

AK LEGISLATURE SPECIAL COMMITTEE FILES SCOMM 150 3248₂₂

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Mining License Tax AS 43.65

Description

Alaska levies a mining license tax on mining net income and royalties received in connection with mining properties and activities in Alaska. The Tax Division collects mining license taxes primarily from businesses engaged in coal and hard rock mining.

Mining Net Income	Rate
\$0 - 40,000	No Tax
\$40,001 - \$50,000	\$1,200 plus 3% over \$40,000
\$50,001 - \$100,000	\$1,500 plus 5% over \$50,000
Over \$100,000	\$4,000 plus 7% over \$100,000

Returns

Mining licensees file annual returns based on the mining business' fiscal year. Calendar year returns and payment of tax are due April 30; fiscal year returns and payment are due before the first day of the fifth month after the close of the fiscal year.

Exemptions

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.

Credits

Education - Taxpayers that make contributions for educational purposes to accredited Alaska universities or colleges may claim a tax credit for 50 percent of the first \$100,000 and 100 percent of the next \$100,000 of contributions.

The maximum credit is \$150,000 for each tax year.

Minerals Exploration Incentive

- Taxpayers may claim a credit for eligible costs of exploration activities related to determining existence, location, extent, or quality of a locatable mineral or coal deposit. An approved exploration incentive credit may not exceed \$20 million and must be applied within 15 tax years after the credit is approved. Application of the credit is limited to the lesser of 50 percent of the person's mining license tax liability related to the mining operation for which eligible mining costs were incurred or 50 percent of the person's total mining license tax liability for all mining operations.

Disposition of Revenue

The division deposits revenue from the mining license tax into the General Fund. Payments received after a tax assessment are deposited into the Constitutional Budget Reserve Fund (CBRF).

History

The mining license tax dates back to 1913 and the legislature restructured it several times over the years. The original mining license tax, enacted in 1913, imposed a 0.5 percent tax on mining net income of more than \$5,000. There was no tax on net income less than \$5,000.

1915 - The territorial legislature increased the tax rate to 1 percent. The tax-free net income base remained at \$5,000.

1927 - The tax-free net income base was increased to \$10,000 and a three-tier tax rate structure was adopted with rates ranging from 1 percent to 1.75 percent for net income of more than \$1 million.

1935 - The territorial legislature restructured the tax to an eight-tier

The Tax Division collects mining license taxes primarily from businesses engaged in coal and hard rock mining.

tax structure with rates ranging from 0.75 percent to 4 percent for net income of more than \$1 million. The legislature decreased tax-free net income to \$5,000.

1937 – The tax-free net income base was eliminated and all net income was subject to tax. A nine-tier tax structure was adopted with tax rates ranging from 0.75 percent to 8 percent for net income of more than \$1 million.

1947 – The mining license tax was restructured by reinstating a tax-free net income base of \$1,000 and restructuring the tax rates to a five-tier structure with rates ranging from 4 percent to 8 percent for net income of more than \$100,000.

1951 – The legislature authorized a 3½ year exemption for new mining operations. This exemption does not apply to sand and gravel mining operations.

1953 – The tax-free net income base was increased to \$10,000 and rates changed to range from 3 percent to 7 percent for net income of more than \$100,000.

1955 – The rate structure as it exists today was adopted.

1987 – The Alaska education tax credit program was enacted allowing for a tax credit up to \$100,000.

1991 – The Alaska education credit was restructured and the maximum amount was increased to \$150,000.

1995 – The legislature authorized the minerals exploration incentive credit. The credit is limited to \$20 million and taxpayers may apply the credit against 50 percent of mining license liabilities over a 15-year period.

2002 – The legislature authorized credits of up to 50 percent for contributions of not more than \$100,000 and 75 percent of the next \$100,000 in contributions made to the Alaska Veterans' Memorial Endowment Fund. The tax credit expired July 1, 2003.

FY 2006 Statistics

Tax Collections (all General Fund)	\$18,637,996
Number of Returns	166
Number of Taxpayers	156
Program Cost	\$10,373
Staffing (full time equivalent)	0.2

Alaska's Mining License Tax

Presented by: Johanna Bales, CPA
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Tax Division

History

- 1913 – Tax imposed at .5% of mining net income greater than \$5,000. No tax on income less than \$5,000.
- 1915 – Tax rate increased to 1%
- 1927 – Three-tier tax rate ranging from 1% to 1.75% on income greater than \$1 million. No tax on income less than \$10,000.
- 1935 – Eight-tier tax rate structure ranging from .75% to 4% on income greater than \$1 million. No tax on income less than \$5,000.
- 1937 – Tax-free net income base eliminated. A nine-tier tax rate structure was adopted with tax rates ranging from .75% to 8% on income greater than \$1 million.
- 1947 – Tax-free net income base raised to \$1,000 and five-tier tax rate structure ranging from 4% to 8% on net income more than \$100,000.
- 1951 – 3.5 year exemption from mining license tax adopted.
- 1953 – Tax-free net income base increased to \$10,000 and rates changed from 3% to 7% on net income greater than \$100,000.
- 1955 – Tax-free net income base increased to \$40,000 with rates of 3% to 7% on income greater than \$100,000. (Existing tax scheme.)
- Between 1987 and 2002 a series of credits were enacted.
- No change to tax rate structure since 1955.

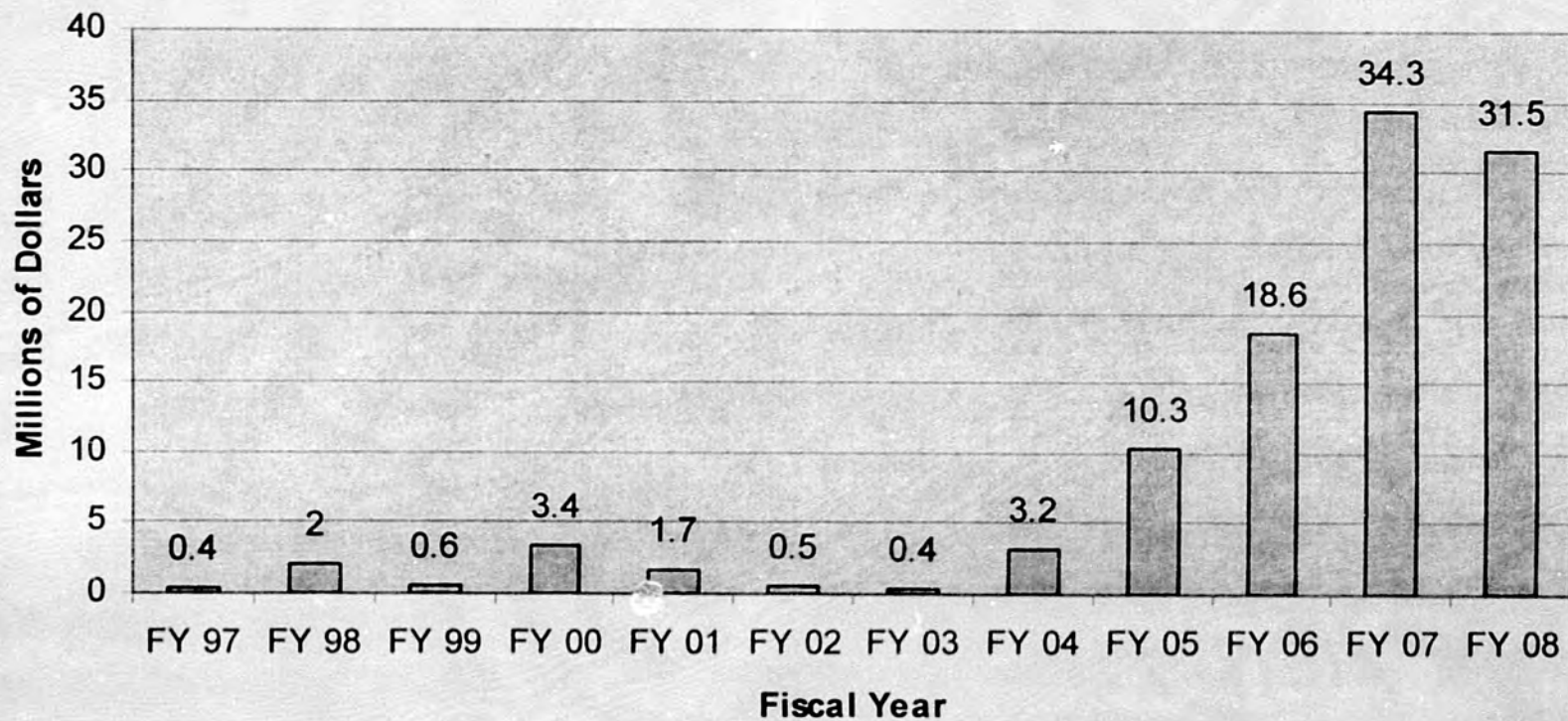
Current Tax Rate Structure

Net Income	Base Tax	Plus %	Of Excess Over
\$0 - \$40,000	0	0	0
\$40,001 - \$50,000	\$1,200	3%	\$40,000
\$50,001 - \$100,000	\$1,500	5%	\$50,000
> \$100,000	\$4,000	7%	\$100,000

Tax Collections

Mining License Tax Revenue

Actual Revenue (FY 97 - FY 06) Projected Revenue (FY 07 - FY 08)



Who Must Hold a Mining License

- A person owning and operating a mining property
- A person owning a mining property and receiving lease or royalty payments based on production
- A person leasing and operating a mining property
- A person possessing a mineral interest in a producing property

A license is required on all state, federal and private lands where minerals are produced.

Who Doesn't Need a Mining License

- A person whose mining activities are restricted to the holding of property for exploration
- A person who holds a mineral interest in undeveloped and non-producing properties
- A person whose sole mining activity consists of extracting sand, gravel, rock or fill from federal, state, or municipal land, if the material is to be used exclusively by that person for public construction projects or for personal use and is not held for resale

Who Must File a Mining License Return

- If you hold a mining license, you must file a return
- A person receiving gross income from more than one licensed mining property must report that income on a single return
- There is an exemption from the mining license tax during the first 3.5 years after initial production

Mining License Tax Calculation

- MLT is an income tax (tax is calculated on net income from the mining property)
- Net income is mining gross income less royalties paid from the property and mining expenses
- Mining gross income –
 - Sale price or value actually received for mined material
 - Royalties received from mining property
 - Production payments received from a lease

Mining License Tax Calculation

(Cont.)

- Mining expenses
 - Direct mining expenses – costs incurred that are incident and necessary to the extraction of mined materials including
 - labor
 - maintenance & repair
 - supplies
 - depreciation
 - transportation
 - depletion
 - Indirect mining expenses – costs incurred that are not directly related to the mining business, but support the mining operation
 - advertising, insurance, office expense, rent, legal fees, utilities
 - employee benefits
 - property, sales, severance, & excise taxes
- (indirect expenses are generally those incurred that support more than one business activity conducted by the taxpayer; indirect expenses must be allocated between businesses)

Deductions not allowed

- Exploration costs
- Federal income taxes
- Mining license tax
- Loss on sale of mining equipment or property
- Net operating losses
- Other capital losses

Depletion

Depletion is the term used for depreciation of mineral property used to extract natural resources.

While property is in development stage, all development costs are capitalized and then depleted when the mine begins production. Taxpayer may deduct depletion from mining gross income. Depletion deduction is the greater of percentage depletion or cost depletion

Depletion (cont.)

- **Cost Depletion**
 - Total development costs are allowed to be deducted over the estimated life of the mine. Once all development costs are deducted (depleted), depletion expense no longer allowed.
- **Percentage Depletion**
 - Depletion is a percentage of gross income less royalties paid. Depletion is limited to 50% of net income. Depletion deduction continues even after all development costs have been deducted (depleted).

Depletion Example

- Cost Depletion

Development costs =
\$1,000,000

Expected recoverable units = 2
million ounces

Actual amount mined each year
for 10 years = 200,000
ounces

Cost Depletion each year =
\$100,000 $(2,000,000/200,000$
 $\times \$1,000,000)$

Total depletion expense over life
of mine = \$1,000,000

- 15% Depletion (Gold mine)

Development costs = \$1,000,000

Expected mine life = 10 years

Gross income = \$10,000,000 each year

Net income = \$1,000,000 each year

Allowed % Depletion each year =
\$500,000

Total depletion expense = \$5,000,000
 $(\$500,000/\text{yr} \times 10 \text{ years})$

(lesser of 15% of gross income or 50%
of net income)

Depletion Example (cont.)

	Gross Income	Net Income Before Depletion	Cost Depletion	% Depletion	Depletion Deduction
Year 1	1,500,000	125,000	100,000	62,500	100,000
Year 2	1,200,000	145,000	100,000	72,500	100,000
Year 3	1,600,000	150,000	100,000	75,000	100,000
Year 4	4,000,000	1,000,000	100,000	500,000	500,000
Year 5	6,500,000	1,750,000	100,000	875,000	875,000
Year 6	10,000,000	2,750,000	100,000	1,375,000	1,375,000
Year 7	11,500,000	2,500,000	100,000	1,250,000	1,250,000
Year 8	4,800,000	1,000,000	100,000	500,000	500,000
Year 9	12,000,000	3,750,000	100,000	1,800,000	1,800,000
Year 10	6,500,000	1,550,000	100,000	775,000	775,000
	59,600,000	14,720,000	1,000,000	7,285,000	7,375,000

Depletion Example (cont.)

	Gross Income	Net Income Before Depletion	Cost Depletion	% Depletion	Depletion Deduction
Year 1	1,500,000	(3,000,000)	100,000	0	0
Year 2	1,200,000	(6,250,000)	100,000	0	0
Year 3	1,600,000	(1,850,000)	100,000	0	0
Year 4	4,000,000	(2,500,000)	100,000	0	0
Year 5	6,500,000	(1,950,000)	100,000	0	0
Year 6	10,000,000	(250,000)	100,000	0	0
Year 7	11,500,000	(40,000)	100,000	0	0
Year 8	4,800,000	150,000	100,000	75,000	100,000
Year 9	12,000,000	3,750,000	100,000	1,800,000	1,800,000
Year 10	6,500,000	1,550,000	100,000	775,000	775,000
	59,600,000	(10,390,000)	1,000,000	2,650,000	2,675,000

Statutory % Depletion Rates

- Coal mines – 10%
- Metal mines (including gold, silver, copper, lead & zinc) – 15%
- Sulphur mines – 23%
- Sand & Gravel - % depletion not allowed

Tax Credits

- Exploration incentive credit – A person may receive a credit for exploration costs incurred up to \$20,000,000. Exploration costs include
 - Surveying
 - Drilling exploration holes
 - Conducting underground exploration
 - Sampling
 - Other exploratory work, i.e. aerial photography, sample analysis, & metallurgical testing

Must be applied within 15 tax years of credit approval and may only be used to offset 50% of tax liability.

Tax Credits (cont.)

- Education Credit – A person may take a credit up to \$150,000 for contributions made to a public or private nonprofit, two or four-year college or university in Alaska.
 - 50% of the first \$100,000 in contributions + 100% of the second \$100,000 in contributions
 - Credit can be taken against 100% of tax liability

Summary

- Tax in effect since 1913
- Increase in revenue due to increase in value of minerals
- State shares in the income of a mining property, but not in the loss
- Most companies have losses during the first 3.5 years of production
- Exploration credit allowed since 1995 to help offset the high cost of mining in the state

Questions



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Pension Obligation Bonds

The Oregon Story

February 14, 2007



SNW

*Oregon vs. Alaska Pension System **

	Oregon	Alaska	
		PERS	TRS
Asset base	\$ 52.9 billion	\$8.6 billion	\$4.0 billion
Covered Employees	324,914	71,009	21,865
Average employer rate	14.80% ⁽¹⁾	21.77% ⁽²⁾	26.00% ⁽³⁾
Projected high rate	30.00% ⁽⁴⁾	35%	64%
Funded ratio	91.00%	65.70%	60.90%
UAAL as of 2005 valuation	\$ 4.6 billion ⁽⁵⁾	\$4.4 billion	\$2.5 billion

* As of December 31, 2005 for Oregon and June 30, 2005 for Alaska.

(1) Tier 1 and Tier 2 only.

(2) 39.76% for 2008. Actuarially computed at 28.19% for 2007 and 32.51% for 2008 by Buck Consultants.

(3) 54.03% for 2008. Actuarially computed at 41.78% for 2007 and 42.26 for 2008 by Buck Consultants.

(4) Prior to reforms.

(5) Not counting bond proceeds in side accounts.

Bonding a Popular Tool

Many Oregon jurisdictions have chosen to finance PERS liabilities with bonds.

- Original statutory authority provided to local governments and school districts in 2001 for issuance of "full faith and credit obligations."
- Jurisdictions also granted authority to enter into intercept agreements with the State, whereby operating funds were additionally pledged. This approach resulted in "State" credit rating.
- State Constitutional amendment approved by voters in 2003 authorizing the State to issue GO bonds for its share of the liability. Voter approval margin was 55.25%.
- Bond proceeds are placed in a "lump sum account" for benefit of employer. Earnings and losses directly accrue to that account.
- Lump sum account is used to provide prepayment credit on payroll rates charged to jurisdictions.
- Although bonds have to be sold on taxable basis, interest rates for most borrowings have been well under 6%.

Alaska Legal Issues

- Under Constitution, "debt" must be for capital improvements and approved by voters.
- Restrictions do not apply to "Certificates of Participation" or other obligations subject to appropriation.
- Subject-to-appropriation debt is somewhat more expensive than full faith and credit debt.
- Although some home rule municipalities may be able to issue obligations under their own charter provisions, there is no general statutory authority for the issuance of pension obligation bonds.
- HB13 would provide authority for the issuance of obligations for this purpose.

Oregon Bonding Examples

Date	Issuer	Par Amount	TIC	PV Savings
September 2005	Local Governments- 12 jurisdictions	\$ 186 m	5.04%	\$ 57 m
June 2005	OSBA - 16 school districts	\$ 492 m	4.77	\$ 171 m
June 2005	OCCA - 6 community colleges	\$ 57 m	4.86	\$ 19 m
May 2004	Local Government Pool - 10 cities, counties, special districts	\$ 126 m	6.11	\$ 23 m
February 2004	OSBA - 23 school districts	\$ 400 m	5.49	\$ 120 m
	OCCA - 6 community colleges	\$ 100 m	5.49	\$ 25 m
October 2003	State of Oregon	\$ 2,000 m	5.78	\$ 481 m
April 2003	OSBA - 44 school districts	\$ 927 m	5.73	\$ 230 m
	OCCA - 6 community colleges	\$ 153 m	5.72	\$ 37 m
October 2002	OSBA - 41 school districts	\$ 775 m	5.60	\$ 207 m
March 2002	Local Government Pool - 10 cities, counties, special districts	\$ 238 m	7.00	\$ 21 m
	Total	\$ 5,454 m		\$ 1,391 m ⁽¹⁾

(1) Assumes 8% return.

Miscellaneous other cities, counties and special districts have sold bonds since 1999 at rates ranging from 6.50% to 7.80%, totaling in excess of \$1 billion dollars.

Recent Returns – Lump Sum Accounts

Issuer	Par Amount	TIC	Total Return	Annualized
Series 2005 - Local Government Pool	\$ 186 m	5.04%	19.27%	15.42%
Series 2005 School District Pool	\$ 492 m	4.77%	26.43%	17.62%
Series 2005 Community College Pool	\$ 57m	4.86%	26.43%	17.62%
Series 2004 - Local Government Pool	\$ 126 m	6.11%	46.96%	18.18%
Series 2004 - School District and Community College Pool	\$ 400 m	5.49%	46.06%	16.26%
Series 2003- School District and Community College Pool	\$ 1,080 m	5.73%	79.60%	21.71%
Series 2002 - School District Pool	\$ 775 m	5.60%	88.03%	21.13%
Series 2002 A&B - Local Government Pool	\$ 238 m	7.00%	69.15%	14.56%

NOTE: Earnings reflected through December 31, 2006.

Oregon vs. Alaska: Potential Savings

<u>Oregon</u>		<u>Alaska</u>		<u>PERS</u>	<u>TRS</u>
Par Amount Issued:	\$5.4 billion	Total System Par Amount:	\$5.0 billion		\$2.9 billion
Number of Jurisdictions:	175	Number of Jurisdictions:	All		All
Average TIC %:	5.65% ⁽¹⁾	Assumed TIC:	6.00%		6.00%
Projected PV Savings:	\$1.4 billion ⁽²⁾	Projected PV Savings:	\$1.123 billion ⁽³⁾		\$652 million ⁽³⁾
Projected Savings %:	26% ⁽²⁾	Projected Savings %:	22% ⁽³⁾		22% ⁽³⁾

(1) Issued between 2002 and 2005.

(2) At assumed rate of 8%.

(3) At assumed rate of 8.25%.

Considerations

Payment to PERS does NOT guarantee UAAL will be paid off in full.

1. Changes in Calculation of UAAL

- Judicial, legislative, regulatory or investment activities can cause future changes to UAAL. Further increases would continue to be responsibility of jurisdiction.
 - Reductions: Lump sum payment would put jurisdiction in surplus. Funds will not be returned to jurisdiction, but surplus is used to reduce payroll rates further.
 - Increases: Lump sum payment would defray total deficit. UAAL would not be as high as would otherwise be the case.

In any case, arbitrage risks remain the same for existing lump sum payment.

Considerations

2. Variations in crediting rate due to changes in payroll growth
 - Rate adjustment will be different in each valuation based upon actual vs. projected growth in payroll.
 - Timing of rate adjustment may cause short-term cash flow mismatch.
3. Bond Related Considerations
 - Bonds are not likely to be subject to early redemption.
 - Rating agencies will scrutinize structure carefully to ensure payment of liability is not further deferred.
 - Changes "soft" liability to "hard" liability, which may put some limitations on financial flexibility.
4. PERS Regulatory and Accounting Issues
 - Adequate protection and proper accounting of lump sum account are critical issues.
 - Oregon statutes and regulations needed to be modified to ensure that the employers making the deposit were the ones getting the credit. HB13 would provide for this in Alaska.

Lessons Learned

- Legislative reforms were necessary to make most significant reductions in cost.
- Pension Obligation Bonding worked to help defray some of the costs, but it is critical to fully understand all risks.

Questions?

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Presentation to the State of Alaska

Pension Obligation Bonds – Overview of Structure and Current Market Opportunities

February 14, 2007

A number of factors have caused a steady growth in unfunded pension and OPEB liabilities nationwide since 2000.

- Funding ratios for Public Pension Funds grew from around an 80% in 1990 to over 100% funded in 2001.
 - Led to the negotiation of more generous benefit contracts with public employees in many states
- Funding ratios fell significantly after 2001, creating an unfunded liability of over \$340 billion nationally by 2005^(a).
 - By 2002, state pension assets nationally fell by \$120 billion – largely as a result of negative investment returns.
 - Over the same period, liabilities grew by 10%
- Exponential growth in Other Post Employment Benefit (OPEB), primarily medical, costs has further contributed to unfunded liabilities of state and local governments.
- *Standard and Poors* refers to the unfunded liability as a crisis because they view the unfunded pension liability the same as they view debt^(a).

Alaska's pension funding experience has been similar to other state pension systems.

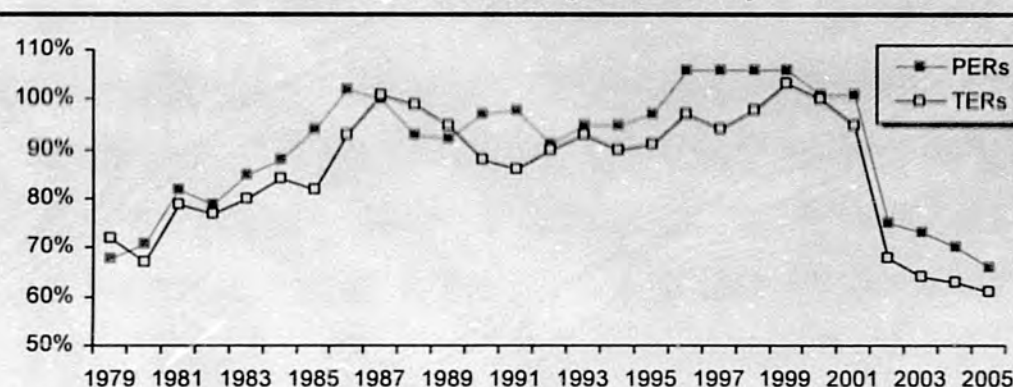
- In 1999 the funding ratios for PERS and TRS were 106% and 103%, respectively.

The current funding ratios for the PERS and TRS Programs is 65.7% and 60.9%, respectively. Accordingly, the State has a large Unfunded Actuarial Accrued Liability ("UAAL")

Funding Status as of June 30, 2005^(a)

	PERS		TRS		Total	
	2004	2005	2004	2005	2004	2005
Valuation Assets ^(a)	\$8,030,414	\$8,442,919	\$3,845,370	\$3,958,939	\$11,875,784	\$12,401,858
Accrued Liability ^(a)	\$11,443,916	\$12,844,841	\$6,123,600	\$6,498,556	\$17,567,516	\$19,343,397
UAAL ^(a)	\$3,413,502	\$4,401,922	\$2,278,230	\$2,539,617	\$5,691,732	\$6,941,539
Funding Ratio (Valuation Assets)	70.2%	65.7%	62.8%	60.9%	67.6%	64.1%

PERS and TRS Funding Ratio History



- "Informally, it is believed that an 80% ratio is the demarcation between a serious and a manageable underfunding situation. If a fund's ratio exceeds 80%, it is likely that investment returns combined with increased contributions will be able to restore the ratio to a level much closer to 100%. However, pension funds with ratios below 80% are likely to face a contribution increase that will significantly strain the budget of the underlying government. Further, if the requirement is not met, the problem is compounded. Like a snowball rolling down hill, the pension obligation then becomes difficult to manage and can significantly affect the government's operating budget."^(b)

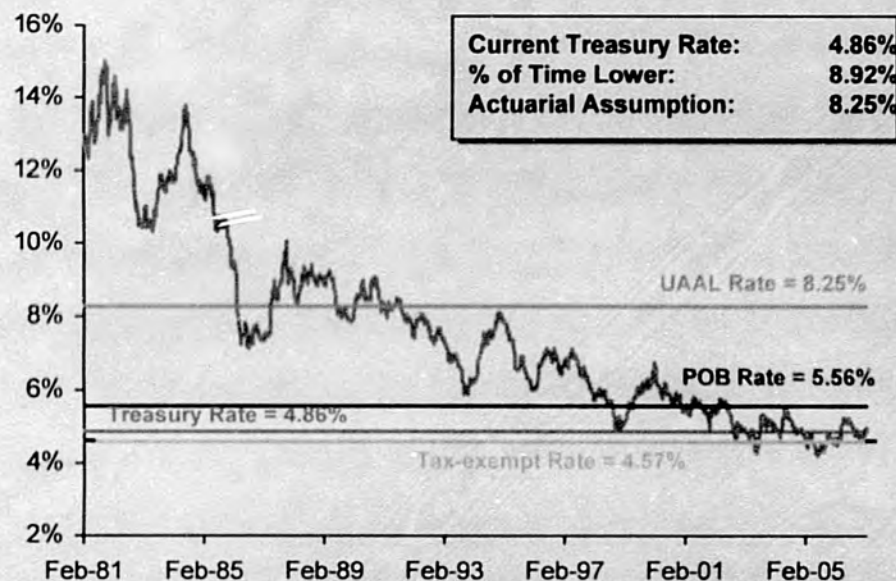
An Unfunded Accrued Actuarial Liability (UAAL) is the difference between the assets currently in the pension fund and the present value of the required payments to existing plan participants over time.

- Each year the State's pension systems review the assumptions in the pension fund actuarial report to determine the required payment stream and compare it to the earnings potential of the assets on hand.
- The pro forma annual shortfall is then discounted at the assumed interest rate (8.25%) to determine the present value of the shortfall known as the UAAL.
- The UAAL, therefore, represents an unfunded liability (i.e. debt) of the State to its plan participants, carrying an interest rate of 8.25% and amortizes like debt.
- This debt obligation to plan participants is constitutionally protected by Article XII, § 7 of the Alaska State Constitution.

Pension Obligation Bonds (POBs) may be used to refinance at a lower cost the State's existing debt to its plan participants.

- This is an ideal time to lock in low rates on POBs and maximize potential cost reductions.
 - Interest rates are near historical lows.
- Taxable POBs would have an all-in True Interest Cost (TIC) of 5.56%^(a) compared to the 8.25% rate on the UAAL liability.
- Potential savings to the State from a POB refinancing are significant.
 - Assuming funding 80% of the UAAL on PERS, the State could issue \$2.1 Bn of bonds for \$626.6 million savings^(b).
 - Assuming funding 80% of the UAAL on TRS, the State could issue \$1.3 Bn of bonds for \$384.2 million savings^(b).

Current 30 Year Treasury and Estimated Yields



Note: As of Close of Business February 9, 2007.

POBs can be used as a single tool or in combination with other strategies to achieve the State's UAAL funding objectives.

■ Factors impacting size of UAAL

- Actuarial assumptions – life expectancy, demographics, etc.
- 8.25% Actuarial Assumed Rate of Return
- Actual Investment Returns
- Changes in contractual benefits
- Benefits cost assumptions vs. actual/experienced, especially medical



- Due to these variables the size of the UAAL is constantly shifting.
- Most pension systems target a funded ratio of 80% to 90% to avoid dramatically under or over-funding^(a).

■ Options for funding UAAL

- Upfront cash contribution from State or employer reserves
- Increased annual employer contributions
- Prefund with Pension Bond proceeds at 5.56%^(b) interest rate



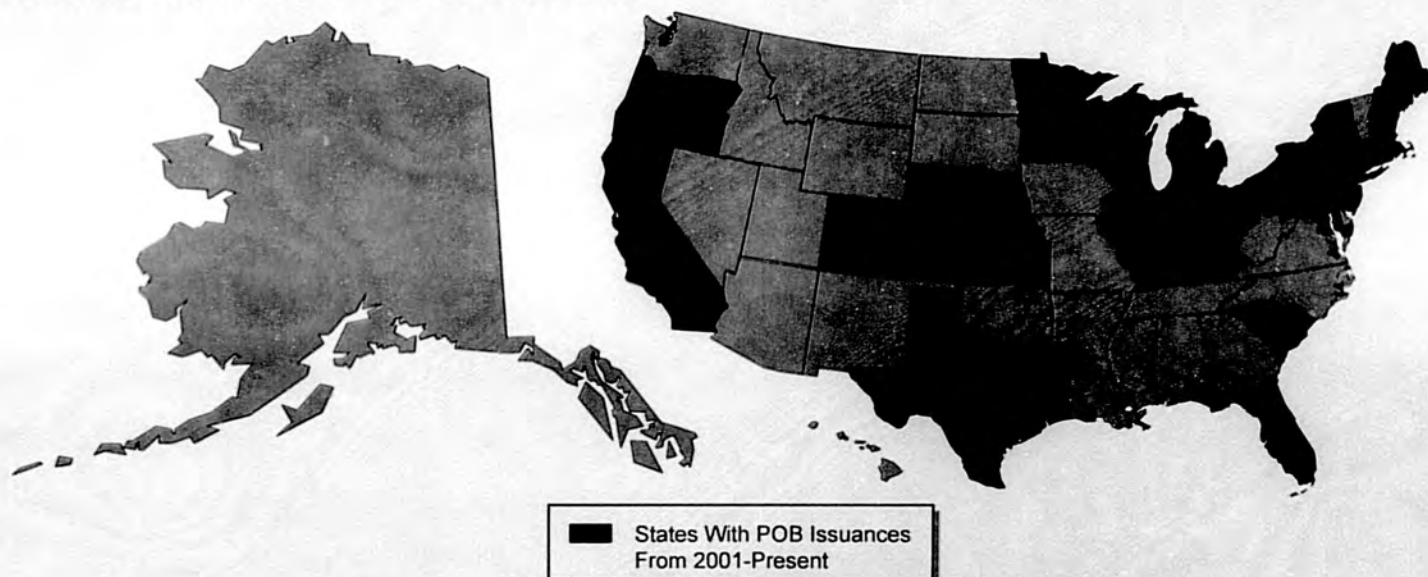
- Pension systems can develop a strategy for reaching the target funding ratio using a variety of funding options.
- Strategies should address both political sensitivities and budget constraints.
- UAAL funding cost savings can likely be achieved through the use of POBs.

As a result of the growth in unfunded pension liabilities and ideal market conditions, there have been a number of POB issuances over the last few years.

- One study of POBs in 2004 concluded that 84% were profitable to their issuers with another 7% at a breakeven, leaving only 9% that have lost money.

Since 2001 over \$29 billion of POBs have been issued nationwide

- \$800 million Detroit Retirement System Fund (6/06)
- \$2.1 billion State of Oregon (10/03)
- \$10 billion State of Illinois (06/03)
- \$927 million Oregon School Boards Association (04/03)



POB Issues by Year

Year	Amount (\$Mn)	Number of Issues
2006	\$1,408.34	10
2005	3,971.32	37
2004	3,676.42	32
2003	17,685.31	71
2002	2,599.31	25
2001	536.64	9
	\$29,877.33	184

POB Issues by Size

Issue Size (\$Mn)	Amount (\$Mn)	Number of Issues
\$100 and under	\$3,292.09	134
\$100-250	4,275.92	28
\$250-500	4,928.48	13
Over \$500	17,380.82	9
	\$29,877.33	184

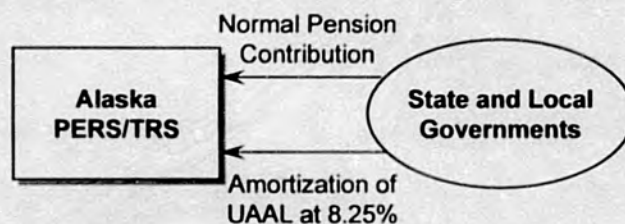
Rating agencies have varying views of pension liabilities and their effect on issuers' credit.

- Moody's generally incorporates a view of the 'soft' cost of unfunded pension liabilities in their debt calculations.
 - Issuing debt to fund the unfunded pension liability is moving a 'soft' cost to a 'hard' cost.
 - Should not have an impact on debt rating
- S&P does not include pension liabilities in the calculation of debt ratios, but incorporates them in the overall rating analysis.
- Implementing a plan to address the existing UAAL and a funding plan for future obligations could be considered a credit positive.
- Issuing pension bonds to pay down UAAL without setting policies for funding liabilities and granting benefits may be viewed as a partial solution by the credit agencies.

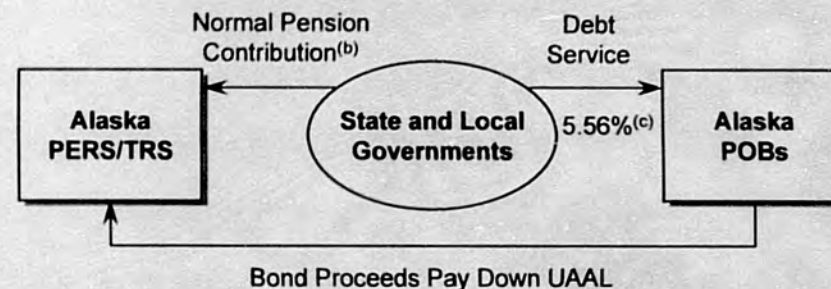
Pension Obligation Bond Mechanics

- Currently the total annual employer contribution for pension liabilities is comprised of two major components:
 - The "normal pension contribution" to meet the annual pension expenses accrued in the current fiscal year;
 - The "UAAL component" is sized to help amortize unfunded liabilities over some period of time.
- As the UAAL has grown in recent years, the second component has become increasingly larger.
- To achieve an 80% funding level the State needs to contribute the following amounts through cash or POBs:
 - \$2.1 billion for PERS^(a)
 - \$1.3 billion for TRS^(a)
- The mechanism could be structured so that employer contributions and debt service do not exceed current contribution levels.

Pension/UAAL Payments Before POBs



Pension/UAAL Payments After POBs



Recognizing and managing risks is key to POB success.

Benefits

■ Arbitrage

- The broad range of investments utilized by pension funds generally result in returns substantially higher than today's debt rates.
- Returns above assumed actuarial investment return will produce greater than expected savings from POBs.
- Returns below assumed actuarial investment return but above POB yield will produce savings, but less than projected.

■ Local Government Benefit

- POBs can be used to improve relations with local governments and political subdivisions by providing more security with a higher funding ratio.
- POBs will permit more stable budget planning for all participants in PERS and TRS

Risks

■ Arbitrage Risk

- Returns below the bond interest rate will result in negative earnings.

■ Conversion of "soft" obligation to "hard" obligation.

■ Market risk

- POBs result in a lump-sum payment into a pension fund, concentrating rather than spreading market timing risk.

Authority to Issue POBs in Alaska

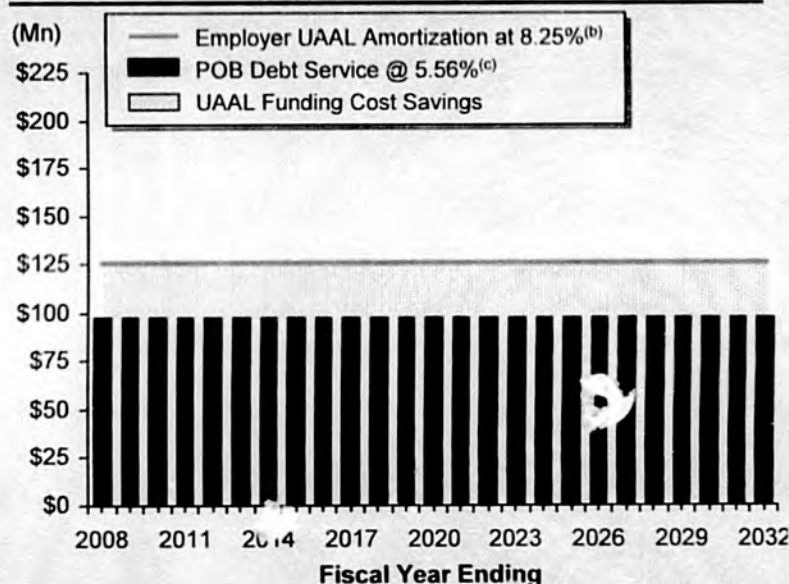
- Since the State Constitution limits the issuance of general obligation debt to capital improvements, POBs cannot be issued as general obligations.
- State issuance of POBs will require new legislative authority. Debt service payment on POBs will be subject to annual appropriation.
- Substantial market demand exists for POBs issued by the State of Alaska and secured by an annual appropriation pledge.
- Alaska could consider a pooled pension obligation program whereby the State's credit serves as backstop to PERS participants or it could create legislative authority for local governments to issue POBs individually, similar to last year's proposed House legislation that would have allowed the Bond Bank to serve as the conduit for such issuers.
- Home rule municipal governments may be able to issue POBs under their charter provisions:
 - Anchorage, Juneau, Sitka, Fairbanks

POB proceeds invested in the pension system are expected to have returns that are higher than the POB borrowing rate, creating significant UAAL funding cost savings.

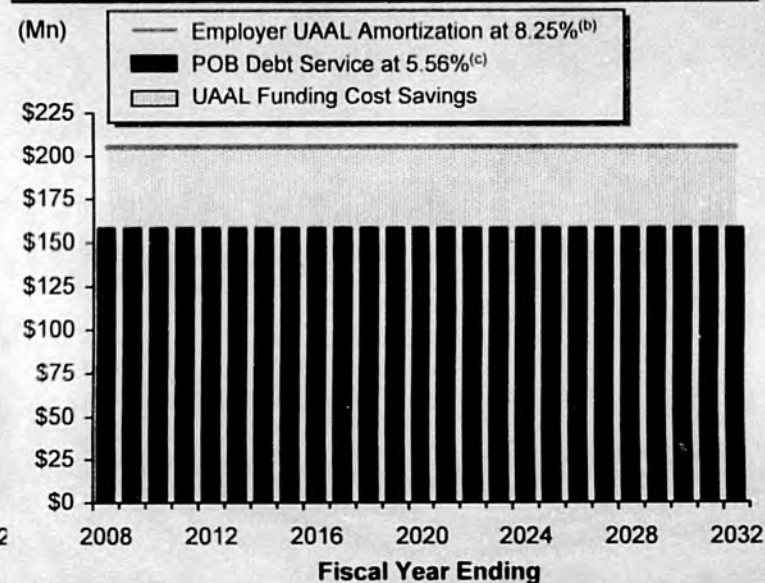
TRS POB Program (000s)	
Target Funding Ratio:	80%
Par:	\$1,320,045
All-in TIC:	5.56%
Assumed Pension System IRR:	8.25%
Estimated Gross Savings^(a)	\$720,166
Estimated PV Savings: ^(a)	\$384,157
Average Annual Employer Contribution Savings:	\$28,806

PERS POB Program (000s)	
Target Funding Ratio:	80%
Par:	\$2,145,330
All-in TIC:	5.56%
Assumed Pension System IRR:	8.25%
Estimated Gross Savings^(a)	\$1,174,594
Estimated PV Savings: ^(a)	\$626,563
Average Annual Employer Contribution Savings:	\$46,984

TRS Payment Structure



PERS Payment Structure



- (a) Estimate. Assumes 8.25% earning rate on investment and PV rate of 5.56%. Savings dependent on actual investment performance
 (b) Assumed level amortization of UAAL based on the Department of Administration of PERS and TRS report dated 2/2/2007. All other assumptions based on the Buck Consultants Actuarial Valuation Report dated 9/15/2006.
 (c) Cost of debt service based on current market conditions.

Summary of Changes in Employer Contribution Rates

Teachers' Retirement System – 8.25% Earning Rate

UAAL: \$2.5 Billion as of June 30, 2005

- The matrix provides employer contribution rates required to achieve a target funding ratio of 80% by 2032, given corresponding cash contributions and POB issuances.

Status Quo Contribution Rate 44.96%	Pension Obligation Bond			
	\$0	\$500 Mn	\$750 Mn	\$1 Bn
Cash Contribution	10 yr. Avg. Employer Contribution Rate	10 yr. Avg. Employer Contribution Rate	10 yr. Avg. Employer Contribution Rate	10 yr. Avg. Employer Contribution Rate
\$0	44.96%	43.84%	43.28%	42.72%
\$250 Mn	41.39%	40.27%	39.71%	39.15%
\$500 Mn	37.82%	36.70%	36.14%	NA
\$750 Mn	34.25%	33.13%	NA	NA
\$1 Bn	30.68%	NA	NA	NA

Annual
Contribution
Rate
40.27%

- Through a combination of a \$250 million cash infusion and \$500 million POB issuance, the State can lower their projected annual contribution rate from 44.96% to 40.27% while still achieving a funding ratio of 80% in 2032.
- A decrease of 5% in the employer contribution rate equates to \$31.2 million annually.
- Instead of a one-time up-front payment, the contribution could be spread over a period of years.
 - An annual contribution of \$250 million for 3 years would lower the contribution rate to 35.04%.

Note: Estimate, Savings dependent on actual investment performance.

Assumed level amortization of UAAL based on the Department of Administration of PERS and TRS report dated 2/2/2007. All other assumptions based on the Buck Consultants Actuarial Valuation Report dated 9/15/2006.

Summary of Changes in Employer Contribution Rates

Public Employees' Retirement System – 8.25% Earning Rate

UAAL: \$4.4 Billion as of June 30, 2006

- The matrix provides employer contribution rates required to achieve a target funding ratio of 80% by 2032, given corresponding cash contributions and POB issuances.

Status Quo Contribution Rate 29.53%	Pension Obligation Bond		
	\$0	\$1.0 Bn	\$2.0 Bn
Cash Contribution	10 yr. Avg. Employer Contribution Rate	10 yr. Avg. Employer Contribution Rate	10 yr. Avg. Employer Contribution Rate
\$0	29.53%	28.84%	28.15%
\$250 Mn	28.36%	27.66%	NA
\$500 Mn	27.18%	26.49%	NA
\$750 Mn	26.01%	25.31%	NA
\$1 Bn	24.83%	24.14%	NA

Annual
Contribution
Rate
26.49%

- Through a combination of a \$500 million cash infusion and \$1 billion POB issuance, the State can lower their projected annual contribution rate from 29.53% to 26.49% while still achieving a funding ratio of 80% in 2032.
- A decrease of 5% in the employer contribution rate equates to \$94.8 million annually.
- Instead of a one-time up-front payment, the contribution could be spread over a period of years.
 - An annual contribution of \$250 million for 3 years would lower the contribution rate to 26.27%.

Note: Estimate, Savings dependent on actual investment performance.

Assumed level amortization of UAAL based on the Department of Administration of PERS and TRS report dated 2/2/2007. All other assumptions based on the Buck Consultants Actuarial Valuation Report dated 9/15/2006.

Sensitivity of Employer Contribution Rates to a 8.1% Earnings Rate Teachers' Retirement System

- The matrix provides employer contribution rates required to achieve the target funding ratio of 80% by 2032 assuming the actual earnings rate achieved is 8.1%.

	Pension Obligation Bond			
	\$0	\$500 Mn	\$750 Mn	\$1 Bn
Cash Contribution	10 yr. Avg. Employer Contribution Rate	10 yr. Avg. Employer Contribution Rate	10 yr. Avg. Employer Contribution Rate	10 yr. Avg. Employer Contribution Rate
\$0	46.09%	45.07%	44.55%	44.04%
\$250 Mn	42.57%	41.54%	41.03%	40.52%
\$500 Mn	39.04%	38.02%	37.50%	NA
\$750 Mn	35.52%	34.49%	NA	NA
\$1 Bn	31.99%	NA	NA	NA

- Lowering the assumed earnings rate on the system from 8.25% to 8.1% increases the projected Employer Contribution Rate by approximately 1% annually.
- All other variables used to calculate and amortize the UAAL are assumed to remain the same.
- A lower actuarial assumed earning rate will increase the size of the UAAL.

Note: Estimate, Savings dependent on actual investment performance.

Assumed level amortization of UAAL based on the Department of Administration of PERS and TRS report dated 2/2/2007. All other assumptions based on the Buck Consultants Actuarial Valuation Report dated 9/15/2006.

Sensitivity of Employer Contribution Rates to a 8.1% Earnings Rate Public Employees' Retirement System

- The matrix provides employer contribution rates required to achieve the target funding ratio of 80% by 2032 assuming the actual earnings rate achieved is 8.1%.

	Pension Obligation Bond		
	\$0	\$1.0 Bn	\$2.0 Bn
Cash Contribution	10 yr. Avg. Employer Contribution Rate	10 yr. Avg. Employer Contribution Rate	10 yr. Avg. Employer Contribution Rate
\$0	30.48%	29.84%	29.21%
\$250 Mn	29.32%	28.68%	NA
\$500 Mn	28.15%	27.52%	NA
\$750 Mn	27.00%	26.36%	NA
\$1 Bn	25.83%	25.20%	NA

- Lowering the assumed earnings rate on the system from 8.25% to 8.1% increases the projected Employer Contribution Rate by approximately 1% annually.
- All other variables used to calculate and amortize the UAAL are assumed to remain the same.
- A lower actuarial assumed earning rate will increase the size of the UAAL.

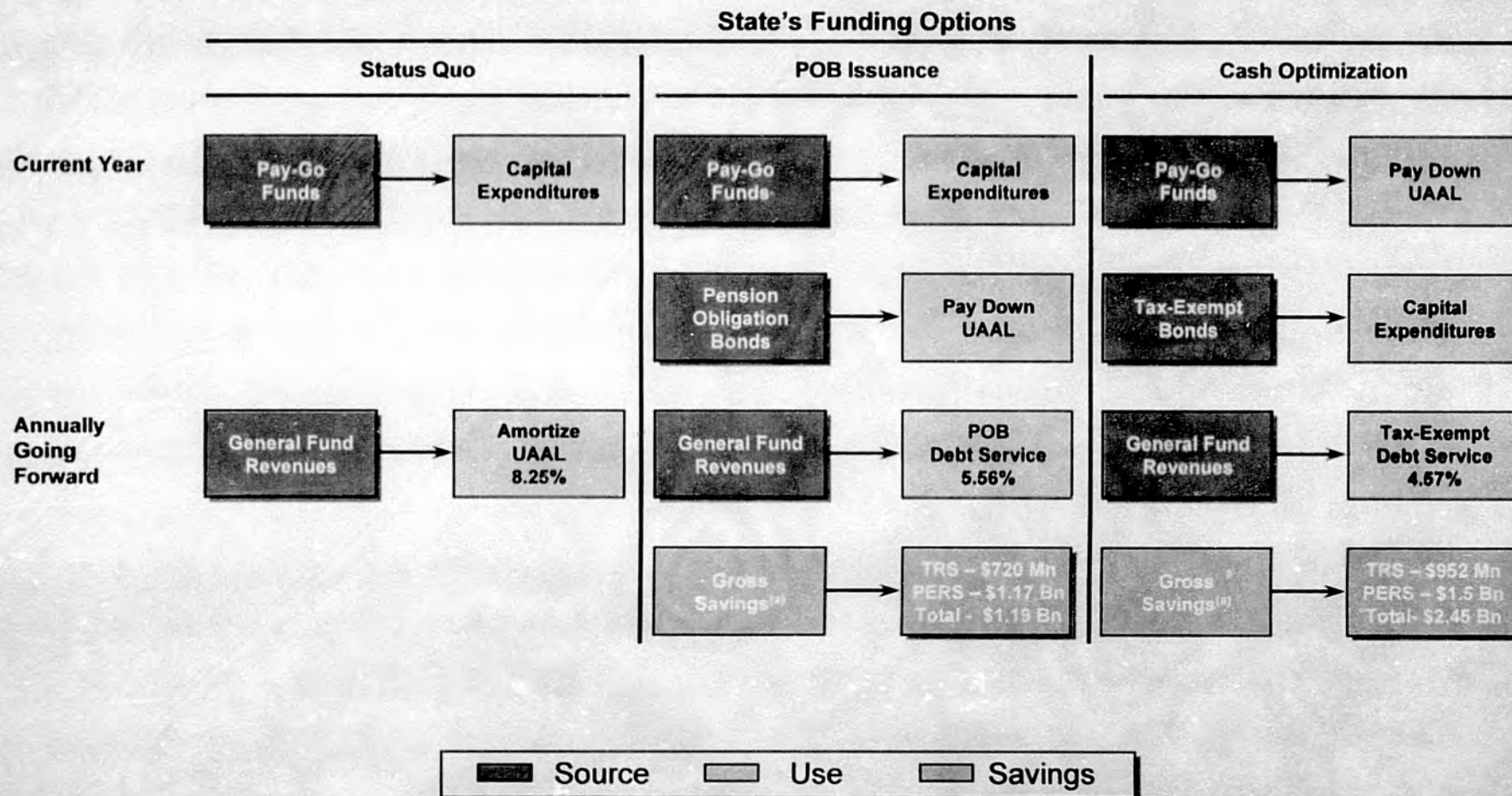
Note: Estimate, Savings dependent on actual investment performance.

Assumed level amortization of UAAL based on the Department of Administration of PERS and TRS report dated 2/2/2007. All other assumptions based on the Buck Consultants Actuarial Valuation Report dated 9/15/2006.

A Cash Optimization Program could provide a cost-effective strategy to reduce the State's overall portfolio cost.

- Under a Cash Optimization Program, the State re-deploys General Fund revenues, currently projected to be used for current Capital Expenditures, to make contributions to the pension system to reduce the UAAL.
- Capital Expenditures that would otherwise have been funded with current funds are funded with tax-exempt bonds.
- Revenues from the General Fund are re-deployed to pay debt service on tax-exempt bonds.
- The net effect is a reduction in borrowing costs for the State's overall portfolio and an increase in the benefit of funding the UAAL.

Using Cash Optimization, the State achieves all of its policy goals at an overall lower net cost.



A Cash Optimization Program provides a cost-effective strategy to reduce the State's cost to amortize the UAAL of the TRS program.

- A Taxable Pension Obligation Bond decreases the State's imputed cost of capital of 8.25% to 5.56%.
- A cash optimization program with tax-exempt financing results in a borrowing cost for the State on its debt of 4.57%.
- Assuming a \$1.2 billion issuance, the net benefit of the lower cost to the State translates into an increase in gross savings of \$232 million, which is equivalent to a 1.49% reduction to the average annual employer contribution rate.

TRS Program (000s)	
Target Funding Ratio:	80%
Par:	\$1,247,015
All-in TIC:	4.57%
Assumed IRR:	8.25%
Estimated Gross Savings:	\$951,890
Estimated PV Savings: ^(a)	\$560,544

(a) Estimate. Assumes 4.57% PV Rate. Savings dependent on actual investment performance

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25th Alaska State Legislature

House Special Committee on Ways & Means

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Changes between HB 13 and CS HB 13 (W&M) – work draft 25-LS0084\E

The major changes between HB 13 and CS HB 13 work draft version E are the requirement for an employer's contribution rate to be recalculated within 180 days of a lump sum payment authorized under this bill, the authorization for the Alaska Housing Finance Corporation and the state bond committee to participate in the sale of Pension Obligation Bonds, and the creation of the Alaska Pension Obligation Bond Corporation.

- Added new sections to require the plan administrator to recalculate the employer's contribution rate within 180 days of a lump sum payment to reduce their unfunded accrued actuarial liability (page 2, lines 27-28 and page 17, line 31 – page 18, line 4).
- Authorized the Alaska Housing Finance Corporation to create a subsidiary corporation to assist in the financing of Pension Obligation Bonds (new sections 2-5).
- Authorized the state bond committee to assist in the financing of Pension Obligation Bonds and set guidelines and requirements for bond issuance, sale, structure, repayment and the investment and accounting of bond and investment proceeds (new Section 7).
- Created the Alaska Pension Obligation Bond Corporation to assist in the financing of Pension Obligation Bonds, defined its organization and structure, and set guidelines and requirements for bond issuance, sale, structure, repayment and the investment and accounting of bond and investment proceeds (new section 8).
- Necessary title and conforming amendments to accommodate new language (page 1, lines 2-4 and lines 5-7; page 2, lines 5-7; page 4, lines 18-20; and page 5, lines 6-8).

CS House Bill 13
Work Draft Version E
Sectional Analysis

Prepared by Representative Mike Hawker's Office

Section 1: Allows a Teacher's Retirement System (TRS) employer to make a lump sum payment to prepay all or a part its share of the unfunded accrued actuarial pension liability (UAAL); allows the commissioner to accept a lump sum payment that is less than the full amount; allows administrative fees to be charged; outlines how the lump sum payment and earnings or losses will be credited; and holds an employer who prepays its liability harmless if there are future state discretionary payments that benefit multiple employers.

NEW SECTION (b): Requires the administrator of the TRS plan to recalculate the employer contribution rate within 180 days of the lump sum prepayment authorized under (a) of this section.

Sections 2 - 5: **NEW:** These sections allow the Alaska Housing Finance Corporation (AHFC) to create a subsidiary to aid an employer in the financing of a prepayment of all or a portion of that employer's UAAL.

Section 6: **PREVIOUS SECTION 2.** Outlines how municipalities can join together to issue debt obligations and allows funds diversion agreements between the municipalities and state agencies. **New CS ADDS:** "a subsidiary of the Alaska Housing Finance Corporation, the state bond committee, or the Alaska Pension Obligation Bond Corporation" in sections (a) and (c).

Section 7: **NEW SECTION:** Adds Article 8 to the State Bonding Act, which authorizes the state bond committee to issue Pension Obligation Bonds (POBs) and provides guidelines and requirements for bond issuance, sale, structure, repayment and the investment and accounting of bond and investment proceeds.

Section 8: **NEW SECTION:** Creates the Alaska Pension Obligation Bond Corporation, which is authorized to issue POBs. Provides guidelines and requirements for bond issuance, sale, structure, repayment and the investment and accounting of bond and investment proceeds.

Sections 9 & 10: **PREVIOUS SECTIONS 3 & 4:** Adds facilitating language to two sections of the accounting statute for the Public Employees Retirement System (PERS) to accommodate the lump sum payments allowed in section five of this bill.

Section 11: **PREVIOUS SECTION 5:** Allows a PERS employer to make a lump sum payment to prepay all or a part its share of the accrued actuarial pension liability; allows the commissioner to accept a lump sum payment that is less than the full amount; allows administrative fees to be charged; outlines how the lump sum payment and earnings or losses will be credited; and holds an employer who prepays its liability harmless if there are future state discretionary payments that benefit multiple employers.

NEW SECTION (e): requires the administrator of the PERS plan to recalculate the employer contribution rate within 180 days of the lump sum prepayment authorized under (d) of this section.

Section 12: **PREVIOUS SECTION 6:** Adds to the statutory policies established for the Municipal Bond Bank Authority. Provides a directive to assist governmental employers to meet their unfunded retirement system obligations by issuing debt instruments (often generally called Pension Obligation Bonds) on their behalf. Specifies that the bond bank should provide the lowest rates possible without subsidizing the employers beyond their means.

Section 13: **PREVIOUS SECTION 7:** Grants the Municipal Bond Bank Authority the power to create subsidiary entities to assist governmental employers as outlined in section eight of this bill.

Section 14: **PREVIOUS SECTION 8:** New statute defining the powers of the Municipal Bond Bank Authority to engage in "Pension Obligation Bond" transactions on behalf of governmental employers.

Section 15: **PREVIOUS SECTION 9:** Exempts "Pension Obligation Bonds" from the current limit for revenue bonds that the Municipal Bond Bank may issue each year.

Section 16: **PREVIOUS SECTION 10:** Authorizes the Municipal Bond Bank to issue "Pension Obligation Bonds."

Section 17: **PREVIOUS SECTION 11:** Exempts "Pension Obligation Bonds" from the current limit for total revenue bonds and notes that the Municipal Bond Bank may have outstanding at any time.

Section 18: **PREVIOUS SECTION 12:** Adds a definition for "governmental employer" to the definitions section for the Municipal Bond Bank.

Section 19: **PREVIOUS SECTION 13:** Immediate effective date.

An Introduction to



Pension Obligation Bonds

ROGER L. DAVIS


ORRICK