THE STATE of ALASKA
GOVERNOR BILL WALKER

Department of Administration

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The Honorable Bill Walker, 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, 2014. 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

Management Discussion and Analysis (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, 2014, 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 Amendments of 1996 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

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 for governmental funds (General, Permanent, and Special Revenue) 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 14, petroleum revenue decreased $1.9 billion to 48 percent of all General Fund revenues. This is significantly lower than in past years. The largest source of nonpetroleum revenues is federal, which makes up 27 percent of revenues. With stronger markets, revenue from interest and investment income is continuing to grow and is expected to become more significant in future years. In FY 12, interest and investment income was 2.5 percent. It increased to 7.4 percent in FY 13 and then nearly doubled to 14.5 percent in FY 14.

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) Petroleum Revenue	FY 14	Percent	FY 13	Percent
Property Tax	$ 128.1	1.5%	$ 99.6	1.0%
Corporate Petroleum Income Tax	344.5	3.9%	478.1	4.6%
Severance Tax	2,035.2	23.1%	3,674.2	35.5%
Mineral Bonuses and Rents	15.1	0.2%	19.0	0.2%
Oil and Gas Royalties	1,705.0	19.3%	1,895.6	18.3%
Total Petroleum Revenue	4,227.9	48.0%	6,166.5	59.6%
Nonpetroleum Revenue				
Taxes	446.5	5.1%	513.9	5.0%
Licenses and Permits	124.3	1.4%	119.4	1.2%
Charges for Services	184.0	2.1%	193.4	1.9%
Fines and Forfeitures	16.7	0.2%	30.1	0.3%
Rents and Royalties	44.4	0.5%	35.0	0.3%
Interest and Investment Income/(Loss)	1,279.6	14.5%	766.7	7.4%
Other Revenue	77.1	0.9%	128.5	1.2%
Total Nonpetroleum Revenue	2,172.6	24.7%	1,787.0	17.3%
Federal Revenue	2,410.5	27.3%	2,392.4	23.1%
Total Revenues	$ 8,811.0	100.0%	$ 10,345.9	100.0%

The total expenditures charged against General Fund appropriations during FY 14 amounted to $10.0 billion, an increase of $165.3 million from FY 13. The Department of Military and Veterans Affairs experienced a significant increase due to emergency disaster relief spending. Expenditures by department are compared with the prior year in the following table:

Department Expenditures (stated in millions)	FY 14	Percent	FY 13	Percent
Office of the Governor	$ 30.1	0.3%	$ 32.5	0.3%
Administration	646.8	6.5%	775.2	7.9%
Law	68.5	0.7%	73.8	0.8%
Revenue	911.5	9.2%	888.1	9.0%
Education and Early Development	1,686.6	16.9%	1,648.8	16.8%
Health and Social Services	2,460.7	24.7%	2,563.3	26.1%
Labor and Workforce Development	148.7	1.5%	145.3	1.5%
Commerce, Community, and Economic Development	929.4	9.3%	878.0	8.9%
Military and Veterans' Affairs	100.6	1.0%	71.1	0.7%
Natural Resources	215.2	2.2%	192.6	2.0%
Fish and Game	139.8	1.4%	129.6	1.3%
Public Safety	191.1	1.9%	203.6	2.1%
Environmental Conservation	141.4	1.4%	145.6	1.5%
Corrections	313.4	3.1%	301.8	3.1%
Transportation and Public Facilities	1,279.7	12.8%	1,145.0	11.7%
Legislature	71.2	0.7%	63.4	0.6%
Debt Service	1.8	0.0%	7.6	0.1%
Alaska Court System	123.2	1.2%	124.2	1.3%
University	518.7	5.2%	423.6	4.3%
Total Expenditures	$ 9,978.4	100.0%	$ 9,813.1	100.0%

Major Industry

Alaska receives more revenue from oil production related activities than any other source. Oil prices have begun to soften and have been below $100 per barrel since August 2014. Currently, spot oil prices are around $80 per barrel; however, it is too soon to conclude that any major structural change has occurred. The Department of Revenue is projecting the while these prices may show considerable volatility in the next several years, annual average prices should increase back to over $100 per barrel based on fundamental analyses of the structure of oil markets. Actual Alaska North Slope oil averaged prices around $107.57 during FY 14, the same as FY 13.

The method of calculating production tax revenue changed during the 2013 legislative session with the passage of the More Alaska Production Act (MAPA). Starting on January 1st, 2014, oil production on the North Slope of Alaska is taxed at 35% of the net value of production, with a credit for each barrel of oil produced and a special reduction in taxes for new oil developments. These incentives have already drawn an industry response, including increased activity in developed areas and increased likelihood that new areas will enter production. The department of revenue is forecasting an increase of $10 billion in investment over the next 10 years and has already seen industry expenditures increase by a third in the short-term. This is a good first step in accessing the billions of recoverable barrels currently undeveloped on the North Slope.

Additionally, the favorable tax environment and business climate in the Cook Inlet basin continues to support four consecutive years of increased oil production in the area. New federal leases offered in the Cook Inlet may also provide opportunities for greater expansion.

Finally, efforts to monetize the massive natural gas accumulations on Alaska's North Slope continue. These efforts include continued interest by major corporations to evaluate a two billion cubic feet per day pipeline that would export liquefied natural gas to Asia and an opportunity to transport a smaller quantity of natural gas from the North Slope to the major urban centers for in-state use. The State and the North Slope Oil and Gas Producers have reached consensus on a new and comprehensive approach to commercializing North Slope natural gas resources. For the first time, the State and Producers have aligned their interests towards building a world-scale liquid natural gas (LNG) project, which will provide reliable supplies of natural gas to Alaska, provide opportunities for expansion of gas exploration outside the North Slope, and open foreign markets to Alaska natural gas. All the parties have agree on a process, entitled Alaska LNG or AK LNG, which is governed by a Heads of Agreement (HOA). Additionally, there is a Memorandum of Understanding (MOU) between the State and TransCanada for participation in the mid-stream of the project. Finally, the passage of House Bill 277 and Senate Bill 138 in 2014 authorized the Department of Natural Resources and Department of Revenue to enter into the project's commercial arrangements described in the HOA and MOU. Such a project would provide significant general fund revenues and payments into the Permanent Fund in the future.

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 remains at AAA, the highest grade, by Fitch Ratings. An AAA rating was received due to the State's large financial reserves, strong financial management, extensive fiscal flexibility, and budgetary restraint.

During FY 14, the State of Alaska issued $170.0 million in General Obligation Bond Anticipation Notes, Series 2014, generating $171.5 million in proceeds to the State from par amount and original issue premium, for the purpose of refinancing $149.6 million of the State's General Obligation Bond Anticipation Notes, Series 2013, $28.9 million for paying additional costs of the projects authorized by the State Transportation Bond Act. These General Obligation Bond Anticipation Notes were rated "MIG 1" by Moody's Investors Service, Inc., "SP-1+" by Standard & Poor's Ratings Services, and "F1+" by Fitch Ratings.

During FY 15, the State of Alaska, through the Alaska State Bond Committee, issued the Series 2014 Certificates of Participation (COPs) for the Alaska Native Tribal Heath Consortium (ANTHC) housing facility project based on authority provided in 2013 by passage of Senate Bill No. 88 enacted as Chapter 63. The State sold $30.9 million in certificates generating $35.3 million in proceeds to the State of which $35.0 million was deposited into the project account and $325.0 thousand was deposited into the cost of issuance account. Moody's Investors Service, Inc., Fitch Ratings and Standard & Poor's Ratings Service assigned the certificates ratings of "Aa1," "AA+," and "AA+" respectively.

Also during FY 15, the State anticipates refinancing the General Obligation Bond Anticipation Notes, Series 2014 prior to their maturity date of March 23, 2015, and if warranted issue additional bonds to fund projects authorized by the 2012 State Transportation Bond Act.

Net position at June 30, 2014 of the two largest pension funds, the Public Employees' (PERS) and Teachers' (TRS) Retirement Systems' funds, were $15.3 billion and $6.3 billion respectively. The funding status for PERS and TRS pensions and postemployment healthcare as of the June 30, 2013, actuarial valuations indicated the actuarial accrued liabilities were 54.5 percent pensions and 46.0 percent postemployment funded for PERS, and 48.1 percent pension and 36.1 percent postemployment funded for TRS. Recognizing that the unfunded pension liability is the largest budget cost driver, Chapter 18 SLA 2014 transferred $1 billion into the PERS and $2 billion into the TRS from the Constitutional Budget Reserve Fund (CBRF) during FY 15. 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 grow 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 investments 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 resource base.

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 became 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 the 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. During FY 14, $27.5 million of royalty revenue was transferred into the CBRF as a result of audit dispute resolution per Article 9, Section 17 of the State Constitution. In FY 14, the unrestricted fund balance in the General Fund was insufficient to cover General Fund appropriations. This resulted in a $1,920 million year-end transfer from the SBRF to the General Fund.

Initiatives

The State is continuing the implementation of 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. The scheduled "go-live" for the financial section of the ERP, named IRIS, is July 1, 2015.

To provide a clear path toward a gasline that can create thousands of jobs, fuel Alaskan homes and businesses, and grow our economy, the FY 15 budget includes $81.5 million to advance the Alaska LNG Project.

All State agencies are reporting program performances that describe 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, 2013. This is the eleventh 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 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,

// signature on file //
Amy Erickson
Acting Commissioner
Department of Administration

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Scot Arehart
Director
Division of Finance

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