

HOUSE FINANCE COMMITTEE
March 29, 2004
9:10 A.M.

TAPE HFC 04 - 69, Side A
TAPE HFC 04 - 69, Side B

CALL TO ORDER

Co-Chair Williams called the House Finance Committee meeting to order at 9:10 A.M.

MEMBERS PRESENT

Representative John Harris, Co-Chair
Representative Bill Williams, Co-Chair
Representative Kevin Meyer, Vice-Chair
Representative Mike Chenault
Representative Hugh Fate
Representative Richard Foster
Representative Mike Hawker
Representative Reggie Joule
Representative Carl Moses
Representative Bill Stoltze

MEMBERS ABSENT

Representative Eric Croft

ALSO PRESENT

Senator Gene Therriault; Bob Bartholomew, Chief Operating Officer, Alaska Permanent Fund Corporation, Department of Revenue; Cheryl Frasca, Director, Division of Management & Budget, Office of the Governor; Joe Balash, Staff, Senator Gene Therriault

PRESENT VIA TELECONFERENCE

None

SUMMARY

#HB298

HB 298 An Act relating to the distribution of appropriations from the Alaska permanent fund under art. IX, sec. 15(b), Constitution of the State of Alaska, and making conforming amendments; and providing for an effective date.

HB 298 was SCHEDULED but not HEARD.

#HJR9

HJR 9 Proposing amendments to the Constitution of the State of Alaska relating to an appropriation limit and a spending limit.

HJR 9 was SCHEDULED but not HEARD.

#HJR26

HJR 26 Proposing amendments to the Constitution of the State of Alaska relating to and limiting appropriations from and inflation proofing the Alaska permanent fund by establishing a percent of market value spending limit.

HJR 26 was HEARD and HELD in Committee.

HOUSE JOINT RESOLUTION NO. 26

Proposing amendments to the Constitution of the State of Alaska relating to and limiting appropriations from and inflation proofing the Alaska permanent fund by establishing a percent of market value spending limit.

Co-Chair Harris MOVED to ADOPT Amendment #3, #23-LS1006\V, Cook, 3/22/04. (Copy on File). Co-Chair Williams OBJECTED.

SENATOR GENE THERRIAULT spoke to Amendment #3. He addressed concerns voiced by the public and members of the Legislature regarding possible changes to the Permanent Fund and the methodology used to determine that fund. The first issue is one of protecting the principal of the fund. When describing the Permanent Fund, it should be understood that the money of the principal cannot be touched no matter how much it is needed and the only way in which that could change is through a vote by the people of Alaska. He commented that the thought of moving toward a pure Percent

of Market Value (POMV) methodology would lift the bars that protect the principal.

Senator Therriault indicated that Amendment #3 preserves the idea of separate principal. There would remain the protected principal of the Permanent Fund and would create a sub account within the Earnings Reserve Account. The two accounts would then be managed together except for the allowable 5% draw. That amount could only be drawn out of Earnings Reserve Account. If the allowed draw is only 5%, there could be no access to the entire \$4.5 billion dollars.

Senator Therriault mentioned that there are a number of ideas floating around about how to manage it. The Trustees suggested a statutory fund that would protect the principal if the State moved into a series of down market years. He doubted that the public would understand how that worked and thought that the idea of the Percent of Market Value would turn out to be an "easy criticism" for them. Senator Therriault pointed out that the public wants to protect and guarantee the dividend. He voiced support for making the dividend multi generational and was resistant to a one-time disbursement as proposed by Senator Mackie during a past legislature.

Senator Therriault stressed that there should be a long-term dividend acknowledged in the Constitution. The language should indicate that from the 5% draw and out of the earnings reserve, the money can be used for two things:

- Continuation of the dividend; and
- Use of the remaining funds for public education.

Senator Therriault noted that Co-Chair Harris had added language to cover the costs of the fund's management. He thought that would be a policy call. If there is access to use of some of the earnings, the public will want to know what those earnings are being used for rather than assuming purposes of general government. He pointed out that everyone can think of something that they "loathe to hate". The constitutional mandate that enjoys widespread support is public education. That is the recommendation set forth by Amendment #3 to address what the earnings are used for. The term "public education" is broad and could cover K - University, K - 12, or K - 12 operations and capital. The

language could be left broad and/or the numbers could be flushed out or specific to the intent.

Senator Therriault maintained that the language of the amendment addresses concerns indicated by the general public who will understand and appreciate a protected principal. Currently, there is no constitutional protection for the dividend and they want to know what the earnings will be used for. That creates a balance for constitutionally enshrining the dividend and preserving latitude for future legislatures to establish how much can be steered into dividend programs.

Senator Therriault summarized that if the amendment language is adopted, it would provide an indication of what the protected principal can be and the growth would be limited to oil rents and royalties as they get deposited into the principal. All the Permanent Fund earnings would be placed into the Earnings Reserve Sub Account. The only growth would be the amount deposited into the principal from rent and royalties, which could easily be fixed by making an allowance to periodically adjust the principal up. He referenced Page 2 of the amendment, identifying appropriations from the Earnings Reserve Account. That language could be modified to state: "Except for periodic transfers to the principal appropriations". The language could specifically make a constitutional allowance for periodic moving from the Earnings Reserve Account to the protected principal by the Legislature.

Co-Chair Harris commented that there was nothing in the proposed language that would prohibit the Legislature from making an appropriation from the Earnings Reserve Account to the principal protected by the Constitution. Senator Therriault responded that is a question, as it would be limited to only the money that comes off the overall account and amounting to the 5%. It specifically has been identified that the 5% can only be taken from the Earnings Reserve Account. Appropriations from the Earnings Reserve Account may be made only for certain purposes. The Legislature has not provided them the latitude to make appropriations over to the principal, however, the language could easily be modified to specifically address that.

Co-Chair Harris recommended that a sub-floor could be added to indicate that appropriations move back to the principal. Senator Therriault suggested that by adding #4, there is

some question whether an appropriation or principal could come only out of the 5% drawn. He did not think they would want to do that. At this time, Legislative Legal is working on an amendment to modify that language so that a transfer from the Earnings Reserve Account could be made above and beyond the 5%. He believed that would be easy to accomplish and then they would need to address policy questions regarding the veto power of a transfer.

Co-Chair Williams reminded Senator Therriault how difficult it is to get a super majority. Senator Therriault acknowledged that it can be difficult but if the 5% only comes out of the Earnings Reserve Sub Account, it is important to make sure that a healthy balance remains in that account in case there is a down stock market, there would still be sufficient funds. The Legislature could feel pressure to make transfers to the principal; if the Governor believes that too much has been transferred without having a cushion, there might be a veto, which is a part of the check and balance system.

Representative Fate voiced concern about using the Permanent Fund for "rainy day" purposes. He warned consideration for the replenishment of the Constitutional Budget Reserve (CBR). He asked Senator Therriault how he proposed to address these concerns if the above-mentioned items tied up the Earnings Reserve Account. Representative Fate believed this could exacerbate the problem over the years.

Senator Therriault responded that the issue of the CBR repayment would be separate from the proposed consideration. However, if covering the major costs for public education was taken out of the Earnings Reserve Account, then general fund dollars would not be spent. There could be a possibility of a combination using earnings, taxes and/or other revenue generating mechanisms providing general fund dollars at the end of the fiscal year and swept back into the CBR.

Representative Fate realized that those are expectations and that he hoped that they would happen, however, present and past experience indicate they have not yet come. He suggested that the legislation will exacerbate the problems and that the corpus expands and future problems will continue. The worst-case scenario is "worrisome".

Vice Chair Meyer appreciated that the Percent of Market Value concept automatically places funds into the principal and asked how it would work under Amendment #3. Senator Therriault explained that it would work in the same manner. The protective principal and the Earnings Reserve Account would be managed together. If there were a down market without sufficient earnings, then a 5% draw would be taken, without money drawn from the protected principal. The intent is to have the entire fund managed, while maintaining the fund and the 3% and then, the Earnings Reserve Account would continue to grow. It would be good to have flexibility to move some funds to the corpus while automatic inflation proofing keeps happening. He concluded that a 3% would be maintained so that inflation proofing would be automatic.

Vice Chair Meyer understood that in the Percent of Market Value concept as presented statewide. In the years when the return is only 3%, it is highlighted that the payout would continue to be at the 5% level. He hoped it could reach 8%. Vice Chair Meyer asked if that would be enough protection for the principal. He thought that the amendment would provide a "new and different twist" for the voter's comprehension.

Senator Therriault pointed out that in the pure POMV concept, during a protracted down stock market, there could be erosion of the principal. There does not need to be erosion because the full 5% does not have to be taken. He emphasized that the Legislature would be allowed to take up to 5% and that the "suspicious public" might criticize that action. The Legislature cannot assure them that the erosion is not going to happen. If the language of the amendment is adopted, it guarantees a protected principal, noting that the Percent of Market Value methodology is still workable but the State needs create a system in which they can weather any down markets. Given Amendment #3, the general public is assured that there will continue to be a protected principal.

Representative Hawker pointed out that there are two distinct issues being considered through the amendment:

- Consideration of the pure Percent of Market Value, and
- Section #2, involving a dedication of what the earnings might be used for.

Representative Hawker indicated that he would restrict his thoughts to the percent of market value discussion. He inquired if Senator Therriault had mentioned that the income would be accounted for in the Earnings Reserve Account rather than in the principal account. Senator Therriault understood from working with Legislative Legal that once the revenue is realized, it would then be accounted for in the Earnings Reserve Sub Account. Representative Hawker was confused if that meant only the realized earnings and not those that result from increased valuation. Senator Therriault referenced existing language on Page 1, Lines 12 & 13, "All income from the Permanent Fund shall be deposited into the Earnings Reserve Account." He believed that should define all income.

Representative Hawker pointed out that section indicates that all income in the fund shall be deposited into the Earnings Reserve Account as soon as it is received. The intent is that it must be the realized earnings as opposed to valuation changes. If that is the intention, then it is assumed that there could be a decision to sell an investment with the presumption of an absolutely sound economic decision, the income not received and taken from the principle and then placed into the Earnings Reserve Account. He questioned if that was an intended division. Senator Therriault did not know how the Trustees would interpret that language and that it might have to be modified in order to be made clearer.

Representative Hawker interjected that would be an important distinction. Point #2 creates a strong desire on his part to provide the greatest assurance that whatever changes made would not compromise the ability of continuing the dividend. Some earnings would be used for public services and that the qualification of "received" would apply only to realized earnings available for appropriation. The biggest problem in the current structure is that the Earnings Reserve Account would be within the Permanent Fund but subject to appropriation. He thought that it would be possible for someone with ulterior motives to manipulate investment policy within the fund. Likewise, they would be able to sell, which would change the amount in the Earnings Reserve Account. Representative Hawker was troubled that action might create in the constitutional mandate, two buckets of money and subject to

human manipulation. Representative Hawker asked if there were sidebars that would protect the State.

Senator Therriault understood that under the current system, there could be no possible manipulation. There might be pressure to sell in order to spike the earnings. If the State moved to a Percent of Market Value system, he thought that the stream of revenue off the account could spike the earnings. He proposed that nothing could be changed if something was sold, and would not change the value of the fund with no motivation to change the revenue stream if it was 5% of the total value. He believed that the system proposed in Amendment #3 would lend itself less to public pressure.

Representative Hawker summarized that the amendment would place the Earnings Reserve into a separate bucket in the Constitution and that it would be protected. The 5% factor would still be based on aggregate value of the fund. He asked if there would be a secondary constraint and if there was no money in the Earnings Reserve Account, then would there be no money left to withdraw from that fund. Senator Therriault explained that possibility could only exist in the first couple years, after the establishment of the Sub Account. Thereafter, and if a healthy balance is maintained, the State would be able to weather any kind of bear market.

Representative Hawker thought that the probability of the State having a disastrous market in the near future was slim. He referenced Senator Therriault's definition of income. As indicated, a transition into the new mechanism would take place, making certain that there is income coming into the Earnings Reserve Account to support a draw. He noted that specific language indicates that all income from the Permanent Fund shall be deposited into the Earnings Reserve Account. He inquired how the amendment proposes to address loss. Senator Therriault thought that the Earnings Reserve Account could absorb the losses.

Representative Hawker commented that an earnings bucket would hold all gains, losses, income and the sale of investments. Any market valuation change would be accounted for on the income side. He recommended that area of the bill to place Senator Therriault's language that the net income be accounted for in the Earnings Reserve Account, without receipt qualification accounting for the

value change in the Earnings Reserve Account and principal. An amount currently exists because deposits have been made to the fund from the State's oil and gas wealth.

Co-Chair Williams noted it would be difficult to change the Constitution. The State does not know what is going to happen in the future. If the bill was passed as originally proposed, no money could be taken out and a situation could exist where there might be no money left to pay the dividend. Senator Therriault asserted that the Legislature would attempt to balance out the knowns and unknowns and that except for the first couple years, the possibility of moving into an immediate down market, there would be enough money in the Earnings Reserve Account to assure that a 5% stream will be available.

Co-Chair Williams spoke to the deposit made to the Earnings Reserve Account and that by incorporating the proposed amendment, the State could be starting over again with a down market. Senator Therriault stated that in the future, when the Legislature considers making a shift to protect the principal, they might have to waive it. Making a shift should require appropriation if it suffers a governor's veto. If the amount moved over to the earnings principal was large enough and the Earnings Reserve Account was small, there could be a continued dividend and then the governor could not veto it, removing the cushion. It would be preserved. He acknowledged that there might be some disagreement of how big a cushion should be continued. He recommended that enough should be left to guarantee that the 5% would always exist. Senator Therriault stressed that it is important to have a healthy Earnings Reserve Account. Until the Earnings Reserve Account and the protected principal are all managed together, then 5% would often be the total. There should be more benefit to the public given the method proposed in Amendment #3 as it would protect against a down market. He thought that the Earnings Reserve Account could be just as big as the protected principal and that the Legislature could make a policy for shifting money into either of the accounts.

Co-Chair Williams commented on placing money into the principal every year. Senator Therriault stated that it would be important to make sure that there are enough earnings available in the Earnings Reserve Account to allow for the 5% withdrawal, addressing transfers made to the protected principal. He acknowledged the argument

regarding how much to leave in the reserve. There has always been \$100 million dollars remaining in that account. There has always been a little pressure to make sure that enough remained in that account for paying the next year's dividend. Co-Chair Williams pointed out that there are "politics involved".

Co-Chair Harris asked about the point made by Representative Hawker regarding the income and to identify what qualifies as income and loss.

BOB BARTHOLOMEW, CHIEF OPERATING OFFICER, ALASKA PERMANENT FUND CORPORATION, DEPARTMENT OF REVENUE, explained that currently as written, the constitutional amendment and the proposed Amendment #3 would continue to do the accounting as it is done at this time. There are two buckets for income or earnings. The unrealized earnings, which result from an asset going up in value after it is bought and defined in the interpretation of the language remaining "Shall be deposited as soon as it is received". He pointed out that there is a solid record of what that means. When the assets are sold, the realized income goes into the realized earnings reserve. As written, the 5% available for appropriation would come from the realized Earnings Reserve Account.

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Co-Chair Harris asked what would happen to the principal and/or the loss. Mr. Bartholomew commented that they would be treated just like the gains. The unrealized loss is currently part of the principal allocation principle. When a stock is sold for less than it is paid for, that becomes a realized loss and goes into the Earnings Reserve Account.

Co-Chair Harris thought that was more difficult to understand. A gain would be money going in. He asked if money would be taken out of the Earnings Reserve Account and deposited into the principal to make up the loss. Mr. Bartholomew said no, but instead would handle it the same manner it is currently is done. In the middle of a bear market, there were many realized losses and they are reflected in the Earnings Reserve Account. That account goes up when there are gains and down when there is a loss. The portions that are in principal, when it is an

unrealized loss, would stay if it was an unrealized loss. The existing rules of the Permanent Fund were written twenty-five years ago and are a little outdated. He proposed that the area that should be discussed is treatment of gains and losses.

Co-Chair Harris questioned if there are losses from the principal, would they be made up through the Earnings Reserve Account. Mr. Bartholomew responded that, today, as written and as described, the principal value would be reduced until the investments were sold. If there are losses in the stock market, the balance of the fund can fall below the principal level, which has happened. That is a rare situation. If stocks were sold, that would bring down the balance of the Earnings Reverse Account.

Co-Chair Harris asked what would happen if the balance wasn't large enough in a down market. He asked if that would put the Board of Trustees in a situation where they would have to take a loss. Mr. Bartholomew observed that there are short to mid term risks, which they believe works over the long run. If there is a large amount of unrealized earnings and the realized earnings account has little income paid out, the balance could be affected through the selling of investments. Historically, the Board has deliberated on that issue and taken action. The primary policy is to not to make decisions based on what goes in and out of the Earnings Reserve Account and the decisions to sell should be based on the market.

Co-Chair Harris understood that the amendment attempts to protect the principal in the Constitution. Mr. Bartholomew pointed out that Section 1 of the amendment makes the distinction between protecting the principal or moving to a pure percentage of market value so that the 5% spending limit provides statutory guardrails that prevent from over spending when income is not available.

Representative Joule questioned if the amendment would impact the sweep. Mr. Bartholomew responded that he had not been involved in the process to determine the CBR sweep. Senator Therriault did not think it would impact the sweep, noting that the Court's have determined that the Permanent Fund and the Earnings Reserve Account are not sweep able accounts.

Representative Hawker questioned if the value of the principal could erode over time. He inquired if those were issues with the existing structure and if they could be resolved through a pure POMV methodology. Mr. Bartholomew noted that the original POMV and the amendment could achieve the goals of the Trustees, which are, in good years, spend only the sustainable yield of the Permanent Fund and overtime, 5% of the total value. The amendment allows a risk in the near term that there could be less than needed for a full distribution during extended down markets in the short term. He added that the issue of principal is a public image concept. Near term good markets would reduce the risk. Arcane accounting methods would be retained. The Corporation knows that they can deal with continuation of the current accounting methods.

Senator Therriault observed that the Trustees are advocating for the long-term health of the asset. The downside of the accounting method would be done away with through the pure Percent of Market Value and if the public does not accept the POMV method, nothing would change.

Representative Hawker acknowledged the controversy and felt that the Committee should put forth the best policy call. He indicated his concern with Amendment #3.

Co-Chair Williams added that the Committee has taken public testimony on the Percent of Market Value for over a year and that there has not yet been public testimony taken on the proposed amendment. He expressed support for Version /U of the legislation. He observed that the amendment, reflecting the Senate version, could be discussed when the Senate bill moves to the House floor. Senator Therriault emphasized that the language in the Senate version has been debated and that the House should not lose sight of what is possible while striving for what is perfect.

Representative Joule voiced his support for Section 2 of Amendment #3. He suggested that section could be added to Version \U of the bill.

Co-Chair Williams stated that HJR 26 would be HELD in Committee for further consideration.

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ADJOURNMENT

The meeting was adjourned at 10:26 A.M.