fund, the retained capital gains are adequate to inflation proof the fund.
Alaska Children's Trust	The asset allocation policy is such that, in combination with the requirement that the fund's capital gains and losses remain part of the principal of the fund, the retained capital gains are adequate to inflation proof the fund.
Power Cost Equalization Endowment	The legislature, in selecting a 7% distribution policy, expressly elected not to inflation proof this fund, but rather to distribute all, or almost all, of its anticipated annual earnings.
University of Alaska Endowment	The university's distribution policy of 5% of the moving five-year average of the fund's market value should inflation proof the fund.

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X. PUBLIC CORPORATIONS AND THE UNIVERSITY OF ALASKA

Public Corporations

The state has established the following public corporations to carry out certain public policies:

- Alaska Housing Finance Corporation (AHFC)
- Alaska Industrial Development and Export Authority (AIDEA)
- Alaska Energy Authority (AEA)
- Alaska Student Loan Corporation (ASLC)
- Alaska Municipal Bond Bank Authority (AMBBA)
- Alaska Aerospace Development Corporation
- Alaska Railroad Corporation
- Alaska Science and Technology Foundation (ASTF)

These eight corporations, together with the Mental Health Trust and Alaska Science and Technology Foundation (described in Section VIII) and University of Alaska, are component units of state government whose activities are accounted for in the State's Comprehensive Annual Financial Report separately from the activities of primary state government.

Four of these corporations — the Alaska Housing Finance Corporation, Alaska Industrial Development Authority, Alaska Student Loan Corporation and Alaska Municipal Bond Bank Authority — pay some portion of their income as a "dividend" to the state. These "dividends" have been included as income in Section VI — Non-Oil Revenue (Except Federal and Investment) — of this forecast.

Two of these corporations — AIDEA and AEA — share a common staff and board of directors. The other corporations each have their own staffs and boards. While neither the sale of bonds nor the expenditure of bond proceeds by these corporations are subject to the Executive Budget Act, expenditures for the day-to-day administration of all of these corporations except the Alaska Railroad are.

The following six tables summarize the activities of these eight corporations.

Table 56. Public Corporations - Missions

What does the corporation do and how does it do it?

**Alaska Housing
Finance Corporation**

Using proceeds from the sale of bonds backed by its corporate assets, AHFC purchases home mortgages from Alaska banks. Income from payments on these mortgages repays bond holders and adds to the corporation's income, thereby enabling the corporation, since FY1991, to pay an annual dividend and/or return of capital to the state. In addition to ensuring that Alaskans, especially Alaskans of low and moderate income and those in remote and underdeveloped areas of the state, have adequate housing at reasonable cost, the corporation administers federally and state funded multi-residential, senior and low-income housing, residential energy and home weatherization programs. In recent years, the legislature also has authorized AHFC to finance the construction of schools, University of Alaska housing and other capital projects identified by the legislature.

**Alaska Industrial
Development and
Export Authority**

By lending money, guaranteeing loans or becoming an owner, AIDEA makes financing available for industrial, export and other business enterprises in Alaska. The corporation earns money from interest on its loans and from leases and operations of its properties. The corporation has paid an annual dividend to the state since FY1997.

**Alaska Energy
Authority**

A separate entity within AIDEA, AEA provides loans to rural utilities, communities and individuals to pay for the purchase or upgrade of equipment and for bulk fuel purchases. Additionally, the agency administers the Power Cost Equalization program, subsidizing rural electric costs with the earnings of the Power Cost Equalization Endowment. AEA also receives federal and state money to provide technical advice and assistance in energy planning, management and conservation in rural Alaska.

**Alaska Student
Loan Corporation**

The Alaska Student Loan Corporation uses proceeds from bond sales to finance student loans made by the Alaska Commission on Postsecondary Education. Loan repayments satisfy bond obligations and enhance the corporation's capital asset base. Alaska statutes authorize the board of directors to annually declare a return to the state of a portion of its contributed capital. The board has declared a return of capital for FY 2001, FY 2002 and FY 2003.

**Alaska Municipal
Bond Bank Authority**

The Bond Bank loans money to Alaska municipalities for capital improvement projects. The bank's larger capital base, its reserve funds and its credit rating enable it to sell bonds at lower interest rates than the municipalities could obtain on their own. The Bond Bank earns interest on the money it holds in reserve and has returned a dividend to the state every year since 1977.

**Alaska Aerospace
Development
Corporation**

The corporation finances aerospace-related ventures in Alaska, including the establishment and operation of a commercial space vehicle launch facility in Kodiak, space science and engineering research and promoting tourism at the Poker Flat rocket range and other facilities. Eventually, income from investments and operations will be returned to a revolving fund used to make more loans and acquire properties.

**Alaska Railroad
Corporation**

The corporation operates freight and passenger rail services between Seward and Fairbanks, including a spur line to Whittier. In addition, the corporation generates revenues from real estate it owns.

**Alaska Science and
Technology Foundation**

The Foundation was initially incorporated to promote science and engineering research and development in Alaska by awarding grants and by serving as an adviser to and facilitator among various government agencies and industry. The Foundation's mission was later expanded to include administering the International Trade and Business Endowment. However, in practice, the State Division of International Trade and Market Development administers the endowment.

Table 57. Public Corporations - State Capitalization

How did the state capitalize the corporation?

Alaska Housing Finance Corporation	The legislature appropriated \$739.9 million in cash and \$292.5 million in mortgages held by the General Fund to the corporation between 1976 and 1984. The payments on those mortgages and additional mortgages purchased with the cash, have helped build the corporation's asset base and allow it to return some capital to the state each year. In 1993, AHFC received an additional \$27.7 million in cash and \$9.3 million in equity when the legislature merged the Alaska State Housing Authority with the corporation.
Alaska Industrial Development and Export Authority	Between 1981 and 1991, the State of Alaska transferred various loan portfolios worth \$366.1 million and \$69 million in cash to the corporation. In 1998, the state transferred ownership of the Ketchikan Shipyard. The corporation has since written down some assets and returned \$60 million in cash to the state. The state's contributed capital as of June 30, 2001 totaled \$297.2 million.
Alaska Energy Authority	The legislature established the AEA in 1976 to finance and operate power projects. The corporation has also administered rural energy programs at various times, including the present. As a result of legislatively mandated reorganizations, capital has moved into and out of the corporation. At the end of FY 2001, the corporation reported contributed capital of \$963.5 million. Some of that is from the federal government; the corporation does not report what portion.
Alaska Student Loan Corporation	In FY 1988, the state transferred \$260 million of existing student loans to the corporation. Additional appropriations of cash between FY 1988 and FY 1992 totaled \$46.7 million.
Alaska Municipal Bond Bank Authority	Between 1976 and 1986, the legislature appropriated \$18.6 million to the Bond Bank to be use for backing bond issues. In addition, the legislature gave the Bond Bank \$2.5 million in 1981 to cover an anticipated default by a municipality. The municipality did not default, and the Bond Bank retained the appropriation.
Alaska Aerospace Development Corporation	Since 1993, the state has contributed \$10.9 million from the Science and Technology Endowment.
Alaska Railroad Corporation	The state bought the railroad from the federal government in 1985. The purchase price of \$22.7 million was recorded as the state's capitalization.
Alaska Science and Technology Foundation	The corporation is funded from the earnings of the Alaska Science and Technology Endowment. The endowment was capitalized with \$100 million from the General Fund that was paid to the endowment over several years in the late 1980s.

Table 58. Public Corporations - Financial Facts, FY 2002

	(\$ Million) Total Assets	(\$ Million) Assets Less Liabilities Book Value	(\$Million) Unrestricted Net Assets	(\$ Million) FY 2002 Operating Budget	(1) Total Positions
Alaska Housing Finance Corporation	\$5,282	\$1,766	\$210	\$39.1	354
Alaska Industrial Development and Export Authority	\$1,142	\$793	\$789	\$6.5	65
Alaska Energy Authority	\$598	\$438	\$226	\$1.0	See AIDEA (2)
Alaska Student Loan Corporation	\$819	\$302	\$4	\$10.3	103
Alaska Municipal Bond Bank Authority	\$269	\$40	\$22	\$0.5	1
Alaska Aerospace (3) Development Corporation	\$75	\$48	na	\$14.6	18
Alaska Railroad (4) Corporation	\$306	\$114	na	\$77.0	710
Alaska Science and Technology Foundation	\$109	\$107	na	\$10.6	7

(1) Permanent Full Time (PFT), Permanent Part Time (PPT) and Temporary (TMP) are included in total positions.

(2) The Alaska Industrial Development and Export Authority (AIDEA) provides staff for the activities of the Alaska Energy Authority (AEA). A significant portion of AIDEA's 65 member staff are engaged in AEA programs.

(3) Unaudited.

(4) The Alaska Railroad reports financial data on a calendar year. Assets and book value shown here are for 2001. The operating budget figure shown here is for C'Y 2003.

Table 59. Public Corporations - Revenue and Net Income
\$ Million

	FY 2002 Revenue	FY 2002 Operating Income	FY 2002 Net Income
Alaska Housing Finance Corporation	\$349.2	\$75.7	(\$7.9)
Alaska Industrial Development and Export Authority	\$73.3	(\$55.0)	(\$72.5)
Alaska Energy Authority	\$54.8	(\$197.4)	(\$199.7)
Alaska Student Loan Corporation	\$37.1	\$14.4	\$9.1
Alaska Municipal Bond Bank Authority	\$14.5	\$2.2	\$1.1
Alaska Aerospace Development Corporation	\$2.4	(\$1.2)	(\$0.6)
Alaska Railroad Corporation ⁽¹⁾	\$96.2	\$0.0	\$6.6
Alaska Science and Technology Foundation	(\$2.2)	(\$2.3)	(\$5.7)

(1) The Alaska Railroad reports financial data by calendar year. CY 2001 covers the second half of FY 2001 and the first half of FY 2002.

Table 60. Public Corporations - Dividends to the State

How, if at all, does the corporation pay dividends to the state?

**Alaska Housing
Finance Corporation**

By agreement with the legislature, the corporation is to annually transfer an amount no greater than its net income for the preceding year to the state. As established in statute, that amount has been \$103 million (Chapter 130, SLA 2000). The final payment will be in FY 2008. The corporation has customarily regarded \$53 million of the dividend as available for AHFC capital projects, while the remaining \$50 million is a cash transfer for the legislature to spend as it sees fit. In practice, the legislature has in recent years used some of the \$53 million for non-AHFC projects.

**Alaska Industrial
Development and
Export Authority**

By statute, AIDEA must make available to the state not less than 25% and not more than 50% of its total net income for a base year, defined as the year two years prior to the dividend year. The dividend is further limited to no more than the total amount of its *unrestricted* net income in the base year (AS 44.88.088). Booked losses would reduce net earnings and, consequently, reduce the dividend to the state. For example, the write-down of asset values in FY 2003 will likely preclude paying a dividend in FY 2004, unless the legislature wants to change the statute.

**Alaska Energy
Authority**

AEA does not pay a dividend or return capital to the state on a regular basis. However, in FY 2000 the corporation returned \$55.6 million of contributed capital to the Railbelt Energy Fund and the General Fund

**Alaska Student
Loan Corporation**

The corporation, at the discretion of its board of directors, may make available to the state a return of contributed capital for any base year in which the net income of the corporation is \$2 million or more. A base year is defined as the year two years before the payment year. If the board authorizes a payment, the returned capital must be between 10% and 35% of net income for the base year (AS 14.42.295).

**Alaska Municipal
Bond Bank Authority**

By statute, the Bond Bank annually returns earnings or income of its reserve fund in excess of expenses to the state.

**Alaska Aerospace
Development
Corporation**

AADC does not pay a dividend or return capital to the state.

**Alaska Railroad
Corporation**

ARRC does not pay a dividend or return capital to the state.

**Alaska Science and
Technology Foundation**

The foundation itself does not pay a dividend or return capital to the state, however, the legislature regularly appropriates money from the earnings of the Science and Technology Endowment and the International Trade and Business Endowment.

**Table 61. Public Corporations - Operating Expenses and Dividends
\$ Million**

	Operating Expenses Subject to the Executive Budget Act		Dividends and/or Return of Capital	
	Actual FY 2002	Budget FY 2003	Actual FY 2002	Budget FY 2003
Alaska Housing Finance Corporation	\$36.4	\$39.1	\$103.0 ⁽¹⁾	\$103.0
Alaska Industrial Development and Export Authority	\$5.5	\$6.5	\$17.5	\$19.0
Alaska Energy Authority	\$18.2	\$1.0	na	na
Alaska Student Loan Corporation	\$10.0	\$10.3	\$4.0	\$5.3
Alaska Municipal Bond Bank Authority	\$0.5	\$0.5	\$0.7	\$2.0
Alaska Aerospace Development	\$4.8	\$14.6	na	na
Alaska Railroad Corporation	na	na	na	na
Alaska Science and Technology Foundation	\$2.5	\$10.6	na	na

(1) This figure reflects the provision in Chapter 130, SLA 2000, that \$103 million will be transferred to the state each year through Fiscal 2008. Because some of this money is earmarked for multi-year capital projects, actual cash transfers in any given year may vary.

University of Alaska

Established in territorial days, the University of Alaska is organized into four branches: statewide administration and three main campuses in Fairbanks, Anchorage and Juneau. Each main campus administers satellite campuses in rural areas.

The University of Alaska is overseen by a Board of Regents appointed by the governor and subject to confirmation by the legislature. While other semi-autonomous state agencies are created in statute, the university and its board are uniquely embodied in the Alaska constitution.

Accounting standards for state universities and colleges differ from those of public corporations. For instance, they do not record contributed capital. The figures presented here, therefore, cannot be compared directly with those of other state agencies or corporations. Rather, they are intended only to give the reader an idea of the university's size and scope.

Table 62. University of Alaska
\$ Million

<u>Lands and Facilities</u> <u>June 30, 2002</u>	<u>Total Assets</u> <u>June 30, 2002</u>	<u>Unrestricted</u> <u>Net Assets</u>	<u>FY 2003</u> <u>Operating Budget</u>	<u>FY 2003</u> <u>Total Positions</u>
\$651.3 ⁽¹⁾	\$895.6	\$36.5	\$611.8	3,786

(1) Unaudited. Includes depreciation. Past years' figures did not include depreciation, in accordance with accounting principles for universities at that time.

XI. ROSETTA STONE

Introduction

This Revenue Sources Book published by the Department of Revenue, the Summary of Appropriations published by the Legislative Finance Division, and the Comprehensive Annual Financial Report (CAFR) published by the Finance Division of the Department of Administration all present detailed information about where the state gets the money for its budgeted day-to-day operations.

Although these three documents concern the same subject matter, they serve very different purposes. This Revenue Sources Book concerns the first step in the process, estimating available "general purpose" or "unrestricted" revenue for appropriation in the next fiscal year. It is published each fall, just before the legislative session — about seven months before the beginning of the fiscal year for which it is forecasting revenue. While the main focus for us in preparing this book is the unrestricted revenue, we also look at many sources of restricted revenues as well.

At the far end of the spectrum from this forecast is the CAFR. The CAFR reports what actually happened to state dollars during the prior fiscal year, and is published in December about six months after the end of the fiscal year — about two years after the publication of the Revenue Sources Book that had estimated the available revenue for that year. New standards set by the Government Accounting Standards Board in GASB Statement 34, promulgated a fairly major restructuring of its required financial reporting model, and the state will use that model for its 2002 CAFR. In December of 2002, a CAFR covering FY2002 will be published. In April 2003 we will publish a comparison between that and the 2002 numbers in our spring forecast.

In between the publication of our forecast and the CAFR, thousands of events occur and many different "snapshots" of the state's finances are taken. The Summary of Appropriations is one such snapshot, which records how much spending the legislature and governor authorized in the legislative session then just ended. The Summary of Appropriations is published in July, right at the start of the fiscal year. In July 2002, the Summary of Appropriations for FY 2003 was published.

Even though these three books concern the same subject matter, they present it differently. This purpose of this section is to reconcile these documents. Going from one document to the other can be very difficult because each uses a different system to classify various kinds of state money, so a sum of money in one report may be broken up into many different pieces in a different report, or vice-versa. In addition, some of the critical terms used in the classification are defined very differently between the books.

Defining "Fund"

Alaska's public finances are generally described under one of two different systems: "accounting funds" or "budget funds." Many accounting funds have a corresponding budget fund. For other funds, a single budget fund can incorporate several entire accounting funds or parts of various accounting funds, and the reverse is true as well. Some budget funds have no corresponding accounting fund. As will be fleshed out below, a major difference between the two systems of funds is how each defines the "general fund."

Only about 110 of the approximately 181 budget funds are active⁽¹⁾ — and some of these are used to designate duplicated receipts. When a budget writer says money is coming from a particular fund, the writer identifies a source that may include money already set aside under that fund code or a stream of revenues earmarked for that fund code. Of those funds, 83 show up in the 2003 Summary of Appropriations as "other revenues" and can be found in Tables 65-67.

Accounting funds are funds established under general accepted accounting principles as codified by the Governmental Accounting Standards Board (GASB).⁽²⁾ These rules apply to all the states, counties, cities and other public jurisdictions across our country. They are meant to increase the transparency of public finances and the accountability of public officials. Accountants track revenues into specific GASB-defined funds. However, when an accountant says money is coming from such and such a fund, again, he or she is identifying a source that may include money on hand already set aside under that fund code or from a stream of revenues earmarked for that fund code.

(1) The list of fund codes can be found several places including "The Swiss Army Knife of Budget Handbooks," which can be found at <http://www.legfin.state.ak.us/>, with more recent additions found only in the budget itself.

(2) The GASB is a sister organization to the more well know FASB or Financial Accounting Standards Board. GASB sets out generally accepted accounting principles (GAAP) for governmental entities; FASB sets out GAAP for private businesses. Both are under the auspices of the Financial Accounting Foundation.