

ALASKA STATE LEGISLATURE
SENATE STATE AFFAIRS COMMITTEE

February 21, 2002
3:33 p.m.

MEMBERS PRESENT

Senator Gene Therriault, Chair
Senator Randy Phillips, Vice Chair
Senator Ben Stevens
Senator Bettye Davis

MEMBERS ABSENT

Senator Rick Halford

COMMITTEE CALENDAR

SENATE JOINT RESOLUTION NO. 13
Proposing amendments to the Constitution of the State of Alaska
relating to inflation- proofing the permanent fund.
HEARD AND HELD

PREVIOUS COMMITTEE ACTION

SJR 13 - See State Affairs minutes dated 4/26/01.

WITNESS REGISTER

Robert Storer
Alaska Permanent Fund Corporation
P.O. Box 25500
Juneau, AK 99802-5500
POSITION STATEMENT: Testified on SJR 13

Ron Lorensen
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Jay Hogan
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POSITION STATEMENT: Testified on SJR 13

ACTION NARRATIVE

TAPE 02-10, SIDE A

CHAIRMAN GENE THERRIAULT called the Senate State Affairs Committee meeting to order at 3:33 p.m. Present were Senators Davis, Stevens, Phillips and Chairman Therriault.

The first order of business was SJR 13.

#SJR 13

SJR 13-CONST. AM: PERMANENT FUND

CHAIRMAN THERRIAULT established that the Permanent Fund Trustees had previously appeared before the committee. He wanted to use the current meeting to review and discuss the proposal because Senator Halford was unable to attend the meeting and requested that final action be delayed until the next hearing.

ROBERT STORER, Alaska Permanent Fund executive director, explained that the resolution would place a constitutional amendment before the voters that is designed to inflation-proof the fund by limiting the payout. He reinforced the fact that they are recommending that the annual payout of fund income be limited to no more than five percent of the fund's five year average market value. They believe that, over time, they can earn a rate of return that will exceed inflation by five percent.

The board is comfortable with the proposed constitutional amendment as written, but they want to make clear that they support the distinction that income from the fund, not to exceed principal, would be available for distribution.

His next remarks referred to the following table:

Range of **total 5% payout** (in millions)

	FY 03	FY 04	FY 05	FY 06	FY 07	FY 08
Top quartile	\$1,343	\$1,397	\$1,439	\$1,496	\$1,571	\$1,668
Median	\$1,313	\$1,330	\$1,323	\$1,368	\$1,420	\$1,464
Bottom quartile	\$1,260	\$1,007	\$984	\$1,031	\$1,033	\$1,020

Range of **dividend distribution** (in millions)

Top quartile	\$930	\$945	\$953	\$1,086	\$1,270	\$1,341
Median	\$853	\$779	\$732	\$807	\$929	\$1,039
Bottom quartile	\$778	\$620	\$509	\$551	\$570	\$602

Range of **residual income** (in millions)

Top quartile	\$432	\$497	\$545	\$519	\$452	\$417
Median	\$391	\$418	\$438	\$390	\$318	\$272
Bottom quartile	\$331	\$255	\$265	\$203	\$111	\$23

Money available at a 5 percent payout is shown as a median case with a top and bottom quartile. He repeated that they expect the beginning amount for distribution to be \$1.25 billion. The chart shows that amount is slightly increased to \$1.3 billion as the fund has stabilized at \$25 billion. They have extended that number to FY 08 and it is \$1.464 billion on a median case.

For FY 03 the bottom quartile is close to the \$1.25 billion estimate at \$1.26 billion while the top quartile is \$1.343, which is a fairly narrow range.

What does it mean if the statutes remain the same on the dividend formula and the dividend payout? \$853 million would be the median case in FY 03 and \$1.039 million in FY 08. In FY 03 the bottom quartile is \$778 million with a 25 percent probability or top quartile of \$930 million.

The number that has changed speaks to adjusting projections based on short-term market volatility. The median case now is \$391 million with a bottom quartile of \$331 and a top quartile of \$432 million. He reminded members that using a percentage formula based on the market value has less volatility than realized income. He then explained that the reason for the increase from the \$175-300 million projection is explained because the volatility on the total payout is not reduced a lot from six months or a year ago. What has changed is the realized income to compute the dividend formula. This year there is a significantly lower realized income number than in the four or five prior years when there was a bull market. This means that the dividend payout is somewhat reduced and the residual is available for appropriation for government purposes.

He said he is more comfortable with the \$175-300 million because if the bear market ends and the market goes up, the dividend could increase and that would leave a lower residual to fund government.

He said he would be happy to answer questions.

CHAIRMAN THERRIault asked if the residual goes up because the bear market results in losses and brings the five-year average

down.

MR. STORER said that is correct. The residual goes up because the realized income is lower. However, the size of the fund is smoothed out because of the percentage of market value payout.

CHAIRMAN THERRIAULT asked him to comment on the scenario in which things had to be liquidated to achieve a five percent payout and how that impacts the calculations for the dividend. Over time the percentage of the five percent that goes into the dividend starts moving up and the room for the residual starts getting squeezed.

MR. STORER said that potential exists if a substantially greater amount was required to be liquidated. Then you would see accelerated capital gains taking an accelerated dividend payout, which would exacerbate the payout.

He said it is easier to manage money when you have more information on predicted cash flow needs. They realize they must raise substantial amounts of money in September of every year so they build that into the structure of the portfolio so they aren't necessarily forced into taking large capital gains or losses. Predictability certainly helps in managing the fund.

CHAIRMAN THERRIAULT said legislators have different long-term ideas regarding the permanent fund. A criticism of this plan is that it has the potential to guarantee the inflation proofing, and it spins off the revenue stream for the dividends but there is little revenue stream left for general government without the legislature changing the dividend program.

MR. STORER replied that as it now stands, there would be two different formulas. One would be for the percentage of market value approach, which limits the volatility of the amount of money that could be appropriated in any given year. The dividend formula is based on realized gains and not market value. The bull market has masked the fact that realized income is more volatile or less predictive than the percentage of market value payout. As long as the dividend comes first, that residual amount would absorb the volatility.

SENATOR STEVENS asked for a recap of the two formulas.

MR. STORER said the dividend formula is in the statutes and is based on realized earnings. It is dividends, interest, net gains or losses and the liquidation of securities. Unrealized gains or losses are not included in the formula.

SENAOTR STEVENS asked if he was correct that the percent of market value (POMV) is not an average, it is an annual percent of market payout.

MR. STORER said they are proposing that it be the average market value of the fund over the trailing five years and not to exceed five percent.

SENATOR STEVENS asked if they couldn't eliminate volatility in one of the two by adjusting the dividend formula to match the five percent payout formula that is proposed.

MR. STORER said that is correct. If both were a percent of market value you would reduce the volatility of the residual and also the volatility of the dividend payment.

SENATOR STEVENS said the payments would be inflation proofed and they would be real numbers.

MR. STORER agreed.

SENATOR STEVENS asked if he's correct that there is only a payout if there are earnings over the last five years. If there were five years with negative returns there would be no dividend payout.

MR. STORER said that possibility, unlikely as it is, exists whether the law is changed or not. However, the board feels it is very important to maintain a cushion in the earnings reserve. At the end of this fiscal year they will have a cushion of about \$3 billion and if this is maintained, it is the shock absorber for a prolonged bear market.

SENATOR STEVENS asked him to explain the cycle that would occur with prolonged periods of high inflation and what would happen to the payout. He also asked if the fund was inflation proofed first or is it earnings first and the fund itself bears the risk of inflationary times.

MR. STORER said prolonged rising inflation with financial markets not keeping up with that growth such as in the 1970's is close to such a scenario. In response to the second question he said that currently the dividend formula precedes inflation. Following the statutes, the dividend would be paid and then the inflation proofing would occur afterwards. What they are proposing has the effect of putting inflation proofing first.

SENATOR STEVENS asked if we would have a dividend if rates of

return were lower than inflation such as in 1976-1981.

MR. STORER said if the earnings reserve has sufficient cushion then both goals could be achieved. He feels the current cushion can withstand all but an extreme market.

SENATOR PHILLIPS asked if he said inflation proofing would occur before the dividend payout.

MR. STORER said this is his opinion. He believes that by memorializing inflation proofing in the Constitution it would have the effect of putting inflation proofing ahead of the dividend.

SENATOR PHILLIPS asked if it would have some affect on the payout of the dividend.

MR. STORER said it would in an extreme scenario.

SENATOR PHILLIPS thought most people wouldn't care about the mechanics but would want to know how it would affect their permanent fund dividend (PFD). With that in mind, he asked if there were polls to determine voter support.

MR. STORER said they don't feel it's appropriate for the Permanent Fund Corporation to conduct a poll. Expanding on the effect on the dividend, he repeated that by memorializing this in the Constitution it would have the effect of maintaining the purchasing power of the fund and therefore increasing the size of the dividend over time. Without changing the formula, they suggest it would have a long-term positive effect on the dividend for this and subsequent generations.

CHAIRMAN THERRIault said he has cautioned the trustees not to conduct polls or lobby the general public. To do so would give them a political appearance that wouldn't ultimately be beneficial.

SENATOR PHILLIPS asked what they would say if a legislator offered an amendment making it a constitutional right to receive the PFD.

MR. STORER said they have outside opinion that states if the PFD were to be memorialized in the Constitution it would put the tax-exempt status of the permanent fund earnings in question.

SENATOR STEVENS asked if that isn't why they have elected to be "sort of half of an endowment." If you start taking principal

then it jeopardizes how the fund is managed, which in turn jeopardizes the tax-exempt status.

MR. STORER said the key on the IRS ruling is that the fund can be used for government purposes.

SENATOR THERRIAULT asked if all of the earnings had to be used for government services. Would the IRS look favorably on a guaranteed dividend of something less than 50 percent with the balance allocated to government services? He supports the concept of a guaranteed dividend and believes it might keep more Mackie Plans from being presented.

MR. STORER asked if he was referring to a constitutional change or statutory change.

CHAIRMAN THERRIAULT said he was referring to a constitutional change.

MR. STORER doubted that this would be view favorably, but wanted to defer to legal counsel.

CHAIRMAN THERRIAULT then asked about wording on page 1, line 8 that assures that principal couldn't be used for the payout. Legislative Legal Counsel has pointed out that the proposed wording in (b) is in conflict with that line. He wanted to make sure it is the board's view that you would never want to get into a situation where the five percent potentially erodes the principal.

MR. STORER said that is correct; their counsel spoke with the legislative counsel about interpretation. Both the board and their counsel are willing to discuss any language changes that might be helpful.

CHAIRMAN THERRIAULT said it's important that the language is clear and straightforward before it is put before the public. This would be particularly important if questions regarding the sanctity of the principal are raised and the proposed language leaves a gray area.

He then asked if the inflation proofing doesn't occur naturally under the proposal since it's just retained earnings.

MR. STORER said that is correct. If the payout is limited to no more than five percent of that moving average, it would have the effect of inflation proofing.

SENATOR PHILLIPS asked what their reaction would be if the question that is ultimately put before the voters asks if they favor a constitutionally guaranteed dividend.

MR. STORER replied the potential for unintended consequences always exists. The board hasn't addressed this explicitly but they have been consistent in their concern about the tax-exempt status being at risk.

CHAIRMAN THERRIAULT told Senator Phillips that needs exploring because if the public has any suspicion that voting yes seriously jeopardizes the tax-exempt status of the fund it will be turned down.

SENATOR STEVENS asked if this proposal could have any long-term impact on the rate of return the fund could earn in the future.

MR STORER said it would ensure that the fund could be managed to its maximum rate of return without taking undo risk. If uncertainty is created whereby substantial amounts of money from the fund are required to fund whatever purchase in excess of that five percent, the potential exists to manage more conservatively to meet those higher cash flow needs. Currently they manage a balance of meeting the annual dividend flow versus the long-term objective. However, if they knew there was a potential for substantial increases in the fund draws, they would have to take less risk and manage for a less high rate of return because they couldn't accept that interim volatility of the markets.

SENATOR STEVENS said this proposal gives more stability in managing long-term because demands could be forecast.

MR. STORER said the more certainty any fund manager has in terms of payout, the more effectively they are able to manage funds.

SENATOR STEVENS said it would be fair to say that if a POMV were implemented, the Permanent Fund could grow at a faster rate.

MR. STORER said it could grow at an equal or faster rate given the fact that uncertainty has been eliminated in the management of the fund.

CHAIRMAN THERRIAULT asked for the current breakdown between principal and earnings reserve.

MR. STORER said the principal is currently \$21 billion and the earnings reserve is about \$3.7 billion.

CHAIRMAN THERRIAULT said with a vote of 21 and 11, the legislature could appropriate the entire earnings reserve so they must manage accordingly. If the proposal were adopted, they would no longer have that ability, but the earnings reserve could be managed more aggressively.

MR. STORER said that is correct. They are currently managing for a five percent real rate of return because they have heard no discussion to indicate that the fund would be used for anything more than the dividend. As discussions accelerated to using more of the fund they would have to incorporate that information into the management of the fund. If it exceeded more than five percent, then the fund would have to be managed more conservatively.

CHAIRMAN THERRIAULT said there is the issue that the earnings reserve is general fund dollars but it has been put back into the fund to be managed along with the principal. However, if the proposed language is voted on and adopted, it doesn't say what has happened to that earnings reserve. Is it now part of the principal of the fund or is it still available for appropriation by the legislature? To appropriate those funds cannot be part of the vote because the people don't have that power; only the legislature has the power to make appropriations. There is some problem with the wording in how it deals with that.

MR. STORER said it has always been their assumption that the money is in the general fund unless otherwise stated by law and the law states there is an earnings reserve. They have considered that independent of the general fund but that it could in fact be appropriated into the general fund. Again, it's important that the language eliminates any ambiguities. At no time did they consider the earnings reserve as a component of the general fund unless the legislature appropriated it into the general fund. It's been their intent to ensure there is a principal and earnings reserve and that no more than five percent of the fund earnings could be used as long as it doesn't invade principal.

CHAIRMAN THERRIAULT reminded members of the court decision on constitutional budget reserve. Their ruling indicates they will look at the earnings reserve as general fund dollars that is available for appropriation with a simple majority.

He said it's important to try and understand the potential view of the IRS because different people expect different things from the fund. Some people want inflation proofing guaranteed, some want a dividend guaranteed to them, and some want a potential revenue stream available to the government. Each group will be

looking for what is important to them and will have questions that will need to be answered.

RON LORENSEN, outside counsel to the Permanent Fund Corporation, said he is not a tax expert, but has reviewed all the tax opinions that have been prepared for the Permanent Fund over the years and has read a number of court decisions on tax issues in various situations. It is his conclusion that putting the dividend guarantee in the Constitution would place a private interest in a government fund. This would create a bright line and it would make the entire fund susceptible to taxation. The risk of being wrong is so significant that it isn't worth taking the chance.

SENATOR PHILLIPS said, "You're just one lawyer's opinion, right?"

MR. LORENSEN said he's one lawyer who has spent a lot of time reviewing these opinions, but he's not a court and not the IRS.

SENATOR PHILLIPS asked what the odds are if he were "Jimmy the Greek."

MR. LORENSEN said less than 10 percent.

SENATOR PHILLIPS said, "Okay, I like the odds."

CHAIRMAN THERRIAULT asked if he thought the higher the percentage of the payout that is guaranteed as dividend the bigger the problem.

RON LORENSEN said certainly the greater the percentage of payout the stronger the argument becomes that there is a significant private interest rather than just a private interest. He hasn't seen the question whether it is significant or not, just whether a private interest is created. Certainly the smaller it is the better your argument to keep from converting it to a taxable fund, but the risk is still there.

CHAIRMAN THERRIAULT said the Constitution currently guarantees no dividend even though that's really all that the money has been used for.

RON LORENSEN said as long as it is in the power of the Legislature to decide what happens to the money each year it passes the IRS test. It is in the Legislature's power now, but it wouldn't be if it goes into the Constitution.

SENATOR STEVENS remarked the IRS would view it as an endowment

once a guarantee was made.

RON LORENSON didn't know whether they draw the distinction between an endowment or some other kind of fund, but whether or not it creates a private interest that is beyond the control of the Legislature to control or appropriate.

SENATOR STEVENS asked for an explanation of the repercussions if the IRS viewed the fund as a taxable entity.

RON LORENSON said it would be whatever the corporate tax rate is on the realized income. It is his interpretation that all of the income becomes susceptible to taxation once the legislature gives up control of any portion of it.

CHAIRMAN THERRIault said he has examined some private interests but the Permanent Fund is different because it can't be sold, or willed to someone.

RON LORENSON didn't think that was ever the basis for the question of whether it was a private interest or not. It has more to do with the fact that the governmental entity no longer has control.

SENATOR PHILLIPS said he's been in the Legislature for 25 years and he's learned to ask lawyers about odds.

SIDE B
4:20 p.m.

JAY HOGAN asked committee members to read the letter dated February 21, 2002 that was in their packets. His concern is that the Permanent Fund was originally created as a repository for surplus revenues. The assumption of many who voted for it was that it would be available at such time when oil and gas declined. That decline has come sooner than anticipated.

The euphoria of the late 1970's and early 1980's is difficult to understand today. He referred to the \$900 million appropriation to the Permanent Fund in 1980 and the \$1.8 billion appropriation the following year. No Legislature has been able to consider that kind of appropriation since and it is unlikely they will. The Legislature of the 1970's took great care to draft a highly flexible document to leave all the decisions to future Legislatures by statute. The original amendment establishes the fund, says the investments must be earning investments and the income may be appropriated, as the circumstances require. Now that the Constitutional Budget Reserve is running low, it's

important to do nothing precipitous.

Most states west of the Mississippi have small permanent funds that come from original statehood land grants. Unlike states that made land selections by single sections, Alaska was able to select petroleum rich North Slope land by contiguous townships, which gave it tremendous capabilities and opportunities. For comparative purposes, Mr. Hogan included information on both the Texas and the Wyoming permanent funds and that information is in the bill file.

4:30 p.m.

SENATOR PHILLIPS said he is "the only [elected] relic left over from the 70's" and he reminded everyone that in the 1980's the Legislature took some of the earnings reserve account and put it back into the principal of the Permanent Fund. "The \$900 million was symbolic because it paid for past sins of the Legislature prior and then we doubled it again and then we have, in the 80's specially we put in more monies to support the earnings reserve account that was left over after inflation proofing and paying the dividend... And one thing I want to add and you guys can correct me from the Permanent Fund. Last year's PFD, if we did not do that, your PFD would have been about \$1,200 \$1,300, two thirds of what it is today because of the actions of the legislature taken in the 80's and in the 70's to do this. So lots of cases we don't get the credit for it because we get blamed but the public doesn't know that if we didn't take these actions, their check would have been about two thirds the amount versus what is today, around \$1,850."

MR. HOGAN said those numbers are listed on page two of his letter. The dedicated revenues are the 25 percent set out in the constitution. Each source has contributed about one third to the value of the permanent fund today.

CHAIRMAN THERRIault asked Mr. Storer what would happen to the balance of the money if the Legislature didn't use the entire payout in any one year.

MR. STORER told him that money could not be banked at the Permanent Fund; it would have to be banked elsewhere for it to be available at a later time. Monies allowed for payout but not appropriated in one year would become a part of the fund value and could not be appropriated in a subsequent year.

There were no additional questions.

CHAIRMAN THERRIAULT said the bill would be held in committee while they worked to resolve some of the issues that were raised.
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There being no further business to come before the committee, Chairman Therriault adjourned the meeting at 4:47 p.m.