Alaska’s FY 07 Budget Plan

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INTRODUCTION

Alaska began the 2006 fiscal year with oil prices high and rising, which was good news indeed for a state whose general fund budget is highly dependent on oil royalties, severance, and property taxes. Prospects looked good for resolving the state’s outstanding issue with the federal government—opening the coastal plain of the Arctic National Wildlife Refuge (ANWR) for oil and gas exploration and development. The Murkowski administration had been negotiating with the three producers over terms in development of the Alaska natural gas pipeline, and these seemed close to conclusion.

By the start of FY 2007 on 1 July 2006, news was not as good, as action stalled on several fronts. We examine the state’s FY 07 budget plan through investigation of several factors influencing the fiscal process: the Alaska economy in FY 2005-06, demographic changes, changes in state political organization, and a review of four major issues in the state (ANWR, wolves, pork, and base closings). Then we turn to the budget process, the Governor’s budget request, and the legislative sessions. We describe the final state budget, adopted by the close of the first special session, and then focus on the two largest issues of fiscal policy in recent state history—revision to the state’s oil taxation regime and the Alaska natural gas pipeline—which have preoccupied the Legislature and the state in 2006.

THE ALASKA ECONOMY IN FY 2005-06

As mentioned repeatedly in these annual reports, the Alaska economy has two points: oil production, primarily from the Alaska North Slope, and the state’s Permanent Fund (PF). In both areas, developments were strongly positive in 2005 and to mid-2006, as they were in many other sectors of the economy: tourism, hard rock mining, and fisheries.

Oil Prices and Profits. A declining volume of oil passed through the Trans-Alaska Pipeline System (TAPS) in 2005—some 0.9167 million barrels/day. This was less than half the amount produced in the peak year of 1988, and the estimate for 2006 was lower—854,000 barrels/day (Anchorage Daily News [AND], 3/8/06). The average rate of decline from the peak of production in 1988 to 2004 has been 4.5 percent (ADN, 4/9/06). However, oil prices in 2005 and 2006 were quite high. The 2005 calendar year began with oil at $50/barrel, rising to $53/barrel in June, and over $60/barrel in early August. By the end of August, as Hurricane Katrina struck the Gulf Coast, prices rose to $68/barrel (see Fairbanks Daily News-Miner [FDNM], 2/23/05, 6/14/05, 8/7/05, and 8/25/05). Prices continued to rise to over $75/barrel by late April, and stayed in this range into the new fiscal year. Although these prices were much higher than they had been in preceding years, they did not yet equal, in inflation-adjusted dollars, the price of oil in the early 1980s.
Several factors accounted for the general rise in oil prices: snags in the American oil refinery system, shrinking U.S. oil inventories and worries that supplies could not meet global demand, increased summer travel, instability in producing regions (not only Iraq but occasional production difficulties in Saudi Arabia, uncertainty concerning the nuclear standoff in Iran, and increased instability in the Nigerian delta). Also, China’s seemingly inexhaustible demand for energy forced prices upward. When Hurricane Katrina hit the Gulf Coast, it forced a closing of refineries and disruption of oil transportation networks, and this further exacerbated instability in the oil market. In fact, Governor Murkowski asked Alaska’s main oil producers, British Petroleum (BP) and ConocoPhillips, to increase production as one means of stabilizing U.S. oil prices, but the companies claimed they were already operating at full capacity (FDNM, 9/8/05, 9/19/05).

The U.S. Department of Energy forecasted that oil prices would stay above $50/barrel for years (FDNM, 12/13/05). The state’s Department of Revenue, remarking that oil revenues would fund 85 percent of Alaska’s general fund budget until at least 2008, indicated that oil prices would average $57/barrel for the next fiscal year (FDNM, 12/16/05). In March 2006, it raised the floor to $58.72/barrel for 2006 (ADN, 3/8/06). This contrasts with an average price for North Slope crude of $26.81/barrel from 1996 through 2005.

Some of the oil companies, such as BP, indicated they would reduce work on the Alaska North Slope in apparent retaliation to tax changes of the Murkowski administration making their operations more uncertain (FDNM, 9/28/05). Alyeska, the pipeline service consortium responsible for the TAPS announced it would trim 350 jobs as it sought economies in pipeline operation by closing pump stations (action resisted by the state’s Department of Environmental Conservation [FDNM, 9/28/05]). Nevertheless, the main Prudhoe Bay operators indicated they would continue large investments in the North Slope: BP planned to spend $600 million in 2006 and ConocoPhillips some $800 million (FDNM, 12/11/05, 12/23/05). Moreover, Royal Dutch Shell indicated in late 2005 that it would return to Alaska.

Very high oil company profits convinced Alaskans that the companies could pay heavier rates of taxation to the state. Exxon posted record profits of $10.71 billion for the fourth quarter of 2005, and $36.13 billion in profits for the year, the highest for any U.S. company. ConocoPhillips posted profits of $3.7 billion in the fourth quarter and $13.5 billion for the year. Finally, BP reported profits of $4.4 billion in the fourth quarter, and $19.3 billion for the year (FDNM, 1/31/06, 2/8/06). The big three reported first quarter 2006 profits of $16 billion (FDNM, 4/26/06). During 2005, these companies made $7 billion in profits from Alaska operations, a figure legislators repeated during oil tax discussions.

**Pipeline Problems.** In early March 2006, an oil field worker on the North Slope noticed a major spill from a hole in a feeder line of the Prudhoe Bay complex that had been leaking undetected for two weeks (FDNM, 3/11/06). The spill grew to 267,000 gallons of crude oil, the largest ever on-land oil spill in Alaska. BP, the owner of most Prudhoe Bay oil and operator of the North Slope oil facilities, had to shut down the pipeline temporarily to replace the defective pipe. Although the company was unsure what caused the spill—
corrosion in the 29-year old pipes or problems with the cooling, increasingly viscous oil—it claimed the pipeline was safe to operate without major repairs.

Alaska’s pipeline watchdogs have been consistently critical of the pipeline operation by BP and Alyeska, the TAPS manager. The oil spill occasioned the Congress to investigate, and federal inspectors began a criminal investigation of BP’s management (FDNM, 4/7/06). They ordered BP to conduct tests for corrosion in the pipeline, and in early August BP announced that it had discovered 16 anomalies in 12 locations of a transit line on the eastern side of the field (FDNM, 8/7/06). Some 16 miles of pipeline would need to be replaced or bypassed, and for this reason the company began a shut down of transit lines delivering 400,000 barrels of oil a day (about 2.6 percent of US supply, and 8 percent of domestic production). The oil company said it was “surprised” to find severe corrosion; it had not used mechanical pigs to clean out the pipeline in 14 years, because it had not “believed it to be necessary” (FDNM, 8/8/06).

At this writing it is unclear how long the shutdown will last, but company officials said it would take several months to make repairs and replacements. This news sent oil prices up $2/barrel. The effects on Alaska finance would be more devastating. Revenue Commissioner Bill Corbus said the state would lose $6.4 million a day in lost royalties and taxes. State government could operate two months without heading into the red, but if the shutdown continued to the end of the 2007 fiscal year, the state deficit would be $1.3 billion (FDNM, 8/8/06). State officials neglected to mention that the state’s rainy day accounts, exclusive of the Permanent Fund, could easily cover such a deficit.

The Permanent Fund and Dividend. The state’s PF registered growth in its corpus of 8 percent, reaching $34 billion by mid-2006, due to the high performance of domestic and international stocks. Indeed, the fund gained nearly $1 billion in a three month period (FDNM, 1/20/06). Directors of the corporation considered expanding its portfolio by investing in hedge funds and venture capital firms. Also, at the request of the state Department of Revenue, the corporation directors began to consider investing in the Alaska natural gas pipeline, as part of the state’s proposed 20 percent share.

In mid-October 2005, the state deposited permanent fund dividend (PFD) checks in bank accounts of eligible Alaskans. The amount was just $845.76, the lowest total since 1988. The amount of the PFD is calculated on a five-year rolling average of the earnings of the PF, and the 2005 PFD amount registered the fifth year in decline (FDNM, 10/17/05). As in previous years, the PFDs were an important stimulus for the state economy. The PFD is expected to rise to $1,100 in 2006.

Other Economic Sectors. With the exception of the wood products industry, which remained in recession because of closure of pulp mills in Southeast Alaska and restrictions of access to federal forests, other sectors of the Alaska economy did quite well in 2005-06. The state’s second largest industry, tourism, employing nearly 10,000 Alaskans and reporting $2 billion in revenue, called 2004 a banner year. An additional 100,000 tourists visited the state for a total of 1.4 million tourists (FDNM, 10/06/06). The attempted boycott of Alaska
tourism by animal rights’ organizations opposing the state’s wolf control policies apparently had little effect.

The hard rock mining industry reported the ninth straight year of revenues in excess of $1 billion. The 2004 season was worth $1.6 billion, and the industry employed 3,000 (FDNM, 11/3/06). With the price of gold at $460/ounce, the pace of exploration was frenetic, called the “second Alaska gold rush” by a number of observers. The Fort Knox and Pogo gold mines in the Interior produced record amounts; a new find, the Pebbles prospect (in the Iliamna region of the state) appeared to have at least 2.7 million ounces of gold and 16.5 billion lbs. of copper (FDNM, 9/23/05), and experts called the find “incredible” (FDNM 12/31/05).

The state’s fishing industry recorded significant gains in 2004-05. The 2005 salmon harvest was the third largest since 1960. Fishers caught 206 million salmon, worth $295 million at somewhat higher prices than in previous years (FDNM, 11/1/05). (The advent of farmed salmon has depressed prices for wild Alaska salmon).

The Alaska coal industry, centered on the Healy operations of Usibelli Inc., continued to produce more of Alaska’s low-sulfur coal than the market can absorb. But discoveries of coal bed methane gas in the Healy area (100 miles south of Fairbanks) excited interest in the future prospects for methane production in both the Interior and South Central regions of the state.

Finally, 2005 was a booming year for the construction industry statewide. The Associated General Contractors, an industry-wide association, estimated that $6.6 billion would be spent on construction activities in 2006, a 13 percent increase over the previous year, divided between $4 billion in private and $2.6 billion in public construction projects (FDNM, 2/22/06).

These impressive increases in economic activity translated into upticks in the state’s indices of personal income and wages. Alaska’s average personal income had been the first in the nation from 1975 until the 1986 recession. In 2004, personal income increased 3.7 percent, and the state ranked sixteenth, with per capita personal income of $34,085 compared to the national rate of $32,937. Alaska wages in 2004 were the sixth highest in the nation at $41,390. They were higher because of larger earnings from oil/gas field employment, construction trades, and health care professions (FDNM, 8/13/05). Significantly, in this year, income was more evenly distributed in Alaska than in any other state. The median income of $66,200 compared to the U.S. average of $53,700 (Anchorage Daily News [ADN], 11/18/05).

STATE DEMOGRAPHICS

In 2005, Alaska’s population stood at 655,435, and the breakdown in population categories remains essentially unchanged. Most Alaskans, about two-thirds, are Caucasians (non-Latinos). Alaska Native is the most significant ethnic minority group—socially, culturally, economically, and politically—and comprises about 16 percent of the population. “Native” is the term preferred by the aboriginal residents of Alaskans, who are Yupik or
Inupiat Eskimos, Aleuts, or Indians. They have lived in the state “since time immemorial” and at least for 30,000 years. Most of Alaska’s Natives had limited contact with the Russians who colonized Alaska in the eighteenth century and with Americans who purchased the territory in 1867, until the twentieth century. Unlike Indians in what Alaskans call the “Lower-48” states, most Natives have remained close to their original sites of residence, and many are still engaged in traditional subsistence pursuits of hunting, fishing, and gathering.

Alaska’s other ethnic minorities include African Americans (3.4 percent), Asians (3.9 percent), and Latinos (4.1 percent), with the remainder of the state’s population split among two or more races or other groups. A large number of the non-Native minority Alaskans as well as many Caucasians came to Alaska in the military and retired in the state.

As reported in 2005, the median age of the state is rising and the sex disparity (106 males for every 100 females) is narrowing. In these two respects, the population of the state is growing to resemble more closely that of other states. Currently, the population is younger, however, and more rural than is typical in most other states. About 20 percent of the population receives Medicaid assistance. The state in 2005 ranked 30th on the American Health Rankings, and dropped some six points from previous years’ ranking because of limited prenatal care (especially in rural areas), low immunization rates, and a higher than average rate of smoking (FDNM, 12/13/05).

Alaska Natives have some of the highest infant death rates in the nation (FDNM, 7/21/06). Lack of jobs and other adverse social conditions in rural Alaska influences health of adults and children. A Kids Count survey of the health and well-being of children and teens showed that more Alaska youth died proportionately than in any other state (FDNM, 6/27/06), a statistic shaped by rural conditions.

POLITICAL ENVIRONMENT

Alaska entered FY 2006 with a Republican governor and legislature. In his third year in office, Governor Frank Murkowski built suspense by declining to file for re-election until 4 days before the June 1st filing deadline. He announced a preoccupation with gas line negotiations, but his approval ratings were the second lowest in the nation (slightly higher than Ohio’s Bob Taft), and the state’s leading pollster David Dittman measured disapproval at 61 percent and approval at 35 percent in late 2005 (FDNM, 12/12/05). By July 2006 the Governor’s approval rating was just 21 percent (ADN, 7/24/06), and considerably less than 50 percent among Republicans. Two Anchorage House Democrats filed early—Eric Croft (son of Chancy Croft, a 1976 Democratic gubernatorial candidate) and Ethan Berkowitz (House Minority Leader). Former Wasilla mayor and second-ranking lieutenant governorship candidate in the 2002 Republican primary, Sarah Palin, filed in late October. Then, in late December, former legislator John Binkley of Fairbanks filed and quickly raised four times the amount of the closest candidate (FDNM, 2/17/06). Former Governor Tony Knowles indicated an interest in the race, which some thought voters owed him after his narrow loss to Lisa Murkowski in the U.S. Senate elections of 2004.
Just before the close of the filing period (and one day after the Governor announced he would run for re-election), Knowles entered the gubernatorial race, saying “I will restore trust and integrity to the office of governor. No more secret deals, ethical lapses, or special interest agendas” (ADN, 5/30/06). Like the other candidates, he promised to renegotiate the gas pipeline contract. Ethan Berkowitz then left the governor’s race to run for lieutenant governor, on the future Knowles ticket. In the state’s August 22nd primary, Knowles will face Eric Croft and, by the 30-day campaign finance report period, had raised three times as much and was considered the sure winner of the Democratic primary. The Republican primary has three candidates. The leading fund raiser was Binkley, with over $1 million, followed by Pailin ($295,000), and Murkowski ($260,000) (ADN 7/24/06; FDNM, 7/25/06). Polls based on quite small samples indicated that Pailin would win more votes than Binkley; all polls showed Murkowski in third place. Indeed, the chief focus of the primary campaign has been the Murkowski administration.

A minor reshuffling of committee positions occurred in the State House when the legislature convened. On the Democratic side, Eric Croft left his finance seat to devote time to his campaign for the governorship and was replaced by Juneau legislator Beth Kertula (D). The House Republican Caucus disciplined first-term member Nancy Dahlstrom (Anchorage), because she voted against the party-endorsed capital budget (it spent $57 million from the PF she had vowed to defend). She lost her position on the Judiciary Committee but kept two other posts (FDNM, 1/10/06). The Senate saw no changes, and no Senator attempted to remove Anchorage Republican Ben Stevens (son of U.S. Senator Ted Stevens) from the Senate presidency, when the media revealed a conflict of interest. (The junior Stevens had a secret option to buy into an Alaska seafood company at the time his father was negotiating for a special fishery that would supply the company with millions of dollars worth of pollock a year [FDNM, 9/18/05].)

MAJOR CURRENT ISSUES

Two fiscal issues dominated state politics in 2006—the proposal to increase taxes on oil companies and the contract for an Alaska Natural Gas pipeline. We discuss these briefly in the section on the executive budget request, and then explore them at length after presenting the final state FY 07 budget. Four other issues occupied Alaska’s leaders in FY 2005-06, and each had important federal dimensions: ANWR, wolf control, Alaska earmarks in Congress, and military base closings. Only the last was resolved during the year.

Arctic National Wildlife Refuge (ANWR). The issue of opening ANWR for oil/gas development has been before the president and Congress annually in the last dozen years, without a successful resolution from the perspective of most Alaskans. The Alaska National Interest Lands Conservation Act (ANILCA), passed by the Congress in 1980, requires congressional action to open the small section of the wildlife refuge thought to contain between 5.6 and 16 billion barrels of oil (FDNM, 12/20/05). Because ANWR is the poster issue of the American environmental movement, in most years it has not been possible to collect the 60 votes in the U.S. Senate that would override attempts to filibuster legislation opening the refuge. For this reason, the recent strategy of development proponents has been to include federal earnings from ANWR oil and gas development in the executive budget
proposal and to include the opening of ANWR in budget reconciliation legislation (which cannot be filibustered) in the House and Senate.

In 2005, President Bush again included ANWR revenues in his budget proposal. Ordinarily, the House has adopted reconciliation bills easily while the Senate has had difficulty doing so, but in late 2005 the Senate adopted reconciliation legislation including ANWR on a 52-47 vote (ADN, 11/4/05). Action in the House took an unusual twist, however. Democrats were united in their opposition to the president’s budget reductions and intended to vote against the reconciliation bill, denying ANWR proponents support they usually received from a handful of Western Democrats. Then, about 15 moderate Republicans announced they would oppose the President’s budget proposal (and the reconciliation legislation) if ANWR remained in the bill (ADN, 11/10/05). For this reason, the House leadership dropped ANWR from the budget bill and included it in the defense appropriations bill. That legislation in the Senate did not include ANWR and thus Senator Ted Stevens adopted an unusual tactic. He attached language opening ANWR as a rider to appropriations legislation then in conference committee which increased funding for military operations in Iraq and Hurricane Katrina relief (FDNM, 12/16/05). Because it was added in conference, Senate Rule 28 was engaged, which allowed filibusters, and Stevens was unable to collect 60 votes (he fell short by 3 votes) to avoid a threatened Democratic filibuster. Calling this “the saddest day of my life,” Stevens threatened retaliation against Senate ANWR opponents (FDNM, 12/22/05). A Senate resolution to strip the ANWR language from the defense spending bill passed 48-45. However, both Alaska senators remained optimistic that the Congress would open ANWR for oil and gas exploration in the future. Stevens remarked “It’s not over until we win,” while Lisa Murkowski said “The trick is finding the right way to do it.”(FDNM, 2/22/06)

In 2006, Congress addressed ANWR in several different ways. The Senate passed a FY 07 budget resolution including ANWR revenues, and dedicated them to aid Gulf recovery, by a vote of 51-49 (FDNM, 3/17/06). But the House budget bill did not include ANWR revenues. Higher gas prices encouraged the House to pass a stand-alone bill to open ANWR for drilling. The vote was 225-201 and attracted 27 Democrats (while 30 Republicans defected) (FDNM, 5/26/06). Later a bipartisan group of House members filed legislation that would tie ANWR revenues to alternate energy projects (ADN, 8/1/06). Meanwhile, Governor Murkowski urged the state’s newspapers (now the major papers in Anchorage, Fairbanks, and Juneau are owned by media conglomerates outside Alaska) to advocate drilling. He gained legislative support of a $3 million appropriation for a more aggressive congressional lobbying campaign, and hired the conservative public relations firm PacWest to do the work (FDNM, 4/4/06).

Wolf Control. Alaska has an abundance of wolves, with numbers estimated from 7,500 to 11,000. In areas of their range in the Interior and South Central, they are predators of caribou and moose, and for this reason sports and subsistence hunters have urged the state Board of Game to reduce their numbers. The Murkowski administration, in its first year, established a permit system for wolf hunters to engage in airborne hunting, with annual quotas of 400 wolves. Yet only 564 wolves have been killed under this program in the last three years (FDNM, 1/27/06, 4/4/06).
In the last two years, Friends of Animals has fought in state courts to curtail airborne hunting. In January 2006, Superior Court Judge Sharon Gleason blocked the state’s program, remarking that the Board of Game had not followed its own rules. It had not indicated which alternative means (to airborne hunting) had been used in each area, and why they didn’t work, as required by the state’s Wolf Conservation and Management Policy (ADN, 1/18/06). The Board retooled its stipulations and the program continued; the judge declined further requests of Friends of Animals for restraining orders. The environmental group, which has held some 230 “howl-ins” to protest Alaska wolf control, continued its campaign to boycott Alaska tourism (FDNM, 2/14/06). The environmental organization spent $60,000 on full-page ads in USA Today and other media. Picturing a wolf pack in a snowfield, the ads commented: “If you shoot wolves to save moose and then you shoot the moose, you’re either out of your mind or in Alaska” (FDNM, 5/3/06). The campaigns have had no influence on the Murkowski administration and little, if any, impact on the flow of tourists to Alaska.

**Alaska Earmarks.** When Ted Stevens chaired the Senate Appropriations Committee, per capita federal funding in Alaska reached the zenith. It declined in the first year after he left this post (but he remained the senior Republican on the committee and chair of the Defense Appropriations Subcommittee). What attracted national attention, however, was transportation legislation originating in the House, under the aegis of the state’s sole congressman, Don Young, who chaired the House Infrastructure Committee.

Congress had tussled with this legislation in the previous session, when the Bush administration requested a reduction in overall funding. By late July, the renewal legislation, called SAFETEA-LU (Safe, Accountable, Flexible, Efficient Transportation Equity Act—“A Legacy for Users”) in honor of Young’s wife Lu, passed both houses. The bill provided five-year funding, and the amount allocated to Alaska included $2.12 billion plus $1 billion in earmarks, an increase of 30 percent (FDNM, 7/30/05). The state would receive $5.26 for every $1 paid in gas taxes. The subject of attention, however, was funding for two bridges, some $223 million for a bridge from Ketchikan to Gravina Island (the site of Ketchikan’s airport) and $230 million for the Knik Arm bridge, which would connect the Anchorage area to Pt. Mackenzie. Because Gravina Island has only 50 inhabitants, and the Pt. Mackenzie area has no permanent residents, the bridges quickly were called “bridges to nowhere.”

Passage of this legislation soon caused distress among regional advocates for roads in Alaska when it was discovered that the bridge earmarks would divert funds from other road projects (FDNM, 8/5/05). But it was the Hurricane Katrina disaster in New Orleans that focused national attention on what the Congress had done about infrastructure in the Gulf Coast. After the hurricane, several members of the Congress proposed that money be shifted from Alaska bridges to relief of Katrina victims. The response of the Alaska delegation was predictable: Don Young said “They can kiss my ear. That is the dumbest thing I’ve ever heard;” and Stevens said “That’s a total non-sequitur” (ADN, 9/21/05). Both Young and Stevens were blamed for having diverted funding to Alaska that otherwise would have been available to prevent flooding in New Orleans. Even a group of activists in Alaska formed to seek transfer of road dollars in Alaska to aid Katrina victims (FDNM, 9/28/05).
In late October the Senate acted on an attempt to divert bridge funding to New Orleans; the motion failed on a vote of 15-82 (FDNM, 10/21/05). The issue did not die quickly. In November, an issue of the national magazine *Parade* featured the bridges’ controversy (11/6/05), which by then had become a national joke. Later that month, the Congress acted to remove the $462.5 million earmarked for the bridges from the transportation legislation, but the money remained in the Alaska column. The Governor held $200 million for bridge work in his capital budget. As a side note, critical commentary on the bridges became personal to two members of the state’s congressional delegation. The media reported that Nancy Murkowski, Senator Lisa Murkowski’s mother, had an interest in property on Gravina Island (FDNM, 10/30/05), and Congressman Young’s kin, with property in Pt. Mackenzie, would benefit from the Knik Arm crossing (FDNM, 12/19/05).

The “bridges to nowhere” controversy was an element in the attempt to reform congressional earmarking of funds. During the legislative investigation it was revealed that in the period 1995-2000, the Alaska delegation—but primarily Senior Senator Ted Stevens—had added $3.3 billion to federal budgets through 1,723 earmarks on appropriations bills and added another $534.27 million in 470 conference committee earmarks (FDNM, 3/7/06). Stevens supported revisions to earmarking procedures that would affect only additions on conference committees and not on appropriations bills.

**Base Realignment and Closing Commission (BRAC).** Alaska is more dependent on federal military installations than any other state and the news in early 2005 that Eielson Air Force Base, some 25 miles south of Fairbanks, was on the BRAC list sent shock waves throughout the state. We reported on the spirited defense the state prepared to this recommendation in our 2005 report (see McBeath, 2006, AK-7-8). By mid-year the BRAC had reinvestigated the Eielson case and had added the Galena AFB to its closing list (FDNM, 8/5/05).

At its hearings in Washington, DC, commissioners concluded that moving Eielson to a “warm” status (removing both A-10s and F-16s, but leaving the base available for summer air flight exercises) would produce few savings and definitely not the $2.78 billion estimated (FDNM, 8/21/05). In late August, the commission voted unanimously to keep Eielson open year-round. It recommended cutting the A-10s, but keeping the F-16s on base; however, the commission also voted to close the Galena air station. This recommendation was accepted by the Bush administration and made final in November. Eielson AFB would lose 18 A-10 jets and 600 personnel, but the F-16s would remain, and the base population would be lowered only to 2,500 (FDNM, 11/10/05).

The state spent $800,000 in its defense of Eielson. In other military news, Ft. Wainwright, adjacent to Fairbanks, added a helicopter unit and additional personnel (FDNM, 11/2/05). Anchorage lost some F-15 fighters from Elmendorf AFB. News about the National Missile Defense (NMD) in Alaska was sparse in 2005-06, but in his FY 07 budget proposal, President Bush proposed an increase in spending of $1.6 billion, especially for ground-based interceptors, most of which are located in Ft. Greely south of Fairbanks (FDNM, 2/15/05). The ninth interceptor was installed at Ft. Greely in late May (FDNM, 6/2/06).
THE BUDGET PROCESS

Budget Staff. The essential outline of the budget process remained unchanged in 2005-06. The executive begins the process with the executive budget request for operating and capital funds, issued by December 15th, one month prior to the start of the legislative session. The Legislature is limited by constitutional amendment to a session of 121 days, which means it must conclude in early May.

Alaska’s budget staff is large for a sparsely populated state. In the executive Office of Management and Budget, more than a dozen analysts work on fiscal planning issues. The Legislative Finance Division of the Alaska Legislature has six analysts. Each of the co-chairs of finance committees in the House and Senate has two to three budget staff members. Thus, more than 30 staff members have highly specialized knowledge of budget data, which excludes budget staff personnel in the state’s departments.

The natural gas pipeline and oil tax issues of 2005-06 occasioned an increase in budget staff expertise. The Governor added nationally-renown consultants to his negotiating team with the producers. The Legislature spent $1.4 million to expand the roster of experts to review both oil tax and gas line legislation (ADN, 1/31/06). By late June, the Legislature had spent $3 million on consultants (FDNM, 6/23/06). It remains unclear whether the addition of this expertise was sufficient, given the weighty decisions on Alaska’s future revenue to be made.

Fiscal Problems. Alaska’s FY 06 general fund budget was $3 billion, an increase of 400 million or 14 percent over the previous year. Nevertheless, the budget did not rectify problems from previous lean budget years. Like other states, Alaska has an unfunded liability for the state pension system, estimated at $6.9 billion (FDNM, 3/25/06).

The elimination of the longevity bonus in the first year of Governor Murkowski’s administration exposed the state’s programs and benefits for lower-income Alaskans to critical review. Increasingly in lean budget years, the state has attempted to transfer state expenses to federal program categories, but by the middle of FY 06, with tightening at the federal level, state expenses for low-income Alaskans began to rise precipitously. For example, unbudgeted Medicaid costs totaled $69 million alone (FDNM, 10/1/05).

The elimination of the state’s revenue sharing and municipal assistance programs brought hardship to a number of municipalities. The Alaska Municipal League (AML) reported that nine rural towns had ceased operation as municipalities; 18 had serious management and fiscal problems; and another 39 might become insolvent within two years (FDNM, 9/17/05). The AML sought revival of the municipal revenue sharing program which ended in 2003 (FDNM, 11/19/05).

Finally, high fuel costs prompted concern statewide, but especially in rural areas where costs of heating oil and gasoline are two to three times higher than in Alaska’s urban centers. These issues were featured in both the Governor’s budget request and in legislative deliberations.
THE EXECUTIVE BUDGET REQUEST

The executive budget request unfolded in three acts. First, the Governor outlined his FY 07 budget plan on December 15th, as required by state law. He repeated many of these budget points to the Legislature in his State of the State and State of the Budget addresses. Then, in late January 2006, the Governor unveiled his large supplemental budget request. Finally, by late February, the Governor had presented the Legislature with his proposal to revise the state’s oil taxation regime, as part of the gas line negotiations. In each of these three actions, the Governor held the initiative on budget issues.

In mid-December, Governor Murkowski announced that he sought a general fund budget of $3.6 billion (with federal and other state funds, the operating and capital budgets would reach nearly $8 billion), nearly $500 million greater than the FY 06 budget, and the additional funds would be spent on education, roads and transportation enhancements, and preparation for the natural gas pipeline (ADN, 12/16/05). High oil prices meant that the state would have an additional $1.2 billion in revenues, and the Governor surprised observers by preparing to spend all of it. He wanted to commit $565 million to K-12 education, locked into the public education fund (which would effectively increase public school spending by over $90 million and raise the per student funding level to $5,352). The Governor proposed a $400 million investment in gas line preparation costs, and $130 million for state road and other projects (FDNM, 12/16/05).

In his first of two addresses at the start of the legislative session, the Governor remarked on negative national reaction to the state’s campaign to open ANWR as well as to the bridge projects in national transportation legislation. He said the nation’s view of Alaska was “sorely distorted,” and he called for a two-year national marketing campaign to “make over” the state’s image (ADN, 1/11/06). Then in his State of the Budget address, the Governor gave more details about plans for additional spending, including a new prison to house 770 Alaska prisoners now housed in Arizona, increased funding for Medicaid, and moneys for salary increases for state employees. He also announced a capital budget of $1.3 billion, mostly for highway projects (based on a federal contribution of $873 million and including nearly $200 million for the two bridge projects). This proposal also included small amounts for relief to Alaskans paying high home heating fuel costs, and to municipalities (FDNM, 1/27/06).

The Governor’s supplemental budget request was the largest in memory. The Governor asked for an additional $294 million to be spent in FY 06, about 10 percent of this fiscal year’s general fund budget. Some $164.6 million would be spent to recoup rising, unanticipated costs of public agencies, and $129.5 million for public works maintenance and construction. The Governor also wanted to spend $565 million on education and $400 million on the gas line, which would have used the entire amount available.

The most controversial of the Governor’s budget proposals concerned revision of the state’s oil taxation regime. The state collects royalties from oil companies, assesses property taxes (shared with local governments), and charges an income tax (as does the federal government). In addition, the state taxes oil as it leaves the ground, a severance tax. Since
1977, when oil first entered the Trans-Alaska Pipeline System, this taxation regime has not changed substantially. Altogether, oil taxes and royalties produce between 65 and 85 percent of the state’s general fund budget. Many Alaskans question whether the state receives its fair share of revenue from its ownership of oil-bearing lands. These concerns increased due to two factors: the very high profits of the three multinational oil companies doing business in Alaska (ConocoPhillips, BP, and ExxonMobil), and the impact that the Economic Limit Factor (ELF) would have on company taxes as Alaska’s oil is depleted.

The state implemented the ELF in order to encourage oil companies to develop smaller fields, which would be taxed at lower rates or not at all. Analysts have been alarmed at taxes that would be paid in the future on the state’s current second largest oil field, Kuparuk. In 2000 the field produced 212,000 barrels of oil a day and had an ELF rate of 0.6 (effectively a 9 percent production tax). By 2003, with declining production, this tax rate would be reduced to 3.75 percent. By 2007, the field would not be taxed at all, even though it would be producing 125,000 barrels of oil daily (FDNM, 3/5/06).

On a global basis, it is difficult to determine whether oil taxes in Alaska are high or low. In 2006, as compared to 25 oil state areas, Alaska ranks 19th with an average federal/state/local tax rate of 59 percent of the value of its oil. Venezuela has the highest take, at 89 percent; the America Gulf Coast has an average rate of 64 percent (FDNM, 2/24/06). However, Alaska’s arctic environment of oil production means it has the highest costs globally, and transportation costs are high as well. It does not compare well to other states in the American oil patch because the state owns the oil (but offshore oil deposits engage federal ownership and sharing of taxation powers).

Certainly, when oil companies negotiated with the Murkowski administration on the gas line project, they had the state’s oil taxation regime in mind. In late January, as negotiations neared completion, the Governor announced that he was tying changes in the oil tax system to the gas line (FDNM, 2/1/06).

The state discussed a variety of tax options with the oil companies, including both higher effective rates on oil company production (the net profits tax), tax relief to the companies when oil prices fell to the mid-$20 range, and tax credits and deductions for oil company investments in the state (FDNM, 2/2/06). The state’s final offer to the companies in mid-February was a 25 percent net profits tax and a 20 percent tax credit for profits reinvested in Alaska (FDNM, 2/16/06). Then the companies requested a final meeting with the Governor to negotiate specifically on production tax rates.

On February 21st, the Governor announced the conclusion of negotiations, linking an agreement with the producers on the natural gas pipeline with legislative acceptance of a new oil production tax. Elements of the proposal included a 20 percent tax on company net profits (a drop of 5 percent from the Governor’s earlier proposal, worth $650 million annually at oil prices of $60/barrel), a 20 percent deduction to companies for capital and operating expenses, a 20 percent tax credit on investment in Alaska, and a standard deduction of $73 million/year for each company in the Alaska oil business. Overall, the change would boost the state’s take
by 6 percent and produce $1 billion more annually to the state when oil prices were high, but at $25/barrel or less, the state would earn less (ADN, 2/23/06).

The Governor mentioned that oil companies had wanted to pay just 12.5 percent of net profits and that 20 percent was a “good balance, a fair return to state government that would attract exploration and investment” (FDNM, 2/22/06). Exxon spokesperson Susan Reeves said “the oil contract terms consistent with the governor’s proposed oil tax bill would provide the predictability and durability necessary to advance the gas project to the next phase” (FDNM, 2/22/06). The overall effect of the Murkowski proposal would be to move the state from its taxation rate of 59 percent to 62 percent, and to a 15th place ranking compared to other oil states instead of its 19th place ranking in 2006 (FDNM, 2/24/06).

THE LEGISLATIVE SESSIONS

The Legislature convened on January 9, 2006 and finished the regular session on May 9th. It finished most work on both capital and operating budgets by the end of the session, but did not adopt the Governor’s petroleum profits tax (PPT). Thereupon, the Governor called a special session (limited constitutionally to 30 days with the Governor setting the agenda) to begin the next day. At the start of the 1st special session, Governor Murkowski and Revenue Commissioner Corbus presented the negotiated contract for the gasoline and later added the PPT and amendments to the state’s Stranded Gas Development Act (SGDA). When legislators failed to adopt the PPT at the end of this special session, the Governor called a second session, beginning July 12th and finishing August 10th. The agenda for this special session was crowded with all unfinished business from the first as well as a few legislative proposals.

Legislators were critical about the outlines of the proposed FY 07 budget. House Minority Leader and gubernatorial candidate Ethan Berkowitz said: “He doesn’t put $1 in a state savings account. He spends every cent.” (12/11/05) The conservative House Majority Leader, John Coghill, called the plan “spendy,” while House Speaker John Harris said:

“If you continue to do and promise every program under the sun, you know, pretty soon, you’ve got to pay for it somehow. It’s easy to pay for it now, but you’re driving the base budget up.” (FDNM, 1/15/06)

Other conservative legislators proposed saving half of the expected surplus of $1.2 billion. Freshman representative Mike Kelly (Fairbanks, R) introduced legislation to amend the Constitution to restrict spending by limiting how much revenue from mineral extraction could be spent in any year (FDNM, 2/13/06). Response to the capital budget was similar. Anchorage Republican Kevin Meyer, co-chair of the Finance Committee, said it “encompasses a lot of items that normally and typically would be operating items” (ADN, 4/29/06).

The supplemental budget proposal evoked immediate condemnation from both Republicans and Democrats. Senate Finance Co-Chair, Gary Wilken, said of the requests: “They’re big, they’re unusual, and they’re unsustainable.” House Minority Leader Ethan
Berkowitz said that the large supplemental demonstrated inconsistency and inaccuracy in budgeting (FDNM, 2/3/06). Fairbanks Republican House member, Jim Holm, said that the road construction moneys should have been in the capital budget and that only the unanticipated expenditures should be funded (FDNM, 2/10/06).

Yet, while criticizing the Governor’s proposals, legislators lined up to provide energy rebates to residents and aid for municipalities (FDNM, 12/14/05, 12/22/05). They spent more time in hearings and meetings on the PPT than on review of agency budget requests. Definitely, the Governor dominated legislative sessions. His priorities—revision of the state’s oil taxation regime and the natural gas pipeline contract—occupied most legislative time. Legislators were resentful about being called twice into special session, particularly during a state election season. Although less than one-third of legislative seats are competitive in the primary, two-thirds are competitive for the November general election. Anchorage Democrat, Harry Crawford, expressed the view of many legislators when he said that he had 6,000 homes to canvass before the general election, and that the special sessions were cutting into this time (as well as making it difficult for him to redress the financial advantage of a well-heeled Republican challenger).

FINAL STATE BUDGET

Revenues. Alaska’s FY 07 total, all-source, budget (including capital funding) is $7,855.5 million. Table 1 indicates the sources of revenue:

<table>
<thead>
<tr>
<th>Revenue Source</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Unrestricted General Fund Revenue</td>
<td>3,436.7</td>
</tr>
<tr>
<td>Federal Funds</td>
<td>3,068.8</td>
</tr>
<tr>
<td>Other Funds</td>
<td>1,350.0</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$7,855.5</strong></td>
</tr>
</tbody>
</table>

The primary sources of unrestricted state revenues are royalties, property and severance taxes assessed on North Slope oil and gas production. This amount is considerably greater than listed in last year’s report because of higher oil prices. Federal funds projected to support the FY07 budget, the second largest category of funding, are nearly $300 million greater than for FY06. Other funds—including agency program receipts, license fees, and tuition at the University of Alaska, as well as bond proceeds and other borrowing and net corporate dividends are about the same as in FY06. Typically, PF earnings of well over $3 billion are not counted as revenue sources for state government. About half of the earnings were allocated to dividends ($878 million) and inflation proofing the PF ($732 million).

Capital Budget. During the second week of the first special session, the Legislature passed the largest capital budget in state history. It included $760.5 million in general funds,
$1.2895 billion of federal dollars and $274.5 million of other funds for a total of $2.324 billion. The next largest capital budget was that of 1985. At $1.2 billion ($2 billion adjusted for inflation) it relied more on state funds than the FY 07 capital budget (FDNM, 5/4/06).

The capital budget included funding for transportation projects, other public works, and grants. It paid for projects in virtually every legislative district. The large bill contained $101 million for the Gravina Island Bridge and $93 million for the Knik Arm Bridge (two bridges to nowhere), $45 million for a road north of Juneau (a road to nowhere), and $3.2 million for studies for a Bradfield Canal transmission line from Wrangell (a power line to nowhere) (FDNM, 5/15/06).

The Governor signed the legislation but vetoed $73.5 million from railbelt utility projects, saying they lacked integration with other power projects.

**Supplemental Budget.** The Legislature also passed the largest supplemental budget in state history, some $1.4 billion. This increased the FY 06 GF budget to $4.117 billion, making the FY 07 budget effectively smaller than that of 06. The supplemental paid for increased fuel costs and contained an unusual provision. It saved $600 million from the 2006 fiscal surplus by depositing $300 million into the public education fund and $300 million into the Alaska Housing Finance Corporation (AHFC) for possible use in gas line construction (ADN, 7/28/06).

House Minority Leader Ethan Berkowitz criticized the “sweeping” of surplus revenues into “questionable accounts.” He wanted them placed in the Constitutional Budget Reserve, where interest rates would be higher (and where a three-quarters vote of the Legislature would be needed to appropriate them, thereby empowering minority Democrats (FDNM, 5/15/06).

**Operating Budget.** The state’s operating budget, displayed in Table 2*, is $5.971 billion. It included $3.324 billion in general funds, $1.8 billion in federal funding, and $3.479 billion of other state funds. The GF portion of the operating budget is nearly $500 million larger than the FY 06 general fund budget (before the 2006 supplemental raised this total).
TABLE 2.
GF Operating Budget FY 06/07, and Changes
(in thousands)

<table>
<thead>
<tr>
<th>Agency</th>
<th>FY 2006</th>
<th>FY 2007</th>
<th>Change in Percent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Administration</td>
<td>79,593.7</td>
<td>86,026.3</td>
<td>8.1 %</td>
</tr>
<tr>
<td>Commerce, Community &amp; Econ Development</td>
<td>15,535.7</td>
<td>53,433.5</td>
<td>243.9 %</td>
</tr>
<tr>
<td>Corrections</td>
<td>177,302.4</td>
<td>185,376.7</td>
<td>4.6 %</td>
</tr>
<tr>
<td>Education &amp; Early Development</td>
<td>892,071.7</td>
<td>1,023,284.1</td>
<td>14.7 %</td>
</tr>
<tr>
<td>Environmental Conservation</td>
<td>14,481.3</td>
<td>16,259.1</td>
<td>12.3 %</td>
</tr>
<tr>
<td>Fish and Game</td>
<td>33,992.0</td>
<td>38,665.2</td>
<td>13.7 %</td>
</tr>
<tr>
<td>Governor</td>
<td>27,419.3</td>
<td>42,522.8</td>
<td>55.1 %</td>
</tr>
<tr>
<td>Health &amp; Social Services</td>
<td>688,636.8</td>
<td>747,581.1</td>
<td>8.6 %</td>
</tr>
<tr>
<td>Labor &amp; Workforce Development</td>
<td>16,030.5</td>
<td>19,384.7</td>
<td>20.9 %</td>
</tr>
<tr>
<td>Law</td>
<td>54,963.3</td>
<td>39,643.8</td>
<td>-27.9 %</td>
</tr>
<tr>
<td>Military &amp; Veterans Affairs</td>
<td>12,829.8</td>
<td>12,740.9</td>
<td>-0.7 %</td>
</tr>
<tr>
<td>Natural Resources</td>
<td>68,483.5</td>
<td>58,865.2</td>
<td>-14.0 %</td>
</tr>
<tr>
<td>Public Safety</td>
<td>95,150.9</td>
<td>104,898.2</td>
<td>10.2 %</td>
</tr>
<tr>
<td>Revenue</td>
<td>20,320.8</td>
<td>12,453.4</td>
<td>-38.7 %</td>
</tr>
<tr>
<td>Transportation</td>
<td>192,490.7</td>
<td>191,304.7</td>
<td>-0.6 %</td>
</tr>
<tr>
<td>University of Alaska</td>
<td>245,443.7</td>
<td>279,651.0</td>
<td>13.9 %</td>
</tr>
<tr>
<td>Alaska Court System</td>
<td>64,048.9</td>
<td>74,037.3</td>
<td>15.6 %</td>
</tr>
<tr>
<td>Legislature</td>
<td>49,866.2</td>
<td>51,047.8</td>
<td>2.4 %</td>
</tr>
<tr>
<td>Debt Service</td>
<td>53,145.1</td>
<td>81,168.9</td>
<td>52.7 %</td>
</tr>
<tr>
<td>Fund Capitalization</td>
<td>35,127.6</td>
<td>209,122.7</td>
<td>495.3 %</td>
</tr>
<tr>
<td>Public Education Fund</td>
<td>2,692.4</td>
<td>-3,352.6</td>
<td>-224.5 %</td>
</tr>
<tr>
<td><strong>Total Operating Budget</strong></td>
<td>2,839,626.3</td>
<td>3,324,114.8</td>
<td>17.1 %</td>
</tr>
</tbody>
</table>

* This table, like Table 4, reflects an “apples-to-apples” comparison, prepared by the state’s Legislative Finance Division. Director David Teal notes: “The combination of surplus GF revenue in recent years and a desire to avoid having those surpluses “swept” into the Constitutional Budget Reserve Fund has resulted in substantial appropriations that cross fiscal years. This makes traditional year-to-year budget comparisons (meaning an appropriation is attributed to the year in which it becomes effective rather than to the year the money is actually spent) misleading. That is why we have added the apples-to-apples view of the world.”

Source: Legislative Finance Division, 8/7/2006

Table 3 presents the changes (from FY 06) of 10 percent or greater in the budgets of each state agency:
### TABLE 3.
**Operating Budget, Major Changes**

<table>
<thead>
<tr>
<th>Agency</th>
<th>Nature of Adjustment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Administration</td>
<td>Added $2.3 million for distribution to state agencies for increased chargeback rates. The funds will be distributed to agencies in FY 07 and appear in their budgets in future years. Added $1.3 million for Enterprise Technology improvements and $1.3 million for legal/advocacy services.</td>
</tr>
<tr>
<td>Commerce, Community &amp; Economic Development</td>
<td>Increased seafood marketing institute’s budget by $1 million of GF. Added $48.1 million of GF for grants to municipalities to defray increased energy (and other) costs. Added $6.5 million to the Power Cost Equalization program (contingent on the price of fuel).</td>
</tr>
<tr>
<td>Corrections</td>
<td>Added $3.3 million GF for out of state contracts, the amount spread through the institutions.</td>
</tr>
</tbody>
</table>
Significantly, the Governor made no vetoes to the operating budget of the state.

Table 4 presents agency totals for all sources of funding. For details of agency appropriations, see: [http://www.legfin.state.ak.us](http://www.legfin.state.ak.us) The total operating budget relies to the extent of 39 percent on state unrestricted general fund appropriations.

**TABLE 4.**
Agency Summary—FY07 Operating Budget, all sources
(in thousands)

<table>
<thead>
<tr>
<th>Agency</th>
<th>GF</th>
<th>Federal</th>
<th>Other</th>
<th>All Funds</th>
</tr>
</thead>
<tbody>
<tr>
<td>Administration</td>
<td>86,026.3</td>
<td>2,984.2</td>
<td>195,290.4</td>
<td>284,300.9</td>
</tr>
<tr>
<td>Commerce, Community &amp; Economic Development</td>
<td>53,433.5</td>
<td>28,235.9</td>
<td>119,017.1</td>
<td>200,686.5</td>
</tr>
<tr>
<td>Corrections</td>
<td>185,376.7</td>
<td>4,695.6</td>
<td>23,981.8</td>
<td>214,054.1</td>
</tr>
<tr>
<td>Education &amp; Early Development</td>
<td>1,023,284.1</td>
<td>214,382.0</td>
<td>37,192.4</td>
<td>1,274,858.5</td>
</tr>
<tr>
<td>Environmental Conservation</td>
<td>16,259.1</td>
<td>19,009.1</td>
<td>26,044.2</td>
<td>61,312.4</td>
</tr>
<tr>
<td>Fish and Game</td>
<td>38,665.2</td>
<td>63,432.6</td>
<td>66,792.6</td>
<td>168,890.4</td>
</tr>
<tr>
<td>Governor</td>
<td>42,522.8</td>
<td>167.7</td>
<td>4,164.9</td>
<td>46,855.4</td>
</tr>
<tr>
<td>Health &amp; Social Services</td>
<td>747,581.1</td>
<td>1,075,109.5</td>
<td>152,488.9</td>
<td>1,975,179.5</td>
</tr>
<tr>
<td>Labor &amp; Workforce Development</td>
<td>19,384.7</td>
<td>99,226.2</td>
<td>51,522.9</td>
<td>170,133.8</td>
</tr>
<tr>
<td>Law</td>
<td>39,643.8</td>
<td>2,740.6</td>
<td>23,681.3</td>
<td>66,065.7</td>
</tr>
<tr>
<td>Military &amp; Veterans Affairs</td>
<td>12,740.9</td>
<td>20,179.9</td>
<td>10,090.3</td>
<td>43,011.1</td>
</tr>
<tr>
<td>Natural Resources</td>
<td>58,865.2</td>
<td>16,282.4</td>
<td>45,271.3</td>
<td>120,418.9</td>
</tr>
<tr>
<td>Public Safety</td>
<td>104,898.2</td>
<td>12,487.9</td>
<td>20,776.9</td>
<td>138,163.0</td>
</tr>
<tr>
<td>Revenue</td>
<td>12,453.4</td>
<td>41,912.8</td>
<td>160,351.7</td>
<td>214,717.9</td>
</tr>
<tr>
<td>Transportation</td>
<td>191,304.7</td>
<td>3,738.9</td>
<td>285,013.6</td>
<td>480,057.2</td>
</tr>
<tr>
<td>University of Alaska</td>
<td>279,651.0</td>
<td>149,524.0</td>
<td>344,933.1</td>
<td>774,108.1</td>
</tr>
<tr>
<td>Alaska Court System</td>
<td>74,037.3</td>
<td>1,675.6</td>
<td>971.3</td>
<td>76,684.2</td>
</tr>
<tr>
<td>Legislature</td>
<td>51,047.8</td>
<td>0.0</td>
<td>681.7</td>
<td>51,729.5</td>
</tr>
<tr>
<td>Debt Service</td>
<td>81,168.9</td>
<td>9,295.1</td>
<td>251,930.7</td>
<td>342,394.7</td>
</tr>
<tr>
<td>Fund Capitalization</td>
<td>209,122.7</td>
<td>14,294.7</td>
<td>1,659,736.8</td>
<td>1,883,154.2</td>
</tr>
<tr>
<td>Public Education Fund</td>
<td>-3,352.6</td>
<td>0.0</td>
<td>0.0</td>
<td>-3,352.6</td>
</tr>
</tbody>
</table>

**Total—Operating Budget**

<table>
<thead>
<tr>
<th>GF</th>
<th>Federal</th>
<th>Other</th>
<th>All Funds</th>
</tr>
</thead>
<tbody>
<tr>
<td>3,324,114.8</td>
<td>1,779,374.7</td>
<td>3,479,933.9</td>
<td>8,583,423.4*</td>
</tr>
</tbody>
</table>

*Includes Permanent Fund Dividends.

Source: Legislative Finance Division, 8/4/06

The federal share is $1.779 billion. As in past years, the Department of Health & Social Services receives 60 percent of the federal funding. Both K-12 and university education also receive substantial federal support. Program receipts, such as user and license fees and tuition, are large parts of the budgets of many state agencies. As in previous years, they comprise over 40 percent of the University of Alaska’s budget, 60 percent of the Transportation & Public Facilities budget, and 74 percent of the Revenue Department’s budget.
OIL & GAS ISSUES IN THE SESSIONS OF THE 24TH LEGISLATURE

Changes to the State’s Oil Taxation Regime. At the start of the legislative session, Democratic legislators introduced bills that would significantly increase taxation on oil companies, including a 30 percent net profits tax, exempting only the first 1,000 barrels of oil. This, said its authors, would bring $2.5 billion in revenue to the state if oil prices were above $60/barrel. In response to the Governor’s full discussion of the oil tax proposal with the Legislature, Democratic gubernatorial candidate Eric Croft remarked “I think it’s a sad day. One hundred thirty-nine years ago Russia sold Alaska for peanuts, and we just sold Alaska for peanuts” (FDNM, 2/22/06).

Then, while just beginning substantive examination of the Governor’s budget proposal, the Legislature shifted gears and responded to the changes proposed to the oil taxation system. From late February to mid-March, legislators heard from parades of witnesses. Oil company officials said the 20 percent net profits tax was too steep, but that they would support it; yet company executives declined to say whether passage of the tax bill was a condition for signing a gas pipeline deal (ADN, 3/2/06). Independent oil producers said that the net profits tax also was too high, but that the incentives in the proposal struck a balance that was “grudgingly acceptable” (FDNM, 3/5/06).

Chairs of resources and oil/gas committees generally believed the net profits tax was too low and the incentives for oil company exploration and development too generous. But by mid-March, they had not proposed more than marginal increases of the former and reductions to the latter.

Six objections to the Governor’s PPT proposal surfaced during legislative deliberations. Most legislators opposed a lock-in of 30 years for the new tax regime, which the Governor had contended was essential to begin gas line development. Second, most legislators believed the tax rate—at 20 percent of net profits—was too low. Third, a number of legislators believed the tax needed to discriminate between old “legacy” fields, such as Prudhoe Bay, and new fields. Fourth, most legislators wanted escalator provisions, to harvest more revenue for the state as oil prices passed $50/barrel. Fifth, most legislators thought the Governor’s tax credit provisions were too liberal. Finally, some legislators—and virtually all Democrats—believed the oil companies would not reveal their true profits and that the PPT would tie the state up in litigation with the oil companies for years. As mentioned, they proposed a gross profits tax instead.

The oil companies sided with the Governor’s proposal throughout. They spent more on lobbying in the first quarter of 2006 than in the previous year (FDNM, 5/5/06). BP and ConocoPhillips published nearly daily full-page ads in support of the PPT agreement. But with $7 billion in profits from Alaska operations, high gas prices, and windfall profits, the oil industry was vulnerable, even to criticism from pro-growth and fiscally conservative Republican legislators.

Toward the close of the regular session, the House passed a PPT version close to the Governor’s proposal (a 21.5 percent tax on net profits and a 20 percent credit), but added an
escalator provision. On a 10-10 vote, the Senate failed to adopt the House version (FDNM, 5/10/06). A split among Republican leaders of the Senate led to this outcome (ADN, 5/11/06). The PPT was reintroduced in the first special session. A compromise would have taxed net profits at 22.8 percent with an escalating surtax of .175 percent for every $1 increase over an oil price of $50/barrel. Fairbanks Republican Mike Kelly said the bill had something for everyone to dislike (FDNM, 6/9/06). During the second special session, legislators considered a gross profits tax and aligning the tax on oil industry investment. Then they shifted focus to a “produce or pay” system which would differentiate existing from new production, charging a 25 percent tax on the former and a 15 percent tax on the latter. Oil companies objected, saying such a system would penalize companies drilling dry holes (ADN, 8/2/06). Consultants complained about the complexity of this proposal.

Finally, at the eleventh hour of the second special session, legislators reached a consensus on oil taxation changes. The new production tax sets a 22.5 percent tax rate on oil production and offers a 20 percent credit for investment—very close to the Governor’s original proposal. However, the new tax has an escalator provision, kicking in when oil prices rise above $55/barrel. At high oil prices—such as those of early August ($75/barrel)—the new tax would produce $3.7 billion a year, nearly three times what the current severance tax on oil supplies. A final section responded to recent events: the bill included a provision preventing the state from subsidizing repairs needed for oil field shutdowns that may have been caused by poor maintenance of infrastructure (FDNM, 8/11/06).

The votes in the House and Senate were 26-14 and 14-5 respectively, with Republicans generally being supportive and Democrats opposed. Democratic Anchorage Representative Les Gara noted: “The money it raises today, we’re going to lose tomorrow.” But Republican Mike Kelley from Fairbanks said: “We have a mixture here that is not making anyone perfectly happy,” but “It’s time to act.” The Governor’s spokesman said the new tax “wasn’t exactly what (the Governor) was looking for” but was “in the ballpark.” (FDNM, 8/11/06).

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The Alaska Natural Gas Pipeline. The Prudhoe Bay area has nearly 35 trillion cubic feet of natural gas, and leases to the gas are owned by three multinational oil companies—Exxon Mobil, ConocoPhillips, and BP. For more than a year the state has been considering three proposals to develop and transport gas to the lower-48 states: 1) the three companies’ (called the “producers”) proposal to transport the gas to Fairbanks and then through Canada to the Mid-West, 2) the Alaska Gasline Port Authority (a group joining three municipalities with strong interests in the gas line—Fairbanks, Valdez, and the North Slope) proposal to transport the gas to Valdez, entirely in-state, with feeder lines to Anchorage; and 3) the transCanada proposal, that would group Alaska natural gas with Canadian Mackenzie Valley gas. The Murkowski administration conducted serious negotiations only with the producers, because they hold the leases to the gas.

In September 2005, Governor Murkowski proposed that the state invest $4 billion into pipeline construction, which would represent a 20 percent interest (were the project to cost only $20 billion [ADN, 9/15/05]; current estimates are that it will cost from $25 to 30 billion.) State ownership of a pipeline is unprecedented in the United States, and the proposal
was questioned by critics (FDNM, 10/8/05). By October, the state announced it had reached agreement with ConocoPhillips, but Tom Irwin, Commissioner of Natural Resources (DNR) leaked to the media a memorandum from his department to the Department of Law, requesting a ruling on the legality, under the state’s Stranded Gas Act, of the agreement. The Governor proceeded to fire Irwin for questioning the way the state was pursuing the gas pipeline, whereupon six top DNR officials resigned (FDNM, 10/28/05). There was an outpouring of support for Irwin, including large demonstrations against Murkowski’s actions in Fairbanks and Anchorage, and the firing was yet another factor adding to the Governor’s unpopularity.

Not only legal issues hampered the negotiations; the producers also were reluctant to develop the gas. Currently, gas is re-injected into the oil fields to force out oil, and to exploit North Slope gas might leave millions of barrels of oil stranded underground (ADN, 12/10/05) at a time of high oil prices. Democratic legislator Eric Croft announced a proposal to tax gas reserves (an option available under Alaska law if lessees do not develop oil and gas leases) as one means to strengthen the interest of producers in gas line development, and that proposal has become an initiative for voters in the November election. Meanwhile, former Governor Tony Knowles criticized the secret negotiations as “alarming and disturbing,” and asked for a state majority interest in the gas line and that no incentives be offered the producers (FDNM, 1/25/06).

The Murkowski administration finally reached closure with all of the producers by the end of February. However, the producers insisted they would develop the gas line only if the state provided certainty in its oil taxation regime. The oil tax legislative changes (discussed above) are what the Governor introduced to the Legislature in February, and the six points of the state’s proposed 30-year contract with the producers for construction and transportation of natural gas remained secret (FDNM, 2/22/06). For this reason, Democratic Senator Hollis French (Anchorage) went to the Superior Court to force release of the contract (ADN, 4/22/06). The court ordered the release of the contract but the administration did not fully reveal it until the start of the first special session.

For the first two weeks of the session, the Governor and his Commissioner of Revenue walked legislators through the contract. Briefly, the administration proposed a 20 percent state ownership share in the pipeline. The producers would pay the state’s share of profits in gas and not cash. The contract spelled out a lengthy process to move toward construction in these stages: 1) feasibility studies, 2) engineering studies, 3) declaration of an “open season sale” for shippers to build capacity, 4) application for permits, 5) ordering the 6 million tons of steel necessary for the pipeline, 6) start of construction by 2012, and 7) conclusion, with gas flowing by 2015 (FDNM, 5/23/06). The contract did not commit the producers to build the gas line and indeed consultants mentioned a 20-30 percent probability that the line would not be built. It held them harmless from litigation concerning construction of the line and protected them if, as expected, a voter initiative on gas reserves passes in the November 206 general election.

Nearly mid-way through the first special session, the Governor introduced three gas bills that would amend the Alaska Stranded Gas Development Act (SGDA). Provisions of the
The bill would allow the Governor to negotiate oil and gas agreements, freeze oil and gas taxes and royalties, allow partial state ownership of the gas line, give the state supreme court final jurisdiction over gas line matters, and create an Alaska Natural Gas Pipeline Corporation to finance and manage the state’s interest in the pipeline.

During the remainder of the first and throughout the second special session, both houses held hearings and meetings on the proposed contract. The Senate established a special committee on the pipeline, chaired by Fairbanks Republican Ralph Seekins. During the 45-day public comment period, the administration received more than 2,000 individual comments. Although most commentators (like most residents in the state) wanted to see a natural gas pipeline constructed, opinions differed on these points: routing, state ownership and its implications, anti-trust problems, guarantees, tax rates, viability of a gas line, and speed of the process. We discuss each in turn.

The Governor had negotiated with the three corporations that have leased most of North Slope gas—ExxonMobil, BP, and ConocoPhillips. He paid scant attention to two other competing proposals, the Alaska Gas Line Port Authority and TransCanada. Mayor Jim Whitaker of Fairbanks questioned the integrity of the Murkowski administration, and throughout the legislative session attempted to rally support for the all-Alaska gas line.

The Governor had proposed a 20 percent state ownership interest in the pipeline, which would be unprecedented in the U.S. Gas line discussions focused on the ramifications of state ownership, with concerns that the state would bear a larger proportion of construction costs than its ownership interest would justify. The state would also receive profits in the form of natural gas and would then have to market the gas in competition with the producers.

Several questions arose concerning the antitrust implications of the state’s contract with the three multinational oil/gas corporations. Particularly, independent producers wondered if they would have access to the gas line and, if so, on what terms.

To many observers, the contract made commitments on the part of the state but none on the part of the producers. They would not be legally required to construct the pipeline. They would not be required to guarantee a certain size of pipeline, or access to it by other producers. They would not be required to guarantee in-state use of gas produced from North Slope reserves. If the state were dissatisfied with the producers’ performance under the contract, the contract restricted the state from suing the companies, outlining instead a process of arbitration. Finally, the local hire provisions were weak.

The contract specified stable taxes on gas for 45 years. Like the 30-year oil taxation proposal, this bothered many observers, who pointed to the volatility of both oil and gas prices and the difficulty of achieving the state constitutional mandate of “maximum benefit” for the people if taxation rates could not be altered. Furthermore, objections were raised to linking oil and gas taxation rates.
A number of observers questioned whether the state should make any concessions to the producers at all. They believed that an Alaska natural gas pipeline would be viable without the special terms written into the contract.

Finally, most observers (including the state’s major newspapers) questioned the need to make an instant decision on the contract and they resented pressure from those urging them to act quickly. In late June, a number of national officials urged speedy action on the contract. Vice President Cheney urged legislators to act quickly. The Secretary of Energy promised an expedited review of the contract (ADN, 6/23/06). Senator Domenici, the author of the 18 billion federal loan guarantee for the Alaska natural gas pipeline, criticized the Legislature for delay in ratifying the contract (FDNM, 7/21/06). Senator Ted Stevens urged action before the November election, fearing that a flood of cheap gas imports would reduce the demand for Alaska gas (FDNM, 7/8/06). Governor Murkowski repeatedly urged action, saying “Nobody’s walking out of here without taking a position and standing up and being counted” (FDNM, 7/14/06).

When the Legislature concluded the second special session, it had taken no action on the gas line contract and had adopted none of the amendments to the SGDA. It seems likely that the winner of the November gubernatorial election will need to renegotiate a contract with the producers.

CONCLUSIONS

FY 2006 was a very good budget year for Alaska. High and rising oil prices through the 2005 and 2006 calendar years made it unnecessary for the Governor and Legislature to seriously address the state’s lack of a broad-based tax to fund government or, alternatively, to allocate part of the earning reserve of the Permanent Fund toward that purpose. High oil prices and a FY 06 surplus of over $1.2 billion made it unnecessary for the Republican Governor and Legislature to exercise fiscal restraint.

Governor Murkowski initiated the FY 07 spending plans: one of the largest operating budgets in state history, the largest capital budget, and the largest supplemental budget. Legislators made few significant changes to the Governor’s proposals and he vetoed just one appropriation in all of the spending bills passed by the Legislature. Total spending from all funds (including some appropriations from FY 05 and FY 08, as well as appropriation of Permanent Fund earnings) added up to $11 billion, a huge budget for a sparsely populated state and, on a per capita basis, the largest in the United States. But Alaska’s continued wealth is uncertain, as shown in the shutdown of the Prudhoe Bay field to deal with corrosion problems in the aging pipeline.

The Governor also set the agenda for the regular legislative session by emphasizing the need to change the state’s oil taxation regime. He then called legislators into two special sessions to review the contract his administration had negotiated with the natural gas producers. By the close of the second special session, the Legislature had adopted a new taxation system for oil company profits, which bore a close relationship to the Governor’s
proposal. However, legislators balked at the gas line contract, and it will be the focus of attention during the 2006 campaign season.

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