

STATE OF ALASKA

DEPARTMENT OF ADMINISTRATION

OFFICE OF THE COMMISSIONER

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The Honorable Sean Parnell, Governor
Members of the Legislature
Citizens of the State of Alaska

In accordance with Alaska Statute (AS) 37.05.210, it is our pleasure to present the Comprehensive Annual Financial Report (CAFR) of the State of Alaska for the fiscal year ending June 30, 2012. This report has been prepared by the Department of Administration, Division of Finance. Responsibility for both the accuracy of the data, and the completeness and fairness of the presentation, including all disclosures, rests with the State. To the best of our knowledge and belief, the enclosed data is accurate in all material respects and reported in a manner designed to present fairly the financial position and results of operations of the State. Statistical and demographic information are included to enable the reader to gain an understanding of the State's financial activities.

INTRODUCTION

Internal Controls

The Department of Administration, Division of Finance, is primarily responsible for the overall operation of the State's central accounting system. The State's system of internal controls over the accounting system has been designed to provide reasonable, but not absolute, assurance regarding the safeguarding of assets against loss from unauthorized use or disposition, and the reliability of financial records for preparing financial statements and maintaining accountability for assets. The concept of reasonable assurance recognizes that the cost of a control should not exceed the benefits likely to be derived, and the evaluation of costs and benefits requires estimates and judgments by management.

Some component units operate outside the State's central accounting system. Those component units are responsible for establishing and maintaining their own separate internal control structures.

Audits

The Division of Legislative Audit is the principal auditor of the State's reporting entity. The audit of the CAFR was conducted in accordance with generally accepted auditing standards (GAAS). The independent auditor's report is the first item in the financial section of the CAFR and precedes the MD&A and basic financial statements. The goal of the independent audit is to provide reasonable assurance that the financial statements of the State for the fiscal year ended June 30, 2012, are free of material misstatement. The audit involved examining, on a test basis, evidence supporting the amounts and disclosures in the CAFR, assessing the accounting principles used, and evaluating the overall financial statement presentation.

In addition to the annual audit of the State's CAFR, the State is required to undergo an annual single audit in conformity with the provisions of the Single Audit Act of 1984 and the U.S. Office of Management and Budget's Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*. Information related to this single audit, including a schedule of expenditures of federal awards, the auditor's reports on internal controls and compliance with applicable laws and regulations, and a schedule of findings and questioned costs will be published at a later date under separate cover by the Division of Legislative Audit.

Management's Discussion and Analysis (MD&A)

Governmental Accounting Standards Board Statement No. 34 requires that management provide a narrative introduction, overview, and analysis of the State's financial activities. This transmittal letter is intended to complement the MD&A and should be read in conjunction with it. The MD&A can be found immediately following the independent auditor's report.

PROFILE OF THE STATE OF ALASKA

The State of Alaska was the 49th state admitted into the Union in 1959. The Alaska Constitution was adopted by the Constitutional Convention February 5, 1956, ratified by the people of Alaska April 24, 1956, and became operative with the formal proclamation of statehood January 3, 1959.

There are three branches of government: legislative, executive, and judicial. The legislative power of the State is vested in a legislature consisting of a Senate with a membership of 20 and a House of Representatives with a membership of 40. The executive power of the State is vested in the governor. The judicial power of the State is vested in a supreme court, a superior court, and the courts established by the legislature. The jurisdiction of courts and judicial districts are prescribed by law. The courts constitute a unified judicial system for operation and administration.

The State of Alaska reporting entity reflected in this CAFR, which is described more fully in Note 1 to the basic financial statements, conforms with the requirements of Governmental Accounting Standards Board Statement No. 14, *The Financial Reporting Entity*. These criteria include financial accountability, fiscal dependency, and legal standing. The concept underlying the definition of the financial reporting entity is that elected officials are accountable to their constituents. The financial statements should allow users to distinguish between the primary government (the State) and its component units, with the emphasis being on the primary government. Consequently, this transmittal letter, the MD&A, and the financial statements focus on the State and its activities. Although information pertaining to the discretely presented component units is provided, their separately issued financial statements should be read to obtain a complete overview of their financial position.

The State provides a range of services including education, health and human services, transportation, law enforcement, judicial, public safety, community and economic development, public improvements, and general administrative services.

Budgetary Control

The State maintains budgetary controls. The objective of these controls is to ensure compliance with legal provisions embodied in the budget appropriated annually by the legislature. Annual operating budgets are adopted through passage of appropriation bills (session laws) by the legislature with approval by the governor. These laws also identify the source of funding for the budgeted amounts. Control is maintained at the departmental level by recording budgeted amounts, funding sources, expenditures, and

encumbrances within the appropriation structure in the State's central accounting system. Open encumbrances are reported as reservations of fund balance at the end of the fiscal year.

ECONOMIC CONDITION AND OUTLOOK

Economy

The well-being of the State of Alaska is best reflected in the operations of the General Fund. The General Fund is the State's primary operating fund and accounts for all financial resources except those required to be accounted for in another fund. The State maintains many accounts and subfunds (created by law) that are accounted for and reported within the General Fund. Four of the most notable are the Constitutional Budget Reserve Fund, the Statutory Budget Reserve Fund, the Permanent Fund Dividend Fund, and the Public Education Fund. Because of materiality and public interest in these funds, individual fund data for each is provided in the combining statements for the General Fund included in this report.

The table below shows General Fund revenues by category for the current and previous fiscal year. Clearly, the State's major source of unrestricted revenue is related to petroleum taxes, rents, and royalties. In FY 12, petroleum revenue increased \$2 billion to 71 percent of all General Fund revenues.

The largest source of nonpetroleum revenues is federal, which makes up 20 percent of revenues. During FY 09, Governor Palin signed the certification required to receive federal funding under the American Recovery and Reinvestment Act of 2009. Alaska is authorized to receive nearly \$1.3 billion in formula and competitive funding available under the Act. The amount expended, as of June 30, 2012, is approximately \$992 million.

Not all revenues that flow into the General Fund are available to pay for unrestricted government activities. The most notable are federal revenues, which are provided for specific purposes.

(Stated in millions)	FY 12	Percent	FY 11	Percent
Petroleum Revenue				
Property Tax	\$ 215.4	1.7%	\$ 184.3	1.6%
Corporate Petroleum Income Tax	571.8	4.6%	601.8	5.4%
Severance Tax	5,950.3	48.0%	4,131.4	36.9%
Mineral Bonuses and Rents	6.3	0.1%	10.3	0.1%
Oil and Gas Royalties	2,026.8	16.3%	1,853.5	16.6%
Total Petroleum Revenue	8,770.6	70.7%	6,781.3	60.6%
Nonpetroleum Revenue				
Taxes	426.1	3.4%	440.8	3.9%
Licenses and Permits	117.9	1.0%	117.3	1.1%
Charges for Services	197.1	1.5%	179.3	1.6%
Fines and Forfeitures	13.3	0.1%	11.6	0.1%
Rents and Royalties	29.0	0.2%	12.0	0.1%
Interest and Investment Income/(Loss)	309.5	2.5%	1,159.0	10.4%
Other Revenue	82.9	0.7%	77.4	0.7%
Total Nonpetroleum Revenue	1,175.8	9.4%	1,997.4	17.9%
Federal Revenue	2,464.9	19.9%	2,407.9	21.5%
Total Revenues	\$ 12,411.3	100.0%	\$ 11,186.6	100.0%

The total expenditures charged against General Fund appropriations during FY 12 amounted to \$9.4 billion, an increase of \$56.3 million from FY 11. The debt service subfund of the General Fund experienced a significant increase in expenditures due to the defeasement of General Obligation and Revenue Bonds, and extinguishment of Certificates of Participation and Capital Leases. The Department of Law also experienced a significant increase due to judgment and litigation costs. Expenditures by department are compared with the prior year in the following table:

<u>Department Expenditures (stated in millions)</u>	<u>FY 12</u>	<u>Percent</u>	<u>FY 11</u>	<u>Percent</u>
Office of the Governor	\$ 51.3	0.6%	\$ 114.7	1.2%
Administration	663.4	7.1%	505.5	5.4%
Law	100.9	1.1%	70.2	0.8%
Revenue	1,084.0	11.6%	1,016.5	10.9%
Education and Early Development	1,584.8	16.9%	1,526.1	16.4%
Health and Social Services	2,486.1	26.6%	2,351.2	25.3%
Labor and Workforce Development	145.3	1.6%	148.2	1.6%
Commerce, Community, and Economic Development	565.5	6.0%	909.3	9.8%
Military and Veterans' Affairs	72.6	0.8%	105.9	1.1%
Natural Resources	162.6	1.7%	188.8	2.0%
Fish and Game	121.9	1.3%	109.8	1.2%
Public Safety	207.2	2.2%	206.2	2.2%
Environmental Conservation	143.7	1.5%	152.8	1.6%
Corrections	278.9	3.0%	260.2	2.8%
Transportation and Public Facilities	1,090.2	11.6%	1,066.6	11.5%
Legislature	60.0	0.6%	57.3	0.6%
Debt Service	32.0	0.4%	9.0	0.1%
Alaska Court System	106.2	1.1%	99.8	1.1%
University	406.8	4.3%	409.0	4.4%
Total Expenditures	<u>\$ 9,363.4</u>	<u>100.0%</u>	<u>\$ 9,307.1</u>	<u>100.0%</u>

Major Industry

The State's major source of revenue is petroleum related. The price of oil has risen fairly steadily since the 2008/2009 recession, ending FY 12 well above \$100 per barrel. The Department of Revenue projected a FY 12 average price of \$114.59 per barrel for the Alaska North Slope West Coast price in its Spring 2012 forecast. Actual Alaska North Slope oil prices were \$1.94 per barrel lower than the estimate, averaging \$112.65 for the fiscal year.

The method of calculating production tax revenue changed on April 1, 2006 with the implementation of the Petroleum Profits Tax (PPT). The tax rate structure changed again in November 2007 with the passage of the Alaska Clear and Equitable Share (ACES) legislation (Chapter 1, SSLA 07).

The increase in petroleum revenues collected in FY 12 is attributable to higher prices as discussed in the MD&A and further explained in Schedule B-2 of the statistical section of this report.

With the State so dependent on petroleum revenues, the price of oil and gas is always a critical element for budgeting. After the Alaska Gasline Inducement Act (AGIA) was signed in June 2007, the Administration initiated a competitive process to select a licensee to build a natural gas pipeline. On August 1, 2008, the Twenty-Fifth legislature passed Chapter 3, 4 SSLA 08, which authorized the issuance of a license to TransCanada Alaska Company, LLC and Foothills Pipe Lines, Ltd. In May 2009 ExxonMobil joined with TransCanada Alaska to form the Alaska Pipeline Project (APP). From 2010 to 2011 the APP completed the first open season to commercialize North Slope natural gas in a project that was designed to ship gas through a pipeline to be constructed from the North Slope to Alberta, Canada.

During this time APP also engaged in the regulatory approval process through the Federal Energy Regulatory Commission (FERC). Despite significant progress on regulatory issues with FERC and significant initial interest by prospective parties in the “Alberta” project, APP and the major North Slope producers, at the request of Governor Parnell, initiated efforts to explore the prospects for a large LNG project from the North Slope to South-central Alaska to export LNG to Asia under the AGIA-framework. APP requested and received the state’s approval to amend the project to explore LNG export. The Alberta project remains “shelf-ready,” but has been placed on administrative hold with FERC pending developments on the LNG project. The administration set out benchmarks for 2012-2013 for the APP and the North Slope producer team to develop and advance the LNG project concept.

Long-term Financial Planning

With declining oil production, an uncertain national economy, and an unfunded pension liability, the State of Alaska has placed excess funding in our Statutory Budget Reserve Fund and the Constitutional Budget Reserve Fund, and has provided forward funding for K-12 Education and the Alaska Performance Scholarship program. These deposits will contribute towards the future fiscal health of the State of Alaska.

The State of Alaska’s bond rating was upgraded in January 2012 to AAA, the highest grade, by Standard and Poor’s Ratings Services. According to Standard and Poor, this rating is due to the State’s large financial reserves, strong financial management, extensive fiscal flexibility, and budgetary restraint.

During FY12, the State of Alaska reduced current debt service on bonds outstanding through two separate series of refunding bond issuances, the Sport Fishing Refunding Revenue Bonds in December 2011, and the General Obligation Refunding Bonds Series 2012A in February 2012. This is in addition to the three extraordinary appropriations from the first session of the 27th Legislature (2011-2012). Below is a summary of these reductions in long-term debt:

- The Sport Fishing Refunding Revenue Bonds in December 2011 were used to refund certain outstanding sport fish revenue bonds the state previously issued in 2006. In connection with the sale of \$28.8 million aggregate principal amount the bonds achieved a net present value savings of over \$2.7 million.
- The General Obligation Refunding Bonds Series 2012A in February 2012 were issued for the purpose of refunding a portion of the State’s General Obligation Bonds, Series 2003A. In connection with the sale of \$175.6 million aggregate principal amount the bonds achieved a net present value savings of approximately \$27.1 million.
- A capital lease obligation of the State was diminished through the extinguishment of \$20.6 million of optionally redeemable lease revenue bonds of the Municipality of Anchorage in October 2011.
- Optionally redeemable obligations of three state certificates of participation issues totaling \$22 million par amount were extinguished in November 2011.
- An FY 12 General Fund appropriation of \$150 million replaced authority to issue general obligation bonds approved in 2008, and extinguished the ability to incur this previously approved debt.

By reducing the State’s debt service, the State has strategically allowed for additional capacity of future debt. Looking forward to FY13, the State anticipates utilizing all, or a portion, of the unissued authorized amount of \$197 million in connection with the general obligation bond proposition passed in November of 2010 for capital projects. Additionally, in November 2012 voters approved a \$453 million transportation bond package.

Net assets at June 30, 2012 of the two largest pension funds, the Public Employees' (PERS) and Teachers' (TRS) Retirement Systems' funds, were \$11.6 billion and \$4.8 billion respectively. The funding status for PERS and TRS pensions and postemployment healthcare as of the June 30, 2011, actuarial valuations indicated the actuarial accrued liabilities were 61.9 percent pensions and 55.6 percent postemployment funded for PERS, and 54.0 percent pension and 43.8 percent postemployment funded for TRS. Further information on these and other pension funds, including the Supplemental Benefits System and Deferred Compensation plans, can be found in Notes 7, 8, and 9 to the basic financial statements.

Looking ahead at the next 10 years, Alaska must move toward expansion and diversification of its revenue base. The main emphasis of the 10-year plan is to facilitate Alaska's transition from a predominantly oil revenue base to an oil and natural gas revenue base. Revenue and other economic activity generated from the commercialization of Alaska's natural gas would help diversify Alaska's revenue sources and provide a potentially substantial source of revenue to offset declining oil revenue. In addition, commercialization of North Slope gas, in conjunction with other state investment to reinvigorate natural gas production in Cook Inlet, will provide economic opportunity and a stable, clean source of energy to fuel Alaskan businesses and homes for years to come. Efforts to diversify and enhance revenue sources cannot solely rely on commercializing Alaska's natural gas. Alaska must continue to make strides to maximize production from existing oil fields and develop other economic opportunities, particularly from its abundant natural resources.

Relevant Financial Policies

Spending Limitation

Since July 1, 1981, the Alaska Constitution Article IX, Section 16, establishes the annual appropriation spending limit of \$2.5 billion plus a formula which factors in changes in population and inflation. This is further discussed in Note 2.

Investments

As discussed more fully in Note 4 to the basic financial statements, the State's cash is managed by the Treasury Division in the Department of Revenue or by other administrative bodies as determined by law. All cash deposited in the State Treasury is managed to achieve a particular target rate of return as determined by the investment objectives set for a given fund. Cash in excess of the amount needed to meet current expenditures is invested pursuant to AS 37.10.070-071, which requires that investments shall be made with the judgment and care under circumstances then prevailing that an institutional investor of ordinary professional prudence, discretion, and intelligence exercises in managing large investment portfolios.

Treasury has established an array of investment pools with varying investment horizons and risk profiles. Investments are managed in a pooled environment unless required by statute or bond resolution to be held separately. Commingled investment pools maximize earnings potential, provide economies-of-scale, and allow smaller funds to participate in investment opportunities that would otherwise be unavailable to them. Rather than each participant (fund) buying identical individual securities, larger quantities of securities can be purchased at one time, reducing the operating costs and number of transactions. A fund's equity ownership in a pool is based on the number of shares held by the fund.

Cash Flow and Revenue Shortfalls

After oil began flowing through the Trans-Alaska Pipeline in the late 1970s, the State enjoyed the enviable position of having sizeable sums of cash flowing into the State Treasury. This cash funded a steadily growing state operating budget, large and small annual capital budgets, and the State's permanent fund.

In more recent years, the reality of declining oil production and the corresponding decrease in available cash has become more apparent. The volatility of oil prices has a profound effect on the annual budgeting process. Also associated with this volatility, though less widely understood, is a cash flow situation that could lead to a cash deficiency for the State.

Prior to 1985, most unrestricted revenues flowed directly into the State's General Fund where they were available to pay day-to-day costs of operating State government. This is no longer the case. Over time, the legislature has established many subfunds of the General Fund to segregate cash for budgeting purposes. In 1990 the legislature appropriated the entire General Fund balance available for appropriation at the end of FY 91 to a statutory Budget Reserve Fund (SBRF). By a vote of the people in 1990, the Alaska Constitution was amended to establish a separate Constitutional Budget Reserve Fund (CBRF) into which oil tax settlement revenues are deposited. The effect of these actions diverted cash historically destined for the General Fund to other cash pools that were not available to pay day-to-day State operating costs.

Also contributing to the potential for a cash deficiency is the fact that the inflow of unrestricted revenues does not mirror the outflow of cash expenditures. Revenues and expenditures are cyclic with high and low periods, which do not necessarily coincide. The first quarter expenditures of each fiscal year are generally higher than revenues for the same period. Clearly, if the General Fund (excluding the subfunds) does not have a large cash balance at the beginning of the fiscal year or if other sources of funds are not available, the State faces the possibility of a cash deficiency before the end of the first quarter. A memorandum of understanding outlines the steps to be taken in various scenarios involving a cash deficiency.

Borrowing from the budget reserve funds has been the solution for both cash flow shortages and revenue shortfalls. Between FY 93 and FY 05, the legislature addressed the possibility of a revenue shortfall by including language in the appropriation act permitting the executive branch to borrow cash from the SBRF and the CBRF in the event expenditures exceeded revenues; which did occur in several years. All borrowings from the CBRF were repaid by FY 10 and no additional borrowings have taken place. In FY 10, the legislature appropriated General Fund monies to the SBRF. In order to continue to increase the reserve fund, in FY 12 the legislature appropriated \$2.0 billion from the General Fund to the SBRF. In addition, the legislature appropriated the remaining available balance of the General Fund at year-end to be transferred to the SBRF; which amounted to \$805 million.

Initiatives

Over the next four years the State is implementing an Enterprise Resource Planning (ERP) solution powered by AMS-Advantage to replace disparate administrative systems. The integration of financial, Human Resource/payroll, and procurement functions into one statewide system will provide greater transparency and more efficient management of resources.

All State agencies are reporting program performance that describes the results of their service efforts and accomplishments. This information is available on the Office of Management and Budget web site at www.omb.alaska.gov.

AWARDS AND ACKNOWLEDGMENTS

The Government Finance Officers Association of the United States and Canada (GFOA) awarded a Certificate of Achievement for Excellence in Financial Reporting to the State of Alaska for its CAFR as of and for the fiscal year ended June 30, 2011. This is the ninth year the State of Alaska has received this award on the CAFR. The Certificate of Achievement is a prestigious national award, recognizing

conformance with the highest standards for preparation of government financial reports. It represents a significant accomplishment by a government and its management.

To be awarded the Certificate of Achievement, a government must publish an easily readable and efficiently organized CAFR, the contents of which conform to GFOA standards and satisfy both generally accepted accounting principles and applicable legal requirements. The certificate is valid for only a one year period. We believe the CAFR for the State of Alaska as of and for the fiscal year ended June 30, 2012 conforms to the award criteria, and we are submitting it to the GFOA for review.

We wish to express our sincere appreciation to the many individuals whose dedicated efforts have made this report possible. The preparation of this report could not have been accomplished without the professionalism and dedication demonstrated by the financial and management personnel of each State agency, each component unit, and the dedicated staff within the Division of Finance.

Sincerely,

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Becky Hultberg
Commissioner
Department of Administration

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