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Rating Update: Alaska (State of)

MOODY'S REVISES STATE OF ALASKA CREDIT OUTLOOK
TO NEGATIVE FROM STABLE

Affirms Aa2 Issuer Rating

Opinion

NEW YORK, Aug 27, 2002 -- The State of Alaska's (Aa2 Issuer Rating) credit outlook has been revised to negative, from stable, reflecting the significant budgetary stress the state continues to face due to its fiscal dependence on the oil extraction industry. Oil industry tax and royalty payments comprise nearly 83% of total unrestricted General Fund revenues, and recent oil price volatility has resulted in substantial revenue shortfalls in fiscal 2002 and 2003. The state has continued to face budget problems resulting from the weak performance of oil revenues, the rising costs of programs like Medicaid, as well as policy driven goals to increase funding for schools. Still, Alaska's economy is in its 14th consecutive year of economic growth, with record low unemployment and the nation's 4th fastest growth in personal income in 2001.

Alaska homeownership is up, bankruptcies are down, business start-ups are up, and Alaska's savings accounts, including the \$23.1 billion Permanent Fund, are sound. At this time, Moody's will maintain its Aa2 issuer rating for the state, based on Alaska's low debt load (i.e., the state has one of the lowest debt burdens in the nation); expanding yet still narrow economic base; and its conservative financial planning efforts to accommodate the eventual limitation of oil revenues.

Since the state legislature has rejected the governor's proposals to either enact a modest broad-based state tax or tap the excess earnings of the Permanent Fund, these budgetary shortfalls have been primarily offset through substantial draws on the state Constitutional Budget Reserve Fund (CBRF). Absent draconian budget cuts to ongoing state programs or changes to the state's revenue structure, the state will continue to be forced to rely on CBRF draw-downs to balance its budget. However, the CBRF - which is now funding about 35% of total general fund spending - will be entirely exhausted by Oct 2004 or July 2005 (fiscal 2005) depending upon price and economic growth assumptions. This potential near-term eventuality highlights the need for the state to develop a long-term solution to its structural imbalance.

The state remains deadlocked over how to address future sizable projected budget gaps, as efforts to implement a modest broad-based state tax have been rejected by the legislature. (NOTE: Alaska is the only state in the nation with no broad-based tax; e.g. sales or personal income.) Other options for addressing the chronic structural budget imbalance include major spending reductions and accessing the excess earnings of the state's Permanent Fund. This latter choice would require the tradeoff of reducing Alaska residents' annual dividend payment which is funded from the Permanent Fund earnings, a choice so far rejected by the legislature and the voters.

Recognition of the "Prudhoe Curve", the long-term decline of Alaska's rich oil reserves, in the state's long-term financial structure should enable the state to adequately prepare for its future in a post-oil

resource economy. The creation of the Alaska Permanent Fund and the CBRF, respectively provide for long term and short term financial stability. Also important is the recognition by state elected and appointed officials of the finite nature of the resource that has brought wealth to the state and the need to reduce the demand for governmental services as that resource dwindles. To that end, Alaska has been the only state in the nation over the last five years to reduce the size of its budget.

While the State of Alaska has tax capacity, lacking any broad-based tax and access to the substantial asset of the Permanent Fund and its earnings, the state has not yet begun the transition to budget structural balance that will be necessary after the exhaustion of the CBRF. Our issuer rating of Aa2 is predicated on the assumption that the state will ultimately make the hard decisions necessary to fund state expenditures, but we expect the state finances to be under continued financial stress in the near future as these structural budget problems persist.

For further discussion, please refer to Moody's Special Comment entitled, "Outlook for State Sector Remains Negative", published August 27, 2002.

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