

ALASKA LEGISLATURE

HOUSE and SENATE FINANCE COMMITTEE FILES, 2005-2006 2794


Economic & Capital Market Update

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Callan's Capital Market Projection Process

Economic Outlook Drives Our Projections

- Evaluate the current environment and economic outlook for the U.S. and other major industrial countries:
 - Business cycles, relative growth, inflation.
- Examine the relationships between the economy and asset class performance patterns.
- Examine recent and long-run trends in asset class performance.
- Apply market insight:
 - Consultant experience - Plan Sponsor, Manager Search, Specialty
 - Industry consensus
 - Client Policy Review Committee
-  Test the projections for reasonable results.

Capital Market Expectations as a Set

- Relationships between asset class assumptions are as important, or more important, than the individual asset class level of assumptions, with the following relationships being most important:
 - Inflation versus cash equivalents.
 - Fixed income returns versus inflation.
 - Stock returns versus bonds - the equity premium.
 - Large capitalization versus small capitalization equities.
 - U.S. equity versus international equity.
- These relationships will have a strong effect on the generation of efficient asset mixes using the optimizer.

The Capital Markets - Context

Wild Ride for Investors Over the Last Six Years

	<u>2000</u>	<u>2001</u>	<u>2002</u>	<u>2003</u>	<u>2004</u>	<u>2005</u>	Average Ann Return		
							<u>Five Years 2001-05</u>	<u>Ten Years 1996-05</u>	<u>Fifteen Years 1991-05</u>
Russell 3000	-7.46	-11.46	-21.54	31.06	11.95	6.12	1.58	9.20	11.86
S&P Super Composite 1500	-6.98	-10.64	-21.31	29.59	11.78	5.66	1.48	9.47	11.97
Russell 1000	-7.79	-12.45	-21.65	29.89	11.40	6.27	1.07	9.29	11.85
S&P 500	-9.10	-11.88	-22.10	28.80	10.88	4.91	0.54	9.07	11.52
Russell 2000	-3.02	2.49	-20.48	47.25	18.33	4.55	8.22	9.26	13.04
S&P 600 Small Cap	11.80	6.54	-14.63	38.79	22.65	7.68	10.76	12.16	15.17
EAFE (\$US)	-14.17	-21.44	-15.94	38.59	20.25	13.54	4.55	5.84	7.00
LB Aggregate	11.63	8.43	10.26	4.10	4.33	2.43	5.87	6.16	7.26
SB Non-US Bonds	-2.63	-3.54	21.99	18.52	12.14	-9.21	7.27	4.42	6.94
90-day T-bill	6.18	4.42	1.78	1.15	1.33	3.07	2.34	3.84	4.06
CPI-U	3.39	1.55	2.38	1.88	3.26	3.42	2.49	2.51	2.61



Brief Overview

- Economy
 - Recovery
 - Consumer
 - Investment spending
 - Housing
 - Energy
 - Dollar
 - Inflation
- Capital Markets
 - Bonds
 - Stocks
 - Projections
 - Efficient Frontier



Consumer Spending: Slowdown or Retreat?

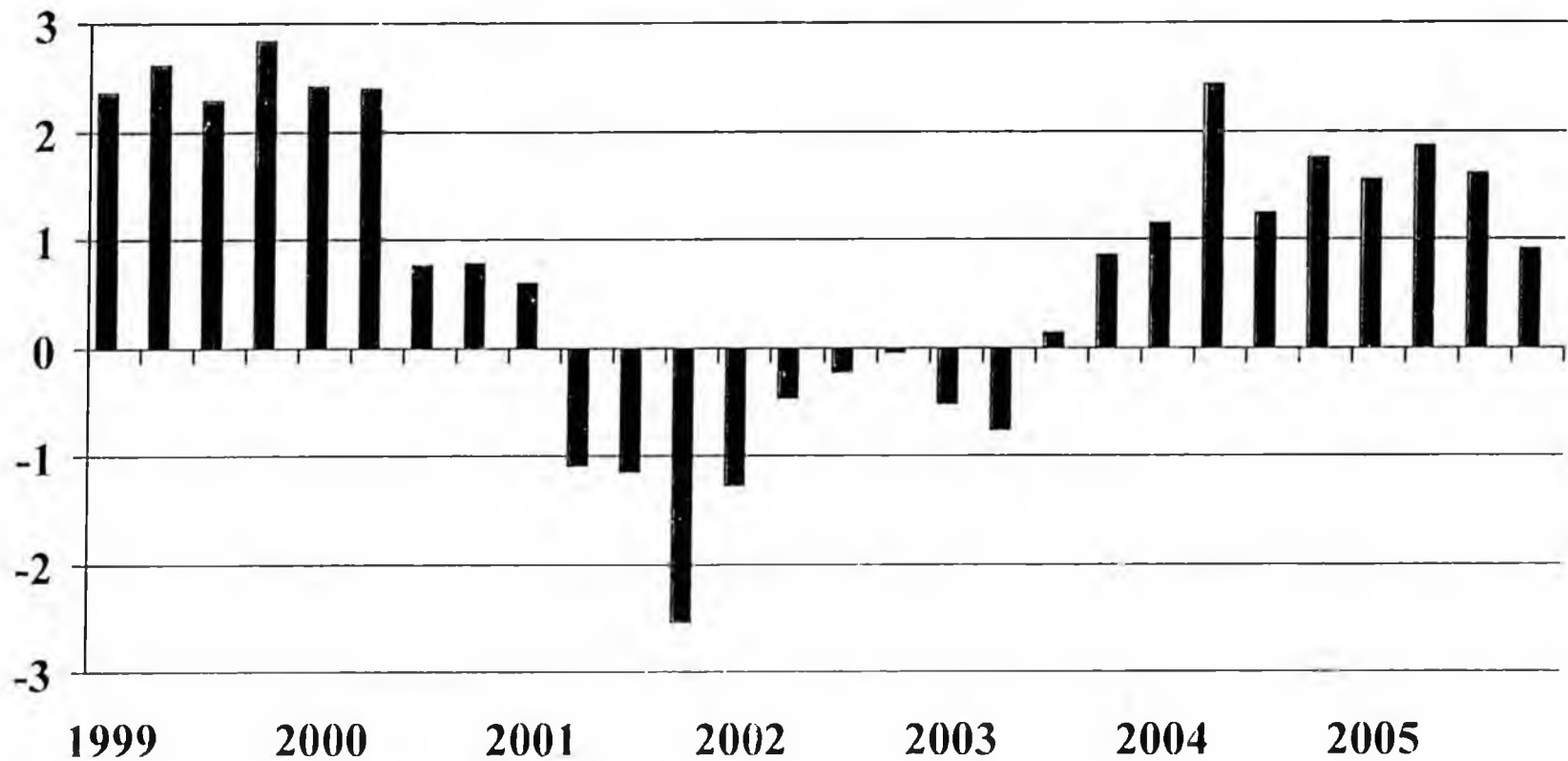
- Consumer spending carried the economy since 2000, fueled by low interest rates, tax cuts, and a housing boom.
- The housing boom triggered a “wealth effect” on confidence and spending, and encouraged the extraction of home equity.
- However:
 - Savings rate is low,
 - Tax cuts are over,
 - Interest rates are rising,
 - The housing market shows signs of cooling, and
 - Energy costs are substantially higher.
- Most observers expect the housing bubble to fizzle rather than pop.
- The bursting of the housing bubble has replaced deflation as the next disaster sure to strike.



2005 Best Year for Job Growth Since 2000

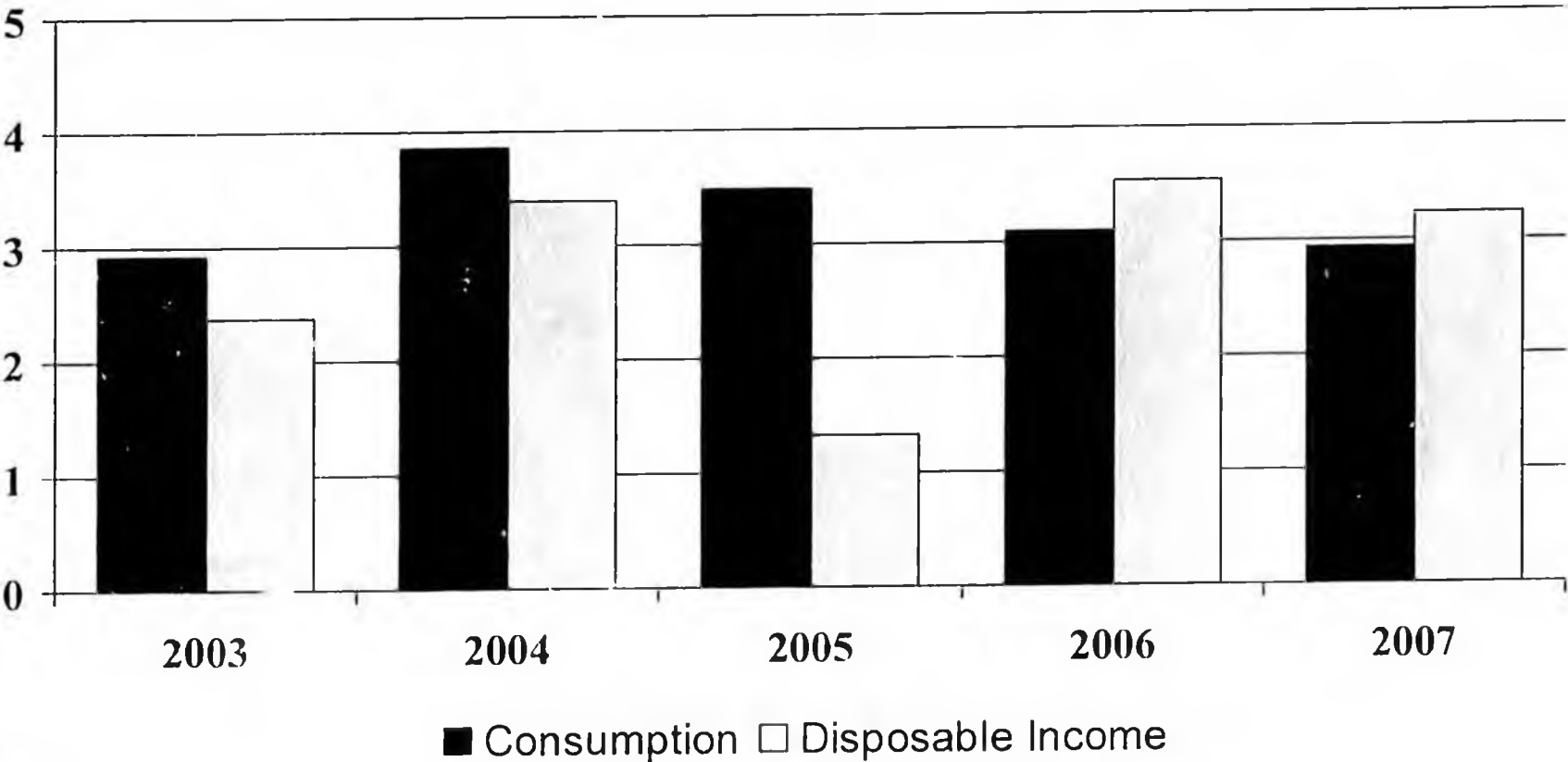
Employment finally surpassed the February 2001 peak in January 2005.

(Employment - percent change, annual rate)



Real Consumer Spending Has Outpaced Real Income Growth

(Percent Growth)

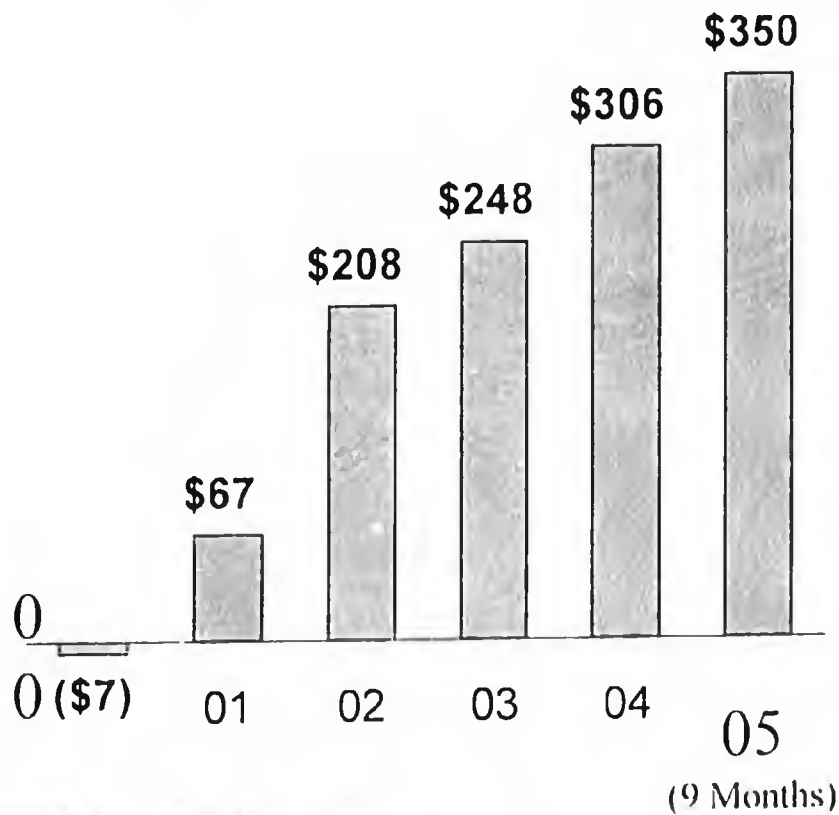


Source: Global Insight

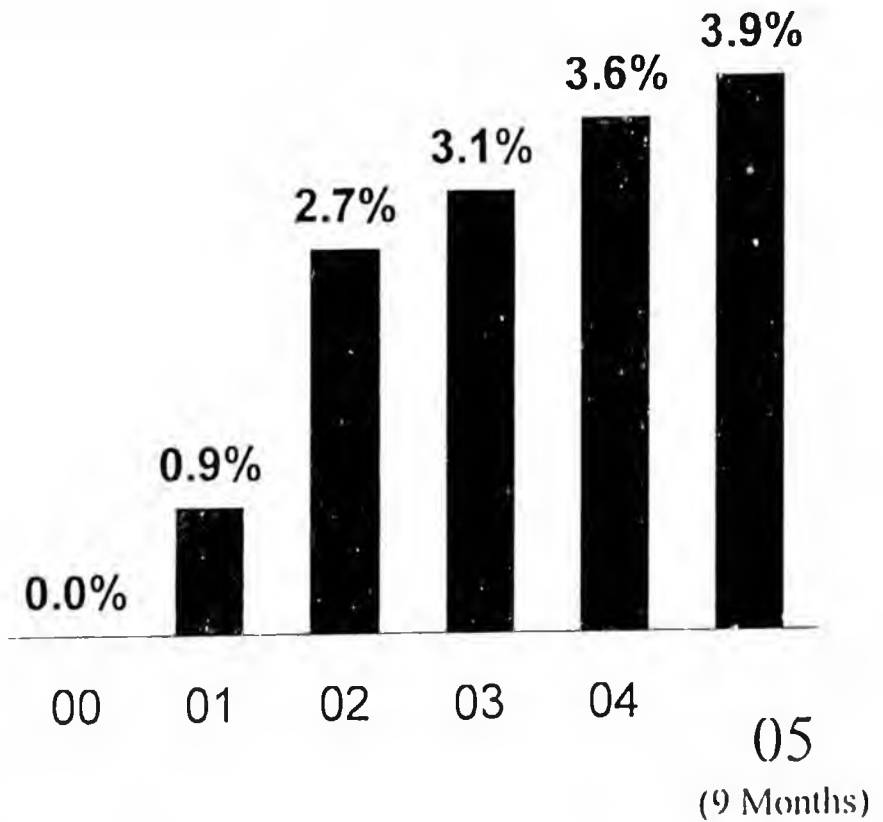
Cash Generated from Mortgages Stimulating Consumer Spending

source AllianceBernstein/CII 1/30/06

**Mortgage Growth in Excess of
New Housing Investment**
(\$ Billions)



**% of Personal Consumption
Expenditures**

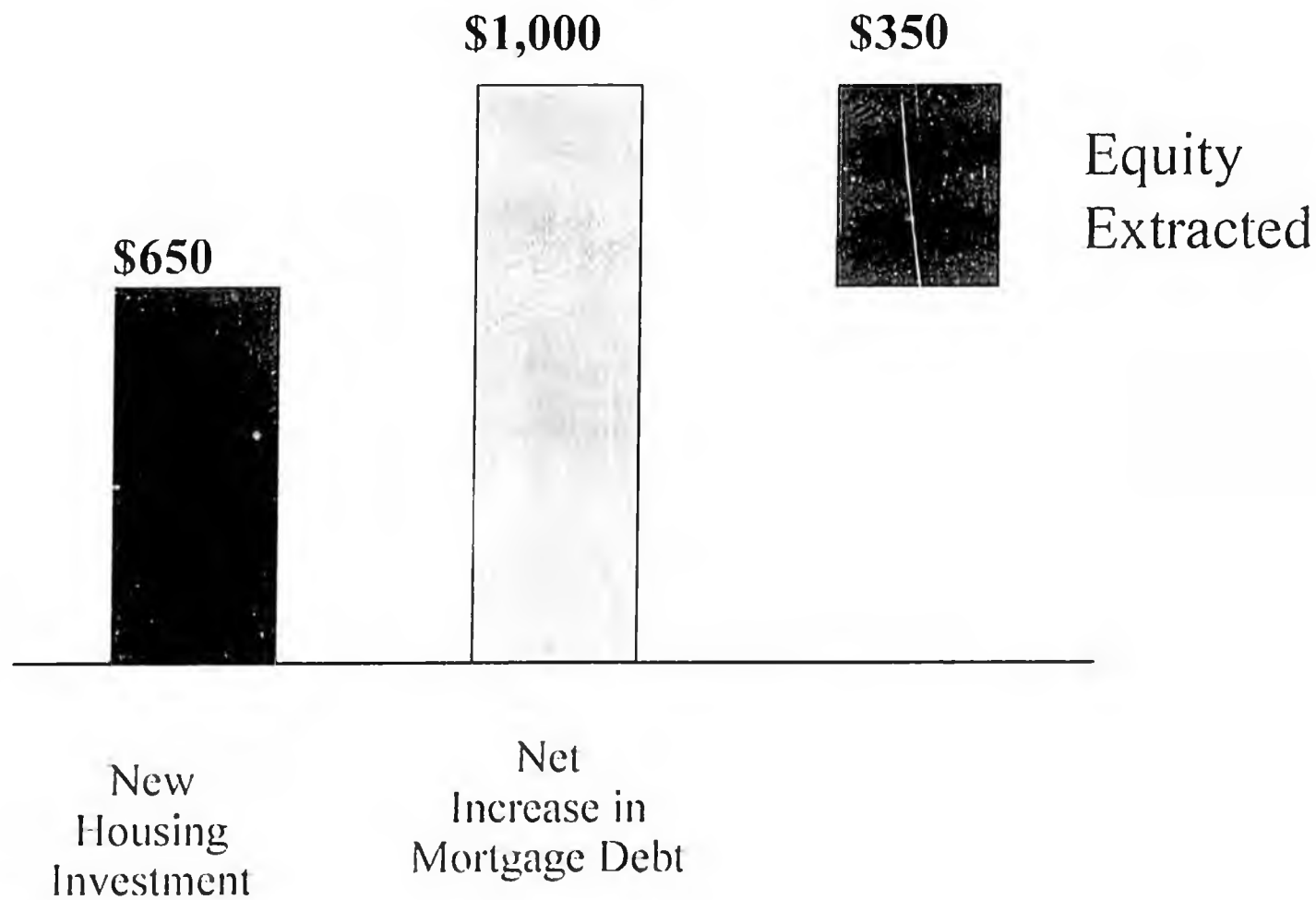


*2005 first half annualized
Source: Federal Reserve Board and AllianceBernstein estimates

Equity Extraction from Housing Was Huge in 2005

source: Alliance Bernstein/CII 1/31/06

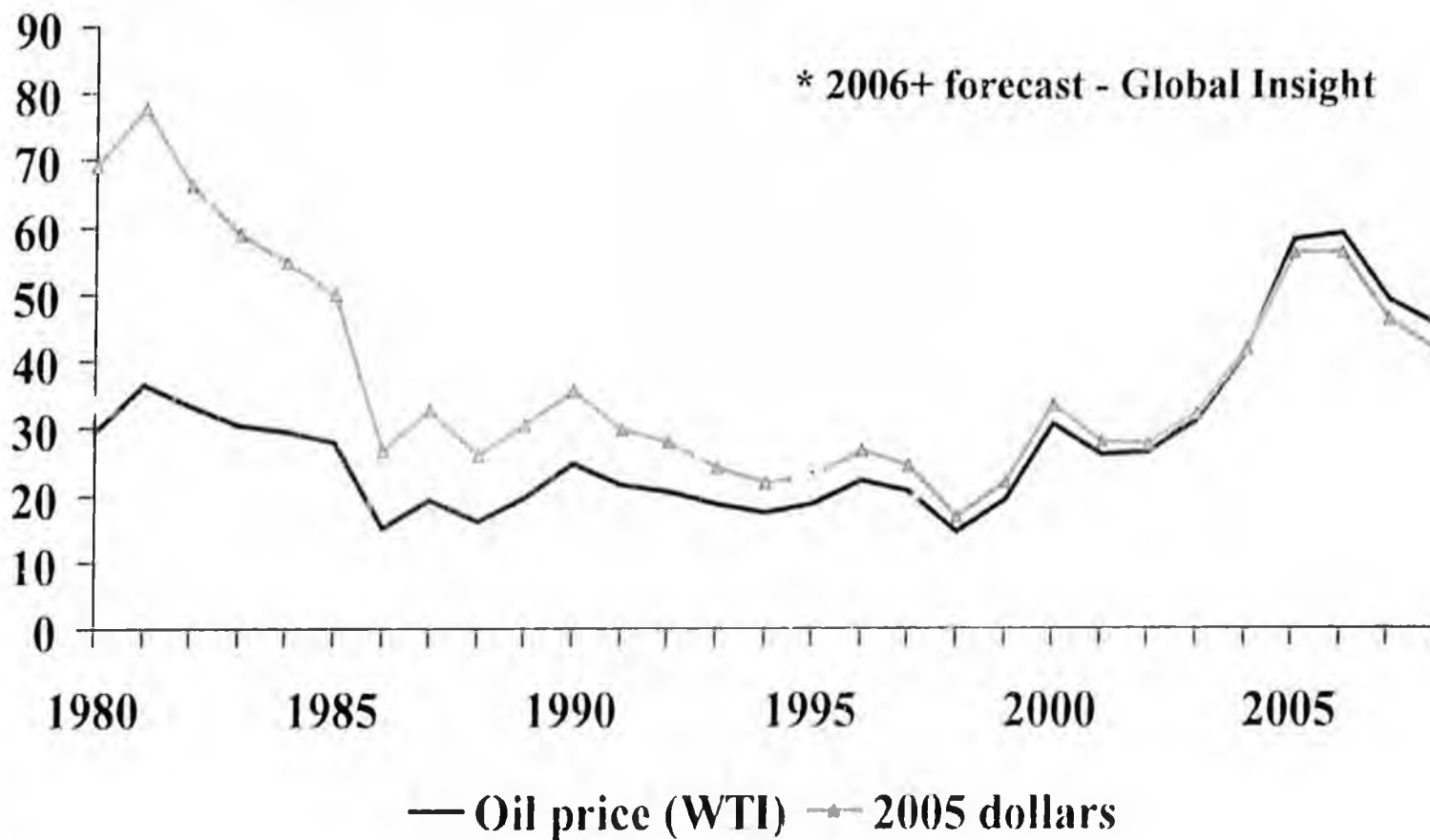
(\$ Billions)



Source: AllianceBernstein estimates

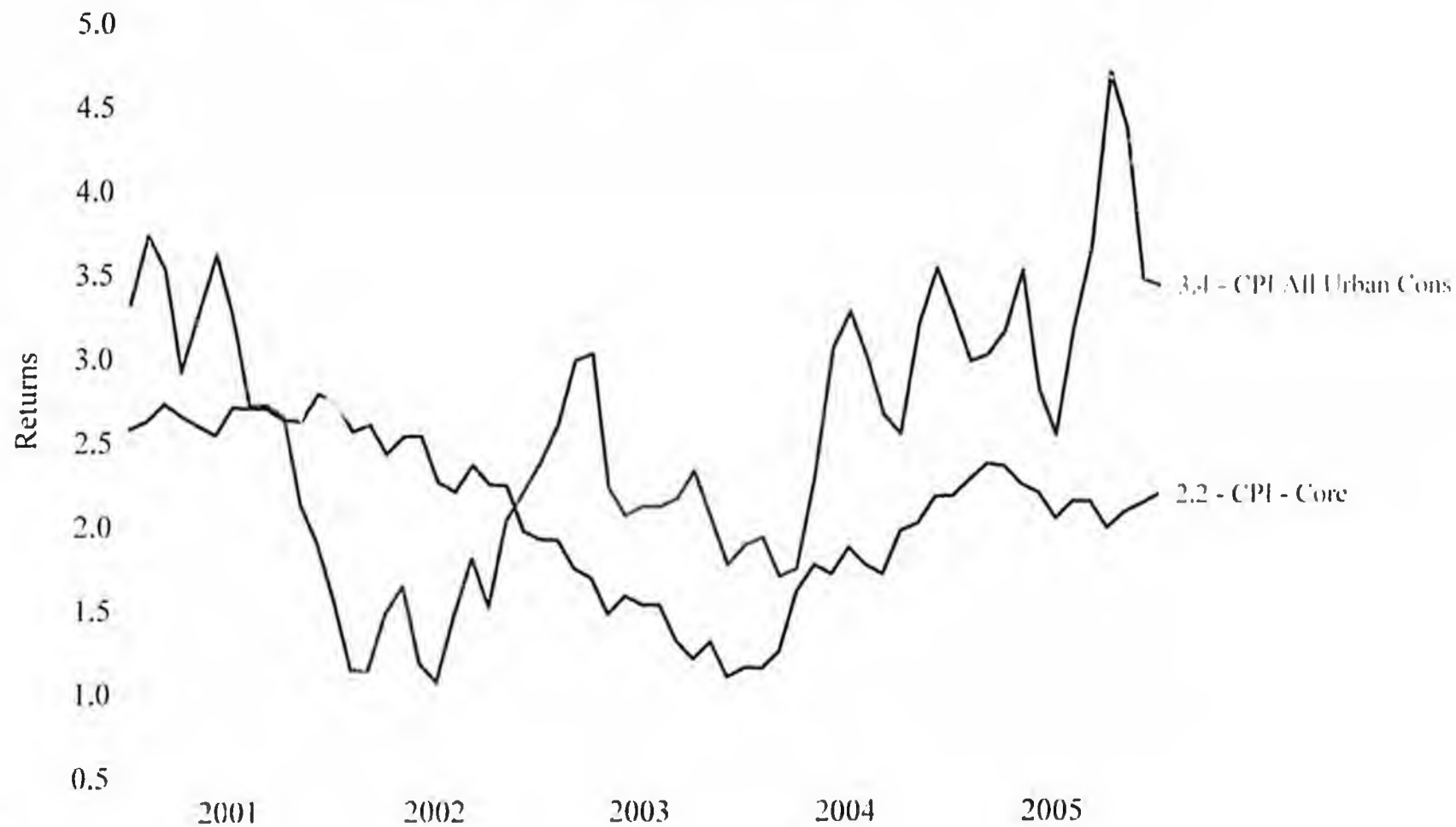
Oil Prices Are Hitting New Highs...

(\$/barrel, WTI and deflated by CPI)



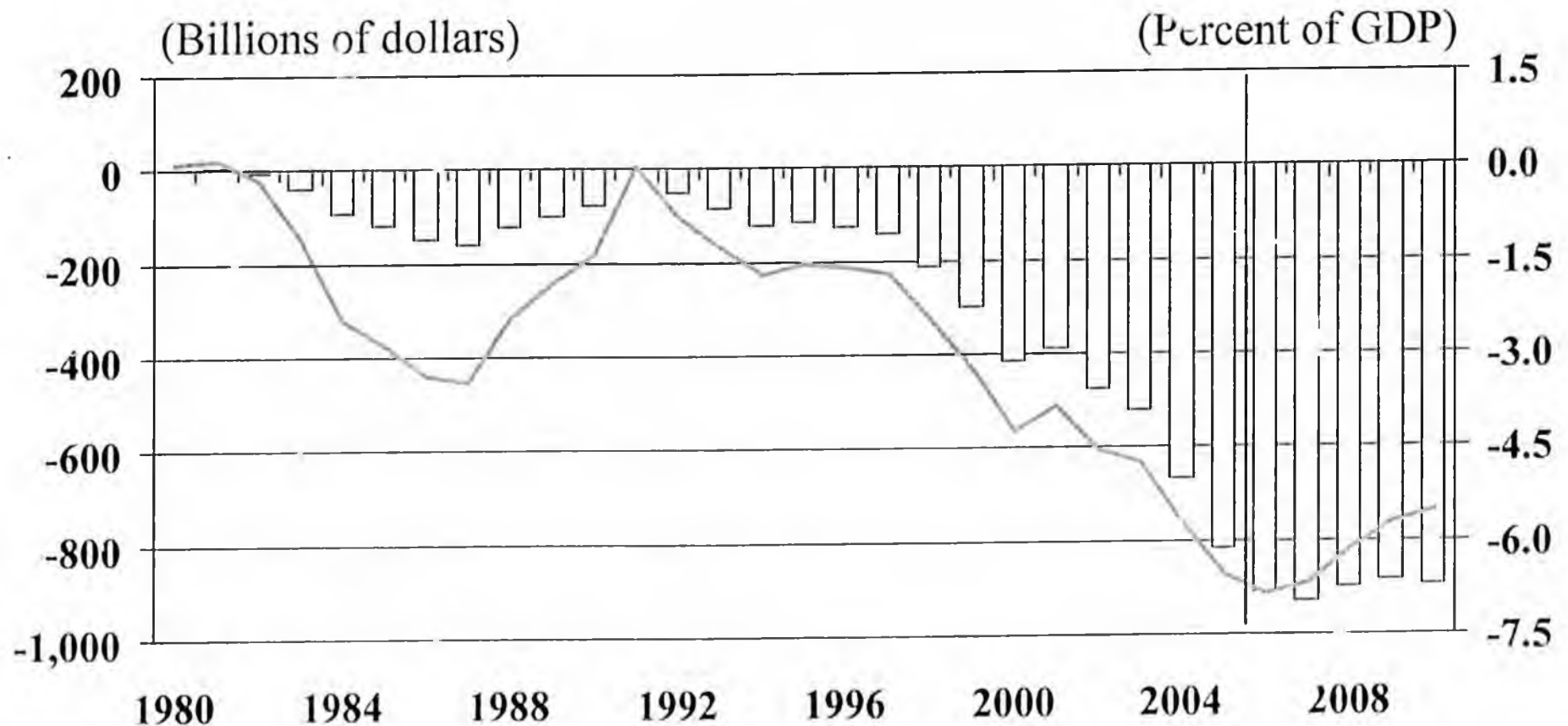
Inflation Has Ticked Up...

Year-Over-Year Change in Consumer Prices



The U.S. Current Account Deficit Heading to \$900 Billion in 2006

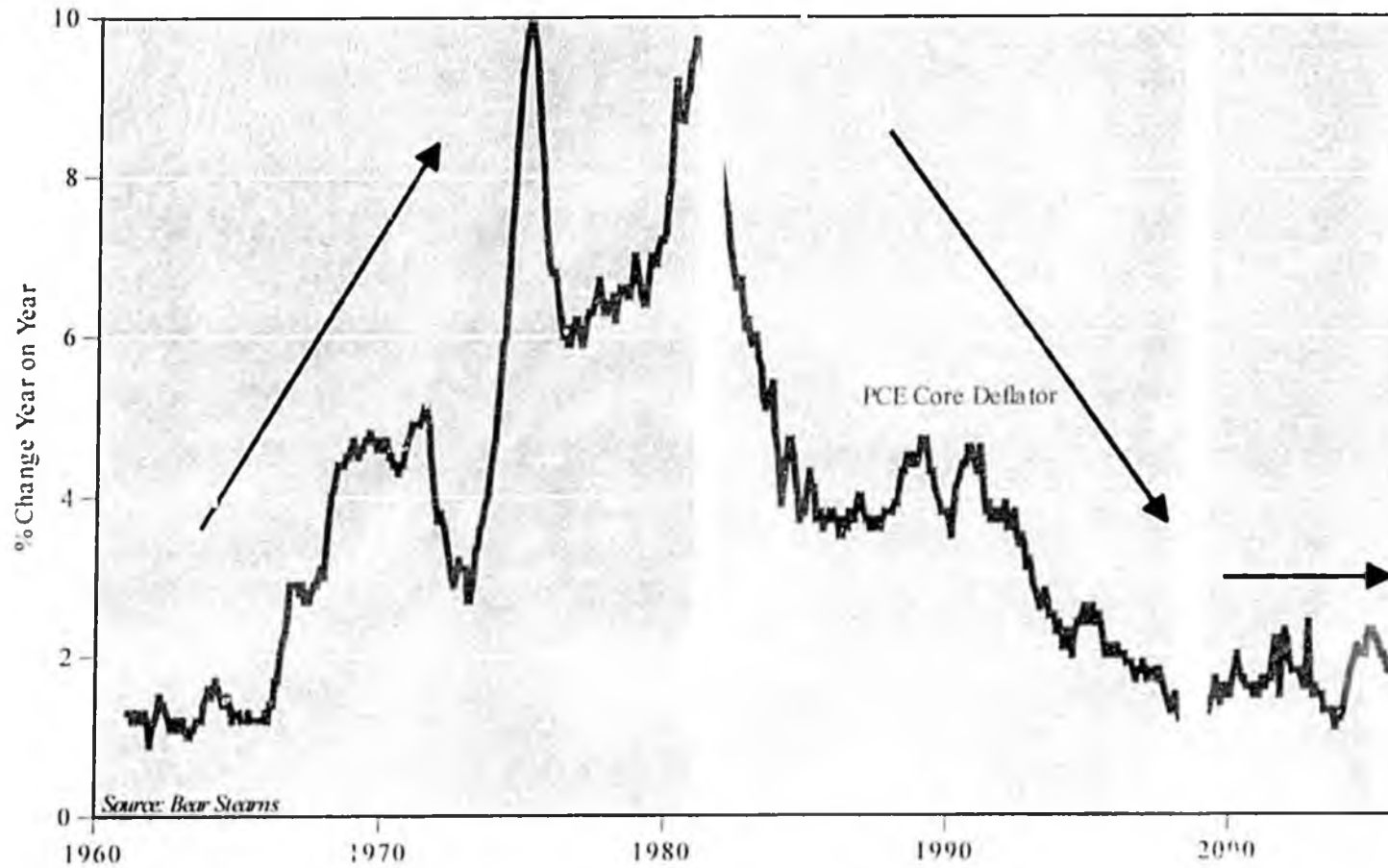
* 2006- forecast - Global Insight



□ Current Account Deficit — Deficit as % of GDP

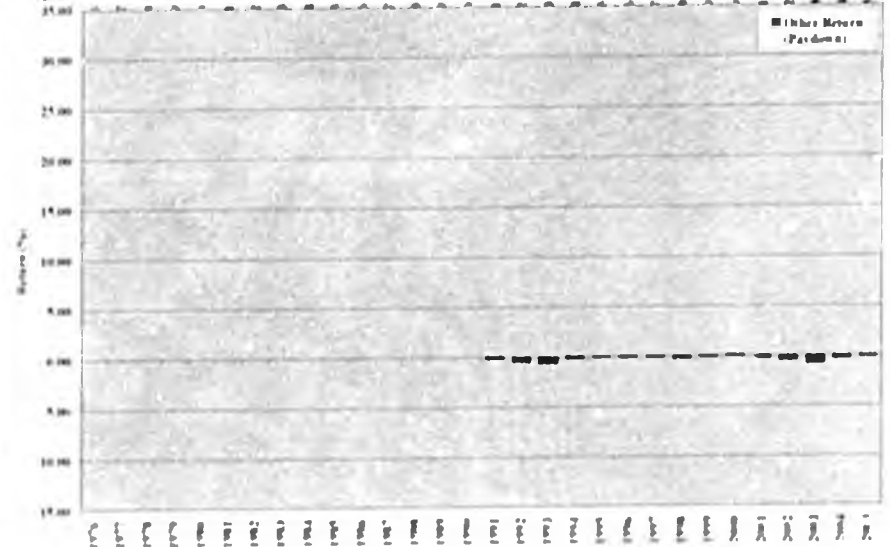
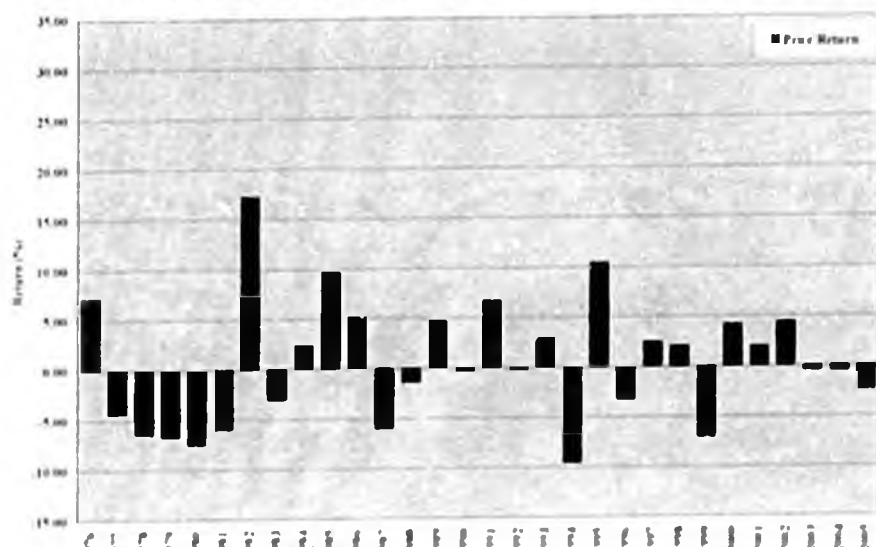
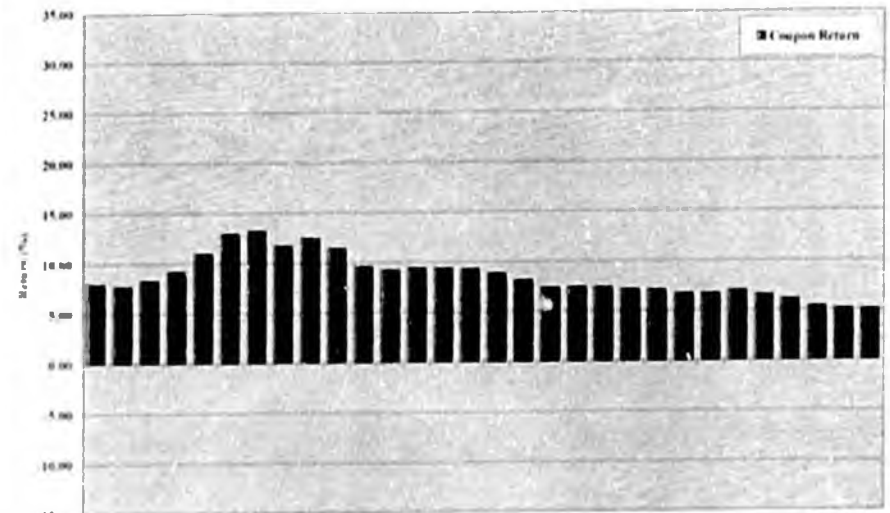
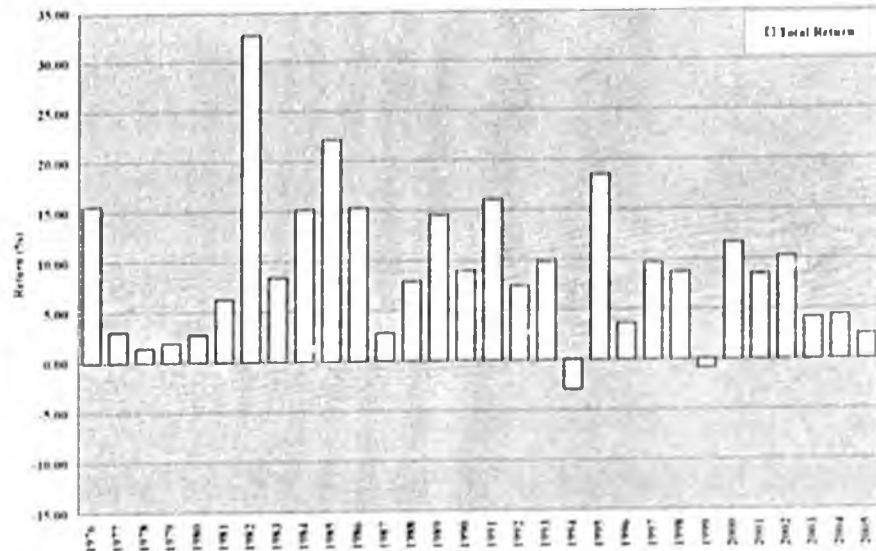
INFLATION HISTORY

Source Western Asset Management/CII 1/31/06



Composition of Bond Returns

I.B. Aggregate Index - Annual Return Breakdown



Source: www.lehmanhlc.com



Domestic Fixed Income

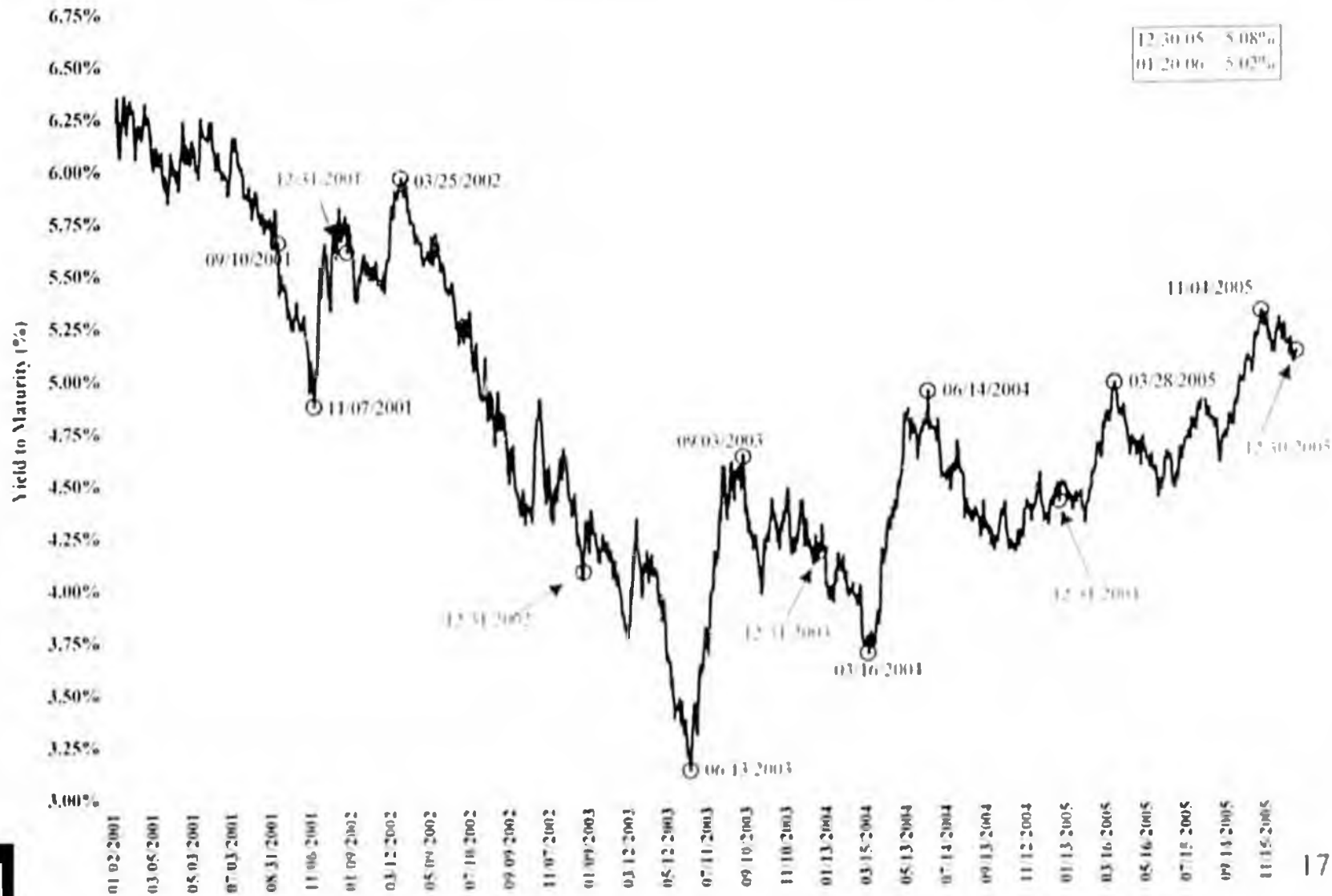
Current Yield Is A Strong Predictor of Returns

Lehman Aggregate Index 5 Year Returns vs. Lagged Yield to Worst



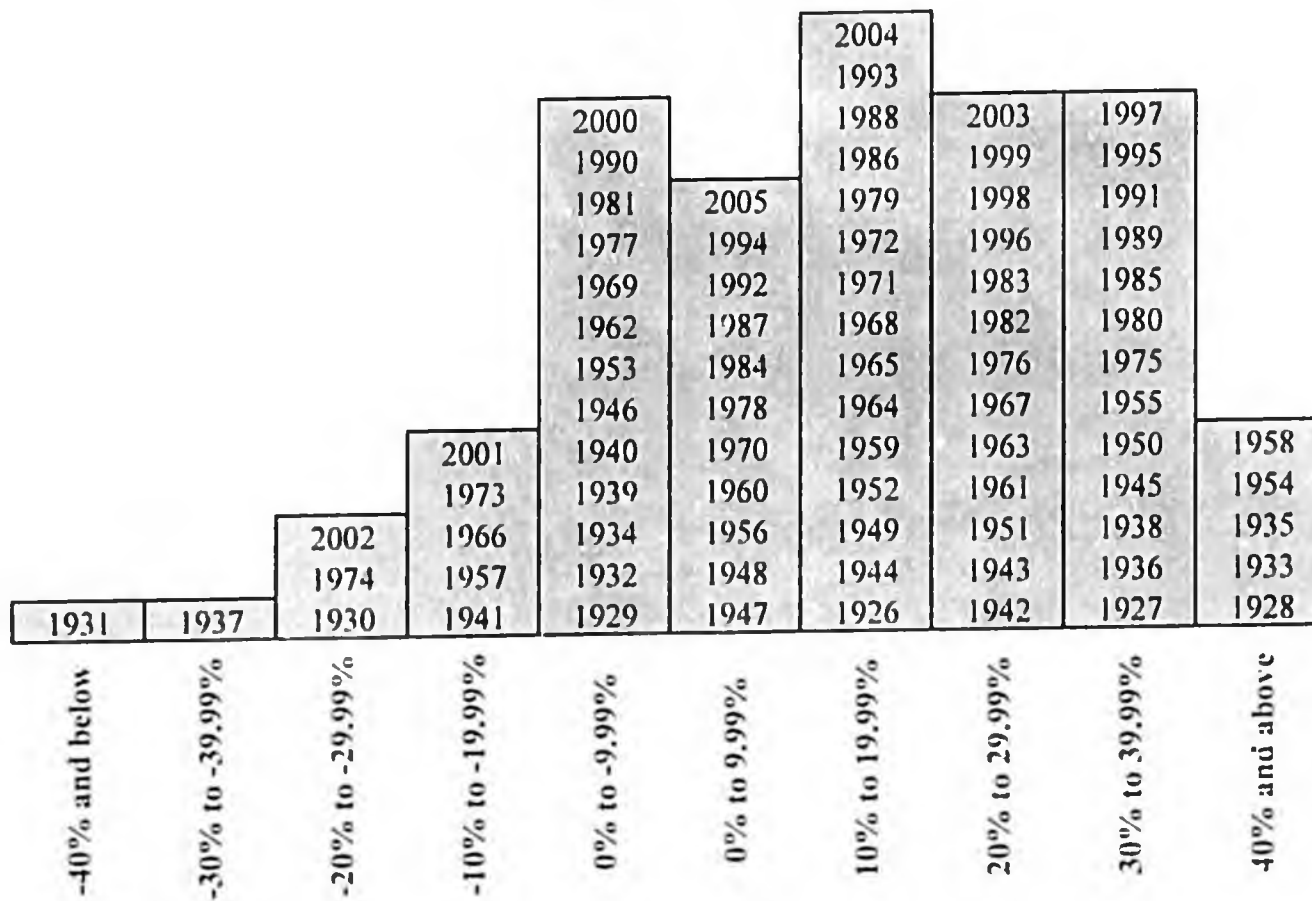
Domestic Fixed Income

Lehman Aggregate Index - Daily Yield to Worst from 1/1/01 to 12/31/06



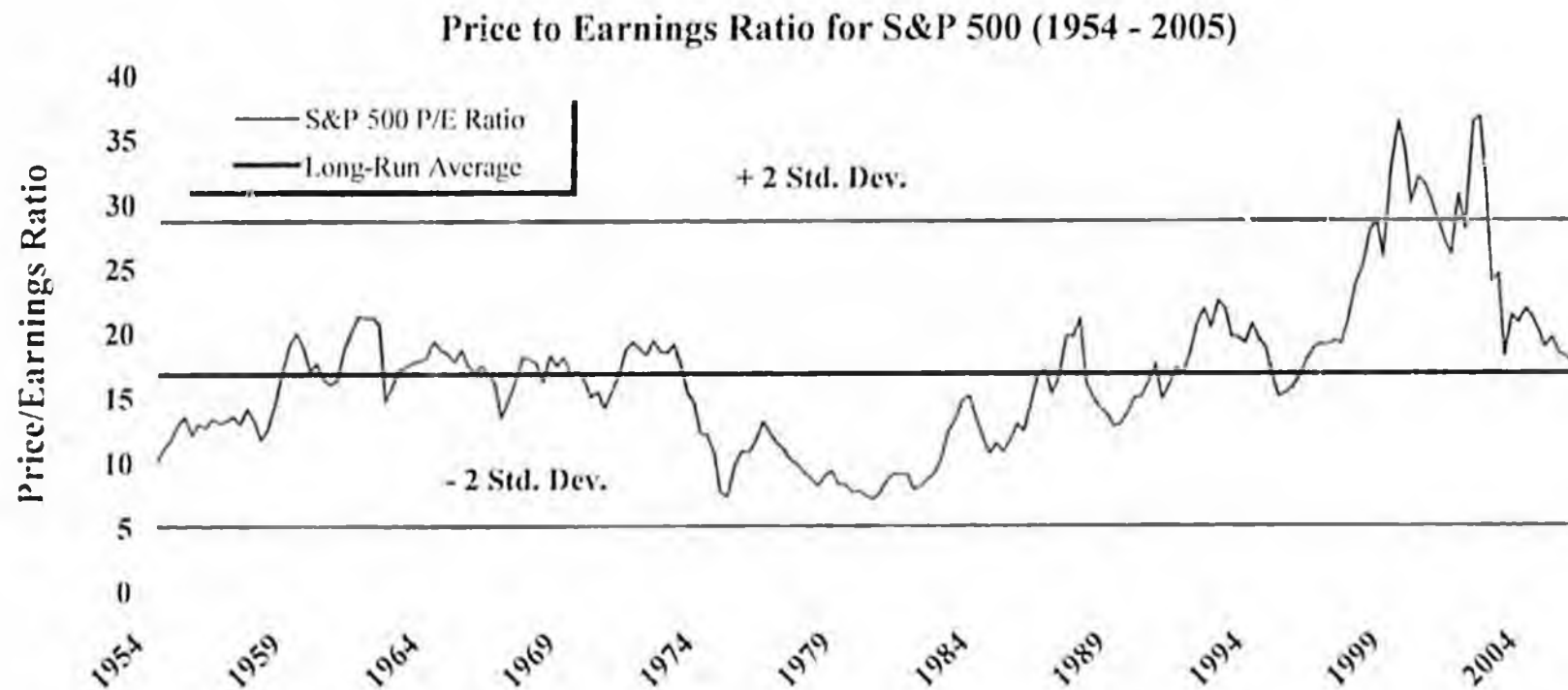
Annual Return Histogram for S&P 500

Distribution of S&P 500 Annual Returns
(1926-2005)



Equity Is Now More Reasonably Priced

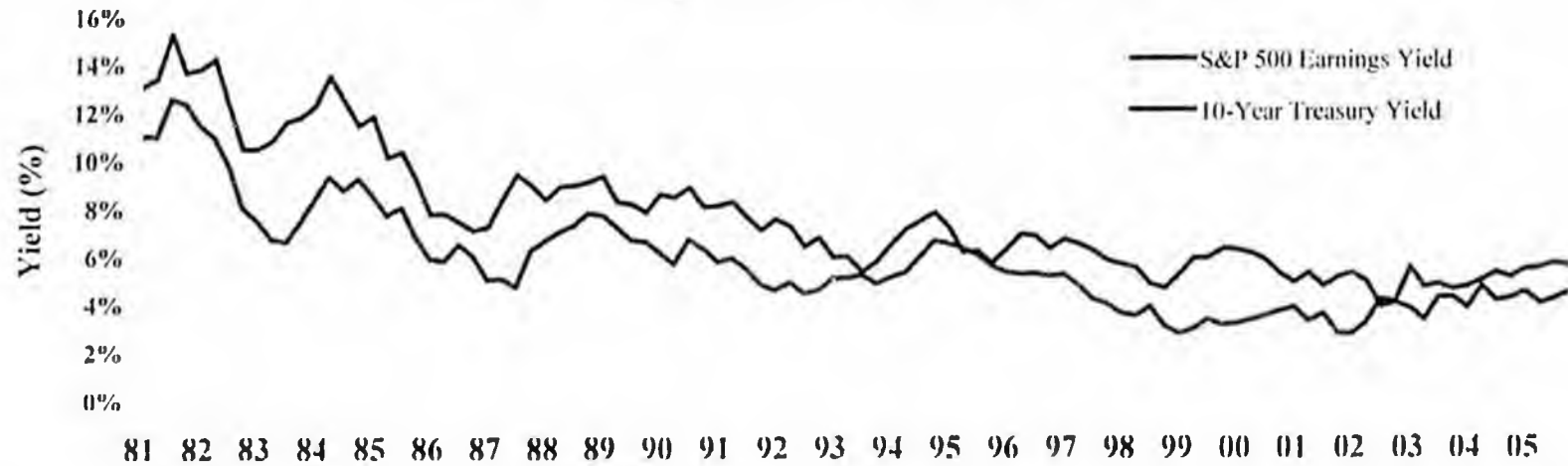
Trailing P/E Approaching Long-Run Average



Trailing earnings as reported for the fiscal year; includes negative earnings from 1998 onward.

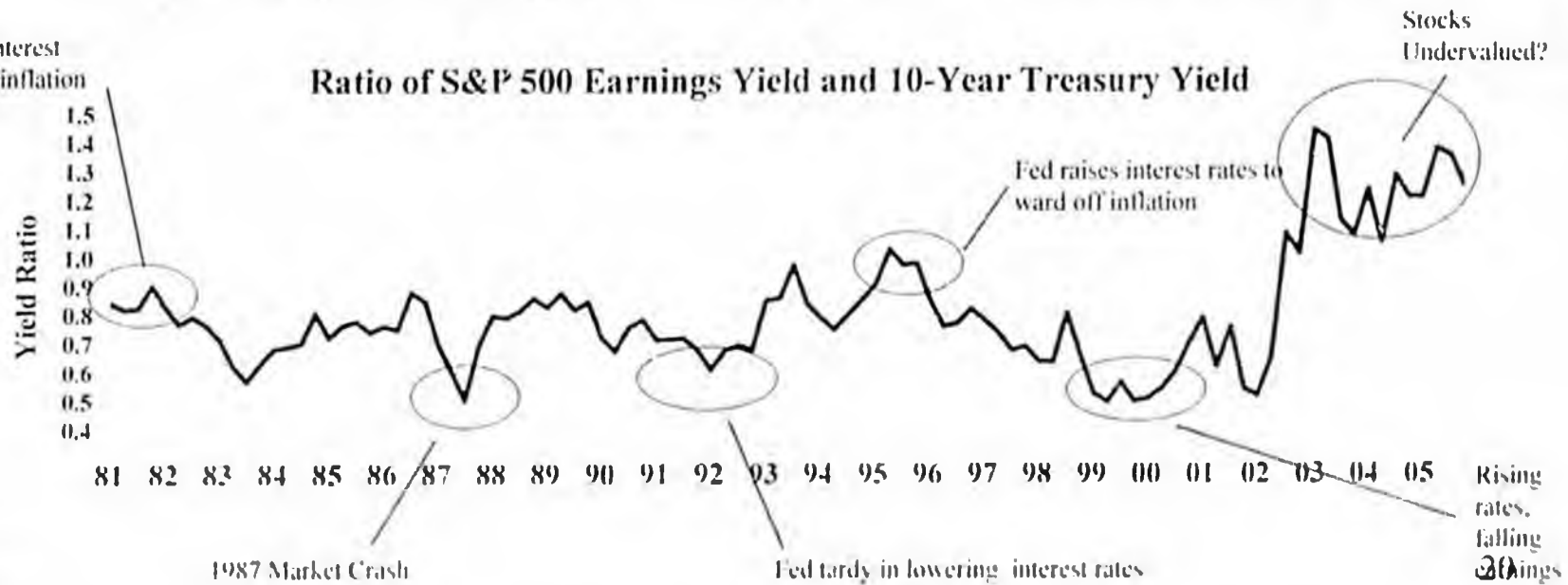
Domestic Equity vs. Bond Yields

S&P 500 Earnings Yield vs. 10-Year Treasury Yield



Peak of interest rates and inflation

Ratio of S&P 500 Earnings Yield and 10-Year Treasury Yield



2006 Capital Market Projections

- Modest changes from last year's projections. Not much has changed in the environment except that Fed executed policy exactly as expected.
- Inflation is nudged up to 2.75%, which implies moderation from current levels.
- Cash returns reflect higher short-term yields, a real return of 1.25%, and expectations that interest rates will peak in 2006.
- Bond returns are set at 5.0%:
 - Reflects current yield-to-worst, with no adjustment.
 - Project upward sloping yield curve (if only slightly so), with a very small risk premium for bonds over cash (1.0%).
- Equity returns built from fundamentals: 3-4% real GDP growth which means 5.5%-6.5% nominal earnings growth, 2% dividend yield, 0.5%-1% "buyback" yield.
- Real estate return held at 7.6%, reflecting income expectations as high as 8% but acknowledging rich levels of property valuations.
- Private equity return held at 12%, a 3% premium over public markets.
- Premium of international equity over domestic will continue to be narrowed, reflecting recent performance and relative valuations.



2006 Capital Market Projections

Summary of 5-Year Capital Market Projections (2006-2010)

Asset Class	Index	Projected Annual Return	Projected Standard Deviation (Risk)	Projected Yield	2005 Projections	
Equities						
Broad Domestic Equity	Russell 3000	9.00%	16.90	2.10	9.00%	16.90
Large Cap	S&P 500	8.85%	16.40	2.20	8.85%	16.40
Small/Mid Cap	Russell 2500	9.85%	22.70	1.20	9.85%	22.70
International Equity	MSCI EAFE	9.20%	20.10	2.20	9.25%	20.10
Emerging Markets Equity	MSCI EMF	9.80%	32.90	0.00	9.80%	33.00
Fixed Income						
Domestic Fixed	LB Aggregate	5.00%	4.50	5.90	4.75%	4.50
Defensive	LB Gov't 1-3 Year	4.25%	2.30	4.25	3.75%	2.30
TIPS	LB TIPS	4.65%	6.00	4.65	4.40%	6.00
High Yield	CSFB High Yield	6.75%	12.10	6.75	6.75%	12.10
Non US\$ Fixed	Citi Non-US Gov't	4.90%	9.60	4.65	4.65%	9.60
Other						
Real Estate	Callan Real Estate	7.60%	16.50	7.00	7.60%	16.50
Private Equity	VE Post Venture Cap	12.00%	34.00	0.00	12.00%	34.00
Absolute Return	Callan Hedge FoF	6.50%	10.20	0.00	6.50%	10.50
Cash Equivalents	90-Day T-Bill	4.00%	0.80	4.00	3.25%	0.80
Inflation	CPI-U	2.75%	1.40		2.60%	1.40

- Consider passively invested, broad markets at asset allocation level.
- Active/passive, capitalization and style decisions within the broad markets are made at the structural level.



APFC Current Policy With 2006-2010 Projections

Component	Portfolio						
	Max	Mix 1	Mix 2	Mix 3	APFC-11-05	Mix 4	Mix 5
Large Cap	100	16	21	27	29	34	40
Small/Mid Cap	100	4	5	6	6	8	9
International Equity	100	7	9	12	16	15	18
Emerging Markets Equity	100	1	1	2	2	2	3
Private Equity	4	2	4	4	4	4	4
Domestic Fixed	100	55	45	33	25	21	10
Non US Fixed	100	5	4	4	4	3	2
Real Estate	100	6	7	8	10	9	10
Absolute Return	4	4	4	4	4	4	4
Cash Equivalents	100	0	0	0	0	0	0
Totals		100	100	100	100	100	100
Expected Return		6.50	7.00	7.50	7.77	8.00	8.50
Standard Deviation		7.30	8.91	10.64	11.61	12.43	14.27
Sharpe Ratio		0.45	0.42	0.40	0.39	0.38	0.37

Note that private equity and absolute return have been constrained to 4% in each area. Also note that high yield bonds & commodities were not explicitly modeled.





ALASKA PERMANENT FUND FUND FINANCIAL HISTORY & PROJECTIONS as of January 31, 2006

* Fiscal year end results for FY06 are trending to be greater than the mid case.

Projections will extend ten years, and are based on best available information (\$ in millions)

Reserved Fund Balance - Principal							Unreserved Fund Balance										TOTAL FUND	
FY	FY-Begin Contrib. Balance	Appro. (1)	Dedicated State Revenues	Inflation Proofing	FY-End Balance Contributions	Unrealized Gain (Loss)		FY-End Reserved Balance	Distributions of Statutory Net Income					Realized Earnings		FY-End Balance	FY	FY-End Balance
						Net Change	FY-End Balance		Acct. Net Income (6)	Statutory Net Income (6)	Dividends	Inflation Proofing	Gen. Fund / Other	Net Change	FY-End Balance			
77-98	0	6,734	6,250	5,533	18,517	3,971	3,971	22,488	20,683	18,667	7,589	5,533	268	1,389	1,389	77-98	23,877	
99	18,517	41	155	288	19,001	(430)	3,541	22,542	2,148	2,544	1,045	288	3	1,201	2,590	99	25,132	
00	19,001	264	326	423	20,014	(12)	3,529	23,543	2,249	2,222	1,172	423	3	382	2,972	00	26,515	
01	20,014	8	339	686	21,047	(2,146)	1,383	22,430	(924)	1,199	1,113	686	4	(588)	2,384	01	24,814	
02	21,047	(23) (2)	258	602	21,884	(878)	505	22,389	(617)	257	926	602	5	(1,248)	1,136	02	23,525	
03	21,884	354 (3)	398	352	22,988	601	1,106	24,094	963	355	691	352	0	(1,035)	100	03	24,194	
04	22,988	(339) (4)	353	524 (5)	23,526	1,909	3,015	26,541	3,434	1,502	581	170 (1)	0	759	859	04	27,400	
05	23,526	0	480	641	24,647	859	3,874	28,522	2,640	1,754	532	641 (1)	27 (10)	581	1,440	05	29,962	
10% 06	24,647	0	579	855	26,081	(2,980)	894	26,975	(1,704)	1,259	538	855	18	(135)	1,306	06	28,281	
25% 06	24,647	0	579	855	26,081	(1,750)	2,124	28,205	(183)	1,545	568	855	22	121	1,562	06	29,767	
Mid 06	24,647	0	579	855	26,081	777	4,151	30,232	2,243 *	1,939 *	610	855	28	474	1,914	06	32,146	
25% 06	24,647	0	579	855	26,081	1,749	5,623	31,704	4,178	2,395	658	855	34	882	2,323	06	34,027	
10% 06	24,647	0	579	855	26,081	2,921	6,795	32,877	5,765	2,804	701	855	40	1,248	2,688	06	35,565	
07	26,081	0	466	690	27,238	359	4,510	31,748	2,408	2,021	795	690	28	536	2,450	07	34,198	
08	27,238	0	366	718	28,322	382	4,822	33,214	2,559	2,150	983	718	28	449	2,900	08	36,113	
09	28,322	0	202	742	29,265	402	5,294	34,559	2,697	2,268	1,064	742	28	462	3,362	09	37,921	
10	29,265	0	198	766	30,229	422	5,716	35,945	2,833	2,383	1,130	766	28	487	3,849	10	39,794	
11	30,229	0	187	791	31,207	443	6,159	37,365	2,973	2,503	1,189	791	28	523	4,372	11	41,738	
12	31,207	0	179	816	32,202	464	6,623	38,825	3,119	2,627	1,253	816	28	558	4,931	12	43,756	
13	32,202	0	169	842	33,212	487	7,110	40,322	3,271	2,757	1,316	842	28	599	5,530	13	45,851	
14	33,212	0	160	868	34,240	510	7,619	41,859	3,428	2,891	1,382	868	28	641	6,171	14	48,030	
15	34,240	0	152	894	35,286	534	8,153	43,440	3,592	3,030	1,450	894	28	686	6,857	15	50,296	
16	35,286	0	160	922	36,367	559	8,713	45,080	3,763	3,176	1,520	922	28	734	7,591	16	52,671	
Cumulative Totals Proj. for 2006-2016	0	2,817	8,903			4,838			32,887	27,745	12,692	8,903	303	6,150				

Assumptions:	Total Return - Inflation	Total Real Return	Statutory Return	
10% FY 2006	5.95%	3.37%	9.34%	10% 4.22%
25% FY 2006	0.46%	3.39%	3.85%	25% 5.18%
Mid FY 2006 (6)	7.60%	3.39%	4.21%	Mid (6) 6.50%
25% FY 2006	15.25%	3.35%	11.90%	25% 8.03%
10% FY 2006	21.71%	3.39%	18.32%	10% 9.40%
FY 2007-2016 (6)	7.61%	2.60%	5.01%	6.50% (6)

Notes to financial history and projections FY77 - FY16:

- (1) Appropriations include special general fund and earnings reserve appropriations to principal, royalty settlement earnings transferred to principal through FY04 per AS 37.13.145(d), and other miscellaneous appropriations to principal.
- (2) Represents a final adjustment to principal based on reconciliation of State of AK v. Amerasia Hess et al royalty case.
- (3) FY03 Senate Bill 100 transferred \$354 million from realized earnings account to principal.
- (4) Senate Bill 283 defines the FY03 special appropriation of \$354 as pre FY04 inflation proofing and appropriates the remaining \$170 million needed to fully inflation proof contributions and appropriations in FY04. An additional \$15 million in settlement earnings (earnings above inflation) is appropriated to principal per AS 37.13.145(d).
- (5) Statutory inflation proofing for FY04 is based on the inflation rate of 2.26% or \$524 million (\$354 million pre inflation proofing plus \$170 million FY04 appropriation).
- (6) Accounting net income is statutory net income plus the net change in unrealized gains (losses) and settlement earnings. Statutory net income is realized earnings less settlement earnings and is used to calculate the annual dividend transfer.
- (7) Total Fund equals reserved fund balance plus the realized earnings balance.
- (8) Based on 2005 Calan capital market assumptions and a range of expected returns based on the probability of the return outcomes.
- (9) Based on 2005 Calan capital market assumptions and median expected returns (the mid case). Actual results will vary from projections.
- (10) Am Hess settlement earnings transferred to Alaska Capital Income Fund as per HBI # 187 & SB # 46.

Income year-to-date as of January 31, 2006

FY06 Statutory net income	
Interest, dividends, real estate & other income	\$ 657.8
Realized gains on the sale of invested assets	978.6
Less operating exp / Leg's appropriations	(32.4)
Less AK Capital Inc. Fund committed realized earnings	(21.8)
Statutory net income	\$ 1,582.2

FY06 GAAP (accounting) net income	
Statutory net income	\$ 1,582.2
Adjustment for unrealized gains (losses) on invested assets	1,422.1
AK Capital Income Fund committed realized earnings	21.8
GAAP (accounting) net income	\$ 3,026.1

PERFORMANCE SUMMARY

(preliminary as of January 31, 2006)	Current Month	Last 3 Months	Fiscal Y-T-D	Calendar Y-T-D	Last 12 Months	Last 3 Years	Last 5 Years
Alaska CDs	0.35%	0.90%	2.12%	6.35%	3.29%	2.12%	2.72%
Domestic Fixed Income	0.04%	1.36%	0.21%	0.04%	2.07%	3.84%	5.59%
Non-Domestic Fixed Income	0.97%	1.15%	-0.22%	0.97%	0.18%	6.65%	7.16%
Domestic Equities	3.90%	8.25%	11.60%	3.90%	13.99%	18.47%	2.24%
Non-Domestic Equities	6.78%	15.62%	24.02%	6.78%	26.40%	28.10%	6.75%
Real Estate	2.99%	6.08%	13.82%	2.99%	27.01%	22.82%	16.36%
Absolute Return	2.20%	5.58%	7.96%	2.20%	9.25%		
Total Fund	3.21%	7.31%	10.57%	3.24%	13.62%	15.27%	6.58%
<i>Total Fund Return Benchmark</i>	<i>2.90%</i>	<i>6.76%</i>	<i>9.17%</i>	<i>2.90%</i>	<i>12.03%</i>	<i>14.92%</i>	<i>5.78%</i>

15 AAC 137 is amended by adding new sections to read:

**ARTICLE 4. ALASKA PERMANENT FUND CORPORATION
OPERATIONAL ACTIVITIES**

Section

610. Confidential records

15 AAC 137.610. Confidential records. (a) The APFC may preserve the confidentiality of information that discloses the particulars of the business or the affairs of a private enterprise or investor if the executive director concludes that such disclosure would

(1) unfairly prejudice the ability of the APFC or its investment managers to invest and manage fund assets;

(2) reveal trade secrets or technical data reasonably held as confidential in the finance industry;

(3) reveal matters, the immediate knowledge of which would clearly have an adverse effect upon the finances of the APFC or the permanent fund, including information relating to pending transactions or investments under consideration; or

(4) violate provisions of applicable law.

(b) In taking action under this section to preserve confidentiality, the executive director may declare specific records of the APFC, or appropriate portions of specific records, including documents submitted to the APFC that were

prepared by others, to be confidential and exempt from the public disclosure provisions of AS 40.25.110 and AS 40.25.120 based on

- (1) express determination of the board;
- (2) guidelines of the board,
- (3) confidentiality provisions included in contracts; or
- (4) confidentiality provisions in requests for proposals or invitations

to bid.

(c) For purposes of AS 37.13.200 and this section, "private enterprise or investor" includes investment managers, advisors, consultants, counsel, issuers of securities, and borrowers. (Eff. ___/___/2005, Register _____)

Authority: AS 37.13.200 AS 37.13.206 AS 44.62.310(c)

ARTICLE 5. GENERAL PROVISIONS

Section

990. Definitions

15 AAC 137.990. Definitions. Unless the context indicates otherwise, in 15 AAC 137.610 – 15 AAC 137.990,

- (1) "APFC" means the Alaska Permanent Fund Corporation established under AS 37.13.040;
- (2) "executive director" means the executive director of the APFC;

Register ____, _____ 200__ REVENUE

(3) "permanent fund" has the meaning given "fund" in

AS 37.13.900. (Eff. ___/___/2005, Register ____)

Authority: AS 37.13.200 AS 37.13.206

15 AAC 137 is amended by adding new sections to read:

**ARTICLE 3. ALASKA PERMANENT FUND CORPORATION
INVESTMENT ACTIVITIES**

Section

- 410. Purpose of 15 AAC 137.410 – 15 AAC 137.530
- 420. Permanent fund investments; institutional quality
- 430. Fixed-income investments
- 440. Publicly traded equity investments
- 450. Real estate investments
- 460. Alternative investments; other investment types and strategies
- 470. Interests in collective or commingled investment funds
- 480. Foreign currency transactions
- 490. Short-selling
- 500. Leverage
- 510. Lending of permanent fund-owned securities
- 520. Form of asset holdings
- 530. Investments not otherwise permitted

15 AAC 137.410. Purpose of 15 AAC 137.410 – 15 AAC 137.530. The purpose of 15 AAC 137.410 – 15 AAC 137.530 is to implement the authority granted the APFC Board of Trustees under AS 37.13.120(a) to specifically designate the income-producing investments eligible for permanent fund investments. (Eff. 01/01/2006, Reg. _____)

Authority: AS 37.13.120 AS 37.13.206 Sec. 4, ch. 46, SLA 2005

15 AAC 137.420. Permanent fund investments; institutional quality.

All permanent fund investments must be of a quality considered acceptable by other prudent institutional investors, including endowments. (Eff. 01/01/2006, Reg. _____)

Authority: AS 37.13.120 AS 37.13.206 Sec. 4, ch. 46, SLA 2005

15 AAC 137.430. Fixed-income investments. (a) The assets of the permanent fund may be invested in the following fixed-income investments:

- (1) obligations of, or obligations insured by or guaranteed by, the United States or agencies or instrumentalities of the United States;
- (2) obligations secured by reserves paid in by the United States or agencies or instrumentalities of the United States or obligations of corporations in which the United States is a shareholder or member;
- (3) certificates of deposit and term deposits of United States domestic banks that are members of the Federal Deposit Insurance Corporation and that may be readily sold in a secondary market at prices reflecting fair value or that are fully secured at all times as to payment of principal and interest as described in (b) of this section;
- (4) certificates of deposit and term deposits of federally chartered savings and loan associations in Alaska that are fully secured at all times as to payments of principal and interest as described in (b) of this section;

(5) certificates of deposit and term deposits of mutual savings banks in Alaska that are fully secured at all times as to payments of principal and interest as described in (b) of this section;

(6) fixed-term certificates of indebtedness of federally insured credit unions in Alaska that are fully secured at all times as to payments of principal and interest as described in (b) of this section;

(7) debt instruments that have been issued by domestic entities and that are rated investment grade, or debt instruments of comparable quality issued by nondomestic entities;

(8) subject to (d) of this section, debt instruments that have been issued by domestic or nondomestic entities that are rated below investment grade or are unrated;

(9) short-term

(A) promissory notes that have been issued by domestic entities and that are rated investment grade; or

(B) promissory notes of comparable quality issued by nondomestic entities;

(10) subject to (d) of this section, short-term promissory notes that have been issued by domestic or nondomestic entities that are rated below investment grade or are unrated;

(11) bankers' acceptances drawn on and accepted by United States banks each of which has a combined capital and surplus aggregating at least \$200,000,000;

(12) repurchase agreements and reverse repurchase agreements, the securities underlying the agreements being any of the items listed in (1) - (6) of this subsection;

(13) the portions of business and industrial loans made under the Rural Development Act of 1972 that are guaranteed by the Farmers Home Administration;

(14) the guaranteed portion of Farmers Home Administration loans;

(15) certificates of deposit, term deposits, or bankers' acceptances, that are issued by a United States or nondomestic bank or trust company located outside of the United States and are denominated in United States or nondomestic currency if either

(A) those instruments may be readily sold in a secondary market at prices reflecting fair value; or

(B) the issuing bank or trust company has capital, surplus, and retained earnings at the date of issue equaling at least \$500,000,000;

(16) securities of nondomestic governments and nondomestic government agencies, the principal of, or interest on, which is payable in either United States dollars or nondomestic currencies;

(17) taxable or tax-exempt municipal or state debt instruments whether supported by revenues, general obligations, or guarantees;

(18) shares in a money market or short-term investment fund that has either collateral securities of a type authorized elsewhere in this section as acceptable collateral or securities of similar quality to those authorized elsewhere in this section as acceptable collateral;

(19) fixed-income derivatives, including forwards, futures, options, collateralized securities, structured notes, and swaps, including credit default swaps;

(20) debt instruments issued by an entity described in 15 AAC 137.450(a)(3).

(b) Except for investments made under (a)(15) of this section, certificates of deposit or the equivalent instruments that are not of a quality that may be readily sold in a secondary market at prices reflecting fair value must be secured by a pledge as collateral of

(1) investments authorized for the permanent fund under (a)(1), (2), or (4) of this section;

(2) obligations of the State of Alaska or instrumentalities of the state that are rated at least "A" by a major bond rating service and have a demonstrated secondary market; or

(3) letters of credit issued by an agency of or enterprise sponsored by the United States Government, including the Government National Mortgage

Association, the Federal National Mortgage Association, and the Federal Home Loan Mortgage Corporation.

(c) Investments or obligations pledged as collateral under (b) of this section must have value at least equal to the face value of the certificates of deposit being secured. The APFC may require substitution of collateral in order to ensure continued satisfaction of the requirements set out in (b) of this section.

(d) The aggregate value of investments made under (a)(8) and (10) of this section may not exceed 15 percent of the total value of the permanent fund. (Eff. 01/01/2006, Reg. _____)

Authority: AS 37.13.120 AS 37.13.206 Sec. 4, ch. 46, SLA 2005

15 AAC 137.440. Publicly traded equity investments. The assets of the permanent fund may be invested in the following publicly traded equity investments:

(1) preferred and common stock and other equity interests in entities organized in the United States and elsewhere, including ordinary shares, convertible debt securities, initial public offerings (IPO's), exchange traded funds (ETF's), American depository receipts (ADR's), American depository securities (ADS's), global depository securities (GDS's), and grantor trusts;

(2) equity derivatives, including forwards, futures, options, swaps, collateralized securities, and structured notes. (Eff. 01/01/2006, Reg. _____)

Authority: AS 37.13.120 AS 37.13.206 Sec. 4, ch. 46, SLA 2005

15 AAC 137.450. Real estate investments. (a) The assets of the permanent fund may be invested in the following real estate investments:

(1) equity interests in, debt obligations secured by mortgages granting a lien on, and other structured investment forms to finance, real estate that is located in the United States, is professionally managed, and is

(A) improved by completed and substantially rented buildings;

(B) located within the market area of real property in which the permanent fund holds an existing interest and is acquired

(i) for the purpose of creating or adding to a portfolio of similar properties; or

(ii) to retain or service the needs of existing tenants; or

(C) timberland or other agricultural land;

(2) subject to (b) of this section, equity interests in, debt obligations secured by mortgages granting a lien on, and other structured investment forms to finance, real estate that is located outside the United States, so long as the property otherwise meets the requirements of (1)(A) or (B) of this subsection;

(3) subject to (c) of this section, equity interests in entities formed to develop for commercial purposes vacant or underdeveloped real estate located in the United States that, when completed and occupied, would meet the requirements of (1)(A) of this subsection;

(4) interests in a titleholding entity, real estate investment trust, real estate operating company, or other entity whose assets consist predominantly of

(A) property of a type in which the APFC is otherwise permitted to invest permanent fund assets under (1), (2), or (3) of this subsection; or

(B) interests in other entities in which the APFC is permitted to invest permanent fund assets under (4)(A) of this subsection.

(b) The aggregate value of investments made under (a)(2) of this section may not exceed five percent of the total value of the permanent fund.

(c) The aggregate value of investments made under (a)(3) of this section may not exceed five percent of the total value of the permanent fund. (Eff.

01/01/2006, Reg. _____)

Authority: AS 37.13.120 AS 37.13.206 Sec. 4, ch. 46, SLA 2005

15 ACC 137.460. Alternative investments; other investment types and strategies. (a) The assets of the permanent fund may be invested in the following additional investment types and strategies:

(1) limited liability private equity investment entities and funds-of-funds whose investments and investment strategies include one or more of the following approaches:

(A) acquisitions, including buyouts, growth buyouts, platform add-ons, and industry consolidation;

(B) venture capital, including seed, early, middle, late, expansion, and diversified;

(C) debt, including mezzanine/subordinated debt, distressed debt, and venture leasing/debt;

(D) special situations, including industry-focused, turnaround, and diverse;

(E) other, including secondaries;

(2) co-investments with entities and funds of funds described in (1) of this subsection;

(3) limited liability hedge fund investment entities and funds-of-funds whose investments and investment strategies include one or more of the following approaches:

(A) relative value, including equity market neutral, fixed income arbitrage, and convertible arbitrage;

(B) event-driven, including merger arbitrage, distressed securities/discounted bank debt, and special situations;

(C) directional/tactical/opportunistic, including long-short equity, managed futures, and global macro;

(4) commodities and commodity-linked securities and derivatives, including forwards, futures, options, swaps, and structured notes;

(5) hybrid investments and strategies; these investments may include domestic, nondomestic, public and private market equity, or fixed income

securities, financial derivatives, and short positions in publicly traded domestic and international equity and fixed income securities;

(6) managed futures funds.

(b) An investment under (a) of this section may be made only

(1) through an investment manager under contract with the APFC with demonstrated skill and experience investing in the specific investment type or strategy authorized under (a); or

(2) on the recommendation and advice of an independent fiduciary retained by the APFC to evaluate a specific proposed investment or investment strategy. (Eff. 01/01/2006, Reg. _____)

Authority: AS 37.13.120 AS 37.13.206 Sec. 4, ch. 46, SLA 2005

15 AAC 137.470. Interests in collective or commingled investment funds. The assets of the permanent fund may be invested in shares or other interests in collective and commingled investment funds that invest predominantly in investments otherwise permitted under 15 AAC 137.410 – 15 AAC 137.530. (Eff. 01/01/2006, Reg. _____)

Authority: AS 37.13.120 AS 37.13.206 Sec. 4, ch. 46, SLA 2005

15 AAC 137.480. Foreign currency transactions. A manager of permanent fund assets may, with the prior approval of the executive director or the chief investment officer, utilize foreign exchange transactions. Such transactions

include currency forwards, futures, swaps, and options, as well as currency strategies, including hedging, cross-hedging, and long or short directional strategies. (Eff. 01/01/2006, Reg. _____)

Authority: AS 37.13.120 AS 37.13.206 Sec. 4, ch. 46, SLA 2005

15 AAC 137.490. Short-selling. In addition to the specific authority for the use of short-selling strategies granted under 15 AAC 137.460, a manager of permanent fund assets may, with the prior approval of the executive director or the chief investment officer and consistent with the limitations on the use of leverage provided under 15 AAC 137.500, utilize short-selling as a part of the manager's overall investment strategy. (Eff. 01/01/2006, Reg. _____)

Authority: AS 37.13.120 AS 37.13.206 Sec. 4, ch. 46, SLA 2005

15 AAC 137.500. Leverage. (a) A manager of permanent fund assets may, with the prior approval of the executive director or chief investment officer, utilize leverage as part of the investment strategy for the portfolio for which the manager is responsible, so long as the creditor's recourse on the leverage amount is

- (1) not a general obligation of the permanent fund or the APFC; and
- (2) is limited to either

(A) the permanent fund assets for which the manager acts as manager; or

(B) other specific assets of the permanent fund.

(b) A manager of permanent fund assets shall use leverage, if at all, in a prudent manner that is consistent with leverage applied by professional asset managers using similar investment strategies. (Eff. 01/01/2006, Reg. ____)

Authority: AS 37.13.120 AS 37.13.206 Sec. 4, ch. 46, SLA 2005

15 AAC 137.510. Lending of permanent fund-owned securities.

Securities purchased by or otherwise held for the permanent fund may be loaned to securities dealers or financial institutions, provided the loan is collateralized by cash or securities having a market value of at least 102 percent of the market value of securities loaned (Eff. 01/01/2006, Reg. ____)

Authority: AS 37.13.120 AS 37.13.206 Sec. 4, ch. 46, SLA 2005

15 AAC 137.520. Form of asset holdings. Unless otherwise provided in 15 AAC 137.410 – 15 AAC 137.530, the APFC may invest permanent fund assets directly in the name of the permanent fund, through a limited liability entity, including a corporation, limited partnership, limited liability partnership, or limited liability company, or through a collective or commingled investment fund, including a fund-of-funds. (Eff. 01/01/2006, Reg. ____)

Authority: AS 37.13.120 AS 37.13.206 Sec. 4, ch. 46, SLA 2005

15 AAC 137.530. Investments not otherwise permitted. (a) The permanent fund may hold assets not otherwise authorized under 15 AAC 137.410 – 15 AAC 137.520 that

(1) were held by the permanent fund before January 1, 2006;

(2) are distributed to the permanent fund as the result of a liquidation of other assets held by the fund; or

(3) are acquired by a manager of permanent fund assets because the assets are included in an investment index that is applied by the APFC to measure that manager's investment performance.

(b) The permanent fund may hold an asset described in (a) of this section so long as holding the asset satisfies the prudent-investor rule stated in AS 37.13.120(a).

(c) The APFC must liquidate, restructure, or otherwise bring into compliance a permanent fund investment that ceases to satisfy the prudent investor rule stated in AS 37.13.120(a) within six months after the asset first fails to satisfy that rule. (Eff. 01/01/2006, Reg. _____)

Authority: AS 37.13.120 AS 37.13.206 Sec. 4, ch. 46, SLA 2005

15 AAC 137.990 is repealed and readopted to read:

15 AAC 137.990. Definitions. Unless the context requires otherwise, in 15 AAC 137.410 – 15 AAC 137.990

(1) "APFC" means the Alaska Permanent Fund Corporation established at AS 37.13.040;

(2) "chief investment officer" means the chief investment officer of the APFC;

(3) "co-investment" means a direct investment of permanent fund assets in an entity at the same time and on the same economic terms as an investment of permanent fund assets in that entity made through a private equity fund under 15 AAC 137.460(a)(1);

(4) "collective or commingled investment fund" means an entity whose purpose is to direct the collective investment of assets, including a common trust fund, a collective trust fund, a unit investment trust, an open-end or closed-end mutual fund, an open-end or closed-end registered investment company, or any other collective or commingled investment vehicle that is engaged primarily in the purchase and sale of securities or other assets;

(5) "commodities" means

(A) materials, such as gold, copper, silver, and petroleum;

(B) timber and other agricultural crops;

(C) foods;

(D) other natural resources; and

(E) products of the items identified in (A) – (D) of this

paragraph;

(6) "derivative" means an instrument whose value, usefulness, and marketability is dependent upon or derives from an underlying asset; classes of

derivatives include futures contracts, options, forward contracts, including currency forward contracts, swaps, and options on futures;

(7) "derivative based strategy" means an investment strategy used by investors that invest in markets typically dominated by derivative instruments;

(8) "executive director" means the executive director of the APFC;

(9) "hybrid investment or strategy" means a multi-part investment that may include hedge funds, arbitrage funds, derivative-based strategies, strategic block investment funds, or crossover funds where the underlying investments consist of both public and private investments, including both debt and equity instruments;

(10) "includes" or "including" has the same meaning given in AS 01.10.040;

(11) "investment grade" means a Standard & Poor's Corporation rating BBB or better, or Moody's Investors Service, Inc., rating of Baa or better, including a rating with a "+" or "-" designation or other variations that occur within these ratings, or a comparable rating by another nationally recognized rating organization or by a recognized rating service in the jurisdiction of the issuer;

(12) "leverage" means the use of various financial instruments or borrowed capital, such as margin, to increase the potential return of an investment;

(13) "manager of permanent fund assets" means an individual, firm, or other entity that, either by contract or employment with the APFC, has

responsibility for the investment and management of a portion of the assets of the permanent fund;

(14) "permanent fund" has the meaning given "fund" in AS 37.13.900;

(15) "security" means an instrument that signifies an ownership position in a corporation or other private entity, a creditor relationship with a corporation, other private entity, or governmental body or entity, or rights to ownership such as those represented by an option, future or forward contract, subscription right, or subscription warrant; "security" includes

(A) stocks, bonds, convertible bonds, bills, notes, debentures, bankers acceptances, commercial paper, certificates of deposit, and shares of a real estate investment trust or real estate operating company;

(B) the types of securities identified under (A) of this paragraph purchased on a when issued basis; and

(C) combinations of the types of securities identified under (A) and (B) of this paragraph issued as a single instrument;

(16) "short-selling" means

(A) the selling of a security that the seller does not own; or

(B) any sale that is completed by the delivery of a security borrowed by the seller. (Eff. 01/01/2006, Reg. _____)

Authority: AS 37.13.120 AS 37.13.206 Sec. 4, ch. 46, SLA 2005

3/4/06

**PRESENT-
ATION ON
OIL & GAS
PRODUC-
TION TAX**

SFIN

FILE

SENATE BILL NO. 305

IN THE LEGISLATURE OF THE STATE OF ALASKA

TWENTY-FOURTH LEGISLATURE - SECOND SESSION

BY THE SENATE RULES COMMITTEE BY REQUEST OF THE GOVERNOR

Introduced: 2/21/06

Referred: Resources, Finance

A BILL

FOR AN ACT ENTITLED

1 "An Act repealing the oil production tax and gas production tax and providing for a
2 production tax on the net value of oil and gas; relating to the relationship of the
3 production tax to other taxes; relating to the dates tax payments and surcharges are due
4 under AS 43.55; relating to interest on overpayments under AS 43.55; relating to the
5 treatment of oil and gas production tax in a producer's settlement with the royalty
6 owner; relating to flared gas, and to oil and gas used in the operation of a lease or
7 property, under AS 43.55; relating to the prevailing value of oil or gas under AS 43.55;
8 providing for tax credits against the tax due under AS 43.55 for certain expenditures,
9 losses, and surcharges; relating to statements or other information required to be filed
10 with or furnished to the Department of Revenue, and relating to the penalty for failure
11 to file certain reports, under AS 43.55; relating to the powers of the Department of
12 Revenue, and to the disclosure of certain information required to be furnished to the

1 Department of Revenue, under AS 43.55; relating to criminal penalties for violating
 2 conditions governing access to and use of confidential information relating to the oil and
 3 gas production tax; relating to the deposit of money collected by the Department of
 4 Revenue under AS 43.55; relating to the calculation of the gross value at the point of
 5 production of oil or gas; relating to the determination of the net value of taxable oil and
 6 gas for purposes of a production tax on the net value of oil and gas; relating to the
 7 definitions of 'gas,' 'oil,' and certain other terms for purposes of AS 43.55; making
 8 conforming amendments; and providing for an effective date."

9 BE IT ENACTED BY THE LEGISLATURE OF THE STATE OF ALASKA:

10 * Section 1. The uncodified law of the State of Alaska is amended by adding a new section
 11 to read:

12 INTENT OF SEC. 11 OF THIS ACT. It is the intent of the legislature through sec. 11
 13 of this Act to confirm by clarification the long-standing interpretation of AS 43.55.020(f) by
 14 the Department of Revenue.

15 * Sec. 2. AS 43.20.031(c) is amended to read:

16 (c) In computing the tax under this chapter, the taxpayer is not entitled to
 17 deduct any taxes based on or measured by net income. The taxpayer may deduct the
 18 tax levied and paid under AS 43.55.

19 * Sec. 3. AS 43.20.072(b) is amended to read:

20 (b) A taxpayer's business income to be apportioned under this section to the
 21 state shall be the federal taxable income of the taxpayer's consolidated business for the
 22 tax period, except that

23 (1) taxes based on or measured by net income that are deducted in the
 24 determination of the federal taxable income shall be added back; the tax levied and
 25 paid under AS 43.55 may not be added back;

26 (2) intangible drilling and development costs that are deducted as
 27 expenses under 26 U.S.C. 263(c) (Internal Revenue Code) in the determination of the
 28 federal taxable income shall be capitalized and depreciated as if the option to treat

1 them as expenses under 26 U.S.C. 263(c) (Internal Revenue Code) had not been
2 exercised;

3 (3) depletion deducted on the percentage depletion basis under 26
4 U.S.C. 613 (Internal Revenue Code) in the determination of the federal taxable income
5 shall be recomputed and deducted on the cost depletion basis under 26 U.S.C. 612
6 (Internal Revenue Code); and

7 (4) depreciation shall be computed on the basis of 26 U.S.C. 167
8 (Internal Revenue Code) as that section read on June 30, 1981.

9 * Sec. 4. AS 43.05.230(f) is amended to read:

10 (f) A wilful violation of the provisions of this section or of a condition
11 imposed under AS 43.55.040(1)(B) is punishable by a fine of not more than \$5,000,
12 or by imprisonment for not more than two years, or by both.

13 * Sec. 5. AS 43.55.011(a) is repealed and reenacted to read:

14 (a) There is levied upon the producer of oil or gas a tax for all oil and gas
15 produced each month from each lease or property in the state, less any oil and gas the
16 ownership or right to which is exempt from taxation. The tax is equal to 20 percent of
17 the net value of the taxable oil and gas as calculated under AS 43.55.160.

18 * Sec. 6. AS 43.55.017(a) is amended to read:

19 (a) Except as provided in this chapter, the taxes imposed by this chapter are in
20 place of all taxes now imposed by the state or any of its municipalities, and neither the
21 state nor a municipality may impose a tax upon

22 (1) producing oil or gas leases;

23 (2) oil or gas produced or extracted in the state;

24 (3) the value of intangible drilling and development costs, as defined
25 in 26 U.S.C. 263(c) (Internal Revenue Code), as amended through January 1,
26 1974 [EXPLORATION EXPENSES].

27 * Sec. 7. AS 43.55.020(a) is repealed and reenacted to read:

28 (a) The production tax on oil and gas shall be paid as set out in this subsection.
29 Ninety percent of the tax levied under AS 43.55.011, net of any credits applied under
30 this chapter, is due on the last day of each calendar month on oil and gas produced
31 from each lease or property during the preceding month. The remaining portion of the

1 tax levied under AS 43.55.011, net of any credits applied under this chapter, is due on
 2 March 31 of the year following the calendar year during which the oil and gas were
 3 produced. An unpaid amount of tax that is not paid when due in accordance with this
 4 subsection becomes delinquent. An overpayment of tax with respect to a month may
 5 be applied against the tax due for any later month. Notwithstanding any contrary
 6 provision of AS 43.05.280, interest on an overpayment is allowed only from a date
 7 that is 90 days after the later of (1) the March 31 described in this subsection; or (2)
 8 the date that the statement required under AS 43.55.030(a) and 43.55.030(e) to be filed
 9 on or before that March 31 is filed. However, interest is not allowed if the
 10 overpayment was refunded within the 90-day period.

11 * Sec. 8. AS 43.55.020(b) is amended to read:

12 (b) The production tax on oil and [OR] gas shall be paid by or on behalf of the
 13 producer.

14 * Sec. 9. AS 43.55.020(d) is amended to read:

15 (d) In making settlement with the royalty owner with respect to oil or gas
 16 that is taxable under AS 43.55.011, the producer may deduct the amount of the tax
 17 paid on taxable royalty oil and [OR] gas, or may deduct taxal royalty oil or gas
 18 equivalent in value at the time the tax becomes due to the amount of the tax paid.
 19 Unless otherwise agreed between the producer and the royalty owner, the
 20 amount of the tax paid on taxable royalty oil and gas for a month is deemed to be
 21 the product of the quantity of that taxable royalty oil and gas produced during
 22 the month times the quotient of the producer's total tax liability for the month of
 23 production under AS 43.55.011 divided by the producer's total quantity of
 24 taxable oil and gas, other than royalty oil and gas, produced from all leases and
 25 properties in the state during the month. For purposes of the product calculated
 26 under this subsection, 6,000 cubic feet of gas are considered to be equivalent in
 27 amount to one barrel of oil.

28 * Sec. 10. AS 43.55.020(e) is repealed and reenacted to read:

29 (e) Gas flared, released, or allowed to escape in excess of the amount
 30 authorized by the Alaska Oil and Gas Conservation Commission is considered, for the
 31 purpose of AS 43.55.011 - 43.55.160, as gas produced from a lease or property. Oil or

1 gas used in the operation of a lease or property in the state in drilling for or producing
2 oil or gas, or for repressuring, except to the extent determined by the Alaska Oil and
3 Gas Conservation Commission to be waste, is not considered, for the purpose of
4 AS 43.55.011 - 43.55.160, as oil or gas produced from a lease or property.

5 * Sec. 11. AS 43.55.020(f) is amended to read:

6 (f) If oil or gas is not sold, or if oil or gas is sold under circumstances where
7 the sale price does not represent the prevailing value for oil or gas of like kind,
8 character, or quality in the field or area from which the product is produced, the
9 department may require the tax to be paid upon the basis of the value of oil or gas of
10 the same kind, quality, and character prevailing during the calendar month of
11 production for that field or area.

12 * Sec. 12. AS 43.55 is amended by adding a new section to read:

13 **Sec. 43.55.024. Tax credits for certain losses and expenditures.** (a)
14 Notwithstanding that a qualified capital expenditure may be a deductible lease
15 expenditure for purposes of calculating the net value of oil and gas under
16 AS 43.55.160(a), a producer or explorer that incurs a qualified capital expenditure
17 may also elect to take a tax credit in the amount of 20 percent of that expenditure,
18 unless a credit for that expenditure is taken under AS 43.55.025. A credit under this
19 subsection may be applied only against a tax due under AS 43.55.011 - 43.55.160.
20 Only for a calendar year for which the producer makes an election under
21 AS 43.55.160(f), a producer that incurs a qualified capital expenditure during that year
22 and that wishes to apply a credit based on that expenditure against a tax due under
23 AS 43.55.011 - 43.55.160 shall calculate and apply every month an annualized tax
24 credit in an amount equal to one and two-thirds percent of the total qualified capital
25 expenditures incurred during that year and for which the tax credit is taken for that
26 year, instead of taking a tax credit of 20 percent of each separate qualified capital
27 expenditure after it has been incurred.

28 (b) A producer may elect to take a tax credit in the amount of 20 percent of a
29 carried-forward annual loss. A credit under this subsection may be applied only
30 against a tax due under AS 43.55.011 - 43.55.160. For purposes of this subsection, a
31 carried-forward annual loss is the amount of a producer's adjusted lease expenditures

1 under AS 43.55.160 for a previous calendar year that was not deductible in any month
2 under AS 43.55.160(a) and (b).

3 (c) A credit under this section may not be used to reduce a person's tax
4 liability under AS 43.55.011- 43.55.160 for any month below zero; any portion of a
5 credit not used for that reason may be applied in a later month.

6 (d) A person entitled to take a tax credit under this section that wishes to
7 transfer the unused credit to another person may apply to the department for a
8 transferable tax credit certificate. An application under this subsection must be on a
9 form prescribed by the department and must include supporting information and
10 documentation that the department reasonably requires. The department shall either
11 grant or deny an application, or grant it as to a lesser amount than that claimed and
12 deny it as to the excess, no later than 60 days after the latest of (1) March 31 of the
13 year following the calendar year in which the qualified capital expenditure or carried-
14 forward annual loss for which the credit is claimed was incurred; (2) if the applicant is
15 required under AS 43.55.030(a) and 43.55.030(e) to file a statement on or before the
16 March 31 described in (1) of this subsection, the date the statement was filed; or (3)
17 the date the application was received by the department. If, based on the information
18 then available to it, the department is reasonably satisfied that the applicant is entitled
19 to a tax credit, the department shall issue the applicant a transferable tax credit
20 certificate for the amount of the credit. A certificate issued under this subsection does
21 not expire.

22 (e) A person to which a transferable tax credit certificate is issued under (d) of
23 this section may transfer the certificate to another person, and a transferee may further
24 transfer the certificate. Subject to the limitations set out in (a) - (c) of this section, and
25 notwithstanding any action the department may take with respect to the applicant
26 under (f) of this section, the owner of a certificate may apply the credit or a portion of
27 the credit shown on the certificate only against a tax due under AS 43.55.011 -
28 43.55.160. However, credits shown on transferable tax credit certificates may not be
29 applied so as to reduce a producer's total tax due under AS 43.55.011 - 43.55.160 on
30 oil and gas produced during a calendar year to less than 80 percent of the tax that
31 would otherwise be due without applying those credits. Any portion of a credit not

1 used for that reason may be applied in a later period.

2 (f) The issuance of a transferable tax credit certificate under (d) of this section
 3 does not limit the department's ability to later investigate or audit a tax credit claim to
 4 which the certificate relates or to adjust or deny the claim if the department determines
 5 that the applicant was not entitled to the amount of the credit for which the certificate
 6 was issued. The tax liability of the applicant under AS 43.55.011 - 43.55.160 is
 7 increased by the amount of the credit that is in excess of that to which the applicant
 8 was entitled. That amount bears interest under AS 43.05.225 from the date the
 9 transferable tax credit certificate was issued. For purposes of this subsection, an
 10 applicant that is an explorer is considered a producer subject to the tax levied under
 11 AS 43.55.011.

12 (g) The department may adopt regulations to carry out the purposes of this
 13 section, including prescribing reporting, record-keeping, and certification procedures
 14 and requirements for purposes of verifying the accuracy of credits claimed and
 15 ensuring that a credit is not used more than once, and otherwise implementing this
 16 section.

17 (h) For purposes of this section,

18 (1) "explorer" has the meaning given in AS 43.55.025(k);

19 (2) "qualified capital expenditure"

20 (A) means, except as otherwise provided under (B) of this
 21 paragraph, an expenditure that is a lease expenditure under AS 43.55.160 and
 22 is

23 (i) incurred for geological or geophysical exploration;

24 or

25 (ii) treated as a capitalized expenditure under 26 U.S.C.
 26 (Internal Revenue Code), as amended, regardless of elections made
 27 under 26 U.S.C. 263(e) (Internal Revenue Code), as amended, and
 28 either is treated as a capitalized expenditure by the person incurring the
 29 expenditure or is eligible to be deducted as an expense under 26 U.S.C.
 30 263(e) (Internal Revenue Code), as amended;

31 (B) does not include an expenditure to acquire an asset (i) the

1 cost of previously acquiring which was a lease expenditure under
 2 AS 43.55.160(c) or would have been a lease expenditure under
 3 AS 43.55.160(c) if it had been incurred on or after July 1, 2006; or (ii) that has
 4 previously been placed in service in the state; an expenditure to acquire an
 5 asset is not excluded under this subparagraph if no more than an immaterial
 6 portion of the asset meets a description under (i) or (ii) of this subparagraph;
 7 for purposes of this subparagraph, "asset" includes geological, geophysical,
 8 and well data and interpretations.

9 * Sec. 13. AS 43.55.030(a) is amended to read:

10 (a) The tax shall be paid to the department and the person paying the tax shall
 11 file with the department at the time the tax or a portion of the tax is required to be
 12 paid a statement, under oath, on forms prescribed by or acceptable to the department,
 13 giving with other information required, the following:

14 (1) a description of each [THE] lease or property from which the oil
 15 and [OR] gas were [WAS] produced, by name, legal description, lease number, or
 16 [BY] accounting codes [CODE NUMBERS] assigned by the department;

17 (2) the names of the producer and the person paying the tax;

18 (3) the gross amount of oil and the gross amount of [OR] gas
 19 produced from each [THE] lease or property, and the percentage of the gross amount
 20 of oil and of gas owned by each producer for whom the tax is paid;

21 (4) the gross [TOTAL] value at the point of production of the oil
 22 and of the [OR] gas produced from each [THE] lease or property owned by each
 23 producer for whom the tax is paid; [AND]

24 (5) the name of the first purchaser and the price received for the oil
 25 and for the [OR] gas, unless relieved from this requirement in whole or in part by
 26 the department; and

27 (6) the producer's lease expenditures and adjustments as
 28 calculated under AS 43.55.160 [IF SOLD IN THE STATE].

29 * Sec. 14. AS 43.55.030(d) is amended to read:

30 (d) Reports by or on behalf of the producer are delinquent the first day
 31 following the day the tax is due. [EACH PRODUCER IS SUBJECT TO A PENALTY

1 OF \$25 A DAY FOR EACH LEASE OR PROPERTY UPON WHICH THE
 2 REPORT IS NOT FILED. THE PENALTY FOR FAILURE TO FILE A REPORT IS
 3 IN ADDITION TO THE PENALTY FOR DELINQUENT TAXES, AND IS A LIEN
 4 AGAINST THE ASSETS OF THE PRODUCER.]

5 * Sec. 15. AS 43.55.030 is amended by adding a new subsection to read:

6 (e) In addition to other required information, the statement required to be filed
 7 on or before March 31 of a year must show any adjustments or corrections to the
 8 statements that were required under (a) of this section to be filed for the months of the
 9 preceding calendar year during which the oil or gas was produced.

10 * Sec. 16. AS 43.55.040 is amended to read:

11 Sec. 43.55.040. Powers of Department of Revenue. Except as provided in
 12 AS 43.05.405 - 43.05.499, the department may

13 (1) require a person engaged in production and the agent or employee
 14 of the person, and the purchaser of oil or gas, or the owner of a royalty interest in oil
 15 or gas to furnish, whether by the filing of regular statements or reports or
 16 otherwise, additional information that is considered by the department as necessary to
 17 compute the amount of the tax; notwithstanding any contrary provision of law, the
 18 disclosure of additional information under this paragraph to the producer
 19 obligated to pay the tax does not violate AS 40.25.100(a) or AS 43.05.230(a);
 20 before disclosing information under this paragraph that is otherwise required to
 21 be held confidential under AS 40.25.100(a) or AS 43.05.230(a), the department
 22 shall

23 (A) provide the person that furnished the information a
 24 reasonable opportunity to be heard regarding the proposed disclosure and
 25 the conditions to be imposed under (B) of this paragraph; and

26 (B) impose appropriate conditions limiting

27 (i) access to the information to those legal counsel,
 28 consultants, employees, officers, and agents of the producer who
 29 have a need to know that information for the purpose of
 30 determining or contesting the producer's tax obligation; and

31 (ii) the use of the information to use for that

1 purpose:

2 (2) examine the books, records, and files of [SUCH] a person
3 described in (1) of this section;

4 (3) conduct hearings and compel the attendance of witnesses and the
5 production of books, records, and papers of any person; and

6 (4) make an investigation or hold an inquiry that is considered
7 necessary to a disclosure of the facts as to

8 (A) the amount of production from any oil or gas location, or of
9 a company or other producer of oil or gas; and

10 (B) the rendition of the oil and gas for taxing purposes.

11 * Sec. 17. AS 43.55.080 is amended to read:

12 Sec. 43.55.080. Collection and deposit of revenue. Except as otherwise
13 provided under art. IX, sec. 17, Constitution of the State of Alaska, the [THE]
14 department shall deposit in the general fund the money collected by it under
15 AS 43.55.011 - 43.55.160 [AS 43.55.011 - 43.55.150].

16 * Sec. 18. AS 43.55.135 is amended to read:

17 Sec. 43.55.135. Measurement. For the purposes of AS 43.55.011 - 43.55.160
18 [AS 43.55.011 - 43.55.150], oil is [SHALL BE] measured in terms of a "barrel of oil"
19 and gas is [SHALL BE] measured in terms of a "cubic foot of gas."

20 * Sec. 19. AS 43.55.150(a) is amended to read:

21 (a) For the purposes of AS 43.55.011 - 43.55.160 [AS 43.55.011 - 43.55.150],
22 the gross value at the point of production is [SHALL BE] calculated using the
23 reasonable costs of transportation of the oil or gas. The reasonable costs of
24 transportation are [SHALL BE] the actual costs, except when the

25 (1) [WHEN THE] parties to the transportation of oil or gas are
26 affiliated;

27 (2) [WHEN THE] contract for the transportation of oil or gas is not an
28 arm's length transaction or is not representative of the market value of that
29 transportation;

30 (3) [WHEN THE] method of transportation of oil or gas is not
31 reasonable in view of existing alternative methods of transportation.

1 * **Sec. 20.** AS 43.55.150 is amended by adding a new subsection to read:

2 (d) Under regulations adopted by the department, the department may allow a
3 producer, subject to limitations prescribed by the department as to the frequency of
4 making elections, to elect prospectively to calculate the gross value at the point of
5 production of oil or gas based in whole or part upon

6 (1) a royalty value determined under a royalty settlement agreement
7 between the producer and the state, with adjustments if appropriate;

8 (2) a formula prescribed by the department that uses, with adjustments
9 if appropriate, a royalty value or valuation methodology accepted by the

10 (A) Department of Natural Resources under AS 38.05, in the
11 case of oil and gas produced from a lease issued by the Department of Natural
12 Resources or produced from a lease or property that is part of a unit approved
13 by the Department of Natural Resources; or

14 (B) United States Department of the Interior under applicable
15 federal oil and gas leasing statutes, in the case of oil and gas produced from a
16 lease issued by the United States Department of the Interior that is not part of a
17 unit approved by the Department of Natural Resources, or produced from a
18 lease or property that is part of a unit approved by the United States
19 Department of the Interior but not approved by the Department of Natural
20 Resources; or

21 (3) another formula prescribed by the Department of Revenue that
22 reasonably estimates a value for the oil or gas at a specific geographical location such
23 as the point of tender or delivery into a common carrier pipeline; the formula may use
24 such factors as published price indices for oil or gas in or outside the state, quality
25 differentials for oil or gas, transportation costs between markets, and inflation
26 adjustments.

27 * **Sec. 21.** AS 43.55 is amended by adding a new section to article 1 to read:

28 **Sec. 43.55.160. Determination of net value of oil and gas.** (a) Except as
29 provided in (f) and (i) of this section, for purposes of AS 43.55.011, the net value of
30 the taxable oil and gas produced during a month is the total of the gross value at the
31 point of production of the oil and gas taxable under AS 43.55.011 and produced by the

1 producer from all leases or properties in the state, less (1) first, the producer's lease
2 expenditures for the month as adjusted under (e) of this section, and (2) second, to the
3 extent allowed under (g) of this section and until the total amount of the producer's
4 transitional investment expenditures has been deducted, an amount equal to 1/72 of the
5 producer's transitional investment expenditures. However, the net value calculated
6 under this subsection may not be less than zero.

7 (b) Any adjusted lease expenditures that would otherwise be deductible in a
8 month but whose deduction would cause the net value calculated under (a) of this
9 section of the taxable oil and gas produced during the month to be less than zero may
10 be added to the producer's adjusted lease expenditures for one or more other months in
11 the same calendar year. The total of any adjusted lease expenditures that are not
12 deductible in any month during a calendar year because their deduction would cause
13 the net value calculated under (a) of this section of the taxable oil and gas produced
14 during one or more months to be less than zero may be used to establish a carried-
15 forward annual loss under AS 43.55.024(b). An amount of transitional investment
16 expenditures that would otherwise be deductible in a month but whose deduction
17 would cause the net value calculated under (a) of this section of the taxable oil and gas
18 produced during the month to be less than zero

19 (1) may be deducted in a later month during any calendar year to the
20 extent allowed under (g) of this section, but no more than 1/72 of a producer's
21 transitional investment expenditures may be deducted in any month;

22 (2) may not be used to establish a carried-forward annual loss under
23 AS 43.55.024(b).

24 (c) For purposes of this section, a producer's lease expenditures for a period
25 are the total costs upstream of the point of production of oil and gas that are incurred
26 on or after July 1, 2006, by the producer during the period and that are direct,
27 ordinary, and necessary costs of exploring for, developing, or producing oil or gas
28 deposits located within the producer's leases or properties in the state or, in the case of
29 land in which the producer owns no working interest, direct, ordinary, and necessary
30 costs of exploring for oil or gas deposits located within other land in the state.
31 However, lease expenditures do not include the costs incurred to satisfy a work

1 commitment under an exploration license under AS 38.05.132. In determining whether
 2 costs are direct, ordinary, and necessary costs of exploring for, developing, or
 3 producing an oil or gas deposit located within a lease or property or other land in the
 4 state, the department shall give substantial weight to (1) the typical industry practices
 5 and standards in the state and in the United States as to costs that an operator is
 6 allowed to bill a working interest owner that is not the operator, under unit operating
 7 agreements or similar operating agreements that were in effect on or before
 8 December 1, 2005, and were subject to negotiation with working interest owners, not
 9 the operator, with substantial bargaining power; and (2) the standards adopted by the
 10 Department of Natural Resources as to the costs, other than interest, that a lessee is
 11 allowed to deduct from revenue in calculating net profits under a lease issued under
 12 AS 38.05.180(f)(3)(B), (D), or (E). The Department of Revenue may authorize a
 13 producer to treat as its lease expenditures under this section the costs paid by the
 14 producer that are billed to the producer by an operator in accordance with the terms of
 15 a unit operating agreement or similar operating agreement, if the Department of
 16 Revenue finds that the pertinent provisions of the operating agreement are
 17 substantially consistent with the Department of Revenue's determinations and
 18 standards otherwise applicable under this subsection and that at least one working
 19 interest owner party to the agreement, other than the operator, has substantial incentive
 20 and ability to effectively audit billings under the agreement.

21 (d) For purposes of (c) of this section, direct costs

22 (1) include

23 (A) outlays for capital assets;

24 (B) payments in lieu of property taxes;

25 (C) a reasonable allowance, as determined under regulations
 26 adopted by the department, for overhead expenses directly related to exploring
 27 for, developing, and producing oil or gas deposits located within leases or
 28 properties or other land in the state;

29 (2) do not include

30 (A) depreciation or amortization of capital assets;

31 (B) royalty payments;

- 1 (C) taxes based on or measured by net income;
- 2 (D) interest or other financing charges or costs of raising equity
- 3 or debt capital;
- 4 (E) acquisition costs for a lease or property or exploration
- 5 license;
- 6 (F) costs arising from fraud, wilful misconduct, or negligence;
- 7 (G) fines or penalties imposed by law;
- 8 (H) costs of arbitration, litigation, or other dispute resolution
- 9 activities that involve the state or concern the rights or obligations among
- 10 owners of interests in, or rights to production from, one or more leases or
- 11 properties or a unit;
- 12 (I) donations;
- 13 (J) costs incurred in organizing a partnership, joint venture, or
- 14 other business entity or arrangement;
- 15 (K) amounts paid for purposes of indemnification.
- 16 (e) A producer's lease expenditures must be adjusted by subtracting any
- 17 payment or credit the producer receives
- 18 (1) for the use by another person of a production facility in which the
- 19 producer has an ownership interest;
- 20 (2) for a reimbursement or similar payment that offsets the producer's
- 21 lease expenditures, including any payment from the state or federal government for
- 22 reimbursement of the producer's upstream costs, including any costs for gathering,
- 23 separating, cleaning, dehydration, compressing, or other field handling costs
- 24 associated with the production of oil or gas upstream of the point of production;
- 25 (3) for the sale or other transfer of
- 26 (A) an asset, including geological, geophysical, or well data or
- 27 interpretations, acquired by the producer as a result of a lease expenditure or an
- 28 expenditure that would be a lease expenditure if it were incurred on or after
- 29 July 1, 2006; and
- 30 (B) oil or gas
- 31 (i) that is not considered produced from a lease or

1 property under AS 43.55.020(e); and

2 (ii) the cost of acquiring which is a lease expenditure
3 incurred by the person that acquires the oil or gas.

4 (f) In place of the adjusted lease expenditures for a month under (a) of this
5 section, a producer may at any time elect to substitute for every month of a calendar
6 year one-twelfth of the producer's adjusted lease expenditures for the calendar year.

7 (g) For the purposes of this section, a producer's transitional investment
8 expenditures are (1) the sum of the expenditures the producer incurred on or after
9 July 1, 2001, and before July 1, 2006, that would be qualified capital expenditures, as
10 defined in AS 43.55.024(h), if they were incurred on or after July 1, 2006, less (2) the
11 sum of the payments or credits the producer received before July 1, 2006, for the sale
12 or other transfer of assets, including geological, geophysical, or well data or
13 interpretations, acquired by the producer as a result of expenditures the producer
14 incurred on or after July 1, 2001, and before July 1, 2006, that would be qualified
15 capital expenditures, as defined in AS 43.55.024(h), if they were incurred on or after
16 July 1, 2006. An amount of transitional investment expenditures may not be deducted
17 under (a) of this section for a month for which the average price of Alaska North
18 Slope oil delivered on the United States West Coast, as determined under (h) of this
19 section, is equal to or less than \$40 per barrel, as adjusted for inflation under (h) of this
20 section.

21 (h) The average price described in (g) of this section shall be an average, as
22 calculated using a formula prescribed by the department by regulation, of published
23 daily spot price assessments during the month for Alaska North Slope oil delivered on
24 the United States West Coast. However, if the department determines that such daily
25 assessments cease or appear likely to soon cease to be published throughout the
26 calendar year or that they cease or appear likely to soon cease to be reliable evidence
27 of market conditions, the department shall by regulation provide that the average price
28 described in (g) of this section is the prevailing value of Alaska North Slope oil
29 delivered on the United States West Coast as determined under regulations of the
30 department implementing AS 43.55.020(f). For each year after 2006, the reference
31 price of \$40 per barrel set out in (g) of this section shall be adjusted for inflation using

1 an appropriate consumer price index published by the United States Bureau of Labor
2 Statistics, as prescribed by the department by regulation.

3 (i) For a month for which the net value of the taxable oil and gas produced
4 during the month calculated under (a) of this section exceeds zero, a producer that is
5 qualified under (j) of this section may reduce the net value by deducting an allowance
6 in an amount calculated such that (1) the net value for the month is not reduced below
7 zero; and (2) the total of the allowances deducted for all months during the calendar
8 year does not exceed \$73,000,000. An unused allowance or portion of an allowance
9 under this subsection may not be carried forward to a later calendar year or used to
10 establish a carried-forward annual loss under AS 43.55.024(b).

11 (j) Upon written application by a producer, including any information the
12 department may require, the department shall determine whether the producer
13 qualifies under this subsection for a calendar year. To qualify under this subsection, a
14 producer must demonstrate that its operation in the state or its ownership of an interest
15 in a lease or property in the state as a distinct producer entity would not result in the
16 division among multiple producer entities of any net value of taxable oil and gas, as
17 defined under (a) of this section, that would be reasonably expected to be attributed to
18 a single producer entity if the allowance provision of (i) of this section did not exist.

19 (k) If a cost that would otherwise constitute a lease expenditure under (e) of
20 this section is incurred to explore for, develop, or produce (1) both an oil or gas
21 deposit located within land outside the state and an oil or gas deposit located within a
22 lease or property, or other land, in the state, or (2) an oil or gas deposit located partly
23 within land outside the state and partly within a lease or property, or other land, in the
24 state, the department shall specify or approve a reasonable allocation method for
25 determining the portion of the cost that is appropriately treated as a lease expenditure
26 under (e) of this section.

27 (l) The department may adopt regulations that establish additional standards
28 necessary to carrying out the purposes of this section.

29 (m) For purposes of AS 43.55.024(a) and (b) and only as to expenditures
30 incurred to explore for an oil or gas deposit located within land in which an explorer,
31 as defined in AS 43.55.025(k), owns no working interest, the term "producer" in (c)

1 and (e) of this section includes "explorer."

2 (n) For purposes of this section,

3 (1) "explore" includes to conduct geological or geophysical
4 exploration;

5 (2) the drilling of a stratigraphic test well is considered geological
6 exploration for an oil or gas deposit located within land in the state only if the well's
7 target zones are located in the state; for purposes of this paragraph, a stratigraphic test
8 well is a well drilled for the sole purpose of obtaining geological information to aid in
9 exploring for an oil or gas deposit.

10 * Sec. 22. AS 43.55.201(b) is amended to read:

11 (b) The surcharge imposed by (a) of this section is in addition to and shall be
12 paid in the same manner as the tax imposed by AS 43.55.011, except that
13 notwithstanding anything to the contrary in AS 43.55.020(a), the full amount of
14 the surcharge is due on the last day of each calendar month on oil produced from
15 each lease or property during the preceding month. The surcharge [AS 43.55.011
16 - 43.55.150; AND] is in addition to the surcharge imposed by AS 43.55.300 -
17 43.55.310.

18 * Sec. 23. AS 43.55.201(c) is amended to read:

19 (c) A producer of oil shall make reports of production in the same manner and
20 under the same penalties as required under AS 43.55.011 - 43.55.160 [AS 43.55.011 -
21 43.55.150].

22 * Sec. 24. AS 43.55.201 is amended by adding a new subsection to read:

23 (d) Oil not considered under AS 43.55.020(e) to be produced from a lease or
24 property is not considered to be produced from a lease or property for purposes of this
25 section.

26 * Sec. 25. AS 43.55 is amended by adding a new section to read:

27 **Sec. 43.55.205. Tax credit for surcharge payment.** The amount of a
28 surcharge paid by a producer under AS 43.55.201 may be applied as a credit against
29 the producer's taxes due under AS 43.55.011 - 43.55.160. A credit under this section
30 may not be used to reduce a person's tax liability under AS 43.55.011 - 43.55.160 for
31 any month below zero; any portion of a credit not used for that reason may be applied

1 in a later month.

2 * Sec. 26. AS 43.55.300(b) is amended to read:

3 (b) The surcharge imposed by (a) of this section is in addition to and shall be
4 paid in the same manner as the tax imposed by AS 43.55.011, except that
5 notwithstanding anything to the contrary in AS 43.55.020(a), the full amount of
6 the surcharge is due on the last day of each calendar month on oil produced from
7 each lease or property during the preceding month. The surcharge [AS 43.55.011
8 - 43.55.150; AND] is in addition to the surcharge imposed by AS 43.55.201 -
9 43.55.231.

10 * Sec. 27. AS 43.55.300(c) is amended to read:

11 (c) A producer of oil shall make reports of production in the same manner and
12 under the same penalties as required under AS 43.55.011 - 43.55.160 [AS 43.55.011 -
13 43.55.150].

14 * Sec. 28. AS 43.55.300 is amended by adding a new subsection to read:

15 (d) Oil not considered under AS 43.55.020(e) to be produced from a lease or
16 property is not considered to be produced from a lease or property for purposes of this
17 section.

18 * Sec. 29. AS 43.55 is amended by adding a new section to read:

19 **Sec. 43.55.305. Tax credit for surcharge payment.** The amount of a
20 surcharge paid by a producer under AS 43.55.300 may be applied as a credit against
21 the producer's taxes due under AS 43.55.011 - 43.55.160. A credit under this section
22 may not be used to reduce a person's tax liability under AS 43.55.011 - 43.55.160 for
23 any month below zero; any portion of a credit not used for that reason may be applied
24 in a later month.

25 * Sec. 30. AS 43.55.900(b) is repealed and reenacted to read:

26 (b) "gas" means

27 (A) all natural, associated, or casinghead gas;

28 (B) all hydrocarbons that

29 (i) are recovered by mechanical separation of well
30 fluids or by gas processing; and

31 (ii) exist in a gaseous phase at the completion of

1 mechanical separation and any gas processing; and

2 (C) all other hydrocarbons produced from a well not defined as

3 oil;

4 * Sec. 31, AS 43.55.900(7) is repealed and reenacted to read:

5 (7) "gross value at the point of production" means

6 (A) for oil, the value of the oil at the automatic custody transfer
7 meter or device through which the oil enters into the facilities of a carrier
8 pipeline or other transportation carrier in a condition of pipeline quality; in the
9 absence of an automatic custody transfer meter or device, "gross value at the
10 point of production" means the value of the oil at the mechanism or device to
11 measure the quantity of oil that has been approved by the department for that
12 purpose, through which the oil is tendered and accepted in a condition of
13 pipeline quality into the facilities of a carrier pipeline or other transportation
14 carrier or into a field topping plant;

15 (B) for gas, other than gas described in (C) of this paragraph,
16 that is

17 (i) not subjected to or recovered by mechanical
18 separation or gas processing, the value of the gas at the first point
19 where the gas is accurately metered,

20 (ii) subjected to or recovered by mechanical separation
21 but not gas processing, the value of the gas at the first point where the
22 gas is accurately metered after completion of mechanical separation;

23 (iii) subjected to or recovered by gas processing, the
24 value of the gas at the first point where the gas is accurately metered
25 after completion of gas processing;

26 (C) for gas run through an integrated gas processing and gas
27 treatment facility that does not accurately meter the gas after the gas
28 processing and before the gas treatment, the value of the gas at the first point
29 where gas processing is completed or where gas treatment begins, whichever is
30 further upstream;

31 * Sec. 32, AS 43.55.900(10) is repealed and reenacted to read

- 1 (10) "oil" means
 2 (A) crude petroleum oil; and
 3 (B) all liquid hydrocarbons that are recovered by mechanical
 4 separation of well fluids or by gas processing;

5 * Sec. 33. AS 43.55.900 is amended by adding new paragraphs to read:

- 6 (17) "gas processing"
 7 (A) means processing a gaseous mixture of hydrocarbons
 8 (i) by means of absorption, adsorption, externally
 9 applied refrigeration, artificial compression followed by adiabatic
 10 expansion using the Joule-Thomson effect, or another physical process
 11 that is not mechanical separation;
 12 (ii) for the purpose of extracting and recovering liquid
 13 hydrocarbons; and
 14 (iii) upstream of any gas treatment and upstream of the
 15 inlet of any gas pipeline system transporting gas to a market;
 16 (B) does not include gas treatment;

- 17 (18) "gas treatment"
 18 (A) means conditioning gas and removing from gas non-
 19 hydrocarbon substances, for the purpose of rendering the gas acceptable for
 20 tender and acceptance into a gas pipeline system; and
 21 (B) may include incidentally removing liquid hydrocarbons
 22 from the gas.

23 * Sec. 34. AS 43.55.011(b), 43.55.011(c), 43.55.012(b), 43.55.013(b), 43.55.013(c),
 24 43.55.013(d), 43.55.013(g), 43.55.013(h), 43.55.013(i), 43.55.013(j), 43.55.013(k),
 25 43.55.016, 43.55.900(1), 43.55.900(8), 43.55.900(11), 43.55.900(12), and 43.55.900(16) are
 26 repealed.

27 * Sec. 35. The uncodified law of the State of Alaska is amended by adding a new section to
 28 read:

- 29 APPLICABILITY. (a) Sections 5, 7 - 10, 12, 13, 15, and 19 - 34 of this Act apply to
 30 oil and gas produced on or after July 1, 2006.
 31 (b) Section 11 of this Act applies to oil and gas produced before, on, or after the

1 effective date of sec. 11 of this Act.

2 * Sec. 36. The uncodified law of the State of Alaska is amended by adding a new section to
3 read:

4 TRANSITION PROVISIONS. (a) Notwithstanding any contrary provision of
5 AS 43.55.024(a), enacted by sec. 12 of this Act, for oil and gas produced on or after July 1,
6 2006, and before January 1, 2007, the phrase "every month an annualized tax credit in an
7 amount equal to one and two-thirds percent" in AS 43.55.024(a), enacted by sec. 12 of this
8 Act, shall be replaced by the phrase "every month during the period July 1, 2006, through
9 December 31, 2006, an annualized tax credit in an amount equal to three and one-third
10 percent."

11 (b) Notwithstanding any contrary provision of AS 43.55.024(e), enacted by sec. 12 of
12 this Act, for oil and gas produced on or after July 1, 2006, and before January 1, 2007 the
13 phrase "a calendar year" in AS 43.55.024(e), enacted by sec. 12 of this Act, shall be replaced
14 by the phrase "the last six months of the calendar year."

15 (c) Notwithstanding any contrary provision of AS 43.55.160(f), enacted by sec. 21 of
16 this Act, for oil and gas produced on or after July 1, 2006, and before January 1, 2007, the
17 phrase "for every month of a calendar year one-twelfth of the producer's adjusted lease
18 expenditures for the calendar year" in AS 43.55.160(f), enacted by sec. 21 of this Act, shall be
19 replaced by the phrase "for each of the last six months of 2006, one-sixth of the producer's
20 adjusted lease expenditures for that six-month period."

21 (d) Notwithstanding any contrary provision of AS 43.55.160(i), enacted by sec. 21 of
22 this Act, for oil and gas produced on or after July 1, 2006, and before January 1, 2007, the
23 number "\$73,000,000" in AS 43.55.160(i), enacted by sec. 21 of this Act, shall be replaced by
24 the number "\$36,500,000."

25 (e) For oil and gas produced before July 1, 2006, the provisions of AS 43.55, and
26 regulations adopted under AS 43.55, that were in effect before July 1, 2006, and that were
27 applicable to the oil and gas continue to apply to that oil and gas.

28 * Sec. 37. The uncodified law of the State of Alaska is amended by adding a new section to
29 read:

30 TRANSITION REGULATIONS. The Department of Revenue may proceed to adopt
31 regulations to implement the changes made by this Act. The regulations take effect under

1 AS 44.62 (Administrative Procedure Act), but not before the effective date of the law
2 implemented by the regulation.

3 * Sec. 38. The uncodified law of the State of Alaska is amended by adding a new section to
4 read:

5 REVISOR'S INSTRUCTION. The revisor of statutes is instructed to change the
6 heading of

7 (1) AS 43.55 from "Oil and Gas Production Taxes and Oil Surcharge" to "Oil
8 and Gas Production Tax and Oil Surcharge";

9 (2) article 1 of AS 43.55 from "Oil and Gas Properties Production Taxes" to
10 "Oil and Gas Production Tax";

11 (3) AS 43.55.011 from "Oil production tax" to "Oil and gas production tax";

12 (4) AS 43.55.025 from "Tax credit for oil and gas exploration or gas only
13 exploration" to "Alternative tax credit for oil and gas exploration or gas only exploration";

14 (5) AS 43.55.150 from "Determination of gross value" to "Determination of
15 gross value at the point of production."

16 * Sec. 39. Sections 1 - 4, 6, 11, 14, 16, and 37 of this Act take effect immediately under
17 AS 01.10.070(c).

18 * Sec. 40. Except as provided in sec. 39 of this Act, this Act takes effect July 1, 2006.

Presentation by Jim Eason

SB 305/HB 488--Oil & Gas Production Tax

March 4, 2006

- Consultant to Legislative Budget and Audit Committee
- My Background

WHO SAID IT ... and when?

✱ “Since discovery of oil in commercial quantities on the Kenai Peninsula in 1957, two great interrelated responsibilities face the Legislature. One will be that of encouraging further exploration and greater production. Greater cost factors such as those incurred in reaching and developing inaccessible fields may affect Alaska’s competitive position in world markets. We will wish to consider how far to go in creating a favorable investment climate toward attracting new payrolls and realizing rental and royalty income for the state.”

The Challenge

-
- ✘ Your responsibility is not unique – but you are relatively better situated because you have the benefit of historical perspective.
 - ✘ Among your considerations, there is only one certainty – your numbers are wrong, but not necessarily bad.
 - ✘ Why are your numbers wrong?
 - ◆ Geological uncertainty
 - ◆ Production volume forecasts
 - ◆ Price forecasts
 - ◆ Failing to identify and quantify the range and magnitude of credits and deductions
 - ✘ Not much control of these uncertainties – best judgment.
 - ✘ Your choice of words, however, can reduce fiscal risk and provide greater certainty.

The Past

-
- ✘✘ Cook Inlet example – “wells” versus “completions”
 - ✘✘ North Slope example – the disaggregation and aggregation issue.
 - ✘✘ ANS Litigation History – the past can be the key to the future.
 - ✘✘ The most costly words – the ANS royalty litigation.
 - ✘✘ Where and how – “at the well” and in a multitude of ways.

The Lessons

-
- ✦ Milestones in the ANS Litigation.
 - ◆ ANS field cost allowance settlement (1980)
 - ◆ TAPS Agreement – “just and reasonable rates” (1985)
 - ◆ Royalty Settlement Agreements (early 1990’s)
 - ✦ One common lesson learned – reasonable opportunity to revisit fiscal provisions critical to long term satisfaction
 - ◆ ANS field cost allowance history and magnitude
 - ◆ TAPS Settlement
 - ◆ Royalty Settlement Agreements

Examples of Concerns

- ✧ Point of Production
- ✧ Definition of Gas Processing Facilities
- ✧ Definition of Gas Treatment Facilities
- ✧ The unknown relationship of terms to a stranded gas contract
- ✧ The unquantified but major deduction and/or credit exposure – “abandonment”
- ✧ Pending Questions

Recurring Historic Themes

- ✧ The use of the unit operating agreements
 - ◆ Substantial weight (see Sec. 21, pg. 12)
- ✧ The adoption of royalty settlement methodologies (see Sec. 20, pg. 10)
- ✧ Arbitration

Recommendations

- ✦ Take the time to confirm the lessees' AND the DOR's intent where there is an ambiguity
- ✦ Expect linkages and try to understand how they may affect or be affected by future events
- ✦ Take advantage of your "extra eyes"