1 PRESENTATION TO THE LEGISLATURE ON ALABAMA'S FINANCIAL CONDITION

2 JANUARY 16, 2008

3 I. Introduction

A. Today, I will discuss with you the revenue and appropriation structure of the state; the status of the General Fund and the Education Trust Fund for FY 2007; the revised LFO revenue estimates for FY 2008; the LFO revenue forecasts for FY 2009; and a few general fiscal issues

4 II. Revenue and Appropriation Structure of the State

A. Exhibit 1 shows the appropriation of all state funds for FY 2008 at the time appropriations were made by the Legislature

1. for FY 2008, the General Fund appropriations total $1.8 billion of the grand total of $11.6 billion in state appropriations
2. the ETF appropriations total $6.7 billion and other earmarked appropriations total $3.1 billion
3. recently, the Alabama Medicaid Agency has received a lot of attention; you can see on this chart that the agency will receive the largest amount of General Fund appropriations-$470.8 million or 25.7% of the entire fund for FY 2008
    a. Medicaid also receives other earmarked state funds in FY 2008 totaling $802.2 million
        i. this is also the largest amount of earmarked funds outside of the Education Trust Fund
        ii. transportation is second with $612.7 million (primarily gasoline tax receipts)
    b. Medicaid has a total of $1.27 billion in state funds which is used to match federal funds primarily at the

rate of $2.09 for every $1 in state funds

c. Medicaid expenditures are a major economic factor in Alabama

B. Exhibit 2 shows the percentage that certain revenue sources contributed to the General Fund in FY 2007

1. insurance premium taxes accounted for the largest single source of revenue at approximately 15% of the fund (this tax is in lieu of income taxes for insurance companies)
    a. CAPCO credits
        i. Act 2002-749 created the CAPCO program which allowed the Alabama Development Office to allocate up to $100 million in insurance premium tax credits to insurance companies making investments in ADO certified venture capital firms
        ii. the maximum amount of credits available in a fiscal year under this act was $12.5 million
        iii. the effect of these credits to the General Fund were first realized in FY 2006
        iv. Act 2007-742 extended the CAPCO program by allocating an additional $100 million of insurance premium tax credits
        v. the effect of these additional credits will first be realized in FY 2010 (the maximum amount of credits in any one year allowable under this act will be $17.5 million)
2. interest income accounted for 13% of the General Fund
    a. this includes interest on regular state deposits and interest earned on the Alabama Trust Fund
    b. the recent interest rate reductions and projected future reductions by the Federal Reserve Board will negatively affect this revenue source to the General Fund and will be evidenced by the LFO revised estimates

3. property taxes accounted for 7% of the fund-the General Fund receives 2.5 mills of the state's 6.5 mills of ad valorem tax (most property taxes are levied by local governments)
4. you can see the other major sources of revenue to the General Fund on this pie chart

C. Exhibit 3 shows the percentage that certain revenue sources contributed to the ETF for FY 2007
1. income taxes (both corporate and individual) accounted for approximately 58% of the ETF
2. sales taxes accounted for approximately 30% and
3. utility taxes accounted for almost 7%
4. there are fewer sources of revenue to the ETF than the General Fund but most of the growth taxes are earmarked to the ETF
5. this is a double-edged sword; these revenue sources respond quickly to shifts in the economy
    a. the downward shift in the economy was evidenced in the last several months of the fiscal year that ended September 30, 2007
    b. when this office was revising its revenue projections last February, the fund was growing at a rate of 12.96% through December, 2006
    c. the LFO revised estimate was for a 8.1% growth for FY 2007 but the fund ended the fiscal year with only a 6.5% growth rate
6. I have asked the Legislature each year to spend less than LFO revenue estimates in respect for economic cycles which affect the ETF very quickly
    a. I want to commend this Legislature for providing a mechanism for setting aside funds in the statutory Proration Prevention Account over the last three fiscal years

5 III. Exhibit 4 shows the Condition of the General Fund for FY

2007

A. the General Fund began the fiscal year with a balance of $263.2 million

B. actual receipts for the year were $1.533 billion

  1. in addition, there were $5.3 million in transfers from state agencies' earmarked funds to the General Fund
     a. the Public Service Commission-$3.8 million and
     b. the Securities Commission-$1.5 million
  2. there was a $25 million extra transfer from the abandoned property escrow account to the General Fund and
  3. a $15 million transfer from the business privilege tax above the regular estimates
  4. an $11.2 million appropriation from tobacco revenues to the General Fund
  5. $35 million in realized and unrealized capital gains in the Alabama Trust Fund recognized by the Alabama Trust Fund Board and transferred to the General Fund and
  6. a reimbursement of $9.9 million from the Federal Emergency Management Agency (FEMA) for previous years state expenditures for natural disasters
  7. that made a total of $1.635 billion in receipts for FY 2007

C. with the addition of the beginning balance, there was a total of $1.898 billion available for expenditure in FY 2007

D. there were total appropriations of $1.659 billion from the General Fund net of reversions

E. therefore, FY 2007 ended with a balance of $239 million in the General Fund

6 IV. Exhibit 5 Shows the LFO Projected Condition of the General Fund for FY 2008 and FY 2009

A. the General Fund began FY 2008 with a balance of $239 million which is $37 million more than anticipated and appropriated for FY 2008

1. the LFO revised revenue estimates for the General Fund for FY 2008 are $1.5 billion
2. this is $45.8 million less than LFO original estimates due mainly to
   a. a decrease in the estimate for interest income on state deposits of $31 million
      i. this reduction is the result of lower interest rates and the loss of balances in the various funds (especially in the ETF) to invest and
   b. a major reduction in insurance premium tax estimates ($13.3 million)
3. just as the Legislature did in FY 2007, $5.3 million was transferred from the Public Service Commission and the Securities Commission
4. there is an extra transfer from the abandoned property reserve fund of $15 million
5. the FY 2008 budget was built on the expected transfer of $19.5 million from the Exxon escrow account
   a. many of you will remember that after the first jury verdict against Exxon and in favor of the state for underpayment of oil and gas royalties, the company chose to give the state a prepayment of $20 million in lieu of posting a 10% supersedeas bond of that amount, $18 million was allocated to the General Fund (after attorney's fees)
   b. that amount has accrued interest since 2001 and that accounts for the $19.5 million available to be transferred
      i. I will talk about the Exxon litigation later in this presentation
   c. in addition, the Legislature appropriated $12.2 million from tobacco revenues to the General Fund for FY 2008
   d. in October of this year, the Alabama Trust Fund

Board elected to recognize 75% of all realized and unrealized capital gains in the Alabama Trust Fund on September 30, 2007 as authorized by Amendment 666
    i. that amounted to a total of $165.4 million
    ii. 70% was transferred to the General Fund ($117.3 million)
    iii. 20% was transferred to the City and County Capital Improvement Trust Funds ($33.5 million) and
    iv. 10% was transferred to the Forever Wild Trust Fund ($14.6 million)
    v. the Legislature had anticipated and appropriated only $35 million in capital gains to the General Fund for FY 2008
    vi. so the General Fund has $82 million more than anticipated from this transfer
  e. in addition, the Attorney General announced a settlement with 2 of the total 71 pharmaceutical companies (Dey and Takeda) which the state of Alabama sued for alleged overpricing of prescription drugs sold to Medicaid clients
    i. from the settlement with these 2 companies, $4.7 million will be deposited into the General Fund
  f. the total receipts now estimated by the LFO to the General Fund for FY 2008 are $1.680 billion
6. when estimated receipts are added to the beginning balance, there is a total available of $1.920 billion
7. the current estimated appropriations from the General Fund total $1.844 billion
8. this would leave an ending balance of $75.9 million
  a. assuming that no supplemental appropriations for FY 2008 are enacted by the Legislature and
  b. that the Governor does not release any of the $7

million in conditional appropriations still pending which includes

i. Departmental Emergency Fund-$2.2 million

ii. Finance Department-$1.3 million

iii. Alabama State Port Authority-$3.5 million

B. based on these estimates, the General Fund could begin FY 2009 with a balance of $75.9 million

C. LFO projected receipts for FY 2009 are $1.515 billion

1. if the same transfers are made from the Public Service Commission and Securities Commission, you can add $5.3 million
2. the State Treasurer has indicated to us that she will transfer an additional $15 million from the abandoned property reserve fund
3. this makes total receipts of $1.535 billion
4. if capital gains are projected by the Alabama Trust Fund Board to be transferred to the General Fund for FY 2009, that amount could be added to the amount available

D. there would be a total of $1.611 million available if the entire projected beginning balance is preserved

E. this is $232 million less than current year's appropriations from the General Fund

7 V. Projected Outlook for the General Fund for FY 2009

A. the LFO revenue estimates project that there will be $232 million less to appropriate in FY 2009 than the current level of projected expenditures for FY 2008

B. state employees

1. however, the employers' retirement rate will increase from 9.84% to 11.37% for FY 2009 (the law enforcement rate will increase from 30% to 30.48%)
    a. for a total increased cost of $33.6 million with the General Fund's share being $12.1 million
    b. last session, the Legislature passed a bonus for

retirees and funded it by increasing the employer rate by .42% at a cost of $2 million to the General Fund

2. the employers' rate for health insurance is estimated to increase from $775 to $837 per employee per month
    a. for a total cost of $56 million
    b. the General Fund share of $20 million
3. the cost of the 3.5% pay increase for state employees authorized by law last year for FY 2009 has a
    a. total cost of $67.1 million with the
    b. General Fund's share of $24.2 million

C. Medicaid
1. the Agency is requesting an increase of $150 million from the General Fund for FY 2009
2. Katrina relief
    a. the federal government gave some Medicaid relief to those states struck by Hurricane Katrina
    b. Alabama did not have to pay the state match for federal Medicaid funds from August, 2005 to September, 2006 for the 11 counties that were hit by the hurricane
        i. this saved the Alabama Medicaid program a total of $231.7 million over several fiscal years
        ii. $185.4 million to the Medicaid Agency itself and
        iii. $46.3 million for other state agencies that provide Medicaid services such as Public Health, Senior Services, Mental Health and Human Resources
    c. the amount of Katrina relief funds carried forward to be used in FY 2008 which will not be available for FY 2009 is $71 million for the Medicaid Agency and $14.1 million for the Department of Mental Health
3. the budget request by the Medicaid Agency does not include funding for program expansions mandated by the Legislature for FY 2008 which included

a. an extra name brand prescription drug (5) each month
b. 505 additional Medicaid Waiver slots (30 with Senior Services and 475 with Public Health) and
c. prosthetic and other devices for Medicaid clients 21 to 65 years of age

4. Medicaid has not completed negotiations with Centers for Medicare and Medicaid Services (CMS) on the conversion from Intergovernmental Transfers to Certified Public Expenditures (CPEs) in regard to hospital reimbursements
   a. the outcome of these negotiations will affect the FY 2009 budget

D. Children's Health Insurance Program (CHIP)
1. the Department of Public Health is requesting an increase of $7.3 million (from $26.3 million in FY 2008 to $33.6 million in FY 2009) from the General Fund for FY 2009 for the CHIP program
2. there are currently around 71,000 children being served
3. the requested increase will allow the Department to continue to enroll eligible children for the health insurance program
4. the Department has been told by the CMS that states will have access to their entire allotment of federal funds at the beginning of FY 2009 instead of quarterly allotments so the CHIP program will be protected for the first 6 months of FY 2009
5. the act that provides federal funds expires in March, 2009 and there is uncertainty as to the level of federal funding for the remainder of the fiscal year
   a. if no additional federal funds are provided for FY 2009, there would be a deficit of $53.5 million in federal funds
6. in FY 2009, the state will receive approximately $3.46 in federal funds for every $1 in state funds for the CHIP

program

E. Department of Corrections
   1. the Department has already sold and is expecting to sell additional property in FY 2008 to meet some of its capital improvement needs
      a. already sold-$2.6 million
         i. 540 acres at the cattle ranch for $1.6 million
         ii. 101 South Union Street property for $1 million
      b. pending land sales could generate an additional $17.5 million based on appraised values
         i. 2045 acres at Red Eagle in Montgomery County for $4 million
         ii. 3988 acres at the Cattle Ranch in Hale County for $9 million
         iii. 32 acres in Wetumpka for $3.9 million and
         iv. 10 acres at Old Kilby in Montgomery County for $450,000
   2. the Department is expected to request a supplemental appropriation of between $3 million to $7 million for FY 2008 depending upon the amount of revenue realized from pending land sales

F. current available budget requests total $481 million in increased appropriations from the General Fund for FY 2009

8 VI. Exhibit 6 Shows the Condition of the ETF for FY 2007

A. the ETF began FY 2007 with a balance of $686 million plus $8.8 million in a debt service reserve for a bond payment due on October 1, 2007 for a total beginning balance of $695 million

B. actual receipts to the ETF for the fiscal year were $5.854 billion
   1. this was $91 million less than LFO estimates for FY 2007 and $118.5 million less than contemplated in the FY 2008 legislative budget

2. the two major revenue sources that did not meet LFO projections were corporate income taxes and sales taxes
    a. corporate income taxes were growing at a rate of 32.8% at the end of December, 2006 when this office revised its revenue estimate for FY 2007
    b. the LFO estimated a growth rate of 12.4% for the year
    c. actual receipts at the end of the year were a negative growth rate of almost 3.5% ($84 million less than LFO estimates)
    d. that was a dramatic drop in only 9 months
    e. suspected reasons for the decline
        i. estimated payments began to decline after the Circuit Court's ruling in VFJ Ventures, Inc. v. Alabama Department of Revenue which I will discuss later in this presentation
        ii. the growth in federal corporate income tax collections also slowed in 2007 indicating a widespread decline in corporate profits
    f. sales tax receipts were less drastic but
        i. the LFO projected a growth rate of 4% and
        ii. actual receipts grew at a rate of 2.7% ($26 million less than LFO estimates)

C. the total available for expenditures in FY 2007 was $6.549 billion

D. the amount actually expended was $5.941 billion (net of reversions)
1. under the provisions of the ETF budget act, 75% of any unanticipated and unappropriated beginning balance for FY 2007 would be transferred to the statutory proration prevention account
    a. that amount was approximately $150 million
2. there was a one-time appropriation pursuant to a settlement agreement in the Knight v. Alabama lawsuit

of $45.6 million to be expended with
    a. $10 million for needs-based scholarships through the Alabama Student Assistance Program
    b. $7.3 million by the Public School and College Authority (PSCA) at Alabama A&M University for capital projects
    c. $25.8 million by PSCA at Alabama State University for capital projects
    d. $1 million for plaintiff attorney fees and
    e. $1.5 million for court fees and expenses
  3. in addition, the Legislature appropriated $16 million directly to the statutory proration prevention fund
  4. and $72 million was appropriated for the last 2 repayments to the Constitutional Rainy Day Account- the ETF had received approximately $180 million from this account to mitigate 4.4% proration of the ETF in FY 2003
  5. $12.5 million was expended to settle a lawsuit against the Department of Youth Services that alleged employee misconduct at the Chalkville campus
  6. $32 million was appropriated to the Enterprise School System for rebuilding the schools damaged and/or destroyed by the March 1, 2007 tornado
    a. this amount is anticipated to be repaid in FY 2008 from the ETF bond proceeds and
  7. $4.3 million was appropriated for the debt service reserve for the bond payment due October 1, 2008
E. therefore, total expenditures from the ETF for FY 2007 were $6.273 billion
F. leaving an ending balance of $275.7 million plus the $4.3 million debt service reserve

9 VII. Exhibit 7 Shows the LFO Projected Condition of the ETF for FY 2008 and FY 2009

A. the ETF began FY 2008 with a beginning balance of

$280 million including the debt service reserve

1. however, the Legislature had anticipated and appropriated a beginning balance of $398 million ($118 million more than actual)

B. LFO revised receipts for FY 2008 are $6 billion

1. this represents a growth rate of 2.7%
2. this is $280 million less than LFO original estimates for FY 2008 due mainly to
   a. a reduction in gross individual income tax growth rate from 6% to 3.5%
   b. a reduction in gross sales tax growth rate from 3.5% to 2% and
   c. a reduction in gross corporate income tax growth rate from 12% to 4%
3. there is a reduction in receipts of $22.9 million that was anticipated for payment of debt service for the $1.07 billion bond issue authorized in Act 2007-415
4. also, the Legislature increased receipts by $32 million in anticipation of repayment of the FY 2007 appropriation to the Enterprise School System from the ETF bond issue
5. after these adjustments, total LFO projected receipts for FY 2008 are $6.021 billion
6. which when added to the beginning balance makes the total available of $6.3 billion

C. current estimated appropriations from the ETF for FY 2008 are $6.7 billion

1. the ETF would need to grow 9.6% to fund this level of expenditures
2. there is one conditional appropriation in the FY 2008 budget of $22 million to AIDT for Workforce Development
3. if that conditional appropriation were to be released by the Governor, the ETF would need to grow 10% to fund the revised level of expenditures

    4. it is our understanding that the conditional is currently being processed for release
    5. as you can see on Exhibit 7, the LFO is estimating only a 2.7% growth rate for FY 2008

D. based on LFO revised estimates, there will be a deficit of $405.8 million (if the conditional appropriation is released, this amount will be $427.8 million)

E. because the state cannot deficit spend, the LFO revised revenue estimates for FY 2008 would reflect a need to tap into the proration prevention account to prevent 6% proration of the ETF in the current year

F. Exhibit 8 shows the status of the statutory proration prevention account

1. the current balance in that account is $434 million
    a. the Legislature inserted language in the FY 2004, FY 2005 and FY 2006 budget acts providing that 75% of any beginning balance that was unanticipated and unappropriated would be transferred to the proration prevention account
    b. therefore, $366 million accrued pursuant to that provision in those acts
    c. in addition, the Legislature made direct appropriations of $18 million in FY 2006 and $16 million in FY 2007 to the account and
    d. $34 million in interest income has accrued to the account to date
2. the monies in this account can be accessed in two ways
    a. the Governor can withdraw funds in order to prevent proration of ETF appropriations or
    b. the Legislature can withdraw funds in this account by a legislative act with a two-thirds vote

G. Exhibit 9 shows the status of the constitutional Rainy Day Account

1. Amendment 709 created a rainy day account for the

ETF within the Alabama Trust Fund

2. the current balance is $248 million which is the maximum amount allowed by the amendment based on 6% of FY 2002 ETF appropriations
3. funds within this account may only be withdrawn to mitigate proration of appropriations to public schools; colleges and universities; public schools for the deaf and blind; public schools for the mentally ill and retarded; and other entities established by general statute for public school students
4. so in the event of proration, not all appropriations from the ETF would be protected such as the
    - a. Examiners of Public Accounts
    - b. Arts Council
    - c. Public Libraries and others

H. if LFO projections for FY 2008 prove correct, $405.8 million would need to be withdrawn from the $434 million statutory proration prevention account in order to avoid proration of the ETF in FY 2008 leaving only $28 million in the account to offset reductions in FY 2009 (only $6 million if the conditional is released)

I. going back to Exhibit 7

1. LFO revenue projections would have no beginning balance for FY 2009
2. estimated LFO receipts are $6.238 billion for FY 2009 (representing a 3.75% growth rate)
    - a. this amount would be reduced by $82.6 million representing a full year's debt service on the $1.07 billion ETF bond issue
    - b. leaving $6.155 billion for appropriations for FY 2009
3. this amount is $552 million less than the projected expenditures for FY 2008

10 VIII. Outlook for the ETF for FY 2009

A. teacher and education employee benefits

1. the TRS employer rate for FY 2009 will increase from

11.06% to 12.07%

a. the total cost of the TRS rate increase is $78 million with the ETF share being $55 million

b. last session, the Legislature passed a one-time bonus for retirees and funded it with an increase in the employer's rate for TRS of .69% at a cost of $32.4 million from the ETF

c. if the retiree bonus is not repeated for FY 2009, this amount could be used to offset part of the cost in the TRS increase

2. the PEEHIP employer rate for FY 2009 will increase from $775 to $795 per employee per month

a. the cost to the ETF for K-12 entities is estimated to be $18 million

b. and the cost to the ETF for the 2-year college system is estimated to be $1.18 million

B. mandatory divisors increases

1. Act 2007-284 provided for a three year phase-in of weighting factors used to calculate the instructional support units for public schools

2. these factors provide salary supplements for instructional support personnel (principals, counselors for example) who typically work more than 187 days per year

3. the estimated cost of these extension increases to the Foundation Program is $15.5 million for FY 2009

4. FY 2009 is the second year of the three year phase-in provided for in the 2007 act

C. 16th Section Lands repayment

1. a 1785 federal land ordinance required states to reserve a 1 square mile plot of land in every township for education

2. these plots became known as 16th section lands and income from these lands were to be used in perpetuity for education

    3. after a lawsuit was filed in 2002 to prohibit the transfer of 16th section income to the ETF, it was discovered that over $36 million had not been distributed to 98 school systems
    4. those funds were distributed in 2005 and the settlement agreement instructed the Examiners of Public Accounts to calculate the interest that would have been earned by those systems had the funds been properly distributed
    5. the Examiners estimated that amount to be $17.8 million
    6. a total of $8.9 million in 16th Section Land Grant interest income was appropriated in the FY 2008 budget to those 98 school systems
    7. this represented 1/2 of the undistributed interest due to these systems
    8. the other 1/2 was expected to be appropriated in the FY 2009 budget

D. requested increases from the ETF for FY 2009 total $644 million

11 IX. General Fiscal Issues

A. Alabama Trust Fund history

    1. in 1982, the state received $467 million from off-shore oil and gas leases that were deposited into the Heritage Trust Fund
    2. Amendment 450 to the Alabama Constitution ratified in 1985 established the Alabama Trust Fund (ATF) which was funded with $333.6 million received by the state from off-shore oil and gas leases
    3. the Heritage Trust Fund merged with the ATF in 2001
    4. the assets in the ATF have grown to $3.1 billion as the result of royalty payments
    5. the assets of the ATF are held in perpetual trust and cannot be appropriated, expended or disbursed except as provided by constitutional amendments such as the

one that created the Alabama Capital Improvement Trust Fund (ACITF)

B. Alabama Capital Improvement Trust Fund

1. this trust fund was established by Constitutional Amendment 666 ratified in November, 2000 and is funded with 28% of the royalties deposited into the Alabama Trust Fund in the previous fiscal year
   a. $521.9 million has been deposited into the ACITF since its inception
2. the amendment created a Bond Commission with authority to issue up to $350 million in economic development bonds
   a. a Constitutional amendment was ratified by the voters in June, 2007 to increase this authority to $750 million
   b. $710 million in bonds have been issued
   c. the remaining bonding authority is approximately $40 million
   d. royalties are used to pay debt on these bonds
   e. the remaining royalties in the ACITF may be used for other debt of the state or for economic development purposes
3. Exhibit 10 shows the history and status of the ACITF
   a. the beginning balance in the Alabama Capital Improvement Trust Fund for FY 2007 was $63.7 million
   b. the 28% of royalties deposited into the Capital Improvement Trust Fund in FY 2007 amounted to $103.4 million
   c. expenditures from the ACITF for FY 2007 were $127.7 million
   d. the ending balance in the ACITF for FY 2007 was $39.4 million
   e. the royalties for FY 2008 are $71.7 million; the ending unobligated balance in the ACITF for FY

2008 will be \$10 million if additional bonds are not issued by the Commission; the Legislature does not make any additional appropriations from the ACITF; and the State Docks expends the remainder of its allocation in FY 2008

4. of the amount appropriated from the ACITF to date
   a. \$233.1 million has been appropriated for new economic development projects and
   b. \$278.8 million has been appropriated to pay existing debt service payments
      i. in 2008, the Legislature appropriated \$44.5 million for existing debt service
   c. the LFO projections for FY 2009 would allow enough revenue to continue to supplant \$28.5 million in existing debt; fulfill the obligations of debt on bonds issued by the Commission; pay the \$2 million earmarked for the Industrial Development Authority; and leave a balance of \$8.8 million

C. Act 2007-415 authorized an education bond issue of \$1.071 billion
   1. the PSCA authorized the issuance of the entire amount in December, 2007
   2. Exhibit 11 outlines the distribution of the ETF bond issue
      a. K-12 will receive \$658.6 million
      b. the two-year college system will receive \$48.2 million
      c. the senior institutions will receive \$178.2 million and
      d. other entities will receive \$185.5 million

D. Tobacco settlement revenues
   1. the Master Settlement Agreement (MSA) that Alabama entered into in 1998 with the major tobacco manufacturers has resulted in \$873 million in payments to Alabama since FY 2000

2. FY 2006 payments were affected, and future payments will be affected, by the outcome of current litigation in Alabama and other states concerning the interpretation and application of a provision in the MSA that the amount paid to states would be reduced if
    a. the participating manufacturers' market share fell more than 2 percent as compared to 1997 and
    b. a determination was made by an independent auditor that the MSA was a significant factor in that decline of market share
3. however, a state's payment is exempt from the reduction if the state "diligently enforced" its statute that requires companies not participating in the MSA to create escrow accounts to pay judgments in any future litigation
4. in March, 2006 an independent auditor determined the participating manufacturers' market share for 2003 had fallen more than 2 percent and that the MSA was a significant factor, but also determined that all states qualified for the "diligent enforcement" exemption because they were "presumed" to have diligently enforced their statutes
    a. several tobacco companies filed a motion in circuit court in Montgomery asking the court to enforce the mandatory arbitration provision of the MSA on the question of whether Alabama diligently enforced its statute
    b. the circuit court ordered arbitration but the Attorney General has appealed that decision to the Alabama Supreme Court
5. nationally, the manufacturers contended they were entitled to a $1.2 billion reduction in the April, 2006 payment and some companies paid their share of the $1.2 billion into an escrow account rather than to the states
6. this reduced Alabama's FY 2006 payment by 10%

(from $105.4 million to $94.6 million)

7. the amount received in FY 2007 was $99 million
8. it is difficult to estimate payments because some tobacco companies pay the disputed amount to the states while others choose to pay into a disputed payment account
9. the amount this office projects the state to receive in FY 2008 is $106.2 million
10. Exhibit 12 shows FY 2008 appropriations from tobacco revenues of $111.4 million
11. if we assume that all the companies will escrow the disputed amount in April 2009, rather than pay it to the states, our current estimate for FY 2009 from tobacco revenues is $109.8 million

E. Governmental Accounting Standards Board (GASB) rule

1. historically, state and local governments have funded retiree healthcare benefits on a "pay-as-you-go" or cash basis
2. the Governmental Accounting Standards Board adopted a new rule (Rule 45) that requires governments to begin providing information about these incurred costs when they issue their financial statements; Alabama will be required to provide this information beginning with its financial statement for FY 2008
3. in the First Special Session of 2007, the Legislature authorized the PEEHIB Board and the SEIB Board to create health care trust funds which they did in March, 2007
4. the PEEHIB has transferred a total of $419 million into the trust from reserves
    a. the unfunded liability for PEEHIP was valued at $12.5 billion at the end of September, 2006
5. the SEIB has transferred a total of $50 million from its reserves
    a. the unfunded liability at the end of September, 2005

was valued at $5.3 billion

F. Gulf of Mexico Energy Security Act

1. Congress passed an act that will open 8.3 million acres of deepwater areas in the Gulf of Mexico for energy production and send 37.5% of federal royalties from the new energy exploration to the four Gulf states of Alabama, Louisiana, Mississippi and Texas
2. the 37.5% will be allocated among the 4 states based on each state's proximity to the center of the leased tract, however, each state will receive at least 10% of the amounts available each year
   a. 20% of each state's share will be paid directly to the coastal political subdivisions
3. the states receive funds in 3 ways
   a. the bonus bid which is the up-front amount the winning bidder pays for the lease
   b. annual rent that the lessee must pay until production begins and
   c. the royalty once production begins
4. there are 4 purposes within the federal law for which these funds may be expended
   a. projects and activities for the purpose of coastal protection
   b. mitigation of damage to fish, wildlife or natural resources
   c. implementation of a federally-approved marine, coastal or comprehensive conservation management plan
   d. mitigation of the impact of Outer Continental Shelf activities through funding of onshore infrastructure projects
5. beginning in 2017, the four Gulf states will receive 37.5% of royalties from all Gulf leases entered into beginning in 1982
6. and beginning in 2022, the states share in all lease

revenue from all blocks in the Gulf

7. according to the Minerals Management Service, the first leases that are affected by this law go out for bid in March, 2008 which means that the earliest revenue-sharing distribution to Alabama and the other affected Gulf states could be in FY 2009
8. there is no estimate for the amount Alabama will receive because
    a. there is no way to know what blocks will be bid on or
    b. the amount of the bids or
    c. the proximity to Alabama

G. Status of selected pending litigation
1. Exxon litigation
    a. in 1999, Alabama filed a lawsuit against Exxon alleging that the company intentionally underpaid oil and gas royalties owed the state
    b. in 2000, a jury awarded the state $3.5 billion ($3.42 billion in punitive damages and $87.7 million in compensatory damages)
    c. in 2002, the Alabama Supreme Court reversed the verdict and remanded the case for a new trial
    d. in 2003, a second jury awarded the state $11.9 billion ($11.8 billion in punitive damages and $102.8 million in compensatory damages)
    e. the court reduced the verdict to $3.6 billion ($3.5 billion in punitive damages and $102.8 million in compensatory damages)
    f. Exxon appealed and the Alabama Supreme Court heard oral arguments on February 6, 2007
    g. lawyers for the state argued that Exxon committed intentional fraud against the state and thus justified the juries' award of punitive damages while Exxon attorneys argued that the case is a contract dispute and therefore punitive damages were inappropriate

h. in November, 2007 the Alabama Supreme Court held that the state did not prove fraud and therefore was not entitled to $3.5 billion in punitive damages

i. the Supreme Court went further, reducing compensatory damages the trial court had awarded the state for royalties (from 1993 through 2002) from $63.8 million to $51.9 million and remanded the case to Circuit Court to determine the amount of interest Exxon must pay

j. there was a dispute between the state and Exxon on the calculations of interest (the state argued for an additional $21 million in interest)

k. the trial court sided with Exxon's calculations and the attorneys for the state have indicated that the state will appeal that decision

l. Exxon has agreed to pay $121 million this month of which approximately $97.5 million will go to the state and the rest will pay attorney fees and expenses

m. the distribution of the $97.5 million between the Alabama Trust Fund and the General Fund has not been finally determined

2. VFJ Ventures Inc. v. Alabama Department of Revenue

a. this is a case of first impression and other states with add-back statutes are watching the resolution of this dispute

b. in 2001, Alabama passed the "add-back statute" that requires companies to add back to their income any deductions that they take for royalty and interest payments made to related companies

c. VFJ made royalty payments to other members of the VFJ company for the use of the Lee and Wrangler trademarks

d. the Alabama Department of Revenue added back the royalty payment to VFJ's Alabama income

e. VFJ challenged the constitutionality of the add-back statute and the application of the statute by the Department

f. the trial court ruled in favor of the taxpayer on statutory grounds and did not address the constitutional question
g. the Department appealed the decision to the Court of Civil Appeals in March, 2007 where it is pending
h. the Department estimates that if the add-back statute is struck down, the state would owe $80 million to $100 million in refunds with a prospective annual loss of $30 million to $50 million from the ETF

3. ExxonMobil v. Department of Revenue
   a. the state of Alabama levies a tax for the removal of oil and gas from its soil and water
   b. that tax is levied on the value of the raw product at the point of production
   c. the Department of Revenue administrative law judge ruled in September, 2007 that all required costs of bringing the product to market should be allowed as deductions in calculating the taxable value
   d. the Department of Revenue has appealed this decision to Circuit Court
   e. the administrative law judge's order granted ExxonMobil approximately $41 million including interest in oil and gas severance tax refunds
   f. the Department of Revenue estimates that if the ruling is upheld and is applied to other companies that have filed for refunds with the Administrative Law Judge, the state could be forced to refund a total of $83.4 million
   g. this amount is for refunds pending through June, 2004
      i. $69 million from the General Fund and
      ii. $14.4 million from various counties and cities

with oil and gas wells

a) $7.6 million from Mobile County
b) $1.6 million from Baldwin County
c) $3.4 million from Escambia County
d) $258,000 from Jefferson County
e) $229,000 from Tuscaloosa County
f) $1.1 million from Dauphin Island
g) $244,000 from other cities

h. the Department does not have a good estimate for refunds that will be filed for returns from July, 2004 to date if the state loses the lawsuit nor does it have a good estimate for the prospective annual loss but both would be significant

12 X. Closing Remarks

A. Website

1. outline
2. exhibits and
3. budget hearings schedule