Report Highlights

Why DLA Performed This Audit

The audit reviews DOR's tax credit-backed loan to MOC 1. Specifically, the audit evaluates DOR's compliance with Alaska Statutes, policies and procedures, and the loan agreements. Additionally, auditors determine whether tax credit-backed loans were offered to other entities, whether the MOC 1 loan was accurately recorded in the State's financial statements, whether there were any conflicts of interest related to the loan, and whether the legislature was notified of the loan.

What DLA Recommends

1. DOR's commissioner should ensure investments are made in accordance with established investment objectives and procedures.
2. DOR's commissioner should ensure collateral is required in accordance with AS 37.10.071(b)(5).
3. DOR's commissioner should ensure conflicts of interest are avoided or prevented when carrying out the department's duties and responsibilities.

A Special Review of the Department of Revenue (DOR), Mustang Operations Center 1 LLC (MOC 1) Loan

July 24, 2020

Audit Control Number 04-30093-20

REPORT CONCLUSIONS

The audit concludes that the MOC 1 loan was, in substance, an advance payment of MOC 1's 2015 tax credits, legally permissible under DOR's statutory investment authority. Although the loan was legal, DOR management did not comply with all statutes governing the investment function. The loan was not adequately collateralized for a period of 19 months. Additionally, the loan was made outside DOR's established investment processes and not subject to procedures designed to meet investment objectives and minimize risk. Further, the loan was not properly managed, which led to inaccurate financial accounting and reporting.

Although DOR obtained an opinion regarding the legality of establishing a tax credit-backed loan program, a "program" was never created. DOR management could not explain why tax credit loans were only offered to MOC 1.

The MOC 1 loan created two conflicts of interest. The DOR commissioner's interest in collecting payment on the MOC 1 loan conflicted with duties to represent the Alaska Industrial Development and Export Authority (AIDEA) in matters relating to MOC 1 as part of AIDEA's board of directors. Secondly, the DOR commissioner's statutory duty to ensure the MOC 1 loan was collateralized conflicted with the commissioner's authority over the valuation and approval of tax credits.

DOR recorded a gain of $4.29 million over the life of the MOC 1 loan, however, AIDEA's assumption of the loan from DOR resulted in a decrease to AIDEA's net income of $1.77 million. AIDEA management estimates the loss will decrease AIDEA's FY 21 state dividend by $885.5 thousand.

Report Highlights (Continued)

4. The legislature should consider enhancing oversight of DOR's investment functions.

REPORT CONCLUSIONS (Continued)

Given the decline in oil prices, it is possible AIDEA will record a significant allowance for loan loss, write off, or substantially write down the amounts owed to AIDEA on the Mustang project by Caracol Petroleum LLC, independent of assuming the DOR MOC 1 loan. Any loss incurred will reduce net income and further reduce AIDEA's dividend.

Overall, the audit found the DOR commissioner's decision to loan up to $22.5 million to MOC 1 under the authority of the department's investment statutes was inappropriate when compared with behavior that a prudent person would consider reasonable. In support of this conclusion, auditors noted the following: the loan was made outside of DOR's established investment procedures and DOR management failed to adequately document consideration of the associated risks when making the loan; adequate internal controls were not implemented over the accounting, reporting, and management of the loan; and the loan created conflicts of interest that were not sufficiently mitigated. These facts demonstrate the need for additional oversight of DOR's investment functions.

ALASKA STATE LEGISLATURE

LEGISLATIVE BUDGET AND AUDIT COMMITTEE

Division of Legislative Audit

P.O. Box 113300
Juneau, AK 99811-3300
(907) 465-3830
FAX (907) 465-2347
legaudit@akleg.gov

September 1, 2020

Members of the Legislative Budget
and Audit Committee:

In accordance with the provisions of Title 24 of the Alaska Statutes, we have reviewed the Mustang Operations Center 1 LLC (MOC 1) Loan and the attached report is submitted for your review.

DEPARTMENT OF REVENUE
MUSTANG OPERATIONS CENTER 1 LLC LOAN
SPECIAL REVIEW

July 24, 2020

Audit Control Number
04-30093-20

The audit reviews the Department of Revenue's (DOR) tax credit-backed loan to MOC 1. Specifically, the audit evaluates DOR's compliance with Alaska statutes, regulations, policies and procedures, and the loan agreements. Additionally, auditors determine whether tax credit-backed loans were offered to other entities, whether the MOC 1 loan was accurately recorded in the State's financial statements, whether there were any conflicts of interest related to the loan, and whether the legislature was notified of the loan.

The audit was conducted in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives. Fieldwork procedures utilized in the course of developing the findings and recommendations presented in this report are discussed in the Objectives, Scope, and Methodology.

Kris Curtis, CPA, CISA
Legislative Auditor

ABBREVIATIONS

AAM	Alaska Administrative Manual
ACN	Audit Control Number
AIDEA	Alaska Industrial Development and Export Authority
ARMB	Alaska Retirement Management Board
AS	Alaska Statute
BRPC	Brooks Range Petroleum Corporation
CAFR	Comprehensive Annual Financial Report
CES	Charisma Energy Services Limited
CIO	Chief Investment Officer
CISA	Certified Information Systems Auditor
CPA	Certified Public Accountant
DLA	Division of Legislative Audit
DOR	Department of Revenue
GeFONSI	General Fund and Other Non-Segregated Investments
MOC 1	Mustang Operations Center 1 LLC
SMU	Southern Miluveach Unit

CONTENTS

(Intentionally left blank)

ORGANIZATION AND FUNCTION

Department of Revenue

The Department of Revenue's (DOR) primary mission is to collect and invest State of Alaska funds for public purposes. Alaska Statute 37.10.070 gives DOR's commissioner the authority to invest monies that exceed the amount needed to meet the State's immediate expenditure needs. The department's Treasury Division has the primary responsibility for investing.

Per AS 43.05.010(1), DOR's commissioner supervises and directs the activities of the department, including the Tax Division. The Tax Division's mission is to collect taxes, inform stakeholders, and regulate charitable gaming. This includes collecting the annual tax on oil and gas, and approving oil and gas credits under AS 43.55.023.

Alaska Industrial Development and Export Authority

Per AS 44.88.070, the purpose of the Alaska Industrial Development and Export Authority (AIDEA) is to promote, develop, and advance the general prosperity and economic welfare of the people of the state, to relieve problems of unemployment, and to create additional employment. AIDEA is governed by a seven-member board, including five public members appointed by the governor and the commissioners of DOR and the Department of Commerce, Community, and Economic Development, or designees.

AIDEA fulfills its mission by providing financing and assistance for projects and businesses that economically benefit the State. AIDEA also has the authority to own and operate facilities, which is done under its project, infrastructure, and energy development programs. AIDEA's ownership and operation of facilities is intended to advance the prosperity of a region. The projects range in type and size, and cover several sectors of industry. Eligible projects include manufacturing facilities, roads, ports, infrastructure for tourism destination facilities, federal facilities, community public purposes, and communications essential for regional economic well-being.

AIDEA pays the State an annual dividend from the Revolving Fund, the Sustainable Energy Transmission and Development fund, and the Arctic Infrastructure Development fund. The dividend, determined by AIDEA's board, must be between 25 percent and 50 percent of audited net income for the "base year." The "base year" is the fiscal year ending two years before the end of the fiscal year in which the dividend is paid.

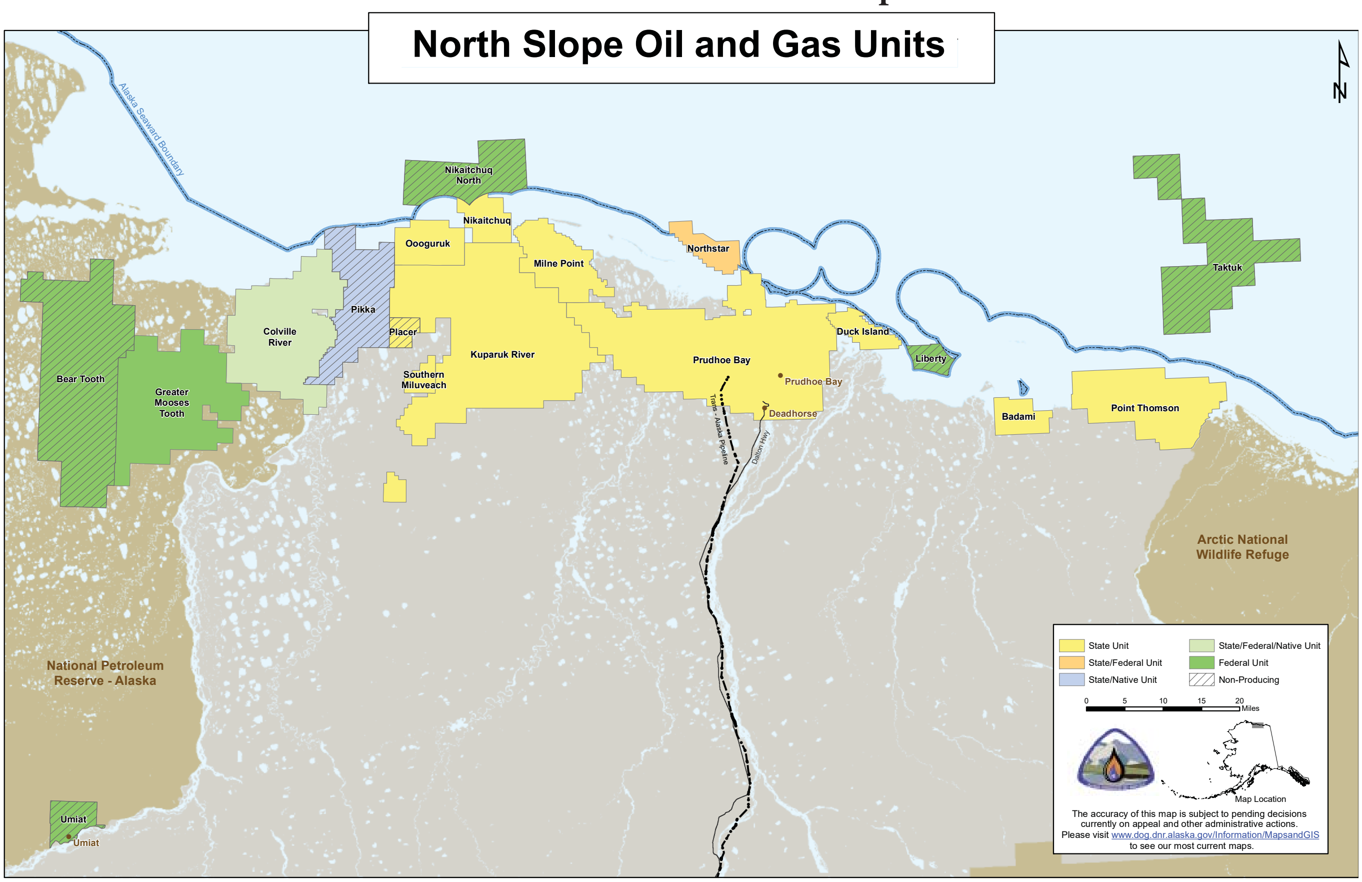
BACKGROUND INFORMATION

Mustang Development Project

Brooks Range Petroleum Corporation (BRPC) is an onshore oil and gas exploration and development company. In October 2011, the Department of Natural Resources approved BRPC's application to form the Southern Miluveach Unit (SMU) located in the North Slope Borough of Alaska (see Exhibit 1). The application designated BRPC as the operator of the SMU and approved the initial development plan titled Mustang Development Project. The objective of the Mustang Development Project was to construct an oil processing facility capable of delivering sales quality crude oil.

Exhibit 1

Location of SMU in Relation to Other North Slope Oil and Gas Units

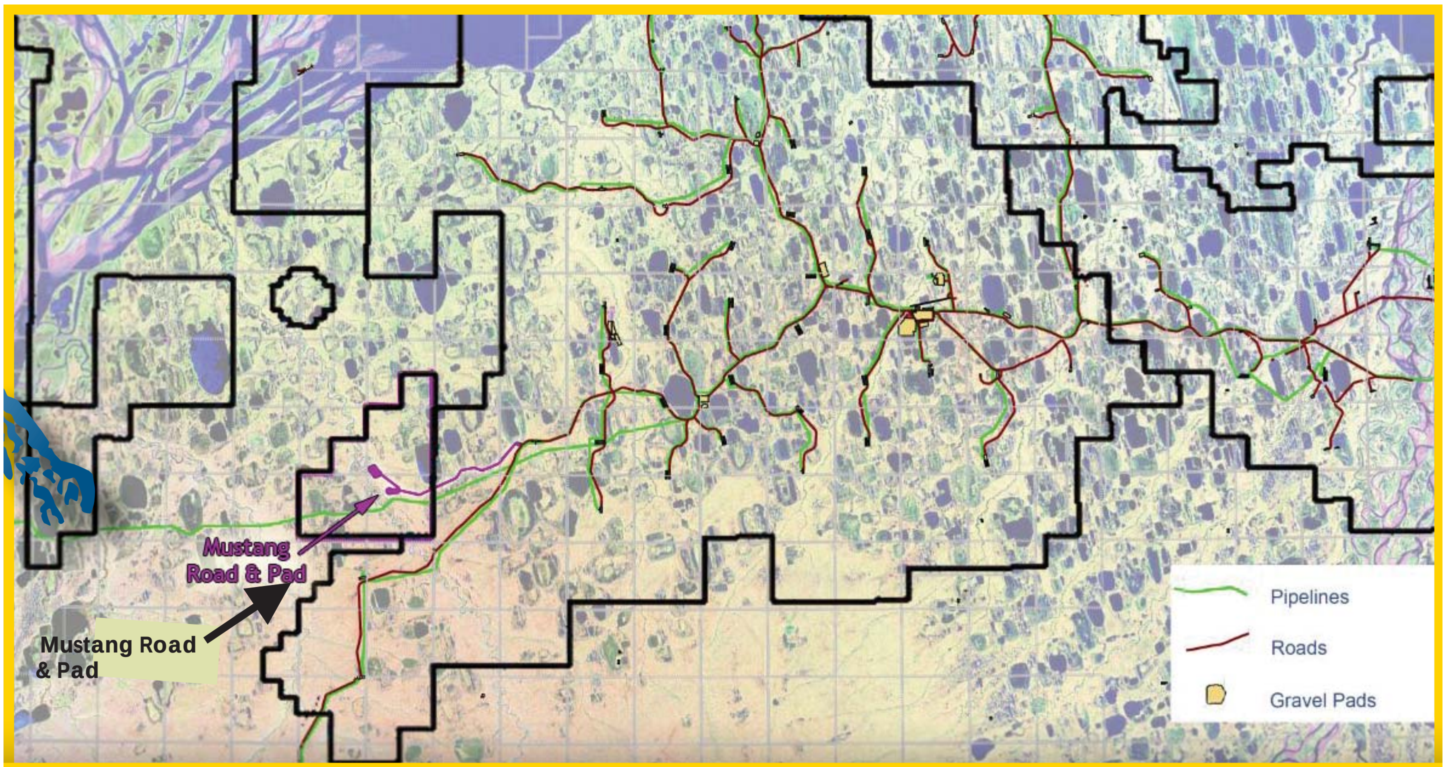


Source: Department of Natural Resources, Division of Oil and Gas, North Slope Unit Map as of December 2019.

One of the Mustang Development Project's first steps was creating access to the oilfield. In December 2012, the Alaska Industrial Development and Export Authority (AIDEA) board approved a $20 million investment in the Mustang Oilfield Road and Production Pad Project, and creation of the Mustang Road LLC.[1] The purpose of Mustang Road LLC was to develop, construct, own, and operate a four-mile road and a gravel pad that would facilitate the production of crude oil and natural gas from the SMU. The road provided the only access to the oil field and was critical to the oil field production plan. Exhibit 1 shows the SMU as part of the North Slope region and Exhibit 2 shows the road and pad within the SMU.

Exhibit 2

Map of SMU (With Four-Mile Mustang Road and Pad Shown in Purple)



Source: AIDEA Phase 1 - Mustang Road and Pad Fact Sheet.

After the road and pad project was completed in April 2013, AIDEA began considering investing in the Mustang Development Project's production facility. AIDEA's board noted that the project had a high level of risk, but carried a reasonably high rate of return of 10 percent. Estimates placed the cost of the proposed facility

[1] AIDEA Board Resolution G12-08.

at $200 million to $225 million. In April 2014, the AIDEA board[2] authorized entering into an agreement with Charisma Energy Services Limited (CES) to create the Mustang Operations Center 1 LLC (MOC 1). MOC 1 contracted with BRPC to serve as its operator. As part of the agreement's financing plan, AIDEA was to provide up to $50 million of equity funding and in return AIDEA was to receive a 10 percent dividend, paid quarterly, on the redemption value of AIDEA's shares, starting no later than December 1, 2016. CES was to provide $1 million of equity funding and facilitate up to $175 million of additional financing.

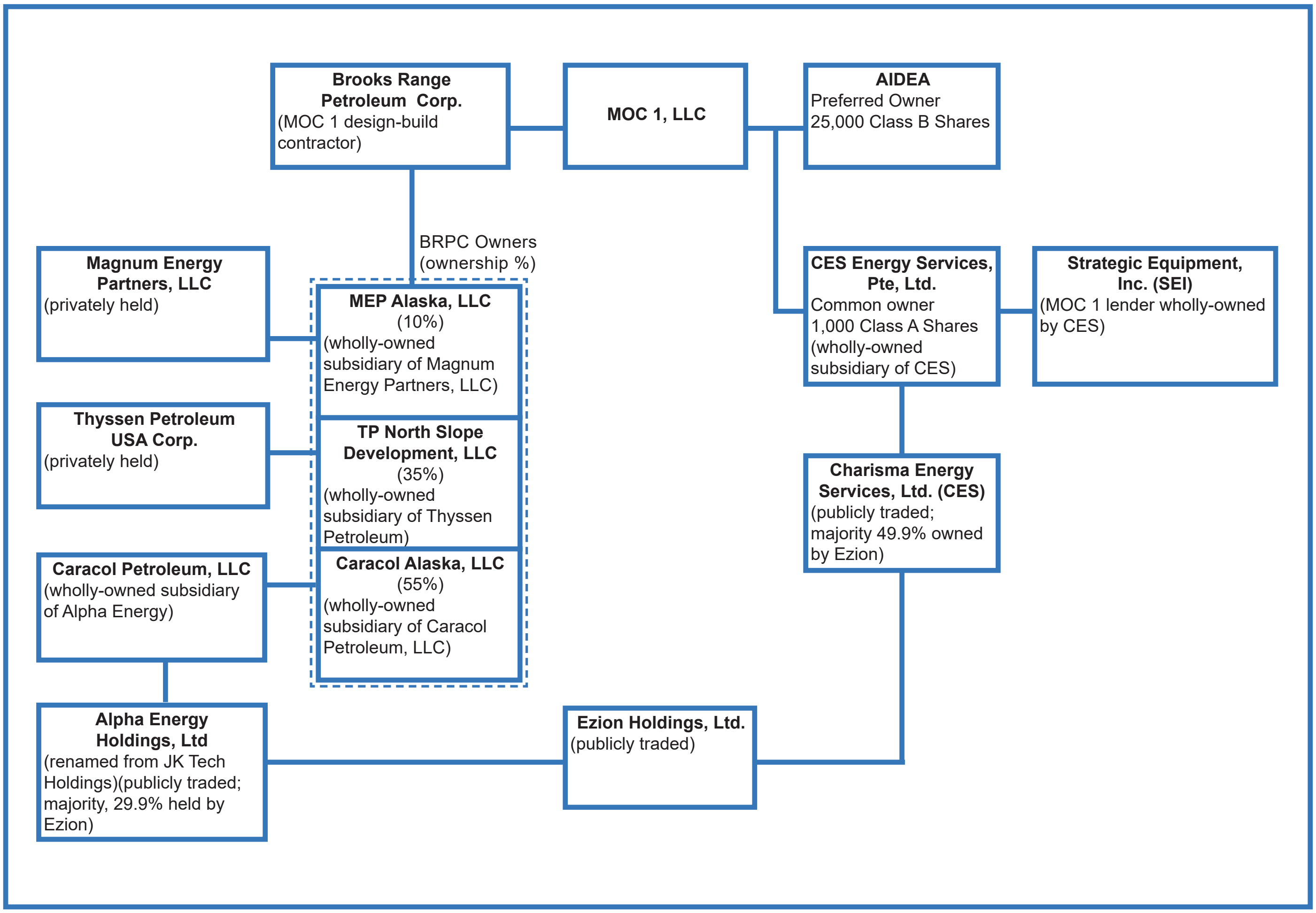
AIDEA ultimately provided $50 million to MOC 1 in several transactions between November 2014 and June 2018. The MOC 1 financing plan also stipulated a seven-year repurchase plan for AIDEA's ownership interest, which would have resulted in CES being the sole owner of MOC 1. Other sources of financing outlined in the plan included State of Alaska oil and gas capital expenditure tax credits, issued under AS 43.55.023, which were to be used to partially repay the $175 million of additional financing.

Exhibit 3 provides an organizational chart showing ownership of the companies involved with MOC 1 and the managing company BRPC as of January 2016. As shown in Exhibit 3, MOC 1 was owned by AIDEA and CES. Three companies owned BRPC: Magnum Energy Partners LLC, Thyssen Petroleum USA Corp., and Caracol Petroleum LLC (Caracol). Caracol, a wholly-owned subsidiary of Alpha Energy Holdings Limited, held the majority share of BRPC.

[2] AIDEA Board Resolution G14-09.

Exhibit 3

MOC 1 Organizational Chart as of January 2016

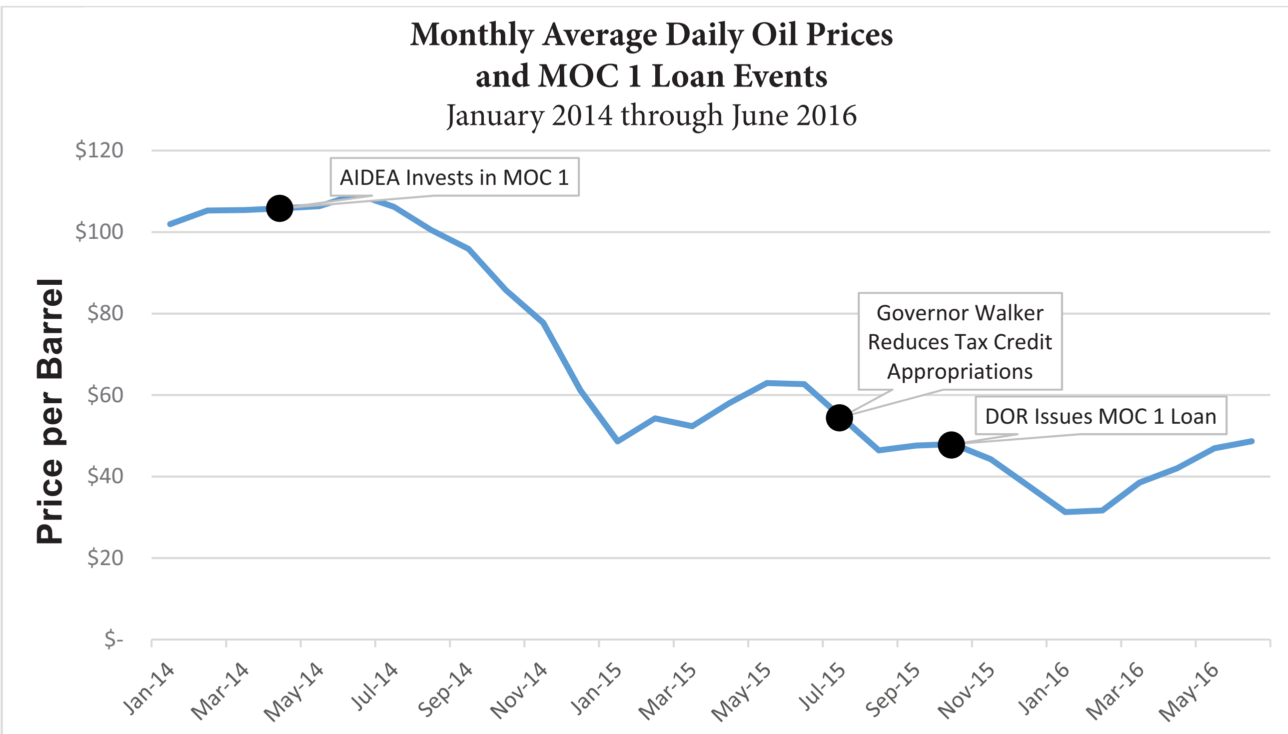


Source: AIDEA management.

Declining Oil Prices and Reductions in Tax Credits Impacted MOC 1 Financing Plan

When AIDEA approved the MOC 1 investment in April 2014, the average price of oil was over $100 per barrel and MOC 1 was expected to produce 15,000 barrels of oil per day. Beginning September 2014, declining oil prices quickly changed the trajectory of the MOC 1 project. As seen in Exhibit 4, oil prices reached a low of $47 to $50 per barrel in January 2015.

Exhibit 4



Source: Oil prices obtained from DOR, Tax Division website.

After March 2015, prices remained below $65 per barrel until the end of 2017. Per AIDEA management, as a result of the drop in oil prices, the planned $175 million third party financing for MOC 1 was not obtained. Without the third party financing, the project lacked sufficient funding for completion. As noted previously, the estimated cost of the Mustang project was $200 million to $225 million, yet the project possessed only $51 million in committed funding.

Governor Walker's veto of $200 million from the FY 16 operating budget for cash payments of oil and gas tax credits further complicated matters. Subsequent years' appropriations for payment of oil and gas tax credits were approved at significantly reduced amounts, ranging between $50 million and $100 million. A schedule of tax credit appropriations from FY 14 through FY 19 is documented in Exhibit 5.[3]

Exhibit 5

Schedule of Tax Credit Appropriations
FY 14 through FY 19
(in millions)

Fiscal Year	Appropriation Amount
FY 14	$400.0
FY 15	$450.0
FY 16	$500.0
FY 17	$50.0
FY 18	$57.0
FY 19	$100.0

Source: Legislative Finance Annual Summary of Appropriations Publications.

DOR Standard Investment Policies Guide Investments

Alaska statutes give the Department of Revenue (DOR) statutory authority to invest State monies. DOR's Treasury Division invests State monies by fund. Some funds are grouped together to form larger treasury funds, with the largest being the General Fund and Other Non-Segregated Investments (GeFONSI) fund. Treasury funds have established investment objectives, including risk tolerance, liquidity, and expected returns. The chief investment officer (CIO) has investment authority over Domestic Fixed Income Investments,[4] as delegated by the commissioner. The CIO approves standard GeFONSI fixed income investments, which are made according to the fund objectives and allocations.

[3] The amounts appropriated for FY 14 and FY 15 were estimated appropriation amounts, which allowed DOR to pay all tax credits eligible for payment in those fiscal years, even when the payments exceeded the estimated appropriations. In FY 16, the estimated tax credit appropriation of $700 million was vetoed and a fixed appropriation of $500 million was approved in its place, limiting total tax credit payments in the year to no more than $500 million. FY 17 through FY 19 appropriations were also for fixed amounts.

[4] Fixed income investments are commonly defined as investments that pay fixed interest or dividend payments until the investment's maturity date.

The GeFONSI invests in various pools, including several in the Fixed Income Investment category. A loan is an example of a fixed income investment.

MOC 1 Loan and Terms

In July 2015, BRPC's chief executive officer contacted the governor's chief of staff regarding terms for a possible advance payment of tax credits. The chief of staff forwarded the request to DOR's commissioner. The commissioner and deputy commissioner[5] sought legal guidance from the Department of Law to determine whether legal authority existed to implement a tax credit-backed loan program.

In October 2015, DOR provided a line of credit[6] (loan) to MOC 1 of up to $22.5 million, due in full on December 31, 2016. The loan was to be used to fund the planning, design, and construction of an oil processing facility intended to process oil, gas, and minerals from the SMU on the North Slope. By February 2016, DOR had loaned MOC 1 $19.3 million.[7] Loan collateral consisted of reimbursable oil and gas tax credits for 2015 yet to be approved.

Loan draw requests were based on expenditures to be claimed as tax credits by MOC 1. The eligibility of these expenditures, and the ultimate tax credit amount, was estimated based on a third party's[8] review of expenditures. The loan agreement limited draws to a maximum of 95 percent of the total estimated eligible tax credits.

Loan terms required MOC 1 to pay all state taxes related to the project when due. The loan charged simple interest of seven percent per annum and included a five percent penalty for any payment not made within 30 days of the due date. The MOC 1 loan met the definition of a fixed income investment, as the rate of return was defined by the loan's interest rate.

---

[5] In 2015, DOR's deputy commissioner served as the head of the Treasury Division.

[6] The line of credit was composed of three documents: line of credit agreement, line of credit note, and security agreement.

[7] Only $18 million was actually disbursed, as MOC 1 prepaid $1.3 million in interest via reduced disbursements.

[8] Third party review was performed by Petrotechnical Resources Alaska.

Since state laws precluded MOC 1 from applying for tax credits prior to the end of the tax year, MOC 1 was unable to apply for the 2015 credits until January 1, 2016, three months after the loan was issued. The Tax Division approved and certificated the credits during July 2016.

The loan was originally due in full on December 31, 2016. However, DOR amended the agreement twice to extend the maturity date by over 18 months to July 15, 2018. During that period, funds appropriated to pay tax credits were significantly decreased (see Exhibit 5 on page 8).

MOC 1 Loan Repayment

During the period the loan was outstanding, two loan payments were made. MOC 1 made a $1.6 million payment in February 2018, which was applied to accrued interest on the loan. The second payment of $4.1 million was made in February 2019, and applied to both interest and principal on the loan.[9] MOC 1 made no other payments until May 2019 when AIDEA purchased the loan from DOR. In total, the loan was outstanding from October 1, 2015, through May 28, 2019.

Beginning in March 2018, DOR began requesting AIDEA assume the outstanding principal and interest on the MOC 1 loan. During this time, AIDEA began the process of restructuring the MOC 1 owner/equity relationship to a creditor/debtor relationship where AIDEA's equity investment was converted to a loan. AIDEA's board approved a resolution[10] in September 2018 which guaranteed AIDEA's repayment of the MOC 1 loan. As part of the agreement, the interest rate was reduced from seven to three percent prospectively from September 1, 2018. AIDEA ultimately paid DOR the full balance of the MOC 1 loan principal and accrued interest on May 28, 2019, shortly after AIDEA's conversion of its interests in MOC 1 was finalized.

[9] $2.9 million was applied to principal and $1.2 million to accumulated interest.

[10] AIDEA Board Resolution G18-11.

AIDEA acquired DOR's lender position in MOC 1 by an assignment and assumption agreement. The loan was classified in AIDEA's FY 19 financial statements as non-current based on the extended maturity date in the final loan amendment.

AIDEA's Restructure of MOC 1 Interests

Per AIDEA management, converting AIDEA's equity interest to debt for both the Mustang Road LLC and MOC 1 was part of a larger development plan for the Mustang Field. The restructure was intended to consolidate over 90 percent of the exploration, development, and production rights in the Mustang project to Caracol. According to AIDEA management, the restructure would allow Caracol to raise additional capital necessary to continue development of the Mustang project. AIDEA expected to benefit, as the conversion would further the economic development of the Mustang project and provide what AIDEA viewed as the best opportunity to recover its investment.

A summary of key events relating to the MOC 1 project and the State's loan are documented in Appendix A.

(Intentionally left blank)

REPORT CONCLUSIONS

The audit reviews the Department of Revenue's (DOR) tax credit-backed loan to Mustang Operations Center 1 LLC (MOC 1). Specifically, the audit evaluates DOR's compliance with Alaska statutes, regulations, policies and procedures, and the loan agreements. Additionally, auditors determine whether tax credit-backed loans were offered to other entities, whether the MOC 1 loan was accurately recorded in the State's financial statements, whether there were any conflicts of interest related to the loan, and whether the legislature was notified of the loan.

The audit concludes that the MOC 1 loan was, in substance, an advance payment of MOC 1's 2015 tax credits, legally permissible under DOR's statutory investment authority. Although the loan was legal, DOR management did not comply with all statutes governing the investment function. The loan was not adequately collateralized for a period of 19 months. Additionally, the loan was made outside DOR's established investment processes and not subject to procedures designed to meet investment objectives and minimize risk. Further, the loan was not properly managed, which led to inaccurate financial accounting and reporting.

Although DOR obtained an opinion regarding the legality of establishing a tax credit-backed loan program, a "program" was never created. DOR management could not explain why tax credit loans were only offered to MOC 1.

The MOC 1 loan created two conflicts of interest. The DOR commissioner's interest in collecting payment on the MOC 1 loan conflicted with duties to represent the Alaska Industrial Development and Export Authority (AIDEA) in matters relating to MOC 1 as part of AIDEA's board of directors. Secondly, the DOR commissioner's statutory duty to ensure the MOC 1 loan was collateralized conflicted with the commissioner's authority over the valuation and approval of tax credits.

DOR recorded a gain of $4.29 million over the life of the MOC 1 loan; however, AIDEA's assumption of the loan from DOR resulted in a decrease to AIDEA's net income of $1.77 million. AIDEA management estimates the loss will decrease AIDEA's FY 21 State dividend by $885.5 thousand.

Given the decline in oil prices, it is possible AIDEA will record a significant allowance for loan loss, write off, or substantially write down the amounts owed to AIDEA on the Mustang project by Caracol Petroleum LLC (Caracol) independent of assuming the DOR MOC 1 loan. Any loss incurred will reduce net income and further reduce AIDEA's dividend.

Overall, the audit found the DOR commissioner's decision to loan up to $22.5 million to MOC 1 under the authority of the department's investment statutes was inappropriate when compared with behavior that a prudent person would consider reasonable. In support of this conclusion, auditors noted the following: the loan was made outside of DOR's established investment procedures and DOR management failed to adequately document consideration of the associated risks when making the loan; adequate internal controls were not implemented over the accounting, reporting, and management of the loan; and the loan created conflicts of interest that were not sufficiently mitigated. These facts demonstrate the need for additional oversight of DOR's investment functions.

Detailed report conclusions are as follows.

Advance payment of MOC 1 tax credits in the form of a loan legally circumvented the need for an appropriation.

In substance, DOR's investment authority allowed the commissioner to pay MOC 1 tax credits in advance of an appropriation. DOR issued MOC 1 a loan on October 1, 2015, collateralized with tax credits expected to be approved for calendar year 2015 expenditures. The loan was made under DOR's investment authority. As such, advance payment of tax credits in the form of a loan legally circumvented the need for an appropriation. Article IX, Sec. 13 of the Alaska Constitution provides that no money shall be withdrawn from the treasury except in accordance with appropriations made by law. In other words, all expenditures require an appropriation. However, the Constitution also states in Article IX, Sec. 16 that the governor shall invest unexpended and unappropriated balances. Therefore, as long as the MOC 1 loan is considered an investment, it was permissible under the Alaska Constitution.

Under AS 37.10.070 and AS 37.10.071, DOR is provided investment authority. No regulations further expand or restrict the department's authority. Alaska Statute 37.10.070 requires DOR's commissioner to invest the money in the state treasury above an amount sufficient to meet immediate expenditure needs. Per statute, the commissioner shall determine appropriate investment objectives, establish investment policies to achieve the objectives, and act only in the best financial interests of the state.

Alaska Statute 37.10.071(b)(5) further provides that the commissioner or fiduciary may lend assets, under an agreement and for a fee, against deposited collateral of equivalent market value. There are no statutory or constitutional requirements for the department to notify the legislature of the loan. Therefore, the loan was legally made without notice.

The audit also concludes DOR had the legal authority to use tax credits as collateral and did not violate state laws in doing so. Legal review of the oil and gas statutes under AS 43.55.023 determined that no state law prohibits the use of tax credits as collateral. Related statute AS 43.55.029 specifically allows for assignment of tax credits to third parties, which, in substance, is similar to the use of credits as collateral.

The MOC 1 loan was made outside DOR's established investment processes and not subject to procedures designed to meet investment objectives and minimize risk.

Per AS 37.10.070, DOR's commissioner is required to identify investment objectives and establish investment policies and procedures in order to achieve stated objectives. As described in the Background Information section of this report, DOR's Treasury Division invests State monies by fund. Treasury funds have established investment objectives including risk tolerance, liquidity, and expected returns. The division maintains established investment pools in which the treasury funds can invest. These investment pools have defined investment criteria and limits, and treasury funds are authorized to allocate assets and receive returns on the fund's share of the investment pool.

Investments are made according to the objectives laid out in the Treasury Division's Investment Policies and Procedures Manual. The chief investment officer (CIO) has investment authority over fixed income investments, which include loans. The CIO approves standard fixed income investments made according to the fund objectives and allocations.

The MOC 1 loan, made by DOR's deputy commissioner, fell outside of the established process described above. Effective August 13, 2015, DOR's commissioner signed an investment policy allowing for up to two percent investment in tax credit-backed loans. This policy was signed to allow for the MOC 1 loan, rather than to ensure the investment was appropriate in terms of the State's overall investment objectives and allocations. Auditors found no evidence that DOR management evaluated the risk tolerance, objectives, and time horizon of the loan as specified in the investment policies.

The MOC 1 loan was under-collaterized for approximately 19 months.

The MOC 1 loan was issued as a line of credit for up to $22.5 million. Alaska Statute 37.10.071(b)(5) allows the commissioner to loan assets against deposited collateral of equivalent market value. DOR attempted to meet the collateral requirements by requiring third party review of MOC 1's 2015 expenditures eligible for tax credits. The loan was limited to 95 percent of the eligible tax credits as estimated by the third party. DOR withheld prepaid interest for approximately the first year of the loan term to help ensure the collateral was sufficient to cover the interest that would become due within the first year. At the time the loan payments were made (October 2015 through February 2016), DOR management could reasonably expect collateral to exceed the loan value at the maturity date. When the Tax Division certificated the tax credits during July 2016 for $19.6 million, the face value of the tax credits fully collateralized the loan.

The loan did not remain fully collateralized. The collateral was insufficient beginning October 2017 and the loan remained under-collateralized through the payoff date in May 2019. (See Recommendation No. 2) The following factors negatively affected collateral:

- DOR's Tax Division approved the tax credits in July 2016 for $678 thousand less than the amount estimated based on the third party review of expenditures.

- In October 2017, $3.1 million of MOC 1's 2015 tax credits were purchased; however, statutes[11] required the department to withhold $1.5 million due to outstanding state property taxes. The delinquent taxes effectively reduced collateral by $1.5 million.

- The maturity date of the loan was extended twice, which added over 18 months without adding collateral. A draft version of the first loan extension added MOC 1 2016 tax credits as collateral. However, the final version of the loan amendment did not require additional collateral. DOR management could not explain why the collateral was dropped from the final version of the amendment.

Alaska Statute 37.10.071(b)(5) allows assets to be loaned against *deposited* collateral of equivalent *market* value. DOR management was unable to show that the department evaluated the market value of tax credits at any point before or during the loan period. The face value of the tax credits was evaluated rather than the market

[11] AS 43.55.028(j).

value. Auditors also noted that the tax credits were not certificated by the Tax Division at the time of the loan, which raises questions as to whether the collateral was "deposited" at the time of the loan as required by statute.

DOR management did not enforce all loan terms.

Auditors noted two instances the MOC 1 loan terms were not enforced. First, the loan agreement required MOC 1 to pay all taxes related to the project when due. MOC 1 did not comply with this provision and did not pay its 2016 and 2017 taxes. As discussed previously, statutes required cash payments for a recipient's oil and gas tax credits to first be applied to any outstanding tax liabilities owed to the State. Consequently, when a cash payment on MOC 1's tax credits was made in the fall of 2017, $1.5 million was withheld for outstanding taxes, interest, and penalties. The use of tax credits to pay delinquent taxes reduced the MOC 1 loan collateral. DOR management did not require additional collateral and the loan became under-collateralized.

Secondly, a five percent late penalty was not enforced. The loan included a five percent penalty on any payment not made within 30 days of the due date. MOC 1 made no payment within 30 days of July 15, 2018, which was the due date as of the second extension. DOR management did not enforce the penalty because DOR was in negotiations with AIDEA to assume the loan. DOR management believed that it was not in the State's best interest to enforce the penalty and put the loan into default, as it could have caused AIDEA to lose financing opportunities and incur a loss on the loan. Forgiveness of late penalties is not uncommon when negotiating the payment of past due loans.

DOR did not correctly report the MOC 1 loan in the FY 16 and FY 17 State Comprehensive Annual Financial Reports.

The atypical nature of the MOC 1 loan and the lack of internal controls led to erroneous accounting and reporting in the State's FY 16 and FY 17 Comprehensive Annual Financial Reports (CAFR or financial statements). In addition to a lack of adequate internal controls, there was confusion between DOR management as to whether the MOC 1 loan was an investment or a loan. The transactions that recorded the loan differed from established procedures in several ways:

- The CIO was aware of the loan, but did not approve the loan; rather, a deputy commissioner approved the loan. Additionally, the loan disbursements were made directly from the State's general fund rather than the central treasury investment fund, the General Fund and Other Non-Segregated Investments (GeFONSI), which did not follow the Treasury Division's typical investment process. Recording the disbursements directly from the general fund rather than a treasury investment fund resulted in the loan being excluded from the annual Treasury Division investment audit.

- The loan disbursements processed by DOR's Administrative Services Division erroneously debited revenues (essentially recording negative revenues) in the State accounting system by $18 million, obscuring the nature of the transaction. The loan disbursements were reported in FY 16 as a reduction of general fund revenue, but should have been reported as an investment asset. Since there were no loan disbursements in FY 17, no activity was reported in the FY 17 financial statements. The loan should have continued to be reported as an FY 17 investment asset.

- Confusion existed over the responsibility for managing the MOC 1 loan investment. Emails reviewed by auditors indicated that the Treasury Division did not manage or include the loan in the annual Treasury Division investment audit because Treasury Division management considered the MOC 1 line of credit to be a loan rather than an investment. The Treasury Division believed the loan should have been managed by the Administrative Services Division. However, the Administrative Services Division, which was responsible for the distribution of loan funds to MOC 1, never reported or managed the loan beyond processing the cash distributions. The Administrative Services Division believed the loan was the responsibility of the Treasury Division.

When the new DOR commissioner reviewed the loan during 2018, the commissioner determined that the loan was an investment and should have been accounted for and reported as such. After the commissioner's decision, DOR recorded the loan as an investment in the Treasury Division's FY 18 investment audit and in the CAFR. The misstatements in the FY 16 and FY 17 CAFRs were immaterial with respect to the impacted accounts.

DOR management could not explain why a tax credit loan was only offered to MOC 1.

The audit objectives included a determination as to why a tax credit loan was only offered to MOC 1. The audit found that, although DOR sought guidance from the Department of Law regarding the legality of implementing a tax credit loan program, a program was never implemented. The MOC 1 tax credit-backed loan was the only loan offered to tax credit holders.

Audit evidence shows that the MOC 1 managing company, Brooks Range Petroleum Corporation (BRPC), requested the loan. The request to the governor's chief of staff was made shortly after the governor's FY 16 veto of $200 million from the operating budget for payment of oil and gas tax credits. The governor's chief of staff subsequently contacted DOR's commissioner about the possibility of a tax credit-backed loan. After receiving the request from the chief of staff, DOR's commissioner directed the deputy commissioner to work with staff to draft an agreement and seek a legal opinion to determine the legality of the proposed loan. As noted previously, the audit concluded the loan was legal under the department's statutory investment authority, and no state laws preclude the use of tax credits as collateral.

In August 2015, prior to issuing the MOC 1 loan, DOR implemented an investment policy allowing for tax credit-backed loans as part of the GeFONSI investment mix. However, DOR had no procedures for governing a loan program at the time of the request and the implemented policy added no procedures for administering loans. There were no procedures for determining eligibility, soliciting potential borrowers, establishing borrower qualifications, and requiring rates of return, or other criteria to evaluate potential loans. Management asserted that staff began to draft procedures for issuing tax credit-backed loans out of GeFONSI, but the procedures were not finalized. DOR management could not explain why a program that offered loans to other tax credit holders was not established.

The loan was made to MOC 1 despite conflicts of interest.

The commissioner's issuance of the MOC 1 loan created two conflicts of interest:

1. The DOR commissioner's interest in collecting payment on the MOC 1 loan conflicted with duties to represent AIDEA in matters relating to MOC 1 as part of AIDEA's board of directors. Between October 1, 2015, and March 1, 2018, AIDEA held 25 board meetings that included executive session discussions related to MOC 1. The DOR commissioner's designee participated in 23 (92 percent) of the meetings. During the same time period, AIDEA's board passed two resolutions related to MOC 1. The commissioner's designee voted on both resolutions, which provided MOC 1 \$2.8 million of additional funding. In March 2018, the commissioner's designee self-identified a potential conflict of interest and recused from AIDEA board actions related to MOC 1.

2. The DOR commissioner's statutory duty to ensure the MOC 1 loan was collateralized conflicted with the commissioner's oversight of the valuation and approval of the tax credits. DOR's commissioner presides over the Tax Division, which receives and approves tax credit applications

per AS 43.55.023(d). Further, under AS 43.05.010(8), the commissioner presides over any dispute regarding the value of tax credits. Allowing the use of tax credits as collateral created a conflict between the commissioner's oversight responsibility for valuing the collateral and the duty to ensure the loan was fully collateralized. If the value of the tax credits was lower than the loan, the loan would have been under-collateralized, causing non-compliance with investment statutes.

Safeguards were not implemented to mitigate the conflicts of interest. (See Recommendation No. 3)

AIDEA's purchase of the MOC 1 loan will reduce AIDEA's dividend.

Under governmental accounting standards, AIDEA is a component unit of the State and its financial activity is included in the State's financial statements. As such, the financial impact of the MOC 1 loan must be considered from the viewpoint of the State as a whole.

AIDEA paid $16.5 million to DOR for all principal and accrued interest on the MOC 1 loan as of May 2019. In substance, AIDEA's purchase of the MOC 1 loan simply moved the investment out of the general fund and reclassified it as a loan receivable of a component unit. Although the general fund recognized revenue of approximately $4.29 million over the life of the loan, AIDEA recognized a loss of $1.77 million when it purchased the MOC 1 loan. Because AIDEA pays an annual dividend to the State in an amount between 25 and 50 percent of AIDEA's statutory net income, AIDEA estimates the loss will reduce the general fund dividend by $885.5 thousand in FY 21.

According to AIDEA management, AIDEA has first rights to all outstanding MOC 1 tax credits, which total $15 million. However, the timing of appropriations for cash payment of oil and gas tax credits impacts AIDEA's ability to receive payment for the credits. Continuing accrual of unpaid interest on the loan, coupled with the possibility of other MOC 1 creditors challenging AIDEA's rights to the tax credits, could increase AIDEA's losses over time.

AIDEA's overall investment in the Mustang project could reduce subsequent AIDEA dividends.

Subsequent to assuming the DOR MOC 1 loan, AIDEA combined all outstanding interests in the Mustang project[12] in a debt reorganization with Caracol. As of March 31, 2020, Caracol and its affiliates (including BRPC) owed AIDEA $90.5 million. This includes $16.6[13] million (as of June 30, 2019) related to the DOR tax credit-backed loan assumed by AIDEA. Caracol has not made required payments to AIDEA according to the restructured debt agreement. According to AIDEA management, given the significant decline in oil prices as of March 31, 2020, it is possible that AIDEA will record a significant allowance for loan loss, write off, or substantially write down the amounts owed to AIDEA for the Mustang project by Caracol.

MOC 1 produced a small amount of oil in November 2019, but never met the definition of an oil producer. As of March 2020, the MOC 1 project had insufficient capital to produce oil and AIDEA management believed it is unlikely additional capital in the amount needed can be obtained due to low oil prices. The facility was in the process of transitioning from warm storage to cold storage (a shutdown of the facilities so that no heating is necessary for equipment remaining at the site).

Moving to cold storage was the initial step in a non-judicial foreclosure process in order to reduce the carrying costs of the project. According to AIDEA management, AIDEA has organized a steering committee for the Mustang Field comprised of major creditors and experienced vendors working on the project, as well as a working interest owner to develop a path forward after non-judicial foreclosure. The objective of the steering committee is to work together to develop and implement a project development plan that facilitates the repayment of creditor investments in the project, including AIDEA.

[12] The Mustang project includes AIDEA's equity interests in both Mustang Road LLC and MOC 1.

[13] AIDEA's loan receivable from Caracol ($16.6 million) is greater than the amount paid to DOR ($16.5 million) due to accrued interest though the end of the fiscal year.

A change in value of the outstanding Mustang project loans will further affect "net income" used in calculating AIDEA's dividend to the State. AIDEA will make a final determination as of June 30, 2020, regarding the Mustang project loans in preparation of AIDEA's FY 20 audited financial statements and the appropriate accounting entries will be made at that time. Any allowance, write off, or write down will reduce statutory "net income." The dividend will be decreased by 25 to 50 percent of any loss, as determined by AIDEA's board.[14]

The MOC 1 loan was not a prudent investment.

The DOR commissioner's decision to loan up to $22.5 million to MOC 1 under the authority of the department's investment statutes was not appropriate when compared with behavior that a prudent person would consider reasonable. In support of this conclusion, auditors noted the following: the loan was made outside of DOR's established investment procedures and DOR management failed to adequately document consideration of the associated risks when making the loan; adequate internal controls were not implemented over the accounting, reporting, and management of the loan; and the loan created conflicts of interest that were not sufficiently mitigated. These facts demonstrate the need for additional oversight of DOR's investment functions. (See Recommendation No. 4)

Several red flags that appeared before the loan was issued should have raised significant concern regarding the viability of the MOC 1 project. Insufficient documentation exists to support DOR's consideration of the following risk factors.

- **MOC 1's risk as a going concern due to inability to obtain financing and a drop in oil prices.** When MOC 1 was created in 2014, the project was expected to cost between $200 million and $225 million. The agreement stipulated that AIDEA provided $50 million of financing. As part of the arrangement, Charisma

[14] AIDEA's board declares the dividend paid to the State at an amount between 25 and 50 percent of AIDEA's statutory net income in the fiscal year two years before the dividend is paid.

Energy Services Limited (CES) agreed to secure $175 million in additional financing. When DOR entered the MOC 1 loan agreement in October 2015, CES had not secured the financing. AIDEA management cited a drop in oil prices as the primary cause for failure to obtain financing. Oil prices remained low at the time of the loan, yet the commissioner used DOR's authority to provide a loan to MOC 1. The unwillingness of third party sources to finance the MOC 1 project diminished MOC 1's desirability as an investment, as there was significant risk that the project would not be viable.

- **Risk of valuation and collectability of tax credits as collateral.** DOR collateralized the loan with future tax credits, which had not been approved by the Tax Division and were valued based on a third party estimate. Further, because of MOC 1's inability to secure additional financing from other sources and a lack of other revenue, the only plan for repayment of the loan was through the State's purchase of oil and gas tax credits. Prior to DOR's issuance of the loan, the governor vetoed $200 million of the appropriation for purchase of oil and gas tax credits. While there is some documentation to support that DOR considered the risk that appropriations would be insufficient to collect on the loan, no documentation was available supporting why DOR made the loan despite the risk.

Considering all the above factors, the audit concludes issuance of the loan was deficient or not appropriate when compared with behavior that a prudent person would consider reasonable and a necessary business practice.

(Intentionally left blank)

FINDINGS AND RECOMMENDATIONS

Recommendation 1

DOR's commissioner should ensure investments are made in accordance with established investment objectives and procedures.

Department of Revenue (DOR) accounting staff did not properly account for or report the Mustang Operations Center 1 LLC (MOC 1) loan and the loan was not adequately managed for over two years. The State's FY 16 Comprehensive Annual Financial Report (CAFR) erroneously reported the $18 million in loan disbursements as reductions to general fund revenues and the FY 17 CAFR failed to report the loan. The reporting errors were corrected in the FY 18 CAFR via an audit adjustment.

Alaska Statute 37.10.070(a) provides DOR's commissioner the authority to invest residual State funds. The statute requires that the commissioner identify investment objectives, establish investment policies, and act only in the State's best interests. The Alaska Administrative Manual[15] (AAM) establishes that each agency head is ultimately responsible for establishing and maintaining a system of internal controls. Internal controls are required to preserve evidence to substantiate a decision, event, or transaction.

A lack of adequate internal controls caused the accounting and reporting errors. Internal controls were insufficient to:

- document the evaluation of the risk tolerance, objectives, and time horizon of the investment, as required by the Treasury Division's investment policies; and
- ensure accurate reporting of the loan as an investment in the State's financial statements.

The lack of procedures for non-routine investments and a breakdown in DOR internal communications resulted in the loan being recorded and reported incorrectly. Further, DOR staff could not show that the MOC 1 loan complied with investment objectives or fully explain the loan decision. This increased the risk that the investment would not provide an adequate return. Further, the FY 16 and FY 17 CAFRs failed to disclose the loan, which contributed to a lack of transparency and inaccurate information for policy makers.

[15] AAM Sections 05.020, 05.030, and 05.130.

In 2018, two years after the loan disbursements, DOR's new commissioner determined the loan should be managed by the Treasury Division and included in the annual Treasury Division audit of invested assets. At that time, a policy for non-routine investments was added to help ensure non-routine investments were properly managed and reported in the future.

We recommend DOR's commissioner ensure future investments are made in accordance with established investment objectives and procedures.

Recommendation 2

DOR's commissioner should ensure collateral is required in accordance with AS 37.10.071(b)(5).

The MOC 1 loan was adequately collateralized at the time it was made in 2015. Subsequently, four events contributed to the loan's under-collateralization:

1. In setting the loan and collateral amounts, DOR did not allow for a sufficient margin of error between the value of the tax credits estimated based on third party review and the value certificated by the Tax Division. MOC 1's 2015 oil and gas tax credits were certificated at approximately $678 thousand less than estimated.

2. No additional collateral was added when the loan was extended to December 2017. A draft version of the loan extension added MOC 1 2016 tax credits as collateral. However, the final version of the loan amendment did not require additional collateral. DOR management could not explain why the collateral was dropped from the final version.

3. No additional collateral was added when the loan was extended to July 2018.

4. The Tax Division repurchased $3.1 million of MOC 1's 2015 tax credits in October 2017, but retained $1.5 million to pay delinquent property taxes. Consequently, only $1.6 million was subsequently paid to DOR for interest on the

loan. Effectively, loan collateral was reduced by $3.1 million without an equivalent reduction of principal.

In May 2019, the outstanding balance of the loan was $16.5 million and the collateral had a face value of $12.3 million. Not securing additional collateral, such as subsequent years' tax credits or other collateral, put the State at risk of loss in the event of loan default. The non-standard nature of this investment, coupled with inadequate procedures, led to the collateral not being added each time the loan was extended.

Alaska Statute 37.10.071(b)(5) provides the authority to lend assets, under an agreement and for a fee, against deposited collateral of equivalent market value. Alaska Statute 43.55.028(j) requires the Tax Division reduce the payment for tax credits by the amount of taxes owed to the State.

We recommend DOR's commissioner ensure collateral is required in accordance with AS 37.10.071(b)(5).

Recommendation 3

DOR's commissioner should ensure conflicts of interest are avoided or prevented when carrying out the department's duties and responsibilities.

The MOC 1 loan decision conflicted with the commissioner's statutory responsibilities as an Alaska Industrial Development and Export Authority (AIDEA) board member and as head of the Tax Division, the division responsible for valuing and approving tax credits. Further, the loan conflicted with the commissioner's responsibility to rule on tax credit appeals. More specifically, the loan caused the following conflicts:

1. The DOR commissioner's interest in collecting payment on the MOC 1 loan conflicted with duties to represent AIDEA in matters relating to MOC 1 as part of AIDEA's board of directors. Between October 1, 2015, and March 1, 2018, AIDEA held 25 board meetings that included executive session discussions related to MOC 1. The DOR commissioner's designee participated in 23 (92 percent) of the meetings. During the same time period, AIDEA's board

passed two resolutions related to MOC 1. The commissioner's designee voted on both resolutions, which provided MOC 1 $2.8 million of additional funding. In March 2018, the commissioner's designee self-identified a potential conflict of interest and recused from AIDEA board actions related to MOC 1.

2. The DOR commissioner's statutory duty to ensure the MOC 1 loan was collateralized conflicted with the commissioner's oversight of the valuation and approval of the tax credits. The DOR commissioner presides over the Tax Division, which receives and approves tax credit applications per AS 43.55.023(d). Further, under AS 43.05.010(8), the commissioner presides over any dispute regarding the value of tax credits. Allowing the use of tax credits as collateral created a conflict between the commissioner's oversight responsibility for valuing the collateral and the duty to ensure the loan was fully collateralized. Auditors noted that tax credits were approved as collateral prior to the Tax Division valuing and approving the tax credits. If the value of the tax credits was lower than the loan, the loan would have been under-collateralized, causing non-compliance with investment statutes.

The MOC 1 loan was a non-routine investment issued outside of established investment procedures. (See Recommendation No. 1) DOR's inquiry with the Department of Law regarding the legality of issuing the loan identified the commissioner's conflict of interest due to responsibility to enforce tax laws, but the department did not document consideration of the conflicts of interest and could not justify why the loan was made despite the conflicts.

DOR Investment Policies and Procedures – Section VI-Standards of Care and Loyalty Applicable to the Investment of State Funds (A)(1) identifies fiduciary responsibilities of the commissioner. The procedures state that it is the commissioner's responsibility to avoid conflicts of interest. Alaska Statute 44.88.030

establishes the DOR commissioner, or designee, as a member of the AIDEA board. Alaska Statute 44.88.180 prohibits AIDEA board members from voting on resolutions related to a contract if the member is a party to the contract.

Entering into transactions with conflicts of interest decreases trust and transparency of government operations.

We recommend DOR's commissioner ensure conflicts of interest are avoided or prevented when carrying out the department's duties and responsibilities.

Recommendation 4

The legislature should consider enhancing oversight of DOR's investment functions.

The DOR commissioner's decision to loan up to $22.5 million to MOC 1 under the authority of the department's investment statutes was not illegal; however, the decision was not appropriate when compared with behavior that a prudent person would consider reasonable. The following actions provide support that DOR's decision was not prudent.

- The chief investment officer responsible for fixed income investments was aware of the loan, but was not involved with formally evaluating or approving the loan. Therefore, the loan lacked documentation of any standard due diligence evaluation or asset management procedures. Further, the loan was inaccurately accounted for and reported in the State's financial statements and was made without transparency.

- Internal confusion existed regarding management responsibilities for the MOC 1 loan. Consequently, the loan was not adequately managed and not picked up as part of the Treasury Division's annual audit of invested assets.

- Evidence showed that MOC 1 had long-term funding needs that would not be satisfied by DOR's loan of up to $22.5 million. MOC 1's risk as a going concern due to its inability to obtain financing and the drop in oil prices diminished MOC 1's desirability as an investment. At the time the loan was made, there was no evidence to show DOR management considered this risk.

- The collectability of tax credits as collateral increased the investment's risk. MOC 1's only plan for loan repayment was the use of funds from the State's purchase of oil and gas tax credits. Prior to DOR's issuance of the loan, the governor vetoed $200 million of the appropriation for purchase of oil and gas tax credits. At the time of the loan, there was evidence that DOR management considered the risk, but no evidence as to why the loan was made despite the risk.

- The loan's issuance resulted in conflicts of interest for DOR's participation on AIDEA's board regarding matters related to MOC 1, and the commissioner's authority over both DOR's investments and authority over the approval and valuation of the collateral used for the investment. The Department of Law identified the conflict of interest from the commissioner's role over enforcing tax laws when reviewing the legality of the loan program. There was no evidence that the DOR commissioner considered this risk.

- DOR only offered tax credit-backed loans to MOC 1, providing preferential treatment to a majority State-owned entity.

- The loan was partially issued in order to protect AIDEA's investment in MOC 1, which conflicts with Alaska's prudent investor rule statutes.[16]

A lack of procedures governing non-routine investments and a lack of formal oversight of the DOR commissioner's investment functions contributed to the actions described above. Article IX, Sec. 16 of the Alaska Constitution states that the governor shall invest unexpended and unappropriated balances. Statutes provide the DOR commissioner with the authority to invest these monies, but there are no statutory provisions that provide for formal ongoing oversight of the investment function. In contrast, the State's pension funds are subject to oversight by the Alaska Retirement Management Board (ARMB). Per AS 37.10.220, the ARMB, in

[16] AS 13.36.225 and AS 13.36.230.

part, determines the appropriate investment objectives, obtains an external performance review to evaluate the investment policies, and submits quarterly updates of the investment performance reports to the Legislative Budget and Audit Committee. This oversight function provides transparency and assurance over the propriety of pension investments.

The MOC 1 loan decision created conflicts of interest that eroded the public's trust in government. Further, the loan led to inaccurate financial information for policy makers and an undisclosed investment, decreasing the transparency of government operations. While DOR recognized a $4.29 million gain over the life of the MOC 1 loan, AIDEA recognized a loss of $1.77 million when it purchased the MOC 1 loan that will decrease AIDEA's future dividend to the State by an estimated $885.5 thousand.

Given that a lack of oversight contributed to the decision to pay MOC 1 tax credits in advance of a legislative appropriation, we recommend the legislature consider enhancing the oversight of DOR's investment functions. Oversight similar to the ARMB may lead to a more transparent investment function and increase the public's trust in government operations.

(Intentionally left blank)

OBJECTIVES, SCOPE, AND METHODOLOGY

Objectives

Generally, this audit reports on the Department of Revenue's (DOR) loan to Mustang Operations Center 1 LLC (MOC 1). Specifically, the audit includes the following objectives:

- Determine whether DOR followed all State statutes, regulations, policies and procedures, and/or terms of the agreement(s) between DOR and MOC 1 in making the 2015 loan and later amending terms.
- Evaluate whether the loan and any subsequent amendments were reported accurately in the State of Alaska's financial statements.
- Determine whether all State statutes, regulations, DOR policies and procedures, and/or the terms of the agreement(s) between DOR and MOC 1 were followed.
- Examine the use of oil tax credits as collateral for the MOC 1 loan and whether such actions comply with State statutes, regulations, DOR policies and procedures, and the terms of the agreement(s) between DOR and MOC 1.
- Review legal issues related to the loan, including notice to the legislature and how the legislature's appropriation authority applies to the loan.
- Examine how broadly the tax credit-backed loan program was offered and, if the opportunity was only offered to MOC 1, determine why the program was limited to MOC 1.
- Determine whether there were any conflicts of interest internally or externally.
- Determine how the Alaska Industrial Development and Export Authority's (AIDEA) assumption of DOR's MOC 1 loan affected AIDEA's dividend to the State.
- Report on the status of the Mustang project as of March 31, 2020.

Scope

The scope period was December 1, 2012, through March 31, 2020.

Methodology

To address the objectives, auditors:

1. Obtained and reviewed newspaper articles, press releases, and AIDEA annual reports to gain an understanding of the history of the Mustang Road LLC, MOC 1, and the DOR tax credit-backed loan to MOC 1. Additionally, to identify complaints against AIDEA or DOR related to the MOC 1 loan.

2. Reviewed all AIDEA board meeting minutes between January 14, 2014, and January 15, 2020. The meeting minutes were reviewed to gain an understanding of the Mustang Road LLC and MOC 1 projects; identify complaints about the DOR loan to MOC 1; and to determine whether DOR representatives on the AIDEA board participated in matters related to MOC 1, including voting on MOC 1 resolutions.

3. Examined the MOC 1 line of credit agreement, line of credit note, security agreement, and amendments to these documents to determine whether DOR complied with and enforced all loan terms.

4. Reviewed accounting transaction data related to the loan disbursement and repayment:

    - Reviewed the loan transactions on the State accounting system along with related documentation to determine whether the loan was recorded accurately in the State's accounting system and the FY 16 through FY 19 financial statements.

    - Examined and recalculated DOR's amortization schedule to determine whether DOR correctly calculated principal and interest on the loan, and collected the entire outstanding balance of the loan.

    - Reviewed third party reports analyzing MOC 1 tax credit eligible expenditures supporting draws on the loan for compliance with loan requirements.

5. Reviewed Alaska Statutes, administrative code, and DOR investment policies to determine which were applicable to DOR's investment authority; investment requirements and procedures; and tax credit approval, issuance, and payment.

6. Consulted with the Legislative Division of Legal and Research Services regarding the audit objectives.

7. Reviewed DOR's attorney general opinion regarding a tax credit-backed loan program to help determine the authority and legality of the MOC 1 loan.

8. Reviewed the DOR Treasury Division's historical Investment Policies and Procedures Manual to determine if and when the division had policies in place supporting investments in tax credit-backed loans per AS 37.10.070(a)(3).

9. Reviewed notes to the DOR Treasury Division's FY 18 and FY 19 audited financial statements to verify that a tax credit-backed loan was only issued to MOC 1, and to verify that a loan program was not established and why.

10. Conducted internet searches for potential relationships or conflicts of interest between DOR personnel responsible for the MOC 1 loan and board members or employees of MOC 1 or related companies.

11. Evaluated the DOR commissioner's role over both the Treasury Division and Tax Division (AS 43.05.010) to determine whether there was a conflict of interest resulting from using uncertificated tax credits as collateral for the MOC 1 loan.

12. Reviewed daily oil price reports from DOR's website from January 1, 2014, through May 28, 2019, to track the average price of oil and its correlation to MOC 1 investments and loan requests.

13. Using the Division of Legislative Finance's Summary of Appropriations publications for fiscal years FY 14 through FY 19, created a schedule of appropriations for payment of oil and gas tax credits under AS 43.55.023.

14. Reviewed Uniform Commercial Code filings for evidence of a security interest filing or lien placed on MOC 1's FY 15 through FY 17 tax credits.

15. Obtained and reviewed emails from the state treasurer, DOR deputy commissioner, and DOR chief investment officer (CIO) related to the MOC 1 loan to gain an understanding of the parties' involvement in the loan, and what consideration of risks was performed prior to loan issuance. Additionally, reviewed the chain of events leading up to the loan, negotiations with AIDEA on assuming the loan, and final loan classification decisions.

16. Reviewed MOC 1's financial statements from FY 15 through FY 18 to identify disclosures related to the DOR loan and the use of funds by MOC 1.

17. Reviewed AIDEA's financial statements from FY 14 through FY 19 to identify disclosures related to MOC 1 and Mustang Road LLC investments.

18. Inquired with AIDEA's board chair and chief financial officer to gain a historical perspective of AIDEA's investment in MOC 1 and involvement with DOR's loan to MOC 1.

19. Obtained and evaluated AIDEA's accounting of the purchase and assumption of DOR's loan to MOC 1 to determine the fiscal impact.

20. Obtained representation letters signed by DOR and AIDEA management confirming that all relevant information was provided to auditors.

21. Interviewed DOR's management and prior management involved with the loan. Key interviews included:

    - DOR's CIO to gain an understanding of DOR's standard investment practices and policies, the process for updating policies, DOR's rationale for providing the loan to MOC 1 and consideration of risks associated with the loan. Additional topics included the CIO's involvement with the MOC 1 loan, examples of the comparable investments, and why a tax credit-backed loan was offered only to MOC 1.

    - DOR's former CIO, as of October 1, 2015, to gain an understanding of the origination of the MOC 1 loan, the CIO's involvement with the MOC 1 loan, and DOR's consideration of the collateral value and risks associated with the loan. Additional topics included rationale for how the loan was recorded in the accounting system and why a tax credit-backed loan was offered only to MOC 1.

    - State treasurer to gain an understanding of why loan disbursements were paid directly from the general fund versus treasury investment accounts; rationale for how the loan was recorded in the accounting system; and consideration of collateral suitability, risks, and value. Additional topics included why the commissioner allowed the Tax Division to disburse funds from the MOC 1 loan collateral to pay property taxes and why a tax credit-backed loan was offered only to MOC 1.

    - DOR's former Administrative Services Division director, as of October 1, 2015, to gain an understanding of why loan disbursements were paid directly from the general fund versus treasury investment accounts, rationale for how the loan was recorded in the accounting system, and DOR's consideration of the collateral value and risks associated with the loan.

    - DOR's former Tax Division director, as of October 1, 2015, to gain an understanding of the director's involvement with the issuance and management of the MOC 1 loan and consideration of risks related to the loan. Additional topics included why the commissioner allowed the Tax Division to disburse funds from the MOC 1 loan collateral to pay property taxes and why a tax credit-backed loan was offered only to MOC 1.

- DOR's state investment officer and former state comptroller, as of October 1, 2015, to gain an understanding of why the commissioner allowed the Tax Division to disburse funds from the MOC 1 loan collateral to pay property taxes, DOR rationale for enforcing the loan agreement terms, communications with the legislature regarding the loan, and the individual's role in the issuance and management of the loan.

- DOR's deputy commissioner to gain an understanding of the deputy commissioner's history with the loan and rationale for enforcement of the loan agreement terms.

- AIDEA's two previous chief executive officers to obtain an understanding of the status of the MOC 1 project as of March 31, 2020, and AIDEA's involvement with DOR's loan to MOC 1.

No sampling was conducted as part of this audit. Additionally, no internal controls were tested as no controls were found significant to the audit objectives.

APPENDIX SUMMARY

Appendix A: Timeline of Key Events Related to the Mustang Operations Center 1 LLC (MOC 1) Loan

(Intentionally left blank)

APPENDIX A

Timeline of Key Events Related to the MOC 1 Loan

FY 12:

- December 2012: AIDEA approves investment of $20 million in Mustang Road and Pad Project.

FY 13:

- April 2013: Mustang Road and Pad Project completed.

FY 14:

- April 2014: AIDEA approves initial investment in MOC 1 and guarantees up to $50 million of funding. This resulted in the formation of MOC 1.

FY 15:

- September 2014: Oil prices begin to decline.

- June 2015: Governor Walker uses line item veto authority to reduce FY 16 tax credit payments by $200 million, from an estimated $700 million to a fixed $500 million.

FY 16:

- July 2015: Brooks Range Petroleum Corporation contacts the governor's chief of staff regarding advance payment of tax credits in the form of a tax credit-backed loan. This request is forwarded to the DOR commissioner, and ultimately the DOR deputy commissioner, who oversees the Treasury Division.

- August 2015: DOR obtains a legal opinion in the form of a memo from the assistant attorney general to the commissioner and deputy commissioners of DOR supporting a tax credit-backed lending program.

- August 2015: DOR's commissioner approves an amendment to the GeFONSI investment policy to permit up to two percent of investments in tax credit-backed loans.

- October 2015:
  - DOR provides MOC 1 with a line of credit loan up to $22.5 million, collateralized by yet to be applied for or issued 2015 tax credits and due in full December 31, 2016.
  - DOR disburses $15.1 million to MOC 1 (total principal and fees $16,184,155 less prepaid interest of $1,132,506).

- December 2015: DOR disburses $2.4 million to MOC 1 (total principal $2,480,635 less prepaid interest of $115,763).

APPENDIX A
(Continued)

- February 2016: DOR disburses final payment of $625 thousand to MOC 1 (total principal $651,845 less prepaid interest of $26,617).

FY 17:

- July 2016:
  - MOC 1 is approved for a $19.6 million 2015 AS 43.55.023(b) tax credit by the DOR Tax Division.
  - First loan amendment extending maturity date from December 31, 2016, to December 31, 2017.

FY 18:

- July 2017:
  - Alaska Statute 43.55.023(b) tax credit legislation repealed.
  - Second maturity date extension from December 31, 2017, to July 15, 2018.

- October 2017: DOR repurchases MOC 1 2015 tax credits for $3.14 million. The Tax Division withholds $1.48 million to pay State property taxes.

- December 2017: AIDEA contributes $2.5 million of additional bridge financing to MOC 1. The additional funding was approved as part of AIDEA resolution G17-08 at the June 29, 2017, board meeting.

- February 2018:
  - MOC 1 uses $1.66 million from the October 2017 tax credit repurchase to pay back interest on the MOC 1 loan.

- March 2018:
  - AIDEA approves a $300 thousand line of credit to MOC 1. The line of credit was approved as part of AIDEA resolution G18-02 at the March 1, 2018, board meeting.
  - The DOR commissioner’s designee on AIDEA’s board identifies that DOR has a potential conflict of interest and begins recusing from AIDEA MOC 1 board meeting discussions.
  - DOR begins working with AIDEA to identify alternative MOC 1 loan repayment options.

- June 2018:
  - Effective June 30, 2018, DOR implements procedures for non-traditional investments. The procedures include steps for the evaluation of potential investments not covered specifically in the department’s investment policies and procedures.

APPENDIX A
(Continued)

FY 19:

- July 2018: The DOR Investment Policies and Procedures removes the two percent tax credit provision from the GeFONSI asset allocation policy.

- September 2018: AIDEA board unanimously approves a deal to sell MOC 1 to Caracol Petroleum LLC. As a part of the sale, AIDEA's initial investment in MOC 1 is converted to a loan.

- January 2019: MOC 1 repays $4.16 million in principal and interest via its 2015 tax credit payment from DOR.

- May 2019:
  - Third loan amendment signed on May 24, 2019, interest rate reduced from seven percent to three percent, effective September 1, 2018.
  - AIDEA pays DOR $16.5 million on May 28, 2019, for the outstanding balance of the MOC 1 loan principal and interest.

(Intentionally left blank)

Agency Response from the Department of Revenue

THE STATE of ALASKA
GOVERNOR MIKE DUNLEAVY

Department of Revenue

Office of the Commissioner

PO Box 110400
Juneau, Alaska 99811-0400
Main: 907.465.2300

October 6, 2020

RECEIVED
OCT 06 2020
LEGISLATIVE AUDIT

Kris Curtis, CPA
Legislative Auditor
Division of Legislative Audit
333 Willoughby Avenue, 6th Floor
PO Box 113300
Juneau, AK 99811-3300

Re: Confidential Preliminary Audit Report--Department of Revenue MOC1 Loan

Dear Ms. Curtis:

Thank you for the opportunity to review the Division of Legislative Audit's (DLA) confidential preliminary report dated September 16, 2020. DLA has compiled a substantial amount of information, and makes recommendations that, in general, I think have considerable merit.

This matter took place during the Walker Administration, well before I was appointed commissioner by Governor Dunleavy. Many of the events in this matter took place before Deputy Commissioner Barnhill was first appointed deputy commissioner in 2018. So our ability to confirm some of the facts and conclusions in this draft audit is somewhat diminished.

Nevertheless, I agree there are internal control issues identified by this audit that occurred during the Walker Administration timeframe 2015 to 2018. But no financial harm to the general fund ultimately resulted.

The audit report suggests that the AIDEA dividend to the general fund was reduced as a result of this loan. This is a debatable assertion. The MOC1 investment by AIDEA has struggled primarily because of oil price declines in 2014, 2018 and 2020. The Department of Revenue obviously did not cause those declines, and arguably has no role whatsoever in the reduction of the AIDEA dividend.

Additionally, I believe it is premature to declare the Mustang project a loss. AIDEA passed a resolution to restructure the debt and authorized the sale of the Mustang oil field leases to Finnex. On October 1, 2020, Brooks Range Petroleum and Finnex filed a plan of development for the

Southern Miluveach unit with Alaska Division of Oil and Gas. Sustained oil production from the units' Mustang field is planned by third quarter of next year. According to BRPC & Finnex "…the project remains fundamentally sound and (capable) of being brought to fruition."

Corrective Action

1. *Non-traditional investment policy and process.* In 2018 the Treasury division drafted and implemented a policy and process to govern requests for "non-traditional" investments that are brought to the attention of the Treasury. Treasury staff believe that this process is effective in evaluating non-traditional investment ideas in an appropriate and transparent manner. I intend to strengthen this policy, as well as ensure this policy remains in place and is adhered to. Additionally, I am pursuing additional governance controls.

2. *Governance.* The assets that are invested under the Commissioner's authority are assets for which no board of fiduciaries exist. Our larger funds, such as the permanent fund, the PERS and TRS trusts, and the public-school trust all have an external commission that provides a level of governance. Whenever there are large sums of money at issue (i.e., billions of dollars), the existence of appropriate controls, transparency, and checks and balances must be present. An external commission is one of the most common ways to achieve all of these safeguards. I am in the process of establishing a nonpolitical, external investment commission for the Commissioner's assets. Further, as mentioned above I will mandate that all DOR investment decisions reside within the Treasury Division, and work towards a similar permanent legislative solution.

3. *Culture Change.* Since my arrival I have worked to communicate the importance of transparency and internal controls. The addition of a non-political external investment commission will help to provide assurance to the staff that adherence to internal controls, policy and procedures is important and will be followed and political pressures can be minimized via an independent commission.

Audit Recommendations

Recommendation 1 -- "We recommend DOR's commissioner ensure future investments are made in accordance with established investment objectives and procedures."

I agree. As noted above, policies were implemented in 2018, are in place and are adhered to. I am in the process of establishing a nonpolitical, external investment commission of fiduciaries for the Commissioner's assets. Our first meeting will be in 4Q 2020.

Recommendation 2 – "We recommend DOR's commissioner ensure collateral is required in accordance with AS 37.10.071(b)(5)."

Ms. Kris Curtis, Div. of Legislative Audit | October 6, 2020
Re: MOC1 Loan, Conf. Preliminary Audit Rpt. | Page 3

I agree, however, the statute should be amended to reflect standard risk, underwriting and collateralization practices.

Recommendation 3 – "We recommend DOR's commissioner ensure conflicts of interest are avoided or prevented when carrying out the department's duties and responsibilities."

I agree.

Recommendation 4 – "[w]e recommend the legislature consider enhancing the oversight of DOR's investment functions."

I agree. I am in the process of establishing a nonpolitical, external investment commission of fiduciaries for the Commissioner's assets. I have engaged with the current Investment Advisory Commission that provides investment advice for the ARMB board. This group of three independent advisors is selected by the ARMB based upon qualifications and investment expertise. I am planning the first meeting with this commission in 4Q 2020 where we will do an introduction to DOR investments, discuss portfolio allocation and review 3rd quarter performance. Additionally, the commission has agreed to be available on an as needed basis for non-traditional type investments that may come before the Commissioner.

Thank you for the opportunity to comment.

lucinda mahoney

Lucinda Mahoney
Commissioner, Department of Revenue

(Intentionally left blank)

Agency Response from the Alaska Industrial Development and Export Authority

Alaska Industrial Development and Export Authority

RECEIVED

OCT 05 2020

LEGISLATIVE AUDIT

October 5, 2020

Kris Curtis
Legislative Budget and Audit Committee
Division of Legislative Audit
PO Box 113300
Juneau, Alaska 99811-3300

RE: Department of Revenue, Mustang Operations Center 1 LLC Loan, July 24 2020

Dear Ms. Curtis,

Thank you for providing the Alaska Industrial Development and Export Authority (AIDEA) with a copy of the confidential preliminary audit report and for providing us an opportunity to submit a response. We note that the report is thorough and well-documented on the transaction under review.

We generally defer to the Department of Revenue (DOR) to respond to the report's conclusions and recommendations as these are directed to the department specifically related to the DOR Mustang Operations Center 1 LLC tax credit loan.

With regard to the report's third recommendation on pages 29 through 31 of the report, AIDEA recognizes that AS 44.88.180 prohibits AIDEA board member from voting on resolutions related to a contract if the member is a party to the contract. Please know that AIDEA and its Board are committed to advancing the public's trust and transparency in our operations as a public corporation of the State of Alaska. We confirm the committee's recommendation to ensure conflicts of interest are avoided or prevented when carrying out the Board's duties.

Respectfully,

J. Dana Pruhs
Board Chairman
Alaska Industrial Development and Export Authority

Investing in Alaskans aidea.org

813 West Northern Lights Boulevard Anchorage, Alaska 99503 T 907.771.3000 Toll Free (Alaska Only) 888.300.8534 F 907.771.3044